Debt is not a dirty word

Japanese companies are now creditworthy and the banks are recapitalized but neither side seems keen to enter into loan transactions. But companies can see the long-term value of establishing access to capital markets. And lenders are keen to repackage and redistribute credit risk in new ways and define a new relationship with corporate customers. Peter Lee **reports**

IN THE FIRST weeks of 2006, it seemed that leading Japanese companies had engaged in some strange competition to outdo each other with announcements of ever more extravagant new investments.

Fujitsu unveiled plans to spend ¥120 billion ($1 billion) over two years to boost microchip production in central Japan. Matsushita Electric Industrial trumped it by announcing it would invest ¥180 billion in a new plant to build plasma display panels in western Japan. Sharp upped the stakes: it intends to invest ¥275 billion to increase production at its liquid crystal display factories. And so it goes on – steel companies, industrial companies, technology companies.

It is the continuation of a trend among Japanese manufacturers that first began in the second quarter of 2003 to replace and upgrade ageing plant and machinery and expand capacity in markets where new demand is evident, such as TVs, digitized home electronics and hybrid cars. Japanese companies are spending ¥1.25 trillion a year more on replacement capex than they were at the start of the century.

Service companies are also beginning to get in on the act. "Non-manufacturers will contribute an increasing share of investment this year, possibly as high as 70%," argues Tetsufumi Yamakawa, director of Japan economic research at Goldman Sachs. "Starting in 2005 we have begun to see retailers opening new shopping malls and wholesalers investing in distribution centres. And there is plenty of pent-up requirement for systems investment, in the financial services sector, for example." The Tokyo Stock Exchange's woes bear him out.

Almost as astonishing as the size of these new investments is the capacity of Japanese companies to fund them out of cash. Having just crawled out from under the crushing weight of debt from the bubble era, companies are not rushing to releverage – yet.

"I believe bank borrowing hit rock bottom in roughly August last year," says Hiroshi Saito, president and CEO of Mizuho Corporate Bank. "Since then, it has started to turn around. And even though the first instinct of companies is to fund investment out of cash or equity, I believe borrowing will continue to increase steadily from here on, albeit at a gradual pace."

Saito says that in the Japanese syndicated loan market annual volumes have risen to ¥25 trillion from just ¥1 trillion in 1998.

Banks' risk appetite has also returned, although lenders are no more inclined to rush wildly into the market than Japanese borrowers are to pile on debts. Typically, banks are happy to lend to the stronger credits that don't want to borrow and less keen to lend to the country's thousands of lesser-rated small and medium-size enterprises that actually need funding. The opportunity to pioneer a high-yield bond market in Japan is clear.

"After a humongous disposal of bad debts, we simply cannot allow history to repeat itself," says Saito. "But neither can we take no risk. We must re-engineer and redistribute risk in ways we did not in the past, rather than avoiding risk altogether."

Saito wants to change Mizuho Corporate Bank into more of a hybrid commercial and investment bank than a pure lender. He aims to grow fee earnings to 40% of the group's P&L, with traditional lending contributing 40% and trading and market risk businesses another 20%. "The idea is to combine lending with the collective efforts of group companies of Mizuho in products such as as leasing, securitization, even equity, when we make proposals to companies."

This is how Saito sees the bank engaging with corporate borrowers. "Say we analyse a specific need of ¥100 billion. We would try to segment that into high-risk, medium-risk and low-risk components and distribute it to appropriate investors. There might be a time lag, so we would provide a bridge loan and then seek to bring in mezzanine investors, convertible buyers and pure equity investors. We wouldn't want to keep more than 20% of any loan we originate."

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Hiroshi Saito, Mizuho

It's an approach that most of Saito's domestic and foreign competitors are also adopting. At Shinsei Bank, CEO Thierry Porté has a similar message. No, the bank cannot allow itself ever again to get into the NPL problem that nearly destroyed Long-Term Credit Bank, the shell from which Shinsei was rescued. But yes, it will make new loans. "We look at many on a case-by-case basis and some credit decisions end up on my desk. But taking no risk is a huge risk itself. We simply have to have the right credit risk management systems."

Porté has undertaken a study of the bank's credit exposures on a portfolio basis with Moody's KMV in an attempt to instil a more scientific approach into adjusting its obligor-specific,

sectoral and geographic exposures. And Shinsei's relationship managers have been going back out to corporations, including some of those from which the bank had to call loans and pull credit lines in the darkest times. Porté says: "We've gone back to them with humility, with an apology and in most cases that has been accepted."

Like Mizuho Corporate Bank, Shinsei is selling a combination of funding approaches to clients, not just simple loans. It has a newly acquired and restructured leasing business and it has also developed expertise in securitization and non-recourse lending that companies might find well suited to real estate projects.

Japanese liquidity and economic growth have supported a resurgence in real estate prices, and lending against real estate assets has resumed. A runaway real estate bubble and dud property loans were huge contributors to banks' NPL problems in the 1990s. It's hoped things will be different this time.

In the past a lot of real estate loans were predicated on ever-rising land prices. Recent real estate lending is more project specific. "It is based on analysis of cashflows from the property – be it condominiums, commercial offices, retail space," says Saito. Japanese banks are increasingly keen to make initial bridge loans for such projects and then repackage the risk and distribute it in securitized form to various investors with different risk appetites – regional banks, life insurance companies and institutional investors running various funds with differing risk/reward profiles. "And where exposures become too large, they can be organized into a Reit with a discrete debt and equity capital structure," Saito points out.

Porté is cautious about the overall prospects for the wholesale business. "Institutional banking is a tough, competitive market and it's not high growth compared with, say, retail. We won't grow earnings 20% annually. But we can still increase operating profit by 10% a year, which I would argue is not too bad."

There were signs last year of a resurgence in debt capital markets as well, when leading Japanese corporations such as Nissan and Sony launched large, long-dated multi-tranche domestic bond issues. Nikko

Loosening up banking relationships

As senior bankers devise their new strategy for dealing profitably with resurgent Japanese corporations, they are struggling to define a new model of relationship banking.

They know what it shouldn't be: what it was in the past. Formerly, the main bank to a company was wedded to it. If the company hit problems and its second- or third-tier relationship banks stepped back, the main bank kept lending to it to the bitter end. It was almost to the bitter end of the entire Japanese banking system.

Mizuho has close relationships with 70% of listed companies in Japan and accounts itself the main bank to 40% of those customers, according to Hiroshi Saito, CEO of Mizuho Corporate Bank. Among all those close corporate customers – nearly one-third of all listed companies in the country – no more than a handful still have balance sheet problems. The overwhelming majority are good credits and potentially good customers. That's the good news. The question is: what should be the basis of a new relationship between bank and corporate customer?

Saito knows that corporates want the freedom to deal with more suppliers of wholesale financial services. They don't want to be tied to too close a relationship: neither do the banks themselves. "It is still a relationship of trust, but rather being than their main bank, I think we are their first-call bank," he says.

What's the difference?

Saito seems to suggest that it boils down to a best-effort kind of commitment, one that stops short of economic irrationality.

"We don't want just to do a transaction, take the fee and walk away," he says. "We want the customer to be better off in future as a result of the work we do for them. And if the customer needs something or has a problem, they should make the first call to us and we will be committed to offering the best proposal that we can. If some other bank makes a better proposal, then the customer should be free to go with them."

Thierry Porté, the American CEO of Shinsei Bank, undertook in 2003 the kind of exercise many US wholesale banks went through with customers in the mid-1990s, analysing across the full range of businesses which customers it makes money from and which it doesn't. "And guess what," he says. "Only a small percentage were profitable for us."

The next step is obvious, if painful. "We have to develop the profitable relationships and end some of the others." That doesn't sound like the kind of approach that will go down well in Japan.

But Japan is changing. "I go and visit a lot of customers," says Porté, "which they still find a little surprising. 'Normally,' they say, 'we have to come and visit the bank.' And when you do that, having an honest and frank discussion about the profitability of the relationship can be quite a tonic. But," he continues, "you must be transparent with customers: they must understand exactly how you make money from your business with them as well as your costs."

Citigroup managed to snare several of these mandates. Its co-head of fixed income, Brian Mccappin, suggests that this year could be even busier, even if Japanese companies have no crying need for net new debt and even if Japanese banks are offering low-cost loans.

"We won't compete on price with the loan market and we won't have to," he declares. "Big corporate issuers are well versed in the dynamics of yield curves and understand the strategic value of maintaining an actively traded spread of bond maturities as a potential funding resource. That value has been proved around the world time and again."

The pitch to bond market issuers is a familiar one. Think of issuing now, because rates, especially long-term rates, are likely to rise before long. Access to bond market finance will be very important if your capex needs continue to grow, if you come under pressure from shareholders to readjust your capital structure in their favour, and if you see strategic M&A opportunities and wish to refinance expensive and covenanted short-term bank debt.

And if you buy all those arguments, why not go the whole way and issue in large size to ensure goodwill among domestic investors.

Liquidity is not great in the Japanese domestic bond market, where electronic trading is not widespread, two or three dealers dominate and investors can find themselves asked to wait an hour or so for a dealer to respond to an order and even then on a 5 to 10 basis point spread.

Being able to execute large orders in lots from a ¥100 billion to ¥200 billion issue, in a matter of seconds on a 1bp turnaround is a new experience for domestic institutions.

More than securitizing bank loans and leading straight corporate debt to fund capital expenditure, it is the prospect of raising substantially more M&A financing that has debt capital markets bankers in Japan excited. "Corporates are still deleveraging," shrugs Reiko Hayashi, head of corporate and public finance debt capital markets at Merrill Lynch, "but financial sponsors simply have to lever to meet their return targets. We are having plenty of discussions about M&A finance, and not just