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Corporate divestments, PE investments and activist campaigns: a virtuous circle for Japan

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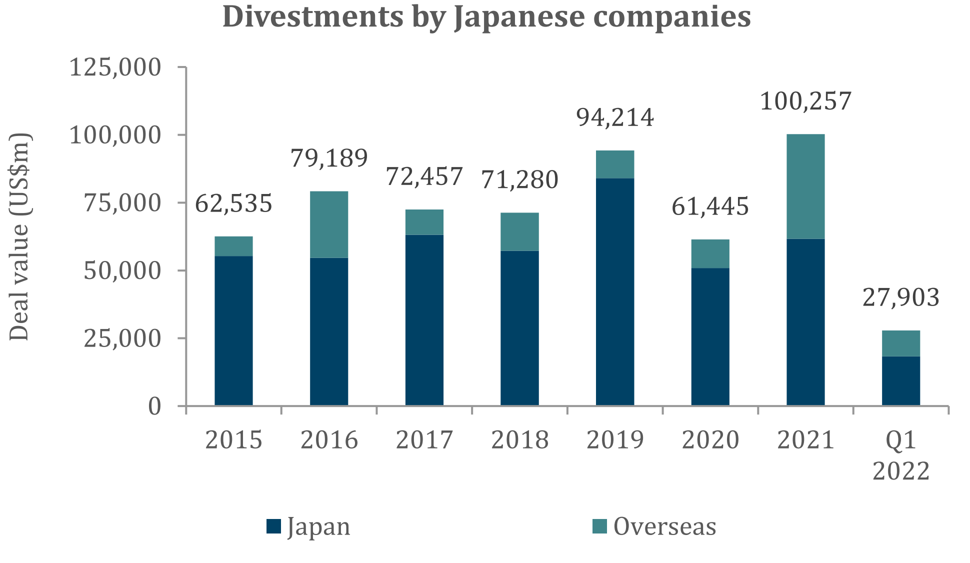
Corporate divestments, PE investments and activist campaigns: a virtuous circle for Japan

In the last few years, several trends have gained traction in Japan's M&A market. The trends had already begun to take hold before COVID, which did not slow their development. In our latest insight, we take a closer look at three of the most significant trends, which are interrelated and are driving one another: 1) divestments by Japanese companies; 2) the ever-increasing activity of PE funds; and 3) the growing influence of activist funds.

Divestments by Japanese companies

The first noticeable trend has been the increasing willingness of large Japanese companies to divest subsidiaries and assets that they have deemed to be non-core. Japanese companies had long been known as reluctant sellers of any asset, especially with such divestments almost traditionally viewed as taboo. However, these sentiments have been rapidly changing, as more and more companies recognise the benefit in, and come under intense external pressure from activist investors to consider (more on this later), divesting non-core assets and allocating the cash/resources to strategic growth areas. This trend is clearly visible in the marked increase in the total value of divestments by Japanese companies in the last few years[(1)]:



Since 2015, there has been a general increase in the total annual deal value of Japanese companies divesting assets; in 2021 it passed the US$100bn mark, while 2022 has also gotten off to a strong start in Q1. In particular, the share of overseas divestments has been increasing markedly.

Source: (1) Dealogic

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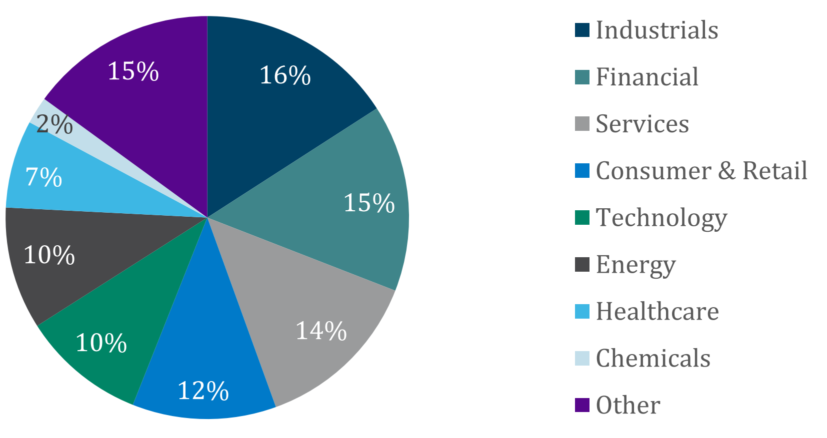
Some of the leading Japanese companies that have divested assets in recent years include Toshiba, Kirin, Shiseido, Panasonic, Bridgestone, Takeda and Hitachi. However, we also expect a growing number of divestments by not only the large-cap Japanese companies, but also the mid-cap companies, which will similarly be driven by changing attitudes and priorities, as well as external pressure from activist investors.

Demonstrated by the variety of the above household corporate names, the divestment trend has been witnessed across all major sectors. The split was fairly even across sectors in 2021, with Industrials, Financial, Services, Consumer & Retail, Technology and Energy all accounting for 10% or more of the total by deal value[(2)]:

Deal value by sector (2021)



We at BDA Partners have been active participants in this trend of Japanese corporate divestments, recently advising:

1) **Toshiba on the sale of its subsidiary in Italy (press release)**
2) **Shimano on the sale of its subsidiary in the US (press release)**
3) **LG Energy Solution on the acquisition of NEC's battery storage business in the US (press release)**
4) **Furukawa Electric on the establishment of a global JV for magnet wire (press release)**

This trend remains strong and we are actively advising other Japanese clients on strategic options for their non-core subsidiaries.

Source: (2) Dealogic

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In conclusion, we believe that the increasing divestments made by Japanese companies are driven by fundamental changes in the market and will only accelerate as smaller companies join the trend. This will in turn provide significant opportunities for PE funds to grow in the Japanese market, as they represent an attractive destination for companies to divest their carved-out businesses.

Ever-increasing activity of PE funds

It has been over 20 years since the world's biggest PE funds first entered the Japanese market, but the past few years have seen a fresh wave of global GP capital flowing into Tokyo. In 2018, the likes of New York-headquartered Apollo Global Management and Blackstone established PE buyout teams in Tokyo after previously focusing on other asset classes such as real estate, and more recently, 2021 saw Sweden-based EQT and Hong Kong-based PAG (re)joining in on the action. While EQT has yet to make its first Japanese investment (it did, however, recently announce the acquisition of Baring Private Equity Asia, which has its own sizeable Tokyo team), Apollo and Blackstone have been busy putting their dry powder to work: the former acquired Showa Denko's aluminium cans business and Mitsubishi Chemical's polycrystalline alumina fibre business, while the latter acquired Takeda's consumer healthcare business, among other investments.

Japan's domestic PE funds have also been highly active in their investments as well. In aggregate, **the total value of PE investments in Japan reached a record in 2021 with US$28bn**, which represented **a 152% increase compared to 2020** and **a 138% increase compared to the average between 2016 and 2020**. It was a similar story on the exit side, with **the total value of PE funds' divestments in Japan worth US$16bn in 2021**, **a 486% increase compared to 2020** and **a 123% increase compared to the 2016-2020 average**. Another noteworthy trend of the Japanese PE market is **the proportion of buyout deals**, which stood **at 85% of the total in terms of value**, which is **by far the highest among Asia's major economies**.(3)

Total PE investments in Japan

152%+ increase
2021 vs. 2020

138%+ increase
2021 vs. 2016-2020 average

85%
Share of buyout deals (highest among Asian's major economies)

Total PE divestments in Japan

486%+ increase
2021 vs. 2020

123%+ increase
2021 vs. 2016-2020 average

Source: (3) Bain & Company, AVCJ

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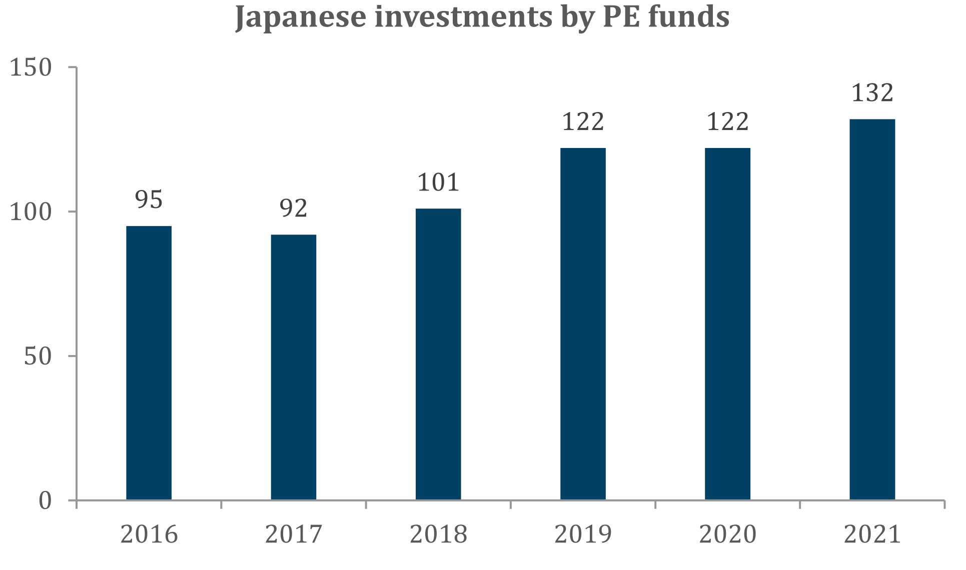
This sharp rise in investment by PE funds is backed by their aggressive fundraising activities in recent years: **fundraising by PE funds in Japan reached an all-time high in 2020 at nearly US$8bn**, which was **more than double the amount raised in any year since 2006** (it is important to note that this figure does not include funds raised by PE firms that make Japanese investments out of regional or global funds). The largest recent Japan-focused fundraises include Carlyle's fourth Japanese buyout fund (nearly US$2bn), Polaris Capital Group's Fund V (nearly US$1.5bn) and Integral Corporation's Fund VI (over US$1bn). Two reasons that have been attributed to this elevated level of fundraising are: 1) low interest rates and the flow of capital towards expected high returns; and 2) the increasing appetite for providing risk capital towards enhancing the industrial competitiveness of Japan.(4)

As PE funds in Japan have been raising ever-more capital and dry powder has increased rapidly, this money has been reflected in the number of investments made by the PE funds – the number of Japanese PE investments and portfolio companies held by PE funds has been consistently rising in recent years(5):



Sources: (4) PwC, Refinitiv; (5) MARR, PitchBook, PwC

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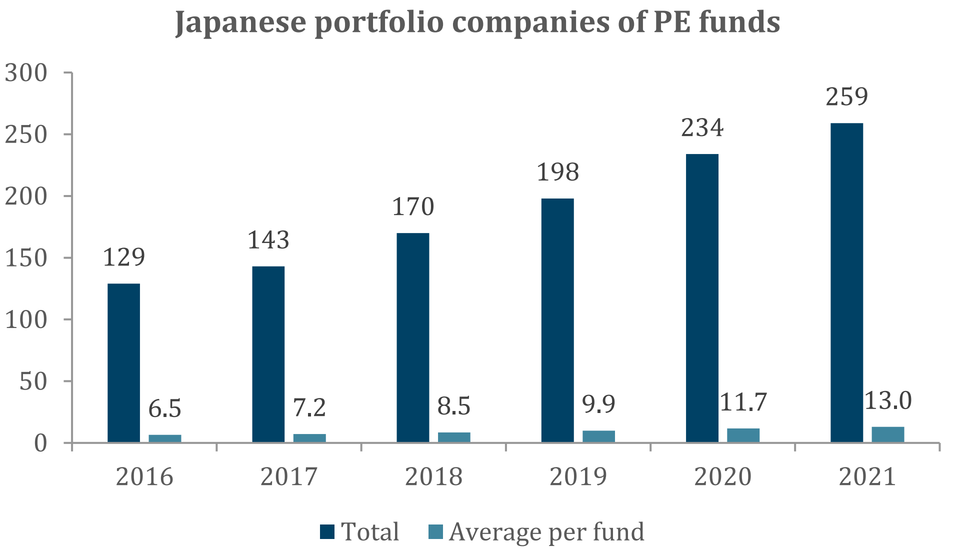

As mentioned in the previous section, one major reason for the rise in PE investments in Japan is the increasing number of divestment opportunities from companies, as PE funds are typically appropriate new owners of corporate assets. In fact, the most notable theme of recent buyouts by PE funds in Japan is their propensity for carving out businesses from major Japanese companies. This is said to be the primary reason for the latest rush of global PE funds into the Japanese market: as already mentioned, divesting non-core assets was long seen as taboo, and particularly so when the acquirer was an overseas fund, who was often labelled as a "vulture fund" and a "barbarian". However, there has been a noticeable shift in the thinking of Japanese companies as they increasingly acknowledge exiting to PE funds as a viable option to achieve their corporate goals.

Other notable corporate carveouts by PE funds include:

- Acquisition of Hitachi Transport System by KKR
- Acquisition of Hitachi Construction Machinery by Japan Industrial Partners and Itochu
- Acquisition of Hitachi Metals by a consortium led by Bain Capital
- Acquisition of Showa Denko's printed wiring board business by Polaris Capital
- Acquisition of Shiseido's personal care business by CVC Capital Partners

In summary, PE activity in the Japanese market has been on a constant rise over the past few years. A major driver of this has been the increase in divestments by Japanese companies over a similar period, a space in which PE funds will continue to play a key role given their increasing fundraises and dry powder.

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The growing influence of activist funds

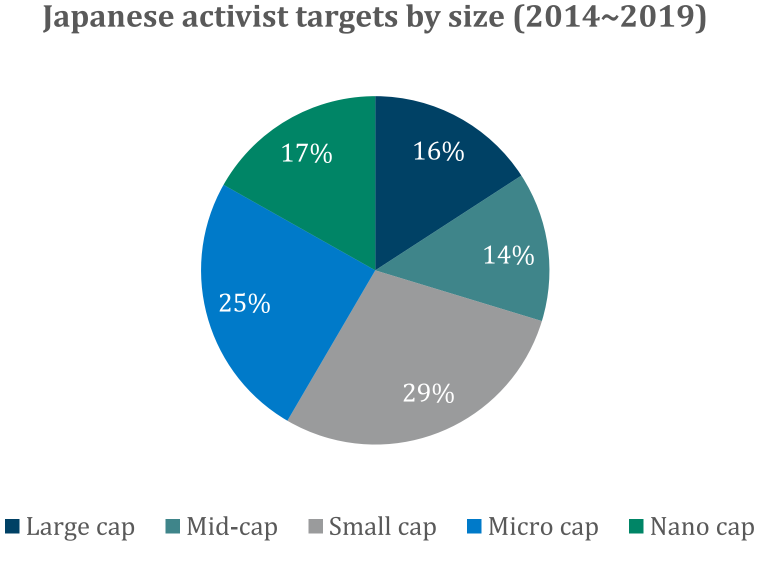
Another trend in Japan over the past few years has been the increasing influence of activist investors over their investee companies. Activist investors focus on building up stakes in undervalued listed companies and using their shareholder rights to strengthen companies' corporate governance and otherwise boost their corporate value. A major reason why activist investors have been interested in Japan is the historically cash-rich, low-return nature of Japanese companies. At the end of the 2020 fiscal year, companies listed on the Tokyo Stock Exchange held a total of ~US$4.0tn of cash on their balance sheet. Activist investors are keen to encourage these companies to put the cash towards more efficient use, such as investing in growth and distributing to shareholders, with the goal of achieving higher return-on-equity targets.

The number of campaigns in Japan by activist investors has been increasing consistently in recent years, to the point where the country ranked second globally in H1 2021[(6)]:

Activist investor campaigns in Japan

10 campaigns	#2	6% → 26%
H1 2021	Highest market globally	Japan's share of non-US shareholder campaigns, 2015 vs. H1 2021

The companies that have been targeted by activist investors have had a fairly varied mix in terms of size and sector, which indicates that activists consider all segments of the Japanese public markets as potential targets[(7)]:



Sources: (6) Lazard; (7) Activist Insight

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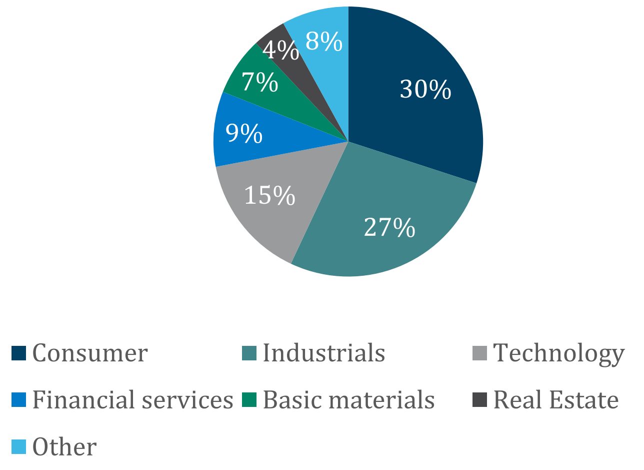
Japanese activist targets by sector (2014~2019)



Toshiba's attempts to thwart activist funds have dominated the Japanese financial press over the last year, but Toshiba is far from being the only Japanese company to be targeted by activist hedge funds: the likes of Olympus, Seven & i Holdings (both ValueAct Capital), LIXIL (Platinum Asset Management) and Kirin (Independent Franchise Partners) have also seen activist investors enter their shareholder registers.

As activist investors have gradually enjoyed successful campaigns, other major global activists such as Elliott Management and Third Point have entered the Japanese market, in a similar fashion to the global PE funds mentioned in the previous section. Third Point has targeted Sony, while Elliott has targeted Toshiba and SoftBank.

With regard to Toshiba, Bain Capital announced in April 2022 that it had been working with activist investor Effissimo Capital Management, Toshiba's largest shareholder, to secure its support for a potential take-private offer for the whole company, while 3D Investment Partners, another activist investor and Toshiba's third-largest shareholder, also expressed its desire for the privatisation of Toshiba by a PE fund. Following these developments, Toshiba decided to solicit proposals on "strategic alternatives" from a targeted group of investment funds and received ten such proposals (eight of which were for privatization), with four proposals being shortlisted to conduct further due diligence. In the meantime, Farallon Capital Management, Toshiba's second-largest shareholder, and Elliott Management have secured one board seat each as independent directors.

These developments underline the increasing collaboration between PE funds and activist hedge funds to improve the value of corporate Japan, with increasing degrees of success.

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One of the primary demands by activists for their targets is related to M&A, including the divestment of non-core assets to raise capital to be invested in other areas or distributed to shareholders. Although balance sheet-related demands have always been the biggest topic for activists, **the share of M&A-related activism has been on the rise, with 17% on average between 2014 and 2019**. As examples, Independent Franchise Partners called for Kirin to divest its non-beer assets, while ValueAct Capital has been pushing for Seven & i to divest non-core assets and focus on its 7-Eleven convenience store chain. As more activist investors become active in Japan and the number of M&A-related demands rises, we expect the number of divestments by Japanese companies to continue increasing further.

In conclusion, we expect Japanese companies to commit to even more divestments going forward, partly driven by external pressure from activist shareholders. In turn, corporate divestments would lead to further growth of PE investments in Japan, backed by the record levels of dry powder available to PE funds; and as shareholder activism continues to grow in Japan, more companies would be pressured to divest non-core assets, thereby continuing the cycle.

We at BDA Partners will continue to monitor closely and actively partake in these, and other, trends in the Japanese market, as we strive to deliver optimal solutions for our corporate and financial sponsor clients in Japan.

Relevant transactions advised on by BDA

TOSHIBA	SHIMANO	LG Energy Solution	FURUKAWA ELECTRIC GROUP
Divested Toshiba Transmission & Distribution Europe to	Divested PEARL iZUMi USA to	Acquired NEC Energy Solutions from	Established a JV with
MUTARES	UNITED SPORTS BRANDS	NEC	SUPERIOR ESSEX
2022	2022	2022	2020

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