The Use of Debt-Equity Swaps by Japanese Companies

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Recently a number of major heavily indebted Japanese companies have made headlines by announcing plans to carry out debt-equity swaps. Such swaps are intended to help solve the problem of excessive corporate debt, which is itself part and parcel of the whole bad debt problem in Japan. In particular, it is hoped that they will be used by companies trying to recapitalize as part of an informal workout. Perhaps because debt-equity swaps are still relatively new in Japan, they are not always seen in a favorable light. This report surveys the use of such swaps by Japanese companies so far and examines some of the issues their use raises.

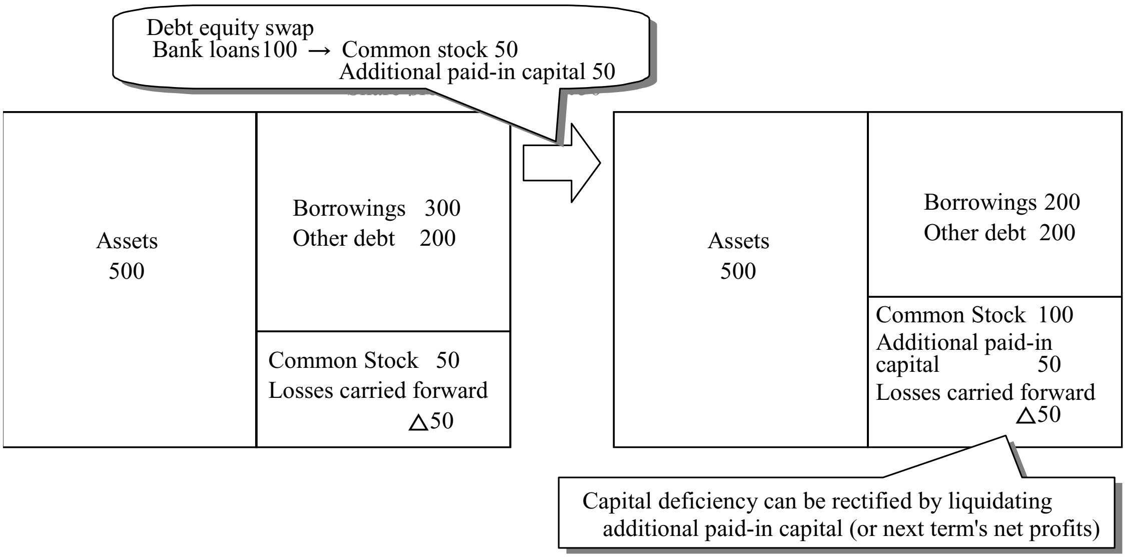
1. Meaning of "Debt-Equity Swap"

The term "debt-equity swap" (or "debt-equity conversion") means the conversion of a heavily indebted or financially distressed company's debt into equity or the acquisition by a company's creditors of shares in that company paid for by the value of their loans to the company. In the United States, debt-equity swaps are also used to recapitalize companies—whether it be (1) as part of a voluntary workout or (2) as part of a plan of reorganization in a Chapter 11 case or a prepackaged bankruptcy plan.

Or, to put it more simply, debt-equity swaps transfer bank loans from the liabilities section of company balance sheets to common stock or additional paid-in capital in the shareholders' equity section.

Let us imagine a company, as on the left-hand side of Figure 1, with assets of 500, bank loans of 300, miscellaneous debt of 200, common stock of 50 and a carry-forward loss of 50. By converting 100 of its debt into equity (transferring 50 to common stock and 50 to additional paid-in capital), thereby improving the balance sheet position and depleting additional paid-in capital (or using the net income from the following year), as on the right-hand side of Figure 1, the company escapes insolvency. The former creditors become shareholders, suddenly acquiring 50% of the voting shares and control of the company.

Figure 1 An Example of Debt Reduction by Means of a Debt-Equity Swap



Source: NRI.

The first benefit that results from this is the improvement in the company's finances produced by the reduction in debt. The second benefit (from the change in control) is that the creditors become committed to reorganizing the company, and the scope for moral hazard by the management is limited. Another benefit is one peculiar to equity: a return (i.e., repayment) in the form of an increase in enterprise value in the future. In other words, the fact that the creditors stand to make a return on their original investment if the reorganization is successful and the value of the business rises means that, like the debtor company, they have more to gain from this than from simply writing off their loans. If the reorganization is not successful, the equity may, of course, prove worthless.

2. The Debate about Debt-Equity Swaps in Japan

1) The Law on Special Measures for Industrial Revitalization

In Japan debt-equity swaps first attracted attention in early 1999 when, at the first meeting (on 29 March 1999) of the Competitiveness Commission, which had just been set up by the Obuchi government, the Finance Minister, Kiichi Miyazawa, called on heavily indebted companies to convert their debt into equity. Various proposals and discussions then followed, including one to set up a body (modeled on the Financial Reconstruction Commission and generally referred to as the Industrial Reconstruction Commission) to assess (in the public interest) the chances of turning around problem companies and the degree of blame that should be put on their management. It was at this stage that the consensus shifted from one that individual companies and financial institutions should be left to discuss matters among themselves to one that debtor companies should be encouraged in every way possible to carry out debt-equity swaps.

These views were reflected in the Law on Special Measures for Industrial Revitalization, which came into force in October 1999. The Law allowed companies to issue shares to their creditors on certain conditions and in accordance with an officially approved reorganization plan in order to reduce their debt. Similarly, companies were encouraged to carry out debt-equity swaps by (1) simplifying the rules requiring the value of investments in kind to be assessed by an officially approved expert, (2) reducing the rate of tax on company registration and licensing, and (3) increasing the issuance limit on preferred stock.[1]

In fact, however, the Law has not been particularly successful in encouraging companies to carry out debt-equity swaps. As of the end of 2001, only one of the 117 corporate reorganization plans officially approved by the various ministries concerned—that of Sky Entertainment (now JSky Sports)—has involved the use of a debt-equity swap.

The two main reasons why the Law did not lead to greater use of debt-equity swaps were probably the fact that the Law required companies (1) to submit their reorganization plans for official approval and (2) to demonstrate in their plan that they could "achieve significant productivity improvements" (e.g., an increase in return on equity of at least 2%) within three years. However, as the incentives offered were later incorporated in amendments to the Commercial Code, there was no compelling reason for companies to use the Law.

Sky Entertainment's debt-equity swap appears to have been the first example in Japan of a debt-equity swap based on the par value of the debt, and it is reported to have been followed in the course of fiscal 2000 by a number of similar deals.[2] (See below for a detailed explanation of a debt-equity swap based on the par value of the debt.)

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1 Motomi Hashimoto, “Recent Developments in Corporate Restructuring Legislation,” Capital Research Journal, Winter 1999.

2 According to Jun Haritsuka, "Tokyo Chisai Shobu ni Okeru Genbutsu Shusshi to Kensayaku Sennin Jiken no Genjo" [The Current State of Cases in the Commercial Division of the Tokyo District Court Involving the Appointment of External Experts to Value Investments in Kind], Shoji Homu [Commercial Law Review], 25 March 2001, there have been six cases (as of the time of writing) where debt-equity swaps have used the book-value approach.

2) The Reorganization Law

In Japan the use of debt-equity swaps has been complicated by the legal procedures for reorganizing companies. Under the Corporate Rehabilitation Law (Articles 221 and 222), companies are permitted to increase or reduce their capital in accordance with a reorganization plan in order to offer equity in part exchange for their debt. This enables them to carry out debt-equity swaps regardless of the procedures required by the Commercial Code. However, the fact that the Composition Law contained no provisions for capital reductions meant that it would have been difficult for companies to carry out a capital reduction as the Commercial Code required them to allow shareholders to take a special vote on this at a general meeting.

In contrast, the Reorganization Law, which replaced the Composition Law in April 2000, allows debtor companies in the process of reorganization to obtain permission from a court to carry out a capital reduction in accordance with their reorganization plan. This allows such companies not only to require their existing shareholders to accept a loss (in the same way as creditors) but to issue new shares to creditors once a capital reduction has taken place, thereby making it much easier to carry out a debt-equity swap. By the end of 2001 1,502 companies (with debts totaling just over ¥12 trillion) had applied to reorganize under the Reorganization Law—an indication that such procedures are becoming accepted by Japanese businesses.

3) Coordinating the reorganization of Japanese finance and industry

In the spring of 2001 there was much talk in Japan about the need to coordinate the reorganization of finance and industry and to remove any obstacles to the introduction of debtor-in-possession finance and debt-equity swaps. The origin of this debate was probably the call by the Director of the Financial Services Agency, Hakuo Yanagisawa, in January 2001 for a coordinated approach by the Agency and the various departments responsible for industry to dealing with the problems faced by finance and industry as, in his opinion, any solution to the problems of the former (i.e., the banking sector's problem loans) would involve a solution to those of the latter (i.e., industry's debt mountain and the need to allow heavily indebted companies to sink or swim). The response by the Ministry of Economy, Trade and Industry and the Ministry of Land, Infrastructure and Transport was to initiate interdepartmental discussions. What was needed to halt the vicious cycle whereby every year the problem loans (debts) only increased (in spite of efforts to deal with them) was incentives for companies to reorganize and for banks to deal with their problem loans off their balance sheets or to write off their losses rather than just increase their loan-loss provisions.

Following this debate, in April 2001, the Mori government announced a package of measures. These included a commitment (1) to clarify the application of the "5%

Rule"[3] to holdings acquired by means of a swap in order to remove one of the obstacles to the use of debt-equity swaps and (2) to examine ways of helping banks to liquidate their problem loans.

In its announcement the government also mentioned the urgent need to draw up and publish a set of guidelines on forgiving the debts of financially distressed companies as part of their reorganization. As a result, a study group (chaired by Professor Shinjiro Takagi of Dokkyo University) was set up with representatives from the Federation of Economic Organizations (Keidanren) and the Japanese Bankers Association together with a number of experts to draw up guidelines on informal workouts. These were published in September 2001. Although the study group discussed the role of debt-equity swaps in informal workouts, they decided not to include any new measures in their guidelines as action had already been taken to deal with the problems presented by the 5% Rule and the requirement in the Commercial Code that investments in kind be valued by an officially approved expert. However, the stringency of the guidelines with regard to reorganization plans (e.g., the fact that a company would be expected within three years of an informal workout to (1) return to profit, (2) clear all its net liabilities in real terms and (3) carry out a capital reduction) has meant that apparently very few companies have chosen to adopt the guidelines.

4) The debate on the role of debt-equity swaps in the reorganization of big companies

In August-September 2001, just before the interim reporting season, there was a heated debate about whether banks should provision for the loans they had made to big companies with large Category II ("care required") debts. In other words, they had to decide how to deal with the fact that a large proportion of their loans to 20 or 30 big companies, officially categorized as either Category I ("pass") or Category II, were alleged to have become "nonperforming."[4] One of the proposals that was made was that a public or neutral body similar to the Industrial Reconstruction Commission (see above) should be set up to identify the problem companies and oversee their shareholding structure once they had carried out debt-equity swaps.

The various opinions were reflected in the Reform Timetable and the Reform Program that were published on 21 September. Particularly noteworthy is the fact that, for the first time in a government document, a proposal was made in the Reform Timetable that the Development Bank of Japan, private investors and the Resolution and Collection Corporation should be encouraged to either set up or invest in a

3 The 5% limit imposed by the Banking Law and the Antimonopoly Act on bank shareholdings in individual companies.

4 Yasuyuki Fuchita, “Recent Developments Concerning Japan’s Bad Loan Problem and the Outlook for its Financial System,” Capital Research Journal, Winter 2001.

corporate recovery fund, which would purchase shares (acquired by banks and other lenders as a result of debt-equity swaps) in companies that had drawn up rigorous reorganization plans in order to help these companies reorganize.

This was followed, in October 2001, by measures to tighten up inspections by the Financial Services Agency, including the introduction of special inspections for debtor companies whose share price or credit rating had taken a tumble. As companies whose Category II debts have to be reclassified as Category III ("recovery doubtful") or Category IV ("irrecoverable") debts following such an inspection are likely to be obliged by the guidelines on informal workouts to (1) draw up a thorough reorganization plan, (2) apply to be subject to proceedings under the Reorganization Law and (3) sell problem assets to the Resolution and Collection Corporation, debt-equity swaps are likely to be used as part of this process.

5) Daiei's reorganization plan

The reason debt-equity swaps have been in the limelight again this year is that it was reported in January that Daiei, whose financial year ends in February, had begun to seriously consider drawing up a reorganization plan and applying to carry out a debt-equity swap under the Reorganization Law. To begin with, the company announced that it was planning to reduce its common stock by 50% and either offer its principal creditors equity (nonvoting preferred stock) in place of ¥300 billion in loans or ask them to write off these loans. However, in February it announced a new proposal that involved reducing its common stock by 99% and converting ¥230 billion of debt into ¥220 billion of preferred stock and ¥10 billion of common stock. (The capital reduction was approved at the company's annual meeting in May.) It will be the biggest debt-equity swap ever in Japan in terms of the amount of debt converted and the number of existing shareholders affected. Daiei's reorganization plan has prompted a number of other companies to consider carrying out large debt-equity swaps.

The debate in Japan about whether or not to introduce debt-equity swaps has gone through a number of phases, and the focus has shifted gradually from one where they were advocated for macroeconomic reasons to one where they are seen as a means of helping individual (and especially heavily indebted) companies to reorganize. Moreover, the wider range of legal procedures now available to companies wishing to reorganize means that greater use is likely to be made of debt-equity swaps in informal workouts.

3. Types of Debt-Equity Swap

1) Valuing debt at par and at market

There are two ways in which creditors can take part in a debt-equity swap: one is for them to pay in new equity capital into a company and to use that to repay the company's creditors; the other way is for them to use their existing loans to a company to purchase shares in it (i.e., make an investment in kind). In the former case, creditors will have to raise the capital to purchase the shares they have agreed to subscribe to—a not altogether unproblematic undertaking. Even if they are able to raise the capital, this will involve costs, including the cost of servicing the debt until their capital is repaid. There is also the risk, in certain circumstances, that other creditors may try to attach this capital.

The second way of taking part in a debt-equity swap would therefore seem simpler. However, the fact that such swaps are normally only carried out by companies with weak finances means that such companies have to decide whether to value their debt at market (and issue equity of equivalent value) or at book value (and issue equity of equivalent value).

If they decide to value their debt at market, they will have to persuade their creditors to agree to forgive the difference between the book value of the debt and its market value. Creditors and financial institutions will probably find it difficult to make a decision on such a matter. Also, if the size of the debt they are being asked to forgive is large, financial institutions face the risk of a class action by their shareholders. There is a further complication in that the value of any investment in kind (as this would be) would have to be assessed by an officially approved expert—a time-consuming and expensive undertaking.

The Commercial Division of the Tokyo District Court therefore decided in 2000 that debt could be valued at its book value—mainly for the following reasons. First, there is the logic of accounting theory. If a company values its debt at market, it is obliged to record the difference between the book value and the market value of the debt as a gain resulting from forgiveness of the debt—hardly the aim of the parties concerned. In other words, the parties concerned are obliged to post a gain or loss as part of the capital transaction. Second, there is the principle of capital adequacy of the enterprise. An investment in kind that resulted in an immediate unrealized loss to a company would appear to violate this principle. However, the fact that a debt-equity swap extinguishes a company's debts means that no such unrealized loss is incurred. In that sense, a debt-equity swap does not prejudice the interests of other creditors or existing shareholders. Although these were not the only reasons for the court's decision, the benefits produced by the widespread use of debt-equity swaps suggest that book valuation is the preferred method.

Be that as it may, valuing debt at book value was much cheaper and quicker than valuing it at market and therefore having to use an officially approved expert to assess the market value. Nevertheless, although valuing debt at book value has numerous practical advantages, it does not ensure that the cost of restructuring the capital of a heavily indebted company is spread evenly. If one believes that this is important, then an objective reassessment of the value of a business is a vital piece of information, and any attempt to carry out a debt-equity swap without it risks clouding the judgment of shareholders and third parties.

2) Debt-equity swaps involving a capital reduction

Companies that decide to reorganize under either the Corporate Rehabilitation Law or the Reorganization Law tend to carry out a capital reduction before later carrying out a capital increase and restructuring their finances. Similarly, as is explained below, companies that carry out a debt-equity swap as part of an informal workout tend to carry out a capital reduction, be it on a large or small scale.

In the days when there was no Reorganization Law and no guidelines on informal workouts, support for a distressed company often involved its main bank forgiving a large chunk of its debt without demanding any capital reduction. Perhaps this is why in Japan capital reductions are often seen as "the responsibility of existing shareholders" or "a deterrent to moral hazard." More realistically, perhaps, they can also be seen as a means of eliminating capital deficiencies or as an incentive for new shareholders.

The key relationship on a balance sheet is: assets = liabilities + shareholders' equity. However, companies that have accumulated losses in their main business or posted extraordinary losses on investments in affiliates sometimes find that their net assets (i.e., assets - liabilities) are less than their common stock (i.e., that they have a capital deficiency). A company with a capital deficiency cannot take on any more liabilities or pay its shareholders a dividend. The only way for it to break this impasse is to raise new capital to invest in plant and equipment in order to improve its performance—hence its need to reduce its capital. The first reason for this is that, if it allows the capital deficiency to continue, any new equity investors are likely to be deterred by the fact that, even if they become shareholders, they cannot expect to receive any dividend in the foreseeable future. The second reason is that, if the company leaves its existing capital unchanged, any new shareholders investing in the company will find it difficult to acquire more shares than the existing management team and gain control of the company. Therefore if the company reduces its capital and rectifies its capital deficiency, it will be able to resume dividend payments (as the cost of this will be less than before it reduced its capital) and reduce the number of shares owned by the existing management team, thereby increasing the incentives for new investors. This also means that capital reductions would be a good way of increasing incentives for new investors where a company carries out a debt-equity swap. In Japan, however, the fact that the new shareholders in such cases have generally been financial institutions such as banks and life insurance companies and that creditors have usually had to forgive most of the debts of the companies involved has meant that the debate has tended to focus on striking a balance with shareholder liability.

3) Debt-equity swaps and shareholders

There is no established theory of the effect of debt-equity swaps and capital reductions on the share price of listed companies. Although, generally speaking, shareholders' rights should not be affected provided no dilution occurs, companies that have just carried out a capital reduction or a debt-equity swap are likely to be in a vulnerable position, and investor perceptions are likely to fluctuate between bullishness and bearishness. In theory, the fact that the value of a distressed company is roughly the same as that of its liabilities (if one assumes that the value of a business is the present discounted value of its future expected earnings) means that its intrinsic shareholder value will be very low indeed. As shares can also be valued as options on changes in the value of a company produced by factors such as (1) creditors forgiving companies some of their debt and (2) acquisitions, it is hardly surprising that share prices tend to be volatile. If debt-equity swaps and capital reductions can ensure that companies can rectify their capital deficiencies and make a net profit, clearer indications that corporate reorganizations will lead to increases in profits and a resumption of dividends should lead to share prices behaving in a normal way. (Incidentally, investors need to be aware of a number of facts if debt is swapped into preferred stock. For example, this preferred stock could be designed to range in nature from products that are similar to common stock to ones that are similar to bonds, depending on whether there is any provision for conversion into common stock. Similarly, any failure to pay a preferred dividend could lead to holders of these shares regaining voting rights.)

4. Examples of Japanese Debt-Equity Swaps

1) Japanese companies that have carried out debt-equity swaps

Table 1 is a list of Japanese companies that are reported in the press and other media to have carried out debt-equity swaps as of the end of fiscal 2001. These cases display a number of features in common. The first is that in most of them the companies appear to have persuaded their creditors to forgive them their debts and to have agreed to issue them with new shares on a third-party basis. The second feature they have in common is that the capital increase is much smaller than the amount of financial support received by the companies—in most cases, less than one tenth the amount. As a result, most of the impact on their balance sheets comes from the reduction in their debt. In the case of Kumagai Gumi, for example, only ¥20 billion came from a third-party share allotment following a reduction in the company's common stock to par value and a reverse stock split whereas ¥450 billion in debt reduction came from debt forgiveness. Moreover, with one exception (Dia Kensetsu, where the new equity was funded by a private equity firm), all the companies in the list carried out a capital reduction of approximately the same size as the capital increase at about the same time.

Table 1 Debt-Equity Swaps by Japanese Companies in Fiscal 2000

Company	Date	Description (including de facto swaps)	Summary of reorganization plan	Consolidated debt	(Fiscal year ended)
Sky Entertainment (unlisted)	Jan. 2000	¥12.1 billion in borrowings from shareholders swapped into shares	Capital increase carried out and cumulative debts written off Approval by Ministry of Posts and Telecommunications of application to file under Law on Special Measures for Industrial Revitalization.	NA	—
Hazama	Aug. 2000	Allotment of ¥8.2 billion in shares to third party	Part of a package (involving a total of ¥105 billion in financial support) that included forgiveness of debt Capital reduced to par value (¥8.2 billion) in August 2000.	¥422.4 bil ¥286.1 bil	2000/3 2001/3
Dia Kensetsu	Jan. 2001	Issue of ¥3.2 billion in convertible bonds	Purchased by Cerberus, which forgave ¥17.0 billion of the ¥23.0 billion (book value) in mortgages the company had purchased from Nippon Credit Bank (the remainder being the value of the collateral). Roughly ¥400 million of this was converted in the course of March 2001 and added to the company's common stock.	¥318.8 bil ¥288.0 bil	2000/3 2001/3
Kumagai Gumi	March 2001	Allotment of ¥20.0 billion in shares to third party	Capital was reduced to its par value and a reverse stock split carried out (reducing capital by a total of ¥ 65 billion) Part of a package (involving a total of ¥450 billion in financial support) that included forgiveness of debt.	¥1,057.2 bil ¥645.5 bil	2000/3 2001/3
Mitsui Construction	March 2001	Allotment of ¥20.5 billion in shares to third party	Part of a package (involving a total of ¥163 billion in financial support) that included forgiveness of debt Annual general meeting of shareholders in June 2001 agreed to liquidation of ¥4.8 billion in capital from additional paid-in capitral.	¥422.6 bil ¥249.3 bil	2000/3 2001/3
Chiyoda	March 2001	Allotment of ¥1.8 billion in shares to third party	Part of a package (involving a total of ¥26.2 billion in financial support) that included forgiveness of debt In February 2001 capital was reduced to its par value and a reverse stock split carried out (reducing capital by a total of ¥14.2 billion) In March 2001 the company increased its capital by ¥ 11.6 billion, liquidated ¥8.4 billion in capital from its additional paid-in capital and covered a carry-forward loss of ¥14.2 billion.	¥83.9 bil ¥37.3 bil	2000/3 2001/3

Source: NRI, from newspaper articles, securities reports and the Japan Company Handbook.

2) Daiei's plans for a debt-equity swap

Daiei's financial situation in the period leading up to its announcement of a debt-equity swap can be summarized as follows. In fiscal 2000 (ended in February 2001) the company's consolidated debt, which had been gradually declining until the previous fiscal year, suddenly increased. At the same time, the company's net assets (of roughly ¥24.5 billion) were considerably lower than its common stock (of ¥52.0 billion), creating a capital deficiency. In February 2001 (i.e., at the end of the same fiscal year), Daiei issued roughly ¥120 billion in preferred stock to its main bank, some of which was used to write off losses and some of which was capitalized. An analysis of Daiei's capital structure as reported in its fiscal 2001 financial statements shows that the company's consolidated surplus was continuously in the red in the five years to fiscal 2001 and that its losses were mounting. In its financial statements for the first half of fiscal 2001 (to August 2001) the company still had a capital deficiency with net assets of roughly ¥56.9 billion compared with common stock of ¥112.0 billion (and a consolidated surplus of -¥145.2 billion). Its additional paid-in capital (of ¥68.3 billion) was insufficient to cover this.

Table 2 Daiei's Consolidated Debt (from consolidated financial statements)

Sudden increase in debt in fiscal 2000

Daiei (8263) (¥ mil)

Consolidated financial statements (extract)	1997.2	1998.2	1999.2	2000.2	2001.2	2001.8
Interest-bearing liabilities	1,271,752	1,170,771	1,110,935	1,076,861	2,534,087	2,275,437
Short-term borrowings	733,156	556,944	562,254	517,748	1,864,926	1,670,832
Current portion of straight bonds	6,509	23,479	32,576	30,000	30,000	30,000
Current portion of long-term borrowings	54,297	72,202	53,063	164,007	240,000	250,778
Commercial paper	112,000	170,000	111,400	175,865	64,400	108,600
Long-term borrowings	365,790	348,146	351,642	189,241	334,761	215,227
Straight bonds	153,479	130,000	112,800	82,800	30,000	30,000
Convertible bonds	5,239	5,239	2,663	2,663	—	—
Common Stock	52,000	52,000	52,000	52,000	52,000	112,030
Paid-in advances on new shares	—	—	—	—	119,970	—
Additional paid-in capital	152,414	152,414	152,414	152,414	152,414	68,357
Earned surplus reserve	13,000	13,000	13,000	—	—	—
Revaluation reserve	—	—	—	—	37,966	38005
Capital surplus/deficiency	-81,114	-90,142	-134,876	-143,820	-315,375	-145,168
Net assets	121,691	112,662	67,930	57,591	24,556	56,875
Total assets	2,196,324	2,150,435	2,021,803	1,834,612	3,244,071	3,037,123
Net profit (loss)	-11,908	1,213	-41,294	-21,944	45,894	26,249

Capital increase by means of preferred stock issue in fiscal 2000

¥1,333 × 90 mil shares = ¥120 bil

↓

①¥66 billion added to common stock

②¥59.9 billion added to addtional paid-in capital (increasing it to ¥ 212.3 billion)

③¥144 billion from capital surplus account liquidated on 24 May 2001 to write off losses, leaving ¥68.3 billion in share premium account at end of first half of fiscal 2000 (August 2001)

As of February 2001, net assets < common stock

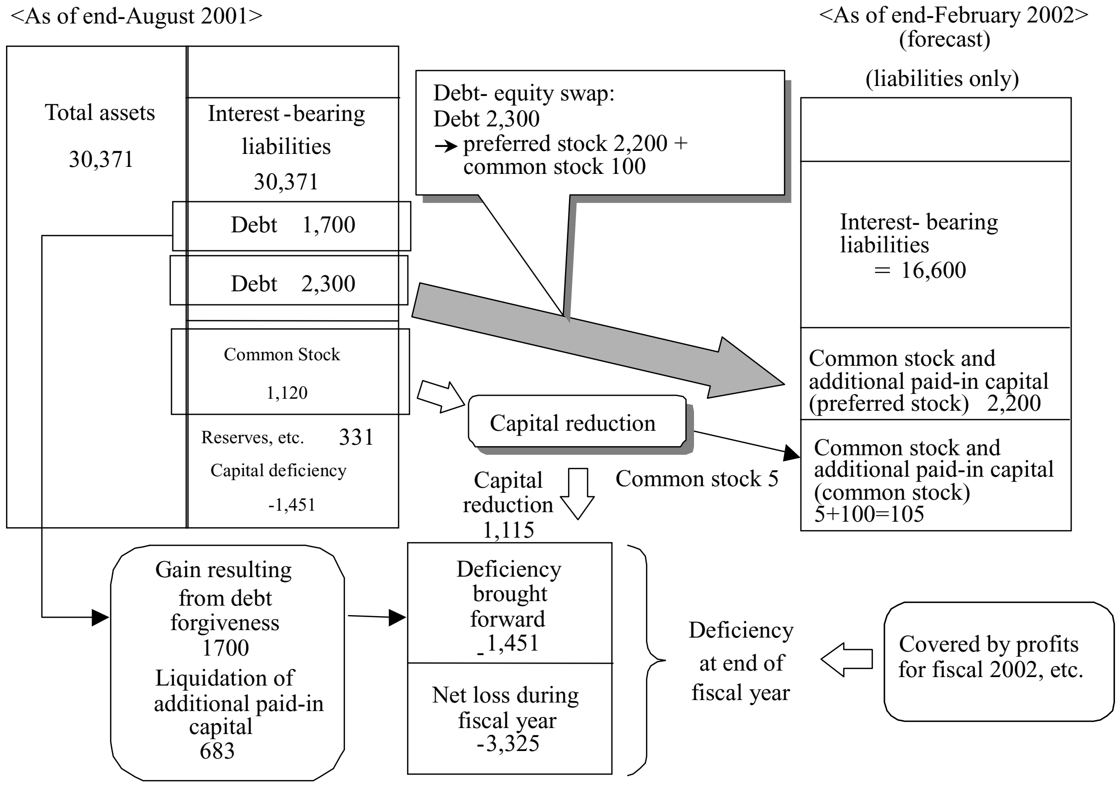
¥68.3 billion in additional paid-in capital insufficient to cover capital deficiency

Source: NRI, from company securities report.

Figure 2 tries to capture the effect of the debt-equity swap announced by Daiei on 27 February of this year. The company will exchange ¥230 billion in debt for ¥220 billion in preferred stock and ¥10 billion in common stock that it will issue and allot to its main bank. It will reduce its common stock by ¥111.5 billion, leaving only ¥500 million. However, the swap is expected to boost its common stock and additional paid-in capital by ¥115 billion each. Whether or not the capital reduction and forgiveness of its debt will enable the company to correct its capital deficiency will depend on how well it does in fiscal 2002. Forgiveness of ¥170 billion in debt and the disposal of assets are expected to enable the company to reduce its debt to ¥1,660 billion. Although the financial support will have a big impact, opinion is divided on whether it will be enough.

Figure 2 Schematic Diagram of Daiei's Consolidated Balance Sheet and Its Debt-Equity Swap

(¥100 mil)



Note: Fiscal 2001 losses are preliminary figures (announced on 19 April 2002). The fiscal 2001 figure for interest-bearing liabilities is the company's own forecast (as of February 2002).
Source: NRI, from company securities report, etc.

By reducing its capital by 99% and issuing new common stock, Daiei will dilute the rights of its existing shareholders. However, the fact that its current common stock is insufficient and that the percentage of its shares held by financial institutions will increase means that the company may need to raise more capital in the near future. The company will also restrict the voting rights attached to the ¥220 billion in preferred stock it will issue and has attracted considerable attention because it is apparently considering various ways of restricting its conversion into common stock, including imposing a closed period for this. Further details are due to be announced at the annual general meeting of shareholders in May, when the necessary amendments to the company's articles of association will be discussed. In addition to these reorganization plans, the company has announced that it will carry out reverse splits of both its common stock (1:2) and its preferred stock (1:10) as well as make 500 shares (rather than 1,000) its minimum trading lot.

3) Companies planning debt-equity swaps

Table 3 lists companies that in January-March of this year announced plans to reorganize themselves (e.g., by issuing debt-equity swaps). Daiei and Haseko have carried out debt-equity swaps totaling more than ¥100 billion each—large even in comparison with the amount of debt they have been forgiven. Although Iwataya Department Store and Toyo Shutter are both apparently planning to use the guidelines on informal workouts, Ichida's new shares will probably be acquired by a corporate recovery fund, albeit one led by its former main bank.

Table 3 Japanese Companies Planning a Debt-Equity Swap

	New share issuance (¥100 mil)	Total financial support (¥100 mil)	Capital reduction plans	Remarks	Consolidated interest-bearing liabilities (as of end of fiscal 2000) (¥100 mil)
Haseko	1,500	1,500	Under consideration	Proportion of common and preferredstock ¥354.6 in debt had already been forgiven by end of fiscal 2000	5,211
Iwataya Department Store	10	280	50% reduction planned	Will apply to file under guidelines for informal workouts	896
Daiei	2,300	5,200	99% reduction planned	To be converted into ¥10 bil in common and ¥220 bil in preferredstock	25,640
Tobishima	100	800	NA	To be converted into preferred stock	1,392
Daikyo	(approx. 400)	(4000-5000)	50% reduction under		1,729
Ichida	5	97	Plan exists	Debt-equity swap to be carried out after Japan Recovery Fund6 purchases MTFG's unsecured loans to the company	284
Toyo Shutter	10	116	Under consideration	Will apply to file under guidelines for informal workouts	287

Note: Figures for new share issuance and total financial support (including debt-equity swaps) are approximate.
Source: NRI, from Nihon Keizai Shimbun of 12 March 2002, Japan Company Handbook, etc.

5. Outlook

1) Debt-equity swaps and corporate recovery funds

Investors should realize that greater use of debt-equity swaps by Japanese companies will not necessarily be a positive development for Japanese banks and financial institutions.

First, there are regulations governing share ownership. Although a certain degree of flexibility is allowed in how the 5% Rule (see above) is applied, shareholders are normally expected to dispose of any holdings in excess of 5% within 12 months. Second, the Law Governing Limits on Bank Shareholdings, which came into force on 1 April of this year, requires commercial banks, long-term credit banks, Norinchukin Bank, Shinkin Central Bank and bank holding companies to dispose of any shareholdings in excess of their own shareholders' equity by 30 September 2004 (or, in exceptional circumstances and only with official approval as an interim measure, by the end of September 2006 at the latest).

Another factor is the possibility that banks, which try to maintain a long-term relationship with their customers, may prefer to avoid the kind of difficult negotiations that capital reductions tend to involve. Furthermore, a drastic decline in the value of a loan often means that creditors are asked to forgive debts even if borrowers value their debts at book value. Similarly, as happened to the preferred stock issued by Daiei at the end of fiscal 2000 and now subject to a capital reduction, losses can even arise after a conversion has taken place. Selling such shares can be difficult if they are unlisted and illiquid.

Some people take the view that commercial banks are not the best institutions to invest in the new shares produced by debt-equity swaps and that this is better done (as part of the business of corporate recovery) by private equity funds or investment banks on their own accounts as they are more likely to be committed to overhauling the companies concerned. A well-known example of this line of thought is the proposal for a "Japan deleveraging fund" by international bankruptcy expert and former representative of INSOL International, Richard Gitlin. His idea is that, instead of becoming shareholders in debtor companies, banks should swap the shares they acquire as a result of debt-equity swaps for participation certificates in corporate recovery funds in order to make a capital gain when the value of the shares rises at some point in the future.

In the United States there are private equity funds (e.g., distressed funds and specialty funds) that invest in a wide range of corporate debt and securities (e.g., senior debt and unsecured debt). In Japan, too, there is a role for specialist investors other than banks to facilitate debt-equity swaps. However, in the case of the kind of major companies (often listed and with numerous shareholders) that are the current focus of concern and have debts of anything from several hundreds of billions of yen to more than a trillion yen, the sensitivity of Japanese public opinion to large-scale layoffs and the complexity of the relations between debtors and creditors/shareholders means that even those investment banks and private equity funds that are already active in this field would probably have their work cut out to recapitalize these companies and overhaul them in a short space of time. Nor is the Japanese market for such debt likely to be mature enough to enable private equity funds with no track record to raise capital easily even if Japanese investors do have the kind of liquidity they are reputed to have. Rather it might be more realistic to wait for (1) Japanese banks to part company with their debtor clients (as Gitlin's proposal seems to suggest may happen) and for (2) Japanese private equity funds to establish a track record in their own good time.

2) Japanese attitudes to corporate recovery

Japanese attitudes to the kind of corporate reorganization plans described in this report (i.e., involving debt-equity swaps) are probably still not particularly positive. One of the reasons for this kind of hostility is probably that, because the decision-making process in informal workouts is not very clear and swapping large amounts of debt into preferred stock tends to be done in such a way that voting rights are unaffected, debt-equity swaps tend to be seen as an expedient. Whether or not they are an expedient is a matter that requires further study. However, the attitude of Japanese investors indicates that they have yet to fully understand and accept the approach to corporate valuation and capital restructuring that underlies corporate reorganization plans. In particular, debt-equity swaps that are carried out without any change of management or any capital reductions risk being seen both at home and abroad as unfair and unlikely to bring a fresh start.

In this regard, a study of the financial aspects of corporate reorganizations in the United States may be instructive. When US companies draw up a reorganization plan, they appear to attach considerable importance not just to reducing their debts but also (where they hope to maintain the company as a going concern rather than liquidate it) to how much should be allotted to investors in each class of asset on the basis of how much the business is worth. Therefore the fact that they regard valuing a business as a whole as the most important consideration and that the effect on existing shareholders of a capital reduction is an integral part of this appears to help to maintain a sense of fairness. Moreover, the fact that, in many cases, the new shares that are issued are acquired by strategic buyers and corporate recovery funds who sometimes send in a new management team helps to bring about a clear shift in control as part of the debt-equity swap.

In Japan, debt-equity swaps are likely to be seen increasingly not merely as a means of reducing corporate debt but as a step towards adjusting balance sheets so that companies can remain going concerns and make a fresh start.