Trends in Japan's private equity market and related considerations - 2022

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Contents

Introduction

The COVID-19 pandemic began at the start of 2020, but it dominated 2021 as well, with necessary measures taken against a series of new virus variants. The challenges facing business executives grew increasingly complex in light of other developments as well, including changes in the balance of diplomatic and political power, mainly in connection with the US and China, increasingly active discussions on fiscal exit strategies led by the US, concern over rising prices, supply chain disruptions caused by a range of factors, and climate change. However, in our 25th Annual Global CEO Survey, 77% of CEOs worldwide responded that they are expecting the economy to recover in 2022, indicating a generally positive outlook.[1]

With all of us looking ahead to a post-pandemic world, the unique problems faced by corporate management in Japan have come into greater relief. In 2021, during the pandemic, the balance of cash and equivalents at publicly traded companies in Japan increased to 109 trillion yen, and at all companies in Japan, it increased to 259 trillion yen.[2] Most of these companies are fiscally conservative and are not effectively utilising their surplus funds in order to fuel growth. Moreover, they are also cautious about recording intangible fixed assets associated with digitalisation and M&A. The ratio of intangible fixed assets is 6%, which is lower than the US (30%) and Europe (25%).[3] Some analysts have pointed to the rigidity of the labour market and the advanced age of many corporate executives as factors for this cautious approach to management. Given the economy's structural complexity and rapid pace of change, without an infusion of new talent or progress in business transformation, it is possible that the gap between Japanese and non-Japanese companies will widen.

Against this backdrop, private equity, owing to its track record of success, has garnered attention as a new solution to some of the problems faced by Japanese companies. The COVID-19 pandemic also may be nudging companies in Japan toward corporate reforms and greater use of private equity. Issued previously in 2018, 2020 and 2021, this year's report is the fourth in the series. In this latest edition, along with providing an overview of the year 2022, we take a more in-depth look at the significance of private equity in the Japanese market, along with ESG, which has recently attracted a great deal of attention. Like last year, this report is also being published both in English and Japanese to meet the high level of interest overseas in private equity activities in Japan. We hope the report will serve to further your interest and understanding of private equity in Japan and internationally.

In publishing this report, we received the invaluable opinions and suggestions of innumerable people involved in private equity, and for this we are deeply grateful.

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[1] PwC, '25th Annual Global CEO Survey', 11 March 2022.

[2] *Nihon Keizai Shimbun*, 'Mountains of Cash, Inconvenient Truths, Japanese Companies Piled High with "Dead Capital" Even During COVID-19', 20 September 2021.

[3] *Nihon Keizai Shimbun*, '"Intangible Assets," Management Fortune-Teller in the Digital Age, High Ratios in Europe and US, Accelerating M&A and DX', 27 May 2021.

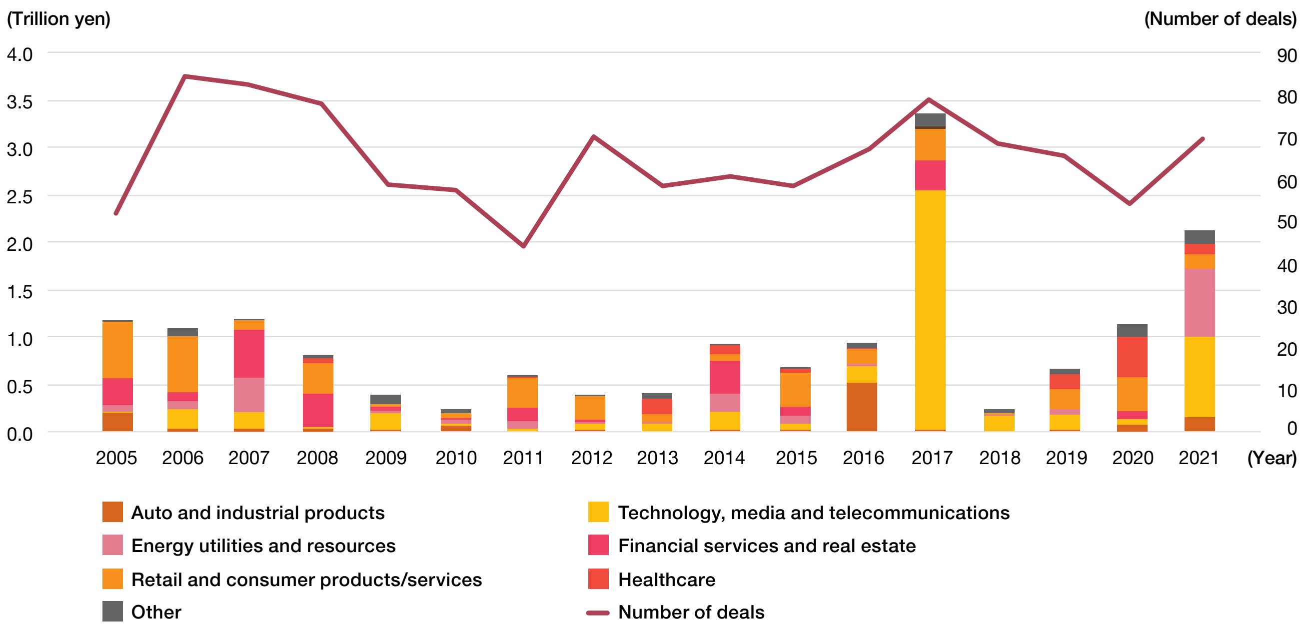
1 Trends in investment by private equity funds

In ‘Analysis of Japan’s private equity market and recommendations for Japanese companies’, the 2021 edition of this report, we wrote, ‘Private equity can also be prescribed effectively to stimulate the non-core businesses of large companies when investing additional resources is not feasible, or to deal with the problem of business succession when a business has no successor.’ Looking back at trends in investment by private equity (PE) funds in Japan, 2021 was a year of further growth in investment activities for both carve-outs and succession.

1-1. Carve-outs

Many carve-out deals—deals in which a non-core subsidiary or business is carved out for investment—occurred in 2021. Particularly noteworthy was the acquisition of Hitachi Metals, one of the ‘big three’ key companies of the Hitachi Group, which was the largest deal on record after Toshiba Memory (now Kioxia) in 2017. The deal was announced 28 April 2021, and a tender offer was expected to begin in late 2021, but the start was delayed due to the procedures and paperwork required in various countries under antitrust laws and other regulations.[4] When it closes, it will be an over 800.0 billion yen deal by Bain Capital, Japan Industrial Partners and Japan Industrial Solutions. Hitachi Metals has four main product segments[5]—specialty steel products; functional components and equipment; magnetic materials and applications and power electronics; and wires, cables and related products—but its business is broad, and because ‘it is difficult for operating companies like nonferrous metal manufacturers to acquire whole companies’[6], the company has decided to pursue new growth under the PE fund umbrella. Hitachi Metals’ representative executive officer, chairperson, president and CEO Mitsuaki Nishiyama said, in the company’s integrated report, ‘We believe this restructuring will provide an excellent opportunity for the Group to accelerate its transformation and growth by, for example, enabling the Group to implement growth strategies without being constrained by the portfolio strategy of Hitachi, Ltd. Moreover, by becoming a non-listed company, we can plan strategies from a long-term perspective and implement bold reforms promptly, rather than focus on quarterly results, which a listed company must do. These are the major benefits of the capital restructuring. In addition, we believe we can respond more quickly and more professionally to rapid market changes by utilising the global knowledge and networks of our new partners to explore investment opportunities, obtain funding, and develop and implement growth strategies. We will fully deploy the resources of our new partners to restore our competitiveness and profitability and thus achieve sustainable growth and increase corporate value.’[7]

Figure 1: Monetary amounts and number of domestic investment deals involving PE funds (by industry)



Source: Created by PwC from databases provided by Dealogic (including additional acquisitions)

Note: The amount of information disclosed in relation to investment amounts is limited. This figure does not include investments of an undisclosed amount.

[4] Hitachi Metals, ‘Announcement Concerning Progress of the Tender Offer by K.K. BCJ-52 for the Shares of Hitachi Metals, Ltd. (Securities Code 5486)’, 30 November 2021.

[5] Hitachi Metals, ‘Consolidated Financial Report [IFRS] For the Year Ended March 31, 2021’, 26 April 2021.

[6] *Nihon Keizai Shimbun*, ‘Funds Priming the Pump for Materials Industry Reorganisation’, 9 April 2021.

[7] Hitachi Metals, ‘The Hitachi Metals Group Report 2021’, 2021.

Figure 2: Major domestic investment deals involving PE funds

Date of announcement	Acquired company/business	Industry of acquired company	Acquiring company	Selling company	Amount (million yen)
Dec. 2021	Yayoi	Computers and electronics	KKR	ORIX	240,000
Nov. 2021	Universal Can, etc.	Metals and steel	Showa Aluminum Can	Mitsubishi Materials	60,000
Nov. 2021	Accordia Golf	Leisure and recreation	Fortress Investment	MBK Partners	400,000
Nov. 2021	Space Value Holdings	Construction/ building	Polaris Capital Group	Global hedge fund	51,517
Nov. 2021	Trygroup	Professional services	CVC Capital Partners		100,000
Sep. 2021	Maftec	Chemicals	Apollo Global Management	Mitsubishi Chemical Holdings	85,000
Sep. 2021	Spiber	Textiles	Carlyle Group		24,400
Aug. 2021	JAG Energy	Utilities and energy	Carlyle Group	Japan Asia Group	39,493
Aug. 2021	Kokusai Kogyo	Professional services	Carlyle Group	Japan Asia Group	32,408
Jul. 2021	Showa Denko Materials (Energy storage devices business)	Automobiles and trucks	Advantage Partners	Showa Denko Materials	60,000
Jun. 2021	Oliver	Consumer products	Integral		38,593
Jun. 2021	Nishinihon Healthcare	Healthcare	NICHIIGAKKAN	LeTech	
Jun. 2021	Showa Denko Materials (Printed wiring board business)	Computers and electronics	Polaris Capital Group	Showa Denko Materials	
May 2021	AOI TYO Holdings	Leisure and recreation	Carlyle Group		22,634
Apr. 2021	Hitachi Metals	Metals and steel	Bain Capital		434,766
Apr. 2021	Via Mechanics	Machinery	Advantage Partners	Longreach Group (Hong Kong)	
Mar. 2021	KOHIKAN	Dining and lodging	CHAT NOIR		
Mar. 2021	Increment P (now GeoTechnologies)	Computers and electronics	Polaris Capital Group	Pioneer	30,000
Mar. 2021	IGNIS	Consumer products	Bain Capital		50,000
Feb. 2021	Tsukui Holdings	Healthcare	MBK Partners		77,234
Feb. 2021	N Field	Healthcare	Unison Capital		15,511
Feb. 2021	Shiseido (Personal care cosmetic product business)	Consumer products	CVC Capital Partners	Shiseido	104,000
Jan. 2021	Showa Aluminum Can Showa Denko Sakai Aluminum	Metals and steel	Apollo Global Management	Showa Denko	50,000
Jan. 2021	Rigaku	Computers and electronics	Carlyle Group		100,000

Source: Created by PwC from databases provided by Dealogic (lists deals of 10.0 billion yen or more; includes additional acquisitions)

Note: The amount of information disclosed in relation to investment amounts is limited. This figure does not include investments of an undisclosed amount.

In another deal in the metals industry, Apollo Global Management acquired the aluminium businesses of chemical giant Showa Denko and Mitsubishi Materials for around 60.0 billion yen respectively.[8] Regarding the Showa Denko business, it was explained that 'though the investment burden was large, synergies with chemical products and other businesses were minimal.'[9] With the Mitsubishi Materials business, on the other hand, the company faced the problem of 'not having the production capacity to be able to pursue scale',[10] and in the process of optimising its business portfolio, the company was looking for an opportunity to restructure its aluminium business, for which it was difficult to generate synergies with other businesses.[11] Apollo Global Management has substantial experience investing in aluminium rolling and beverage packaging outside of Japan, and by acquiring these two middle-market Japanese companies in the sector, it will move forward with the sector's restructuring.

The Ministry of Economy, Trade and Industry, in its strategy for the aluminium sector, which is part of a larger strategy for the nonferrous metals industry, diagnoses the weakness in Japan's aluminium industry as 'discrepancies in R&D expenditure, stemming from differences in the average company size, and inferior productivity compared to the large-scale production and dedicated factories of the West, which have leveraged their ample capital resources to obtain scale merits'.[12] This rollup (defined as a case where, 'as a way to accelerate industry restructuring, an investment fund acquires or invests in multiple companies in succession, expands their scale and markets, and consolidates the management resources possessed by each to generate business synergies and raise overall value'[13]) is highly significant for the materials industry, where restructuring has lagged.

In a press release, Showa Denko stated: 'In light of the rapidly changing business environment, the Company [Showa Denko] has been examining the optimal allocation of management resources and portfolio management to realize sustainable growth. After careful consideration of all available options, the Company reached the conclusion that the expansion of the aluminum can business and the aluminum rolling business would be best achieved through business partners that have specialized knowledge and management resources to enable future growth of these businesses together with the employees engaged in the respective business. Taking these factors into consideration, the Company decided to execute the transactions set forth in the Master Agreement with Apollo, which is one of the world's leading alternative investment managers and has a wealth of experience supporting aluminum-related industries for more than 20 years.'[14]

Apollo Global Management was invited to participate in the Japanese market in December 2019 under the responsibility of Tetsuji Okamoto.[15] The firm's acquisition of Showa Denko's aluminium business at the start of 2021 was its first deal in Japan. Along with the aluminium business of Mitsubishi Metals, in September the firm also acquired the aluminium fibre business of materials major Mitsubishi Chemical Holdings for 85.0 billion yen.[16] All three deals were announced in 2021. In addition, in 2021, EQT, a major European PE fund, set up an office in Japan under the responsibility of Tetsuro Onitsuka.[17] Prominent funds have been coming to Japan in succession since the Blackstone Group first arrived in 2018, and Japan's private equity market is expected to continue to expand.

As we noted above, 2021 was a year of major activity in the materials sector, but significant deals took place in the consumer sector as well. Shiseido sold its 'personal care' business, which deals in daily necessities and other such items, to the European PE fund CVC for 160.0 billion yen. After the sale, Shiseido invested 35% in the parent company and made it a joint venture. The personal care business accounted for 9% of Shiseido's sales and had a history dating back to 1959, but the company made the decision to sell in order to focus on its skincare category, which consists primarily of high-price skincare products and is one of Shiseido's core businesses. Proceeds from the sale will be 'used to invest in digitalisation and carry out mergers and acquisitions.'[18] According to Tetsuo Komori, president of the parent company under the CVC umbrella, 'Sales are around 100.0 billion yen. In 2019, half of that was domestic, but we subsequently established offices and sales channels overseas in China and elsewhere. Growth in Asia, including China, we hope will push sales to around 150.0 billion in 2026. There'll be an initial public offering in a number of years.'[19] The sale of Shiseido's personal care business is similar to Takeda Pharmaceutical's sale of its consumer healthcare business to the Blackstone Group in 2020. The operating margin of Shiseido personal care products is around 5-10%, well below the 20% margin of high-end cosmetics,[20] and, as President and CEO Masahiko Uotani points out, 'the business model for daily necessities differs from cosmetics, such as in the use of mass advertising.'[21] Similarly, the consumer healthcare business of Takeda Pharmaceutical has a different business model than its ethical drugs business, and President Christophe Weber mentions that 'it was difficult for Takeda Pharmaceutical to be involved even from such perspectives as advertising investment and profit margin.'[22] Both businesses have high name recognition from television commercials and other marketing, and their sale reveals a trend in management toward 'substance over appearance'.

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8 *Nihon Keizai Shimbun*, 'Materials Industry Reorganisation Led by Funds, Hitachi, Mitsubishi Materials Hasten Restructuring', 2 December 2021

9 *Nihon Keizai Shimbun*, 'Showa Denko Sells Aluminium Business to US Fund for Financial Improvement', 28 January 2021.

10 *Nihon Keizai Shimbun*, 'Mitsubishi Materials Sells Aluminium Business to US Fund for 60.0 Billion Yen', 26 November 2021.

11 *Nihon Keizai Shimbun*, 'Mitsubishi Materials Announces Aluminium Business Restructuring', 25 November 2021.

12 Ministry of Economy, Trade and Industry, 'Nonferrous Metals Strategy 2.1: Aluminium Industry Strategy', https://www.meti.go.jp/policy/nonferrous_metal/strategy_top.html

13 Glossary of investment terms

14 Showa Denko, 'Announcement of Execution of Master Agreement regarding Series of Transactions to Effect, among other matters, the Succession of the Aluminum Can and Aluminum Rolling Businesses through Company Splits (Simplified Absorption-Type Company Splits), and Result in Certain Consolidated Subsidiary Ceasing to be a Consolidated Subsidiary of Showa Denko K.K.', 28 January 2021.

15 Apollo Global Management, 'Apollo Global Management Appoints Tetsuji Okamoto to Head Private Equity Business in Japan', 5 December 2019.

16 Mitsubishi Chemical Holdings, 'Notice on Company Split (Simplified Absorption-type Company Split) and Share Transfer in Line with Transfer of the Polycrystalline Alumina Fiber Business of the Consolidated Subsidiary (Mitsubishi Chemical Corporation)', 30 September 2021.

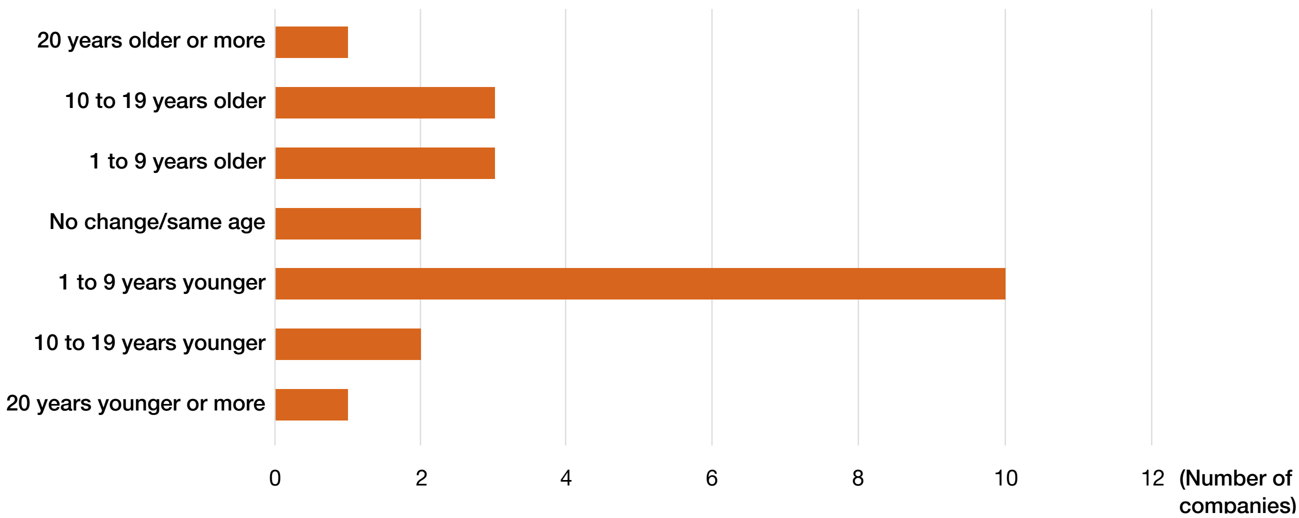
1-2. Business succession

As we discussed in the 2021 report, with many business owners and executives in Japan advancing in age, it goes without saying that business succession remains an issue companies must address in order to continue to develop and sustain growth. Tokyo Shoko Research, in its 2021 survey of the ages of company presidents nationwide, found 'a high correlation between aging presidents and worsening corporate performance. Based on the most recent financial data, 48.8% of companies with declining earnings had presidents aged 60-69 and 48.1% had presidents aged 70 or older. Moreover, 22.3% of companies in red ink had presidents aged 70 or older, the highest percentage among all age groups. Companies with older presidents tend to have difficulty formulating a long-term vision and tend to lag behind in capital investment and operational improvements, which are underlying factors for their poor performance.'[23]

Given this state of affairs, for companies invested in by PE funds from 2015 to 2021 in which the amount invested was 30.0 billion yen or more, we compared the difference in age of the chief executive the year prior to the investment and the year following the year the investment was made.

There were 49 companies in this group, 22 of which had a change of chief executive. Seven of these companies installed a chief executive who was older than the executive prior to investment and 13 of the companies installed a chief executive who was younger.

Figure 3: Age difference of chief executives at portfolio companies before and after PE investment



Source: Created by PwC from data provided by Teikoku Databank.

Analysis of the age difference in chief executives in the year prior to and the year after the year the investment was made at companies in which PE funds made investments of 30.0 billion yen or more from 2015 to 2021 (based on information available in databases provided by Dealogic). Does not include changes to chief executives made subsequent to the year following the investment year.

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[17] *Nihon Keizai Shimbun*, 'Global Funds Total Corporate Acquisitions Rise a Record-High 2.4 Times in January to September Period', 13 October 2021.
[18] *Nihon Keizai Shimbun*, 'Sell Daily Articles, Strengthen Asia, New Shiseido / CVC Company Targets 60% Overseas Sales', 1 July 2021.
[19] *Nikkei Sangyo Shimbun*, 'New Shiseido/CVC Company Launches', 14 July 2021.
[20] *Nihon Keizai Shimbun*, 'Shiseido Focus on High-Price Products, Major Restructuring to Sell Daily Necessities Business for Over 100.0 Billion Yen, Selection Based on Earnings Contribution', 23 January 2021.
[21] *Nihon Keizai Shimbun*, 'Shiseido Announces Daily Necessities Sale for 160.0 Billion Yen to "Focus Resources on High-Price Products"', 4 February 2021.
[22] *Nikkei Business Online Edition*, '"Hiroaki Hashimoto's Outlook for Pharmaceuticals and Medicine", Departing for Growth, Takeda Pharmaceutical's Transfer of OTC Business', 25 August 2020. https://business.nikkei.com/atcl/gen/19/00110/082500045/
[23] Tokyo Shoko Research, 'Average Age of Presidents 62.49, Performance Clearly Deteriorates the Older the President, "Survey of Ages of Presidents Nationwide"', 4 August 2021.

Though business succession is a frequently used term, it is actually difficult to define because the each company's situation is different. If a business owner, or someone in a similar position such as a major shareholder or chief executive, outwardly and unequivocally sells their shares to a PE fund, we consider this a business succession deal in the broad sense. Here, we look at CVC's investment in Trygroup, MBK Partners' investment in Tsukui Holdings, and the Carlyle Group's investments in Rigaku, Japan Asia Group and AOI TYO Holdings as examples. The ages of the owner, major shareholder or chief executive of each company when they were sold are as follows. The founder of Trygroup was 65 years old, the founder of Tsukui Holdings was 56, the president and founder of Rigaku was 73, the representative director, chairman and president—who was also the major shareholder—of Japan Asia Group was 69, and the founder of AOI TYO Holdings passed away at age 88 in November 2020. PE funds are expected to play a wide variety of roles, generally consisting of industrial restructuring via digital transformation or additional acquisitions, the forming of alliances, and enhancements to management systems to prepare for public offerings. Many deals have also come about in response to the impact of COVID-19.

Based off the definition above, the largest business succession deal in 2021 was CVC's acquisition of Trygroup, an unlisted company that provides home tutoring services, for around 110.0 billion yen. CVC established a special purpose company (SPC) for the acquisition and acquired the company's shares from founder and chairman Osamu Hirata and its other shareholders. Chairman Hirata and company president Yurie Nitani subsequently used the funds from the sale to reinvest in the SPC and will continue to participate in its management to a certain degree.[24] As with Shiseido's personal care business, CVC is aiming to list the company publicly, but the main objective of the investment is 'edtech', the digitalisation of educational services.

CVC Asia Pacific Japan partner and co-head Yukinori Sugiyama commented, 'Try leads the industry in utilising AI and other technologies in education, but we wanted to add to the company's knowledge by leveraging CVC's experience and networks and bringing in expertise from overseas in order to further accelerate its digital transformation strategy going forward.'[25]

MBK Partners' investment in Tsukui Holdings in the long-term care sector followed the management buyout of NICHIIGAKKAN by Bain Capital in 2020. The long-term care industry is expected to grow over the long term, but in the short term, the outlook is cloudy. Day services for elderly and disabled persons account for a majority of Tsukui Holdings' sales, and this business was greatly affected by COVID-19. 'With people staying at home because of the spread of COVID-19 infections, customers refrained from using day services in order to prevent transmission, which caused an increase in cancelations. It remains unclear when COVID cases will subside, we expect that customers will continue to refrain from using these services. The Tsukui Holdings Group also held back from active sales activities and taking in new customers, so new customer acquisitions have been lower than in normal years. The outlook is uncertain.'[26] As with NICHIIGAKKAN, the investment in Tsukui Holdings has industry restructuring and alliance formation as the pillars of its growth strategy. According to the press release, '[Tsukui Holdings] expects that MBK Partners Group will fully support each and every step of such M&A deals, from implementation/funding and project sourcing to post-merger integration (PMI), by making use of its expertise, network and resources to the fullest extent possible.'[26] At the same time, NICHIIGAKKAN, under the Bain umbrella, promptly rolled up West Japan Healthcare, a wholly owned subsidiary of LeTech that operates a nursing care business.

The Carlyle Group completed three deals related to business succession in 2021. It announced investments in Rigaku, a top manufacturer of X-ray analysis, measurement and testing machines, in January; in AOI TYO Holdings, which oversees subsidiaries involved in advertising content strategy, planning and production and conducts group management, in May; and Kokusai Kogyo and JAG Energy, subsidiaries of Japan Asia Group, in September. Rigaku is in an advantageous financial position with an overseas sales ratio of around 65%[27] and an operating margin of 15%,[28] and that investment was in excess of 100.0 billion yen.[28] Through a new holding company created through joint investment, the Carlyle Group acquired all of Rigaku's outstanding shares. Carlyle now owns around an 80% stake, and the company's founder, President and CEO Hikaru Shimura, around a 20% stake, and they aim to become publicly listed within several years.[27] Shimura's decision was affected by the COVID-19 pandemic. 'We expect a rapid rise in pent-up demand when COVID-19 subsides,' he says. 'We plan to quickly enhance our systems while there is still time in order to take full advantage of this demand.'[28]

For AOI TYO Holdings, as well, COVID-19 was the main driver that prompted the deal. AOI TYO was established as a holding company through the merger of AOI Pro., which had the second-highest sales in the TV commercial production sector, and TYO, whose sales ranked third in the same sector, in January 2017. Through the merger, AOI TYO captured the top share in TV commercial production, but under the impact of COVID-19, sales in the year ended December 2020 declined 21.7% compared to the previous period to 51,087 million yen, and the company suffered an operating loss of 727 million yen. Seeing this an opportunity for change, the company decided that it would be necessary to build a system for promoting decisive management reforms. To do so, it needed a new business model that included a revenue model for digital media, alongside its traditional model pivoting on the production of TV commercials, and it decided that going private via a management buyout was the best way to do so.[29] Shares connected with AOI Pro. founder Hitoshi Hara and the shares of TYO founder Hiroaki Yoshida were also sold, and the business was succeeded by Yasuhito Nakae, the company's representative director and group CEO, and Hiroaki Uekubo, its representative director and group COO. This made the deal, in some senses, a business succession. Jumpei Ogura, managing director at Carlyle Japan, says that 'the environment surrounding the industry is undergoing rapid change due to lifestyle changes prompted by COVID-19' and that going private 'offers the chance to grow by accelerating reform'.[30]

Like AOI TYO Holdings, the Japan Asia Group's performance deteriorated under the impact of the pandemic. According to a press release, 'As a result of the phenomenon mentioned above—consumer sentiment being negatively affected by the spread of the coronavirus—impacting the Group's earnings, the smooth supply of funds to growth areas through direct and indirect financing has been affected, and we acknowledge that businesses are stagnating due to the dispersion of management resources.'[31] In light of these circumstances, the company had announced an MBO on 5 November 2020, but City Index Eleventh, the former Murakami Fund family, announced a hostile takeover bid on 14 January 2021, and an MBO by the Carlyle Group failed on 10 February 2021. Ultimately, the deal was consummated in the form of the Carlyle Group acquiring the shares of Kokusai Kogyo and JAG Energy for around 58.5 billion yen on 7 September 2021.

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[24] *Nihon Keizai Shimbun*, '"Home Tutor Try" Acquired by UK Fund CVC for 110.0 Billion Yen', 12 October 2021.

[25] MARR Online MARR Report, 'Company Case Study: Trygroup: Reasons Highly Profitable Education Company Partnered with CVC Capital Partners Investment Fund', 13 January 2022.

[26] Tsukui Holdings, 'Statement of Opinion on Tender Offer for Tsukui Holdings Company Shares by MBKP Life LLC', 8 February 2021.

[27] Rigaku, 'Carlyle to Acquire Major Stake in Rigaku Corporation', 6 January 2021.

[28] *Nikkan Kogyo Shimbun*, 'Major Global X-Ray Analyzer SME Receives Investment from US Carlyle, From "Family Firm" to Public Company', 25 January 2021.

[29] MARR Online MARR Report, 'Company Case Study: AOI TYO Holdings Partners with Carlyle for MBO, CEO Yasuhito Nakae Discusses Growth Strategy for Re-Listing', 10 November 2022.

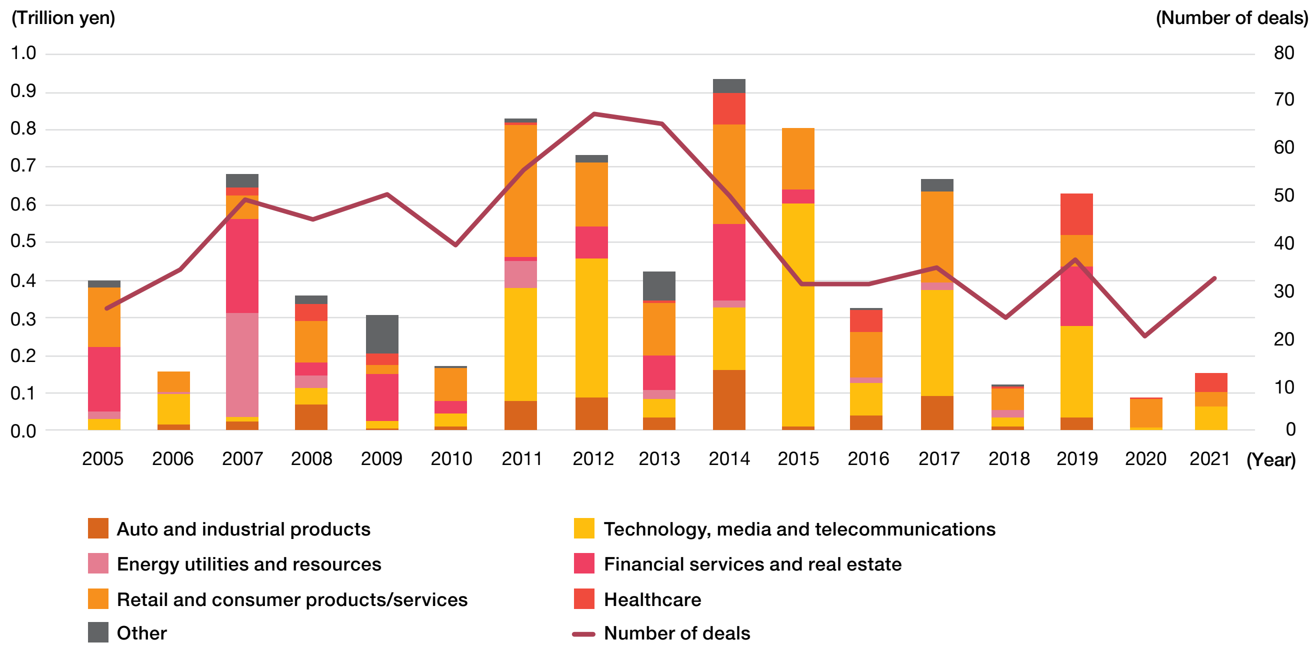
[30] Bloomberg, 'Carlyle Acquires Major Domestic Television Commercial Producer; Opportunities in TMT Industry During Pandemic', 20 July 2021.

[31] Japan Asia Group, 'Notice on Measures etc. Related to Raising the Company's Corporate Value and Shareholder Returns', 1 March 2021.

2 Trends in exits by private equity funds

Figure 5 shows major exits by private equity funds in 2021. PE funds eventually exit a majority of the companies they invest in, but diving into the details reveals many so-called 'secondary deals' in which a PE fund sells to another PE fund. In this section, we look at the 22 main exit deals made by PE funds in 2021. Of these, nine are secondary transactions between funds.

Figure 4: Monetary amounts and number of domestic exit deals involving PE funds (by industry)



Source: Created by PwC from databases provided by Dealogic

Note: The amount of information disclosed in relation to investment amounts is limited. This figure does not include investments of an undisclosed amount.

Figure 5: Major exit deals by PE funds involving Japanese companies

Date of announcement	Portfolio company	Industry of portfolio company	Acquiring company or exit	Selling company	Amount (million yen)	Secondary investment
Dec. 2021	Sunsho Pharmaceutical	Healthcare	Towa Pharmaceutical	Carlyle Group	47,694	
Dec. 2021	Cosmolife	Food and beverage	Tokyo Electric Power Timeless Capital	Advantage Partners		✓
Dec. 2021	Enjin	Professional services	Tohokushinsha Film	Endeavour United		
Nov. 2021	Misuzu Life	Agribusiness	Marunouchi Capital	iSigma Partners		✓
Nov. 2021	Accordia Golf	Leisure and recreation	Fortress Investment	MBK Partners	400,000	✓
Nov. 2021	Senqcia Chain	Machinery	Rising Japan Equity	Senqcia		✓
Oct. 2021	BC Ings	Professional services	Eishinkan	CLSA Capital Partners Hiroshima Innovation Network		
Sep. 2021	Net Protections Holdings	Finance	MY Alpha Management HK Advisors Ltd	Advantage Partners	2,700	
Sep. 2021	Four Nines	Healthcare	Kaneko Optical	CITIC Capital Holdings		✓
Sep. 2021	Alaxala Networks	Computers and electronics	Fortinet	Japan Industrial Partners		
Jul. 2021	Palemo Holdings	Retail	Nishimatsuya Chain	Endeavour United	382	
Jul. 2021	Kaishokusan	Food and beverage	Lopia	Endeavour United		
Jun. 2021	IONIC	Healthcare	Dentas	Advantage Partners		
May 2021	Q'sai	Food and beverage	euglena	Advantage Partners		
Apr. 2021	Sankyu	Dining and lodging	Central Forest Group	ACA		
Apr. 2021	Via Mechanics	Machinery	Advantage Partners	Longreach Group (Hong Kong)		✓
Mar. 2021	Sokan	Food and beverage	Nippon Sangyo Suishin Kiko Group	Ant Capital Partners		✓
Mar. 2021	Ohizumi Mfg.	Computers and electronics	Ferrotec Holdings	Integral	3,173	
Mar. 2021	B.P.S.	Machinery	Daiichi Kogyo	Integral		
Mar. 2021	WingArc 1st	Computers and electronics	Listed on TSE First Section	Carlyle Group		
Mar. 2021	Increment P (now GeoTechnologies)	Computers and electronics	Polaris Capital Group	Pioneer	30,000	✓
Jan. 2021	Primo Japan	Retail	Integral	Longreach Group (Hong Kong)		✓

Source: Created by PwC from databases provided by Dealogic (Lists major exit deals by PE funds with a fund value of 30.0 billion yen or more)
Note: The amount of information disclosed in relation to investment amounts is limited. This figure does not include investments of an undisclosed amount.

On 10 March 2021, Pioneer announced the sale of all shares in Increment P (now GeoTechnologies), a wholly owned subsidiary, to the Polaris Capital Group for approximately 30.0 billion yen.[32] Pioneer was acquired in 2019 by the Asia-based PE fund Baring Private Equity Asia and is currently undergoing business restructuring.[33] This is a secondary transaction in the broad sense: a PE fund selling the subsidiary of an acquired company to another PE fund. Increment P compiles mapping data from vehicles driven all over Japan and sells it to Pioneer, other car navigation companies and major IT firms, but the new management team believes sales activities targeting non-Pioneer manufacturers were hampered by being under the Pioneer umbrella.[32] In addition, proceeds from the sale will be allocated to congestion prediction and safety management services that use positioning data.[32] In the press release, the Polaris Capital Group explains, 'Based on the knowledge accumulated through the numerous carve-out projects that Polaris has undertaken to date, while continuing the existing strengths of Increment P and its cooperative relationship with Pioneer, Polaris, through this 'Second Foundation', will quickly build an optimum system to further advance as an independent corporate entity and a unique presence in the field of map information and location information. At the same time, we will improve operations and strengthen product competitiveness by utilising technologies such as AI and big data analysis.'[34]

In a similar case, Senqcia, another company invested in by the Carlyle Group, sold Senqcia Chain, a wholly owned subsidiary that manufactures and sells chains, to Rising Japan Equity. As with Increment P, this sale can also be considered a secondary transaction in the broad sense, as a subsidiary of an investment target of a PE fund was sold to another PE fund. Senqcia (formerly Hitachi Metals Techno) was a publicly listed subsidiary of Hitachi Metals, which we discussed at the start of the carve-out section, and it was taken private in 2015 through a management buyout by the Carlyle Group. 'Senqcia's main businesses are construction materials and chains, and its chain business accounted for around one-quarter of the company's 29.7 billion yen in net sales in FY2020. The decision to sell was made after careful consideration of the future growth of the chain business.'[35]

Such carve-outs by PE funds are extremely interesting. Companies becoming independent under new sponsors must rebuild independent administrative divisions, and, at first glance, there is an increase in subscale players which seems to run contrary to the goals of industry restructuring and consolidation. Eliminating the longstanding tendencies of Japanese companies toward self-sufficiency and 'pleasing all parties involved' while injecting new life into them requires companies to review and analyse their business portfolios in light of the current management environment and conduct cross-company restructuring. This process is likely to take a considerable amount of time. With the structure of global industry undergoing rapid change, including digital transformation, we will be closely watching the ways in which companies carved out by PE funds successfully raise their corporate value going forward.

Major exit deals in 2021, excluding secondary transactions, include the sale of Sunsho Pharmaceutical to Towa Pharmaceutical by the Carlyle Group for a price of 47.6 billion yen. Sunsho Pharmaceutical was a business succession deal executed by the Carlyle Group in 2014. What makes this case noteworthy is that the company made large-scale capital investments when it was owned by Carlyle. Sunsho Pharmaceutical invested around 7.0 billion yen in 2018 and built a soft capsule manufacturing plant with national-class production capacity.[36] Towa Pharmaceutical focuses primarily on generics, but 'its mainstay generics exist in a business environment that is difficult to forecast due to drug prices being lowered each year and the impact of quality problems discovered at another company, so the company plans to develop health foods as a new growth pillar.'[37] This was an exit in which a PE fund's investment in growth will underpin the future growth of the operating company.

As shown in Figure 6, the average number of companies invested in by the twenty major PE funds specialising in Japan doubled between 2016 and 2021 from 6.5 to thirteen companies. Among the companies acquired by these PE funds, exits have been delayed in some cases due to COVID-19, but we expect PE funds to continue to be active and build up their investments. However, if we consider the typical investment period to be 5 years, it is likely that PE fund exits from investment targets will further increase going forward.

[32] *Nihon Keizai Shimbun*, 'Pioneer, Precipitous Separation from Hardware, Dependence on Car Navigation, Drive Recorders at 80%, Pressing Need for Data Utilisation for Restructuring', 11 March 2021.

[33] *Nihon Keizai Shimbun*, 'Pioneer Sells Off Mapping Data Subsidiary to Fund for 30.0 Billion Yen', 10 March 2021.

[34] Polaris Capital Group, 'Acquisition of All Businesses of INCREMENT P CORPORATION', 10 March 2021.

[35] *Japan Metal Daily*, 'Senqcia Withdraws from Chain Business, Transfer of Subsidiary Shares to Construction Materials Manufacturer', 2 November 2021.

[36] *Health Industry Marketing News*, 'Sunsho Pharmaceutical Completes New Soft Capsule Plant', 24 May 2018.

[37] *Nihon Keizai Shimbun*, 'Towa Pharmaceutical Acquires Health Products Company Sunsho Pharmaceutical for 47.6 Billion Yen', 18 December 2021.

Figure 6: Number of companies invested in by major PE funds in Japan (average per PE fund)

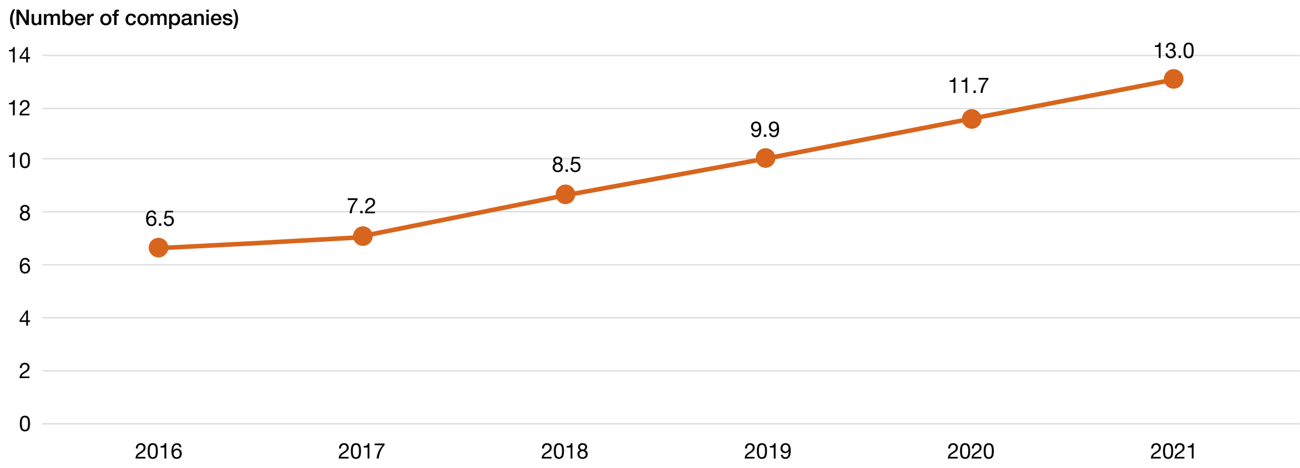
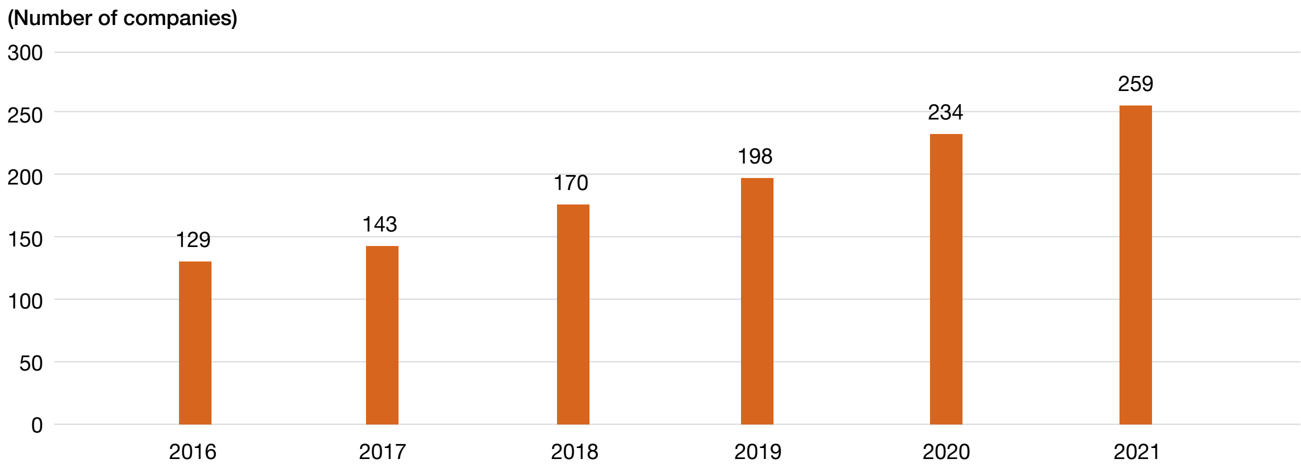


Figure 7: Number of companies invested in by major PE funds in Japan (total)



Source: Created by PwC based on Quzilla Capital's 'Industry Landscape Map of Domestic PE Funds (2022)' and company websites of the larger funds. The survey covers a total of 20 companies: Carlyle Group, Polaris Capital Group, Integral, Japan Industrial Solutions (JIS), Japan Industrial Partners (JIP), Nomura Capital Partners, Marunouchi Capital, Advantage Partners, T Capital Partners, JAFCO, Unison Capital, Longreach Group, Nippon Sangyo Suishin Kiko (NSSK), Aspirant Group, CLSA Capital Partners Japan, Japan Growth Investments Alliance, Endeavour United, J-STAR, iSigma Capital, and Ant Capital.

3 Trends in dry powder and fundraising

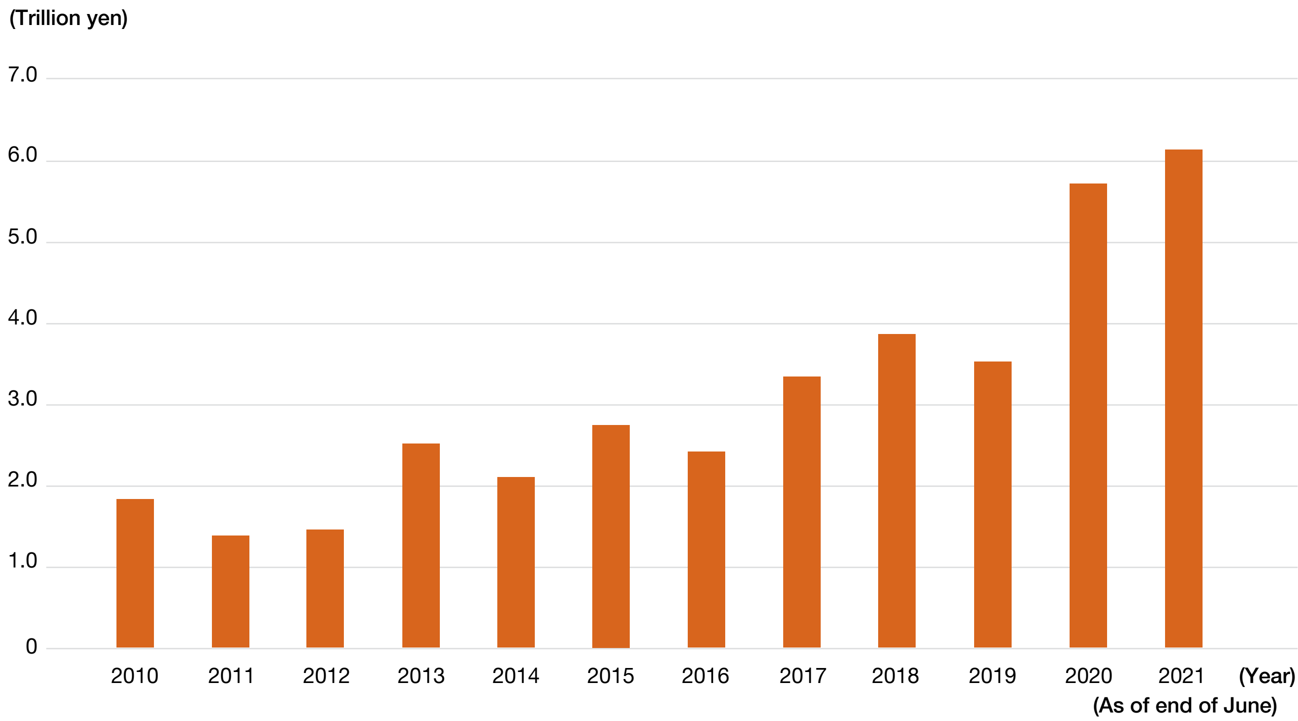
Owing in part to excess liquidity worldwide, PE funds focused on Japan continued to actively raise funds in 2021. The dry powder (funds that have been committed but not yet allocated) of PE funds with an interest in Japan among countries targeted for investment also continued to increase.

This includes a fund of 110.0 billion yen established by Bain Capital to invest in middle-market companies in Japan, which, like the entry into Japan by forerunners such as Apollo and EQT, is symbolic of the proactive stance taken by foreign funds to investing in Japan. This is the first fund established by Bain Capital that has narrowed its investment target to a specific country.[38] The fund's size of 110.0 billion yen makes it the fourth largest fund focused on Japan after the Carlyle Group's Fund IV of 258.0 billion yen, the overseas fund of the Polaris Capital Group in which advising is provided by its Singapore affiliate and Polaris Fund V, which together total 150.0 billion yen, and the Integral Group's Integral Fund IV, which totals 123.8 billion yen, all of which were formed in 2020.

In addition, KKR established its Fund IV for Asia and succeeded in raising a record-high 15.0 billion US dollars (approximately 1.65 trillion yen). The fund is 'putting around 30% into Japan',[39] so a simple calculation shows it plans to invest almost 500.0 billion yen in the country. Considering the strong willingness to lend of balance sheet lenders like mega banks, which have ample deposits, there is a latent possibility that deals double this amount will be formed through KKR alone.

The PE market is said to account for around 0.2% of Japan's GDP; in the US, this ratio is 3.2% and in Europe, 2.4%, so there is still room for growth. There are a considerable number of players of all sizes, small, medium and large, and they are steadily building up results. PE funds therefore are expected to continue ramping up their activities mainly in carve-outs and business succession deals.

Figure 8: Trends in dry powder of PE funds with an interest in Japan



Source: Created by PwC from data provided by Preqin.

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[38] *Nihon Keizai Shimbun*, 'US Bain, Japan Succession Fund, Eyes Mild-Market Reorganisation', 27 April 2021.

[39] *Nihon Keizai Shimbun*, 'US KKR New Asia Fund, "30% of Funds in Japan", Expanding Start-Up IT Investment', 7 April 2021.

Figure 9: Major fundraising efforts by PE funds in Japan (2021)

Date	Fund	Company	Main targets	Fund size
Dec. 2021	Unison Capital V, LPS and Unison Capital Partners V (J), L.P.[40]	Unison Capital	Controlled investment in middle market Japanese companies (healthcare, consumer-related, B2B services)	71.1 billion yen
Aug. 2021	Bridge No. 6-B LPS[41]	Ant Capital Partners	Focused on secondary investment in equity of private equity funds etc. owned by existing investors	20.0 billion yen
Apr. 2021	Bain Capital Japan Middle Market Fund[42] *Fund name from PitchBook data	Bain Capital	Middle market companies with corporate value of between 20.0 billion and 50.0 billion yen	110.0 billion yen
Apr. 2021	KKR Asian Fund IV[43]	KKR	Carve-outs of conglomerate companies, business restructuring (Japan included in investment target)	15.0 billion US dollars (approx. 1.65 trillion yen)
Feb. 2021	Fund VI[44]	T Capital Partners	Business succession for middle market companies and SMEs and spin-offs etc. of subsidiaries and business divisions through business restructuring at major firms	81.094 billion yen

[40] Unison Capital, ‘Final Closing of Unison Capital Partners V(J), L.P. and Unison Capital Partners V, LPS’, 6 January 2022.

[41] Ant Capital Partners, ‘Notice on Establishment of Bridge No. 6-B LPS’, 13 August 2021.

[42] *Nihon Keizai Shimbun*, ‘US Bain, Japan Succession Fund, Eyes Mid-Market Reorganisation’, 26 April 2021.

[43] KKR, ‘KKR Closes Asia Fund IV at 15.0 Billion US Dollars (Approx. 1.65 Trillion Yen)’, 6 April 2021.
Nihon Keizai Shimbun, ‘KKR, New Asia Fund Increases Investment in Start-Up IT, “30% in Japan”’, 6 April 2021.

[44] T Capital Partners, ‘T Capital Partners Closes Maiden Independent Fund at the Hard Cap’, 1 February 2021.

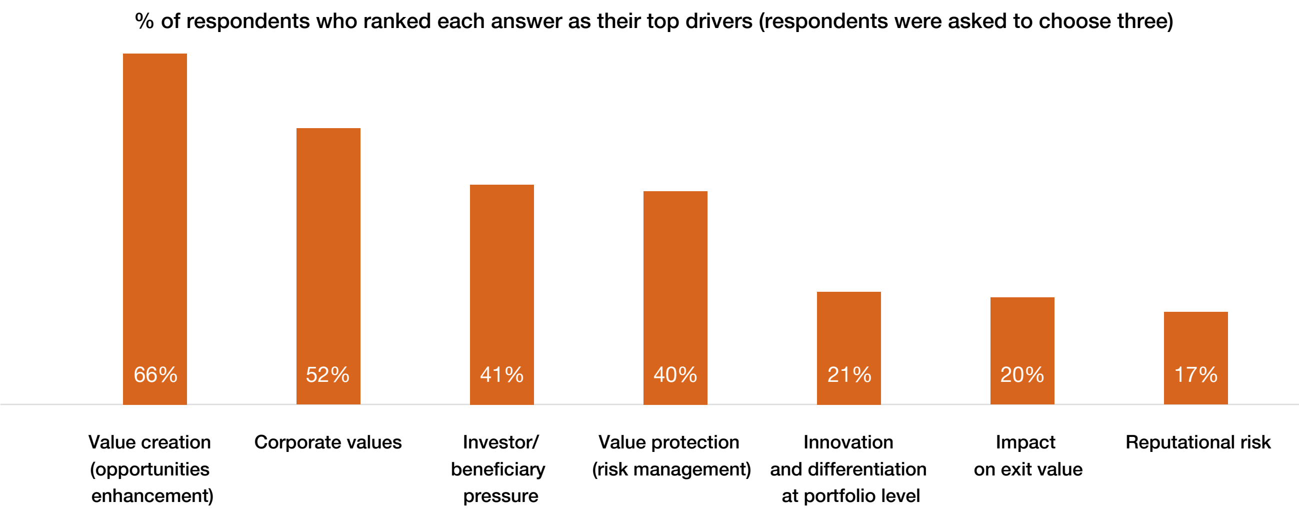
4 Trends in ESG activities of private equity funds and recommendations for the future

Trends in ESG activities of PE funds

With ESG (environment, social and governance)-related activities accelerating throughout the world, the Government Pension Investment Fund (GPIF) began making investments in 2017[45] while taking into account ESG indicators from FTSE, MSCI, S&P and other players from a long-term investment perspective, and this served as a springboard for ESG investment in Japan. And now, with carbon neutrality, TCFD (Task Force on Climate-related Financial Disclosures) requirements and other developments, even more focus is being placed on ESG activities. Activities have just recently gotten underway at PE funds in Japan, and discussions have begun on how to integrate ESG into investment activities. Funds have steadily emerged that are strengthening their ESG initiatives, which have included signing the Principles for Responsible Investment (PRI), utilising ESG checklists, and establishing organisations and assigning personnel to be in charge of ESG-related activities.

At the same time, PE funds in the West are ahead of funds in Japan with regard to ESG, where awareness is changing significantly from ESG as a form of compliance and risk management—the conventional view—to ESG as a driver for creating future value. Actually, our 2021 survey of global PE funds found that value creation is the most emphasised factor driving responsible investing (RI) and ESG activities.[46]

Figure 10: Drivers of responsibility investing and ESG activities



Source: PwC's Global Private Equity Responsible Investment Survey 2021

It possibly goes without saying, but the ESG activities of PE funds in the West specifically include negative screening to eliminate companies that are not qualified from an ESG perspective prior to investment, in sectors such as weaponry and gambling. These PE funds also conduct ESG due diligence, which consists of careful research to identify ESG-related risks and opportunities. In addition, after investing, they not only take measures against the ESG risks that have been identified but also implement ESG strategies and improvements with respect to ESG opportunities as a way to actually create value. Recently, one development in ESG investing has been the emergence of PE funds that perform impact investing, which takes into account social impact alongside financial returns. In fact, as an example, Bain Capital and KKR are managing impact funds of more than 1.0 billion US dollars respectively.[47,48]

Development of ESG systems by PE funds

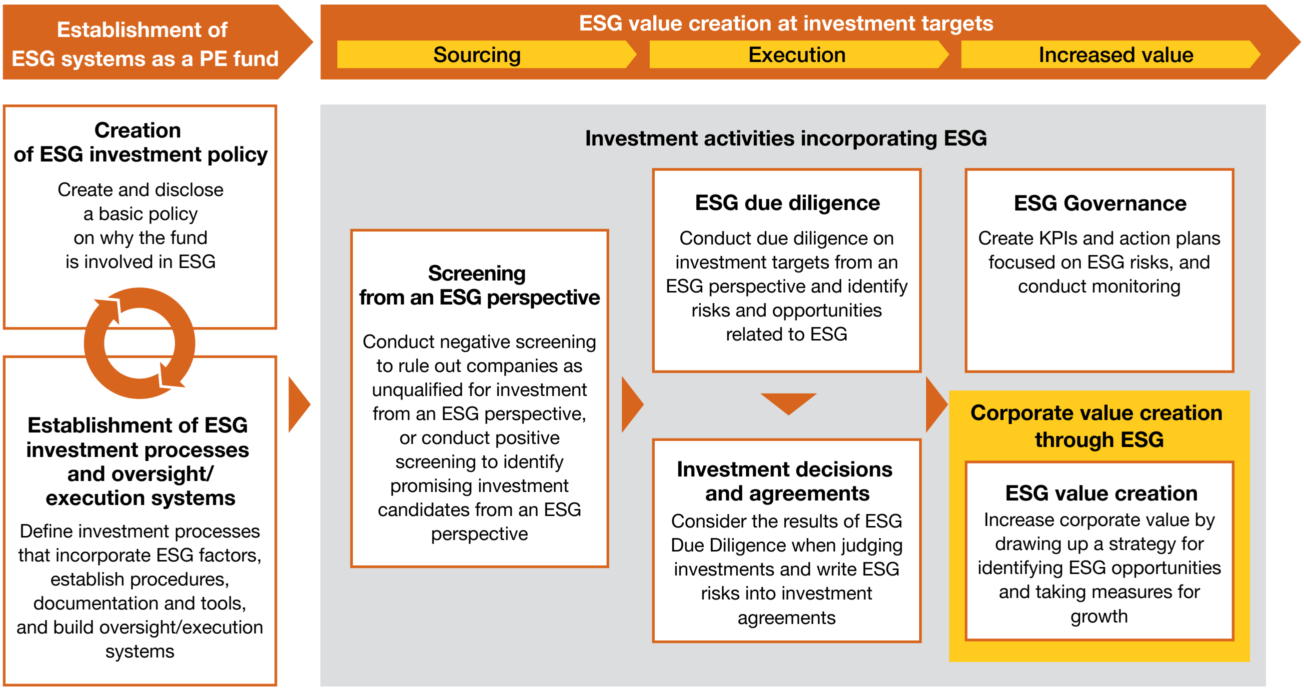
The ESG initiatives of PE funds in Japan are behind those of PE funds in the West, and should they miss the opportunity and fail to develop ESG-responsive systems, it could impact fundraising from limited partners(LP) investors and leverage loan providers that are sensitive to ESG trends.

Recently, more and more LP investors are requiring PE funds, as the general partner (GP), to explicitly disclose their investment approach—how they incorporate ESG factors into investment decisions and how they will generate returns—and comply with industry standards as laid out in the Principles for Responsible Investment (PRI) and other guidelines. In fact, some overseas investors have declared they will hold off on LP investments if ESG initiatives are inadequate. For example, the California

Public Employees' Retirement System (CalPERS), the largest public pension fund in the US, has announced ESG evaluation factors as guidelines for GPs.[49] In addition, in our survey of LP investors—60 institutions in 14 countries with total LP investment of 500.0 billion US dollars—71% of respondents indicated that they would decline investment and fundraising opportunities on the grounds of the GP's ESG rating.[50]

Given the recent increase in ESG awareness among LP investors, including those in Japan, building ESG systems is a pressing issue for PE funds. Specifically, they need to craft ESG investment policies for themselves and develop investment processes and supervision and execution systems. In terms of public-facing initiatives, it will be important for the funds to express their commitment to ESG investing by signing onto the PRI principles, and to promote transparent ESG initiatives at portfolio companies by disclosing information on ESG measures taken by those companies as well as their policies for promoting ESG going forward.

Figure 11: Overview of recommended ESG activities for PE funds



We should also mention the need for ESG measures from the standpoint of fundraising through leveraged loans. There have been cases of so-called 'ESG financing' in Japan, like green loans and sustainability-linked loans, but most have not assessed penalties when their KPIs are not achieved, and currently, no PE funds have made use of these loans. By contrast, the leveraged loans used by PE funds in the West include, for example, an LBO loan procured by Carlyle[51] that has a mechanism that lowers the interest rate by 5-10 bps when certain ESG targets are achieved for water conservation and carbon dioxide reduction. There are also other progressive cases, such as a mechanism for assessing a penalty of ± 2.5 bps based on relative achievement of KPIs related to ESG.[52]

Leveraged loans in Japan are not far from adopting such mechanisms as well, and it will likely become even more important for PE funds to establish ESG systems and for their portfolio companies to create and execute ESG strategies.

ESG value creation at portfolio companies

The impact of ESG is not limited to fundraising. In actual investment activities as well, there is a risk of corporate value being eroded after the investment is made if ESG risks at the portfolio company are overlooked, and it is possible that latent opportunities for creating value through ESG will be missed. There are actual examples of ESG risks materialising in recent years, cases of falsified testing, serious labour problems due to harassment and abuse of power, and human rights issues related to Xinjiang cotton among them. ESG measures at portfolio companies also have the potential to increase the exit multiple. According to a study by MSCI, one of the major ESG rating agencies, companies with high ESG ratings have lower capital costs than companies with low ratings, which clearly indicates that improving ESG ratings leads to lower capital costs.[53] Going forward, in order to protect and raise the corporate value of their portfolio companies, it will be essential for PE funds to analyse ESG risks and opportunities prior to investment, and after investment, for those companies to shift to management focused on ESG and create and execute strategies for making ESG a factor for competitive differentiation.

In particular, the importance of ESG due diligence in the pre-investment phase is increasing. Funds must not only focus on discovering risks, knockout factors and other relevant information, as has traditionally been the case, but must also understand that this traditional approach is insufficient on its own for identifying and solving ESG issues. To combat this insufficiently, they must work to uncover ESG opportunities that will help generate sustained growth in corporate value. One way of performing ESG due diligence is to identify ESG risks and opportunities based on an international ESG disclosure framework like the Sustainability Accounting Standards Board (SASB) Standards.[54] It is often difficult to quantify the information that is discovered through ESG due diligence, and often issues may only emerge when viewed from a long-term standpoint, but like other forms of due diligence, if findings cannot be incorporated into the price and agreement, it is important that actual actions be undertaken after the investment is made.

In the post-investment phase, the key is how much value creation can be realised based on the findings of ESG due diligence. The injection of new resources along with the investment, to address ESG issues that could not be solved by the portfolio company previously and to capture ESG opportunities that had not been previously identified, has the potential to be a growth driver for the company. For example, CVC transformed the management of Softex, an Indonesian company in its portfolio, to focus on ESG and improved its ESG efforts to the point where it has now won numerous awards for sustainability. Then it was sold to major US paper product and daily necessities company Kimberly-Clark.[55] Softex's community contributions, both social and environmental, earned a strong evaluation and made it a point of appeal in buyer Kimberly-Clark's public relations.[56]

PE funds, in their hands-on activities, had also already been involved in strengthening the governance portion of ESG in particular, but going forward, they will need to take even more active initiatives for the environment and society aspects. Specific ESG measures that they will need to focus on include creating a net zero strategy and roadmap, making external diseconomies (CO_2 emissions, water use, etc.) transparent, converting to renewable energy, and promoting new businesses such as new ESG products and services. For example, Partners Group of Switzerland has ESG specialists for its funds in order to promote ESG-related value creation,[57] and such initiatives are becoming standard in Europe.

At the same time, funds generally invest for the relatively short period of three to five years, so if during the investment period ESG costs increase or new R&D costs rise, it can put pressure on profits. Also, most portfolio companies of PE funds are SMEs, so they often struggle with limited management resources, and it becomes necessary to prioritise certain measures over others. Short-term measures often include cutting the cost of indirect materials by conserving energy and water and streamlining logistics to help reduce environmental impact, so funds are able to provide joint procurement programs that leverage their purchasing power to their portfolio companies, which allows an ESG perspective to be integrated into quick-win measures. For medium- to long-term measures, it will no doubt be important to work ahead of time to clarify non-financial KPIs and establish monitoring systems with a view to integrating latent value into the valuation at exit as well as accurately understanding the progress of ESG measures during the investment period.

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[45] Government Pension Investment Fund, 'ESG Indicators Selected', 3 July 2017.

[46] PwC, 'Global Private Equity Responsible Investment Survey 2021'

[47] KKR, 'Invested in Impact', https://kkresg.com/impact#invested-in-impact

[48] Bain Capital, 'About Double Impact', https://www.baincapitaldoubleimpact.com/about-us

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[54] Value Reporting Foundation, 'SASB Standards'

[55] CVC Capital Partners, 'ESG Report 2021'

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Conclusion

On 24 February 2022, while this report was being written, Russia began its military invasion of Ukraine, shocking the world. Changes in the international balance of power, political and diplomatic, are making the general global outlook increasingly unclear and complex. Resource prices, including for crude oil, which had already been rising on the expectation that economies would normalise, are surging due to the Russian invasion. It goes without saying that Japan, as a country with few natural resources, has also been impacted. With international tensions escalating, it is essential that Japan work to solve the problems facing its companies and reinforce its strength as a nation, which has generally been waning, for the sake as well of maintaining its influence in diplomacy, international relations, humanitarianism and national security. Amidst this highly volatile global situation, Japanese companies need to reform themselves quickly, and PE funds, which can make decisions rapidly and effect more thoroughgoing reforms, are likely to have an increasingly strong presence as an option for corporate management. Going forward, we expect that even more Japanese companies will utilise PE funds as a way to create further economic and social value.

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