

# Japan

*M&A figures continue to grow, pointing to continuing maturity and diversification of the market*

## Current Environment

Macroeconomic indicators suggest that the Japanese economic recovery is continuing at a healthy pace, with real gross domestic product growth for the fiscal year ended March 2006 reported at 3.2%, the highest reported growth rate in a decade. This figure has held broadly consistent through June 2006. Of particular note, the primary driver behind fiscal year growth was private-sector capital investment, which grew a remarkable 7.5% year-on-year. Such growth outpaced domestic private sector consumer demand of 2.4% and net export growth (exports minus imports) of 2.4%.

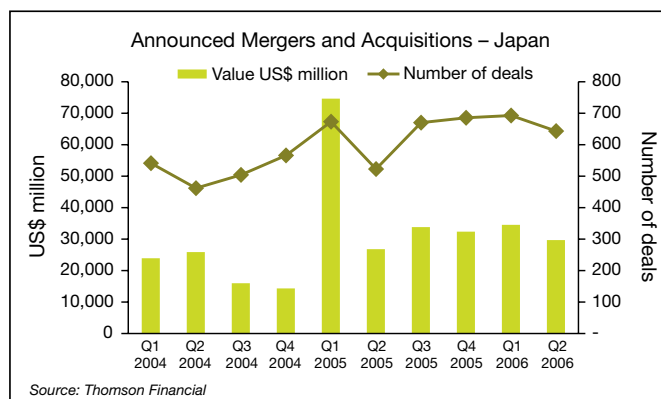
Recently, there have also been some positive turns on the geopolitical front. Japanese Ground Self-Defence Forces have completed their withdrawal from Iraq, an action which polls indicate that most Japanese approve of.

Closer to home, North Korean test missile firings, which most observers agree was a thinly veiled manoeuvre to gain bargaining concessions from Japan, the US and others, ended up working more in Japan's favour in the eyes of most analysts and the world at large. Japan and the US were able to convince the United Nations Security Council to issue an official reprimand against North Korea, thus helping to legitimise Japanese dissatisfaction with its North Asian neighbour regarding alleged arms development and abductions of Japanese. Nonetheless, North Korea continues to be an unpredictable factor not to be taken lightly.

The general sentiment among the Japanese public is relatively upbeat, a rarity in Japan in recent years. Probably the largest uncertainty that may act as a damper to this mood is whom the LDP will emplace as prime minister, and what policy directions that person will take, when the 5-year regime of popular reformist prime minister Junichi Koizumi comes to an end in September.

As for other indicators, the Nikkei 225 stock market index has been somewhat volatile, with levels as high as 17,500 in early April and dipping to just above 14,000 in June. It stood near the 15,000 mark by mid-year 2006, which is well below the 16,500 level at the beginning of the calendar year.

## Deal Activity



The pace of M&A activity set in 2005 remained intact through the first half of 2006, as total deal volume, at 1,336 deals announced, was essentially the same as that of the second half of 2005. Total deal value, at US\$64.2 billion, also matched the pace of the second half of 2005. Although flat, these results still represent historically high levels of activity. The first half of 2005 appeared to have been especially strong in dollar terms, but these results were skewed by the US\$41.4 billion acquisition of (then) UFJ by the Bank of Tokyo-Mitsubishi. There was one notable major acquisition in the first half of 2006, with the US\$17.5 billion acquisition of Vodafone Japan by Softbank, a high-tech and communications group.

Despite these high levels of deals relative to historical trends, however, there still appears to be room for more, as relative to the size of the economy activity lags well behind that of other developed countries.

### Lessons learned from aggressive investing?

Scandal, however, continued to surround M&A in Japan and cloud its image. Livedoor president Takafumi Horie, a key figure highlighted in last year's Bulletin as a symbol of the brave new world of hostile takeovers and other less orthodox acquisition methods new to Japan, was arrested and charged with false reporting and other Securities Exchange Law violations. This stemmed from his various acquisitions, most notably his attempt to acquire Nippon Broadcasting early in 2005. In 2006 the fallout continued as Yoshiaki Murakami, president of the eponymous Murakami Fund and notorious activist shareholder in Japan, was charged with insider trading for his involvement in the Livedoor/Nippon Broadcasting controversy.

Some have pointed at these arrests as the just desserts for unscrupulous money games played by the two high-flyers; others see the scandal as the price paid by those on the vanguard testing the waters of the regulatory environment. Both Horie and Murakami have adamantly asserted that their actions, whilst possibly aggressive, were not in violation of regulations. There has at least been some acknowledgement



of the vague nature of current regulations as lawmakers and regulators struggle to understand the complex underlying trading activity and attempt to legislatively address the issues. There has yet to be any specific outcome other than, perhaps, a precedent being set for interpretation of what actions comprise violations of current laws.

In spite of the potential dampening effects of such high-profile arrests, especially to the image of aggressive investors, the M&A market continues to thrive.

### A change in composition

The underlying composition of deals in 2006 has changed rather dramatically compared to 2005, with cross-border deals (both incoming and outgoing) representing a much larger piece of the total deal pie. Outgoing deals have performed better thus far in 2006, with US\$14.3 billion from 163 deals topping the US\$11.4 billion announced in the second half of 2005. These were led by the proposed acquisition of Westinghouse Electric of the US by Toshiba Corporation for an announced US\$5.4 billion.

Meanwhile, incoming acquisitions also rebounded significantly after a relatively slow year in 2005, with US\$2.8 billion arising from 84 deals compared to US\$4.6 billion during the whole of 2005.

One interesting deal announced was the management buyout (MBO) of the Skylark restaurant chain for a reported US\$3.1 billion, with funding from Nomura Principal Finance and CVC Asia Pacific. This makes the Skylark MBO the largest ever in Japan. Whether MBOs will become part of the wave of the future remains to be seen, but this deal does point to the increasing diversification of deal schemes and structures in Japan. Fund activity (including hedge funds) remained stable during the period, with acquisitions comprising roughly 11% of the deals announced in the first half.

Deal activity was not prevalent in any one particular industry, with the top ten deals being in the telecommunications, electronics, transportation, and financial service sectors, among others. There was no significant new legislation aimed at any particular industry that might affect deal-making, as mentioned above, the regulatory environment for M&A has yet to see major changes stemming from recent scandals.

All of these indicators point to the continuing maturation of Japan's M&A environment into an active healthy market.

## Outlook

The macroeconomic indicators suggest that Japan is in line for a medium term recovery, albeit not at the rate of some of its up-and-coming Asian neighbours.

On 14 July 2006, the Bank of Japan raised its overnight interest rate to 0.25%, the first departure from its zero interest rate policy in six years. Whilst some have criticised the move as premature, most see it as a positive sign of a Japanese economy that is finally back on track. Among other indicators that the economy is healthy and growing is an eight-year-low unemployment rate of 4.0% and seven straight months of increases in consumer prices after nearly 8 years of zero or deflationary trends.

Public sentiment also appears to reflect these trends, as the Tankan quarterly survey of business sentiment conducted by the Bank of Japan continues to show positive results after a long run of negative reports since the late nineties.

Potential regulatory barriers, such as difficulties in consummating stock-for-stock deals between a foreign acquirer and Japanese target, have not deterred investment activity, as shown by increased foreign investment and the generally high level of M&A activity. The conclusion appears to be that there are enough attractive deals to overcome these barriers.

In light of the positive macroeconomic factors and continued development and diversification of the Japanese deal market, we expect M&A levels will at least be maintained. The potential upsides outweigh the vulnerabilities in the near to medium term for all players, whether they be domestic or foreign, strategic or financial buyers.

