KEYNOTE INTERVIEW

How to succeed with succession

Family-owned businesses account for more than half of all PE deals in Japan. Instilling a professional management culture requires a careful leadership transition, says Jun Tsusaka, founding partner of NSSK, one of Japan's leading GPs

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Q How do you think Abenomics is shaping the PE landscape?

My view is that the robust PE market in Japan today is in thanks to Abenomics. Most pundits say Japan is not growing, but Japan's GDP on an apples-to-apples basis was ¥498 trillion ($4.5 trillion; €4.1 trillion) when Shinzo Abe took office in 2012 and as of last year was ¥540 trillion, an increase the size of the Philippines economy.

People view the Nikkei 225 as having under-performed, but when Abe became prime minister it was at 10,395 and it's now around 20,000. How many stock markets can you name, besides the US, that have doubled this decade?

In general, you're talking about 1 percent to 2 percent GDP growth, similar to the US, which is a benign environment for private equity investing. People think of Japan as exporters due to household names like Toyota and Sony, but exports are less than 18 percent of GDP. The big part is private consumption, which represents 55 percent, which makes us similar to the US economy.

Unemployment levels have nearly halved and labour costs have increased, leading to higher wages and steady consumption. There's a serious shortage of human resources for small-cap companies, which is driving merger and acquisition activity as owners are unable to grow their teams and are becoming more willing to sell due to a number of economic reasons. Business growth under private equity ownership is possible as long as you have operational capability and a good reputation and brand to compete for talent. This confluence of factors has made Japan a legitimate market for private equity.

Q How is Japan impacted by Asia's headline risks, such as the US-China trade war?

Exposure to China is decreasing from around 30 percent of exports in 2017 to around 20 percent today. The key to managing through this crisis is for Japan to have a strong domestic consumption economy coupled with a diversified export business. Investors need to diversify as well.

What is driving the rise in Japanese business succession deals?

Since Abe became prime minster, business succession deals have had a 41 percent compound annual growth rate. Ten years ago business succession deals accounted for just 15 percent of the market, compared with more than half of annual dealmaking in 2018.

You have 3.8 million SMEs in Japan with an average CEO age of 60, two-thirds of which don't have a successor. If that founder dies, the family has a 55 percent inheritance tax to pay in cash on top of the repayment of corporate debt, which tends to be family guaranteed. It is no wonder that privately held businesses are now selling at a dramatic pace.

You've hired a chief corporate philosophy officer. Why?

We may be the only firm in Japan that has a chief corporate philosophy officer. Yoshihito Ohta came from Kyocera Corporation, a multinational electronics and ceramics business, and had previously served as a key government advisor to Japan Airlines in one of the most successful business turnarounds in Japan's bankruptcy history.

When bringing in a new CEO or management team to a portfolio company, we don't want someone focused only on returns. Returns are an outcome of effective management and building strong and sustainable businesses. And this is driven by leaders who are focused on making all employees proud of working at their companies and building career paths for them that present a bright future.

Ohta-san visits our portfolio company on a fixed schedule to engage with employees at all levels about what it takes to be successful. He often references an algorithm for success: "attitude x effort x ability". We spend a lot of time at our management meetings discussing ways to maximise the "happiness" of our employee base. Happy and committed employees are critical for driving customer satisfaction. This in turn drives financial results. We have gone from a hardware and software driven environment to a "heart ware" focused environment.

What does PE bring to the table in business succession cases?

Private equity goes in and creates accounting and finance transparency, and institutes full compliance measures, real-time governance, business manuals, policies and procedures. We're upgrading the organisation, installing professional management and business procedures, and creating a funding programme for growth. Creating an institutional-quality business drives future growth and is critical to attract strategic buyers or take these businesses public.

There is a growing preference to sell to private equity, which enables an orchestrated transition and preserves the family legacy. We have seen material upside in taking the best of family-run operations and overlaying professional business tools, procedures and management talent. At NSSK, we have several tool kits related to value creation that have been developed and proven over the years.

In every company we invest in, we have brought on board new management talent to supplement and energise the existing management teams. We have a deep bench of operating executives and our competitive advantage is to bring in proven, successful business leaders from large-cap settings to smaller-cap businesses. Executives from companies like McDonalds, Rakuten, Unicarrier, DHC and Berlitz have all made successful transitions to our portfolio companies. Owners know that when we acquire a company, we're going to make it better. They're less worried about hanging on to their jobs and more motivated by orchestrating a graceful exit for their families and ensuring that their companies will be in a stronger position post-sale.

"Privately held businesses are now selling at a dramatic pace"

What's the environment like for take-privates?

Stock market valuations are arguably low compared with the US and Europe, meaning there are opportunities for private equity. You're going to see more public-to-privates and more opportunities related to activism as a result of the recent governance and stewardship reforms driven by the government. There were 50 shareholder proposals to public companies last year with more to come. Things are moving in the right direction, but take private deals will remain opportunistic opportunities.

Is there too much capital chasing too few deals?

Before the global financial crisis there were around 100 Japanese GPs with $22 billion raised over a five-year period, and if you look at the past five years, there are about 60 GPs with $16 billion raised. The numbers suggest that the conventional wisdom is not accurate

Turnaround specialist: Ohta's role in the revival of the national airline under Kazuo Inamori was dubbed a "miracle" in Japan

and that both the amount of dry powder and GPs is lower today than pre-GFC by approximately 30 percent and in a growing PE market.

Q What about corporate carve-outs?

There has been significant anticipation around the development of corporate carve-outs. The opportunity to deploy large amounts of capital and the operational improvement available have long driven investor interest in carve-outs. Historically, there have been roughly 260 corporate carve-outs per year. But private equity engagement has only represented about 10 percent of all activity.

Most carve-outs end up being sold to strategic buyers. This is driven by acquisition hungry Japanese corporates that have lower cost of capital and the occasional preference for sellers to sell only to other corporate buyers. The wave of corporate carve-outs has yet to materialise, but with rising shareholder engagement and activism there may be more opportunities ahead. But a GP needs to have the requisite capabilities and experience to execute carve-outs successfully.

Q How is NSSK preparing for a downturn?

We have been concerned about the cycle for a while, so as investors we look to take investment dollars off the table early and often. In addition, we continue to be disciplined buyers. Our average entry multiple is about 6.9x, and we have focused on solid businesses with strong cashflow and growth potential. But the core for preparing for a downturn is founded on our NSSK Value-UP Program (NVP), which includes a module called "Crisis Mode" which we have activated in the wake of the coronavirus outbreak. For every investment, the Crisis Mode module requires our investment and operating leaders to develop a "crisis management programme" assuming a major business downturn.

During due diligence, we work with management teams to understand what could go wrong with the business (including the impact of global shocks to the business) over the next five to seven years to create a detailed playbook that we can take out of the drawer if that situation comes to pass. Our companies are prepared for any "fire drill" and we have moved into phase 1 implementation for all of our portfolio companies irrespective of the level of financial impact as we prepare for the worst, and manage to the best.

Q What role have regional banks played in your borrowing arrangements?

In 2016, we created the Chubu/Hokuriku Region Vitalization Investment fund, which includes investments from banks representing the eight prefectures in central Japan to form an ecosystem of regional banks that enables us to source and invest in small cap companies in the region, but also to secure attractive financing terms for PCs across all of our funds.

We currently have over 40 regional banks with whom we have an LP or syndicated loan relationship. All of these banks are looking for loan assets and PE-led business succession deals are attractive to them. In addition, our strong regional presence and long-term relationship with major regional banks have driven strong local dealflow, which has led to proprietary opportunities.

Q How do you bring environmental, social and governance into your dealmaking?

We have incorporated ESG into our business procedures and processes since we established NSSK. Today, ESG impact is part of our mission. Process-wise, we created a best-practice ESG long list and customise relevant ESG KPIs for our portfolio companies. It's a continuous improvement process. The ESG KPIs are monitored as part of our normal reporting process and we provide our LPs with quarterly reports.

Our ESG Committee is chaired by the CEO with representatives from the investment, operating and back office teams. One of our near-term initiatives is around diversity and inclusion. It is not enough just to hire someone from a minority background, we look to develop career paths that include engagement in leadership positions.

Q How do you plan to develop PE talent in a highly competitive market?

By continuing to demonstrate excellence in everything that we do. And this starts with having the best people and team, and building a track record of superior outcomes. Our current approach has typically been to hire people with the basic skills needed for private equity and teach them how to do business the "NSSK way".

So far, we have been fortunate to have been able to recruit and retain very talented and motivated employees with a common goal to build a best-in-class investment business and deliver superior outcomes that will contribute to the environment, society and governance of Japan and the rest of the world. ■