Solving Challenges at Japanese Firms with M&A

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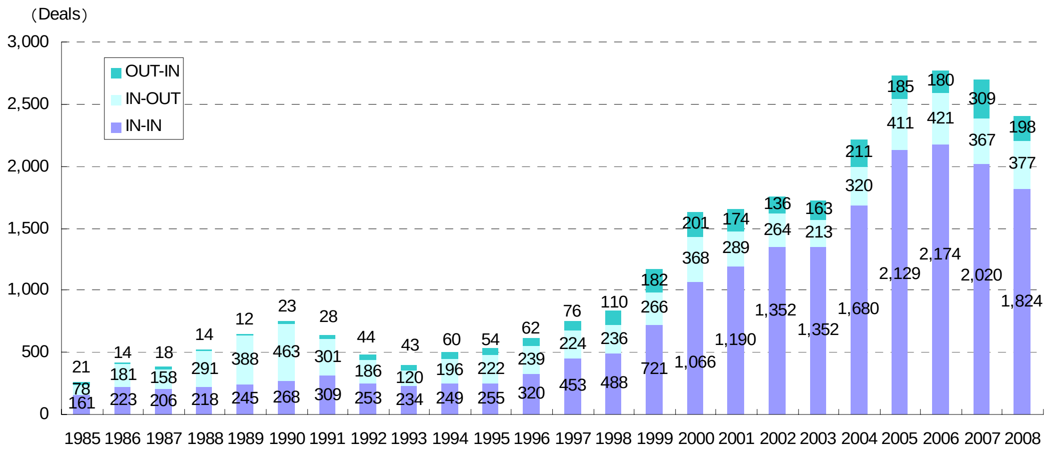
I. M&A is finally taking root in Japan

In the late 1980s, at the height of Japan's economic bubble about 20 years ago, most of the acquisitions made by Japanese companies were of European- and US-based companies and their assets. The high share prices and strong earnings of Japanese companies enabled a series of high profile deals, including Bridgestone's acquisition of Firestone, Sony's acquisition of Columbia Pictures Entertainment, and Matsushita Electric Industrial's (now Panasonic) acquisition of MCA (all three of which were US companies). After the bursting of the bubble at the start of the 1990s put the Japanese economy into a long-term slump, however, there was an increase in M&A deals among Japanese companies in pursuit of business and industry restructuring. The number of domestic M&A deals surpassed 1000 in 2000 and topped 2000 in 2005, an indication that M&A has become an accepted way for Japanese companies to restructure. Other factors promoting M&A during that time were the introduction of consolidated accounting, which increased awareness of managing business portfolios at the group level, and the development of M&A-related regulatory infrastructure, including for share exchanges, transfers, and corporate spin-offs.

Figure1: M&A by Japanese companies



Note: M&A includes mergers, acquisitions, business transfers, equity participation, and increases in equity stakes, except when such deals are done within the same corporate group.
Source: Nomura Institute of Capital Markets Research, based on data published in MARR, by Recof

The global economic crisis and credit crunch initially triggered by the subprime loan mess caused a substantial reduction in M&A activity in 2008, and the number of such deals involving Japanese firms has also been in a declining trend recently. Given the conditions that Japanese firms are now dealing with, however, an increase in their M&A activity appears likely. We look below at why we expect such growth in the context of four specific challenges facing Japanese firms.

II. Development of overseas markets with cross-border M&A

The first challenge is the peaking of Japan's domestic demand resulting from its aging demographics and sluggish economy. The growth of sales in such domestic demand-driven sectors as retail, food, pharmaceuticals, and telecom has been slowing as a result of the domestic market maturing, and Japanese firms are increasingly finding themselves in crisis and having to develop business in emerging markets, which are growing fast, and in the US and European markets, which are large. Many companies in the retail sector, including convenience stores and supermarkets, have been opening stores in emerging markets in Asia and elsewhere by establishing their own local subsidiaries, but a growing number of food manufacturers and pharmaceutical companies have been acquiring overseas firms in order to quickly setup local sales networks and expand overseas sales (Figure 2).

For example, Kirin Holdings, an integrated beverage manufacturer, has been actively acquiring companies in Asia and Oceania over the past few years with the goal of raising overseas sales to 30% of its total sales by 2015. In 2007, it acquired National Foods, Australia's leading manufacturer of dairy products and fruit juice, and in 2008, it acquired Dairy Farmers, Australia's second-ranked dairy business. Although it aborted its attempt to acquire Coca Cola Amatil, Oceana's largest beverage company, in 2009, Kirin announced plans to take an equity stake in San Miguel Beer, the Philippines' largest brewer, and to make its subsidiary Lion Nathan, Australia's second largest brewer, into a wholly owned subsidiary, both steps toward its goal of becoming a leading company in the Asia-Oceania region. Kirin's domestic rivals are fighting back by making their own acquisitions in Oceania. In 2008, Asahi Breweries acquired Schweppes Australia, Australia's second-largest beverage manufacturer, and Suntory acquired Frucor Beverages, the No. 2 beverage manufacturer in New Zealand.

During periods like now when the yen is strong and global share prices are weak, the expansion of overseas markets through cross-border M&A provides a good opportunity for domestic demand-driven industries suffering from saturated domestic markets to revive flagging growth, and for that reason we expect the number of such deals to increase.

Figure2: Recent examples of cross-border M&A by Japanese firms

Year announced	Acquiring company	Acquired company	Target country	Target industry	Value of deal ($ mns)
2006	Daikin Industries	OYL Industries	Malaysia	Air conditioning	1,343
	Nippon Sheet Glass	Pilkington	UK	Glass	4,282
	Asahi Tec	Metaldyne	US	Automotive parts	1,113
	Nomura Holdings	Instinet	US	Securities	1,200
	Japan Tobacco International	Gallaher	UK	Tobacco	19,020
	Toshiba	Westinghouse	US	Electric power	5,400
	Marubeni, Tokyo Electric Power	Mirant Asia Pacific (Philippine IPP)	Philippines	Electric power	3,424
2007	Eisai	MGI Pharma	US	Pharmaceuticals	3,583
	Olympus	Gyrus ACMI	UK	Medical devices	2,097
	Kirin Holdings	National Foods	Australia	Foods	2,589
	Tokio Marine & Nichido Fire Insurance	Kiln	UK	Insurance	886
2008	Takeda Pharmaceutical	Millenium Pharmaceuticals	US	Pharmaceuticals	7,680
	Daiichi Sankyo	Ranbaxy Laboratories	India	Pharmaceuticals	2,237
	Mitsubishi Rayon	Lucite International	UK	Chemicals	1,600
	Ricoh	Ikon Office Solutions	US	Computers	2,363
	Mitsubishi UFJ Financial Group	Morgan Stanley	US	Investment banking	9,000
	Otsuka Pharmaceutical	Alma	France	Foods	1,148
	Kirin Holdings	Dairy Farmers	Australia	Foods	788
	Asahi Breweries	Schweppes Australia	Australia	Foods	809
	Suntory	Frucor Beverages	New Zealand	Foods	769
	Mitsubishi, BHP Billiton	New Saraji Coal project	Australia	Coal	2,450
	NTT DoCoMo	Tata Teleservices	India	Telecom	2,657
	Nippon Steel, JFE Holdings, Posco, and ITOCHU, among others	Nacional Minerios	Brazil	Steel	3,008
	TDK	Epcos	Germany	Electronic components	1,819
	Marubeni, Kansai Electric Power, Kyushu Electric Power	Senoko Power	Singapore	Electric power	2,765
	Tokio Marine & Nichido Fire Insurance	Philadelphia Consolidated	US	Insurance	4,518
2009	Asahi Breweries	Tsingtao Brewery	China	Foods	670
	Kirin Holdings	San Miguel Brewery	Philippines	Foods	1,366
	Kirin Holdings	Lion Nathan	Australia	Foods	3,442
	Sumitomo and others	Oranje-Nassau Energie	The Netherlands	Petroleum	838

Note: Deal values shown are as of when deal was announced. Some of the deals shown have yet to fully close.

Source: Nomura Institute of Capital Markets Research, based on Bloomberg data.

III. Industry consolidation aimed at survival

The second challenge is the small size of Japanese firms relative to their global competitors. Up until about ten years ago, there were very few major consolidations among domestic Japanese companies, and many of Japan's industries had a large number of companies fighting for market share. Over the past decade, there has been substantial consolidation in a number of Japanese industries, including the financial sector, which includes banks, life insurers, and nonlife companies, the retail sector, which includes department stores, drugstores, and consumer electronic discounters, and the pharmaceutical sector. Japan's market has become more oligopolistic in these sectors as a result. Nevertheless, the number of industries in Japan with leading companies that are among the top companies in the world has declined, because while Japanese firms were dealing with their triple excesses of debt, facilities, and personnel, the leading global companies, primarily in Europe and the US, were busy getting larger and becoming fewer in number.

In the pharmaceutical sector, for example, Yamanouchi Pharmaceutical and Fujisawa Pharmaceutical merged in 2005 to create Astellas Pharma, Japan's No. 3 drugmaker, while in 2007, Daiichi Pharmaceutical and Sankyo Pharma merged to form Daiichi Sankyo, Japan's No. 2 drugmaker. A number of large-scale M&A deals done elsewhere in the world in the late 1990s and early 2000s, however, gave rise to several giant pharmas, including US-based Pfizer, UK-based GlaxoSmithKline and AstroZeneca, and France-based Sanofi-aventis. Consequently, Japan's No. 1 drugmaker, Takeda, only ranks No. 17 in sales among the world's pharmaceutical companies.

There are several disadvantages to having a large number of companies fighting it out within a single industry. To begin with, having more than the optimal number of companies within a single industry makes it difficult to leverage economies of scale, and raises the burden of spending on capital equipment and R&D. This becomes truer in times like these, when weak earnings are causing financial positions to deteriorate. A smaller overall scale also weakens a company's bargaining power with upstream and downstream vendors, while increasing the risk of becoming an acquisition target of its global competitors. Since 2000, Japan has also had some hostile takeovers by activist hedge funds, and this sharply raised the number of companies introducing poison pills and other takeover defenses. To overcome the disadvantages noted above, the number of M&A deals in pursuit of industry consolidation and greater scale has been on the rise. This type of M&A should remain popular, given the many industries that still have room for consolidation.

There has also been an increase in acquisitions by Japan's leading firms of overseas companies in the same industry, in order to increase global market share and profits from economies of scale. These include the acquisition of UK-based Pilkington by Nippon Sheet Glass and the acquisition of UK-based Gallaher by Japan Tobacco in 2006, and the acquisitions of UK-based Kiln in 2007 and of US-based Philadelphia Consolidated in 2008 by Tokio Marine & Nichido Fire Insurance. The pursuit of greater size is not always an effective strategy for competing globally, but without a certain degree of size, it is difficult to achieve as much bargaining power, cost competitiveness, new product development capabilities, and marketing muscle as the global leaders.

IV. Raising profit margins by rebuilding business portfolios

A third challenge is addressing the lack of progress in selecting and focusing on specific businesses. In Japan, corporate groups have fought with rivals for market share by getting involved in a variety of businesses, as seen with the integrated electronics manufacturers and the integrated chemical companies. Ideally, a company would own the leading market share in all of its businesses, but that is difficult to achieve given limited management resources and stiff competition. This points to the need to select and focus on specific businesses, but the decision to exit from an existing business often does not happen until that business's profitability has worsened substantially, owing to management's psychological resistance to, and lack of incentives for, abandoning a business, as well as to the difficulty of accurately assessing the future risks and returns of a business. This results in companies holding on to unprofitable businesses for many years, and offers one explanation for why Japanese firms have tended to be less profitable than the top US firms. Investors have long argued for the need to selectively focus business portfolios through disinvestment and acquisitions, but even though some individual companies have aggressively done so, Japanese firms have in general been slow to restructure.

In the electronics sector, where the need for business restructuring has long been recognized, there has recently been considerable activity selling/exiting businesses and forming mergers and alliances (Figure 3). For example, Sharp formed a business alliance with Pioneer, and purchased enough shares to become its largest shareholder, in 2007. The two companies then merged their optical device businesses, and announced a new joint venture, in 2009. Both Sanyo Electric and Mitsubishi Electric pulled out of the mobile phone business, in which they had low market shares, in 2008. Earnings at the integrated electronics manufacturers have worsened as a result of lower domestic sales and a decline in exports caused by the global economic crisis, and we expect this to result in an increase in the frequency with which that sector sells off and exits from unprofitable businesses. This should create favorable conditions for a thorough reshuffling of business portfolios.

Figure3: Recent business restructuring by Japan's electronics industry

《Business alliances, equity investments》

Target	Buyer/investor	Status
Pioneer	Sharp	Took 14.3% stake in 2007.
Kenwood	Victor Co. of Japan	Acquired entire company in 2008, transferred to JVC Kenwood Holdings.
Sanyo Electric	Panasonic	Announced acquisition in December 2008, still pending.

《Businesses sold》

Seller	Business/asset sold	Acquiring company and status
Sony	Semiconductor facilities	Toshiba (completed in 2008)
Sanyo Electric	Mobile handset business	Kyocera (completed in 2008)
Oki Electric Industry	Semiconductor business	Rohm (completed in 2008)
Fujitsu	Hard drive business	Toshiba (announced in February 2009, still pending)

《Businesses exited》

Company	Status
Toshiba	Exited HD-DVD business in 2008
Mitsubishi Electric	Exited mobile phone and washing machine businesses in 2008
Pioneer	Announced exit from display business in 2009

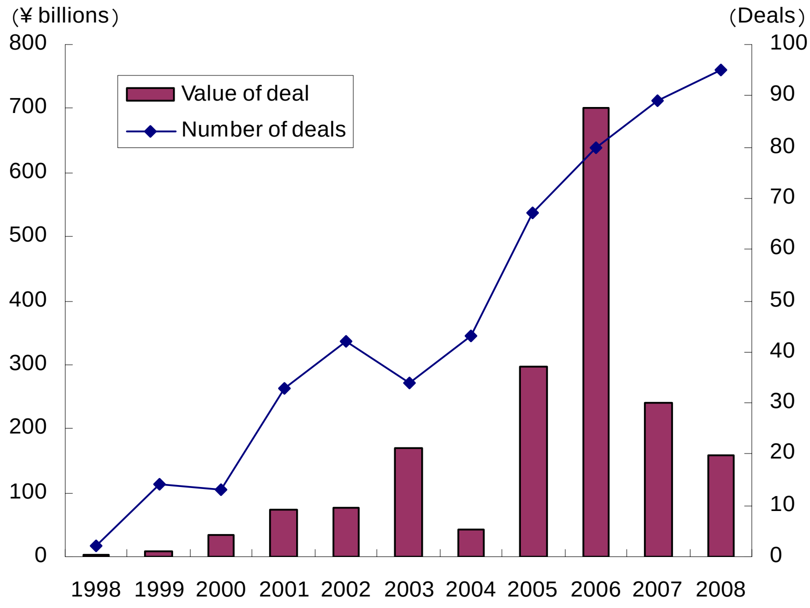
Source: Nomura Institute of Capital Markets Research, based on Bloomberg data and company websites

V. Going private with a management buyout

A fourth challenge is dealing with the large number of smaller listed firms that have stagnated share prices and low market liquidity, despite their being traded on an exchange. Many of those firms are trading below book value and therefore have little likelihood of a successful offering. In addition, the cost of remaining a public company in terms of corporate governance and IR requirements has increased, making it difficult to see the advantages of an exchange listing. One strategic option for such companies is to take the company private with a management buyout (MBO).

MBOs were given a boost in Japan in the late 1990s, when domestic and overseas private equity firms started forming buyout funds targeting Japanese companies. The number of MBOs has increased every year as a result, reaching 95 deals in 2008 (Figure 4). The vast majority of these deals have been small, with acquisition amounts of less than ¥5 billion, but the number of large listed companies being taken private has also been increasing. Japan's largest MBO ever was the ¥270 billion acquisition, funded by Nomura Principal Finance and CVC Capital partners, of the Skylark restaurant chain in 2006. As in Europe and the US, the number of deals has declined recently because the credit crunch has made it more difficult to get loans to fund a buyout, although weak share prices have actually increased the number of firms that are potential candidates for being taken private, and we expect the number of listed firms taken private with an MBO to grow moving forward.

Figure4: Volume and value of MBO deals in Japan



Source: Nomura Institute of Capital Markets Research, based on data published in MARR, by Recof

This report looked at four of the challenges facing Japanese firms and the role that M&A could play in addressing those challenges. M&A is not always the best solution, of course, and in some cases can actually destroy the value of a company. Furthermore, the success of an M&A deal depends greatly on how well the process of integration is executed following the acquisition. That said, M&A is regularly considered by Japanese firms as an approach to restructuring, and we expect to see an increase in such deals, both cross-border and purely domestic.