"It is very difficult for an overseas investor to grasp the full universe of Japanese GPs."

Joji Takeuchi, CEO and co-founder of Brightrust PE Japan, tells *PEI Asia* why the reality of Japan's buyout market is very different to the common perception of it.

The view outside Japan is that the country has never fulfilled its potential as a buyout market, despite having all the key ingredients. Would you agree with this assessment?

I agree that Japan's buyout industry has not grown to the size people would expect from an economy half the size of that of the US, but it has been growing. The Japanese buyout industry is primarily a space for small cap players, which may be surprising to many overseas investors. In the past 10 years, 480 buyout transactions have been carried out in Japan: some 80 percent of them had a transaction size of less than $100 million and nearly two thirds were less than $50 million. There were only 12 transactions larger than $1 billion. If you are sitting outside of Japan, you may think it is a place for large buyouts, with disappointing deal flow. But large buyouts, like the Shinsei Bank deal in 1999, are exceptional and are only one facet of the Japanese market.

Why is that?

According to a government survey, more than 99.7 percent of Japanese companies have less than $3 million in capital or less than 300 employees. But it is these small companies that are supporting well-recognised Japanese brands. And many have very advanced technologies. If you look at the listed market, among some 2150 companies listed on the main boards of the Tokyo Stock Exchange, nearly 1100 companies have less than a $200 million market cap. There are only 250 to 300 companies that have a market cap of over $2 billion. As a result, we have a very small universe of potential large buyouts.

Why have so many foreign private equity firms failed to find success in Japan?

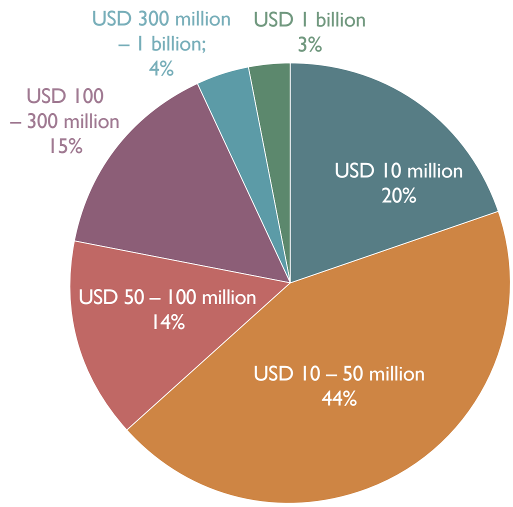
Recently a few foreign private equity firms have closed their Tokyo office and they all cited lack of opportunities. While foreign firms have robust resources on a global basis, their Tokyo team is usually quite small. They are competing against local funds, other foreign funds and a long list of cash-rich strategic buyers. Being a foreign fund does not give any advantage in winning deals. A Japanese seller tends to respect the voices of the unit to be sold, and the investee company often prefers to work with a Japanese GP.

Also, a network of contacts is very important in the Japanese market. This most notably translates into GPs' deal sourcing ability. Small deals are often privately originated. Quite a few small cap-focused local GPs do not participate in bidding. Captive funds greatly benefit from their parents' networks, which cover listed and unlisted companies throughout Japan. The network also counts in recruiting the management and industry experts to be sent to portfolio companies. Japan has a broad and deep group of industry experts, which differentiate it from other emerging economies.

Japanese GPs have tended not to seek commitments from LPs outside of Japan. Why is this?

Japan has a large pool of investment capital and GPs here have historically been able to raise as much capital they need from local institutional investors. However, even before the current crisis started, an increasing number of Japanese GPs had started to seek non-Japanese investors. I think this trend will continue.

Japan Buyout Deals by Transaction Size
Number of deals up to April 2009



Source: Brightrust PE Japan

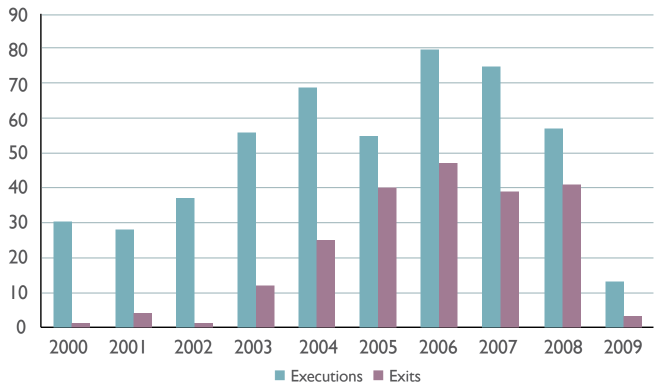
Do you think local Japanese GPs will be able to raise funds from overseas investors?

I think it could prove to be a very difficult challenge for many. I often find a communication problem is one of the very common reasons why international investors shy away. It is no coincidence the Japanese funds with superior English communication skills tend to attract more capital from overseas.

What does Japanese private equity offer to investors from outside the country?

Japan's private equity has a 10-year track record of producing

Japan Buyout Deals : Executions and Exits
Number of deals up to April 2009



Source: Brightrust PE Japan

returns without being heavily dependent on macro economic growth. Since the late 1990s, approximately 480 deals have been executed and about 30 percent were turnaround deals. Several dozens of exit records we have show a 2.3x gross multiple over 3.2 years on average. The average equity investment size of these exits was around $22 million. While a better economic environment will definitely help Japanese buyouts, returns will remain less dependent on the macro economy than those in growth markets. I think Japan could add less-correlated returns to an investor's portfolio.

If you are investing in Japan today, your focus will be on turnaround, corporate successions and other broad opportunities that are driven by quality rather than quantity. Investments in Japan and investments in some of Asia's key growth markets, for example China and India, are complimentary and provide different sources of returns to an investor's portfolio.

The tax system in Japan has previously been unfavourable for investors in private equity: has this now changed?

There has been a major improvement in Japan's fund taxation from this April. Previously, a limited partner of a domestic partnership was seen as a permanent establishment in Japan and was subject to 40 percent corporate tax. A new fund tax bill provides for exemptions to the permanent establishment rule as well as to the 25 percent/5 percent rule, commonly known as "Shinsei tax". Though there are certain conditions on investor eligibility, the new system is expected to solve most of the tax hurdles previously faced by international investors.

What do you see as the biggest problem faced by international investors in investing in Japan?

It is very difficult for an overseas investor to grasp the full universe of Japanese GPs. It would be very challenging to obtain in-depth understanding of a GP's strategy and the quality of investments if there are communication hurdles. We often find overseas investors, including funds of funds, are selecting investments from a handful of GPs for various reasons. By doing so, they are missing a very large opportunity set available in this market. For example, there are about 50 active Japanese GPs who have been focusing on deals with up to $50 million equity tickets. About half of them are in their second, third and forth funds. Some of them have very respectable track records, comparable to top US and European funds.

The economic situation in Japan is something many international investors are watching with worry. What is your view?

Last year, many thought Japan was doing better than other countries. But the Q4 2008 GDP announced in mid-February changed the picture quite drastically and now Japan is seen as the hardest hit country. Major Japanese manufactures, such as Toyota, have been very quick to cut production and lay off workers – probably much more aggressively than their US and European peers. This is their "lesson learned" from the past recessions. Now we start to see some signs of improvements. Inventories are reduced. Clean-tech products are attracting demands and the larger than ever government stimulus package is taking effect in certain sectors. Increased orders from China are supporting the recovery. China is the second largest importer of Japanese goods and by far the largest exporter to Japan. Given Japan has provided over $35 billion in Official Development Assistance to finance China's infrastructure since the 1970s, it is possible Japan could benefit a lot from China's $570 billion stimulus package.

How has the economic downturn impacted on the Japanese private equity industry?

Japanese GPs are almost unanimous in saying transaction enquiries have substantially increased, but they remain very selective. They are also spending more time on improving portfolio companies. So, new deals are done, but at a slower pace. Japanese banks continue to provide LBO loans to high quality, small to mid-sized transactions.

Looking ahead to the next 12 months, what sectors do you see being favourable for private equity investment?

We do not have a particular sector view nor rely on such. I asked a local GP a similar question and he told me that he sees investment as a game of relativity. I agree with him. It is not how to get the greatest company you can afford, it is how to get the greatest value for what you pay. In private equity, I believe the source of excess return lies in the idiosyncratic nature of deal sourcing, in value-up and at exit. We look for GPs who can source deals cheaply, preferably based on non-financial stories, who can work well with portfolio companies to enhance their value and who can bring attractive returns through a risk controlled manner.

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