AVCJ

Digital dynamics

Private equity looks to retool Japan's middle market

- How activists influence PE deal flow
- Why LPs are warming up to mid-cap funds
- JIC's domestic ecosystem agenda


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EDITORIAL

Managing Editor
Tim Burroughs
tim.burroughs@iongroup.com

Associate Editor
Justin Niessner
justin.niessner@iongroup.com

Reporter
Larissa Ku
larissa.ku@iongroup.com

Design
Edith Leung,
Rana Tang

RESEARCH

Event Directors
Sarah Doyle
sarah.doyle@iongroup.com

Jonathan Cohen
jonathan.cohen@iongroup.com

Sales
Darryl Mag
darryl.mag@iongroup.com
Anil Nathani
anil.nathani@iongroup.com

Publishing Director
Allen Lee
allen.lee@iongroup.com

Hong Kong Headquarters
9/F Standard Chartered Bank Building,
4-4A Des Voeux Road,
Central, Hong Kong
T. (852) 2158 9700
F. (852) 2158 9701
E. subs@avcj.com
URL. avcj.com

Beijing Representative Office
Unit 07, Level 6, China Central Place Tower 2,
79 Jianguo Road, Chaoyang District,
Beijing 100025, P.R. China
T. (86) 10 5869 6203
F. (86) 10 5869 6205
E. CAVCJ@avcj.com

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Japan in six trends

1 Divestment drive

It remains to be seen whether CVC Capital Partners renews its interest in Toshiba Corporation. An initial approach in April with a $20 billion buyout offer, quickly melted away as the GP told Toshiba that it would step aside and await guidance as to how to proceed. Nevertheless, the fact that a privatization was broached demonstrates how the upper reaches of corporate Japan have come into play. Even without Toshiba, PE investment in Japan is $22.7 billion year-to-date, the second-highest total on record. Buyouts contributed $17 billion and two of the three largest announced deals are carve-outs: Bain Capital teamed up with Japan Industrial Partners and Japan Industrial Solutions to buy Hitachi Metals for as much as JPY816.8 billion ($7.5 billion), and CVC agreed to acquire a majority stake in Shiseido's personal care business at a valuation of JPY160 billion. These divestments are usually driven by a desire to focus on core businesses or pivot towards digital and advanced technologies. Around the time of the metals deal, Hitachi offered a glimpse of its future through the $8.5 billion purchase of IT services provider GlobalLogic.

2 Disruptive voices

Toshiba did not emerge as a purported private equity target by accident. The company had become embroiled in a corporate governance scandal after it emerged that management colluded with government to rig votes on the reappointment of senior executives at the 2020 annual general meeting. It represented a victory for the activist investors who pushed for the investigation – as well as for broader reforms – and a warning for corporate Japan in general. Activist campaigns, mostly targeted smaller companies, have proliferated. Hostile takeovers are creeping up, including one launched by City Index Eleventh, which has ties to activist investor Yoshiaki Murakami, for Japan Asia Group. On one hand, activists have a history of thwarting PE take-private attempts if they believe the terms do not favor investors. This happened with Japan Asia Group, which was set to do a deal with The Carlyle Group before City Index Eleventh (although the GP ended up securing the specific assets it wanted). On the other hand, Japan Growth Investments Alliance bought home décor business Francfranc from Seven & i Holdings, the parent of 7-Eleven, after an activist investor called for divestment or restructuring.

3 The (large-cap) rivals

Global private equity firms have been actively recruiting investment professionals in Japan in recent years, positioning themselves for an expected uptick in large-cap corporate carve-outs. EQT is the latest big-name arrival. The Europe-headquartered GP has wants to replicate its global template in Asia, which means a narrower sector focus, more portfolio support, and larger equity checks. Since the start of the year, EQT has opened an office in Tokyo, established a partnership with Japan Industrial Partners to collaborate on local deals with a global angle, and set about building an investment team. Most recently, it hired a head of Japan private equity. The focus is described upper middle market, with commitments in the $100-300 million range, but there will still be plenty of investors poring over a relatively small number of deals. Japan has seen about a dozen $1 billion-plus buyouts since 2017, twice as many as in the preceding five years. The amount of capital put to work has increased threefold to $32.3 billion. In the $300-999 million segment, change has not been so dramatic. There have been two dozen deals worth $13.5 billion since 2017, up 15% and 30% on the earlier period.

4 Fundraising still fruitful

Japan PE fundraising reached a record $11.8 billion in 2020 as only two mainstream strategies across Asia – Japan buyout and US dollar-denominated China venture capital – attracted more capital than they did in 2019. That total is unlikely to be surpassed in 2021, but India is the only major jurisdiction in the region on course to outperform 2020 and the drop-off in Japan is less substantial than in most other markets. Indeed, the $6.4 billion raised year-to-date is roughly on par with the average of the preceding 10 years. The number of incremental and final closes is down, but there have been some significant breakthroughs. Bain Capital closed a JPY110 billion ($1 billion) middle-market fund, becoming only the second global GP to raise a dedicated Japan vehicle. T Capital Partners, having separated from Tokio Marine, tapped overseas investors for the first time in raising JPY81 billion for its sixth fund. The venture capital space also remained popular, with $2.2 billion raised as of mid-October, compared to $3.5 billion in 2020. LPs have committed $12.8 billion to VC since 2018, beating the total for the preceding 10 years.

5 Early-stage awakening

Momentum in venture capital fundraising is inextricably tied to rapidly improving sentiment on Japan's start-up ecosystem. Nearly $2.9 billion had been channeled into early-stage transactions as of mid-October, equal to the all-time 12-month high set in 2019. Similar advances have been made in growth-stage investment in the technology sector, with more than $900 million deployed in 2021 to date, nearly double the 2020 figure. Investment in this segment exceeded $200 million for the first time as recently as 2019. Notably, enterprise software provider SmartHR closed a $142.5 million Series D in June and news app SmartNews raised a $230 million Series F in September. The post-deal valuations were $1.6 billion and $2 billion, respectively. Meanwhile, Paidy secured a $120 million Series D in April and then, just five months later, PayPal announced it would buy the payments start-up for $2.7 billion. More than a dozen investors of various sizes are set for liquidity events. In terms of IPOs, HR software-as-a-service (SaaS) start-up Visional raised $615 million, the second-largest PE-backed offering of the year so far. Cloud video platform Safie and skills marketplace Coconala also feature in the top 10.

6 Exits flatter to deceive

Private equity is among the beneficiaries of a surge in large-cap M&A in Japan, but industry participants claim that uncertainty still looms over the middle market as prospective trade buyers ponder a post-pandemic future. Paidy is one of several bumper acquisitions in Asia's payments space – alongside BillDesk in India and Afterpay in Australia – as global consolidation touches the region. At $2.7 billion, the transaction accounts for 57% of the trade sale total for 2021. Another 38% comes from the $1.8 billion acquisition of Japan Renewable Energy by Eneos Holdings. With Innovation Network Corporation of Japan's sell-down of Renesas Electronics Corporation contributing more than 80% of the public market exit sub-total, the $8.6 billion in overall exit proceeds – the most since 2017 – looks less like a turnaround. Sales to local strategic players and to other financial sponsors with resources on the ground have risen across Asia as travel restrictions prevent international buyers from conducting due diligence in traditional fashion. Japanese strategics are still reticent, but financial sponsors remain reasonably active. The Longreach Group alone has sold two assets to private equity since the start of the year.

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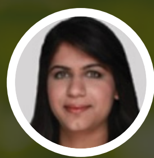

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Registration enquiries:	Anil Nathani	t: +852 2158 9636	e: book@avcj.com
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Digitization: Easy targets, hard to hit

Japan's massive mid-sized business sector is still trading in its fax machines for the cloud, sometimes willingly, sometimes begrudgingly. PE's help is most needed in terms of mindset

When Japanese private equity firm NSSK acquired Bunkasha Publishing, the 80-year-old manga comics company was part anachronism, part stereotype. Paper was everywhere, and artists and editors had wooden pencils lodged behind their ears. The CEO was using a flip-open mobile phone – in 2017. NSSK calculated the business would go bankrupt within five years.

A digitization drive had already been initiated, but there was only one person working on it in-house. Meanwhile, the pain points of remaining analog in a digital world were intensifying. Bunkasha had to estimate how much to print and absorb the cost of returned copies, while still paying royalties to authors and juggling paper and ink expenses. A good EBITDA margin for this model is 4-6%.

Digital transformation in cases such as this is not exactly rocket science. The technological aspect was mostly as simple as incorporating paperless illustration tools and converting content to a PDF format. This not only streamlined production processes and opened up intellectual contracting prospects with e-booksellers, but it also revitalized a warehouse of back issues for 8,000 titles by bringing them online for the first time.

NSSK accepted the challenge based on a recognition of several fundamental strengths within the company: a leading sales position in certain manga genres, as well as a loyal, longstanding, and mostly female readership. It also noted that manga has proven to be a category where users are willing to pay for online content rather than seek illegal free downloads.

> "Just because you've been doing it one way for 80 years doesn't mean that's the right way in the digital world"
>
> *– Jun Tsusaka*

With management support, the investor reshuffled leadership, recruiting a digital department head from local e-commerce giant Rakuten, and redirected the company economics to favor the best performing business lines. By the time Bunkasha was sold to internet content provider Beaglee last year, almost half of production output had gone online.

Digital revenue increased 50% during the holding period, with thousands of new releases distributed, and came to represent about 70% of overall earnings, while the EBITDA margin grew to 20%. This performance enabled NSSK to realize a 3x return and a 40% IRR on what was its second-largest investment at the time of acquisition.

"In Japan, the three tenants of conventional wisdom are: don't mess with the business strategy, don't change compensation systems, and don't change seniority systems. We violated all three, which was the reason we were successful," says Jun Tsusaka, a managing partner at NSSK.

"Just because you've been doing it one way for 80 years doesn't mean that's the right way in the digital world. Changing that mindset and getting buy-in from the management is the only way to survive."

Global laggard?

A distinctive cultural export like manga makes for a fitting case study on digital transformation in Japan because so much about this opportunity set is colored by a uniquely local style. The country is in an odd position in that it doesn't have the robust digital innovation industry like many other developed markets nor the leapfrogging technology adoption benefits of emerging economies.

Instead, Japan has a population of 3.8 million mid-sized companies established between the 1960s and 1980s that either don't know they need to change, don't know how, or simply can't justify investing in systems they don't understand. Digital talent is sparse and usually finds its way to a handful of brand-name service providers, leaving the broader business sector without sufficient in-house strategic guidance.

According to McKinsey & Company, a mix of developed and developing countries represent best-in-class digitization, but Japan is never among them. For example, only 9% of Japanese retail is online (versus 24% in China); digital

Japan's digtial scorecard, 2020

Metric	Japan 2020	Best in class
Total factor productivity (5-year average % growth)	-0.11%	2.81% - China
Digital competitiveness	#27	#1/2 - US, Singapore
Universities with software-related programs	29	117 - US
Digital talent as % of workforce	1%	3% – US
Industrial manufacturing: Lighthouse 4.0 factories	2	5 - China
Retail: e-commerce penetration	9%	24% - China
Healthcare: telemedicine penetration	5%	31% - Saudi Arabia
Finance: % mobile banking penetration	6.90%	35.2% - China
% citizens using digital government apps	7.50%	99% - Estonia
Smart city ranking	#79 (Tokyo)	#1 - Singapore
Public cloud spend (% of IT spend)	3%	10% - US
% of global published AI conference papers	6%	29% - US
Start-up market cap as % of total market cap	1%	31% - US
Number of unicorn start-ups	5%	320 - US

Source: McKinsey & Company

talent represents 1% of the workforce (3% in the US); penetration of mobile banking is 6.9% (35.2% in China); and telemedicine penetration is 5% (31% in Saudi Arabia).

COVID-19 has brought these shortcomings into clearer focus and, last month, prompted the government to establish a "Digital Agency" that will employ 500 officials. "The delay in digitization of the bureaucracy and private sector has become apparent," then-Prime Minister Yoshihide Suga said following the launch. "Japan cannot move forward unless we take the plunge with digitization, for which we need a strong command tower."

This could be an important development for private equity as a signal of a much-needed cultural shift and high-level buy-in for the concept of digital transformation. Most GPs recognize this aspect of operational value-add as a challenge of hearts and minds, not widgets, and consequently approach management with due diplomacy. Talking business rather than technology is the preferred inroad.

"We start with a strategy-driven approach. What is the purpose of this kind of work? What do we want to get out of it? People tend to want to use a more bottom-up approach with digital transformation, but you can easily lose sight of your original target," says Hiroshi Hayakawa, a partner at Advantage Partners who leads digital transformation in the buyout portfolio.

"We try to keep our minds at a high business strategy level, and if there's a certain action is needed, we can allocate for that. However, in reality, in the middle market, our first step is usually to make legacy IT systems cloud-ready."

> "People tend to want to use a bottom-up approach with digital transformation, but you can easily lose sight of your original target"
>
> *– Hiroshi Hayakawa*

Strategic alignment

This exercise is mostly a matter of running the numbers, showing that non-digital processes are unsustainable and how other players that failed to evolve have gone bust. Next steps involve onboarding new systems and tools, guidance on engaging a new set of stakeholders, and bringing in talent. The last of these is arguably the most uniquely challenging in a Japan context.

Advantage's solution is a partnership with NTT Docomo. The local telecoms giant has anchored a fund under Advantage's public markets strategy – known as Private Solutions – and offers technical support across the portfolio.

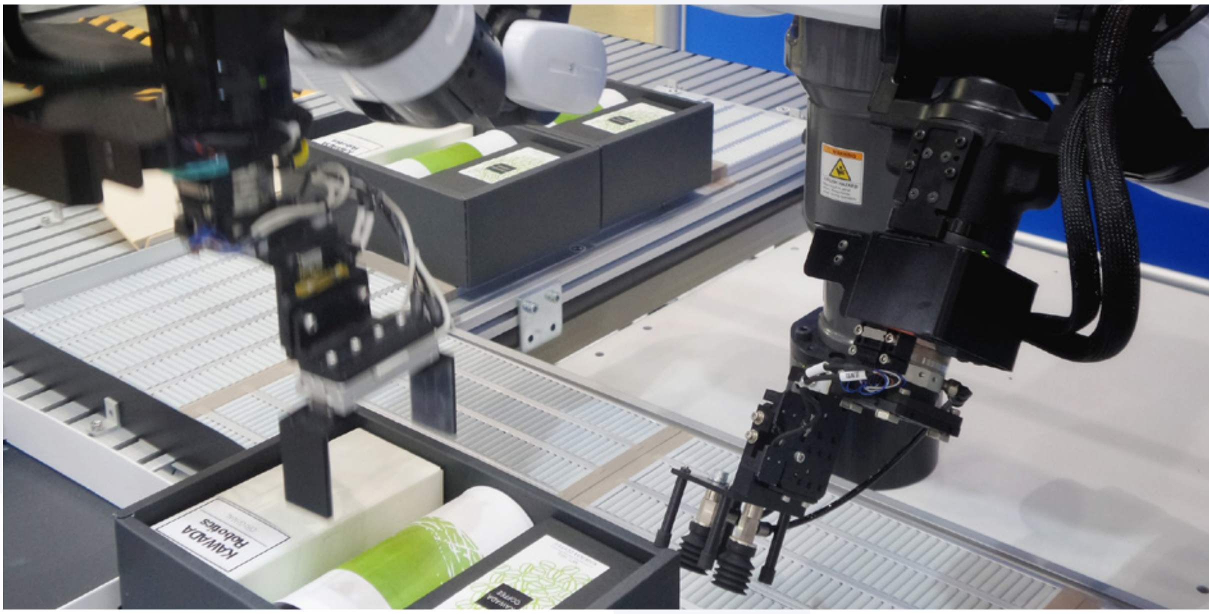
Recent investments include coffee shop chain Saint Marc, which has recorded slumping sales in recent quarters as it faces pandemic-related pressures with an underdeveloped digital strategy. Transformation is still in the planning stages but there is an intention to implement customer engagement management technology, with Docomo also supporting data-driven advertising and cafe location selection.

"It's hard for retail, restaurant, and B2C companies like that to hire IT experts, so it's useful for us to help them recruit a digital transformation head and eventually building out a department of several people," says Noriatsu Furukawa, a partner at Advantage who leads the Private Solutions strategy.

"Due to the higher salaries, that requires a different structure, so we commit that talent across several companies. Those teams also get support from NTT Docomo."

Although they struggle to attract digital talent, retail and B2C businesses benefit from more direct paths to bottom line improvement through transformation versus B2B areas such as manufacturing. Effectively, data about customers represents intuitive new revenue streams and easily monetizable insights, while smart factory upgrades, for example, represent a longer-dated cost-saving paradigm.

In industries where the fruits of a digitization



program take longer to come to light, private equity investors need to flex their people skills. For CLSA Capital Partners, this is being put into practice in one of Japan's most stubbornly conservative industries – automotive.

The GP acquired Hokuto, a manufacturing systems supplier for the likes of Toyota, General Motors and Tesla, in February with a view to putting its global data sharing procedures on the cloud. The longstanding practice – burning data onto USB thumb drives and physically delivering them clients – was an efficiency and security disaster. The company could see that it needed revamping, but management wasn't prepared to take the risk.

"People don't want to be held personally liable for trying to carry out digital transformation projects, so it helps for PE to come in and take the lead. But the biggest challenge is still explaining why we are incurring the cost," says Shota Kuwaki, an executive director at CLSA CP. "It's typical for companies to focus on the upfront expense of IT personnel and consulting firms, so we really have to explain the big picture and benefits they receive from the return on investment."

Systems upgrade

CLSA CP has also been active in healthcare, which is commonly flagged as one of the most difficult sectors to digitize due to its large teams and a strong human nature factor. For example, persuading veteran nurses to take up new ways of treating patients can be a delicate process. Still, Masamune Konakamura, a vice president at the firm, notes that because medical institutions have significant budgets and a larger market size, they can adopt digital transformations more quickly.

Dentistry is another matter, especially in Japan. There are more dentist clinics in the country than convenience stores, and most of them are mom-and-pop operations. Less than 20% of these businesses, which number some 68,000 in total, have virtual private network (VPN) access for managing patient data and interactions with insurance companies.

CLSA CP tackled this space in 2018 with the acquisition of an 85% stake in Nhosa Corporation, an IT provider specializing in dental clinics, for about JPY8 billion. It made a partial exit in February to Tokyo-listed healthcare IT player EM Systems but retains a majority position. Nhosa started in 1979 as a packaged software seller and graduated to cloud infrastructure to fill the VPN hole. It now has more than 9,500 dentistry clients.

"Companies in Japan have been spending big on customized IT systems, but there are

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REGISTRATION: Anil Nathani
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> "Midcap companies are slower in adopting these new services and behind on digital transformation. What they need is more like basic IT as a starting point"
>
> *– Masamune Konakamura*

so many venture companies providing cloud-based services out there now, you can get better results for less money," says Konakamura, who led the deals for Hokuto, Nhosa, and Rise Consulting Group, a service provider helping modernize Hokuto's file sharing system.

"Those cloud services don't sound that advanced, but the midcap companies, especially, are slower in adopting these new services and behind from a digital transformation perspective. What they need is more like basic IT as a starting point."

This is a fertile theme for venture capital. Although Japan's fledgling start-up space is mostly known for consumer-oriented success stories such as e-commerce players Mercari and Paidy, it has a strong B2B bent and corporate VC presence. As a result, the ecosystem is gradually beginning to attract the digital talent that historically has channeled into groups such as Fujitsu or NEC.

One of the start-ups most directly leveraging these themes is Herp, a human resources software-as-a-service (SaaS) provider that is handling talent management, applicant tracking, and job description creation for Digital Agency. It received a JPY950 million Series B round this month featuring DCM Ventures, Money Forward, Japan Finance, and DNX Ventures.

DNX, a B2B specialist formerly known as Draper Nexus Ventures, focuses on horizontal SaaS plays and therefore has exposure to transformation-resistant industries, including automotive. Kyohei Mukaigawa, a principal at the firm, observes that in some of these areas, start-ups are active, but they're not necessarily getting access to the true pain points.

"We've seen a lot of start-ups in things like consumer services or customer relationships, but in order to really make an industry efficient, digital transformation has to go into the back-end systems and the core of the manufacturing plants," he says. "In that sense, it's been superficial."

All in the mind

Service provider headwinds like this are yet another reminder of the psychological – rather than technological – nature of digital transformation in this market. And it's one of the reasons NSSK tapped its "philosophy program" and "happiness index" strategies during value-add work with Bunkasha.

The idea involves an understanding that digital transformation plans are often targeted at struggling companies and industries – places where cost-cutting is the mantra and morale is low. This requires working closely with staff who might feel expendable as well as keeping the most essential talent from leaving the company by tying compensation schemes to performance, not seniority.

Japan is not an easy market to do this, although it is one of the most in need. When companies are digitized, young professionals tend to begin outranking their older colleagues, causing cultural chaos. In the case of Bunkasha, this process involved bringing in a woman in her 40s – some 10 years younger than the existing all-male leadership – as head the company's now-dominant digital division.

"Not all PE firms have the experience or personnel for digital transformation, so you outsource to parties that have the tools and software packages you need. But the training and education element is key. That's where PE firms need to spend a lot of their internal resources, time, and attention," says NSSK's Tsusaka. "You can't just have these digital people flying in and flying out. You need everyone in the company to be fluent in the digital world to be successful." ■

Fundraising: Middle-market machine

Buoyed by strong macro fundamentals and robust returns, Japan's buyout managers continue to attract capital even as other strategies in Asia struggle. Will this popularity be sustained?

Annual Asia private equity fundraising first surpassed $170 billion in 2016 and has been on a gradual downward trajectory ever since. The 2020 total came in at $128 billion as COVID-19 travel restrictions played havoc with due diligence efforts. For most LPs, if a manager isn't already in the portfolio or in the pipeline, making a commitment becomes that much harder.

Only two mainstream strategies confounded this trend. Chinese venture capital managers with US dollar-denominated funds and Japanese buyout managers accumulated more capital in 2020 than they did in 2019.

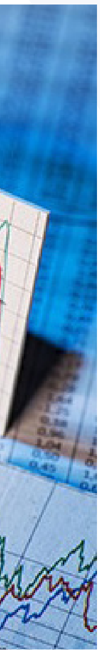
Indeed, Japan enjoyed a record year. Local buyout managers raised $5.6 billion, according to AVCJ Research, surpassing the 2008 figure, which marked a pre-global financial crisis high point. This will not be replicated in 2021 – the market is small and stable, so a lot depends on who is fundraising in any given year. But the $6.4 billion collected across all strategies represents less of a retrenchment in percentage terms than most other Asian jurisdictions.

There are various contributing factors, from local LPs rediscovering their appetite for the asset class to local GPs becoming more experienced raising capital from international investors to local company owners losing their inhibitions about selling to private equity.

However, the most compelling reason is arguably economic. Monetary easing and fiscal stimulus policies introduced in 2012 by then Prime Minister Shinzo Abe – retained under his successors – have turbocharged the economy. They offer helpful tailwinds to a Japan middle-market investment thesis typically underpinned by relatively low entry valuations, ▶

"We are seeing greater interest from overseas investors, and it is synchronized with increasing China-US tensions"

– Gregory Hara



modest leveraged financing, and the scope for operational improvement.

"Since 2012, it's been a benign macro environment with monetary easing, readily available loans, and stock market strength. Corporates are flush with cash so there are plentiful exit options as well," says Jun Tsusaka, a managing partner of NSSK. "LPs might ask why they should invest in Japan when they can get good returns in North America. Well, those returns have been challenged because pricing has gone up. In Japan, pricing is lower than in North America, Europe, and Asia. Net-net, you are now seeing consistent and attractive returns out of Japan, and deal flow is strong."

Several industry participants offer another explanation for the rising popularity of Japan, which might explain why fundraising has proven resilient in the face of COVID-19: LPs are reluctant to back Chinese managers given uncertainty arising from tensions with the US.

It is a theory that exists in anecdote rather than in hard numbers – while commitments to US dollar-denominated China funds are down, VC is flying – but investors with heavy China exposure in Asia might want to diversify their portfolios. And Japan is perhaps the antithesis of China: slower growth, smaller scale, and fewer start-ups on steroids; but traditional buyouts, conservative valuations, and a reputation for stability. Japan's economy is also less correlated to China than others in Asia.

"We are seeing greater interest from overseas investors and it is synchronized with increasing China-US tensions," says Gregory Hara, a managing partner at J-Star. "Western investors have made so much money in China, mainly from VC and growth capital. Now they appear to be more cautious. If they are managing portfolios geographically, with a certain allocation to Asia, when they look at Asia ex-China maybe Japan middle market buyouts come up."

Others subscribe to the notion of Japan as anthesis without necessarily tying it to US-China issues. The economy is developed and stable and the private equity industry has a track record of delivering returns with no venture-style risk. Niklas Amundsson, a partner at placement agent Monument Group, suggests that these characteristics are appealing to international investors during times of global insecurity. There might be some truth to this, but Japan is also a slow-burn story.

Return to form

The tide began to turn in 2013. During the three years to 2008, $20 billion was committed to country-focused across all strategies. Buyout managers received $11 billion – nearly twice what they had raised in the entire history of Japanese PE to that point. A few blow-ups and generally dispiriting returns followed, prompting many LPs to pull back and some GP to drop out.

Adams Street Partners made its first commitment to a Japanese manager in 2013, when fundraising recovered to $1.7 billion after four years of sub-$1 billion totals. Yar-Ping Soo, a partner at Adams Street, describes a market that had gone through a period of consolidation as the weaker players were rooted out, resulting in reduced competition for deals. Abenomics had yet to make its mark.

"Nobody was interested in Japan, but we had been tracking the market and we started to see valuations dropping and the number of competitors going down," she says. "It used to be every bank was investing in private equity, but they were shutting their businesses, and global funds that had set up shop in Japan went away. The prices were low, we thought it would be good to step into the market and that call was proven right. I just wish we had done more."

Middle-market managers as a group have raised more in every vintage since then. This was most visibly demonstrated in 2017 when six final closes – at their respective hard caps – were announced in the month of April alone. There were four more by the end of the year, taking the aggregate to $2.7 billion. It hit $3.7 billion in 2018 with the addition of some larger-cap funds.

The rich vein in fundraising coincided with a surge in local investor sentiment. There were approximately 80 buyouts in Japan in each of 2016 and 2017, compared to an average of 50 for the preceding four years. Activity was concentrated towards the smaller end of the spectrum – during the two-year period, two dozen buyouts of $100 million and above accounted for 90% of capital deployed – and local GPs were expecting more of the same.

Deal flow has dropped off, but GPs remain bullish. "In the last 4-5 years, founder-succession has been 60% of the market and 75% of what we have done. We're now seeing more carve-outs coming through and they are more accessible to PE than in previous cycles," says Richard Folsom, a representative partner at Advantage Partners. "Carve-outs are somewhat cyclical, but succession deals are not. There's an ongoing underlying demographic theme there."

Advantage is a prime example of how fortunes turned. Having raised a bridge vehicle in 2013 to restate its middle-market credentials following a troubled previous cycle, in 2017 the firm's closed a full-size fund at JPY60 billion ($569 million). Local LPs accounted for 65% of the corpus as insurers, pension funds, trust banks and regional banks returned to the asset class.

That gravitation towards domestic investors was typical of middle-market funds of that vintage. Of those six final closes from April 2017, only J-Star and CLSA Capital Partners (CLSA CP) received a clear majority of their commitments from international LPs, with 60% and 75%, respectively. Now, though, the industry appears to be shifting in the other direction.

For the current vintage, J-Star and CLSA CP saw no change in their foreign-domestic LP ratios, but they were already skewed towards foreigners. Advantage, meanwhile, closed Fund VI in April at JPY75 billion, with a 50-50 split. Aspirant Group completed fundraising for its third vehicle in late 2019 with JPY50 billion and the overseas LP share went from zero to 45%.

T Capital Partners performed a similar feat, having spun out from local insurer Tokio Marine. The firm closed its sixth fund at JPY81 billion earlier this year, with overseas LPs accounting for 40%. Integral Corporation's fourth fund came in at JPY123.8 billion with 50% of the money coming from overseas, compared to 25% out of JPY73 billion in the previous vintage.

Collecting capital

These shifts are partly driven by necessity: the pool of domestic capital might be growing, but it is still finite, so a jump in fund size might involve a wider marketing effort. Polaris Capital Group raised JPY75 billion for its fourth fund with a 50-50 split and JPY150 billion for its fifth last year. The overseas share was tipped to grow – as suggested by Pennsylvania Public School Employees' Retirement System and Canada Pension Plan Investment Board writing large checks.

At the same time, Japanese GPs and international LPs appear better equipped to deal with one another. On the manager side, local managers have strengthened their investor relations and back-office functions in recent years, and they are generally more comfortable engaging with foreign investors. However, it is debatable how widely reforms reach.

"Even if the track record is good enough for a global audience, the presentation style often is not. We are pulling teeth trying to get information from them because they are not used to presenting," says one placement agent. "More managers are now good at marketing, but it's a small cadre, maybe two handfuls."

Fashioning a story for an international audience is time-consuming. A different agent, Monument, ran the most recent Aspirant fundraise. Three dozen reference calls conducted before taking on the mandate were transcribed and translated into English and placed in the data room. Fundraising documentation was translated into English and revised to meet international criteria, while due diligence calls involving team members with limited English were simultaneously translated.

CLSA CP and J-Star are to some extent fortunate that they were set up to accommodate foreign investors from the outset. Most funds comprise a Japan limited partnership and a Cayman Islands feeder vehicle for foreign investors, but CLSA CP was always unusual in its preference for a Cayman limited partnership. "We seem very foreign to domestic investors," says Megumi Kiyozuka, a managing director at the firm, adding that all internal and external documentation is in English.

J-Star's first fund was backed by Secured Capital Japan, which in turn drew on commitments from California Public Employees' Retirement System (CalPERS) and Pacific Life Insurance. Broadening the LP base for Fund

II was difficult, but at least there was some momentum. Hara questions whether smaller GP starting out from scratch can justify the cost of targeting overseas LPs. It is not just a matter of hiring English-speaking IR professionals.

"We end up managing four parallel offshore funds – it would be much more cost-efficient to have a single fund, domiciled in Japan," he says. "From a GP perspective, it's not worthwhile unless you are at least $200-300 million in fund size. New guys normally cannot start at $200-300 million because they lack track records."

If managers can invest in establishing a platform that is structurally and commercially appealing, they might find an increasingly receptive audience. One GP drily observes that "LP perceptions often lag what's happening in the market by 2-3 years," but investors appear to be reengaging with Japan at different speeds.

Towards the end of November 2020, several firms had succeeded in attracting new investors despite COVID-19. In almost all cases these are LPs that have previously met the GPs. One fund – sources requested that it not be named – received commitments from two new investors that had considered participating in the previous two vintages and ultimately declined. As such, they have been conducting off-and-on due diligence for 10 years. A third LP hasn't set foot in Japan but made a substantial investment based on video calls and work done by its advisor.

"In 2016-2017, the interest was from fund-of-funds and consultants, mainly international investors with Asian offices. Today we see more direct interest from investors that don't have offices in Asia," says Monument's Amundsson. "It helps that in the last few years global investors have stepped up their activity in Japan. When they come around marketing their Japan story, LPs think they should get some exposure to the middle market as well."

For sub-$1 billion funds, these tend to be endowments and foundations, insurance companies, family offices and gatekeepers, rather than US public pension funds and sovereign wealth funds.

Sustainable alpha?

This interest is undoubtedly returns-driven and there is a sprinkling of individual highlights: CLSA CP, J-Star and T Capital defying the global financial crisis to deliver gross multiples of 3x or more on 2005-2006 vintage funds; Advantage's return to form with its bridge vehicle; T Capital never losing money on a single deal;

Largest Japan private equity fund closes, 2020-present

Final closes

Fund	Manager	Raised (US$m)	Previous vintage (US$m)
Carlyle Japan Partners IV	The Carlyle Group	2,448	1,134
Polaris Private Equity Fund V	Polaris Capital Group	1,350	711
Integral 4	Integral Corporation	1,200	692
JIC Venture Growth Fund No.1 Investment	JIC Venture Growth Investments	1,116	-
Bain Capital Japan Middle Market Fund	Bain Capital	1,000	-
SBI 4+5 Fund	SBI Investments/Mitsubishi Logistics	900	-
Advantage Partners VI	Advantage Partners	806	569
T Capital VI Investment	T Capital Partners	773	490
AG III Investment	Aspirant Group	474	373**
J-STAR No.4	J-Star	460	308
Sunrise Capital IV	CLSA Capital Partners	450	400
J-GIA No. 2	J-GIA	333	164

Source: AVCJ Research

NSSK achieving top decile status within the global middle-market buyout category based on distributions from its 2017-vintage second fund.

However, performance is not uniformly strong across the segment. Net multiples for funds raised between 2010 and 2014 range from 1x to 3.3x, according to data pertaining to eight middle-market managers shown to AVCJ. Nevertheless, several industry participants have observed a halo effect in the market, with unfulfilled demand for heavily oversubscribed funds spilling over into perceived "next best options."

There aren't necessarily more managers in the market but most of the incumbents are raising larger funds. A frequent observation in recent years is that increased intermediation and rising competition has pushed entry valuations from 5-7x EBITDA into double-digits.

"Aggregate dry powder in Japan exceeds the potential investment opportunities at this moment. It is most excessive in the large-cap space, but it's still excessive in mid-cap and slightly excessive in small-cap," says CLSA CP's Kiyozuka. "It is harder to identify non-negotiated deals, even in the lower mid-cap space. More sellers are retaining advisors and arranging auctions, so you have to pay a higher price."

For this reason, the GP sanctioned a relatively modest $50 million increase in fund size to S450 million for the current vintage. Others are not being so restrained, to the point that the existing middle-market structure – Advantage and Unison Capital in the upper segment, everyone else in the lower segment – is fragmenting. The likes of Polaris and Japan Industrial Partners have the capacity to challenge for deals in the lower reaches of the pan-regional buyout fund range.

"The opportunity set is there and continues to grow and private equity as a group is underpenetrated in overall M&A. More PE capital will lead to more penetration, which is still plus or minus 10% of the market," says Folsom of Advantage. "If a single GP raises too large a pool of capital that could put pressure on them to do something outside of scope or outside of where the market opportunity really is. That is a continuous dialogue we've had with LPs."

For all the current interest in Japan, concerns about a potential demand-supply mismatch, are causing some to question the implications for future performance. "Fundraising is great right now, which is justified," one advisor observes. "Will this be a good vintage? I don't know, ultimately." ■

Activists: Enablers or destabilizers?

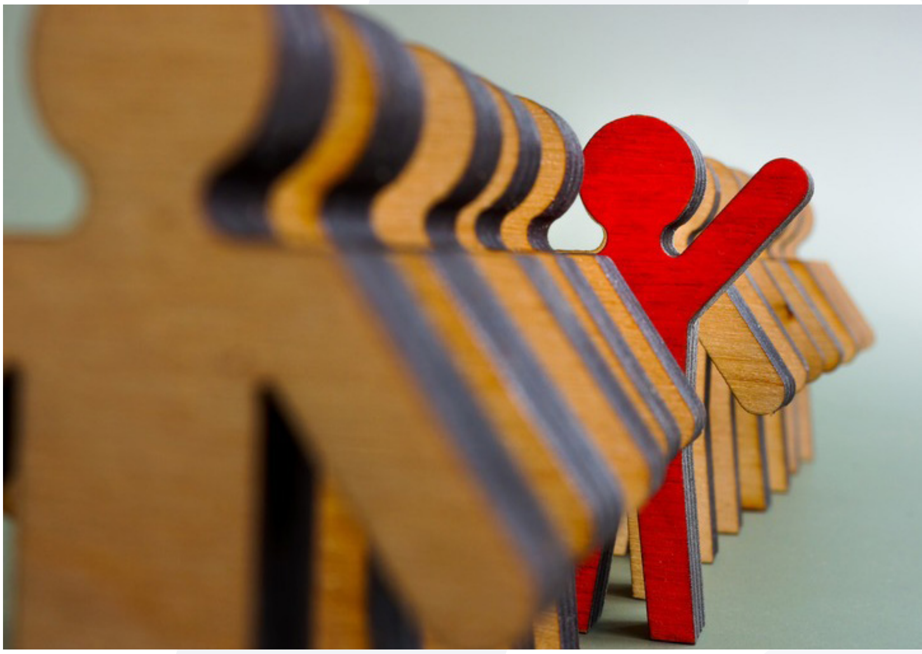
The corporate governance scandal at Toshiba underlines the increasing influence of activist investors in Japan. For private equity firms, there are two sides to the coin

The private equity tilt at one of the crown jewels of corporate Japan fizzled within a fortnight. CVC Capital Partners made what is described as a broad and vague $20 billion offer for Toshiba Corporation in early April, then told the company it "would step aside" and await guidance from the board and management as to whether privatization was desirable.

Opinion is divided as to the significance of the bid. One source close to the situation suggests that it marks the beginning rather than the end: CVC has asked whether Toshiba would be best placed under private ownership, an outcome company management previously resisted. Another GP or a consortium of various interests could end up doing a deal, or there might be no deal at all, but the possibility can be discussed.

A rival school of thought is that it was an opportunistic punt, perhaps partly driven by a desire to buy time for CEO – and CVC alumnus – Nobuaki Kurumatani, who was under pressure to step down. (He did a few days later.) Companies like Toshiba are not realistic targets for PE-backed take-privates, multiple industry participants insist. The relationships within government, not to mention the national security concerns, are too deep, rendering these businesses virtually untouchable.

Alternatively, there's an argument that the bid is less significant than the circumstances that led to it. Less than four weeks earlier, Toshiba shareholders had defied the board to approve an investigation into alleged misbehavior at the company's annual general meeting last year. The probe found that management had colluded with government to rig voting, prompting the



"The way people talk about activists has changed; certain campaigns are considered a positive thing"

– Alicia Ogawa

removal of four senior executives, among them two board nominees.

It represented a big win for Effissimo Capital Management, the activist investor that proposed the investigation. Alicia Ogawa, director of the project on Japanese corporate governance and stewardship at Columbia Business School's Center on Japanese Economy & Business, claims this clears the way for activists to play an even more prominent role in cleaning up listed companies.

"The way people talk about activists has changed; certain campaigns are considered a positive thing. But Toshiba is going to rest that conversation entirely," she says. "Effissimo has gone so far out of its way to ensure it dotted every 'i' and crossed every 't' and used every honorific when speaking to the government. They played 100% by the rules, and Toshiba did not. That story is being heard loud and clear. It will add to the degree of sympathy people have for activists."

For PE investors, activists could accelerate an existing trend whereby corporate Japan recognizes that profitability is more important than scale. They have tracked increased deal flow from conglomerates carving out non-core assets, a result of increased emphasis on corporate governance, transparency, and return on equity (ROE). It helps when other investors, albeit with their own agendas, are pushing companies in the same direction.

"Many listed Japanese companies are trying to figure out how to work with activists. One of the solutions to answer to the activists is divestments and using the cash to make a dividend payment to shareholders," says Koji Sasaki, a managing partner at T Capital Partners. "Activists have more influence over listed companies than before. There is a need to respond to the market voice."

Getting active

Toshiba is exceptional among activist targets in terms of its size, the intricacy of the governance scandal, and the way in which it was very publicly exposed via the independent investigation. Activists were also unusually well represented on its shareholder register – for a large company – due to a widely distributed $5.3 billion share issue in 2017 intended to shore up the balance sheet.

Most activist campaigns focus on Japan's small to mid-cap space, where companies often trade below book value, and they do not involve high-profile international activist investors who typically target larger stocks that have a lot of liquidity. Moreover, the resolution, be it dividend payment, share buyback or divestment, might never be widely known.

"There is no requirement for a publicly disclosed settlement agreement. A board seat might be nominated by an activist, but no one admits that. And then a year later the entire company is sold," says one Tokyo-based lawyer. "I've worked on activist campaigns and then someone else has approached me about working on a buyout. Maybe in 30% of situations, a campaign ends up in a transaction – higher if you include share buybacks."

A total of 60 activist campaigns were launched in Japan last year, more than twice the 2017 total, according to Dealreporter, AVCJ's sister publication. Less than six months into 2021, there have already been 86. Only four of these targeted companies with market capitalizations above $20 billion. Two-thirds are sub-$1 billion.

It is difficult to draw a definitive positive correlation between activism and M&A, but the number of deals involving listed corporates jumped nearly 50% year-on-year in 2020. In the first quarter of 2021 alone, there were 13 management buyout proposals in the listed space, just two short of the 12-month total for last year. In 2019 and 2018, there were 10 and two, respectively.

As for corporate divestments to private equity, the ascent has been more gradual: pre-2015, the annual carve-out total barely exceeded single digits; the average for the past four years is 18. They have become increasingly prevalent at the large end of the market – nine of the 12 biggest buyouts in Japan are carve-outs and eight were announced in the past five years – although most smaller GPs claim they are seeing more divestments in traditionally family succession-heavy pipelines.

Increased activism doesn't necessarily

"It is easier to approach management and say, 'Activists are worrying you, it's a headache, can we work something out?' And management is more inclined than before to think positively about it" *– Koichi Tamura*

require a more aggressive approach to deal-sourcing from private equity firms. Corporate carve-outs are often years in the making. Investors establish relationships, make proposals, and maintain lines of dialogue in the hope that they can pick up assets on a proprietary basis or be well-placed to compete in an auction should opportunities arise.

CVC's acquisition of a majority stake in Shiseido's personal care business, announced in February, was the culmination of a five-year journey that started when senior executives at the private equity firm broached the possibility of a carve-out, according to Koichi Tamura, a senior partner at EY. Activist pressure will not change the mode of interaction, though it could speed up the process.

"It is easier to approach management and say, 'Activists are worrying you, it's a headache, can we work something out?' And management is more inclined than before to think positively about it," Tamura says.

One manager in the upper middle-market buyout space adds that he will proactively approach companies that are likely targets of activist campaigns and present solutions. Some CEOs get in touch directly when they are under pressure, but most of the time transactions are intermediated.

Sasaki of T Capital has also been approached by companies looking for a white knight. He is wary of these situations because there might be little pre-existing knowledge of the industry or management team and getting involved in a public fight could lead to reputational damage. Two other sources, one an activist investor, claim that private equity firms – not T Capital specifically – take advantage of white knight scenarios to pick up assets on the cheap.

Deal blockers

The flip side is that increased activism is disrupting as well as enabling private equity deal flow. While the amount of M&A involving listed corporates has risen, so has the failure rate for definitively announced transactions. In seven out of eight years to 2018, it was 0% for targets of more than $200 million in value; for 2021 to date, it is 44.4%, Dealreporter's records show. This is a result of bidders abandoning deals in the face of activist minority shareholders contesting perceived low-ball bids.

A recent example saw The Carlyle Group support a privatization of Japan Asia Group (JAG) in return for the chairman facilitating its acquisition of controlling stakes in two subsidiaries. They doubled their offer in response to opposition from City Index Eleventh – which has ties to activist investor Yoshiaki Murakami – and pulled out when the shares tendered fell short of the target. Meanwhile, City Index launched its own tender offer for JAG and continues its pursuit of the company.

Several other global private firms have faced activist challenges to privatizations in the last couple of years. Bain Capital's acquisition of printing and IT services provider Kosaido was thwarted but it succeeded in buying aged care provider Nichii Gakkan after sweetening the deal. KKR and Japan Industrial Partners (JIP) adopted a similar ploy with high-tech manufacturer Hitachi Kokusai Electric.

"Some buyout firms are getting more used to dealing with activists," says Kirk Shimizuishi, a managing director at KPMG. "It is useful to have an additional pocket ready, so you can pay up if they demand a higher share price. A lot of it comes down to putting together the right tactics – engaging with them to a certain extent, knowing how they will react to different things, and helping them get over the barrier to acceptance."

An assortment of lawyers, tender agents, and investment banks participate in this process. In proxy contests that involve the likes of Institutional Shareholder Services (ISS), they help frame the proposal so that it is more likely to get endorsed. Where competing offers do not comprise only cash – it might be cash plus stock or there are proposals to address in advance of the deal proposal – there is greater ambiguity and more scope to craft an argument.

However, the lawyer who has worked on activist campaigns observes that "everyone knows MBOs in Japan are conducted at the lowest possible price that can be imagined minus 20% because there is no effective regulation of deals." As such, activist investors get involved in the expectation that private equity sponsors have the capacity to pay 20% more.

Willing to engage?

Even as PE firms become more acquainted with these situations in Japan, the activist community itself is evolving. There are still plenty of investors that are, with varying degrees of accuracy, described as greenmailers. This might be applied to "bumpitrage" players that build up positions in MBO targets and complain about the price in the hope of pushing it upwards or to any of the multitude of groups that latch onto companies in search of payoff via share buyback.

Alexander Kinmont, CEO of Milestone Asset Management, which focuses on smaller listed Japanese companies, acknowledges that activists can be effective in terms of solving the problem as they define it – improving corporate efficiency as measured by ROE – even if the broader economic contribution is less clear. He also believes some of these investors overemphasize their achievements for the sake of fundraising, claiming credit for driving outcomes that were largely predetermined.

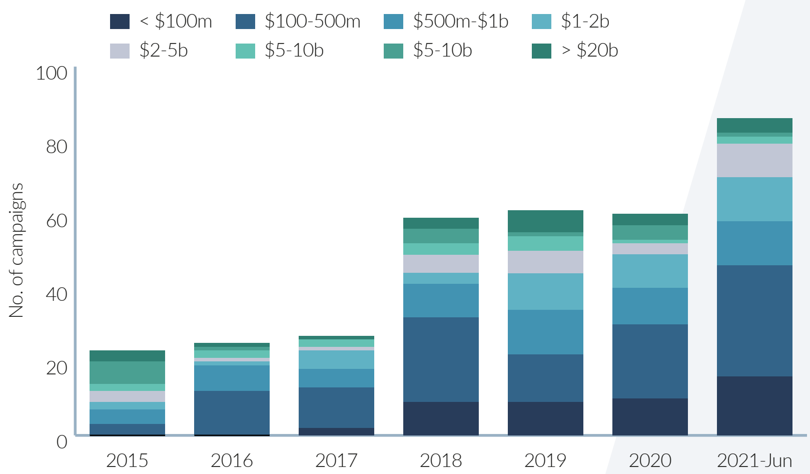
"If you examine a lot of the denouement of activist campaigns, one is left with the feeling the whole thing was in the pursuit of headlines rather than investment returns or corporate efficiency," Kinmont says. "We've had contact with companies that have activists in their shareholder register, and they don't ever hear from the management of those funds."

The aforementioned activist investor adds that a degree of sensitivity is required to local shareholder dynamics and company management, stressing that some of the dramatic campaigns staged overseas simply wouldn't work in Japan.

ValueAct Capital is seen as the poster child for a more progressive approach. In 2019, Olympus Corporation took the unprecedented step of appointing a partner at the activist group to its board as part of a broader engagement effort. KPMG's Shimizuishi describes the ValueAct approach as going behind the scenes and working with management on portfolio optimization. The firm is selective in its targeting – the Olympus team was seen as Westernized in its thinking – and acts as a catalyst for disposals.

One of these disposals came last year when JIP acquired Olympus' imaging division. A source close to that transaction also emphasizes the willingness of Olympus to embrace reform as a trigger factor, specifically the company's ambition to reinvent itself as a medical technology business, and contrasts that with the bulk of corporate Japan. However, the source

Shareholder activist campaigns in Japan



Source: Deal Reporter

acknowledges that activists are becoming more sophisticated in their approach, making it harder for proposals to be rejected out of hand.

Misaki Capital, a firm established by a group of ex-management consultants that claims to pursue a "constructive shareholder concept," is one of several other groups highlighted in this context. Columbia's Ogawa questions how far removed its approach is from PE firm Advantage Partners' private solutions strategy, which involves making minority investments in public companies that don't want to be privatized but are receptive to value creation proposals put forward by Advantage.

Sign of the times

There is also evidence of activist investors positioning themselves where the reformist tailwinds are strongest.

Various initiatives are credited with contributing to the increased focus on corporate governance in Japan, emboldening activist investors: the corporate governance code as a means of better aligning the interests of corporate parents and public shareholders; the stewardship code as a tool for holding institutional investors to account; and the JPX-Nikkei Index 400, which assesses candidates based on criteria such as return on equity, the use of independent directors, and transparent reporting.

Industry participants attach different levels of importance to each one. The corporate governance and stewardship codes are either gradual game-changers or toothless in the absence of proper enforcement. An overhaul of the Tokyo Stock Exchange, streamlining six boards into three and tying membership to criteria such as no cross-shareholding and having a certain number of independent directors, is expected to be transformative, but there is uncertainty as to the pace of cultural change.

However, the issue that comes up time and again is compliance with environment, social and governance (ESG) protocols. Japanese companies are generally seen as lacking in this area, and activists are expected to target the weakness or use it as a platform for engagement. Several groups are said to be making proposals that address ESG as part of wider shareholder value creation.

"ESG-related divestitures should further increase. The ESG wave is definitely there in Japan and there should be cases where anti-ESG businesses are sold to private equity from the emergence of ESG activists," says Shoya Okuma, co-founder of Questhub, a proxy advisor firm based in Japan, which claims to have experience of activism-related deals.

He points to Oasis Management's recent approach to packaging container manufacturer Toyo Seikan Group Holdings as an example of a traditional activist embracing an environmental and social agenda. Alongside proposals for performance-linked remuneration, changes to corporate structure, greater empowerment of management and a share buyback program, Oasis called for enhanced climate-related financial disclosure to improve transparency on sustainability issues.

Japan has a fundamental appeal as a relative value play. As a second activist investor puts it, everyone has too much cash, a nice office building, a listed affiliate, and room to cut costs. While campaigns tend to come in waves, it is argued that the current one could be protracted, albeit with some fluctuations. The power of policy reforms and the combined weight of scandals like Toshiba, which underscore the notion that management isn't always right, cannot be underestimated.

Private equity players stand to benefit from this trend but given the amount of dry powder these GPs are sitting on, so can the sellers. "Larger fund sizes lead to more competitive bidding and higher returns for sellers in an environment where greater emphasis is being placed on corporate governance. This raises logical questions from activists and other shareholders: Why aren't you embarking on a more aggressive divestment program?" says Paul Ford, a Japan-based partner at KPMG.

The virtuous cycle of more divestments begetting more private equity deal flow will at some point get broken by valuations becoming too rich. For now, though, investors have enough conviction in the turnaround and growth story with these assets that they are continuing to pay up. ■

Fundraising: Regional banks revisited

Japan's regional banks have risen from a low base to become a meaningful LP constituency for local middle-market managers. Their staying power might be a function of broader industry consolidation

Shinsei Bank broke new ground in 2000 when the lender – then known as Long-Term Credit Bank of Japan – was acquired out of bankruptcy by Ripplewood Holdings and JC Flowers. Foreign investors had never previously secured control of a Japanese bank, and it led to a remarkable, and lucrative, turnaround that impacted the broader financial services sector.

More than two decades on, it's possible Shinsei will once again play a pioneering role in Japan M&A as part of a new wave of hostile takeovers in Japan. Last month, SBI Holdings offered JPY116.4 billion ($1.1 billion) to increase its holding from 20% to 48%, pushing the bank's board on the defensive. Private equity is not an actor in this drama, yet it might become an indirect beneficiary.

SBI, a holding company with a diverse range of interests across financial services, has outlined grand ambitions to create Japan's fourth megabank. Shinsei may form part of the puzzle. But SBI is already busy buying up stakes in Japan's regional banks, taking the lead in a national consolidation drive.

Negative interest rates have made life difficult for these lenders as they accumulate deposits yet struggle to extend loans. This dilemma has prompted many to make commitments to private equity funds rather than hold assets on their balance sheets. Consolidation could result in the emergence of a handful of larger players better equipped and resourced to participate in the asset class.

"There is a lot of pressure on tier-two regional banks to consolidate," says Hiroshi Nonomiya, CEO of local placement agent Crosspoint Advisors. "This trend will continue, and it is

"There is a lot of pressure on tier-two regional banks to consolidate. This trend will continue, and it is good news for private equity"

– Hiroshi Nonomiya

> "Board members are saying, 'We need to revisit this fee issue because we are spending a lot of time and resources on mutual funds and making money there, and then paying it out again with one private equity fund commitment'" – *Taketo Furuya*

good news for private equity. If the regional banks consolidate, they will have the capability to do sophisticated private equity investment. Right now, smaller banks can only do alternative investment on a limited scale."

Burst of activity

There are currently 99 regional banks in Japan, 62 in the first tier and 37 in the second. The top tier has changed little in the past 20 years, while the number of second-tier members has shrunk by more than one-third. First-tier lenders held JPY394 trillion in assets as of March (five city banks, including the three megabanks, had nearly twice as much), led by a handful of large players.

The 10 largest regional banks account for approximately one-third of tier-one assets, with Bank of Fukuoka, Bank of Yokohama, Chiba Bank, Shizuoka Bank, and Joyo Bank making up the top five.

It was in the 2016-2017 vintage of domestic funds, which launched in the months following the introduction of negative interest rates, that regional bank participation became noticeably more visible. Ten middle-market buyout managers achieved final closes in 2017 – six were announced in the month of April alone – with local LPs accounting for the bulk of commitments in most cases.

Notably, megabanks and insurers were willing to commit larger sums than before, and regional banks followed suit, albeit with smaller checks. Almost every GP noted an uptick. Tokio Marine Capital closed its fifth fund with JPY51.7 billion from 34 LPs, all of them domestic, compared to JPY23.3 billion from 18 in the previous vintage. One-third of the Fund V corpus came from 17 regional banks.

Industry participants openly questioned whether this subset of LPs would stick around long enough to re-up, citing a lack of expertise in private equity. Most regional banks didn't have teams dedicated to the asset class and staff were rotated through the general investment teams every few years, resulting in a relationship-driven, opportunistic approach.

Tokio Marine went fully independent and rebranded as T Capital Partners before raising JPY81 billion for its sixth fund earlier this year. While foreign investors were tapped for the first time, there were still over 40 local LPs. However, the number of regional banks fell below a dozen. The likes of CLSA Capital Partners and Aspirant also saw a drop in regional bank participation on the previous vintage.

"The major players that have some experience committing to private equity are still there," says Koji Sasaki, a managing partner at T Capital. "But 2016 was a boom period for regional banks and we saw a lot of newcomers with no experience making LP commitments. Some of them decided to withdraw, perhaps because their expectations were much higher than they should have been."

The macroeconomic case for stepping back is weak. Until interest rates turn positive, regional banks will effectively be paying Bank of Japan (BoJ) for every yen they retain on their balance sheets. Meanwhile, domestic private equity has performed well.

"The market is growing, there are more deals, and the returns have been great – 2x is fantastic by domestic standards," one international placement agent who covers the Japan market observes. "If you only need to generate 5% net and you are getting 15-20% net, why would you not continue to invest unless there is a liquidity crunch? And the problem in Japan is too much liquidity."

A couple of regional banks were prevented from re-upping in T Capital because of policy changes that required them to prioritize investments or other financing solutions in their localities over commitments to Tokyo-based GPs. As for the expectations factor, financial returns are only one consideration: banks also want to establish relationships and secure leveraged financing work.

If these downstream opportunities haven't materialized, a re-up may not be forthcoming, notes Niklas Amundsson, a partner at Monument Group. Equally, the relationship might be established and fruitful, but the regional bank sees the new fund is oversubscribed, so there's no pressing need for its capital and it looks for other ways to be helpful.

Another explanation is fees. According to Taketo Furuya, founder and CEO of Ark Totan Alternative, another local placement agent, management fees paid to GPs are often categorized with brokerage fees, on opposing sides of the ledger. How much of what is made on mutual fund sales is wiped out by PE exposure and is it counterbalanced by additional leveraged financing mandates?

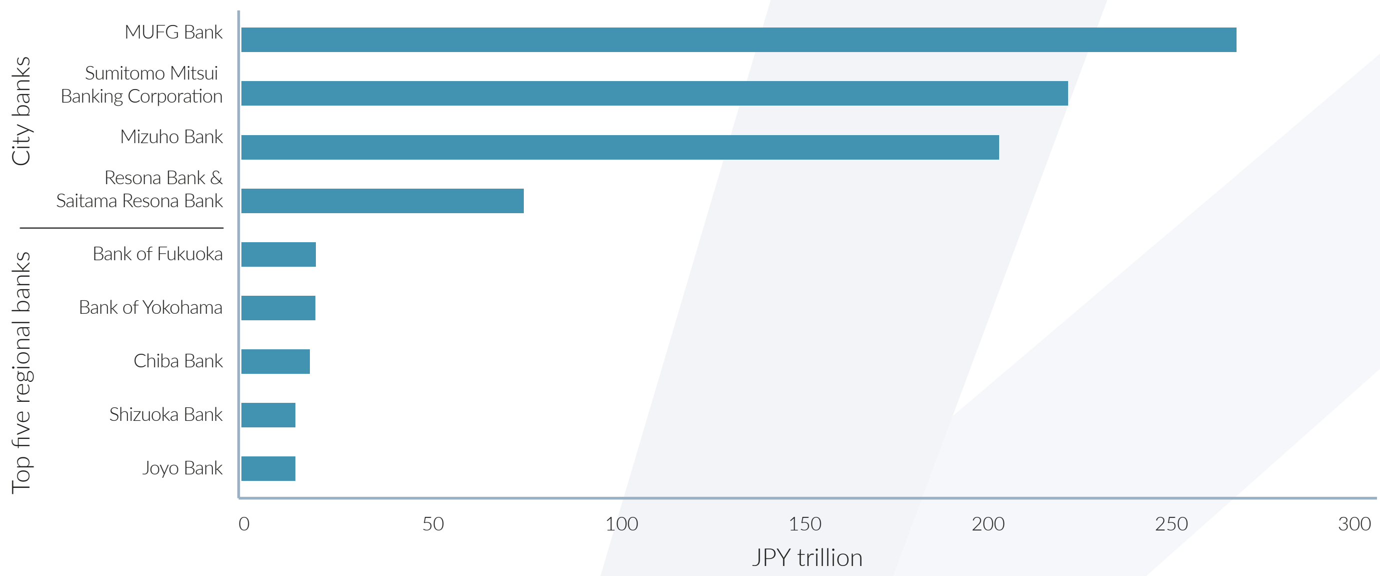
"If they are paying 2% on a $20 million investment, that's $400,000 in management fees every year. Board members are pushing back, saying 'We need to revisit this fee issue because we are spending a lot of time and resources on mutual funds and making money there, and then paying it out again with one private equity fund investment.' Some banks have stopped investing," he explains.

This perspective highlights the distinction between relative newcomers to private equity and those seasoned enough to have seen beyond the j-curve and recognize the long-term appeal of the asset class. There tends to be a positive correlation between asset size and length of exposure to private equity and the quantum of internal resources devoted to it.

Relationship, strategic, financial

Kazushige Kobayashi, a managing director at MCP Asset Management who oversees a local fund-of-funds program, places regional banks into three

Japan - megabanks vs regional banks by assets



Source: Company filings

categories – relationship-driven, strategic-driven, and financial-driven. The first group usually assign PE coverage to the general investment team, while the second group lumps it with business development because they prioritize synergies.

Financial-driven investors are more likely to have dedicated private equity teams. Bank of Fukuoka and Shizuoka Bank – both members of the top five regional lenders by assets – are said to fit this profile. "I still remember meeting a guy from Shizuoka Bank who had private equity on his business card," Furuya recalls. "I'd never come across anyone else like that from a regional bank."

In certain cases, an external private equity program is a natural extension of an internal principal investment business intended to help local corporates facing succession or turnaround challenges. Chiba Bank Capital and Hiroshima Bank's Hirogin Capital Partners are cited as examples.

There are also situations in which regional banks team up to boost their firepower. Shikoku Alliance Capital was established in 2018 by Awa Bank, Hyakujushi Bank, Iyo Bank, and Shikoku Bank to invest in Shikoku, the smallest of Japan's major islands. However, it is unclear where the socioeconomic mandate stops and the financial mandate begins, which can have implications for recruitment.

"One of the difficulties of Japan is that investors don't like to jump into transactions if they haven't found any cases before. At the same time, they don't like making decisions themselves"

– Moriyoshi Yatsumuto

"Captive private equity funds often aren't managed well because anyone from a regional bank could be seconded to manage them as opposed to professional investors. And they don't raise capital from institutional investors," says Crosspoint's Nonomiya. "But we have seen banks team up with local private equity firms that do know how to manage funds."

RBG Partners might represent the next evolution in that thinking. An independent manager set up in 2018 by a team from Sumitomo Mitsubishi Banking Corporation (SMBC), a debut fund of JPY4 billion was raised from Yokohama Bank, Hokuriku Bank, and Japan Post Bank. Yokohama Bank also took a minority stake in the GP, suggesting it sees private equity as a long-term strategic priority.

RBG is now looking to raise a second vehicle of $150-200 million from a broader institutional investor base, according to a source close to the situation. The firm remains headquartered in Yokohama and its name derives from Yokohama Red Brick Warehouse, a Meiji era customs building turned culture and retail venue that is one of the city's most iconic landmarks.

Regional banks tend to write equity checks of $10-30 million for domestic private equity funds, but T Capital's Sasaki notes that the larger players can commit $50 million-plus, approaching megabank territory. It's possible that industry consolidation will lead to larger checks and more strategic initiatives along the lines of RBG and Yokohama Bank.

These lenders might also become more comfortable allocating to overseas private equity funds. A few are said to have done this on their own or under the close guidance of gatekeepers. Asset managers such as Development Bank of Japan (DBJ) have also established structures to aggregate commitments and deploy the capital internationally.

Secondaries to come?

SBI said last year that it would invest in up to 10 regional banks as part of its fourth megabank agenda, and it has ties to around 40 others through a regional revitalization joint venture. Meanwhile, the Financial Services Agency (FSA) ▶

and BoJ are encouraging consolidation. BoJ has offered subsidies in the form of preferential interest rates to lenders that move in this direction.

It all points to a bifurcated universe in which a handful of large players increase their competencies and capabilities and the rest fall back. Industry participants see a nascent secondary opportunity as some regional banks retrench and pare their private equity exposure. However, this will take years to play out. Groups that have ceased new commitments aren't necessarily selling existing positions.

Bee Alternatives, formed following a spinout by Ant Capital Partners' secondaries team, expects to invest no more than 40% of its debut fund in Japan. But there is a regional bank angle, specifically helping lenders generate the capital for re-ups in new funds – so they can retain relationships with GPs – by facilitating partial exits from earlier vintages, according to a source familiar with the firm.

The challenge is largely educational and procedural, and confined to the less sophisticated groups. Some banks are not only unaware of secondaries and how they work, but they also lack the systems to monitor fund performance, the source adds. Assets might be held at cost, and no one knows how to assess whether a theoretical secondary transaction represents fair value.

Moriyoshi Matsumoto, a managing partner at WM Partners, another local secondary investor, alludes to the same problem. WM recently launched a fund with Alternative Investment Capital that will target LP positions in domestic funds. The manager previously concentrated on direct secondaries, but it believes the market is now large enough to justify a broader strategy. Larger banks, life insurance companies, and corporates are expected to be the primary sources of deal flow.

Matsumoto admits that the regional bank opportunity "is warming up" but he cautions that sellers will require a lot of support from the likes of SMBC and DBJ – WM's strategic partners in the new fund – because they "do not know how to sell and how to evaluate the funds they hold now."

"One of the difficulties in Japan is that investors don't like to jump into transactions if they haven't found any cases before," he explains. "At the same time, they don't like making decisions themselves – so they need advice to move forward – and they don't have much idea about the market or process of the transaction."

LP interview: Ecosystem enabler

Japan Investment Corporation aims to help a sparse venture capital market catch up with a slightly more mature buyout space. Balancing private and public interests remains the key challenge

Japan Investment Corporation (JIC) had a rough start. Launched in September 2018 as a JPY2 trillion ($18.3 billion) government support program for the technology sector, it was supposed to offset local tendencies of risk aversion, build a fledgling start-up ecosystem, and help steer mature industries towards a digital future. By January 2019, all nine board members had quit, and everything was in limbo.

At the heart of the drama was a familiar mistrust about the role of government in private investment and a breakdown in communication. This manifested itself in disputes over leadership compensation, government influence over fund management, and the idea that an insufficient level of independence would reduce JIC to a prop for pet projects and a rescuer of dead-end companies.

Stability returned later in 2019 with Keisuke Yokoo, formerly chairman of Mizuho Securities, joining as CEO, and Toshiyuki Kumura, ex-head of PE at Tokio Marine Asset Management, coming in as CIO. The following year, they hired Yuka Hata, previously PE head at Nissay Asset Management and Nomura Asset Management, to lead fund investments. JIC's investment capacity was subsequently lifted to JPY3 trillion to help shore up the pandemic-hit economy.

"JIC does not intend to intervene in the private market so long as the market is in a healthy condition," Hata says. "Our intent is to strengthen the ecosystem of PE and VC markets and to transform the industry for the next generation. In this way, JIC exists in a very important transition period of Japan."

Hata's mandate has provided comfort on one of the key sticking points about government control by including scope to back non-Japanese

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>
> – *Yuka Hata*

funds. No such investments have closed to date, but they are expected to be pursued where US, Israeli or Asian managers are keen to collaborate with domestic industries and contribute global knowledge. Part of the thinking is to fill financial and capacity gaps in the later-stage VC space.

So far, JIC has made four LP commitments to independent GPs. They include seed-stage investor Anri, Miyako Capital, which is working with Kyoto University, and Beyond Next Ventures, a firm set up by an ex-Jafco executive. First-time funds are also on the menu, with Catalys Pacific Fund, a life sciences specialist launched in 2019, receiving JIC backing in February. Checks sizes are in the $30-40 million range.

On the surface, this activity betrays a preference for deep tech and the commercialization of "sleeping science." But the underlying plan is more about professionalizing a class of local fund managers that remains under the industry radar yet has demonstrated a modest amount of traction and is believed to possess the potential to be ecosystem leaders.

Support on governance is an important part of this agenda, especially in terms of helping entrepreneur-led GPs avoid the conflicts of interest that come with playing both sides of the table. Ultimately, the idea is to help portfolio GPs attract other institutional LPs.

This value-add focus is perhaps the key differentiator between JIC and Innovation Network Corporation of Japan (INCJ), the government VC investor it made redundant in 2018. INCJ still exists as a subsidiary of JIC, but most of its team has been moved into new divisions, leaving a core of senior leadership to wind down the legacy portfolio.

"We found that there is not enough risk capital in the venture growth space in Japan, and there are no original local funds in the larger end of buyouts," Hata says. "So, we had to create our own to achieve policy objectives and enhance international competitiveness."

Going direct

Hata's directly managed team includes two directors, two vice presidents, three associates, and it is expanding. JIC's overall headcount is 142, including 66 in the parent company, 27 in INCJ, 24 in a VC unit called Venture Growth Investments (VGI), and 25 in the PE unit, JIC Capital (JICC).

JIC seeded VGI and JICC last year with JPY120 billion and JPY400 billion, respectively. VGI aims to solve social and industrial challenges through technology, while JICC's mandate is to supply risk capital for the creation of new industries that can realize "Society 5.0."

Although these are essentially an indirect means of making direct government investments, they are viewed in-house as part of JIC's mission to build up an underweight ecosystem of private-sector GPs. In time, there is also potential for the captive GPs to be spun out.

"Japanese managers are still in the development stage. That's why we're here: to support and to bring them to the next stage," says Hata. "We will share our knowledge and experience so managers can build their teams and communicate with investors properly. We're not here just to provide them with money."

Robust interest in Japan's carve-out and succession opportunities has meant that LP commitments to external middle-market managers are not yet required. Still, these investments are considered a possibility, where they can help take the buyout ecosystem to a new level of maturity. This could include supporting the creation of funds dedicated to specific sectors or industry consolidations.

JICC's direct investment experience could help inform some of these moves down the track, given the program is likely to concentrate on the more dynamic large-cap end of the buyout space. This process will be guided by Kumura's and Hata's global investment backgrounds.

"The small to mid-sized buyout market is healthy in Japan, so we don't necessarily feel the need to support that as an LP at this time. However, at the larger end, we feel that as a government-backed investor, we need to support these industries," Hata says.

"We will not provide them with rescue capital – our mission is to support the buyout ecosystem so the right industries can be competitive globally. We're going to have to be very selective in picking the right buyout investment theme for our LP investments."