An industry hampered by its bumpy local history
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If there was ever a time for private equity to deepen its' foothold in Japan, this should be it. The international credit squeeze has left the country relatively untouched. Assets are cheaper thanks to the recent stock market slump, and shareholders are becoming tetchier - giving managers an incentive to sell underperforming divisions or take their companies private.

Dozens of buy-out funds and billions of dollars in capital have flooded into the market. "On paper, this should be boom times for private equity," says Iain Drayton, a mergers and acquisitions banker at Goldman Sachs.

The boom has yet to happen. The roughly $6bn worth of private equity deals completed in Japan last year amounted to just 5 per cent of the country's total M&A by value. In the US, a much bigger mergers market, the ratio was closer to one-third. Business has picked up a bit this year but competition for scarce assets remains fierce.

"There are so few deals that everyone feels pressure," says John Woodard, managing director at Vestar, a US buy-out firm.

Private equity has had a bumpy history in Japan. At the start of the decade, US distressed-asset specialists pulled off some of the most lucrative deals on record by buying defunct Japanese banks:, casting off their worst loans to taxpayers and re-listing them.

But pickings have been slim since the economy began to recover in 2002. Many Japanese still resent the industry for the "unfair" profits it made during the banking crisis: it has not helped that shares in the relisted banks have performed poorly since the funds sold them back to the public.

Japanese managers, meanwhile, have proved reluctant to sell non-core businesses or cut ties to public markets - moves that could alienate the suppliers and customers to whom many are beholden through cross-shareholdings.

When they do sell, the country's consensus-based decision-making can make it difficult to push change by parachuting in "star" managers. "The whole organisation needs to be moving," says Takeo Sumino, a banker at Nomura who works with private equity clients.

Many in the industry had hoped that the arrival of rabble-rousing hedge funds such as New York-based Steel Partners and Britain's TCI -which buy big stakes in companies and agitate for dividend increases and other changes - would drive more managers into the arms of private equity, as sponsors of the management buy-outs used to take groups private.

In the event, this "good cop, bad cop" scenario has not panned out. Buy-out specialists have instead been lumped together with the activists in the general category of troublesome "foreign funds". None of the 30-odd companies in which Steel Partners owns shares has so far opted to go private.

A popular theory is that Japan is simply waiting for the "golden deal" that will erase the stigma associated with MBOs and asset sales. Such a deal would need to be big enough to draw public attention and benign enough to satisfy the many stakeholders whose welfare counts in Japan from shareholders, managers and employees to nosey ex-bosses, suppliers and customers.

In the messy world of buyouts, such a perfect deal is difficult to imagine. But a few lower profile deals have been touted as next-best-things. Carlyle's 2006 buy-out of Toshiba's semiconductor wafer business has won praise and helped the US group land further deals. Many are waiting for Carlyle's eventual exit to see if the good feelings last.

Unfortunately, uglier deals tend to generate more headlines. The $2.4bn management buy-out of Skylark, a restaurant chain, in 2006 turned sour when its chief executive, Kiwamu

Yokokawa, clashed with the deal's private equity sponsors, Nomura Principal Finance and CVC Capital. Mr Yokokawa was finally ousted last month.

While they wait for the golden deal, many buy-out firms are looking for alternative ways to put their capital to work. Texas-based Lone Star is marketing mezzanine loans to Japanese property buyers who have been left short of funds by a downturn in the mortgage-backed securities market and tighter lending requirements at banks.

Other groups are looking to piggyback on an upturn in Japanese acquisitions of foreign companies by pitching "private equity-enhanced" deals, in which a buy-out firm pairs with a company on a foreign takeover, adding capital and global deal-making experience to the mix.

It is a template that has existed for years but buy-out firms believe it has fresh appeal now that more Japanese companies are seeking ways around slow growth and low returns at home. "It's an easier sell than doing an MBO," says Mr Woodard of Vestar, which partnered three such deals in the 1980s and 1990s before it set up an office in the country. "It's a good warm-up for traditional private equity."

The downside to such deals is complexity. Sumitomo Heavy Industries and TPG, the US buy out fund, have struggled to win over Axcelis Technologies, a US manufacturer of semiconductor machinery that they have targeted with a joint takeover bid.

Whether or not more "enhanced" partnerships follow, industry insiders say the deeper significance of such approaches is that buyout groups have come to realise that capital alone is not enough to win over sceptical managers.

"The only way to position yourself is as a solutions provider," says Mr Drayton of Goldman. "Clearly, if you are a financial sponsor and can also offer management expertise, that is a huge plus."

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