Volume 4 • Issue 8

GETTING THE DEAL THROUGH

market intelligence

M&A

2017 – the year of boom and bust?

Global interview panel led by Alan Klein

Sector focus • Keynote deals • Shareholder activism • 2018 outlook
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Cover: iStock.com/onurdongel

Law Business Research

Published by
Law Business Research Ltd
87 Lancaster Road
London, W11 1QQ, UK
Tel: +44 20 3780 4104
Fax: +44 20 7229 6910

ISSN: 2056-9025

ABA Section of International Law
Your Gateway to International Practice
Strategic Research Sponsor of the ABA Section of International Law

Printed and distributed by
Encompass Print Solutions
Tel: 0844 2480 112

market intelligence

Welcome to *GTDT: Market Intelligence*.

This is the fourth annual issue focusing on global M&A markets.

Getting the Deal Through invites leading practitioners to reflect on evolving legal and regulatory landscapes. Through engaging and analytical interviews, featuring a uniform set of questions to aid in jurisdictional comparison, *Market Intelligence* offers readers a highly accessible take on the crucial issues of the day and an opportunity to discover more about the people behind the most interesting cases and deals.

Market Intelligence is available in print and online at www.gettingthedealthrough.com/intelligence

Getting the Deal Through
London
November 2017

In this issue

M&A IN

JAPAN

Kenichi Sekiguchi is a partner at Mori Hamada & Matsumoto and practises in mergers and acquisitions and general corporate matters, including corporate litigation regarding M&A transactions. He has particular experience in transactions involving conflicts of interests such as management buyouts and in cross-border M&A transactions, for which he advises both international and domestic clients. His clients include various international companies and private equity funds.

He was admitted to the bar in Japan in 2005 and in New York in 2011. He is recognised as one of the leading M&A lawyers in *Who's Who Legal: Japan* 2017.

Akira Matsushita is a partner at Mori Hamada & Matsumoto. He focuses on, and has extensive experience in, inbound and outbound cross-border and domestic M&A transactions (involving listed and private companies); matters involving corporate governance, shareholder activism, proxy fights, unsolicited takeovers and takeover defence; and general corporate and securities law matters.

He was admitted to the Japanese Bar in 2006 and the New York Bar in 2013. He received his LLB from Keio University in 2005 and his LLM from Cornell Law School in 2012. He also worked at Kirkland & Ellis LLP, Chicago, from 2012 to 2013. He has published *Comprehensive Analysis of M&A Laws of Japan*, *TOBs in Japan – Systems and Demonstrations*, *Shareholders' Proposal and Proxy Fight* and the Japan chapter in *The Shareholder Rights and Activism Review*.

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

Kenichi Sekiguchi & Akira Matsushita: M&A practitioners in Japan were quite busy in 2016 and into 2017. In particular, outbound transactions by Japanese companies hit a record high in 2016 both in terms of the number of transactions and the transaction value. As to domestic M&A transactions between Japanese companies, we saw a steady deal flow in 2016 into the first half of 2017. There were many divestment transactions by Japanese conglomerates as they continued to implement their strategies of focusing on their core competencies, while Toshiba was forced to divest many of its subsidiaries and other assets because of financial problems.

Private equity in Japan has been quite active as some major Japanese private equity firms successfully launched new funds and obtained additional funding from a variety of investors. Also, there were a few major recent inbound transactions including Foxconn's acquisition of Sharp in 2016 and KKR's takeover in 2017 of Calsonic Kansei, a tier 1 auto parts supplier that was a subsidiary of Nissan Motors. However, inbound transactions represented around 10 per cent of all M&A activities in Japan in 2016. The government has been implementing various policies, such as tax incentives and issuance of work permits, with more loosened requirements to facilitate foreign direct investment in Japan, but the effect remains to be seen.

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

KS & AM: For outbound M&A transactions, the most active sectors are technology, media and telecommunications (TMT), life and non-life insurance, consumer and pharmaceutical. Softbank's acquisition of ARM Holdings in 2016 at US$31.8 billion broke the record for the deal size of outbound M&A transactions by Japanese companies. Softbank has continued its deal-making and recently announced the establishment of the Softbank Vision Fund, which has major investors such as the Saudi government and has US$100 billion of committed capital. Softbank is aiming to become the world leader in the high-tech industry.

In the insurance sector, we've seen a series of sizeable transactions in recent years. Since 2015, there have been eight M&A transactions by Japanese companies exceeding US$10 billion, seven of which were outbound transactions. In the non-life insurance sector, Sompo Holdings acquired Endurance at US$6.3 billion in 2016, while its rival MS&AD Insurance Group Holdings acquired Amlin in 2015 at US$5.3billion and recently announced the acquisition of First Capital, a Singapore-based non-life insurance company, at US$1.6 billion. Life insurance companies have also been active in recent years, as shown by Nippon Life's acquisition of MLC at US$2.2 billion, which was completed in October 2016. The Japanese insurance market is already mature, and in light of Japan's ageing and shrinking population, room for domestic growth is quite limited. Therefore, going abroad for growth is an inevitable trend for insurance companies.

Likewise, the consumer sector remains active in outbound M&A transactions for the same reasons. Two outbound transactions by Asahi Group Holdings were ranked among the top five outbound transactions by deal value in 2016.

GTDT: What were the recent keynote deals? What made them so significant?

KS & AM: The acquisition of Sharp in early 2016 by Taiwan-based Hon Hai Precision Industry (also known as Foxconn) was a notable transaction as it may affect the historical hesitance of the Japanese government or management of Japanese companies in accepting foreign capital.

In April 2016, Sharp, a major Japanese electronics company going through financial difficulties, agreed to accept approximately ¥388 billion in the form of equity from Foxconn, making Foxconn the controlling shareholder of Sharp. According to the public disclosure of Sharp, Sharp had been discussing the transaction with the Innovation Network Corporation of Japan (INCJ), a Japanese public-private partnership aimed at promoting innovation and enhancing the value of businesses in Japan. Many M&A practitioners thought Sharp would choose INCJ to avoid the leak of its technology from Japan to overseas and to avoid potential culture clashes with Foxconn's more aggressive management style. Needless to say, many were surprised Sharp ultimately chose Foxconn as its partner.

There have been some cases in recent years in which major Japanese companies were put up for sale but, because of the de facto influence of the government mixed with the fear of the Japanese companies being managed in a westernised way, foreign companies were not successful in

> *"Outbound transactions by Japanese companies hit a record high in 2016 both in terms of the number of transactions and the transaction value."*


Kenichi Sekiguchi


Akira Matsushita

acquiring these Japanese companies. Sometimes unsuccessful foreign strategic bidders criticised the Japanese market for not being sufficiently fair and transparent. Since the investment by Foxconn, however, Sharp has been doing quite well and its decision is generally recognised among Japanese companies' management as the right decision.

GTDT: 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?

KS & AM: While cash is more commonly used as consideration in acquisitions, the type of consideration varies depending on the nature and structure of the acquisition. In a share purchase or business transfer, the consideration is predominantly cash only. An exchange offer through which the acquirer offers its own securities as consideration in a tender offer is legally permitted but the use of exchange offers has not developed in practice in Japan because capital gain taxes may not be deferred in the case of an exchange offer.

In a statutory business combination, such as a merger, share exchange or company split involving a listed company, stock is more commonly used as consideration, although cash or other consideration is legally permitted and is often seen in the case of a company split.

Considerations comprising a mix of cash and stock is not common in Japan, although such a mix is legally permissible. However, a cash tender offer followed by a second-step stock-for-stock merger or share exchange is often seen, and this structure effectively provides the shareholders with both cash and stock.

Japanese shareholders are not generally willing to accept shares issued by a foreign acquirer because access to information about the foreign acquirer would likely be limited for most domestic shareholders. If shares of a foreign acquirer are issued to shareholders of a listed company, the foreign acquirer must file a security registration statement in Japan.

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

KS & AM: Amendments to the Companies Act were made in May 2015, which introduced a squeeze-out right for a 'special controlling shareholder', which is a shareholder who holds at least 90 per cent of the voting rights of a company. A special controlling shareholder has the right to force the other shareholders in the company to sell their shares to the special controlling shareholder. As a result, if a buyer becomes a shareholder holding 90 per cent or more of the voting rights of a target through a first-step tender offer, the buyer no longer needs to cause the target to hold an extraordinary shareholders meeting to consummate the squeeze-out of the minority shareholders.

Important tax reforms also have been made in 2017. Prior to the tax reform, cash-out mergers or share exchanges were rarely used for squeeze-out transactions in Japan because assets of targets may be subject to capital gains taxation. As a result of the 2017 tax reform, a tax qualified treatment is now available for a cash-out merger or share

exchange if the surviving company or parent company holds at least two-thirds of the total outstanding shares of the disappearing company or subsidiary company and other requirements are met. Thus, cash-out mergers or share exchanges may become feasible options for conducting a squeeze-out of minority shareholders.

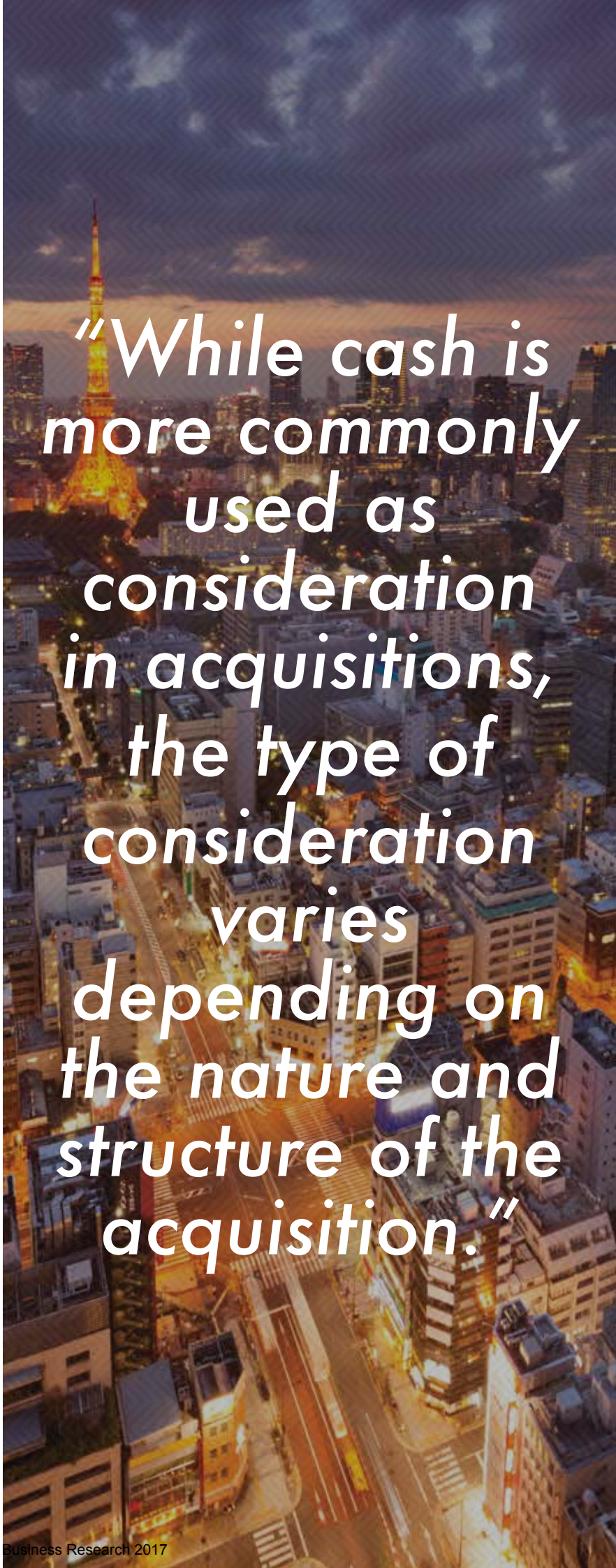
Also, prior to the 2017 tax reform, if a company that adopts the consolidated taxation system had made a target a wholly owned subsidiary through a squeeze-out transaction, assets of the target would have generally been subject to taxation, and net operating loss carry forward of the target could not be used in the consolidated taxation. As a result of the 2017 tax reform, if a squeeze-out transaction meets the requirements of the tax qualified treatment, such taxation on assets of the target can be avoided and net operating loss carry forward of the target can be used in the consolidated taxation. Consequently, the number of squeeze-out transactions conducted by companies adopting the consolidated taxation system may increase.

Furthermore, the 2017 tax reform now permits deferral of taxation arising from certain spin-off transactions in which a part of a company's business, or its wholly owned subsidiary, is carved out and shares in such business or wholly owned subsidiary are distributed to the company's shareholders through a dividend in kind. This tax reform may increase the options available for a company to structure a carve-out of a part of its business.

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

KS & AM: Although there are many more outbound M&A transactions in Japan, inbound M&A transactions are not uncommon. During 2016 into 2017 especially, the number and volume of M&A transactions in which Chinese companies acted as buyers or investors of Japanese companies increased substantively. Chinese companies have also been acquiring the operations and Chinese subsidiaries of some Japanese companies that have recently pulled out of China or decreased their operations in China pursuant to company restructurings. While M&A transactions by Chinese companies with Japanese companies may at times be affected adversely by diplomatic relations between Japan and China, such M&A transactions are expected to continue to increase in the near future.

Also, foreign private equity funds, such as KKR and Bain Capital and other US- or UK-based funds, were actively engaged in M&A activity in Japan during 2016 into 2017. For example, in 2017, KKR acquired Calsonic Kansei, an automotive parts manufacturer and supplier, in the largest acquisition of a Japanese company by a private equity fund in Japanese M&A history.



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THE INSIDE TRACK

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

Typical M&A practices and M&A processes in Japan are generally not so different from those of the US and Europe. The main transaction agreements in M&A transactions, such as stock purchase agreements and shareholder agreements, including with respect to the scope and content of their provisions, are generally similar to the agreements utilised in M&A transactions in the US and Europe. Of course, as with all jurisdictions, parties conducting transactions in Japan should take note of some local rules particular to Japan, such as with respect to certain restrictions on lay-offs under the labour laws and the company governance requirements under the Companies Act.

One noteworthy thing is that few hostile takeovers have been successfully completed in Japan, partly because the identity of shareholders in listed companies has been quite stable and public opinion in Japan has been generally against hostile takeovers. Also, counter proposals against a disclosed transaction have rarely been made by third-party bidders in Japan. However, in the event cross shareholdings in Japanese companies dramatically decrease in the future due to the new corporate governance rules, more cases of hostile takeovers or counter bids could potentially occur.

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

First, a law firm should be able to set up a suitable team composed of a variety of relevant specialists, because a complex transaction usually requires a wide range of expertise. Since prompt attention and support are necessary in such transactions, and due to the volume of work such as in due diligence and the preparation of transaction documents, the size and resources of the firm are also important considerations.

Second, it is important for a client that a counsel is not only competent in ability and experience; the counsel should have the right mentality and business judgement to seek the true understanding of the needs and goals of the client in order to provide the best solution and advice for the client.

Third, a client should confirm which lawyers in the transaction team will actually handle or serve as the point persons for the transaction. To successfully complete a complex transaction, reliable lawyers must be heavily involved in the transaction including maintaining good and regular communications with the client.

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

We represented Jupiter Telecommunication (JCOM), the largest Japanese cable TV operator, in its going-private transaction by KDDI and Sumitomo Corporation. The transaction was a two-step going-private transaction involving a tender offer and a subsequent statutory squeeze-out process. The transaction was announced in October 2012 and the tender offer was commenced in February 2013 because it took a few months for the buyers to complete merger filings in China. The squeeze-out became effective in early August 2013. During this period, because of a series of new economic policies implemented by the then newly inaugurated Prime Minister Shinzō Abe, the Japanese stock market recorded a significant raise. Foreign institutional shareholders claimed that the tender offer price was too low considering the general changes of the market condition and initiated appraisal proceedings in the court. After lengthy proceedings through the district court and the High Court, we were able to successfully obtain a decision from the Supreme Court clarifying that the court's review in appraisal proceedings should focus on procedural fairness. The transaction and subsequent appraisal proceedings were interesting because they include various implications that may affect the practice of going-private transactions in Japan including how the parties should manage conflict of interest issues.

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

KS & AM: The environment surrounding shareholder activism in Japan has been changing over the past few years. Japan's Stewardship Code was introduced in 2014 and Japan's Corporate Governance Code was introduced in 2015. Reform of the practices under these codes has led to the decrease of unquestioning supportive votes by cross-shareholding shareholders or institutional investors for the management of listed companies. In fact, at annual shareholders' meetings held in 2016 and 2017, the ratio of votes against agendas proposed by management with respect to the appointment of directors, especially CEOs, has noticeably increased. Moreover, at the annual shareholders' meeting of Kuroda Electric in June 2017, a shareholder proposal made by an activist fund to elect an outside director designated by the activist fund was approved. This case reflects the trend of shareholders in Japan becoming more comfortable with, and supportive of, shareholder activism.

The number of M&A transactions involving shareholder activism has been increasing, especially in transactions involving conflicts of interests between an acquirer and minority shareholders, such as in management buyouts and

"Due diligence procedures have become more efficient and streamlined in recent years, such that the time required by parties to complete due diligence has become shorter than in the past."

transactions involving squeeze-outs of minority shareholders in listed subsidiaries by parent companies. Some shareholder activists have expressed their views regarding such transactions through public campaigns or in private dialogue, and have stated that the transaction considerations are lower than fair value, and demand that the buyers or companies increase such considerations. Thus far there are only a few precedents in which a transaction proposed by management was not approved at a shareholders' meeting as a result of a proxy fight conducted by a shareholder activist. However, given recent trends, management of listed companies should appropriately take into account potential reactions and actions of shareholder activists when conducting M&A transactions. Shareholder activists may exercise, and some have exercised, their appraisal rights as dissenting shareholders to file a petition to the court for a determination of the fair price of the relevant shares after the completion of a certain M&A transaction.

GTDT: Take us through the typical stages of a transaction in your jurisdiction.

KS & AM: M&A transactions are typically initiated either by discussions between managements of a seller and buyer or contact by a financial adviser to a potential seller or buyer depending on the particulars of the transactions, such as transaction value, relationships between the parties or the industries and businesses of the target companies. Sellers often implement an auction process to find a buyer as such process often results in a higher purchase price. Negotiating with more than one potential buyer in an auction process may also give a seller a bargaining advantage to negotiate more favourable terms and conditions for the seller in the definitive transaction agreements.

A seller and potential buyers usually execute non-disclosure agreements, after which the seller provides the potential buyers with fundamental information regarding the target. A seller and a buyer sometimes enter into a memorandum of understanding that is often legally non-binding before proceeding to the due diligence phase. An auction process typically has two stages. In the first stage, potential buyers are usually provided with an information package prepared by the seller. After the potential buyers review the information and perhaps after conducting preliminary due diligence, they submit bid letters stating their preliminary offer prices to the seller. The seller then selects a few preferred potential buyers to proceed to the second stage in which further due diligence is conducted and the parties negotiate the transaction agreements.

A buyer often requests that a seller or target give the buyer exclusivity in the negotiation of a transaction before due diligence because the buyer wants to avoid spending unnecessary costs and resources for due diligence and evaluation of the transaction. With respect to the duties of directors of a target in Japan, there is no court precedent expressly requiring directors of a target to conduct market checks to seek the best available purchase price. However, the Tokyo High Court held with respect to a management buyout that directors owe a duty to ensure that the fair corporate value of a target is transferred among the shareholders.

In many large cases, documents for the due diligence are provided to potential buyers through a virtual data room. It is also common for potential buyers and their advisers to hold some interview sessions with the target during the course of their due diligence of the target. Due diligence procedures have become more efficient and streamlined in recent years, such that the time required by parties to complete due diligence has become shorter than in the past.

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

KS & AM: As mentioned earlier, shares of a listed company may be used as consideration in a tender offer, but the use of shares as consideration has not been used for tax reasons. There is an anticipated amendment to the tax laws in early 2018 that will likely allow the deferral of capital gain taxes in share-for-share tender offer transactions. If such amendments pass, it will enable an additional structuring option to Japanese listed companies when they consider M&A transactions.

The amendment to the Civil Law was promulgated on 2 June 2017 and will be effective within three years after the promulgation.

However, this amendment is not expected to materially affect M&A practices in Japan, although legal practitioners should take it into account when advising their clients.

GTDT: 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?

When considering an acquisition, management is always concerned about possible goodwill impairment. Such sentiment was fuelled by the recent announcement of Japan Post Holdings that it will have goodwill impairment arising from its acquisition of Toll Holdings in the amount of US$3.6 billion. Toshiba also disclosed huge goodwill impairment related to its US nuclear power plant construction business, CB&I Stone W Webster, which was acquired for US$229 million in late 2015 by Toshiba's subsidiary, Westinghouse.

Nevertheless, faced with an ageing population and a shrinking domestic market, Japanese companies will have no choice but to look into foreign markets for growth. Therefore, we expect that the trend of increasing outbound M&A transactions will continue. As mentioned earlier, the TMT, insurance, consumer and pharmaceutical sectors will continue to be the main areas for M&A growth.

Domestic M&A transactions will also likely continue to increase toward the activity levels that existed before the financial crisis. The Japanese government has been trying to improve the corporate governance of Japanese companies and, although still far from the activity level in the US, shareholder activism is becoming less unusual and is becoming a factor in facilitating M&A transactions in Japan because activist funds often demand divestment of non-core businesses.

The financial environment in Japan is also supportive for M&A activities regardless of whether the transaction is outbound or domestic. The Bank of Japan has implemented a number of monetary easing policies and the current interest rates on Japanese government bonds are close to zero. Japanese companies can benefit from the close-to-zero interest rates to finance their outbound M&A transactions. Regarding the contemplated tax reform of the carry forward of capital gains tax in the context of share-for-share tender offer transactions, if this reform is enacted, Japanese listed companies, which are said to hold more than US$ 200 billion of treasury shares, will have another viable option to finance their acquisitions.

In addition, government-owned financial institutions such as the Development Bank of Japan and the Bank for International Cooperation are ready to provide additional financing support. Also, INCJ is continuing equity investments in various Japanese companies or in foreign companies jointly with Japanese companies.

We are therefore quite optimistic about the long-term future of the Japanese M&A market.

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