Going Private as a Strategic Option

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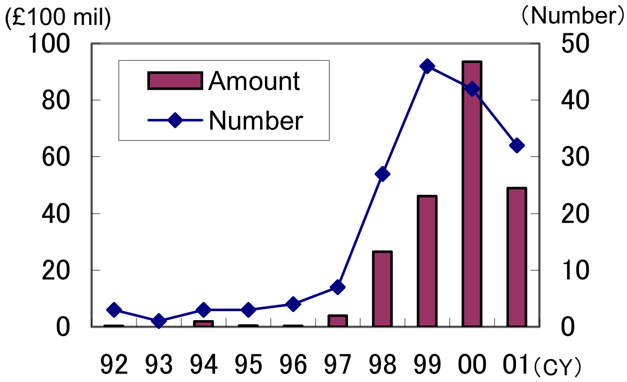
In Europe and the United States it has become commonplace for companies that no longer see any advantages in remaining public to choose to delist and go private as a strategic option. In Japan most companies that delist do so as a result of failure or a merger, so going private has a rather negative image; but even in Japan an increasing number of companies are choosing this as a strategic option.

1. Going Private Commonplace in Europe and the United States

In the United States, leveraged buyouts (LBOs) or, as they are often called, management buyouts (MBOs) (i.e., the acquisition of a company by a private equity firm or the company's existing management team) have been common since the 1970s, and many of these buyouts have been in order to gain control of public companies and then take them private. If the acquisition target is a small company, the existing management team may be able to fund the buyout themselves or with a loan; but, if the company is any larger, it is normal for private equity firms such as Kohlberg Kravis Roberts (KKR) to raise the necessary capital. In 1998 there are reported to have been 22 going-private deals and in 1999 50.[1]

Figure 1 Going-Private Transactions in the United Kingdom



Source: NRI, from Management Buy-outs Quarterly Review, The Center for Management Buy-out Research.

1 According to data from Piper Jaffray.

In the United Kingdom, management buyouts became commonplace in the 1980s, but it was only in the 1990s that going private became one of their aims, with the number of buyouts surging in 1998. In 2001 the level of buyouts declined in both number (32) and value (£4.9 billion) on the previous year but remained high in absolute terms (see Figure 1).[2] Of these, 14 were major deals worth more than £100 million each.

There have also been going-private deals in other European countries (e.g., Germany, France and the Netherlands), albeit on a smaller scale.

2. Reasons for Going Private

1) Poor liquidity and share price discounts

Weak stock markets and poor liquidity sometimes lead companies to go private in the hope that this will enable them to overcome problems such as (1) difficulty in raising capital on the markets, (2) the threat of a hostile takeover and (3) difficulty in selling the owner's equity in order to transfer ownership.

One of the reasons for going public is to increase the liquidity of a company's shares. However, a stock exchange listing is no guarantee of good liquidity. In other words, shares in several thousand companies may be listed on an exchange, and not all of them will be traded frequently. Institutional investors managing large funds tend to invest mainly in large-capital stocks. Similarly, broker analysts cannot cover every company in their sector and therefore tend to focus on a selection. As a result, trading also tends to be concentrated in a few stocks, and shares in smaller companies that are not covered by analysts as well as shares in companies in unfashionable sectors tend to have poor liquidity and to trade at a discount.

For example, the turnover ratio[3] on the New York Stock Exchange (NYSE) has been rising every year since the early 1990s, reaching a record 94% in 2001. However, a closer look shows that only 50 of the 2,800 stocks listed on the exchange account for 30%, and 250 stocks for just over 60% of volume. Similarly, even on the NASDAQ, which is supposed to be a highly liquid market, small-cap stocks, which make up some 20% of the stocks listed there, account for only 1% of the volume, with most of the trading being done in so-called National Market stocks, most of which are large-caps.

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2 These were deals involving finance from private equity firms. Another, more recent term for "going private" is "public to private" (P2P).

3 Turnover ratio = total volume/average number of shares listed.

It would seem reasonable to assume that, if the management of a company feel that the company's share price does not reflect its true value, they should put more effort into improving their relations with investors. Such efforts are sometimes successful, with the result that the share price rises and liquidity improves. However, there are cases where, even if earnings improve, the company concerned fails to attract investor interest and the share price fails to rise. In such cases, going private is one possible option.

2) Concentration of control

Although going public subjects companies to disclosure requirements and the scrutiny of its ordinary shareholders, thereby making the process of management more transparent, the fact that shareholders, investors and analysts tend to focus on short-term performance means that management sometimes finds it more difficult to pursue medium- to long-term growth strategies and carry out decisive reforms. In such cases, going private may free a company from shareholder pressure to boost short-term earnings and allow control to be concentrated once again in the hands of a minority of shareholders such as the management team and the owner.

The resulting increase in their share of the equity acts as an incentive for them to manage the company better and develop its business as any increase in company earnings has a direct effect on their own equity returns. It is also likely that going private makes it easier for companies to conclude compensation agreements that offer better incentives.

Although private equity firms usually take a significant equity stake in the companies they help to go private, the fact that they hope to eventually make a capital gain on their investment means that they generally advise the management team on how to enhance the value of the business.

3) Cost of remaining a public company

In order to remain public, companies have to shoulder a whole range of costs. These include the cost of preparing disclosure documents for the US Securities and Exchange Commission (SEC) and carrying out audits; the cost of holding general shareholder meetings; the cost of fostering good relations with investors (e.g., by means of investor briefings and annual reports); and stock exchange fees to maintain a listing (see Table 1). Nor are the costs purely financial: they are also considerable in terms of human resources. For example, directors spend considerable time dealing with investor relations. Similarly, companies have to pay staff to provide various services for shareholders. Relatively small public companies sometimes find the burden a heavy one, and it is in cases where this burden is felt to outweigh any benefits from being a public company that management may decide to take a company private.

Table 1 Examples of the Cost of Maintaining a Listing (on the Nasdaq National Market)

Shares listed	Annual cost
0-10 mil	$21,225
10-25 mil	$26,500
25-50 mil	$29,820
50-75 mil	$39,150
75-100 mil	$51,750
100 mil or more	$60,000

Note: As of January 2002.
Source: NRI, from NASDAQ data.

3. Process of Going Private

1) Procedures

(1) Satisfying delisting requirements

The first way a company can go private is to ensure that in so doing it will satisfy a stock exchange's delisting requirements.

The delisting requirements of US and Japanese equity markets (the Tokyo Stock Exchange, the New York Stock Exchange and the NASDAQ) include criteria for the number of shares listed, market capitalization, the number of shareholders, volume and share price (see Table 2). If a company meets these criteria, its shares will be delisted once a specified period of grace has expired.[4] In order to meet these criteria, the company will arrange for its shares to be traded in such a way that the number of its shareholders is reduced to below a certain level (400 in the case of the above three markets) and share ownership is concentrated in the hands of specified shareholders.[5]

4 In the United States many companies are delisted every year because they meet an exchange's delisting requirements. In Japan, however, such cases are rare.
5 The Tokyo Stock Exchange defines "specified shareholders" as "a company's 10 largest shareholders or the company's officers or the company itself," while the New York Stock Exchange and the NASDAQ define the term as "company officers and their families or shareholders with at least 10% of a company's shares."

Table 2 Summary of Delisting Requirements of Major US and Japanese Stock Markets

	TSE	NYSE	NASDAQ
Shares listed	Less than 4,000 trading lots	Fewer than 600,000 shares are held by shareholders other than specified shareholders	Fewer than 750,000 shares are held by shareholders other than specified shareholders
Market capitalization	No requirements	Average market capitalization for the past 30 business days of less than $15 million, etc.	Market capitalization of float worth less than $5 million
Shareholder distribution	・ More than 75% (currently 80%) of listed shares are held by specified shareholders ・ Less than 400 shareholders (less than 10,000 lots of listed shares) ・ Grace period of 12 months for both provisions	Fewer than 400 shareholders	Fewer than 400 shareholders
Volume	Fewer than 10 lots traded on average every month for the past 12 months or no shares traded for three months	Fewer than 100,000 shares traded on average every month for the past 12 months (but fewer than 1,200 shareholders)	No regulations
Share price	No regulations	Less than $1 (for 30 consecutive business days)	Less than $1 (for 30 consecutive business days)[6]
Other	If company fails, is involved in an unsuitable merger, violates its listing agreement, or becomes a wholly owned subsidiary as a result, for example, of an exchange of shares, etc.	If company fails, violates its listing agreement, etc.	More than two market makers, shareholders' equity worth less than $10 million

Notes: 1. Of the two sets of requirements for the NASDAQ National Market only the first set has been given.
2. The requirements for the Tokyo Stock Exchange are those for the First and Second Sections.

Source: NRI, from data provided by each of the exchanges.

UK delisting requirements are slightly different. Under the Financial Services and Markets Act 2000, it is the UK Financial Services Authority (FSA) rather than the London Stock Exchange that is responsible for listing and delisting requirements.[7]

6 However, if the share price then holds above $1 for 90 days, the company is saved from delisting.

7 Section 77.

Accordingly, the UK Listing Authority "may cancel the listing of any securities if it is satisfied that there are special circumstances which preclude normal regular dealings in them" and it "will cancel the listing of any security where such security is no longer admitted to trading."[8] Although the Authority has considerable discretion, its guidance manual stipulates that a company's shares must be delisted (1) if listing has been suspended for six months or more or (2) if inadequate equity (less than 25% of the shares listed) is held by nonminority shareholders. The commonest reason for a listing being suspended is if a company fails to satisfy the disclosure requirements.

(2) Applying for a delisting

The second way a company can go private is for it to apply for the securities concerned to be delisted. If its application is granted, the securities will be delisted.

According to the New York Stock Exchange's rules, (1) applications for delisting must be approved by the audit committee and the board of directors; (2) a press release must be issued; and (3) at least the 35 largest shareholders must be sent a written notice.

According to the UK Financial Services Authority's rules, "an issuer that wishes the UK Listing Authority to cancel the listing of any of its equity securities or preference shares must notify the Company Announcements Office and send a circular to the holders of those securities, giving at least 20 business days notice of the intended cancellation."[9]

Although the Tokyo Stock Exchange's rules also contain a section on applying for a delisting (Article 15), it does not contain any details of the conditions that an application would have to satisfy or of the circumstances in which the Exchange would grant an application. As it happens, there have been virtually no such applications in Japan.

8 Listing Rules, paragraphs 1.19 and 1.20.
9 Listing Rules, paragraph 1.21.

2) Types of going-private deal[10] (mainly in the United States)

(1) Cash-out merger

This is one way of eliminating all minority shareholders by making them a cash payment (also called a "squeeze-out") and is the commonest type of going-private deal in the United States. The normal pattern is for the minority shareholders in the company that is to be taken private to be made a cash payment in lieu of shares in the new company, which is formed by merging the original company with the special-purpose company set up with funds from the private equity firm that is facilitating the deal. This enables the insiders (e.g., the management team and the owner) and the private equity firm to gain full control of the company.

(2) Self-tender offer

This involves making a tender offer for the company's shares in order to reduce the equity of the minority shareholders and increase that of the controlling shareholders. As the funds for the offer come from retained earnings or a bank loan, this method is often used by medium-size companies. If the tender offer enables the controlling shareholders to gain a significant controlling stake, a cashout merger is sometimes used to eliminate all the remaining minority shareholders.

(3) Reverse stock split

This involves using a reverse stock split to reduce the size of the holdings of the largest minority shareholders so that they are left with odd lots and to pay them cash for these. It takes advantage of the fact that many US states have adopted corporate takeover statutes that allow shareholders to exchange for cash any odd lot shares produced by a transaction.

3) Protection of minority shareholders

Minority interests need to be protected in cases where a going-private transaction results in a few shareholders gaining control of a company. Unless adequate provision for this is made, there is a risk that minority shareholders may bring a class action.

The first requirement in a going-private transaction is that minority shareholders must be informed. In the United States, for example, Rule 13e-3 ("Going Private

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10 For further details see Nishimura & Partners (ed.), "M&A-ho Taizen" [Compendium of Japanese M&A Law], Ch. 13, and Hiroshi Uchima and Tomoko Sasho, "Nihon ni Okeru MBO no Fukyu, Kasseika ni Mukete" [Fostering the Development of Management Buyouts in Japan], Shoji Homu [Commercial Law Review], No. 1538.

Transaction by Certain Issuers or Their Affiliates"), which is based on the Securities and Exchange Act of 1934, sets out specific requirements for information disclosure in the case of such a transaction. The company that is initiating the transaction is required to submit disclosure documents to the Securities and Exchange Commission giving information about such matters as the reason for and the details of the transaction, the procedures, and the opinion of any outside expert consulted about the transaction's fairness.

The second requirement in a going-private transaction is that minority shareholders must not be forced to sell their shares at an unreasonable price. In Europe and the United States an investment bank or a certified public accountant normally acts as an external adviser in such transactions to calculate the price at which shareholders may sell their shares to the company, thereby ensuring that the transaction is fair. In the United States a significant premium to the market price is normally paid in such cases.

4. Case Studies

1) Springs Industries: an example of a cashout merger facilitated by a private equity firm

This is a classic example of a going-private transaction where a cashout merger financed by a private equity firm is used to pay cash for minority interests in order to eliminate them.

Springs Industries ("Springs") is a leading textile manufacturer specializing in home furnishings and based in South Carolina. Founded in 1887, Springs was listed on the New York Stock Exchange in 1966. After rising for most of the 1990s on strong earnings growth, the share price tumbled from a June 1998 peak of $61 on weaker earnings. The company then came under pressure from its institutional shareholders to improve earnings and boost the share price in the short term. Although management wanted to pursue a long-term strategy, shareholder pressure forced it to try to achieve an earnings recovery as quickly as possible. As a result, earnings recovered in 1999, producing a return on equity of 8%-9%. In spite of this, however, the share price failed to respond, falling in October 2000 to $21, its level of 10 years earlier.

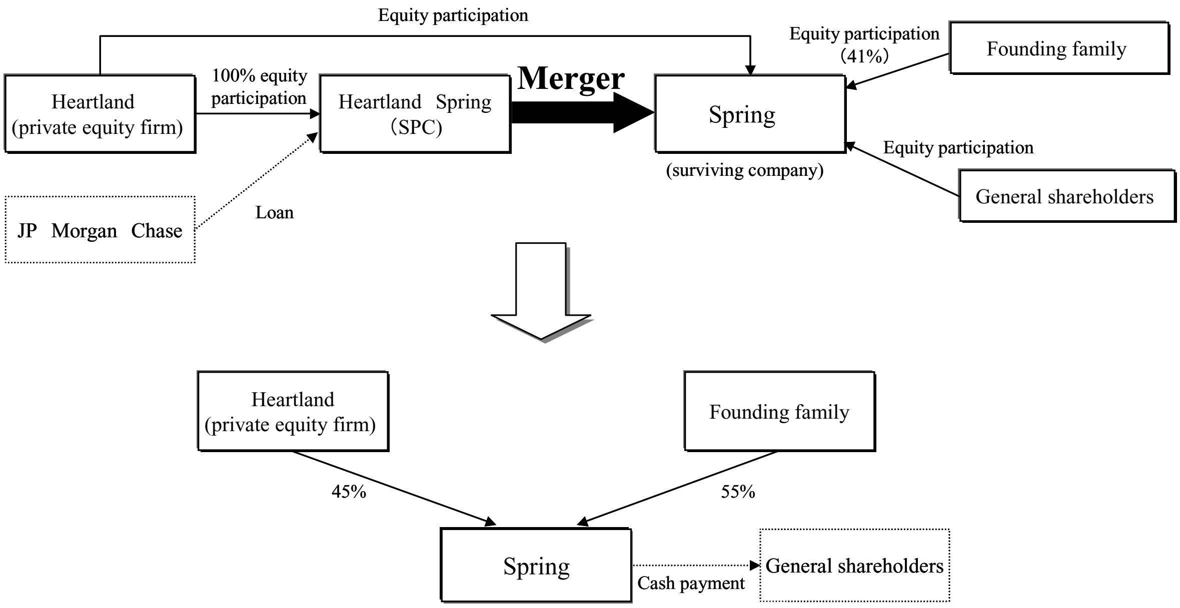
Management's response was to hire an investment bank as an adviser in July 2000 to examine the options open to it, including going private and forming an alliance with another company. The following month the company, centered on the founding family, which was also involved in the business, began to negotiate with Heartland Industrial Partners ("Heartland"), a private equity firm, with a view to going private and recapitalizing. This led, in April 2001, to the following recapitalization transaction (see Table 3 and Figure 2).

Table 3 Summary of Recapitalization Plan

- Springs and the special purpose company wholly financed by Heartland, Heartland Springs, merge, and Springs becomes the surviving company.
- Heartland Springs's shares are exchanged on a 1:1 basis for shares in Springs.
- Any shares in Springs other than those owned by the founding family (including Springs's chairman and chief executive officer, Crandall Bowles) and Heartland are exchanged for a cash payment of $46 per share (a 27% premium on the closing price on the day prior to the announcement of the recapitalization).
- Following recapitalization, 55% of the shares were owned by the founding family and 45% by Heartland. (Prior to recapitalization, 41% of the shares were owned by the founding family.)
- The funds for recapitalization consisted of an equity participation by Heartland and a loan from JP Morgan Chase.

Having eliminated the minority shareholders by paying them cash for their shares and gained control of the company, the founding family set about devising a medium- to long-term strategy for the company with the support of Heartland. In September 2001 the company's shares were delisted and it went private.

Figure 2 Schematic Diagram



Source: NRI.

2) Willis Group Holdings: an example of a company that restructured after going private and then relisted

Willis Group Holdings is the world's third-largest insurance broker. Based in the United States and the United Kingdom, it has an international sales network in more than 100 countries. In the late 1990s the insurance broking industry, which was suffering from a proliferation of players, saw a wave of restructuring, and Willis Group Holdings had no alternative but to follow suit in order to survive. However, in view of the time that this would take, the management decided to take the company private in order to escape the pressure from shareholders and the stock market to boost short-term earnings.

The company, whose shares were listed in London and New York, went private in 1998 in a transaction which involved it being acquired by a shell company (financed by the private equity firm Kohlberg Kravis Roberts and six insurance companies) for $1.4 billion. The management team also had a stake in the new company. Once the transaction was completed, the company appointed a new chief executive officer from outside as well as more than 150 new managers. At the same time, it restructured its operations, especially those in North America, thereby boosting its profitability. Finally, the company relisted its shares on the New York Stock Exchange in June 2001, since when they have risen steadily while the US economy has been in recession (see Figure 3).

Figure 3 Share Price of Willis Group Holdings

Source: Yahoo Finance (http://finance.yahoo.com)

3) Knürr Group: an example of a business succession

Founded in 1931 and listed in Munich, the Knürr Group manufactures enclosure systems for telecommunications, electronics, and computing equipment and is an example of the kind of large family business that is so common in Germany. At the time of the transaction in question, most of the shares were owned by the chairman and owner-manager, Hans Knürr, and his family. Because of his age Knürr was looking to retire, but no suitable successor could be found either within the family or the existing management team. Knürr therefore contacted 3i, a leading private equity firm in London, and, after intense negotiations, 93% of the outstanding shares, including Knürr's own stake, were sold to a holding company set up by the 3i Group and its private equity arm. The holding company then made a tender offer for the remaining minority interests.

5. The Situation in Japan

1) The emergence of going-private transactions as a strategic option

Japan has also seen a gradual increase in the number of going-private transactions facilitated by private equity firms. In 2001 there were three such transactions while this year there has already been one and another is planned[11] (see Table 4). Partly because the Commercial Code does not recognize cashout mergers, going-private transactions always take the form of a shell company funded entirely by a private equity firm making a tender offer for the company concerned. In these cases, the tender offer has been at a premium of 32.5%-94.7% to the market price.

Companies that are hoping to go private tend to have a number of characteristics in common. First, equity tends to be concentrated in the hands of a few shareholders (more than 60% in all cases). In all cases after a going-private transaction, however, the existing management team has remained in place, but the private equity firm tends to own most of the equity while the management team tends to own very little. Second, the market value tends to be low (less than ¥8 billion in all cases). This probably has something to do with the fact that companies looking to go private tend to be small and the fact that private equity firms find it easiest to invest in companies with a market value ranging from several billion yen to several tens of billion of yen.

[11] In addition, a wholly owned subsidiary of Nomura Principal Finance made a tender offer for UHT (listed on JASDAQ) in March of this year, acquiring 94% of the company's outstanding shares. This was a friendly offer that assumed that the company would go private at some time in the future, and the plan is for the existing management team to own up to 30% of the shares once the company goes private.

Table 4 Examples of Going-Private Transactions

Company	Mine Mart	Tocalo	Kansai Maintenance	CCI	Kiriu
Sector	Retailing	Metal products	Building management	Chemicals	Auto parts
Exchange where formerly listed	JASDAQ	JASDAQ	OSE 2nd Section	JASDAQ	TSE 2nd Section
Month of delisting	March 2001	August 2001	December 2001	March 2002	May 2002
Private equity firm acquiring the company	Unison Capital	JAFCO	Orix	Nomura Principal Finance	Unison Capital
Tender offer premium	94.7%	32.5%	38.0%	52.9%	45.8%
% of shares closely held	62.2%	78.6%	72.0%	60.3%	64.1%
Market capitalization	¥5.93 bil	¥4.77 bil	¥5.03 bil	¥7.96 bil	¥4.73 bil
Remarks	Business succession	Sale of subsidiary by Nittetsu Shoji (TSE 2nd Section)			Affiliated to Nissan Motor, the company is being sold as part of Nissan's revival plan

Notes: 1. Premiums were calculated by comparing the tender offer price with the average price of a company's shares for the six months preceding the day on which it announced the tender offer.

2. The "% of shares closely held" is the percentage of all the shares held by the 10 largest shareholders and the company directors as reported in Toyo Keizai Shimposha's Japan Company Handbook for the fiscal year immediately preceding the one in which the tender offer took place.

3. The figure for market capitalization is that for the end of the month preceding that in which the tender offer was announced.

Source: NRI.

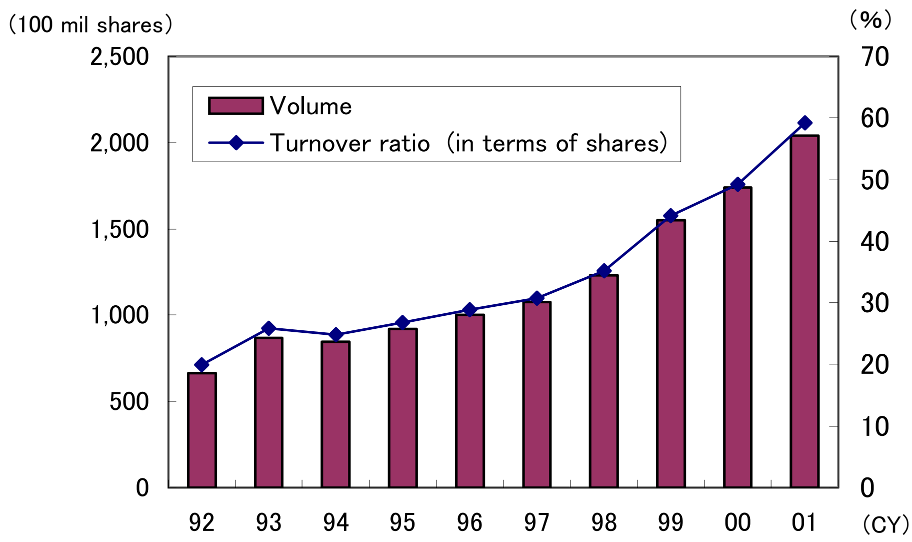
There are several reasons for the increase in the number of Japanese companies looking to go private. First, a number of private equity firms specializing in buyouts have been set up in recent years. Also, companies have become less reluctant to recapitalize with funds from private equity firms as awareness of management buyouts has increased.[12]

Second, in recent years large companies have been keen to restructure (e.g., by refocusing on their core operations and trimming assets). As one of the ways of doing

[12] For further information on the current situation surrounding management buyouts in Japan and some of the issues outstanding see Yuta Seki and Masanobu Iwatani, Management Buyouts in Japan, Capital Research Journal, Winter 2001.

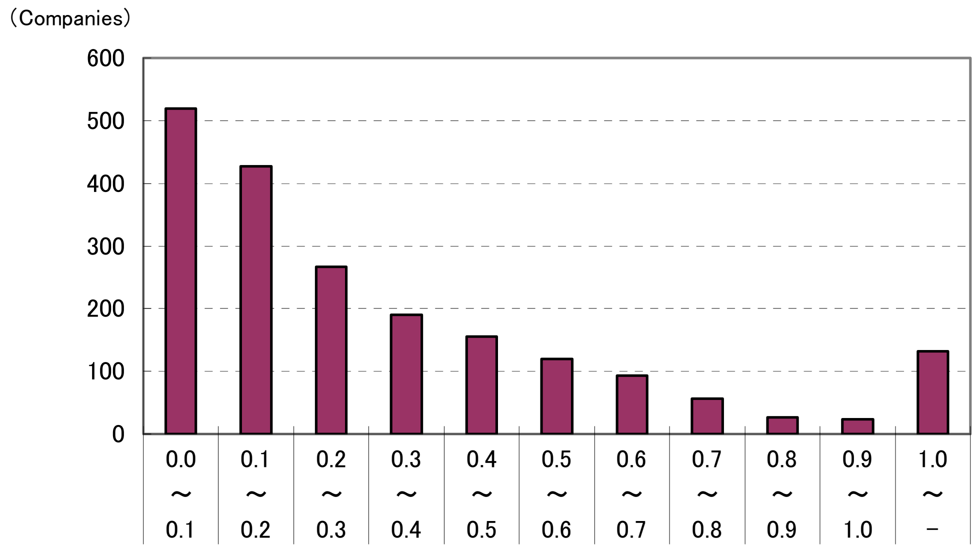
this is for a company to sell its shares in a listed subsidiary or affiliate to a third party, this has indirectly encouraged companies to go private.

Figure 4 Volume and Turnover Ratio on the Tokyo Stock Exchange



Note: Covering all the companies listed on the Tokyo Stock Exchange (including Mothers). Turnover ratio = total volume/{(number of shares listed at beginning of year + number of shares listed at end of year)/2}.
Source: NRI, from Tosho Tokei Geppo [TSE Monthly Bulletin of Statistics].

Figure 5 Distribution of Turnover Ratio on the Tokyo Stock Exchange (2001)



Note: Covering the 2010 companies listed on the Tokyo Stock Exchange (including Mothers but excluding companies listed during the course of 2001). Turnover ratio = total volume (during 2001)/number of shares listed (at end of 2001).
Source: NRI.

Third, owner-shareholders of listed companies have sometimes taken the view that the existing management team or the private equity firm supporting them are the most suitable counterparty to sell their shares to in order to ensure the succession of the business. This is partly because selling the shares in the market would be difficult because of the risk that this might push down the price and partly because selling them to a rival company would be difficult because the owner-shareholder is likely to have reservations and be concerned about the effect this would have on jobs and relations with business partners.

Fourth, many Japanese companies also suffer from the fact that their shares are illiquid and trade at a discount. Although volume and the turnover ratio on the Tokyo Stock Exchange have tended to increase steadily for the past 10 years (see Figure 4), volume has varied considerably from one stock to another, with hardly any trading taking place in a large number of stocks. In 2001 there were more than 500 stocks with a turnover ratio of less than 0.1 (i.e., 10%), indicating that only a few stocks are highly liquid (see Figure 5).

2) Potential demand for going-private transactions

Table 5 shows the results of screening all 2,010 companies listed on the Tokyo Stock Exchange as of the end of 2001 (including companies listed on Mothers but excluding companies listed in the course of 2001) according to the following three criteria: (1) very low liquidity (turnover ratio[13] less than 10%), (2) right size for private equity firms to invest in (market value of between ¥2 billion and ¥20 billion), and (3) low market rating (price-book value ratio of 1 or less, or 0.5 or less).

Table 5 Screening Results

(Companies)

Turnover ratio: less than 10%			519 (25.8%)
	Market value: ¥2 billion to ¥20 billion		316 (15.7%)
		PBR: 1 or less	258 (12.8%)
		PBR: 0.5 or less	118 (5.9%)

Note: The figures for the turnover ratio are the annual figures for 2001. The figures for PBR are those as of end-2001.
Source: NRI.

Even with a price-book value ratio of less than 0.5, 118 companies satisfied all three criteria, and the number of potential going-private transactions would probably be quite considerable if the screening was extended to cover JASDAQ. Of these 118 companies, the vast majority (99) are listed on the Second Section of the Tokyo Stock

13 Turnover ratio = total volume/number of shares listed (as of year-end).

Exchange and come from sectors such as wholesaling, construction, chemicals, machinery and electrical equipment.

3) Conclusion

There are many good reasons (enhanced social esteem and access to market capital) for going public. Therefore, if a company begins to feel that the benefits of being publicly owned are not all it believed they would be, it should try to remedy the situation by putting more effort into its investor relations before even considering other options. However, if its share price fails to respond and continues to trade at a discount or if it has a good reason for going private (e.g., if the concentration of control that that would produce would enable it to restructure its operations more quickly), it should consider this as a strategic option.