

Encourage Competition for Controlling Rights

Investor Diversity Should be Promoted

Exclusion of Activist Funds Is Counterproductive

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There has been an upsurge of M&A activity in recent years, fueled partly by the demands of activist funds, which buy shares in companies to make proposals to the management in hopes of enhancing the value of their holdings. This has touched off a flurry of management buyouts and the conversion of publicly held subsidiaries to wholly owned ones. For M&A activity to lead to improved corporate management, though, it is necessary to encourage competition for controlling rights based on participation by a variety of investors. The adoption of anti-takeover measures and the strengthening of cross shareholding will prove counterproductive.

Activist funds, which buy sizable percentages of shares in public companies to gain a say in management, have become more conspicuous in Japan of late. Additionally, the number of delistings resulting from management buyouts, moves to turn listed subsidiaries into wholly owned ones, and other attempts at corporate restructuring have also been on the rise. While these moves are expected to lead to more efficient management, they have also drawn considerable criticism. The Japan Center for Economic Research's M&A and Capital Market Study Group, of which I serve as chairman, has compiled a report on these trends. In this article I will introduce some of the study group's findings.

Improvements in Corporate Governance and Shareholder Value

Activist funds have earned the enmity of not only corporate managers but also a broad spectrum of society. This was reinforced after Yoshiaki Murakami, head of M&A Consulting (popularly known as the Murakami Fund), was convicted of insider trading and Steel Partners attempted a foiled hostile takeover bid for Bulldog Sauce. Judgment of their activities, though, should be based on more objective criteria.

Most of the empirical studies conducted in Japan and the United States has found that the actions of these funds have boosted share prices and improved corporate

governance at the target companies. Particularly in Japan, they have played a positive role in increasing dividends and improving shareholder returns through share repurchase at companies that have stable cash flow but suffer from lackluster growth.

When management chooses to continually retain earnings, rather than pay them out to investors, even when no promising investment opportunities exist, it cannot be said to be acting in the interest of shareholders, for whom managers are essentially agents. This kind of behavior at companies where corporate governance mechanisms are not functioning properly will only lower their market value. The intervention of activist funds can help correct this problem.

The Need for Full Disclosures and Appropriate Rules

MBOs, which have been increasing recently in Japan, are also thought to bring about improvements in efficiency. Funds needed for such buyouts are generally financed by non-recourse loans, and interest payments for such loans are tax deductible, and lower the tax burden of those companies. Moreover, based on empirical studies in the United States, which has examined a large number of MBOs, companies can look forward to not only lower taxes but also improvements in the efficiency of their business operations. This is because an MBO provides an extremely powerful incentive to management to improve the performance of the firm—as this will also benefit them as shareholders—and largely eliminates the conflict of interest between investors and the management.

This is not to say that MBOs and activist funds are without their problems. Many managers complain that activist funds use aggressive methods to pursue short-term gains, accusing them of being greenmailers that buy up a large share of a target company and then demand that management pay high prices to buy back the shares.

MBOs can also engender conflicts of interests. Board directors have a duty to maximize firm value, but in an MBO, they are also the purchasers of their companies' shares. On the one hand, they have an interest in boosting share prices as high as possible for the benefit of shareholders, but on the other they are keen to purchase the shares as cheaply as possible. This raises the concern over information manipulation by management involved in an MBO. Claims have been made in Japan that management intentionally understates earnings projections before conducting an MBO. Similar findings have been made in the United States of earnings being understated through the manipulation of discretionary accruals prior to an MBO. Less visible but just as problematic are the fact that directors have privileged access to information, enabling them to conduct MBOs when share prices are undervalued, and that they can use the coercive power to purchase shares at a discount; fearing that their shares will lose liquidity as a result of the delisting, ordinary shareholders may feel coerced into

agreeing to a takeover bid at a buyout price that is not altogether satisfactory. The coercion risk for ordinary shareholders also exists when the reorganization of a company results in a publicly held subsidiary becoming wholly owned, leading to its delisting.

To circumvent these risks to investors' profits and promote transactions involving the transfer of controlling rights as means to improve managerial efficiency, there must be full disclosure of information and the establishment of a bare minimum of clear rules to which market participants must adhere.

The current rules and conventions governing information disclosure are in need of improvement. For instance, there is insufficient disclosure of the basis for determining the purchasing price in MBOs and other transactions. Intentions should also be clearly stated in advance of whether there are plans to keep the company listed in the event of a successful TOB, thereby preventing management from arbitrarily changing its mind following such a transaction. The rules governing the private placement offering while in the midst of a hostile TOB also must be clarified. These topics will require further attention, with some necessitating a more detailed examination before final decisions are made.

However, it is undesirable to increase the number of rules and regulations that offer only symptomatic treatment. Investors will lose their incentive if too many restrictions are imposed, leading to a decline in market participants and transactions that could enhance management efficiency. This would not be in investors' long-term interests.

Guaranteeing Fairness and Increasing Liquidity

Rules and regulations that only treat the symptoms could also lead to unintended side effects and necessitate an endless series of stopgap measures to seal up loopholes. For instance, if a rule was introduced requiring shareholder approval to prevent the court from issuing an injunction against triggering poison pill measures, companies fearing hostile takeovers would be motivated to increase cross shareholdings or reach prior agreement with business partners on the purchase of new, privately placed shares.

With regard to transactions that result in the transfer of controlling rights, the chief concern from the viewpoint of protecting the interests of ordinary investors should be, rather, to promote competition. The various restrictions that make it difficult for domestic and international funds to operate in Japan should be lifted to spur competition. Empirical studies in the United States show that the most effective way of ensuring fair prices for MBOs is to invite tenders from third parties. Because investment funds are not so popular in Japan, there are few funds that submit counter bids to those put

forward by the management or that voice objections to management plans. The interests of ordinary investors may consequently be sacrificed in such buyouts. In May 2007 DaVinci Advisors intervened in an MBO attempt by building-management firm TOC Co. with an aggressive takeover bid. If there were more frequent interventions of this sort, surely there would be fewer cases of shares being bid at unreasonably low prices.

The market presence of counterbalancing entities like investment funds, which have the financial clout and specialized knowledge to wage lawsuits and proxy fights, is necessary to protect the interests of ordinary shareholders, as they would be able to represent the views of minority shareholders and negotiate with management and larger shareholders.

Attempts are being made in some sectors to reduce the threat of aggressive takeovers and limit the impact of activist funds with anti-takeover measures, private placement offerings, and strengthening of cross-held shares. Driving activist funds out of the market, though, would result in a loss of diversity and vitality. The capital market would no longer be able to serve an important function as a market for corporate control, and efforts to enhance the efficiency of Japan's economy would slow down.

Increasing the number of investors with diverse objectives is essential to maintaining liquidity in the market and improving its ability to effectively allocate resources. Achieving this requires ensuring ex-ante fairness among market participants. Should investors feel that management is not being fair with them or that large shareholders are unfair with smaller ones, they will pull out of the market, resulting in a loss of liquidity.

Corporations and other market participants should take heed: When the capital market becomes a comfortable place only for incumbent managers and loses liquidity and investor diversity, both domestic and foreign investors will begin looking elsewhere for better investment opportunities.

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