THE GLOBAL CHALLENGE:

APPLYING BUSINESS TRANSFORMATIONS IN CORPORATE JAPAN

BAKER & MCKENZIE

MERGERMARKET

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Foreword

Based on market data, business leaders in Japan today are ready to take their companies global. We have seen this in increasing waves of outbound M&A emanating from the country, transactional activity that has shown new vigor in the past four years. This is happening as the double challenge of a major demographic shift – a declining and aging population – and overcrowded domestic market place pressure of corporate Japan's bottom-line.

However, becoming a global corporation requires more than completing a handful of cross-border transactions. Doing so means re-evaluating internal operations, optimizing business structures, and maintaining best practices that have worked in the past, discarding those that have not, and integrating innovative and international ideas into the existing corporate conscious. We call this business transformation.

Across the globe, corporations are transforming, deploying a variety of tactics to instill change and enter the global arena, where higher returns and new sources of revenue can be found. Japanese corporates are also following this trend, although perhaps at a different pace than their counterparts around the world. This very pace, and their overall strategies and approaches, could be having a profound impact on successes for Japanese corporates as they tackle the global challenge.

This was the motivation behind the research in our report: to analyze business practices among global corporations, comparing Western approaches with those in Japan, and opening the door for a conversation with Japanese business leaders on how to instill the change needed to help their companies reach the next level. Through research on corporate motivations and strategies in Japan, the United States, and Europe, we have compiled a unique overview of these practices and identified key areas – including compliance, HR management, tax concerns, information technology – as a starting point for Japanese corporations to focus on as part of a business transformation.

This report is based on Baker & McKenzie's global experience in cross-border M&A, combined with research and data from Mergermarket, leaders in M&A research. Data was compiled from a market survey of 200 corporations in Japan, the United States, and Europe and contains a mix of quotes from respondents on their experiences in recent cross-border acquisitions and business transformations. Baker & McKenzie partners from our offices around the world contributed practice advice and insights on identifying and addressing challenges in executing business transformations in the key areas we focus on in this report.

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INTRODUCTION:
A CONVERSATION FOR CHANGE

Japan's corporate leaders are quickly discovering that keeping pace with intensifying competition and game-changing technology in the current market demands a reconsideration of the traditional approach to business and management strategy. While this requires adopting an enhanced international mindset it does not mean abandoning best practices and values that these corporations have relied upon. After all, they would not have reached their current positions in the market without internally developed solutions and tactics for growth and expansion. Rather, it is about building upon what is already known and incorporating new ideas and fresh perspectives into existing corporate structures. It is the start of a conversation on change and a broader transformation to grow, improve, and succeed.

To complete this kind of transformation, Japanese business leaders must look inward, analyzing what has produced the best results in the past and amalgamating these with innovative practices used in the global corporate community. Above all else, creativity is key. In this way, a better determination can be made on how to engender change and accomplish long-term corporate strategy.

When implemented changes result in mere "internal reorganizations" – rather than a full business transformation – there are still causal effects which have merit to the company. However, to bring about a broader and more impactful transformation, in addition to bricks-and-mortar assets, proactively adopting ideas, talent, and even innovative ideas from the external environment is essential. A common way of achieving this involves conducting a large cross-border deal, so that it becomes inevitable for the headquarter company to become global.

Market data supports this notion. Over the past four years, corporate Japan's outbound acquisition activity has seen a noticeable uptick. This rise in cross-border activity, is being driven, to a large extent, by a domestic transition as a major demographic shift, aging population, and increased competition take their toll on corporate profits. As such, Japanese business leaders may be beginning to realize that relying on the domestic market or even minority investments abroad will not ensure their survival. In addition, Japanese corporations have started to realize that fundamental changes must take place for their corporation to become truly global. In order to achieve this goal, they have recognize that large-scale cross-border acquisitions can be the catalyst to instigate this change, and prioritized cross-border market activity,

The difficulty, or perhaps the more forward-thinking "opportunity", is that Japanese corporations still have many hurdles to overcome. Often cited by Japanese corporate leaders in their cross-border undertakings, differences in language, culture and common practice have been known to create headaches between buyer and seller. To some degree, these have also been known to stand in the way of higher success rates.

This report attempts to address some of these issues and commence a dialogue with corporates facing similar challenges. Through continuous conversations and self assessment, ideas can be explored and tailored solutions can be formulated, that will ultimately lead to further success for corporate Japan and its global endeavors.

The Baker & McKenzie perspective

"Business transformation is about optimizing the business. You streamline the existing internal operating model by integrating new assets that will raise efficiency and add value to the whole company, or achieve the same by various other means. It's about realizing what you need to change versus what you don't need to change to achieve these ends."

Kirsty Wilson
Head and Partner of the Global Transformations Group, Baker & McKenzie, London

The Baker & McKenzie perspective

"The way in which these transformations are executed differ from company to company, location to location, management to management. The key to any successful execution is to study these differences, and work out a solution which is conducive to the existing environment. For Japanese companies, this means elucidating the domestic successes of the past, and applying them to the global business world in a technique that is unique, sensible and solution-oriented."

Hiroshi Kondo
Head and Partner of the Corporate/M&A Group, Baker & McKenzie, Tokyo

EMBRACING CHANGE:

BECOMING A GLOBAL COMPANY

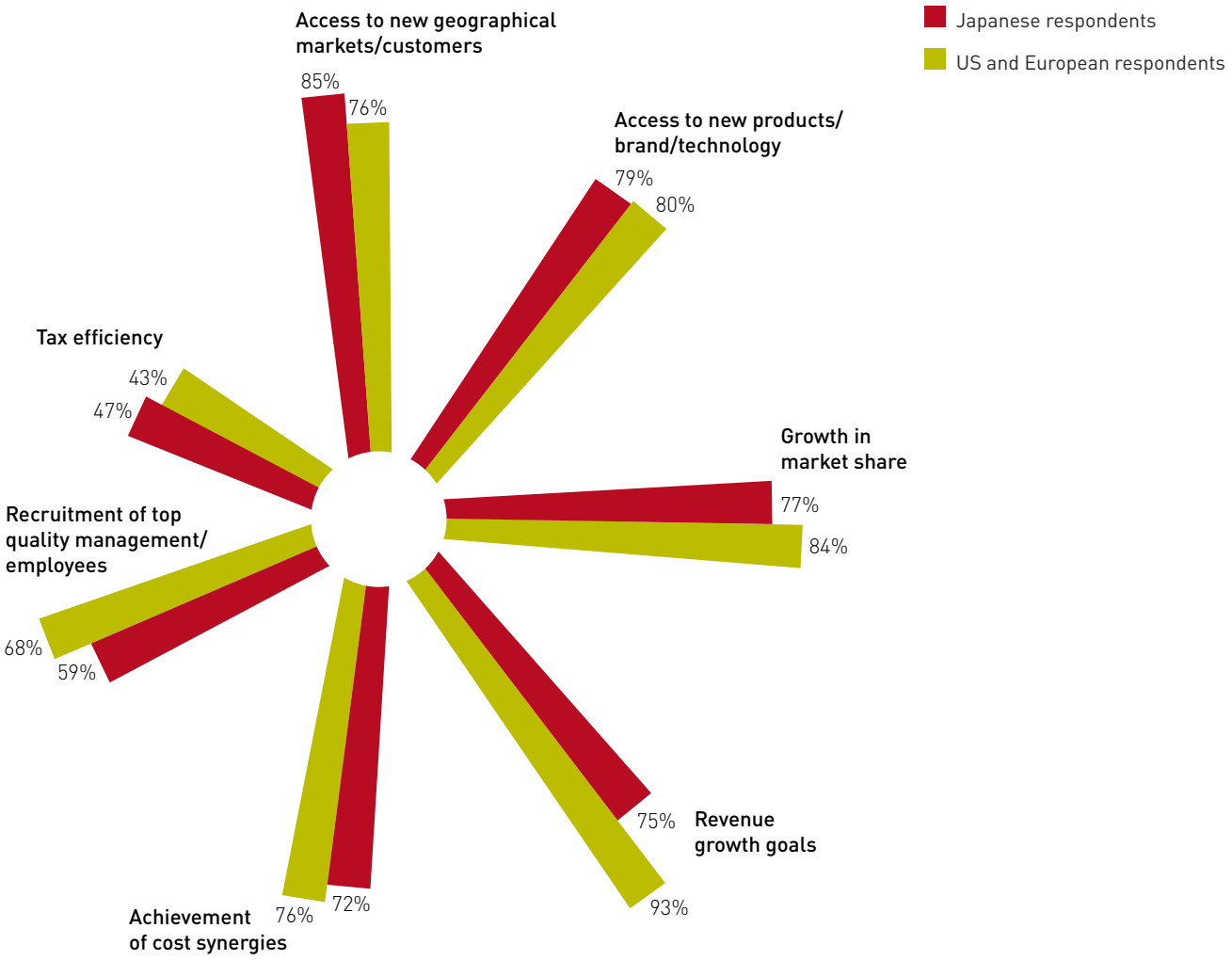
Going global: Deal drivers

International M&A opens the door for corporations to realize geographic synergies that may not be available in their home markets. As enticing as these prospects may appear, operating outside the familiarity of their home markets can leave even the most experienced companies vulnerable to a network of new challenges. These were frequently noted obstacles among Japanese participants in our survey. There are also differences in goals and issues between acquisitions made in mature and emerging markets.

In their decisions to go global, the motivations among corporations from Japan, the United States, and Europe were largely aligned in terms of the strategic and financial rationale. In both respondent groups, top consideration was given to accessing markets and customers, achieving revenue growth, acquiring new products, brands, and technology, and growing market share (Figure 1).

While the similarities are apparent, real differences emerge when putting the success rates

Figure 1: Strategic and financial objectives of respondent global expansion strategies



of these endeavors under the microscope (Figures 2).
In most instances, US and European respondents said their recent acquisition met expectations, with achievement rates above 50%. In some instances, these figures reached 75% or higher.

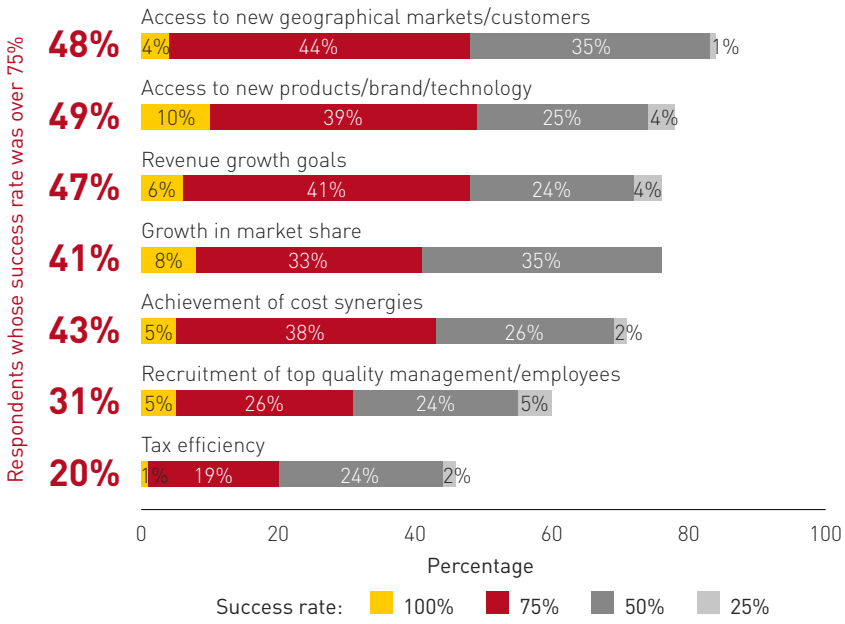
The one area where Japanese respondents had greater success was in achieving cost synergies. As one of the prevailing goals of most, if not all, acquisitions, realizing synergies that meets expectations is a feat in itself. This is especially true as research shows that the majority of transactions, especially international deals, fail to yield anticipated value and achieve growth targets.

In our analysis, data showed that both respondent groups placed roughly the same emphasis on execution of pre- and post-deal issues. Yet, a closer examination of the rates of success and post-deal participation from various parties within the companies (addressed later in this report) paints a very different picture indeed.

In greater numbers, US and European respondents said objectives within each of the main categories achieved either 75% or 100% of the desired results (Figures 3). In contrast, a larger number of Japanese respondents only achieved up to 50% of their targets. This was most noticeable in compliance

Figure 2: Success rates upon execution and completion of global expansion strategies

Japanese respondents



US and European respondents

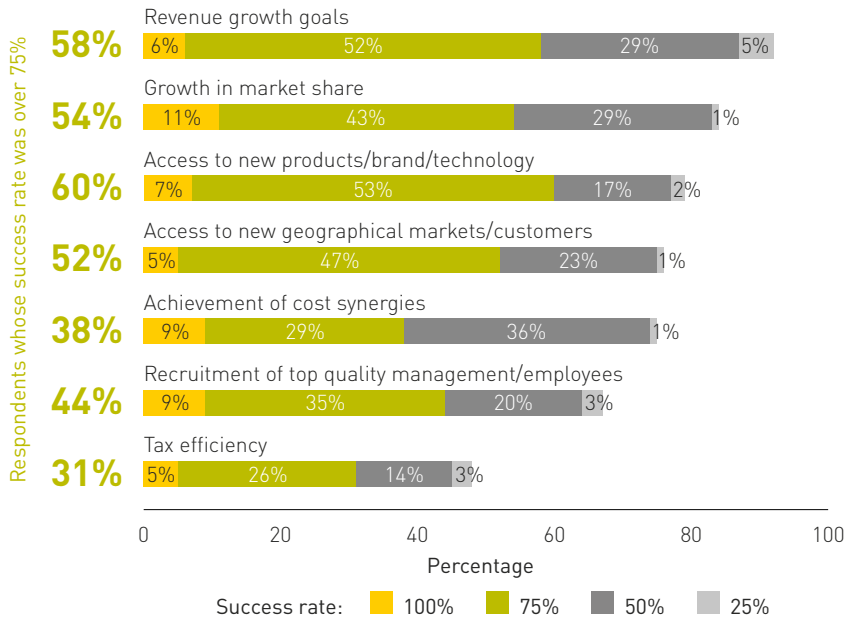
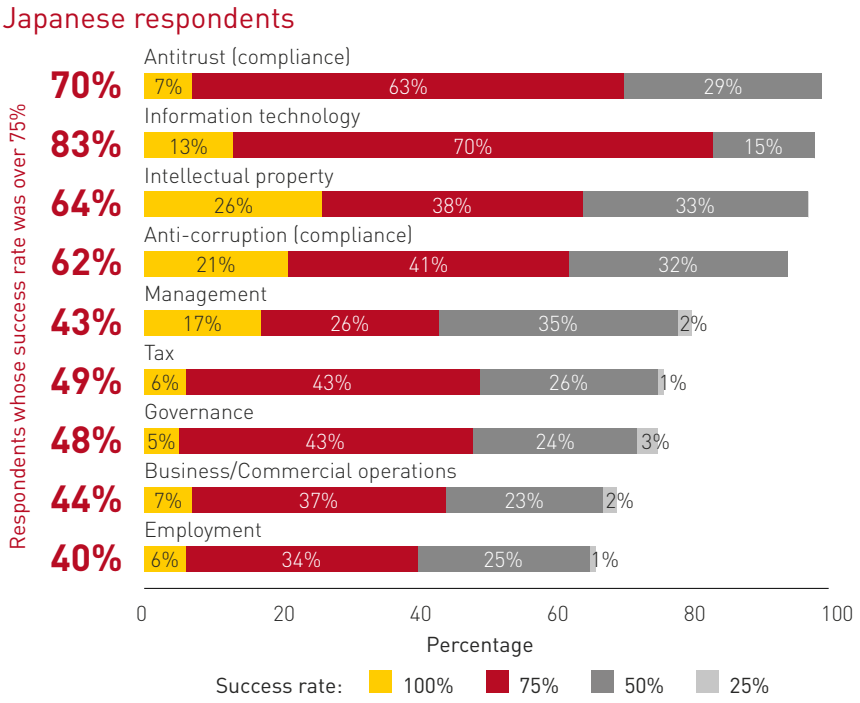
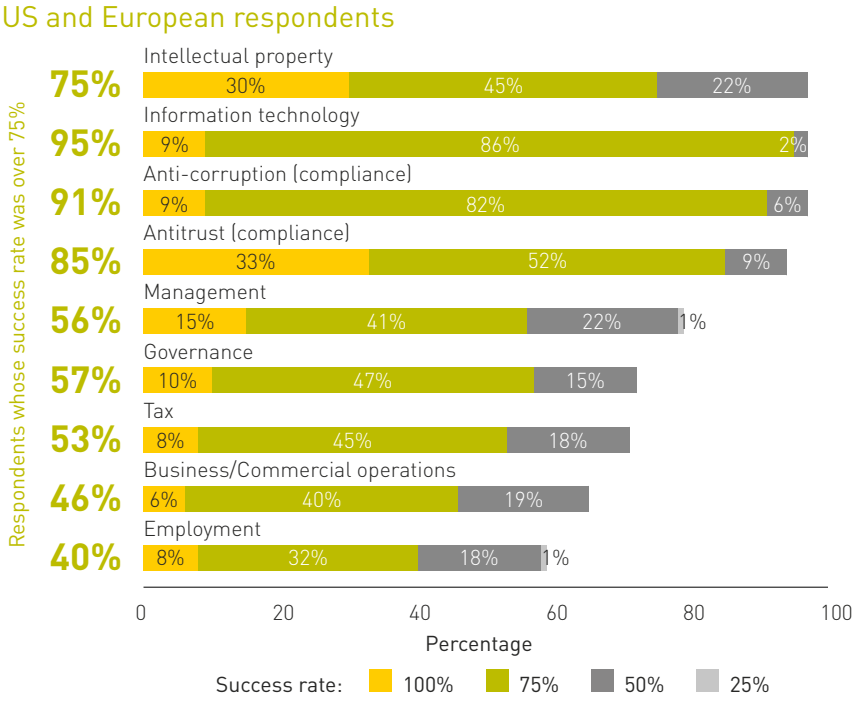


Figure 3: Tasks executed in implementing business transformation





where US and European-implemented antitrust and anti-corruption programs saw some of the greatest differences in success over their Japanese counterparts. As you will see, this applies throughout this survey. Since the weight of self-evaluation on "success" is not consistent across corporations and individuals, this may partly be attested to the fact that Japanese corporations apply a stricter measurement on realizing goals.

The qualitative responses from Japanese respondents shed extra light on some of the reasons why these success rates were so low. For one, limited experience in the cross-border domain played to their disadvantage. As the director of strategy at a Japanese tech company pointed out, "One of the biggest challenges from our recent cross-border transaction revolved around integrating tax, financial, and legal functions within the two companies. Since we'd never operated in this market before, our inexperience prevented us from achieving all our goals and successfully integrating functions." Likewise, numerous instances of cultural incompatibilities and communication barriers were cited as the proverbial nail-in-the-coffin that sealed the fate of a number of international transactions.

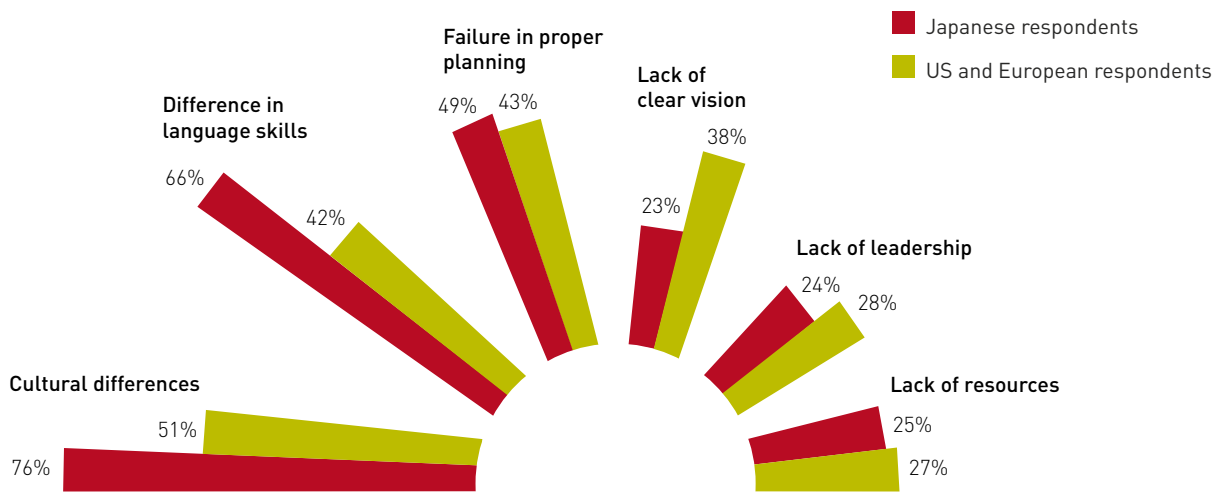
When language and culture collide

Longstanding traditions and culture, be it national traditions or local business practices and standards, within each country matter more than some dealmakers realize. While an inherent part of international deal-making, cultural clashes and corporate incompatibility when left unaddressed can spell doom for an acquisition. In our analysis, corporate leaders across the world recognized cultural differences as the top challenge in executing their recent cross-border deal (Figure 4). Three out of four Japanese respondents held this belief, as opposed to only half of respondents from the US or Europe.

The language barrier also added to difficulties. Communication is key to ensuring the corporate strategy percolates throughout the target organization. When language becomes an issue, these messages can be lost or misinterpreted, causing the overall mission to miss its mark. As the director of strategy at a Japanese consumer goods company notes from experience in one of his recent cross-border transactions, "Inefficient language skills and our inability to communicate with the seller reduced the effectiveness of the conversation. This, matched with the overall cultural differences, quickly stacked up against us and became difficult to address later in the process."

For Japanese business leaders, cultural issues may be even more entrenched and less flexible than their counterparts in the US and Europe. For this reason, Japanese business leaders must consider re-evaluating their overall approach and mentality to several key areas of the M&A process to yield the results they have set out to achieve. The broader question, however, remains how to do so.

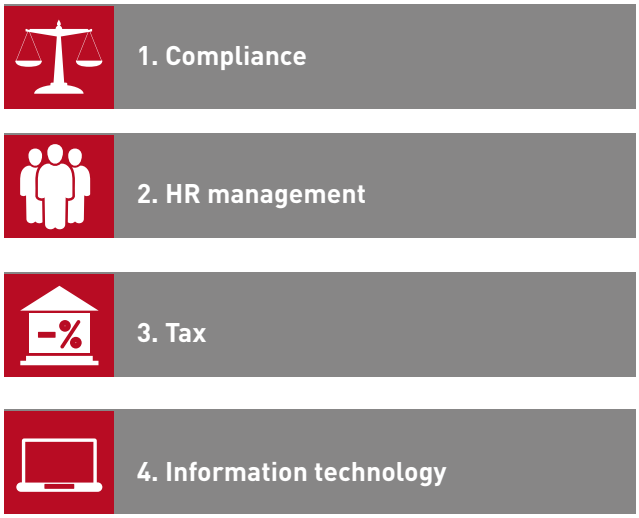
Figure 4: Greatest deal challenges in recent business transformations



Focus areas: Where to start

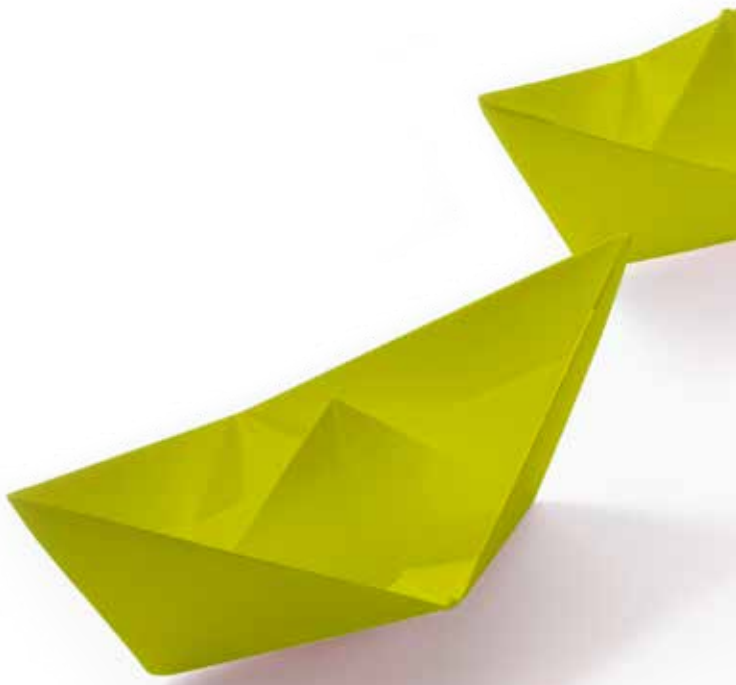
From our analysis of data and respondent commentary, we have focused this report on four areas where lower rates of success point to greater improvement opportunities for Japanese corporates to reassess current approaches and consider new practices to adopt. These areas appear to be on the corporate conscious of the majority of Japanese executives and decision-makers, based on the sheer number of references made during follow-up interviews. These areas were particularly relevant due to the impact – both positive and negative – they could have on early deal developments. Perhaps more importantly, they had some influence over the post-deal integration phase when the culmination of corporate efforts either yielded synergies or saw value deteriorate.

These areas involve:



While our report emphasizes these four areas, they are by no means the only issues Japanese dealmakers must consider. Rather, they are a starting point to analyzing the challenges – both seen and unseen – facing Japanese business leaders, as well as their US and European counterparts, as they set out to become global companies.

> This report focuses on four areas where lower rates of success point to greater improvement opportunities for Japanese corporates



COMPLIANCE:

MITIGATING ANTI-CORRUPTION AND ANTITRUST RISKS

Recognizing the risks

Risk and compliance issues sit at the forefront of challenges facing cross-border dealmakers. These matters can be tricky for acquirers unfamiliar with the regulatory and business environment in a target's market.

The importance of compliance as it relates to anti-corruption and antitrust was recognized by a high percentage of Japanese respondents (Figure 5). Addressing this issue, the director of strategy at a Japanese consumer goods company said compliance was among his company's most pressing undertakings. Describing a recent transaction into Southeast Asia, he said that "due to a relative lack of transparency and higher levels of corruption in this country and other emerging countries where we operate, we had to be even more vigilant in maintaining our company's image and avoiding unnecessary losses or litigation due to compliance oversight."

This director was not alone in his cautious stance toward emerging markets. As an ongoing trend, a large portion of Japanese respondents noted greater compliance concerns in emerging markets over more advanced economies. Part of this stems from the wide reaching influence of FCPA, which stipulate that the acquirer in a cross-border transaction may be liable for bribes paid by its subsidiary either before, during, or after the deal has been completed.

Figure 5:
Compliance programs implemented

Anti-corruption

Japanese respondents: 98%

US and European respondents: 96%

Antitrust

Japanese respondents: 100%

US and European respondents: 96%

The global fight against corruption

Legislation in a number of markets has seen compliance rise up the corporate agenda in recent years. The Foreign Corrupt Practices Act (FCPA) in the United States holds companies doing business or issuing securities in the US accountable for engaging in acts of bribery or corruption. This applies even if offenses are committed outside US territory. The UK Bribery Act 2010 also carries heavy penalties for violators and applies to conducts outside the UK even between private businesses.

Similar regulations are being considered globally in a worldwide effort to make inroads into fighting corruption. Governments in Australia, the United Arab Emirates, and Canada have stepped up efforts, with legislators in several emerging markets following suit, to clamp down on corruption and anti-competitive practices within their borders.

Rooting out corruption

When conducting M&A in emerging countries where bribery and other corrupt practices can be common, such as those countries comprising the top quartile of Transparency International's list of least transparent countries, a more surgical, creative approach to addressing these issues can help prevent financial loss and reputational damage. One popular tactic in gauging risks and developing a more comprehensive view of potential breaches within the target company is the completion of anti-corruption audits at subsidiary or target offices. Doing so clandestinely through surprise visits to target facilities can help uncover violations overlooked in previous investigations.

"We conducted a surprise audit and discovered a number of corrupt practices involving vendor management, where the target was going with a more expensive option instead of the most cost effective one based on long-term, personal business relations. Because of our audit, we were able to correct this misconduct," said the director of M&A at a Swiss industrials company.

Establishing a specialized team or deploying a compliance officer were also effective measures taken by US, European, and Japanese groups. As one Japanese director of strategy at a consumer retail company said, "We put the various business units and leaders under the microscope, and appointed an efficient team to monitor activities at the target firm throughout the deal. Even the smallest elements were monitored so that there was no oversight."

Avoiding antitrust breaches

As with anti-corruption treatments, respondents implemented a basket of policies and procedures to avoid investigations from antitrust authorities and any affiliated financial and reputational repercussions. A large percentage of Japanese respondents said these policies often focused on establishing a compliance organization inclusive of a compliance officer, compliance committee, and relevant departments, at the subsidiary company.

The director of strategy at a Japanese chemicals company said, "We develop practical tips, guidance and advice to assist our affiliates and subsidiaries in building and reinforcing credible antitrust compliance programs, taking into account both the risks we and our subsidiaries face and the resources available."

The Baker & McKenzie perspective

The best corporate compliance programs have a clearly articulated policy that is not only understood by employees at all levels of the company, but also supported by senior management and executive officers. This support should be strong, explicit, and visible throughout the organization. Top level commitments and oversight can help improve program effectiveness and create disincentive for breaches of standards.

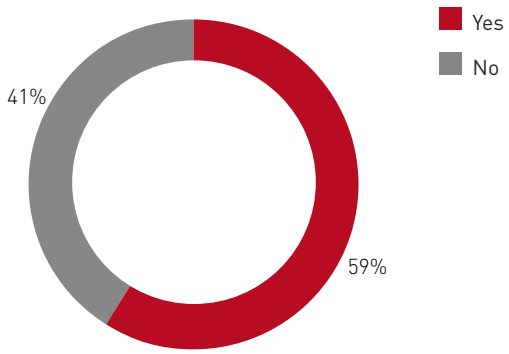
Differences in compliance results

Adopting a culture of compliance early can help manage risks and avoid regulatory missteps. The effectiveness of this culture will depend on the approach taken to compliance. In our survey, the majority of respondents said comprehensive programs were launched to minimize corruption and bribery issues. These programs involved implementing policies and procedures, as well as specialized training for employees and managers.

Perhaps in a display of confidence from recent cross-border successes, a large segment of Japanese respondents felt their compliance programs were more robust than their US and European counterparts. Almost 60% of respondents held this belief, citing internal training and extensive risk mitigation as providing their programs with scope and scale to effectively manage compliance (Figure 6).

Despite overwhelming feedback supporting the strength of compliance efforts, Japanese respondents also noted in higher frequency that these programs more often were only 50% effective in managing risk, adhering to regulation, and fighting corruption (Figures 7 & 8). Comparatively, US and European respondents rated their programs as either 75% effective or even 100% effective. This was likewise true of antitrust compliance between the two survey groups.

Figure 6:
Do you feel your anti-corruption compliance program was more robust than similar compliance programs used by US and European corporations?



In many cases, Japanese respondents cited inexperience in the target market as being one of the root causes of failure. As the director of strategy at a Japanese consumer retail company said, "We were not very effective in evaluating compliance requirements and challenges due to a lack of knowledge about changes in the target market. This meant we had to spend more time investigating compliance regulation to make sure we did not breach these laws."

Currently many Japanese companies do not have a compliance program that operates independently from the legal department. This means that already limited legal resources must be divided and delegated to conducting compliance due diligence. In some cases, compliance concerns are not addressed until just prior to the integration phase.

The Baker & McKenzie perspective

Training employees at the target and parent organizations will raise awareness to compliance programs and standards. Likewise, active monitoring and audits, as well as maintaining an effective, confidential reporting mechanism, can help deter corrupt practices while encouraging employees to report instances of fraud.

"Resources may not always be available during the deal process, but not conducting compliance and risk analysis will only leave the company vulnerable to anti-corruption or other breaches. If internal resources are not available, one should delegate this responsibility to an external firm," notes Baker & McKenzie Partner Toshio Ibaraki.

To compensate for inadequacies in local knowledge and bolster programs, respondents hired third-party consultants and experts with experience in the local market for support in navigating the local regulatory environment. "We generally take advice from third party experts on anti-corruption compliance programs to expedite the process and provide a comprehensive view of the requirements we face in operating in that market," a senior managing director of finance at a Japanese retail company confirmed.

Figure 7: Success rates in implementing anti-corruption compliance programs

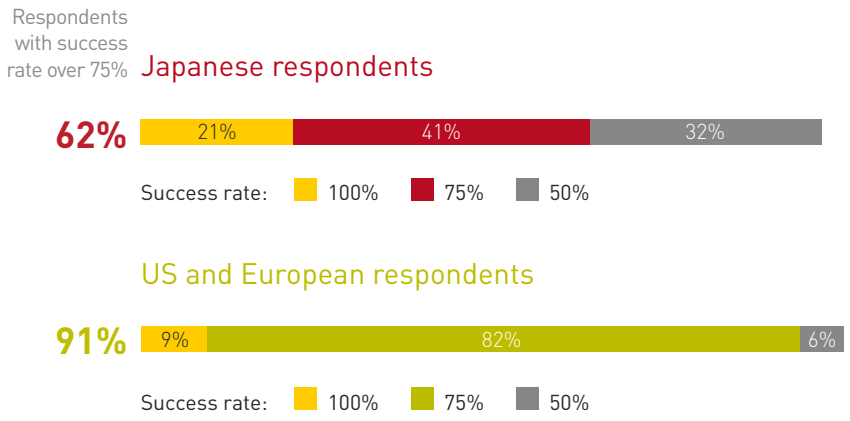
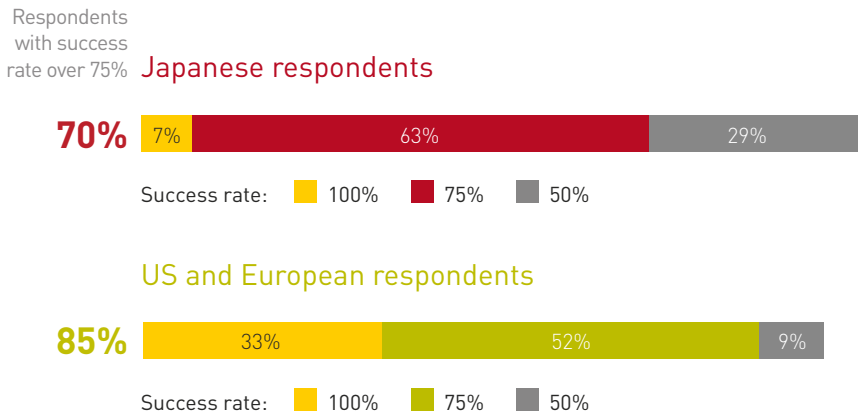


Figure 8: Success rates in implementing antitrust compliance programs



> Currently many Japanese companies do not have a compliance program that operates independently from the legal department

The Baker & McKenzie perspective

Five essential elements of corporate compliance

Enforcement authorities across the globe are placing an increased emphasis on the importance of establishing robust and risk-based corporate compliance programs. While the precise formulation and detail of the guidance issued varies, for example, under the US Sentencing Guidelines, the official guidance relating to the UK Bribery Act, or the Good Practices program guidelines endorsed by the OECD, there are key themes that are common to all. Baker & McKenzie has distilled those key themes into the following essential elements of corporate compliance:

1. Leadership

Leaders should thoroughly understand and oversee the compliance program to verify the effectiveness and adequacy of support being provided by their high-ranking compliance officers. These officers should manage the program on a day-to-day basis. Equally important, employees who have engaged in misconduct should be denied leadership positions.

2. Risk assessment

Thorough risk assessment is essential to the success of any business transformation. Conducting periodic reviews will identify criminal misconduct and help avert or reduce risk, and also help leadership determine which risks are necessary to accomplish corporate goals.

3. Standards and controls

Adopting and adhering to corporate standards and controls will assist in preventing and detecting criminal misconduct at a very early stage. This will be most effective when policies clearly and visibly state that bribery is strictly prohibited and that breaches will result in immediate disciplinary action. At the same time, incentives and open, confidential channels should remain open to report misconduct.

4. Training and communication

Providing thorough compliance training and maintaining effective communications programs will help instill core values throughout the ranks of the organization. It will also raise awareness of where potential breaches may arise and how best to handle these situations.

5. Monitoring, auditing, and response

Constantly monitoring and auditing operations within various businesses, and responding quickly to allegations is a key factor in being compliant. This will not only help mitigate risk and breaches but also help modify compliance programs to better suit the needs and circumstances of the company, which will ultimately lead to the most effective compliance structure that works for the company.

Impact on integration: Fines and reputational damage

Conducting compliance on an ad-hoc basis instead of making it a fundamental component of due diligence or general deal processes creates long-term exposure to risk. This short-sighted approach, which is observed all too often, has led many dealmakers to see their reputations damaged, making it difficult for them to continue business in the target market. In extreme cases, the fallout from a breach in compliance can impact broader corporate strategies.

As an example, a Japanese company with a significant presence in the US and therefore bound by FCPA regulation, had recently established a subsidiary in an emerging market in the Asia-Pacific. It was later discovered that local managers at the subsidiary had paid bribes to country officials. In response to the breach, the Japanese company was forced to fire the managers. With no one to oversee operations and drive the broader strategy, not only did the company's financials suffer, but the repercussions were also felt on the global strategy of the headquarter company itself. In other words, the loss was large enough that the Japanese company's global business expansion strategy lost momentum and ultimately stalled.

While in this case, the effect of the compliance breach was relatively immediate, sometimes infractions in FCPA regulation will go unnoticed for several years after integration is complete. By then, the merged company is likely to have captured at least some of its intended synergies, causing the repercussions from compliance violations to be more harmful to the company than had they been discovered and rectified sooner.

HUMAN CAPITAL:
THE VALUE OF PEOPLE

Retaining key talent: A global approach

People are widely regarded as a company's greatest asset. From managers and executives, to workers at the various tiers of the corporate hierarchy, high-value talent plays a vital function within the organization and thus can help catalyze a business transformation when brought under the umbrella of a new owner. If talent retention efforts during cross-border M&A lack the vigor necessary to retain key people, employees that leave will often take large portions of the deal value with them. In some cases, this can lead to the failure of the entire transaction itself.

In our analysis, Japanese business leaders noted that while their recent transactions were not motivated by the need to access human capital in foreign markets, they nonetheless had an appreciation for the people power within the targets they were acquiring. Respondents were most outspoken about the possible financial consequences that could ensue from high turnover immediately following deal close. Among Japanese corporations, the conventional approach taken during an acquisition is to respect the acquired company and its employees and implement as little change as possible, all the while exploring opportunities for integration. "Retaining employees was crucial during our deal since we didn't want to lose any of the value the talent had or contributed to the target company. Also, having to recruit and train new employees would only increase our costs, and getting these new hires ready to take on responsibilities would have created uncertainty during post-deal integration," said the head of corporate strategy at a Japanese manufacturing company.

> "Employees that leave will often take large portions of the deal value with them"

CULTURE SHOCK: CASH INCENTIVES AND PAY SCALES

In many cases, Japanese acquirers will offer retention bonuses to employees identified as critical to the business. While remuneration packages may provide security for some employees, financial incentives do not always hold the key to retaining key talent.

The type of salary structure is also often a concern among employees at an acquired company. Japanese companies have historically adopted hierarchical salary systems based on years of service and individual loyalty, with less emphasis on performance-based promotions. While this has worked for employees in Japan (who prefer an annual guaranteed amount over year-to-year fluctuations), it does not bode well for talent in other parts of the world who prefer performance-based pay. Consulting with advisors on how to structure performance management schemes can help companies retain top talent to ensure that value and a business-as-usual environment is maintained.

The target market will also greatly influence the approach that Japanese acquirers take when addressing employment issues. In advanced markets, Japanese acquirers will take a more laissez-faire approach, making few management or employee changes and allowing the target to conduct business as usual. At a minimum, managers from headquarter offices in Japan will be given short-term assignments at the target companies.

In emerging markets, a more aggressive approach is taken. Often, Japanese companies will make deeper changes in management to assert control over operations, once they have a good understanding of the value that management brings to the company. While this presents the danger of removing former decision-makers with influence over staff or connections in the local market, it provides greater authority to manage the integration process.

"Decisions based around employment differ when you compare acquisitions in mature and emerging economies. Japanese corporations tend to focus on skill sets and talent that will add value to the target company in mature markets, while there is more of a focus on local connections that senior employees have in emerging markets," states Tomohisa Muranushi, Head of Employment at Baker & McKenzie.

The Baker & McKenzie perspective

Talent retention may not always be the main driver for a business transformation, but underestimating the value that people bring to the business can result in lost talent, which results in lost value.

CULTURE SHOCK: A DIFFERENCE OF CORPORATE CULTURES

When an acquirer with a strict, regimented corporate culture acquires a company with a softer, relaxed atmosphere the incompatibilities can cause rifts to form between the two companies. When the transaction is across borders, differences in national cultures and the chances of language issues or cultural misunderstandings will also increase.

Creating a newly developed, shared identity between staff on both sides of the acquisition is a helpful tactic in filling the cultural divide. Internal marketing can help create trust between employee groups and avoid an us-versus-them mentality from forming. It can also help alleviate uncertainty among employees suffering from the culture "shock" of the deal. Addressing these concerns early is crucial, as a number of respondents described instances where such issues were left to fester and ultimately create headaches later in the deal.

Hiroshi Kondo, Head of M&A at Baker & McKenzie, notes that differences between corporations in cultural aspects is one element that cannot be uniformly measured, and requires a great deal of psychological due diligence from a business perspective. A good starting point is to compare the longstanding cultural and business philosophies of both sides, try to measure the depth of loyalty that employees have, and then make a determination on compatibility.

Rethinking secondments

When addressing employee issues and preparing for integration, one practice that is falling out of favor among business leaders from the US and Europe is short-term secondment of managers to the target company (Figure 9). Sending managers from the home office can sometimes send the wrong message or cause existing management and employees to panic.

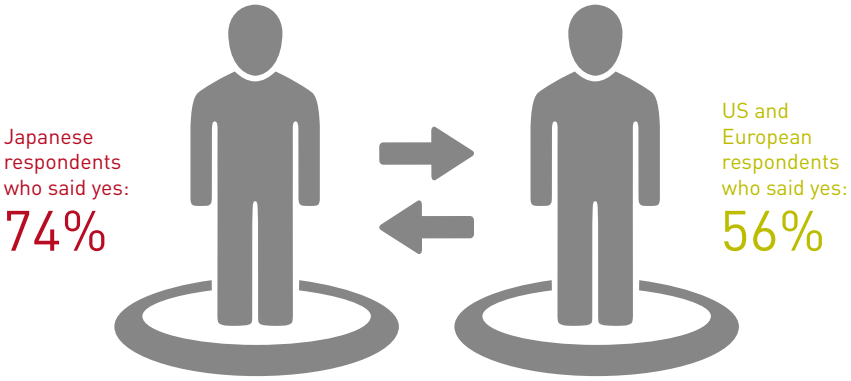
Equally, short-term secondments do not afford the assigned parties enough time to truly understand the business and culture at the target company. As Baker & McKenzie Partner Tomohisa Muranushi elaborates, "Japanese companies will often send three or four managers to the target company for the purpose of helping to oversee the integration and develop loyalty among employees. But the problem is that they're only there for a few months, sometimes on two-month secondments. This isn't really enough time to overcome the distance between the local people and new owners, and at the end of the day they just come back to Japan without making any visible progress." Having said that, however, he notes that this is a result of the underlying Japanese tactic around making as few changes as possible in the target company. This has sometimes worked in gaining more loyalty from employees of the target company as they feel less threatened or controlled by headquarters.

One alternative that acquirers may consider is to invite managers from the target company to the home offices of the new owners. This will allow them to see firsthand how operations are handled in Japan and what expectations are in terms of their management and performance back at the subsidiary. In this way, the foundations of a stable relationship between the acquired and the acquirer can be set, and target managers come away with new knowledge of their place within the global strategy.

The Baker & McKenzie perspective

Inviting managers from the target to your home offices can help build rapport and trust between parties and convey a sense of investment with employees at the acquired company. Face-to-face opportunities are a valuable proposition, whether headquarter employees are seconded or target company employees are invited to the home office.

Figure 9: Did you use short-term secondment of employees in your recent cross-border transaction?



Impact on integration: Lost talent, lost time, lost value

The loss of key talent during the early stages of a cross-border transaction can ripple throughout the deal process. Ultimately, the impact will most likely be felt during post-deal integration. As respondents note, deals and acquisitions will generally succeed when employees vital to the company, like management with deep local connections and experience running operations, continue to work in their current capacities and contribute to merger efforts. As the senior director of M&A at an American business services company notes, "staff dedication and retention has a greater impact on the deal than most acquirers realize and can increase profits and efficiency significantly."

The head of corporate strategy at a Japanese industrials company also brought up the point that having to focus on recruitment and training took resources away from other parts of the deal that may have required more attention. "Having to train and hire new employees had a direct impact on our pre-deal timelines and our overall success," the respondent said.

To maximize time and talent retention efforts, cross-border acquirers should formulate a blueprint for identifying and approaching key employees as early in the deal cycle as possible. Enlisting cooperation from senior management in hand picking these individuals will help drive the process and ensure greater rates of retention.

Tackling these issues early will also bring up another key area where companies need to focus: complying with local employment laws. Prior to implementing redundancies and conducting down-sizing procedures, dealmakers must make sure they are not in breach of employee contracts or national laws, investigations which can be bolstered by enlisting support from advisors in the target market familiar with local regulatory regimes.

TAX:
FINDING THE SYNERGIES

Is tax a priority?

The search for tax synergies is a search for value. Addressing tax issues opens the door to reducing costs and improving returns, opportunities that are present in almost all acquisitions. Yet, despite the weight that tax considerations carry, in our analysis tax was given less priority than other tasks, such as compliance.

The comments of one survey participant from Japan, the director of strategy at a Japanese tech company, shed light on the issue and sum up opinions of the larger pool of Japanese respondents. According to the director, "integrating the cross-border functions proved difficult for the legal department, especially in areas such as tax and finance, because the target market and our home market were completely different. Our inexperience in this field prevented us from achieving a higher rate of success as we lacked the knowledge and foresight to fully integrate these functions and realize the benefits."

The Baker & McKenzie perspective

Corporations should note that every cross-border transaction offers the chance for tax savings, while at the same time exposing the corporation to the risk of double taxation or non-compliance issues. Dealmakers need to ensure that the right tax professionals are involved from the beginning, experts who possess the skill set to guide these dealmakers to discover opportunities while navigating potential threats and ultimately capturing synergies.

The role of the tax director

Perhaps one of the underlying reasons Japanese companies faced difficulties in generating tax synergies was the involvement – or lack thereof – of a tax director to guide review and strategy procedures. Among Japanese respondents, only 34% said their company employed a dedicated tax director to manage tax issues (Figure 10). In contrast, 96% of US and European respondents had a tax director in place within the ranks of their companies.

In Japan, including a tax director in the process is more of an afterthought and tax in general tends to be a backburner concern. The bulk of corporate resources and priorities are usually placed on the deal and purchasing the target. Under corporate structures in Japan, tax responsibilities generally fall under the auspices of the accounting department. However, when issues involving tax do arise, the accounting team tends to lack the authority and the experience to act proactively and aggressively.

In the past, tax rules have been closely linked with those under accounting, however, the gap between these rules has widened in today's market. Instead, the treatment of tax has become more closely linked with the underlying legal effects, and as a result a more thorough legal analysis is becoming necessary.

"Tax is typically viewed only as a number by Japanese corporates. They view it as something they have to pay in each country and not part of a strategic vehicle for growth. Once tax is taken care of and that 'tick box' is checked, they move on with other parts of the deal," says Baker & McKenzie Tax Partner Ryutaro Oka.

Another value-add for the tax director is the support they provide in risk planning and mitigation efforts. In doing so, these directors can often identify areas where more attention is needed during due diligence, or where possible synergies and other post-deal advantages can in some way impact valuation during negotiations. By finding a balance between these risks and the financial rewards, companies which have an active tax director can ensure that acting on tax concerns in the present can drive long-term realizing of value and synergies long past the post-deal integration phase.

When no such role exists, it may make sense to bring in a professional with tax director experience to drive tax efforts in the run-up to post-deal integration. While instances of such actions have been rare, companies that are trying to globalize can benefit from the value that advisors offer or by integrating personnel from target companies into the larger corporate push toward globalization.

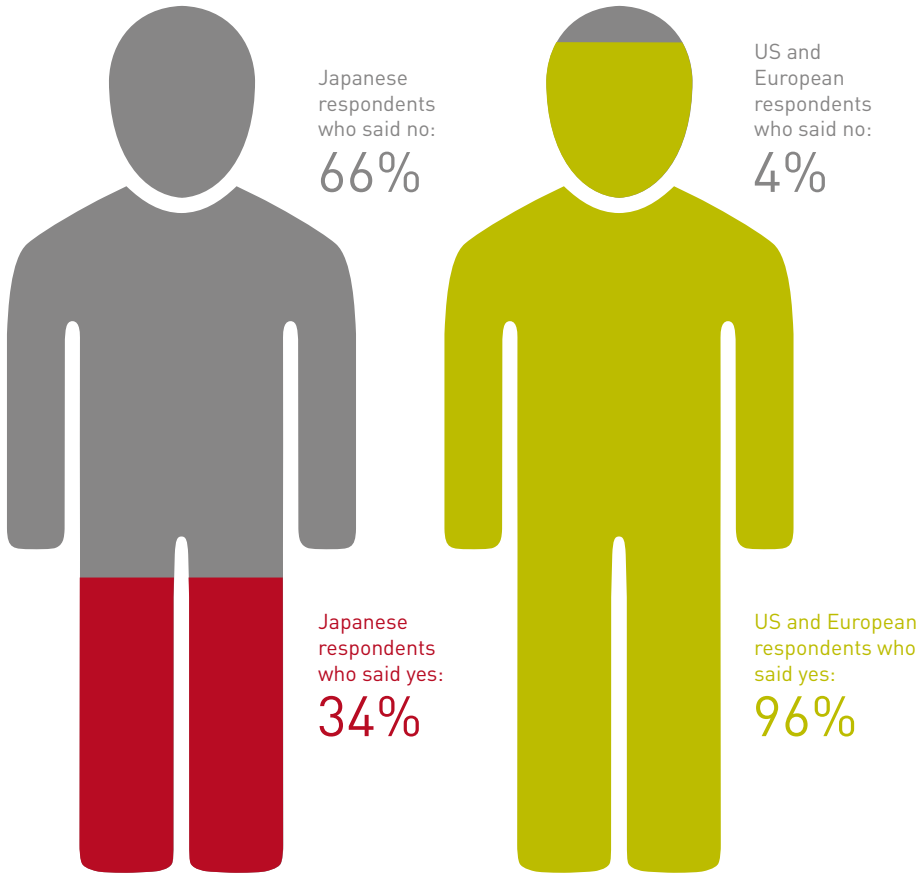
TALENT RETENTION

Acquiring a foreign company in a developed market, like the United States, may bring highly skilled individuals in the tax field under the parent company's corporate umbrella. Retaining these employees in the post-acquisition phase can help Japanese corporates learn best practices in tax to apply in their current deal and future overseas ventures.

The Baker & McKenzie perspective

Tax is a two-pronged vehicle which corporations must correctly handle to remain compliant, while also looking for ways to ease the financial burden under the correct laws. Assigning responsibility for tax issues to a tax director – either internally or by consulting professional tax advisors – takes pressure off other teams and allows for a concentrated approach in these areas to realize synergies and tax savings.

Figure 10: Do you have a dedicated tax director role in your company who is solely responsible for handling tax issues?



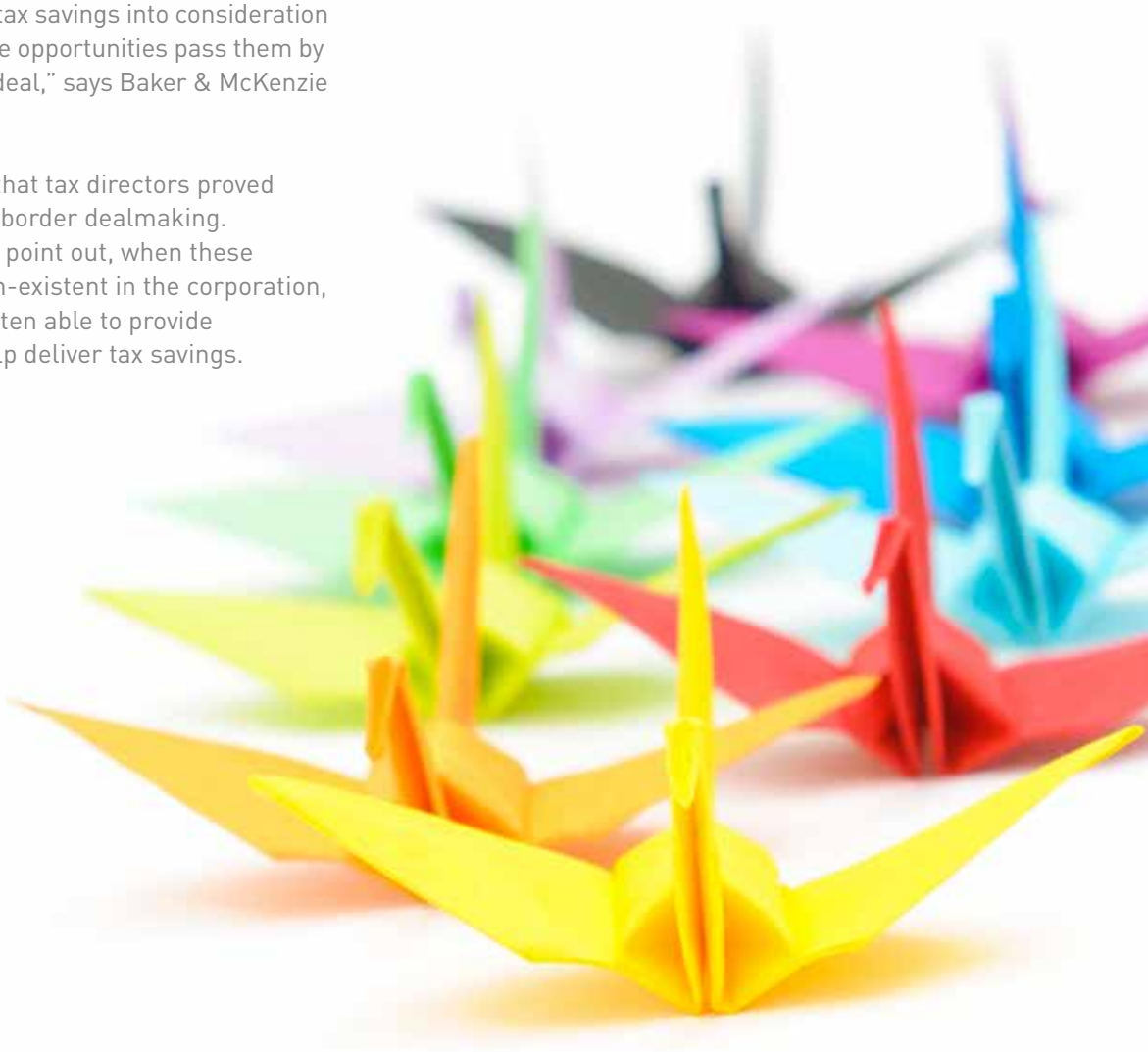
> Perhaps one of the underlying reasons Japanese respondents faced difficulties in generating tax synergies was the involvement – or lack thereof – of a tax director

Market differences and opportunities

In some countries, tax legislation is written to encourage inbound investment through reduced corporate tax rates and incentives for new investment. In others, restrictions may limit the availability of tax relief. Regardless of the jurisdiction, a cautious approach should be taken due to shifting tax regimes in both the developed and emerging world.

Starting tax due diligence early gives dealmakers the advantage of adequate preparation and can even have an impact on the purchase price of the asset. "In the US, companies tend to take tax into consideration in determining valuation. Japanese companies, on the other hand, aren't taking tax savings into consideration enough and often let these opportunities pass them by as they rush to close the deal," says Baker & McKenzie Tax Partner Ryutaro Oka.

It was for these reasons that tax directors proved their worth during cross-border dealmaking. However, as respondents point out, when these internal experts were non-existent in the corporation, external advisors were often able to provide professional advice to help deliver tax savings.



Impact on integration: Missed opportunities

Merging tax functions and finding tax optimization schemes can have a dramatic impact on the overall integration blueprint and various departments involved in the transaction. Waiting until the deal is closed to develop and manage tax integration will therefore yield vastly different results in terms of maximizing deal value and managing an effective tax rate than consolidating these functions earlier. Likewise, tax compliance issues could arise to slow the momentum of the entire transaction.

Failing to take advantage of tax synergies or utilize optimization schemes will sometimes result in acquirers paying higher taxes. Japan is already home to some of the highest corporate taxes in the world, and additional tax liabilities can quickly begin to drain financial resources from acquiring companies post-M&A.

Planning early allows acquirers to act quickly once tax opportunities arise. For example, a Japanese company was able to migrate intellectual property (IP) from its HQ office to a subsidiary in a low tax jurisdiction to avert greater tax liabilities in the home market. With the IP under the ownership of the subsidiary, it was able to generate greater income and yield tax savings.

INFORMATION TECHNOLOGY:

A UNIFIED PLATFORM FOR GROWTH

The importance of IT

Information technology (IT) involves more than just the wires and network cables. These systems are vital arteries providing information and connectivity between business functions. In cross-border M&A, merging IT functions will not only help organizations communicate more effectively, it will also act to catalyze post-deal integration efforts and deal synergies.

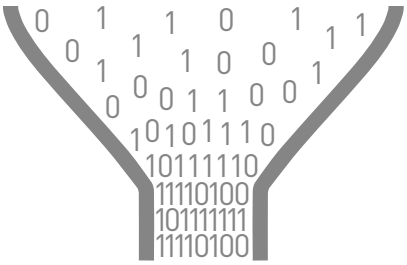
The ubiquity of IT means few leaders can afford to sideline information system overhaul or integration. Indeed, in our survey, respondents ranked IT as one of their top two considerations during business transformation (Figure 11). While differences in success rates existed between the respondent groups, qualitative feedback, especially among Japanese respondents, shows an understanding of where mistakes were made and how these issues could be or were eventually rectified (Figure 12).

"During the planning stage of the acquisition, our IT department was given a seat at the due diligence table. The IT team was able to spot potential obstacles to integration such as compatibility issues with information platforms. They also identified potential liabilities, like underinvestment in technology at the target company, which helped us in finding alternative solutions to complete integration successfully," said the vice president of strategy at a Japanese energy company.

The Baker & McKenzie perspective

Information technology is the backbone to any business. Understanding a target's technology structure and the extent that it is shared throughout the company is critical to assessing how effectively and efficiently this component can be 'separated' from the target and 'integrated' into the newly formed organization. Getting the IT departments from both companies involved in the deal from the outset will give these teams time to create a plan to integrate information systems and capture cost savings.

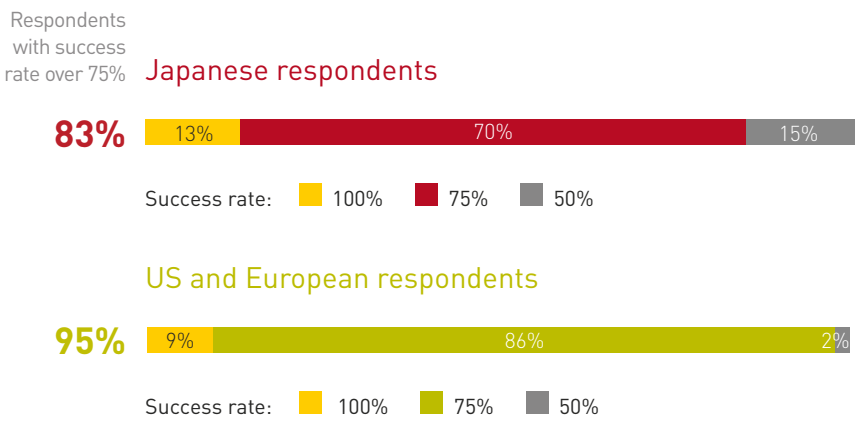
Figure 11: IT system overhaul / integration



99%

of all respondents have overhauled or integrated their IT systems

Figure 12: Success rates in implementing IT system overhaul or integration



Positioning IT to drive the deal

Taking a detailed approach to information system-based due diligence as early as possible in the deal allowed IT to be a driver of success instead of a burden on integration. To bolster these efforts, reserving a place at the table for IT teams and giving them the bandwidth within the company to operate can help broaden corporate understanding of IT needs. In this way, respondents received valuable input on the costs and practical realities of integration.

Doing so at the outset of the business transformation also provided ample time for an assessment of IT procedures and systems at the target company. Exemplifying this point, the managing director at a Japanese business services company said, "We evaluated the target company's technology to determine how it could complement our IT strategy. This helped us determine which operations to retain and what data should migrate to the platform. This step was particularly important as we reviewed cost and revenue synergies."

Likewise, reviewing ownership rights and licensing of software and systems used at the target company can prevent fines from being imposed due to breaches of contracts. This was the case for a Japanese company that had recently acquired the subsidiary of a foreign corporation operating in Japan. Under a licensing agreement at the target, a specially developed software was only to be used with a specific processor. When the new owners began integrating IT systems, they upgraded the platform under a new operating server and hardware, which included use of a new chip that violated the licensing agreement. When the developer of the software found out about the system upgrade, he demanded payment for breaching the licensing agreement, which the new owner was obligated to pay.

Since IT systems at any company can be developed and maintained by numerous parties – with platforms provided by one vendor and software from another – it's important to understand ownership and licensing structures and agreements. "Breaching these agreements creates the burden of not only financial consequences, but also delays imposed on the deal that can negatively affect the integration and business transformation process," says Baker & McKenzie Partner Daisuke Tatsuno.

> "The ubiquity of IT means few leaders can afford to sideline information system overhaul or integration"

The Baker & McKenzie perspective

Completing IT due diligence early provides more time to determine what the most cost effective approach will be to integrating information systems. Buyers will also become aware of what rights the target has to its technology and if breaches of contracts will result from the acquisition. An effective transition services agreement can help expedite a deal's close, reduced costs, and ensure a smooth post-deal integration by assigning responsibility for support services to various parties.

Consider which IT integration option will best maintain or boost momentum for the business transformation strategy and who is best positioned – be it internal IT teams or consultants with specialist knowledge – to execute the systems merger.

Impact on integration: Data security and compliance

As global corporations continue to suffer from the backlash of breaches of corporate data and confidential customer information, upgrading security controls has jumped to the top of corporate agendas. However, many may not realize the ease with which these breaches occurred or how best to safeguard data, information, and other trade secrets.

"When the target is a technology company, the rights to its data and its compliance with privacy laws and security standards are critical in assessing the target's value and risk. During integration, merging IT systems opens companies to a variety of risks, so when you're conducting due diligence, you really have to ask where software at the target was developed, or who was responsible for managing certain parts of the broader platform. Conducting background checks on these parties will reveal past leaks or breaches and help acquirers manage their exposure to these risks," says Baker & McKenzie Partner Kei Matsumoto.

The seriousness of a data breach onset, regardless of the size or volume of data leaked, can destroy a company's reputation and brand. More importantly, it will also shake customer trust and loyalty, which can take years and costly marketing campaigns to restore.

Equally, acquirers must make sure that targets are compliant with local regulation and legal standards regarding protection of data and customer information. Different countries have different legal regimes and varying degrees of punishment for compliance infractions. To avoid unnecessary penalties, acquirers should diligently monitor data transfers and handovers while safeguarding from external threats to business operations and IT integration and infrastructure.

PREPARING FOR INTEGRATION:

WHO HAS A PRIMARY ROLE?

Like pieces in a chess game, positioning the right teams and managers at the right time will have a profound impact on the outcome of a deal. The key is developing a sound strategy and integration blueprint earlier in the process and knowing when to deploy employees from various departments.

Respondents in our survey revealed that as integration plans were rolled out, participants involved in the final act of the transaction came from key departments in the four areas addressed in this report – compliance, employment, tax, and IT – as well as specialized teams with various responsibilities throughout the deal's lifespan. This varied between respondents from Japan and those from the US and Europe in both pre-deal planning and post-deal execution (Figures 13 & 14).

From respondent feedback, the gap in involvement levels between US, European, and Japanese corporations was minimal during the pre-deal integration planning. However, the gulf in participation began to widen once agreements were signed and the deal transitioned into the integration phase. These differences were most pronounced for functional leads and local managers in driving integration and molding the new company.

Figure 13: Groups involved in integration process (Pre-deal)

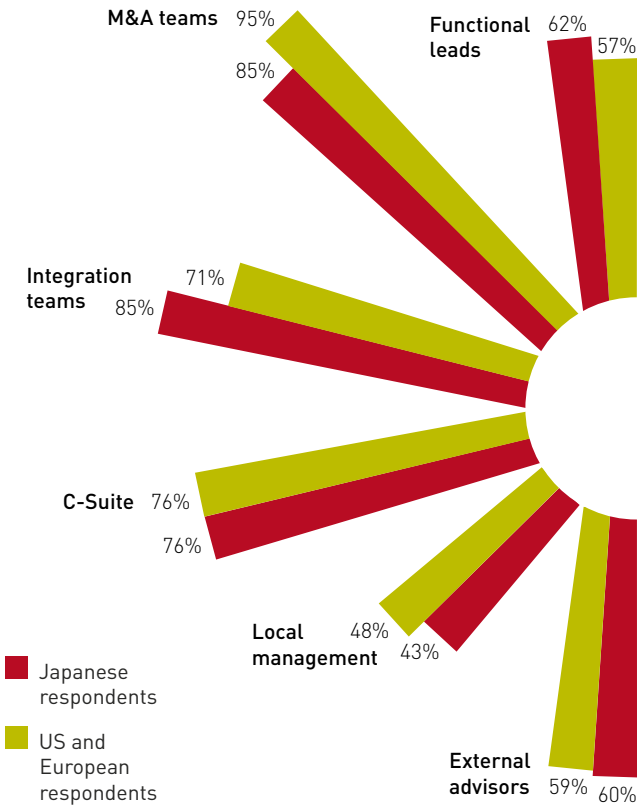
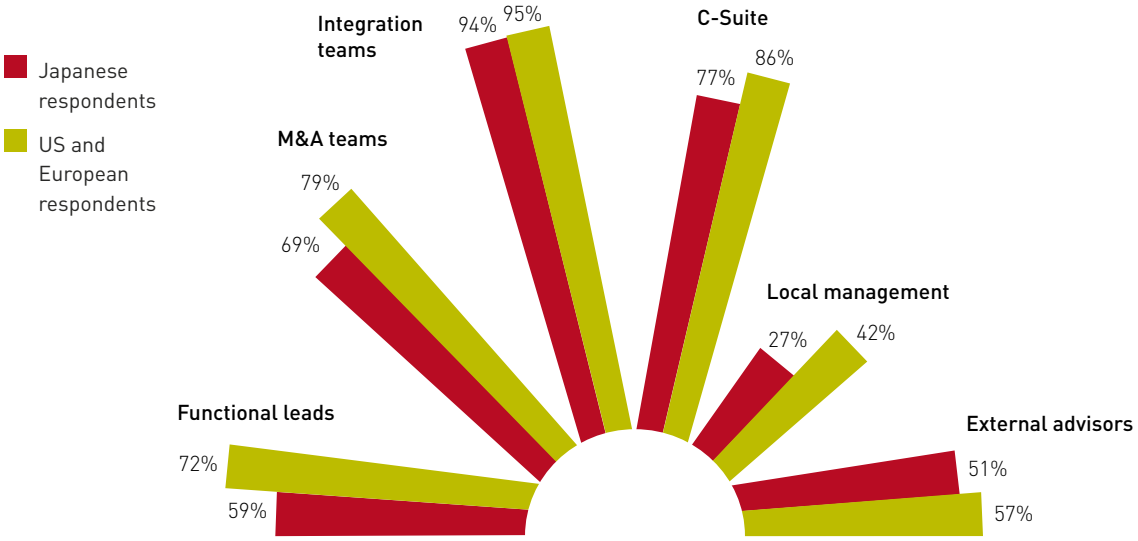


Figure 14: Groups involved in integration process (Post-deal)



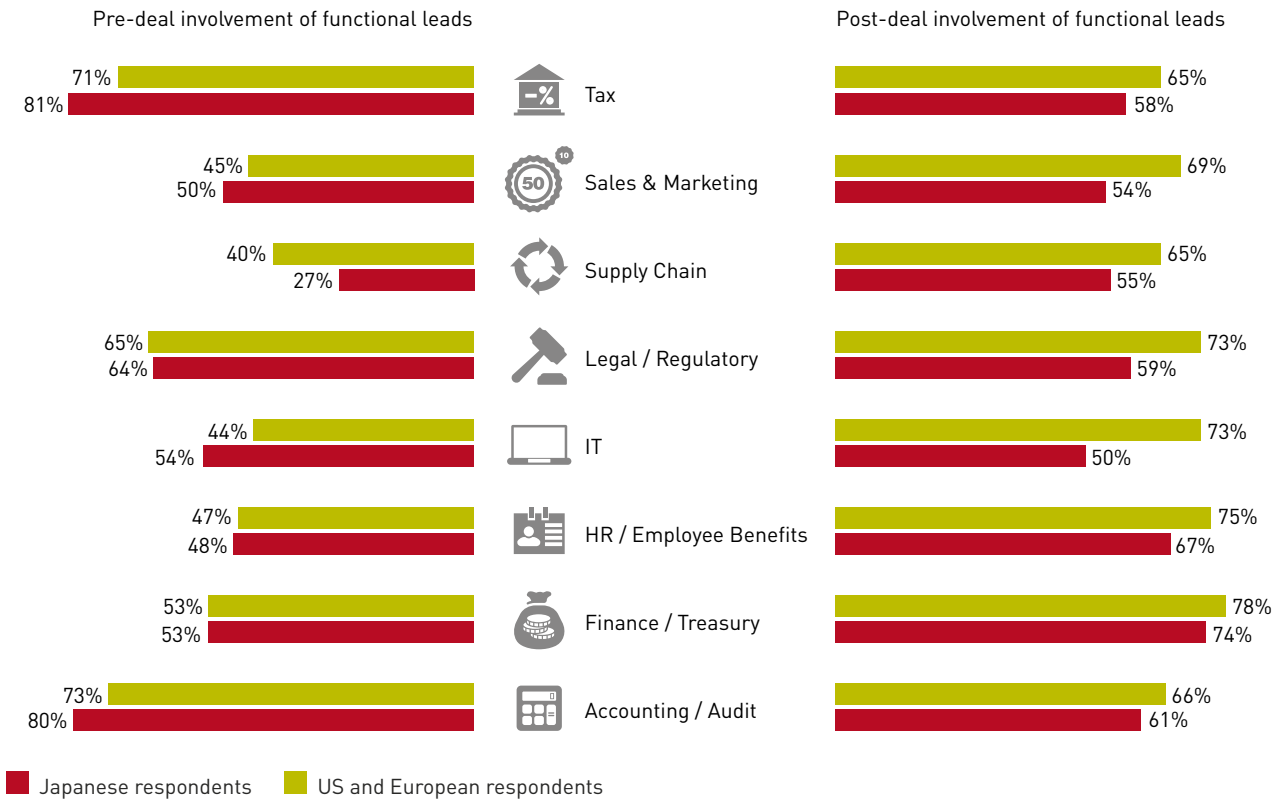
Functional leads: Compliance, HR, tax, and IT

As noted throughout this report and in follow-up interviews with dealmakers, early involvement of the functional leads in the business transformation process can increase the chances of identifying and avoiding risks. Additionally, it can also help to preserve value in the target company and realize cost savings.

In our analysis of pre- and post-deal involvement of functional leads, Japanese respondents in many cases noted roughly equal or greater activity from compliance, HR, tax, and IT departments compared to their US and European counterparts prior to closing the deal (Figure 15). Yet, once the ink was dry, respondents from the US and Europe placed more emphasis on these leads compared to their Japanese counterparts. This is not necessarily to say that Japanese dealmakers scaled back involvement, only that such involvement fell short of US and European execution.

Respondents from the US and Europe noted that department heads were active in employee training and development programs. They were also focused on improving performance and setting performance targets at the acquired company. In some cases, these respondents noted high level mandates from the CEO and boards directing functional leads to thoroughly implement new standards at the target organization due to new and changing regulations and policies. Similar opinions were absent from Japanese business leaders who, while mentioning measuring and monitoring

Figure 15: Pre- and post-deal functional leads



responsibilities for financial and legal aspects of the deal, did not specify a more direct, active hand in the integration process.

Local management

In our survey, Japanese business leaders were more confident in the abilities of their own managers over similar personnel at the target company. This difference was most noticeable post-deal where a sharp drop-off was recorded from pre-deal involvement. As the head of strategy at a Japanese manufacturing company said, "Our management has better industry expertise and they were more effective in planning and analyzing ways of improving performance of the overall firm."

Among US and European respondents, local managers were given a wider range of responsibilities and authority. The head of finance at a Swedish pharmaceutical company, echoing the sentiment of several respondents, said "We very much needed the support of the local management as we faced language barriers. With their influence in the market we were able to clear the licensing and documentation required."

The benefit of local managers to integration, or any part of the deal, seems apparent. There are few replacements for the skills, insight, and networks these professionals can offer from years of on-the-ground experience in the target region. Whether these experts are maintained long-term or on shorter incentive packages to boost morale post-close, respondents agree that retaining these employees can help to ensure a smooth transition in ownership and merger of core staff and assets.

C-Suite

The CEO and other C-Suite executives had varying degrees of involvement in pre- and post-deal integration efforts. While their day-to-day duties usually revolved around managing affairs at the acquiring company, they were also key players in driving the deal forward and had some involvement post deal.

Respondents noted the importance of the CFO in the integration process, especially in stabilizing the finances of the firm to provide value and make returns to shareholders. "The finance heads hold the main key to the integration which is the allocation of budget for integration. He is expected to provide sufficient budgets and at the same time control the expenses to see an upstream slope in revenues," said the director of strategy at a Belgian financial services company.

M&A and integration teams

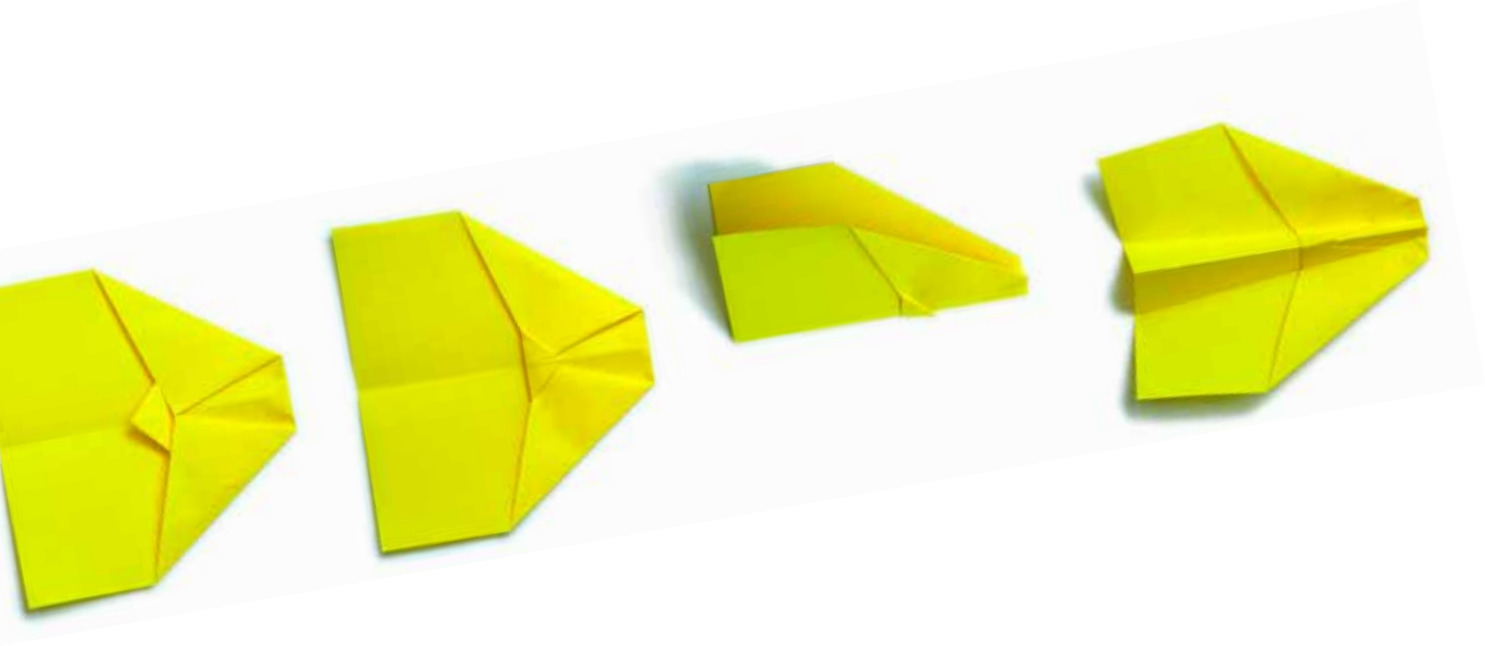
For Japanese business leaders, M&A and integration teams both had varying degrees of involvement in the pre- and post-deal phases. According to survey participants, these teams generally follow orders from senior management and worked in tandem with the various functional leads.

Allowing the integration team to work side-by-side with the M&A team can help ensure a smooth handoff once the deal is completed. While the M&A team usually involves mostly employees from the acquiring company, integration teams should, when possible, comprise staff from both the target and acquiring company. By representing both parties in the team, perspectives from each can be incorporated into running integration and combining assets and functions from both companies.

External advisors

Enlisting the help of external advisors to support legal, tax, financial, or other issues proved invaluable to a number of respondents. The head of strategy at a Japanese manufacturing company says, "Though they come at a high price they are worth the expense as they help in providing the expert advice and they are more up to date with all the changes in the regulatory and policy environment." These experts also provided an extra layer of insight in managing risks and preparing to enter a foreign market.

CONCLUSION:
THE FIRST STEPS



Does transformation for corporate Japan mean rising to meet the global challenge of becoming a modern, innovative, and successful international enterprise? If so, change of this nature may require a willingness to adapt to, and sometimes embrace, the long-standing business practices, procedures, and standards of the world's multinational corporations.

Having said that, however, recognition must be given to the traditional business philosophies, corporate principles, and success stories that Japan enjoyed in the past, especially in the way that Japanese business empires were forged and flourished in the 1980s. Most should agree that these philosophies, principles and best practices must not be lost or sacrificed for the sake of change. Rather, they should be integrated into the building blocks of whatever new strategies Japanese corporations create on the road to transformation. Perhaps more importantly, tackling the global challenge may not be about how fast corporate Japan can change, but how fast and effectively it can integrate tradition and change cultures to devise a new step-by-step approach that works for the unique globalization of Japan.

A good starting point can be found in creating effective strategies to address issues in the four areas mentioned in this report. While many can succeed by duplicating acquisition methods from successful Japanese companies or their counterparts in the US and Europe, the best outcomes may only be found if tailor-made solutions are ultimately created.

These four areas are but the tip of the iceberg. Within each transaction, unique obstacles will likely arise. The level of preparation and willingness to adapt to changing circumstances and environments should act as a key determinant to whether these business leaders struggle or succeed on the road to business transformation.

For the purposes of this report and from the research within, several key takeaways stand out, serving as a condensed blueprint to improve the likelihood of a successful cross-border transaction. We can only hope that these can be the first steps to transform Japan into a truly global partner in the corporate playing field.

Plan for compliance

Risk and compliance concerns are inevitable in any jurisdiction. Conducting thorough due diligence at an early stage of the target company and management, particularly when both are based in an emerging market, can put dealmakers minds at ease and pave the way for a smoother integration. Rooting out counts of bribery and corruption early in the deal will allow more time to address and amend these breaches. It will also enable acquirers to decide if the deal should be abandoned altogether before time and resources are spent.

The most effective compliance programs are ones that receive support from top management and corporate executives. Knowledge that a high level of commitment from a company's decision-makers are behind such programs is the most effective tool to deter employees at all levels of the company, at both the acquiring company and target, from misconduct or acts of corruption. Likewise, implementing effective training programs and reinforcing these with incentives and confidential reporting schemes will entice employees to remain vigilant to acts of corruption while maintaining the company's corporate image and reputation.

Engage employees and managers

Aside from the immediate benefits of maintaining business continuity, retaining employees and engaging them across all development processes can be helpful to future deals that will be made by the headquarter company. Talent at acquired companies provides invaluable insight and know-how into their home markets, expertise that can be applied as part of the long-term business transformation and future expansions. Likewise, their skill sets and industry-specific acumen may be worth more than initially anticipated – and in some cases make up the majority of the value at the target company.

When addressing management issues and the direction in which changes should be implemented, the traditional approach to overseeing integration through short-term secondment of Japanese leaders to the acquired company may need to be re-evaluated. The limited nature of their stay leaves little time to affect change. Instead, applying a system where managers from the target company are brought to headquarter offices in Japan, where local training will be provided, can help build rapport and understanding of the overall corporate strategy between the two companies.

Expecting a "natural fusion" to occur between employees and business philosophies at the buyer and target, no matter how small the issue, is becoming more and more difficult to realize. This is in no small part due to language barriers and cultural issues that often arise. To ease this transition while retaining and integrating personnel, corporate leaders must ask of themselves: How can we become a more attractive "buyer" – where forward-thinking global talent would want to devote their skills and employment – to the target company?

Prioritize tax

Tax opportunities are present in almost all transactions – all dealmakers have to do is put in the effort to spot the opportunity. Tax is more than just a game of numbers and when approached proactively, can yield significant financial rewards for Japanese acquirers.

If unfamiliar with tax laws and opportunities in target jurisdictions, utilizing a tax director can help uncover these opportunities and realize synergies. When no such role exists, it may make sense to bring in external experts or start the hiring process of a professional with tax director experience to drive tax efforts in the run-up to post-deal integration.

Involve IT early

With a number of headline making breaches in recent months, the rights of a technology rich target to its data and its compliance with privacy laws and security standards are critical in assessing the target's risk. Ownership of data and technology patents will also have an impact on valuing the target. If a company does not own rights to software or hardware, breaches of contracts and/or infringement of third-party IP rights can occur, imposing unforeseen costs on potential acquirers.

Merging information systems must also be given priority. Getting the IT department involved from the outset of the deal will provide teams time and resources to create a plan to integrate IT platforms, or develop new solutions, and capture cost savings. Doing so early will provide ample time for an assessment of IT procedures and systems to determine the best approach to combining resources, platforms, and technology.

Culture and language

Two other overarching challenges that affect these four areas in addition to all other aspects of the deal are language and culture. The oft-encountered inability to communicate effectively with various parties at the merging organizations creates space for misunderstandings in corporate messages and in defining a clear mission for the new company. Likewise, cultural misunderstandings and obstacles stemming from entrenched national beliefs and business practices in Japan can make it difficult to find a meeting of the minds between buyer and target.

As stated previously, overcoming these challenges will be key for corporate Japan, and also most likely require a rethinking of the traditional approach to cross-border M&A. If and when traditional mindsets can make a gradual shift to alternative methods, one that incorporates international best practices into the fabric of traditional strategy creation and implementation, Japanese corporations could see further success in their cross-border M&A and business transformations.

The Baker & McKenzie perspective

The research and survey undertaken for this report is only the first small step in identifying the solutions that Japanese corporations can bring to the innovation-heavy, evolving world of business transformations. However, the conclusion from this first phase is clear - there is no one standard that works, and there is no right or wrong way. The key takeaway is a thorough and proactive assessment of all aspects, not just of the target company and its assets, but also of the headquarter company, its current and future way of doing business, as well as making changes when and as necessary to achieve real success.

Hiroshi Kondo
Head and Partner of the Corporate/M&A Group,
Baker & McKenzie, Tokyo

Methodology

In the second quarter of 2014, Mergermarket surveyed 200 C-level executives and other corporate leaders on behalf of Baker & McKenzie. All of the companies identified in the survey were identified as having conducted a recent cross-border transaction.

Among respondents, half were based in Japan, with a quarter based in the United States and Europe each.

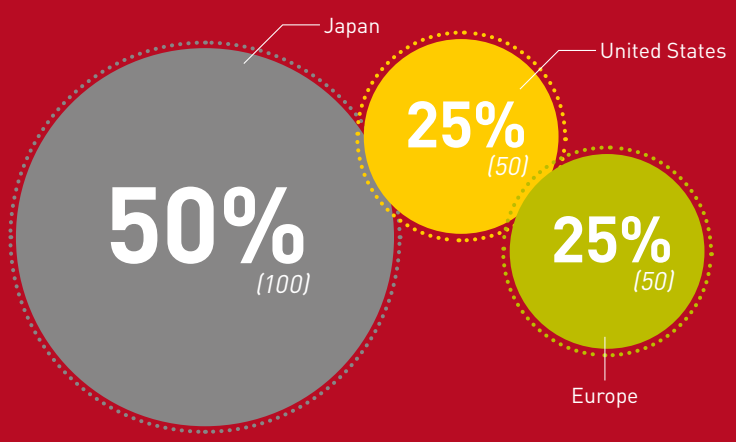
Respondents from Japan were active in the following sectors: industrials (21%); consumer (18%); pharma, medical and biotech (12%); TMT (11%); financial services (10%); energy, mining, and utilities (8%); chemicals (6%); business services (3%); transportation (1%); and construction (1%). Respondents from the United States and Europe were active in the following sectors: industrials (21%); TMT (18%); pharma, medical and biotech (16%); business services (11%); energy, mining, and utilities (9%); consumer (5%); financial services (4%); construction (3%); real estate (2%); leisure (2%); agriculture (2%); and aerospace and defense (1%).

About 35% of respondents from both Japan and United States and Europe had at least five years of experience completing cross-border transactions. About 13% had greater than 16 years of experience.

The survey included a combination of qualitative and quantitative questions. Interviews with Japanese respondents were conducted in Japanese. Results were analyzed and collated by Mergermarket. All responses are anonymized and in aggregate.

This research was complemented by a series of interview with Baker & McKenzie practitioners in a number of jurisdictions.

Respondent mix by region



About Mergermarket

Mergermarket is an unparalleled, independent mergers and acquisitions (M&A) proprietary intelligence tool. Unlike any other service of its kind, Mergermarket provides a complete overview of the M&A market by offering both a forward-looking intelligence database and a historical deals database, achieving real revenues for Mergermarket clients.

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Our difference is the way we think, work and behave – we combine an instinctively global perspective with a genuinely multicultural approach, enabled by collaborative relationships and yielding practical, innovative advice. Serving our clients with more than 4,200 lawyers in more than 45 countries, we have a deep understanding of the culture of business the world over and are able to bring the talent and experience needed to navigate complexity across practices and borders with ease.