Letter from Tokyo.

Ringing the changes

The Japanese private equity industry is not known for its dynamism, especially when compared to the growth markets that neighbour it. It is, however, still possible to look ahead to 2010 and predict some – potentially quite major – changes to come.

1) An increase in China and Asia-related plays in new deals and value-add efforts

With the continued growth of neighboring economies, it is anticipated that private equity deals in Japan will have more focus on China- and Asia-related plays. Many Japanese corporations have a large part of their business in China and other parts of Asia. Questions like 'Does the investee candidate have a growing business in China?', 'Will this product/service sell well in Asia?', have become increasingly important in selecting investments and GPs' value-add efforts very often focus on growing the portfolio company's Asia business. In addition, Asian companies are likely to increase in importance as potential buyers of portfolio companies. We have already seen some examples in 2009 and it would be fair to assume this trend will gain momentum considering the business synergies between Japanese companies and China/Asian companies. I suspect Japanese companies' allergy to foreign owners will give way given the merits of larger market access.

2) Possible clearing of deal backlogs

If the gradual economic recovery continues – and when people become reasonably comfortable in managing the potential risk of a second bottom to the downturn – there could be a spurt of new deals in the small to mid cap sector. It appears there are a good number of potential transactions, but the uncertain economic outlook is causing GPs to hold back. Once the economic prospect improves, this backlog could bring active deal flow.

3) Large funds sliding down to the mid cap sector

We have already started to see that large funds are increasingly eyeing the mid-cap sector. This is a logical move considering the available deal opportunities and unavailability of large sized leveraged loans, which have historically been provided by the foreign banks in Japan. The larger funds will enjoy a resource advantage over their smaller funds and those middle market specialists without a strong proprietary deal sourcing channel will face stiff competition.

4) The as yet unknown impact of the two huge new government-backed private equity funds

In the past months, two organisations have been newly set up at the initiative of the government; the Innovation Network Corporation of Japan (INCJ) and the Enterprise Turnaround Initiative Corporation (ETIC).

The Innovation Network Corporation of Japan (INCJ) was established in July and "aims to provide financial, technological and management support in order to promote the creation of next-generation businesses", according to an official statement. INCJ has a life of 15 years and it can deploy up to JPY 900 billion ($10 billion). While the INCJ can invest in private equity funds, the majority of the capital is likely to be spent on direct investments. INCJ states it will work with private equity funds and not compete against them. Be it an LP, co-investor or competitor, INCJ could have a significant impact on the activities of GPs across the deal spectrum. INCJ has collected several ex-private equity firm veterans who, I suspect, could have otherwise opted for setting up their own PE funds.

The Enterprise Turnaround Initiative Corporation (ETIC) started operations in October. ETIC "will provide support for mid-sized companies, SMEs and other businesses, including large corporations, which have revitalisation potential but are carrying excessive debt. Private sector companies will be eligible for support with no restrictions based on size, category, type or location" says an official statement about the fund. ETIC can deploy up to JPY 1.6 trillion ($17.5 billion) in the next five years. ETIC's influence on the private equity industry could well be similar to that of the Industrial Revitalisation Corporation of Japan (IRCJ, 2003-2007) given the identical mandate. The IRCJ assisted the restructuring of 41 companies, some of which, namely Daiei, Kanebo and OCC, were subsequently acquired by private equity funds.

Should be an interesting year!

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