2016

Private Equity in Japan

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April 20, 2016

CONTENTS

I. INTRODUCTION

The aim of this paper is to analyze Japan's role in the Asia-Pacific private equity market and to predict whether it will increase or decrease in the future. The first step to understanding Japan's role is to assess the health of the global private equity industry by evaluating four key vital signs of the private equity industry: the amount of fresh capital contributed by investors, the amount of capital deployed by managers in new acquisitions, the amount of capital returned to investors after disposition of assets, and the rate of return on equity investments. Once the pulse of the industry as a whole is measured, the Asia-Pacific market will be examined independently of Europe and the United States using the same indicia of health. Finally, the scope of the analysis will be narrowed to only the performance of Japan. After considering all the data, the paper will suggest potential reasons for Japan's poor performance in comparison to its Asia-Pacific peer countries and explain the Japanese Government's strategy to remedy the issues.

II. A BRIEF SUMMARY OF THE HISTORY, LEGAL FORMATION AND BUSINESS OPERATION OF PRIVATE EQUITY FIRMS

Private equity, defined broadly, is. "a source of investment capital from high net worth individuals and institutions for the purpose of investing and acquiring equity ownership in companies."[1] The idea of using private capital for investment opportunities is said to be, "as old as capitalism itself," but the formation of private equity firms for the specific purpose of purchasing controlling stakes in existing businesses is a relatively new tool in the capitalist belt.[2] Indeed, investment professionals did not begin to leave other financial institutions, such as bank

[1] http://www.investopedia.com/articles/financial-careers/09/private-equity.asp
[2] http://www.wsj.com/articles/SB10001424052970204468004577166850222785654

holding companies and insurance companies, to form private funds until the late 1970s and early 1980s.[3] Despite its youth, the private equity industry has grown from a cottage industry into a multi-trillion-dollar asset class which is large enough to be a major player in the U.S. economy and a potential catalyst for world-wide economic development.[4] Arguably, this rapid evolution was a result of the advent of the American entrepreneurial economy, which is characterized by unprecedented business start-ups and expansions, an increase in job creation, and an increase in intellectual property and high-tech development.[5] This shift caused private equity fund formation to geometrically accelerate both in quantity of funds and size of funds. In turn, funds have elected to specialize in particular areas in an effort to distinguish themselves from competitors in the industry. Commonly, private equity firms will distinguish between: early state businesses (venture capital) v. later stage businesses (private equity), high-tech v. lo-tech v. no-tech, mid-market deals ($50-200m) v. mega deals ($1bn+), U.S. v. Europe v. Asia v. South America, successful companies (LBO/Recap) v. troubled companies (debt restructuring/turn around), or control v. minority stakes. Additionally, it is common for firms to invest in only one industry, in an effort to build expertise and a positive reputation among players in the field.

It is important to distinguish between a private equity firm and a private equity fund. A single private equity firm will likely have several funds within it, each with its own investment strategy. After solidifying a strategy, the private equity firm will begin the investment process by setting a capital raise goal and soliciting funds from investors to meet this goal. The firm will create a fund to hold the capital and pursue the investment objectives. The fund is formed as a limited partnership with the firm acting as the general partner ("GP") of the partnership and the

[3] *Structing PE Transactions - Levin*
[4] http://www.pegcc.org/app/uploads/preqinglobalreport.pdf
[5] *Levin Slides*

investors acting as limited partners ("LPs") of the partnership.[6] Typically, GPs are compensated for their business expertise and management of the fund with a management fee equal to 2% of aggregate LP commitments and a carried interest bonus equal to 20% of the funds overall net profit.[7] The LPs exchange a capital commitment letter, which is an agreement in which the LP promises to provide capital to the fund when it is "called down" by the GP, for an ownership stake in the partnership.[8] The number of LPs in a given fund can vary widely and common LPs include: accredited individual investors, cash-rich corporations, public & private pension plans, university endowments, and charitable endowments.[9] Additionally, Non-U.S. individuals, corporations, pensions, & sovereign wealth funds are sometimes investors.[10]

After completing the formation and capital raise, the GP will source a variety of potential purchases over a five-year investment period.[11] The number of acquisitions a fund will make varies widely based on the total assets of the fund and its stated investment strategy. As deals are identified, the GP will submit a capital call to the LPs which will cover the acquisition cost, expenses and management fees. After acquisition, the purchased business is referred to as a portfolio company, and the firm will monitor portfolio companies across different funds by "vintage year" – the year in which the business was acquired determines its vintage year.[12] Depending on the fund strategy and market conditions, the fund may hold a single portfolio company anywhere between five and seven years before disposing of the asset. The fund will increase the value of the portfolio company by either increasing revenue, reducing costs, or,

[6] https://www.financialpoise.com/accreditedinvestormarkets/article/a-brief-history-of-private-equity/
[7] <u>Levin</u>
[8] https://www.financialpoise.com/accreditedinvestormarkets/article/a-brief-history-of-private-equity/
[9] <u>*Id.*</u>
[10] *Id.*
[11] Slide 26 PE
[12] *Corp & Ent Finance*

more likely, a combination of the two. It is common for a fund to increase revenue by growing a portfolio company's market share via strategic acquisitions of competitors, known as tack-on acquisitions.[13] The fund will dispose of a portfolio company in one of three exit scenarios: an initial public offering, a sale of the company to a strategic or financial buyer, or a recapitalization where the portfolio company buys back the funds interest in the company.[14] The fund will distribute proceeds to LPs as each portfolio company is sold.

The private equity industry, similar to any other industry, is subject to expansion or contraction depending on market conditions. There are four measurable vital signs which aid in understanding the current health of the private equity industry. The first vital sign is a measure of how much fresh capital LPs are committing to the private equity funds in a given year. The second is a measure of how much capital GPs of private equity funds are deploying in new acquisitions. The third is a measure of how much capital GPs are returning to investors after exiting investment positions. The final, and the most important vital sign to LPs, is the internal rate of return on equity investments.

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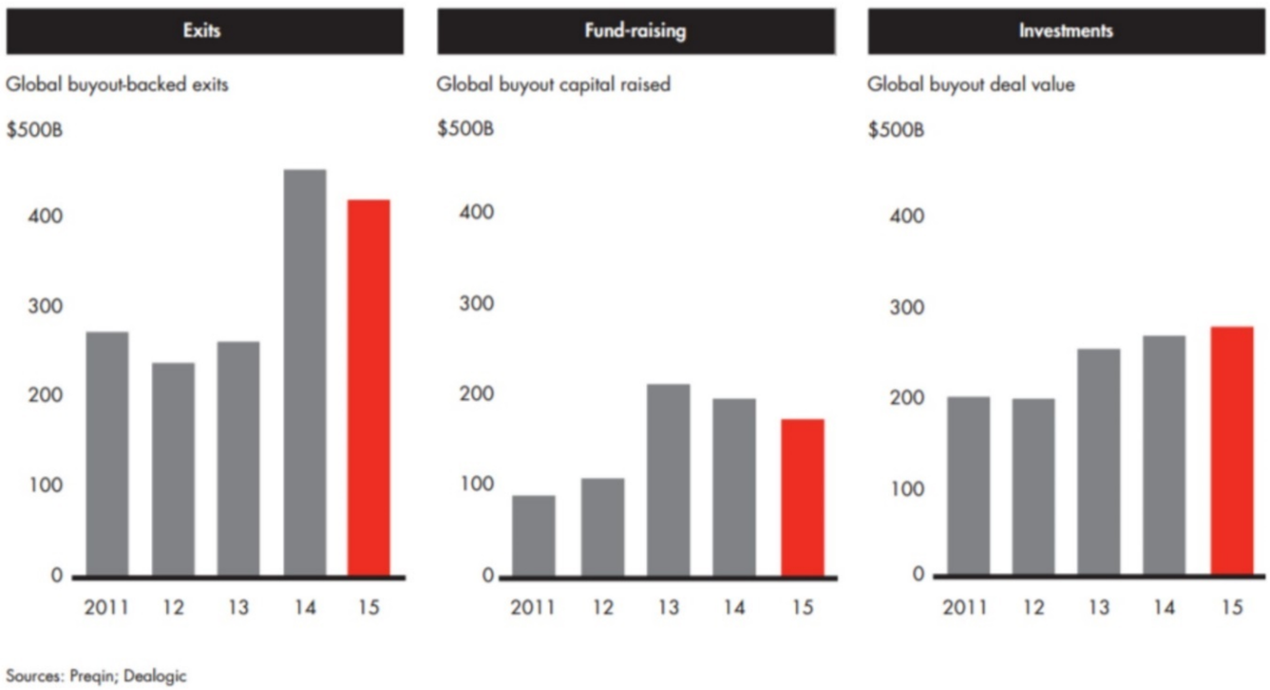
[13] Also known as, add-on acquisitions. The fund will engage in a strategic purchase of a competitor.
[14] Levin ch. 9

III. The State of Affairs of the Global Private Equity Industry

An analysis of the private equity vital signs indicate that the 2015 business year continued a trend of strong performance for the industry.[15] The following visual from Bain & Company's Global Private Equity Report 2016 succinctly summarizes the data:



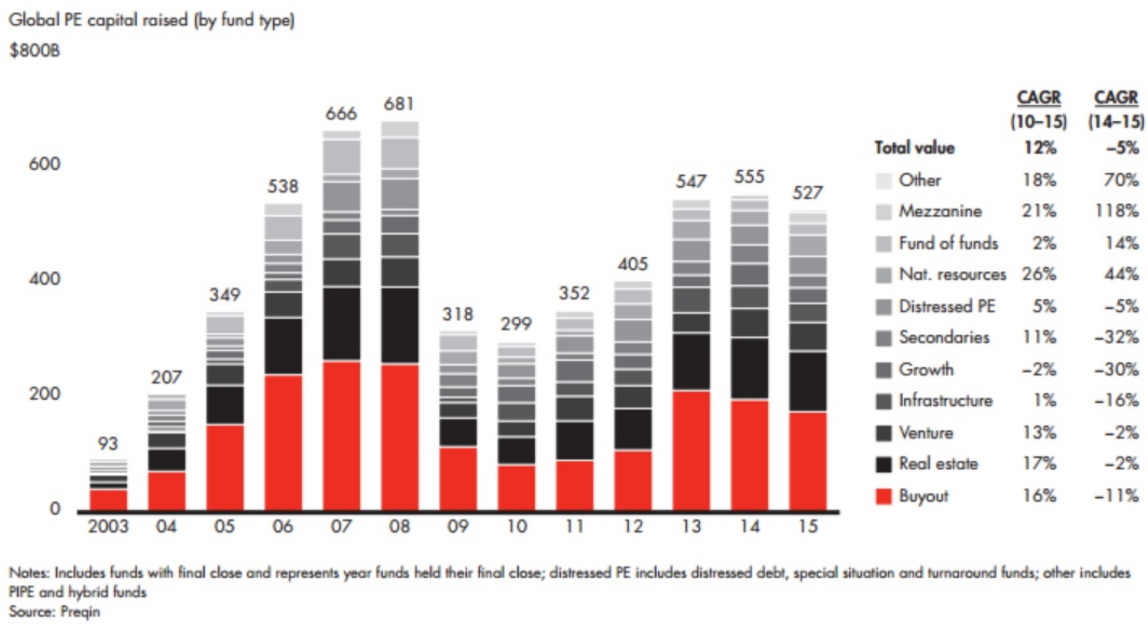
This chart isolates data on buyout[16] funds from the entire sample of private equity funds. Although not as strong as 2014, buyout funds are raising more money, buying more companies and selling more companies than in the past. In terms of fund-raising, buyout funds attracted an additional $185 billion from investors in 2015.[17] Further, funds put an additional $282 billion of

[15] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf
[16] Buyout funds are funds which purchase a controlling stake in new acquisitions
[17] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf pg 1.

investor money to work by acquiring new companies and disposed of $422 billion worth of portfolio companies.[18]

A. ANALYSIS OF 2015 GLOBAL FUND RAISING EFFORTS

2015 represented ideal conditions for GPs to solicit additional funding from LPs because, for the fifth consecutive year, GPs distributed more capital to LPs than LPs contributed to the funds.[19] Specifically, GPs have distributed $300 billion more capital than they requested via capital calls over the last 5 years.[20] Moreover, LPs are readily contributing additional capital because nearly 50% of current LPs expect the private equity industry to outperform the public equity markets by more than 4 percentage points.[21] As shown below, the industry, as a whole, raised an additional $527 billion of financing in 2015.



[18] *Id.*
[19] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf pg2
[20] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf pg 5
[21] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf pp5

Notably, this data excludes funds which began a capital raise in 2015 but did not complete the raise before the end of the year. At the start of 2016, there were 12 funds, representing an aggregate capital raise value of $86 billion, which were excluded from this calculation.[22]

B. Analysis of 2015 Global Acquisitions

As mentioned above, the aggregate acquisition value for global buyouts in 2015 was $282 billion.[23] Although this number is slightly more than the 2014 total of approximately $260 billion, the quantity of deals closed in 2015 is lower than in 2014. This implies that the uptick in deal value may be caused by inflated valuations and not an actual increase in fund activity. Indeed, the average EBITDA multiple[24] used in buyout transactions hit a record high in the United States at valuations equal to 10.1x EBITDA.[25] Similarly, the European market EBITDA multiple stands at 9.9x.

There are several possible explanations for the impressive increase in valuations. First, most funds have a large amount of "dry powder," or cash waiting to be deployed, on hand because the pace of acquisition has lagged fund-raising activity.[26] The large dry power stores influence EBIITA multiples because GPs are more likely to engage in a bidding war with a competing fund while pursuing limited investment opportunities. Second, GPs are facing increased competition for investment opportunities from strategic buyers. Global corporate M&A transactions topped $4 trillion in 2015, up more than 40% from 2014.[27] The large spike in

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[22] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf pp 4.
[23] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf pg 9
[24] EBITDA – Earnings before interests, taxes, depreciation, & amortization. LBO transactions commonly value potential targets by multiplying this value by the market multiple for comparable companies.
[25] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf pg 13
[26] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf 10
[27] *Id. 11*

M&A activity is likely caused by cash-rich corporations pursuing growth through strategically acquiring competitors. There is significant overlap between targets among strategic purchasers and financial buyers, which leads to competition during the bidding process and a subsequent increase in EBITDA multiple data.

Savvy GPs should shift to a buy-and-build strategy to avoid overpaying in the competitive auction landscape.[28] As briefly discussed earlier, some GPs elect to increase revenues by making tack-on acquisitions. The buy-and-build strategy is a formalized version of this process, which consists of purchasing a solid player in a consolidating market. After the initial purchase, the GP will make several tack-on acquisitions to grow the portfolio company's core business. The buy-and-build strategy is attractive because ideal tack-on acquisition candidates are often too small to attract the attention of the big corporate acquirers. Further, once the portfolio company has grown through the tack-on process, it will be large enough to attract the attention of corporate purchasers. This allows the GP to avoid overpaying for the asset on acquisition but the GP will benefit from the increased competition on the disposition of the asset.[29] Indeed, it appears GPs are pursuing this strategy as the value of tack-on acquisitions by portfolio companies has doubled to a record $267 billion in 2015, which almost matches the $282 billion invested in buyouts.[30]

[28] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf 15
[29] *Id.*
[30] *Id.*

C. Analysis of 2015 Global Dispositions and Investor Returns

The aggregate value of buyout-backed exits in 2105 was $422 billion across a reported 1,166 dispositions.[31] A closer look at this statistic reveals two critical signs of health. First, pre-2010 vintages accounted for 57% of exits, a significant decrease from 76% in 2014 and 87% in 2013. Second, the median holding period among portfolio companies in 2015 was 4.9 years, down from a median of 5.8 years in 2014. This indicates that funds have exited the bulk of their pre-2010 vintage investments, which is a sure signal that there is an abundance of exit options available in the market.

Ironically, strategic acquisitions by large corporations accounted for the bulk of buyout backed exits in 2015. In fact, seven of 2015's ten largest exits, including the largest - Blackstone and Permira's $16.8 billion sale of Freescale Semiconductor to NXP Semiconductor, were exits to a strategic buyer.[32] In total, roughly $280 billion of dispositions were to strategic buyers in 2015 with an additional $84.5 billion worth of dispositions to financial buyers.[33] Finally, GPs unloaded $60 billion worth of assets into the IPO market in 2015.[34] Notably, strategic buyers were much more popular in North America whereas the European and Asia-Pacific markets preferred selling to financial buyers.[35]

Private equity buyout funds outperformed the Modified Public Market Equivalent ("mPME") tracking the S&P 500, the MSCI Europe and the MSCI All Country Asia indexes on a one-year basis in 2015.[36] Cambridge Associates, a well-respected institutional investment

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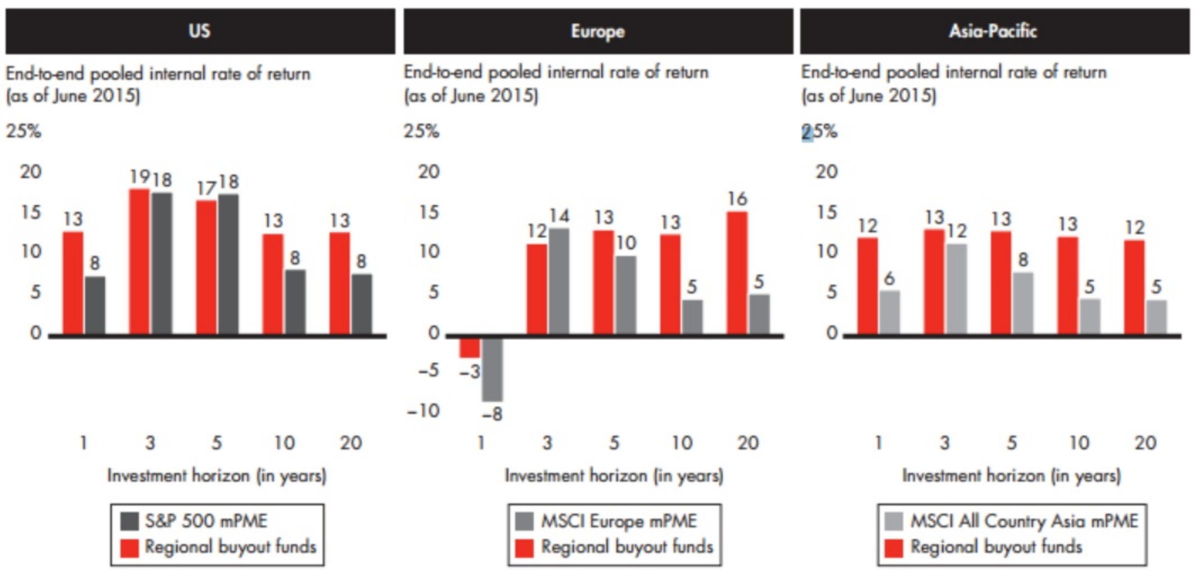
[31] *Id.* 20
[32] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf 23
[33] *Id.*
[34] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf 25
[35] *Id.*
[36] *Id. 28*

advisor, developed the mPME benchmarking methodology to draw LPs a clearer picture of private equity returns compared to public equity market returns.[37] The benchmark achieves clarity by discounting private equity returns for illiquidity and administrative expenses.[38] In the US and Europe, private equity returns were 5% higher than their respective equity benchmarks and in the Asia-Pacific region returns were 6% higher. On a 10-year time horizon, private equity returns in the United States edged the S&P 500 by 3.7% net of fees. [39]



Notes: Europe includes developed economies only; the Cambridge Associates mPME is a proprietary private-to-public comparison methodology that evaluates what performance would have been had the dollars invested in PE been invested in public markets instead; the public index's shares are purchased and sold according to the PE fund cash-flow schedule
Source: Cambridge Associates

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[37] http://www.cambridgeassociates.com/news/articles/new-method-for-comparing-performance-of-private-investments-with-public-investments-introduced-by-cambridge-associates/
[38] http://www.cambridgeassociates.com/news/articles/new-method-for-comparing-performance-of-private-investments-with-public-investments-introduced-by-cambridge-associates/
[39] *Id.*

IV. The State of Affairs of the Asia-Pacific Private Equity Industry

The 2015 vital signs of the Asia-Pacific region are, as a whole, stronger than any year in the last decade.[40] First, Asia-Pacific funds raised $50 billion in new capital.[41] This number is on par with the 5-year average for the region.[42] Next, aggregate acquisition value jumped to $125 billion, dwarfing 2014's previous record of $87 billion by 44%.[43] Additionally, the number of individual transactions increased to 955, another record for the Asia-Pacific region.[44] Finally, funds disposed of $88 billion in assets over 489 transactions despite the extreme volatility in the equity markets for most of 2015.[45] Both numbers fall in line with their five-year historical averages.[46] Asia-Pacific funds reported a mere 12% net internal rate of return for investors, which may be too low to attract investors given the higher risk in Asia-Pacific. [47] However, if the data is truncated to show only the top-quartile of funds, the IRR jumps to 21%.[48] This implies that there will be a flight to quality private equity firms in the Asia-Pacific region.

Despite the favorable statistics, GPs face unique challenges when investing in the Asia-Pacific region. First, it is historically uncommon for GPs to purchase controlling stakes in Asia-Pacific companies. Second, the greater Asia-Pacific economy has stagnated.

Buyout transactions averaged only $22 billion in value over the past five years, which is well under 50% of total deal value in the region for each of the last five years.[49] Without a

[40] http://www.bain.com/publications/articles/asia-pacific-private-equity-report-2016.aspx
[41] http://www.bain.com/publications/articles/asia-pacific-private-equity-report-2016.aspx
[42] *Id.*
[43] http://www.bain.com/bainweb/PDFs/Bain_and_Company_Global_Private_Equity_Report_2016.pdf pg 9
[44] http://www.bain.com/publications/articles/asia-pacific-private-equity-report-2016.aspx
[45] *Id.*
[46] http://www.bain.com/publications/articles/asia-pacific-private-equity-report-2016.aspx
[47] http://www.bain.com/publications/articles/asia-pacific-private-equity-report-2016.aspx
[48] *Id.*
[49] http://www.dealstreetasia.com/stories/36561-36561/

controlling stake, GPs cannot influence management of portfolio companies and, instead, must rely on a rising tide to generate returns for LPs. The current stagnation of Asia-Pacific economy places pressure on GPs to negotiate controlling stakes with potential targets, despite the region's aversion to the idea, because GPs cannot rely on economic growth to increase revenue. Instead, GPs must convince management to implement cost reducing or revenue boosting strategies. This process may require a controlling stake in the target company because the GP will need to credibly threaten the incumbent management with replacement if it refuses to cooperate. However, it appears that GPs are negotiating successfully with the target management as there were $53 billion of buyout purchases in 2015, a significant jump from the 2014 number of $22 billion. While this is an optimistic sign that Asia-Pacific directors are selling controlling stakes to private equity investors, this number is inflated by the overall increase in deal value in the region. As an alternative, some GPs have negotiated path-to-control provisions when purchasing minority stakes instead of pushing for a majority stake in the company.[50] As of April 2016, 39% of minority ownership portfolio companies have such a provision.[51] GPs expect this number to move towards 50% in the coming years.[52]

Second, the stagnation of some Asia-Pacific countries puts downward pressure on valuations of existing portfolio companies and confuses valuations for new investments. For new investment, as growth slows it becomes more difficult to predict future earnings. This leads to inaccuracy in EBITDA forecasting, and ultimately, overvaluation. Moreover, GPs purchased older vintage portfolio companies when the Asia-Pacific economy was growing. As such, the valuations assumed higher EBITDA values which, again, leads to overvaluation. Luckily, the

[50] http://www.dealstreetasia.com/stories/36561-36561/
[51] http://www.dealstreetasia.com/stories/36561-36561/
[52] http://www.dealstreetasia.com/stories/36561-36561/

damage from these errors can be offset by competition within the market. Indeed, competition is so fierce in the Asia-Pacific region that enterprise value/EBITDA multiples rose to 17.8x, a 18% increase from 2014, despite the lagging economy.[53] Notably, the impact of the "stagnation" may be overestimated as real GDP growth for the Asia-Pacific as a whole is 4%, which is still well above the global average.[54]

On balance, the 2015 Asia-Pacific private equity market vital signs are a marked improvement from the 5-year historical averages in the region. However, one Asia-Pacific country did not improve: Japan. In 2015, Japan posted a paltry $2.6 billion in acquisitions across 31 deals – a respective decrease of 64% and 28% from the 5-year historical average.[55] Moreover, GPs disposed of $7.9 billion in assets across 55 deals – a respective decrease of 29% and 16% from 5-year historical averages.[56] These numbers are the smallest in the Asia Pacific both in terms of deal size and deal volume. Vital signs this weak paint a grim picture for private equity in Japan.

V. The State of Affairs of the Japanese Private Equity Industry

Japan is the world's third largest economy. It is a large, wealthy and sophisticated market with a strong rule of law and governing party committed to increasing foreign direct investment. Additionally, there is minimal risk of expropriation and nationalization of assets in comparison to other countries as Japan has an independent judiciary, consistently applied commercial law and strong intellectual property protections.[57] Further, Japan has one of the lowest corruption

[53] http://www.bain.com/publications/articles/asia-pacific-private-equity-report-2016.aspx
[54] http://www.bain.com/publications/articles/asia-pacific-private-equity-report-2016.aspx
[55] http://www.bain.com/infographics/apac-pe-2016/
[56] http://www.bain.com/infographics/apac-pe-2016/
[57] http://www.state.gov/e/eb/rls/othr/ics/2015/241609.htm

indexes and one of the highest World Bank "Ease of Doing Business" scores.[58] Moreover, the corporate tax rate will be trimmed to 29.97% in the 2016 fiscal year from 32.11% and nearly all foreign exchange transactions are freely permitted.[59] Finally and perhaps the most tantalizing fact to GPs, Japan is filled with small and medium-sized enterprises which are still owned and operated by their founder. The average age of a CEO among these companies is between 61 and 65.[60] Reports indicate that many of these owners lack transition plans and, instead, are ready to sell their stakes. Despite these positives, the data shows that GPs are electing to deploy dry powder in Greater China and India instead of Japan.

There are two likely explanations for the lack of private equity investment in Japan. First, there is a significant risk that the Japanese economy will slip into a period of deflation. Second, the Japanese business culture is generally distrustful of foreign investments and companies are highly unlikely to sell a controlling stake to non-Japanese investors.

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[58] **doingbusiness.org/rankings**

[59] http://www.reuters.com/article/us-japan-economy-tax-idUSKBN0TV02D20151212

[60] http://www.ft.com/intl/cms/s/0/2797523e-fcaa-11e4-800d-00144feabdc0.html#axzz46mBQF5S4

A. THERE IS A SERIOUS RISK OF THE JAPANESE ECONOMY SLIPPING INTO A PERIOD OF DEFLATION

Japan's economy has been in a state of stagnation, or worse deflation, since its real estate and stock bubble burst in the early 1990s.[61] An economy contracts when it is in a state of deflation because consumers are incentivized to defer consumption as the cost of goods decreases over time.[62] An economic contraction will cast doubt on future corporate earning power and, ultimately, lead to a decrease in valuations of portfolio companies.[63] Moreover, deflation is a risk to private equity firms because it increases the real value of debt. As most portfolio companies are highly leveraged, an increase in the real value of debt can further dampen returns to LPs.

B. JAPAN HAS AN INSULAR BUSINESS CULTURE AND TRADITIONALLY POOR CORPORATE GOVERNANCE LAW

Japan's notoriously insular business culture is a large concern for GPs considering investment in the country. Trust is a necessary ingredient in any business relationship, but in Japan the level of trust necessary before parties will conduct business together is far beyond any other country. For example, in the United States it is common for potential business partners to agree to work together after a single meeting over coffee. This is not so in Japan. There, it may take several meetings before a relationship is built and, still, a conservative Japanese businessman may be unwilling to conduct business together until a third party independently suggests the venture. As a result, foreign-backed firms are likely denied access to supplier networks and inter-business alliances of Japanese corporations because they do not devote

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[61] http://www.investopedia.com/articles/investing/040715/japans-strategy-fix-its-deflation-problem.asp
[62] *Id.*
[63] http://www.schwab.com/public/schwab/nn/articles/Deflation-What-Investors-Need-to-Know

enough time to developing relationships.[64] This high-touch expectation does not mesh well with the purchase, hold, and exit strategy of major private equity firms and requires firms to shift to a "longer bake" model, which requires a longer investment holding period, to meet the relationship demands of the business culture. This may be hard to sell to potential LPs because they are used to a traditional timeline of five to seven years.

Japanese business leaders have traditionally viewed private equity firms as vultures.[65] At one time, this stigmatism was so severe that it was near impossible for a private equity GP to request an audience with a company founder.[66] This fact, coupled with the high-touch requirement of business relationships, made investing in Japan an unattractive proposition at best. However, there is evidence that the devastation experienced by owners during the financial crisis and the dire succession situation of others has eroded the stigmatism of working with private equity funds.[67]

Private equity firms are unlikely to invest in Japanese companies because they are often unable to purchase a controlling stake in the companies. Japanese companies are difficult to acquire for three key reasons. First, many public Japanese companies maintain the tradition of cross-shareholding. Second, managers can consider stakeholders other than shareholders when making corporate decisions under Japanese corporate law. Finally, poison pills and other defense measures are common in Japanese corporate charters.

The current cross-shareholding tradition in Japan is derivative of the Japanese *keiretsu* system, which dominated the Japanese economy until the 1980s. Put simply, a keiretsu is a set of

[64] http://www.state.gov/e/eb/rls/othr/ics/2015/241609.htm
[65] http://www.ft.com/intl/cms/s/0/2797523e-fcaa-11e4-800d-00144feabdc0.html#axzz46mBQF5S4
[66] http://www.ft.com/intl/cms/s/0/2797523e-fcaa-11e4-800d-00144feabdc0.html#axzz46mBQF5S4
[67] http://www.ft.com/intl/cms/s/0/2797523e-fcaa-11e4-800d-00144feabdc0.html#axzz46mBQF5S4

companies, commonly suppliers, distributors, banks and insurers of a business, which purchase equity in each other to create an, "interlocking web" of ownership.[68] Presumably, Japanese corporations are reducing opportunism within the supply chain and agency costs between shareholders and managers by aligning interests between business partners.[69] More importantly, the investment is considered a "blood-brotherhood" in corporate Japan – a way to cement a business relationship – rather than an actual investment.[70] Although it is an effective trust building exercise, cross-shareholding creates information asymmetry among shareholders, reduces transparency, and discourages firms from working with outsiders.[71] This reinforces Japan's inflexible business environment. Moreover, cross-shareholding increases the downside risk if the public equity market falls, as a company will lose value in its share price as well as the friendly shares it is holding. This is a huge issue for private equity funds, as cross-shareholding can quickly erase large amounts of value if the market drops, dampening returns for LPs. Further, Although the frequency of cross-shareholding has fallen from its peak in the '80s, it has resurged in the 2000s and 2010s.[72]

Japanese manager's penchant for strongly considering the implications of a business deal on its workers further complicates acquisitions in Japan. Japanese corporate law, similar to German corporate law, explicitly grants directors the authority to consider stakeholders other than shareholders when deciding if an acquisition is in the best interests of the corporation. An opinion survey of directors across the globe asked whether shareholder interest should be given priority over other stakeholders.[73] An overwhelming 97% of Japanese managers disagreed with

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[68] http://www.jstor.org/stable/pdf/796835.pdf pg 883
[69] *Id.*
[70] http://www.economist.com/node/12564050
[71] http://www.economist.com/node/12564050
[72] http://www.economist.com/node/12564050
[73] http://apps.eui.eu/Personal/Carletti/JF-MS6731-Revision-corporate-governance-with-figures-16sep09-final.pdf

the statement.[74] The US and UK are quite to the contrary, with 76% and 71% of managers reporting that the shareholder's interest should be given priority to other stakeholders.

Not only does the law grant board discretion to directors to consider stakeholders, but the broader Japanese business culture considers worker interests pre-eminent to other stakeholders. In Japan, the colloquial "company man" is an actual cultural norm, as an employee is expected to spend his entire working life with one firm.[75] Many corporations elect to continue employing unnecessary personal because it is a social taboo to lay off a full time worker and eliminating personal would have negative market repercussions. For example, the New York Times mockingly reported that Sony, a leading public Japanese firm, silos obsolete personnel in the "boredom room."[76] Additionally, entrepreneurs, likely because of their tendency to move between ventures, are seen as eccentrics or misfits in Japan.[77]

The concept of other stakeholders, specifically workers, taking priority over the interest of shareholders complicates private equity in Japan because many GP cost cutting strategies involve eliminating redundancy in the workforce. Japanese directors may decline an offer for a controlling stake, even if the offer would create significant value for shareholders, because they do not want their workers fired from the company. GPs have limited recourse against the directors because of the autonomy granted to directors by the Japanese corporate code.

The pervasive use of defensive measures, such as the poison pill, is the biggest impediment preventing GPs from purchasing controlling stakes in public Japanese companies. A

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[74] http://apps.eui.eu/Personal/Carletti/JF-MS6731-Revision-corporate-governance-with-figures-16sep09-final.pdf
[75] http://www.nytimes.com/2013/08/17/business/global/layoffs-illegal-japan-workers-are-sent-to-the-boredom-room.html?_r=0
[76] http://www.nytimes.com/2013/08/17/business/global/layoffs-illegal-japan-workers-are-sent-to-the-boredom-room.html?_r&_r=0
[77] http://www.venturejapan.com/japan-business-culture-company.htm

startling 20% of public firms included in the Japan Topix index have poison pill provisions in place. The TOPIX benchmark is composed of over 1700 publicly traded Japanese companies.[78] Comparatively, only 5.8% companies within the United States S&P 500 index have active poison pill provisions. Defensive measures are problematic for private equity investments because they can be used to force the acquirer to pay more money for a controlling stake in the company. If the acquirer does not agree to increase the offer price, they may be forced to abandon a partial stake at a significant discount.[79] Further, they make pursuing a hostile takeover near impossible because an aggressive shareholder will trip the poison pill and dilute his stake in the company.

VI. THE JAPANESE GOVERNMENT HAS IMPLEMENTED SEVERAL CHANGES TO ENCOURAGE FOREIGN DIRECT INVESTMENT

Prime Minister Shinzo Abe and his Cabinet have committed to improving the Japanese economy and reforming Japan's corporate code as a means to encourage direct foreign investment in Japan. Prime Minister Abe refers to his strategy as "The Three Arrows" but it is commonly referred to as Abenomics – a tip of the hat to United States President Ronald Reagan's "Reaganomics" of the 1980s.[80] Abe's first arrow is a quantitative easing policy designed to bring cash to consumers and corporations. The second arrow is aimed to increase government spending in welfare, debt serving and public works.[81] The third arrow, known as the Japanese Revitalization Strategy, calls for significant structural reform of Japan's corporate code and business culture to attract private investment. The first and third arrows are of particular

[78] http://www.wikinvest.com/index/Tokyo_Stock_Price_Index_-_TOPIX_(TPX/09M-TO)#List_of_companies
[79] http://www.news.com.au/news/macquarie-pulls-out-of-narita-investment/story-fna7dq6e-1225756083795
[80] http://www.bloombergview.com/quicktake/abenomics
[81] https://www.tofugu.com/japan/abenomics-3-arrows/

interest to private equity fund GP because, if successful, they may ameliorate the risk of deflation and liberalize GPs ability to negotiated for controlling stakes.

Prime Minister Abe's quantitative easing plan requires the Bank of Japan to purchase Japanese Government bonds from financial institutions in the hope that the institutions will lend the new cash flow back to households and corporations.[82] Theoretically, this will encourage spending and business expansion, thereby jumpstarting the Japanese economy and minimizing the risk of deflation. Although the bond buying strategy has yielded an increase in the monetary base and bank lending, there has been a decrease in real wages and corporate debt ratios.[83] The lack of corporate interest in debt can easily be explained by examining the balance sheet of Japanese corporations - the corporations have no need to borrow money to expand business because they are flush with cash. In terms of cost of goods, the most recent inflation numbers show a meager .3% rise in overall prices compared with 2014.[84] Despite this modest increase and the lack of corporate borrowing, Prime Minister Abe has declared that Japan is, "no longer in a deflationary period."[85] This declaration appears misguided, and just a few months prior, Japanese Economics Minister Akira Amari openly stated that it is, "too early to claim that Japan has escaped the risk of returning to deflation."[86] Politics aside, it is clear that there is a still a risk of deflation in Japan, a fact which GPs should strongly consider before investing LP capital in Japan.

The third arrow, which is designed to spur private investment in Japan by reforming Japan's infamous corporate governance system, is of particular interest to GPs. The policy is

[82] http://www.investopedia.com/articles/investing/040715/japans-strategy-fix-its-deflation-problem.asp
[83] http://www.investopedia.com/articles/investing/040715/japans-strategy-fix-its-deflation-problem.asp
[84] http://www.ft.com/cms/s/0/d79a1d06-b2a8-11e5-8358-9a82b43f6b2f.html#axzz46mBQF5S4
[85] http://www.ft.com/cms/s/0/d79a1d06-b2a8-11e5-8358-9a82b43f6b2f.html#axzz46mBQF5S4
[86] http://www.reuters.com/article/us-japan-economy-amari-idUSKCN0R13ML20150901

hard to identify as it is an amalgamation of policies, but the most relevant changes are two code enactments, the Japanese Stewardship Code and the Japanese Corporate Governance Code, the creation of the JPX-Nikkei Index 400 by the Tokyo Stock Exchange and an amendment to the Companies Act of Japan.[87]

The code enactments are a two-pronged approach to promote transparency and collaboration between shareholders and directors. The Japanese Stewardship Code, effective as of February 2014, calls on shareholders to disclose how they vote at annual meetings and engage actively with company management.[88] Ideally, the code will create a dialogue between shareholders and directors which will lead to improved business operations.[89] The code is entirely elective, but has been adopted by 127 investors, including nearly all institutional investors in Japan.[90]

The Japanese Corporate Governance Code, effective as of June 2015, aims to make Japanese directors more transparent, responsive to shareholders, and subject to more effective oversight by boards of directors.[91] The code takes a principle-based approach which gives public companies the autonomy to determine whether its activities are in line with each prescribed principle.[92] Further, a company must either comply with the principles within the code or explain why it chose to ignore the principles in a corporate governance report which is disseminated to stakeholders.[93] There are five general principles in the code, some of which are new and others which are codifications of longstanding traditions. First, directors must secure the rights and treat

[87] http://www.jpx.co.jp/ http://www.investopedia.com/articles/investing/041615/understanding-japans-new-corporate-governance-code.asp english/equities/listing/cg/
[88] http://www.reuters.com/article/japan-stocks-stewardshipcode-idUSL4N0OR2CC20140610
[89] http://www.reuters.com/article/japan-stocks-stewardshipcode-idUSL4N0OR2CC20140610
[90] http://www.reuters.com/article/japan-stocks-stewardshipcode-idUSL4N0OR2CC20140610
[91] http://www.eastasiaforum.org/2015/11/29/will-japans-corporate-governance-reform-work/
[92] http://www.klgates.com/introduction-of-new-corporate-governance-code-07-09-2015/
[93] http://www.klgates.com/introduction-of-new-corporate-governance-code-07-09-2015/

shareholders, including minority and foreign shareholders, equally.[94] Second, Japanese directors must consider a decisions impact on all stakeholders, not just shareholders.[95] Third, directors are expected to, "strive to actively provide information beyond that required" by law.[96] Fourth, the code recommends that companies appoint at least two independent directors to their boards.[97] If a company elects not to appoint two independent directors, it must explain its reasoning to its shareholders. [98] Finally, the code recommends that directors engage in open and constructive dialogue with their shareholders.

The JPX-Nikkei Index 400, also known as the "shame index," is a compilation of the 400 firms in Japan with the largest return on equity.[99] The idea behind the new index is that managers will either place a larger emphasis on return on equity or bear the shame of not being listed among the top performing firms in Japan. If the index works, firms will be encouraged to put their large cash stores to use – either by acquiring new companies or by distributing the cash out to shareholders – or they will be unable to compete in the market.[100] Early indications show that the strategy is working. For example, Amada, a tool producer, has promised to return all of its net profits to shareholders over the next two years to improve its standing among firms.[101]

The Diet amended the Companies Act of Japan to further encourage the appointment of outside directors and facilitate certain transactions.[102] First, the amendment requires listed

[94] http://www.klgates.com/introduction-of-new-corporate-governance-code-07-09-2015/
[95] http://www.klgates.com/introduction-of-new-corporate-governance-code-07-09-2015/
[96] http://www.klgates.com/introduction-of-new-corporate-governance-code-07-09-2015/
[97] http://www.klgates.com/introduction-of-new-corporate-governance-code-07-09-2015/
[98] http://www.klgates.com/introduction-of-new-corporate-governance-code-07-09-2015/
[99] http://www.economist.com/news/business/21653638-prospects-shaking-up-japanese-firms-have-never-looked-so-good-winds-change
[100] http://www.economist.com/news/business/21653638-prospects-shaking-up-japanese-firms-have-never-looked-so-good-winds-change
[101] http://www.economist.com/news/business/21653638-prospects-shaking-up-japanese-firms-have-never-looked-so-good-winds-change
[102] http://www.city-yuwa.com/english/publication/shared/PDF/JLG201415_cy_56-59.pdf

companies to either appoint one outside director or explain at a shareholder meeting why the corporation did not appoint an independent director.[103] If a public company breaches its duty to comply or explain, then the Japanese government has the authority to take remedial action against the corporation, which includes mandatory appointment of an outside director. The new squeeze out right, which allows an acquirer to force a cash-out of minority shareholders if they acquire 90% of a company, is of particular interest to fund GPs.

VII. Conclusion

On balance, it is likely that Japan's private equity market will expand in the future because the government has taken affirmative steps towards liberalizing controlling ownership of Japanese companies by foreign companies and increasing transparency between directors and shareholders. These preliminary changes, though modest, will begin to breakdown Japan's insular business culture and encourage foreign direct investment. On a broader scale, the Asia-Pacific region has attracted significant attention from private equity GPs but GPs, on average, have posted less than stellar returns. This will cause a flight of LP capital to top quartile firms, limiting the opportunity of non-top performing firms in the Asia-Pacific region. Finally, private equity on a global scale remained healthy in 2015, hallmarked by record exit EBITDA multiples, strong additional capital commitments by LPs and a cycling of old vintage investments. Moreover, returns for private equity funds have outpaced other equity investment options. In sum, 2015 vital signs, and the preceding few years, indicate an expansion of the global private

[103] http://www.mofo.com/~/media/Files/Articles/2014/10/141022DJJapaneseCompaniesAct.pdf

equity market. The Asia-Pacific region has driven part of this growth, but Japan is nearly irrelevant in driving foreign direct investment in the Asia-Pacific region.