Acquiring a Japanese Public Company:

Will Abenomics Corporate Governance Reforms

Lead to a Robust M&A Environment and Increased FDI?

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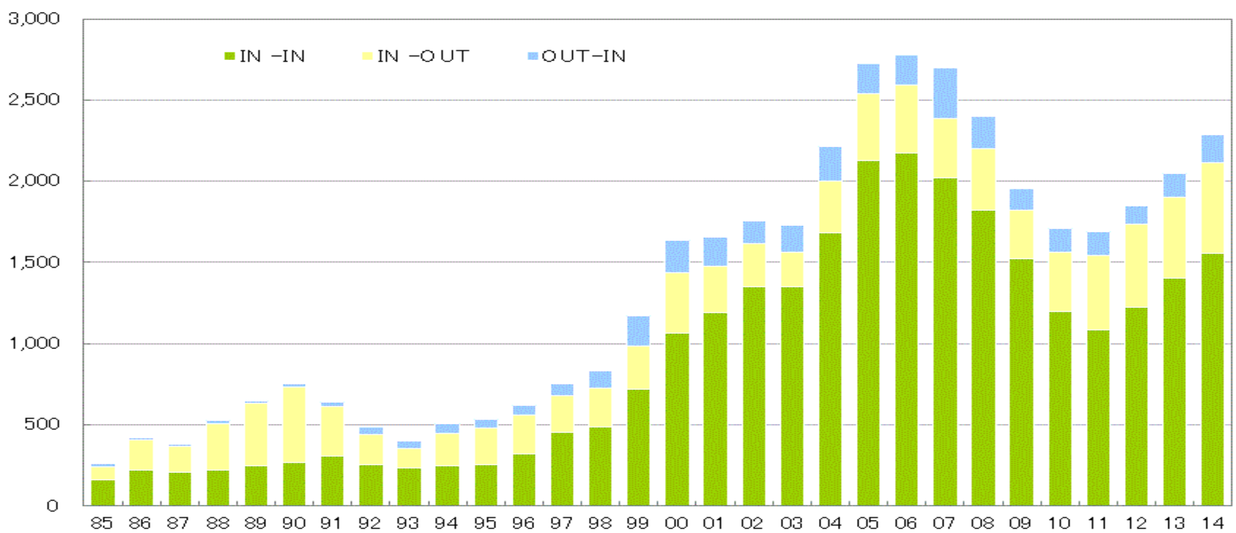
Numerous commentators and investors have written about the successful efforts by the Japanese Financial Services Agency and Tokyo Stock Exchange, Inc. to improve Japanese corporate governance through government lead initiatives that are symbolized by the establishment of Japan's Corporate Governance Code that took effect on June 1, 2015. The combined effects of the reforms at the GPIF, amendments to the Japanese Companies Act, as well as the focus on ROE have been impressive. Global institutional investors have taken notice and continued investment in the Japanese stock market with its high percentage of foreign ownership.

One question is whether these governance reforms will manifest themselves in fundamental long-term business changes, even after the wave of foreign fund investors recedes. In this context, one less mentioned aspect of the reforms, the gradual unwinding of traditional corporate cross-shareholdings of Japanese public company stock, has the potential of transforming the Japanese public company landscape, and even open the doors to a major foreign acquisition of a Japanese public company, at the same time as domestic M&A acquisitions between Japanese corporations has increased.

While traditional xenophobia will continue as to major acquisitions by foreign corporations, such acquisitions or other major investment could increase badly needed foreign investment/FDI. Furthermore, a healthier M&A market with major domestic and foreign players could free up corporate resources trapped in underperforming companies and help increase productivity as Japan faces shrinking market and aging related demographic challenges.

There are so many Japanese corporations, notable recently in the electronics industry, that could have benefited from early restructuring or acquisition, instead of continuing with entrenched management, and becoming an increasing burden on Japan's financial economy through increased (and imprudent) bank borrowing. While foreign acquisitions are said to not be welcome in Japan, one has but to look back to Japan's banking crisis (in the early 2000s) and the failure and subsequent successful acquisitions of major Japanese insurance companies by foreign firms, to see the benefit of active foreign participation in Japan's economy. The work of the Industrial Revitalization Corporation of Japan that resulted in many successful restructurings and acquisitions with foreign participation also demonstrates the positive role in Japan's economy that foreign investment participation can bring.

Japanese M&A market



Source: MARR Online

Cross-Shareholding's Long History

The Japanese tradition of cross-shareholdings needs little explanation as it goes back in time to the earlier control by "Zaibatsu" group control of key industries in order to promote rapid modernization and growth of Japanese industries both before and after World War II. In many ways, such cross-shareholdings were a hallmark of the Japanese economic miracle. This web of ownership, with banks, vendors, customers and group companies holding each other's shares, contributed to stability in management and a strong cushion against the vicissitudes of business cycles. With corporate boards consisting mostly of directors who are current or former executives, reaching consensus is easier.

However, as recent Japanese corporate scandals and the debates on governance reform debate have highlighted, the lack of real shareholder input, as well as the dearth of effective outside director oversight, has also had negative side effects. Commentators have attributed insular management to the lower productivity and competitiveness (compared to international competitors) in many Japanese industries, particularly in the nonmanufacturing sector, including the services industry. The Nikkei and other observers often point out that the average ROE of Japanese public corporations (which is now about 8-9 percent) is far lower than the typical 15-20 percent of their western counterparts. If this "gap" were to be addressed, and Japanese public corporation valuations reach that of their average foreign counterparts, the Nikkei stock index could soar higher in a very short period of time.

Currently there are hopeful signs as 60 percent of major Japanese listed companies have reduced their cross-shareholdings during 2014 according to the Nikkei. All major Japanese banks have announced measures under the Japanese Corporate Governance Code to reduce cross shareholdings. Also, the regional banks have reportedly also been encouraged by regulators to take measures to justify cross-shareholdings as well as to increase their oversight of companies in which they own shares.

Japanese Aversion to Contentious Acquisitions

However, whether it is a domestic Japanese corporation takeover of a Japanese corporation, or a takeover of a Japanese corporation by a foreign buyer, contentious acquisitions will never be easy in Japan. The process to commence a tender offer or proxy battle to replace a majority of the board, in order to complete such acquisitions, is riddled with institutional and cultural obstacles (not the least of which is the very long lead time of over 9 months to place a shareholder proposal on the ballot at an annual general meeting). With the past level of cross shareholdings, seeking managerial change has been largely impossible. This is among the many reasons why since the 1950s there has been no successful hostile takeover of a Japanese public corporation by a foreign investor by a shareholder vote in response to a proxy solicitation or tender offer.

However, with less cross shareholding, there could be fewer shareholders entrenched with current management that would automatically block an acquisition. More effective and independent outside directors may also encourage an objective evaluation of such acquisitions. Even in the use of anti-takeover measures, corporations and their directors will need to be more vigilant as to their fiduciary duties in explaining the business reasoning for any rebuff of an acquisition proposal. Let us hope that this is not wishful thinking.

In any event, more acquisitions, whether contentious or not, will create discipline and focus among management and in Japanese boardrooms. While government guidance is crucial, actual acquisitions, objective evaluation and in some cases change in management control, will be crucial in fundamental governance reform.

Changes Not Easy

Of course, change of this scale does not come easily in Japan. The Corporate Governance Code simply requires Japanese listed companies to provide a detailed explanation of the objective and rationale behind cross shareholdings (the “comply or explain” model familiar in the UK), but it does not ban cross shareholdings. In addition, one sensationalized hostile takeover bid by a Chinese acquirer or an aggressive vulture fund could set back any change by years. However, the benefits resulting from a more open and healthy M&A market where foreign investors will increase their longer term investment into Japan as they can acquire Japanese public companies, participate more actively in their restructuring and assist in their global expansion, are clear and cannot be denied by managers or policymakers. History suggests that only pro-active Japanese government support and advocacy of change of this scale can help halt the long-term decline of Japanese business and its economy.

Fortunately, with the current governance reforms and market trends in Japan, the question may not be if it will happen, but how long it will take to happen.