

# Japan

*Acquisitions abroad will remain popular whilst domestic M&A growth continues*

## Current Environment

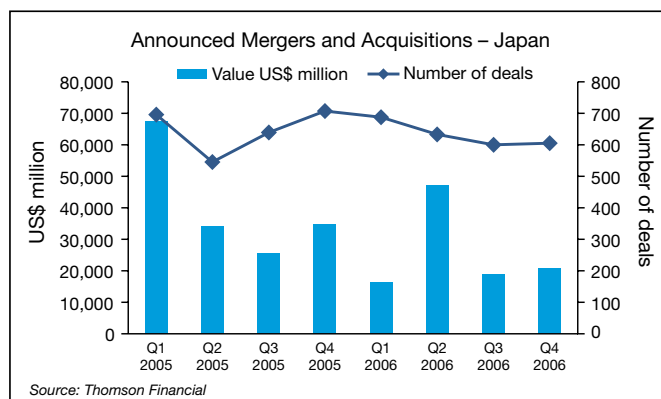
In September, Shinzo Abe, the 52 year-old former Chief Cabinet Secretary, was inaugurated as Prime Minister in a planned and expected succession to retiring Junichiro Koizumi, who had held the post since April 2001. The legacy of the Koizumi years are yet to be fully weighted and the views on his premiership might differ in Japan and abroad. The appointment of Abe created an opportunity for much needed improvements in political ties with neighbours in Asia, particularly China and South Korea, whose leaders broke off summit talks with Koizumi due to his controversial visits to the Yasukuni war shrine in Tokyo.

On his first foreign trip as Prime Minister, Abe met the Chinese President, Hu Jintao, in Beijing on 8 October and visited Seoul the next day to meet the South Korean President, Roh Moo Hyun. Hours before the Seoul summit, the world learnt about North Korea's claim of a nuclear test. This made the case for cooperation in Asia stronger than ever, and Japan was able to coordinate its North Korea policies with its neighbours. Abe secured various ministerial level meetings both with the Chinese and South Koreans, and the three leaders held a trilateral meeting in January on the Philippine island of Cebu on the sidelines of the ASEAN summit. Overall, in the first few weeks of his premiership, Abe appeared to be able to balance the need for cooperation with China and South Korea, whilst maintaining the support of the mostly conservative members of his party and the Japanese public. However, he has seen a continuous decline in the popularity of his cabinet from an inflated 71 percent at his inauguration to a still respectable 51 percent by the end of December. Halting this trend in the foreseeable future will be a key test of his political skills.

Annual GDP growth in fiscal year 2006 (the year to March 2007) is expected to be around 2.1 percent. This is lower than earlier forecasts following downward revisions from the government announced at the beginning of December. Frequent and occasional surprising revisions to macroeconomic statistics are a fact of life in Japan, but there are areas where the government statisticians and independent economists agree and there is absolutely no doubt that, overall, Japan continues to be on a growth track. However, weak domestic consumer spending remains an area of concern, highlighting the dependence on exports and capital investments as sources of overall GDP growth.

The January policy board meeting of the Bank of Japan decided to keep overnight interest rates at 0.25 percent, as set in July 2006, but economists expect the rate to be raised during the course of the year. During the calendar year 2006, the benchmark Nikkei 225 index grew 5 percent, from 16,362 to 17,226, marking the fourth year of consecutive growth and more than double the lowest year-end level in recent Japanese history, 8,579 points at the end of 2002.

## Deal Activity



The pace of deal activity targeting Japan based companies slowed down in the second half of 2006, both in comparison to the first half of the year and to the second half of 2005, leading to a slightly lower annual number of deals announced in 2006 than in 2005 (2,526 compared to 2,587). Deal values have declined at a higher rate, leading to a total annual deal value of US\$103 billion, compared to US\$162 billion recorded in 2005. This is a step back even after excluding the 2005 mega deal: the acquisition of UFJ bank by The Bank of Tokyo-Mitsubishi (valued at US\$41.4 billion). Although not reaching the 2005 records, M&A activity was still more than US\$20 billion above deal volumes in 2003 and 2004. More importantly, 2006 set other records, tested new waters in terms of possible deal structures, and continued to challenge the business community, legislators and the public to take sides in discussions about the role of M&A in Japan.

Acquisition of Japanese targets by foreign companies remains low compared to the size of the economy, the increasing acceptance of (friendly) acquisitions and the purchasing power of Japanese consumers. Foreigners accounted for around 4 percent of the total M&A pie in Japan, both in terms of the number and value of the deals announced in 2006. The only foreign deal above US\$500 million was announced just before Christmas by Air Liquide Group of France, targeting the 45 percent stake it does not already own of Japan Air Gases Ltd. The transaction was valued at US\$778 million. The total value of deals conducted by foreigners were US\$4.6 billion, the same as in 2005. These transactions were outweighed by the revision in the global strategy of Vodafone that prompted the US\$17.5 billion sale of its Japanese operations in April. It is important to note, however, that foreign ownership of Japanese firms reached a record level of 20 percent during the year.

At the same time, Japanese companies are increasingly confident in acquiring companies overseas. The year ended on a very high note, with Japan Tobacco's December announcement of a US\$18.8 billion acquisition of the UK based Gallaher Group PLC that runs tobacco businesses in 17 - mostly European - countries. (The deal is naturally subject to regulatory approval).



In other transactions during the second half of the year, the US\$5.4 billion acquisition of Westinghouse Electric by a Toshiba led consortium was completed. Major deals announced included two acquisitions made by Nomura Holdings targeting Instinet Group, a USA based owner and operator of electronic trading platforms in a deal valued at US\$1.2 billion, and Fortress Investment Group, a USA-based private equity firm in a deal valued at US\$888 million. In addition, Asahi Tec Corporation announced a US\$1.3 billion acquisition of Metaldyne a USA-based automotive company.

2006 will be remembered, amongst other reasons, for the arrest of two of the most visible Japanese businessmen embracing and promoting M&As, Takafumi Horie, founder of Livedoor, and Yoshiaki Murakami, founder of the eponymous Murakami fund. Whilst the cases are far from over, their business dealings exposed weaknesses in legislation and enforcement relating to, for example, hostile takeovers, insider trading, declaration of shareholdings, appropriateness of stock splits right before acquisitions, and after-hours trading. In general, a gap was exposed between rules written for more conservative times of consensus driven business practices and aggressive tactics not considered by legislators before. Further milestones reached in 2006 include the record setting US\$18.8 billion acquisition of Gallaher by Japan Tobacco, the US\$17.5 billion exit of Vodafone, the US\$3.1 billion management buy-out of the Skylark restaurant chain and, very importantly, a major domestic hostile takeover attempt by Oji Paper, the number one paper company in Japan.

#### Hostile takeovers – Oji paper tries its hand

As we wrote in our mid-year 2004 bulletin, hostile take over attempts in Japan are few and far between. However, the attempts of the Steel Partners Japan Strategic fund to take over two cash-rich companies in early 2004, commonly referred to in Japan as Steel Shock, have drastically raised awareness in corporate Japan of unwanted bidders and led many companies to raise dividend payouts or repurchase stock. In addition, the possible use of a poison pill, approach to a white knight and similar concepts associated with defensive behaviour became part of the executive agenda. The writing has long been on the wall for maverick Japanese companies to test the waters again. With the benefit of hindsight, the unsuccessful attempt of the now discredited Livedoor to take over the Nippon Broadcasting System in the summer of 2005 is now seen as an eccentric move from a company with rocky foundations. However, it is well worth recalling that during 2005, in connection with the mega banking deal mentioned earlier, Sumitomo Mitsui Financial Group also made headlines by approaching UFJ with an unsolicited merger proposal, although it refrained from further action following its rejection.

In 2006, it was Oji Paper's (Japan's largest paper manufacturer) turn to try to make history. Oji was reported to have formally approached No. 6 firm Hokuetsu Paper in July to propose a merger. Hokuetsu Paper declined to respond and opted to

introduce anti-takeover measures. Undeterred, Oji Paper launched a tender offer for a controlling stake in Hokuetsu, offering a 35 percent premium. There followed a dramatic series of events which were played out on the front pages of local newspapers, involving a major Japanese conglomerate, a well-known Japanese investment bank and two additional suitors. Yet, by the end of August, Oji Paper predicted that no more than 30 percent of the outstanding shares would be tendered and by not revising the tender conditions, conceded defeat.

According to a survey conducted by Nikkei at the beginning of September, 42 percent of business leaders backed Oji's bid, the majority giving credit for the clearly articulated merger benefits that Oji was seeking to realise and the transparent handling of the whole process. It proved to be another unsuccessful attempt at breaking one of the remaining taboos in corporate Japan, but the writing does remain on the wall.

## Outlook

Gross Domestic Product growth expectations for fiscal year 2007 are within the range of 1.7 percent to 2.5 percent. Unemployment remains low at 4 percent. The latest Tankan survey of business confidence conducted by the Bank of Japan reveals continued growth in optimism, both amongst manufacturers and other companies. The expected high earnings are mostly driven by exports, supported by a weak yen and lower cost base, principally due to the fall in oil prices. The survey also highlights a strong commitment to continued capital investment.

Despite the fact that not all M&A indicators broke records in 2006, there is reason to be optimistic about 2007. Growth by acquisition is firmly on the agenda at most Japanese corporates: a recent Nikkei survey indicated that 70 percent of executives at major companies are willing to consider acquisitions. Furthermore, a growing number of managers privately agree with the sentiments of one top executive of a pharmaceutical producer, who said, "If it were possible, I would certainly conduct hostile takeovers."

In May 2007, a long awaited legislation will finally be introduced to allow "triangular mergers"; a situation in which a foreign firm could merge its Japanese subsidiary with a Japanese target in a stock for stock transaction. However, the tax treatment of such deals is not yet finalised. In particular, it remains to be seen if the creation of special-purpose companies that might be set up to facilitate mergers will be allowed.

The resistance to or the ability to resist being acquired is likely to continue its slow but steady decrease. Acquisitions abroad are likely to remain popular in most industries and, despite the relative passivity of foreign companies buying targets in Japan during 2006, nothing but growth is expected during 2007.