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Opportunities in Japanese Private Equity

Analysis of how PE can capitalize on Japan's evolving dynamics

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Key takeaways

- Despite record high corporate profits, EV/EBITDA multiples for publicly traded Japanese companies sit at 7.9x, as opposed to 11.9x for US public companies. Given a historically less competitive M&A environment in Japan it is likely there is even greater variance between public and privately held companies relative to the US or EU.

- The Japanese corporate tax rate is roughly 24%, one of the lowest tax rates in the developed world. Combined with cheap debt, this could enhance potential PE returns.

- 23.3% of company presidents were over the age of 70 in 2015, and this number is expected to climb. Business owners looking for succession plans can potentially provide the type of proprietary PE deal flow that is so difficult to find in other developed nations.

- Japan's corporate governance has historically placed less emphasis on enhancing shareholder value. As a result, many Japanese companies are bloated with poor capital allocation; however, recent regulatory and governance reforms are bringing about change. This provides potential opportunities for PE firms to streamline operations, divest non-synergistic lines of business and greatly expand margins.

The Japanese economy has been in a slow growth cycle since the 1990s and consequently continues to be a relatively undervalued market given its level of economic development and financial stability . After being trapped for decades in a deflationary spiral, the Japanese government in recent years has instituted numerous changes to the corporate governance code that make it appealing for PE activity. The focus on monetary easing, fiscal stimulus, and further structural reforms to spur economic development make the country's private markets even more alluring. PE investors have several reasons to be bullish on Japan, chief among which are the factors discussed below.

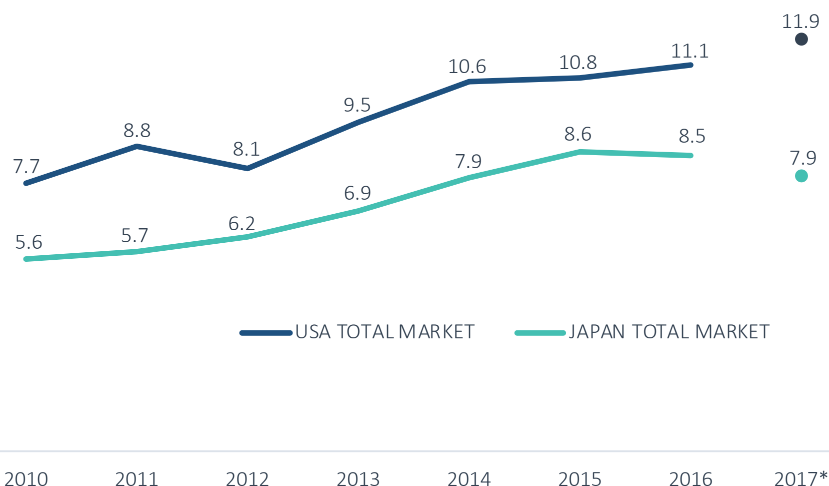
Price

The prolonged, albeit lackluster, global economic expansion experienced following the financial crisis has driven most asset classes to elevated valuations across North America and Europe. However, this is not the case in Japan, where the median EV/EBITDA multiple for public companies sit at 7.9x. Given the country's relatively less competitive M&A environment, two factors suggest that buyout multiples are even lower:

- Private acquisition multiples tend to be lower than their public counterparts due to illiquidity and higher risk factors associated with taking control of an entire company, as opposed to being a minority owner.
- With the third-largest economy in the world but a small number of PE firms and limited PE-focused capital (in comparison to the rest of the developed world), the number of privately held companies in Japan outweighs investor demand. We believe this leads to a greater divergence between public and private multiples relative to what would normally be found in the US or EU.

In the US, the median EV/EBITDA multiple of public companies sits at 11.9x, while the median private buyout multiple is slightly cheaper at 10.2x. Given the large role that multiple expansion plays in driving returns, the relatively lower valuations and

Public company median EV/EBITDA (TTM) multiples

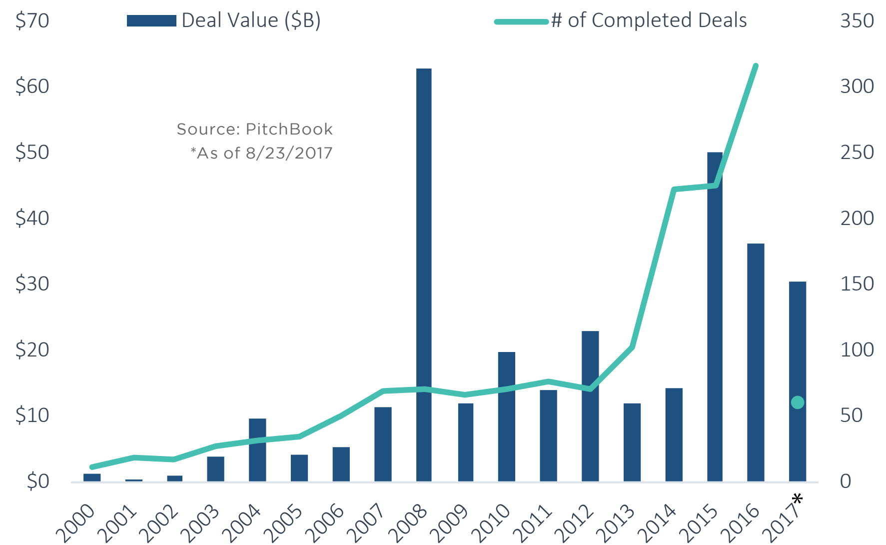


Source: PitchBook
*As of 7/31/2017

decreased competitive environment make Japanese private markets ripe for PE firms to potentially buy low. Of course, these same factors present headwinds to PE managers looking to sell high. The ability to sell a company at a higher multiple than it was acquired is dependent on the prevailing market environment and the ability to expand multiples through other value creation levers prior to exit. Japanese M&A is primed to become more competitive over the next five to 10 years due to recent inflows of capital to PE by Japanese limited partners. This influx of capital is still early stage and likely to result in a larger general partner presence in the region, which inevitably leads to greater competition. Holding all else equal, increased competition alone will serve to drive PE multiples higher.

M&A has skyrocketed as of late

M&A activity with Japan-headquartered companies

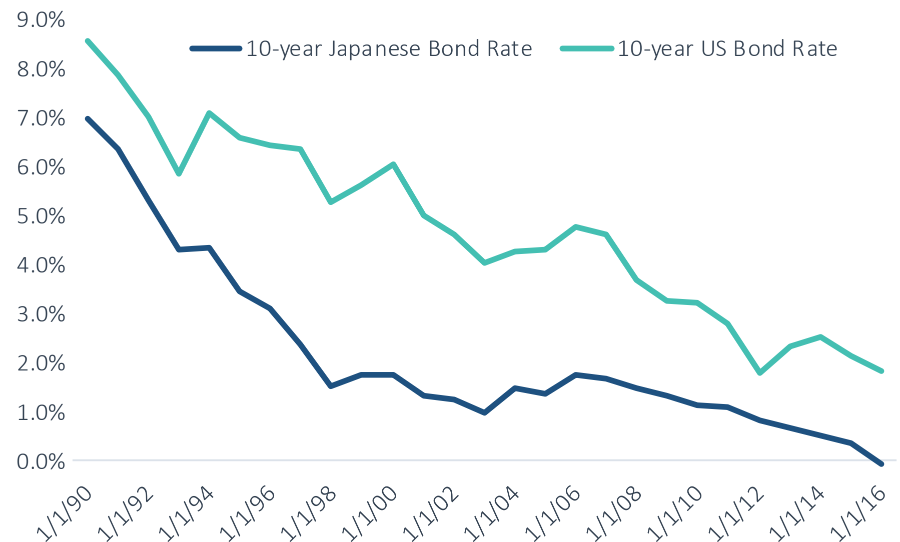


Abenomics

The administration of Prime Minister Shinzo Abe plans to continue massive spending and deregulatory efforts to continue the recent acceleration of the Japanese economy after two decades of slow growth. A short list of government priorities includes financial support for key sectors, further reductions in corporate tax rates and greater deregulation. The standard corporate tax rate currently sits at 23%, with a special tax rate of 19% for small to medium-sized enterprises. This compares to 35% in the US, roughly 30% in Germany, and 33% in France. In addition to lower tax rates, PE firms can obtain more favorable debt rates to fund leveraged buyouts in Japan as negative yields on government bonds have led Japanese banks to compete for higher-yielding loans. Both factors, along with additional government support, add to the argument that Japan is a more favorable PE business environment, worthy of greater PE capital allocation than it currently garners.

Yield opportunities continue to remain depressed

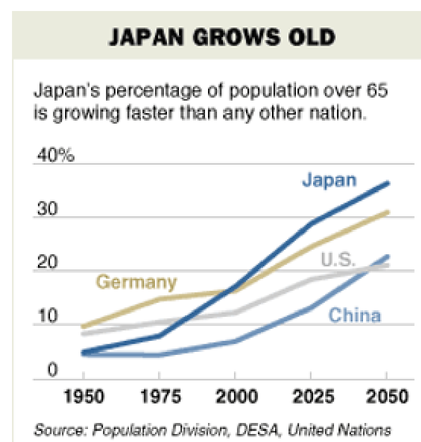
10-year bond rates, not seasonally adjusted



Source: Federal Reserve Economic Data

Demographics

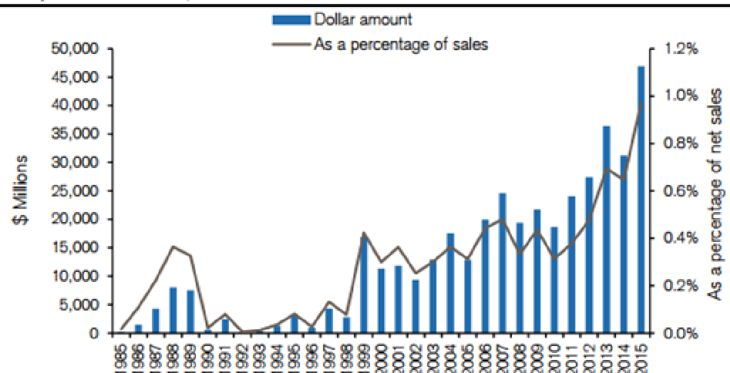
The demographic situation in Japan is a significant risk factor for institutional investors and one of the reasons some remain bearish on the country. 33.3% of the population was over 60 years old in 2015, and that percentage is expected to continue growing over the next decade. This presents further deflationary problems as demand for domestic goods and services decreases. While this is a legitimate risk that cannot be ignored, an aging population brings investment opportunities for PE as older business owners look for liquidity to fund retirement. According to a government survey, 23.3% of company presidents were over 70 years old in 2015, with the average age of presidents at small firms sitting at 70.5 years. PE firms can benefit from significant deal flow as the population continues to age and succession plans become a priority. As PE activity constitutes a small percentage of the overall Japanese economy when compared to the US or EU, it is currently possible for a firm to be a sole bidder on an acquisition, providing PE managers with significant leverage when negotiating the terms of a purchase. This is not typically the case in other developed economies, where it is common to have three or more bidders for a single company.



Poor Capital Allocation

Japanese companies are historically known for poor capital allocation decisions that have led to bloated conglomerates lacking strong synergistic value among their subsidiaries. The 20-year average cash flow return on investment (CFROI) is only 3% for Japan, compared to 10% in the US and 6% in the EU. As of 2015, CFROI for Japanese companies had risen to 3.7%, likely due to a shift toward emphasizing shareholder return. Poor earnings during the low-growth environment has led to increased pressure for companies to divest poor-performing business lines, even though Japanese corporate culture has historically been opposed to such events. According to a report by Deloitte, divestitures made up 22% of all M&A in 1H 2016 in Japan, continuing an upward trend that began in 2012. This same report points out that in most cases these divestitures are brought on during times of duress and are reactive to negative performance issues. These associated factors provide opportunity for savvy dealmakers to acquire a steeply discounted divested asset, creating the ability to achieve margin expansion by restructuring and streamlining operations.

Exhibit 19: Japan Divestitures, 1985-2015



Source: Thomson Reuters and Credit Suisse.
Note: Announced divestitures; excludes debt tender offers, equity carve-outs, exchange offers, loan modifications, and open market repurchases; Dollar amounts not inflated.

Risks

- *Government debt*

Japan's debt-to-GDP ratio is 220%, the highest ratio of any country around the globe. This is cause for concern, but the government deficit has been decreasing since 2011 and Japan remains the center of global activity for several industrial industries. Despite high levels of debt, Japan is positioned to service their debt requirements and, should the economy pick up, the load of government debt will become less of a concern.

- *Politics*

Many of the recent changes in Japan stem from the Abe administration and its plan to turn around the Japanese economy. With polls placing the current administration's approval at 30%, there is a risk that the Japanese people grow tired of the current administration and move in a different direction, potentially derailing the pro-business reforms of Prime Minister Abe. However, demographics are working against the economy, putting the Japanese government between a rock and a hard place. With the lingering risks of rapid deflation and economic contraction, any administration will face continued pressure to uphold current fiscal and monetary policies.

Geopolitical concerns affecting the stability of the region can be cause for concern to long-term investors. However, the US has recently reaffirmed its commitment to swiftly step in and defend economic interests and allies in the area. From an investment perspective, the risk of geopolitical uncertainty has not deterred investment in other western-aligned east Asian countries.

- *Cultural risks*

In the US, corporate focus is generally geared towards maximizing shareholder return. In Japan, however, there is greater emphasis placed on other stakeholders and managers hold greater influence over the company than shareholders do. This is a big yet not insurmountable hurdle for international PE firms to overcome, as one of Abe's "three arrows" of economic reform is efforts to reform Japan's corporate culture, transforming it into a more shareholder-friendly environment.

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