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Japan's PE firms favour small- to mid-cap deals

By Jane Wu February 2, 2011

The Japan-focused private equity market is dominated by small- to mid-cap deals, according to industry analysts who expect this trend to continue. Such a scenario allows smaller-sized private equity firms to compete with major international players that typically engage in larger-sized deals, according to market players.

"Japan is a small-, mid-cap market. GPs (general partners) who chase large deals will continue to face difficulties," says Joji Takeuchi, CEO and co-founder of Brightrust PE Japan, a Tokyo-based investment advisor focused on Japanese private equity. Takeuchi notes that large deals are rare and very competitive in Japan.

Joji Takeuchi, Brightrust PE Japan

The small- to mid-cap deals – typically valued at less than ¥10 billion (US$121 million) – account for more than 75% of total private equity deal flow in Japan, according to data from Brightrust. The large-cap deals – valued at more than ¥100 billion (US$1.2 billion) – accounts for only 3% of the total deal flow, according to the advisor, which is planning to raise a fund of funds investing in Japan-focused PE funds.

Small- and mid-cap deals often involve relatively attractive valuations, especially when it comes to privatisation deals, says Takeuchi.

In terms of types of transactions, Takeuchi says he expects more flows into deals related to listed companies going private and succession deals. When asked why, he says many companies with small capitalisations are listed at low valuations, such as three times earnings before interest, taxes, depreciation and amortisation (Ebitda). Since the cost of maintaining a listing on the exchange is high, some see little point in being listed, and that creates opportunities for private equity firms when these listed companies opt out of their listed status.

In terms of the succession deals, Takeuchi notes that many of the small and mid-cap enterprises were established after World War II in the 1940s, and the founders are now at or well over the retirement age. Without a successor, the company founder will usually sell the business to private equity firms.

"Retiring owners are very sensitive to the future of [their] beloved company and less sensitive to small price differences," says Takeuchi, adding that non-pricing factors could play a major role in a seller's fund selection when it comes to succession deals.

The share of succession and management support deals, in which cases the private equity firms provide operational support to management in order to help them grow a better company, increased in 2010 compared with the early 2000s, while the share of divestment deals, or companies selling off a part of their businesses to private equity funds, and turnaround deals, which means private equity firms help to turnaround a company which is going down the hill, have both decreased in the same period. .

Japan's private equity market matured in the early 2000s with turnaround deals, many of which were a divestment of subsidiaries by large manufacturers or real-estate players. That worked well under those economic and stock market conditions up until 2006, but the situation has changed, says Takeuchi.

More private equity firms are becoming aware of the importance of investing in non-cyclical sectors. The manufacturing sector has a 17% share in all the buyout deals and followed by service, property and construction sectors, according to data from Brightrust.

In terms of potential exits, Takeuchi says he expects a good flow of deal exits in the future, where cash-rich Japanese firms will remain the main buyers, while overseas buyers will increase its presence.

"We will see more exits to non-Japanese buyers, especially those from China and other Asian economies," he says. Since the late 1990s, 588 private equity deals have been executed in Japan, of which 280 have completed exits, according to Brightrust.

Starting April 2009, the Japanese government made it easier for foreign investors to invest in Japanese firms through private equity funds. Under the revised Japanese tax laws, small- to mid-mid cap private equity funds without offshore vehicles are allowed to seek overseas investors.

There are about 80 buyout private equity firms in Japan, of which about 55 are Japan-focused firms that manage third-party money. The total assets invested by buyout private equity firms in the past 10 years was around US$88 billion.

Takeuchi recommends that investors create a portfolio of 40 to 60 small- to mid-cap deals with a heavy bias toward non-cyclical sectors through several primary investments and a few co-investments and secondary investments.

Takeuchi co-founded Brightrust in 2007. He was previously a partner at Konomi, a Japanese investment bank. Before that, he was a managing director and global co-head of trading at General Re Financial Products.