By J Ryan Dwyer, III and Grant S Tanabe, ***K&L Gates***

Against the odds

Despite the negative impact of the March 11 earthquake on Japan's economy, Japanese corporations appear willing to loosen their purse strings and invest abroad, say J Ryan Dwyer, III and Grant S Tanabe of *K&L Gates.*

The triple disaster

This year has not been kind to Japan. On March 11, the country's Tohoku region was hit with a triple disaster: an earthquake, tsunami, and nuclear crisis. Estimates of the physical damage as reported by Japan's Ministry of Economy, Trade and Industry have ranged from US$195 billion to as much as US$305 billion, which is roughly the equivalent of the GDP of Greece. The release of radiation from the crippled Fukushima Daiichi Nuclear Plant has brought further consequential damage in the form of rolling blackouts, banned agricultural and other products, and disruptions in global supply chains.

The economic impact of the triple disaster has clearly been felt not only in Japan, but throughout the world. Global corporations such as Sony had to temporarily close seven damaged plants which produced digital video discs, lithium batteries, optical devices, and other items that were sold throughout the world. Japanese automakers with manufacturing plants in the US will be unable to assemble a sufficient amount of complete automobiles for the US market because many parts such as the engine and transmission are imported from factories in Japan that have been damaged by the earthquake. Overall, Morgan Stanley MUFG Co. Ltd., has forecast a short and deep recession with the economy shrinking by between one and three percent in 2011.

Interestingly, however, the triple disaster may actually stimulate outbound M&A activity. Many would expect that the negative effects of the triple disaster on the Japanese economy would hinder any outbound M&A activity, but in certain industries, it is expected that there will be a rise in the number of Japan-outbound M&A transactions following the earthquake. The logic expressed by securities and M&A advisory firms is that due to the disruptions in the supply chain for certain manufacturing companies, many companies are looking to diversify the location of their resources and are actively seeking to disperse their operations outside of Japan. The earthquake has in fact "forced" Japanese companies to look outward rather than inward, which combined with the following financial, demographic, and macroeconomic factors, will likely result in an overall increase of outbound M&A for 2011.

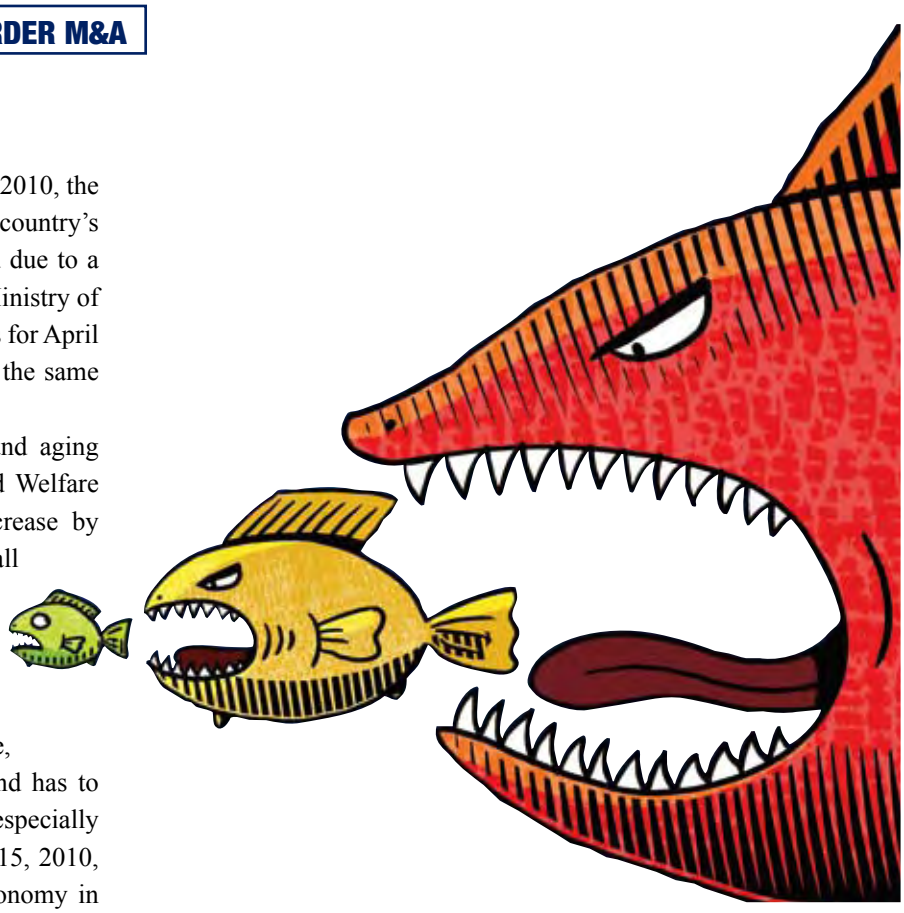
Strong yen, future reduction in labour force, and pressure from Asia

As a country, it is well-known that Japan faces significant financial, demographic, and macroeconomic issues. The yen reached an unprecedented level of 76.25 yen/US$ on March 17 before weakening slightly to the 80 yen level after the Group of Seven Industrial Nations agreed to cooperate and stand by in support of the Bank of Japan's intervention in purchasing large amounts of US currency. A strong yen means that Japanese products will be more expensive overseas, which has a dampening effect on

Japan's export-driven economy. In the autumn of 2010, the Japanese government stated that it expected the country's economy to remain weak for a prolonged period due to a decline in exports as a result of the strong yen. Ministry of Finance statistics indicate that the value of exports for April 2011 was down 12.7 percent when compared to the same month last year.

Japan is also confronted with a declining and aging population. The Ministry of Health, Labour and Welfare has estimated that Japan's population will decrease by approximately 30 percent by 2055. With the overall decrease in population, Japan's labour workforce will continue to shrink, and Japanese companies will no longer be able to rely on its citizens to prop up the country.

Finally, from a macroeconomic perspective, Japan is clearly feeling pressure from abroad and has to deal with increased competition from Asia, especially China and India. As widely reported on August 15, 2010, China surpassed Japan as the second largest economy in the world as Japan's economy was valued at US$1.28 trillion in the second quarter, which was lower than China's US$1.33 trillion. India's economy has also grown substantially with GDP growth of 9.1 percent in 2009, exactly the same as China's. Japan in 2009 experienced a contraction of GDP at a rate of negative 5.2 percent. India also benefits from its population of 1.2 billion people with an immense workforce consisting of 58 percent of the population categorised as being economically active.



Resulting M&A trends

Strong Yen

With the yen at levels unseen for more than 15 years, an interesting and logical trend has developed: Japanese corporations are taking advantage of their increased buying power and spending large amounts of cash abroad. In fact, according to the *Economist,* many Japanese corporations have stockpiled their cash and have built up their reserves to total more than US$2.4 trillion, and with the strong yen in mind, many major Japanese corporations have allocated large amounts of funds for acquisitions in 2011. For

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example, Fujitsu has apportioned more than US$1 billion, and Asahi Breweries has designated US$9 billion for M&A foreign deals. Additionally, other Japanese companies such as Takeda Pharmaceutical Company Limited, Canon Inc., and Sony which have been active in acquiring foreign companies, all have excess cash in the amounts of US$9.2 billion, US$8.6 billion, and US$6 billion, respectively. Takeda Pharmaceutical Company Limited has already fully tapped into its reserves, as it was reported on May 12, 2011 that the company reached agreement on a US$12 billion deal to purchase the Swiss pharmaceutical company Nycomed, which is the largest acquisition ever by a pharmaceutical company.

According to Reuters, much cash has already flooded the market in 2010, and the total value of outbound M&A was US$3.5 billion for the first nine months, which was double the figure for 2009. As the above budgeting and activity by Japanese companies indicate, it appears the trend will continue for 2011.

Future reduction in labour force

With Japan's shrinking domestic labour force, global-minded foreign employees will be in high demand, and Japanese companies have begun looking towards acquiring foreign entities as a means of not only bringing such talent into the Japanese company, but also providing an opportunity for the company to train its Japanese employees abroad.

For example, Rakuten, the largest Internet mall operator in Japan, has begun the process of hiring foreigners and announced it will bring aboard 150 foreigners among 600 new recruits it plans to employ in the 2011 fiscal year. Rakuten's business strategy is to expand into 30 different countries, and in line with this strategy, it recently acquired two foreign entities: Buy.com, a leading U.S. online retail marketplace, and PriceMinister S.A., the most visited e-commerce site in France.

Pressure from Asia

Adding to the movement to be more global is the intense competition coming from Asia, which has pressured Japanese companies to look overseas to grow, restructure, and increase profitability.

Kirin is another great example of a company which is looking beyond the borders of its domestic market. Due to sluggish domestic sales, Kirin Holdings Company's corporate strategy is to generate 30 percent of its sales and profits from markets outside Japan – primarily in the Asia and Oceania countries – by 2015. Kirin's latest purchase of 14.7 percent of Fraser & Neave, Singapore's biggest soft drink maker, for US$984 million is a reflection of its strategic goal of establishing growth and facilitating greater synergy with group companies outside of Japan.

Indeed, despite the triple disaster that has temporarily disabled Japan's economy, for the last half of 2011 and beyond, the financial, demographic, and macroeconomic indicators all suggest that Japanese corporations, whether out of necessity or not, will be loosening their purse strings and indulging in attractive outbound M&A transactions.

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