KPMG FAS Newsletter

Driver

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Close-up

A foray into overseas markets

The current M&A environment and its challenges (Part 1)

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Navigating the U.S. M&A market

Authors:
Shinichi Yoshino / Partner (photo left)
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The U.S. ranks as the world's largest M&A market. For the past decade it has been the top M&A destination for Japanese companies, receiving about 3.5 times more Japanese investment than the UK - their next favorite M&A destination. Looking at cumulative totals of the past 5 years, Japan is the world's largest investor in Silicon Valley, with China a distant second. The U.S. is clearly an important market for the future growth of Japanese companies seeking to expand globally, and while the history of Japanese M&A activity in the U.S. dates back to the 1980s, it remains to be a market with inherent challenges that require careful attention. In recent years there are signs of a shift in the reputation of Japanese companies as buyers in the U.S. Below we uncover some of the unique characteristics and challenges of M&A in the U.S., as well as offering some advice for achieving success.

Uncertainties and political risks in the U.S. market

While the US-China trade war began to take hold from summer 2018, it took until January 2020 for the U.S. and China to finally form an agreement - after imposing various sanctions and tariffs on each other - helping avoid further turmoil for the time being. Nonetheless, the first phase of their agreement clearly specified numerical targets for the export of goods and services from the U.S. to China, including more than doubling U.S. agricultural products to China, and with time limits for each item. Depending on how things progress going forward, it is quite possible that dark clouds could appear above U.S.-China relations once again.

Since taking office in 2017, the Trump administration has focused on its "America First" policy. Aside from trade with China, the administration has repeatedly invoked policies that affect how business is carried out in the U.S., including sanctions and tariffs on Mexico stemming from the illegal immigration issue. Japanese companies operating in the U.S. need to continually monitor the effects of such administrative policies and seek the advice of experts in related fields.

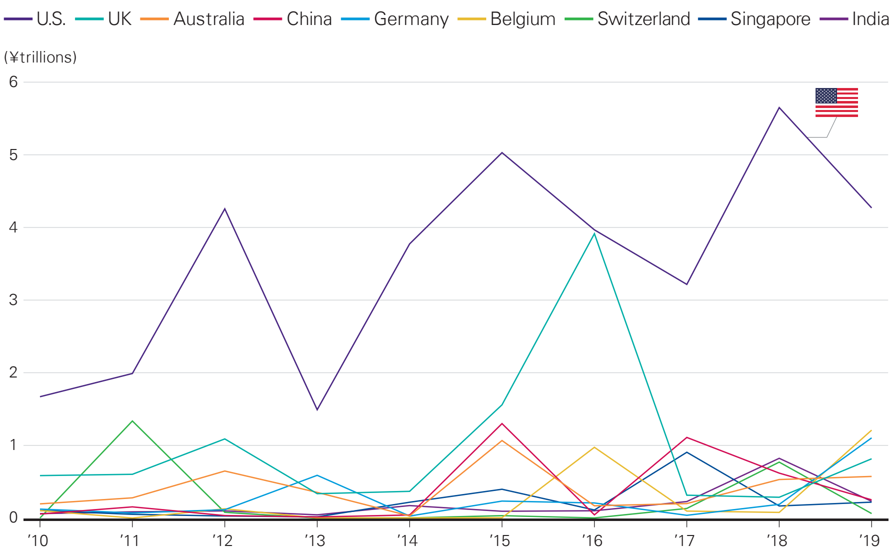
As a foreign company considering investing in a U.S. company, one law that requires particular attention is the Foreign Investment Risk Review Modernization Act (FIRRMA). FIRRMA gives the Committee on Foreign Investment in the United States (CFIUS) the authority to review and regulate investment in the U.S. from the perspective of U.S. security. FIRRMA regulates foreign investment in U.S. companies with significant technology and industrial bases. In the past, there have been cases where CFIUS pre-screening has prevented foreign companies from conducting large-scale M&A deals with U.S. companies. As shown by the U.S. government ban on Chinese telecommunications giant Huawei, the essential target of FIRRMA is said to be Chinese companies, but Japanese companies also need to consider the impact.

New FIRRMA rules being introduced in February 2020 bring an expanded scope to CIFUS screening, and the definition of technologies important to the U.S. is left unclear, triggering concerns that their interpretation may be expanded. In the future, it is highly probable that this will impact Japanese companies with a presence in China, limiting their ability to conduct free investment activities in the U.S. market. If a company goes to sell a U.S. subsidiary as part of restructuring, there is a chance they could have a deal blocked, depending on who the buyer is.

Speed in decision making

Overseas M&A by Japanese companies has significantly exceeded the volume of M&A carried out domestically in Japan over the past decade. The U.S. has continued to be the largest foreign investment destination for Japanese companies, including during the early 2000s when investment in emerging markets such as India and China became popular. Japan also has the highest track record of any country for investing in startups, with activity mainly centered around Silicon Valley. From 2015 to 2018, the total investment by Japanese companies in Silicon Valley was $24.9 billion, well above China in second with $16.0 billion.

M&A investments by Japanese companies (by country)

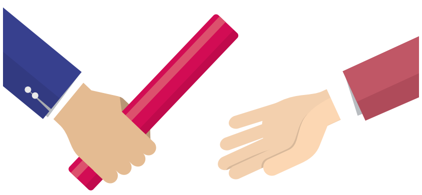


Source: RECOF M&A Database
Note: Excludes Takeda Pharmaceutical's acquisition of Shire (Ireland) in 2018 (approximately ¥6.8 trillion)

Behind this record of investment in Silicon Valley, is a strategy of many Japanese companies to incorporate innovation to strengthen or develop their existing businesses, or to bridge the development of new businesses that will become earnings pillars in the future. While Japanese companies generally seek out startups with innovative technologies and business models in Silicon Valley, they often face various barriers before reaching the point of actually investing. One of the major obstacles is the difference in corporate culture. Startup founders and their shareholders place high value on the speed of operations, and usually maintain clearly defined decision-making criteria. In contrast, Japanese companies take time to make decisions, and in many cases, the person in charge of on-the-ground negotiations is not authorized to make the final investment decision.

It is common for Japanese companies to have locally based staff gathering information without being given a clear investment strategy from their head office. The plan may be to collect some information before deciding the direction and strategy of the investment, but this is inefficient and time consuming.

It is important to clearly define the positioning of M&A within the overall company strategy and to clearly explain the purpose of any acquisition both inside and outside the company. Based on this premise, in order to succeed at M&A in Silicon Valley and in the U.S. as a whole, Japanese companies must utilize their best human resources directly from head office, give them final decision-making power on investment, and have them directly negotiate with sellers of the target company. Since they will be working in partnership with U.S. managers and shareholders who demand a sense of speed in operations, it is vital to proceed with the M&A process efficiently and effectively, while maintaining an unwavering focus on your final goal.



Addressing high valuations and impairment risks

The U.S. is the world's largest M&A market, with an annual scale that has surpassed $2 trillion in three out of the last five years. While it may be the largest overseas M&A destination for Japanese companies, it tends to have high M&A valuations due to the fierce competitive environment. A portion of the premium paid in acquisition price may be recorded as goodwill on the acquiring company's balance sheet, and is subject to impairment risk.

However, in the current business environment, where markets are globalizing and industries are becoming increasingly oligopolized by certain top-tier companies, there is an undeniable strategic risk in not doing M&A in the U.S., in the sense that it would be a missed opportunity to secure a U.S. firm with a well-established brand in the largest economy in the world.

Post-acquisition impairment risk should be considered as part of the overall future growth strategy of the company as an individual entity. The ultimate investment decision is a judgement based on the envisaged value that will be created over the mid to long term as a result of integrating the target company into your own group.

The first step a company should take in M&A to manage the risk of goodwill impairment after an acquisition is to carry out a valuation of the target company based on thorough due diligence (DD). A thorough valuation of the target company based on DD, including its brand power and intellectual property, should be carried out across its business, finance, legal affairs, human resources and IT divisions. While things may be different if the acquiring company has a long-standing business relationship with the target company, for many acquiring companies DD is a process that will need to be carried out on repeated occasions—before and during the M&A negotiations, and even after the acquisition. Based on the results, it is important to establish governance

systems including an appropriate organizational structure and allocation of personnel, and also to continuously implement and review the synergy plan in order to achieve strategic value creation goals.

Retaining key people

Following the acquisition of a U.S. company, maintaining the motivation of its managers and other key people in the company is vital to achieving success with early integration and realizing synergies.

Average annual incomes across the U.S. are generally higher than those in Japan, and depending on the industry and job title they can sometimes be several times the Japan average. It is not uncommon for managers and executives to have exceptionally high income. At a relatively early stage in the M&A process, it is important to gain an understanding of the employment conditions and salary levels of the managers and employees of the target company, and launch a new post-acquisition HR and compensation system, as well as a directive system that incorporates the head office.

Japanese companies carrying out M&A deals often shift the target company to the acquiring company's own employment standards, or they establish a global standard after the acquisition. A change in employment standards may trigger a key person to leave the company, which could not only jeopardize your ability to achieve the original synergy plan but may also affect the performance of existing businesses.

This is an extremely important point, and the head office needs to be prepared to transform itself to match global management standards.

Japanese companies as buyers in the market

In the 2000s when we saw rapid growth in emerging economies, Chinese companies became more active in the U.S. At that time, Japanese companies gained an unfavorable reputation in the U.S. for being slow to make decisions and more likely to engage in prolonged negotiations. Contrastingly, Chinese companies were seen to have comparatively quick decision making and strong financial resources. However, this reputation in the U.S. has recently been changing. Due to the recent sanctions and tariffs and an overall deterioration of U.S.-China relations, Chinese companies have been facing a headwind, and there has been an increase in cases of Chinese companies in the U.S. breaching investment contracts and causing negotiation issues. Despite being cautious in negotiations and investment decisions, Japanese companies are starting to gain a reputation as buyers who respond in good faith once the terms of the contract are determined.

With its world-leading and continuously growing economy, the U.S. attracts talent from around the world, not only to Silicon Valley but across all its centers. The U.S. will remain a center of global business, and a core target for Japanese companies seeking to fulfill their growth strategies and global business goals. Despite some uncertainty about the business environment, both U.S. and overseas companies are essentially on a level playing field. Our hope is that many Japanese companies can successfully overcome the unique challenges of M&A in the U.S., surpass global competition, and build a sustainable growth base for the future.

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