

## Deals and Divestitures: Trends in Japanese M&A

October 2014 Update



Stimulus measures from Prime Minister Shinzo Abe's blue print for structural reform, known as Abenomics, continue to play a largely positive role in rejuvenating the Japanese economy. The first two phases of his "three arrows" policy have been warmly received; however, success with the next arrow has been challenging for the Abe administration. As a result, Abe unveiled a new set of economic reforms on June 24, 2014 that many believe may actually result in a "third arrow" that hits its mark. What remains to be seen is how long it will take for the reforms to be implemented and tangible results to appear. Despite the current uncertainty with the latest attempt at a third-arrow and recent fluctuations in the Nikkei, the Japanese market

and dealmakers continue to be driving forces for M&A in the region. Japan's ongoing wave of outbound transactions remains firmly in the spotlight as a defining feature of the country's M&A scene. While mega deals like Suntory Holdings acquisition of U.S. distiller Beam Inc. for ¥1.6tn. (US\$ 16bn) have been rare, overseas transactions have reached record levels in recent years as domestic enterprises target foreign shores to expand.

In the domestic market, M&A activity has been more moderate as of late, with deal values shrinking and deal volumes leveling off in 2014 compared to the previous year. New policies encouraging corporate

restructuring, in the form of consolidations and divestitures, are driving a number of corporates to sell off non-core or underperforming businesses; thereby, providing opportunities for private equity firms and international players to enter the market.

### Outbound M&A: The wave continues

Japan's outbound forays continue to make waves in international markets as corporate acquirers pursue a record-setting cross-border campaign<sup>1</sup>. With the domestic market contracting as Japan's population grows older, in tandem with increased competition from local and international competitors, Japanese corporates have had little choice but to look abroad for new sources of revenue growth.

The search for new growth has seen Japanese corporates completing transactions in familiar markets in the West. Outbound deal flow has concentrated largely into North America, which accounted for 30% of outbound deal volume and 78% of outbound deal value in YTD 2014<sup>2</sup>. Western Europe also saw a large piece of the outbound pie, with 14% of deal volume but only 4% of deal value in YTD 2014, as Japanese acquirers search for reputable brands, industry best practices, and high-tech innovation.

Emerging markets have also seen increased investment from Japan. Southeast Asia in particular has become a focal point for investment as Japanese manufacturers look for cheaper labor forces as wages increase in China. The Southeast Asia region accounted for 16% of related deal activity and 4% of deal values for YTD 2014.

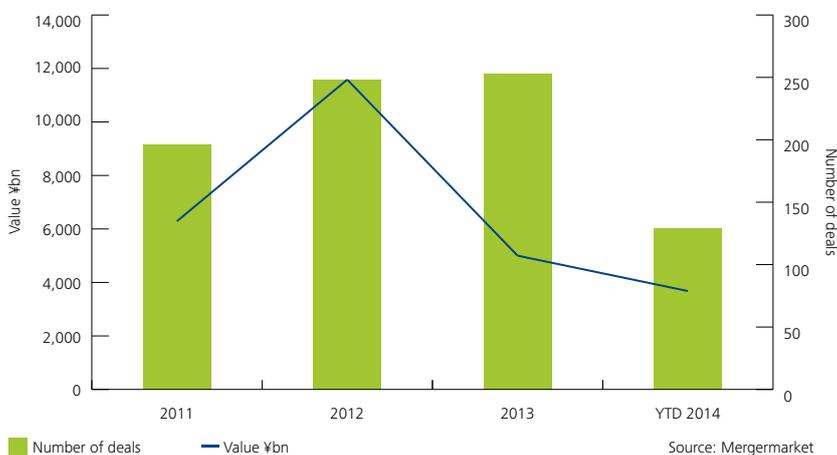
By sector, outbound deal volumes for YTD 2014 have centered on acquisitions of targets in the industrials and chemicals space. However, consumer retail and services companies and financial service firms have captured Japanese interests as well.

### Domestic market M&A: Industry consolidation

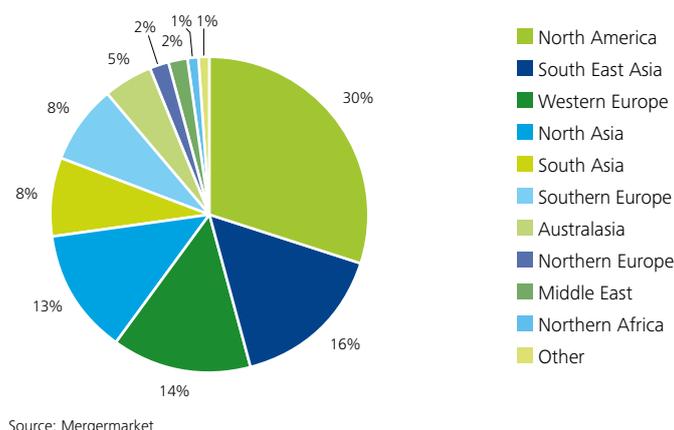
The domestic Japanese market has witnessed subdued deal activity as of late, the possible result of a weaker yen or increases in the national sales tax. So far in 2014, only ¥1.19tn (US\$11.7bn) worth of deals came to market, a 50.1% drop from the same period in 2013.

Deals over the past 18 months were dominated by acquisitions into the traditionally deal heavy industrials and chemicals space as government incentivized consolidations resulted in mergers within the sector.

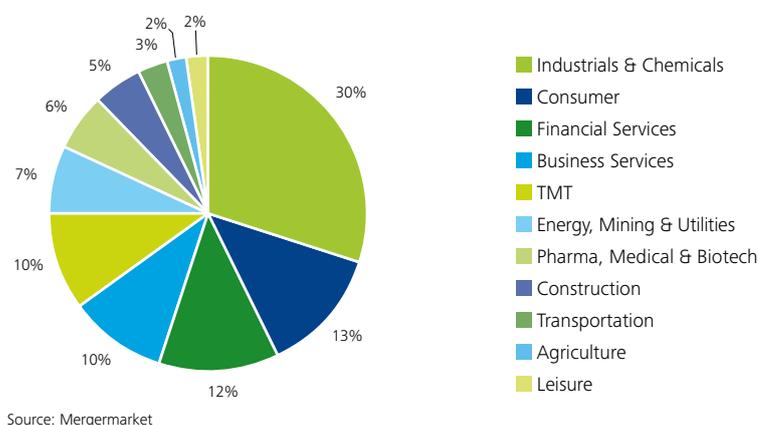
### Japanese outbound M&A



### Outbound target geographies, volume (YTD 2014)



### Outbound target sectors, volume (YTD 2014)



<sup>1</sup> 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.

<sup>2</sup> YTD 2014 refers to deal activity updated as of 04 August 2014.

For example, in the steel space, Nakayama Steel Works began a consolidation of its five subsidiaries to improve business performance. Overall, the sector has accounted for 22% of deal volume and 11% of value since 2013.

However, for YTD 2014, consumer sector deals have experienced the strongest deal activity, with almost a quarter of transactions and 19% of deal dollars. Japan's tech sector has likewise seen a hearty portion of the deal dollar pie, accounting for 23% of transaction values in the year's first half.

### Ongoing opportunities for foreign investors

Interest from foreign investors maintained its momentum from previous years. Deals totals for YTD 2014 consist of 27 transactions worth ¥706bn (US\$6.9bn).

Bidders from the United States accounted for 41% of inbound deal volume and 96% of inbound deal value. This large piece of the value pie came from global pharmaceutical company Mylan Inc's ¥532bn (US\$5.2bn) acquisition of the non-U. S. developed markets business of Abbott Laboratories. Excluding this deal, US values accounted for 81% of the value pie.

A number of US-based private equity firms contributed to deal figures in the current year, including the Carlyle Group's control-stake buy in Oyatsu Company, the Japan based snack maker, for close to ¥20.5bn (US\$200m). Likewise, Carlyle Japan Partners III, the Japan-based private equity fund managed by the Carlyle Group, acquired Sunsho Pharmaceutical, the Japan-based contract manufacturer of dietary health foods and cosmetics, for an undisclosed consideration.

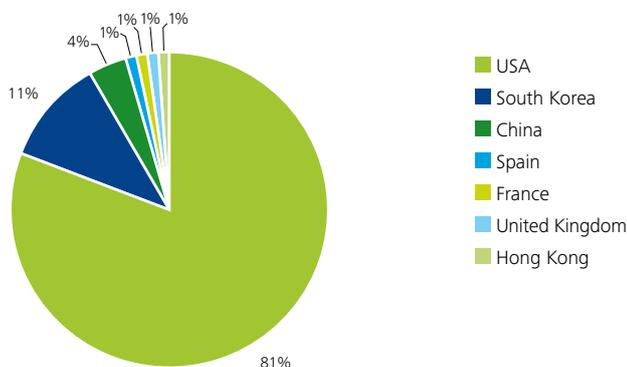
South Korea also accounted for a large portion of inbound activity into Japan. It's seven deals worth ¥17.7bn (US\$173m) positioned it as the second largest inbound investor geography for YTD 2014, with deals concentrated in the consumer retail and consumer food subsectors.

In a breakdown of sectors, the consumer space saw the most inbound deal traffic with nine deals valued at ¥55.2bn (US\$540m). Japan's tech industry likewise saw a large percentage of deals with five worth ¥57bn (US\$558m).

### Divestitures create opportunities

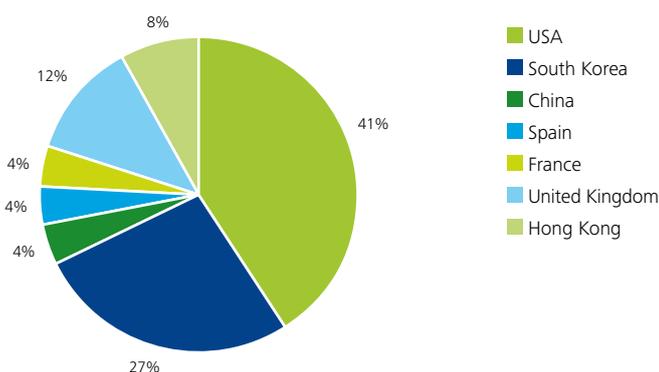
In tandem with industry consolidations in the domestic market, Japanese companies are also shedding non-core and underperforming businesses to become leaner,

Foreign inbound M&A, value (YTD 2014)\*



Source: Mergermarket \*Excludes Mylan Inc deal

Foreign inbound M&A, volume (YTD 2014)\*



Source: Mergermarket \*Excludes Mylan Inc deal

Foreign inbound M&A



Source: Mergermarket

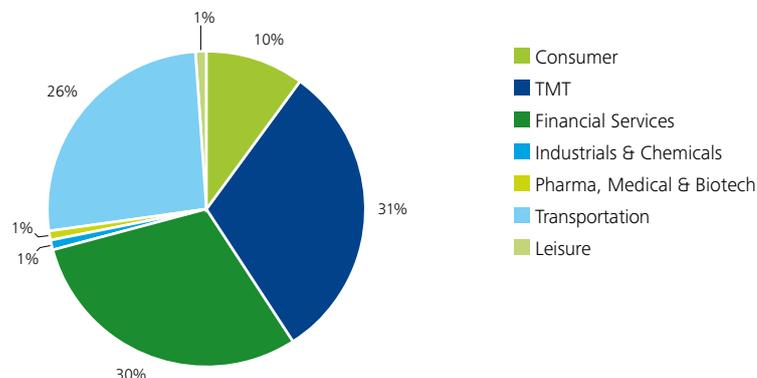
more efficient companies. These divestitures have strengthened balance sheets and allowed companies to pay off mounting debts when necessary. While corporate divestitures have been driven by small and mid-cap deals, higher profile divestitures have placed the spotlight on the growing opportunities these transactions can create.

For example, in September 2013 Panasonic announced it would be selling its healthcare unit to global buyout firm KKR for a consideration of ¥164bn (US\$1.6bn). KKR had previously announced its intentions to increase its activity in the Japanese market, with founding partner Henry Kravis explaining that a significant portion of its Asia II Fund raised in 2013 would be committed to investments in Japan. These words were followed up by another acquisition in 2014, when KKR bought the disc-jockey audio equipment unit from Japan's Pioneer. That deal was worth ¥59.8bn (US\$550m). Now, with several tech companies divesting non-core business units and opportunities growing in the consumer goods space, private equity activity could increase in similar KKR-style transactions.

In YTD 2014, there were 19 divestiture-related transactions worth ¥297bn (US\$2.9bn) in Japan, most involving domestic transfers in ownership, but signaling a potential increase in Japanese assets available for sale. This was an increase over the same period the previous year, which had only 16 similar deals worth ¥79.2bn (US\$775m).

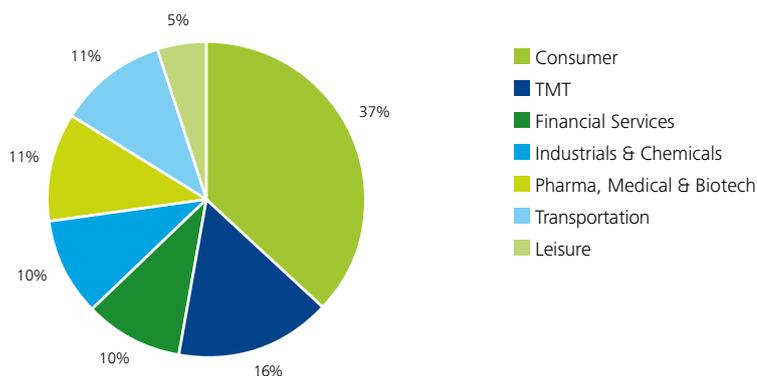
Broken down by sectors, the consumer space saw the most divestiture-focused deal activity with seven deals (37% of deal volume), followed by the tech sector with three deals (16%). In value terms, the tech space saw the most deal dollars with ¥93.7bn (US\$916m) (31% of deal value), followed by the financial services (30%) and transportation (26%) sectors.

**Japanese corporate divestitures, value (YTD 2014)**



Source: Mergermarket

**Japanese corporate divestitures, volume (YTD 2014)**

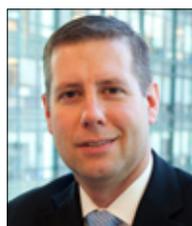


Source: Mergermarket

# Understanding corporate divestitures



Atsushi Noda



Brian Lightle

Corporate divestitures often allow struggling companies or those looking to restructure a means to shed underperforming or non-core businesses to refocus resources on key competencies and strategic business lines. While Japanese companies by-in-large have been hesitant to use such tools in the past, recently public companies and trading houses have turned to divestitures to sell underperforming or non-core businesses to raise capital and improve operating results. **Atsushi Noda, Partner, Deloitte Tohmatsu Financial Advisory Co., Ltd.,** and **Brian Lightle, Executive Officer, Deloitte Tohmatsu Financial Advisory Co., Ltd.,** discuss this trend and the benefits to Japanese businesses.

## What are the defining features of a corporate divestiture?

A corporate divestiture is generally a sale or partial sale of a business unit or product line within a company. This kind of sale can occur for a number of reasons. Sometimes, a company determines that it has too many business lines to effectively manage or certain business lines are redundant or overlapping, which can occur after a merger or acquisition.

It could also be that certain businesses within a company are no longer core to the company's business strategy or competency, or that the business unit is no longer producing the desired financial results. In these cases, a divestiture may allow management an opportunity to redeploy capital by selling off certain businesses in order to make other investments or repay debt.

## What are the common types of corporate divestitures?

Divestitures can take many forms, but the most common form in Japan is a sell-off. A sell-off generally

involves either selling the stock of the legal entity that is being divested or selling the underlying net assets of the business. While not common in Japan, other typical forms of corporate divestitures are a split-off, whereby a parent company offers its existing shareholders the option of exchanging a certain number of their existing shares in the parent company for new shares in the entity being split off; or a spin-off, whereby a parent company distributes new shares of stock in a subsidiary to its existing shareholders on a pro-rata basis such that an existing shareholder owns the same percentage of stock in both the parent and the newly spun off entity.

Regardless of the form of divestiture, the divested business often times has to be carved-out from the larger parent company. The level of effort required to perform the carve-out process can vary significantly depending on the level of integration. It is not uncommon in Japan for companies to divest of businesses that are integrated or receiving services and support from the parent company. Common areas that often have to be segregated during the carve-out process can include: employees who provide services to the business to be divested as well as to other businesses in the organization, information technology, human resources, accounting, tax and legal services, shared real estate or other assets.

## In which sectors are we likely to see the most divestitures in corporate Japan?

Divestitures are beginning to become more prevalent in the "conglomerate" style industries that helped drive Japan's economy in the aftermath of World War II, such as the technology, chemical, and heavy-industry sectors. Historically, these large conglomerates were often times more focused on revenue growth and less focused on profitability. With the increase in global competition and a local Japanese market that is not rapidly growing, Japanese companies have been forced to focus on growing their core businesses and divesting of the underperforming or non-core businesses. This is creating opportunities for competitors and international investors to purchase these assets, bring them to scale, and grow their own existing business portfolios. A common domestic trend has been for competitors to acquire one another or come together and form joint ventures in an

effort to consolidate/streamline manufacturing capacity to create scale and enhance efficiency and profitability.

Japan's tech sector is another major industry where we see companies divesting of underperforming and non-core business lines. As it stands, there's tremendous competition from abroad which is hurting the bottom lines of Japan's traditional industry leaders. Technology manufacturers are experiencing market share erosion as a result of cheap labor in China, Indonesia, and Korea, and tech innovation from R&D coming out of Silicon Valley and India.

### **What can sellers do to attract not just potential buyers, but the best potential buyers?**

There are a number of strategies companies can undertake when divesting of a business in order to enhance deal attractiveness. Foremost among these is ensuring a business-as-usual culture within the divested business. Some of the successful approaches to maintaining business continuity include:

- **Management continuity**

Many buyers interested in the business being divested will desire to see management remain in place, at least for a certain period of time, to maintain business continuity. The value these managers bring to table is often difficult to measure but necessary to ensure the viability of the business as their networks and knowledge of the local business environment can prove invaluable, especially for a foreign investor looking to enter the Japanese market for the first time.

- **Start the carve-out process early**

There will always be some disruption within the business; however, advanced preparation helps to reduce strains from the frantic pace often associated with a carve-out transaction. Companies should strive to carve out operations to be divested as early as possible in order to allow time to address issues that arise and provide potential buyers with a thorough understanding of the net assets and operations being sold.

- **Prepare detailed information packets**

Sellers should anticipate that buyers will want to conduct due diligence. Compiling information and maintaining a data room of financial, operating, and legal documents supporting the business being divested will help expedite the due diligence process. Buyer attractiveness can also be increased by preparing a robust and detailed information memorandum and potentially hiring a third-party

to perform financial due diligence on the business being sold, often referred to as vendor due diligence. The third-party vendor due diligence report is generally distributed to potential buyers with the objective of providing the potential buyers with a higher level of comfort around the business. This can prove particularly valuable when buyers, unfamiliar with the local market, show interest in the business being divested.

- **Retain financial advisors**

Consideration should also be given to hiring a financial advisor to help manage the sales process. These advisors will interact with potential buyers and guide parties through the sales process. Financial advisors, such as accounting firms, can also help sellers prepare carve-out financials when needed, and, perhaps more importantly, help reduce the amount of time company personnel spend on the carve-out / divestiture process.

### **What complications typically arise during divestitures, especially for foreign investors or acquirers relatively new to the Japanese market?**

Common complications and challenges of doing business in the Japanese market often involve culture and the language barrier. Most foreign buyers will not be able to speak or read Japanese. This can lead to misunderstandings between buyer and seller, and occasionally the Japanese seller is uncomfortable with the complex legal requirements or documents, written in English, that foreign buyers often require a Japanese company to execute.

Another area of concern for both foreign investors and Japanese companies involves employee matters. New entrants to the Japanese market may not fully appreciate the Japanese labor laws and the social obligation between Japanese corporations and their employees. For foreign investors, rationalizing an acquired workforce can be difficult, costly, and may result in a negative perception of the buyer among the Japanese public. This sometimes results in Japanese companies being hesitant to sell to foreigners due to concerns about employee right-sizing.

Bridging these culture gaps is not impossible. Hiring advisors on both the buy- and sell-side can help foster a culture of trust between parties while streamlining the sales process.

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# End notes



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