

# **Japan Corporate Restructuring: Does The Sun Always Rise in the East?**

*by John F. Tsui*

Mired with thousands of “zombie companies” that are on life support, corporate bankruptcies are occurring at an unprecedented rate. Bad news after bad news strap the headlines – “Half of Japan’s six major non-life insurers posted losses totaling \$2.3 billion due to hefty valuation losses on securities holdings”, “Land prices in Tokyo continue to spiral downward reaching 1984 levels”.

The cost structure of Japanese companies is excessive. General and administrative expenses to revenue is 2.5 to 3 times the size of any comparable US company. Corporate debt to equity still hovers over 300%. And layers and layers of middlemen and distributors squeeze profits in the entire supply chain of vendors. From the time a fish arrives in Tokyo’s fishmarket until the time it reaches your table at the sushi bar, as many as 26 middlemen were involved. With Japan’s myopic corporate focus on sales growth and asset growth, it is no surprise that over 40% of all listed companies on the Tokyo Stock Exchange earn less than 1% after tax on their assets.

Sub-performing and non-performing loans are draining the lifeblood of the Japanese economy. While \$64 billion in book value of NPL were disposed of since 1997 among the 12 major banks, an estimated \$133 billion of new non-performing loans surfaced during this period. The FAS estimated \$275 billion of problem loans, but Goldman Sachs put an estimate close to \$2.6 trillion. An amazing 60% of Japanese listed companies trade at market capitalization lower than their asset value.

## ***Management Buy-ins and Distressed Investing: Minefield or Goldmine***

According to an old Chinese proverb, “ You cannot catch big fish in still, clear water”. According to Nihon Keizai Shimbun, corporate restructuring funds targeting Japan will top over \$8 billion in 2003 with enough gunpowder to acquire \$25 billion of businesses. Compared to the volume of American buyout transactions - \$33 billion in 2002, the Japanese buyout market is much smaller, with 39 deals completed in 2002 with a corresponding transaction volume of \$900 million.

Private equity and management buyout industry spawned in 1995. The sharp rise in MBO is due in part to the underlying weakness of Japanese companies and the concomitant rise in corporate restructuring and spin off of non-core subsidiaries. Though the prevailing low interest rate have helped fuel equity returns, the lack of deal flow is the biggest problem facing private equity players. Buyout transactions under \$20 million are brisk. But middle market deals in \$100 - \$300 million capitalization are quite competitive and few to speak of.

Certainly there is an expectation gap between the typical returns expected by US buyout groups compared to the historical legacy of low equity returns in Japan. Japanese sellers generally look for investors that bring operational value added and not just purely capital. And capital alone is not the panacea. The lack of qualified professionals in the distressed turnaround profession hinders the pace in which restructuring and corporate renewal takes place.

## ***Gaishin-ization of Japanese Companies – Strategies to Revitalize***

Gaishin is defined as western ways. Japanese companies have an old world, feudal and even tribal character. Corporate boards are packed with insiders who have been in place for decades. And business arrangements and investments are often maintained not for economic or strategic reasons but because of family ties, long standing relationships with suppliers and distributors and loyalty to employees.

The maturation of businesses in Japan is requiring Japanese executives to be change agents and foster process change management. As Japan moves from Keiretsu to Gaishi style management, there will be greater adoption and acceptability of Kaiko (firing), Kitsui (demanding) and Kyoso (competition).

### ***Turnaround Surgeons: Strategies for Revitalization of Japanese Companies***

Construction, retail trade, real estate, transport, finance and insurance are among the first casualties of Japan's economic demise. According to Tokyo Shogo Research, manufacturing sector bankruptcies are now pervasive and are leading the second wave of restructuring.

The need for turnaround professionals is rampant. But neither the banks nor the debtors are willing to pay professional fees to retain

turnaround professionals. Specialists such as buyers of receivables and inventory, DIP lenders, lease liquidators, GOB sponsors and exit financing providers are virtually non-existent. For the most part, when a debtor company is facing liquidity problems or in default of a secured loan, typical remedy is to second a bank officer to be the interim manager in hopes of effectuating a turnaround strategy. Operations remedies may encompass senior executive replacement, liquidity concerns, vendor/supplier relationships, cost reductions initiatives, disposition of non-core assets, real estate spin-off and/or sale leaseback, outsourcing, off-shore production, supply chain optimization.

### ***Real Estate as a Source of Liquidity in Corporate Workouts***

Real estate represents a significant percentage of total assets of Japanese corporation. It is not uncommon to uncover as much as 50%. Land alone make-up on average 23% of corporate assets. Liquidation of non-core assets such real estate will be integral to the corporate revitalization. The impairment accounting rule to be introduced in 2004 will further accelerate real estate spin-offs.

### ***Legal, Accounting and Labor Issues in Corporate Failures, Restructuring and Bankruptcy***

As cross-shareholding unravels and assets are marked to market, the speed at which troubled banks work out and purge out bad loans from moribund companies will accelerate. The raison d'être in Japan relating to turnaround strategies involves out-of-court workouts, debt for equity swaps and DIP financing. Keep in mind that Japan's business culture is rooted on relationships and trust. That may be why the accounting profession employs 13,000 accountants compared to 350,000 in the United States and 120,000 in the United Kingdom.

Government officials and bankers alike are showing signs of getting serious. Record number of bankruptcy filings are occurring because the financial life support provided by its creditors are finally being severed. What's certain is that corporate restructuring and the resolution on problem loans will occur over the remainder of this decade. With a third of the world's savings held in Japanese hands, the world should not underestimate the capacity and the will of Japan, Inc. to effectuate a turnaround – the Japanese way at the Japanese pace.

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