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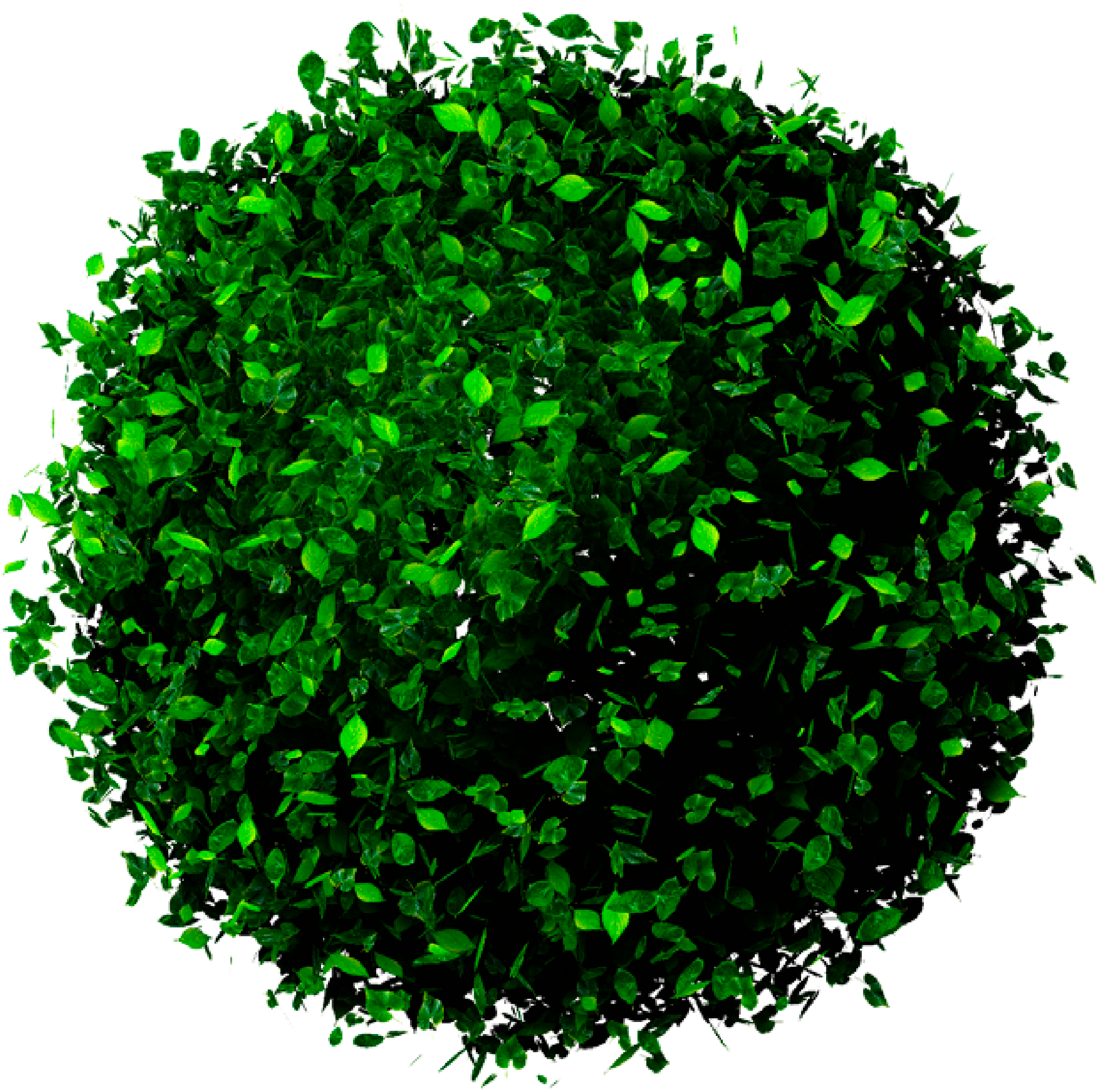


Japanese M&A review

Divestiture and portfolio planning in corporate Japan

December 2016

"Divestiture" is the watchword of the day in Japan, with corporate divestments making up 22% of the country's first half M&A transactions for 2016. Under the new corporate governance code and structural reforms known as "Abenomics", Japanese companies are facing increasing pressure to improve return on equity while restoring their global competitiveness by selling noncore assets to focus on their main businesses. Waves of industry consolidation have also called for companies to turn their attention to leaner, more efficient operations.

In many instances, companies tend to turn to divestitures reactively when under duress. Not only does this leave room for oversight and error during the sales process, but it also places downward pressure on valuation when an exit becomes unavoidably urgent.

Rooted in traditional values of continuity and succession, patriarchal Japanese corporates have often been reluctant to divest in their efforts to foster and protect stable organic growth. In light of today's quick-changing macroeconomic conditions, however, perceptions are changing as Japanese management teams become increasingly aware of the benefits of using divestitures to sustain long-term growth. As such, divestitures are becoming an increasingly viable proactive strategy for exiting noncore or unprofitable assets, and as a way of streamlining existing businesses.

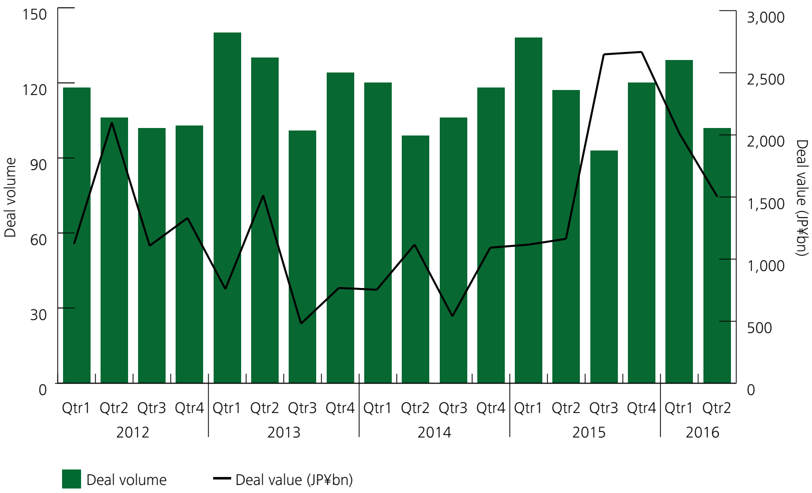
Japanese M&A trends

Despite a volatile opening on global equity markets this year, Japanese M&A in the first half of 2016 reached JP¥3,512.9bn (US$33.5bn) with 231 transactions, representing a 54% increase in value from the JP¥2,279.6bn (US$21.7bn) announced in H1 2015. By target sectors, industrials and chemicals (32%); pharma, medical and biotech (21%); and consumer (15%) contributed to the highest proportion of total deal value. In industrials and chemicals, megadeals set the tone for industry consolidation in several of its sub-sectors. A major Japan-based automotive manufacturer's JP¥388bn (US$3.7bn) acquisition of the remaining stakes in an industry player, for example, may be a harbinger of further reshuffling in the crowded automotive industry. This is likely to involve larger players absorbing the competition and combining resources to pave the way for sustained innovation and expansion on a global scale.

Divestitures, in particular, made a strong showing in H1 2016 as various industries underwent realignment in the face of China's continued slowdown. In the first six months of the year, Japan posted 50 deals worth JP¥806.4bn (US$7.7bn), a marked increase over the 26 deals worth JP¥129.8bn (US$1.2bn) in H1 2015.

The pharma, medical and biotech sector saw the most divestiture-focused deal activity by value, with eight deals worth JP¥632.1bn (US$6bn), followed by the consumer sector with eight deals worth JP¥79.7bn (US$763m). Industrials and chemicals led the pack by volume, with nine deals worth JP¥34.4bn (US$329m). As local corporates sell off noncore units, this enables them to strengthen their balance sheets and improve shareholder returns, while giving them the extra firepower to build up their core competencies by reinvesting locally or abroad.

Japanese M&A overview



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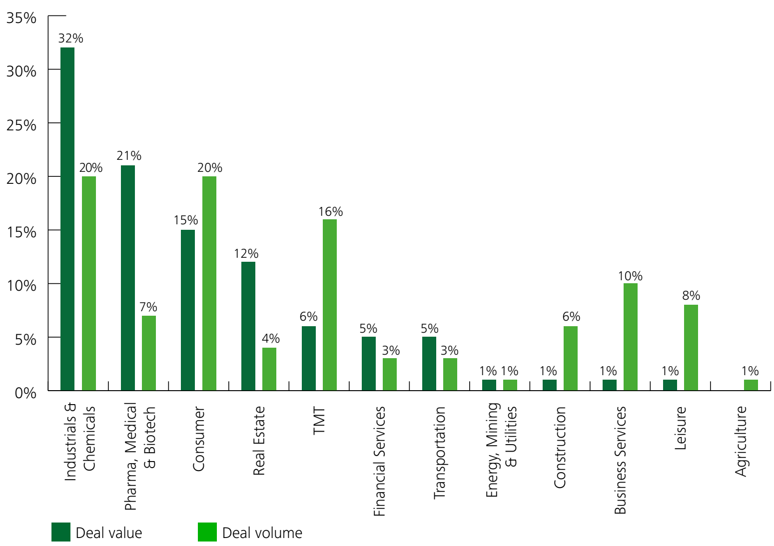
Japanese M&A target sectors (H1 2016)*



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*Percentages may not sum to 100% due to rounding.

The largest Japanese divestment ever came from the pharma, medical and biotech sector, with a large Japan-based electronics company's announcement of a JP¥620bn (US$5.9bn) asset sale of its medical equipment manufacturing unit in March. The deal was motivated by the corporation's efforts to raise funds to restructure and streamline its operations, while revising its business strategy to reinvest in and sharpen its focus on its core businesses in the energy and storage segments. In industrials and chemicals, a major Japanese automaker completed the first round of auction for its stake in a Japan-based auto-parts manufacturer in June, with a view of investing in manufacturers with more advanced technologies. In November, a multinational private equity firm announced its acquisition of the automaker's stake in the auto-parts manufacturer for JP¥498.3bn (US$4.5bn), in its largest deal in the country.

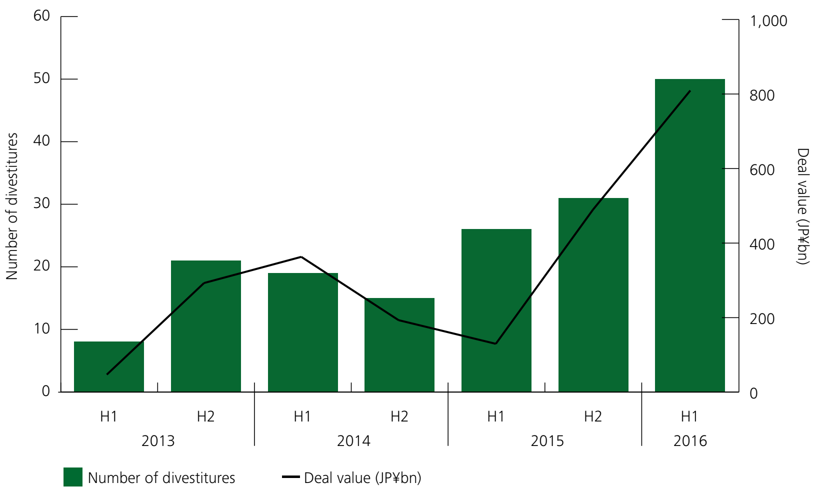
Looking to foreign markets, Japanese outbound M&A decelerated as deal flow in the financial sector slowed to a trickle against the backdrop of a global slowdown in deal activity in the second quarter. Nonetheless, as corporate Japan sees negative interest rates while its cash reserves remain high, a shrinking and ageing population at home, coupled with a weak domestic market, is likely to continue feeding its fundamental appetite for acquisitions in overseas markets.

The United States accounted for 41% of Japan's outbound transactions in H1 2016 with 39 deals worth JP¥774.2bn (US$7.4bn). In H1 2016, the United Kingdom contributed to 8% of Japan's outbound volume at 11 deals worth JP¥78.6bn (US$700m). Whether outbound activity will pick up is unclear amid geopolitical and economic uncertainty surrounding the result of the United States presidential election and Britain's vote to leave the European Union.

The challenges of divesting

While large Japanese corporates have taken the lead in executing proactive divestitures, companies that see divesting as an option only to be resorted to in distress may find it difficult to turn it into a forward-looking business strategy. Such hesitancy is not unfounded, for there are inherent challenges and considerations attendant to corporate change. Those associated with executing a proactive divestment include financial issues such as the cost of selling the asset and the loss of revenue the asset is expected to generate, synergies with other parts of the company's operations, the reputational impact on the business and brand, and issues in realigning interests with business partners.

Corporate divestitures in Japan



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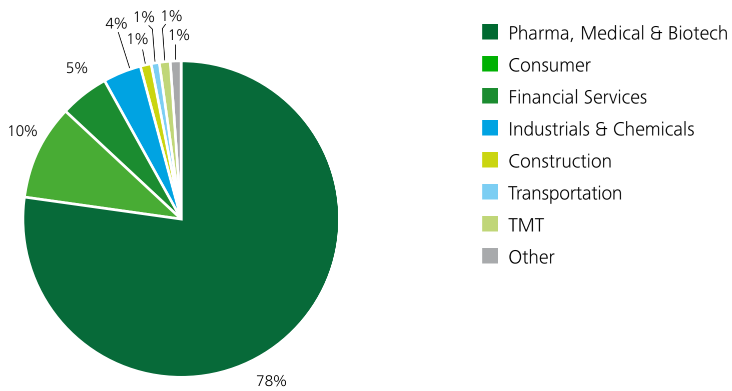
Japanese corporate divestitures by value (H1 2016)*



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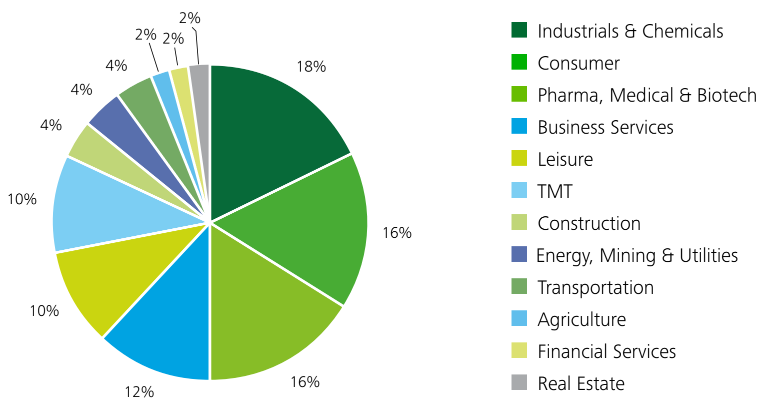
Japanese corporate divestitures by volume (H1 2016)*



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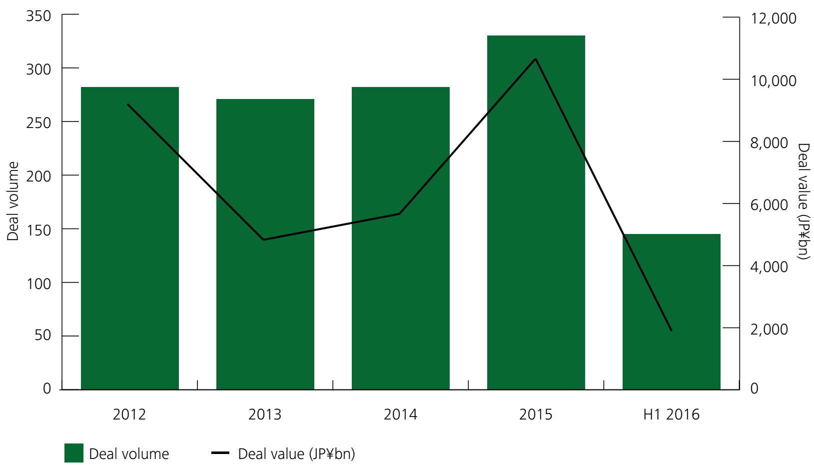
Japanese outbound M&A



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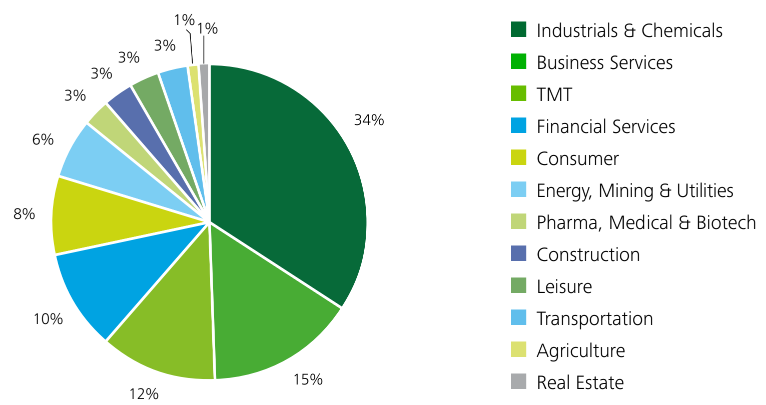
Outbound target sectors by volume (H1 2016)*



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Moreover, would-be sellers are often myopic to some degree when it comes to examining an individual asset or business unit in their portfolios on a standalone basis. They are often too close to their businesses or too embroiled in day-to-day operations to be able to establish an objective and dispassionate understanding of the commercial viability, sustainability and financial standing of their standalone entities or assets.

For companies to be able to overcome hurdles and achieve best-scenario results in a divestiture, management teams need to identify, assess and chart a course of action for potential challenges long before they appear on the horizon. This would help them conceptualize asset sales and divestitures as part and parcel of holistic corporate strategy and as a stimulus for long-term growth, while at the same time avoid being blindsided by unforeseen circumstances that necessitate a hurried and costly exit. To be able to arrive at the ideal timing and price for a divestiture, agility and speed in responding rapidly to favorable market conditions is essential. Preparation is key.

Paradigm shift: Divestitures as part of forward-looking business portfolio management

To build in the capabilities to anticipate and prepare for a proactive divestiture, it is essential for companies to integrate divestiture-related planning into strategic business portfolio management. The aim of engaging in strategic portfolio management is to lay solid groundwork for business and portfolio realignment, enabling a company to adjust its sails and stay on course in the vicissitudes of today's business climate. This involves putting in place and strictly managing policies and strategies that cover not just the operations of individual entities but the overall corporate structure and portfolio. Addressing risks and challenges in the context of the overall business portfolio allows management to see a clearer picture of the parts of the business that are augmenting or eroding shareholder value and minimize the potential impact of a divestment before it becomes an eventuality. A large Japan-based electronic company's sale of its LCD panel manufacturing equipment business to an investment fund in July, for instance, was precipitated in connection with a comprehensive business portfolio review, as part of its long-term strategy to offload noncore or underperforming assets while refining the company's focus on its core strategies, most recently its social innovation business.

Divestiture planning fits into business portfolio management as a vital first step. To be able to streamline a business portfolio, the assets and units that are noncore or unprofitable in relation to the overall business portfolio need to be identified and either exited or restructured. This entails disaggregating the overall business portfolio, and assessing and understanding the going and potential position of each business unit, and then determining its place and worth in relation to the portfolio on the whole. This allows management teams to identify assets or business units which pose as a drag factor by consuming a large amount of business resources and assets without pulling its weight in terms of contributing to overall enterprise value. Planning an exit for such assets or business units by way of divestiture allows companies to raise funds for reinvestment in other portfolio segments which strengthen the core business by playing more vital roles in driving growth or generating cash. At the same time, this facilitates asset recycling or the reallocation of business resources, helping to maintain organic growth by efficiently shifting existing resources from operations with less favorable returns to those with higher potential. Failure to jettison extraneous or burdensome assets may deplete the cash and resources needed to support high-growth opportunities aligned with the core strategy.

On the whole, the clearer, timelier identification of noncore or underperforming assets facilitates decision making in asset recycling, reallocation, sale or disposal, freeing up management attention and resources to build up core competencies. Thorough planning also ensures that the proceeds from the sale are utilized in a manner that is optimally beneficial to the overall enterprise.

Putting portfolio management into action

Through every stage of a portfolio review, the most crucial consideration is the allocation of human resources. The stewardship of experienced, strong and decisive executive personnel is crucial for establishing an all-encompassing bird's eye view of the business portfolio's performance, and bringing in external advisory support may be vital for an objective and dispassionate take on things. For business portfolio management to be put into motion, regular portfolio reviews need to be fitted into corporate management procedures. This can be boiled down to three recurrent steps:

1. **Planning**
   Begin with the end-game in mind. This entails drawing up a roadmap and choosing appropriate financial metrics to evaluate the portfolio. With the growing range and severity of today's business risks, forward-looking companies are shifting from focusing on quantitative financial indices (profitability, cash flow, return on assets, economic value added) to qualitative indices, risk management and considerations involving the relation between capital and risks (return on invested capital, risk adjusted return on capital, value at risk, earnings at risk). This facilitates a better assessment of the reality of business uncertainty, though the indices used are more complicated and may not point towards a clear line of action.

2. **Implementation**
   Review policies need to be implemented to establish a framework for decision-making. Such policies need to be implemented in stages for easy uptake, and then revised from time to time, allowing for flexibility in relation to business exigencies.

3. **Execution**
   Executing portfolio reviews can be made easier by synchronizing portfolio management cycles with company management cycles. Communications between corporate management and individual business entities could also be recalibrated from top-down to flat to facilitate the flow of on-the-ground feedback.

Asset sales and divestments should not be used only as a last-ditch attempt to survive. Instead, they should be regarded as an integral part of business portfolio management in the process of organic growth. While a difficult and seemingly counterintuitive decision, the best practice may be for businesses to divest a noncore asset when its profitability is at its peak. By pruning the branches—even healthy ones—that are sapping the core vitality of a business, management teams would be able to simplify excessively complex operations and channel attention and resources towards boosting overall performance and profitability. In this way, divestitures can become part of an ongoing, holistic revitalization and regeneration process of adding new and shedding old assets to make room for innovation. It can also help the business to adjust to the constantly changing demands and pressures of value migration in a globalized age. This is especially relevant under the auspices of Abenomics' new-improved corporate governance code, which retains the potential to gain traction, albeit slowly.

Business portfolio management enables companies to regularly analyze the risk-return balance of individual businesses and the portfolio on a whole. In managing portfolios actively, companies can better ensure that the direction, speed and character of its growth is in line with the core corporate vision. It is the bedrock of business realignment, allowing for the timely identification and mitigation of risks, as well as the efficient recycling or reallocation of business assets and resources.

Key considerations for effective portfolio management

Kazunari Watanabe

Terushige Asakuno

Planning for proactive divestitures as part of portfolio management enables corporates to be sale ready, shedding noncore or underperforming assets at an opportune time to streamline operations and recycle or reallocate resources. While Japanese businesses have generally been reluctant to use strategies as such in the past, management teams are seeing growing value in using divestitures to raise capital for reinvestments in their core competencies. **Kazunari Watanabe**, Managing Director, and **Terushige Asakuno**, Senior Director, Deloitte Tohmatsu Anchor Management, discuss methods of approach and their efficacy for Japanese businesses.

How should Japanese corporates approach business portfolio management to ensure that portfolio reviews are conducted in a timely, comprehensive and effective manner?

To begin with, corporates should synchronize the portfolio management cycle with existing business management cycles. This ensures that portfolio reviews are cyclically triggered at appropriate junctures in the business cycle, better informing the formulation of mid-term business strategies, annual fiscal budgets, and resource allocation.

Next, monitoring processes should be formulated and implemented to ensure that performance monitoring of business units, especially distressed or noncore ones, is automatically set into motion on a regular basis. The business units' progress on the achievement of objectives and action plans created in prior reviews should be evaluated, triggering the execution of pre-formulated countermeasures if performance has fallen short.

Furthermore, promoting continuous portfolio management across business lines enables management and employees at each unit to understand the concept's relevance to day-to-day operations and the concrete action they need to take. This enables them to proactively run review programs to measure their latest business conditions, as well as to implement countermeasures to tackle problems that may arise. This can be made easier by having business units share the same qualitative evaluation indicators where appropriate, or by introducing a scheme to monitor leading indicators.

What role does the external advisor play in the portfolio review process?

In the review process, businesses are often reluctant to be subjected to closer scrutiny and monitoring by their corporate management, while the latter tends to seek comprehensive oversight, often resulting in an impasse. Hiring an external advisor helps bridge the gap between corporate management and the business unit. The external advisor can provide objective observations on each of a corporate's businesses, while offering insights on the successes and failures of other companies. Equally, these advisors can also design objective management benchmarks and processes on behalf of management teams, making it easier to win support for such measures from business units.

What are the key benefits of integrating proactive divestitures into portfolio management?

Planning for the possibility of proactive divestitures encourages a company to be sale ready, even and especially when it is profitable. From an asset-recycling perspective, this prevents a company from suffering declines in asset value, missing the best timing for a sale, or becoming unable to sell an asset when it wants to and end up having to hold on to distressed businesses.

Proactive divestitures enable a company incapable of improving the business value of a subsidiary to sell it while the subsidiary is able to produce positive synergies under a different owner. Selling such a subsidiary may return higher value to shareholders than holding the unit.

In disposing assets expected to generate a significant exit loss, splitting the assets and selling them over a staggered time period can help mitigate the negative financial impact expected from the sale.

In what ways can noncore or unprofitable business units or assets be identified? What are some of the main considerations to bear in mind?

To identify noncore or unprofitable business assets, periodic and comprehensive evaluations on business performance need to be conducted, using a combination of quantitative and qualitative evaluation indices. Quantitative indices measure past performance, while qualitative evaluation indices factor in potential growth, value and the rationale behind maintaining a business unit on the back of the company's corporate vision and its long-range business strategies. Specifically, qualitative indices measure external factors such as the impact of changes in market conditions and competition environment, as well as internal factors such as the advantages and weaknesses of the business unit, and its structural operating status in its industry.

Prompt reevaluations should be conducted whenever external factors alter, or when the company changes its business strategies.

What can management teams do to make noncore or underperforming assets more attractive as an investment proposition for multinationals or private equity investors?

Management teams should prepare for the potential divestment in a timely manner, compiling separate financial statements for the target business and mapping out stand-alone business simulations. To cater to strategic acquirers, management teams can present conceivable business scenarios illustrating potential operation synergies for the possible buyers, both in a quantitative and qualitative manner. For private equity buyers, management teams should present financial benefits such as cash flow stability, on top of growth potential and potential synergies with companies in the buyer's portfolio. This demonstrates that the deal carries a high probability of securing a bank loan to finance the acquisition, raising the buyer's confidence in executing a leveraged buyout.

What are some of the complications and intricacies of conducting divestitures as part of portfolio review in Japan?

In terms of labor, such as staff cuts and the transfer of employees, divestitures are subject to extensive regulatory restrictions, and the social impact of those moves are significant as the Japanese labor market remains inflexible. In rural areas in particular, there are cases of regional local governments slipping into financial difficulties once the area is hit by workforce reduction. Delays could also stem from potentially negative responses from clients who are loathe to interruptions in the supply of existing products or services.

When it comes to corporate image, business divestitures carry a persistent negative stigma in Japanese society. Once a divestiture is announced, questions and concerns involving the company's health are raised. Those involved in the transaction need to respond to those questions quickly and thoroughly.

What are some of the cross-jurisdictional challenges, considerations and risks in portfolio management for Japanese corporates with international presence?

Legal matters regarding business divestments are subject to laws and regulations of the jurisdictions in which a targeted sub-subsidiary and its shareholder, a subsidiary, are domiciled.

For example, the subsidiary of a company in Japan or in Germany sells a sub-subsidiary, located either in a home market or in a foreign market, to a third party. The subsidiary repays a debt to its parent company with the proceeds of the sale of the sub-subsidiary. After the debt repayment is completed, the subsidiary is liquidated. In this case, there is a risk that the sale of the sub-subsidiary as well as the debt repayment by the subsidiary to the parent company could be revoked as those may be regarded as fraudulent acts.

In the United Kingdom, when a subsidiary sells a business to a third-party company, the acquirer is legally bound to maintain the employment of employees in the sold business, potentially posing a hindrance to the sale where the targeted business has redundant employees.

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