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Middle matters

Why mid-cap private equity spinouts remain a relative rarity in Japan

- Corporate carve-outs and value creation agendas
- Corrections cloud uptick in late-stage tech funding
- Japan becomes front-line market for HNWI fundraising


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Japan in six trends

1 Carve-outs: Going large

Should a privatisation of Toshiba proceed, it would be Japan's largest-ever PE buyout, based on the market capitalisation of JPY 2.18trn (USD 15.5bn). Most industry participants consider the situation to be exceptional: if Toshiba were not in such dire straits, having been brought to its knees by underperformance and a governance scandal, this stalwart of corporate Japan would not be available. Neither is it a carve-out, but many of the operational challenges are similar. Toshiba is weighed down by non-core subsidiaries that would be best sold off. So too is Hitachi Metals, a listed division of Hitachi being pursued by a Bain Capital-led consortium. When KKR acquired Panasonic Healthcare in 2014, it repositioned the business through seven bolt-ons, but also sold off 11 units. What Toshiba demonstrates is private equity's willingness to take on larger and more complex challenges. Between 2018 and 2021, USD 59.3bn was put to work in Japan, a one-third increase on the prior four years. Of the country's 10 largest PE deals (announced and completed), six date from 2021. And six of the top seven are carve-outs.

2 SoftBank: Blurred vision?

SoftBank Group invests globally – and aggressively – through its Vision Fund series, but the firm's Japanese origins are flagged with every landmark quarterly earnings call. These events are as notable for founder Masayoshi Son's idiosyncratic briefings as they are for the feast-to-famine financials illustrated in the presentation decks. A record quarterly gain of JPY 3.66trn (USD 26bn) in January-March 2021 turned into a record quarterly loss of JPY 2.99trn 12 months later as performance tracked swings in overall sentiment on global technology. There was no rebound in April-June 2022, with protracted valuation corrections contributing to a JPY 2.94trn loss. Speaking to analysts, Son professed shame at hyping up big profits in the past. He said the broad vision is unchanged but announced plans to cut costs and emphasised how Vision Fund 2 is pursuing a different line to its predecessor. Rather than "aim for the home run" by writing large equity cheques for the likes of Uber and WeWork, Fund II is aiming for first-base and second-base hits. Unfortunately, the strategy didn't deliver in the first nine months of 2021 as the fund took "too many swings" at companies with elevated valuations, leading to a "large variation loss."

3 Buyout funds: Keen to deploy

"We want to put more capital to work in Japan, reflecting our strong commitment to the market," said Koichi Ito, co-head of Japan private equity at PAG, regarding the recent acquisition of local theme park. China serves as the historical foundation stone of the firm's private equity business, more so than for any other pan-Asian GP. PAG invested USD 1.19bn in Asia ex-China last year, marginally exceeding the China total. This continues a trend of increased activity outside China: annual average deployment rose from USD 207m in 2013-2015 to USD 323m in 2016-2018, and USD 504m in 2019-2021. Nevertheless, it has struggled to keep pace with investment in China, as demonstrated by Asia-wide average for the same periods: USD 404m, USD 968m, and USD 1.56bn. With uncertainty looming over China, all pan-regional managers – not just PAG, which is currently in fundraising mode – may have to rethink their geographical deployment over the next few years. If they can't rely on Asia's largest economy for robust deal flow, where should the capital go? Ramping up investment in mature markets where meaningful sums can be put to work in leveraged buyouts is one answer, and Japan is a logical target.

4 Middle market: New blood needed?

Global PE firms continue to direct more resources towards Japan in search of large-cap deal flow. Still, the middle-market remains the beating heart of local private equity, often turning succession situations into attractive industry consolidation platforms for larger peers. But success hasn't translated into a glut of new GPs. Rather than grow in number, Japan's incumbent middle-market managers have grown in fund size. There have been around 10 closes in the buyout space each year for the past decade, yet the average amount raised in 2018-2021 was USD 3.2bn, a two-thirds increase on the prior four years. The dynamics are gradually changing, with a few more spinouts from established firms and a few more captive GPs going independent. It remains to be seen whether they can muster the scale, track records, and compelling narratives (plus the communication skills to bind it all together) required to register on the radar of international LPs. Talent might be the ultimate bottleneck, with mid-cap managers often noting they lack the experienced heads to act on all the opportunities they see. Fixing this will take time.

5 Technology: Growth-stage agenda

Technology investment in Japan has followed the general global trend of acceleration. Early and growth-stage investors deployed USD 2.9bn in 2021, twice the 2018 total and a near six-fold increase on 2014. However, while other markets have been spurred by capital finding its way into later-stage deals, Japan remains primarily an early-stage story. Growth-stage activity rose from USD 231m to USD 528m to USD 917m between 2019 and 2021, but it still trails venture, which posted totals of USD 1.71bn, USD 1.34bn, and USD 1.99bn over the same period. (It does conform with global norms in terms of the subsequent correction: USD 2.16bn has been deployed year-to-date, with less than USD 150m in growth-stage.) One explanation for the relatively low historical growth-stage contribution is start-ups going public earlier than their peers in other markets due to a lack of capital aimed at pre-IPO rounds. Steps are being taken to remedy supply-demand imbalance. More global growth investors, such as Tiger Global Management and DST Global, are looking for Japan deals. Meanwhile, local players – from government-backed Japan Investment Corporation to independent newcomer Fiducia – increasing allocations to the space.

6 Renewables: Investing towards net-zero

In October 2020, Japan pledged to achieve net-zero carbon emissions by 2050, adding that – using 2013 as a baseline – emissions would be cut by nearly half by 2030. This will be a difficult journey for the world's sixth-largest greenhouse gas emitter, which must ease its reliance on fossil fuels and decarbonise real estate, transportation, and industrials. Coal was responsible for 30% of Japan's electricity production in 2020, with gas on 35%, renewables on 13%, hydro on 8%, and renewables on 4%, according to BP's Statistical Review of World Energy 2021. McKinsey & Company estimates that solar and wind capacity would need to increase threefold to 275 gigawatts by 2050 to meet the net-zero target, while noting that deep coastal waters and mountainous terrain are obstacles to installing offshore and onshore facilities. Still, solar capacity increased 75% between 2016 and 2020 to reach 67 GW. Infrastructure investors building out renewables platforms in Asia are generally bullish on Japan, citing the impact of regulations enacted several years ago and the prospects in areas like offshore wind. Among the local GPs, Advantage Partners has even created a dedicated renewables and sustainability strategy.

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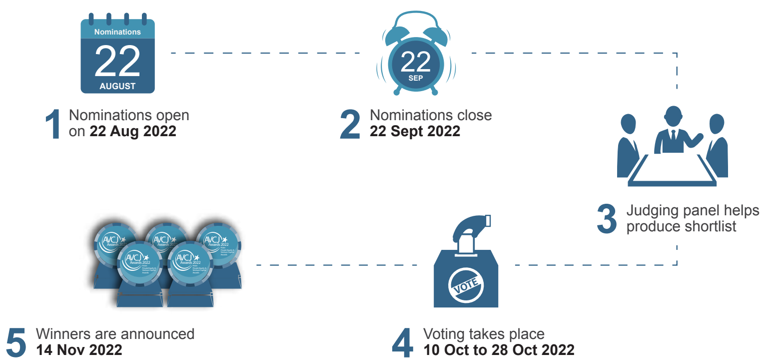

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Middle market: Crowded field

The expansion of Japan's middle-market private equity scene has not kept pace with the rise in global investor interest. Spiking competition is inducing GP formation, but impediments are myriad

The fragmented, ageing nature of Japan's small to medium-sized enterprise (SME) space and growing momentum in corporate divestments, coupled with strong and rising LP appetite for exposure to these themes, suggests the local middle-market PE scene is set to be flooded with new players. But no one expects that.

Middle-market GP creation in Japan has ticked along at a rate of about one or two new managers every few years since the 1990s, and the industry unanimously expects this to continue. The reasons for the slowness despite a host of snowballing incentives to the contrary should not be ignored.

The supply-demand equation is tiered: Are there enough GPs to serve LP demand for exposure to local SMEs, and are there enough SMEs for sale to justify the existence of those GPs?

This question is arguably more complicated in Japan, however, due to cultural factors. Private equity has firmly entrenched itself as part of the business and investment landscape, but it's still a long dance getting companies comfortable with MBOs and carve-outs, which makes the theoretical deal opportunity significantly larger than the realistic or practical one.

At the same time, the dividing lines between middle-market segments have blurred as competition rises. Global and regional actors like Bain Capital and The Carlyle Group are venturing into the small end of the market, while traditionally lower-end investors such as CLSA Capital Partners (CLSA CP) and Integral Corporation are now raising big enough funds to spar in the large-cap space.

Furthermore, the smattering of new entrants with international exposure is only half the story. There is a less visible but rapidly expanding

> "When spinouts happen, there's usually a specific motivator, which may not always be just positive, and it makes things cumbersome"
>
> *– Shota Kuwaki*

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universe of corporate PE and quasi-strategic joint ventures. For example, MSD Investment – a GP controlled by Mitsui & Co, Sumitomo Mitsui Banking Corporation, and Development Bank of Japan – reached a second close on its second fund in March. Fund I quietly closed on JPY 30bn (USD 217m) in 2015.

"People don't realise that there have been a lot of new entrants in this market. Probably the biggest concern is that the number of GPs exceeds the supply of deals," said Kirk Shimizuishi, a partner at KPMG. "A lot of people won't admit it just because they want to raise capital, but even in the USD 100m to USD 200m EV [enterprise valuation] range, it's gradually becoming a red ocean."

Supply-demand issues

For the moment, rising LP interest has mostly manifested itself in larger funds among the established names. Annual buyout fund closes have hovered around 10 for the past decade, but there has been a noticeable shift in size. The average raised per year in 2018-2021 was USD 3.2bn, up 66% on the prior four despite an anomalously low total in pandemic-hit 2021, according to AVCJ Research

For 2022 to date, there have already been 14 buyout fund closes with total proceeds amounting to USD 2.2bn. The most recent of these was a final close of JPY 75bn for J-Star's fifth flagship fund, which beat a target of JPY 65m after six months in the market.

Bigger funds are a symptom and a driver of increasing competition, but there are several natural checks on the phenomenon. They include LP suspicion that deploying larger funds is outside the skillset of middle-market managers, a sense of discipline among managers that recognise oversized funds will be unwieldy with a small-cap strategy, and general LP caution amid macro uncertainty.

GPs also note there are lessons to be learned from the local industry's historical and ongoing difficulties in deploying large funds. Outsized vintages from Polaris Capital Group (Fund V closed on JPY 150bn in late 2020) and Advantage Partners (Fund IV closed on JPY 215bn in 2007) are often evoked as examples of going too big.

It therefore remains an open question how the local industry can service growing LP demand for access. Even when spinouts are achieved from reputable managers, the track records don't come with them, and global investors tend to hold on for Fund II or Fund III. For local investors, first-time funds from spinouts are of significant interest – if they come to market at all.

"Some people consider spinouts in the back of their heads, and experienced professionals get approached by people thinking about starting a fund. But most people ultimately don't take the final step because there are fewer opportunities available than in markets such as in the US and many obstacles to consider," said Shota Kuwaki, an executive director at CLSA CP.

"If they are successful in their current role, they may have a lot to lose. When spinouts happen, there's usually a specific motivator which may not always be just positive, and it makes things cumbersome."

CLSA CP is experiencing a cumbersome – although friendly – spinout of its own from China's CITIC Securities. The GP, currently a 50-50 joint venture with CITIC-owned Hong Kong investment unit CLSA, is expected to rebrand and formalise its separation on launching the next fund in its Sunrise series. Kuwaki declined to comment.

In this case, the specific motivating factor is the current difficulty raising global money with Chinese organisational heritage. In other cases, there could be disputes about strategy (J-Star), LP wariness of strategic parentage (MCP Capital), or a global parent shutting down operations locally (NSSK).

Points of differentiation

Pure entrepreneurialism is seldom the primary motivation, which indicates such separations are likely to continue to happen piecemeal rather than as a growing trend. But Unison Capital, one of Japan's first private equity firms, has proven a breeding ground for exceptions to this rule.

Three middle-market managers have spun out from Unison, including Integral and Japan Growth Investments Alliance (JGIA), both of which have gone on to attract foreign capital. Integral aims to distinguish itself as a long-hold, operational player, while JGIA claims unique in-house capacities in consulting, marketing, and branding.

"You can no longer go to the international market and ask for capital just because you're a Japan expert. That playbook was played by us 20 years ago, and I don't think it's viable anymore," said T.J. Kono, a partner at Unison.

"Performance is important, and it originates from a GP's ability to add value. New GP ideas must bring a specific value-add strategy. In more mature markets, new GP leadership sometimes include specific industry experts. Today, not many of Japan's first-time funds have presented such value propositions."

Unison's third and most recent spinout, D Capital, hopes to do this by bringing together technology and investment specialists for what is touted as Japan's first GP dedicated to digital transformation. Healthcare, consumer, and manufacturing are sector priorities, but the core aim to wire traditional SMEs for modern business. Indeed, the D in D Capital stands for digital.

Buyouts are the focus because comprehensive digital transformation is seen as requiring top-down buy-in at the company level. But the first two investments are minority stakes: multi-modal transport provider FC Standard Logistics and JGIA-owned furniture retailer Franfranc. Targets typically have an EV of around USD 100m.

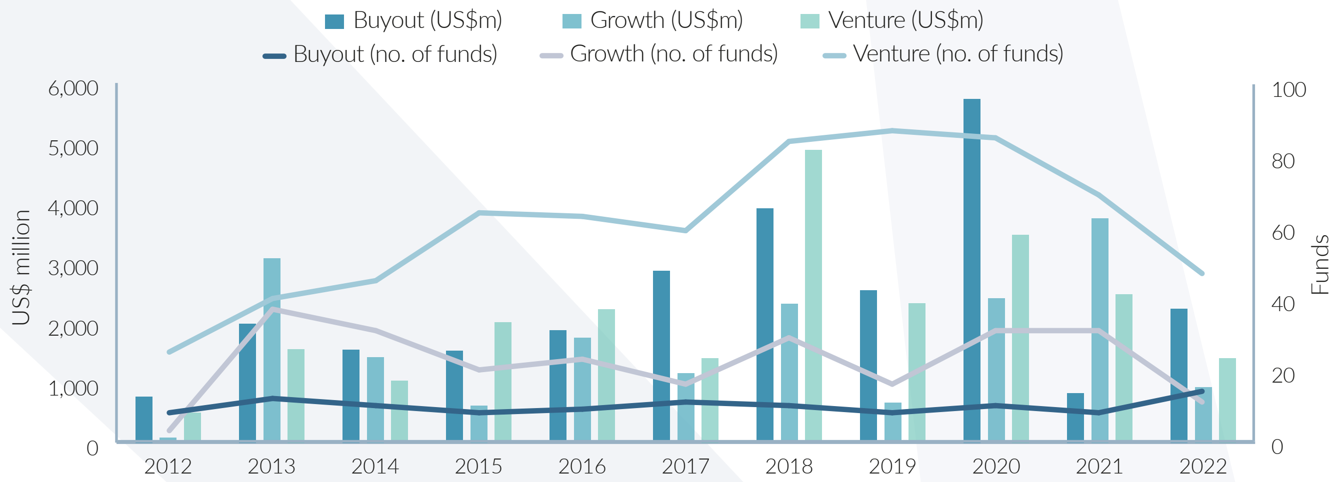
The debut fund is targeting JPY 30bn. A second close of JPY 20bn happened in April and the running total is now JPY 26bn. LPs include some Unison relationships, as well as technology majors like KDDI and SCSK Corporation. The initial concern was that conservative investors would baulk at the untested concept and youth of the team. But regional banks, for example, have shown strong support.

"Fundraising has been a good experience which has been very surprising for us," said Koichi Kibata, a co-founder and partner at D Capital.

"By definition, we don't have a track record, which is a huge issue. But a lot of LPs see us as part of the third or fourth generation of PE firms in Japan, like NIC [Bain spinout Nippon Investment Corporation] and JGIA, which are doing well. They see the younger generation as an opportunity, not a risk."

Global LP access to these kinds of opportunities is limited by more than their rarity. D Capital's website is entirely in Japanese, and the firm refrained from setting up an overseas fund structure, citing the expense. The rule of thumb is that unless a fund is likely to raise JPY 10bn from overseas investors, it is uneconomic to pay for everything that goes into setting up a parallel feeder.

Japan fundraising



Source: AVCJ Research

Select Japan fundraising totals

(JPY billion)	Current vintage	Vintage -1	Vintage -2	Vintage -3
The Carlyle Group	258	119.5	165.6	50
Bain Capital	110	-	-	-
Advantage Partners	85	60	215.6	46.5
Unison Capital	71.1	70	140	75
Polaris Capital Group	111.1	75	39.1	31.9
J-Star	75	48.5	32.5	20.4
CLSA Capital Partners/ Sunrise Capital*	48	43	17	38
Integral Corporation	123.8	73	44.2	11.2
T Capital Partners	81.1	51.7	23.3	32.6
Japan Growth Investment Alliance (J-GIA)	38	17.3	-	-
Aspirant Group	50	39.3	8.3	-
Japan Industrial Partners	102.3	67.4	63	30
Japan Industrial Solutions	105	100	-	-

* Fund size converted to Japanese yen at approximate exchange rate at time of closing
Source: AVCJ Research

Other deterrents are operational in nature, such as a new GP's inability to meet higher environmental, social, and governance (ESG) requirements or to deploy at the speed of more mature ecosystems. "I have found global LPs frustrating because they expect much more speed in terms of deployment. One year after fundraising, they expect it fully deployed, but we take five years," said one manager.

Language is likewise a recurring sticking point, even for firms such as Aspirant Group, which committed to targeting international investors with its third fund, closing the vehicle on JPY 50bn in 2019. When Monument Group was brought in to advise, none of the presentation materials were in English. The placement agent placed about 55 reference calls, 50 of which were in Japanese.

"If the website is in Japanese, all the documentation is going to be in Japanese, and it's going to be very difficult to assess the opportunity. That lends itself to a certain subset of LPs that are willing to take on the work," said Niklas Amundsson, a partner at Monument.

"But once it's all been translated and brought up to global standards in terms of what investors expect to see, then the interest is definitely there."

Size matters

Still, the most important factor keeping global LPs out of the emerging manager space in Japan may be GP wariness around raising large funds to target the small-cap – and most prospective – end of the middle market.

JGIA, as a case in point, started attracting overseas investors with its second fund, which closed at a modest hard cap of JPY 38bn in 2020, up from JPY 17.3bn in the previous vintage. The firm's website is Japanese only. Founder, Koichi Tateno, speaks English fluently but notes the process has been long, difficult and largely strategic.

"We do see more overseas investors interested in Japanese private equity, especially in the mid to small end, and we do have a dialogue with them. But our goal is to maximise returns, not assets under management," Tateno said.

"We're in discussions with global LPs because we want the insights and expertise. There's a certain optimal fund size to be effective in this market space, and frankly, it's not going to be very large."

The best example of global LP success in accessing hard-to-access Japanese GPs is T Capital Partners, formerly Tokio Marine Capital. International investors had reached out to the firm without success for 15 years when it was performing strongly as a captive of Tokio Marine & Fire Insurance. By 2019, the GP's management was sufficiently inspired to buy out the business.

T Capital's debut as an independent closed on JPY 81bn in February with 40% of the capital coming from overseas LPs. This compares to JPY 51.7bn in 2017 for the prior fund.

"There were very strong voices overseas encouraging us to be independent. We raised our fund within one year, in the middle of coronavirus restrictions. It was an overwhelming response," said Koji Sasaki, managing partner of T Capital.

"There are big expectations when you're no longer captive. Can you survive and continue to replicate the track record you had in the past with the parent company? What is the continuity in the business plan? That's one of the main questions that we were asked by overseas investors."

Few industry participants expect this kind of story to become a significant opening for global LPs. The number of so-called institutional captive GPs with clear financial mandates is dwindling. And those that remain can be difficult to access. Daiwa Securities' Daiwa PI Partners is considered in this camp; it declined to be interviewed for this story.

Some of the latest activity on this front includes MCP Capital spinning out last year from Mizuho Bank, with the parent reducing its stake in the GP from 100% to 15% after a more than one-year negotiation process. MCP is currently looking to raise its first fund as an independent entity, targeting JPY 30bn by the end of the year.

The episode says much about why new GP creation in Japan remains sporadic, with MCP CEO Masahide Sato describing large conglomerates and private equity firms as "fundamentally incompatible" in terms of nature, culture, mindset, and speed of decision making. The separation was said to be needed to fulfil fiduciary duties as well as tap new domestic and foreign LPs.

"The road to independence was very bumpy. It was hard to get the understanding from the parent company on why we wanted to become non-captive. Such a request might have sounded to them as if we were just being selfish," Sato said, adding that one of his priorities was to make sure that his team was incentivised in the long term.

"If we remained a captive firm, there would be no chance to invite foreign investors."

The next generation

The ultimate overarching variable in quality GP creation is talent. It's tough to convince the best and brightest to move toward the lower end of the middle market, where deal flow is still good, but the return-versus-sweat equity ratio is less attractive.

The earliest movers – including Advantage and Unison – are working on leadership transition. This implies an influx of new ideas and personalities, which could in turn stimulate more spinoffs.

But any such splintering of the industry would face questions of credibility, especially given that a lull in hiring after the global financial crisis has resulted in a dearth of professionals with more than 10 years' experience. The number of talented people working in Japanese private equity has increased substantially in the past decade, but most of them are fairly young.

To some extent, the experience issue is about familiarity with economic cycles. But it's also about simply getting a seat at the table.

As competition mounts, GPs are increasingly under pressure to have experienced staff with broad intermediary relationships. Few deals are still 100% exclusive in the middle market, and many auctions don't have the resources to invite more than 15 buyers. At most, five of those invites would be for funds, so getting in the conversation is about deep networks and hence elusive seniority.

"Our biggest bottleneck is not the number of deals – it's having the professionals to handle them. You need senior people to do the job right," said Shinichiro Kita, a senior partner at Advantage. "You need established relationships with intermediaries, and that can't happen in just a few years. Those relationships take time to develop."

As more large-cap GPs establish a presence in Japan, there is scope for talent spinning out and launching middle-market managers in-country. Although historically, this calibre of professional has tended to join established local funds rather than start something new.

There is also an expectation that as the ecosystem matures, the government could eventually establish some systematic programs for supporting rookie funds, which would encourage talent to enter the industry. But this is a long and theoretical game.

In the meantime, LP access to the middle market will be driven by some increase in fund sizes, the creep in spinouts, and the broadening of existing GPs' mandates to include adjacent asset classes. An uptick in sponsor-to-sponsor deals is expected, which could also be a driver, as could a perceived increase in delisting transactions.

"Right now, relatively speaking, the lower end of mid-cap continues to be attractive. But it was like that decades ago in the US, and now it's competitive across the board there. We might be headed in that direction," said CLSA CP's Kuwaki. "There are good signs that the market is maturing with more institutional and capable GPs."

Corporate carve-outs: Improving the old

Private equity investors are keen to acquire mature but unloved assets from Japanese corporates and reposition them for growth. Execution is seldom straightforward, and size often means complexity

KKR is determined to fix Marelli. The equity portion of its USD 4.5bn acquisition of Japanese auto parts manufacturer Calsonic Kansei Corporation in 2017 has already been written off. Meanwhile, two new tranches of equity have been pumped in: one in 2020 when Calsonic, rocked by COVID-19 while still adjusting to a USD 7.1bn merger with Europe's Magneti Marelli, refinanced its debt; and another earlier this year as part of a restructuring.

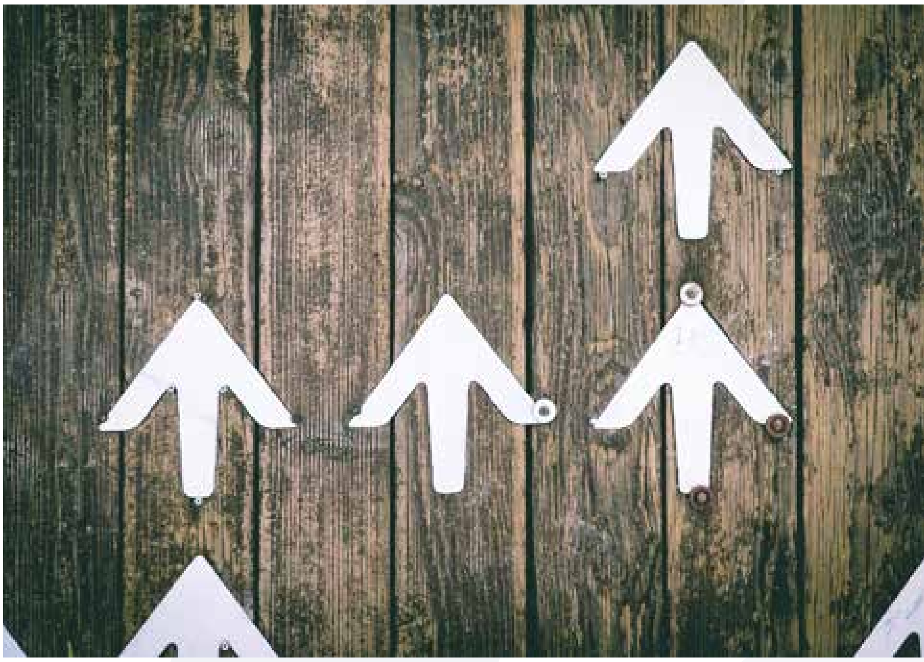
The latter action – a two-stage process that saw KKR reappointed as Marelli's sponsor on the strength of its revitalisation plan – involved convincing banks to forgive JPY 450bn (USD 3.2bn) out of a JPY 1.1trn debt pile. The private equity firm's equity contribution at this juncture was USD 650m.

"With the greater financial stability provided by this revitalisation plan, I am confident the team at Marelli are well placed for the future," Hiro Hirano, co-head of Asia Pacific private equity at KKR and the firm's Japan CEO, said on announcing the capital injection.

"The automotive industry has faced unprecedented challenges over the last couple of years, and KKR is determined to work together with Marelli to improve its global operations and return to growth."

KKR has completed seven corporate carve-outs in Japan since 2010; Calsonic Kansei, previously a listed subsidiary of Nissan, was the fifth. The GP and its peers have spent years preparing for the trickle of non-core divestments by corporate Japan to become a flow, making their case as good custodians of those assets. No one wants a black mark against their name.

Marelli amounts to an extraordinary tale of



> "These are competitive auctions, so the winning bidder has underwritten a meaningful amount of value creation already"
>
> *– Jim Verbeeten*

misfortune. KKR's plans to drive change in the business have seemingly been thwarted at every turn by pandemic-driven factory shutdowns, global semiconductor shortages, and rising raw material costs. Freak events like factory fires, extreme weather events, and the arrest of Nissan chairman Carols Ghosn can also be factored into the mix.

At the same time, it underscores the inherent risks of corporate carve-outs in Japan even as GPs set their sights on ever-larger targets. These undermanaged and underinvested assets represent a huge value creation opportunity, but execution is akin to steering a tanker. If enough things go wrong in a business that might be relatively low-growth and highly leveraged, it is difficult to get back on course.

"These are competitive auctions, so the winning bidder has underwritten a meaningful amount of value creation already – they aren't buying the business for current profit and a few percent of growth. There's a lot of pressure to improve profitability," said Jim Verbeeten, a partner at Bain & Company. "You also need to do stress testing because you never know what might happen."

Low-hanging fruit?

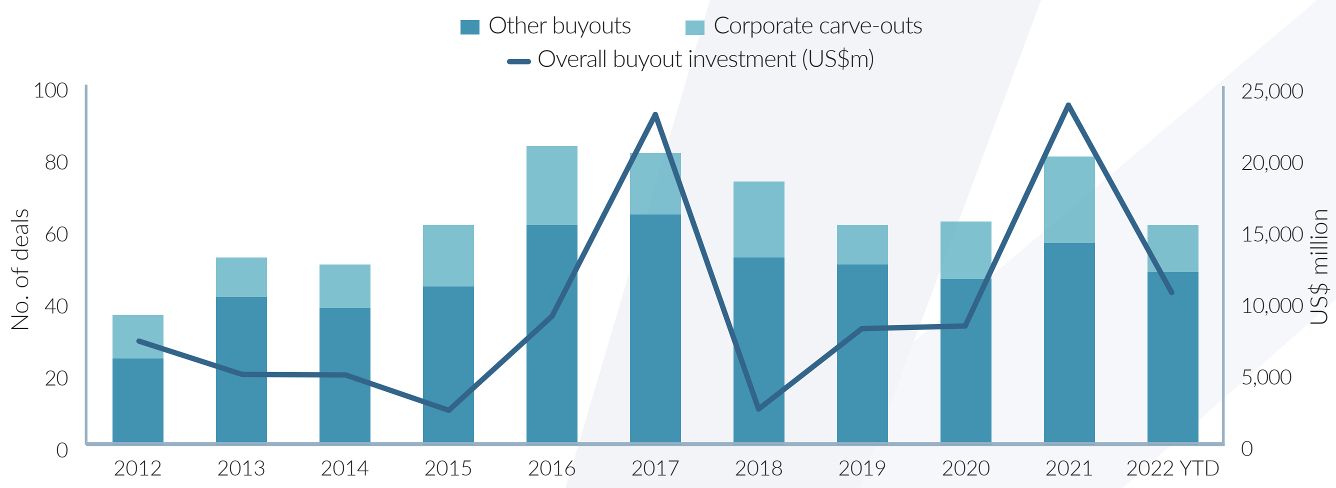
The carve-out share of Japan buyouts over the past 10 years is around 25%. It has been consistent during this period, tracking broader private equity investment trends. AVCJ Research has records of 24 transactions of this kind in 2021, only the third time deal flow has surpassed the teens.

What they lack in volume, carve-outs make up for in value. This is in part driven by the circumstances of the seller. Japanese corporates are under pressure from all sides – lenders, regulators, institutional shareholders, activist investors – to deliver performance rather than scale; and when forced to divest something, they prefer transactions that make a meaningful impact on the balance sheet.

Advisors name about 10 offshore players, plus a few local GPs, as credible bidders for these assets. Bain Capital recently overcame competition from at least three rivals to secure a JPY 427.7bn medical devices carve-out from Olympus Corporation. Meanwhile, Toshiba received eight privatisation bids and two minority investment proposals, most of them backed by financial sponsors.

Pricing is described by several sources as aggressive. "It continues to be high as competition amongst sponsors remains intense for certain deals, and banks are still willing to underwrite attractive deals," said Paul Ford, a partner

Carve-out share of Japan buyouts



Source: AVCJ Research

Japan's largest private equity buyouts

Investee	Date	US$m
Toshiba Memory*	2017	14,712
Hitachi Metals*^	2021	7,574
Hitachi Transport Systems*^	2022	6,060
Calsonic Kansei*	2016	4,515
Accordia Golf	2021	3,512
Hitachi Kokusai Electric*	2017	2,951
Takeda Consumer Healthcare*	2021	2,287
Yayoi	2021	2,117
Skylark	2011	2,072
Nippo Corp^	2021	1,867
Renesas Electronics	2013	1,680
Panasonic Healthcare*	2013	1,660
Unizo Holdings	2019	1,626
Seiyu*	2020	1,401
Asatsu-DK	2017	1,351
Hitachi Koki*	2017	1,266
Accordia Golf	2016	1,265
Jupiter Shop Channel*	2012	1,077
Nichii Gakkan	2020	1,029

* Carve-out from a Japanese seller
^ Yet to close
Note: Some valuations exclude rollover equity
Source: AVCJ Research

at KPMG, emphasizing the importance of an achievable value creation thesis in this context.

That isn't necessarily difficult, given the characterisation of non-core assets as uncompetitive, inefficient behemoths helmed by ageing salarymen who prioritise expense accounts and golf club memberships. They have essentially been cast adrift within the conglomerate structure, the parent redeploying whatever cash is generated and leaving nothing for growth.

Not all carve-outs start from the same point. Hitachi Metals, which is subject to a JPY 816.8bn tender offer from a Bain Capital-led consortium, is a listed entity with a freestanding corporate structure. However, size brings complexity. The company is almost a conglomerate in and of itself with assorted subsidiaries that often have little in common and could be divested.

At the other end of the spectrum, last year J-Star – which typically makes investments of JPY 1bn-JPY 3bn – acquired a waste management business from NEC Corporation. Greg Hara, the private equity firm's CEO and managing partner, said that turning the business into a standalone entity, notably the personnel and systems elements, represented a significant challenge.

Typical early assignments include installing proper corporate infrastructure: SG&A (selling, general, and administrative expenses) reporting; systems that track money flows by customer, region, and product; and key performance indicators (KPIs) that can be used to hold everyone accountable.

To begin with, management might be augmented rather than replaced, for example by bringing in a professional CFO or a hands-on chairman. Ultimately, there could be redundancies, but these are accompanied by initiatives to promote, empower, and incentivise younger talent.

"There are talented and motivated people, but the incentive structure is different to the US and Europe, where people have shares in the company, so they look beyond annual compensation and care about long-term growth," said Tatsuya Ochi, head of Japan private equity at Partners Group.

"In Japan, they have less skin in the game. The right incentive schemes can help change behaviour."

There is a need to disentangle the business from its former parent, but also maintain some form of dialogue. This should be business-like, with the separated entity choosing which services to purchase, said Tom Noda, a managing director at AlixPartners, although he noted that redrawing relationships along commercial lines means breaking entrenched habits.

Cost reductions can be wide-ranging, but often include phasing out less profitable business lines and focusing on a concentrated number of perceived winners. This gives shape to mid-term strategic plans and growth-oriented investment programmes that had previously been lacking.

"You need at least 18 months to start seeing real effects and that initial period can be high impact in terms of management, systems, culture, strategy, and business plan change," said Mark Chiba, a partner and group chairman at mid-market buyout player The Longreach Group. "Solid outcomes may emerge after three years, and then you might want to hold for 4-5 years to harvest it all."

Bolt-on bonanza

The Carlyle Group went through this process with Senqcia Corporation, a supplier of earthquake-resistant building materials it acquired from Hitachi Metals in 2015 and recently agreed to sell to Lone Star. The GP claims to have installed a more flexible organisational structure, divested non-core assets, revised pricing strategies, and established new business lines.

According to Kazuhiro Yamada, head of Japan at The Carlyle Group, after that initial 18-month period of change, it is standard practice to consider bolt-on acquisitions and strategic alliances, usually with a view to international expansion. Cross-border M&A has been a feature of most of Carlyle's Japan carve-outs. While the emphasis used to be on sales, supply chains are now a key consideration.

"We may take businesses where most of the manufacturing is done in Japan and establish factories and distribution overseas. These days, we must think carefully about supply chain stability and where key components come from," Yamada said.

M&A has served KKR well in the past. The firm's JPY 165bn purchase of PHC Holdings Corporation – Panasonic's medical equipment division – in 2014 was followed a year later by the USD 1.15bn bolt-on acquisition of Bayer's diabetes care business. This diversified a Japan-centric revenue base and secured a global leading position in blood glucose monitoring meters and diabetes sensors.

Six more acquisitions were executed through 2020 as PHC's revenue increased 3x. At the same time, the company divested non-core business units and introduced new management systems and compensation structures. It listed in October 2021 with a market capitalisation of JPY 397bn.

The Calsonic Kansei-Magneti Marelli tie-up was driven by a similar desire for diversification. Nissan was by some distance the former's main customer, accounting for 80% of transactions, while one-third of the latter's revenue came from Fiat Chrysler Automobiles. It also doubled EBITDA at a stroke.

However, a month after the deal was announced in October 2018, Ghosn was arrested in Japan on charges of under-reporting his salary and gross misuse of company assets and dismissed as chairman of Nissan. The company, beset by internal strife, took more than a year to appoint a replacement, which contributed to delayed product launches, reduced output, and loss of market share.

In March 2020, with COVID-19 rampant, Marelli temporarily shuttered 100 of its 145 factories globally at the same time, crippling EBITDA. Two months later, it obtained JPY 130bn in funding to ride out the downturn, comprising an equity cure from KKR and debt from Japanese banks.

Global light vehicle sales fell from 87.8m units in 2019 to 74.7m units in 2020 and recovered to 78.5m units last year, according to IHS Markit. As of April, it was predicting 80.6m units for 2022. A more fulsome recovery was expected in 2021 but automakers found themselves competing with the computer and consumer electronics industries for a limited number of semiconductor chips.

Supply chain issues at Marelli were compounded by a blockage in the Suez Canal, reduced production volume at Renesas Electronics – which supplies nearly one-third of the automotive industry's microcontroller chips – following a factory fire, and ice storms in Texas that shut down numerous chipmakers.

"Various things turned against Marelli that were unexpected, things that don't happen with most private equity carve-outs," said one industry advisor.

> "If revenue fails to grow or even falls, it becomes difficult to underwrite planned investments or sustain capital-intensive businesses"
>
> *– Paul Ford*

Marelli took action to reduce fixed costs, but in March it applied for alternative dispute resolution (ADR), an out-of-court mediation used in Japan to impose a standstill on debt payments and allow companies to continue operating while they negotiate with creditors on a restructuring.

"This was an effort to help a genuinely good company receive the resources it needed to see through the bottom of the cycle and reach recovery. The goal is to be a partner to Marelli and to corporate Japan," said a source close to the situation.

An ADR process can only proceed with 100% credit support. Approximately 90% of Marelli's outstanding debt was held by Japanese banks, and the rest was split between lenders from Singapore, Taiwan, and mainland China, the source noted. Some of the overseas players declined to approve the deal.

Consequently, the company moved in July to a court-led rehabilitation, where KKR's bid to be reappointed as sponsor could be challenged by other parties. With a clear majority of lenders in favour of KKR's proposed haircut and its revitalisation plan, the court proceeding was swiftly concluded.

Putting aside the danger of being blindsided by unforeseen events, industry participants observe that automotive can present a challenge to investors, with Bain's Verbeeten noting that there are "systemic risks that make it a bit trickier than other sectors." This feeds into a general aversion to cyclical industries.

"We stay away from cyclical industries like parts of the semiconductor, high-tech, and commodity sectors," said Carlyle's Yamada. "Significant change is happening in many other areas, and business models are evolving rapidly. We are focused on carefully identifying these longer-term changes and trends that will take place over the next 5-10 years and capturing these opportunities."

The fear tied to cyclical exposure is essentially poor timing. Investors might misread or misjudge the cycle, resulting in a holding period that coincides with a protracted contraction. This is especially difficult when a company already has heavy-duty value creation programmes underway and suddenly there is limited capital available.

"If revenue fails to grow or even falls, it becomes difficult to underwrite planned investments or sustain capital-intensive businesses. As distress builds, suppliers may accelerate payments, customers may delay orders, and employees may get skittish," said KPMG's Ford.

"In response, operational flexibility is essential, but in certain situations companies may lack this flexibility due to the combination of high-cost structures, lack of labour scalability, and the implications of high debt service obligations."

Unknowns around cyclicality are also the caveat weighing on the investment timeline illustrated by Chiba of Longreach. He recommends focusing on certain operational levers that can be controlled irrespective of broader market conditions – such as cost reductions – to counterbalance risks presented by cyclicality and building cross-border platforms.

In addition, external headwinds can disrupt meticulous and incremental progress towards another key objective of corporate carve-outs: facilitating a shift in management mindset and an acceptance of the merits of private equity-driven operational initiatives.

Yamada explained that Carlyle is deliberately patient in its approach, recognising that the cumulative benefits of other efforts – from bolt-ons to systems upgrades – might fall short if those tasked with execution don't embrace the corporate vision. The GP begins with small steps and small successes, which are highlighted internally to demonstrate the contribution to larger change.

"The biggest risk is not being able to align with the company on the change agenda," added Bain's Verbeeten. "If you don't have a plan that resonates, management might say, 'That sounds interesting, let's discuss it internally,' which means 'We will see what we can do with it and continue with business as usual.' The result might be no action or only a mediocre attempt at your ambitious plans."

Rich pickings

Despite its difficulties with Marelli, KKR remains an active player in Japan's carve-out space. In April, it launched a tender offer for logistics provider Hitachi Transport Systems at a valuation of approximately JPY 749.5bn after agreeing to acquire parent company Hitachi's controlling stake in the business. As part of the deal, Hitachi will be awarded 10% of the acquisition vehicle.

This would be KKR's third carve-out from Hitachi in the space of five years. All three rank in the top 20 Japan private equity buyouts on record. Six of the top seven are carve-outs, with Hitachi Transport Systems set to occupy third place behind Hitachi Metals, which is also pending completion.

Hitachi is unusual in that it embarked on a systemic divestment programme, pledging to reduce its number of group companies from 800 to 500 by 2022. Attention is now shifting to what the conglomerate might buy as it continues its strategic repositioning, but the likes of Fujitsu, Mitsubishi, and Seven & I Holdings are all tipped as potentially active sellers.

Meanwhile, the opportunity set is broadening. "A wide variety of assets are becoming available in terms of size and industry," said Ochi of Partners Group. "Corporates in Japan have been over-diversified for a long time, but now they realise the importance of portfolio adjustment and optimising their portfolios to achieve long-term growth."

This view is echoed by Longreach's Chiba, who has been tracking a shift in his deal pipeline towards consumer and services businesses. "The market was opened by industrial conglomerates that were under the most pressure to get these deals done. Now we see more deal flow from consumer and services companies that have lots of cash but are shedding assets for strategic reasons," he said.

In addition, it might be argued that macroeconomic conditions are highly conducive to buyouts by GPs with offshore funds. The yen has depreciated significantly against the US dollar, from JPY 115 in March to JPY 138 as of late August, making Japanese assets relatively cheaper. Meanwhile, inflation remains benign compared to other markets and deal financing remains available on attractive terms.

"Despite various macro and geopolitical and uncertainties, we still have significant and growing capital held by private equity firms looking to do deals in Japan, and a large industrial sector here that offers rich opportunities for strategic and operational renewal," said KPMG's Ford.

"With the continued acceptance and awareness of private equity as an exit candidate, the weak yen, low interest rates and a good financing environment relative to other markets, we can reasonably expect strong deal activity in the near term." ■

Venture capital: Late-stage crossroads

Japan's late-stage technology start-ups are finally beginning to attract meaningful attention from global investors. They should not pop open the champagne

Cross-border schmoozing is not a strong suit for Japanese venture capital investors. Even industry leaders with bases overseas are often described as having strongly domestic-focused agendas. Insularism is held up as one of the core explanations for a lack of global investor attention and consequently a persistent funding gap for late-stage start-ups.

Japan and US-based crossover investor World Innovation Lab (WiL) believes it has made meaningful progress on this front in recent years. Co-founder and CEO Gen Isayama, who has been based in Silicon Valley for 22 years, claims extensive connections in the global VC community and has helped the likes of Sequoia Capital and Light Street Capital make inroads in Japan.

Evidence that this bridge-building is working came in May when DST Global and WiL co-led a JPY 15bn (USD 115m) Series C for corporate credit card issuer Upsider. This was the first time DST had taken a lead role in a Japan deal. Two weeks earlier, SoftBank Vision Fund led a JPY 8bn Series C for smart endoscopic imaging developer AI Medical Service, with support from WiL.

Isayama isn't forecasting a flood of foreign capital, however. Viewed through a certain lens, Japan has never been more attractive: a normalisation in valuations following a feverish two years means a Series C or D for a B2B software-as-a-service (SaaS) company is priced at 6-8x annual recurring revenue, down from 10-20x. But this is symptomatic of a broader malaise, a global correction.

The cultural context is uniquely Japanese: this is an environment where flat-rounds and down-rounds are not merely embarrassing suggestions of stagnation – they're impolite.

> "You have to understand the background. You can't use the same logic as in the US, where there's plenty of capital and there's no need to IPO"
>
> *– Tiffany Kayo*

Delayed IPOs have left start-ups needing to reconstruct their budgets, but cultural pressures to maintain the heady valuations of 2021 have often proven overwhelming. If a potential incoming investor proposes a flat or lower buy-in price, existing backers may also balk, claiming a new normal run by new technologies requires new approaches to valuing companies.

"This has happened so many times in the past. People say it's a bargain deal because it's a flat-round, but the company is better than it was before. If I put last November's environment around me, yeah everything looks like a bargain today. But right now, we're seeing a major adjustment," Isayama said.

"Some later-stage companies are still a bit too optimistic, and we know that things are going down. People say it will be much better at the end of the year, but when you see this massive inflation pressure in the overall economy, I fear the worst for 2023 and at least 2-3 years of recession."

Selling a story

Nevertheless, the campaign to bring foreign VC into Japan is in full swing. Coral Capital, formerly 500 Startups Japan, considers this a matter of awareness and changing the perceptions of global institutional investors who see poor upside in a dearth of unicorns.

By Coral's count, there are only 10 unicorns in Japan, but another 41 so-called hidden unicorns reside on the Tokyo Stock Exchange. These are start-ups that were forced to IPO at sub-unicorn valuations due to a lack of access to private late-stage funding but that went on to meet the USD 1bn threshold as public companies within 10 years.

The essential message of the research is that the talent and markets are here – but Japanese start-ups grow differently.

"When you're looking at Japan, you have to understand the background. You can't use the same logic as in the US, where there's plenty of capital and there's no need to IPO," Tiffany Kayo, an analyst at Coral, said. "It's important to get out of that mindset of applying the global benchmark, where we don't consider an IPO as a fundraising round. Really, it's just another fundraising round."

Coral is tracking some successes in this charm offensive, having closed its third flagship fund on JPY 14bn last year with 30% of the capital coming from global investors across the US, Asia, and Europe. This came shortly after a JPY 15.6bn Series D for the jewel of its portfolio, enterprise software supplier SmartHR, led by Light Street. SmartHR has also received backing from WiL and Sequoia.

Similar traction is being charted by Incubate Fund, a local early-stage investor that raised JPY 16bn for its first pre-IPO fund last year with 47% of the capital coming from institutional overseas LPs. Incubate co-founder Masahiko Honma has been meaning to raise such a vehicle for years but needed to wait for the geopolitical stars to align.

"There is an oversupply of money in the growth and later stage in the US on one side, and on the other, we're seeing a slowdown in the China tech scene based on tightening regulation," Honma said. "For a lot of the money seeking Asian growth, the allocation for China is going to Japan."

The fund invests exclusively in existing portfolio companies; one of its first moves was taking the lead in a JPY 5.1bn Series C for lunar exploration technology developer iSpace. This precipitated an investment from fund-of-funds Axiom Asia, possibly the start-up's first non-Japanese investor other than foreign space agencies.

Honma observes that there is also a sector lens to the idea of global capital coming into late-stage VC in Japan. Although Mercari, a flea market app that raised USD 1.2bn in Japan's first major tech IPO in 2018, is widely credited with initially stoking unicorn ambitions locally, consumer is not the predominant theme.

Deep tech in domains such as space, materials, and medical science plays better here than in most markets, but B2B SaaS is the main draw. Incubate's other late-stage portfolio companies include Wovn, an IT provider that helps companies localise websites, and marketing technology supplier Bellface.

Policy permutations

The government has been pressing this agenda in earnest for about a decade with mixed results, which could be instructive to private players now getting involved. There is a sense that government investors like INCJ, which is mandated to support late-stage start-ups, have given companies underserved runway. To some extent, lingering demand for high valuations has been attributed to this effect.

But private sector sentiment for policy support has been largely positive – and still improving. INCJ, for example, has been reborn as Japan Investment Corporation (JIC) with what is perceived to be a more properly incentivised investment team. Last year, it backed a USD 230m Series F for media unicorn SmartNews that featured US-based Princeville Capital and Woodline Partners.

The most meaningful development on this front is arguably the idea that public VC entities can eventually seed the private sector with investment talent rather than the other way around. This happened in 2020, when Tokihiko Shimizu, previously head of a government-linked private equity program for Japan Post Bank, left to start his own growth-stage shop Fiducia.

Shimizu, a mathematician by training, initially made his mark in the industry by helping Government Pension Investment Fund (GPIF) diversify its portfolio into alternatives. In 2015, he moved to Japan Post Bank and later took the helm of Japan Post Investment Corporation, a direct investment unit that earmarked about JPY 36bn for direct growth-stage technology deals.

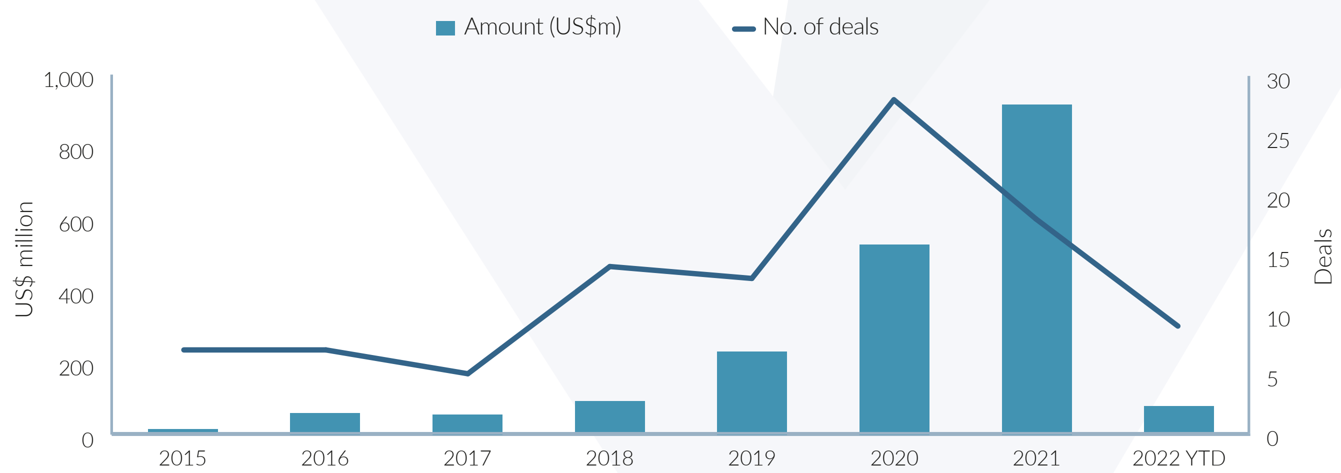
On the back of this experience, Shimizu convinced the recently retired Takumi Shibata, previously CEO of Nomura Asset Management and Nikko Asset Management, to be a co-founding partner of Fiducia. Their debut fund reached a first close of JPY 3.3bn in February with support from Pavilion Capital, Nanto Bank, and Tokyo University of Science Investment Management.

"An independent fund can provide very quick investment and operations decisions, respond to situations and be very flexible, which is especially important in hands-on investment in the growth stages," Shimizu said.

The fund is targeting JPY 10bn, 90% of which will be deployed in growth to pre-IPO-stage companies. There is a strong focus on deep tech, business digitisation, social impact through tech-driven economic growth, and meaningful ownership stakes. Four investments have been made to date, including the acquisition of a 30% stake for an undisclosed sum in advertising start-up Lightz.

Cheque sizes theoretically max out around USD 10m but significant co-investment from LPs, especially Pavilion, a subsidiary of Singapore's Temasek Holdings, is expected. The preference for sizeable positions is part of an operational involvement thesis that Fiducia sees as

PE investment in Japan tech



Source: AVCJ Research

lacking in Japan's current growth-stage capital environment.

"Venture capital firms are good at employing 30 and 40-year olds and sending them to board meetings of the companies they invest in," said Shibata, whose experience since the 1980s includes roles as Nomura Group COO and Europe CEO of Nomura International.

"They participate every few months, write reports, and job done. The crucial importance of outside directors giving strategic advice and opportunities to build networks is completely missing."

The operational, B2B slant in Japan's late-stage opportunity set has resulted in significant diversity in terms of incoming actors. In addition to government entities, foreign VC firms, and local early-stage players expanding their remits, conglomerates trying to go digital with internal VC arms and traditional private equity firms are getting into the mix.

Growth-stage private equity investment, excluding VC, in Japanese technology companies increased exponentially between 2015 and 2021, when it hit USD 917m, according to AVCJ Research. This compares to USD 528m and USD 231m in the prior two years.

The Carlyle Group arguably led the standout deal in this theme, a JPY 24.4bn round for an advanced biomaterials developer called Spiber. Goldman Sachs and Bain Capital have made Series C investments in recent months, and Advantage Partners has explored minority, even early-stage, investments.

Prospects uncertain?

The phenomenon is partly about seeking pre-IPO returns and partly about recognising the zeitgeist in corporate Japan toward digital transformation via start-up service providers. But the question remains how far it can go when minimum cheque size requirements and stubbornly high valuations prevent global VCs from underwriting a larger population of private late-stage companies.

What's more, rightly or wrongly, there have been no signals from the Tokyo Stock Exchange that it intends to change the policies that have encouraged companies to go public before they achieve scale. Local VCs do not complain about the field of available late-stage investment targets, but from the private equity perspective, it's slim pickings.

"Many PE funds in Japan are emphasising technology-driven approaches. Investment theses incorporate additional value creation through digital transformation, and portfolio ops teams increasingly have a CDO [chief digital officer] or in-house analytics group," said Paul Ford, a Japan-based partner at KPMG.

"There is also increased appetite for growth capital investments, particularly in high-opportunity areas like B2B SaaS, but the relatively smaller late-stage tech market in Japan has severely limited such opportunities."

Layer on the current macro deterrents – rising interest rates, geopolitical tensions, public market volatility, rising inflation – and the horizon narrows even further. Growth stage PE investment in Japan tech amounts to only about USD 79m so far this year, putting 2022 on track for a 74% decline versus 2021.

Investors that AVCJ contacted for this story observed that Vision Fund, which recently posted an investment loss of JPY 3.5trn across both vintages for the 12 months ended March, has been quieter this year. Likewise, Tiger Global Management is said to have perceptibly decelerated amidst various challenges. The former has only recently begun to target Japan; the latter has yet to make a significant move, according to AVCJ Research.

Global VC woes are not expected to spook all late-stage investors interested in Japan, most of whom are a decidedly more conservative lot than the likes of Tiger and Vision Fund. Additional growth funding will be needed to create the unicorn breeding ground that existing participants in the market envision. But the fact that it must now come with renewed discipline around pacing, valuations, and governance suggests a continued, protracted expansion rather than a boom.

"I've seen a lot of people at late-stage funds changing jobs because we get job offers and they ask if we're hiring. Why? Did they invest heavily into later-stage companies which are big-time underwater," WiL's Isayama said. "There is always the market cycle, and it doesn't mean that late-stage growth opportunities are gone. We're just going back to normal." ■

Private wealth: Talent war

A shortage of fundraisers familiar with the high-net-worth segment is being keenly felt in Asia as global GPs look to raise more capital through private bank channels

Markus Egloff joined KKR last year with a brief to build out the firm's coverage of Asia's private wealth segment. He has assembled a team of nine so far in Hong Kong, Singapore, Japan, and mainland China, with several roles still open. Finding the right people in the right places is not easy.

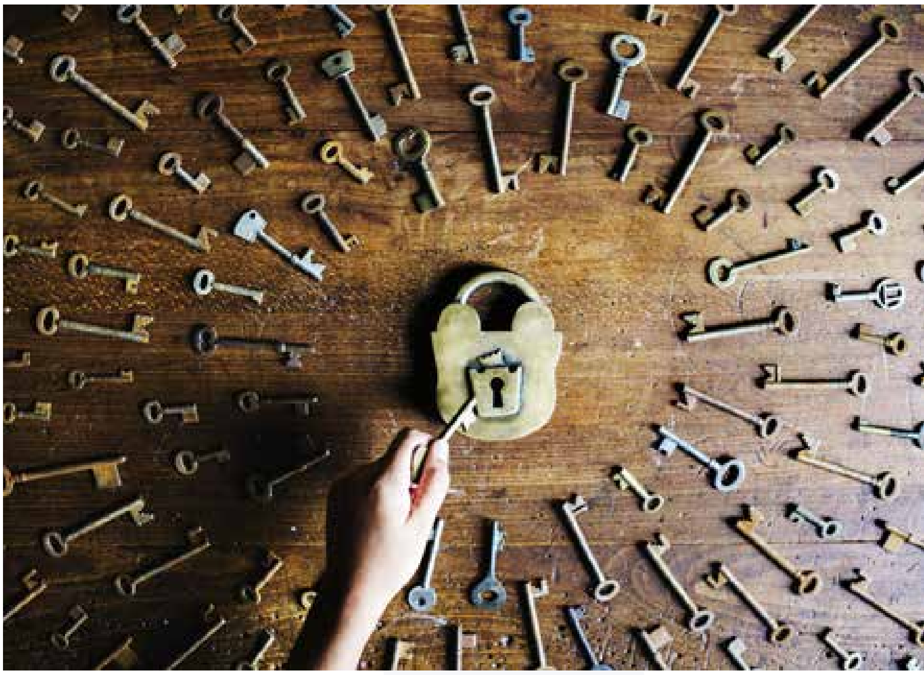
"I've been very active myself, activating my network, and most people I've found were in one or two degrees of separation. The pond we are fishing in is small," said Egloff, a managing director and head of Asia wealth at KKR.

"We want people who understand the asset class, understand asset management distribution, and understand private banks, maybe from the inside. I'm excited by what I've found, but it's rare to find all three criteria in one person. You must build teams that bring these skillsets together."

Typically, investor relations executives are organised by geography rather than by client type: coverage of private banks in Singapore, for example, falls to those responsible for institutional LPs in that market. KKR brought in Egloff as part of a push to develop the family office and high net worth individual (HNWI) segment, including having dedicated people in this area.

An early win came with the firm's fourth pan-regional fund, which closed on USD 15bn last year. Half of the 85 investors that had not previously committed to KKR's Asian private equity strategy were private wealth clients, many based within the region. Their participation helped drive the overall LP count to 290, higher than any other vehicle the firm had raised globally at that point.

Ultimately, KKR and its peers will be pitching more than just traditional drawdown funds to ▶



> "We want people who understand the asset class, understand asset management distribution, and understand private banks"
>
> *– Markus Egloff*

Asia's HNWIs. Semi-liquid products, arguably better equipped to address client concerns around liquidity, transparency, and minimum cheque sizes, are seen as a game-changer in the relationship between private equity and private wealth. Most global GPs are looking for people to sell them.

"Demand has spiked across IR capital formation, capital raising, and business development. It applies to the multi-strategy asset management platforms and the alternative asset management platforms," said Arthur Leung, a consultant in the Asia financial services practice at Egon Zehnder.

"Clients want a more permanent presence in Asia because they recognise that covering the region from outside is challenging. The wealth and family office space is a particular area of focus."

Early movers?

Egloff came to KKR from UBS, where he spent 25 years in wealth management and asset management. Other senior hires include Edward Moon, who Apollo Global Management brought in from HSBC Private Banking to perform a similar private wealth coverage buildout. Apollo wants to have a team of six by year-end as overall Asia IR headcount doubles to 25-plus.

Herbert Suen made the transition from wealth management at Barclays to The Blackstone Group six years ago, reflecting his firm's status as an early mover among the global firms. Blackstone now has USD 192bn in private wealth assets under management (AUM) – 20% of the total – and most of that comes from HNWIs. Its dedicated HNWI headcount is more than 200 globally, including 20 in Asia.

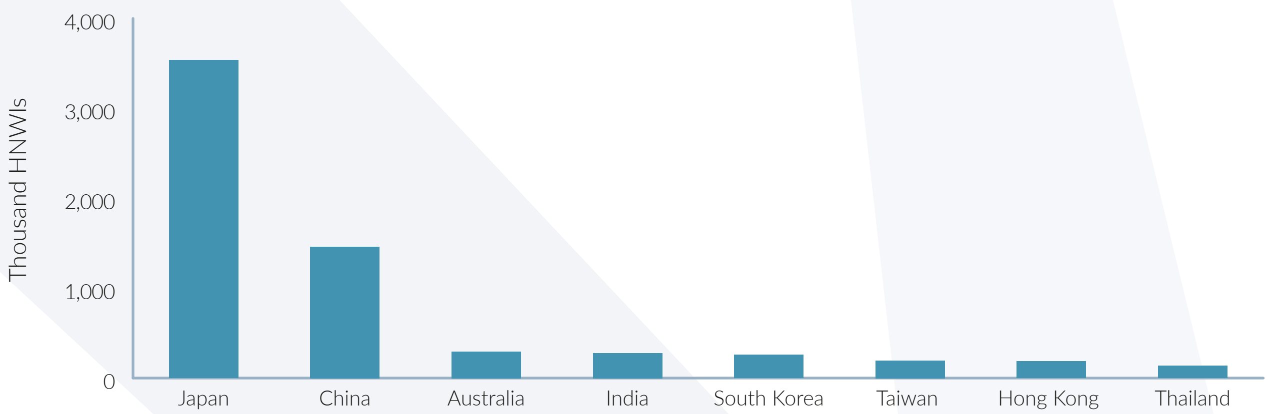
Blackstone was also among the first to gain meaningful traction with semi-liquid products that account for the bulk of HNWI money. They resemble mutual funds and can be sold directly into the US retail market as opposed to just accredited investors. BREIT and BCRED, which focus on real estate and private credit, respectively, had USD 100bn and USD 37.8bn in total asset value as of March.

"More than 10 years ago, we asked ourselves at Blackstone: how can we diversify our client base for the long-term?" said Suen, the firm's head of private wealth solutions in Asia.

"We were committed to the private wealth space since day one. It's not just about the products, but awareness of certain concepts, which is why we've centred our approach on education, product development and services. We have dedicated teams in the private wealth solutions group to design educational resources to assist investors in understanding more about alternative investments."

In the US, Blackstone started out focusing on the larger private banks or wirehouses and then created specific coverage teams, which

Asia's largest HNWI markets



Source: Capgemini

led to the cultivation of a network of registered investment advisors (RIAs). Asia, which the firm began targeting in earnest seven years ago, doesn't have the same kind of infrastructure. HNWI distribution is about working with private banks.

"We are seeing more PE firms talking to private banks as intermediaries," said Michael Di Cicco, a senior client partner at Korn Ferry. "I think Asia is a step or two behind Europe, where most of the big global firms are looking to build coverage of HNWIs directly as well as through intermediaries. That's an indication of where things are likely to go."

The emphasis on private banks as conduits means that Hong Kong and Singapore are the regional fundraising hubs. The former is a staging point for Greater China, notably the nearly 1.5m mainland Chinese individuals who reached the HNWI watershed of having at least USD 1m in investable assets in 2020, according to Capgemini. The latter serves Southeast Asia and non-resident Indians (NRIs).

Local nuance

While private equity specialists are being recruited in mainland China as well, they primarily function as educational nodes for business that takes place offshore. Some GPs are looking at the qualified domestic limited partnership (QDLP) program as a means of bringing the entire process onshore, but progress is limited.

Australia and Taiwan are also named as places where it helps to have on-the-ground IR talent, but the biggest coverage gap is Japan.

With more than 3.5m HNWIs, Japan is the second-largest private wealth market globally after the US, yet it remains underpenetrated by alternatives managers. This is typically blamed on local regulatory and licensing requirements, complications around tax and creating fully hedged yen-denominated products, and a need for concerted educational efforts in Japanese.

"Over the last 15-20 years, while the drawdown fund concept developed globally, Japan's private placement framework remained very rigid," said KKR's Egloff. "There is no regulation hindering semi-liquid alternatives, but intermediaries haven't had enough exposure to alternatives generally. It will take time and education, from everyone, to access what is a huge opportunity."

Luca, a digital platform launched by a former Blackstone fundraiser in Japan to tap local investors below the top-tier institutions, estimates there are 1.3m HNWIs with at least JPY 100m (USD 768,000) in assets. Together, they are responsible for JPY 333bn, of which 30% is held by approximately 87,000 households in the JPY 500m and above category.

Japan wants to increase onshore investment options, in part to stem the flow of wealth offshore, and lowering the qualified investor threshold from the current level of JPY 300m is said to be under consideration. Nevertheless, Keiko Sydenham, Luca's CEO, noted that global private equity firms struggle to access the market because there are relatively few private banks.

There are independent financial advisors, much like RIAs in the US, that work through local securities houses. Private equity firms must establish partnerships with securities houses and trust banks, but these effective gatekeepers often lack the resources for end-to-end coverage, Sydenham added.

"You need the right product and branding to succeed in Japan," said Leung of Egon Zehnder. "You also need the right distribution partners, and there aren't many of them. There are a lot of post-investment demands around reporting, valuation, and liquidity, and the local talent pool is small."

Outside of Japan, a lack of sophistication in Asia's local private banks remains a challenge. Global GPs work reasonably seamlessly with the major international wirehouses, often establishing lines of dialogue in the US, switching to Asia for product launches, and then relying on US-based colleagues to handle due diligence and onboarding. After-sales duties are normally fulfilled in Asia.

Within the region, Blackstone is pushing below the private banking tier into priority banking channels, regulations permitting. However, most global GPs are currently focused on Asian private banks and some wealth management platforms, citing limited bandwidth and the heavy lifting required when venturing beyond a small set of local champions.

Private bank relationships, at the global and regional level, are expected to account for the bulk of private wealth commitments out of Asia in the near term. Digital channels, which are being actively cultivated, are regarded as more of a long-term play.

One phenomenon noted by several industry participants is that leading private banks have become more demanding. In some cases, the number of feeder vehicles launched each year has doubled to nearly a dozen. They have a clearer understanding of what resonates with their clients and what they want from private equity firms in terms of marketing support and reporting.

This adds weight to the argument for dedicated IR resources on the GP side, although recruits don't necessarily come from private banks. Talent is also found in rival PE firms and broader asset managers, often with an emphasis on product specialists who can interact with relationship managers at banks rather than salespeople.

"There is a balance to be struck between a subject matter expert, who knows about the product we are delivering, and the salesperson, who can convince the distributor and end clients that the solution makes sense," said one IR executive at a large-cap private equity firm. "I wish there were more people with both qualities."

Even in the institutional space, proven fundraisers are a relative scarcity in Asia. Di Cicco of Korn Ferry claims the market is shaped like a barbell: a handful of senior professionals have built up track records raising capital across strategies and geographies; a reasonably deep base of unproven up-and-comers sits below; and there is little in between.

"Within private wealth, supply is thinner," he added. "For years, private banks have employed alternatives specialists who could speak to clients. But not many; maybe one or two in any geography. If you want people who understand private banking and private wealth and who understand private equity or illiquid strategies, it is thinner still."

> "For years, private banks have employed alternatives specialists who could speak to clients. But not many; maybe one or two in any geography"
>
> *– Michael Di Cicco*

Distribution dynamics

These people are prized not only because there is more demand for alternatives exposure from the private wealth clients, like most LP constituencies. The nature of distribution is changing as well – to the point that, in global multi-strategy firms, products and modes of engagement in the private wealth and institutional segments might be fundamentally diverging.

HNWIs in Asia are chiefly accessed through feeders, typically established by private banks to enter specific fund products. To some GPs, however, these structures are suboptimal: too complex, cumbersome, and costly, with multiple parties involved and multiple layers of fees.

Should feeders be supplanted by semi-liquid products – and for now, only a handful of large-cap managers are offering these – approaches to IR may shift. Rather than work on feeders within specific timeframes, and then reverting to core institutional coverage until the next vintage, fundraisers would be talking to private banks on a continual basis.

In this context, PE firms don't see themselves competing against each other for private wealth money as much as the dozens of mutual fund products currently offered to HNWIs. When Blackstone brought its semi-liquid real estate strategy to Asia three years ago, some private banks were more focused on public markets, but China's property crunch proved a rude awakening.

"In the US, retail investors can invest in listed REITs if they want exposure and income from income-oriented real estate assets, such as warehouses. However, listed REITs are exposed to equity market volatility in addition to real estate risks. Private or non-traded REITs on the other hand can provide more stability, typically generate regular income and have the potential to appreciate," said Suen.

"Non-traded REITs are generally less liquid than daily mutual funds, but they typically can provide ▶

access to real assets with some liquidity. You also generally have transparency on the underlying assets – you may see who the tenants are and can see the rental income coming through."

The equivalent credit strategy launched in Asia last year and met with a generally positive response. Blackstone was able to highlight the performance of public market fixed income products and make the case that they were not as uncorrelated to liquid equities as advertised. Private credit was positioned as a truly uncorrelated alternative.

Others are making similar pitches. Apollo's yield business, which accounts for more than 70% of the firm's AUM and spans corporate credit, structured credit, and direct lending, is marketed as an effective fixed income replacement.

"Whether you are a sovereign wealth fund or an individual, the hunt for yield continues. Interest rates are rising, there is increasing volatility, and most wealth clients don't have enough exposure to private markets. They want diversification, downside protection, and alpha – and we are providing solutions that deliver this," said Moon, Apollo's head of Asia Pacific global wealth management.

A broader suite

Real estate and credit have traditionally accounted for a significant portion of HNWI portfolios in Asia. Semi-liquid products, whether as interval funds, business development companies (BDCs) or REITs, are intended to facilitate a transition from public to private markets.

It remains to be seen whether private equity and infrastructure are embraced as readily. KKR is preparing to find out as it develops a semi-liquid product range that will soak up much of the additional volume as the private wealth share of annual fundraising rises from 10-20% to a planned 30-50% in the next several years.

The expectation is that private wealth-focused IR professionals will work on a combination of drawdown funds and semi-liquid products over the next three years, with the latter growing in importance and share of commitments. In the long term, Egloff doesn't anticipate much HNWI demand for drawdown funds outside of private equity in certain situations or geographies.

"The product landscape is changing so quickly. I think the unexpected winner could be infrastructure, which could be a fixed income alternative," he added. "Why would a client access core-plus infrastructure through a 10-year drawdown fund with a j-curve when there are semi-liquid products with good yields, a total return expectation, and some liquidity?"

Portfolio: Aspirant Group and Yamoto Group

Improving cost controls and realising efficiencies underpinned Aspirant Group's investment thesis for Japanese fish retailer Yamoto Group, and they have helped the company withstand external pressures

Restaurant owners bid aggressively at the first bluefin tuna auction of the year at the Toyosu wholesale market in Tokyo, driven by superstition and bragging rights. The event is widely regarded as a bellwether for Japan's high-end dining industry and even for wider business sentiment.

Peak prices have risen significantly over the past 15 years, the most recent surge culminating in a winning bid of JPY 333.6m (USD 3.1m) in 2019. It fell to JPY 193.2m the following year, but this was still the second-highest total on record.

In 2021, with restauranteurs counting the cost of the pandemic, the price collapsed to JPY 20.8m. Notably, Kiyoshi Kimura, owner of the Sushi Zanmai restaurant chain and a serial auction victor, declined to participate. He abstained again this year when a 211-kilogram tuna sold for JPY 16.9m.

Japan lifted its initial state of emergency in May 2020, but the economic rebound has been fitful. GDP grew by 1.7% in 2021, the first expansion in three years, but it flipped between positive and negative growth every quarter as new waves of infections broke and receded. State of emergency measures remained in place for six months and then returned in 2022 with the onset of omicron.

Many businesses are unable to operate normally, not least restaurants, which are subject to limits on booking size and, in some cases, opening hours. Large-scale events had yet to return in any meaningful way even prior to omicron. Moody's Analytics said last month that Japan's recovery "is unlikely to proceed along a straight line."

This gives some context to Aspirant Group's ownership of Yamoto Group, a fresh fish wholesaler and retailer with a presence in Toyosu. The GP was in the process of engineering a turnaround

> "We were introduced to the founder because we had invested in a similar company, so we were familiar with the business"
>
> *– Yuichi Shin*

when the pandemic hit – though it helps that the investment thesis is more about delivering operational efficiencies and boosting the bottom line than rolling out dozens of new outlets.

"In May 2020, we had to shut stores, shorten working hours, and get as much government support as possible. Conditions started to improve a few months later, but then a third wave came in early 2021," said Taichi Nakamaru, a principal at Aspirant and formerly CEO of Yamoto.

"However, thanks to the improvements we made to the business, such as introducing better controls so inventory levels can be adjusted based on expected customer numbers, Yamoto remained profitable and its financial performance is still above the pre-investment level."

A succession situation

As a Japanese middle-market private equity firm, Aspirant targets companies with enterprise values of JPY 3-30bn. Of the 23 investments made to date, 12 constituted business succession, where ageing founders opted to sell to private equity in the absence of candidates within their families who can assume control. In this respect, Yamoto conforms to type.

Founded in 1981 by a fisherman who wanted to move into distribution, the company expanded from wholesale to retail stores to conveyor belt sushi restaurants and casual dining izakayas. Securing a position in Toyosu – formerly Tsukiji – in 1997 supported these efforts because it enabled Yamoto to source fish and shellfish nationwide at affordable prices.

Though Chiba prefecture, situated on Japan's east coast not far from Tokyo, remained its stronghold, the company joined a select group of suppliers approved to help cater imperial household events.

When the husband-and-wife team that ran the business decided to sell up, they were put in touch with Aspirant. The private equity firm completed an acquisition in early 2017, committing capital from its second fund, which closed the same year on JPY 27.2bn.

"We were introduced to the founder because we had invested in a similar company, a seafood restaurant chain, so we were familiar with the business," said Yuichi Shin, a managing partner at Aspirant who led the deal. "The independent advisor thought we could be a potential buyer."

The previous investment was Teraken Corporation, an operator of izakaya establishments specialising in seafood. It was exited in 2019 to Umenohana, a Tokyo-listed restaurant operator.

Private equity is no stranger to Japan's food services industry. Several investors have acquired izakaya chains, often as part of multi-dining concept restaurant portfolios, in recent years with a view to executing roll-up strategies.

Meanwhile, Sushiro Global Holdings – now known as Food & Life Companies – is the standout example in conveyor belt sushi. Permira bought the business from Unison Capital in 2012 and listed it five years later, having supported an expansion to 470 outlets. There are now more than 600, plus a couple of other dining concepts.

Yamoto differs from these investments in two key aspects. First, the company has a diversified revenue base. When Aspirant arrived, there were five wholesale outlets, six retail stores, 14 conveyor belt sushi restaurants, and five izakayas. Wholesale, retail, and restaurants each accounted for about one-third of revenue.

Second, the business has a specific geographic footprint. Yamoto emphasises its local credentials, sourcing all its fish within Chiba, often through direct relationships with ports, which brings down costs and ensures freshness. Rice and most condiments are sourced locally as well.

"There are limitations in terms of shipments. If stores are too far from their markets, they cannot deliver. In this sense, Yamoto is very different from Sushiro, which has many stores all over Japan. The company focuses on Chiba and area around Tokyo," said Tetsuro Monobe, a partner at Aspirant.

On a basic level, the challenges Aspirant faced on acquiring Yamoto were not dissimilar to those at Teraken. Both were succession planning situations, where existing management had to be augmented or replaced as the founder-owners departed. Moreover, companies of this type often lack standardised systems and processes, have outdated storefronts, and require IT upgrades.

"The first thing we did was strengthen the internal controls," Shin explained. "The company was run by a husband and wife, so the foundational controls you expect with professionalised management – such as inventory management systems – weren't there."

The founders didn't leave immediately. Aspirant seconded a team member to serve as financial controller, assuming responsibilities from the wife, while an external CEO was recruited to work alongside the husband and eventually take over from him.

Building up a solid financial management infrastructure offered insights into store-by-store and product-by-product performance that were not previously available. It became clear where and why sales were declining. The CEO resolved to execute a restructuring, which resulted in the closure of six restaurants and two wholesale outlets.

Yamoto's existing employees did not respond well to the development. Despite the CEO's best efforts to engage staff and outline growth plans, he was unable to regain their trust. Aspirant felt that a change in leadership was the only option.

Installed as replacement CEO, 18 months after the acquisition, Nakamaru moved quickly to improve relations with employees. He visited every outlet and met with staff delegations, listening to their ideas. It contributed to store renovation work and the development of new menus. Through these interactions, Aspirant also won support for its business priorities: quality, service, and cleanliness.

Process engineering

Yamoto has approximately 600 staff and more than two-thirds of them work on a contract basis. The combination of uncertainty within the business and below-market-rate terms meant the company was unable to make any new hires in the first year. Aspirant subsequently increased salaries and reduced working hours.

This was done in the expectation that other reforms would deliver efficiencies and improved productivity. Procurements and shipments were previously the responsibility of individual stores, which meant the same suppliers and buyers had multiple accounts. Centralising these processes removed redundancies, reduced cost, and cut payment cycles from three months to two weeks.

Standardisation swept through the business, from deep freezes to kitchens to customer relations. Yamoto maintained significant stocks of fish in its warehouses and smaller inventories at each restaurant, but little was done to coordinate these efforts company-wide.

"They didn't perform inventory counting at all. The fish is stored at minus 50 degrees Celsius, and the staff were reluctant to go in there regularly and take stock," said Nakamaru. "We introduced an inventory control system with monthly reviews."

Another performance bottleneck occurred during food preparation. The various parts of a red flesh tuna are classified as akami and toro, or meat and fatty belly. Premium cuts, referred to as o-toro and chu-toro, are high in fat, light pink in colour, have melt-in-the-mouth texture, and are priced accordingly. The size and classification of different pieces impact a restaurant's bottom line.

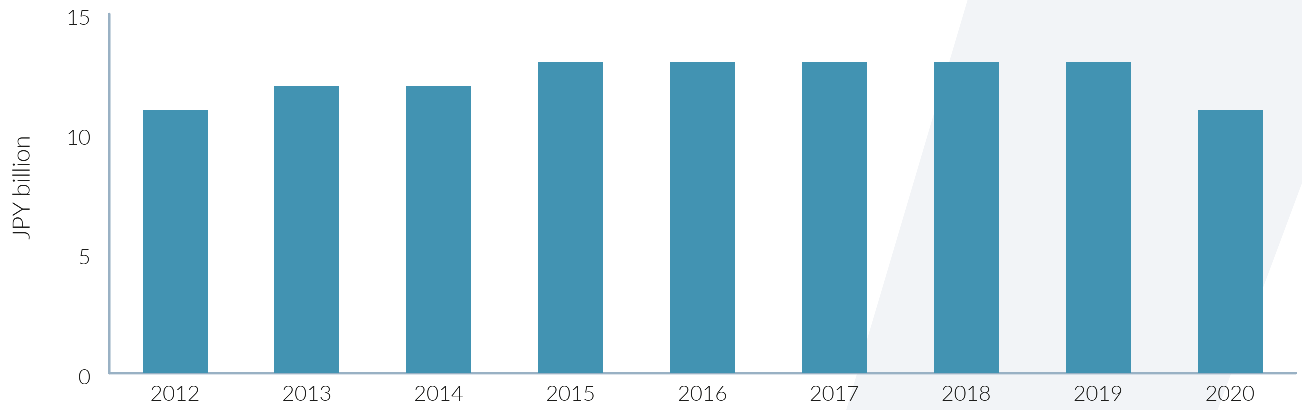
Aspirant found that individual chefs at Yamoto were following their own habits, which often resulted in a disconnect between the overall cost of a fish and the price of each part sold to consumers. This was addressed by establishing a unified pricing approach across all outlets. At the same time, the company set up three central kitchens, one for preparing fish and two for other dishes like rice.

The shift from fragmented, often paper-based processes to integrated digital systems was mirrored at the front end of the business. Advertising switched to search engines and social networks, while iPads were introduced at conveyor belt sushi outlets, which made ordering more efficient. Order data was collected and analysed, with the results feeding into menu design and marketing.

Equipped with proper performance breakdowns and analysis, Yamoto's management was able to ▶

> "These stores were also trying to capture tourists. After the typhoon, tourists stopped coming"
>
> *– Taichi Nakamaru*

Japan's sushi industry



Source: Japan fishing industry association

set key performance indicators (KPIs) and figure out where to pursue growth. Having closed six restaurants, the company opened three new ones and renovated another five. There are now three wholesale and six retail outlets, 11 conveyor belt sushi restaurants, and two izakayas.

Enter the swans

It is telling that Aspirant pinpoints Yamoto's nadir as May 2019, predating the operational reforms and two black swan events. The first of these came in October 2019 when Typhoon Hagibis became the strongest tropical cyclone to hit Japan in decades. It spawned a tornado that hit Chiba prefecture and conditions were worsened by a near-simultaneous earthquake off the coast.

Cumulative damage amounted to USD 15bn, making it the costliest typhoon on record at the time. It cost Yamoto alone USD 2m, according to Nakamaru. "There was property damage, rooftops were blown off, and we had to protect employees," he added. "But these stores were also trying to capture tourists. After the typhoon, tourists stopped coming."

COVID-19 arrived not long after the effects of Hagibis receded. Facing substantial operating losses, the company adapted where it could, for example by doubling the takeout and delivery share of revenue to 20%, and returned to profit in three months.

Sales were JPY 6bn when Aspirant invested and have since dropped to JPY 5bn. EBTIDA fell from JPY 200m to JPY 100m, but it has since recovered to JPY 300m. The improvement in EBITDA – plus an increase in gross profit margin from 43% to 46% and a decrease in equipment costs to sales ratio from 14% to 8% – reflects the realisation of efficiencies.

To some extent, Yamoto remains a work in progress, yet Aspirant believes the business may prove an attractive acquisition target to larger restaurant operators or fish processing players. The private equity firm overcame significant strategic interest to buy it in the first place.

The lingering concerns are slow-burn structural rather than pandemic-driven. Conveyor belt sushi has proliferated in the past decade but now growth is flatlining and the segment is consolidating around a handful of big-name brands. More fundamentally, Japan's JPY 20bn fishing industry appears to be losing momentum as well.

Both appear to challenge the Yamoto credo of pursuing quality – much of it driven by product freshness – as opposed to just scale.

"Our strength is having our own supply chain, so we need to leverage that in building our brand and attracting more customers," said Kazunari Shimizu, the company's current CEO. "The threat is the decline of the local fishing industry, which may result in smaller catches."

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