Case Study of a Failed Purchase

A Recent $2 Billion Failed Acquisition Attempt – *Yet another failure:* Five unwitting world-class investors led through an acquisition strategy predictably doomed to fail.

A $2 Billion Failed Acquisition Attempt – Just Another Failure?

This case study concerns the failed sale of a substantial Japanese property portfolio. The study exemplifies how American businessmen unknowingly repeat the same mistakes that result in the failure of their intended Japanese-American transactions. The cast consists of the seller, it's brokerage firm, and five world-class investors bidding to purchase the portfolio.

The seller borrowed $2.2 billion in full-recourse loans to acquire the portfolio. The $2.2 billion remains unpaid. The loans are current; however, the seller is in technical default of its mortgage agreement because the portfolio's market value is estimated to have decreased to about two-thirds of its cost. The portfolio has a positive cash flow, i.e., the seller was motivated to sell only for it's own investment reasons. The seller selected a well-known and respected brokerage to sell the portfolio.

The broker thought it had developed a brilliant selling strategy for a quick sale and commission. It knew the seller paid $2.2 billion, but that the portfolio was worth approximately $1.5 billion. The broker, knowing the seller was Japanese, assumed it was in dire need of cash, desperate to sell, and would ultimately *take the hit* and sell the portfolio at market value. To capture the listing, the broker assured the seller it would sell the portfolio for $1.8-$2 billion. The seller took the bait, but insisted the sale be secret.

Shortly after the broker was engaged, several news stories appeared in the local and national press reporting that the portfolio was for sale. The underlying theme of every story was that the market value of the cash-strapped seller's portfolio was worth only two-thirds of its purchase price. Several articles suggested that the seller had accepted that the portfolio's value had decayed to $1.5 billion. One article had the owner agreeing to a $300 million loss on two buildings alone. Five qualified investors came to the bidding table. They were inappropriately instructed by the broker to bid $1.4-$1.5 billion, the current market value.

When the bids were delivered, the broker apologetically explained that it had been wrong. The portfolio apparently was not worth $2 billion. The five offers were all approximately $1.5 billion--market value. Obviously this must be the value as five expert investors couldn't all be wrong. Several recent newspaper articles supported the values bid. Other recent news stories reported that the Japanese were dumping their U.S. properties into the market, and suggested that the property glut would further drive down prices. In other words, Mr. Japanese Seller, you had better act now, before it's too late. The broker's strategy was working brilliantly--or so it thought. Aside from the broker's questionable ethics, to an American businessman, nothing in this strategy appeared extraordinary or in error.

What the Japanese seller did next surprised everyone, especially the broker. Instead of acquiescing to the offering prices, or attempting to conduct a private auction, or even indicating a willingness to negotiate, the seller terminated the bidding process and removed the portfolio from the market!

An immense sale was suddenly terminated! Was this just yet another one of those *mysteriously* failed Japanese transactions? Five world-class investors spent substantial time, effort, and a small fortune only to fail. What went wrong? How could this failure have been prevented?

AES sees this failure as completely predictable. It could have easily been prevented, and a scenario leading to a consummated transaction could have been established. If the broker and investors had only known and understood the *Japanese issues*, this deal could have moved forward.

What Happened? – *AES explains the reasons for the failure and why it was predictable:* Ignoring or failing to understand the complex Japanese legal and cultural issues associated with every Japanese transaction caused the broker to craft a flawed selling strategy.

What Happened?
The Reasons for the Failure and Why it Was Predictable

A $2 billion deal was suddenly terminated by a Japanese seller! What happened? What went wrong?

The broker, investors, and sideline American observers all point to the same basic reason for the failure of this and other attempts at acquiring Japanese properties. They claim the prices offered were much lower than what the seller expected to receive, so it pulled the portfolio from the market. This philosophy, while accepted conventional wisdom, is blatantly incorrect. It is the product of several years of continuous but faulty advice from uninformed, yet widely followed *experts*, repeating over-and-over, the same myths they have postulated. Unrealistic expectations may be common among Japanese property owners, but attributing those expectations as the reason for the low number of successes is sheer folly.

The succinct reason for the failure is that the broker's selling strategy was faulty because it ignored the *Japanese issues* surrounding the contemplated sale. The Asian economic upheaval, Japanese legal issues pertaining to almost all current sales transactions, and cultural issues prevalent among Japanese businessmen all worked independently against the broker's selling strategy.

Because of the crisis in the Asian banking system, the seller's lenders could not afford to discount the seller's mortgage by the amount required for the delivery of clear title. The sale of any property could be consummated only if the seller utilized it's own funds to pay the anticipated mortgage deficiency balance, up to $700 million, well beyond the seller's immediate reach. Notwithstanding the seller's inability to pay a substantial deficit, had the banks discounted the mortgage consistent with the offers, the forgiveness of indebtedness would be classified by the Japanese government as taxable income (phantom income). Instead of owing the lenders, the seller would instead owe taxes to a revenue-deprived government. It was also incorrect to presume that just because the seller is Japanese, it was forced to divest the portfolio at a loss. The seller in this case was under no extreme pressure to sell.

There are several fundamental Japanese legal issues pertaining to the seller's sale of the portfolio. One principal issue relates to the mortgage deficiency balance that would have resulted had the seller moved forward with the sale without the ability to pay the deficit. This scenario would arise if the seller simply 'walked' from the property, e.g., handing the lenders the properties and a deed in lieu of foreclosure. Under Japanese law, lenders are required to pursue the borrower to collect the deficiency until they have no further avenue of pursuit, i.e., the seller's bankruptcy.

The peculiarities of the Japanese business culture are widely recognized and misunderstood and almost always disregarded by U.S. businessmen. The newspaper articles were designed to condition the seller to realize the portfolio's true value. An American seller would probably react to the newspaper stories by acquiescing to the fact that it could rationally expect to receive only $1.5 billion. Instead of reacting to the articles by lowering the expectations inspired by the broker's assurance of $2 billion, the seller became livid. The seller, a typical Japanese businessman, without even knowing the news articles were an element of the broker's strategy, found the articles insulting, slanderous, and challenging. The seller was livid at being publicly labeled a cash-needy loser. It was angered at the suggestion it had agreed to accept a *low price*, or that it had better sell before it was too late. When the seller saw the articles, it quickly decided that if these investors chose to challenge it by offering prices that would lead to financial ruin, the selling process would stop. Perhaps the broker's strategy may have worked with an American seller, but predictably it failed miserably with a Japanese businessman. Similar strategies have, and will always fail.

Had the broker and investors understood the lenders situation, and the laws governing deficiency balances, it is doubtful they would have attempted to implement a strategy that could only result in the seller's economic disaster. The development of a strategy that is untenable in light of Japanese issues clearly indicates that the broker did not possess appropriate knowledge to deal effectively with Japanese transactions. The investors, unwittingly following the broker as they did, indicates their similar knowledge deficit. Had they understood the issues, the inappropriateness of the broker's strategy would have been recognized and an alternative approach attempted. Unfortunately, for buyers and sellers alike, this scenario is repeated in almost every Japanese-American transaction. The same set of mistakes are unknowingly repeated time after time.

With only a rudimentary understanding of the Japanese business system, it is retrospectively easy to see why this transaction ended before it had a chance to begin, as has almost every attempt by Americans to purchases Japanese assets. An understanding of the issues is not necessary to realize that something is radically wrong. Almost every American attempt to conduct a Japanese-American transaction fails. Why? American businessmen, without realizing it, continuously repeat the same mistakes. Recognizing that they have, and understanding why they do, is an essential step toward rectifying the situation.

Why Do U.S. Businessmen Repeat Their Mistakes?
Their Paradigm is Based on Myths!

Why US Businessmen Repeat the Same Mistakes – *Their paradigm is based on a myth!* Investors have inadvertently accepted incorrect reasoning for why Japanese transactions fail.

Some Japanese owners have tried selling their U.S. properties, but American buyers have repeatedly failed in their attempts to acquire them. In fact, they seldom pass the initial offering phase, *first base*. Are American investors repeatedly making the same mistakes? The answer is a resounding yes. American investors have a false impression of Japanese sellers, their reasons for selling, and the reasons why they don't sell.

In the example case, as in past failures, the American investors and observers were shocked at what happened. Nevertheless, they all gave the same wrong reason for the failures. This should come as no surprise as they all employed a similar strategy built in large part by the broker's incorrect approach. Everyone lost again because neither the broker nor the investors realized the strategy was faulty, based on misunderstandings, and predictably destined to fail from the start. What can be done to prevent similar debacles in the future?

When repeated attempts result in repeated failures, and the strategies employed in those attempts conform to a widely adopted paradigm, it is essential to scrutinize the validity of the paradigm itself. Several understandable and logical reasons exist for the failed attempts, but none are embodied in the model currently accepted for developing acquisition strategies. The common paradigm which American investor's base their attempted Japanese real estate purchases must be considered dubious, if not entirely flawed.

Sometimes paradigms are erroneous because they are based on misunderstanding or ignoring the issues involved. AES has long maintained this is true for the issue of failed Japanese property acquisition attempts by Americans. The perceived stereotype is a myth comprised of the following three erroneous illusions:

- Japanese owners are forced to sell their properties at substantial losses to avoid bankruptcy.
- Japanese-owned U.S. properties offered for sale are beginning to flood the market.
- Sellers will refuse to sell if the offering price is lower than their unreasonable expectations.

Japanese owners are not forced to sell. Numerous news articles report that Japanese owners, already close to financial ruin, are forced to sell their properties at substantial losses. This is untrue. Yes, the Japanese unquestionably are suffering serious financial distress. Japan's banking system is in shambles. It is so bad, they can't foreclose on their delinquent loans, measured in the trillions, without creating their own insolvency. Even if the banks wanted to act against the sellers, they can't. Furthermore, most sellers entered into forbearance agreements with the banks that by design, qualify their loans as performing. They are, therefore, in no immediate danger of foreclosure. At worst, the Japanese mortgages are in technical default only because their collateral value has decayed. The belief that Japanese owners must sell is a myth based on misunderstanding and ignoring the facts.

The market is not flooded with Japanese properties. For years, news stories have periodically appeared that quote experts as saying that Japanese-owned properties are starting to be offered for sale in flood-like proportions. The stories identify several properties as recently sold for prices substantially below cost as proof of their assertions. With only a modicum of scrutiny, however, the stories are discovered to be rubbish. There is no flood of Japanese property offered for sale. Not only is there no glut, it is unusual to even find a Japanese property offered for sale. Where are all the properties that have been sold? More rubbish. Only a handful of properties have been sold. For the three or more years the stories have appeared, the list of recently-sold properties always cites the same few properties. Plain nonsense, or is some public relations department doing a fine job of planting stories?

A seller's expectations play little, or no role in it's decision to accept an offer. The difference between a property's current market value and the owner/seller's unreasonable expectations of selling price has been labeled the *Expectation Gap*. The experts who coined the phrase wrongfully concluded the Expectation Gap is the reason for the failed attempts. They reached their conclusion after hearing the Japanese sellers repeatedly exclaim, "I paid a high price, so I should be able to expect to receive a high price!" This attitude is attributed to the seller's resistance to *lose face* because the loss incurred is a product of his poor investment. Regardless of the rationale employed for accepting the Expectation Gap as the reason, it is not the reason. The experts simply did not understand that the sellers were actually expressing shock. The experts also failed to hear the seller say that can not sell at current market prices without committing financial suicide. AES contends that a seller's inappropriate expectations or face-losing fears are not legitimate causes for failed acquisition attempts by American investors. A rudimentary understanding of legal issues in Japan leads to the conclusion that the seller cannot sell at current market values without suffering financial catastrophe.

How could such a flawed paradigm become so widely adopted by the American investment community? Notwithstanding the experts flawed thinking, investors have heard the experts repeating the same unfounded myths over and over. When people are repeatedly told the same falsehood, they ultimately accept the lie as truth. Politicians, advertisers, and public relations agencies have employed this technique for years.

Every American reader of this study has read the numerous news stories always quoting the same experts. It would be difficult to not have encountered them. For years they have appeared with regularity every three- to six-months in daily newspapers, the financial news media, and major periodicals, e.g., Time, Newsweek, etc. It may be surprising to some that the stories were created (and planted) by the same experts who are quoted as experts within the stories. The stories are an integral part of a misdirected strategy designed, in part, to cast their author's as experts to the real estate investment community. Unfortunately, their ploy seems to have met with success as they are viewed and followed as experts, despite their expertise being manufactured in their own conference room. The large number of failed attempts by their followers is a tribute to the efficacy of the expert's campaign. The intended audience for the news stories is not limited to the American investors. The stories were also crafted to serve another roll, but, with the Japanese community.

Japanese-owned U.S. property is a near-rarity in the marketplace, but reports to the contrary abound. A business firm with a profit motive to increase the flow of Japanese property to the market, fabricates the reports of a flooded market. By design, the news stories inform Japanese owners that their peers have started to rush to market with properties for sale to the highest bidder. They are informed the current value of their property is much lower than what they paid, and it would be foolish to expect higher prices. The owners are implicitly warned that further hesitation to sell will only lead to further price erosion, and greater losses. Japanese businessmen are appropriately insulted by the news stories. They and their peers cannot sell at current market values, so there is no rush to do so. To think they would is labeling them as stupid! The experts claim to possess an extensive understanding of the Japanese, but their strategy indicates the opposite is true.

The widely-adopted paradigm upon which American businessmen base their acquisition strategies is terribly flawed. Its replacement must comprise the following facts:

- Japanese owners are not forced, or under pressure to sell their properties.
- Japanese sellers will sell if the sale relieves them of all encumbrances.
- Japanese sellers will sell if losses are minimized and tolerable.
- Japanese cultural and business issues must be understood and applied.

The investor's buying strategy was based on the broker's and the so-called expert's flawed thinking, misunderstood cultural issues, and ignorance of Japanese legal issues. Obviously the time has come for the American investment community to follow a different piper, or develop a working knowledge of the Japanese business system, or better yet, employing appropriate expertise to deal with the issues. The latter choice is probably the most efficacious, as the issues are monumental in number and complexity.