

Deloitte Tohmatsu LLC

Deloitte CFO Signals

2015 Q4

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About Deloitte CFO Signals

Deloitte CFO Signals is a CFO opinion survey conducted by Deloitte periodically at the global level in cooperation with Deloitte member firms in each country. The responses obtained from the CFO survey are gathered and analysed by specialist Deloitte professionals, then the report is distributed as "CFOs Signals" to CFOs.

The questionnaires comprising the survey include the globally conducted "survey on the economic environment" and "survey on a hot topic", which are tailored to each region.

The first survey was conducted in Japan in August 2015, and this is the second survey. "The survey on the economic environment" chronologically investigates changes of views among CFOs, as well as their economic prospects at the time of the survey. In addition to this regular survey, an opinion survey was also conducted regarding baseline scenarios and risk scenarios from a macro viewpoint for both Japan and other developed nations. Global M&As are featured as the "hot topic" in this survey conducted in Japan.

This survey was conducted between December 2015 and January 2016, and answers from the CFOs of 33 companies were obtained.

We are sincerely grateful for your cooperation.

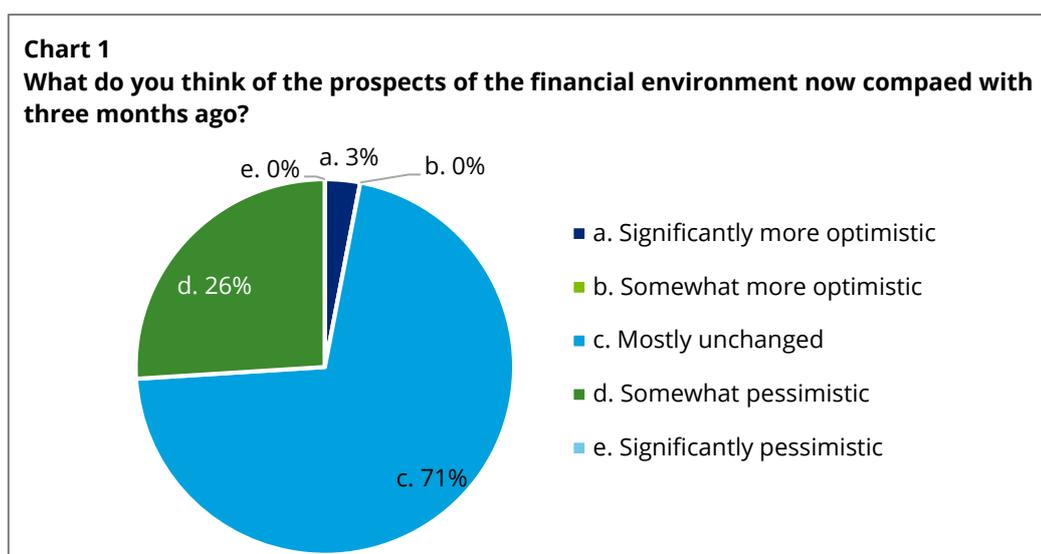
Deloitte Tohmatsu CFO Program
2016/2/4

Survey on the economic environment

This time, like last time, the survey asked about prospects for the financial environment in one year's time and the business performance outlook. In addition, we asked new questions about possible baseline scenarios and risk scenarios for the Japanese economy in 2016. Concerning risk scenarios in particular, we asked CFOs to choose some possible trigger factors from various domestic and foreign events. We believe that we gained an understanding of CFOs' outlooks and of the necessary conditions for those outlooks to come true, as well as the risk scenarios that would force them to consider revising their corporate management direction.

Prospects for the financial environment

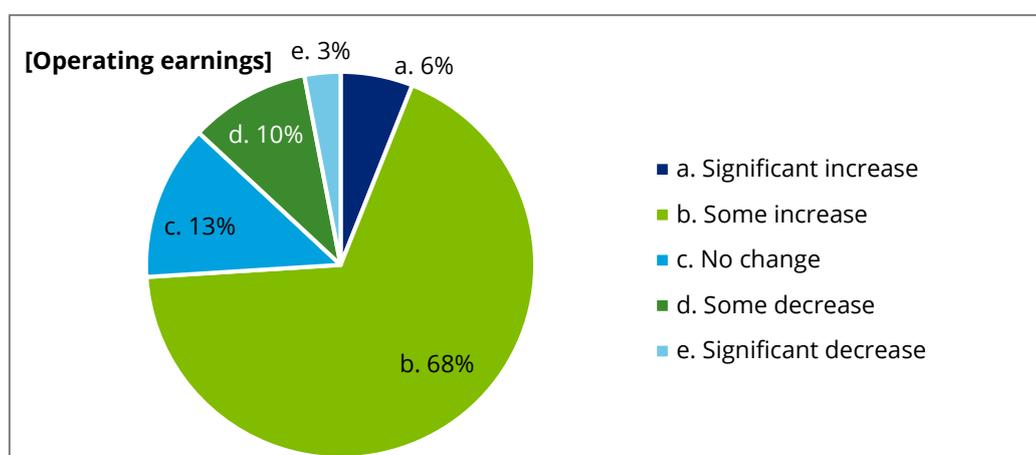
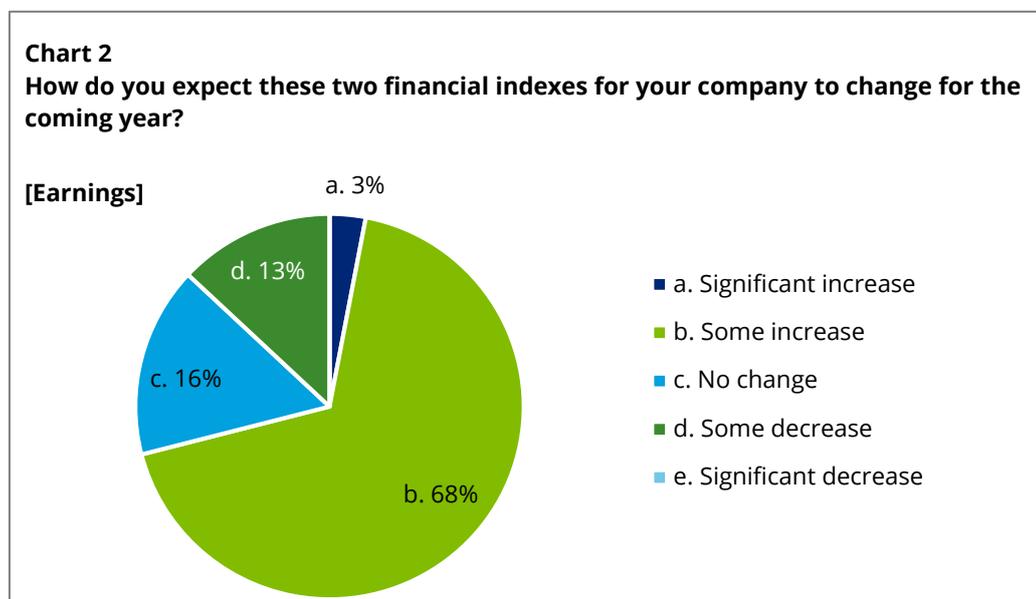
Chart 1 shows the CFOs' forecast regarding the business environment at the time of the survey compared with 3 months earlier (previous survey).



71% of the CFOs answered “c. mostly unchanged”, which means that most of the companies think their financial environment is stable. The second most popular answer was “d. somewhat pessimistic” (26%), and the third answer given, with only one respondent, was “a. significantly more optimistic”. Compared with the previous survey, it can be said that the number of CFOs who answered “b. somewhat more optimistic” decreased greatly while choice “d. somewhat pessimistic” increased in popularity. This result indicates **that while the business environment surrounding Japanese companies is largely unchanged, more companies are becoming cautious.**

Business performance outlook

In the one-year business performance outlook, we can see that the CFOs are confident that their companies' revenue and profit will increase. Chart 2 shows the results of the survey on business performance outlook for the next year.

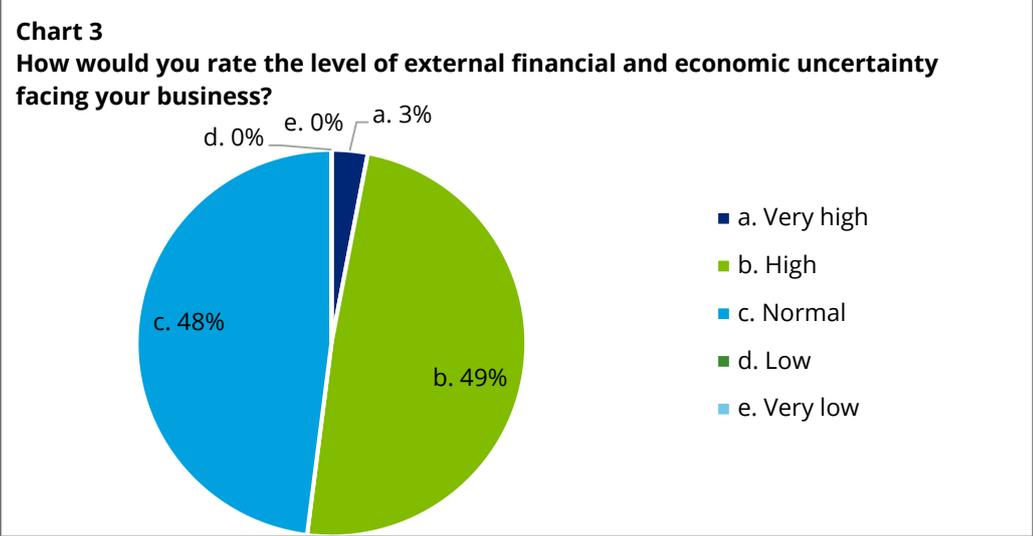


In short, 68% of CFOs answered "b. some increase" and 3% answered "a. significant increase", which is to say that 71% of CFOs predict that their earnings will increase. The same is true for operating earnings, i.e. 74% of CFOs answered that their operating earnings would increase. From this, we can say that **the rising trend in both sales and profits is continuing.**

At the same time, cautious prospects for earnings and operating earnings are also increasingly common. The CFOs who answered "d. some decrease" or "e. significant decrease" increased by 13 points in comparison to the previous survey. Accordingly, **the proportion of CFOs who fear a fall in both income and profits has increased slightly in the last three months.**

Uncertainty

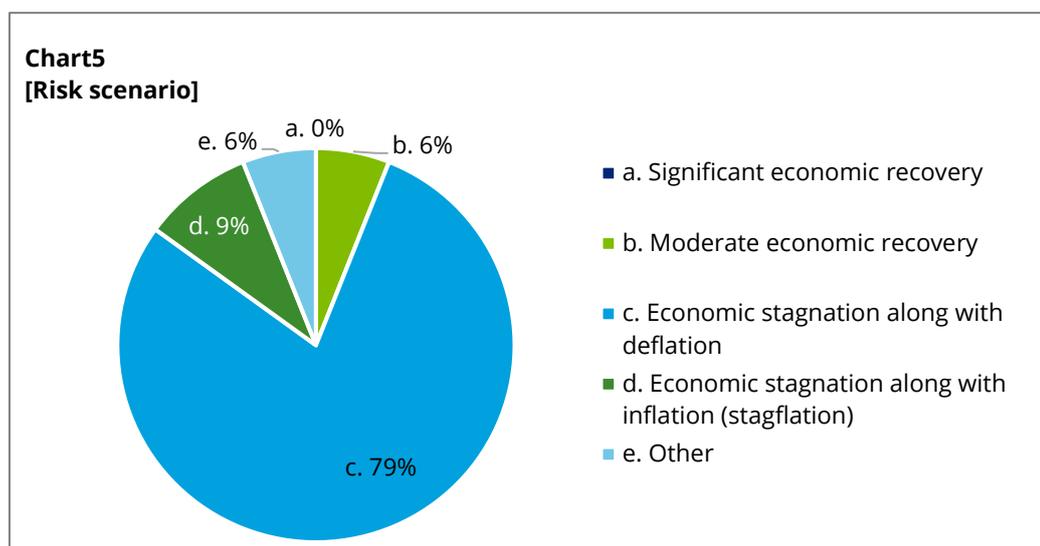
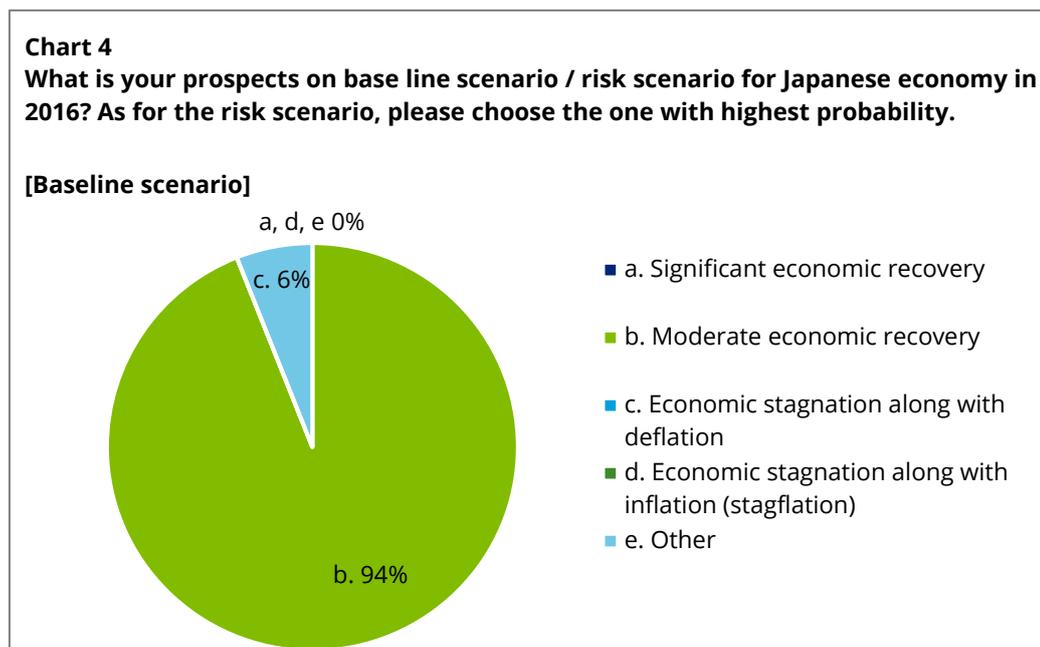
The CFOs' uncertainty is still high. Chart 3 shows results concerning financial and economic uncertainty.



52% of CFOs answered “b. high” or “a. very high” and the rest answered “c. normal”, while none answered “d. low” or “e. very low”. This result is almost the same as last time, showing that **uncertainty for corporate management remains high.**

Prospects for baseline scenarios and risk scenarios

Chart 4 displays the very interesting answers to the question about possible baseline scenarios for the Japanese economy in 2016. 94% of CFOs chose “b. moderate economic recovery”. The rest (only two companies) chose “c. economic stagnation along with deflation”. **It is surprising that no-one expects an economic slowdown, and this result may be too optimistic.**



In contrast, chart 5 shows the answers to the question about possible risk scenarios for the Japanese economy. Here also, there is a high level of agreement among CFOs, many of whom predicted the same scenario. 79% of them chose “c. economic stagnation along with deflation” giving “d. economic stagnation along with inflation (stagflation)” and “e. other” a low share of responses. As for the

Japanese economy at the time of conducting this survey, the Bank of Japan said that prices were strong, based on substantial increases in product prices; in other words, businesses have changed their price-setting policy. However, judging from this result, even **the companies who are increasing their product prices are concerned with deflation rather than stagflation.**

Trigger event for risk scenarios

The next two questions are about the factors that may trigger the aforementioned risk scenarios. Chart 6 shows whether CFOs think that domestic or foreign factors are more likely to trigger the risk scenarios. All CFOs answered “b. foreign factors”. Considering both the result above and this result, CFOs mostly agree that the Japanese economy will recover slowly. But if the recovery process were to fail, it would be because of foreign factors, not domestic factors. In other words, **they think that the Japanese economy will recover spontaneously only in the absence of foreign trigger factors.** According to these results, CFOs do not seem to be much concerned about the Japanese economy in itself.

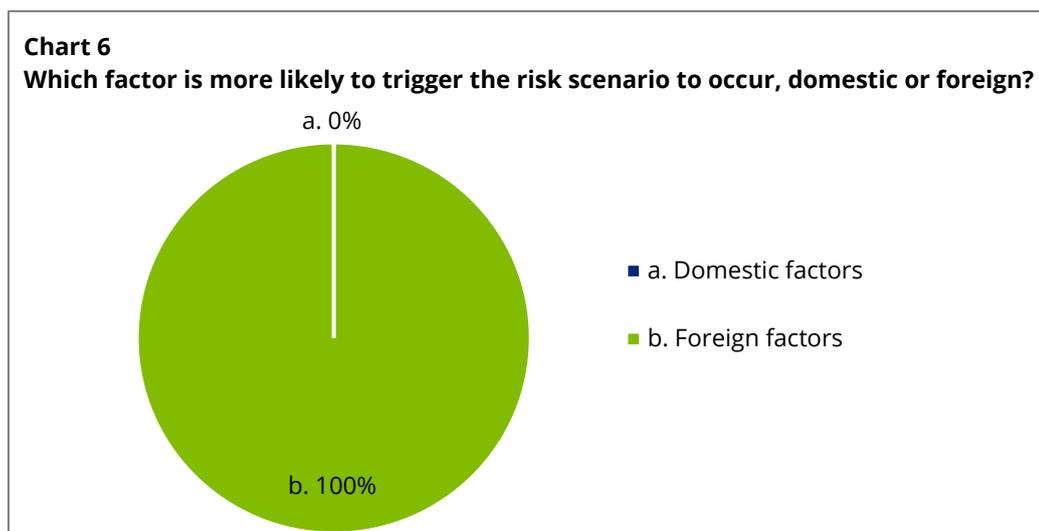
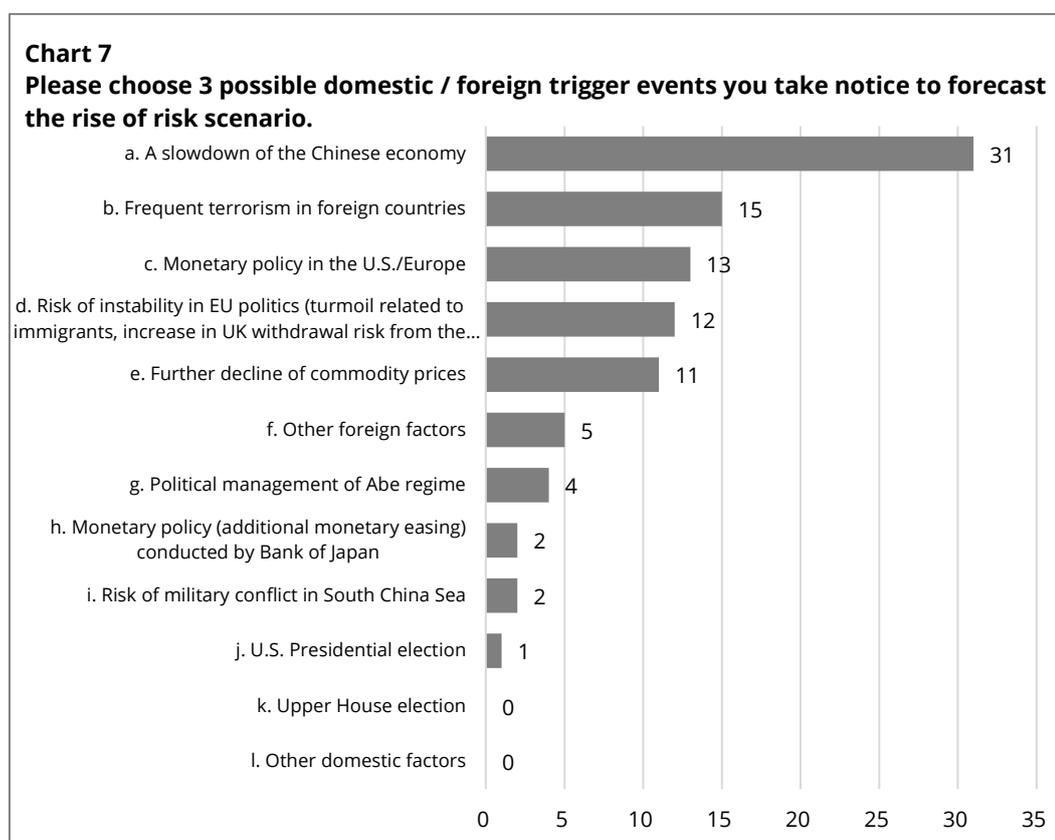


Chart 7 (next page) shows the trigger factors which CFOs think are most important regarding risk scenarios. Though it is not as obvious as in chart 6, foreign factors gathered more attention than domestic factors. The most popular answer was by far “a. a slowdown of the Chinese economy”. **In fact, one of the causes for global risk starting from the beginning of 2016 really was anxiety about a slowdown of the Chinese economy and increasing indecisiveness in Chinese politics. At the time of conducting the survey, CFOs foresaw this risk scenario from China as an important factor, even though it was yet to come true.**

Otherwise, “b. frequent terrorism in foreign countries”, “c. monetary policy in the U.S./Europe”, “d. risk of instability in EU politics (turmoil related to immigrants, increase in UK withdrawal risk from the EU, etc.)”, and “e. further decline of commodity prices” gathered relatively many answers. Because the question did not touch on how these trigger factors, should they occur, may lead to deflation in Japan, the mechanism behind deflation was not clarified. Possible explanations are that deflationary pressure may promote borrowing, or that an increasingly strong yen (caused by a lack of global demand or by increased exports of Chinese products due to a rapid slowdown of the Chinese economy) is reinforcing deflationary pressure in Japan.

In any case, **it is concerning that CFOs do not think of domestic factors as possible risk scenario triggers for the Japanese economy: is it a sign of stability and trust in Japanese domestic policy, or does it reveal the limits of that policy and hint at political stalemate?** Furthermore, “f. other foreign factors” includes a deterioration of the situation in the Middle East, which would cause a sudden rise of crude oil prices or other Middle-East-related risks. Keeping in mind the very high volatility of crude oil prices in recent years, we may have to account for such a risk as a sub-scenario.



Main upcoming concerns

These survey results promise a continuous increase of revenue and profits. This is very reassuring, but more than half of CFOs are still highly concerned about uncertainty. Besides, more and more CFOs, albeit a small number, are getting worried about a decrease in revenue and profits. In such a situation, if some risk-carrying events happen, companies may start preparing for further risk scenarios, resulting in hesitation about raising wages or capital investment.

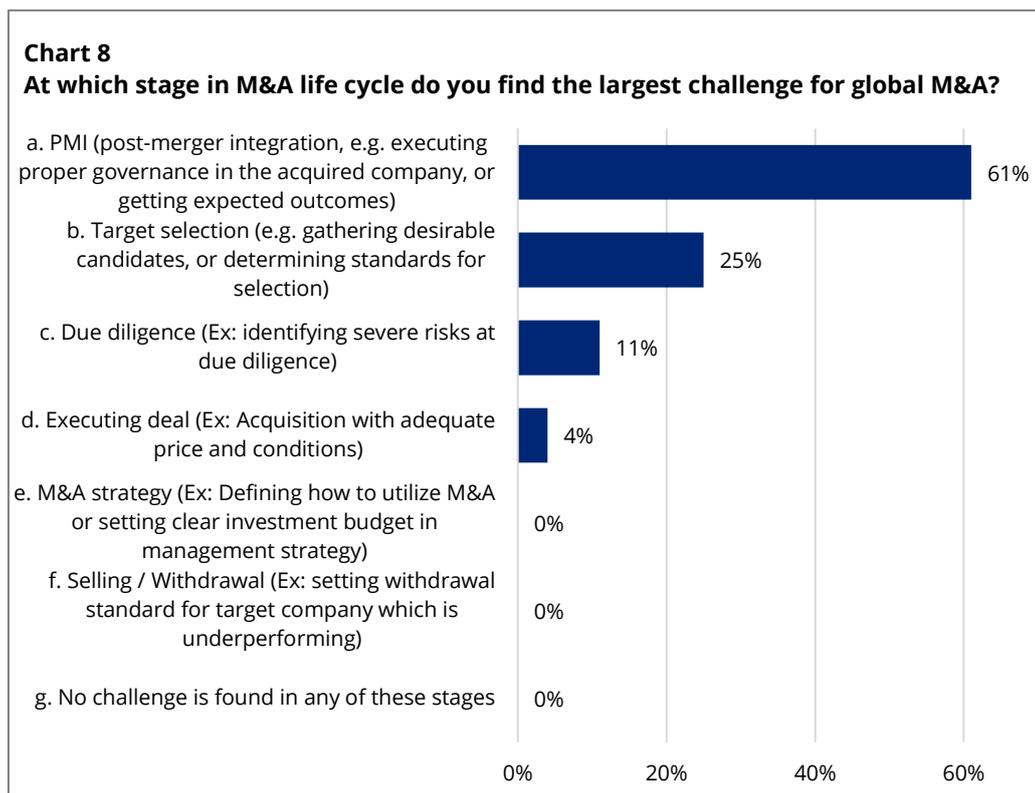
CFOs are also highly anxious about the recovery of the Japanese economy due to global risks that appeared in the beginning of 2016. Under these circumstances, the CFOs' expected baseline scenario of "moderate Japanese economic recovery" may not materialize if wages raises are postponed or if investment amounts are reduced. The foreign factors regarded as possible triggers for risk scenarios in this survey are undoubtedly important, but we think we should also be concerned about the possible domestic trigger factor of a vicious circle caused by withering corporate management confidence.

Survey on organizational ability for global M&As

We conducted a survey on organizational ability for global M&As to find out to what extent preparedness for global M&As affected CFOS' corporate activities.

Issues surrounding global M&A activities

Chart 8 shows issues identified by CFOs when carrying out global M&As.



The most popular answer was “a. PMI (post-merger integration, e.g. executing proper governance in the acquired company, or getting expected outcomes)” (17 companies). It seems that they faced great difficulty after M&As. Some companies who succeeded in buying a foreign company by using large sums of money earned through good corporate performance find it difficult to promote the growth of the business they acquired, be it through governance or by conducting joint activities to maximize synergy.

Overcoming these difficulties may require **companies to strengthen their “global M&A organizational ability” to strongly enhance post-M&A activities**, which they can do by adopting some of the initiatives below:

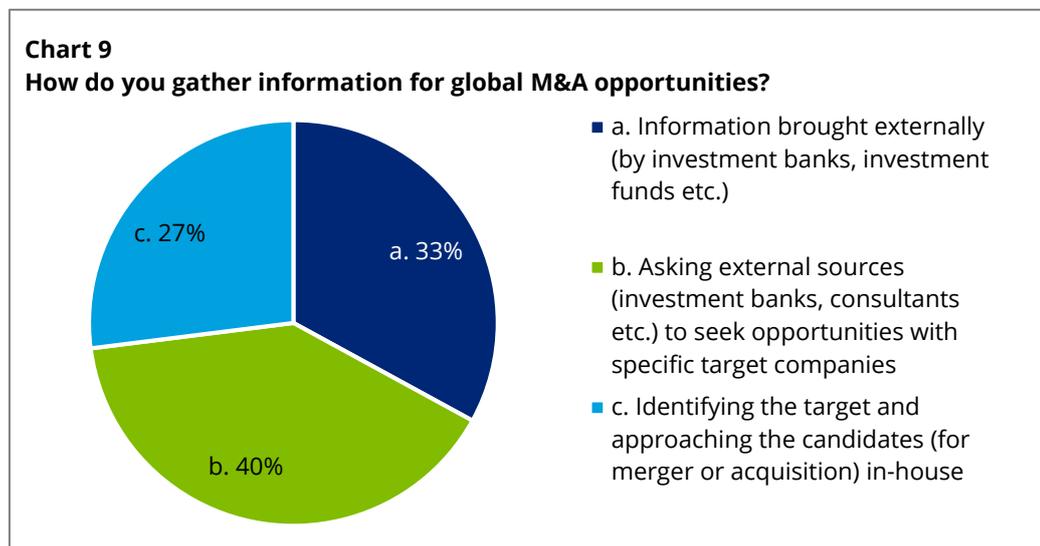
- **Building “their own guideline” for business management in the foreign subsidiary or applying their own model of governance (e.g. policy, management practices, functional/system design, and corporate structure for acquisition purposes)**

- **Acquire/develop global talents who can get over language barriers and gaps in business practices and culture**
- **Accumulate PMI experience from global M&As and share it inside the company**

The second most popular answer was “b. target selection (e.g. gathering desirable candidates, or determining standards for selection)”, selected by 7 companies. This choice shows awareness of the problem of gathering information and setting selection standards during the process of finding M&A candidates; we shall return to it in more depth below.

Search for M&A opportunities

Chart 9 shows answers to a question about methods for gathering information about M&A opportunities



The answers to the question on methods for gathering information on M&A opportunities are divided into autonomous selection of M&A targets and related information on the one hand and reliance on external sources on the other. It is arresting that over half of CFOs (4 of 7) who answered that they have target selection problems to the last question (cf. chart 8) also chose “b. asking external sources (investment banks, consultants etc.) to seek opportunities with specific target companies”.

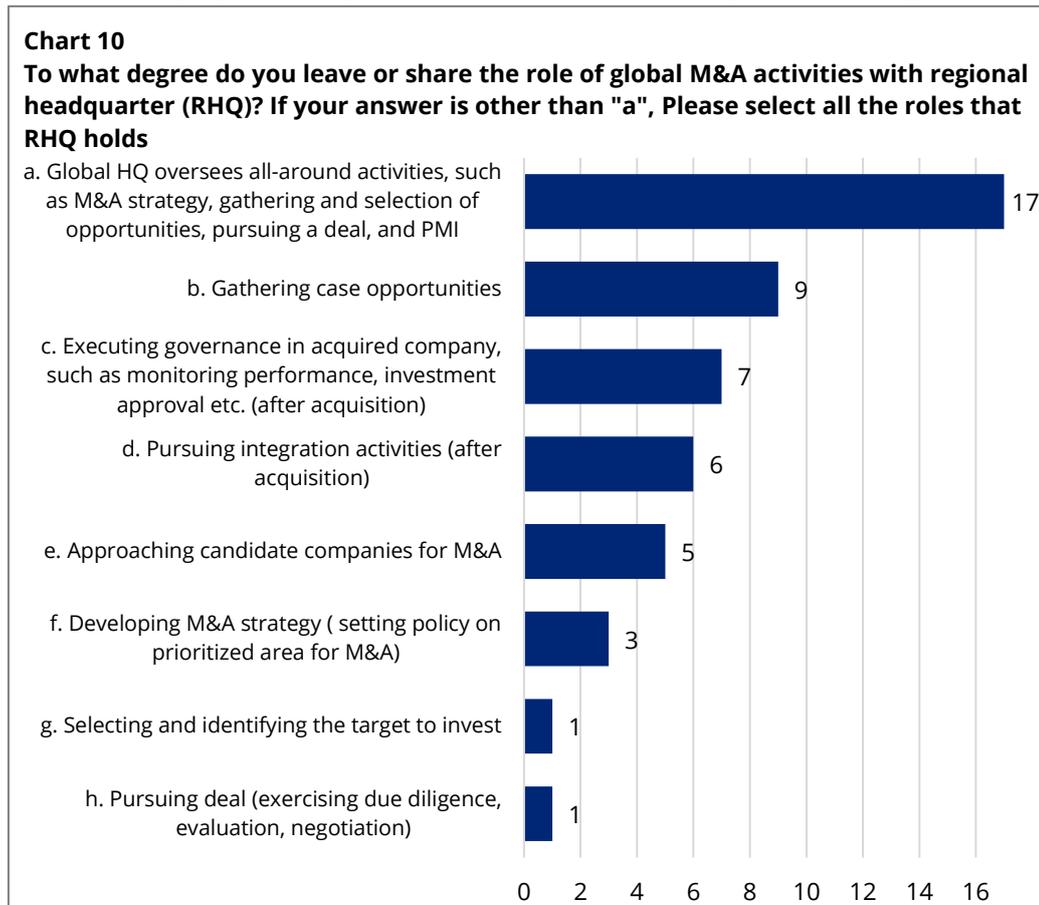
The companies that express concern about global M&As have to beat global players who have much more experience of M&As. It is difficult for them to find good candidates for acquisition if they are just waiting to be made aware of an M&A opportunity from external sources, because those global M&A players actively gather information about M&A opportunities and approach candidates in a proactive way by making full use of both internal and external resources. **In order to survive global M&A competition, it is important to have a clear M&A strategy and to use it as a base to proactively engage in M&A activities such as candidate research while making good use of internal networks as well as external players.**

These days, some Japanese companies make claims such as: “We were unable to obtain good results after approaching target companies out of a long list of M&A candidates. After that, we recognized that M&As would be difficult for us and did not try ever since”. In terms of M&A opportunities, the results can be timing-dependent, because of the economic environment, industry trends, and the

business conditions of candidates. Therefore, **companies looking for M&A opportunities need to stick with a PDCA cycle of M&A investigations (select candidates, approach them, verify the results, reconsider candidates).**

Role of headquarters and regional headquarters (RHQ) in global M&As

Chart 10 shows the role of regional headquarters (RHQ) in a series of M&A activities ranging from acquisition consideration to the post-M&A stage.



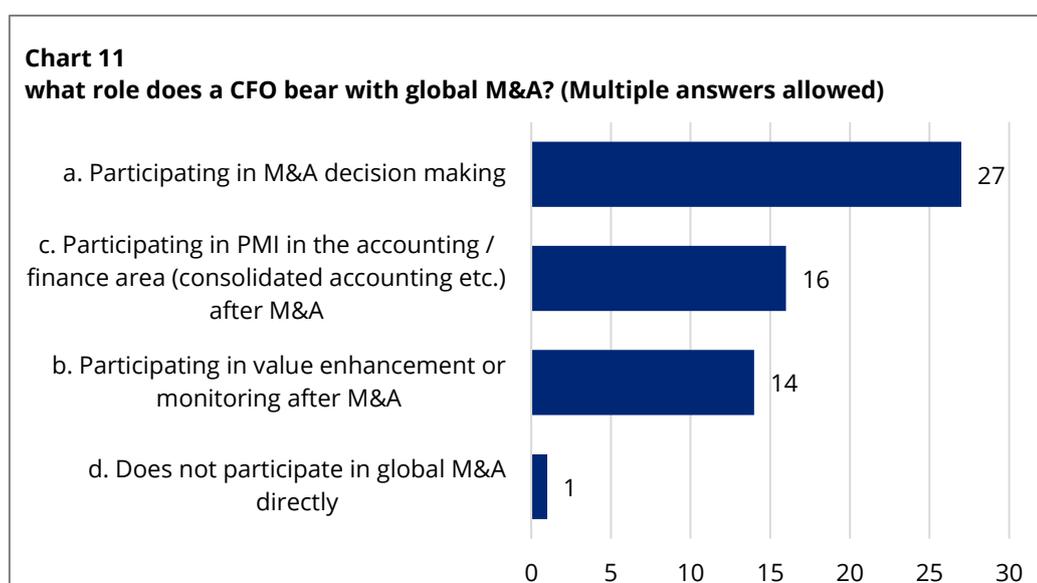
The most popular answer was “a. global HQ oversees all-around activities, such as M&A strategy, gathering and selection of opportunities, pursuing a deal, and PMI”, which gathered 17 answers. In terms of M&A activities, usually either the corporate planning department or a planning group within the relevant business department of headquarters is in charge, given that M&A deals are large-scale and retain a high level of confidentiality for a long time.

On the other hand, the rest of the answers show that this trend is changing. Other companies answered that they transfer the role of searching for M&A opportunities as well as PMI to RHQ. We can see that RHQ works toward finding M&A opportunities in answers such as “b. gathering case opportunities” (9 CFOs) and “e. approaching candidate companies for M&A” (5 CFOs) because RHQ can

access local information easily. There are also cases of RHQ working on integration and governance activities after acquisition, such as “d. pursuing integration activities (after acquisition)” (6 CFOs) and “c. executing governance in the acquired company, such as monitoring performance, investment approval, etc. (after acquisition)” (7 CFOs). In this way, **RHQ used to mainly assumed business control responsibilities such as fund management or performance monitoring of the local subsidiary. But now, the function and role of RHQ in M&A activities are reinforced: they are becoming more strategic to include the search for M&A candidates as well as internal control after the acquisition.**

Role of CFO in global M&As

Chart 11 shows the answers to the question about the role of CFOs in global M&As.



The most CFOs (27) answered “a. participating in M&A-related decision-making”. Judging by this result, we recognize that many CFOs take part in discussions regarding the validity and process of financial arrangements, the acquisition scheme, and decision-making from the viewpoint of financial impact (e.g. return on investment). Meanwhile, CFOs are less involved in post-acquisition activities than they are the investigation stage. There were 6 CFOs who chose “b. participating in value enhancement or monitoring after M&As” and 14 CFOs who chose “c. participating in PMI in the accounting/finance area (consolidated accounting etc.) after M&As”.

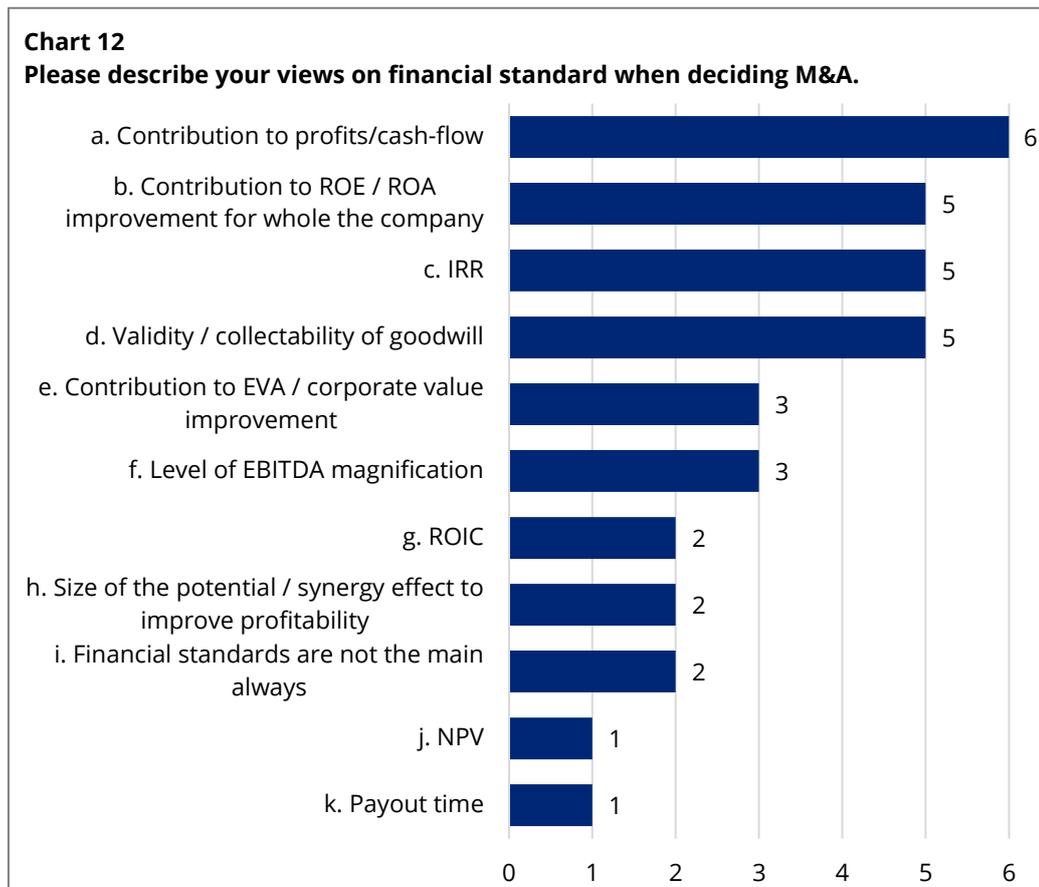
We saw many cases where corporate planning departments/relevant business departments improve investment value or control internal governance and CFOs

do not participate so much in post-acquisition activities. However, **active participation of the finance function is needed even after the acquisition because the reduction of financial risk/management costs through exchange control and fund management is a key issue for corporate management** when buying a foreign company. **In addition, some smart global M&A companies' CFOs see the monitoring of M&A investment return as their mission and get deeply involved in PMI. For example, they often monitor acquired companies for a certain period after the acquisition.**

Besides, the decision-making cycle of foreign companies is usually quicker than that of Japanese companies and this gap sometimes has a bad influence on foreign companies. In order to continuously promote global M&As, **it is necessary that Japanese companies reduce such gaps in business management level between them and the companies they acquire, in order to raise the corporate management of their headquarters to a global standard by strengthening its foundation or by increasing its speed. In the future,** CFOs will be expected to contribute to those activities.

Financial standards for deciding on global M&As

Chart 12 shows financial standards for deciding on global M&As

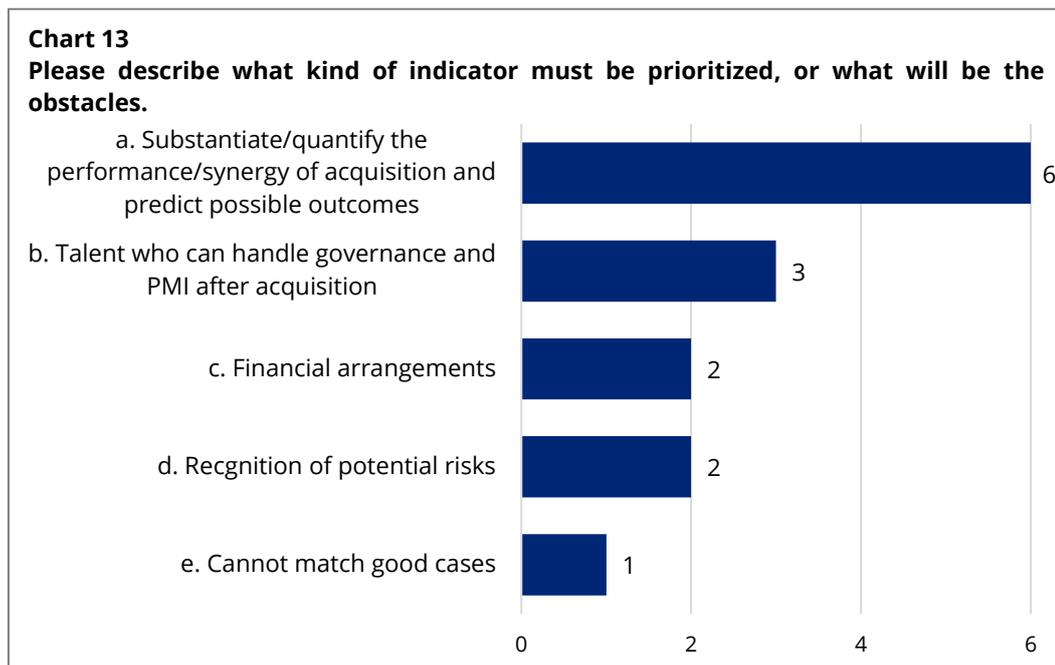


“A. contribution to profits/cash-flow” is the most selected answer (6 companies). There are 5 CFOs who selected “c. IRR (Internal Rate of Return)” and one CFO who selected “j. NPV (Net Present Value)”. There are many CFOs who mentioned that they made investment decisions from the investment payback possibility by estimating capital cost using “c. IRR (Internal Rate of Return)” (5 companies), “j. NPV (Net Present Value)” (1 company), and “e. EVA (Economic Value Added)” (3 companies). 5 CFOs answered “d. validity/collectability of goodwill”, indicating that CFOs are sensitive to detraction risks because impairment loss of goodwill is frequently reported in the media these days.

Option “b. contribution to ROE / ROA improvement for the whole company” (5 companies) received the same number of answers.

Obstacles to M&A investment

We also used a free-description-type question about the obstacles to M&A investment and chart 13 shows the primary answers to it.



The most popular answer was “a. substantiate/quantify the performance/synergy of acquisition and predict possible outcomes” (6 companies). There are many cases of failure caused by misjudging the value and risks of candidate companies at the investigation stage. For example, it is difficult to get a return on some companies bought for a high price because the acquiring company had been too optimistic regarding synergy, expecting such outcomes as a far-reaching, immediate jump in sales of their product or short-term development of a groundbreaking product through the acquisition of promising technology. In other cases, their revenue declined drastically just after the acquisition due to unforeseen problems, such as issues with product quality or plant-management standards. In order to avoid such problems, **we think it is important to conduct appropriate due-diligence at the acquisition stage and to judge how the acquired company will contribute to the acquiring company’s growth strategy after accessing the capabilities of both companies.**

In addition, “b. talent who can handle governance and PMI after acquisition” is also an important point according to three companies. As we heard in our discussions with many companies who face talent-related issues, companies that are just beginning to consider a global M&A without much related experience worry that they cannot pursue the project because there is no-one in-house who can communicate globally and also has M&A-related knowledge. Companies that pursue many M&As also worry about a lack of human resources because they send good, highly-adaptable talent to the acquired companies with the expectation that they will commit to the goals they have been set.

After all, we should keep it in mind that the demand for talent who has both global and M&A-related skills cannot be fulfilled completely. Therefore we need to work on themes such as:

- **Ascertain what functions are needed in-house (i.e. what experience and knowhow should be accumulated by the company) and also utilize external resources effectively.**
- **Build the necessary structures to acquire and develop bright talent (i.e. structures to strengthen the skills of internal talent and to acquire external talent).**

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◆ What is the CFO program?

Deloitte's Chief Financial Officer (CFO) Program brings together a multidisciplinary team of Deloitte leaders and subject matter specialists to help CFOs stay ahead in the face of growing challenges and demands.

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