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Unsolicited Takeover Bids Become a Reality in Japan – Shiro Hayashi

Last August, following the release of the new "Guidelines for Corporate Acquisition" from Japan's Ministry of Economy, Trade and Industry ("METI"), Dalton predicted an increase in unsolicited takeover bids within the Japanese market. Eight months later, this prediction is coming true, with several unsolicited bids emerging, including:

1. Nidec's successful acquisition of TAKISAWA
2. YFO's unsuccessful bid for Toyo Construction
3. Daiichi Life Insurance's successful acquisition of Benefit One
4. Brother Industries' counter bid against the attempted MBO by Roland DG management, resulting in an increase in the MBO tender offer price
5. A-Z Maruwa Holdings' ongoing bid for C&F Logistics, which now has several competing offers

The new guidelines place Boards of Directors under public scrutiny, requiring them to prioritize shareholder interests and corporate value in considering acquisition offers. This is particularly evident in the bids for Roland DG and C&F Logistics. Both cases, despite being in different industries, have made public a previously hidden problem with Japanese board behavior – secretly rejecting takeover offers without shareholder disclosure (in Roland DG's case, the management countered with an MBO). This lack of transparency only became public after the acquirers announced their intentions.

Traditionally, limited management stock ownership in Japan has led to decisions driven by entrenchment rather than shareholder interests. Takeover bids themselves were often seen as "hostile," raising the risk of a quiet rejection based on "cultural differences"

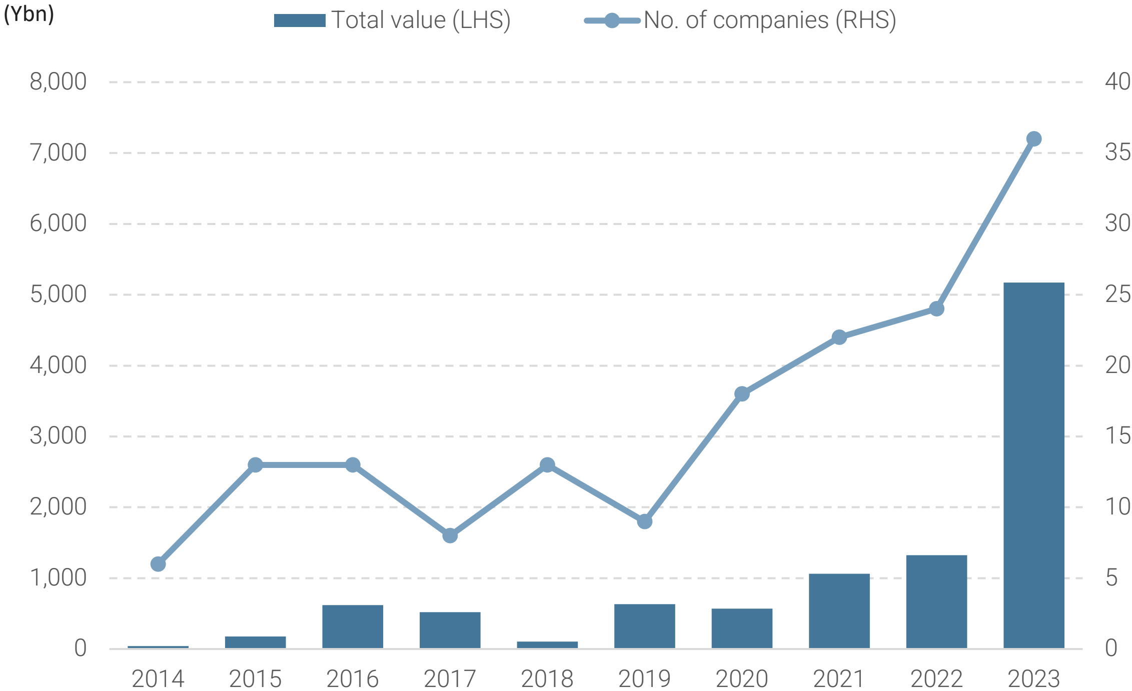
that shareholders could never fully understand. We suspect such cases, though rarely publicized, were likely quite common. A recent example involves Japan Aviation Electronics, where parent company NEC's stock buyback through a discounted tender offer bid ("TOB") was pushed through, despite the company receiving multiple superior takeover bids. Examples such as this show a severe disregard for shareholder interests. The board's actions were criticized and the directors of both NEC and Japan Aviation Electronics may yet be held accountable for their actions.

METI's new guidelines are a game-changer for Japanese corporate governance. They discourage management entrenchment and incentivize boards to seriously consider the unconventional corporate action of "unsolicited bids". While these bold decisions are still uncommon, their impact is significant. Boards that fail to transparently explain their actions regarding takeover offers risk public scrutiny and potential breach of fiduciary duty lawsuits. This serves as a strong message to directors – they have a duty to seriously consider takeover bids or face the consequences of inaction.

The stricter standards required of listed companies has led to an increasing number of listed companies going private (see chart below). This trend is fueled by factors beyond the Tokyo Stock Exchange's leadership, including growing shareholder pressure and the decline or even total dissolution of cross-shareholdings. With regards to cross-shareholdings, Dalton was delighted to see Japan's Financial Services Agency (FSA) recent pressure on the country's nonlife insurance companies to sell down their vast cross shareholdings, a move which would leave many more companies vulnerable to shareholder activism. In this environment, going private has become a more realistic option for management and has injected new vigor into the stock market. Additional fuel has been provided by the record levels of private equity assets in Japan, with private equity firms actively competing for deals and sometimes paying, in our view, premium valuations. Recent examples would be KKR and Carlyle's deals for Alps Logistics and KFC Japan, respectively, both of which closed at a multiple of 16-17x Enterprise Value/Earnings Before Interest Tax and Amortization (EV/EBITDA).

Previously, being listed was a prestigious status symbol for Japanese companies, with minimal costs or risks associated with it. That is no longer the case today.

Chart – Going Private Deals Trend in Japan



Source: Bloomberg

Conclusion

Despite the recent strong performance of the Japanese stock market, in general, the companies listed in Japan continue to trade at a significant discount to comparable global peers. This is particularly true in the small and mid-cap section of the market, which has seen much more limited appreciation due to foreign inflows (which have mostly been in the form of passive ETFs and derivatives). We believe that with the new takeover regulations in place, the Japanese stock market has the potential to evolve into a true market for corporate control. This would lead to stock prices reflecting the value of

control rights, ultimately creating further upside for investors. The willingness of private equity firms to pay EV/EBITDA multiples which are in-line with those paid globally, say 15-20x EV/EBITDA, in a public market where many companies continue to trade below 6x EV/EBITDA indicates that there is material value remaining to unlock.

As an engagement focused manager, the new regulations provide additional tools to Dalton in our efforts to realize the intrinsic values of the companies in which we invest. These tools range from encouraging the leading businesses we own to acquire weaker rivals and consolidate market share, all the way to making bids for companies ourselves. It is truly an exciting time for shareholder activism in Japan!

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