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Daiwa SB Investments

PM'S PERSPECTIVES

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The Conditions for Success in M&A

Japanese companies are rolling in cash. In terms of uses for this cash, the argument for returning cash to shareholders has generally been at the forefront, however going forward I foresee an increase in the cases for M&A. By that I mean that there has been an increase in the number of companies who have countered demands from shareholders saying "If you're not going to use the money immediately, then please return it," with "We need money for M&A," and establishing a framework for M&A investment. Even if companies do not return funds to shareholders, their cash holdings have value, but when M&A is implemented poorly, it can reduce the value of cash to zero. Unfortunately, the history of M&A implemented by Japanese companies is littered with failures, and as a result, when acquisitions are announced, there is a tendency for share prices to fall. Conversely, overseas, there are companies whose share price rises when they announce acquisitions, due to them having executed M&As well in the past, which begs the question, how can Japanese companies succeed in M&A?

The table below explains the conditions for M&A success and failure.

Table 1: Major conditions for M&A success or failure

Item	Conditions that make success likely	Conditions that make failure likely
Party unearthing deal	Deal uncovered by self, exclusive negotiations	Deal involving a tender offer brought by bank/securities company
Acquisition target	Business that makes a strong business even stronger	Business unrelated to own, strong, business
Timing	Acquire when results are temporarily depressed	Acquire when business is good and results are good
Acquisition price	Low price before synergies are achieved	Reasonable price after synergies are achieved
Synergies	Aim for improved profitability through cost-cutting	Aim to increase sales by cross-selling, etc.

Source: Daiwa SB Investments

My conclusion is that the secret to being successful in M&A is to (1) acquire a business that you have unearthed yourself, (2) that is strong in an area peripheral to your own core business, (3) at a low price, then (4) improve the profitability of the acquired company to generate synergies.

Table 2, shown over the page, is a summary of the characteristics of companies that are good at M&A, and the majority have a network that allows them to uncover acquisition targets themselves. Deals that have been unearthed yourself, with no other competing suitors involved, allow leisurely negotiations and enables you to acquire a counterparty you know well at an appropriate price. On the other hand, deals brought to you by a bank or securities company that involve a tender offer are apt to become expensive, and there are often restrictions on the level of capital participation and the timing. In addition, when you are able to find targets for yourself, it increases the options for acquisition, which also puts you in an advantageous position in negotiations with the other party.

M&A that involves making a strong business even stronger also tends to have a good success rate. Already having a strong business means that you often receive information on acquisition deals before any others, and that you understand the features of the industry. However, when acquiring a business that is not your own core business, you have the handicap of being involved in a deal that the leading companies in the industry have already passed on, in addition to which there is the risk that you will misread the features of the industry and buy at the highest price. It is also unclear whether you will be able to manage the acquired company or not.

If you manage to acquire a target cheaply, you can control the premium you pay, and this increases the probability of success. Companies that are good at M&A invariably have some kind of proprietary system to help them to buy cheaply. For example, **HANWA** uses capital participation at times the targets are temporarily loss-making, while **RIZAP Group** makes acquisitions at a discounted price by means of third-party allocations of new shares. **Relo Group** approaches business owners considering succession issues for their own corporate group, and **Komatsu** targets acquisitions using KOMTRAX and other internal data to gauge inflection points in demand.

As it is extraordinarily difficult for the acquired party to make a serious effort to sell the products of the acquiring party, rather than increasing sales, a more successful strategy is to improve the profitability of the company being acquired. Companies like those mentioned in table 2 that are good at M&A have methods to improve profitability. There are many Japanese companies that have improved their earnings capabilities over the past few years. If they can next strengthen the ability to use the money they have earned, I expect Japanese companies to become increasingly attractive.

Table 2: Characteristics of companies that are good at M&A

Name	Methods for acquiring cheaply	Methods for avoiding failures	Methods for improving profitability of acquired party
HANWA Co., Ltd.	・Doesn't buy in tenders, but only through exclusive negotiations (protects employees, leaves company name unchanged, and as a result of this others approach it for deals) . ・Takes equity stake when other party is temporarily loss-making.	・Does not acquire in industries where the pace of technological change is rapid, nor acquire companies with many fixed assets. ・Takes equity stakes in overseas companies through business alliances.	・Raises employee wages. ・Pays founder of company an appropriate wage. ・Has thorough administrative manuals for accounting, legal affairs, etc.
RIZAP Group	・ Telephones companies and basically just tries to meet with a large number of potential investment projects (because if they only have a few options, the acquisition price will be high). ・Makes active use of third-party allocations of new shares. ・Targets are EV/EBITDA of 5x or lower, or PBR of 1x or lower.	・Worst-case scenario is verified. ・President is not in charge of M&A. ・Focuses on growth potential after rehabilitation of brand. ・Avoids industries requiring substantial investments in equipment, wants as few assets as possible.	・Focuses on providing good products. ・Works to cut head office costs in half. ・Increases advertising expenses, reduces fixed cost ratio. ・Rather than sales, requires acquired companies to understand customer needs, adhere closely to the business philosophy, and have a sense that they are contributing to customers.
Relo Group	・Makes approaches to business owners considering succession issues, mostly from their pool of 500 corporate members.	-	・Promotes outstanding management teams. ・As being trusted in the locality is an important issue, stock options are allocated to directors and they are asked to remain. ・Pays founder of company an appropriate wage. ・Energizes sales organizations.
AIKA Kogyo	・Frequently it is AIKA that approaches them (potential deals are also brought to AIKA, but if they consider dozens of projects, they are lucky to get one deal out of them). ・Takes an equity stake at a price reflecting profits even after amortization of goodwill.	・Acquires businesses that make strong core business even stronger. ・Decision-making should be rapid, so capital participation is 50.1% or higher.	・What is important is a positive attitude to synergies with Aika, and that the key personnel in the acquired business remain. ・Mutual disclosure of recipes and technical information. Thinking regarding financial aspects must be clearly conveyed.
Digital Garage, Inc.	・They are in a closed circle from which they gather early-stage information, enabling them to invest more quickly than others. ・Maintains a large number of acquisition candidates.	・Invests in companies that are related to its business, and in companies in which it appears possible to increase value. ・Rather than seeking to just get passing grades, they aim to hit a home run once every few years.	・Dispatches executives to acquired companies as required. ・Performs matching between investors. ・Transplants existing investment tools/know-how.
Komatsu Ltd.	・Acquires targets when demand is beginning to recover (it is difficult to extract profits from acquisitions made in demanding conditions, and it is challenging to carry out backward-looking business and perform PMI in the same time).	・Komatsu employees take over positions at the acquired company, such as finance and legal.	· Get themselves included in such functions as development, sales, finance and legal affairs early on, and discover issues by working together, and then taking the next step.

Source: Daiwa SB Investments, based on interviews with companies

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