Japan

M&A statistics remained constant but the mix has changed to bigger and bolder deals

Current Environment

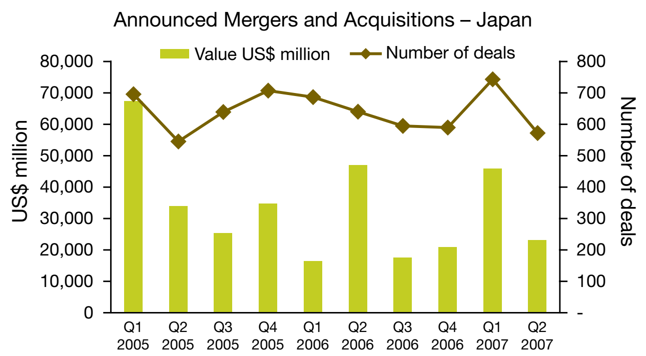
Domestic politics were quite eventful in the first half of 2007, as the nation prepared for elections for the upper house of Parliament scheduled for 29 July. Prime Minister Shinzo Abe has seen his popularity continue its rapid decline from 71 percent at the time of taking office in September 2006 to 36 percent as of the end of June. The news of roughly 50 million unaccounted-for public pension records was particularly damaging and fixing pension record keeping has thus become one of the main campaign topics. In addition, there were several ministerial scandals, including the suicide of the Agricultural Minister ahead of hearings on corruptions charges, and the resignation of the Defence Minister following remarks about utility of the atomic bombings of Hiroshima and Nagasaki. In light of these events, Mr. Abe's ability to pick the right people for the right jobs, and to some extent his crisis management skills, are being questioned with increasing frequency.

The annualised rate of GDP growth in the first quarter of 2007 was 3.3 percent and a survey of private-sector economists indicate an expectation of around 1.25 percent growth in the second quarter. GDP growth for the full year is still anticipated to be above 2 percent.

As expected, the Bank of Japan decided to raise the overnight interest rates from the 0.25 percent set in July 2006 to 0.5 percent. The decision was made in February, when the bank's policy board voted 8 to 1 in favour of the increase. Economists believe a further increase is possible at the August policy meeting, the first after the upper house elections. During the first half of 2007, the benchmark Nikkei 225 index grew 5.3 percent from 17,226 to 18,138, continuing the growth trend since the below 10,000 point levels of 2002 and 2003.

The Yen continued to weaken against major currencies. At the end of June US$1 traded for 123.39 Yen compared to 118.79 at the end of 2006, and the Euro cost 166.55 Yen up from 156.58. In trade-weighted value, the Yen has declined to its lowest level in 22 years. Whilst exporters continue to benefit, there is more and more discussion about the downsides too. For example, one of the pillars of Japan's international status, the country's position as a leading aid donor, is eroding. Japan has already been overtaken by the UK, and Germany and France are closing the gap on the back of donations denominated in the record high Euro. Japan's per-capita gross domestic product in dollar terms also factored in this lower international ranking.

Deal Activity



Source: Thomson Financial

M&A activity in Japan remains on its long term growth trend. Although the deal values of 2005 that were boosted by major deals during the consolidation of the bank sector are unlikely to be matched, indicators for the first half of the year point towards easily surpassing the US$100 billion level. The total value of the 1,315 deals announced involving Japanese targets were US$69 billion by the end of June, compared with US$63.5 billion (1,327) deals in the first half of 2006. Despite the lack of growth in the deal numbers, 2007 has been anything but boring so far. Foreign buyers were responsible for four of the ten highest value deals during the period, there were record-setting corporate transactions, and hostile takeovers remained firmly in the headlines.

According to Thomson Financial, Citigroup's US$7.9 billion acquisition of 55.46 percent of Nikko Cordial (in addition to the 4.87 percent it already owned) was the biggest ever acquisition of a Japanese target by a foreign company. Citigroup is pursuing an aggressive expansion strategy in Japan, both in retail and wholesale financial services. Nikko Cordial shareholders chose to go with Citigroup after interest expressed by Mizuho Financial Group Inc. did not lead to a specific offer.

In January, two mid-sized brokerage firms affiliated with the Mizuho Financial Group, Mizuho Securities and Shinko Securities announced a merger agreement. The deal is valued at US$6.6 billion. The merged entity is expected to start operating in January 2008, and will be the fourth-largest brokerage in Japan in terms of assets under management, and the third biggest in terms of operating revenue.

In a sign of further consolidation of the domestic pharmaceuticals industry, in February, the US$4.4 billion merger between Tanabe Seiyaku Co. and Mitsubishi Pharma Corp. was announced. The merged entity is expected to be the fifth biggest pharmaceutical company in Japan.

There has been a major merger in the retail sector too, pointing toward consolidation. Daimaru, one of the most profitable department store chains in Japan, and Matsuzakaya announced their US$2.1 billion tie up in March.

In a deal valued at US$2.4 billion, All Nippon Airways (ANA), agreed to sell its entire hotel business to an investment fund operated by Morgan Stanley. According to Nikkei, Japan's leading financial daily, the eventual sales price turned out to be 2.8 times that which ANA originally expected. The deal valuation therefore has started new waves of discussion on the state of the Japanese property market. The deal is also notable as an example of a Japanese corporation selling non-core assets.

Volvo AB of Sweden increased its equity stake from 19 percent to 96 percent in Nissan Diesel Motor Co., Japan's fourth-largest truck maker, turning it into a subsidiary in March in a deal valued at US$2.3 billion.

Outbound activity

Energy was the key behind the two biggest overseas acquisitions during the first half of the year. Nippon Oil Corp and Mitsubishi Corp announced the US$1.2 billion acquisition of a 23.2 percent stake in K2 Unit located in the Gulf of Mexico, from Anadarko Petroleum Corp, an oil and gas exploration and production company.

In April, Marubeni Corporation agreed to acquire an 80 percent interest in Jamaica Public Service Co Ltd, an electric utility. In addition, the company also agreed to buy a 55 percent interest in Grand Bahama Power Co Ltd, a 39 percent stake in Power Generation Co of Trinidad & Tobago Ltd and a 25.5 percent stake in Curacao Utilities. The counterparty to all four transactions was Mirant Corporation of Jamaica. The combined transaction value is US$1.1 billion. Marubeni, one of the largest Japanese conglomerates, entered the domestic power retail market in 2002 and intends to use the acquired know-how in its overseas operations.

In a major deal outside the energy sector, Ricoh Co Ltd paid US$725 million for a 51 percent stake in the Printing Systems Division of IBM.

A relatively small but important deal was announced in June. The Tokyo Stock Exchange (TSE) acquired 4.99 percent interest in Singapore Exchange Ltd., (SGX) for US$303 million. The TSE thus became the second biggest shareholder of the exchange after the Monetary Authority of Singapore's 26 percent stake. This was the first acquisition the TSE ever made abroad. The move is in line with the TSE's commitment to be an active participant in the global consolidation of markets. During the year, the TSE signed technical cooperation agreements with the London Stock Exchange and the New York Stock Exchange.

Private equity transactions

Private equity deals are now well recognised part of the Japanese M&A scene. Paradoxically, the most talked about deals this year so far were the ones that did not or are yet to happen, including Matsushita's intended sale of its loss-making consumer electronics company, JVC. In February, Texas Pacific Group (TPG) and Cerberus emerged as key bidders in a formal auction. Whilst TPG won exclusivity, it has failed to reach an agreement. By the end of June, it appeared that a previously ruled-out trade sale to Kenwood Corporation would be agreed.

Another major deal that has been talked about and is yet to happen, is the planned sale of private equity fund Lone Star's 67 percent stake in Tokyo Star Bank. Once a deal goes through, Lone Star will realise huge capital gains in exiting an investment made in 2001.

Steel Partners, the US activist fund that has gained nationwide fame in business ever since its failed attempt at the hostile takeover of two companies at the end of 2003, has been particularly active and launched unsolicited bids to take control of iconic Japanese corporations. The bids triggered shareholders and managers to enact anti-takeover measures. Steel Partners' key targets were Sapporo Holdings, one of Japan's biggest brewers, and Bull-Dog Sauce Co. Ltd. Japan's biggest sauce vendor.

Whilst the strong-arm tactics of Steel Partners continue to attract controversy, it is undeniable that the threat of hostile takeovers in Japan is now much better understood than even just a year ago. It is yet to be seen whether the adverse publicity received by Steel Partners will impact upon the short-to-medium term M&A activities of other foreign funds.

Outlook

Whilst the outcome of the upper house elections and its impact on domestic politics is extremely hard to predict, it is safe to assume that Japan will continue to gradually increase its involvement in international matters, both in terms of politics and business. In particular, relationships with China and South Korea, sensitive during the Koizumi years, remain good.

In line with expectations, on 1 May the ban on triangular mergers involving foreign buyers has finally been lifted. Yet the fears of the opponents of the legislation so far appear to have been unfounded, as the invasion of foreign predators did not materialise. In fact, some commentators now argue that the major impact of the legislation is to keep the wave of consolidation amongst Japanese companies fearful of foreign takeovers.

Cultural attitudes towards M&A, although still far away from the USA or Europe, continue to change. It is notable that whilst hostile takeover attempts of Japanese companies continue to be seen against the unwritten rules of doing business, the unsolicited offer that Fast Retailing Co. (parent company of the ubiquitous apparel retailer Uniqlo Co.) made to acquire US luxury retailer Barneys New York Inc. for US$900 million in early July, did not generate negative publicity.

Overall, we expect increasing deal activity across the board in domestic deals, inbound and outbound M&A.