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SPOTLIGHT

On Japan

An outline of the country's PE activity

WITH EXPERTS FROM:

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J-Star Co. Ltd.

Asia Alternatives

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Japan: Is a Slumbering Goliath Awakening?

The world's third-largest economy is remarkably underpenetrated by private equity.

The question for investors: for how long?

For at least 20 years, observers have remarked that Japan represents a dream landscape for private equity, replete with corporations in need of fresh ideas, transformational capital and expertise. But that enthusiasm hasn't been met with a commensurate rise in deal volume or embrace by the country's corporate culture.

Does a bigger role for private equity lie ahead in Japan? In this report, we ask top GPs and an LP to describe the limitations on private equity's growth in the country and whether the time for change is finally here.

Japan should be of great interest to global private equity market participants for another reason—its enormous institutional investors are gradually increasing their interest in private equity and being given the regulatory framework to allocate more to the asset class. But how real is the possibility that Japan could become a prime destination for fundraising?

Clearly, Japan is not expected to become an overnight private equity hotspot. And yet, given its size and the momentum toward structural reform, perhaps we're moving to an era where there's less talk about PE in Japan and much more action. If so, the insights shared in this report will give you a good head start.

Enjoy,

David Snow
CEO & Co-founder, Privcap
@SnowsNotes

Why One Segment of Japan's Deal Market is Booming

There has been a record amount of M&A in the country—particularly in smaller deals—with no signs of the flow stopping anytime soon, says Richard Folsom of Advantage Partners

Richard Folsom
Co-founder,
Advantage Partners

An aging population of business founder-owners has combined with a widening acceptance of private equity as an exit option to make the last two years the most active for deals in the entire 20-year history of one of the most well-regarded PE firms in Japan. And there's more to come.

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"There's the acceptance and recognition that private equity is the best solution for the founder-owner in terms of monetization and transition to professional management."

Richard Folsom,
Advantage Partners

Advantage Partners, which focuses on the smaller end of the deal market, has closed three deals in 2016 as of mid-March, co-founder Richard Folsom says, and could close two more by June. "These are some of the best deal opportunities we've seen. Back in the mid-2000s, there were a lot of global and pan-regional players in the market. Post-financial crisis, those players have withdrawn or moved on from Japan to other parts of Asia, leaving a relatively limited competitive environment for the robust deal opportunity set, which is focused on the smaller part of the market."

According to data provider Preqin, overall PE- backed buyout deals in Japan have decreased significantly from 2007, when there were 49, to 2015, which saw 31. The aggregate deal value also plunged, from $6.5B in 2007 to $1.2B in 2015.

Folsom asserts that the part of the market Advantage focuses on—smaller deal sizes of $30M to $300M in enterprise value—is seeing more action than those looking to write larger equity checks. The Preqin data shows that, indeed, deal sizes fell sharply between 2007 and 2015. "I don't think it's just us," he says. "I think our peers in the market are seeing the same." There is a latent number of potential deals with aging founder-owners, and a large number of non-core assets held by large corporations, Folsom says. "We're just chipping away at the tip of the iceberg."

Much of the deal activity in the lower-middle market and middle market has stemmed from succession planning and large corporations that have strayed from their focus on the core business, and are identifying non-core businesses that they might be willing to spin off. Of the former category, there are many businesses in Japan that were founded during the economic growth period in the 1960s, '70s, and '80s that have reached a certain stage, and the founder-owner is ready to retire. "Within that group, there's a growing acceptance and recognition that private equity provides the best solution for the founder-owner in terms of monetization, and transition to professional management…we're better able to deal with the complexities of the market and the competitive environment," he says.

For instance, Advantage invested in 35-year-old Hukuba Dental in March 2015, as the founder-owner family and the current president were intending to retire. The company, which develops, manufactures, and distributes unique products in the dental industry, was seeking a reliable buyer who could succeed the company and pursue future growth, according to a document from the firm.

But it's not only older business owners looking for a way to retire that are increasingly reaching out to private equity. Folsom says that in the past two or three years he's been seeing increasing deal activity from a different cohort of business founder-owners—those between the ages of 35 and 40. "They are the breed of serial entrepreneur that got the business up-and-running, reached a certain level of scale, and would like to monetize, start another business, or do something else."

With a small number of absolute competitors for deals—just a handful, according to Folsom—Advantage is expecting to be busy at least through 2016. "Most of the global names, the pan-regional names with fund sizes of $4, $5, $6B are not going to write $30M equity checks in Japan. It's mostly domestic players, keeping entry multiples at attractive levels." ■

Why Small Companies are Ideal for Japan's PE Players

The country's domestic PE firms are focusing on a slice of the market bigger international players ignore

Gregory Hara
CEO and Managing Partner,
J-Star Co. Ltd.

When Gregory Hara, the CEO and managing partner of J-Star Co. Ltd., was starting out in private equity, he realized that the smaller end of the market was the best place for a domestic player acquiring Japanese companies.

That was in 1999, and Hara—then a member of the buyouts team at JAFCO, organizing buyouts for companies in the service industry—says that his strategy remains the same today: stay independent and stay in the smaller end of the market where competition is less fierce.

"One of my favorite stats is that Japanese corporations have $2.2B in cash on the balance sheet," he says. "Half of the listed companies are debt-free, and the return on equity of Japanese corporations is so low. These three stats, plus the negative interest rate situation, [means] banks are desperate to lend money to [those with] good credit and to large corporations."

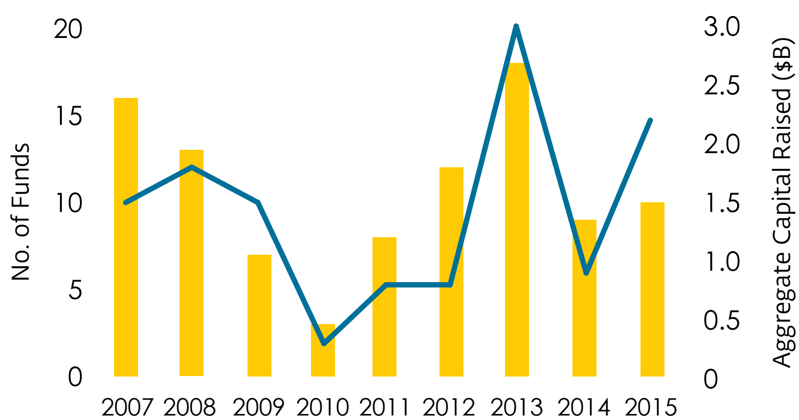
That means that in an auction, buyers that banks are willing to finance are difficult competitors because they can pay well, Hara says, and they can avoid the competition from strategics. "It makes our life difficult," he says. "You have to have 30 percent [of the money at hand]. But on the smaller end of the market that competition melts away because these large, blue-chip corporations like Fuji and Suntory generally don't have an interest in buying small companies."

Demographics also work in Hara's favor. Japan has the fastest-aging population in the world—the government of Japan reports that as of October 2014, 26 percent of its population was aged 65 years or older, with that percentage set to increase to 40 percent by 2060—and low birth rates (1.42 per woman versus 1.88 per woman in the U.S.). Consequently, many people are trying to liquidate shares in the smaller end of the market. "Some of the (better) companies can be bought by blue chip names, but not all of them," he says.

Another plus: Many founder-owners have been in competition with another small company for the past 20 years, and think "We're not going to be bought by the competitor that the owner has hated for the last 20 years," he says.

Most importantly, perhaps, is that smaller companies are particularly well-suited for private equity style value creation. Often they lack the transparency required by bigger investors, and a small-size company often need more modern and sophisticated management. ■

PE in Japan, By the Numbers

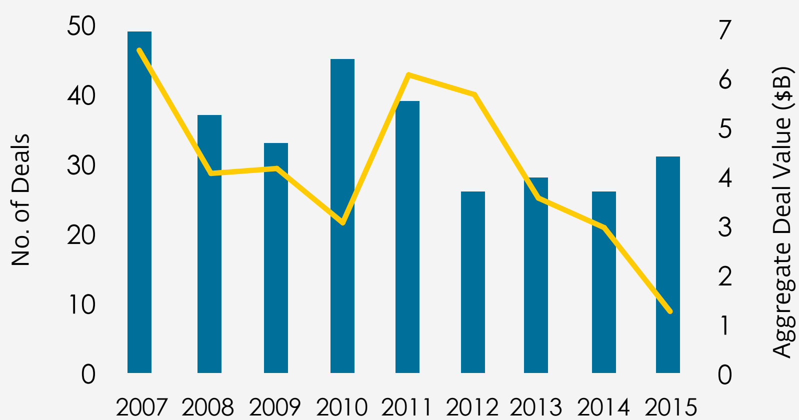


Japan-Focused Fundraising on a Rollercoaster

The amount of funds raised since 2007 in Japan has fluctuated, hitting a high in 2013 with $3B raised in 18 funds. That compares to 2010 when only $300M was raised in 3 funds.

No. of Funds Closed

Aggregate Capital Raised ($B)

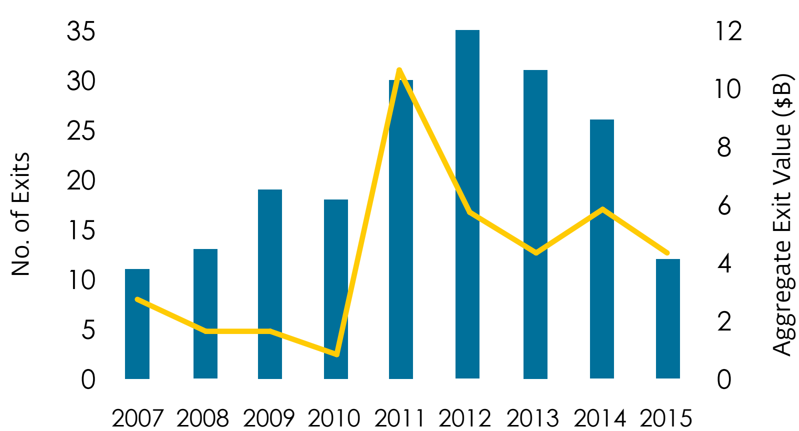


PE-Backed Deals Slide

Other than a spike in 2011-2012, PE buy-outs in Japan have mostly gone downhill since 2007. In 2015 there were 31 deals amounting to $1.2B.

No. of Deals

Aggregate Deal Value ($B)



The Rise and Fall of PE-Backed Exits

Exits from Japanese companies peaked in 2012, with 35 valued at $5.7B, dropping to 12 exits valued at $4.3B in 2015.

No. of Deals

Aggregate Deal Value ($B)

A Recovery in Progress

Akihiko Yasuda, managing director of Hong Kong-based fund-of-funds Asia Alternatives, says that after years of false starts, Japanese private equity may be turning a corner

Akihiko Yasuda
Asia Alternatives

To say the last decade has been a challenge for the Japanese economy and its private equity sector would be a considerable understatement. Between the global financial crisis, the 2011 tsunami, and the country's decades-long battle with deflation, it's no wonder the promise of this "great market for private equity" has never quite been fulfilled.

Yet with those headwinds beginning to lessen, Japan's private equity market may be ripe for a turnaround, says Akihiko Yasuda, managing director of Asia-focused fund-of-funds Asia Alternatives.

"My expectation is that this year [the private equity market] will be recovering," Yasuda says. "By the end of 2016, I expect Japan's private equity investments to be up."

Looking beyond the clear financial challenges, Yasuda says that local sellers have long been reluctant to work with private equity firms. That's a particular problem, since Japan's aging population of business owners have long been viewed as the primary source of Japan's private equity opportunity.

"If you talk to family owners, there was some hesitation about what these guys are doing," Yasuda says. That was particularly so in the early-to-mid 2000s, where private equity battled a perception as "vulture investors" after foreign investors acquired Shinsei Bank out of bankruptcy in 1998.

As time has passed, Yasuda says, the reception has warmed, and lately, given the recent falloff in the Nikkei index, the stature of private capital has been raised. And global PE firms are signaling their renewed confidence in Japan through hiring—last year, Permira hired an ex-KKR professional to head its Japanese investments, and CVC Capital hired a partner from Advantage Partners, one of the long-standing domestic GPs.

Beyond the cultural shift, Prime Minister Shinzo Abe's much-touted "Abenomics" policies have prodded structural reforms that are improving corporate governance; many see increased transparency and a stronger management culture as an essential part of expanding PE's role.

But significant challenges remain. Yasuda says that among the greatest role private equity could play in Japan—given its size and relatively slow growth—is helping local businesses expand internationally. Global firms may be better positioned to execute an expansion strategy, but they also tend to have weaker "local" relationships, which Yasuda considers essential.

"You have to be local—to know the language, the culture, and how Japanese firms do business," he says. "Local funds are great from the 'trust' perspective. Global is great when it comes to management style and reach."

Sourcing operating talent is an essential part of the equation in Japan, as operational improvements are becoming critical to value creation for the country's private equity deals.

Then there's currency risk. "The exchange rate is always a tricky part," Yasuda says. "PE is a long-term investment, and PE firms aren't currency traders."

One area that isn't a problem is financing, Yasuda says. In addition to having fairly simple capital structures—most deals are financed solely with senior and mezzanine debt—money is plentiful. "If you are a solid GP, generally you won't have a problem," he says. "Banks are coming to you and giving you money." ■

Click to watch this video at privcap.com

Mounir Guen
CEO,
MVision Private Equity Advisers

Change is in the Air for Japan's PE Market

The CEO of fundraising advisor MVision discusses the evolution of private equity in Japan

Privcap: Why is Japan so underpenetrated by private equity?

Mounir Guen, MVision: The difficulty was always access to deals. It wasn't lack of local strength and local private equity capabilities. But when you look at Japan today, it's really changing in my view. There is a lot more entrepreneurialism. There's a lot more open-mindedness. And that is starting to get into the system.

How big is the potential PE deal opportunity in Japan?

There are about 3,400 listed companies in Japan. They have 40,000 departments that could potentially be candidates for private equity. Now, it's not as if private equity doesn't have good rhythm. They do about 40 to 50 deals per year, which is pretty good, but the ability to have that type of ownership positioning and create the value is more in the mid-market, as in the smaller deals.

Can you talk about the evolving LP community in Japan?

Change is in the air. Both at the large and small end, the number of LPs in alternatives is increasing dramatically. They're learning faster about other LP programs. They are bringing in advisors and consultants to review their programs.

And I think that today they've opened by necessity because they need returns. And having opened up to private equity, they've uncovered a fantastic performing community that's very receptive and happy to share information. ■