Between a rock and a hard place

A shrinking domestic LP base is forcing some of Japan's small- to mid-cap focused GPs to market their funds to foreign LPs for the first time. Jenny Blinch reports.

> "If you wanted to raise funds now domestically you would not be successful – Japanese LPs stopped investing in private equity."

Ask your average Western LP what his or her view of Japanese private equity performance is and you are likely to get a one-word reply: "Disappointing."

In fact, in an increasingly pro-Asian private equity world, Japan stands out as the only Asia-Pacific market predicted to see a net outflow of LP capital in the near future, according to the Summer 2010 Coller Capital Private Equity Barometer. Some 14 percent of investors surveyed said they planned to decrease or stop investing in Japan over the next two years, compared to the 12 percent who plan to start or expand investment there.

Though a necessary caveat to these figures is the fact that Japan is a fairly established investment destination with global LPs, compared to other markets like India and China, it still constitutes "a very clear signal coming from LPs that they have been disappointed with the performance of Japanese private equity funds", states Hiro Mizuno, partner and head of Asia at Coller Capital. To put it into context, only around 2 percent of LPs said they planned to pull back from Australia, an Asian buyout market with similar longevity, compared to the 20 percent that intend to up or begin investment there in the next two years.

Against this backdrop, a number of Japanese small- to mid-market GPs are preparing to target foreign LPs – several for the first time – for significant portions of their next funds. Among these GPs are Tokio Marine Capital, which is about to launch its fourth buyout fund, TMCAP2010, with a $350 million to $500 million target; DRC Capital, which is currently raising its fourth fund, DRC2, launched last year with a $150 million target; and Ant Capital, which is raising its fourth fund, which has a $300 million to $400 million target.

Having raised three previous funds either mostly or entirely from domestic investors, these GPs have found themselves stuck in the hard place between a shrinking domestic LP base and a largely jaded foreign one.

Domestic LPs take flight

So where have all the Japanese LPs gone?

Aside from the fact many Japanese GPs, like Tokio Marine Capital, are affiliates of a larger parent group which also functions as anchor investor in their funds, they have been relying on a small pool of banks and insurance companies for third party funding.

"Up till now, there have been 20 to 30 active private equity investors in Japan in any one year, but the composition of those 20 to 30 LPs has been changing," says Naoto Mizoguchi, managing director at DRC Capital.

Fukazawa: Negative perception of Japan is single biggest fundraising hurdle

Post-downturn, that group of 20 to 30 investors looks to have dwindled significantly.

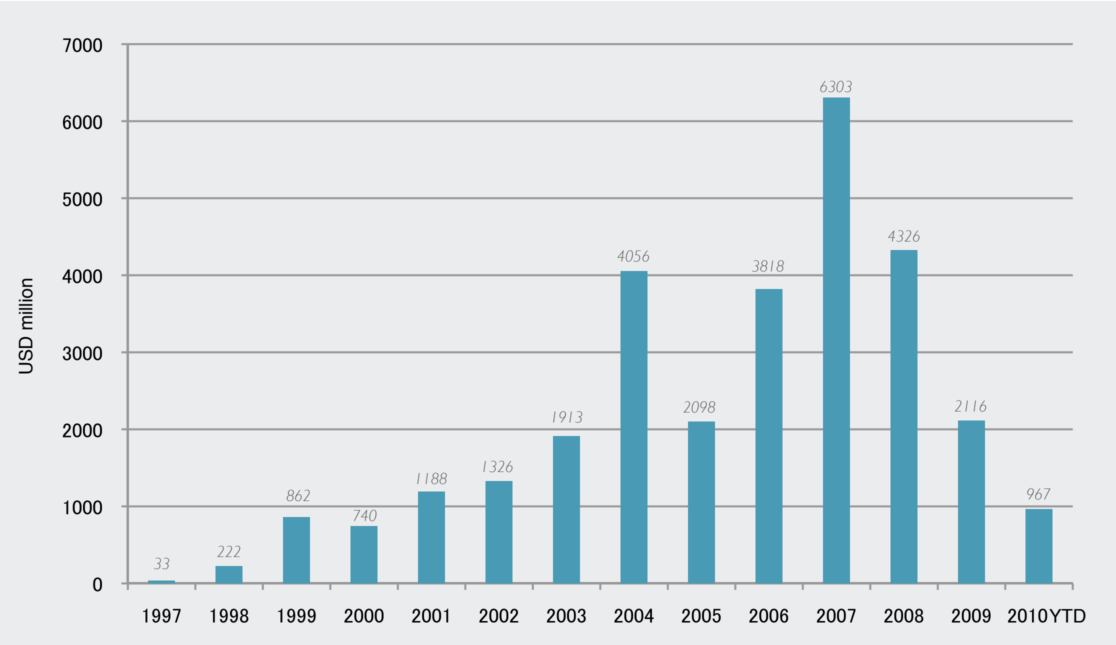
"If you wanted to raise funds now domestically you would not be successful – Japanese LPs stopped investing in private equity, and stopped from a position which wasn't very active anyway," asserts Daisuke Kawano, a partner at mid-market focused buyout firm ACA, which span out from Nikko Antfactory in 2008 and is currently raising its first pooled fund.

Where insurance companies have pulled back from private equity, it is generally due to the poor recent overall performance of their "equity" portfolio, which lumps private equity in with public equity. Instead of committing to private equity this year, they are choosing to allocate to fixed income and other less risky liquid investments.

But while insurance companies may "come and go" in the words of one local GP, banks – which were heavyweight investors in the 2006/07 crop of Japanese funds – seem to have said a more permanent goodbye to the asset class.

"In the past, banks participated in the industry with the hope of getting to provide leverage, but they have realized they can provide debt without contributing equity," states DRC's Mizoguchi. "In fact, they need Chinese walls in place to do both activities, and BASEL II has made it hard for them to continue as

Funds raised by Japan Focused Buyout Funds



Source:Brightrust PE Japan

active LP investors from a risk management point of view."

That's not to say that there will be no one to step into the breach: corporate pension funds are predicted by many to become bigger contributors to the asset class. In addition, recent political intimations that Japan's Government Pension Investment Fund, at $1.4 trillion the world's largest, might branch out from its super-conservative investment remit would seem to suggest that private equity will one day be on its radar. If that happens, other public pension funds, which have up till now been notable for their complete lack of appetite for private equity funds, will no doubt follow, says Joji Takeuchi, CEO and co-founder of private equity investment advisory and fund manager Brightrust PE Japan.

However, those are very much long-term predictions. And in the meantime, many mid-market Japanese firms have no choice but to attempt to tap into an unfamiliar and indifferent foreign LP base.

Japan deals snapshot

Data provided by Brightrust PE Japan, based on analysis of 90 out of 192 exits by Japan focused funds, gives a picture of the average profile of a Japanese buyout investment.

Average size of equity investment per buyout: $18 million
Average holding period of investment: 3.2 years
Weighted average gross ROI: 2.3x
Weighted average gross IRR: 44 percent

Tricky business

Even putting aside the fact LP appetite for private equity globally remains dampened by the lingering effects of the global financial crisis, the challenges for these GPs are multiple. Not least of these is their often low level of English and lack of familiarity with the increasingly stringent due diligence processes of foreign LPs.

However, the single biggest challenge facing these GPs is, says Hideaki Fukazawa, managing partner at Tokio Marine Capital, "that even before we are able to talk to LPs about our fund strategy, we have to overcome the negative perception towards the Japanese market".

This negative perception – the aforementioned disappointment – is, say these small- and mid-market GPs, based on the largely underwhelming performance of the group of large-cap GPs that constitute Japan's most well-known private equity firms outside of Japan.

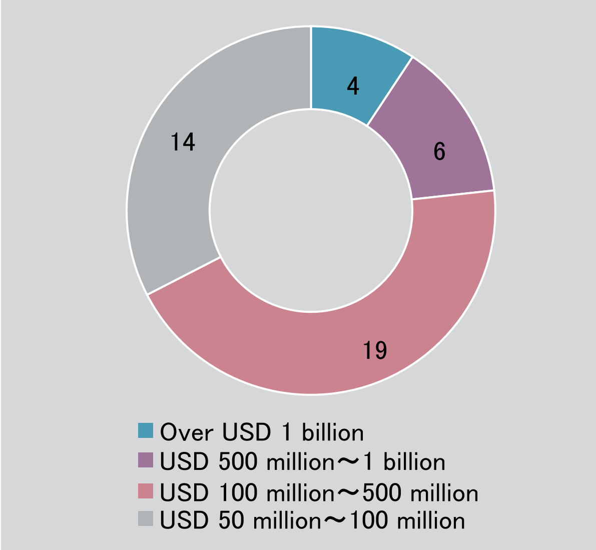
"Many LPs in the past have only been interested in known names in the large cap space," says DRC's Mizoguchi. "When performance hasn't been so good, they have made the very quick judgment that Japan is not the place for them."

The foundations to Japan's bad reputation amongst LPs lie in the country's most famous private equity investment: The JC Flowers- and Ripplewood Holdings-backed $1.2 billion turnaround of Shinsei Bank (known as the Long-Term Credit Bank of Japan at the time of its acquisition in 2000), which stands as one of the most profitable private equity deals of all time. The success of this deal caused many LPs – and GPs – to look at Japan for the first time, seeing it as a potentially lucrative large cap market.

However, Shinsei was an “exception”, say GPs, both in its timing – it was purchased in the direct aftermath of the Asian Financial Crisis when distressed banks and corporates were selling off assets – and in its size (see boxed feature: Size matters). So not only did most LPs miss the window of deal opportunity afforded by Asian Financial Crisis, but they also found their money languishing in large cap funds which have struggled in many cases to find profitable investments.

Yasutoshi Ohata, director and CEO at mid-market firm Mizuho Capital, states that “in the case of large ticket transactions, competition is very fierce among the very large managers and prices of transactions tend to be much higher than fair market value”.

Number of Japan Focused Buyout Funds By Current Fund Size (in USD)



Source:Brightrust PE Japan

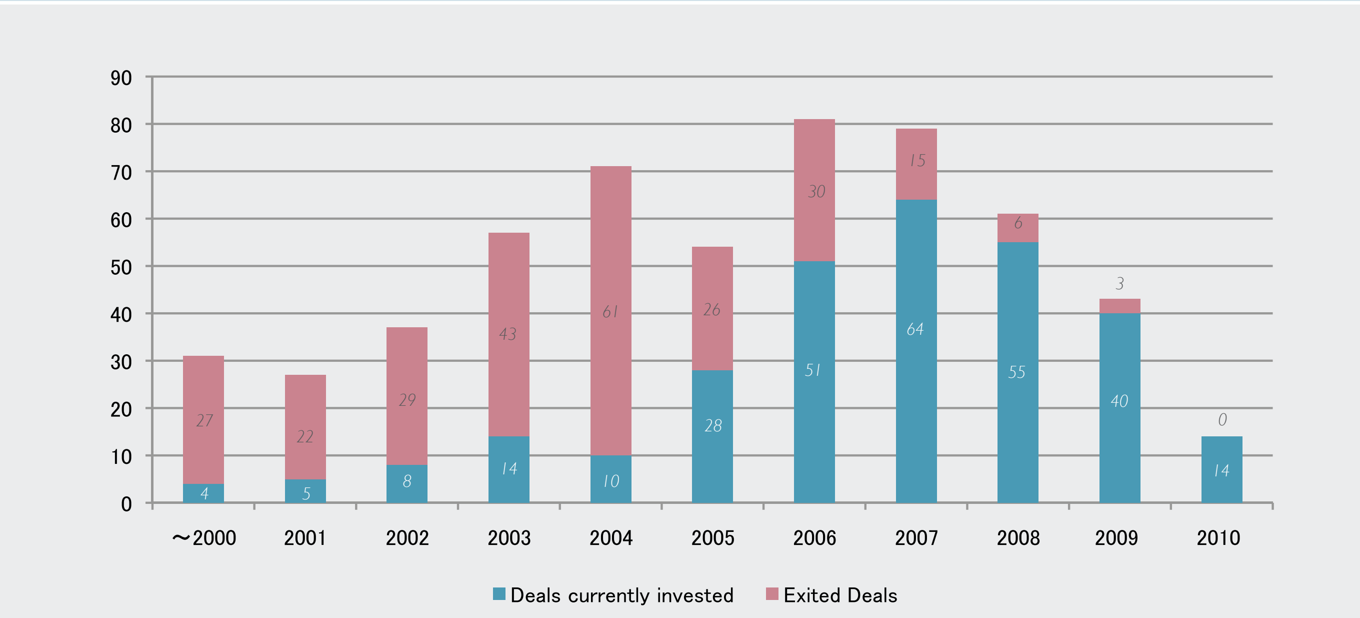
He adds that this over-pricing has led to poor returns, explaining, “In a stable market like Japan it’s very difficult to make a profit, in order to do so you need to increase the value of the portfolio company. If you pay fair market value, you have more opportunity to do this; but if you pay too much in the first place it becomes very difficult to raise value.”

LPs partly to blame

To some extent, there is a view among GPs that LPs themselves are to blame for the disappointing performance of their Japanese investments. They have been short-sighted on Japan, investing with the wrong people at the wrong time for the wrong reasons, and giving up on the country too easily when high expectations haven’t been met, says more than one GP.

“Culturally it’s so different from the West that when investments

Exited Deals: by Year of Original Investment



Source:Brightrust PE Japan

go wrong it's an easy cop-out for LPs to say 'oh well, it's Japan' and leave it at that. But that's not what really happened," says one Japan-focused GP, stressing that (poor) GP selection has played a crucial role in LP disappointment.

LPs have also misunderstood the nature of Japan's market. As a mature economy, they have expected to invest into a mature buyout market, equivalent to that found in the US or Europe. But while private equity has been around for decades in those regions, it only really took off at the time of the Asian Financial Crisis in Japan, and no allowance has been made for what another GP terms the "trials and errors" of a young and growing market – instead LPs have exercised a 'one strike and out' policy. On the other hand, as an 'Asian' market, Western investors have looked at Japan in the same way they might look at its emerging neighbour China and let their decision be governed by macro trends.

"Investors can really get themselves all twisted up – they look at Japan from afar on a macro level and they also tie GP selection mainly to macro trends," continues the first GP. "But Japan is a mature economy with mature companies and needs to be looked at more from the bottom up – for comparison, does anyone go into Western European private equity driven by a mainly macro thesis?"

Up till now, foreign LPs have also largely over-looked the small- and mid-cap focused managers who make up the bulk of the Japan's 55-strong GP base. However, the GPs mentioned earlier are attempting to change that – and are hopeful they will be able to change LPs' minds on Japan.

"The first time we see some of the big funds of funds with a Hong Kong base they say to us: '*Unfortunately*, we have invested in Japanese buyout funds.' Once we talk about how active the small buyout space is and our investment strategy, their opinion begins to change – now they are starting due diligence on us," says Iinuma Ryosuke, senior managing partner at Ant Capital.

Ryosuke: Foreign LPs are beginning to look at Japanese mid-market GPs

Nonetheless, he anticipates it will be a slow process, and adds: "Foreign LPs are starting to look at the small- to mid-cap space, but it would take at least a year and a half to collect $150 million to $200 million from foreign investors." ●

Size matters

While large-cap deals have grabbed all the attention in Japan, it's the small- and mid-cap spaces that see most of the action.

GPs in Japan's mid-market space are keen to explode the "myth" of the country as a predominately large-cap market.

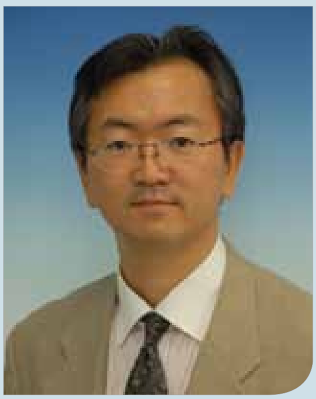
"Large cap deals are sporadic and rare," says Joji Takeuchi, CEO and co-founder of private equity investment advisory and fund manager Brightrust PE Japan. "Japan is a market for small- to mid-cap investments led by local GPs."

He is supported in his statement by Brightrust statistics which show that of the 555 buyouts the firm has recorded in Japan since 2000, only 15 have come in above the $1 billion mark – a mere 3 percent. In contrast, the bulk of Japanese private equity activity, a whopping 78 percent, has happened in the sub-$100 million bracket (see chart).

Also supporting the mid-market label are the much-publicised difficulties some of the global firms attempting to crack Japan's "tough nut" large cap space have had. They were recently highlighted again by the completion of US firm Kohlberg Kravis Roberts' first buyout in Japan since opening an office in Tokyo four years ago. Not only was the deal – the ¥32 billion ($350 million) acquisition of recruitment services company Intelligence – a long time coming for the firm, but the fact it was acquired through competitive auction (reportedly against The Carlyle Group and Advantage Partners) has led some in the market to raise their eyebrows at the price paid.

"The issue for larger funds is not only the return or IRR they are able to generate, but also the lack of deals generally - they can't find large cap deals," says Megumi Kiyozuka, managing director at CLSA Japan.

KKR is of course not the only global firm to take its time over deals in Japan. While The Carlyle Group and Bain Capital have each scored a significant number of investments, other foreign firms like European buyout house Permira have struggled to gain ground. Permira opened an office in 2005 and has to date only transacted one deal in the country: the 2007 purchase of Arysta LifeScience, a Japanese agrochemical company, for $2.2 billion in a secondary buyout from private equity firm Olympus Capital Holdings Asia.

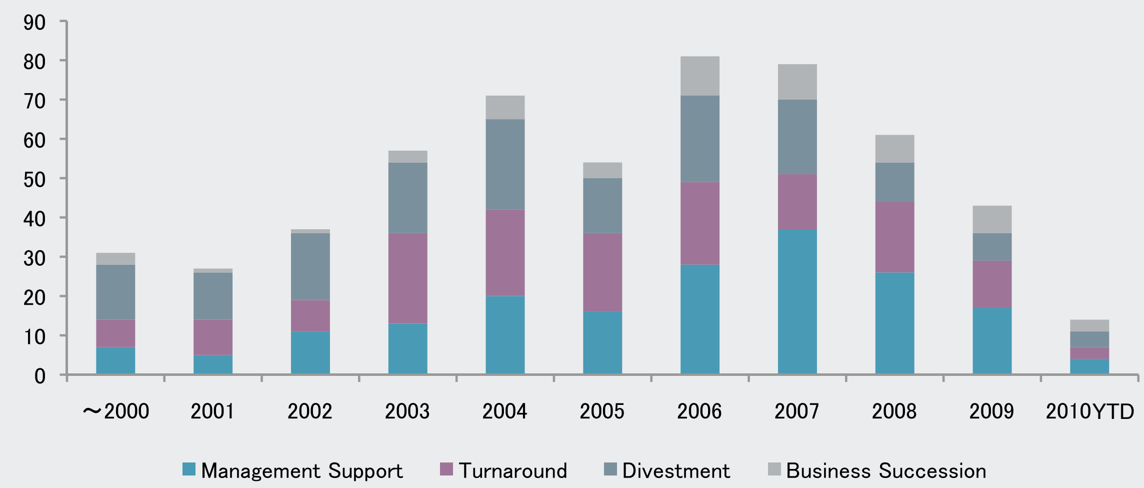


Kiyozuka: Succession issues are a key source of deal flow

The slow pace is causing some to ask difficult questions. "The patience of the global players isn't going to last forever. Deals generally tend to be smaller in Japan, so is it worth it for them?" asks Daisuke Kawano, a partner at mid-market focused buyout firm ACA.

Emmett Thomas, a partner at local large cap player Advantage

Number of Buyout deals: by Transaction Type



Source:Brightrust PE Japan

Partners, which is currently investing from a $2.4 billion fourth buyout fund, admits "the single biggest question in Japan is what it will take to get more sellers into the market". However, he is positive there is "forward momentum" and predicts we will soon see "wave 2" of corporate divestitures in Japan, as CEOs become more profit-driven in their outlook.

"Wave 1 happened in the early 2000s when corporate balance sheets were more distressed – the motivation then was survival," he says. "We feel the motivation for wave 2 may be performance improvement. Companies realise they can survive without selling off subsidiaries for cash, but on the other hand, if they sell them off they will be able to approach global levels of profitability. These are the kinds of conversations we're having with various companies in our pipeline."

It is exactly that kind of conversation that ultimately led Usen Corp, a Japanese media content provider, to sell Intelligence to KKR, according to many of the media reports around the transaction.

However, while Thomas says this trend may take time to come to fruition as a reliable source of deal flow, many mid-market GPs believe they are seeing good opportunities for investment right now, and highlight succession issues as a key source of deals.

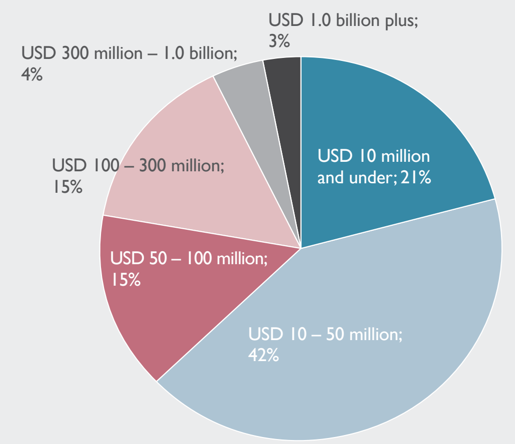
"There are many mid- to small-size high quality companies in Japan with succession issues, especially compared to carve-out deals from large conglomerates – the numbers of which are limited right now," states CLSA's Kiyozuka.

"The percentage of companies with owners over 60 years old in Japan is above 50 percent now. More than 40 percent of them have no solution for succession, which creates lots of opportunity for M&A: it's the most active space in Japan for private equity and M&A," states Iinuma Ryosuke, senior managing partner at Ant Capital.

Above all, mid-market managers claim that there is much more room to be proactive and thus drive their own destiny in their section of the size spectrum.

"Companies in Japan are generally very inefficient, so there are opportunities. If you are capable of making good proposals, you can find deals because everyone else is doing next to nothing," says ACA's Kawano.

Japan Buyout Deals Since 2000: by Transaction Size



Source:Brightrust PE Japan