

Mixed feelings in the middle ground

Japan's mid-market is opening up as weak public market valuations facilitate take-private deals, corporations divest non-core assets and aging founders seek an exit. GPs have plenty to aim at, provided they can raise funds

WHEN THE FOUNDER OF BAROQUE

Japan decided to sell up in September 2007 to CLSA Capital Partners, he had been at the helm of the women's fashion chain for just eight years and was in his mid-30s. Similarly, the man behind Everlife, who had spent nearly two decades building the business from nothing to a leading player in the food supplements market, was well short of retirement age when he agreed to a private equity buyout.

These examples go against the grain of perceived private equity succession planning opportunities in Japan – founders in their late 70s finally ceding control of companies they set up in the years after World War Two – but industry participants attest to their realism.

"Everyone thinks the sellers are 75-80 years old, but in my experience, it's difficult to get these people to sell. Many are opposed to private equity and they would rather take their shares to the grave," says Megumi Kiyozuka, managing director at CLSA Capital Partners. "Instead we look at the younger generation, people in their 40s with consumer and lifestyle-related businesses. They are more willing to pass on ownership."

Given recent market conditions, these sentiments are echoed by Gregory Hara, director and president of J-Star, another mid-market GP. In ordinary circumstances, younger entrepreneurs with consumer-oriented businesses would seek to liquidate their holdings via IPOs – the multiples tend to higher than for domestic M&A – but appetite for new listings has been so weak that this is no longer an option. Private equity is therefore an alternative.

"Younger entrepreneurs are more able to make decisions," Hara adds. "They get the capital and can go and do something else. If the owner is 70, they might get \$20 million, but that is the end of them as a business person, so many try to hold on." In the case of Baroque Japan and Everlife, the middle-aged founders severed ties

with the companies completely, desiring a clean break and no further role in management.

Mixed market

According to anecdotal evidence, succession planning plays a direct or indirect role in 30-40% of PE deals in Japan. Yet the deceptive nature of the opportunities available says much about the country's mid-market. To some it is an area rich

says Brian Strawn, a partner with White & Case's M&A group in Tokyo. "A lot of these companies are majority-owned by founding families and they are looking to get out because there is no successor."

While there is a clear preference for sectors that exhibit potential for overseas expansion, some industry participants highlight sub-segments of the domestic economy that are

regarded as resilient against the wider downturn. Healthcare and insurance are frequently cited and, by extension, products and services that target the elderly.

On the consumer side are lifestyle-related industries – CLSA's Kiyozuka notes the growth seen by budget apparel retailers such as Uniqlo – and niche areas like single women and pets.

J-Star's most recent investment, for example, was Tokyo-based pet clothing manufacturer Three Arrows. Japan is now the world's second-largest market for this particular kind of apparel, driven in part by the growing popularity of smaller animals as pets among

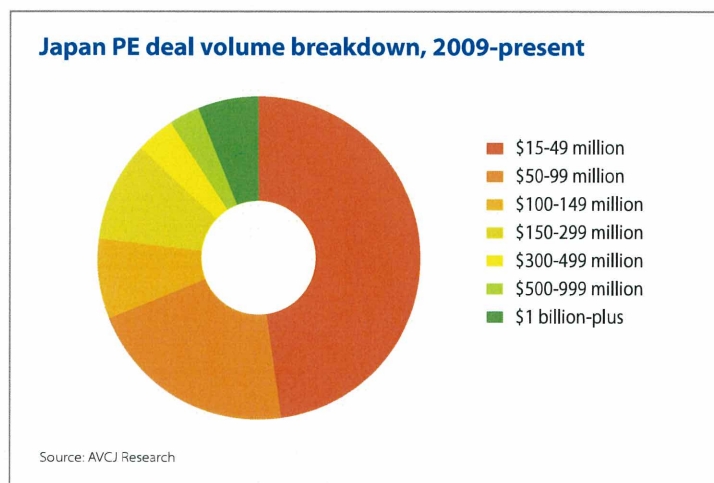
older and smaller households.

Falling prices

Opportunities are also being created by plummeting valuations. One mid-market GP, which concluded several deals in 2011, claims to have paid a minimum of 2x EBITDA for its assets and no more than 4.5x EBITDA.

Public market valuations have been hit particularly badly, with the Nikkei 225 Index down 22% on its post-global financial crisis peak of 11,300 points in April 2010. More than half the listed companies in Japan are trading at less than 5x EBITDA, which means there is a strong appetite for take-private transactions among management teams, often backed by private equity. When Nippon Mirae Capital announced the \$53 million buyout of education services provider ALC Press in May, the company was trading on JASDAQ at below 4.7x EBITDA.

For many listed companies, hopes for



in opportunity as weak public market valuations create openings for take-privates, corporations divest non-core assets and, yes, aging founders seek an exit. To others, it is a slightly more active part of an otherwise tepid industry.

AVCJ Research has records of 88 private equity transactions in Japan valued between \$15 million and \$150 million since the start of 2009. Of these, nine in 10 were worth less than \$100 million and nearly two thirds were below \$50 million. During the same period, there were 31 deals of \$150 million or more, of which 11 exceeded \$500 million.

The cumulative total for the large cap deals is obviously several times that of the smaller transactions, but clearly something is going on in the mid-market.

"I believe there is still a lot of opportunity in the mid-market, particularly in areas where there has been consolidation over the last few years, such as autos, pharmaceuticals and electronics,"

future equity financing are diminishing just as compliance costs are going up. This is yet another reason for companies expressing willingness to de-list and restructure in the interests of economic efficiency.

"There is a high hurdle for listing due to new regulations similar to the Sarbanes-Oxley Act that were introduced in 2007. Companies have to do more in terms of corporate governance, which can be expensive," says J-Star's Hara. "We are providing liquidity to entrepreneurs as a substitute for the capital markets."

Kazushige Kobayashi, managing director at Capital Dynamics, adds that small- and medium-sized enterprises (SMEs) in Japan are likely to come under even more pressure when the government relaxes banking legislation next April. Lenders are notoriously wary of extending loans to smaller companies as the risk of default is higher, so measures were introduced to encourage them to do business with SMEs. Once these measures expire, SMEs will need to show stronger equity levels to qualify for loans, creating another potential inroad for PE investors.

Kazushige Kobayashi, managing director at Capital Dynamics, adds that small- and medium-sized enterprises (SMEs) in Japan are likely to

companies he looks at are dismissed because they are unprofitable, in unattractive industries or being sold via auction. Of the remaining 10, four might raise red flags during due diligence and in another four cases the owners are unwilling to sell.

According to the Japan Buyout Research Institute, about half the investments announced in 2011 were take-private deals and up to 60% were worth US\$50 million or less. There is a lot of crossover between these transactions and succession planning issues: typically the family owners hold 10-20% of the public company and the prospective buyer wants to delist it, reorganize operations and possibly go public again in the future.

Given the hesitancy older owners have about selling to private equity investors, the challenge is finding viable targets among the myriad companies that make up Japan's mid-market space. Jun Usami, another partner in White & Case's M&A group, stresses the importance of getting on side with commercial banks that have been lending to family owners for years. "These banks have detailed information on these businesses and, in the event of a restructuring, they usually take the lead," he says. "Private equity

another is fundraising. Many domestic institutional investors have stepped back from the asset class: banks that are obliged to comply with the Volcker Rule introduced after the global financial crisis; insurers still dealing with the fallout from last year's earthquake, tsunami and nuclear crisis; and others that have become disillusioned by the poor track records of some of the larger GPs.

Fundraising in Japan tumbled to \$253 million in the first six months of the year, compared to \$2.2 billion in 2011 and \$1.5 billion in 2010. Yet according to Japanese investment advisor Brightrust, as of February, 15 buyout funds were in the market, another 11-12 GPs expected to start fundraising in 2012 and three more are operating on a deal-by-deal basis. J-Star, which is seeking around JPY15 billion for its second fund, is one of several mid-market players trying to raise capital from overseas LPs for the first time.

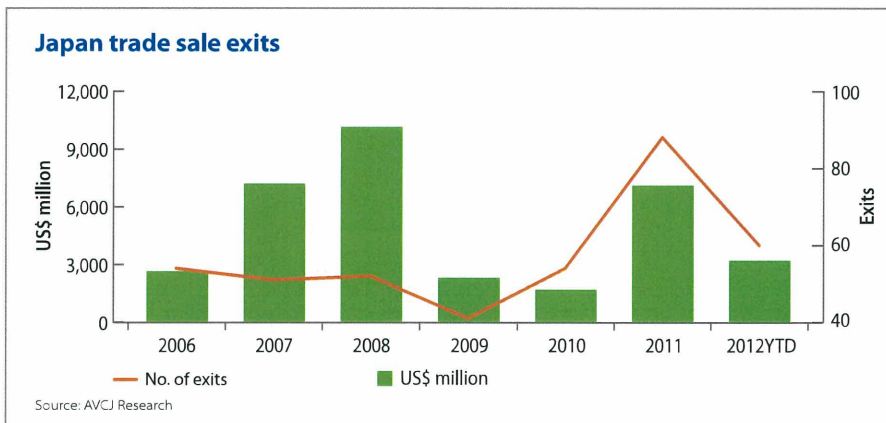
Where are the exits?

Some GPs have already abandoned their efforts. Others are on the exit path, keen to show prospective LPs that they can return money to investors. PE firms completed 60 trade sale exits in the first eight months of 2012, generating \$3.2 billion. This compares to 54 exits (\$1.7 billion) and 88 exits (\$7 billion) in 2010 and 2011, respectively. It's worth noting that the 2011 proceeds were inflated by Bain Capital and The Carlyle Group's secondary buyouts of Skylark and Tsubaki Nakashima, which accounted for nearly \$2.9 billion.

J-Star's Hara describes the exit environment as "not great, but decent," adding that Japanese corporations are largely debt-free and have plenty of cash on their balance sheets for acquisitions. Excluding financial services, he puts the total cash reserves at \$833 billion. The GP recently completed its first trade sale since 2008. Other independent mid-market players to record exits in recent months include J-Will Partners, Ant Capital Partners, Polaris Capital, Valiant Partners and Cas Capital.

It remains to be seen whether this will be enough. The consensus is that those who survive should find a reasonable number of opportunities in the next few years as valuations remain relatively low and competition for deals weakens.

"It's like a chicken-and-egg situation – there are a lot of potential deals out there, but the problem is raising capital," says Tatsuya Kubo, managing director at HarbourVest Partners. "If you have capital, it's a great play because SMEs have outperformed the large corporations, and there are so many of these companies. But it can be difficult to find GPs that are respected, reliable and trustworthy, and are able to make good investments." ■



come under even more pressure when a the SME Moratorium Law, which obliged banks to support smaller companies despite concerns about default risks, expires in March 2013. No longer protected by legislation, SMEs will need to show stronger equity levels to qualify for loans, creating another potential inroad for PE investors.

Next Capital Partners' recent JPY500 million acquisition of cooking school operator Sunrich supposedly came about because the company ran into distress after failing to secure financing through traditional channels.

Opportunities don't necessarily translate into acquisitions, however. Describing the nature of the dealflow that crosses his desk each year, CLSA's Kiyozuka says that 90 of the 100

firms that have relationships with banks will get dealflow. It is very hard for outsiders to find these opportunities."

Building relations with founders can take years – one industry participant suggests it takes 2-3 times longer than on other deals in Japan, and questions whether PE firms are patient enough – and it is not unknown for transactions to fall apart at the last minute. "Owners can get emotional and sometimes price is not the most important consideration," says Capital Dynamics' Kobayashi. "They are also thinking about their reputation in the market, their families and their employees."

For private equity firms, the rewards and trials of the mid-market are just one consideration. The