JCER Researcher Report No. 67

Investment Funds Target Cash Rich Firms
–Foreign Share Ownership Not To Be Overlooked As a Factor –

Nov, 2005

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Numbers of Japanese companies sought approvals to the measures aiming to counter hostile takeovers at the shareholders meetings in June, which included the introduction of "poison pills." Now the hostile takeovers have been common since the takeover bids (TOBs) for Nippon Broadcasting System, Inc. by Livedoor Co., Ltd. and for Japan Engineering Consultants Co., Ltd. by YumeShin Holdings.

Even before these hostile takeovers with strategic purposes, investment funds, foreign and domestic, attracted public attention for their takeover attempts against Japanese firms. Steel Partners Japan Strategic Fund acquired shares of Sotoh Co., Ltd. and Yushiro Chemical Industry Co., Ltd., which lead to powerful resistances by the management because it was perceived that the aim of the fund was to dispose of the redundant assets of these companies and to distribute among shareholders. It is still new in everyone's memory that an investment fund known as Murakami Fund acquired shares including those of Tokyo Style Co., Ltd., and made proposals to oppose merger plans, to substantially increase dividends and to raise corporate value through buying back their own shares.

What type of companies, then, have been the targets of investment funds? While there are many views on this, this paper aims at identifying factors common to target companies by a quantitative method, based on data from NEEDS-FinancialQUEST of Nihon Keizai Shimbun, Inc.

Several Common Factors Other Than "Cash Richness"

Table 1 compares the averages of several financial indicators of 80 companies with all listed companies. The 80 companies were all the takeover targets of the Murakami Fund and/or Steel Partners[1], of which consistent data were available,

[1] It is not clear in how many companies the Murakami Fund has a stake. A search using the CD-ROM version of Nikkei Kaisha Joho ("Nikkei Company Information"), Spring 2005 Edition, identified 28 companies. However, a total figure of 56 was obtained by adding the companies whose names had appeared in newspapers, etc. By excluding Seibu Railway, which was a special case, and the three other companies for which uniform data were not available, 52 of these companies were used in this analysis. Using the same method, 30 companies were identified as the objects of investment by Steel Partners Japan Strategic Fund, and two of those were on the list of companies in which the

including the foreign share ownership. Because it was not clear which year's management indicators the funds had examined to make their investment decisions, this study used the management indicators for fiscal 2001 for all companies[2].

Table 1. Financial Indicators Characteristic to Target Companies

		Average	
		Target companies	All listed companies
Degree of undervaluation	PBR (Price-book value ratio)	0.9	1.7
Degree of cash-richness	Liquidity in hand/ total assets (hereafter %) ***	22.8	14.8
	(Liquidity in hand minus liabilities with interest)/total assets ***	16.4	-9.4
	Liquidity in hand/ market capitalization	56.3	48.9
	(Liquidity in hand – liabilities with interest)/market capitalization***	26.8	-97.4
Dividends	Accumulated surplus/total assets ***	44.9	26.8
	Accumulated surplus/market capitalization ***	113.5	79.1
	Pay-out ratio	78.8	91.7
Financial conditions	Ratio of shareholders' equity***	65.2	47.4
	Debt ratio	75.2	271.6
	Degree of debt dependence ***	6.9	23.8
Profitability and growth potential	ROE (operating profit ratio after the payment of interest on shareholders' equity)	7.8	8.0
	Growth rate of recurring profits (5 years)	0.3	1.6
	Ratio of recurring profits to sales	6.7	2.8
	Sustainable growth rate **	3.7	5.4
Efficiency	Rate of return on investment	11.1	28.8
	Compensation per employee (¥10,000)	932.8	858.4
Shareholder composition	Ratio of foreign share ownership ***	8.6	5.3

Notes: * denotes the indicators in which there were significant differences between the target companies and all listed companies.

*** denotes significant at the 1-percent level, ** significant at the 5-percent level.

Source: Compiled from data in NEEDS-FinancialQUEST of the Nihon Keizai Shimbun, Inc.

Murakami Fund had a stake.

[2] Steel Partners was established in 2002 and made its TOB for Yushiro Chemical Industry Co., Ltd. in December 2003. With regard to the Murakami Fund, at least in the majority of firms, it had been confirmed as a large shareholder from the end of fiscal 2001 onward. In principle, figures are on a parent account basis.

The first characteristic of the target companies is that they are extremely cash-rich [the degree of cash-richness was obtained by subtracting the liabilities from liquidity in hand (cash and deposits plus short-term securities)]. The average ratio obtained by dividing the amount of liquidity in hand less interest-bearing liabilities by the amount of market capitalization was 26.8 percent for the target companies and minus 97.4 percent for all listed companies. This shows that even if the target companies repaid their debts with their liquidity in hand, they would still have surplus liquidity. Out of the 80 target companies, 27 had no borrowings. The theory of corporate governance states that such companies are liable to moral hazards, in that their managements are likely to deviate from their pursuit of shareholders' interests.

The second characteristic of the target companies is their high level of accumulated surplus, which makes it easy for them to increase dividends.

The third characteristic is their high ratio of shareholders' equity. It can be seen that most of these firms have low degrees of dependence on banks, and that they are not very well monitored by their main banks, etc. Because the recent revision of the Company Law relaxed regulations on the maximum profit available for dividend, the ratio of shareholders' equity may be regarded as the indicator of the maximum reserves available for dividend.

Although it is often said that a low PBR (price-book value ratio) is a characteristic of companies that become takeover targets, this was not found to be a clear feature of the target companies in this study. At 0.9, the average PBR of the target companies stood below 1, but in the year from which figures were used for this study, 61 percent of all listed companies had a PBR below 1. There were hardly any differences between the two groups in ROE (ratio of operating profit after the payment of interest on shareholders' equity), and other indicators of profitability. However, the average sustainable growth rate (the five year moving average of net profit on shareholders' equity multiplied by the five year moving average of the ratio of retained earnings) of the target companies was below that of all listed companies, and was significant at the 5-percent level. This could be seen as the fourth characteristic. It is safe to say that the target companies do not use effectively their abundant surplus funds, thereby failing to raise their growth potential.

Finally, an interesting result is that the target companies are those in which the ratio of foreign share ownership is high. A more detailed examination shows that the target firms of Murakami Fund have more of this character and less in case of Steel Partners. Generally, from the perspective of corporate governance, the higher the ratio of foreign share ownership, the stronger discipline exerted on management, rendering the companies in question compelled to focus more on corporate value. Therefore, it is felt that such companies are less likely to become the targets of investment funds, whose objective for investment is short-term capital gains. In Japan, however, investment funds might expect that it would be easier to get favorable responses to their proposals (which focused on shareholder value) from foreign shareholders, which are free from Keiretsu or cross-holdings.

Potential Targets Include Fuji Photo Film

Next, a comprehensive estimation of the probability of a company to be chosen as a target for takeover was made by combining a multiple number of variables. The method of estimation used was the Logit Model, under which a dependent variable takes the value 1 if the company is a takeover target and 0 otherwise. Among the independent variables analyzed, the following four were significant at the 1-percent level: 1) PBR, 2) the degree of cash-richness [(liquidity in hand minus liabilities with interest)/market capitalization], 3) the ratio of shareholders' equity, and 4) the ratio of foreign share ownership. The ratio of accumulated surplus to total assets was significant at the 5-percent level, and the ROE was significant at the 10-percent level.

However, this study has limitations in that such important factors as the status of cross-holdings between parent and subsidiary firms, the amount of latent assets, and whether there was a merger plan or not, were not quantified. Therefore, it is not fully capable of explaining the factors responsible for a company being chosen as a target. Nevertheless, when the companies were ranked in order of likelihood of being taken over, based on fiscal 2001 data, Nippon Broadcasting System, Inc. ranked third from the top, and 10 of the companies which were takeover targets ranked among the top 60 companies. Therefore, it is safe to say that the study captured the trend correctly.

Table 2. The Companies Most Likely to Be Takeover Targets

1. Fuji Photo Film Co., Ltd.	16. Fuji Electric Ind. Co., Ltd.
2. Shimachu Co., Ltd.	17. Fanuc Ltd.
3. Himiko Co., Ltd.	18. Horipro Inc.
4. Sangetsu Co., Ltd.	19. Sankyo Co., Ltd.
5. Chofu Seisakusho Co., Ltd.	20. Shinmei Electric Co., Ltd.
6. Nintendo Co., Ltd.	21. Coca-Cola West Japan
7. Astellas	22. Maezawa Kasei Industries Co., Ltd.
8. Mabuchi Motor Co., Ltd.	23. Toyo Corp.
9. Ono Pharmaceutical Co., Ltd.	24. Shingakukai Co., Ltd.
10. Futaba Corp.	25. TDK Corp.
11. Tenma Corp.	26. Amada Co., Ltd.
12. Tokyo Style Co., Ltd.	27. Atomlivintech Co., Ltd.
13. Rohm Co., Ltd.	28. Shinkawa Ltd.
14. Soft 99 Corporation	29. Hirose Electric Co., Ltd.
15. Ryoyo Electro Corp.	30. Makita Corp.

Note: Estimations by Logit Model (the formula used in the present study) were made based on fiscal 2004 data. However, for the ratios of foreign share ownership, this study used the latest available figures, the latest of which were for the period ending in January 2005.

Using the same coefficients, firms were ranked based on fiscal 2004 data (Table 2) (excluding foreign-affiliated firms). It merits attention that many of Japan's blue chip companies are high in the ranking, with Fuji Photo Film Co., Ltd. occupying the top position. Fuji Photo Film and Takeda Chemical Industries, Ltd. (in 40th place), for example, keep ample cash in hand, in order to purchase promising businesses or to start new businesses. The list also includes Mabuchi Motor Co., Ltd. (in 8th place) and many other highly profitable businesses.

The top Japanese businesses have large market capitalization and may be unlikely direct takeover targets for investment funds. However, if investment funds target them on the grounds that abundant funds in hand are conducive to moral hazards in management, this might induce strategic takeovers.

In this sense, the ratio of foreign share ownership is very significant. The question is whether management is aware that one function of foreign investors is to rigorously monitor corporate value. It is this awareness that leads to management discipline. Management should also clearly state the planned applications of their abundant funds in hand in connection with their management strategy. It should also clearly spell out plans to plough back earnings in order to increase shareholders' value. Otherwise, as the results of this study show, there is always the risk of a high ratio of foreign ownership of shares in a company, a situation that facilitates takeovers. It could be said that a high ratio of foreign ownership is a double-edged sword.