Time to adapt

Japan's small-cap buyout market has been good to Ant Capital Partners. But Japanese SMEs increasingly need to expand offshore and Ant has responded by taking on more complex cross-border work, managing partner Ryosuke Iinuma tells Drew Wilson

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A tiny ant can carry up to 50 times its own weight and doesn't rest much. Tokyo-based Ant Capital Partners would like to draw a parallel. Being a small, hard-working private equity firm in Japan has been a pretty good adaptive strategy in the country's zero growth environment, according to Ryosuke Iinuma, managing partner of Ant's private equity group.

Ant's private equity operation (apart from its venture capital and secondaries units) does strictly small-cap buyouts of mature companies usually in the $50 million to $150 million range. "This is the most active space in Japan in terms of buyouts," he says, adding that his firm buys full control and focuses on operational work to improve EBITDA.

Japan oddly has a reputation for large LBOs, but the country has not been a market for large-cap buyouts, according to data from Brightrust PE Japan. Since 1998, 78 percent of buyout deals have been less than $125 million. Only 3 percent were over $1.2 billion.

Iinuma adds that Japan has 3500 publicly-listed companies and more than half have a market cap of less than $100 million. "Japan is an SME country," he says. "Small-cap companies can still grow in a zero growth macro-environment."

Ant has performed relatively well in this environment. Since its founding in 2000, the firm has raised three funds, two of them purely for buyouts. The firm has invested in 21 companies and exited 16 of them. On average, multiples across all its buyouts have been between 2x and 2.5x, Iinuma says, adding that Ant's average gross internal rate of return ranges from 20 to 25 percent.

Those returns don't match the higher figures some firms have scored in China for example. But for Japan, they stand on their own.

"Fund multiples of 2x – 2.5x are considered good in the context of Japan," says Niklas Amundsson, a partner at MVision Private Equity Advisers in Hong Kong. He adds that he is speaking in general terms and is not familiar with Ant's specific buyout figures.

HANDS-ON, CAREFULLY

Much has been written about Japan's ageing population that results in a diminishing workforce and thus slowing GDP growth. Twenty-five percent of the population is over 65, the highest percentage in the world, according to data from BlackRock iShares. Low fertility rates, almost no immigration and rising longevity compound the problem.

This macro story has another outcome in the business sector. Japan's demographics amplify the need for modern management in small firms run by older owners. According to Iinuma, half of Japan's SME owners are over 60 years old and 30 percent are over 70 years old, creating succession issues.

Older owners would hesitate to sell the company directly to competitors. "The owner is attached to the small businesses and its employees and doesn't want to be seen selling it all off just for money," Iinuma says.

"[Therefore] selling to private equity is good reason for them to keep the same company culture while private equity improves inefficiencies. Most SMEs are family owned businesses. They have a good brand and niche business, but lack modern KPI-based management. This has brought us a huge opportunity to work on EBITDA improvement."

One example is CAA, a used car auction company Ant bought in 2002 for $60 million. Ant cut waste by analysing the company's financials. The operational team found that management was providing car dealers with a huge volume discount to join the auction, a discount exceeding operating profit per car. Ant also returned a $25 million loan the company had taken out because it was determined the money was simply not needed.

A three-year holding period improved EBITDA by 2.5 times, Iinuma says. The company was sold for $220 million in 2005 to Toyota Motors, the auto giant's first private equity purchase.

While Ant cuts inefficiencies, Iinuma says it strenuously tries to avoid cutting staff and salaries.

"Japanese small business owners are interested in private equity firms that can help improve on inefficiencies but don't cut staff or take extreme measures."

Ant's operational work is, in a sense, taken personally: It impacts on further deal sourcing. Dealflow in this sector hinges on recommendations, he explains. The SME community is small and close; everyone talks and shares experiences. Operational work done on one SME becomes well known to others. A private equity firm's work must be non-intrusive and transformational, as defined by the small business owners.

"The Japanese SME is low profile and off the radar. Because they are cash rich and don't plan to go public, they don't have relationships with banks or securities firms. So word of mouth by owner or through a tax advisor is very significant in finding deals with no competition. Many SMEs we've worked with introduced us to another owner who is thinking about selling his share to someone else."

Last year Ant looked at 40 deals, he says, and in the first quarter this year the firm had 10 deals in the pipeline. Two deals are expected to be completed in the second quarter, he adds. "We keep a very good deal flow and are very conservative [in acquisitions]. We keep EBITDA multiples less than six." In an auction, the purchase price as an EBITDA multiple would be more than 10, he says.

FACTORY-MADE

Ant Capital emerged as the product of an internet incubator and a financial house

Ant Capital Partners' origin goes back to 2000, when UK-based internet incubator Ant Factory formed a joint venture with Nikko Principal Investments. Ant Factory wanted to bring the incubator model to Japan, but the new joint venture, headed by Kazunori Ozaki (who is now chairman and CEO of Ant Capital) convinced them that the incubator model wouldn't work in Japan due to stark differences in its business culture.

Ant Capital instead turned into a buyout firm.

An arm of Nikko Securities (owned by Citigroup Japan) bought out Ant Factory's share of Ant Capital. Eventually, in 2008, Ant Capital became independent through a management buyout.

Ant has multiple strategies, with units focused on private equity, venture capital and secondaries. But the core business has always been the small transaction.

Yet the fine tuning and pruning of small firms that Ant engages in requires time and resources and tends to deliver correspondingly small returns, says one local industry source. Many firms figure an operational strategy is best applied to mid- and large-cap companies because the higher revenues and earnings of a larger company would on average generate higher returns.

"[Ant's strategy] is not necessarily a strategy everyone wants to go after when you have limited resources in Japan. That's why the space is not crowded."

GOING OUTSIDE

The future of Japanese companies arguably lies outside the home market. With the demographic situation expected to keep GDP growth near zero for years to come, Japanese companies have found that survival means expanding offshore

The big corporations are out hunting for acquisitions in Asia, the US and Europe. In 2011, Japanese corporations' outbound deal value nearly tripled to $85 billion from the previous year and was 23 percent higher than the 2008 pre-crisis peak of $69 billion, according to a report by McKinsey & Co.

SMEs are now eager to follow, a sentiment that has increased since the March 2011 earthquake, which made clear the risks of depending on the home market, Iinuma says.

"Small businesses have one major customer like Toyota, Sharp or Panasonic, but now there's a renewed sense of urgency to decrease dependency on them. The small-cap company still has an opportunity to grow in Asia. They want to look outside of Japan for partnerships and growth opportunities but don't have the skill set or network."

Ant has already moved on the opportunity by completing two cross-border exits in China in 2010.

The first, Honma Golf, a luxury golf equipment manufacturer (its high-end clubs sell for $100,000), had brand recognition in Korea and China but no network or expertise to help it expand. Ant found partners in those markets and helped Honma establish a presence in Korea. It was then sold to a Chinese conglomerate.

Another cross-border expansion was Tri-wall, a maker of robust corrugated boxes for shipping heavy items such as automotive parts. Ant saw an opportunity to help management expand the business in China due to the large presence of US, European and Japanese auto manufacturers. Before Ant bought Tri-wall, it had 30 percent of revenues outside of Japan; now it has 70 percent, he says. Ant eventually sold a majority stake in Tri-wall to China's Citic Capital Partners for $65 million, according to media reports.

Iinuma sees cross-border work becoming an integral part of Ant's strategy. To facilitate more outbound work, in 2010 Ant opened a Hong Kong office headed by managing partner John Cheuck, who has experience with cross-border expansion and investment in previous roles at GEMS in Hong Kong and Apax Partners in Tokyo.

This year, the Hong Kong office will assist in the planned sale of an undisclosed Japanese company to a Chinese buyer.

Cross-border expansion is something all Japanese private equity firms are talking about, says Cheuck. "It's seen as a glimmer of hope in the cloud over Japan's private equity industry. But in terms of walking the walk, in the SME space the only private equity exit-related transactions have been Ant."

Firms in the mid and large-cap space have tried offshore expansions but for various reasons they haven't worked out as well as expected, he says.

Culture, language and regulatory differences can be obstacles, and due to history, Japanese businesses have a general uneasiness about being taken over by a Chinese company. Ant hopes to smooth the transition through measures such as keeping its executives on board for up to a year after the sale, Cheuck says.

2000
Founded

18
Private equity employees

$545m
Assets under management

2
Offices, in Tokyo and in Hong Kong

$250m
Target size of latest fund

21/16
Invested companies/exits from flagship fund

The cross-border strategy has prompted Ant to reach outside Japan in another area – fundraising. Previously it had exclusively Japanese LPs invested in three funds raised since 2003. For the first time, it's trying to raise foreign money. The fourth fund, targeting small-cap buyouts, is expected to close on $150 million in domestic fundraising this year. The firm hopes to raise an additional $60 million to $100 million overseas.

"The main reason we want outside investors is to develop our network with Asian LPs and GPs. There are hundreds or thousands of GPs in China, making it hard to find an appropriate GP to support our portfolio and expand the business. But if we have a good relationship with Asian LPs through our fundraising, we can develop a network to help us select GPs."

Others say many Japanese GPs are under pressure to raise foreign capital for the first time because domestic LPs have for various reasons curtailed domestic investments. To attract foreign capital, Japanese firms will need to generate higher returns than they have traditionally been expected to deliver.

Returns for Japanese GPs didn't need to be what outsiders would consider high, explains one industry source. A Japanese institutional investor required a 3.5 percent annual return on its private equity investments. "If a GP delivered 10 percent – 12 percent IRR, that was fine for LPs."

Now the situation has changed and Japanese GPs trying to attract outside money are finding it difficult. "For foreigners, those [traditional] returns are not attractive."

Foreign sentiment toward Japan has been low for a while, adds a Japan-based industry source. In 2006, fund managers raised multibillion dollar funds with the expectation of large transactions. Six years later, the performance of those funds is mixed. "Overseas money has been disappointed and a big headwind is facing all managers in Japan who never had a need to go outside Japan to raise money."

Iinuma admits foreign LPs' first impression of Japan is the disappointing zero growth story. After all, Japan is not Indonesia or China and fundraising will be a struggle.

Time will tell if Ant Capital can also draw another parallel with the tiny ant – the ability to deftly maneuver around obstacles. ■