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DEALMAKING

Making a success of succession

Partnering with company founders provides contrarian private equity buyers a rich seam of investments, says CLSA Capital Partners president Megumi Kiyozuka

As Japanese mid-market buyout manager CLSA Capital Partners invests its third Sunrise Capital fund, it is carving a niche as a partner for company founders keen to take their companies to the next level, while also tackling the thorny issue of succession planning. Megumi Kiyozuka, president and representative director, explains how private equity firms can partner with company founders to secure more proprietary deals and drive operational change to transform businesses.

Q What has led to the rise of management succession issues in Japan?

Today, almost two-thirds of primary deals are succession-related transactions, and there are four major reasons driving this. The first is inheritance tax, which Prime Minister Shinzo Abe increased to 55 percent, while at the same time almost eliminating the deductible element. It means that not only super-wealthy people, but also many family business owners, are now subject to very expensive tax liabilities.

Secondly, while you may get the impression that Japanese people are willing to work until their last breath, things are changing. I often meet successful business founders who say they want to retire at the age of 50, move to Hawaii and play golf every day – that group is increasing in size.

Thirdly, after about 20 years of growth, the total number of private equity investments in Japan has exceeded 1,000 – another magic number which means wherever you are, whatever the sector, you can find a very successful private equity investment case. When family business owners start to think about succession, it is not difficult for them to find friends or contacts who have worked with private equity before. Many of the cases are positive, which also helps convince potential sellers.

Finally, we have a very active intermediary sector. Each mega-bank has 20-30 marketing people focused entirely on promoting private equity investments to their clients. So, when business owners hear the same story again and again, they begin to think it might not be a bad idea.

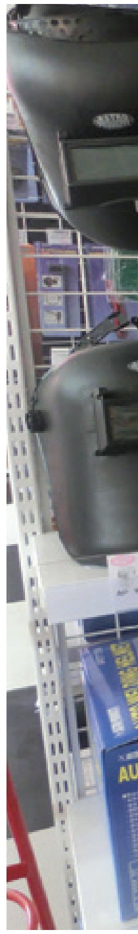
Q What are the types of succession opportunities in Japan and which are you focusing on?

We see four different types of succession opportunities in Japan. The first we call "classic", which are age-driven retirement-based succession transactions. There are many, but these founders have dedicated their lives to their businesses and tend to have a negative feeling about financial buyers. Deals can take a long time and are often small, so it's not a target for us.

The second category, which we call "NEO" – younger founder successions – breaks down into three subcategories. You have early retirements by business founders, as well as sales by serial entrepreneurs. The entrepreneurs tend to want to sell their existing businesses to finance their new ventures in areas like IT. In both cases, the deals come down to economics, so it is very difficult for buyers to benefit from

Unlocking opportunities overseas

CLSA won the trust of the founder of auto maintenance tools retailer World Tool by emphasising its strong commitment, says Yasunori Maeda, director of its Sunrise fund



Q What was the background to CLSA's investment in World Tool?

At the time we heard the founding CEO was thinking of retiring, we had another portfolio company called MIRIVE, which is a car auction company, just a 10-minute drive away. World Tool was one of MIRIVE's clients, so we paid a courtesy client visit. The founder, who was just 50, was very honest and talked about his plan to sell the company and retire.

He didn't use any sell-side advisor and talked to more than 15 financial sponsors himself. Eventually, we won his trust by emphasising our strong commitment to support the company and expand it into Asian countries. Over the course of the discussion, he changed his mind about retiring. He thought it would be fun to work with CLSA, so he decided to stay and keep a significant minority stake.

Q How have you executed your plan to expand World Tool?

World Tool had a large middle management team with long service. The

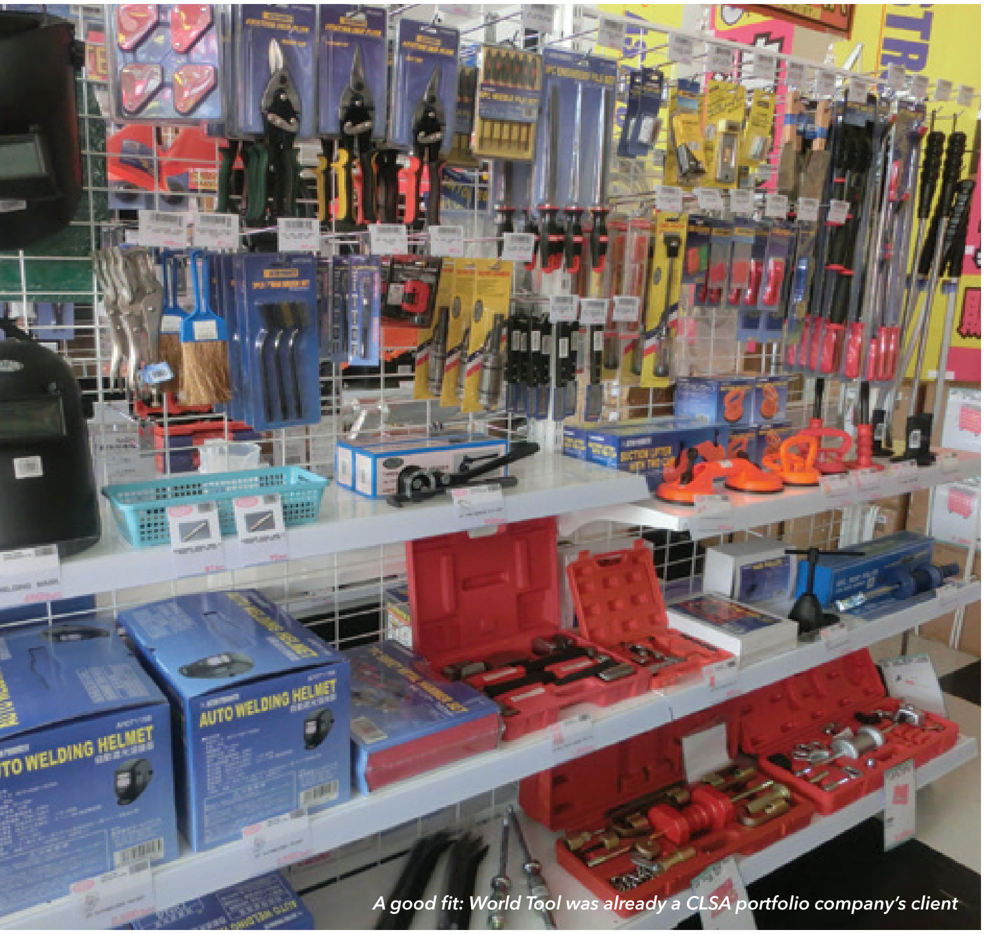
the arbitrage opportunity, or inefficiency, of small or mid-cap succession-related transactions.

The final area – joint ventures with founders – is the most attractive to Sunrise. The founders tend to be in their 30s or 40s and have built a company with $100-200 million in sales. They still love and believe in the business but have also started to feel at the limit of their own management capability. That was a factor at colour contact lens maker Lcode into which we invested in 2016 alongside the 31-year-old founder. They often knock on our door, through an intermediary, to accelerate growth, enter a new business area, or make IPO preparations. They sell a majority but retain a minority and remain in the driver's seat as CEO. We exercise the governance, but the day-to-day operations – once we have agreed a business plan – we leave to them.

Q What's your approach to adding value to the companies you partner with?

We call our approach "body-on" support, because it is much more than hands-on. We often second junior-to-mid level professionals to each portfolio company. They work 24/7 in the companies and immediately start to fix the issues the founders have highlighted. These may be quite basic issues. For example, a lot of SMEs in Japan have no long-term business plans, no KPIs, they've never done a proper board meeting, have never been audited and so on. So, we immediately fix those things and facilitate the appropriate governance infrastructure.

Once that standardised body-on package is complete, we move on to deal-specific body-on support. Typically, that means upgrading the IT system, making additional acquisitions, overseas expansion, and in »



A good fit: World Tool was already a CLSA portfolio company's client

founder wanted to give them the opportunity to work with us, so we decided not to hire outside senior management – only the CFO was hired externally – and instead promoted some good middle managers. We helped them develop, and also implemented very basic corporate infrastructure – KPIs, management meetings and a personnel system.

We also worked on several business initiatives, including new store openings in Japan and overseas expansion into Thailand. Since there was no overseas business team, we sent our junior professional to lead the entire process of opening the first store in Bangkok.

Q Why did you choose Bangkok?

This is an auto-related business – all the tools sold are for Japanese cars, and the majority of cars sold in Thailand are Japanese. They also have the culture of tuning up cars themselves, so it's like Japan 20 years ago. In fact, Thailand is following much the same cultural development as Japan so we can anticipate what will happen in the market. We now have six stores in Thailand and are still opening new ones.

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» many cases IPO preparations as well. That can take much longer and we often hire new professional management talent, such as a CFO or COO, who we work with while gradually handing over to internal management.

Q You try to take a contrarian approach to investing. Why is that, and what kinds of sectors have you highlighted?

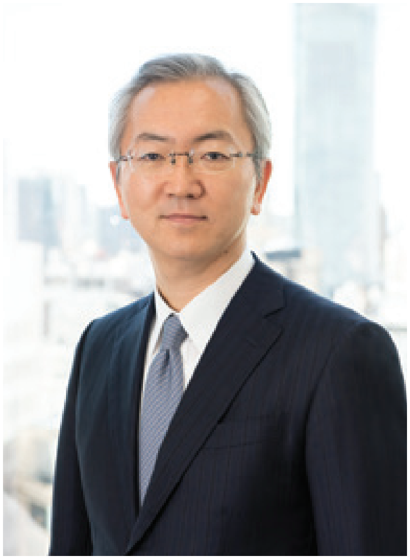
You need to be a smart contrarian and focus on exclusive negotiated transactions or limited competition deals. Otherwise you have to enter into heated auctions and pay a high price just to win.

The most competitive deals in Japan are in macro-positive sectors, such as pharma, medical equipment or elderly care, which are growing in line with the macro demographics. Then there are macro-neutral sectors, like food and beverages, which are regarded as relatively stable regardless of the macro. If we could buy macro-neutral or macro-positive companies at a mid-single digit multiple, we would be very happy, but prices can range from low double-digits up to 20x EBITDA in a fully managed, heated auction.

Instead, we focus on our own areas – the macro-shadow and contrarian subsectors. Macro-shadow sectors tend to be growing because of negative trends. For instance, the Japanese working population has been declining so companies cannot hire enough staff and must rely on outsourcing and staffing companies. Compared to macro-positive or macro-neutral investments, opinions are more mixed among potential buyers and private equity firms – and that is reflected in the multiple, which could be mid-single digits.

The contrarian approach looks for a business which is stable – or slightly growing – despite the negative macro trend. For example, the birth rate in Japan has also been declining very significantly, putting pressure on any business addressed at children. But as a matter of fact, cram schools are stable or even growing if you pick the right name. Many families have only one child but entrance exams are so important in our society that kids cannot afford to fail. Currently 60 percent of Japanese kids attend some sort of cram school.

Another trend we focus on is the Asian growth story. CLSA has an extensive Asian network and Asian know-how. We focus on domestic demand-driven companies which benefit from rising incomes among consumers in some neighbouring Asian countries.



"We often second junior-to-mid level professionals to each portfolio company. They work 24/7 in the companies and immediately start to fix the issues the founders have highlighted

Megumi Kiyozuka

Q How do you source new investments avoiding the auctions?

Most opportunities are introduced by an intermediary, and the most important to us is the independent advisory boutique. Since they are typically staffed by only two or three people, they cannot run full-blown auction processes and instead tend to match-make a seller with a buyer.

To be regarded as an ideal buyer, you need to develop a very good, deep relationship with the intermediary. We explain to them what kind of opportunity we are looking for, how we can help and what kind of track record we have. And when we say we are interested, we have to keep our promises.

We refer to our intermediary contacts as "ninja" and at Sunrise we have more than 50. Each senior member of our team is assigned a certain number of ninjas, and has numerical targets for ninja control. For example, they must meet every ninja at least once a month, go for a drinking session at least once a quarter, and meet with them with me once a year – and so encourage them to introduce as many opportunities as possible.

Last year we closed six standalone deals – half of them were introduced by our ninjas. The flipside of this approach is that we have to pay them introductory fees and feed them sushi! ■