Trends of FDI in Japan for 2009

By Robert GRONDINE

The deepening global recession raises many difficult questions for both international business and governments around the world as to how to cope with these drastic reductions in consumption and corporate investment in order to be able to revive each national economy as soon as possible. So companies are aggressively reducing debt and conserving – some would say even hoarding – cash by slashing expenses, reducing employment and either canceling or postponing significant new corporate investments across the board. The current global economic projections all increasingly point to this trend continuing at least to the beginning of 2010. All of those influences will directly depress the amount of global M&A transactions that will be seen in 2009 and into 2010.

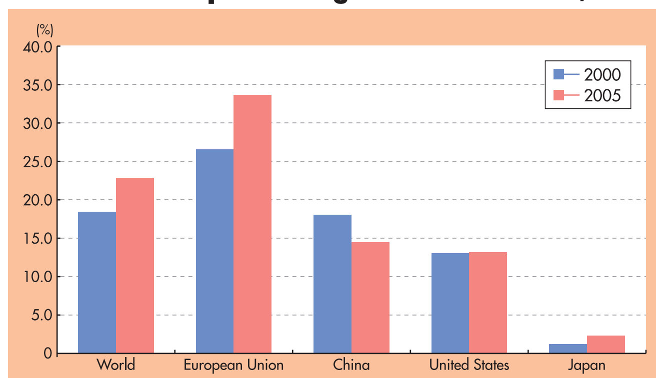
However, within that global trend there will undoubtedly be variations. Cash-rich companies with access to reasonable amounts of debt will be in an enviable position to be able to acquire assets without many competing bidders, at very reasonable prices in this economic environment. Companies that have weak access to operating funding or whose cash flow is impaired by reduced sales or by their banks demanding debt repayment will be forced to sell assets in order to survive – even at the currently unattractive price levels. International currency values have been undergoing very rapid swings as well during this period as investors repatriate their funds to protect their home base operations and repay debt. How do all of these trends potentially affect the level and pace of international foreign direct investment (FDI) into Japan for this period?

Recent Background

In the period 2000-2007, the administration of Prime Minister Junichiro Koizumi issued its “Double FDI” policy to address what had become an increasingly glaring problem that FDI into Japan was less than 2% as compared to the nation’s gross domestic product, the measure most commonly used for this factor within the OECD. Whereas all of the other major economies in the world had FDI levels in double digits and in some cases reaching as high as 30% in Germany and Britain, Japan’s FDI level had been extremely stubborn at this anemic base. Even China and South Korea have built their FDI base very significantly in the period since 1995 to substantial double-digit levels *(Chart 1).*

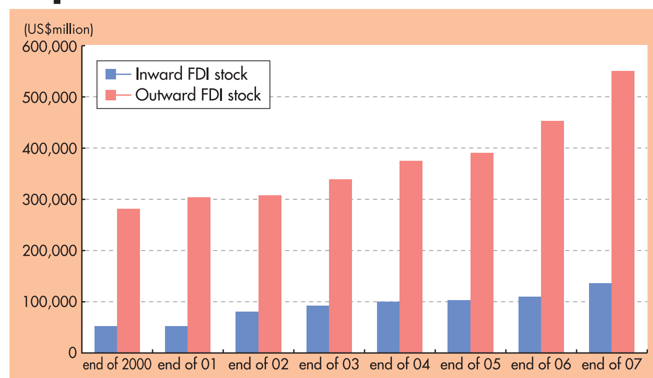
Prime Minister Koizumi’s government set out to double Japan’s FDI base in a five-year plan period to 2005-2006. Through positive changes to the Commercial Code and then the adoption of a completely new and modernized Company Law in 2006, as well as strong information campaigns and efforts to assist foreign companies with their new investments into Japan by matchmaking services, low-cost loans and facilities and facilitation of cross-border M&A activities, Japan did manage to meet this FDI-doubling goal in 2006. The government of Koizumi’s successor, Shinzo Abe, then reaffirmed and renewed that goal to again double FDI within the following five years. The first Koizumi doubling plan had the great fortune to coincide with the years 2003-2005 when the global M&A market and global economies were in a positive growth mode after recovering from the IT bubble implosion in 2001-2002 and the effects of the September 11, 2001 terrorist attacks in the United States. As a natural result of the ebullient global investment environment in those years, FDI into Japan demonstrated significant year-on-year increases. In the opposite direction, Japanese investments abroad were low due to (i) the negative effects on Japanese corporate balance sheets of the 1990s “Lost Decade” and especially the weak balance sheets of Japanese banks, impairing the equity and debt appetite and capacity of Japanese companies and (ii) the wider availability of acquisition finance to international companies,

CHART 1
FDI stocks as percentage of GDP in 2000/2005



Source: World Investment Report 2006, OECD

CHART 2
Japan’s total FDI in 2000-2007



Note: Figures were first released in Japanese yen and converted to US dollars using Bank of Japan average interbank rates for the applicable period.
Source: Prepared by JETRO from Ministry of Finance and Bank of Japan balance of payments and cross-border investment statistics and Bank of Japan foreign exchange rates

private equity and other investment funds to make their bids more competitive at higher prices than the Japanese companies could usually muster *(Chart 2).*

Thus this period of 2000-2007 could be seen as one of the most active and successful periods ever for FDI into Japan. However, with the severe downturn of the global economy in 2008, new cases of FDI into Japan have been falling rapidly. Coupled with the rapid appreciation of the yen against not only the US dollar but all other currencies from mid-2008, how will these macroeconomic trends affect the ability of the Japanese government to meet the second FDI-doubling goal that had been affirmed by Prime Minister Abe in late 2006?

Reversal of Perceived Trends in 2007-2008

Starting from 2007 with Vodafone's sale of its Japan investments to Softbank and the sale of GM's investments in Isuzu, Fuji Heavy Industries and Suzuki, the new incoming FDI was to a significant degree offset by these and other substantial divestitures. At the same time and to some degree related, the increase in outward investment by Japanese companies also overtook the figures on net new foreign investments into Japan. This dual phenomenon gave rise somewhat to an impression globally that new investment into Japan had fallen dramatically in 2007.

At the same time amid the controversies over investments by Steel Partners Japan Fund into Sapporo Beer, Bull-Dog Sauce and other companies, as well as the *tsunami*-like trend of hundreds of Japanese companies adopting "poison pill" defenses under the new Company Law from 2006-2008, totaling to date well over 500 companies representing a very significant percentage of Japan's publicly listed companies, a strong perception began to arise globally that Japan had suddenly become inhospitable to foreign investment.

But quite the opposite, at the practical level, M&A activity continued to spur increases in FDI into Japan during that period on an active basis. The very successful acquisition by Citibank of Nikko Cordial to rescue it from possible insolvency after disclosure of its accounting scandal in late 2006 was truly a landmark transaction where for the first time a foreign company succeeded in purchasing one of Japan's blue-chip financial institutions. This Citi transaction took the form of a two-step acquisition, first for Citi to acquire in excess of 70% of the ownership of Nikko Cordial by an open market publicly registered friendly takeover bid (TOB), and then later using the newly approved triangular merger structure under the Company Law to squeeze out the remaining shareholders of Nikko Cordial to make it a 100% subsidiary and privately held company in Citi Group as a subsidiary of Citi's newly established Japan holding company.

As a net result, however, new FDI growth as a percentage of GDP has begun to go in reverse in this period, primarily due to the size of the divestitures. Now with the severe global economic downturn depressing global M&A generally, and with the sudden extreme appreciation of the yen, what should be the expectation for new M&A activity to build Japan's FDI base in the 2009-2010 period?

New Targets of Opportunity

Notwithstanding these rather dismal global trend outlooks, I remain quite optimistic for new FDI into Japan in this 2009-2010 period, especially through M&A. There are three basic reasons underpinning this optimistic view.

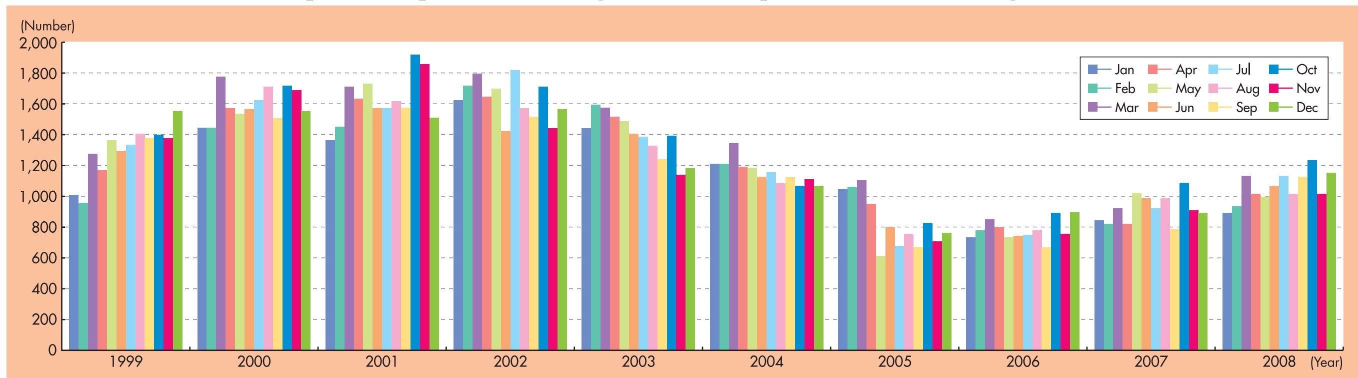
First, precisely because Japan's FDI base as a percentage of GDP continues to be so low, this represents the fact that global investors and especially strategic investors remain very seriously under-invested in the Japanese market. The Japanese market of course continues to be the second largest single integrated economy in the world. Major global industries need to have a greater presence in this market for improving their global consumer market penetration. Many industrial groups that are leading global competitors in autos, heavy machinery, electronics and other leading-edge high-tech industries are based here in Japan. Suppliers to these global industrial giants need to increase and improve their platforms in Japan to be able to effectively supply these companies on a stable and advantageous basis. Although there is likely to be a severe reduction in the amount of M&A and investment into the Japanese financial services market as a result of the global crisis in financial institutions, still that should be more than compensated by new acquisitions and investments by international companies into the auto parts, precision machinery, healthcare and other key industrial and consumer sectors.

Second, the global economic downturn is having an equally if not greater negative impact on Japanese companies along two lines. The first impact is that Japanese companies seem to have been disproportionately adversely impacted by the global credit crunch due to their concentration in the high-value-added (namely "most expensive") market segments. When US consumers have not been able to borrow money to buy Japanese cars, televisions and other high-end items, these rapidly dropping sales in North America and Europe, combined with an equal consumer slump in Japan, have meant a massive negative impact on the Japanese economy to the level of an annualized 12.7% GDP contraction as measured in the period of September-December 2008. As a result of this first impact, operating profits have disappeared, cash flow is impaired and Japanese companies (just as Japanese consumers) have begun to hoard cash to try to soldier through this downturn. The second impact in Japan has also been a very severe credit crunch quite like had been experienced in the worst stages of the late 1990s. The number of bankruptcies has been increasing rapidly in Japan over the past six months, with predictions that the number will grow substantially higher for the next 12 months. Cash shortages at even major Japanese companies have led to major Japanese banks calling in loans from smaller customers and focusing their lending capacity toward their major corporate customers. The direct result will be large numbers of bankruptcies in Japan's small and medium-size businesses *(Chart 3).*

Third, as a direct result of the above deepening Japanese credit crunch, and just as the first real FDI surge in Japan in the late 1990s was fueled by broad availability of assets to foreign purchasers for

CHART 3

Number of bankruptcies per month/year in Japan for last 10 years



Source: Teikoku Databank

the first time, this currently building wave of new bankruptcies should place a large volume of attractive assets into the market for acquisition. As Japanese companies are pushed to the brink, they will be increasingly open to friendly acquisition proposals from foreign suitors who can bring them (a) greater economies of scale in procurement and distribution, (b) new technology and management expertise that can again drive production and distribution economies, (c) access to new markets and customers to also build on economies of scale and (d) access to critical new sources of equity and debt finance. These opportunities for mutual benefit should produce attractive global alliances by Japanese companies and acquisitions by major international companies who are still seriously under-invested in the Japanese market.

Pessimists will say that the very high value of the yen could derail such acquisitions because of high prices, but the high yen will be offset by seriously reduced asset prices and lowered multiples against low profits that will produce enterprise valuations far lower than in any recent memory. Moreover, once past the purchase price stage, the high yen value actually becomes an attraction to the foreign purchaser when the continuing revenue flow from the acquired company's operations translates into larger financial contributions to the international company's financial results and balance sheet. So, all in all, the high yen could be viewed as a net positive benefit rather than only as an entry-level negative hurdle.

Important Rare Investment Oopportunity

The 2009-2010 period is thus shaping up to be a very significant buying opportunity for major international industrial and investor groups who remain under-invested in this important market. Japanese technology remains at the leading edges of global technological development in many fields. Major leading Japanese manufacturers will be looking to preserve and enhance their network of stable suppliers in Japan and globally. By investing into Japanese supplier platforms that can be integrated into the global group, international suppliers can gain a global entry point into these major Japanese manufacturing operations to a degree that has been largely impossible to this date, while at the same time also acquiring new technology and resources from these Japanese bases. In light of the heavy investment by Japan into China in the last 10 years, acquisitions of some Japanese companies will also bring with them manufacturing capacity in China that can also be integrated into the global group.

Although the global automotive industry is currently undergoing severe shock from sales levels that have fallen to those of the late 1970s, the fact that Toyota assumed the mantle of the world's largest auto manufacturer at the beginning of 2009 is still emblematic of the leading status of many Japanese iconic brands in the global marketplace. That continuing high level of technological and manufacturing quality and brand recognition globally will continue into the foreseeable future, regardless of the status of the Japanese domestic economy. Therein lies the basic attractiveness of acquiring assets and operating platforms in Japan in this time frame while the economic crisis makes such opportunities available that usually cannot be found in more healthy economic times.

With the high yen, newly acquired operating revenue streams in Japan will deliver a premium contribution to enhancing any global company's total global revenue flows as well as contribute to beneficial currency hedging of yen assets against those based on the dollar and other currencies.

The legal environment for investments into Japan has never been more open. The Japanese government has varied low-cost loan programs readily available for new FDI, which can also be utilized to at least some degree for acquisition of existing operations, especially where the foreign investor will be adding new investment, equipment, technology and/or management techniques to the existing Japanese operations. The need to sustain employment and create new employment opportunities will be as essential politically in Japan during the coming 24 months as for all other countries seeking to combat the effects of this global economic downturn. All of these factors together make Japan one of the most compelling opportunities that global corporate and financial investors should be evaluating for new investments in the 2009-2010 time frame. JS

Editor's note: This article was completed on February 28, 2009.

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