

White Paper

The Reemergence of Japan's M&A Activity

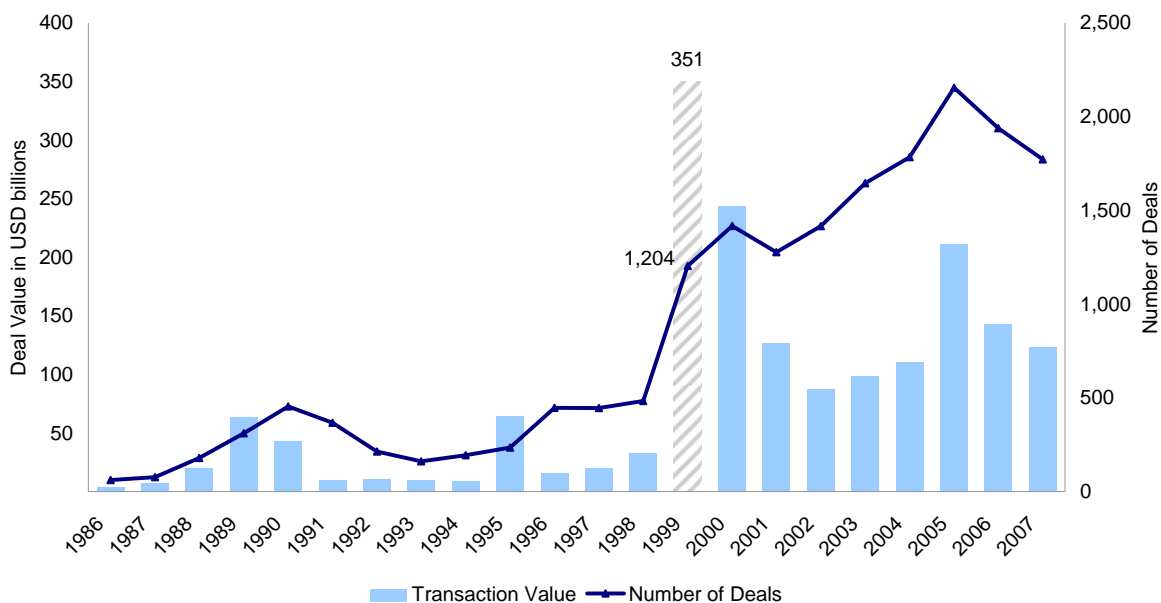
The Reemergence of Japan's M&A activity

While U.S. and European firms have been benefiting from the global M&A boom, recording all-time highs in M&A activity in the past decade, Japan has been preoccupied with internal issues. The time has come for Japan to re-emerge on the international stage. Having suffered only minimal losses through the subprime crisis while accumulating significant cash positions and becoming increasingly hungry for international growth, Japanese companies are back in the M&A business and well positioned to become some of the most important acquirers around the globe.

M&A HISTORY

In the past two decades Japan underwent an important development that will have a lasting impact on the country's future M&A activity. In the past, Japan's corporate landscape has been characterized by the Keiretsu structure: horizontally integrated companies with operations across various industries. Typically, Keiretsus were tightly linked to banks and to each other through cross shareholdings. These conditions adversely affected M&A, resulting in relatively low activity. The following chart presents the number and volume of completed M&A deals with Japanese involvement in the years 1986 to 2007:

Completed M&A transactions with Japanese involvement in the years 1986-2007



Source: Thomson Financial

The first wave of M&A activity began at the end of the 1980's, supported by Japan's strong economy, low interest rates and aggressive lending institutions. As much as 50% of Japanese M&A volume at this time was comprised of cross border transactions, specifically, in-out transactions. As the country experienced an economic slowdown in the early 1990s M&A activity subsided.

Changing structures ease M&A activity in Japan

In the ten year-long recession, cross shareholdings between public companies and banks were significantly reduced and foreign institutional investors increased ownership in Japanese public companies. This development, coupled with the introduction of a number of reforms pertaining to legal, accounting and tax issues, cleared the way for the next major surge in 1999. As the chart shows, 1999 was an outlier in terms of cumulated deal value which amounted to approximately USD 351bn. This level of deal value was primarily due to 'mega-mergers' in the course of the consolidation in the banking sector and restructuring of financially distressed public companies; transactions that were only possible due to the preceding transformation of corporate Japan and legislative reforms.

PRESENT MARKET CONDITIONS

The economic pickup of recent years and restructuring of many Japanese companies, lead to healthier balance sheets, which now financially enables them to pursue acquisition opportunities. In addition general conditions in the legal framework have changed, paving the way for increased M&A activity.

Reforms

While reforms so far have been crucial for allowing more M&A activity, it is expected that there are more reforms underway that will bring about further growth of Japan's M&A market. The following exhibit lists several reforms that have been implemented in the past, proving advantageous for Japan's M&A activity:

Selected reforms setting the course for increased M&A activity in Japan

Year	Reform
1997	Simplification of merger procedures; Lifting of ban on forming holding companies by general companies
1999	Equity-swap system; Equity transfer system
2000	Corporate divestiture system (spin-offs); Simplification of transfer of business procedure
2003	Purchases of treasury stock authorized in the articles of incorporation
2007	Triangular merger (Companies Act: Amendments to provisions mitigating consideration limits on organizational restructuring)

Source: RECOF, *International Financial Law Review*

Increasing number of deals is a long-term trend

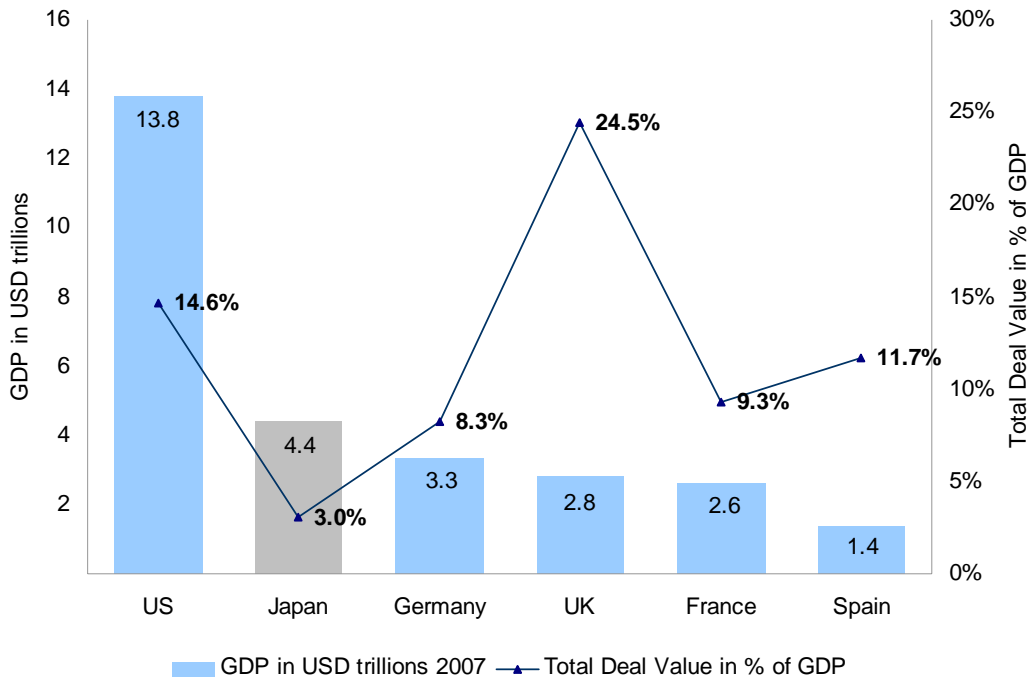
The growth in the number of transactions represents a long-term development rather than a temporary phenomenon.

Lincoln International has identified several underlying factors that will drive cross border M&A activity in Japan in the foreseeable future:

1. Potential of increase in Japan's overall M&A activity

Japan's overall M&A activity is significantly lower than other developed countries'. While the deal value of completed deals in % of GDP in the US was close to 15% in 2007, Japan's equivalent was 3%. The following figure exhibits the deal value in % of GDP for selected countries:

Total Deal Value of Completed Deals in % of GDP for 2007



Source: Thomson Financial League Table

Note: Completed Deals

M&A activity of Japanese companies in terms of deal value is far behind the U.S. and major European countries. In order to avoid falling behind its competitors, Japanese companies will need to increase overall M&A activity.

2. Shift in management's focus towards shareholder value

A change in the perception of M&A has occurred in Japanese companies. Not only has M&A activity become an increasingly accepted strategy for growth, but also the defensive demeanour of Japanese managers towards M&A has been subsiding. This development goes hand in hand with the shift in management's focus on shareholder value; Japanese companies with healthy financial resources will become increasingly active in M&A, using it as a tool to achieve growth expectations. While employee issues remain Japanese manager's priority, an increased observance of shareholders' interests – who are partially foreign investors – and their demand for higher returns as well as more flexibility and responsiveness to global trends, can be noted.

3. Need for Japanese firms to grow through international acquisitions

There are several reasons for Japanese companies to implement more aggressive M&A strategies than observed in the past. Most importantly, Japanese corporations are at risk of falling behind some of their international competitors who have been growing through acquisitions. These are not only companies from Europe and North America, but also emerging economies such as India and China who are increasingly participating in cross border M&A transactions, acquiring know-how and amassing critical size.

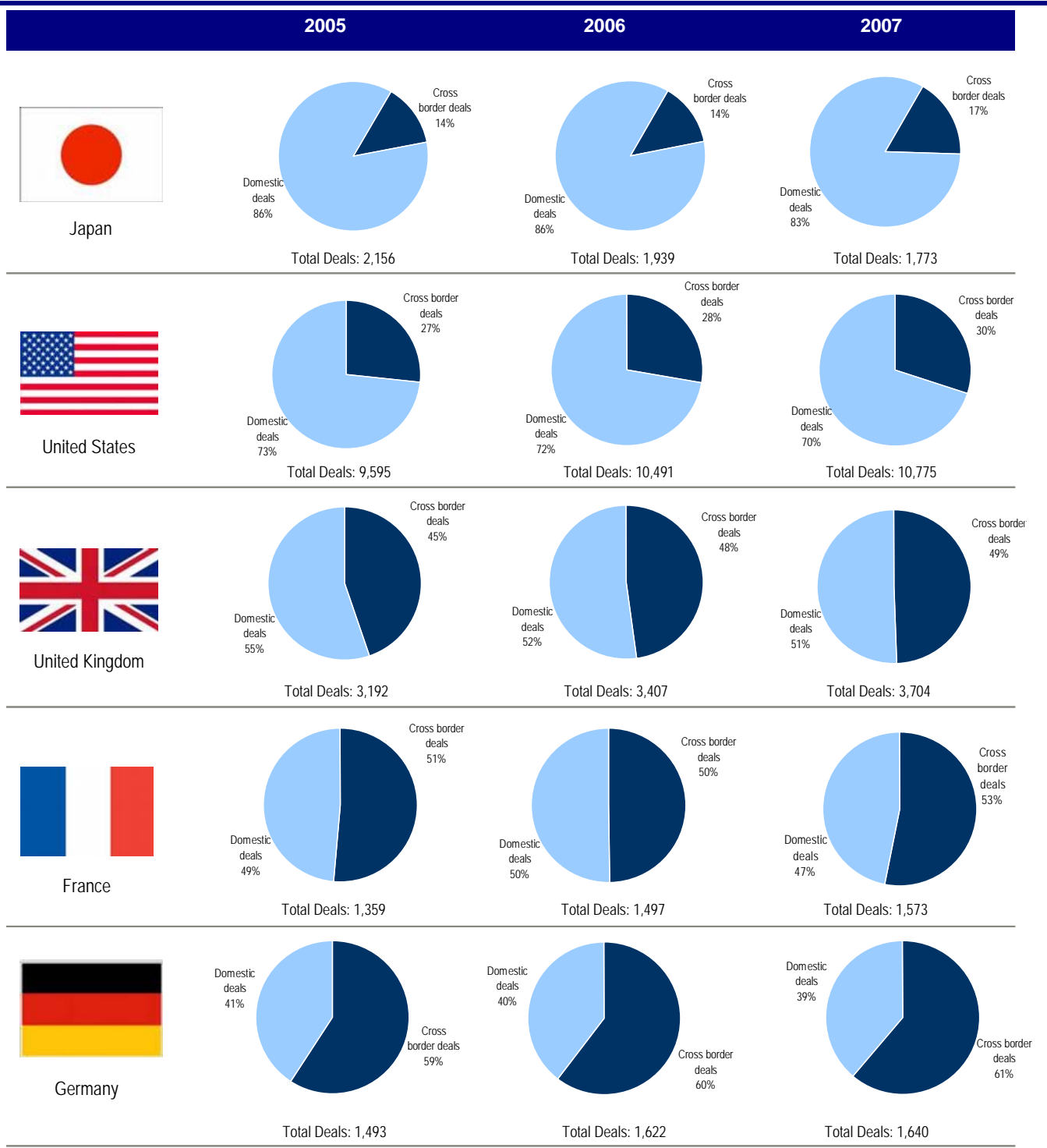
The Japanese economy is in the midst of consolidation which will drive outward M&A as more capital becomes available to invest into new and more promising areas. Also, due to the country's shrinking population, Japanese companies will need to push into other economies to ensure future growth and prosperity.

4. Significant M&A potential for Japanese companies abroad

Japan's corporate landscape holds numerous large companies that already are or should be international players. It is these large companies that will increasingly use small to mid-sized strategic cross-border acquisitions to pursue their growth strategies. The motivation for Japanese companies to pursue cross-border acquisitions often goes beyond simply entering a new geography to acquiring specific technologies, products and/or upstream/downstream vertical functionalities to further strengthen their existing core business. Also, the increasingly global economy and emerged awareness of the necessity of mergers and acquisitions clear the way for more Japanese involvement in global M&A.

There is a worldwide trend to an increasing share of cross border deals. The following exhibit compares the mix of domestic and cross border deals of Japan and other selected countries over the years 2005 – 2007:

Cross border deals vs. domestic deals 2005-2007



Source: Thomson Financial
 Note: Completed Deals

Compared to other countries Japan has been cautious in terms of cross border acquisitions. While the share of cross border deals in total deals has increased by 3 percentage points to reach 17% in 2007 compared to 2005 in Japan, other countries such as the UK, France and Germany feature shares of around or even more than 50%.

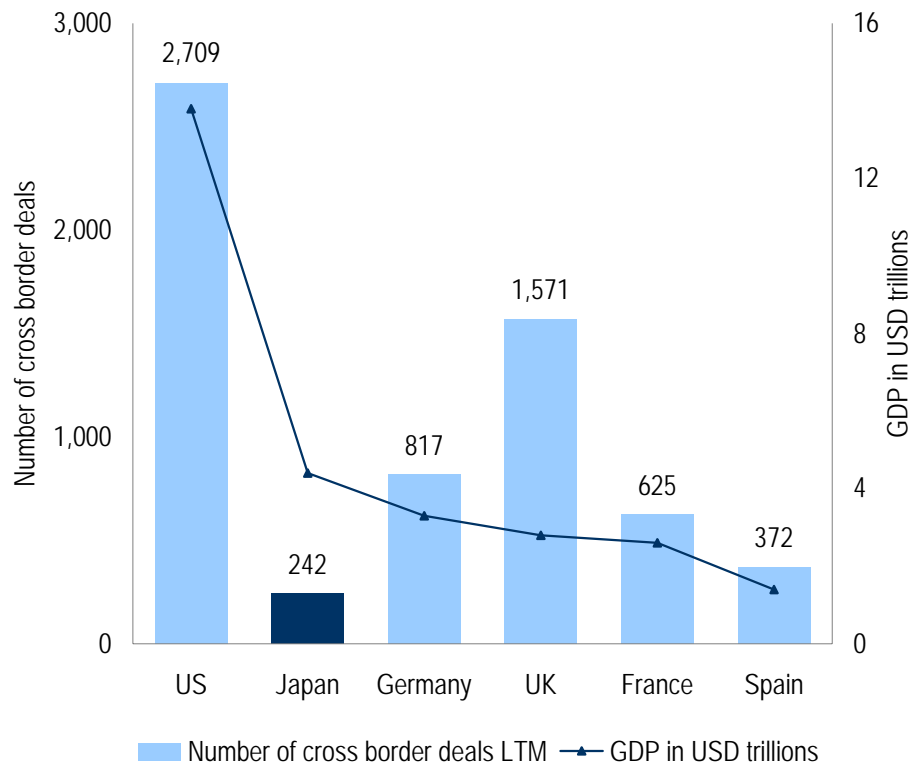
2007 GDP

Country	GDP
US	13.8
Japan	4.4
Germany	3.3
UK	2.8
France	2.6
Spain	1.4

Source: IMF
 Note: GDP in USD trillions

Moreover, while Japan's GDP of USD 4.4 trillion in 2007 is larger than the GDP figures of the cited European countries, the M&A activity is relatively low. For instance, in the last twelve months Spain had 50% more cross border transaction while having an economy less than one third the size of Japan; or while having an economy of less than half the size of Japan's the UK recorded 6.5 times more cross-border deals than Japan. Similarly, the United States had over 11 times the number of cross-border transactions while its GDP is only 3 times larger. The following exhibit highlights Japan's significantly lower level of cross-border M&A transactions:

GDP and number of cross border deals LTM



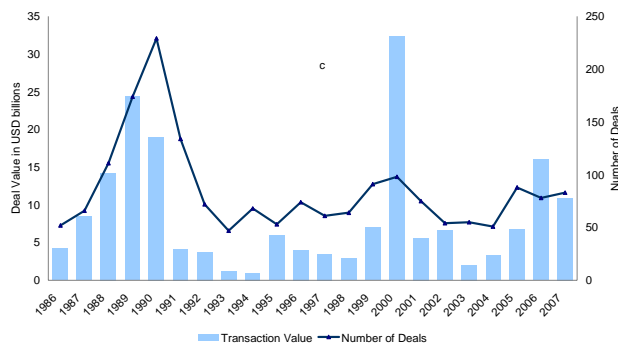
Source: Thomson Financial
 Note: Completed Deals

In order for Japan to reach the same ratio of cross border M&A to economy as recorded in the US and European countries, the number of cross border deals would need to increase by over three and a half times.

The lag in cross border acquisitions is partially rooted in the past corporate culture which has not been conducive to aggressive M&A strategies but also has to do with the perception of Japanese corporate buyers. In the last decade sellers and their advisors did not have to rely so much on Japanese buyers because of a 'hot' market. Therefore, sellers often hesitated to involve Japanese buyers in auctions as they are known to proceed cautiously by seeking broad internal consensus before making decisions. Thus, one of the crucial success factors for Japanese corporations in quest of international acquisitions will be to have the right advisors who will ensure that they compete effectively in the auctions or who can help them to circumvent these completely.

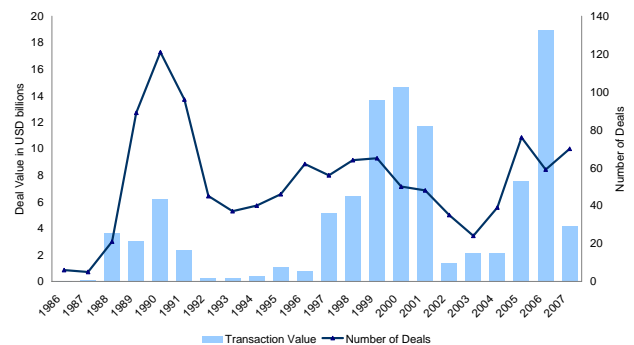
Clearly, there is great potential for Japanese international M&A activity. The following charts of selected target regions reveal that current M&A activity levels are lower than where they have been and far from where we believe them to be headed:

Japanese M&As involving U.S. targets in the years 1986-2007



Source: Thomson Financial
Note: Completed Deals

Japanese M&As involving European targets in the years 1986-2007



Source: Thomson Financial
Note: Completed Deals

INCREASING RELEVANCE OF BUYOUTS

The Japanese market has not been adversely affected by subprime crisis

According to *International Financial Law Review*, Japan exhibits a significant increase in the number of management buyouts in recent years. While in 1997 there were no MBOs, the number increased to 33 in 2001, 67 in 2005 and 89 in 2007. According to the same source, the number of transactions initiated by investment companies (including buy out funds) is also increasing: in 1998, there were only two transactions while in 2003, 149 were recorded; the number exceeded 300 for four consecutive years from 2004 reaching a record high of 402 in 2007. According to the Japan Buy-out Research Institute, the first buy out fund in Japan was established in 1997, while in the years between 1997 and 2006 a total of 110 buyout funds came into existence.

The following selection of buyout transactions after the summer of 2007 demonstrates that Japan's buyout market is continuing to grow, despite the subprime loan crisis and its aftereffects:

Selected recent buy outs in Japan

Date	Target	Seller	Acquiring Fund	Deal value
Aug-07	Yayoi Co.	Livedoor Holdings Co. Ltd.	MBK Partners	USD 610m
Oct-07	Arysta LifeScience Corp.	Olympus Capital	Permira	USD 2.2bn
Dec-07	Tokyo Star Bank	Lone Star Fund	Advantage Partners	USD 2.2bn
May-08	NH Techno Glass Corp.	Hoya Corp. and Nippon Sheet Glass	Carlyle Group	USD 560m

Source: Press

Growth of the buyout market in Japan will contribute to the country's increase in M&A activity. It will also play a crucial role in the further transformation of the M&A market, as buyout funds are likely to push their Japanese portfolio companies to make cross border add-on acquisitions in order to realize growth potentials.

NEW ERA OF JAPANESE M&A ACTIVITY IS APPROACHING

M&A activity lead by mid-market deals rather than 'mega-mergers'

Lincoln International believes that while forthcoming M&A activity in Japan will be robust, it will differ from the activity seen in the country both in the cross border boom of the late 1980s and early 1990s and the substantial increase in M&A since 1999. During the bubble economy M&A boom starting in the late 1980s, most cross border transactions were "mega-mergers". The M&A boom since 1990 has been mostly domestic restructuring. We see that the next phase of the Japanese M&A market will be cross border focused and involve mostly mid-market transactions.

In the U.S. and Europe, the sellers of companies can be divided into four general categories: 1) private owners, 2) private equity owners, 3) divestitures from larger companies and 4) sale of entire public companies. Each of these ownership groups have different dynamics.

With private owners selling their company, the intention is to cash out and retire. Generally, these companies lack good and/or deep management. Foreign owners such as Japanese companies need to be very careful about buying many privately owned businesses.

With private equity firms, they generally have the strategy of selling companies only after they have developed very capable management teams and created a strong company companies. These are the type of deals that are generally attractive to foreign companies and specifically Japanese companies. The challenge, however, is that most private equity deals are sold through an auction

process, which gives the buyers limited time to complete their due diligence. Typically Japanese companies do not participate in auctions.

With divestitures from larger companies, the businesses being sold are viewed as non-core. Most businesses are deemed to be non-core because they do not have a good future because of factors such as old technology, declining end markets or non-competitive production capabilities. These businesses usually require an owner that will be very involved in restructuring the business and management team to develop a brighter future. Foreign buyers need to be careful with corporate divestitures.

There are, however, cases where large companies divest quality operations due to major shifts in strategy or clear need for industry consolidation and not being positioned to be the consolidator. Additionally, large companies often have high quality and well trained managers used to working in global organizations. In these cases, corporate divestitures can be attractive and the post-acquisition integration very successful.

With the last category of buying public companies, such deals often are good companies, but the number of such deals is smaller than the other three categories and tend to be large capitalization, not mid-market transactions.

Based on the above commentary on the types of sellers, the best fit by type of company being sold are portfolio companies of private equity sellers and select corporate divestitures.

In regards to private equity firms, the number of portfolio companies of that are being sold is a large and growing number. In the United States alone, there are more than 1,400 funded private equity firms that own more than 10,000 companies. Most of these private equity firms and portfolio companies are mid-market in size. Between the U.S. and Europe the number of mid-market firms being sold by private equity firms each year is in the thousands.

Because of the type of business being sold and number, we think a key factor in Japanese companies successfully completing more mid-market transactions is to successfully buy from U.S. and European private equity firms. The historical problem and challenge is that 80%+ of private equity firms sell their businesses through an auction process, which Japanese companies often decline to participate. Therefore, a key success factor for Japanese acquirers will be to effectively participate in auction processes.

How can Japanese buyers be more successful in private equity auction processes? We believe there are two key actions to be taken by Japanese companies.

First, Japanese companies need to retain an M&A advisor that has strong contacts and knowledge of private equity firms. Second, the Japanese

companies need to carefully evaluate all the portfolio companies that fit with their acquisition criteria and make proactive approaches to private equity firms.

The best outcome is avoidance of an auction in trying to buy the company. The more likely outcome is that the Japanese company obtains a substantial head start in due diligence, but the business is sold in some form of auction. With the head start on due diligence, the Japanese buyers can now be very competitive in these auctions because they will have time to complete their detailed due diligence efforts and come to consensus within the management team. The role of the M&A advisor is to provide information on the private equity firm portfolio companies, use their relationships to get access to the principal decision makers and information and use their knowledge to advise their clients on how best to avoid or win the auction.

In regards to successfully acquiring corporate divestitures, the best approach is to target businesses that fit the buyer's strategy, rather than waiting to be contacted. Corporations are often cautious in responding to inquiries from strategic buyers and there can be certain competitive issues. To be successful, employing an advisor that is familiar with and respected at the company considering the corporate divestiture can be very helpful. Such an advisor can get more accurate communication from the seller and gives legitimacy to the potential buyers.

The goal of Lincoln International is to help facilitate Japanese buyers become much more active in buying mid-market businesses from private equity and large corporate owners. While this is not the subject of this paper, we believe Lincoln International is uniquely positioned to succeed in achieving this goal.

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