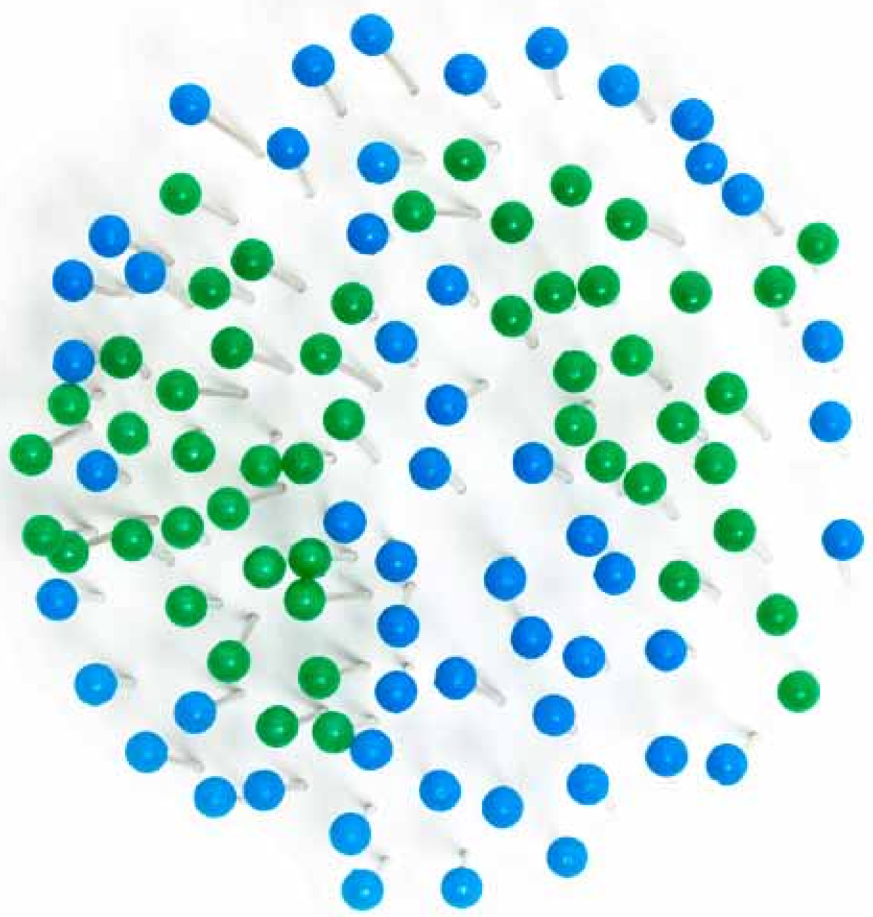
Deloitte.

Japan's inbound potential

February 2014 Update



Japan's overseas buying spree in recent years has been one for the records. In 2012, Japanese corporates closed the books on 251 transactions worth a staggering ¥11.3tn (US$115bn), an impressive outbound feat that was followed up in 2013 with 250 deals worth ¥4.7tn (US$47.5bn)[1].

Japanese M&A, however, is not entirely an outbound story. Inbound interest from foreign investors has piqued in the past year. This interest, however optimistic, has yet to translate into substantial deal numbers. In 2011, foreign acquirers completed 39 deals in Japan, following up in 2012 with 49 transactions. The momentum was short lived, as figures dropped to 35 deals in 2013. Deal values, however, have increased from close to ¥986bn (US$10bn) in both 2011 and 2012, to ¥1.3tn (US$13bn) in 2013.

Compared to neighboring countries – China had 231 inbound deals while South Korea had 41 in 2013 – Japanese inbound figures leave room for growth. Industry insiders and experts, however, remain hopeful: with inbound deal levels at a three year low, deal making is poised for a rebound.

[1] Transactions with a deal value greater than US$5m are included. If the consideration is undisclosed, deals are included on the basis of a reported or estimated value of over US$5m. If the value is not disclosed, deals are included if the target's turnover is greater than US$10m. Unless otherwise specified, deal figures and graphs refer to transactions completed by both corporate and private equity buyers. An exchange rate of 98.66 yen to one US dollar was used for this publication.

Improving investor sentiment follows trends in the Nikkei Stock average, which staged a 61% increase from November 2012 to May 2013. While the market declined in Q2 2013, hopes were lifted following the September announcement of Tokyo's winning bid to host the 2020 Summer Olympics. Stocks in a number of Japanese property developers, contractors and construction companies surged, with already existing anticipation surrounding the real estate sector bolstered by news of winning the Olympic bid. Matched with Prime Minister Shinzo Abe's economic stimulus plan, known as "Abenomics", Tokyo's victory could motivate investors from the sidelines, creating a renewed wave of inbound investment.

Interest builds for property

Despite a decrease in the number of completed deals, industry experts remain confident a surge in investment lies ahead as foreign real estate funds set their sights on Japanese property. Many predict an uptick in inbound deal making since increases in inbound acquisitions typically follow trends in the real estate market, according to Mergermarket intelligence.

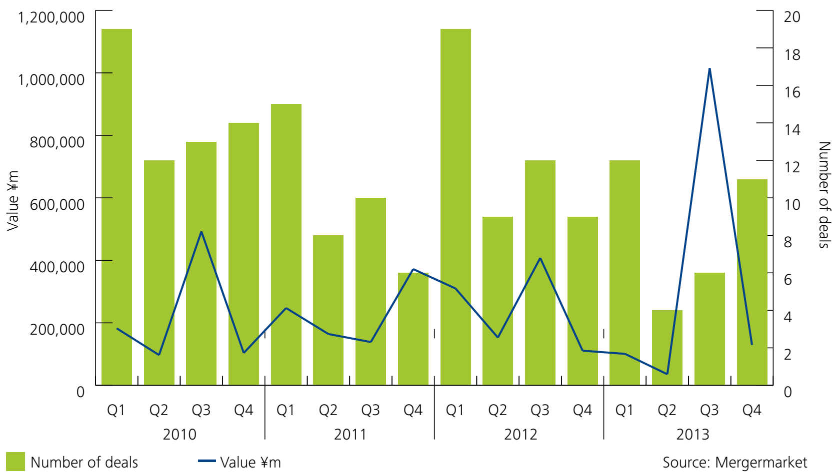
Asian property service firm Jones Lang LaSalle has called Japan a "thriving" commercial property market with demand for commercial and residential space outpacing other markets in Asia. Investment in property for Q2 2013 jumped 78% from the same period the year before, totaling ¥1tn (US$10.2bn).

Enthusiasm for Japanese property has blossomed as investors search for hard assets as opposed to financial assets. With the attractive financing currently available and the general expectation that property values will soon rise, overseas investors and investment trusts are actively pursuing opportunities to purchase property.

Highlighting this trend, a group led by the Abu Dhabi Investment Council recently paid ¥98.6bn (US$1bn) for the Shiba Park Building, an office complex in central Tokyo. Aside from grabbing headlines as the largest property transaction for 2013, the deal also marked the largest property investment involving foreign investors since the global financial crisis.

Similarly, the Olympics is expected to provide impetus to see interest turn into actual growth. With the 2020 games in hand, Tokyo is planning its most extensive housing project in more than four decades, according to news reports. Massive infrastructure projects will create thousands of jobs as the Japanese capital city transforms itself in the run up to the games.

Japan inbound M&A



Source: Mergermarket

However, industry experts have already been quick to point to the wishful thinking of past Olympics, noting how anticipated economic growth and long-term benefits of playing host to the international sporting event rarely materialize. The challenge for Tokyo, and Japan in general, will be finding a way to harness this Olympic energy and maintain momentum once the Olympic flame has been extinguished.

Crosshairs on high-tech

Japan's strength lies in technology. From handheld consumer tech to advanced industrial capabilities, Japan excels in innovation. Perhaps, not surprising, the country's industrial sector and tech space have seen the bulk of inbound investment, the two accounting for a combined 51% of completed deals and 49% of deal value over the past four years.

Since 2010, the industrials & chemicals sector saw 54 completed deals (30% of inbound transaction volume), with foreign investors buying into electrical components and advanced battery manufacturing. In 2012, South Korean Samsung acquired Alphana Technology, the Japanese manufacturer of components used in hard disk drives, for ¥12.8bn (US$130m). More recently, in 2013 US-based AVX Corp. acquired Nichicon for its consumer-focused electronic component and battery production operations for ¥8.4bn (US$86m).

Japan's semiconductor space has also been particularly hot with 14 deals worth ¥1.3tn (US$12.7bn) since 2010.

In early 2013, NeoPhotonics announced plans to buy the optical components business unit of LAPIS Semiconductor, adding the Japanese company's advanced set of high speed optical communication devices to its own repertoire.

Later that year, Silicon Valley-based Spansion Inc closed a deal to acquire the microcontroller and analog device business of Fujitsu Semiconductor.

More recently, Applied Materials, the US-listed semiconductor equipment manufacturing company, announced plans to merge with Tokyo Electron through a stock swap merger of equals valued at ¥848bn (US$8.7bn) with dual headquarters in Santa Clara, Ca and Tokyo, Japan and a dual listing on both the Nasdaq and Tokyo Stock Exchange. After the close, the new company, with an expected market capitalization of approximately $29 billion, will be 68% owned by Applied Materials shareholders and 32% owned by Tokyo Electron shareholders.

A number of these transactions have resulted from carve-outs and spinoffs as Japanese corporates strive to create leaner, more efficient companies. Such divestitures allow tech companies to remain nimble in an industry that demands flexibility. It also allows them to adjust quickly to shifting market conditions and consumer demand.

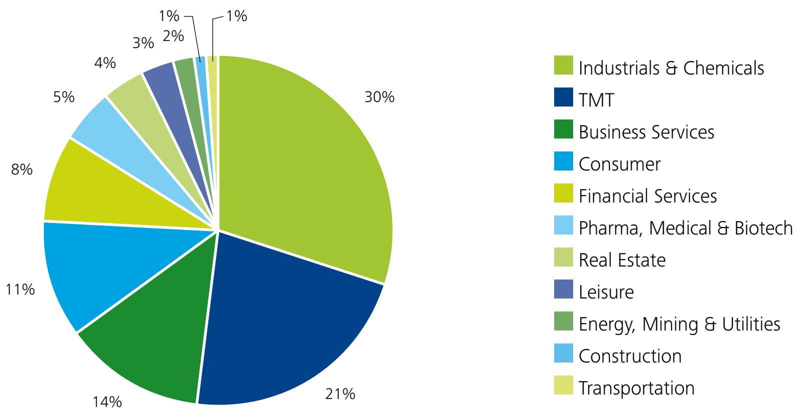
Foreign-backed buyouts continue

While domestic firms have been the dominant participants in private equity in Japan, international firms continue to solidify their place. Since 2010, international private equity firms completed 38 deals worth ¥1.2tn (US$12.3bn), compared to domestic firms with 96 buyouts worth ¥979bn (US$9.9bn).

Inbound buyout values have moderated following a spike in the last quarter of 2011, attributed to Bain Capital's acquisition of Skylark, a Japan-based restaurant chain operator, from investment firm Nomura and private equity firm Chuo Mitsui Capital for ¥207bn (US$2.1bn). Since 2012, the Carlyle Group has completed two management buyouts: the ¥36bn (US$370m) buyout of Diversey, the Japan-based provider of cleaning and hygiene products, and a ¥20bn (US$210m) deal involving computer software company Simplex Holdings.

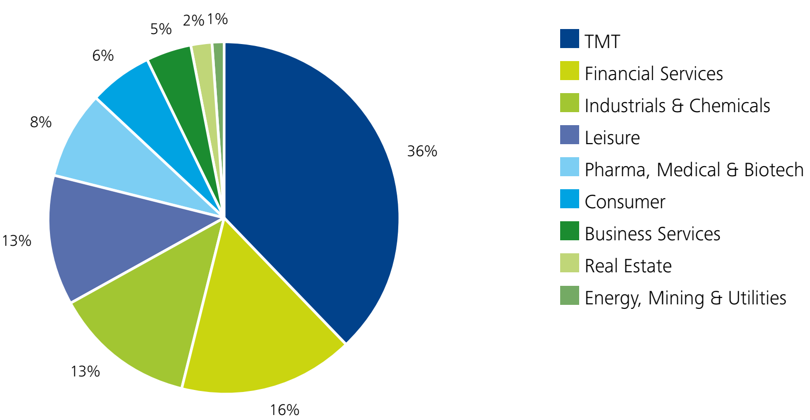
Despite the challenges foreign investors occassionally face, confidence is rising among global private equity firms that foreign investment into Japan will see an uptick in the year ahead. This sentiment was echoed by KKR co-founder Henry Kravis, who in September 2013 said Japanese companies are shedding their bias toward foreign private equity investment as they see the benefits private capital can offer their businesses. Perhaps in a demonstration of this trend, Panasonic sold its healthcare equipment division to KKR in a spinoff transaction worth ¥132bn (US$1.33bn) later

Japan inbound target sector, volume (2010-2013)



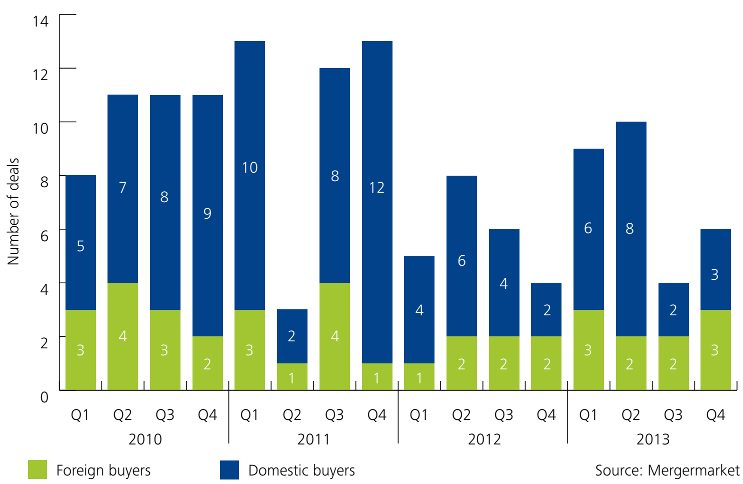
Source: Mergermarket

Japan inbound target sector, value (2010-2013)



Source: Mergermarket

PE buyout activity in Japan, volume



Source: Mergermarket

that month. Similar transactions could follow as a number of struggling Japanese companies divest noncore assets and shed their longtime aversion to private equity.

Fundraising targets also reaffirm private equity's interest in Japan. In July 2013, the Carlyle Group launched its third Japan-focused fund, setting out to raise ¥98bn (US$1bn). Similarly, KKR will commit a portion of its recently raised Asia Fund II, valued at ¥591bn (US$6bn), to completing acquisitions and investments in Japan, with TPG set to follow with similar transactions after closing its sixth Asia fund.

Inbound investment from outside Asia

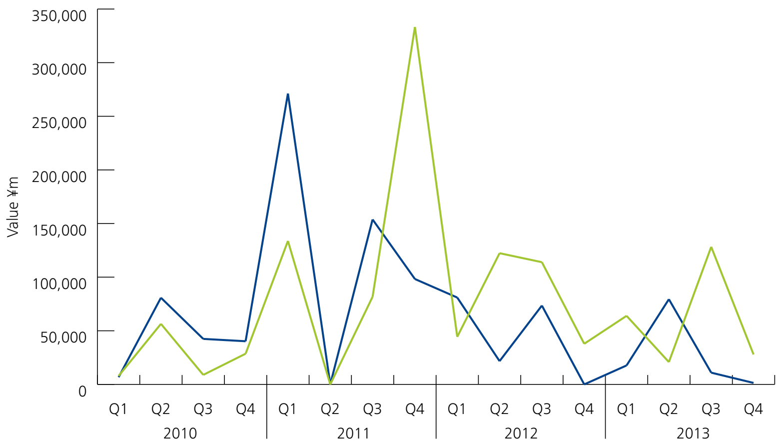
By the numbers, buyers from outside Asia have shown the most interest in Japan, completing 66% of inbound transactions since 2010. In value terms, the divide is even more impressive with non-Asian acquirers accounting for 84% of deal dollars, or roughly ¥3.4tn (US$35bn) in acquisitions.

The United States has accounted for the largest percentage of deal traffic with 75 deals or 42% of inbound activity into Japan since 2010. Like other prospective buyers, US-based firms see Japanese companies as catalysts for growth. The high-tech edge Japanese assets can provide creates an appealing allure, and US investors are willing to pay, a trend exemplified by the fact that the US accounted for 74% of deal value since 2010.

European buyers have likewise experienced significant deal volume over the past four years. Top acquiring countries included France with eight deals worth ¥47bn (US$511m), Germany with six deals worth ¥46.2bn (US$460m), and the United Kingdom with five deals worth ¥138bn (US$1.4bn). The UK's noticeable deal value included UK-based private equity firm Permira's ¥98bn (US$1bn) buyout of sushi chain Akindo Sushiro from its founding family and Japanese private equity house Unison Capital.

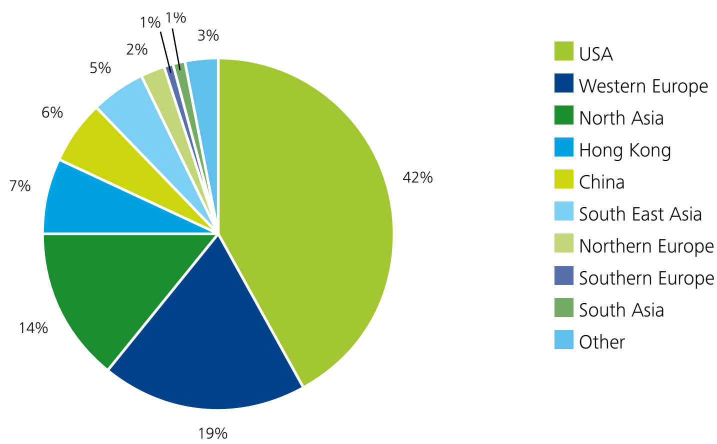
More than a significant dollar amount, the Akindo Sushiro deal goes against historical trends pertaining to foreign investors. Historically, Japanese sellers, particularly family-run businesses, have shown a preference for local buyers over their foreign counterparts, demonstrating efforts to keep national brands and technology closer to home. As a case in point, in 2012 Elpida Memory, a struggling chipmaker, had originally sought an acquisition by Toshiba. The bid, however, was lost to US-based Micron Technology.

PE buyout activity in Japan, value



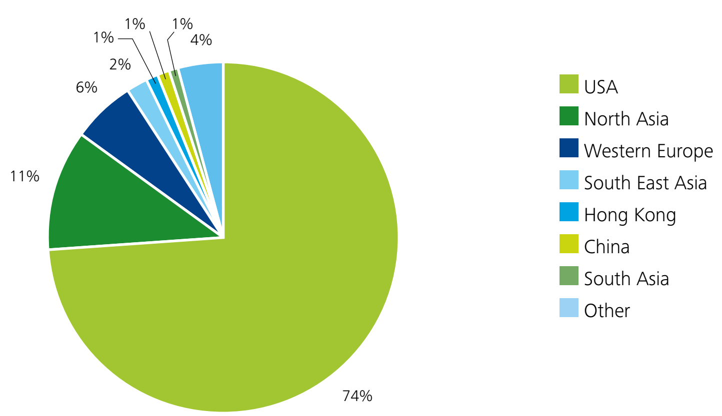
Source: Mergermarket

Bidder geographies, volume (2010-2013)



Source: Mergermarket

Bidder geographies, value (2010-2013)



Source: Mergermarket

Best practices for cross-border M&A

One of the keys to success in Japan's recovery may be through foreign capital, a financial resource that could spur growth across the country. If this is to happen, foreign buyers and Japanese sellers must have a framework to see investment, particularly through M&A, yield its intended value.

Respondents in the recent Deloitte-Mergermarket report on best practices in global M&A, titled "Devising a blueprint for delivering deal success around the globe", pointed out that no deal will move from the boardroom to the deal table without adequate relationship building. Creating rapport and finding common ground ensures that both parties understand strategic goals and intentions.

Likewise, maintaining open lines of communication and adequately conveying messages between parties were factors identified as being crucial to deal success. These are even more critical in the case of cross-border M&A, where the typical challenges of the deal process are exacerbated by cultural and language differences, as well as sometimes conflicting management styles.

While special attention must be paid to each step in the deal-making process, planning for and execution of post-merger integration (PMI) must be a top priority for buyers and sellers. A well prepared PMI process generally results in an easier transition of ownership and expedites integration with existing business operations.

Top inbound deals table (2013)

Announced Date	Status	Target Company	Target Sector	Bidder Company	Bidder Country	Seller Company	Deal value ¥(m)
24/09/2013	P	Tokyo Electron Limited	Computer: Semiconductors	Applied Materials, Inc.	USA		861,302
27/09/2013	P	Panasonic Healthcare Co Ltd.	Medical	KKR	USA	Panasonic Corporation	132,796
08/08/2013	P	Shiba Park Building	Real Estate	Consortium led by Abu Dhabi Investment Council	UAE		98,660
31/10/2013	P	The Tokyo Star Bank, Limited	Financial Services	CTBC Bank	Taiwan	Credit Agricole SA; Shinsei Bank Limited; Lone Star Funds; Aozora Bank Limited	52,290
15/01/2013	C	Komeda Limited	Leisure	MBK Partners LP	South Korea	Advantage Partners, LLP; Pokka Sapporo Food & Beverage Ltd	47,949
11/12/2013	P	Macromill Inc	Services (other)	Bain Capital LLC	USA	Yahoo Japan Corporation; Tetsuya Sugimoto (private investor)	40,451
12/12/2013	C	USJ Co Ltd	Leisure	PAG Capital	Hong Kong		24,665
13/06/2013	C	Simplex Holdings Inc	Computer software	The Carlyle Group, LLC; Karita & Company Inc	USA	Yoshihiro Mikami (Private Investor)	20,817
30/04/2013	C	Fujitsu Semiconductor Limited (Microcontroller and Analog Device Business)	Computer: Semiconductors	Nihon Spansion Limited	USA	Fujitsu Semiconductor Limited	17,266
11/03/2013	P	Seibu Holdings Inc. (3.04% Stake)	Real Estate	Cerberus Capital Management, L.P.	USA		14,898

P = Pending, C = Completed

Source: Mergermarket

Japanese real estate

Tsutomu Kishi

Tomokazu Hashimoto

As the Japanese economy begins a slow recovery, opportunities are opening for investment in Japanese property and infrastructure. **Tsutomu Kishi, Partner at Deloitte Tohmatsu Financial Advisory Reorganization Services, and Tomokazu Hashimoto, Senior Vice President, Deloitte Tohmatsu Financial Advisory Reorganization Services**, discuss developing trends in the real estate market.

What signs of recovery have we been seeing in Japan's real estate market, and what makes Japan an attractive market for investment in property?

Abenomics, Japanese prime minister Shinzo Abe's new economic program, has improved the accessibility to bank financing and the market for investors interested in Japanese real estate acquisitions or M&A. Abenomics is also restoring confidence in Japan as a viable investment destination and creating positive momentum for real estate deals.

Investments in Japan's real estate market offer the opportunity for investors to capitalize on potential market improvements. Property values are expected to rise, and The Bank of Japan has been funneling money into the financial system to keep interest rates low, enabling investors to borrow money at attractive rates.

Achieving success under Abenomics will be key in redirecting global investors, particularly real estate funds and hedge funds, towards real estate investment in Japan. Historically, these large funds have focused on Singapore, Hong Kong, and mainland China. As market trends start to shift, most notably as the Chinese economy slows and investors try to limit exposure or diversify their investments, we're seeing more focus towards Japan and other advanced economies in the region.

The August 2013 sale of the Shiba Park building for US$1bn to a group led by Asia Pacific Land, including the Abu Dhabi Investment Council, Japan's Secured Capital Investment Management Co. and C.V. Starr & Co Inc stands out as a high-profile real estate deal. Are similar transactions likely in the future?

The Shiba Park deal was a special deal, and will not likely become the norm as there are very few real estate investors in the market that have the financial capability to pull off a transaction of this size. When we do see deals like this, they usually involve pension funds or sovereign wealth funds which have large amounts of capital on hand. Similarly, Japanese building owners may be unwilling to sell core building assets, especially as the real estate market rebounds.

This deal in particular was unique, since this building was owned by an investment fund that needed to sell in order to provide returns to investors.

Small and medium-sized transactions will more likely come to define the real estate market in the near-term. Expectations hold that this trend will gain momentum in the run-up to the Olympic Games in Tokyo in 2020.

What will be the impact for Tokyo and Japan as the 2020 Olympic Games approach?

Already expectations are proliferating of a revival to the Japanese economy. While we can expect an upswing and a general economic boost, it is hard to predict the long-term impact.

Investor interest will continue to be driven by the country's overall economic growth and the strength of the Japanese market. While there will certainly be areas of Tokyo that will experience increased rents and possible hotel refurbishments and build-outs, we expect to see greater investment, as a direct result of the Olympics, in infrastructure projects. As the international event draws near, existing infrastructure will need to be replaced or upgraded and new transportation links may need to be constructed to facilitate increased traffic and logistics issues as well as presenting an impressive image of Tokyo as a modern city and capital for international events.

As Japan displays its strengths, investors are also using M&A to enter the market. What types of inbound deal activity has Japan witnessed?

Recently, we've seen increasing deal activity in the middle market, deals valued between US$50m and US$500m. Many foreign investors have expressed a desire to enter the Japanese market but have been hesitant given uncertainties in the economy. Now with the depreciation of the Japanese Yen and the sentiment that the Japanese economy is experiencing positive momentum, many investors that have been sitting on the sidelines are now starting to look to Japan as an attractive market for expansion. Deals, however, have generally been smaller as many foreign investors are initially looking to gain a better understanding of the longer-term opportunities before increasing their capital investment in Japan.

These dealmakers – a population of investors from across the globe – are often looking to invest in Japan to achieve market share and manufacturing capacity and gain access to Japanese consumers. When direct investment is not an available or viable option, these investors have taken to joint-ventures to establish their presence. Foreign investors occasionally use joint venture arrangements as a way to learn about the Japanese business environment and ascertain knowledge of operating with Japanese buyers and sellers.

In terms of challenges, what can investors expect when entering the Japanese market, especially if this is their first time completing a deal?

Issues pertaining to contracts typically come to the forefront, but the language barrier also comes into play. If the investor does not have a local company or partner to assist with the deal process, and the books and records of the target company are in Japanese, this can create a major stumbling block for foreign investors. In competitive situations, these challenges can prove detrimental to the deal.

Investors should also be familiar with the Japanese way of getting a deal done. In Western deals, crucial decisions are often made by one person; whereas in Japan, a consensus among a larger group of decision-makers may be needed.

Often times, real estate transactions follow a Japanese way of executing a deal. As more investors enter the market vying for the limited number of properties for sale, it can be helpful to have a local resource to guide a foreign investor through the deal process. When a foreign investor has an idea of the type of investment or the names of potential targets, professional service firms, such as Deloitte, are able to assist foreign buyers by identifying and/or contacting potential targets to determine if there is any interest in selling. This direct solicitation may help a buyer avoid an auction process.

What tax and legal structures exist when completing a real estate transaction in Japan?

The tax and legal environment in Japan is well established when it comes to real estate, and there are many precedents to draw from. For example, a Tokutei Mokuteki Kaisha (TMK) is a special purpose entity formed under the Asset Securitization Act for the purpose of securitizing real property, and certain non-performing loans, non-recourse loans, corporate bonds, and TMK bonds. A TMK is in many ways similar to a Japanese or US REIT in that it can claim a tax deduction for dividends declared and ultimately paid if it meets certain requirements.

Another structure commonly used is a GK-TK, which is a structure that uses a Japanese Godo Kaisha (GK) to hold real property (or other business assets) and a Tokumei Kumiai (TK) investment to meet part of the funding requirements. The TK is a commercial contract whereby the TK investor provides investment funds in return for an allocation of profits, but the GK controls the assets and makes the business decisions. While the GK is a taxable corporation in Japan, the GK may claim a tax deduction for the contractual allocation of profits to the TK investor.

A Deloitte view

Lessons learned for companies investing abroad

Companies – large or small – seeking potential M&A transactions would do well to focus extra attention on certain key points to increase the likelihood of a successful deal and delivering expected value to shareholders.

Inadequate diligence in the planning and execution stage, as well as poor integration planning, are often cited as contributing factors to unsuccessful deals. The most successful companies are those that have a well-defined, clear and consistent process for deals that can help ensure the team focuses on the essential details. Below are some lessons learned to assist companies considering a potential M&A move.

Planning and execution – Since buyers are limited in terms of how much information can be obtained prior to closing, it is important to understand the 'must haves' versus the 'nice-to-haves'. Don't get bogged down by the latter. Also, consider executing the deal in accordance with standard host-country M&A timelines so as not to delay the deal process and permit other companies with a faster M&A process to obtain a competitive advantage.

Strategy considerations – Understand what drives the deal structure and execute around it to ensure key items are being achieved (i.e. tax goals, cash goals, etc). Companies looking to expand outside Japan often neglect country-specific risks (regulatory, tax and labor). The deal team must be able to recognize and understand these potential issues and how they could create deal hurdles. Companies must evaluate their team's capabilities and consider expanding the outside advisors, where necessary, to ensure that all issues are skillfully addressed. Company leaders should seek advice on host-country laws, regulations, accounting and tax standards as well as the political environment from outside advisors in order to educate themselves on the economic viability of a particular transaction.

Execution considerations – Having a consistent process that can be applied to multiple deals often saves time and money. Determine from an early stage who will lead the due diligence process (central management or the business unit team). Create the internal deal team, then evaluate resources and select the outside deal team (i.e. lawyers, accountants, etc). A communication plan is key to proper information flow and is an area where companies often fail. It is important to stage regularly scheduled checkpoints to assess progress against the plan (both internal and external teams).

Issue focus – Diligence often focuses on identifying risks and trouble areas; however, it should also focus on spotting opportunities. Efficiencies can often be identified and integrated into the deal structure. Coordination among external advisors can help identify issues up front and help formulate a plan to address them post-closing.

Reporting – Devise a robust reporting process to prevent possible broad-reaching issues from falling through the cracks, especially in cross-border transactions. A final report should summarize critical issues and observations from the diligence process. Taking these items a step further includes developing a negotiation strategy and integration plan. Having the same leader for both the diligence process and the integration phase is one of the most effective approaches to information transfer.

Merger integration – Conducting diligence with an eye towards potential integration and post-transaction issues that might arise is critical in order to prioritize needs and issues once the deal closes. Successfully executing and integrating the deal across several dimensions in a compressed time frame is a huge challenge that requires careful consideration. Five other key points to merger integration: 1) remember why you initially wanted to acquire the company, 2) focus on accountability and have a plan for a desired end state, 3) merger integration does not mean an unlimited budget for every project that needs to get done, 4) non-integrated acquisitions are one of the biggest drivers of long-term business complexity and 5) progress, not perfection, is the goal.

Conducting an M&A deal presents many challenges for a potential suitor. Understanding leading practices illustrates how a company can navigate through the tough M&A waters and help drive value.

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