

# Japan

*The economy continues to weaken, however the strong balance sheets of many Japanese companies may help to support outbound M&A*



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## Current Environment

The Japanese economy has experienced negative GDP growth since the second quarter of 2008 at an annualised rate of 0.4%, meaning the country is now officially in recession. A decrease in both corporate capital expenditure and net exports of services contributed to the decline, although consumer consumption has until recently remained relatively stable. However, consumer confidence is weakening, and with machinery investment also in decline, the economic outlook is not encouraging.

Outbound Foreign Direct Investment ("FDI") increased during 2008 (peaking at US\$23 billion during the third quarter), while inbound FDI declined to US\$1.6 billion in the same period. Inbound FDI even turned negative in July 2008, showing an outflow of US\$323 million, indicating that foreign investors were cashing out on their investments. The accumulated level of inward FDI stands at just over US\$150 billion (year-end 2007). Although the government has launched a programme to encourage such investment, in the current economic circumstances it will be a challenge for the country to achieve its stated target of doubling FDI to 5% of GDP by 2010.

On the stock market, the Nikkei Index dipped to a low of 7,141 points at one stage in October, the lowest point since 1982, and the market ended the year at a level of around 8,800. The 10-year Government Bond (JGB) rate decreased to 1.3% by December, but did not stem a flow of pension funds from equities into bonds. Market analysts do not expect to see a marked recovery in the Nikkei Index over the near term.

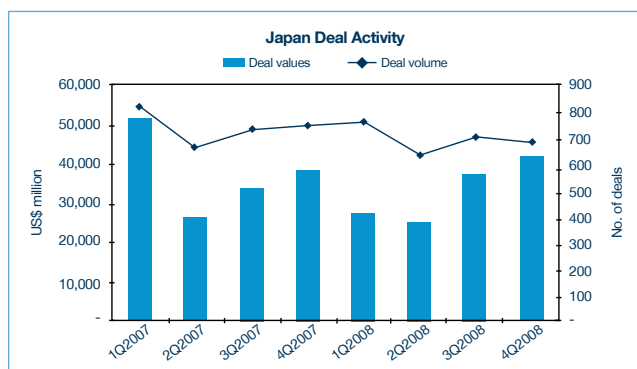
The economy has been heavily impacted by a sustained appreciation of the Japanese Yen during the second half of 2008 against most major currencies. With the exchange rate hardening to a level of around ¥90 to the US Dollar, the strong currency has had a negative impact on the

Japanese export sector, with many major corporates struggling to remain competitive. Even Toyota is forecasting an 18% year-on-year sales decline, and a close to breakeven result (versus profits of US\$17 billion in the prior year). In November, the Fitch credit rating agency announced a downgrade for Toyota to AA status.

The Bank of Japan has continued to move interest rates lower in an attempt to maintain liquidity and the target call rate ended the year at a level of 0.1%.

There are increasing examples of the impact of the downturn on the corporate sector, with Tokyo Shoko Research reporting that over 14,000 companies became bankrupt in the period from January to November 2008. Around 10% of this number had filed due to an inability to finance their working capital needs, and this trend has been increasing month on month. In addition, a total of 30 listed companies filed for bankruptcy, the largest number since World War II, while non-performing loan levels within the 11 major banks had risen to a reported level of US\$43 billion at the end of the third quarter. In response, the Bank of Japan held an urgent monetary policy meeting on 2 December to establish emergency steps aimed at easing the situation for corporations, and improving their ability to finance working capital and capital investment needs. This move constituted the first emergency policy to be issued since 1998 when the Asian economic crisis hit Japan. The policy aims to inject US\$30 billion for banks to provide loans to corporations.

## Deal Activity



Source: Thomson Reuters, based on total domestic, inbound and outbound deals announced as of 31 December 2008

According to MARR (the M&A Research Report), total deal volume in the second half of 2008 was 1,199 against a level of 1,200 deals in the first half. The full year total of 2,399 deals in 2008 compares to a level of 2,696 deals in 2007.

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There were 199 reported outbound deals in the second half of the year, providing a full year total of 377 in 2008 (against 367 deals in 2007). Inbound activity included 100 deals in the second half, with the full year total of 198 deals in 2008, well down on the corresponding level of 309 deals in 2007.

The most notable trend in 2008 has been the acceleration of big ticket outbound transactions, although the announcement by Daichi Sankyo of a US\$3 billion (60%) impairment write-down only months after their initial investment in Ranbaxy tempered the excitement somewhat. This trend was driven by major corporates taking steps to expand beyond a saturated domestic market and acquire brands or market share overseas. While the slowdown in global M&A hit Japan in the fourth quarter, there have still been signs of activity from consumer sector companies looking to take advantage of the strengthening Yen. The most notable outbound activity included:

- Shionogi Pharmaceutical acquired Sciele of US for US\$1.5 billion. The deal brings an international sales force to help Shionogi penetrate overseas markets for its metabolic syndrome products. Shionogi had previously granted overseas distribution rights to Astra Zeneca, a relationship which will continue for existing drugs such as Crestor.
- Kirin Holdings acquired Dairy Farmers, the second largest dairy producer in Australia for US\$570 million through its Australian subsidiary, National Foods. Subsequently Kirin has also announced an offer (as yet unaccepted) to acquire Coca Cola Amatil, the largest beverage maker in Australia, through another subsidiary, Lion Nathan. This activity is intended to build Australasia as an export base for Kirin to expand into Southeast Asian markets.
- Suntory agreed to acquire New Zealand-based Frucor, a beverages subsidiary of Danone, for US\$750 million. Frucor holds the production license for Pepsi in New Zealand (as does Suntory in Japan). In addition, the deal provides a distribution channel for Frucor products into Asia.
- Late in the year, Asahi announced that it had reached agreement to acquire the Australian beverages business of Cadbury in a US\$800 million transaction.

Japanese financial institutions were also prominent investors in cash calls by distressed US financial institutions:

- MUFJ accepted a private placement in Morgan Stanley for US\$9 billion and now holds a 20% stake in the company, structured through a mix of common and preferred shares.

- Nomura Holdings Inc. of Japan surprised the market by moving rapidly in late September 2008 to acquire the European and Middle Eastern equities and investment banking operations of bankrupt Lehman Brothers Holdings Inc, a New York-based investment bank, for a nominal consideration of US\$2.

Although much of the eye catching activity has been outbound, there have also been a number of major domestic deals, especially in the food, wholesale, and pharmaceutical segments. Significant domestic deals announced in the second half of 2008 include:

- Meiji Dairies Corporation, the largest dairy producer, agreed to merge with Meiji Seika, the second largest producer of cakes and baked goods, to form a new company, Meiji Holdings, in a stock swap transaction valued at US\$1.8 billion. The revenues of the merged company will be in the range of US\$11 billion, ranking Meiji Holdings as the fifth largest food and beverage company in Japan.
- Nippon Oil Corporation, the largest oil wholesaler in Japan announced a merger with Nippon Mining Holdings (the number six player), scheduled to complete in the latter months of 2009. The merger of the two companies will consolidate production capacity, and, at US\$130 billion, the revenues of the merged company would rank it as the eighth largest oil/petroleum wholesaler in the world. However, given that the merged business would have a 33% domestic market share, the Japan Fair Trade Commission is still investigating the merger under Anti-Trust Laws.
- Panasonic announced its intention to acquire shares in Sanyo Electric from the three major shareholders: Goldman Sachs, Daiwa SMBC Securities, and Sumitomo Mitsui Bank Corporation (SMBC), each of which had previously invested in preferred shares under Sanyo's business recovery plan. Sanyo has been in financial trouble for more than decade, and the proposed transaction would see consolidation through the reforming of a group that was broken up many years ago when Sanyo was spun out of Panasonic.

Activity in the inbound sector and by financial investors has been relatively muted during recent months, and it would appear that the focus of private equity, after some notable transactions closing in August 2008, is to focus on generating cashflow improvements in their existing portfolio in order to counter the risk of covenant breaches. One of the more prominent and active funds, MKS, has announced an intention to close. The period also has seen



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the withdrawal of opportunist hedge funds and activist funds with The Children's Investment Fund (TCI), divesting its 9.9% stake in JPower in November 2008, and Steel Partners reporting sales of several investments.

On the regulatory front, the Ministry of Economy, Trade, and Industry (METI) recently announced that it is continuing to work on plans for a Comprehensive Economic Partnership in East Asia ("CEPEA"). CEPEA is an economic strategy aimed at creating a virtuous growth cycle in Asia through the formation of an economically united region across 16 Asia Pacific countries (covering ASEAN, China, Korea, India, Australia, New Zealand and Japan). The plans represent a continuation of the progress achieved in 2008 upon the signing of the ASEAN-Japan Comprehensive Economic Partnership ("AJCEP") Agreement with the 10 ASEAN member states and through the establishment of an Economic Research Institute for ASEAN and East Asia ("ERIA").

In other areas, METI has also announced plans to amend tax regulations through the exemption from tax of dividends paid by overseas subsidiaries (with an equity investment of 25% or more) to a parent in Japan. The move is intended to facilitate efficient global fund flows for Japanese corporations. In December 2008, the Ministry of Finance also announced proposals to amend the rules governing foreign private equity and other fund investment into Japan, including changes to the determination of a permanent establishment and the application of the 25/5 rule to certain foreign partners.

## Outlook

Global economic prospects will continue to be the dominant factor influencing the M&A environment in 2009. Tightened liquidity and difficult trading conditions will place pressure on Japanese companies, although this will be mitigated to some degree by their cash holdings. The strong Yen also provides an advantage for companies looking outbound from Japan. However, given the economic environment, even with a relatively healthy financial standing and the backing of a strong currency, it is unlikely that conservative Japanese manufacturers will seek to engage in aggressive M&A activity at levels greater than their free cashflows.

In the outbound sector, we would expect to see a continuation of the trend for companies with a good domestic market position and adequate cash to seek opportunities to acquire overseas brands or patents and international market share. Active sectors are likely to include food and beverages, pharmaceuticals, chemicals and electronics.

The prospects for inbound investment will be limited given the strong Yen, although a further round of corporate restructuring brought on by the challenging economic circumstances will create opportunities in distressed situations. We may see activity in sectors such as construction, general manufacturing, retailing and wholesale distribution, especially in the areas around Tokyo and Osaka. ■