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PRIVATE EQUITY INTERNATIONAL

THE JAPAN SPECIAL 2015

A special supplement

Investors finally put PE on the radar
Deals, exits and value creation in Japan
How Abenomics is reshaping the market
Why carve-outs are back in vogue

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JAPAN OVERVIEW

Corporate shift

Private equity is gaining a higher profile in Japan, with firms now able to access more and better deals. While the overall development of the market remains underwhelming, there are grounds for optimism, writes Clare Burrows

For decades private equity investors have eyed Japan, waiting for the world's second-largest economy (by nominal GDP value) to wake up and deliver on the promise of large buyout transactions in some of the world's most iconic companies. The anticipated deal flow never really materialised. More recently, though, sparked by efforts from prime minister Shinzo Abe to overhaul Japan's corporate culture, this is starting to change. Japan may finally be ripening into what GPs and LPs alike expect to be a very lucrative private equity environment.

Indeed, the level of activity has rebounded in the market. In 2014, private equity firms invested a total of $6.7 billion in the country, a 57 percent increase on the $4.2 billion worth of deals completed in 2013, according to figures from *Thomson Reuters*.

"The wind is at our back right now. The debt markets in Japan are probably as good for a private equity investor as they have ever been," Jean Eric Salata, founder and chief executive of Baring Private Equity Asia, believes.

And it is not just local funds that have been around for many years. International firms such as Baring, KKR and The Carlyle Group list Japan as one of their key target geographies in Asia, with KKR in particular deploying large amounts of capital in the country.

FOR SALE

In the late 1990s, there was a promise that Japan's mammoth conglomerates would restructure and private equity would pick up the pieces, acquiring the non-core divested assets of businesses such as Yamaha, Panasonic and Sony.

While those deals did not come to fruition, the same promise is being talked up today – for good reason, market sources believe.

A key strand of prime minister Shinzo Abe's economic policies, dubbed Abenomics, is forcing Japanese corporations to focus more closely on their return on equity and hire independent board directors who are starting to shine a light on the most profitable business lines, while creating a strategy to divest the rest.

As one local GP put it: "The outside directors will ask [things such as], 'Why do you keep this meaningless business?'", which is likely to prompt management teams to consider divesting non-core parts of their businesses.

Corporate carve-outs have started to happen as a result, with a number of GPs appearing ready to take them on.

For example, KKR completed two such deals in the past 12 months (see p. 17). The firm participated in the $1.67 billion spin-off of Panasonic's healthcare unit, and also in the $550 million into Pioneer Corporation's DJ business – which had earlier been solicited by Baring.

Similarly, this February, Bain Capital secured the tourism business of Japanese conglomerate Odaiba Ooedo Onsen Monogatari, paying about $422 million for it.

And while GPs warn that the trend is likely to develop slowly, other firms also appear to be gearing up to take advantage of such opportunities. Deloitte notes in its 2014 report on corporate divestitures in Japan that with several tech companies also selling non-core assets, and growing opportunities in the consumer goods space, the chances of more KKR-style private equity transactions has increased.

"This is a change that has happened over the last three years, and it continues to happen: it is the willingness of large corporates to restructure and as a result sell subsidiaries or assets," Salata says.

"Every major Japanese company has a divestiture programme in their strategy »

> ***Every major Japanese company has a divestiture programme in their strategy right now, and those assets are slowly coming to the market***
>
> **Jean Eric Salata**

Salata: led the Baring Private Equity Asia team in the acquisition of Bushu Pharmaceuticals

» right now, and those assets are slowly coming to the market. That is creating opportunities [because] some of those assets are being purchased by private equity funds [so] there is much greater deal flow coming out of Japanese corporates."

Another interesting area is deals arising from firms struggling with succession issues, or looking for operational expertise to help with their business strategies. The downside of all this is that the growing interest in the Japanese market is pushing up valuations, making it hard for firms to attain deals at reasonable prices.

Firms can attempt to avoid the pitfalls by avoiding auction processes, or making bets on companies they expect to outgrow the market to offset the higher valuations paid.

Baring acquired Bushu Pharmaceuticals in December last year through an auction process at a relatively high valuation, Salata explains. His firm believes the growth potential justifies the amount it paid for the asset because of the opportunity to make add-on acquisitions and significant operational improvements.

As with any deals, there are of course risks, but on the flip side, higher valuations have created a solid environment for exits.

For example, Baring's acquisitions of Bushu served as an exit for Tokio Marine Capital and generated a return of 6x multiple and 45.6 percent IRR for the Japanese private equity firm.

Fellow domestic player J-STAR has also generated good performance in the Japanese market this year, exiting Burn Holdings in September last year at 8x its money, and 5.1x on its investment in HCM just one month later.

GIANT RESERVES

And there is another trend occurring. Japan has recently attracted the attention of international GPs, not for its investment opportunities but as a new and growing source of capital.

The Government Pension Investment Fund of Japan (GPIF) in particular has been the subject of much discussion in the private equity community, because last year it said it would unlock up to 5 percent of its $1.3 trillion asset base for alternative assets – including private equity.

The move, which makes about $65 billion available for private market investments, came after GPIF hired Hiro Mizuno as its first-ever chief investment officer.

It has also already catalysed some action from other LPs, which are expected to be watching (and following) GPIF's movements closely.

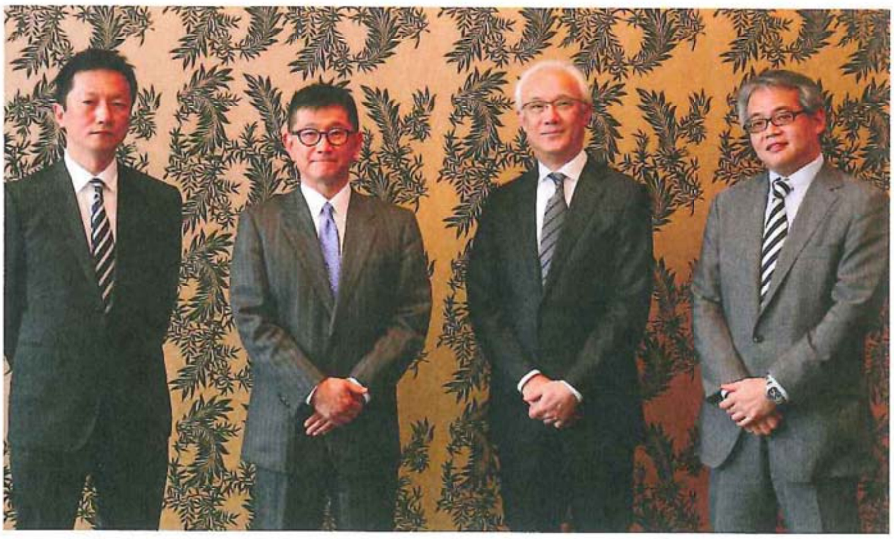
One Asia-focused placement agent told *Private Equity International* that it was encouraging to see some corporate pension funds starting to invest. "Not [the] major ones yet, but second and third tier."

GPs are optimistic over the long term. They are realistic, though, about how quickly an organisation such as GPIF will allocate to private equity funds, because lower-risk asset classes such as real estate or infrastructure are likely to be its first port of call.

"Corporate pensions and financial institutions [have] started to invest in private equity funds, but we see there are more opportunities for Japanese LPs to become more of a major investor in the private equity world," one global fund manager based in Tokyo says.

"The skills and knowledge of these investors in private equity is still very much limited, but once they start to see [that] it gives good investment returns in the long-term, which fits with corporate pension investments, we hope to see more money coming in from Japanese LPs."

Japan seems to be waking up, but the process is slow, with much education to be done in the LP community. However, if GPs can continue to produce exits pushing an 8x return, pension fund managers are likely to start opening their wallets. ■



JAPAN ROUNDTABLE

Back in bloom

Private equity is starting to enjoy a new lease of life in Japan, with exits strong and investors taking note once more. Clare Burrows visited four of the country's most respected private equity players in Tokyo to talk deals, exits, value creation – and find out how Abenomics is shaping the industry

As the rain swept in over Tokyo's business district, four of Japan's seasoned private equity professionals were arriving at the city's Palace Hotel, which overlooks the gardens of the Imperial Palace – still the official residence of the Japanese emperor.

In the dry, the three local GPs, joined by Yasuhiko Hama, head of investment at Mitsubishi Corporation Asset Management's advisory business, settled in to talk to *Private Equity International* about the state of the Japanese market today.

The rain served as a nice metaphor for the authorities' attempts to fertilise Japan's atrophying economy over the past two-and-a-half years. In 2012, prime minister Shinzo Abe set about implementing a raft of new economic policies, from weakening the currency to implementing land reforms, and from opening up the country's trade routes to bringing more women into the workforce. The intention has been to pull Japan out of two decades of economic stagnation, and to kick-start the economy.

There are differing views on whether certain strands of the policy are working, but *Abenomics*, as it was dubbed, is the most dramatic attempt yet to wash away two decades of deflation, boost consumer spending and transform Japan's often inward-looking corporate culture.

Roundtablist Taisuke Sasanuma, a partner at Advantage Partners, one of Japan's longest-standing private equity »

MEET THE ROUNDTABLE

TAISUKE SASANUMA
ADVANTAGE PARTNERS

Taisuke Sasanuma is one of the founders of private equity firm Advantage Partners, which raised one of the earliest buyout funds in Japan. He has significant management consulting experience, formerly working at Bain & Company and Sekisui Chemical Corporation. Sasanuma received an MBA degree from Keio University and MPA from the John F Kennedy School at Harvard University.

KENICHI HARADA
J-STAR

One of the founding partners of J-STAR, Harada has led a number of the firm's most significant transactions, including Primagest, Three Arrows, HCM, Olive des Olive, Tokachi and Kazetodaichi. Prior to J-STAR, he worked at JAFCO where he gained experience as a member of the buyout investment committee, as well as in its venture capital team.

KOJI SASAKI
TOKIO MARINE CAPITAL

Having joined the firm in 1998 as a founding member in its buyout team, Sasaki has devoted himself to developing and executing the firm's investment strategy. Prior to Tokio Marine, he worked for the Long-Term Credit Bank of Japan. Tokio Marine Capital has raised nearly JPY 100 billion in aggregate capital and today focuses on small- to medium-sized local buyouts.

YASUHIKO HAMA
MITSUBISHI CORPORATION ASSET MANAGEMENT

Yasuhiko Hama is the head of the investment advisory department at Mitsubishi Corporation Asset Management. His team acts as a discretionary investment manager, monitoring private equity, hedge fund, infrastructure and real estate investments on behalf of Japanese pension clients.

Every time I have visited company owners more recently, people easily understand the concept of private equity and have even sometimes heard of the Advantage Partners name. That is really different to five years ago

Taisuke Sasanuma

» investors, explains: "With some hope, I think *[Abenomics]* will help. These aren't new laws, but Abe has introduced the concept of corporate governance much more strongly to publicly listed enterprises."

He continues: "These things will change the mentality of management on how to maximise their business portfolio and corporate value."

Corporate carve-outs, though, are not the only current opportunity in Japan. Investors are being pulled back into the country as firms including J-STAR, Tokio Marine, and even some of the global players have been generating impressive returns through trade sales, secondary deals and initial public offerings on the back of the stock market resurgence.

CURRENT AFFAIRS

Having felt the impact of the global financial crisis as much as any other nation, Japan has undergone some significant challenges in recent years. But Koji Sasaki, a director in Tokio Marine Capital's private equity arm, believes the country is now recovering from the series of difficult events it experienced – most notably the 2011 earthquake and tsunami, which shook the country physically and economically.

"The private equity market is now recovering in terms of the number of transactions and the quality of these transactions," he says.

In fact, private equity deal value in 2014 jumped 57 percent year-on-year in 2014, to $6.6 billion from $4.2 billion, according to data from Thomson Reuters.

However, private equity deal flow remains a small part of the overall M&A market: to compare, in 2014 $110 billion worth of domestic M&A activity was completed over 2,779 deals in Japan – far more than the 196 transactions generating the $6.6 billion of private equity deal flow.

Sasanuma adds that the private equity market size on a GDP-adjusted basis is still around one-fifteenth of how much it represents in the US or European markets, meaning the potential for deals is huge. He notes, though, that "there are still some systemic cultural hurdles [stopping] this market from really growing."

Moreover, he says the competition for the relatively small number of deals is increasing dramatically.

"Gradually, auction deal valuations are increasing because M&A is becoming quite popular."

Global private equity firms are also becoming more competent in the local market, with Bain Capital, KKR and Baring Private Equity Asia all doing deals in the country last year.

Sadly for those players firmly fixated on the Japan market, valuations are creeping up, with the new capital pouring in.

The roundtablists agreed that for a typical retail or consumer deal, prices have risen to as much as 7x-10x earnings in some cases, making it a more favourable market for exits rather than new investments.

In fact, this has been a draw for many LPs, Hama says. "Nowadays, the Japanese stock market is recovering quite a lot and people invested in private equity are seeing good exits from private equity funds and so are becoming a lot more comfortable than before.

"Valuations are rising, so for exiting it is good, but for new investments it can be difficult."

Indeed, Japan witnessed a number of solid exits in 2014. For example, Tokio Marine Capital sold Bushu Pharmaceutical in December to Baring Private Equity Asia for JPY 76 billion ($626 million), making a 6x multiple and 45.6 percent IRR on its investment. J-STAR, too, had a successful year, exiting two of its portfolio companies: Burn Holdings at 8x and HCM Holdings at 5.1x.

Other observers agree that the environment is not entirely conducive to new investments. Kenichi Harada, managing partner representing J-STAR at the roundtable, explains: "It is very difficult [due to high valuations] so right now, we are avoiding auction deals. We need to wait, we need time to talk to business owners and wait for the right time [to invest]."

Nevertheless, for one of Asia's most credible buyout markets, leverage is cheap and easy to come by.

Sasanuma says: "Japanese loan providers are learning that private equity loans are the most attractive asset for them. I have not seen many examples of defaults of senior debt loans to private equity deals."

Moreover, refinancing interest rates are becoming cheaper, with the market becoming more competitive for the banks. Sasaki adds: "Banks are becoming much more knowledgeable about how they can rely on credit; they are becoming much more confident in [giving] these loans."

ON THE BLOCK

While the environment is more favourable to exits right now, Japan has a huge potential to provide corporate carve-out transactions for private equity firms, something that a few GPs have already started to take advantage of.

The country's huge conglomerates, which include well-known brands globally such as Mitsubishi, Sony, Nissan, Mistui, Panasonic and Toyota Group, are now being pushed to root out inefficiencies and start performing at a higher level.

In December 2014, Abe was re-elected as Japan's prime minister, with a new mandate to drive corporate efficiency by focusing on return on equity (ROE) – essentially how much profit a business makes using the capital invested by shareholders.

Abe created the new JPX-Nikkei 400 stock index, which only trades companies that rank in the top 400 on the Tokyo Stock Exchange (TSE) – measured by ROE, operating profit and market capitalisation – in order to "promote the appeal of Japanese corporations domestically and abroad, while encouraging continued improvement of corporate value", a statement on the TSE website explains. »

Japanese business owners have been opening their minds to private equity just in the past couple of years. During the carve-outs in the late-90s, Japanese business owners didn't recognise private equity

Kenichi Harada

» Sasanuma explains: "Earlier today I had a foreign LP visiting me and he asked how the corporate divestiture of big enterprises are going and I said they are coming. He said that I said the same thing 15 years ago but that he hadn't seen any!"

However, the new focus on ROE under *Abenomics* has forced businesses to rethink their structures, particularly with the new requirement to have two independent directors on the board of such companies.

So Sasanuma assures observers that this time is different. "Rather than just keeping 300 or 400 subsidiaries at the same time and trying to expand the size of their balance sheet, they have to change their thinking and really optimise the value of their portfolios by divesting non-core businesses and using that cash to make acquisitions in core industries.

"So often recently we're seeing big acquisitions by big Japanese companies domestically, although mainly overseas."

And when the big groups sell, private equity firms are among the possible buyers. Last year for instance, KKR carved out two businesses from Japan Industrial Partners acquired the PC business of Japanese electronics giant Sony.

But it is not that common yet, Sasaki admits, adding that Tokio Marine has been involved in one such deal and it was opportunistic. Nissan was restructuring and had asked for submissions from investors to buy its non-core assets.

"We would like to do more, but these types of deals do not appear that often in the market," Sasaki explains.

"That was done because [Nissan] had a very clear vision about its core and non-core business, which was a good opportunity for private equity funds to [acquire]. So when this type of very big change happens in a conglomerate then there is an opportunity."

J-STAR's Harada agrees: "It is not very common at present, but we are watching the economic situation and if more companies divest their subsidiaries, then maybe [we will invest]."

The private equity market is now recovering in terms of the number of transactions and the quality of these transactions

Koji Sasaki

PRIVATE EQUITY

Unfortunately for GPs, with the lack of opportunities and the growing field of competitors, private equity has to work ever harder to convince vendors they are the right partner.

Historically, private equity firms have suffered a bad reputation in Japan, with many entrepreneurs steering clear of the industry. The problem still exists today, the roundtable guests explain, but it is improving.

"Every time I visit company owners more recently, people easily understand the concept of private equity and have even sometimes heard of the Advantage Partners name," Sasanuma recalls.

"That is really different to five years ago."

Harada agrees, saying: "Japanese business owners have been opening their minds to private equity just in the past couple of years. During the carve-outs in the late-90s, Japanese business owners didn't recognise private equity.

"But strategic companies take a different view [to private equity]. Private equity focuses on the target company, the growth, but strategics don't, so some business owners recognise [this]."

> ***If GPIF invests up to 5 percent, it may lead other pensions – they are gradually increasing their allocations to alternatives, but not so much to private equity***
>
> Yasuhiko Hama

There is still a way to go to alter some of the misconceptions about private equity among entrepreneurs. For example, strategics are still perceived as being less aggressive than private equity when it comes to reducing headcount, the GPs sitting around the table agree. However, this perception is not necessarily true.

"It has been said that in Japan we cannot too casually decrease the headcount [of portfolio companies]. It is not legally impossible, but culturally it is difficult. So we do not assume when we make an investment that we will lay-off many people to create immediate profits," Sasanuma explains.

"Strategic investors will take this action much more aggressively. They gradually decrease the number of people or shut down distribution centres or branches, but will usually take several years to do this."

This means that while strategics have the luxury of making significant changes over a long period of time, private equity firms have to find quick and culturally sensitive ways to add value in their portfolio companies.

These measures are often as expected: helping businesses with financial systems, reporting, succession issues and management. It also comes in the form of helping with manufacturing efficiencies, rental or utilities costs.

"Usually our first step is to [improve] systems, communication – small, housekeeping things, but very important, especially [communicating with management] on how we can change the organisation," J-STAR's Harada explains.

GOING GLOBAL

Increasingly in Japan, though, private equity's value creation comes in the form of international expansion or tapping the global marketplace for new customers.

Sasunama believes that as much as 65 percent of returns are driven by value creation, the balance coming from multiple arbitrage and leverage. He explains: "How to improve the company itself is very, very important. There are many aspects, but we are now encouraging companies to find growth opportunities. To find new customers or to globalise their operations."

Advantage Partners has an office in Hong Kong, which provides its Japan-based portfolio companies information on the validity of their business strategy with regards to China or the rest of Asia.

Even for those companies not expanding abroad, the growth of an international customer base is not to be ignored.

Some firms have had major success tapping overseas customers. For example, Tokio Marine helped portfolio company Miki House, a children's clothing retailer, boost its sales by targeting the high-end consumer from mainland China.

"After we invested, we talked about how to globalise their brand," Sasaki explains. "One approach was to make the brand worldwide, but keeping sales in Japan by selling to tourists. For example, we intentionally made a push in China because lots of very wealthy Chinese people come to Japan as tourists seeking Miki House [products] because it is much cheaper to buy in Japan." »

» Tokio Marine adapted the business strategy to fit the Chinese luxury market, opening exhibitions stores in China, but maintaining the appeal of a true domestic Japanese brand.

"This was a very successful scenario [for us], so changing the strategy even slightly makes a big difference," Sasaki adds.

NEW MONEY

Away from new deals and value creation, another big talking point in the country is an intriguing development on the institutional side. Japan's $1.3 trillion pension fund, the Government Pension Investment Fund of Japan, is gearing up to invest in alternative assets, recently hiring ex-Coller Capital executive Hiromichi Mizuno as its first-ever chief investment officer.

PEI's roundtable participants all agree that this would be a big move – which is undeniable given that the fund has been permitted to invest up to $65 billion in alternative assets, including private equity. It could set an example for other pension plans and encourage them to follow suit.

However, Mitsubishi's Hama cautions that this won't happen over night. "If GPIF invests up to 5 percent, it may lead other pensions – they are gradually increasing their allocations to alternatives, but not so much to private equity."

Hama goes on to explain that although private equity has many characteristics that should in principle appeal to other pensions, few will rush into the asset class any time soon: "The reasons are the J-curve effect, longer-term [investment] horizon and [lack of] liquidity. Also, for LPs, cash management is not easy – both capital calls and distributions. As a discretionary investment advisor, we can help, but it is still not easy for some pension funds – they don't have a lot of people to manage that.

"Some of them will invest in private equity once, but that's it. As discretionary investment managers, we need to suggest they continuously make investments and then they can stabilise the returns and offset cash flows through distributions and capital calls – that is what the larger institutions are doing, but not always the pension funds."

He adds that this is likely to change, but slowly. "The first step is always very difficult. If they successfully make the first step, they will [continue to invest] in private equity. We've experienced not only a good cycle but also a bad cycle in private equity, but the market is improving and we have seen some successful exits. So it will change, I think."

Moreover, Japan's domestic players are sceptical about how much GPIF (and therefore pension) money will come their way.

Sasanuma says: "If the GPIF moves, a lot of pension funds will follow, but it might take a long time. Last I heard, they will start investment into foreign private equity funds initially rather than domestic. They are not experienced enough to really [feel comfortable] committing. As an asset class, private equity is still new to them, so they might prefer by definition more 'experienced' funds."

Sasaki adds: "The private equity market in Japan is still shallow compared to the US market, so that is our responsibility to do more and bigger deals to make it more attractive."

Nevertheless, as the currency has started to work in their favour, Japan's funds can expect continued support from overseas investors, some of the longest-standing supporters of the domestic private equity market.

"Foreign LPs have been observing the Japanese private equity market from its birth date until now, so they have strong feelings that this market is much more sophisticated and has more credibility than fund managers in [emerging] countries," Sasanuma adds. ■