

Japan

Economic growth remains slow and deal activity is limited

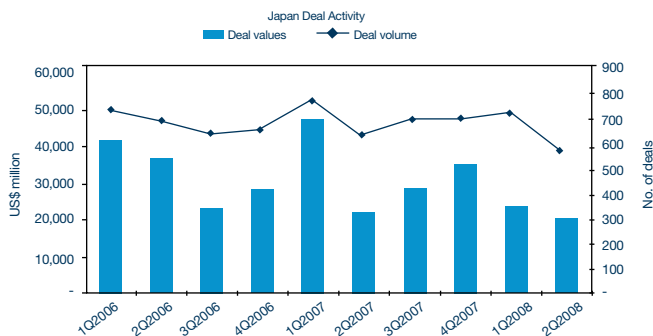
Current Environment

The Japanese government announced that real GDP growth rate in FY2007 (April 2007 to March 2008) was +1.6% (+2.5% in FY2006) and the real GDP growth rate during Q1 2008 was +1.0% on the previous quarter.

Since July 2007, Japanese economic activity had improved until February 2008 but weakened again, reflecting high oil prices and a faltering US economy. In the stock market, the Nikkei Index started at JPY14,691 and saw a dip to JPY11,000 in February and since then fluctuated between JPY13,500 and JPY14,500 during H1 2008. The Tokyo Stock Exchange (TSE) announced that the percentage of total listed shares of Japanese companies held by non-Japanese investors, an important driving force in recent years, at the end of March 2008 decreased by 0.4 percentage points to 27.6%, the first drop in five years.

The Japanese Yen (JPY)'s exchange rate against the US dollar fluctuated between JPY95.7 and JPY112.6 during H1 2008 with a 30 June close of JPY106.2. Although both the Consumer Price Index and the Wholesale Price Index are gradually moving upward, the Bank of Japan announced to keep the overnight rate at 0.5% on 16 June. In the meantime, the 10-year Japanese government bond yield which fluctuated between 1.3% and 1.5% during Jan-April 2008, rose to 1.8% in June 2008.

Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 30 June 2008

In H1 2008, Japanese companies announced 1,318 deals (H1 2007: 1,435) with a total value of US\$44.5 billion (H1 2007: US\$70.4 billion), a decrease of 117 deals and US\$25.9 billion over H1 2007. The decrease was primarily due to Q2 2008 domestic deals experiencing the lowest number of deals as well as the lowest value per deal for the last ten quarters. The value per inbound deal has also declined from an average of US\$120 million per deal in full year 2007 to US\$55 million in H1 2008.

The value per outbound deal rose sharply in Q2 2008 driven by continued deal activity in the pharmaceutical and healthcare sectors, as Japanese companies in this sector are now going global: Daiichi Sankyo – Ranbaxy Laboratories (India) US\$5 billion; Eisai – MGI Pharma US\$3 billion; Takeda – TAP Pharmaceuticals Products (U.S.) US\$1.5 billion; and Otsuka – Alma Group (France) US\$1.1 billion. Takeda Pharmaceutical also announced in April that it has reached an agreement to acquire Millennium Pharmaceuticals Inc., a NASDAQ listed bio-venture in USA, through a tender offer (US\$8.8 billion). This is the fourth largest acquisition of a foreign company ever by a Japanese company. This deal is significant for its size and the fact that its consideration was completely paid out from Takeda's cash pile with no other deal financing (Takeda will still hold another US\$8 billion of cash on its balance sheet post deal).

The excessive cash position of Japanese companies has been a target of criticism mostly by foreign investors due to its inevitable capital inefficiency for some time. Regular targets have been pharmaceutical companies and precision/electronic technology focused companies, whose comparative advantages rely significantly on its R&D activities. The Nikkei Press reported on 25 June that 40% of listed companies in Japan, or 654 companies, have no actual debts and about 5% hold excess cash of more than US\$1 billion on their balance sheets.

Inbound activity

The largest inbound deal in H1 2008 was again in the pharmaceutical industry (where deal values have been made public). Roche completed its tender offer to raise its stake in Chugai Pharmaceutical Co Ltd to 61.53% from 51.45%, for a total value of US\$919 million. Abu Dhabi Investment Authority also announced that it plans to invest US\$100 million in the pharmaceutical industry in Japan. The Japanese government, most importantly Ministry of Finance, has no intention of restricting Sovereign Wealth Funds activities beyond the current investment regulations.

Activist investors in the meantime continued to grab media headlines. Steel Partners who eventually succeeded in restructuring the board of Aderans Holdings, the Japanese listed hair solutions provider, are rumoured to be encouraging the company to carry out a management buyout. In early July, Aderans Holdings requested Steel Partners to return to the company the US\$0.6 million in profits the fund made in its short-term trading. In April, The TCI (The Children's Investment Fund) declined to accept the Ministry of Economy Trade and Industry and the Ministry of Finance's recommendation (for 'uncertainty in national security and well-being grounds') to withdraw its request for an approval to increase its shareholding in J-Power to over 10%, claiming a discriminatory treatment based on its nationality by the Japanese government. The recommendation developed into an order for TCI to withdraw from the suggested activity. TCI changed its



strategy and submitted several proposals to J-Power's management, including a drastic increase of dividends, for general shareholders meeting in June. Glass Lewis & Co., a world-renowned voting advisor, announced its recommendation to J-Power to reject TCI's proposal for it would harm J-Power's future growth, and continuing the trend of similar resolutions by other activists in prior years, all resolutions were rejected.

Private Equity

There has been little change to the inactive private equity market in Japan. The global credit crunch appears to have further increased the general lack of activity. Bain Capital Partners, in June, announced its tender offer for D&M Holdings, which was valued at US\$469 million. This is a 'secondary' transaction between private equity houses as the main vendor was RHJI (Ripplewood) who currently holds 49% of D&M Holdings. This is similar to the Permira - Arysta LifeScience deal back in October 2007, also a 'secondary' transaction. In both of these deals, the fact that top management of the target company are non-Japanese management headquartered in Japan has eased the process, as well as the acceptance of switching shareholders with a view to pursuing "the next phase of growth". The Carlyle Group, in May, announced it has agreed to acquire a 71.5% stake in NH Techno Glass from Hoya Corporation and Nippon Sheet Glass Co Ltd (NSG), the two listed Japanese glass manufacturers, for a consideration of US\$558 million. The latter case is promising in that Japanese management has opened up to private equity but at the same time is an example of Japanese management's perceived 'allergy to giving up full control'.

Outlook

Starting in July, listed companies are now allowed to list class shares with less voting rights than ordinary shares, but not allowed to list class shares with more voting rights than the ordinary shares. Issuance and listing of both types of Voting Rights Class Shares will be allowed for non-listed companies. The TSE expects this rule to offer the more flexible capital raising and an exit option for founders of private companies. The government is also trying to encourage foreign companies to list on TSE in the form of a JDR (Japan Depositary Receipts). Tata Motors of India is understood to become the first to list under the JDR structure.

The TSE is also understood to be planning the establishment of a new stock market for 'professional investors' targeting operations to start in February 2009, with cooperation with the London Stock Exchange (LSE). This has three basic components: (1) the operation of the new stock market will be 51% owned by TSE, the remaining 49% to be owned by LSE; (2) lower listing requirements in order to alleviate companies' burden; (3) disclosure of information is to be made in English.

From the perspective of inbound investment, the Expert Committee on Foreign Direct Investment Promotion established under the Minister in charge of Economic and Fiscal Policy disclosed "Five Recommendations Toward the Drastic Expansion of Foreign Direct Investment in Japan" in May. These recommendations aim to double the amount of foreign investment by 2010. The recommendations include setting up legal infrastructure to facilitate M&A activities, conducting a conclusive study on foreign investment restrictions, cutting business costs (including tax), improving transparency, and revitalising the local economy through inviting foreign investment. However, this report also acknowledged the significance of the 'allergy' to foreign investment held by most Japanese companies.

Private equity houses which entered the Japanese market within a few years of the new millennium are starting to enter the exit phase. Given the increased hurdles the IPO path (number of IPOs in Japan; H1 2008 - 24; 2007 - 121; 2006 - 188), trade sales appear to be seen by the players as a more viable option.

The Cabinet Office of Japan's government announced "The Fundamental Policy on Economic and Fiscal Reform in FY2008" on 23 June. The Japanese economy is expected to gradually grow at a higher rate again after the current slowdown with growth expected to be driven by domestic demand under controlled inflation. Movements in the US economy and the price of crude oil will have significant influence though the Japanese official forecast on real GDP growth rate in FY2008 (April 2008 to March 2009) is +2.0% for the year. However, the latest indicators state that Japan's economic growth is slowing further, mainly due to the effect of globally high energy and material prices. In conclusion, taking all factors into consideration, especially the state of the global economy, M&A activity in general is likely to be moderate in the short-to-mid term.