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M&A Study Report

Hostile takeovers should be positively utilized

Carry out industry reorganization efficiently

“External pressure” acts as leverage for management reform

*Tomio Arai**

Professor, The University of Tokyo

It is a pressing task to carry out industry reorganization efficiently and reallocate economic resources to industrial activities with higher value-added in order to ensure accelerated growth of the Japanese economy. Hostile acquisitions and buyout funds should be utilized positively. Already, there are signs of change in the way of thinking among forward-looking companies and institutional investors.

Even though mergers and acquisitions (M&As) have now become commonplace, there is still strong resistance to hostile M&As, which are proposed without obtaining the prior consent of target companies. However, hostile M&As have elements that are important for enhancing the quality of business management. The Japan Center for Economic Research’s “M&A and Corporate Management” Study Group (this author serves as chairman for the Study Group) has been studying M&A cases involving Japanese companies for one year. This article is intended to present some of the discussions held by the Study Group on the modality of hostile M&As.

Market for Trading “Control Rights”

Many Japanese industry sectors are currently under pressure to carry out reorganization amid changes in the business environment. Such industries include electric machinery manufacturers that currently not uncommonly lose out in the competition with companies from neighboring countries in Asia as well as domestic market-oriented industries faced with sluggish demand as the population ages and fewer babies are born. This latter group includes food and beverage and retail industries. Reorganization is already under way in these industry sectors.

It is a pressing task to carry out industry reorganization efficiently and reallocate economic resources to industrial activities with higher value-added in order to

* *Tomio Arai* was born in 1950. He graduated from the University of Pennsylvania with a Master of Business Administration. He specializes in corporate finance.

ensure accelerated growth of the Japanese economy. Industry reorganization needs to be pursued without delay as companies in neighboring countries are in hot pursuit of their Japanese rivals. To that end, M&As should be utilized effectively as a market for trading “control rights,” meaning a market to decide who should be entrusted with the management of companies. Compared with companies that are finally left to go under after losing out in the competition in the goods and services markets, M&As allow a prompt response that would be more efficient economically and reduce the social costs associated with the bailout of failed companies.

In Japan historically, however, there was the tendency to regard hostile takeover bids for Japanese companies on the home market as taboo. Fundamentally, M&As are an important option in the arsenal of corporate strategies, and as such should not be censured simply for being hostile to the executives of target companies.

In that sense, the hostile takeover bid (TOB) by Oji Paper Co. for Hokuetsu Paper Mills Ltd. last year was an event of great significance that granted “citizenship” to hostile TOBs.

On the other hand, the fact that Oji Paper’s TOB actually failed came as a fresh reminder of problems and issues that exist in Japan’s M&A market. There are numerous systems and institutions in Japan that work as impediments to the success of hostile M&As.

First, in terms of corporate personnel systems, business managers have strong incentives to wage a fierce fight against a hostile M&A that would deprive them of their executive posts. Japanese companies commonly have in place seniority-oriented wage systems, systems to appoint directors on the basis of internal promotions, and retirement benefits for directors paid in proportion to the length of service rather than performance while in office. Assuming these systems and practices, corporate managers and executive officers would be taking very rational action in terms of their own financial interests by carrying out do-or-die resistance against a hostile M&A.

Furthermore, in Japan, there are very few legal risks or constraints related to corporate defensive actions. As Japan has no class action system, business managers run little risk of being sued by shareholders for having prejudiced their interests even where managers resist to the end buyout offers favourable to shareholders.

Response to Changes Tends to Be Delayed If Left Entirely to Corporate Managers

Laws or stock exchange rules do not strictly call for procedures designed to obtain shareholders' consent for the use of poison pills and third-party allotment of new shares as means of defending companies against hostile M&As. Consequently, shareholders may find it difficult to put on the brakes to the defensive actions adopted by business managers.

How best to allocate the rights to control companies? Roughly speaking, in the era of high economic growth in the '60s and '70s, corporate management beneficial to society as a whole was ensured when it was put entirely in the hands of business managers. The mechanism of concentrating actual powers in the hands of business managers and preserving their positions was reasonable enough for that particular era.

At present, however, this is not necessarily the case. When a drastic shift in strategy is required to accommodate to changes in the business environment, leaving responses to internal corporate organizations means, in quite a number of cases, slow progress toward necessary reforms, which in turn would disadvantage society as a whole.

Intense pressure from outside is necessary to change this situation. The first conceivable external pressure is competitive pressure in the goods and services markets. However, companies that maintain a certain level of competitiveness and assets in terms of production technology and brands would not be driven into bankruptcy instantly even when the earnings performance deteriorates.

Under these circumstances, companies essentially need to strengthen their competitive core businesses while undertaking drastic business restructuring, including substantial cutbacks on investments incapable of producing reasonable returns and the sell-off and/or shutdown of less profitable divisions.

However, drastic business restructuring causes considerable pain to business managers selected under the internal promotion system. This is exactly where M&As, as a market in which to trade the rights to control companies, come in and play out their function.

A hostile TOB requires shareholders to be able to exercise clear judgment unfettered by internal constraints regarding the issue of "who they think should take over management in order to facilitate the generation of greater wealth." In that sense,

cross-shareholdings among companies are problematic.

Though considerably down from their peak levels, shares of many listed companies are still held under interlocking arrangements. In addition, an increasing number of companies have reportedly moved recently to again strengthen interlocking shareholdings as part of corporate defensive mechanisms.

Cross-shareholdings would most likely distort decisions on a hostile TOB that should be made essentially from the perspective of efficiency. In a situation where pure investors accept a TOB offer, such factors as business ties with the target company and mutual insurance against hostile M&As are important elements affecting the decision of shareholders in interlocking stock ownership arrangements on whether to accept the TOB.

If the hostile TOB founders because of the reluctance of interlocking shareholders, the losers would be the pure investors who cannot expect to benefit from business ties with the target company. This sort of experience would most likely prompt pure investors to sell off their holdings in the target company as a way of severing any relations with it.

However, pension funds and other institutional investors with indexed investment portfolios might find it difficult to sell off holdings in the target company even when they are not satisfied with the way it is managed because the disposal of shareholdings would widen the deviance from index returns.

Given these circumstances, some forward-thinking institutional investors are considering investment in buyout funds along with moves to vote against company proposals at general meetings of shareholders.

Forward-Looking Companies Changing Their Way of Thinking

While the business community at large is wary of buyout funds, the targets of these funds are usually companies with substantial scope for management improvement. Companies with efficient management need not fear this form of buyout unnecessarily.

An empirical study conducted in the United States indicates that in many cases, the leveraged buyout (LBO, or a buyout financed by borrowings with assets of the target company as collateral) has improved the profitability of acquired companies that had not realized their full potential and at the same time caused managers of other companies to improve their performance propelled by a sense of tension. Buyout funds should be regarded in a positive light, backed up with appropriate measures such as

enhanced disclosure of information.

Meanwhile, there are growing signs of change on the part of companies. Within the business community that has been historically conservative regarding M&As, considerable changes in the mindset can be observed at some forward-looking companies. A questionnaire survey conducted last summer by the “M&A and Corporate Management” Study Group jointly with the Nikkei Financial Daily on companies having experienced an M&A found that 61% of the surveyed companies are beginning to think that hostile M&As are acceptable depending on circumstances.

Furthermore, those companies that are accepting hostile M&As appear to have the confidence to believe that when they themselves become M&A targets, final decisions should be left to the market, supported by the thorough disclosure of information to shareholders, instead of direct regulation by laws or the government. The existence of such forward-thinking Japanese companies is quite encouraging.

As we enter the era of full-fledged global competition, corporate management requires more sophisticated strategic approaches and greater speed. At the same time, high returns on securities investment, backed up with improved corporate profitability, are needed to support the graying society. It seems to this author that a more positive evaluation should be accorded to hostile M&As.

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Japan Center for Economic Research (JCER)

Nikkei Kayabacho Bldg. 2-6-1 Nihombashi Kayabacho, Chuo-ku, Tokyo 103-0025, Japan
Phone:81-3-3639-2810 / FAX:81-3-3639-2839 / E-mail:jcernet@jcer.or.jp