Approaching M&A with Japan

Maximising your success

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Contents

Introduction 3

Executive summary 4

Characteristics of the Japanese business environment 6

Cultural considerations in M&A with Japan 8

Investment trends 12

Inbound investment into Japan 16

Outbound investment by Japanese companies 25

How PwC can help in your Japanese M&A 27

Select useful references 28

Contact details 29

About PwC 30

Introduction

Japan has a distinct business culture, understanding of which plays a crucial role in achieving success. Prospective buyers, sellers or trading partners need to take steps to ensure that they have an awareness of, and an ability to interact within, the Japanese business environment.

A patient approach and adherence to accepted business protocols will enable you to establish trust with the Japanese counterpart, which in turn would help in having an effective partnership or working relationship with them.

Japan is the world's third largest developed economy in terms of nominal GDP, with strong business, manufacturing and technology infrastructure and a sophisticated, discerning consumer base. Whilst many other new markets have "emerged" over recent years, companies and institutions across the globe continue to look towards Japan, with its large market and low country risk, as a potential provider of capital or as a source of technologies or brands that will enable a competitive advantage.

M&A transactions are amongst the most strategically important activities undertaken by an organisation. In larger corporations with global reach, such activities are common place and will often be conducted by experienced teams. Such teams will operate within well-established frameworks which support the investment or divestment process (such as auctions, accelerated sales and in some instances insolvencies or administration proceedings) and where the rules of engagement are generally well understood by all participants, be they buyers, sellers or advisors.

The M&A process becomes more challenging when it takes place in a cross border environment, and this is especially true when transactions start to cross continents. In such situations, it is important to start out on the process, whether as buyer or seller, with a clear understanding of the culture and business dynamics of your counterparty. It is fair to say that nowhere is this more important than in dealings with Japan.

Japan is a highly developed economy and is represented by the leading companies globally in many industries. As such, there is a large market of potential buyers and sellers within Japan. However, the business culture in Japan is distinctive and much significance is given to the following of appropriate etiquette. Whilst this is generally understood by international counterparties, it is particularly important when starting out on a potential M&A process. The ability to understand and interact within accepted business protocols when approaching a Japanese counterparty for the first time can be absolutely critical in determining whether you are able to establish contact and start out on the building of a platform for further dialogue. This is especially the case within largely domestic enterprises, but also holds true within even the largest and most international Japanese business groups.

Japanese are generally polite, earnest, and diligent in dealing with others, as well as placing great pride in their culture and work. Alongside this, people are generally conservative, careful and overly cautious at the beginning and particularly in dealing with the foreigners.

This document aims to provide foreign parties, both buyers and sellers, wishing to interact with potential Japanese counterparts either with some guidance on the mechanics of the initial decision making processes within a Japanese corporate and with some practical do's and dont's covering the opening of communication.

Executive summary

Key considerations for a foreign buyer in dealing with a Japanese seller

In most instances, Japanese institutions will initially be very cautious and skeptical in dealing with someone foreign. In addition, bulks of the small-to-mid sized Japanese companies have limited experience in M&A and thus will be reserved in their approach. In the earlier stages of any interaction, it is very important to make every effort to behave in accordance with established protocols in order to make progress in developing a degree of trust and mutual understanding.

Key characteristics of Japanese business environment, communication style, decision making process and considerations for a foreign buyer in dealing with a Japanese counterpart are summarised below and are discussed later in this document.

#	Area	Description
1	Attractiveness of Japan	Access to a large and affluent customer base, technology and high quality R&D facility, Lower country risk and world class manufacturing infrastructure.
2	Challenges of doing business in Japan	High cost of doing business, Consumer sensitive markets, Difficulty in securing human resources, Language, Unique business practice of cartelisation/working together (known as Keiretsu), Different business customs and protocols.
3	Communication style	Hierarchical communication system, Prefers indirect and implicit communication, Avoidance of conflict and open communication.
4	Decision making style	Investment decisions takes longer due to bottom up approach and group decisions, 'Nemawashi'* or consensus building is an integral part of Japanese decision making process. Flip side is that when decisions are taken they are less likely to be reversed and can be implemented quickly since everyone is already bought in.
5	Approaching Japanese companies	Entering Japan should be planned well, need to understand the Japanese business culture and behave in accordance with established protocols, advisable to approach through trusted intermediary rather than a direct approach.
6	Acquiring a Japanese company	Advisable to start communication through an offer of cooperation, Need to highlight areas of mutual benefits to build trust, Willingness to invest time and having patience is extremely important.
7	Valuation	Price is important but it is not the only consideration in a Japanese M&A. Impact of the deal on other stakeholders is equally or more important, Existing relationship gets preference.
8	Regulatory aspects	Japan has few tax and regulatory laws to govern the M&A transactions, though most of these are still evolving and changing, It is advisable to seek specialist advice to avoid the risk of any non-compliance.
9	Integrating a Japanese business	Need to build trust amongst all stakeholders and buy in confidence before starting any integration process, key challenges – Integration of corporate cultures, Changes in the HR policy and employee related matters, Changes in the business process.
10	Challenges in managing the operations post the deal	Extremely difficult to manage the business operations in Japan by sitting a distant location, Hiring the right people. Consumer sensitive market with different needs and habits, Short term approach and trying to do things faster.

*Nemawashi in Japanese means an informal process of quietly laying the foundation for some proposed change or project, by talking to the people concerned, gathering support and feedback, and so forth. It is considered an important element in any major change, before any formal steps are taken, and successful nemawashi enables changes to be carried out with the consent of all sides.

In Japan, high ranking people expect to be let in on new proposals prior to an official meeting. If they find out about something for the first time during the meeting, they will feel that they have been ignored, and they may reject it for that reason alone. Thus, it's important to approach these people individually before the meeting. This provides an opportunity to introduce the proposal to them and gauge their reaction. This is also a good chance to hear their input. This process is referred to as nemawashi.

Source: http://en.wikipedia.org/wiki/Nemawashi

Key considerations for a foreign seller in dealing with a Japanese buyer

Many Japanese companies are cash rich and are looking to expand their international footprint beyond their domestic market. M&A is a preferred choice for faster growth and penetrating into new territories and business segments. High cost of doing business and shortage of manpower also led to shifting of manufacturing base in low cost countries.

Investments made by Japanese companies in overseas acquisitions/joint ventures are also driven by same set of business practices, decision making style, trust and communication protocols, as we discussed earlier and it is extremely important to have patience while dealing with a Japanese investor.

Key considerations for a foreign seller in dealing with a Japanese counterpart are summarised below and are discussed later in this document.

#	Area	Description
1	Objectives of Japanese investment	Japanese investments are driven by strategic rationale, such as, access to new geographies, product segments or strengthening relations with the existing trading partner. It would help to highlight these aspects more than the return on investment. Impact of the deal on various stakeholders is equally important.
2	Long term investments	Japanese investments are made with long term vision, Provides patient capital to help in the long term growth aspirations, Return on investment is not the most important objective.
3	Clear communication	Avoiding last minute surprises and sharing your thoughts at an early stage in the transaction process helps in building trust.
4	Approaching a Japanese company	In approaching a Japanese company for the first time, it is preferable to find someone who is trusted by the subject company. A direct approach is likely to be viewed as impolite and may be considered to be a sign of mild aggression in Japan. Further, it is important to build some personal connects and build trust, before you get into a business discussion.
5	Patient approach	Japanese companies generally take longer to make an investment decision, as in most cases, companies follow a very formal and layered decision making process. You should be prepared to provide them enough time to follow their decision making process.
6	Valuation	Price is important but it is not always the most important consideration, Existing relationship gets preference, Japanese investor generally do not back out due to valuation related issues, if all other factors are to their satisfaction.
7	Due diligence and carve out considerations	Historically, Japanese buyers tend to focus on financial, legal and tax due diligence. With the changing times, Japanese buyers are now equally concerned about the operational aspects, such as, business, HR, IT etc. Operational aspects become all the more important in an asset sale/carve out transactions and you should be prepared to proactively explain these to Japanese buyers at an early stage of the deal, to provide them a comfort that the target business can be run effectively on a standalone basis.
8	Post deal integration	Inadequate focus on post deal integration, Generally do not take management control at the beginning, Even in case of majority acquisition, prefers to place few Japanese people in the technical and other functions for oversight and support, Willing to take control, once they get comfortable and confident of managing the operations by their own.

Characteristics of the Japanese business environment

Japan, world's third largest developed economy, is known in the World for its strong business, manufacturing and technology infrastructure and a large and affluent customer base. Attractiveness of Japan for foreign buyers and sellers is also driven by lower country risk, access to technology, high quality R&D facilities and new innovation & product development.

Opportunities in Japan come with a set of challenges. Foreign companies operating in Japan have often experienced difficulties in doing business in Japan due to higher labor cost, need to meet high standards of quality, lack of English speaking people and the challenges presented by Japan specific business customs and protocols. Key challenges faced by the foreign companies in Japan are elaborated below.

1. ***High perceived cost of doing business*** due to high labour, real estate and logistics cost. Japan also has a high tax regime, which adds up to the cost of doing business.

2. Japan is one of the most ***consumer sensitive markets*** with significant focus on the quality of products and services often reasonable prices. Foreign companies find it difficult to meet the high quality standards demanded by the customers.

3. Japan is a market with fierce ***price competition*** in some of the product segments, which makes is essential for the foreign players to provide the value added products and services to differentiate itself from the competitor. Further, Japanese consumers generally prefer to receive the services bundled with the products, which also puts a lot of pressure on the product pricing and margins.

4. ***Difficulty in securing human resources*** with foreign language capabilities, resulting in challenges relating to integration with the global network. Ageing population and reduction in birth rate is leading to shortage of manpower and Japan does not seem to be acceptable to the global manpower to bridge the gap between demand and supply.

5. Japan is a ***local language society***, with prevalence of Japanese language everywhere and limited adoption of English in the corporate world, resulting in communication gaps for foreign companies operating in Japan.

6. ***Keiretsu culture***, is a very unique business practice followed by Japanese companies. Keiretsu is a group of large Japanese financial and industrial corporations through historical associations and cross-shareholdings. In a keiretsu each firm maintains its operational independence while retaining very close commercial relationships with other firms in the group and working closely to ensure each other's success. Foreign companies find it difficult to compete under such culture.

7. Japan has its own ***business customs and protocols***, which in many aspects is different from rest of the World. This leads to difference in attitude and approach adopted by the Japanese business community towards foreign companies. Given these differences, it would be helpful to have an early understanding of accepted business protocols.

Cultural considerations in M&A with Japan

Cultural values and communication style[1]

When you do business with the Japanese people, you may more or less have a sense of unique communication style rooted out of their own cultural values.

One of the key cultural values is known as "Wa," i.e. peace and harmony. The "Wa" concept derives not only from an inherent trust in people but also from an empirical knowledge. It is the belief that conflict will not pay and avoidance of its escalation will benefit those concerned in the long run, given Japan has a small territory with scarcity of natural resources. The propensities peculiar to the Japanese, collectiveness and strong loyalty to groups, both represent attitude towards behavior based on the "Wa" concept.

To make "Wa" work well, Japanese people prefers communication in which they express something indirectly and implicitly than directly and explicitly. You may be encouraged to "read between the lines" or "be aware of the context," so that they may not disrupt visceral and sometimes non-verbal communication. Open and clear expression is less encouraged in Japan, both in oral or written communication.

Additionally, they prefer getting a consensus in decision making for the sake of group harmony. With prioritising a consensus of the group, individuals are sometimes prepared to change their positions. Thus, they generally want to avert a confrontational approach in discussion, negotiation and decision making.

Age or seniority turns a part of their cultural values as well. You may find that processes to reach a consensus are mainly led by senior people because age is revered in Japan. The seniority system remains in the workplace (i.e. decision making, promotion and compensation and the like), though it is not as strict as before.

Japan's geographical feature also forms a basis of another propensity of the people: stability oriented, risk aversive and uncertainty avoidance. In practice, processes to get a consensus are made to avoid or reduce the risks arising from arbitrary decision, while it is in accordance with the "Wa" concept.

In M&A transactions, such propensity in some cases leads to overdoing research, due diligence and documentation, resulting in consuming much time in decision making and at times leading to a failure to close a deal. Japanese companies are more cautious in doing M&A in emerging markets, due to limited experience and inadequate information.

[1]Reference and further background: Geert Hofstede, "*Cultures and Organisations: Software of the Mind*"; Farid Elashmawi and Philip R. Harris, "*Multicultural Management: New Skills for Global Success*"; Terri Morrison and Wayne A. Conway, "*Kiss, Bow or Shake Hands Asia: How to do business in 13 Asian Countries.*"; Edward T. Hall and Mildred R. Hall, "*Hidden Differences: Doing Business with the Japanese,*"

Decision making style

It is often said that Japanese companies take longer to make an investment decision than the US, European and other Asian ones. In most cases, companies usually follow a very formal and layered process where decisions are taken by a group comprising of people from various divisions such as strategy planning, finance, operations, R&D and sales & marketing teams.

It could be said that decision making in Japanese companies typically has two characteristics: (1) bottom-up approach and (2) decision on a group basis.

1. **Bottom-up approach:**

In most organisations, it will be necessary to work with and through middle management for most of the M&A process. As noted above, any approach to the senior management of an organisation whilst a gesture of courtesy and respect in a situation where you do have not a trusted intermediary to facilitate an introduction, will normally be courteously received but then quickly filtered down to a lower management level for their review, study and screening. A proposal, regardless of its substance, will usually be passed through a couple of layers of approval before being returned to the top management. Such approval will be obtained following a process of study and view-sharing by line managements and ordinarily can be expected to take multiple weeks or sometimes months.

When seeking an expression of interest from a Japanese company, it should be noted that the decision-making process will vary by the size of transaction. As such, any information provided should include details of the possible investment range. If you are using an advisor, they should know the appropriate level of management to approach in order to expedite the process as far as possible.

Where practical, it will always be more effective to establish early contact with a Japanese company considered as a possible investor, especially within a competitive sale process with tight deadlines and a structured timeline. Japanese companies generally tend to stay out of competitive sale process with tight deadlines, which do not provide them enough time to assess and follow their formal decision making process.

2. **Decisions are reached on a group basis:**

The importance of consensus and the views of the group within a Japanese corporate culture means that you should be prepared to negotiate and discuss a deal situation with more than one individual.

In most cases, decisions will ultimately be reached or heavily influenced by a group, rather than by any individual. Even the CEO will not normally act as a sole decision-maker. You should not be surprised for any meeting with a Japanese counterparty to be attended by several people. At such meetings it will be important to observe the interactions and dynamics amongst the attendees. The group leader may be the sole speaker at a meeting but will not ordinarily be a sole decision-maker.

It is important to ensure that meetings and interactions are held between peers. There may be circumstances where a meeting between peers at a junior management level will be more effective in establishing a relationship, developing an understanding and progressing an agenda.

Under Japanese Company Law, all significant M&A activities and organisational changes must be approved by the Board Committee and by a General Shareholders' meeting. Gaining support from the CEO or group leader will not necessary lead to automatic approval from the Board Committee or other stakeholders. You should take advantage of any opportunities to build consensus with this wider community if they arise.

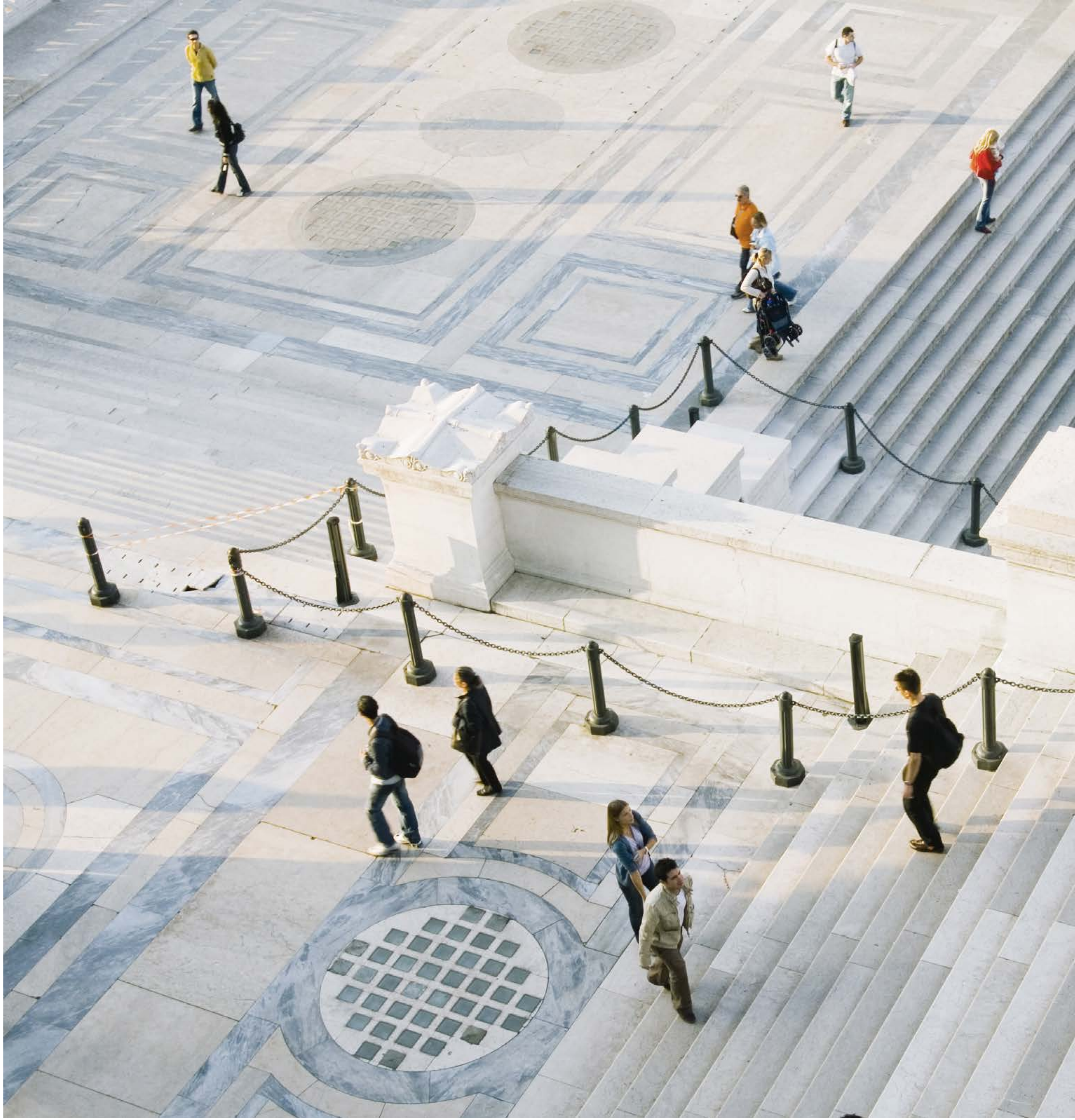
Key considerations relating to Japanese management

When developing business alliance and M&A strategies with Japanese management, their ways of thinking and behaviour may be also worth considering.

Firstly, Japanese executives are less globalised. The survey jointly conducted by PwC and Dr. Katsuhiko Shimizu, Professor of Keio University, revealed, They still stick to their "Japan-centric" views and codes of conducts.

Secondly, an executive of an automobile company pointed out in the survey, "Japanese management generally serve out their time at the same company and promote themselves to executives at the age of more than 55. Thus, they don't have enough time to execute an ambitious, long-standing program until they retire." In addition to it, their priority of "Wa" and sectionalism in organisational management often hinders them from speedily launching business transformation initiatives and taking innovative approaches across business units.

Thirdly, it is also said that they are less likely to make quantitative investment (or divestment) and financing decisions based on return metrics such as Return on Equity (ROE) and Return on Capital (ROC). This is because Japanese companies have long relied on more debt than equity financing. It can be less expected that Japanese management follow a metric-driven decision making process for investments or divestitures.

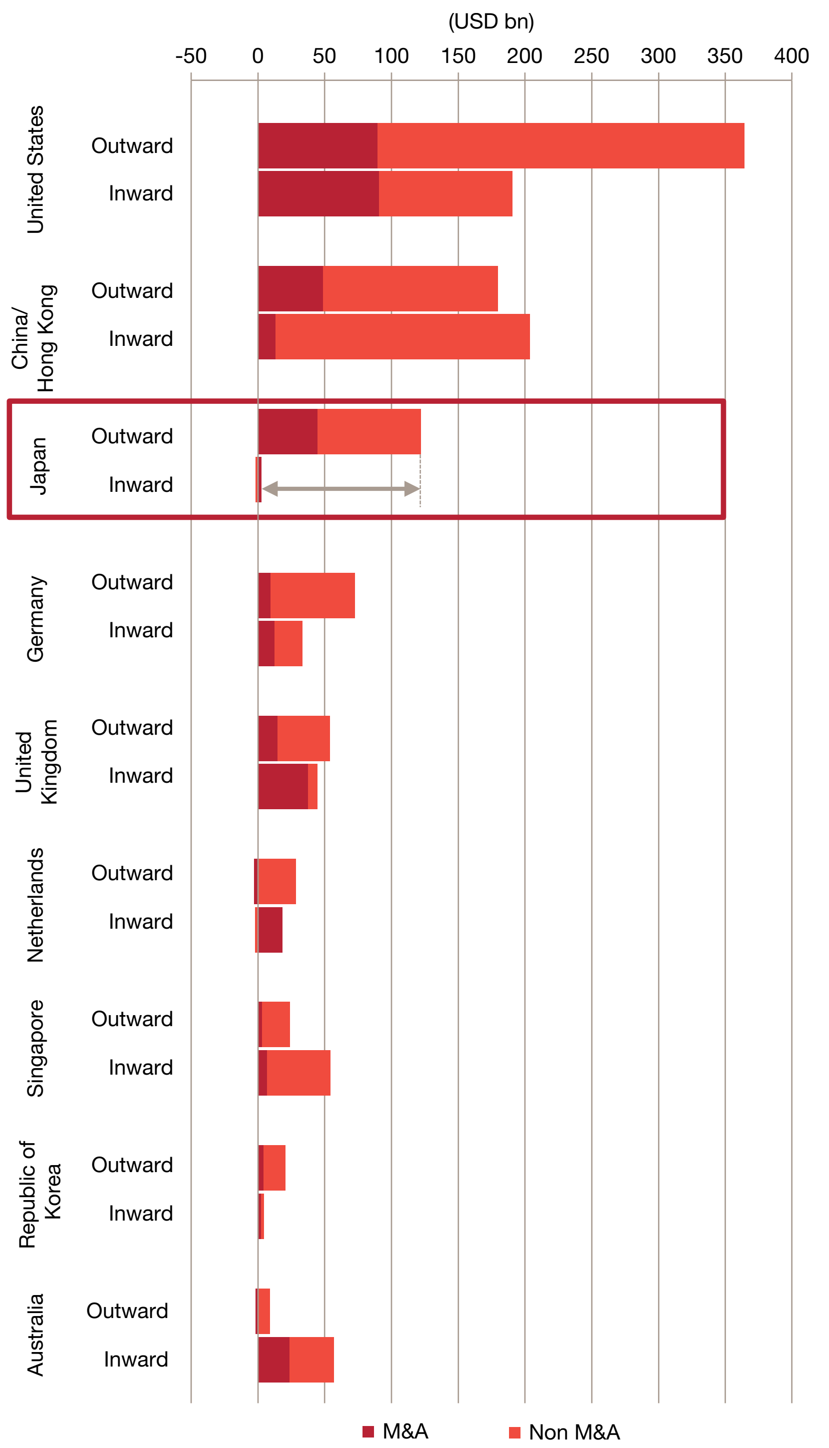


Investment trends

Japan is the third largest investor in the world after USA and China/ Hong Kong. Total outbound investment made by USA, China/ HK and Japan during 2011 to 2013 aggregated $364 billion, $180 billion and $122 billion.

Japan's foreign direct investment (FDI) market is characterised by the imbalance in value between outbound and inbound investments. While Japanese companies have made significant investments in the overseas markets in last two decades, foreign players have rather selectively made investments into Japan. Total inbound investments (net of divestments) into Japan during 2011 to 2013 aggregated only $760 million (Figure 1 and 2).

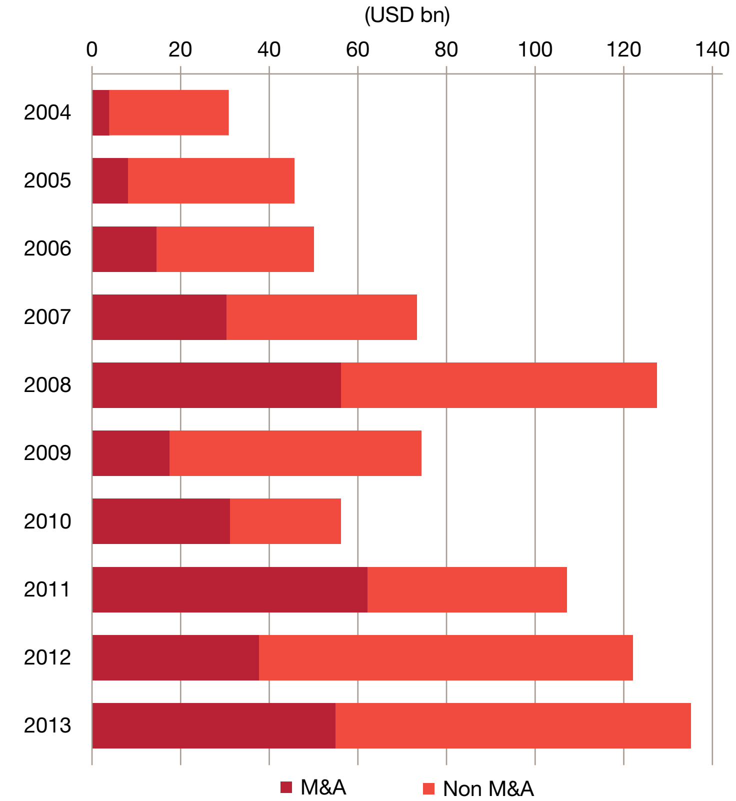
Figure 1: Comparison on Outbound vs Inbound FDIs & M&As: 2011-2013



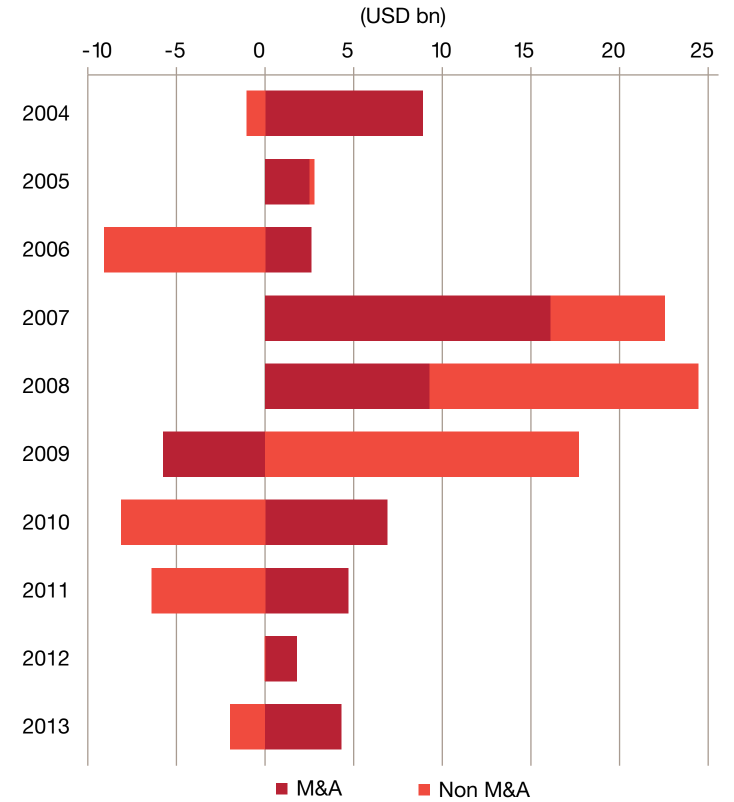
Source: UNCTAD, "World investment report"

Figure 2: Investment trends in Japan: 2004-2013

Outbound



Inbound



Source: UNCTAD, "World Investment Report"

Figure 3: Volume of deals involving Japanese companies: 2005-2014

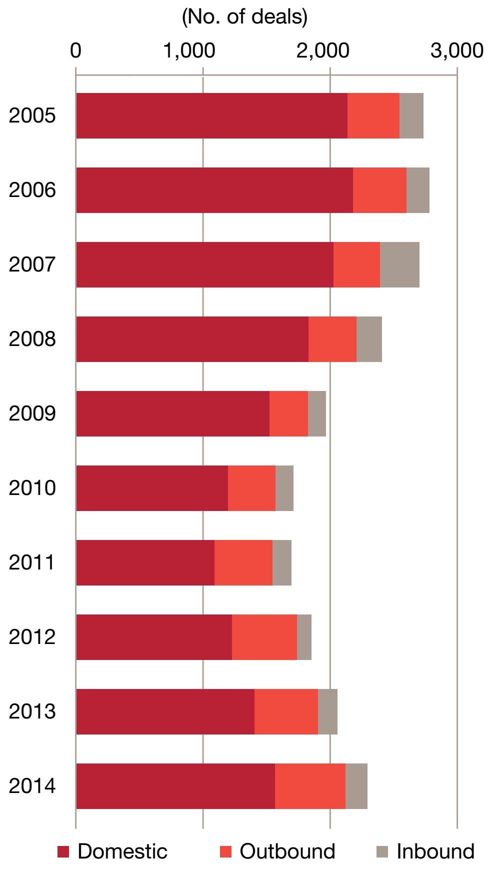
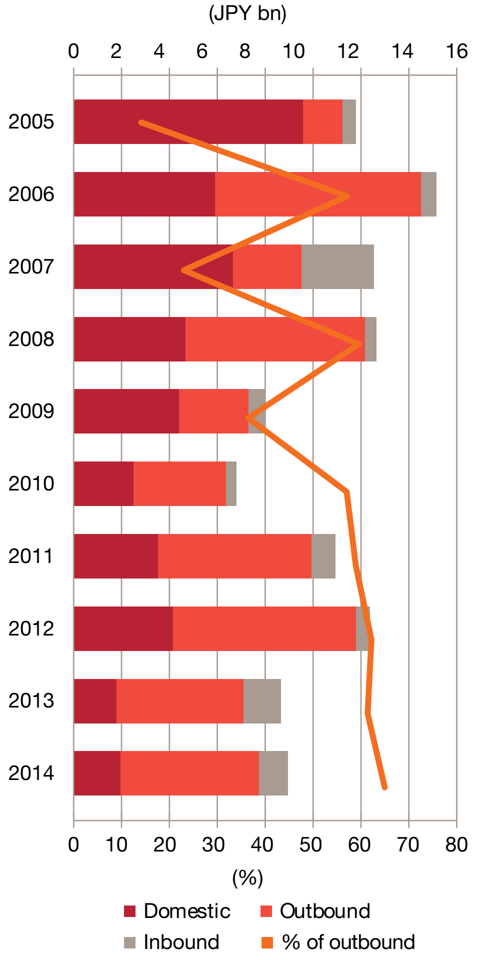


Figure 4: Value of deals involving Japanese companies: 2005-2014

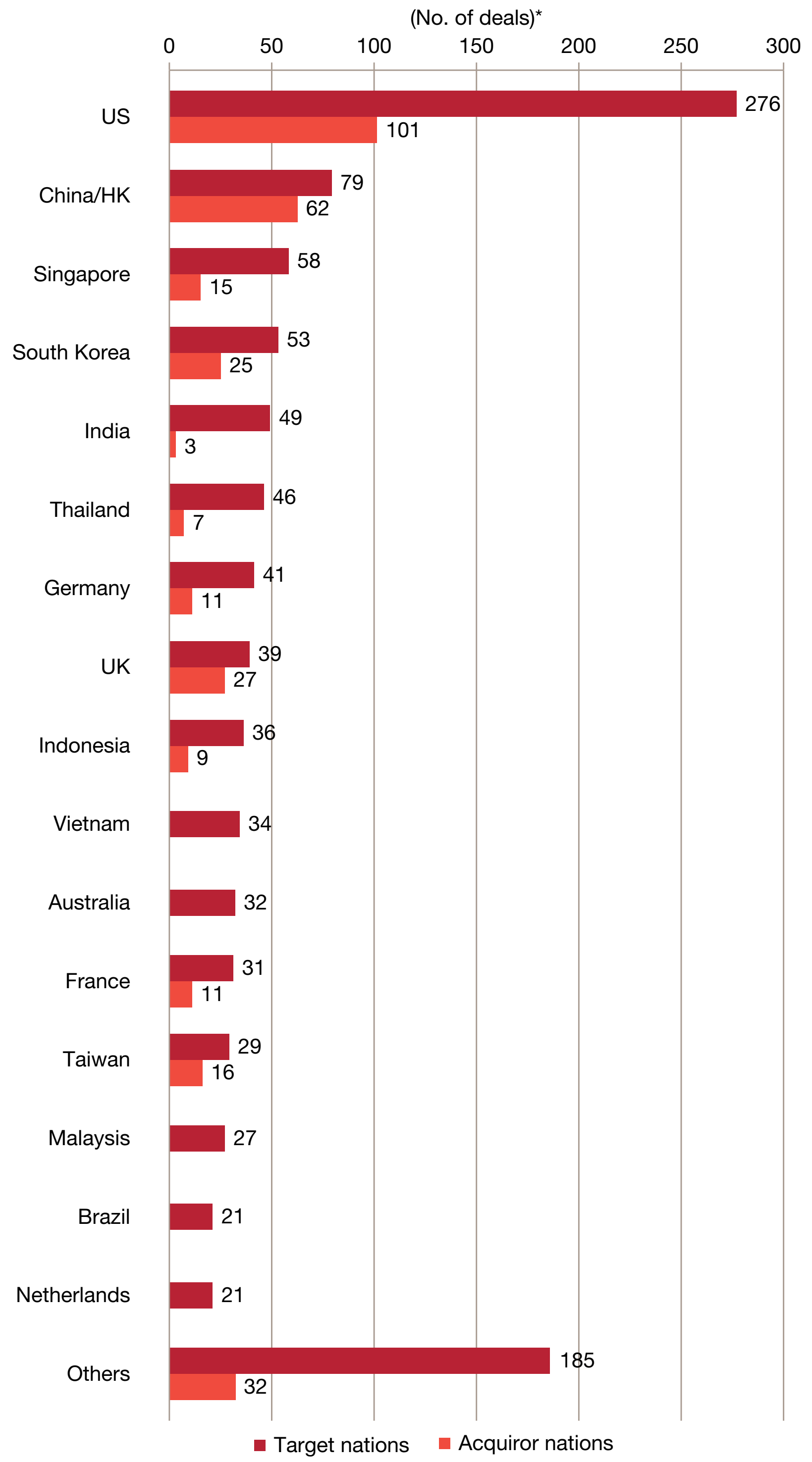


Source: Recof, M&A Database

Japan's M&A market annually records 2,000 to 2,500 deals except 2010 and 2011. Lower deals in these two years can be attributed to adverse investment sentiments due to the Lehman collapse (Figure 3).

For the first five months of 2015, deals involving Japanese companies increased by 8% in number and by 59% in value. Inbound deals increased by 28% in volume, while out bound deals hit a 83% growth in value as some of the large acquisitive Japanese companies executed billion dollar deals in Asia Pacific and European regions.

Figure 5: Breakdown in volume by target country (top) and acquirer country (bottom)



Source: Recof, M&A Database *Deals from January 2013 to December 2014

Country wise break down indicates that Japan's investment into various countries is significantly higher than the investments made by those countries into Japan. While US remains on top among counterpart nations in both outbound and inbound investments, the adjacent chart also indicates that Japan's outbound investment is diversified and spread in both developed and emerging market (Figure 5).

Recent transactions reveal the following three points to suggest how strategically Japanese companies plan and execute cross border M&A investments, both outbound and inbound.

Firstly, Japanese companies prefer acquisition of the targets or alliance with the partners having global footprints and international business experience. This aims to obtain a reach to overseas markets. Acquisitions of Swiss-based Landis+Gyr by Toshiba Corporation and of Nycomed by Takeda Pharmaceutical helped the Japanese investors in increasing their global footprints significantly. The number of deals by which Japanese companies obtained footprints in various countries increased from 240 deals during 2010-2012 to 618 deals during 2012-2014.

Secondly, more and more overseas subsidiaries of Japanese companies have acquired or have been divested to local companies. This has helped the Japanese companies in developing overseas business. Japanese headquarters gradually delegate powers to the overseas subsidiaries to make investment and divestment decisions. This type of deals outside Japan has increased from 20 deals during 2003-2005 to 103 deals during 2012-2014.

Thirdly, Japanese players generally prefer majority acquisitions, which enable them to take control. Earlier, they preferred to acquire minority stake resulting in lower risks when they entered new markets, especially developing countries. This shift is based on their past experience, wherein they realised that minority investment without taking control might not be an effective way of growing their presence in new territories.

Inbound investment into Japan

Introduction

As we have seen in the previous section, inbound investments into Japan are significantly lower compared to outbound investments. Lower inbound investment can be attributed to high cost of doing business, lagging profitability of many Japanese industries compared to international benchmarks, over regulation, over competition and shrinking domestic market.

The Abe administration is taking a bunch of measure to enhance the competitiveness of Japan's economy and fundamentally address the prevailing issues.

Japan Revitalisation Strategy – The Abe administration advocates the economic policy called "Abenomics,"consisting of three"arrows"(pillars): fiscal policy, monetary policy and the growth strategy. While the first two have been in progress under the Bank of Japan, the growth strategy known as "Japan Revitalisation Strategy" is focused around deregulation and liberalisation.

Based on the strategy, the government has embarked on various economic policy changes, some of which is expected to drastically alter the economic environment surrounding the Japanese companies. For example, the Trans-Pacific Strategic Economic Partnership Agreement (TPP) will direct Japan to more focus on cross border investments, i.e. not only outbound investments to the APAC region but also inbound investments from it. The strategy also emphasises on changes in laws including Japan's labor and tax codes, establishment of special economic zone and greater cooperation between the public and private sector.

All these initiatives and structural reforms under "Japan Revitalisation Strategy" is likely to drive more inbound investments into Japan.

Corporate Governance Code – With the objective of seeking sustainable corporate growth and increased corporate value over the mid to long term, Japan has come up with a new corporate governance code. The code has its foundation in the Japan Revitalisation Strategy and is applicable to all companies listed on securities exchanges in Japan. This code lays down principles for securing the rights and equal treatment of shareholders, ensuring appropriate information disclosures and transparency and responsibilities of the board. This code is likely to be of great help in accelerating Japan's economic growth.

IFRS implementation – Availability of reliable and comparable financial statements provides great comfort to any foreign investor in a country. While using International Financial Reporting Standards (IFRS) is not mandatory in Japan, however, this is strongly recommended by the Government. The Accounting Standards Board of Japan (ASBJ) had been working towards converging the requirements of Japanese Accounting Standards with IFRS. Since 2010, eligible listed companies in Japan have been permitted to use IFRS as designated by the Financial Services Agency of Japan (FSA) in their consolidated financial statements, in lieu of Japanese GAAP. Till May 15, 85 listed companies have adopted IFRS and 21 companies have announced that they have decided to adopt it. Implementation of IFRS would be helpful in making the financial reporting framework in Japan comparable to the rest of the World.

Setting the strategy

In this section, we provide some specific advice as to the ways in which an international company can endeavor to overcome differences in attitude and approach towards business by Japanese companies and thus help in the process of developing strong business relationships.

In any M&A scenario, care is needed to ensure you are selecting the right targets or strategic investors/acquirers for your company. This becomes all the more important when dealing with a Japanese company, which is culturally so different. Many times companies end up joining hands with the wrong partners, due to which their transaction objectives are not met.

In starting out on an M&A process involving a Japanese counterpart, it is always advisable to have a Japanese representative (possibly from a Japanese subsidiary or affiliate) involved in any research process. Alternatively, it would be desirable to hire a local consultant or advisor to assist in any target/acquirer selection process involving investment into Japan. Appointing an experienced Japanese deal advisor will also provide you with the input and support needed to bridge any cultural gaps and thereby maximise your chances of success.

Japan is a sophisticated economy, but the bulk of business information on companies and industries is ordinarily only available in the Japanese language. This is particularly true for information on private companies.

Approaching a Japanese company

Trust is the key to success in doing business with Japanese companies. As with any new relationship, you must be prepared to invest time as trust will not be developed overnight. There are certain protocols which should always be followed when approaching Japanese companies. Abiding by such protocols will be an initial step towards establishing trust and mutual respect.

In approaching a Japanese company for the first time, it is preferable to find someone who is trusted by the subject company and to have them introduce you or your company to the Japanese counterparty. Introduction by a trusted intermediary is much more powerful than providing a self-introduction or credentials in Japan. This reflects a situation and approach whereby "the friend of my friend is my friend".

In even the most multinational Japanese corporate environment, you are advised not to consider making an initial direct approach via a phone call or email in English. As a first encounter, without proper introduction by a trusted intermediary, such an approach is likely to be viewed as impolite and may be considered to be a sign of mild aggression in Japan. This seemingly innocent attempt to establish contact may easily offend or disengage your intended Japanese counterpart at a stage before you have established any form of constructive communication.

As a general principle, it would be preferable to disclose the name of your company to the Japanese counterpart at the time of introduction via a trusted intermediary. However, if you would like to sound out the possible interest or intentions of a Japanese counterpart using an independent advisor, then it is acceptable not to disclose the identity of your company at the initial contact stage.

In a scenario where you plan to approach a Japanese company without a third party advisor, then it is preferable for you or your intermediary to endeavor to effect an introduction at the CEO or top management level (although this is quite often a challenging approach). When you are using an advisor, they would ordinarily be able to judge the appropriate level of management to contact.

Another factor to keep in mind is the need to ensure that you are interacting with the right persons or department within a Japanese organisation. Often it can be tempting to focus on interacting with a counterpart who has an ability and willingness to communicate in English (or another foreign language) when it may be better to work through interpreters or advisors with other members of the Japanese organisation, who are more relevant to the process.

It is also desirable to time any interaction with a Japanese counterparty within the key dates in the Japanese business calendar. Most Japanese companies adopt a 31st March fiscal year end and will hold a General Shareholders Meeting during June. This meeting will be the forum for approval of most significant issues and plans, including mergers, acquisitions or divestments. It is advantageous to have secured Board Approval for a transaction in advance of the scheduling of this General Shareholders' Meeting.

Japanese companies undertake a rigorous budget process, which is very time consuming and thus you can expect that the speed of decision making will be much slower during March and April. Series of internal organisational changes (including promotions and rotation of responsibilities) will also slow down the natural decision making process whilst people settle into new roles.

Acquiring a Japanese business

Any acquirer of a Japanese business needs to put time and effort into establishing a relationship. Trust is absolutely key to any Japanese acquisition, which means that an outright or unsolicited approach to buy-out a Japanese company will most likely meet with a very unpleasant reaction from the board of directors of the target. This reaction is also likely to extend to other stakeholders, including employees and often to the general public (in their capacity as direct or indirect customers of a company) and the mass media. In short, widespread resistance can be expected unless an approach has secured the support of major shareholders and even then a potential acquirer will need to take considerable care in managing the wider stakeholder expectations.

A foreign suitor may also wish to consider engaging a media consultant to avoid risks and provide guidance on how best to manage the media reaction to an envisaged acquisition. Close attention to the style of approach and to stakeholder perceptions is still required even in a situation where a Japanese company may actively be seeking investment.

It is preferable to start communication through an offer of cooperation with the intention of establishing and developing areas of mutual benefit. This early collaboration may take an extended period but will be an important part of the process of building trust with the company. To many international investors such a process may seem time consuming and counterproductive, but the willingness to invest time and demonstrate patience will be more likely to reap rewards than a direct or rushed approach which irrevocably damages a strategically important opportunity.

It is also important to consider the communication preference of Japanese counterpart, especially in the initial communication, it will be advantageous to provide information in writing and in Japanese to establish a better first impression. In general, Japanese people have a preference not to speak, read, or write in English although a fair proportion can communicate as such to a reasonable level.

Any information package provided to a Japanese counterparty should contain an outline of the envisaged benefits to all stakeholders of the company, (including. employees, customers, suppliers, and the wider community). There is a strong stakeholder value mentality in Japan and profit is not the only concern that matters to a Japanese company. It would also be desirable to explain your rationale towards any possible strategic and cultural fit with the subject company.

Japanese companies do take lot of time in executing any document. Even signing a confidentiality or non-disclosure agreement ("NDA") may take couple of weeks for the company to review and discuss such a document before signing it. An apparent lack of activity does not mean that there is no interest or enthusiasm around a particular situation. In many instances it may mean that the company is starting to obtain a wide range of views from stakeholders as to a possible situation. As mentioned earlier, the concept of "nemawashi" is absolutely integral to the culture of decision making within any Japanese company. This early consensus and consultation process means that Japanese companies will often fall behind tight deadlines within an auction or structured sale process.

Regulatory aspects

It is advisable to seek specialist advice around M&A regulations involving Japanese companies, especially listed entities. Japan's legal framework relating to M&A transactions is still in the process of evolution, balancing the prevailing legal framework with new developments mostly drawn from the USA and the EU.

Major regulatory frameworks regarding M&A:

Foreign Investment Restrictions under Foreign Exchange and Trade Law

The Foreign Exchange and Foreign Trade Law (FEFTL) and its related regulations govern various matters relating to inbound transactions including equity investments in Japanese companies by foreign investors. The FEFTL provides for both an *ex post facto* notification and prior notification system. The requirement to comply with either of these notification systems depends upon the type of interest in the Japanese company being acquired (eg. shares in a closely held company or a portfolio interest in a listed company), whether the inbound investment concerns national security or related interests and whether the business of the target company is included in a list of business categories specified by the Minister of Finance and related ministers in such industries. In addition, certain businesses are regulated by way of a licensing process, such as, railways, civil aviation, banking, insurance, broadcasting and utilities.

Corporations Law and Corporation Tax Law

The structuring of an inbound investment is critical from various perspectives, including minimising transactional and ongoing tax costs, facilitating a smooth transfer of business assets, contracts, regulatory licences and employees, reducing the tax costs of profit repatriations and exit, etc.

The Corporations Law prescribes various types of corporate reorganisations that a Japanese company may undertake (eg. merger, demerger and share-for-share exchange) and the legal implications of each. The Corporation Tax Law prescribes the tax implications of each reorganisation provided for in the Corporations Law for the target company, its shareholders, the seller and the acquirer. In practice, the optimum acquisition structure from both the perspective of the seller and/or the acquirer is achieved by identifying a balance between legal, tax, accounting and business considerations.

Acquisitions (and Tender Offers) under Financial Instruments and Exchange Act

The Financial Instruments and Exchange Act (FIEA) is the main ***statute*** governing ***securities law*** and regulating securities companies in Japan. In addition to specifying the disclosure requirements applicable to public companies and internal controls in public companies (so called "J-SOX"), the FIEA also specifies the rules relating to tender offer bids (TOB) of public companies. These rules cover TOB procedures, criteria for delisting the target company and squeeze-out of minority shareholders.

Disclosure Rules under Financial Instruments and Exchange Act, Corporations Law and Stock Exchange Rules

The Corporations Law, FIEA and each of the six stock exchanges in Japan prescribe their own disclosure rules. Intention of the disclosure rules under the Corporations Law is to protect shareholders and creditors. The intention of the disclosure rules under the FEIA is the sound development of the national economy and the intention of the disclosure rules of various stock exchanges is to ensure the fair pricing of securities.

Please refer the below link for further guidance in respect of starting operations in Japan – ***http://www.pwc.com/jp/en/tax-services/starting_operations_in_japan.jhtml***

Key valuation considerations

Valuation is an important consideration in any M&A transaction. PwC research shows that nearly 40% of proposed deals globally failed to complete because of a valuation mismatch.

While methods for, and approaches to, carrying out valuations in Japan are similar to those observed in other parts of the world, there are certain factors which differentiate a Japanese seller's approach to a transaction, including valuation; understanding these factors can help you strike a better deal.

Price is important but it is not the only consideration in a Japanese M&A transaction. Japanese sellers are concerned about the impact of a deal on other stakeholders, such as employees, customers and suppliers, and a buyer is likely to be preferred if he can demonstrate that he would take good care of the interests of other stakeholders. Japanese sellers are also concerned about how such decision would be perceived by society and how it would impact their reputation in Japan.

The quality and reliability of information, which forms the basis of carrying out a valuation, can be a big challenge in some countries, particularly in emerging markets. But, this is not such a concern in Japan where the quality of the information received is generally high. Further, due to the low growth environment in Japan, business plans generally reflect conservative expectations and it is not typical to receive projections showing "hockey stick" growth expectations.

It is often the case that mid-sized unlisted companies do not engage a sell side advisor and may not be familiar with sophisticated valuation techniques. As such, it is important to be able to explain in straightforward terms your approach to valuation in order to facilitate price negotiations.

One other differentiating factor is the preference of Japanese sellers to transact with buyers with whom they have an existing relationship. Priority is often given to transacting with a customer or supplier, with whom the seller has an existing long-term relationship. An extension of this would be the preference to transact with another Japanese company. If you are competing with a Japanese buyer, there is a high probability that the Japanese seller would be willing to do the deal with the Japanese buyer, even if you are willing to pay a higher price.

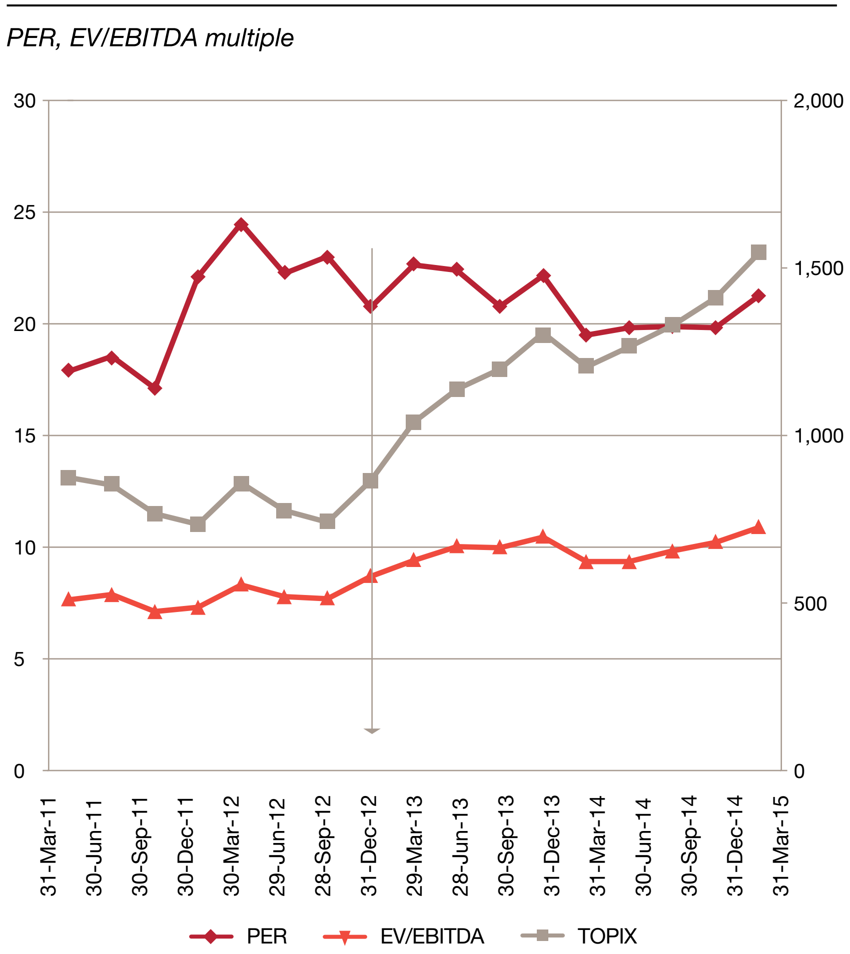
Japan companies enjoy a low cost of capital. A general observation is that many companies with strong operating performance in Japan prefer to pay down debt and hold significant cash balances. For a buyer of this type of company, there might be an opportunity to optimise the capital structure, thus lowering the cost of capital and increasing value. This is similar to the private equity model i.e., push debt onto the balance sheet of the acquired company in order to create an immediate return to shareholders and lower the overall cost of capital.

Locked box mechanisms (i.e. a mechanism where the equity value is known when the deal is signed without involving an adjustment on completion of the deal) are not very common in Japanese deals, unlike in Europe and North America. Japanese companies have a preference for the traditional completion accounts method whereby a purchase price adjustment is determined at the closing date. Also, earn outs or deferred payment methods are generally not preferred by Japanese sellers.

TOPIX, PER and EV/EBITDA trends

The Tokyo stock market has rallied since the Liberal Democratic Party led by Prime Minister Shinzo Abe returned to power in December 2012. Tokyo Stock Price Index (TOPIX) increased by 80% from 859 on 31 December 2012 to 1,543 on 31 March 2015.

Despite such increase in the TOPIX, the average EV/EBITDA multiple increased by a lesser amount from 8.61 in December 2012 to 10.81 in March 2015 while the average Price Earnings Ratio increased from 20.73 in December 2012 to 21.22 in March 2015, indicating that the profitability of Japanese companies has also improved during this period.



Source: Bloomberg, SPEEDA

Beginning of Abenomics, post Shinzo Abe becoming Prime Minister on 26 December 2012

"You learn from diversity ... but you're comforted by commonality".

Carlos Ghosn,
Chairman and CEO of Renault S.A.S and Nissan Motor Co., Ltd.

"If you don't respect people's identity, they will not get motivated and you will not get strong performance".

Carlos Ghosn

Integrating a Japanese business

Integrating a Japanese business will not be an easy and quick task. First step would be to build trust amongst all stakeholders, which may be a time consuming process. Any approaches to the full range of existing stakeholders' of the company, (including suppliers, customers and employees) should continue to follow the protocols described previously.

An early challenge will be to assess the language skills of the Japanese management team and to find ways in which you can ensure that people feel comfortable and are able to communicate their views and concerns. It will be necessary to identify certain individuals who are able to assume a cross cultural role and ensure that the issues of all stakeholders (including those of the new foreign shareholder) are heard and understood.

Integration should be well thought through and process oriented approach with special focus on some of the key areas of difficulties, as described below.

1. **Integration of corporate cultures** – Despite overwhelming evidence that cultural issues must be addressed swiftly, many executives believe it is possible to merge cultures gradually through contact and interaction. Unfortunately, cultures cannot be merged by waving a banner proclaiming shared vision and values. Cultural change does not come from newsletters, logos, or posters. Cultural change comes from deep understanding of the different behavioral characteristics, the gaps and the desired behaviors to support the business strategy. Cultural stereotypes need to be recognised and addressed up front, and turned to be a positive force, rather than a derogatory factor. Of course such behaviors are two sided and not just one, and full inclusion in the behavioral analysis of all stakeholders prevents destructive "us and them" forces from winning.

2. **Human resource –** this is another area, which needs to be dealt with very carefully. Deals do not underperform or fail by themselves; they underperform or fail because of people. People are responsible for taking the actions necessary to realise the planned synergies and deliver the expected results from the acquired business. Similarly people are also responsible for getting in the way of change, for deserting their position, and for all being the root cause of all integration problems. Further, Japan has employee friendly labour laws, which makes it difficult to retrench people, even if the Company is over staffed. Any unfavorable change in HR policies is likely to face significant resistant not only from the employees but also from the management.

3. **Changes in the business process –** Japanese companies follow well defined process for most of the activities and any attempt to reduce or fast track such processes is likely to face opposition.

4. **Other key areas –** changes in/integration of sales & distribution network, production process, product portfolios, IT systems etc. would also require adequate attention and buy in from the Japanese management.

It is advisable to seek involvement of experts having good understanding of both the cultures for an efficient and smooth integration. Do it yourself (DIY) approach is clearly not advisable for integrating a company, which is culturally so different.

Managing the operations post acquisition

There are certain aspects, which can pose significant challenges in managing the operations post the transaction.

It is generally difficult to find experienced and bilingual people. Foreign companies generally hire people from outside of Japan or locally with English language capabilities. Such people are not able to communicate effectively with the Japanese people, as English spoken literacy rate is very low in Japan.

Japan is a country where long standing relationship with existing trading partners (such as, customer, suppliers etc.) are respected. Great consideration should be given in case you wish to change these relationships due to commercial or other reasons.

Entering into partnerships or joint ventures with the wrong partners, either due to entering Japan without a proper strategy & vision or not hiring the right advisors to help find the right partner.

Taking things granted in Japan and considering it as any other market, which is not the case. Japan is a consumer sensitive market and their needs and habits are completely different. Further, it would be wrong to assume that global Japanese corporations have the same depth as elsewhere in the world.

Foreign companies often believe that they can manage the Asia operations (including Japan) from a regional headquarter located in Singapore or Hong Kong. This is a big mistake, as it is not possible to manage the business operations in Japan by sitting at a different location.

Lastly, having a short term approach and trying to do things faster. For example, any immediate steps for cost reduction are likely to face resistance from various stakeholders.

Outbound investment by Japanese companies

$136 billion

Outbound investments made by Japanese companies have increased significantly in the last 3 years from $56 billion in 2010 to $136 billion in 2013, with a CAGR of around 35%

Introduction

Many Japanese companies are cash rich and are looking to expand their international footprint beyond their domestic market. While part of the investment is made in the green field projects, however, M&A is a preferred choice for faster growth and penetrating into new territories and business segments.

Outbound investments made by Japanese companies have increased significantly in the last 3 years from $56 billion in 2010 to $136 billion in 2013, with a CAGR of around 35%. Japan has emerged as the third largest investor in the World after US and China.

Japanese investments are driven by strategic rationale, such as, access to new geographies, product segments, consumer base or strengthening relations with the existing trading partner, rather than purely financial arrangements. High cost of doing business in Japan and shortage of manpower also led to shifting of manufacturing base in low cost countries. Marginal growth in the country also provided impetus to increase in the outbound investment.

In this section, we have aimed to the objectives and thought process of Japanese companies while making outbound investments and it is important for you to understand these, before you engage with them for any investment related discussions.

Key considerations for a foreign seller

Investments made by Japanese companies in overseas acquisitions/joint ventures are also driven by same set of business practices, decision making style, trust and communication protocols, as we discussed earlier and it would be important to have patience when you interact with Japanese companies for potential investment or acquisition.

Decision making process in Japanese company is relatively slow, as most of the decisions are taken jointly by all the stakeholders, as discussed earlier. Due to the delays in decision making, Japanese companies prefer to have exclusive discussions with the sellers. This is also the reason for them not willing to participate into a bidding process with strict timelines. Japanese companies also prefers to move faster in the deals process once decisions are taken at their end and you should be prepared to respond to them quickly at this stage. Many times, you would observe a period of silence during discussions with them, however this does not mean that they are not serious about the deal. They generally do not engage into deeper discussions, when they are not serious about a transaction.

Japanese companies are risk averse and would always want to be fully compliant with the tax and other regulatory requirements of the seller country. Many times they walk away from the deals due to certain anti-corruption related practices adopted by the target companies, particularly in the emerging markets.

Japanese companies do not believe in last minute surprises and you should be prepared to share your thoughts at an early stage in the transaction process. It is also advisable that contribution by both parties, such as, capital, technology, management etc. should be very clearly discussed and agreed sooner than later.

Japanese companies do not have adequate focus on post deal integration and realising the synergies. Further, they generally do not take management control at the beginning, even in case of majority acquisition. Their preference is to place few Japanese people in the technical and other functions for oversight and support. However, you should be prepared that they would be willing to take control, once they get comfortable and confident of managing the operations by their own or with minimum support from the local management.

Most of the Japanese investments are made with long term vision and they are not like Private Equity investors who generally invest for short term with a minimum return expectation. Japanese investments give you a patient capital to help in the long term growth aspirations. While Japanese companies do look for return on their investment, however, this is clearly not the first objective of their investment and they are generally supportive of the long term growth plans of the Company, even if it means no or inadequate profits in the first few years.

Japanese companies also tend to evaluate the impact of any transaction on various stakeholders, including employees, customers and society at large. It would help you to get their early buy in, if you can demonstrate these aspects to a potential Japanese investor.

Key valuation considerations

Similar to the Japanese seller, even for Japanese buyers, price is important but it is not the sole consideration. Japanese buyers are more concerned about the deal meeting the strategic rationale for the transaction, than valuation.

There are certain factors which differentiate a Japanese buyer's approach to a transaction, including valuation; prior understanding of these factors would help you in striking a better deal.

Japan is a country with low interest rate regime, resulting in lower cost of capital for Japanese buyer making investment overseas. Japanese companies generally prefers to make investment either by way of equity or by way of providing debt to the investee company at an interest rate, much lower the rate prevailing in that country. Japanese companies are generally able to offer higher valuation compared to investors from other countries due to lower cost of capital.

Valuation in global transactions often includes an element of value arising out of potential synergies. Identification and quantification of synergy is generally not considered by a Japanese buyer. Hence, it is extremely critical for you to educate them at an early stage of the transaction, in case you are expecting some value for the potential synergies, particularly in case of majority stakes.

Lastly, Japanese buyers do not believe in sitting across the table and doing hard negotiation. They generally convey the message through their advisors and they would quietly walk away from the transaction, in case valuation gap is not bridged amicably. Therefore, it is advisable to assess their valuation expectations and try to reach an agreed value quickly, rather than doing hard negotiations and moving inch-by-inch.

How PwC can help in your Japanese M&A

PwC has been successfully advising on cross-border deals with Japanese counter parties for many years. We know that each deal has unique requirements and will bring its own challenges. Our deal experience and the cultural perspectives of our people can help guide you through each stage of the deal process and contribute towards a successful conclusion.

We are able to provide deals support and input across a wide range of areas at each stage of the deal continuum.

Support to a foreign buyer in dealing with a Japanese seller

Development of Entry Strategy

- Development of market entry strategy and providing proper guidance on adoption of and adherence to the appropriate protocols for interaction with a Japanese counterparty.
- Identification of the right targets for acquisition and suitable partner for a Joint Venture through our knowledge and appropriate research and analysis on the subject companies and/or industry sectors.

Evaluation of the deal

- End to end support as a lead financial advisor.
- Complete deal evaluation support including commercial, financial, HR and tax due diligence, valuation, carve out assessment etc.
- Synergy assessment to identify the potential synergies between the buyer and seller.
- Identification of the likely integration issues and advise on how to deal with them.

Execution of the deal

- Support in negotiation and communication with the countryparty.
- Inputs for the Share/Asset Purchase Agreements with an objective of protecting your rights and interest.
- Structuring of investments into Japan from tax efficiency and regulatory compliance perspective.
- Support in accounting and complying with the GAAP requirements including purchase price allocation and also identify the impact of GAAP conversion.

Integration & operational support

- Support for integrating a Japanese business to help you realise the deal value:
  - Support in taking over control on day 1;
  - Having an effective plan for customer and employee retention;
  - To help you understand the cultural differences and having a cultural alignment;
  - Formulating a business strategy;
  - Integration of various support functions, such as, finance, HR, IT etc.

Exit support

- Plan and support for exit to help you realise the right value at the time of your exit:
  - Finding a right buyer and end to end support as a lead advisor;
  - Execution support: valuation, vendor assistance and vendor due diligence.

Support to a foreign seller in dealing with a Japanese buyer

Support in identification and dealing with a Japanese buyer

- Identification of the right buyer/investor and suitable partner for a Joint Venture through our knowledge and relationship and appropriate research and analysis on the subject companies and/or industry sectors.
- End to end support as a sell side advisor including valuation and inputs for the Share/Asset Purchase Agreement with an objective of protecting your rights and interest.
- Support in negotiation and communication with the counterparty.
- Vendor due diligence and assistance to help you prepare for the transaction.
- Plan and support for exit to help you realise the right value at the time of your exit.

Select useful references

Government Institutions

i. Japan External Trade Organisation (**JETRO**) – *http://www.jetro.go.jp/en/invest/*

ii. Ministry of Economy, Trade and Industry (**METI**) – *http://www.meti.go.jp/english/policy/external_economy/investment/*

iii. Ministry of Foreign Affairs (**MOFA**) – *http://www.mofa.go.jp/policy/economy/japan/invest/*

iv. Cabinet Office – *http://www.invest-japan.go.jp/en_index.html*

v. Japan International Cooperation Agency (**JICA**) – *http://www.jica.go.jp/english/*

vi. Japan Bank for International Cooperation (**JBIC**) – *https://www.jbic.go.jp/en/information/press/press-2014/1128-32994*

Contact details

Our team to provide you comprehensive support in your cross border deals – In additional to our central Tokyo-based teams, we have an established team of senior personnel in geographies and regions to provide your local support.

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About PwC

PwC Japan represents the member firms of the PwC global network in Japan and their subsidiaries. Each firm of PwC Japan undertakes its business as an independent and separate corporate entity.

To address complex and diversified business challenges, PwC Japan consolidates expertise of assurance, deal advisory, consulting, tax and legal services as well as enhances its structure in order to cooperate organically. As a professional service network with a total number of more than 4,000* partners and staff, PwC Japan provides quality client services to meet their needs and expectations.

PwC helps organisations and individuals create the value they're looking for. We're a network of firms in 157 countries with more than 195,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at ***www.pwc.com.***

Major firms comprising PwC Japan

- PricewaterhouseCoopers Aarata
- PricewaterhouseCoopers Kyoto
- PricewaterhouseCoopers Co., Ltd.
- PwC Tax Japan
- PwC Legal Japan
- PricewaterhouseCoopers Research Institute (Japan) Co., Ltd.
- PricewaterhouseCoopers Sustainability Co., Ltd.
- PricewaterhouseCoopers PRTM Management Consultants Japan LLC.
- PwC Strategy& (Japan) Inc.
- PricewaterhouseCoopers Deals Advisory Inc.

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