JDL MBO is a showcase for Strategic Capital's confrontational approach, says activist

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Proprietary

- Four years of pressure results in MBO
- Pay-off is huge once 'harder to influence' company changes
- Additional JPY 1,000 needed to make the offer fair

JDL Technical's launch on 1 November of a tender offer to acquire **Japan Digital Laboratory** (JDL) [TYO: 6935] in a management buyout (MBO) "marks a victory" for Tokyo-based activist shareholder **Strategic Capital**, Tsuyoshi Maruki, CEO of Strategic Capital, told this news service.

"JDL is a showcase for our confrontational approach to activism in Japan against a 'harder to influence' domestic company," said Maruki of Strategic Capital, who agitated for about four years for strategic changes at the Tokyo-based accounting software developer.

JDL announced on 31 October it would be taken private via a management buyout tender offer at JPY 2,420 (USD 22.24) per share by JDL Technical, an asset management company 100% owned by JDL President Kazuo Maezawa.

JDL Technical, which currently holds 38.64% of JDL, is offering at a 55.83% premium over the company's average closing price in the past month to acquire 20,805,116 shares for an aggregate value of JPY 50.35bn (USD 466m).

Strategic Capital, which currently owns a 2.85% stake in the company, began building its stake in December 2012 when the stock was trading at less than JPY 1,000. The fund then stepped up pressure on the JDL management led by President Maezawa for four years "using all sorts of shareholder rights", according to Maruki.

Activist's strategy

Strategic Capital's strategy is to buy into cash-rich companies it considers to have been heavily discounted because of concerns over their governance structures and actively engage with the companies to improve issues that cause stagnant share prices, according to the fund's investment guidelines.

In 2013, Strategic Capital tried to persuade JDL to increase shareholder returns and improve corporate governance and informally suggested it should be taken private via MBO. But the management turned a deaf ear to Maruki's advice.

However, smelling something “fishy” about its accounting practice, Strategic Capital exercised its shareholder’s right to inspect JDL’s accounting books. The company refused it access. Then in April 2014, Strategic Capital sued JDL to gain the right to inspect its accounting book, and filed another suit in April 2015 to obtain the right to examine directors’ meeting minutes.

At this year’s AGM, Strategic Capital made a formal proposal to raise the company’s payout ratio to 100% from 53.4%. This was the third year in a row Strategic Capital submitted its proposal to its AGMs. At this year’s AGM, the fund also urged the board to spin off its non-core airline business IBEX Airlines.

In February, Maruki filed a lawsuit against JDL President Kazuo Maezawa for “unreasonable expensive” payments to his two brothers. JDL paid a tax accounting office run by Maezawa’s brother JPY 8.9m in consulting fees from 2003 to 2013 and JPY 7.2m in annual salary from 2008 to 2013.

Another brother of the president, who is an architect, received payments ranging from JPY 10m to JPY 200m a year for at least seven years up to March 2012, for the design and supervision of Maezawa’s office.

At this year’s AGM, some 24.18% of shareholders voted for Maruki’s proposal to raise its payout ratio to 100%. ISS recommended its clients to vote for the shareholders’ proposal.

Maruki said this is a fairly good achievement in a situation where some 40% of voting rights is held by its founding family. “The point is to what extent we gain the support of shareholders outside these controlling shareholders,” he said.

“We found so many strange practices in this company,” Maruki went on. Its airline unit IBEX Airlines was originally owned by President Maezawa. But 15 years ago, when it was about to go bankrupt, Maezawa sought a capital increase from JDL by third-party allotment.

Strategic Capital, with about JPY 10bn in assets under management, says it currently invests in about 10 small and medium-sized companies which have built up cash to an unnecessary level and have governance issues.

“It requires us considerable energy to make changes at such companies, but once we are able to foster changes, the opportunity for pay-off is great,” said Maruki. “We are hoping such activist pressure would somehow help revitalize the Japanese economy.”

As for its investment in JDL, Strategic Capital’s average cost of investment was below JPY 1,200 per share. Once it held 3.74% of JDL at its peak, but sold 0.8% at above JPY 2,000 in September 2014, according to Maruki.

'Unfair' share offer

Maruki believes, however, the JPY 2,420 per share offer price is far from fair. “It should add another JPY 1,000 to the offer price to make it what is called a fair price,” Maruki said.

JDL has more than JPY 60bn in cash and cash equivalents. Its JPY12.7bn debt is largely due to its airline business, according to its statement. “If it sells its airline business, JDL becomes a debt free company. If we add up all these, the company is worth at least JPY 100bn [versus its MBO cost of only up to JPY 70bn, including fees],” Maruki said.

JDL Technical’s financial advisor – Mitsubishi UFJ Morgan Stanley Securities - and JDL’s fairness opinion provider - Deloitte Tohmatsu Financial Advisory – calculated the offer price based on market share prices, company comparisons and DCF (discount cash flow) analysis.

Maruki said, however, these advisors have not included JDL’s abundant cash for the calculation of the offer price. Nevertheless, Maruki said he had not decided at the moment whether to fight with JDL/JDL Technical over the offer price.

Asked whether the presence of the activist and their agitations is a major reason behind Maezawa’s decision to delist JDL via MBO, a JDL spokesperson said the immediate objective is to continue to produce low-cost products to remain competitive in the industry.

“We probably have to sacrifice our profitability in order to produce low-cost products. We opted for the delisting because we cannot meet expectations of our shareholders for the time being if our profitability is sacrificed to produce low-cost products,” the spokesperson said.

“Yes in the process, Strategic Capital will be forced out from our shareholder list, though this is not our direct objective,” the spokesperson said.

The tender offer period runs for 34 business days, from 1 November to 20 December 2016.

JDL’s share price closed unchanged at JPY 2,410 in Tokyo on Tuesday.

by Norie Hata in Tokyo