While Japan proved unlucky for some in 2010, South Korea provided GPs with better news.

Market watch: Japan & North Asia

2010 has provided mixed blessings for some of the global firms targeting Japan's notoriously difficult private equity market.

Despite being one of the most successful foreign firms in Japan, The Carlyle Group started the year with a write-down of $330 million when investee company Willcom filed for bankruptcy in February. Carlyle, which had a 60 percent stake in the mobile phone company, had been unable to secure further financing from its creditors, despite being willing to inject further equity into the company itself in 2009, a source close to the firm told *PEI Asia*.

To add insult to injury, under a plan led by government-backed distress fund Enterprise Turnaround Initiative Corporation (ETIC) of Japan, Carlyle competitor Advantage Partners and Softbank came on board in March to invest in Willcom and ultimately spin off its next generation high-speed data transfer service. Advantage was expected to invest ¥5 billion in the new venture.

2010 wasn't a lucky year for TPG Capital in Japan either.

The private equity giant had joined forces with Oneworld Alliance member American Airlines (AA) in November 2009 to seek a deal with Japan Airlines (JAL), which filed for bankruptcy early in 2010. In December 2009, the duo offered to invest $1.1 billion in the stricken airline – an offer that was upped to $1.4 billion in January this year in order to head off a rival bid from Star Alliance member Delta Airlines.

In June, TPG was viewed as being one step closer to a deal when JAL and AA applied for antitrust immunity from Japan's Ministry of Land, Infrastructure, Transport and Tourism. However, JAL had in the meantime secured a ¥350 billion capital injection from Japanese government-backed Enterprise Turnaround Initiative Corporation. The TPG deal meantime seems to have died a quiet death.

Things were more rosy for Kohlberg Kravis Roberts, which in June secured its second deal and first buyout transaction in Japan, since opening a Tokyo office in May 2006. The global private equity heavyweight outbid other private equity firms such as The Carlyle Group and Advantage Partners for Intelligence, the recruitment services unit of Japanese media content provider Usen Corp, paying ¥32 billion (then ($350 million; □286.7 million) for the company. The sweetness of success in clinching the deal was marred somewhat by local market chatter, which said that while the Intelligence price tag may not be large by KKR standards, it was still in their eyes a high price for the asset.

The Blackstone Group meanwhile has had the most glowing year of all. The New York-headquartered firm in July teamed with Goldman Sachs and Japanese internet service provider eAccess to invest a total of ¥45 billion (□411 million; $514 million) in mobile data and voice service provider Emobile. The deal, which was made ahead of a merger between Emobile and eAccess, saw Blackstone invest $180 million, though specific shareholdings following the transaction were undisclosed.

South Korea

In contrast to Japan, South Korea seems to have provided more consistent levels of good news over the past year.

In January this year, Hong Kong-based Unitas Capital sold the South Korean convenience store chain Buy the Way to Japanese conglomerate Lotte Group for KRW275 billion, securing a 2.5x return. Unitas bought Buy the Way in 2006 from Korean media and entertainment company Orion Corporation for a total transaction value of KRW190 billion.

In November last year, Affinity Equity Partners agreed to sell its 70.2 percent stake in Korean cosmetics company TheFaceShop to LG Household & Health Care for KRW278.5 billion. The deal completed earlier this year netting the firm a 3.5x return on its 2005 investment, in which Affinity reportedly acquired the stake for KRW80 billion in a leveraged buyout.

Even Lone Star Funds, the firm for which South Korea has seemingly been less lucky, looks to be changing its fortune in the country.

According to various media reports at the time of going to press, Korea's Hana Financial Group was set to secure a deal to buy Lone Star's holding in Korea Exchange Bank for about $4.1 billion. Australia and New Zealand Banking Group, Standard Chartered Bank and MBK Partners had all been named earlier this year as potential bidders on the asset.

The Texan firm's $1.2 billion investment in 2002 for a 51 percent stake of KEB was marred first by controversy and then by bad luck as it came up against charges of corruption and then lived through two failed divestment attempts.

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

Key trend: Getting foreign LPs back on board

A number of Japanese small- to mid-market GPs are targeting foreign LPs – several for the first time – for significant portions of their next funds. Among these GPs are Tokio Marine Capital, which launched its fourth buyout fund, TMCAP2010, with a $350 million to $500 million target in September; 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 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.

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

Tokyo

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

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.

However, 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."

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".

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."

To some extent, there is a view among GPs that LPs themselves have misunderstood the nature of Japan's market.

"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," says one 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.

Expert perspectives

Tatsuo Kawasaki, partner and co-founder, Unison Capital

What for you has been the most significant private equity trend seen in 2010 in the Japanese market and why?

There are an increasing number of transactions involving various types of sellers happening, while some risk capital providers have lost patience with Japan. The macro environment is so much better in 2010, giving better operating grounds for the companies we have invested in the past couple of years. Also, in some cases, our companies are showing early successes in reaching out to markets beyond Japan to bridge growth gaps that are hard to achieve in the Japanese macro environment.

What do you anticipate 2011 will bring?

We believe that many sellers will be back around the discussion table. While there is much uncertainty, both corporate and individual sellers are beginning to formulate clear views on what to do with their holdings to the point where some of them are ready to press the button for transactions. On the portfolio side, we may see a further push for growth beyond Japan.

Megumi Kiyozuka, managing director, CLSA Japan

What for you has been the most significant private equity trend seen in 2010 in the Japanese market and why?

The two key trends in 2010 were, firstly, the majority of deals were mid-cap buyouts, and secondly, the number of secondary buyouts increased as private equity firms, having suffered significant losses on their investments under difficult economic conditions, were forced to sell their portfolio companies. Some funds began to sell their portfolio companies as these investments, which were carried out back when Japanese private equity was on the upswing in 2006 and 2007, entered their exit phases.

As the economic situation improved in 2010, another noteworthy trend was that banks resumed financing buyouts. They also relaxed their restrictions on LBO loans, although with more conservative leveraging.

2) What do you anticipate 2011 will bring?

We expect mid-cap and secondary buyouts to continue increasing in 2011. Given the limited number of large buyout transactions available, large-cap players will enter the mid-cap market, raising the number of players beyond the number of deals available. As such, winner and losers will be clearly distinguishable.

Naoto Mizoguchi, managing director, DRC Capital

What for you has been the most significant private equity trend seen in 2010 in the Japanese market and why?

Buyout deals closed in 2010 will continue to be few at around 40 in number as companies, particularly those in the manufacturing/export sector, recorded low EBITDAs in the recent past, making "plain vanilla" LBOs difficult. However, those buyout managers with less dependence on financial leverage have continued to be able to find good deals, particularly in sectors catering to the domestic market and especially taking advantage of the low entry prices in today's stock market.

What do you anticipate 2011 will bring?

The market trend of low entry prices will continue to prevail, offering a favourable deal environment. Another phenomenon may be that managers with a lack of deal origination abilities and/or with deals done in the past at extremely high prices may face difficulty in fund-raising for follow-on funds.

Joji Takeuchi, CEO and co-founder, Brightrust PE Japan

What for you has been the most significant private equity trend seen in 2010 in the Japanese market and why?

Japan has become recognised as the place for small-to-mid cap buyouts. Having spoken to a few dozen international investors in the past months, I have rarely come across investors who disagree with the view that the small- to mid-cap sector is the place to be in Japan. In fact, the reality of the market has hardly changed. Consistent deal flow and exits probably helped attract people's attention to the small- to mid-cap sector, while global mega funds and local large funds have underlined the trend by executing much smaller deals than they used to target.

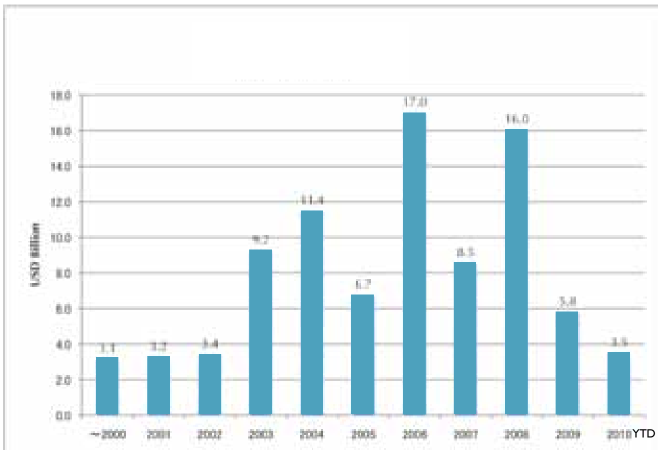
What do you anticipate 2011 will bring?

We are likely to see the continuation of public-to-private deals as the fundamentals that support the trend – such as the large pool of small listed companies with low EBITDA multiples, disproportionately high cost of keeping listed status and possible cash realisation needs of a retiring founder/major shareholder – are unchanged.

I also think we are likely see more exits to non-Japanese strategic buyers. While a strong JPY and political tension with China have brought near-term uncertainty, I would imagine the long-term trend would remain intact.

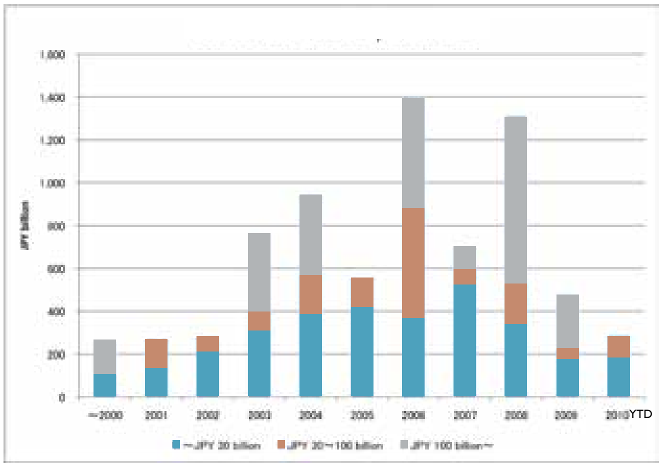
Dataspot: Japan

Japan Buyout Market Transaction Value



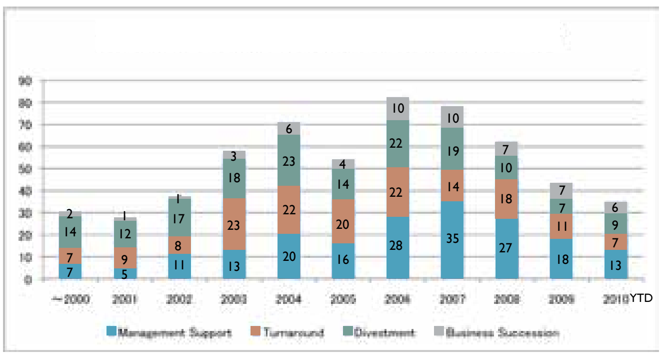
Source: Brightrust PE Japan

Transaction Value: by deal size



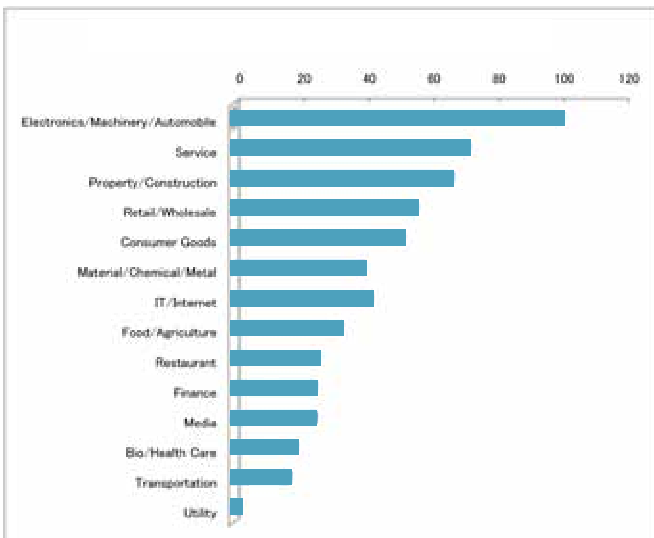
Source: Brightrust PE Japan

Number of Buyout deals by Transaction Type



Source: Brightrust PE Japan

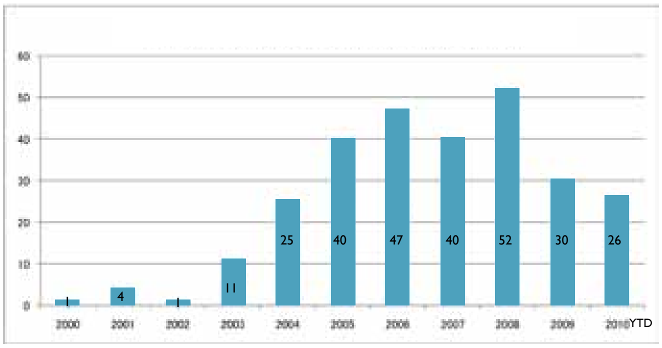
Number of Buyout Deals By Sector 2000 – 2010 YTD



Source: Brightrust PE Japan

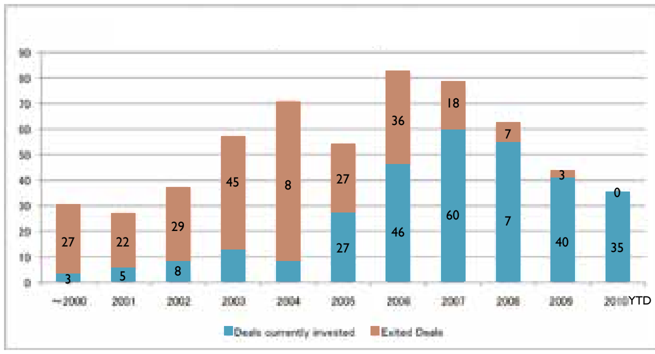
Notes:
2010 YTD data accurate as of 12 November 2010

Number of Exited Deals by Year of Exit



Source: Brightrust PE Japan

Exited Deals by Year of Original Investment

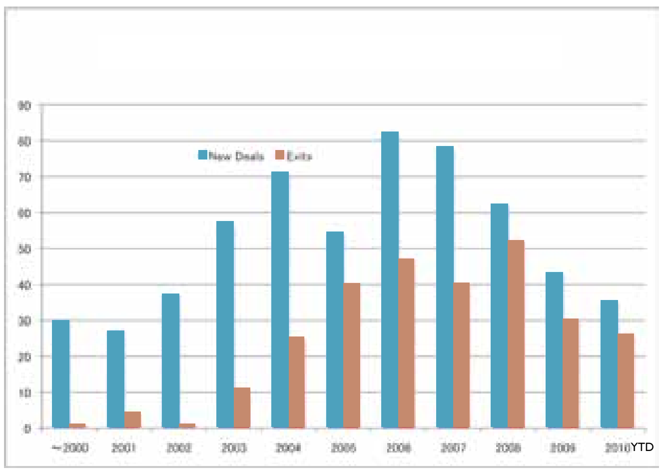


Source: Brightrust PE Japan

Number of Exited Deals: by Exit Type

Source: Brightrust PE Japan

Japan Buyout Market Overview by Numbers of Investments and Exits



Source: Brightrust PE Japan