Dr. Hubbard Talk on M&A
"M&A and Revitalizing Japan's Economy:
21st Century Tools for a World Class Economy

Tokyo American Center
March 25, 2005

Introduction

Thank you for the kind introduction, and thank you very much for the chance to speak here today on the important topic of the role of foreign direct investment, and especially M&A in the Japanese economy. As you know, I have been following economic developments in Japan with great interest over the years, and have visited Japan many times. The Japanese economy is tremendously important to the United States, not just as the world's second largest market, but even more importantly as a strategic partner in the world economy. I believe that the economic relationship has never been stronger, and a growing, flourishing Japan is essential to the U.S. economy – and to the world, <also to Japan’s economic standing in Asia and the world.>

I will try to make my remarks brief in order to leave plenty of time for questions (and possibly even answers) at the end. I will first touch on the current state of the Japanese economy, and then talk about the need for more FDI, especially in the form of M&A. After that I will go over the need for new tools for M&A, and finish by touching on the potential for M&A to contribute to Japanese growth and revitalization.

I. Progress of Japanese economy: now critical point

First on the Japanese economy: I'm pleased to say that Japan appears to be pulling out of the economic slowdown of the "lost decade" thanks to a series of important reforms. Corporate restructuring has made significant progress, with corporate debt greatly reduced, and many Japanese companies broadening their economic base in Asia, the U.S. and indeed throughout the world. This structural improvement applies as well to the financial sector, where a great deal of rationalization has taken place: NPLs at major banks look to be down to more manageable levels, no longer posing a threat to the stability of the Japanese financial system. There even appears to be more flexibility in the work force, with less dependence on life-long employment and more evidence of entrepreneurship and job creation -- as evidenced by the reduced unemployment rate, which has come down to 4.4% (comparing favorably with the U.S., and even more favorably with the EU). <Monetary Policy>

I think that another impetus for recovery has been the slow, but steady progress on regulatory and legal reform, which over the past decade has made Japan a much easier place to do business. Naturally it takes time for the effect of structural reforms to show up in actual economic performance, but I believe we are already seeing the first signs. I would only caution that this is no time for apathy! Reforms should continue to be pushed to prepare for increased growth and productivity in the future.

Thanks to this generally positive news, there is a growing perception abroad (including in the U.S.) that "Japan is coming back," and once again open for business as a leading member of the international community and of the world economy. One might say that Japan is now at a critical point: How can it reap the benefits of this new perception by the international community of renewed openness and reform? In the U.S. economy, we have found that measures that facilitate M&A make up an important component of what is necessary to maintain global economic leadership. (1970’s/1980’s in USA)

II. Need for more FDI, especially M&A

I believe that Japan can and should continue to be a leader of the global economy, and this brings me to my second point: inbound foreign direct investment is important as a major factor in revitalizing economic activity. Indeed, FDI should be one of the expected fruits of openness and reform. I think most of you know that the stock of FDI in Japan is still far lower than that of other major industrialized countries, and it is no secret that China receives far more FDI than Japan, resulting in spectacular growth. Japan's two-way trade with the world has flourished. And outward investment has expanded over the years. But: there has been a serious lack of inward investment, leading to what I might term an "investment deficit" for Japan. The stock of FDI in Japan amounts to only 2 percent of GDP, well below other industrialized countries.

At the same time, it is to Japan's credit that major efforts are being made to increase the flows of FDI into Japan: Prime Minister Koizumi has set the goal of doubling the stock of FDI in the five years to 2007. It appears that good progress has been made, but FDI would have to accelerate over the next two years to achieve the goal. That means continuing to build on the new perception of openness and reform-mindedness that I mentioned earlier. I should add that the U.S. and Japanese governments have been working together for four years toward this goal under the U.S.-Japan Investment Initiative. This Initiative has helped to increase public understanding of the benefits of investment. It has also promoted regulatory reform to make greater investment flows possible.

As a result, prefectures throughout Japan are now actively seeking FDI in all forms – including both Greenfield and M&A – and there have been a number of successful high-profile M&A transactions: Among these are Ripplewood's restructuring of the Seagaia project in Miyazaki; Colony Capital's investment in the Daiei Fukuoka dome complex in Fukuoka; Kodak's investment in Nagano; and Wal-Mart's pairing up with Seiyu across Japan. Thinking from the perspective of the people involved, what these all have in common is that they have injected new capital into local economies, saved and created jobs, and added new managerial know-how to companies and projects that were looking for assistance. All of these were friendly transactions, welcomed by the local communities involved, and bringing significant benefits to owners, workers, and community members. <Workers and consumers benefit!>

M&A is an important force for industrial restructuring and improving company performance throughout the developed world. Indeed, most FDI between developed countries is in the form of M&A. Over the past decade the United States received over a trillion dollars in M&A, explaining in part, at least, its continuing dynamism and productivity growth. Many of you will probably remember the boom of Japanese investment in the United States during the 80s at a time when the Japanese economy was hot and the U.S. economy rather cool. Japanese investment helped us to become more efficient and competitive. By comparison, M&A into Japan over the past decade was very small, on the order of 80 billion dollars.

I think it's also worth noting that the Financial Services Agency's new "Program for Further Financial Reform" has established a goal for Japan to "move toward a financial services nation." The FSA program aims to make Japan's financial system one of the world's best – but to do that the financial system must be internationally open. The FSA acknowledges that this effort will be driven by the private sector, not the public sector. The government's role is to grant the market players the tools to make Japan's financial system a 21st century financial system. In the U.S.

economy, we have found that measures that facilitate M&A make up an important component of that bag of tools.

III. New M&A Tools Important

Let me return to my basic question: How can Japan make use of the new perception of openness to stimulate growth? And now more precisely, what can Japan do to attract more FDI, including M&A? Up until now, cross-border M&A has been hampered by the lack of appropriate legal tools to carry out transactions. In the U.S. and Europe as well as in Japanese domestic transactions, an acquiring company will often use its shares to "pay" the shareholders of the acquired company. Shares can be used instead of, or in addition to cash. This option is not available to foreign investors in Japan!

Fortunately, Japan's Cabinet Office, METI and the Ministry of Justice are aware of this and have been working to correct the situation. I was glad to hear that the Cabinet approved last Friday, March 18, the draft legislation for a new Commercial Code revision, which includes tools for cross-border M&A using stock-swaps. This "triangular merger" method is very much like the practice in the United States and in other OECD countries. This is a significant step forward and should provide for profitable new tie-ups between U.S. and Japanese firms and increased internationalization of the Japanese economy.

However, I believe that there has been some confusion in the media over the link between "triangular mergers" between foreign and Japanese companies and "hostile takeovers." The Livedoor case has apparently created quite a stir in the media as well as in the Diet. I was disappointed to learn that as a result, the implementation of the new triangular merger provisions has been delayed! I am afraid that the delay will disappoint potential investors in Japan and cause them to reassess Japanese perceptions of a new openness in Japan. This decision also runs counter to the Prime Minister's much-publicized goal of doubling the stock of FDI in five years. Slowing foreign investment will necessarily take a toll on Japanese growth. Implementing the M&A provisions and other measures to open Japan's economy will, by contrast, have a positive effect on growth.

There is no logical link between the proposed "triangular merger" technique and the perceived threat of hostile takeovers. The proposed commercial code revision does not appear to increase the feasibility of hostile M&A activity in Japan. A triangular merger would still require shareholder approval of an extraordinary resolution with two-thirds majority, a rule the commercial code revision will not change. While it is theoretically possible to get a two-thirds majority of shareholders in favor of a resolution not supported by management, it is highly unlikely even in the U.S., much less in Japan. As METI has said many times in public fora, triangular mergers are designed to benefit "friendly" mergers and acquisitions.

There has also been considerable debate in Japan recently on the need for "poison pills" and other "defense mechanisms" against hostile takeovers. I can only note that defense mechanisms have fallen somewhat out of fashion in the U.S. and the EU, largely because they may reduce corporate value when instituted, and they are sometimes used to protect members of management from the discipline of the market. The best defense against a hostile buyout is high corporate value as reflected in high stock value, enhanced by good management and quality corporate governance.

IV. Potential of M&A for Japan

Finally, let me talk briefly about the potential for more M&A in Japan and the associated benefits. It is no longer a secret that there are many investment opportunities in Japan, and many U.S. and other foreign firms are now very interested in helping to reduce Japan's "investment deficit." Last week's Wall Street Journal carried an article talking about how investment bankers are "flocking to Japan," noting that both domestic and foreign M&A are increasing rapidly. This is a healthy sign, and bodes well for the Prime Minister's goal of doubling investment in five years. In fact, this goal – while ambitious – is insufficient. The level of FDI in the U.S. is six times that of Japan, and the level of FDI in the U.K. is more than ten time Japan's level. The combined value of all of the high-profile deals in Japan that I described a moment ago – Ripplewood, Colony Capital, Kodak and so on – pales in comparison with the value of Japanese automakers' investments in the U.S. So there is considerable room for growth!

There is an opportunity in the present situation: It is clear that there is a great deal of Asian regional competition for investors: China, Korea, Taiwan, and ASEAN are all very attractive competitors. RGH Traveled throughout the region to see Columbia alums. At the same time, they lack some of the special characteristics that make Japan attractive: a safe and secure environment, rule of law, advanced infrastructure, a highly skilled workforce, and an affluent consumer society. M&A can help parlay these special Japanese characteristics into international business partnerships that are so necessary to maintaining competitiveness in the modern world.

Let me close on that positive note, and I will be happy to take your questions and hear your comments.