THE CARLYLE GROUP
GLOBAL ALTERNATIVE ASSET MANAGEMENT

Carlyle Comment
September 2018

The Transformative Power of Private Equity in Japan

By Kazuhiro Yamada
Managing Director, Carlyle Japan Partners

Japanese companies are increasingly willing to work with private equity firms as they discover the value private equity can add.

Amid pressures from underperformance, corporate governance reforms and an aging population, companies are looking to focus on their core businesses, enhance shareholder returns, and become more efficient.

Foreign private equity firms are emerging as catalysts for change in corporate Japan—helping companies expand operations domestically and overseas, prepare for business successions, and execute carve-outs.

A Warming Towards Private Equity

While historically reluctant to engage with foreign investors, the attitude of Japanese companies towards private equity has been gradually shifting as they discover the value it can add. In 2017, investment firms announced 598 M&A transactions targeting Japanese companies, representing approximately JPY 3.2 trillion (approximately USD 30 billion) in value.[1] This marks a more than 60% increase (in JPY terms) over the previous peak of JPY 2.0 trillion in 2005. We expect to see significant M&A activity continue as companies look to expand their operations domestically and overseas, prepare for business successions, and consider carve-out opportunities.

These deals are transforming Japanese companies. Foreign private equity firms help their Japan counterparts to develop global ambitions and focus their attention on core competencies to boost competitiveness. With their industry knowledge and global resources, foreign private equity firms are emerging as catalysts for change in corporate Japan, supporting the local private equity industry's current momentum and ultimately helping the Japanese economy to thrive in the long term.

This shift in attitude comes at an important time for corporate Japan, as many companies in the country not only harbor ambitions for expansion, but also must contend with struggles on a number of fronts. Among the problems they face is underperformance relative to global counterparts in terms of profitability, stock prices and return on equity – the result of poor management and uncompetitive business structures – as well as the conundrum of an aging population, which is a key obstacle for Japanese companies looking to increase profits domestically.

Private Equity as a Solution

There are three key areas where private equity may prove most valuable to Japanese firms as they seek to transform and overcome current obstacles.

First, conglomerates are increasingly looking to divest non-core assets and enhance core businesses. Frequently, operational inefficiencies exist, stemming from weak

1 RECOF DATA Corporation's MARR Report (April 2018 issue)
Note: Total deal value includes only those deals for which values were announced

board oversight, poor internal decision-making processes and the absence of key performance indicators or clearly defined objectives. Recently, however, the introduction of the Stewardship Code and Corporate Governance Code, in conjunction with the rise of shareholder activism, has driven constructive changes within Japanese companies.

In particular, businesses are increasingly taking a proactive approach to expanding shareholder returns and enhancing corporate value. Companies are now allowing external board members a greater say in corporate strategies, such as embarking on divestitures or seeking growth through overseas acquisitions. According to the Tokyo Stock Exchange (TSE), the percentage of companies listed on the First Section of the TSE with at least two independent external board directors has increased from 12.9% in 2010 to 88.0% in 2017.[2]

> "We are optimistic about the Japanese market. It is the third largest economy in the world, with further growth potential."

With private equity firms onboard, Japanese corporates are finding that they can draw upon their partners' industry expertise and global resources to become more efficient, adopt more clearly defined business foci, and pursue sensible overseas expansion.

Hitachi, for example, has taken numerous such steps to strengthen its corporate governance over the last decade. The percentage of external board directors at Hitachi has increased from 38% as of June 26, 2007 to 67% as of June 20, 2018 and the percentage of non-Japanese external board directors has increased from 0% to 33% during the same period.[3] Furthermore, Hitachi has divested a number of non-core assets to private equity firms in recent years, such as Hitachi Metals Techno (currently known as SENQCIA) to Carlyle in 2015 and Hitachi Kokusai Electric to KKR in 2017. Hitachi has also acquired assets from private equity firms to reinforce its core business, including, for instance, the acquisition of Sullair from Carlyle-backed Accudyne. With enhanced corporate governance and continued efforts to reorganize its businesses, Hitachi improved its profitability and overseas revenue ratio over the past 10 years.

Second, such is the desire to change and execute drastic strategic initiatives, some independent public companies are also seeking the help and support of private equity firms to go private. For example, in February 2012, Solasto was taken private from the Second Section of the TSE through a management buyout transaction. Solasto, with support from Carlyle, strengthened its management team, innovated its business model, completed a number of M&A transactions and became a public company again in June 2016 through an IPO on the First Section of the TSE, paving the way for the company's future growth.

Finally, many founders and CEOs of private companies are looking to external parties to aid in establishing and executing succession plans. Succession-related buyouts in Japan are estimated to have reached a historical high in 2017.

We believe these succession-related buyouts will only continue to grow as founders and CEOs age and the need for succession planning grows ever greater. The average age of Japanese CEOs was 59.5 years old in 2017 compared with 54.0 years old in 1990,[4] and seems likely to keep growing on the current trajectory. Furthermore, out of approximately 420,000 family-owned companies reviewed by the Teikoku Databank in 2016,[5] approximately 70% had not yet identified successors.[6] Private equity firms can add value by helping companies move beyond the previous generation, identify successors, and strengthen management teams.

For example, Oyatsu Company, Japan's third largest snack manufacturer, collaborated with Carlyle to execute the succession planning process. Carlyle worked closely with the company's CEO, Mr. Matsuda, a member of the founding family, to identify and appoint a successor CEO from outside the organization, strengthen the management team, and gradually transform the company's hierarchy into an organizational management structure.

Conclusion

In summary, we are optimistic about the future of private equity in the Japanese market. Japan is the third largest economy in the world, and economic fundamentals are strong, due in part to the structural reforms under "Abenomics." The desire for improved corporate governance, numerous carve-out opportunities, and imminent succession issues are creating a favorable investment environment. As such, we believe foreign private equity players can play an important role in transforming Japanese companies, maintaining the strong momentum of the Japanese PE industry, and reviving the Japanese economy in the long term.

2 Japan Exchange Group: https://www.jpx.co.jp/english/listing/others/ind-executive/index.html

3 Hitachi's Annual Report 2007, page 16 & 18: http://www.hitachi.com/IR-e/library/annual/2007/ar2007e.pdf; Hitachi's website with information about its Board of Directors as of June 20, 2018: http://www.hitachi.com/corporate/about/directors/index.html

4 Teikoku Databank, January 31, 2018

5 The number of "family-owned" companies that were reviewed by the Teikoku Databank in 2016 totaled approximately 420,000 companies, the representatives and shareholders of which were largely equivalent to those of the approximately 560,000 companies in CCR (credit assessment) and COSMOS2 databases provided by Teikoku Databank. According to the National Tax Agency's FY2013 statistics, there were approximately 2.4 million family-owned companies in total in Japan as of 2013.

6 Teikoku Databank, November 25, 2016

Kazuhiro Yamada

Yamada is a Managing Director and Head of Carlyle Japan buyout advisory team. He is based in Tokyo.

Since joining Carlyle in 2001, Mr. Yamada has played a leading role in several of Carlyle's successful investments, including Asahi Security Co. Ltd, Kito Corp., Rhythm Corp., Gakusei Engokai Co. Ltd, Covalent Materials Corp., AvanStarte Inc., Walbro Co., Ltd., Simplex Inc. and WingArc1st Inc.

Prior to joining Carlyle, Mr. Yamada was a Senior Vice President of Daiwa Securities SB Capital Markets Co. Ltd ("Daiwa") where he engaged in cross-border M&A deals along with Lazard Freres. Prior to that, he worked in investment banking for five years, project finance for five years, and commercial banking for five years at Sumitomo Bank (currently "Sumitomo Mitsui Banking Corporation").

Mr. Yamada is a board member at ARUHI Corporation.

Mr. Yamada received a B.S. from the Doshisha University in Kyoto, and completed the Stanford Executive Program at the Stanford Graduate School of Business in 2010.