Market Intelligence

M&A 2020

Global interview panel led by Simpson Thacher & Bartlett LLP

LEXOLOGY® Getting The Deal Through

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M&A 2020

Japan

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Mikiharu is selected as a leading lawyer and notable practitioner by the *IFLR1000*. He was recently a finalist in ALB Japan Awards 2020, as Dealmaker of the Year. Mikiharu is qualified in Japan and in New York and speaks both Japanese and English. He is also registered as a Japan Commercial Arbitration Association panel arbitrator.

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Tomo Greer is an associate with a focus on inbound and outbound cross border M&A transactions. She is qualified as a barrister and solicitor in New Zealand and speaks both Japanese and English.

1 What trends are you seeing in overall activity levels for mergers and acquisitions in your jurisdiction during the past year or so?

The Japanese M&A market has been on a record-breaking streak. In 2019, Japanese companies completed roughly 4,000 deals of which 2,840 were domestic, up from 2,814 domestic deals in 2018. This was nearly double the figures at the beginning of 'Abenomics' in 2012. Before covid-19, these record-breaking numbers suggested the trend would continue in 2020. The boom was in part driven by large numbers of retiring bubble-era entrepreneurs, who faced with succession issues were selling their business to larger corporations. Another driver was a spike in conglomerates divesting non-core businesses as they faced increasing scrutiny from shareholders. This trend does not seem to be slowing despite the pandemic.

Nevertheless, the first half of 2020 saw a 60 per cent reduction in the value of domestic and cross-border M&A deals involving Japanese firms to around ¥2.9 trillion. Cross-border deals were especially hard hit, with overseas acquisitions declining 76 per cent in value from the same period of the previous year. By contrast, domestic deals only shrank by 30 per cent in value.

In June, however, the number of domestic M&A deals were up 7 per cent compared with June 2019. In July, there were 70 domestic M&A cases, making it the third consecutive month that figures were higher than the equivalent month of the previous year. While covid-19 has caused the scale of the deals to decrease, the number has not been as hard hit as many would expect.

We speculate that multiple economic and social factors have softened the blow of covid-19. Japan's corporate cash-hoarding culture – a product of Japan's natural disaster-accustomed economy and having a long-time nemesis in activist shareholders – no doubt provided Japanese companies with more cash than those in other countries. This enabled them to continue deal activity or buyouts of smaller, struggling market players. The market's resilience may also be an inertial effect of the record-breaking 2019.

2 Which sectors have been particularly active or stagnant? What are the underlying reasons for these activity levels? What size are typical transactions?

There has been increasing restructuring in the auto industry. Tight competition forced automakers to make divestments, and to form both horizontal and vertical partnerships and alliances. The rising focus on connected and autonomous cars, and electric vehicles, with car markers becoming more environmentally concerned, has also shaken up the industry.

Mikiharu Mori

Kotaro Okada

Tomo Greer

"We speculate that multiple economic and social factors have softened the blow of covid-19."

The pharmaceutical industry has been particularly active as well. For instance, following Takeda's acquisition of Shire in 2019, which was the biggest M&A deal by value in the Japanese market's history, Takeda divested its over-the-counter business to Blackstone early in 2020 (further discussed in question 2). The case of Takeda is illustrative of an industry-wide trend of companies divesting non-core businesses to specialise and further invest in research and development (in Takeda's case, in oncology and other advanced treatments).

Since the onset of the covid-19 pandemic, most market sectors have seen activity stagnate through the first half of 2020. Activities in the travel and hospitality sectors have been hardest hit. Our experience in the last few months is that mid-market M&A in Japanese industries with assets that are not strictly tangible ones, such as IT and tech companies (rather than manufacturers of physical goods), are beginning to pick up.

3 | What were the recent keynote deals? What made them so significant?

Asahi's US$11 billion acquisition of Carlton & United Breweries from Anheuser-Busch InBev (AB InBev) was significant for its competition law ramifications. After AB InBev's mega-merger with rival SABMiller, competition regulators forced AB InBev to carve out and divest significant assets in the Australian market. Asahi, with its new leadership focusing on overseas growth in the premium beer market (having previously acquired of Peroni and Pilsner Urquell), took the opportunity to expand market share and increase shareholder returns. The deal was signed in mid-2019, but stalled for a time as the Australian Competition and Consumer Commission took issue with the prospect of Asahi commanding over 60 per cent of the market share for the cider market. The deal was only approved in 2020 after Asahi made significant divestments in the Australian market. The deal is also noteworthy as it is an exemplar of the trend of Japanese companies' increasingly aggressive overseas acquisition strategies. This as a result of pressure from shareholders to increase returns on investment as the domestic market stagnates.

Another mega deal was the Line and Softbank's Z Holdings merger. This deal echoes the global trend for the concentration of power in tech and internet giants. Similar to the Asahi deal, it shows the appetite of Japanese companies to challenge global competition. It created another 'Japanese national champion' to compete on the global stage against Silicon Valley and Chinese tech, mobile and data entities.

More recently, Takeda's ¥242 billion sale of its over-the-counter medicines business to Blackstone was illustrative of a trend for opportunistic private equity funds to capitalise on Japanese corporations divesting non-core assets.

Carlyle, a US-based private equity fund with a Japanese operation, has been active throughout 2019 and 2020. Having acquired Orion Breweries, Tokiwa

Corporation and other mid-market companies in 2019, it announced that it raised US$2.3 billion for its fourth Japanese fund.

Carlyle and Blackstone's increased presence in the market is illustrative of many funds' decisions to invest into Japan, eyeing divestments and carve outs.

4 In your experience, what consideration do shareholders in a target tend to prefer? Are mergers and acquisitions in your jurisdiction primarily cash or share transactions? Are shareholders generally willing to accept shares issued by a foreign acquirer?

While cash deals are more common, both cash and share transactions occur. This may be attributable to the culture of Japanese companies hoarding cash. Corporate governance reforms, part of Abenomics, have encouraged Japanese companies to better utilise their idle cash stockpiles for M&As to maximise shareholder returns.

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5 How has the legal and regulatory landscape for mergers and acquisitions changed during the past few years in your jurisdiction?

In this question, we will focus on foreign investment landscape changes. See question 7 for a discussion on corporate governance reforms.

There has been increased scrutiny and restrictions placed on foreign direct investment (FDI). The covid-19 pandemic accelerated this global reversal of approaches toward FDI and Japan is no exception. The same protective attitude directed towards the technology sector is now felt in the medical sector. The Japanese government has added the medicine and medical equipment sectors to the list of protected businesses under the Foreign Exchange and Foreign Trade Act (Forex Act).

While significant, this most recent amendment seems only an afterthought to the lengthy and complex series of amendments made to the Forex Act over the past two years. The Japanese government has an ambitious target to increase FDI by ¥35 trillion by 2020. However, the incremental amendments in the past few years restrict FDI by expanding protected sectors, increasing thresholds for prior notifications and by widening the definition of FDI.

FDI now includes investments not only through share acquisition or subscription to new shares in Japanese companies, but also through other activities of foreign shareholders: including exercising their vote at shareholder meetings, appointing or removing a director and making proposals that have a material impact on the management of the company. The definition of FDI that captures shareholder actions in appointing directors or suggesting agenda items at shareholder meetings could curb FDI trends, especially for US-based activist funds that are looking into Japan.

The amendments empower the government to suspend, modify and rescind FDI. For most investors the main effect is procedural nuisance, not having FDI blocked outright. Since the government implemented prior notification requirements, as far as is known, only one FDI has been blocked by the government. There are also exemptions for investors who meet certain requirements. Foreign investors will need to carefully structure their investment and engage experienced Japanese consultants when investing in a Japanese listed or private company.

6 Describe recent developments in the commercial landscape. Are buyers from outside your jurisdiction common?

As also discussed in question 7, we have seen a rapid rise in foreign buyers – both in numbers as well as in deal value. Most notably and recently, Warren Buffet announced that he has invested US$6 billion into five of the biggest Japanese trading houses: Mitsubishi, Itochu, Marubeni, Sumitomo and Mitsui.

"We have seen a rapid rise in foreign buyers – both in numbers as well as in deal value."

Buffet is not the only one with an appetite for Japanese equity. As noted in question 2, private equity funds, such as Carlyle and Blackstone, are among the foreign buyers lured by shares trading well below market value and by opportunities to acquire assets from conglomerates making divestments and carve outs.

Along with the impact of the increase in foreign buyers, parallel market trends are the rise of management buyouts and companies delisting. This has resulted in a decline of parent subsidiary listings on the Tokyo Stock Exchange. We predict that the covid-19 pandemic will accelerate this trend, as businesses try to restructure to make their operations more efficient.

Earlier this year, Bain Capital, through a management buyout acquired Nichii Gakkan, a nursing home and medical care giant, for ¥27 billion. Delisting from the Tokyo Stock Exchange will allow Nichii Gakkan to restructure its operations away from the public eye.

As Japanese businesses face succession issues (as noted in question 1) and are under pressure to restructure their operations, selling to a private equity fund through a management buyout and delisting has never been a more attractive option for Japanese equity holders.

Another notable trend is the shifting power dynamic in Asia. In 2019, according to Bain & Company, 37 per cent of Asia-Pacific's total outbound M&A deal value was made up of Japanese companies acquiring foreign companies. This is unsurprising, given Japan's strategic and aggressive focus on outbound M&A in the past few years, as the domestic market became stagnant and more competitive. However, in August 2020, we saw Singapore's Wuthelam group acquire a majority stake in Nippon Paint Holdings for ¥1.3 trillion. This is one of the biggest deals in Asia this year and is an outlier, given that a Japanese company was the target. It is worth noting that Wuthlam is not a speculative financial purchaser like Bain or Carlyle, but a strategic one. Wuthlem already held 39 per cent of the shares and will hold just under 60 per cent after the deal closes. The parties have had a more than 50-year strategic relationship, cross-holding each other's shares. While this type of transaction may be novel now, we predict this is the beginning of a shift in power dynamics in Asia. We may see more Japanese companies being invested in and acquired by their Asian counterparts.

7 Are shareholder activists part of the corporate scene? How have they influenced M&A?

The corporate environment in Japan has been slow to adapt to accommodate shareholder activism. There are reasons, such as the traditional view that companies are run for all stakeholders and not just shareholders, and the large

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number of cross-shareholdings among large Japanese conglomerates. Business decisions in Japan have also often been consensus-driven with little deviation from a group approach.

Since Shinzo Abe's reforms of the Corporate Governance and Stewardship Codes in 2014 and 2015 respectively, we have seen a slow but steady decline in cross-shareholdings among public companies. This has brought a decrease in entrenched and management friendly shareholders. Indeed, with this changing of the guard, shareholders are increasingly engaging with their investee companies through dialogue with management or proxy voting.

Japan has seen an increase in shareholder proposals at general meetings. Activist shareholders have made demands on a myriad of matters: transparency, share buybacks, increased dividends and the removal of directors being just a few. Attitudes towards shareholders are changing and an awareness is growing of the need for management to engage in constructive dialogue with shareholders. Accompanying this trend is a recent increase in stock buybacks, a doubling of the total amount of dividends distributed in the market in the past five years and a steady increase in the numbers of foreign shareholding in public companies.

"With an increasing number of foreign private equity firms entering the market, the doors for hostile takeovers have opened: something previously uncommon, almost taboo, in Japan."

With an increasing number of foreign private equity firms entering the market, the doors for hostile takeovers have opened: something previously uncommon, almost taboo, in Japan. For instance, Takeda Pharmaceuticals, in response to activist shareholders, disposed of its cross-shareholdings in 12 companies in 2018. Likewise, in 2019, Sony sold its stake in Olympus, under pressure from the activist fund Third Point. This trend has diversified the M&A market in Japan. The roll of foreign shareholders has increased and will continue to.

8 | Take us through the typical stages of a transaction in your jurisdiction.

The process is not markedly different from that in other economies. Initial contact may be made by the company itself (through networks of friendly C-suite members) or through an intermediary such as an investment bank. The first step would be to sign a non-disclosure agreement and move to preliminary information disclosure (eg, disclosure of the past two to three years of financial records). Preliminary valuations are then conducted, a letter of intent is signed and the parties move to due diligence.

There are no equivalents of US rules such as the 'Revlon Rule', whereby the board has a legal duty to make a reasonable effort to obtain the highest value for a company. Having said that, auctions are common in mega deals. In the case of listed companies, if more than 5 per cent is to be acquired, a 'large shareholder notification' to the Financial Services Agency is required. If foreign buyers are interested in stock-building prior to negotiations for acquisition, this threshold needs to be kept in mind.

9 | Are there any legal or commercial changes anticipated in the near future that will materially affect practice or activity in your jurisdiction?

As outlined already, the market trends that are defining the Japan M&A landscape are restructuring and divestments, along with foreign buyers and private equity funds entering the market. Thus, there has been an increase in previously taboo market activities such as shareholder activism and, recently, the greater acceptance of management buyouts. We will likely see these trends continue.

10 | What does the future hold? What activity levels do you expect for the next year? Which sectors will be the most active? Do you foresee any particular geopolitical or macroeconomic developments that will affect deal sizes and activity?

In the short-term, while domestic and cross border transactions are slowly bouncing back, the covid-19 pandemic will continue to impact deal value. However, the market trends described above – the increased restructuring, divestments,the participation of foreign private equity firms – will continue to have a positive impact on the market and assist Japan's recovery from the fallout of the covid-19 pandemic.

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The Inside Track

What factors make mergers and acquisitions practice in your jurisdiction unique?

Compared with other Asian jurisdictions, especially those in developing ones: Japan is very much open for investment – in theory. Yet cultural and language obstacles remain, making negotiations between Japanese and foreign companies difficult. Strict corporate approval procedures, such as rigidly scheduled board meetings, can become time-consuming. Understanding the business protocols of Japanese companies is important.

What three things should a client consider when choosing counsel for a complex transaction in your jurisdiction?

Clients should not go for the traditional passive, extremely legal detail-focused lawyers. For cross-border deals, they should look to lawyers who are truly global and experienced in cross-border deals, with an acute understanding of business, not just legal issues.

What is the most interesting or unusual matter you have recently worked on, and why?

The Tokyo international law office team successfully assisted a major automaker on its acquisition of shares in other automakers with a view to strengthening business relationships with them based on a 'home and away' strategy. The team also advised financial, technology, healthcare and manufacturing businesses on their cross-border M&As in the United States, Europe and Asian countries. The Tokyo international law office and Mikiharu Mori, managing partner, were selected as finalists in the ALB Japan Law Awards 2020 in several categories, including Japan Law Firm of the Year and Dealmaker of the Year.

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