Toshiba Takeover

Introduction

After years marked by scandals, accounting malpractices, poor strategic decisions, and an overall faulty corporate governance, Toshiba seems to have found a buyer.

On March 23, 2023, the Board of Directors approved a $15bn offer from a consortium of 17 domestic companies and 6 financial institutions, led by Japan Industrial Partners, a Japanese private equity fund. If the deal were to go through, it would be the biggest take-private operation the Japanese market has ever seen.

The deal would pose an end to the years of battles between management and activist investors, who had been demanding turnarounds in strategy and management reshuffles, and would allow top shareholders, such as Effissimo Capital Management, to exit their positions. However, it remains to be seen whether this change in ownership will lead to a revival of the conglomerate, which never fully recovered from the 2015 accounting scandal, in which Toshiba's management was found to have overstated revenues by $1.2bn over 7 years, and the losses incurred after Westinghouse, a company's subsidiary operating in the nuclear power construction business, declared bankruptcy.

About Toshiba

Founded in 1939 by the merger of two Japanese companies, Toshiba is one of the biggest multinational conglomerates in Japan; its operations span across various sectors, among which are electronics, semiconductors, infrastructure, building, and energy.

Toshiba used to be one of the world's largest manufacturers of PCs, household appliances, and medical equipment and was the inventor of flash memory, which allowed the company to be one of the main players in the chip industry. Toshiba is a leader in the production of Hard Disk Drives (HDDs) and semiconductors manufacturing equipment. Within its energy generation business, the company is active in the nuclear, thermal, and renewables spaces, while at the same time providing power transmission and distribution systems. The building division produces elevators, escalators, AC systems, and lighting solutions for offices.

In recent years, the company's strategy involved divesting from underperforming businesses and investing in its most profitable divisions; however, this wasn't enough to bring the company back on its feet after all the turmoil. Despite once being a leader in many of the segments in which it operates, the company's performance has been declining drastically in the past years. In Q3 2022, although sales remained almost stable, EBIT decreased by more than 90%, from ¥87.6bn to ¥8.1bn, and the company had a negative FCF of ¥26.7bn.

The Saga

Toshiba's reputation and performance have been heavily impacted over the years by a series of scandals, which forced the company to sell many of its subsidiaries and even brought it to the brink of bankruptcy.

It all began in 2015, when the company announced it was investigating an accounting scandal. The findings showed top management involved in accounting malpractices, repeatedly pushing for difficult profit targets that ultimately forced division heads into manipulating financial results. By delaying the reports of losses and underestimating project costs, the company had inflated the profits by $1.2bn over the previous 7 years. As a result, top executives resigned and the company had to pay several fines from regulators and restate all the previously published financial statements, which caused the stock price to plummet. To recover from this scandal and its financial consequences, Toshiba had to sell several divisions, including its laptop and television units, and decided to focus its investments on its most profitable businesses, i.e., the nuclear power construction and semiconductor businesses.

However, these investments didn't go as planned either, starting from Westinghouse, its majority-owned nuclear construction subsidiary. The company bought a nuclear construction and services business from Chicago Board and Iron in 2015; however, the assets acquired turned out to be worth much less than initially thought, and Toshiba also reported inefficiencies in the labour force that would drive up costs. In 2017, Westinghouse announced that its construction projects in South Carolina and Georgia, which were already 3 years overdue, proved to be between $1bn and $1.3bn over budget, and forced the company to file for Chapter 11 bankruptcy. This led to a write-down of $6.3bn and a corporate-wide loss of $3.4bn for Toshiba, which posed a concrete risk of bankruptcy. To avoid this, the company decided to sell part of its memory business; initially, it wanted to sell a 20% stake, but eventually, it had to sell it in its entirety to a consortium led by Bain Capital for $18bn in 2018 to get back on its feet. Additionally, $5.4bn worth of new equity capital was raised, attracting several activist investors. These decisions were met with fierce criticism by shareholders, who also questioned how Westinghouse, which should have been one of the company's most profitable businesses, could have gone bankrupt.

In 2021, the company announced it wanted to split into 3 parts: one focusing on infrastructure, one on electronic devices, and one that would have managed the stake in Kioxia and other assets. Many shareholders went against this proposal, claiming that the plan was not enough to lift the value of the conglomerate and that the management should have considered selling the entire company to a private investor. Then, Toshiba revised its restructuring plan, saying it wanted to spin off its device business and split into 2 parts, instead of 3. However, this proposal wasn't accepted by shareholders either. These continuous conflicts between management and shareholders were also since in 2021 Toshiba was found to be colluding with the Japanese government to influence shareholders at annual meetings. Investigators published a 147-page report in which they detailed how senior figures at the Ministry of Economy, Trade and Industry collaborated with the company's management to prevent executives from being voted out from their positions. After this scandal, the chairman of the board, Osamu Nagayama, was forced to resign by shareholders through a vote.

In 2022, many activist shareholders, such as Effissimo Capital Management, a Singapore-based fund run by Japanese managers, started pushing the company to find an acquirer and consider a private equity deal, after Bain Capital was rumoured to be about to submit a proposal for the company.

The bidding process

In April 2021, CVC, a Luxemburg-based private equity firm, proposed a US $20bn buyout and privatization of Toshiba. Even though the Toshiba group claimed the offer was unsolicited, at the time there was information on other private equity funds having non-binding talks regarding the same buyout. However, two weeks after making the initial offer, CVC withdrew their acquisition plans. CVC's intention was to take the firm private, raise its corporate value and relist it three years later. This would allow the firm to grow, as well as freeing it from the existing pressure from activist shareholders. Nonetheless, there were three major factors that affected CVC´s deal. Firstly, Toshiba's board did not support the privatization attempt. Secondly, the sudden resignation of Toshiba's CEO at the time – Nobuaki Turakami, former CVC Head in Japan, left the proposed buyout in chaos, and third, CVC never presented detailed documents to pass the government screening process.

By August 2021, Toshiba engaged in conversations with KKR, Blackstone, Bain, and Brookfield Asset Management. Even though no formal offers existed, there were rumours about the possible acceptance of a takeover if it would lead to a surge in shareholder value. Furthermore, as stated before, Toshiba's board also explored the possibility of breaking up into three different listed companies. The latter with the aim of clarifying the different profit structures of its different segments, and applying targeted growth strategies to each segment, and thereby increasing their value. In December 2021, Toshiba abandoned talks for a minority stake sale to Brookfield as it opposed their current plans of splitting up the company.

In February 2022, Toshiba's board of directors proposed a two-way corporate split, instead of the three-way split previously proposed. Nonetheless, the proposal didn't have support from some of the major shareholders, who instead proposed privatization. In late March, both proposals were presented at an extraordinary shareholders' general meeting in late March, but neither received the necessary support. However, it became clear that most shareholders were inclined towards privatization. Additionally, following the voting procedure, Toshiba's newly appointed CEO expressed that he "privately supports" a privatization scenario. On April 21, 2022, the company announced that they will commence discussions with potential investors and financial sponsors, and later signed NDAs with 10 entities to allow them to access the company's financial information to form an official proposal. Furthermore, the Japanese government stated that they will allow foreign bids for Toshiba if they comply with the rules and regulations on sensitive infrastructure and technology. This is due to Toshiba's involvement in nuclear energy, military radar, infrastructure, and semiconductors, among others.

During its first-round bids, Toshiba received eight initial proposals for privatization and two proposals for strategic and capital alliances. Among the interested parties were Japan Investment Corp (JIC), MBK Partners, Bain Capital, Brookfield Asset Management, Blackstone Group, Japan Industrial Partners (JIP), Polaris Capital Group, Apollo Global Management, CVC Capital Partners, Baring Private Equity Asia, among others.

By July 19, Toshiba selected four bidders: PE firms Bain Capital, CVC Capital Partners, Brookfield Asset Management, and a Japanese consortium composed of both Japanese Investment Corp (JIC) - a state-backed investment group- and Japanese Industrial Partners (JIP) -a domestic PE firm-, to proceed to a second-round bidding process. Regarding the initial contents of the offers, Brookfield Asset Management proposed a capital alliance with Toshiba with the goal of maintaining its listing, while the other three groups aimed at privatizing Toshiba. However, during the due diligence process leading towards the second bidding round, JIC and JIP ended their alliance and submitted separate proposals by the end of September.

On October 11, Toshiba granted Japan Industrial Partners (JIP) preferred status to bid for the company. By receiving a preferred bidder status, JIP had access to further confidential information that hadn't been previously disclosed. This allowed them to have a better understanding of the company's finances, internal processes, among others, ultimately contributing to them presenting a more thorough proposal. Then, on November 7, JPI presented a formal offer of ¥2.2trn (USD 15bn) to acquire Toshiba. The consortium led by JPI included more than 20 Japanese companies which included Japan Post Bank, Mitsui Sumitomo Insurance, The Dai-ichi Life Insurance, Suzuki Motor, ORIX, Rohm, among others.

On February 9, 2023, Japan Industrial Partners made its final offer for the privatization with an estimated price of ¥2trn (USD 15bn). Finally, on March 23, Toshiba agreed to the proposed ¥4,620 per share tender offer which will be launched in late July and will allow shareholders to make their own decisions. However, it is important to note that Toshiba did not recommend its shareholders to support the offer, leaving the decision to each shareholder's own discretion.

Deal structure

JPI gained commitment letters of investment and lending for a total value of over ¥2tr. The bidding consortium, TB Investment Limited Partnership (TBLPS), is composed of four investment funds managed by Japan Industrial Partners, 17 Japanese companies, and six Japanese financial institutions. They aim to acquire a total of 432,630,045 Toshiba shares for ¥4,620 per share, meaning an aggregate value of ¥2trn (USD 15bn), with the minimum amount acceptable set to 288,564,300 shares, a 66.7% stake of the company. If the consortium is not able to achieve the minimum required, the bidder entity won't purchase any Toshiba shares tendered.

When JPI was selected as a preferential bidder in November 2022, an initial offer of ¥5,200 per share was established. However, after the decrease in the company's earnings forecast, the offer price was initially reduced to ¥4,710, and once again cut to ¥4,620 after a further decrease in its earnings forecast. Nonetheless, this still represents a 10% premium on its closing price as of 23rd of March (¥4,213). Furthermore, the offer is around the six-month average share price of ¥4,683, and above the six-month average of ¥3,195 prior to CVC Capital Partners offer in April 2021, which raised Toshiba's price significantly. However, it represents a 15% discount from the price from December 2014, prior to the accounting scandal, as well as a 22% discount to the all-time high of June 2022.

Furthermore, the depreciation of the yen relative to the US dollar (24-year low) has raised concerns about whether international shareholders will tender their shares at the price offered by JIP which has a premium that is only slightly higher than the current share price.

Deal rationale

Toshiba's involvement in sectors such as semiconductors, nuclear power, and defense-related equipment, all considered by the Japanese government as crucial for national security, make the company subject to special norms. According to the revised Foreign Exchange and Foreign Trade Act, any move made by an overseas investor to acquire 1% or more of a company whose activities are related to national security, is subject to notification in advance and scrutiny by Japanese authorities. Therefore, overseas companies faced tougher regulatory hurdles. On the other hand, foreign investors were benefited by the depreciation of the Yen relative to the US dollar, granting them an even higher purchasing power. However, no foreign investor was part of the winning consortium. The tough regulatory hurdles acted as a counterincentive to be part of the consortium, as was the case of Blackstone Group, CVC Capital Partners, and BPEA EQT, or to even submit a first-round bid, as was the case for KKR.

On the other hand, the fact that it was an all-Japan deal resulted in fewer regulatory and foreign direct investment procedures. Additionally, the JIP-led consortium is unlikely to come under thorough regulatory scrutiny given the few overlaps with the entity' business activities and the deal structure. While gathering potential investors, significant effort was made to avoid funds from China, the US, or the Middle East, due to the Foreign Direct Investment Laws of those countries. Furthermore, the deal didn't need to file for China's State Administration for Market Regulation approval, nor did it clash with the Japanese Antimonopoly Act. This, as JIP's sales for the year ended in March 2022, didn't meet the merger filling thresholds required by these countries. In Japan's case, this happened as each of JIP's investments are owned by a certain investment fund, all under JIP as the parent company, but the domestic turnover of the funds is not aggregated when filing at the Japanese regulator.

Furthermore, the deal was necessary for Toshiba's wellbeing. Since 2015 Toshiba had been involved in scandals ranging from accounting malpractices with overstated profit by US 2bn, the bankruptcy of its nuclear business, Westinghouse in the United States in 2017, the sale of Kioxia, its most asset, to persistent board and managerial problems and constant pressure by activist investors. Moreover, during 2023 Toshiba had to cut back projections two times, and it experienced almost a 90% drop in operating profit in its latest quarter.

Outlook

The expectation on JIP's strategy by analysts is a swift and significant restructuring for a troubled Toshiba. This will most likely include the sale of some of the company's remaining units, which include energy systems, batteries, quantum computing, cybersecurity, and infrastructure, among others. The hope of such sales is that the company can increase its performance, which lagged that of the Nikkei 225, the main Japanese index, which itself fell by 2.2% in the past year. A concern regarding Toshiba's ability to do so is its stagnation in development of artificial intelligence, material sciences and quantum technologies, during a time in which competitors have been constantly improving such technologies. Toshiba is also the smallest of the world's three remaining hard-disk drive suppliers and is facing sluggish demand in electronics such as hard drives and semiconductors.

Moreover, Toshiba has said that the main goal of the agreement with JIP is to create stable management and a united shareholder base. This was also signalled by the fact that one of the conditions for the bank loans received were the continuity of CEO Taro Yimada and Former COO Goro Yanase, who stepped down in February 2023 because of inappropriate use of entertainment expenses. It remains a question though if JIP will manage to revive the sleeping giant that Toshiba is, as the private equity fund has never previously acquired a company of this size, although it did previously buy assets from Sony and Olympus. Furthermore, plenty of the companies that are part of the TB Investment Limited Partnership (TBLPS) consortium have past ties with Toshiba. There are rumours that some of those companies were introduced to JIP by Toshiba's management and others by the Trade Ministry. This might take away from the novelty factor needed to turn a company like Toshiba around, adding to the concern that JIP might not be able to bring necessary improvements to the company with its strategy.

The takeover is expected to officially begin in late July 2023 and is pending approval under global competition laws.

TAGS: Acquisition, Toshiba, private equity, deal