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Private Equity

Japan: Trends & Developments

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2020

Trends and Developments

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Investment Deal Trends

The private equity market in 2019 was explosive. The reported number of private equity deals for the year set a new record, however, the total value of all deals in 2018 remains the highest as 2019 did not contain any mega deals like those that occurred in 2018, such as the acquisition of Toshiba Memory Corporation by Bain Capital and its co-investors (USD21 billion) and Kohlberg Kravis Roberts' purchase of Hitachi Kokusai Electric Inc (USD1.7 billion). These transactions greatly increased the total value of transactions in 2018.

That is not to say that 2019 was without any sizable deals. Large deals in 2019 included:

- the acquisition of Godiva Japan by MBK Partners by carving-out the Godiva Japan business from Godiva's global business (reported transaction value of more than JPY100 billion);
- the acquisition of Pioneer Corporation by Baring Private Equity Asia which was a business turnaround type deal (JPY100 billion);
- the acquisition of Ayumi Pharmaceutical Corporation by The Black Stone Group from Unison Capital which was a secondary buy-out deal (JPY100 billion);
- the joint acquisition of Orion Breweries, Ltd by The Carlyle Group and Nomura Capital Partners, which involved a tender offer and following squeeze-out procedure (JPY57 billion);
- the acquisition of Kyowa Pharmaceutical Industry Co, Ltd by Unison Capital from Lupin Limited, which was a carve-out deal for Lupin to divest its Japanese business (JPY57 billion); and
- the acquisition of Sanden Retail Systems Corporation by Integral from Sanden Holdings Corporation, which was a carve-out deal for Sanden Holdings Corporation to focus on their car equipment business as their core business (JPY50 billion).

The number of deals continues to rise due to two increasing trends: first, active investments through carve-out deals where larger companies are divesting their non-core businesses and second, business succession deals involving small to medium-sized companies and family-owned organizations.

The secondary market and P2P transactions

Particular to 2019 was the increased activity in the secondary market where one private equity firm sells its portfolio company(ies) to another. This may develop into a third increasing trend.

On the other hand, a decreasing trend for the year was the fall in numbers of public-to-private (P2P) transactions (only five cases in 2019). This was caused partly by the recent high stock price of listed companies. Another factor to consider is that in 2019, the Practical Guidelines Concerning Group Governance System ("Group Guidelines") were published by the Ministry of Economy, Trade and Industry of Japan (METI).

The Group Guidelines state that due to the risk of potential conflicts of interest between a listed company and its controlling shareholder if the controlling shareholder is also a listed company, unless the listed company can properly fulfil its accountability in relation to such relationship, the listed company with a controlling shareholder who is also a listed company should terminate such relationship (ie, arrange for the controlling shareholder to not be a listed company by divesture of subsidiary).

While the Group Guidelines are merely guidelines rather than laws, given the growing pressure from the market against listed companies having a controlling listed parent company, which the Group Guidelines now clearly evidence as also being the Japanese government's position, the near future may see more public-to-private transactions led by private equity firms involving publicly listed controlling shareholders to help them to have an appropriate corporate group governance. At the time of writing, there are more than 600 listed companies with a controlling shareholder, including those for which the controlling shareholder is a listed company.

Looking forward in 2020

Continuing looking forward, the landscape for investments by private equity firms is expected to be very different in 2020 and beyond due to the COVID-19 situation. Considering the economic downturn caused by the COVID-19 virus, it is foreseeable that there will be more business turnaround deals, some of which may be P2P transactions, due to a slump in the stock value of companies engaged in businesses particularly vulnerable to the disruptions caused by the COVID-19 virus such as the manufacturing, accommodation, travel and transportation, retail and restaurant industries.

Exit Trends

In recent times, there have been approximately 40 to 50 deals per year in which a private equity fund or investor exits their investment (exit deals). Among the private equity investment exits, most of them are trade sales and secondary buy-outs. There were only a few IPO exits in 2019. As noted above, in 2019 there were more secondary buy-outs compared to previous years. Normally, this trend would be expected to continue, however, the COVID-19 situation makes it very difficult to predict how the exit trends will develop in 2020. With that caveat, the general exit trends seem more likely than not to continue in 2020, where trade sales and secondary buy-outs are expected to constitute the vast majority of exit deals.

Impact of COVID-19 on Private Equity

How the COVID-19 crisis will affect the private equity industry in Japan in coming months remains unpredictable.

On 7 April 2020, the Government of Japan declared a state of emergency in relation to COVID-19. Many transactions were suspended or cancelled as a result, all around the same time, and, according to the RECOF database, Japanese M&A transaction activity in April and May of 2020 dropped approximately 30% compared to the same period in 2019.

M&A activity

However, after the lifting of the Declaration of a State of Emergency on 25 May 2020, it appears that M&A activity has restarted and there are some positive signs that deal making could rebound later in 2020. According to the RECOF database, the number of transactions published in June of 2020 revealed a 20% growth compared to June of 2019. Many practitioners have commented that Japanese companies have been forced to review their strategy and business model in the wake of the COVID-19 outbreak, and it is anticipated that the sale of non-core businesses will be accelerated. In this case, private equity firms will have a key role to play as the potential buyers in these deals.

Private equity funds

As for private equity funds, COVID-19's impact on their new investments should not be universally catastrophic, but a heavy impact can be expected, at least in the short term, for their portfolio companies in certain industries such as the accommodation, travel and transportation, retail, and restaurant industries. In response to the hardships caused by the COVID-19 situation, the Japanese government has provided some programs to support such companies who suffered from the downturn in consumption. The COVID-19 induced downturn also affected negotiations with LBO lenders which tended to become more difficult.

Some of the private equity firms were forced to provide additional funds to obtain waivers of financial covenants under their LBO loans or to obtain additional financing from LBO lenders or other financial institutions. Given that there are still many portfolio companies that private equity firms have invested into but not yet exited and that these private equity investments tend to be of a higher level of risk, it would not be surprising if there was an uptake in corporate reorganization or bankruptcy cases.

Recent Amendments to Foreign Exchange and Foreign Trade Act

Recent amendments to the Foreign Exchange and Foreign Trade Act (FEFTA) has tightened the rules applicable to foreign direct investments to align Japan with the global trend towards strengthening regulation of foreign investors.

Under the FEFTA, when foreign investors, including foreign-based private equity firms, seek to perform certain acts, such as the acquisition of shares, in relation to Japanese companies engaged in designated industries, the foreign-based private equity firm must file an advance notification to the relevant Ministry(ies) and wait for the 30 day processing period (which is often shortened to two weeks but may be extended up to five months in very exceptional cases) to elapse before performing such act.

FEFTA amendment

An amendment to the FEFTA which took effect on and from 1 August 2019 expanded the scope of the designated industries by adding certain sectors in the information and communication technology and software development industries. Further, a subsequent amendment added certain types of actions that trigger an obligation for foreign-based private equity firms to submit prior notifications to the specified government authority, such as the foreign-based private equity firm making an affirmative vote to elect a foreign investor (including a foreign-based private equity firm) or its affiliated person as an officer of a company in the designated industry or proposing the transfer or abolishment of the business in a designated industry.

Pre-deal examinations

Private equity firms doing deals in Japan should carefully examine whether a company in which it contemplates investing is engaged in any of the designated industries bearing in mind that such examination may require some time as the classifications of the designated industries is not always clear. As mentioned, the statutory waiting period is in general 30 days, but in practice there is some uncertainty as to whether allowing 30 days for the processing period is sufficient.

In some cases, conditions are attached in relation to a contemplated foreign investment by the specified Ministry, and in such cases, a revised notification may be required to be filed with a declaration that the foreign investor will comply with such conditions. In these cases, the 30 days waiting period starts again from the date of filing of the revised notification.

Fair M&A Guidelines

On 28 June 2019, METI published a new Guideline, the "Fair M&A Guidelines: Enhancing Corporate Value and Securing Shareholders' Interests", completely revising and updating the MBO guidelines issued more than a decade ago.

This new guideline focuses on MBO and the acquisition of controlled companies by controlling shareholders, where conflicts of interest and information asymmetries between the buyer and minority shareholders typically exist. The Guideline stipulates a variety of measures that should be taken by the target company and the acquirer to ensure the fairness in these types of transactions including:

- establishment of a special committee to assess the valuation and the process of the transaction;
- retention of independent external advisers;
- requiring market checks;
- imposing majority-of-minority-conditions; and
- requiring information disclosure.

Although the Guideline states that which, and to what extent, fairness ensuring measures should be taken on a case-by-case basis, it should be noted that the Guideline emphasises the importance of the special committee to ensure the fairness of the transaction.

The purpose of this Guideline is to encourage best practice and it is not legally binding, but the Guideline has influenced the practice of MBO since its publication. In particular, there is a trend for the special committee to become more involved more deeply and actively at an earlier stage of the MBO transaction than before. In Japan, MBOs are typically funded by private equity funds as the equity providing sponsor, and thus private equity funds should closely monitor how the practice in this area develops.

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