Diamonds lurk among the Japanese midcaps

Deal-making opportunities remain in Japan's mid-cap space, spurred by domestic consolidation and corporate ambitions for overseas expansion

BLUNTLY PUT, JAPANESE PRIVATE EQUITY has fallen off a cliff. From its heyday that started in the early 2000s, when billion dollar-plus deals were readily on the cards, activity has quieted to near inertia levels.

In 2006, deals worth $4.3 billion were executed in the $100-500 million range. This slipped year-by-year to $1 billion in 2009 and the modest recovery posted in 2010, when investment reached $2.6 billion, was undone by the earthquake, tsunami and nuclear crisis that hit the country in March. In the first nine months of 2011, only four deals, worth a pallid $1.1 billion, were completed.

This has prompted a widely held view among that there are no deals in Japan. Seen from a small- to mid-cap perspective, it is patently untrue. The majority of transactions – some sources claim at least 80% – fall below $100 million and therefore largely off the international radar.

"The market is very quiet, regardless of segment. But it is stable, if small, in terms of the number of transactions. And relatively speaking, the small- to mid-cap area is where the deals continue to happen," Megumi Kiyozuka, managing director with CLSA Sunrise Capital in Tokyo, tells AVCJ.

Looking for opportunities

Most industry participants who spoke to AVCJ expect the tough times to continue in the short term, especially as regards fund raising. But they also see the likelihood of a "new equilibrium" coming to pass over the next couple of years.

Aside from opportunities that lie in facilitating outbound investments by Japanese firms and inbound deals involving foreign players, there are two key domestic themes: taking public firms private and leveraging corporate succession challenges.

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"Take private" transactions have become prevalent in the last year or so. There are a large number of listed companies in Japan – about 4,000 while only 300 have a market capitalization of $2 billion or more. Joji Takeuchi, CEO of Brightrust PE Japan, a Tokyo-based investment advisor, says this is due to the mentality of Japanese entrepreneurs who were always motivated by the prospect, and prestige, of a listing.

At the same time, Japanese companies traditionally pay little attention to shareholder value. When they earn a profit, they tend to re-invest in production capacity, even if that limits profit margins.

These factors contributes to a low return on capital and, ultimately, depressed stock prices. Many entrepreneurs find themselves at a dead end, forgotten by the analyst community because they are just one of many companies in the $10-20 million range. With the stock trading at 4x EBITDA, they are understandably interested when a private equity firm offers to take the company private at a 50% premium.

It is potentially lucrative for the PE firm as well, Takeuchi adds, when exit multiples of 10x can be achieved through auctions to strategic buyers.

Eager to retire

Succession issues, meanwhile, are not sector specific. Rather they span the whole range of family-owned businesses typically set up in the years after World War II. The founders are now in their 60s or 70s and if there are no children willing to take over, they would prefer to see their life's work streamlined and re-oriented rather than left to wither and die.

"Private equity houses are increasingly seen as candidates who might qualify for this role," says Hideaki Fukuzawa, president and managing partner of Tokio Marine Capital, a unit of one of Japan's insurance groups. "They don't necessarily want to retire. But they recognize they lack the expertise to investigate overseas market possibilities, for instance."

In his estimation, there are quite a number of these "hidden diamonds" in the Japanese small- and mid-cap space. These companies may have low profiles, but they fulfill vital roles in global industrial supply chains, even compared to much bigger competitors in places like Germany, China or India.

A good example of a successful deal of this type was Tokio Marine's sale of Benex Corp., a Japanese manufacturer of very high quality fittings and other specialty industrial products. The private equity firm picked up the asset from MKS Consulting and Mizuho Capital Partners

Leading Japanese outbound investments, 2011

Date	Value (US$m)	Investor	Investee	Stake (%)	Industry
19-May	13,640.7	Takeda Pharmaceutical	Nycomed International Management (Swi)	100	Pharma
7-Mar	2,625.0	Terumo Corp	CaridianBCT (US)	100	Healthcare
1-Aug	2,569.9	Kirin Holdings	Schincariol Group (Bra)	50.45	Consumer
17-May	1,620.0	Toshiba Corp	Landis+Gyr (Swi)	60	Electronics
16-Jun	1,523.5	Itochu Corp	Drummond - Colombian mining operations (US)	20	Energy

Source: AVCJ Research

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Overseas ambitions

CORPORATE JAPAN'S voracious appetite for overseas acquisitions is undeniable. Domestic M&A reached $59.9 billion in 2007 but came to just $16.7 billion in the first three quarters of 2011, according to AVCJ Research. Outbound transactions, meanwhile, amounted to $48.3 billion between January and September, up from $21.6 billion four years ago.

Strategic buyers are also willing to pay high prices. Activity is supported by low borrowing costs and favorable a favorable exchange rate, while the big motivators are Japan's graying population, stagnant GDP growth and longstanding price deflation.

"We doubt there is any space for us to grow in the domestic market so it's important for us to seek overseas expansion," an Asahi spokesperson told AVCJ in September, in reference to the company's recent acquisition of New Zealand beverage firm Independent Liquor.

Another emerging theme is foreign companies, especially those from China, wanting to acquire Japanese companies to enhance their technology, know how or services, and in some cases their brands. A good example is China's Suning Appliance purchasing Japanese electronics retailer Laox with a view to opening 150 Laox-branded outlets in China over the next five years. Plans also call for Suning to leverage Laox's design and manufacturing sophistication to strengthen its supply chain, as well as smarten up store layouts and service levels.

Private equity firms hope to act as agents in these areas, but success has so far been limited – CITIC Capital Partners Japan, Advantage Partners and RHJ International have completed transactions but they are exceptional among Japanese PE firms due to their international outlook.

Industry participants blame the limited progress on conflicts between the short-term, financial objectives of PE firms and the long-term strategic goals of the corporations. "A lot of PE firms want to partner with these companies," says Arthur Mitchell, Tokyo-based senior counselor at White & Case. "But Japanese companies are low risk, low return, while PE is high risk, high return."

in 2005, when it was in distress, and ended up exiting to Canadoil Group, a Bangkok-based firm in related businesses.

Image problems

The challenge PE players face in this regard – apart from the difficulties in sourcing the best small- and mid-cap opportunities in a market with a dearth of industry data – is again overcoming traditional biases, i.e. the still strong tendency among Japanese businessmen to see buyout funds as short-term hustlers motivated only by greed.

"They can't readily distinguish between disruptive 'activist' investors like Steel Partners, a privately owned hedge fund which made itself unpopular a couple of years ago, and a constructive PE fund like ourselves," says Fukuzawa.

Although opportunities remain in the mid-cap space, the overriding problem faced by private equity firms in Japan is fundraising, which is described as "very difficult." According to CLSA's Kiyozuka, the next couple of years will mostly be about survival – with a fair few GPs unlikely to make the cut.

He sees this as a positive, however, as the "new equilibrium" in the market requires a proper balance between supply and demand.