Risk management

M&A Event Risk of Corporate Bonds

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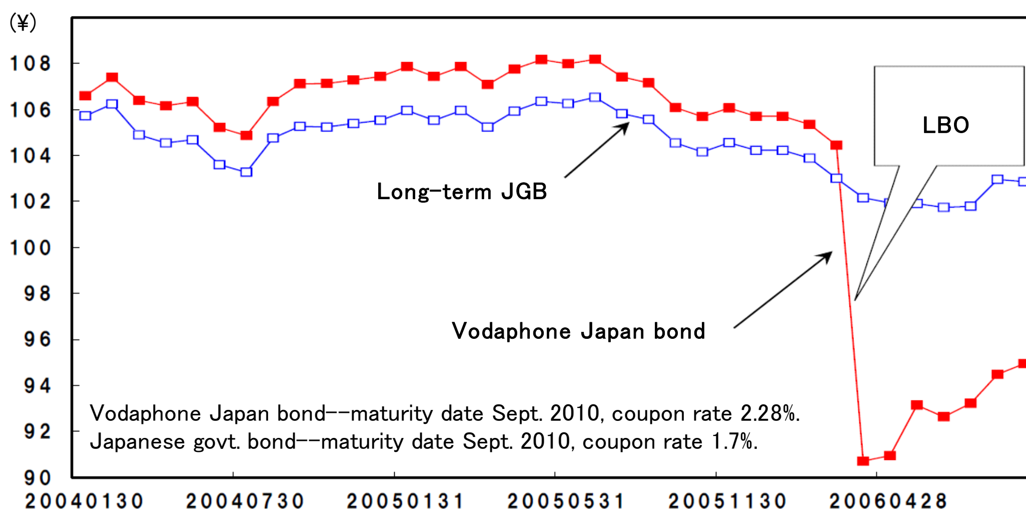
As M&A activity intensifies in Japan, the "M&A event risk" of corporate bonds can emerge in three ways: (1) M&A activity increases the credit risk of bond issuers, causing bond prices to decline; (2) in LBOs, participating financial institutions receive a higher priority for payment in the event of default than bondholders; and (3) takeover defenses put the interests of equity investors ahead of bond investors.

The growth of M&A activity both in Japan and abroad in recent years reflects a new business paradigm in today's highly competitive global markets. Companies are finding that external growth through acquisitions can be more expedient than internal growth through capital investment and R&D spending. In Japan, the infrastructure for M&A activity moved a step forward on May 1, 2007 with the approval of triangular mergers, wherein a foreign subsidiary can use the parent company's shares to acquire a Japanese company.

In light of this trend, corporate bond investors need to be aware of three types of M&A event risk. Softbank's leveraged buyout of Vodaphone Japan in March 2006 is instructive (LBOs are largely financed with loans, with the assets of the acquired company used as collateral). First, Vodaphone Japan's bond price plummeted (bond yield surged) in response to the heightened credit risk, and the company's standalone rating also suffered a downgrade (Exhibit 1). Second, financial institutions that participate in LBOs generally receive a higher priority for payment in case of default than bondholders. Fortunately for Vodaphone Japan's bondholders, however, Softbank refinanced the bridge loans in November 2006 by completing a ¥1.45 trillion whole business securitization scheme (asset-backed securities were issued, backed by the cash flows and assets of the mobile phone business), effectively redeeming the bonds.

Exhibit 1　Bond Price of Vodaphone Japan Bond (now Softbank Mobile) and JGB



A third type of M&A risk stems from activist shareholders such as the tarnished Murakami Fund and U.S. investment funds. These funds invest in cash-rich companies and then pressure managements to distribute the cash to shareholders. Such demands can impair the company's financial condition. As seen above, this would increase the credit risk and thus be detrimental to bondholders. But in addition, when these companies adopt takeover defenses

to protect other shareholders, shareholders' interests are put ahead of bondholders' interests.

Clearly, bond investors need a way to assess the risk of M&A activity. We examined the companies targeted by activist shareholders—specifically the Murakami Fund—for statistically significant indicators (M&A risk factors) in three areas: (1) company size, (2) asset efficiency, and (3) financial strength (Exhibit 2).

Exhibit 2 M&A Risk Factor Indicators

Indicator		Definition: Numerator	Definition: Denominator
Company size:	Market capitalization	--	--
Asset efficiency:	Asset turnover	Revenue	Total assets (avg. for period)
Financial strength:	Equity ratio	Market capitalization	Market cap. + interest-bearing liabilities
	Cash flow ratio	Cash flow (avg. for period)	Current liabilities (avg. for period)
Valuation:	PBR	Market capitalization	Shareholders' equity

According to our results, targeted companies are characterized by: (1) high equity ratio (they carry less debt than others), (2) high cash flow ratio and low asset efficiency (they are cash rich but do not utilize it very efficiently), and (3) low price-to-book ratio and small market capitalization (they tend to be undervalued and small in size).

Using these indicators, we applied a statistical model to estimate the size of M&A risk at 1,933 listed companies as of the start of July 2007. Interestingly, most companies targeted by Steel Partners and other activist shareholders rank high in M&A risk.

Finally, for the 225 listed companies that are bond issuers, Exhibit 3 ranks the top fifteen companies at greatest risk of M&A activity. As might be expected, their credit quality is generally high. While they may not all necessarily become M&A targets, the important point from the perspective of risk management is for bond investors to adequately recognize the risk of M&A activity in advance.

Exhibit 3 M&A Risk Ranking of Bond Issuers

M&A risk ranking		Credit rating 2006.06	Credit rating 2007.06	Market cap (¥ bil.)	Asset turnover	Equity ratio	Cash flow ratio	PBR
1	Kokuyo	A	A	185.8	0.06	85.30	53.71	1.05
2	Takara Standard	A	A	103.5	0.82	83.54	73.62	0.87
3	Kureha Corp.	BBB+	BBB+	113.2	0.57	82.42	49.49	1.18
4	Takara Holdings	A	A	176.3	0.03	85.56	99.64	2.08
5	Kyodo Printing	BBB+	BBB+	39.6	1.03	75.20	41.93	0.77
6	JS Group Corp.	A+	A+	785.8	0.02	96.17	68.42	1.50
7	Nippon Shokubai	A−	A	214.0	0.77	87.27	51.39	1.41
8	Fuji TV Network	AA−	AA−	576.8	0.57	92.02	113.20	1.34
9	Mitsubishi Logistics	A+	A+	354.5	0.45	88.08	101.49	1.70
10	Sanwa Shutter	A−	A−	192.8	0.68	80.55	68.09	1.35
11	Fuji Oil	A−	A−	84.0	0.79	71.72	45.00	0.98
12	Kuraray	A+	A+	546.7	0.50	95.91	123.75	1.79
13	Futaba Industrial	A+	A+	213.5	1.00	82.63	85.35	1.19
14	Nisshin OilliO Group	BBB	BBB+	124.0	1.06	84.94	34.43	1.31
15	Anritsu Corp.	BBB+	BBB+	70.7	0.36	58.34	57.35	1.00
	Average for 225 companies			1,118.9	0.77	70.37	45.88	2.42

Note: Credit rating shown is the lower of ratings by R&I and JCR