Changing J-type firms and the Role of M&A in corporate governance

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Corporate Finance and Governance: Europe-Japan Comparisons

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Today’s menu

- What is going on in Japanese firms in corporate governance?
- Overview of recent increase of M&A: causes and results
- Characteristics of gov. and M&A
- Implication on current debate

Changing J-type Firms

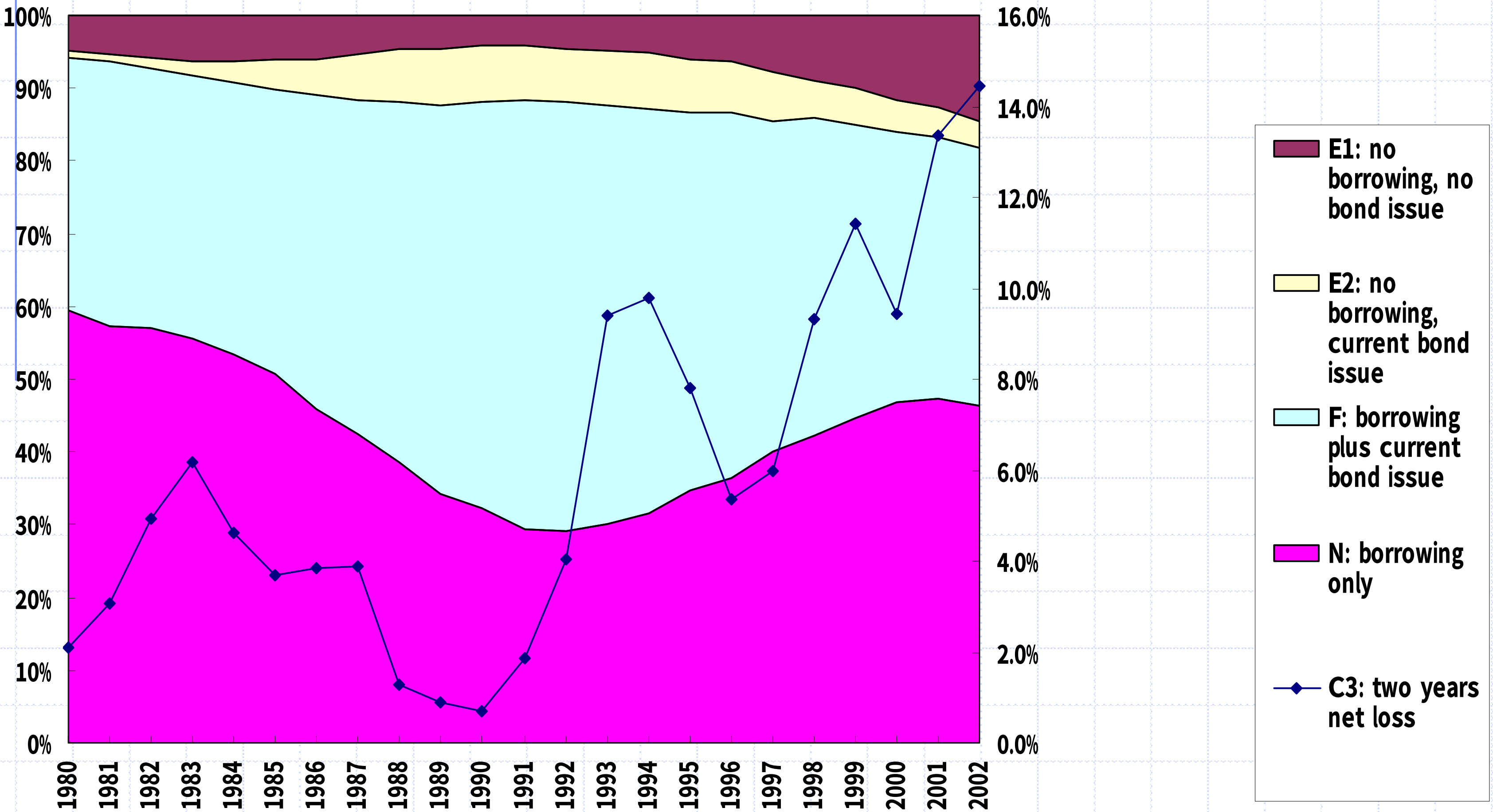
- Japan as a bank-based, relationship-oriented, network, insider, stakeholder or coordinated model of corporate governance (Aoki 1988, 1994, etc).
- Contrast to U.S.-UK style of governance, but had competitive strengths historically
- Solving asymmentric information problem / long-term management

Corporate finance : Main bank relations (Arikawa and Miyajima 2005a)

- Increasing firms without any debt
- Decreasing bank dependence, market base corporate finance.

- Increasing bank dependence
- Increasing main bank concentration (MBR)

Figure 1 Distribution of firms by capital composition and numbers-net loss



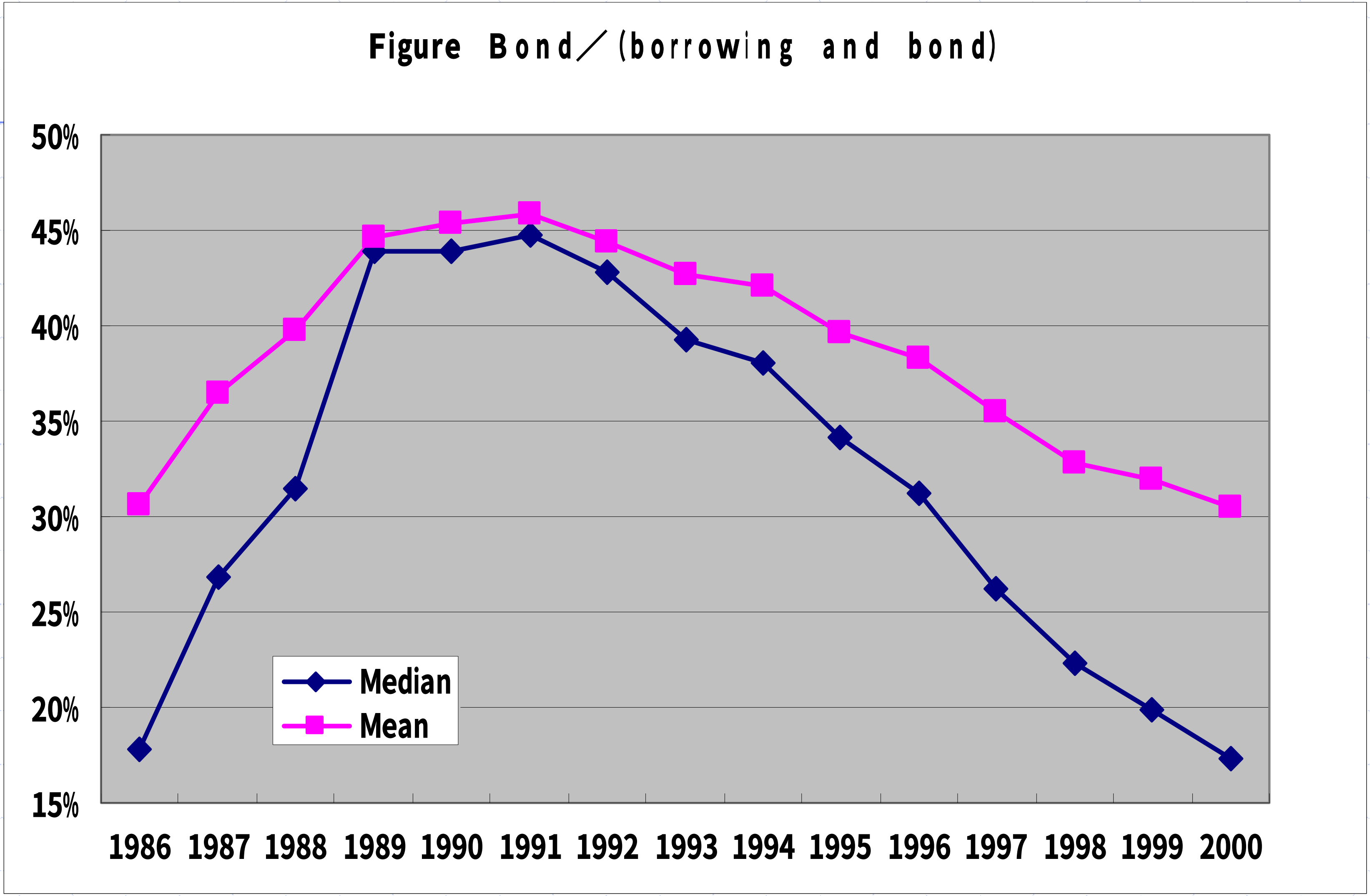


Figure Bond／(borrowing and bond)
50%
45%
40%
35%
30%
25%
20%
15%
1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000
Median
Mean

Concentrated main bank loans

panel 1: Whole sample			
	that is identified as having main bar		
The end of FY	MBR= loan from main bank /total asset		
	Means	median	Std.dev
1987	**5.43**	**4.40**	**5.20**
1988	**5.12**	**4.00**	**5.44**
1989	**4.57**	**3.37**	**4.95**
1990	**4.48**	**3.40**	**4.28**
1991	**4.63**	**3.42**	**4.84**
1992	**4.87**	**3.68**	**5.21**
1993	**5.14**	**3.82**	**5.20**
1994	**5.23**	**3.85**	**5.53**
1995	**5.23**	**3.77**	**5.72**
1996	**5.52**	**3.93**	**6.16**
1997	**5.95**	**4.18**	**6.52**
1998	**6.73**	**4.70**	**7.27**
1999	**7.02**	**4.75**	**8.20**

Corporate finance : Main bank relations
(Arikawa and Miyajima 2005)

- The area where main bank played significant role has been shrinking.
- Discipline of debt no more works, the rise of free cash problems.
- Increasing bank dependence – Non performing problem -- evergreen policy of banks and moral hazard of client firms

Changing Ownership structure : Dissolving cross shareholding

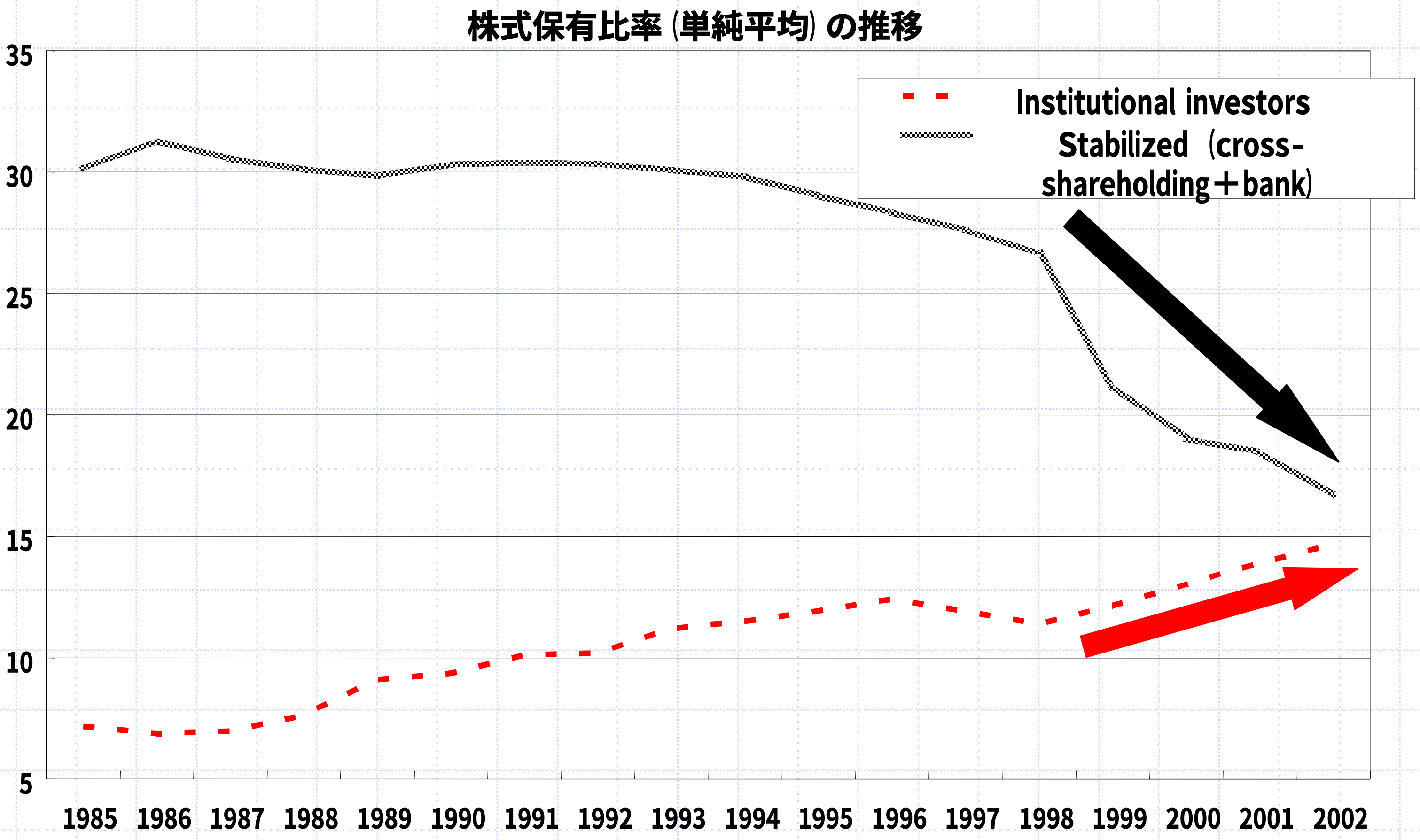
Recent change: (Miyajima and Kuroki 2005)

- Rapid dissolving of cross shareholding
- Cross shareholding among non-financial firms = Relatively stable
- Rapid dissolving between bank and firms (driving force)
- Increasing foreign investors and individuals
- Dissolving did not occur evenly, increasing diversity in ownership structure.

Ownership structure and performance

- Positive effects of foreign shareholder, institutional shareholder
- Large shareholder (parents companies) = not necessary negative
- Bank shareholding = negative to corporate performance (not delegated monitor)

Stable Shareholding and Institutional Shareholding



Board Structure and Incentive schemes

Changes : Board reforms

- The separation between monitoring and management
- Downsizing board of directors
- Outside directors
- The slow of introducing committee system
- Incentive pay – the extent of introduction is still low level

Trends in Corporate Governance Reform (Unit: %)

	Executive officer system		Outside Directors		Stock Options	
	FY 2002 (846 firms)	FY 1999 (1145 firms)	FY 2002 (863 firms	FY 1999 (1138 firms	FY 2002 (864 firms	FY 1999 (1209 firms
Already introduced	33.0	12.8	35.8	30.1	28.1	9.5
Plan to intoduce	2.7	2.3	2.9	1.1	1.9	2.2
Considering introduction	25.8	37.4	32.7	27.3	15.2	25.6
No intention to introduce	38.5	47.5	28.6	41.4	42.7	43.7

Source, MoF Surveys.

Board Structure and Incentive schemes

- Corporate governance reform = positively correlated to firm performance
- IR activities, Downsizing board – high performance
- Outside directors, the US type of board – less clear positive effect

Comparison of Average Performance by CGS Quintile
(Miyajima, Haramura and Inagaki 2003)

	Quintile of CGS	High				Low	Testing
Index		(1)	(2)	(3)	(4)	(5)	the gap
1	Q	2.07	1.40	1.34	1.04	1.03	1.04***
2	Standardized Q	0.92	0.38	0.32	0.04	0.02	0.90***
3	ROA	5.01	4.17	3.38	3.15	2.75	2.26***
4	Standardized ROA	1.39	0.99	0.18	-0.05	-0.43	1.82***
5	Sales growth ratio	5.33	2.63	0.65	8.24	-1.11	6.45***
6	Growth ratio of the # of employees	5.78	1.27	1.79	1.14	-3.06	8.84***

Increasing Diversity

- **J-type firms changed with high diversity, thus no more homogeneous.(Figure)**
- **The relation with outside investor (debt holder and shareholder) converged on the US firms, while internal governance structure (board and incentive scheme) still kept national features.**

Corporate Governance Structure

		the end of FY 1990		the end of 1995		the end of 2000	
		Average	Standard deviation	Average	Standard deviation	Average	Standard deviation
Ownership structure	Institutional investor	9.28	6.87	11.79	8.52	12.89	11.76
	Foreign	4.38	6.79	7.80	8.51	8.13	10.13
	Stabilized shareholder	25.35	11.19	23.71	11.15	18.71	11.41
	cross shareholding	14.63	8.52	14.07	8.41	10.99	8.55
	Individuals	20.62	8.43	22.49	10.10	29.18	14.28
	Ten Largest	45.22	12.07	43.86	12.51	45.01	13.98
	Debt/Asset	51.57	17.77	50.00	19.49	49.60	23.55
Debt	Borrowing from main bank/total	4.61	4.92	5.29	5.77	7.02	8.20
	Number of directors or over	18.72	7.84	17.73	7.66	12.88	6.18
Board composition	Number of directors or over	8.94	4.75	8.39	4.57	6.36	3.71
	Number of anditors	2.94	0.53	3.86	0.53	3.81	0.55
	Number of outside directors	3.69	3.56	3.93	3.65	3.36	3.39
	From Banks	0.69	1.40	0.62	1.18	0.48	0.94
	From Parents firms	1.09	2.46	1.12	2.51	1.00	2.25
	Number of firms introducing the	476 firms/1333 firms(the end of FY 2002)					
	Stock options	333 firms/1333firms(the end of 2002)					

The target of reform

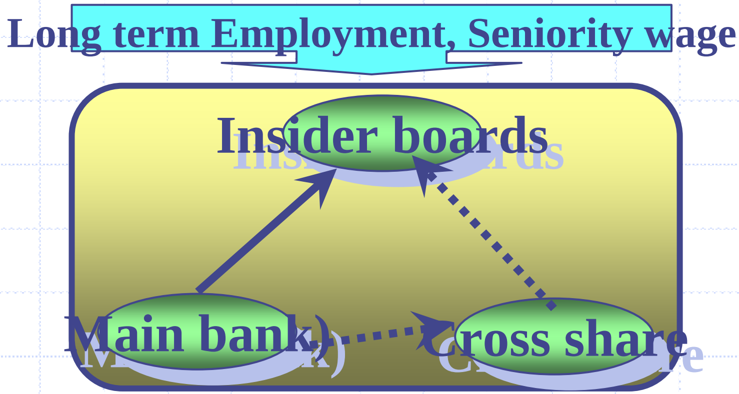
- High performance (High Q) firms associated with market finance, high foreign (institutional) ownership and board reforms.

- Low performance (Low Q) firms associated with bank finance and cross shareholding, low disclosure level and the delay of board reforms

$\Rightarrow$ Target of corporate reforms, less indigenous incentive

- M&A is important for low Q firms

Diversification of J- firm system



Financial Revolution（Increasing capital market pressure）･Technological revolution⇒

Evolution into two types, or variants

A-type firm hybrid

J-type hybrid

M&A in recent Japan

- Increasing number and volume of M&A : 1992=400, 97=700, 02=2200
- Large wave of M&A in the post war history.
- Note: M&A, even hostile takeover, was common in prewar Japan as growth strategy of firms （Example：cotton spinning, paper, brewer, electricity etc）

Characteristics

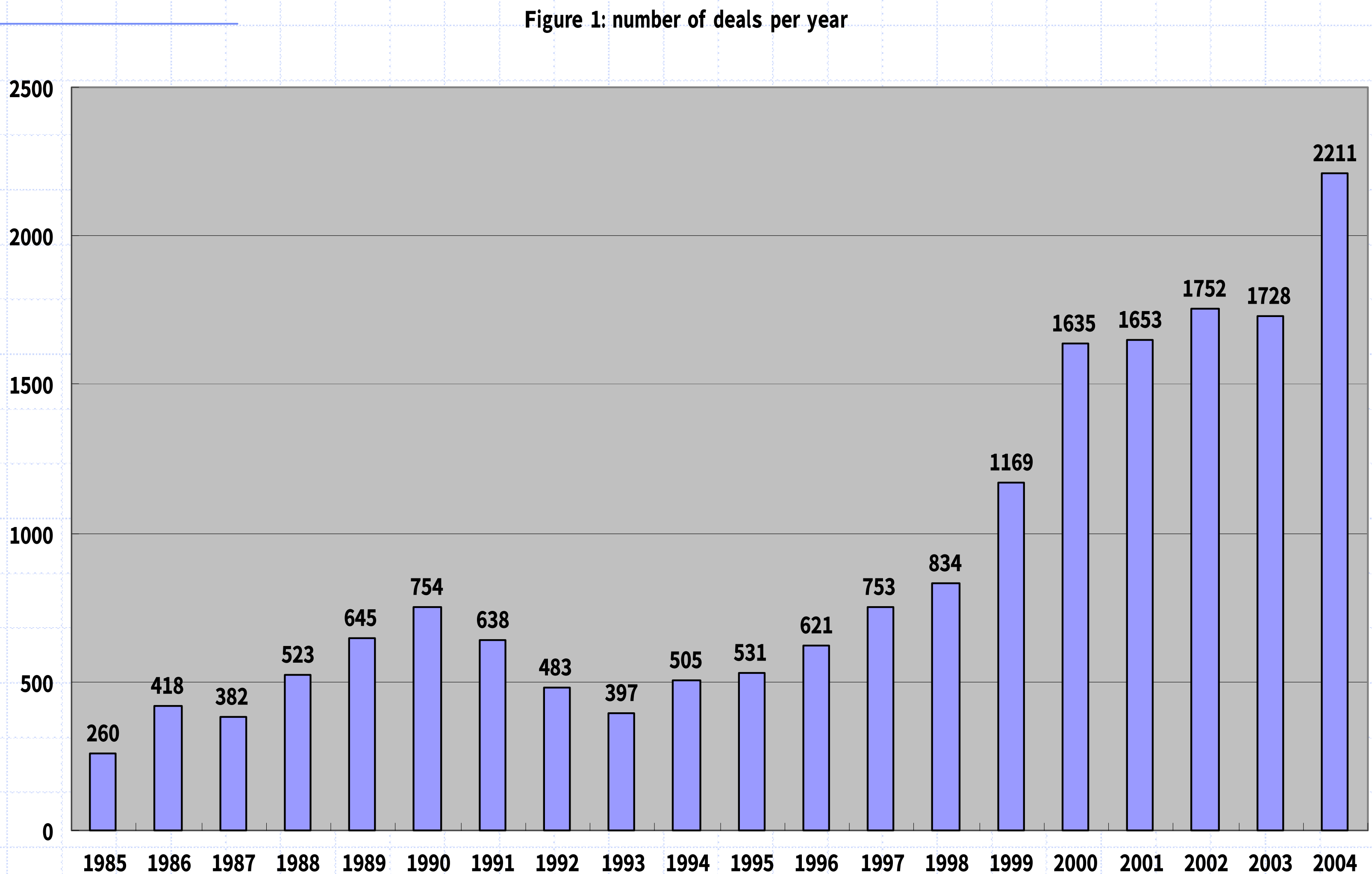
- Main areas: Finance, telecommunication, Electrics, Chemicals

    Top three industries in terms of the number of deals

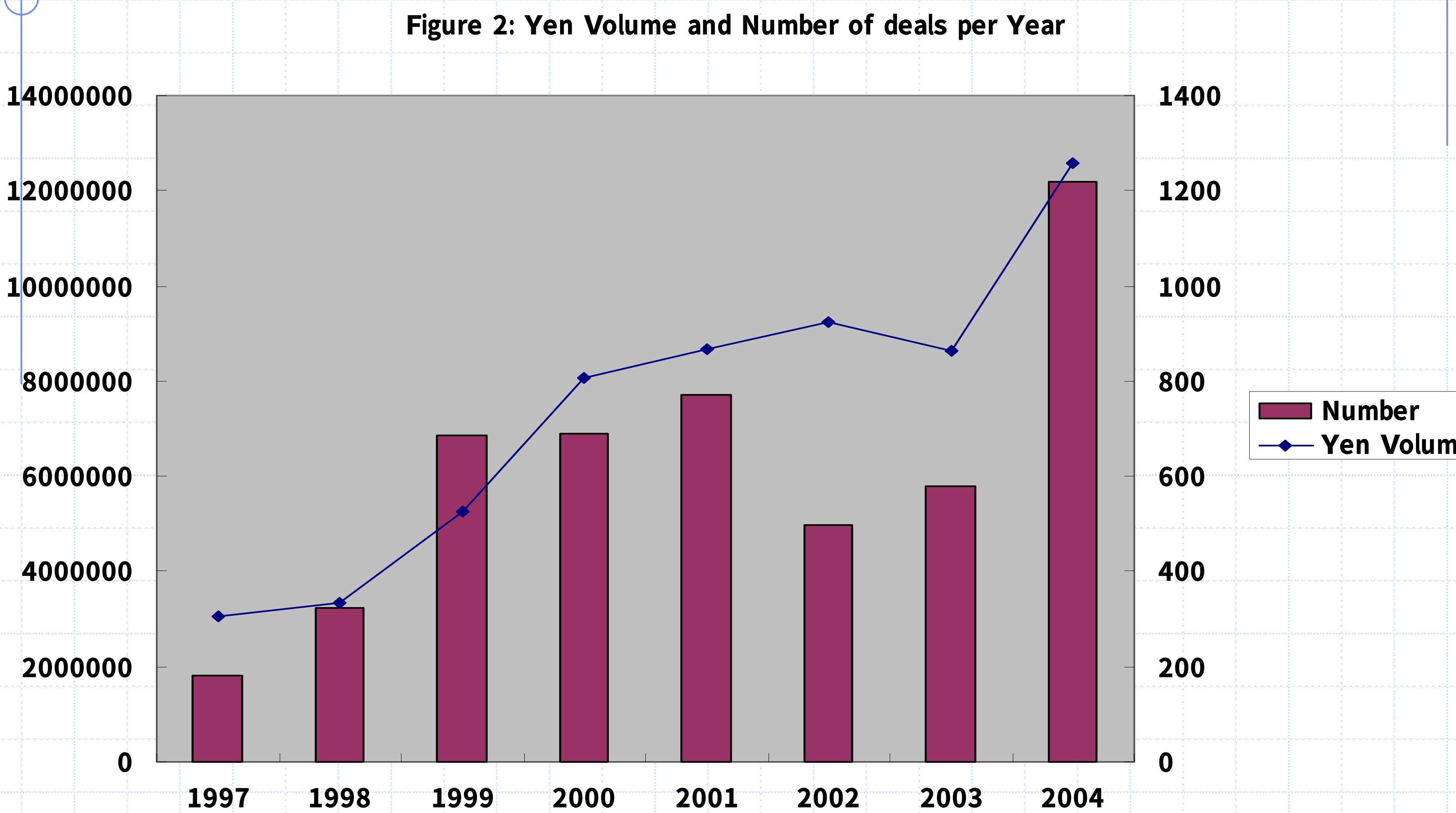
    1. Chemicals 65
    2. Electric equipment 63
    3. Banking 32

- Out-in (Nissan, Vodaphone and Roche)
- Horizontal M&A (JFE)
- Reorganization of group **(listed subsidiary – wholly owned subsidiary)**
- Friendly takeover

The number of M&A Deals



Yen volume and Number of Deals per Year



Why recently increased?

- **Four waves in the US** （Jensen 1993, Michel and Mullheim 1996, Holmstorm and Kaplan 2001)
  - 1920s: Horizontal merger = Market control
  - 1960s: Conglomerate merger wave – firm growth strategy given the strict anti-trust law
  - 1980s: Hostile takeover: Supply shock= Conglomerate discount
  - 1990s: Friendly takeover: Deregulation and innovation

Japan

- The necessity of corporate restructuring (changes in business portfolio)
- Technological innovation / Deregulation
- The arrangement of regulatory framework (Revision of Anti-trust Law, the company law) since the late 1990s

The Effect of M&A

Enhancing efficiency

- **Foreign direct investment (Fukao and Amano 2004) – introducing new know how**
- **Realizing the scale economy by horizontal merger（Iron and steel, paper etc）**
- **Restructuring, enhancing capital efficiency etc.**

The Effect of M&A II

2000-05 emergence of hostile takeover threat

- **Reducing free cash flow (ex. Tokyo Style)**
- **Inducing the dividend policy, financial policy**

  $\Rightarrow$

- **M&A is the efficient way of corporate restructuring/Market for corporate control has began to work.**

The M&A and corporate governance

The volume of M&A in Japan = relatively small

- The world share in M&A deal is small: 5-6%.
- Market Cap.M&A/GDP, 20-30%, compare to the US – 100% (Andrade and Stafford 2004)
- International comparison (Rossi and Volpi 2004): Relatively low level of M&A and less hostile takeover

Volume, the weight of Hostile Takeover, and Premiums

Volume is the persentage of traded companies targeted in a completed deal.
Hostile takeover is the number of attempted hostile takeovers as a % of domestic traded firms
Cross boarder ratio is the number of cross-border deals as a % of all completed deals
Premium is the bid price as a % of the closing price of the target four weeks before the announcement
All-cash bid is a % of the acquisition is entirely paid in cash.

	Civil law countries =○		Volume (%)	Hostile takeover(%)	cross-border(%)	Premium	All-cash bid
Australia	○	212	34.09	4.60	27.16	129.50	0.60
Belgium		7	33.33	0.56	45.14	137.20	0.86
Canada	○	157	30.05	2.73	22.66	132.90	0.36
Finland		7	45.45	0.91	22.67	149.70	1.00
France		112	56.40	1.68	33.81	134.40	0.88
Germany		13	35.51	0.30	26.05	116.70	0.77
Italy		26	56.40	3.04	36.13	127.70	0.88
Japan		73	6.43	0.00	13.25	99.00	0.36
Neatherlands		16	49.82	0.70	46.15	147.70	0.50
New Zealand	○	16	49.82	0.70	46.15	129.20	0.94
Norway		37	61.24	5.86	36.76	136.00	0.76
South Korea		4	4.81	0.00	53.85	145.10	0.50
Spain		10	15.72	0.17	37.55	119.80	0.70
Sweden		45	62.06	3.74	35.48	141.70	0.71
UK	○	614	53.65	4.39	23.46	145.80	0.64
US	○	2443	65.63	6.44	9.07	144.30	0.37
World average (49 countries)			23.54	1.01	42.82	141.60	0.48

Rossi and Volpin (2004)

The M&A and corporate governance

- The Probability of M&A by industry: low frequency of real estate and construction industry
- Structural barriers? (J-type economic system): prevented M&A, resulting in low allocative efficiency
  - Low level of information disclosure
  - Cross shareholding
  - Main bank relations

Tentative Test between M&A and governance structure:

Arikawa and Miyajima (2005b)

- Listed on TSE first section
- M&A data: Deals from 1985 to 2002 in RECOF database.
- Non financial firms
- Focusing on target firms

Estimation : Logit model

Prob(Target=1 otherwise zero) = *F*(q, ROA, SUB,INST,*DAR*, *LDR*, *MBR* , YD)

q: Tobin's q (-)

SUB :ratio of shareholding by parent company(+)

INST: ratio of shareholding by institutional shareholder(+)

DAR: the ratio of debt over total asset(+)

LDR: the ratio of bank borrowing to debt (+)

MBR: the ratio of loans from main bank to total assets(+ or-)

YD: Year dummy

	Discipline by debt				bank dependence				Main bank loan concentration			
Model	1		2		3		4		5		6	
q	-0.777	***		***	-0.815	***		***	-0.777	***		***
	(0.171)				(0.178)				(0.178)			
ROA	-0.057	***	-0.072	***	-0.054	***	-0.068	***	-0.056	**	-0.071	***
	(0.017)		(0.015)		(0.018)		(0.015)		(0.018)		(0.016)	
Sale			0.669				0.510				0.515	
			(0.477)				(0.485)				(0.486)	
SUB	0.761	***	0.668	***	0.779	***	0.681	***	0.778	***	0.677	***
	(0.108)		(0.107)		(0.109)		(0.107)		(0.109)		(0.107)	
Inst	0.035	***	0.024	***	0.035	***	0.023	***	0.035	***	0.022	
	(0.006)		(0.006)		(0.006)		(0.006)		(0.006)		(0.006)	
CF	1.047		0.050		1.029		0.048		0.777		0.064	
	(0.683)		(0.120)		(0.695)		(0.125)		(0.694)		(0.114)	
DARt-1	0.987	***	0.638	**	0.895	***	0.570	**	1.569	***	1.065	***
	(0.270)		(0.257)		(0.287)		(0.274)		(0.348)		(0.321)	
LDRt-1					-0.1703		-0.2742	**	0.0526		-0.101	
					(0.142)		(0.139)		(0.156)		(0.151)	
MBRt-1									-4.798	***	-3.7627	***
									(1.480)		(1.351)	
Size	0.664238	***	0.644943	***	0.64884	***	0.62903	***	0.6161	***	0.59844	***
	(0.037)		(0.036)		(0.037)		(0.036)		(0.039)		(0.038)	
Year Dummy	Yes		Yes		Yes		Yes		Yes		Yes	
Log Likelihood	-1833.71		-1865.4		-1806.6		-1839.4		-1801		-1835	
Pseudo R^2	0.1342		0.1189		0.1301		0.1157		0.133		0.1178	
N	6546		6476		6223		6175		6223		6175	

***, ** and * denote coefficients significant at the 1%, 5%, and 10% levels.

Key Results

- Coefficient of q and ROA is significantly negative

⇒lower q and lower ROA associated with higher prob. of M&A target.

Low profitability in the 1990s leads to the higher probability of restructuring through M&A

- Coefficient of inst is significantly positive

⇒higher ratio of shareholding by institutional investor is associated with higher prob. of M&A target.

Key Results

- Coefficient of total debt is positive

⇒ Higher leverage is associated with higher prob. of M&A target.

- Coefficient of main bank borrowing is negative

⇒ High concentration of main bank borrowing is associated with lower prob. of M&A target.--

Main bank allows firms facing larger performance declines to delay necessary restructuring if its commitment to these firms is high

⇒ Evergreen policy by main bank

Implication on Hostile takeover defense issue

Double edge of M&A:

- Bright side: Restructuring and discipline of management – encouraging M&A
- Dark side: Overvaluation on target (just wealth transfer)/ Greenmail – value destroying – takeover defense

Implication on Hostile takeover defense issue

Two alternatives:

- US –

  * Low regulation of TOB – M&A encouraging

  * Allowing takeover defense (various use of poison pill)

- UK (EU):

  * High level of regulation on bid=Mandatory rule?

  * Strict regulation on takeover defense

Implication on Hostile takeover defense issue

Issues

- In fact, selecting US type.
- TOB regulation: Mandatory rule?
- What should be allowed as takeover defense?
- What is the faire procedure for implementing the poison pills.

Implication I: Excess-defense

- Low Q, bank related, cross shareholding or owner manager (Former J-type firms)
- Main target of reform for keeping allocative efficiency of Japanese economy
- M&A: key of corporate restructuring:

  PE, and threat of hostile takeover

  ↓
- Introducing the mandatory role of TOB–Over defense
- Reviving cross shareholding -- negative

Implication II: lack of appropriate defense ?

- High Q、 market based corporate finance, increasing institutional investors, positive for corporate governance reforms

  ↓

- The needs for the explicit rule == MEIT guide line
- Cross shareholding among firms
- Encouraging to introduce outside directors and the committee system

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