Market Intelligence

M&A 2021

Global interview panel led by Simpson Thacher & Bartlett LLP

LEXOLOGY
Getting The Deal Through

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M&A 2021

Japan

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Mikiharu was 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, and as Managing Partner of the Year in 2021. Mikiharu is qualified in Japan and in New York and speaks both Japanese and English. He is also registered as a JCAA (Japan Commercial Arbitration Association) panel arbitrator.

Kotaro Okada is one of the founding members of TKI. He focuses on inbound and outbound cross-border M&A transactions, joint ventures, data compliance and general corporate across a range of sectors.

Kotaro is qualified in Japan and in New York and speaks both Japanese and English. He is also registered as a JCAA panel arbitrator. He was recently a finalist in ALB Japan Awards 2021 as Young Lawyer of the Year.

Tomo Greer is an associate with a focus on inbound and outbound cross border M&A transactions across various industries. She has taken key roles in various complex multijurisdictional deals, including on a deal nominated as M&A Deal of the Year in ALB Japan Awards 2021. She is qualified as a Barrister and Solicitor in New Zealand.

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

Prior to covid-19, the Japanese M&A market had been on a record-breaking streak. In 2019, Japanese companies completed roughly 4,000 deals of which 2,840 were domestic. This was nearly double the figures at the beginning of 'Abenomics' in 2012. 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 and will likely continue to be a central theme for Japanese corporations.

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.

Activity bounced back in the second half of 2020, with the total deal count for 2020 being approximately 3,730 and the total value approximately ¥14.6 trillion. This was not an overly significant drop from pre-pandemic levels. We continue to see the M&A market bouncing back, with the numbers of deals increasing steadily in the first half of 2021. The deal count and value for the first half of 2021, as expected, surpassed the same period for 2020.

More surprisingly, despite ongoing on-and-off state of emergency declarations in Tokyo and other major Japanese cities (resulting in, among other things, an inability to conduct face-to-face meetings long considered a pivotal part of Japanese dealmaking), the first half of 2021 also surpassed the number of deals completed for the equivalent 2019 period. This is remarkable considering 2019 was a record year for M&A in Japan. These statistics illustrate that Japanese companies are becoming more comfortable with remote deal-making and have begun to spend their cash reserves.

However, while there have been significant cross-border deals during the pandemic (such as Panasonic's acquisition of Blue Yonder, and Hitachi's acquisition of Global Logic, as discussed below), activity has not bounced back to pre-pandemic levels. Cross-border deals that have recently closed or are currently underway were mostly in the pipeline pre-pandemic. This may be because, while deal-making can be done remotely, face-to-face relationship building remains important for Japanese executives. We hope to see more activity in the second half of 2021.

Mikiharu Mori

Kotaro Okada

Tomo Greer

"We continue to see the M&A market bouncing back."

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

'Digital transformation' has been a buzzword in Japan in recent years and coloured many M&A activities during 2019 and 2020. In 2020, the IT and technology sector was particularly active as 'paper Japan' endeavoured to digitalise. In 2021, as part of this general trend, companies traditionally associated with hardware and machinery have been dabbling in software and digital services.

Japanese electronic powerhouse Hitachi completed its first software deal when it acquired GlobalLogic, a Silicon Valley-based software engineering company, for US$9.5 billion. It simultaneously divested a core business, Hitachi Metals, to Bain Capital for US$8 billion.

Similarly, Panasonic, another major Japanese electronics manufacturer, completed its acquisition of US supply chain software company Blue Yonder for US$7.1 billion.

In late 2020, NEC, traditionally known as a PC manufacturer but which has been recently more successful as a multimedia company with a strong focus on telecommunications and AI, purchased Avaloq Group for CHF 2.05 billion. NEC acquired the Swiss financial services software company as part of its strategy to enter the finance software market: echoing the general trend described above.

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

The three deals mentioned in question 2 – Hitachi's acquisition of Global Logic, its divestment of Hitachi Metals to Bain Capital, and Panasonic's acquisition of Blue Yonder – were the top three deals by value for the first half of 2021. These deals are notable because they exemplify the trend of Japanese conglomerates shifting focus from more traditional industries to the software and digital services sectors. Hitachi's divestment of Hitachi Metals also reflects the ongoing trend of large Japanese conglomerates to divest non-core assets.

Further in July 2021, Sumitomo Mitsui Financial Group announced that it would acquire a 4.9 per cent stake in Jefferies for US$386 million. While a Japanese–US (in-out) deal is an outlier in recent years, this could be indicative of a returning appetite for Japanese companies to challenge the US market.

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.

We may, however, see an increase in non-cash forms of payment following the amendment of the Companies Act in early 2021. The Companies Act was amended so that stock consideration can be used through the 'share delivery' mechanism. This method allows the acquirer to acquire all or part of a target company's shares by delivering the acquirer's shares to the other company's shareholders. This 'share delivery' mechanism is limited to acquisitions between Japanese companies. The amendment's impact on M&A practice is yet to be seen.

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

Worldwide, there has been increased scrutiny and restrictions placed on foreign direct investment (FDI). Covid-19 accelerated protectionist attitudes towards FDI. Japan is no exception. The same protective attitude directed towards the technology sector is now evident in the medical sector. In 2020, the Japanese government 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.

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 considering Japan.

The amendments empower the government to suspend, modify and rescind FDI. For most investors, the main effect is procedural nuisance and not having FDI blocked outright. Since the government implemented prior notification requirements, as far as is known, the government has blocked only one FDI. 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?

In the past few years, there has been a rapid rise in the number of foreign buyers as well as in deal value.

Private equity funds, such as Carlyle, Bain Capital and Blackstone, are among the foreign buyers lured by shares trading below market value and by opportunities to acquire assets from conglomerates making divestments and carve outs. Last year, Blackstone acquired Takeda's over-the-counter business for ¥242 billion. Bain Capital acquired Nichii Gakkan, a nursing home and medical care giant, for ¥27 billion through a management buyout. Private equity was everywhere where the opportunity presented itself.

"In the past few years, there has been a rapid rise in the number of foreign buyers as well as in deal value."

2021 seems no different. As noted above, Bain Capital acquired Hitachi Metal for US$8 billion. Toshiba and corporate government failures, discussed more below, have recently become synonymous. During Toshiba's tumultuous times, three private equity companies – CVC, KKR and Brookfield – presented competing buyout offers.

As Japanese corporations come under increasing pressure to restructure operations, selling to a private equity fund has never been a more attractive option for equity holders.

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. The covid-19 pandemic likely will accelerate this trend, as businesses try to restructure to make their operations more efficient.

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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 shareholder activism. The traditional view that companies are run for all stakeholders and not just shareholders and the large number of cross-shareholdings among Japanese conglomerates are some of the causes for this. Business decisions have also often been consensus-driven with little deviation from a group approach.

Since former Prime Minister Shinzo Abe's reforms of the Corporate Governance and Stewardship Codes in 2014 and 2015 respectively, there has been 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 including transparency, share buybacks, increased dividends and the removal of directors. Attitudes towards shareholders are changing and an awareness is growing of the need for management to engage in constructive dialogue with shareholders.

The numbers prove shifting attitudes. In 2013, prior to the corporate governance reforms, there were only 14 activist demands made to Japanese companies. In 2020, there were 66.

Especially notable throughout 2020 and 2021 were the events concerning Toshiba. Effisimo Capital Management, Toshiba's largest shareholder with a stake of approximately 10 per cent, requested that the company conduct an independent investigation into alleged voting irregularities at the company's 2020 annual general meeting. The investigation revealed that Toshiba had colluded with officials from the Ministry of Trade to pressure foreign investors to support company management in a key vote. Such tactics involved using the recently amended Forex Act, described in Question 5, to restrict foreign investment. Even before the report was published, Toshiba's chief executive resigned. In the past, it would have been unthinkable for a foreign fund to embed itself so deeply in matters concerning the company's management: especially one that was highly political.

Another newsworthy activist event occurred in late 2020. City Index Eleventh, backed by the Yoshiaki Murakami from the Murakami Fund, challenged the Japan Asia Group, an energy and environmental services firm. In July 2021, the Murakami Fund successfully increased its stake in that group to 75 per cent. Significantly, this was the first successful hostile bid by a financial buyer in Japan. Similar to Effisimo's challenge of Toshiba, Murakami's successful bid against

"We predict that many companies will divest businesses that are heavy carbon-emitters, as a way to be seen as 'greening' themselves."

Japan Asia Group would have been inconceivable in an earlier legal, political and business climate.

Despite the steadily increasing activist demands seen in Japan, the high-profile shareholder activism as in the cases of Toshiba and Japan Asia Group are still outliers. The current Japanese business environment provides fertile ground for activist shareholders, and it will be interesting to see how many funds will take inspiration from Effisimo and Murakami to challenge other large Japanese corporations.

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.

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

When Prime Minister Yoshihide Suga took office last year, he surprised many by announcing that Japan will be carbon neutral by 2050. 'Environmental, social and governance' (ESG) and 'sustainability' had merely been buzzwords for most Japanese listed companies prior to this announcement. However, this announcement forced companies to take these matters seriously. We predict that many companies will divest businesses that are heavy carbon-emitters, as a way to be seen as 'greening' themselves. These same companies likely will acquire others to pursue ESG goals. Acquiring new technologies and infrastructure will assist in a reduction of carbon footprints. Further, we foresee robust deal activity emerging, especially in the renewable energy sector.

Complementing Japanese companies' new-found emphasis on environmental and ESG matters, we are slowly seeing companies becoming more aware of the need to conduct environmental and human rights due diligence. While human rights due diligence is still uncommon, this may become common practice.

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?

We predict that the second half of 2021 will see the return of outbound M&A deals. Japanese companies continue to hold significant cash reserves. Furthermore, they have become more accustomed to remote deal-making. Stakeholders are also pressuring companies to restructure and divest non-core assets in the name of corporate governance. Companies, such as Toshiba, Hitachi and many more, will continue to be pressured by activist shareholders and non-activists but still active management investors. Moreover, foreign private equity gives no sign of leaving Japan. Their eyes remain on cash-rich, undervalued companies that are under pressure to sell non-core assets. Combining these factors, we see the M&A market, not just returning to, but surpassing, pre-pandemic M&A levels.

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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. However, 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?

Tokyo International Law Office acted as lead counsel in a multibillion-dollar, multi-jurisdictional technology deal involving a Japanese company acquiring a leading EU financial software company. This deal was significant as it was our first cross-border deal completed entirely remotely. As mentioned above, in-person relationship building, management interviews, and for deals involving factories, site visits – are crucial for any company but especially so for Japanese companies. The pandemic enabled Japanese companies to realise that for deals where the focus is on an intangible asset such as IP and know-how – remote dealmaking is entirely possible.

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