

Mergers & Acquisitions

Deal or no deal: successfully executing M&A transactions in Japan



Topic

Laws and Regulations Commercial & Operational Diligence
Negotiations Purchase Price
Financial Due Diligence Working Capital
Financial Model Carve-out
Acquisition Earn-out Spin-off
Divestiture Pro Forma Financials EBITDA
Post-Merger Integration Financial Statements
Synergies Employee Matters Data room
Projections Taxes Information Technology

Agenda

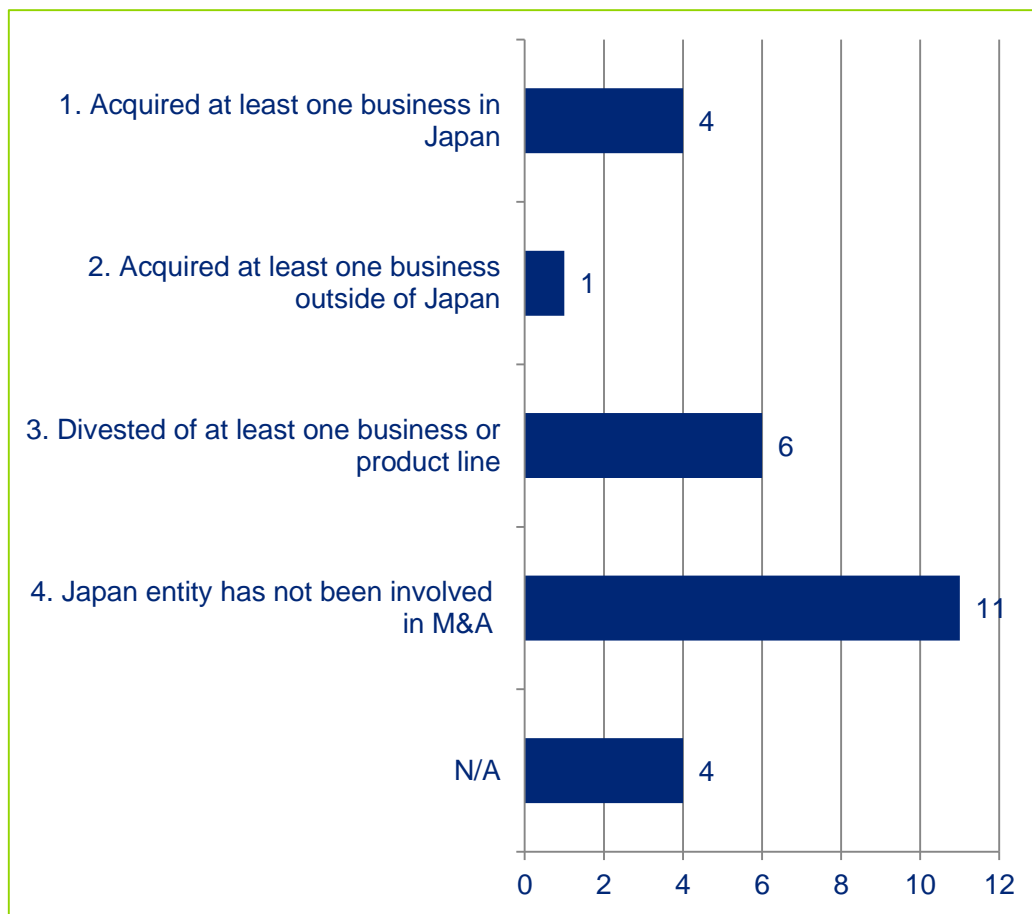
- **M&A market trends in Japan**
- **M&A lifecycle (managing the deal process)**
- **Establishing a due diligence scope**
- **M&A legal considerations**
- **Post-merger integration**

M&A market trends in Japan

Polling Question 1

M&A Experience in Japan

Which types of transactions has your Japanese based entity been involved with in the past 18 months? (mark all that apply, n=24)

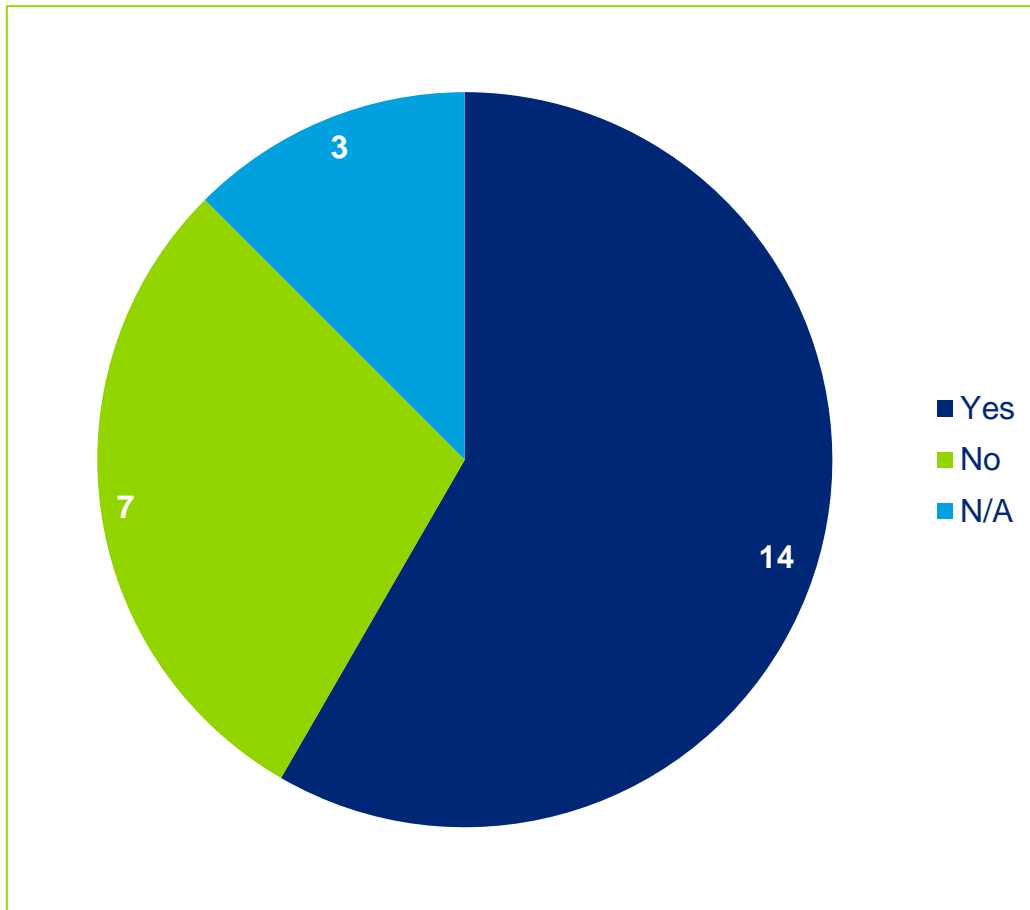


- In the past 18 months, the majority of Japan entities represented in the roundtable have not been actively involved in M&A, but:
 - Four of the CFOs present have been involved in acquiring a business in Japan
 - One CFO has been leading the acquisition of a business outside of Japan (related to shared services)
 - Some of the CFOs involved in acquisitions mentioned joint ventures as a common form to increase their footprint in Japan
 - Six CFOs have been involved in divesting a business or product line

Polling Question 2

M&A Experience in Japan

Do you think your Japan based entity will be involved with an acquisition or divestiture in the next 2 years? (mark one, n=24)



- The majority of entities represented expect M&A activity to affect the Japan subsidiary in the next two years:
 - Many of the CFOs mentioned they are exploring business alliances to strengthen their positioning in Japan
 - Some CFOs plan to buy/ sell product lines
 - Especially the Life Sciences/ Health Care industry aims for in-licensing and out-licensing deals
- Only seven out of 24 CFOs answered they do not expect an acquisition or divestiture in the near future

Japan M&A market

Japan deal activity snapshot:

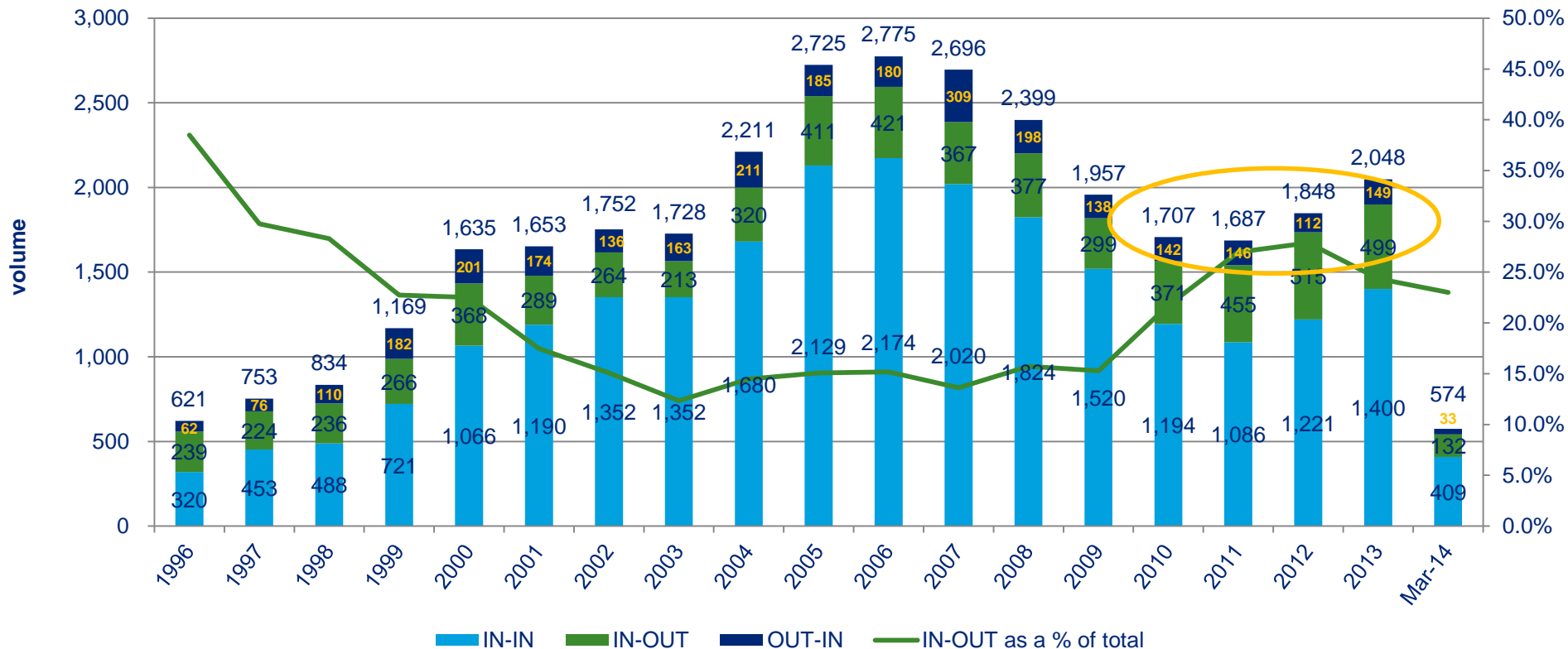
- 2012 – 1,848 deals worth ¥12.3tn (US\$123bn) (Inbound - \$5.7bn, Outbound \$76.1bn, Domestic \$40.9bn)
- 2013 – 2,048 deals worth ¥8.5tn (US\$85bn) (Inbound - \$15.3bn, Outbound \$52.4bn, Domestic \$17.1bn)
- YTD Mar 2014 - 574 deals worth ¥2.6tn (US\$26bn) (Inbound - \$1.4bn, Outbound \$22.1bn, Domestic \$2.8bn)

Recent top deals:

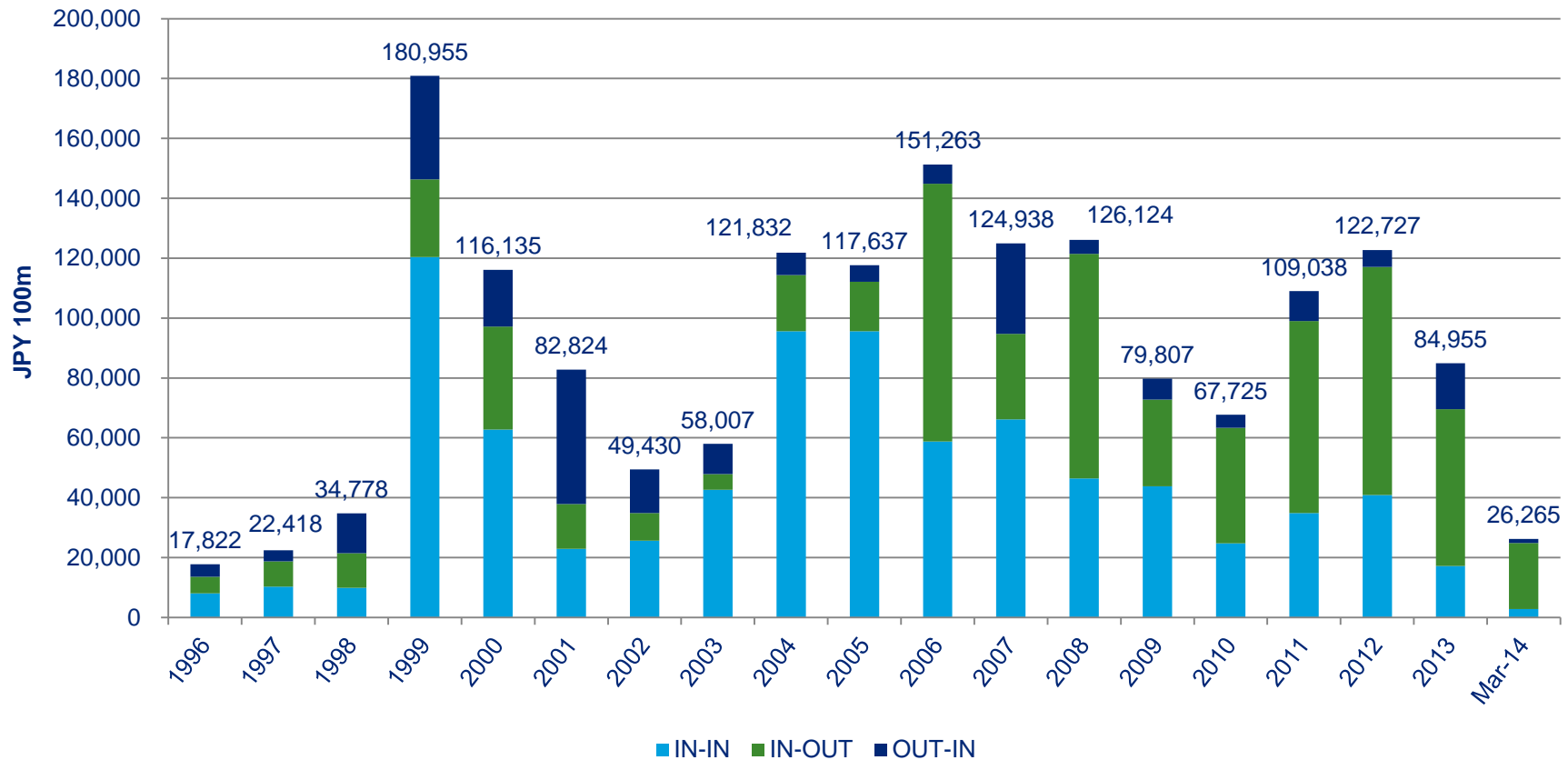
Date	Buyer	Seller	Market	Country	Value JPY(m)
Oct 2012	Softbank Corp.	Sprint Nextel Corp.	Outbound	USA	1,812,100
Jan 2014	Suntory Holdings	Beam Inc.	Outbound	USA	1,679,360
Sep 2013	Applied Materials Inc	Tokyo Electron Ltd	Inbound	Japan	920,263
Jul 2013	Bank of Tokyo – Mitsubishi UFJ	Bank of Ayudhya PCL	Outbound	Thailand	676,088
Sep 2013	Lixil Group	Grohe AG	Outbound	Germany	381,600

Japan M&A market trend (1996-) – Deal volume

Despite a decrease in overall M&A deal volume due to the financial crisis in 2008, the outbound deal volume still increased as a percentage of overall deals – a sign that Japanese companies still need to invest overseas in order to continue to grow. Currently, approximately 1 of 4 deals involves the acquisition of a foreign (non Japanese) company.

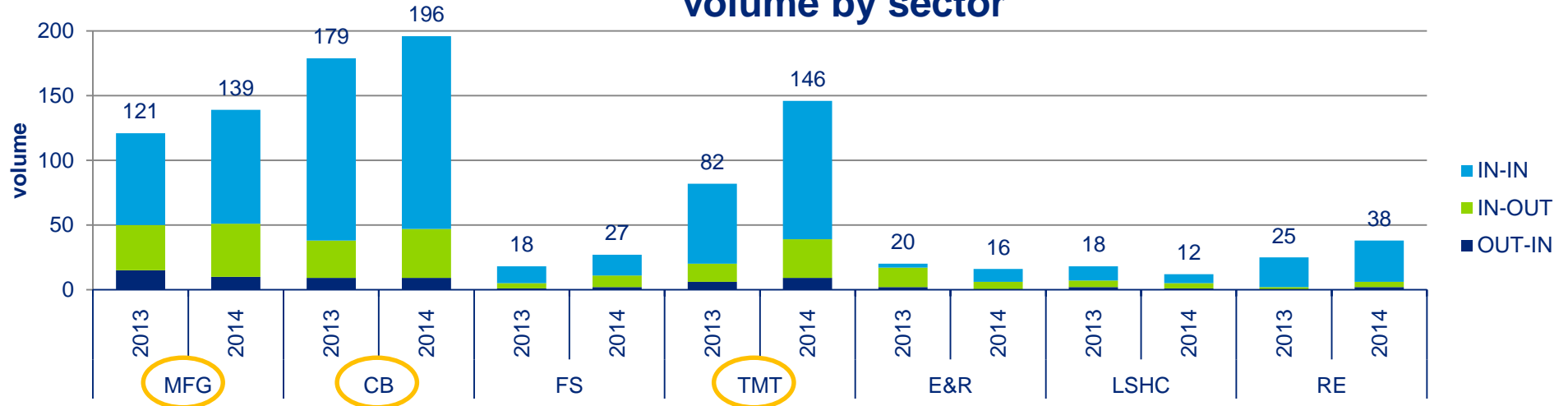


Japan M&A market trend (1996-) – Deal Value

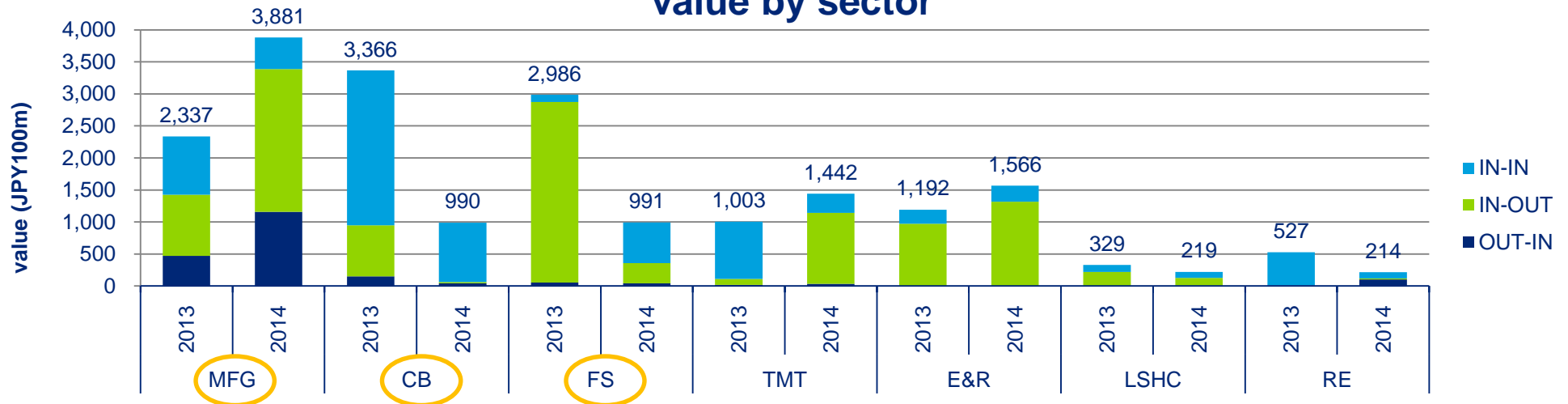


Japan M&A deals: by sector (year-to-date – March)

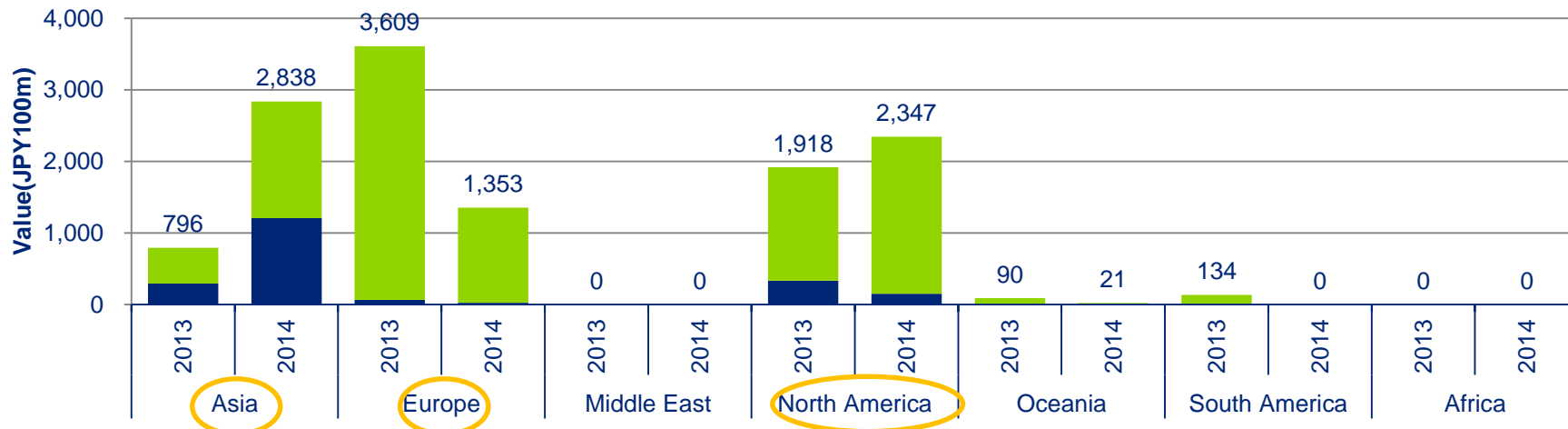
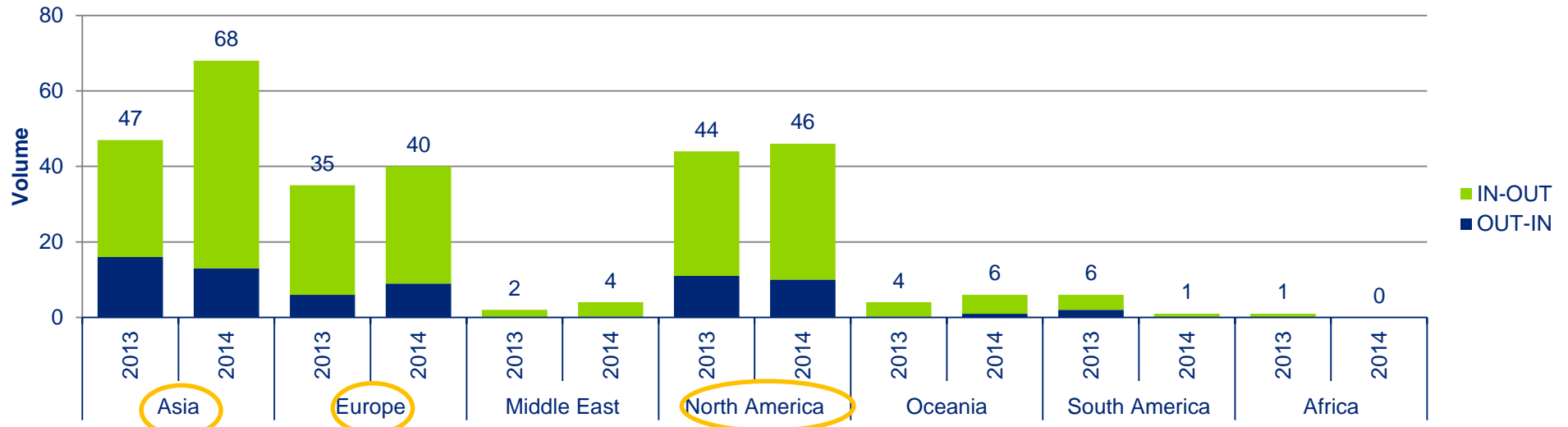
volume by sector



value by sector



Japan M&A deals: by region (year-to-date – March)

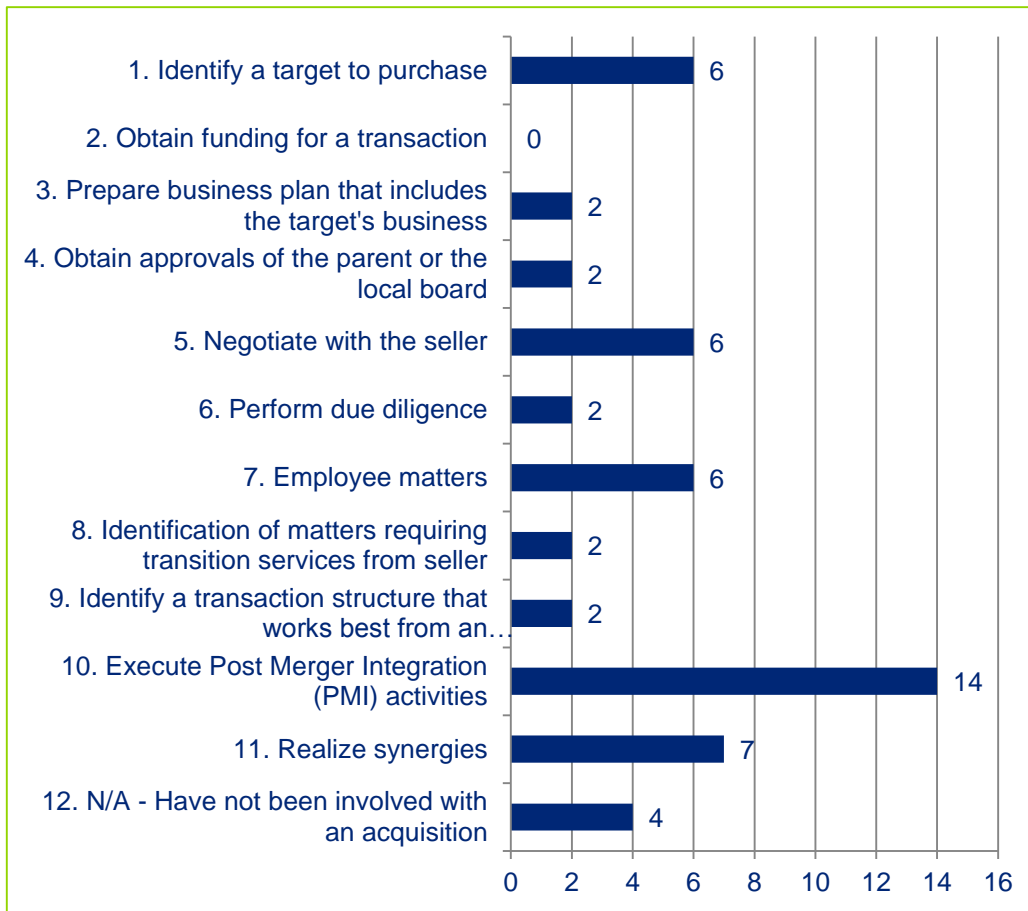


M&A lifecycle (managing the deal process)

Polling Question 3

Acquiring a Business

When considering an acquisition, what activities are often the most challenging? (mark all that apply, n=24)

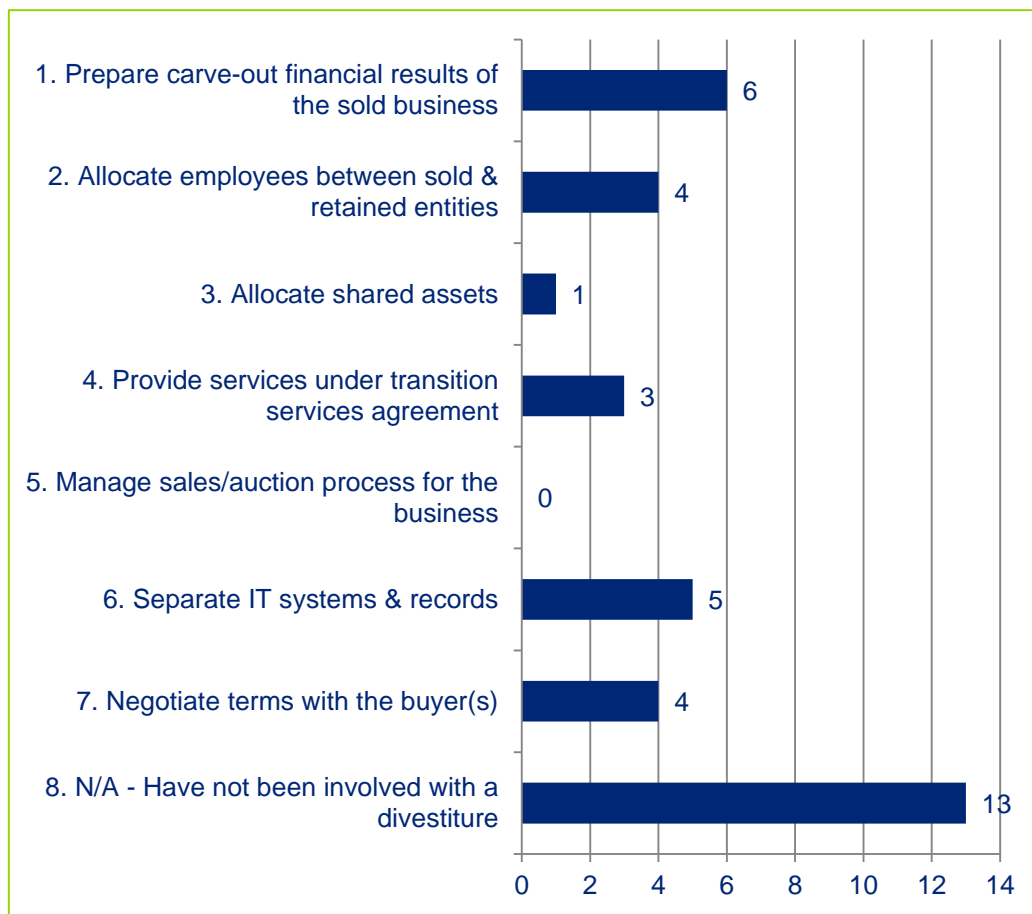


- One in four CFOs thinks identifying a target to purchase, poses a challenge
- The next hurdle is negotiating with the seller, especially starting negotiations and closing the deal with often times inexperienced “local” counterparts can be difficult
- More than half of the CFOs consider post-merger integration as the most challenging activity, and many think realizing synergies is the next major challenge to master
- Culture, process inefficiencies on the target side, and strict employee rights in Japan require experienced management to lead through the integration
- But the majority of roundtable participants consider the M&A Lifecycle “manageable”, even as a foreign company in Japan

Polling Question 4

Selling a Business

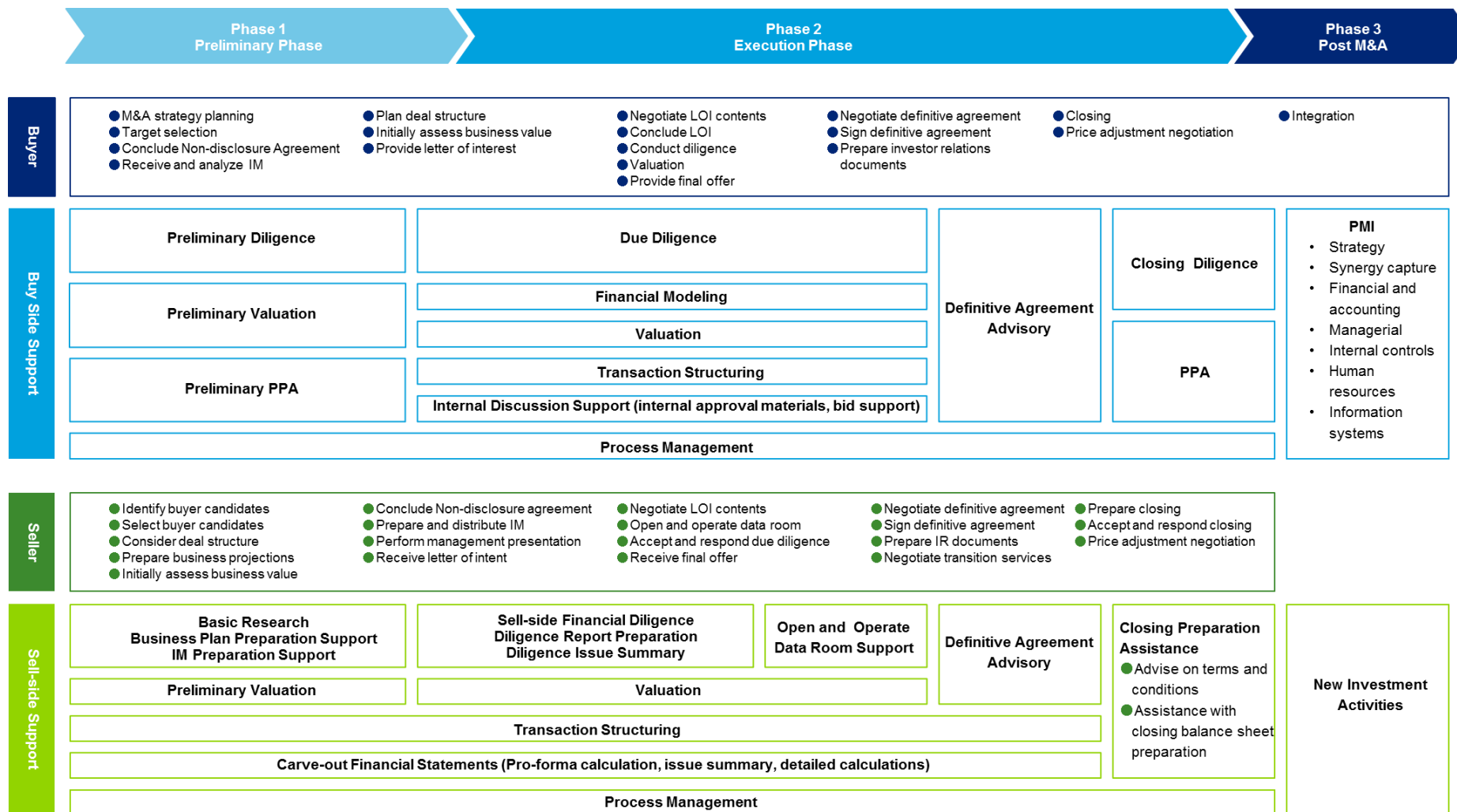
When selling a business or product line, what activities are often the most challenging? (mark all that apply, n=24)



- More than half of the CFOs have not been involved with a divestiture
- The CFOs with experience in divesting consider carving out financial results of the sold business a major challenge
- Especially non-standard items, e.g. the valuation of intellectual property with uncertain future returns can pose a challenge for CFOs and finance teams
- Next high on the list is the proper separation on an operational level – employees, IT, shared assets need to be reliably allocated to either side

The M&A lifecycle

Often times Japan CFO's of foreign owned companies are more involved with the integration portion of the lifecycle for acquisitions or the carve-out financial statement preparation for divestitures.



Managing the “acquisition” process

	Step 1 Preliminary Consensus Building				Step 2 Definitive Consensus Building			Step 3 Closing
Process	Team Building / Kick-off / Requesting Documents & Analysis	Preliminary Analysis/ Preliminary Price Simulation	LOI *2 Negotiation	Signing LOI	DD *3 / Management Interview	DA Negotiation	Signing DA	Payment / Realizing asset & liability, transferring share certificate/ Procedures required for post-merger
Client	<ul style="list-style-type: none"> Decision making of fundamental strategies Decision making of direction of negotiation Constructing business scenario Draft/ signing LOI (with the support of external legal advisors) 				<ul style="list-style-type: none"> Preparation of Management Interview Decision making of direction of negotiation Draft/ signing DA *4 (with the support of external legal advisors) 			<ul style="list-style-type: none"> Payment Realizing asset & liability, transferring share certificate Procedures required for post-merger
Advisor Assistance ¹	<ul style="list-style-type: none"> Coordination of parties, advising communication skill to develop consensus both in-out of the company, controlling deal process, time management and etc 							
	<ul style="list-style-type: none"> Thrasing out tasks at the preliminary stage & drafting schedule Drafting information request list/ managing disclosed information Supporting constructing business scenario based upon preliminary disclosed information, preliminary price simulations, validation of optimum structure Negotiation of LOI/ support in drafting LOI 				<ul style="list-style-type: none"> Coordination of Management Interview Coordination of DD Restructuring business scenario based upon DD findings, updating price simulation, validation of optimum structure Negotiation of DA/ support in drafting DA 			<ul style="list-style-type: none"> Drafting task list for closing, management of schedule, Support in proceeding procedures required for post-merger

Managing the “divestiture” process

	Step 1 List-up ~ 1 st round				Step 2 2 nd round ~ Definitive Agreement				Step 3 Closing	
Process	Team Building / Kick-off / Making list of selling candidate / Dispatching teaser	Signing CA *2 / IM*3, Dispatching 1 st round outline	Q&A Correspond- -ence	1 st round bid	Dispatching 2 nd round outline	DD/ Management Interview	2 nd round bid	DA negotiation	Receipt of consideration / Realizing asset & liability, transferring share certificate/ Procedures required for post-merger	
Client	<ul style="list-style-type: none"> Decision making of fundamental strategies Preparing disclosing documents & determining business forecast Drafting/ signing CA (with the support of external legal advisors) 				<ul style="list-style-type: none"> Preparation of Management Interview Decision making of direction of negotiation Building strategies on DA negotiation Draft/ signing DA (with the support of external legal advisors) 				<ul style="list-style-type: none"> Fulfilling CPs/ covenants correspondence <ul style="list-style-type: none"> Approval of change in shareholding structure Signing TSA *4 (with the support of external legal advisors) 	
Advisor Services ¹	<ul style="list-style-type: none"> Coordination of parties, advising communication skill to develop consensus both in-out of the company, controlling deal process, time management and etc 				<ul style="list-style-type: none"> Thrasing out tasks at the preliminary stage & drafting schedule Drafting/ updating candidate list Contacting the candidate Arrangement of disclosed documents Stand-alone cost based price simulation, validation of optimum structure Drafting Teaser Drafting IM/ Process letter 				<ul style="list-style-type: none"> Coordination of Management Interview Coordination of DD Updating price simulation based upon DD findings, validation of optimum structure Negotiation of DA/ support in drafting DA 	<ul style="list-style-type: none"> Drafting task list for closing, management of schedule, Support in proceeding procedures required for post-merger

Establishing a due diligence scope

Establishing a due diligence scope

So you need to perform due diligence...where to start?

Most companies will perform at least the following types of due diligence and will often use external consultants:

- Financial and accounting due diligence
- Tax due diligence (may include tax structuring)
- Legal due diligence

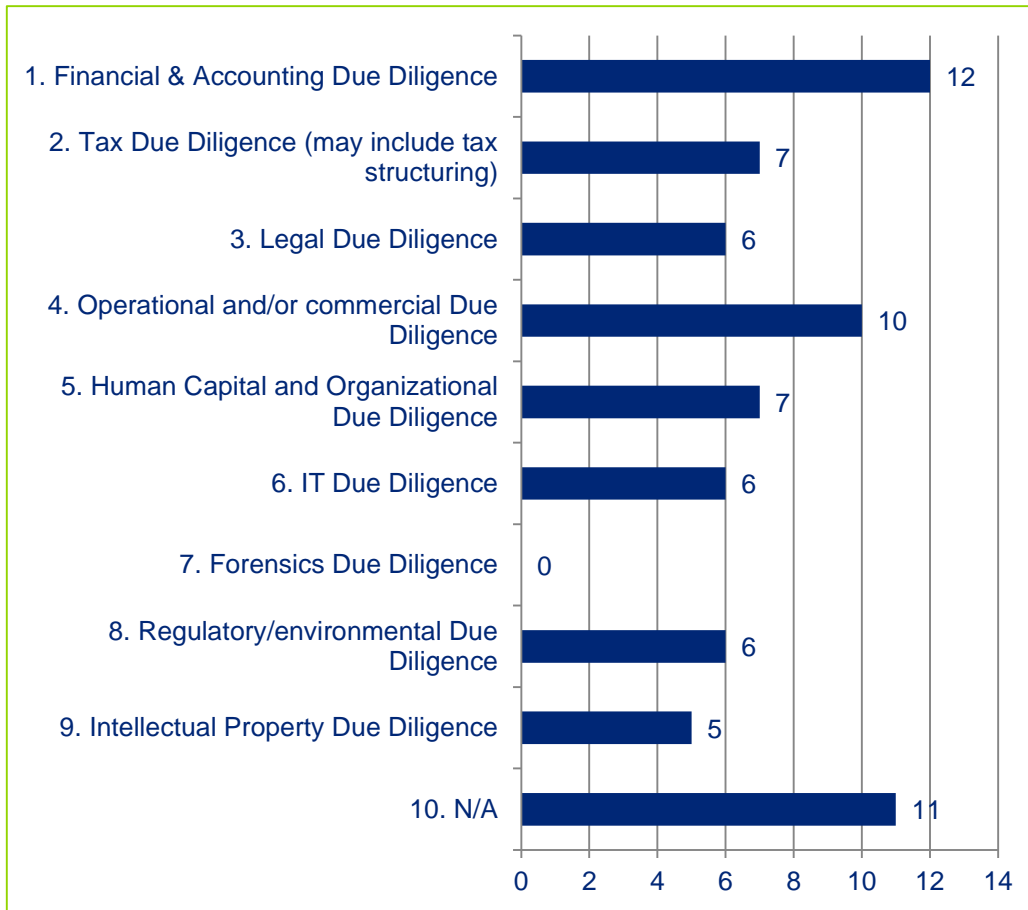
Other common types of due diligence – often performed internally or with consultants:

- Operational and/ or commercial due diligence
- Human capital and organizational due diligence
- IT due diligence
- Forensic due diligence
- Regulatory/ environmental due diligence
- Intellectual property due diligence

Polling Question 5

Performing Due Diligence

Which types of Due Diligence have you performed in the past 2 years for a potential transaction? (mark all that apply, n=24)



- Most of the CFOs have chosen a broad approach to due diligence – looking into all relevant areas of the business to at least some extent
- The importance of each DD activity differs by transaction, target country and deemed reliability of the target's data - Forensics DD plays only a minor role for inbound deals into Japan, but is high on the agenda when acquiring in China and South-East Asia
- Finance & Accounting DD is the standard for any transaction, mostly accompanied by operational and commercial DD

Financial due diligence

Objectives	Common Areas of Focus
<ul style="list-style-type: none"> ▪ Confirm that the business is what the seller has represented with a focus on matters such as: <ul style="list-style-type: none"> ▪ Quality of earnings and cash flows (with a focus on identifying normal, recurring earnings and cash flows) ▪ Quality of assets and adequacy of historical capital expenditures ▪ Identify debt-like obligations ▪ Identification of hidden costs, contingencies and commitments ▪ Understand matters that may have a material impact, positive or negative ▪ Identify matters that could cause the buyer to walk away from the deal, reduce (or increase) the purchase price, seek additional contractual protections, or change post-closing plans 	<ul style="list-style-type: none"> ▪ Quality of earnings and adjustments to calculate normalized EBITDA <ul style="list-style-type: none"> ▪ Revenues and gross margins by product and geography ▪ Product pricing and discounting ▪ Major customers/ supplies, concentration risk, obligations in agreements ▪ Trends in revenue and expenses ▪ Operating costs with a focus on fixed and variable costs, hedging and FX impacts ▪ Nature and breakdown of cost of goods sold by component (materials, direct labor, overhead etc.) ▪ Significant non-recurring, unusual, non-cash and out-of-period charges and credits ▪ If a carve-out, focus on allocations and services being provided by parent company ▪ Related party transactions ▪ Working capital and cash flows <ul style="list-style-type: none"> ▪ Trends and seasonality of working capital, non-recurring items, understand vendor and customer payment terms, peak/ trough analysis (cash needs), impacts on purchase agreement ▪ Capital expenditure requirements <ul style="list-style-type: none"> ▪ Maintenance vs. growth and budget vs. actual CAPEX; deferred CAPEX ▪ Quality of assets <ul style="list-style-type: none"> ▪ Analysis of the trends in the balance sheet accounts and their compilation ▪ Nature and timing of recorded liabilities ▪ Contingent or unrecorded liabilities and other debt-like items <ul style="list-style-type: none"> ▪ Identification of loans, leases, litigation, ARO's, pension liabilities, taxes, trapped or restricted cash, self-insurance, contingent consideration to be paid, change-in-control payments, rebates/ warranties ▪ Provide high-level comments on draft stock purchase agreement <ul style="list-style-type: none"> ▪ Focus on purchase price adjustment mechanism, working capital, debt definition and other financial statement related matters

Financial due diligence – Normalized EBITDA

Common Normalizing EBITDA Adjustments

- Changes in business units
 - Acquisition/ divestiture
 - Major product launches/ cancellations
- Non-recurring/ unusual items
 - Restructuring activities (i.e. severance)
 - Legal expenses
 - Insurance proceeds
 - Bad debt/ inventory write-offs
- Non-operating items
 - Gain/ loss on asset sales
 - Components of other income/ expense
 - Foreign currency
- Non-cash items
 - Stock compensation expense
 - Deferred revenues
 - Pension (cash cost versus expense)
- Out-of-period revenue and expenses
 - Reserve adjustments
- Pro forma adjustments
 - Stand alone costs
 - Public to private costs

Tax due diligence (may include tax structuring)

Objectives	Common Areas of Focus
<ul style="list-style-type: none">▪ For stock transactions, analyze the Target's tax situation to determine if reported tax liabilities are accurate or if there are tax liabilities that may exist that are currently unknown or undisclosed▪ Understand historical compliance with tax laws▪ Analyze target business to determine a tax efficient structure that achieves business and operational objectives▪ Understand any NOL limitations or disallowed deductions▪ Identification of trapped offshore cash and other exposures	<ul style="list-style-type: none">▪ Common areas of focus – national corporate income tax:<ul style="list-style-type: none">▪ Corporate tax return filing status▪ Material tax issues that significantly affect the tax position▪ Tax audit history including any ongoing tax audits▪ Material tax positions taken and/ or planned to be taken▪ Transfer pricing and related party transactions▪ M&A and reorganization history▪ Availability of NOL's▪ State and local tax compliance▪ Tax planning currently considered and potential for step up, tax effective financing/ debt placement, disposition planning, and utilization of tax attributes▪ Future reorganization and/ or M&As currently considered▪ Foreign related party's tax situation▪ Other areas of focus for certain transactions<ul style="list-style-type: none">▪ Local taxes, consumption taxes, tax structuring for the proposed transaction▪ Internal tax department operations▪ Provide high-level tax comments on draft stock purchase agreement<ul style="list-style-type: none">▪ Tax warranties and indemnifications

Points to consider with Financial/ Tax Due Diligence in Japan

Topic	Observations
<ul style="list-style-type: none"> ▪ Target personnel with knowledge of the transaction 	<ul style="list-style-type: none"> ▪ Japan companies often limit the number of people who know about the transaction. ▪ Selling a company to a non-Japanese company can be perceived as a negative event by the employees (fear of being terminated or having the company operated in a cost-constrained fashion). <ul style="list-style-type: none"> ▪ CEO/ CFO and other key execs are often the only people initially aware of the transaction often resulting in: <ul style="list-style-type: none"> ▪ Limited data provided and inadequate explanations to questions ▪ Extended DD process
<ul style="list-style-type: none"> ▪ Target employee's authority 	<ul style="list-style-type: none"> ▪ Often times Japanese employees that are tasked with providing data and answering questions lack the authority to expand on an explanation or provide additional data resulting in: <ul style="list-style-type: none"> ▪ Extended DD process while permission is requested and granted
<ul style="list-style-type: none"> ▪ Information sharing in a JV arrangement 	<ul style="list-style-type: none"> ▪ Japanese JV partner may be unwilling to share certain information until the foreign company shares certain information. <ul style="list-style-type: none"> ▪ Extended DD process while the parties go back and forth.
<ul style="list-style-type: none"> ▪ Target company's financial advisor 	<ul style="list-style-type: none"> ▪ Buyer and/ or seller don't always use a financial advisor <ul style="list-style-type: none"> ▪ Given the differences in culture, language, and western business dealings, transactions where the buyer and seller both have a financial advisor helping them manage the process often times experience a more efficient deal process.
<ul style="list-style-type: none"> ▪ Data requests 	<ul style="list-style-type: none"> ▪ Japan culture is one that considers providing quality information as a high priority and this could result in the target company taking longer than you would expect to prepare diligence materials. <ul style="list-style-type: none"> ▪ Meetings are often required to clarify any ambiguity with requests. ▪ Target companies in Japan often prefer to meet advisors in person – generally helps facilitate obtaining data and receiving responses to Q&A ▪ Public companies are reluctant to provide draft financials until the data is made public

Points to consider with Financial/ Tax Due Diligence in Japan

Topic	Observations
<ul style="list-style-type: none"> ▪ Language preference 	<ul style="list-style-type: none"> ▪ In general, Japan executives have a basic understanding of the English language and are willing to conduct meetings in English. ▪ Executing diligence by soliciting lower level personnel in the company to prepare documents is typically done in Japanese since those employees often have limited English capability. <ul style="list-style-type: none"> ▪ Data requests and questions are often requested in Japanese for a company to efficiently answer. Translation may be necessary. Financial advisors can help.
<ul style="list-style-type: none"> ▪ Items below EBIT 	<ul style="list-style-type: none"> ▪ Japan companies often classify items as non-operational that a buyer might consider as part of operations. <ul style="list-style-type: none"> ▪ Careful review of the items recorded below EBIT is needed to effectively analyze baseline costs. ▪ EBIT is used more frequently in Japan than EBITDA as JGAAP requires goodwill amortization and management teams often desire to understand the impact of the amortization on earnings.
<ul style="list-style-type: none"> ▪ Audit workpapers 	<ul style="list-style-type: none"> ▪ In the US, it is common for the M&A team to review audit workpapers of the Target. This review rarely happens in Japan.
<ul style="list-style-type: none"> ▪ Employee Terminations 	<ul style="list-style-type: none"> ▪ Employee terminations are difficult and expensive in Japan. May be required to pay for underfunded pension benefits in a carve-out and often times have to offer significant severance (6 – 30 months) <ul style="list-style-type: none"> ▪ May wish to consider specific human capital and legal advice in these situations
<ul style="list-style-type: none"> ▪ Earnouts and working capital adjustments 	<ul style="list-style-type: none"> ▪ Small and medium sized enterprises in Japan often try to avoid earnouts and working capital adjustments. Preference is for a known purchase price.
<ul style="list-style-type: none"> ▪ Financial reporting 	<ul style="list-style-type: none"> ▪ SPA may dictate certain financial reporting post close by Target company management or JV partner. ▪ Even though contractually agreed to in the SPA, local Japanese management may be unable to prepare the agreed upon financial reports. Often times, practical remedies are limited.

Legal due diligence

Objectives	Common areas of focus
<ul style="list-style-type: none">▪ Analyze legal documents to confirm ownership of key assets (stock, IP, real properties) (link to valuation model)▪ Analyze legal documents to determine potential exposures (litigation, environmental, regulatory, contingent)▪ Analyze material agreements to determine if the proposed transaction will trigger a change of control or other counter-party early termination right▪ Analyze material agreements to determine existence of unfavorable commercial terms that cannot be terminated post-closing▪ Analyze legal documents to list affiliate transactions (and evaluate whether post-closing transition services required from seller)▪ Analyze legal documents to identify jointly owned or shared assets	<ul style="list-style-type: none">▪ Corporate Organization/ Stock Ledger/ Board & Shareholder Minutes▪ Material Agreements▪ Loan Documents and Other Financings▪ Material Assets/ Intellectual Property▪ Regulatory Matters/ Permits▪ Environmental Compliance▪ Litigation and Disputes▪ Employee Matters and Work Rules▪ Related Party Transactions▪ Prior M&A Agreements

M&A legal considerations

M&A Legal Considerations

General Legal Challenges Faced in Japan M&A Transactions

- Negotiating Dynamics
 - Typically the sole responsibility of the Representative Director (takes longer to finalize and may lead to negotiating frustrations)
 - Typically senior management sits on the Board of Directors, so directors may seek preservation of Board seat post-closing
- Due Diligence
 - No national database for litigation searches
 - Greater reliance on discussions with government regulators (Japanese rules and regulations can be vague, so informal discussions + previewing filings with regulators in advance a common practice)
 - Verbal agreements frequently entered into outside the corners of written agreements
 - Management interviews common source of information
- Post-Merger Integration
 - Only a Japanese organized company can enter into a merger or other statutory combination with a Japanese company, so a buyer may need to add a layer of control through a wholly-owned subsidiary
 - Squeezing out minority shareholders is a time consuming task that requires a change in capital structure
 - Japanese labor laws very pro-employee, so restructuring labor force cannot be assured or may require significant severance payments
 - Employees retain the right to patent inventions made during the course of employment
 - Difficult to terminate long-term contracts (e.g., distribution agreement or franchise agreements), so unfavorable contracts may survive post-closing

M&A Legal Considerations

Japan Acquisition Agreements – Tips to Consider During Negotiations

- Disclosure agreements - No US-equivalent agreement disclosure requirements (or deal surveys), so ascertaining “current market practice” can be subjective
- Non-binding LOI - A non-binding LOI can become binding if a party has led the counter-party to reasonably believe that a definitive agreement would be executed (“breach of trust”)
- Reps & Warranties - buyer’s knowledge of a breach of a R&W or information disclosed to an advisor to buyer during due diligence could prevent a successful indemnification claim by buyer
- Default payments - charactering default payments as a penalty rather than a liquidated damage could be beneficial to a buyer
- Indemnity caps - Indemnity caps typically higher than US market practice (~20% versus Purchase Price)
- Judicial rulings - No punitive damages + no parole evidence rule in Japan (judges may freely determine the evidence presented and make their own findings based on sense of fairness) → out of court settlements are common

M&A Legal Considerations

Regulatory Approvals Commonly Required When Acquiring a Japanese Company

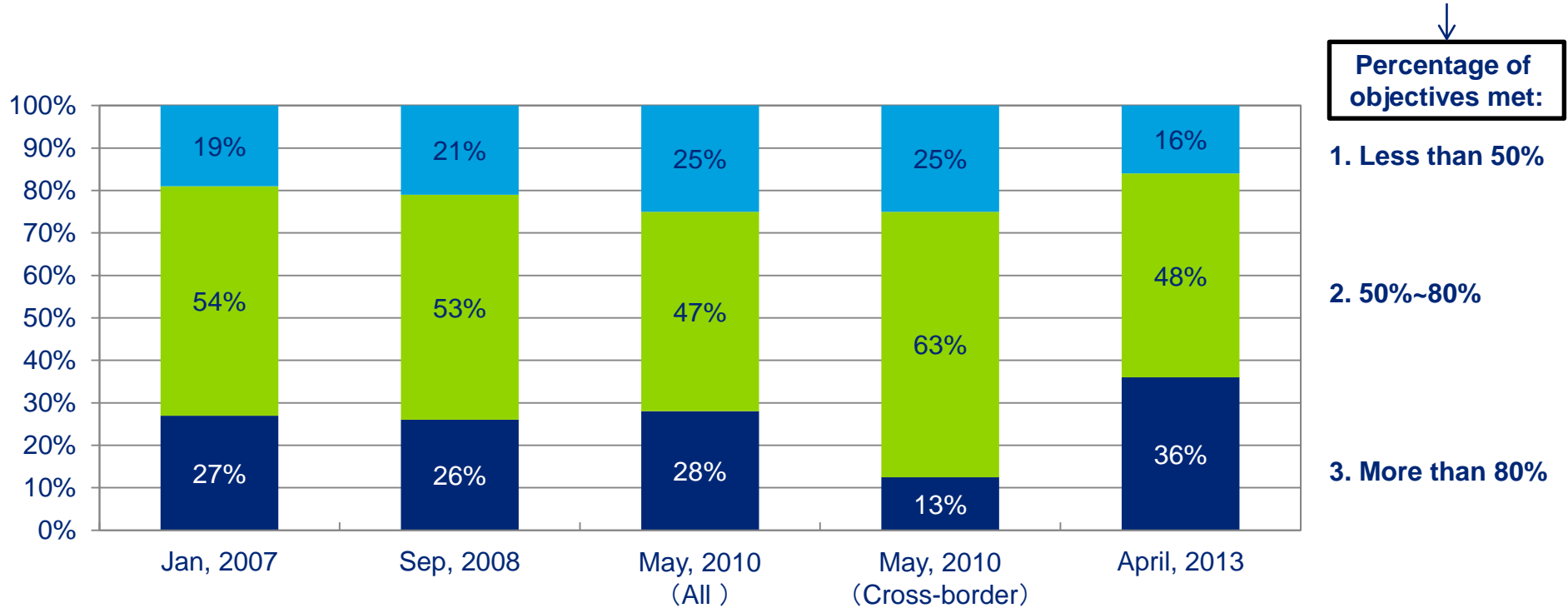
- Antitrust
 - Acquire more than 20% or 50% of the outstanding voting shares, then a filing by the buyer is required with the Japan Fair Trade Commission if during the most recently completed fiscal year, revenues from sales made in Japan by the
 - I. buyer and its “corporate group” (as defined under Japanese antitrust laws) exceeded JPY 20 billion, and
 - II. target company and its subsidiaries exceeded JPY 5 billion
 - Notification should be filed at least 30 days prior to the target acquisition date
- Foreign Exchange Act Clearance
 - If a foreign buyer acquires (either directly or along with its affiliates) 10% or more of the outstanding shares of a Japanese company, then the buyer must file a notification with Japan’s Ministry of Finance and the Japanese economic ministry overseeing the industry in which the target company operates by the 15th day of the month after the month in which the acquisition closes
 - A filing before an acquisition followed by a 30-day waiting period is required pursuant to Japan’s Foreign Exchange and Foreign Trade Act depending on the country of origin of the buyer or if the target company or any of its subsidiaries engage in a business that is either deemed to be critical to Japan’s national security (e.g., weapons, aircraft, and nuclear power) or engage in certain protected industries (e.g., agriculture, petroleum, and leather)
- Tender Offer Rules (a company that files a securities report only)
 - Buyer should be careful to structure the timing, manner and number of shares that it acquires to avoid triggering the application of Japanese tender offer rules to its contemplated purchase
 - Required to launch a mandatory general offer open to all shareholders if the buyer’s ownership interest in the outstanding voting shares and certain derivative securities (as defined under Japanese securities laws) of a public target company will exceed one-third as a result of its acquisition of such company’s shares in an off-market transaction
 - Required to launch a mandatory general offer open to all shareholders if a buyer acquires more than 5% of the outstanding voting shares of a public target company through transactions conducted “outside the market” with more than 10 persons during a rolling 60-day period
- Industry Specific Regulations (e.g., broadcasting, air transportation, telecommunications)

Post-merger integration

Post merger integration

The Japan CFO may not have executed the M&A transaction, but the Japan CFO more than likely will be responsible for its successful integration.

Q. What percentages of the targeted objectives/ goals has the Company accomplished post-transaction?

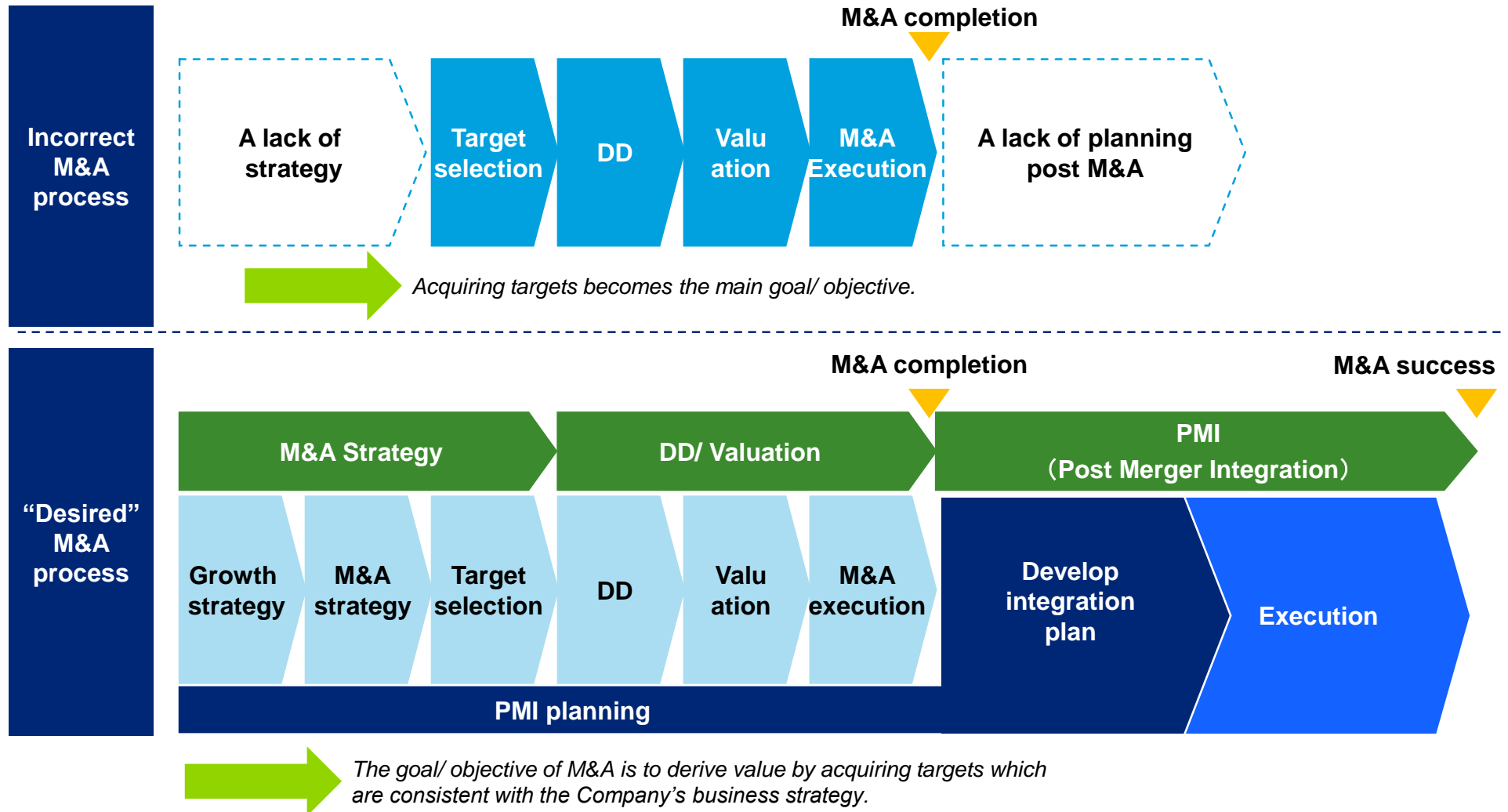


Takeaways:

- A typical success rate for M&A is approximately 30%.
- For cross-border deals, that success rate drops to around 13%.

Post merger integration – Methodology for success

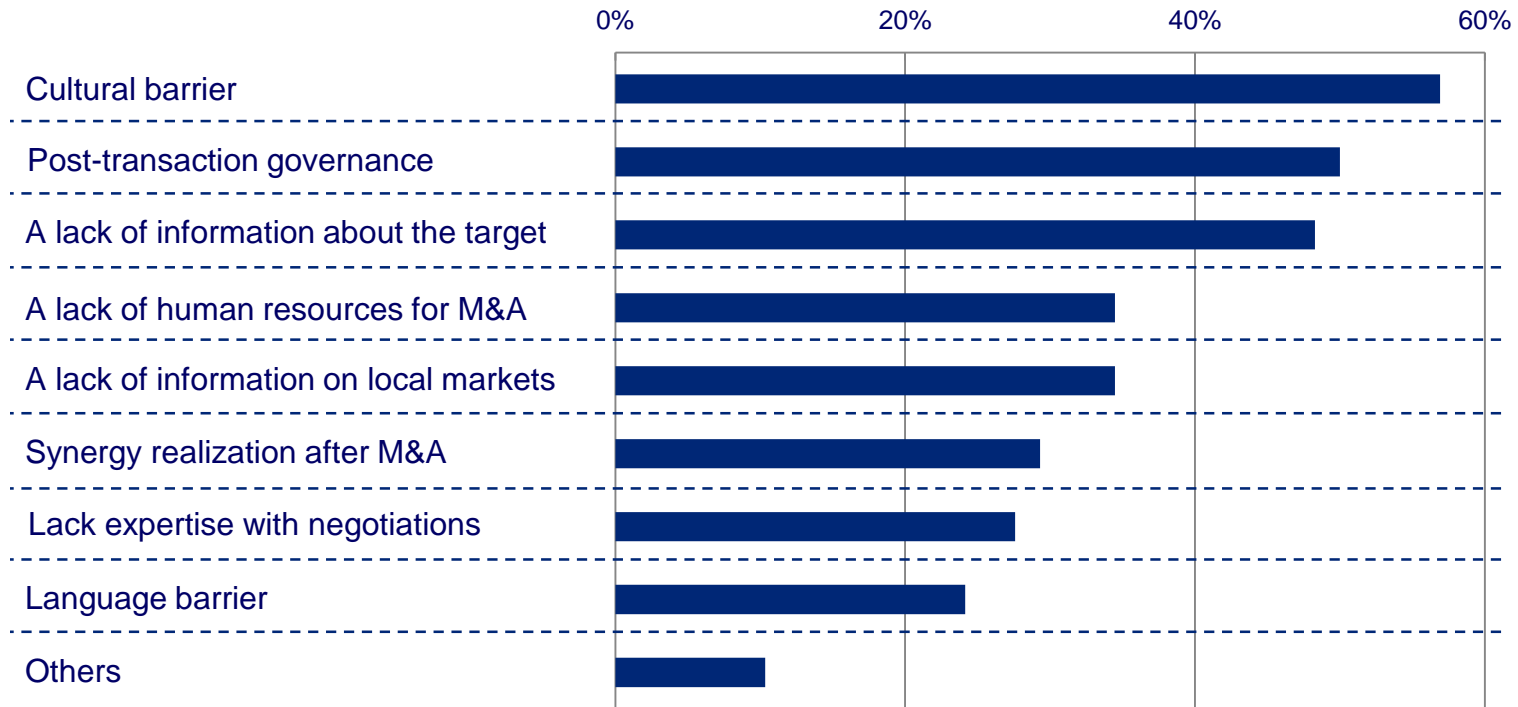
PMI, from early consideration to integration execution, is required for a successful integration:



Post merger integration – Common challenges

Typical issues preventing a successful integration for a cross-border M&A deal

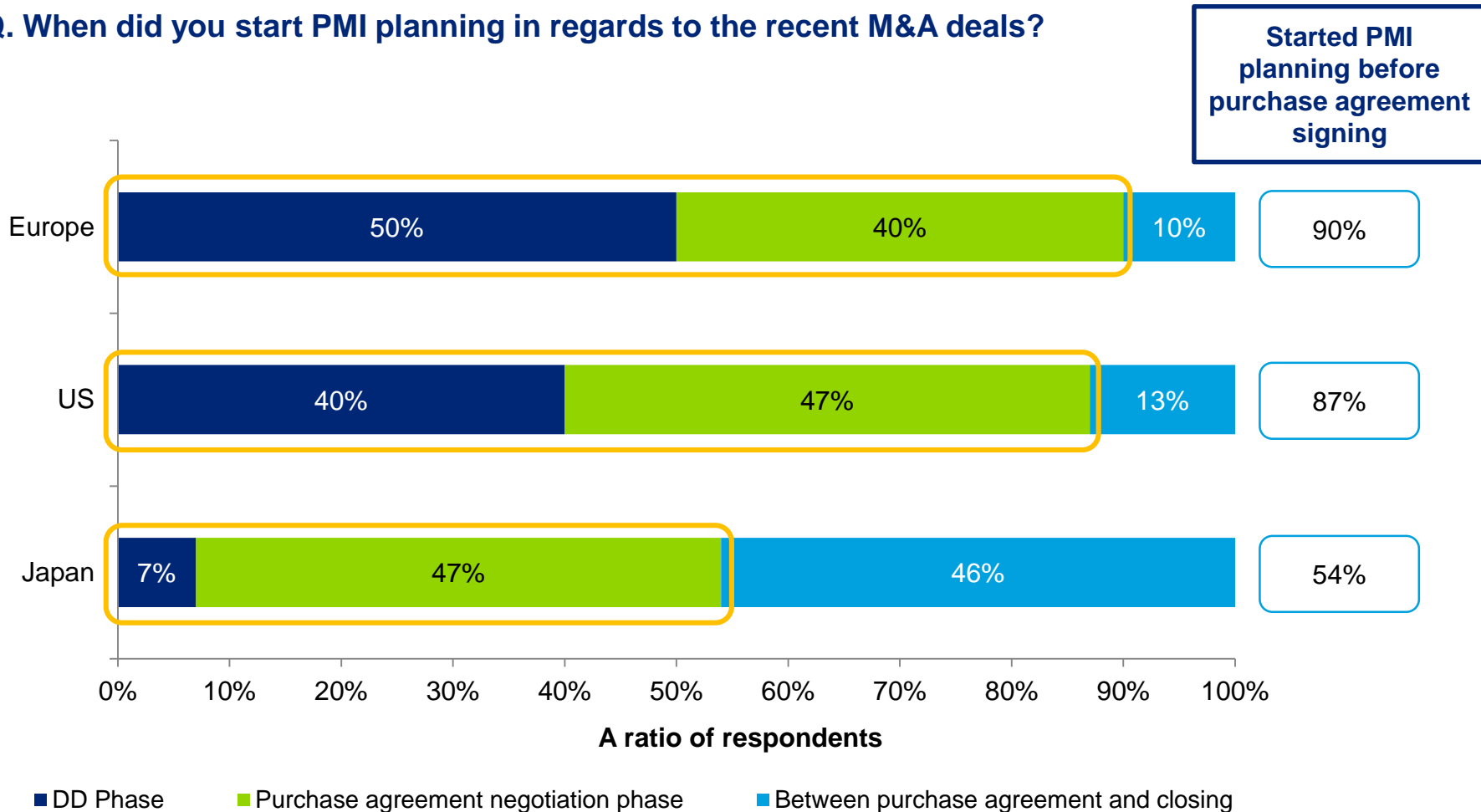
Q. What were the barriers/ obstacles experienced during the planning and execution phases of a cross-border M&A transaction?



Post merger integration – Started planning for PMI

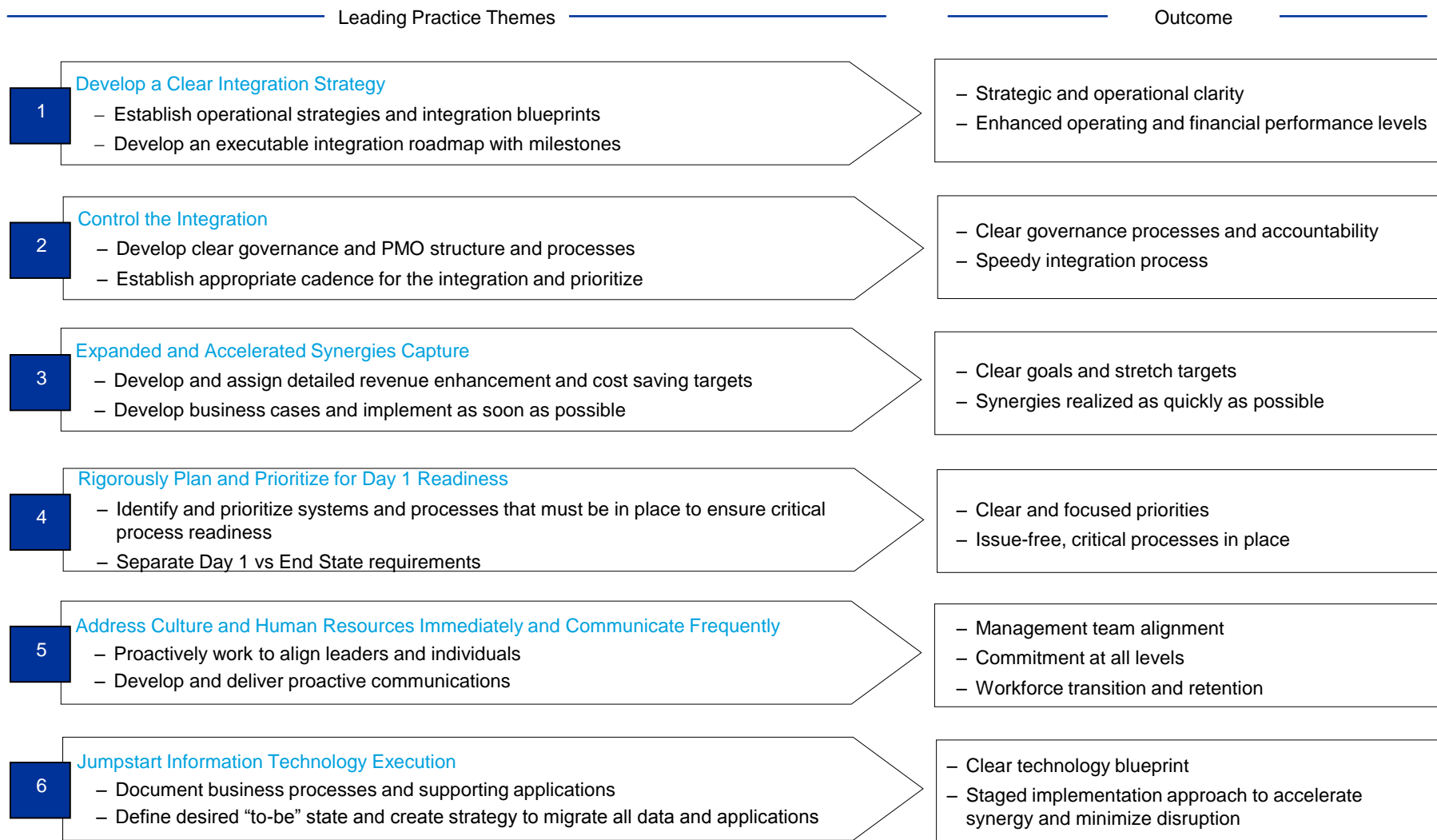
Japan generally lags other countries for PMI planning

Q. When did you start PMI planning in regards to the recent M&A deals?



Post merger integration – Keys to success

Examining many of our recent mergers and acquisitions, those who have been most successful focused their integration effort in six key areas



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