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Buy-out interest grows for mismanaged businesses

PRIVATE EQUITY

The opportunity to gain undervalued but advanced companies is tempting, says **Michiyo Nakamoto**

When the private equity firm, Longreach, acquired OCC, a submarine cable manufacturer founded in 1935, one of the biggest challenges it faced was convincing staff that it was important to make profits.

New management installed by Longreach, which acquired 100 per cent of OCC in 2006, decided to stop producing a particular product that was lossmaking, despite generating substantial revenues.

"People asked why they had to give up that product and warned that the company's customers would get very upset," recalls Masamichi Yoshizawa, a Longreach representative director and partner.

"The view was that even if it was not profitable, you had to make the product if the customer wanted it," he says.

The attitude Longreach encountered at OCC is typical of many Japanese companies with advanced technology but an out-dated approach to the management of their business.

"Japanese companies have tremendous technology skills, but they are being mismanaged," Mr Yoshizawa says.

The situation provides opportunities for the many private equity firms that had sprung up in Japan, and which had previously suffered from a dearth of investment options.

Private equity firms in Japan are showing growing interest in companies such as OCC that have world-class technologies but lack the brand recognition, management skills or funding to make the best of their expertise.

Taiyo Pacific Partners, which has been investing in Japan since 2003, recently increased its stake in Nicera, a maker of infrared and ultrasonic sensors. Taiyo, which has had a stake in Nicera for nearly five years, increased its stake to 5 per cent to become its third largest shareholder.

OCC, the cable manufacturer, presented a tough cultural challenge to its acquirer, Longreach

Meanwhile, Carlyle, the global private equity group, has agreed to acquire 100 per cent of Broadleaf, a provider of repair and inspection software. Such investments look unexciting compared with the headline deals several years ago, such as Ripplewood's investment in Long-Term Credit Bank of Japan or Japan Telecom. But in the technology sector, the products being churned out by many large Japanese companies have lost global competitiveness, making them less attractive to private equity investors, Mr Yoshizawa says.

An absence of large deals however, has encouraged investors to look for smaller gems.

The challenges that face financial investors in many Japanese companies are similar, whether they are a big bank or a maker of niche technology products. At OCC, Longreach found that the company was selling products at prices set by the customer, rather than prices that met OCC's profit objectives. When a price increase was proposed, marketing staff resisted. "If the customer says something costs Y100, then we have to sell it for Y100 or else we will not be able to get any more orders from them," Mr Yoshizawa says.

As a result of this attitude and poor accountability, OCC nearly collapsed in the wake of the IT bubble when it found itself with mountains of inventory and excessive debt.

Such structural problems do mean however that a change of management can make much more difference to the competitiveness of such companies than it might in the US, Mr Yoshizawa says.

Junichiro Sano, executive director and Japan representative of Dalton Investments, believes there are a large number of unknown companies with world-class technologies that have been undervalued.

"Value investors are looking at these companies. They are telling the companies to take their products to China and offering to introduce them to their partners," Mr Sano says.

Japanese fertiliser companies, for example, have competitive technology, but have been undervalued because they receive government subsidies and have not been able to export their products, he notes.

Mr Sano believes this could change under the new government. "Now is a good time to invest in Japanese technology companies because there are a lot of distressed companies," Mr Sano says.

"They are cheap enough to be delisted [from emerging company markets such as Mothers and Hercules] and could come back with values 25 times what they are now," he says.

And while it is difficult to convince Japanese companies to accept private equity investments, the strong yen and global competition are exerting pressure for overseas expansion.

"The yen is at Y90 to the US dollar . . . and Japanese companies can no longer rely on exports for recovery but have to go global in a big way," he says.

The question is whether private equity can provide the international network and management resources required for such a change. Longreach provided management resources to OCC and succeeded in changing the company's culture in the two years before it was sold to NEC and Sumitomo Electric.

If a private equity investor can show it is relationship-driven, has industry knowledge and a local presence, "[Japanese companies] will open their doors," Mr Yoshizawa says.