

May 2, 2008

Do MBOs Pay Sufficient Premiums?

Hirokazu Maezawa
Former Senior Economist

In Japan, the number of management buy-outs (MBOs—acquisitions of companies by parties that include their management) has been increasing in recent years. According to data provided by Recof Corporation, 329 MBOs were announced between 1996 and 2006. Most of these involved unlisted companies, although the MBOs of such listed companies as World Co. Ltd. and Skylark Co., Ltd. have attracted a great deal of attention by resulting in those firms going private.

Since the buyers in an MBO include management, which has thorough knowledge of the company, there is bound to be a great asymmetry of information between the buyer and ordinary shareholders. This gives rise to strong concerns that management may face a conflict of interest and that the rights of shareholders may be impaired. Particularly notable are the following possibilities: (1) MBOs are conducted when share prices are below corporate value, and (2) premiums paid for the acquisition are lower than normal. In fact, in the MBOs of Rex Holdings Inc. and Sunstar Inc., the minority shareholders who turned down the take-over bids requested that the court determine fair acquisition prices for their shares.

Here we seek to determine the value of premiums paid in MBOs in Japan. This paper also attempts to throw light on the question of conflict of interest in MBOs by comparing Japanese data with the results of a study recently conducted in the United Kingdom.

Between January 1993 and March 2007 in Japan, 24 MBOs were announced, all of which resulted in the delisting of the acquired companies. These are compared with public-to-private cases analyzed by Renneboog et al.¹ in an empirical analysis of 177 leveraged buy-outs (acquisitions mainly financed by non-recourse loans) that took place in the U.K. between 1997 and 2003. Of these buyouts, 137 were MBOs.

Japanese companies usually announce premiums based on a calculation in which the acquisition price is compared with the average share price one, three, or six months prior to the announcement of the MBO. Based on this calculation, the average premium for the 24 MBOs was 32.4 percent (the median value was 25.8 percent). When the average share prices for the six months prior to the announcement were used in order to adopt a single standard, the average premium was 28.1 percent (the median value was 26.2 percent).

¹ Luc Renneboog, Tomas Simons, and Mike Wright, "Leveraged Public to Private Transactions in the UK," *ECGI Financial Working Paper No. 78/2005*, April 2005.

This Japanese method of premium calculation is unusual by international standards. If there is no effect from purchases due to a leak of information, and if it is assumed that the market is efficient, then the premium could be calculated by comparison with the share price, even on the day before its announcement. In fact, studies show that in the United States and Europe, comparisons are usually made with the share price one, five, 20, and 40 days prior to the date of announcement. When we calculate the Japanese premiums by comparing the acquisition prices with the share prices 20 and 40 days prior to the announcement, they are found to be slightly lower than those in the U.K. (Table).

Table A Comparison of MBO Premiums in Japan and the U.K. (%)

	Japan	U.K.
Premium compared with the share price 20 days prior to the announcement	31.5	40.6
Premium compared with the share price 40 days prior to the announcement	34.3	39.1
Premium announced by the company	32.4	n/a
Premium compared with the average share price for the six months prior to the announcement	28.1	n/a
Excess rate of return for the 300–41 days prior to the announcement	-2.2	-15.7

Note: the excess rate of return for the U.K. is for LBOs, not MBOs.

Relative Prices Fall before the Announcement

By looking at research from the U.K., one can see that premiums are negatively affected by the movement of share prices prior to the MBO. A comparison of excess rates of return (the rates of increase in the share prices less the rates of increase in the stock price index) shows that the average rate of increase during the 300 to 41 days prior to the announcement of the LBO stood at -15.7 percent in the U.K. The majority of these rates are for MBOs. The average rate of increase for MBOs in Japan was -2.2 percent. When this data is taken into account, it is revealed that Japanese premiums are not substantially lower than those in the U.K.

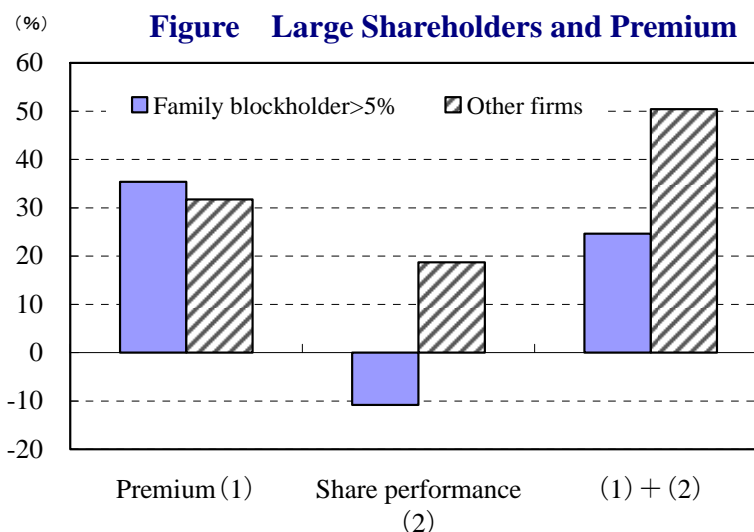
Next we separated the MBOs into two groups. The first group is comprised of companies in which the founder or founding family members are major shareholders. The second is comprised of the remaining companies, most of whose major shareholders are parent companies. If we define the first group of MBOs as those in which family blockholders own more than 5 percent of the shares of the company, 17 firms (approximately 70 percent of our samples) fall into this category. In most of these cases, the founder and his or her family members participate in management, and in 15 of the sampled firms they are also a party to the MBO. Since these people possess insider information about the company and also stand to share in the profit distribution resulting from post-MBO restructuring, the selling of shares at low prices could work in their favor.

Meanwhile, five companies, including Toshiba Ceramics, fall into the latter category. Since the seller (parent company) cannot benefit from post-MBO restructuring, their profit depends on the price of the takeover bid (TOB). In this case, the major shareholder and minority shareholders share the same motive.

When the premium as compared with the share price 40 days prior to the MBO in the former category is compared with the average for the latter category, the difference is positive, but not statistically significant at the 5 percent level. However, when the average

premiums of the two groups are compared in terms of the performance of the shares prior to the MBO announcement, the difference is substantial and statistically significant at the 10 percent level (Figure).

The U.K. studies illustrate that when founding families are blockholders, they are more sensitive to lower share prices. It appears the same holds true in Japan.



The MBOs of Founding-Family-Dominated Firms Are Problematic

As an indicator of the extent to which ordinary shareholders were rewarded, we added the premium as compared with the share price 40 days prior to the announcement to the share price performance prior to the announcement. We found that the average value for the companies in which family blockholders own more than 5 percent of the shares is significantly lower than that for the other companies. There is a wide variance among our samples, ranging from 124.3 percent to -19.2 percent. The bottom six companies are all companies dominated by family blockholders; the figures for four of the companies are negative. As can be expected, it appears that with this type of MBO ordinary shareholders tend to complain unless the premium is higher.

Empirical studies in the United States show that the most influential factor in increasing the premium is the presence of competitive bids. In Japan, the minimum required TOB period is 20 days, which is too short to give competitors ample opportunity to bid. In addition, boards of directors lack neutrality and tend to avoid opening bidding to competitors. Unless efforts are made to rectify this corporate governance problem, there may arise cases in which minority shareholders are inadequately protected.

Hirokazu Maezawa

Former Senior economist in the Economic Research Department, specializing in corporate finance and corporate governance.

For inquiries regarding this paper, please call 81-3-3639-2915.

Copyright © 2008 JCER

※ Copying of this report is prohibited. Please contact us for further details.

Japan Center for Economic Research (JCER)

Nikkei Kayabacho Bldg. 2-6-1 Nihombashi Kayabacho, Chuo-ku, Tokyo 103-0025, Japan

Phone: 81-3-3639-2801 / FAX: +81-3-3639-2839 / E-mail: jcernet@jcer.or.jp