THE PRIVATE EQUITY REVIEW

EIGHTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

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PREFACE

The eighth edition of *The Private Equity Review* follows an extremely active 2018. While the number of global private equity deals completed declined from 2017, the total value of such deals was the highest since 2007, and the third-highest of all time. Deal activity was weighted towards the upper end of the market, and included several large take-private transactions. Fundraising activity was also strong, as institutional investors remained extremely interested in private equity as an asset class because of its strong performance relative to public markets. As a result, private equity funds have significant amounts of available capital, leading to very competitive transactions being completed at increasing purchase price multiples. This has caused private equity firms to become even more creative as they seek opportunities in less competitive markets or in industries where they have unique expertise. Given all of this, we expect private equity will continue to play an important role in global financial markets, not only in North America and western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. In addition, we expect the trend of incumbent private equity firms and new players expanding into new and less established geographical markets to continue.

While there are potential headwinds – including trade tensions, a slowing Chinese economy, Brexit and an eventual end to one of the longest-running recoveries in US history – on the horizon for 2019 and beyond, we are confident that private equity will continue to play an important role in the global economy, and is likely to further expand its reach and influence.

Private equity professionals need practical and informed guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. This review has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 25 different countries, with observations and advice on private equity deal-making and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

I want to thank everyone who contributed their time and labour to making this eighth edition of *The Private Equity Review* possible. Each of these contributors is a leader in their respective markets, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie
Kirkland & Ellis LLP
Chicago, Illinois
April 2019

Part II

INVESTING

Chapter 10

JAPAN

Kei Asatsuma, Ryo Okubo and Yasuhiro Kasahara[1]

I OVERVIEW

i Deal activity

Private equity deals in 2018 were as active as those in 2017. The total value of transactions in 2017 was a record high at that time, but the total value of transactions in 2018 was even higher because of some very large transactions that year. Bain Capital, together with its co-investors, acquired Toshiba Memory Corporation for approximately US$21 billion, and Kohlberg Kravis Roberts (KKR) purchased Hitachi Kokusai Electric Inc for approximately US$1.7 billion. The recent volume of deals is fuelled by continual active investments related to carve-out deals, involving large companies that wish to focus on their core businesses, and business succession, involving small to medium-sized companies and family-owned companies.

During the period from July 2017 to June 2018, there were four public-to-private deals by private equity funds, including the KKR transaction mentioned above. The number of public-to-private transactions peaked in 2011 with 25 deals in total, and since then the number has decreased and remained low, partly because the high stock price of listed companies for the past five years has discouraged such transactions.

In recent years, there have been approximately 40 to 50 exits each year, and during the period from January 2018 to June 2018, of all the private equity investment exits, trade sales and secondary buy-outs constituted approximately 70 per cent, IPOs constituted approximately 15 per cent, and the remaining 15 per cent consisted of other exits.

Quite a few private equity funds are active in Japan. The funds can be categorised as independent domestic funds, global funds, funds managed by Japanese financial institutions or trading firms, and domestic quasi-governmental funds. The history of funds in Japan started with the independent domestic funds in the late 1990s. Since then, many new funds have emerged every year, but the early independent domestic funds, such as Advantage Partners and Unison Capital, are still very active. As to global funds, many of them, such as Bain Capital, the Carlyle Group, KKR, Permira and CVC, are also active in Japan.

ii Operation of the market

Management equity incentive arrangement

In Japan, it is more common, even in the case of large listed companies, to give only stock options to management, and it is uncommon to prepare a complex equity incentive package for management like those in some other jurisdictions. As to the stock options to be granted to management, although it is technically possible to adopt a complex plan, such

1 Kei Asatsuma, Ryo Okubo and Yasuhiro Kasahara are partners at Nagashima Ohno & Tsunematsu.

as a performance-based plan, a 'plain vanilla' stock option is more commonly provided. It is notable, however, that some of the large listed companies are starting to consider introducing more complex plans reflecting their performance.

The Japanese Tax Code allows a holder of qualified stock options to defer applicable tax, namely qualified stock options are not taxable at the time of exercise of the stock option but become taxable at the time of the disposition of the shares acquired by the exercise of the stock option. The criteria for qualified stock options include:

a the commencement of an exercisable period no earlier than two years after the resolution to grant stock options, and expiry within 10 years of the resolution;

b a strike price higher than the price per share at the time of execution of the stock option agreement; and

c an aggregate strike price exercisable in a single year, not in excess of ¥12 million.

In addition to the stock options, if management have a strong connection with the business (e.g., the founder of the business is part of management), they may be offered an opportunity to hold a minority stake in the acquisition vehicle, which is normally in the range of 5 per cent to 10 per cent, with very limited control over the acquired business but with almost the same level of liquidity as have the sponsors (e.g., by way of tag-along rights).

Sale process

The sale process varies as to whether it is conducted through an auction or not and, if conducted through an auction, how the auction process is conducted. For instance, if the auction process consists of multiple rounds of selection (i.e., a long list for the first-round bid and a short list for the second-round bid), the sale process takes more time. While an auction can increase the possibility of achieving the most favourable deal for the seller, the sale process will likely be at least a few months longer than without an auction.

Apart from the auction process, there are some other factors that can affect the duration of the sale process under Japanese law. Under the Act on Prohibition of Private Monopolization and Maintenance of Fair Trade (the Antimonopoly Act), a fund or an investment vehicle must make an advance filing, which requires a 30-day waiting period (though the period can be shortened if the deal is expected to have little or no restrictive effect on competition) if:

a the aggregate amount of the domestic sales of the purchaser group exceeds ¥20 billion;

b the aggregate amount of the domestic sales of the target company group exceeds ¥5 billion; and

c the purchaser acquires more than 20 or 50 per cent of the voting rights of the target company.

Depending on the structure of the fund, the purchaser group may include the portfolio companies of the fund, in which case the domestic sales of the portfolio companies should be included in the domestic sales of the purchaser group.

If the Japan Fair Trade Commission (JFTC) requests the purchaser to submit additional information and materials during the waiting period, the waiting period will be extended until clearance is obtained from the JFTC. Therefore, the closing could be significantly delayed.

In addition, if a fund that falls under the definition of a foreign investor in the Foreign Exchange and Foreign Trade Control Act of Japan (FEFTA) wishes to make an investment in Japan, the fund must submit a notification to the relevant governmental authorities through the Bank of Japan (BOJ) pursuant to the FEFTA. If the target company engages in certain businesses specified by the FEFTA (such as businesses related to national security and important infrastructure), the purchaser must submit an advance notification, which requires a 30-day waiting period (though the period can be shortened to two weeks if the deal presents no issues in respect of the FEFTA). If the target company is not engaged in the businesses specified by the FEFTA, the FEFTA requires the purchaser to submit a post facto notification to the relevant governmental authorities through the BOJ.

II LEGAL FRAMEWORK

i Acquisition of control and minority interests

Laws and regulations

When making an investment in Japan, a fund generally needs to take into consideration the Companies Act, the Financial Instruments and Exchange Act (FIEA), the Antimonopoly Act, the FEFTA and, depending on the business segment of the target company, other industry-specific laws. In addition to statutory laws, stock exchange regulations also need to be considered if the transaction involves a listed company.

The Companies Act

The Companies Act provides broad coverage over the issues that will arise from an acquisition of a Japanese company, whether it be by a straightforward acquisition of stock, acquisition of a business or assets or a corporate reorganisation, such as merger or demerger.

The FIEA and the regulations of the relevant stock exchange

These laws and regulations have a significant effect on investments by funds that involve a listed company. For example:

a if a fund seeks to acquire more than one-third of the voting rights of a listed company, the FIEA requires the fund to undertake a tender offer bid (TOB), which is subject to the scrutiny and supervision of the Financial Services Agency and the relevant finance bureau;

b if the transaction involves a listed company, the stock exchange regulations will require the listed company to make a disclosure about the fund; and

c if a fund desires to acquire a substantial amount of newly issued shares from a listed company so that its fully diluted shareholding ratio will be 25 per cent or more or a change of control will occur, the stock exchange regulations will require the listed company to either go through a procedure to confirm approval by its shareholders (usually by a shareholders' resolution at a general meeting of shareholders) or procure an opinion from an independent person as to the necessity and fairness of the transaction.

The Antimonopoly Act and the FEFTA

The procedures in relation to the Antimonopoly Act and the FEFTA are as discussed in Section I.ii.

Certain industry-specific laws

Depending on the type of business conducted by the target company, a fund's investment may be subject to industry-specific laws and regulations (e.g., banking and insurance business laws).

Typical transaction structure

A typical transaction structure for a buyout by a fund of the shares of a non-listed company is for a special purpose company (SPC), which is newly incorporated as a joint-stock company for the purpose of the acquisition, to (1) receive an equity investment from the fund and financing from lenders, (2) acquire the shares of the target company from the seller, and (3) carry out a merger with the target company with the SPC being the surviving entity, and the fund thereby holding directly the shares of the target company.

A typical transaction structure for a buyout by a fund of a part of the business of a company (i.e., a carve-out transaction) is for an SPC to (1) acquire the shares of a newly incorporated company, which has assumed the target business from the seller through a demerger and (2) carry out a merger with the new company with the SPC being the surviving entity. However, based on tax or other considerations, various other transaction structures may be adopted for a buyout by a fund of a non-listed company or its business.

A typical transaction structure to be adopted for a public-to-private transaction is, in most cases, for an SPC to acquire at least two-thirds of the voting rights of the target through a TOB and to subsequently squeeze out the remaining minority shareholders pursuant to certain technical procedures under the Companies Act using stock consolidation. To accomplish the squeeze-out of minority shareholders, the SPC must secure two-thirds of the voting rights of the target company because this is the threshold required to pass a special resolution at a shareholders' meeting required for the squeeze-out process. Following an amendment to the Companies Act that came into effect in May 2015, it has become easier to conduct a squeeze-out; for example, a new statutory call option was introduced by the amendment. Under this call option, if the SPC has obtained 90 per cent or more of the voting rights as a result of the first-step TOB, it is able to squeeze out the remaining minority shareholders without a shareholders' meeting by simply exercising the statutory call option right against those remaining shareholders.

Finally, a cash-out merger was not used for squeeze-outs before 1 October 2017 because it was not tax efficient in most cases. However, as a result of an amendment to the Corporation Tax Act that came into effect on 1 October 2017, a cash-out merger has become more tax efficient when the surviving company holds two-thirds or more of the total issued and outstanding shares of the absorbed company. As such, we expect that the cash-out merger structure may be widely used in the future for the second-step squeeze-out process in a public-to-private transaction sponsored by a fund.

ii Fiduciary duties and liabilities

Directors

A fund's portfolio companies overwhelmingly take the form of joint-stock companies. The director of each company appointed by a fund as its representative on the board owes a duty of care and loyalty to the company under the Companies Act. Namely they have a duty to the company to use the due care of a good manager in performing their duties. They must comply with all laws and regulations and the company's articles of incorporation (AOI), as well as all resolutions adopted at general shareholders' meetings, and perform their duties faithfully for the benefit of the company. Further, based on court precedents, they have a duty to monitor whether the other directors are performing their duties in a lawful and appropriate manner in compliance with applicable laws and regulations and the AOI.

A director is liable to the company for losses of the company caused by his or her negligence in the performance of his or her duties, including a breach of his or her duty of due care or duty of loyalty. Moreover, if a director causes damage to a third party as a result of his or her wilful misconduct or gross negligence in the performance of his or her duties, the director will be liable to the third party for damages. When examining an alleged breach of the fiduciary duties of a director, Japanese courts follow a rule similar to the business judgement rule in the United States. However, it differs from the US business judgement rule in that courts may examine not only whether an appropriate procedure has been taken but also whether the director's business decision itself is significantly unreasonable.

Shareholders

It is generally understood that a fund that is a shareholder of a company does not owe any fiduciary duty to the other shareholders, even if the fund is the controlling shareholder and there are minority shareholders. Although some scholars are of the view that a controlling shareholder should owe a fiduciary duty to the company and the other shareholders, the Companies Act does not expressly provide for such a duty. Furthermore, to date no court has found there to be a case for such a duty and the above-mentioned view is not the prevailing view in Japan.

Further, in the most commonly used transaction structure where a fund makes an investment through an SPC, the fund is not liable for the buyout undertaken by the SPC, in principle, unless the fund specifically agrees to undertake any liabilities in relation to the seller or the target company pursuant to an agreement with them.

In contrast to the situation where a fund makes an entry investment, a fund usually undertakes various contractual liabilities in relation to the buyer when the fund exits from the investment. A fund may avoid incurring liabilities in relation to the buyer in an exit transaction if the fund arranges the transaction scheme in such a way that only the portfolio company signs the agreement with the buyer as the seller of its business. However, such a transaction scheme is rare, since it is tax-inefficient in most cases. Generally, a fund decides on the transaction structure from the perspective of tax-efficiency and accepts certain contractual liabilities, while trying to include protective provisions in the agreement to limit its liabilities.

III YEAR IN REVIEW

i Recent deal activity

In Japan, details of private equity deals are not disclosed except for certain transactions such as mergers with listed companies and tender offers for the shares of public companies. Even in these exceptional transactions, only the basic terms and conditions are disclosed. Unfortunately, this means little information is available for an analysis of the trends in private equity deal terms and conditions – whereas in certain other countries, such as the United States, listed companies must make more detailed disclosure of any M&A agreements entered into. In addition, as disputes between parties in Japan tend to be resolved through mutual negotiation, there is a dearth of case law regarding agreements related to private equity deals.

There was, however, an important Supreme Court decision in July 2016 for the shares of Jupiter Telecommunications Co, Ltd with respect to a tender offer followed by a squeeze-out transaction (the *JCOM* decision). Under Japanese law, a minority shareholder who opposes a squeeze-out has an appraisal right to request the court to determine the price to be paid to the minority shareholder as a result of the squeeze-out process (the squeeze-out price). Generally, in past similar litigation, while the company claimed that the squeeze-out price should be the same as the tender offer price, the courts decided that the squeeze-out price should be the objective price (which means the market price immediately prior to the disclosure of the tender offer subject to a certain adjustment based on regression analysis for the time difference between the tender offer and the squeeze-out process – an adjustment mechanism adopted by some recent lower court cases based on economic analysis) plus certain premiums (approximately 15 to 25 per cent). The *JCOM* decision, however, stated that even in a conflict-of-interest situation, such as an acquisition of the target company by the parent company as in this case, as long as the tender offer was conducted under a fair and generally accepted procedure, such as seeking opinions from an independent committee and professionals, the squeeze-out price should be the same as the tender offer price unless there exist special circumstances where the fundamental facts underlying the transaction have unexpectedly changed. It is generally understood that the framework of the *JCOM* decision will also apply to the determination of the squeeze-out price in squeeze-out transactions between parties who are not in a conflict-of-interest situation, such as an acquisition of a listed target by a fund. As such, since the *JCOM* decision, the squeeze-out process has become more stable for acquirers.

ii Financing

Recent trends

Since the spreads in general corporate loans have tended to be set low in Japan, in 2018 Japanese lenders continued to be active in providing acquisition finance, which is attractive to them because of the generally higher spreads. A new development is that, as Japanese companies' interest shifts to outbound acquisitions, in response to a shrinking domestic market (which is, in turn, due to a declining and ageing population), Japanese lenders are becoming more active in providing financing for cross-border acquisitions. This has been considered more challenging because of the legal, operational and other difficulties arising out of the cross-border context, such as creating security packages in other jurisdictions. In addition, new types of acquisition financing such as recapitalisation transaction, share financing, 'holdco' financing and subscription financings are growing steadily. These trends will continue in the coming years.

Types of acquisition financing and sources of finance

Usually only senior loans as syndicated loans are used for acquisition financing. As senior lenders, Japanese commercial banks, trust banks and government-related banks play important roles. In particular, the Japanese acquisition finance market is dominated by Japan's three mega banks (i.e., MUFG Bank, Sumitomo Mitsui Banking Corporation and Mizuho Bank).

However, if the size of a deal is large, or the leverage of the deal is high, mezzanine finance is additionally used. As mezzanine financiers, certain mezzanine funds established by banks, insurance companies or securities companies or independent mezzanine funds, bank subsidiaries and lease companies play important roles. Mezzanine financing is typically provided by way of non-voting preferred shares or subordinated loans. An equity kicker in the form of warrants is added to subordinated loans from time to time. A high-yield debt market has not yet developed in Japan.

Key financial and legal terms

Senior loans usually consist of term loan A, term loan B and a revolving loan. Term loan A is fully amortised while term loan B is paid at maturity in a lump sum. Term loan A and term loan B are used to finance the closing of the acquisition, refinancing of the existing indebtedness and the transaction costs. The revolving loan is used to finance working capital. The term of each tranche is typically five to seven years. Financial covenants typically include a leverage ratio, debt service coverage ratio, minimum net worth, positive income and maximum CAPEX. An unusual feature of the Japanese syndication market is that typically investors participate in all tranches on a *pro rata* basis, although this may change in the future.

The preferred shares used for mezzanine financing are usually non-voting, cumulative and non-participating shares because the intention of mezzanine investors is to secure the agreed return. In addition, to secure the mezzanine financier's position, conversion rights to the voting shares are usually attached to the preferred shares so that the financier can exercise the conversion right and seize control of the company in event of the company's financial distress. In addition, it is common for redemption rights to be granted to the mezzanine financier to secure its exit. Since payment of dividends to preferred shareholders is not permitted under a typical senior loan agreement until the company repays the senior loan in full, the mezzanine financier, as a preferred shareholder, is contractually subordinated to the senior lenders.

The subordinate nature of the subordinated loans used for mezzanine financing is also contractually created through an inter-creditor agreement among senior lenders, mezzanine financiers and the borrower.

Senior loans and subordinated loans are secured by a security package that basically covers all assets of the borrower and the target company.

iii Key terms of recent control transactions

Price adjustment

Traditionally, it has been more common, especially in domestic transactions, for price adjustment mechanisms not to be included in stock purchase agreements for the sale of non-listed companies. In such transactions, the seller usually has an obligation to have the target company conduct its business in the ordinary course of business, but any specific provision to avoid leakage to the sellers or their related persons, such as the 'locked-box mechanism', remains uncommon, although this may change in the future.

On the other hand, purchase price adjustment mechanisms are frequently used, especially in the case of large volume deals or deals in which the period between the execution of the definitive agreement and closing is expected to be lengthy for various reasons, such as the antitrust clearance process. In such cases, a closing account is prepared and, typically, the difference between the normalised working capital peg agreed to in the definitive agreement and the actual working capital amount as at the closing date is subject to a dollar-to-dollar adjustment, either upwards or downwards. Recently, however, especially in the auction process, the seller often requires that no price adjustment mechanism be included in bidders' submissions.

Representation and warranty insurance

While representation and warranty insurance is available in Japan, its use is limited and it is still rare to see actual issuances of representation and warranty insurance for domestic transactions. This is probably because it is still not very common in Japan for a party to make a claim for indemnity based on the definitive agreement. Accordingly, given the time and cost of taking out the insurance, its merits are not fully appreciated by M&A players in Japan. However, representation and warranty insurance is receiving more attention, and the time and cost of taking out the insurance is expected to decrease because of the efforts of insurance companies. In addition, especially in the case where a private equity fund is the seller, use of representation and warranty insurance will reduce the residual risk after the closing and provide for a clean exit. As such, the use of representation and warranty insurance may gradually increase in the future.

Reverse break-up fee

It is rare that a reverse break-up fee clause is provided in a definitive agreement in Japan. In Japan, instances of unsuccessful closings due to a failure to satisfy conditions precedent, including financing failures, are scarce. In addition, disputes in which a party seeks liability for an unsuccessful closing are very rare, and it is unlikely that a Japanese court ruling will apportion significant liability in the case of an unsuccessful closing. Accordingly, the parties do not have much incentive to negotiate reverse break-up fees. However, especially in cross-border transactions, there exists an increasing risk that an antitrust clearing cannot be obtained in one or more of the relevant jurisdictions where the subsidiaries of the target company are located, so use of reverse break-up fees may increase in the future in this area to share the risks associated with antitrust filings.

Finance out

In a trade sale of the shares of a non-listed company, whether a finance-out clause is included depends on the outcome of the negotiation of the parties. On the other hand, as explained above, in the case of a listed target, a tender offer is mandatory for a fund to obtain control of the target. Under the FIEA, triggering events that allow a tender offeror to withdraw a tender offer after it has been launched are very restricted and exhaustively listed. In particular, neither a failure of financing nor the occurrence of a material adverse change (MAC) is listed as such a triggering event. In other words, a fund may employ neither a finance-out nor a MAC-out mechanism in the case of an acquisition of a listed target. However, bank commitment letters usually provide many conditions precedent to extending loans, including a business MAC and a market MAC. Accordingly, even if the lenders withdraw from the financing for the tender offer because of a MAC event, the fund must still close the tender offer by raising the necessary funds from other financing sources, including equity, or it will default. However, to date no default cases due to a financing failure of this nature have occurred in Japan.

iv Exits

For the past few years, 40 to 50 exits have occurred annually. Approximately 70–80 per cent of exits are achieved by way of a trade sale including a secondary buyout. During the period from July 2017 to June 2018, 10 initial public offerings were launched. The average period between the entry and the exit is approximately five years.

IV REGULATORY DEVELOPMENTS

Other than fundraising and fund management, there is no regulatory body that is specifically charged with overseeing PE transactions or PE sponsors' activities unless the PE sponsors conduct activities that fall within the scope of a financial instruments business as defined in the FIEA, such as an investment advisory business, which is not common. However, as explained in Section II, various regulations may apply to each PE transaction or to PE sponsors' activities.

V OUTLOOK

It is expected that the general trends described in Section I will continue in 2019. The overwhelming majority of deals in 2019 will be mid- to small-cap transactions, while there could be some mega deals. Investments involving the business succession of small to medium-sized companies will continue to be very active.

Appendix 1

ABOUT THE AUTHORS

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Kei Asatsuma is a partner at Nagashima Ohno & Tsunematsu. His practice focuses on complex business transactions, including M&A, divestitures, spin-offs, joint ventures, strategic alliances, leveraged buyouts, private equity investing, restructuring and workouts, and recapitalisations. He also counsels clients in a wide variety of corporate matters, including corporate governance issues, and is often called upon to represent public companies in matters of takeover and activist shareholder defence.

He graduated with an LLB from the University of Tokyo in 1995 and with an LLM from the University of Chicago in 2002. He was admitted to practise law in Japan in 1997, and worked at Kirkland & Ellis LLP in Chicago from 2002 to 2003, where he focused on international litigation and cross-border transactions involving Japanese companies, and general corporate matters for US and Japanese companies.

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