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Japan deal financing: Who will back the expected rise in large-cap buyouts?

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- Mega bank capacity is likely to become challenged; LBO loan funds are a potential solution
- Regional banks, offering attractive terms, are increasingly prominent in certain deals
- A secondary market is essential to developing more sources of deal financing

MUFG Bank, Japan's largest lender, broke new ground last year with the launch of a JPY 15.9bn (USD 100m) fund that participates in the financing of leveraged buyouts. The size is modest but the statement it makes is not: the mega banks that underwrite senior debt in most of Japan's buyouts want to broaden their syndication channels in anticipation of even more large-cap deal flow.

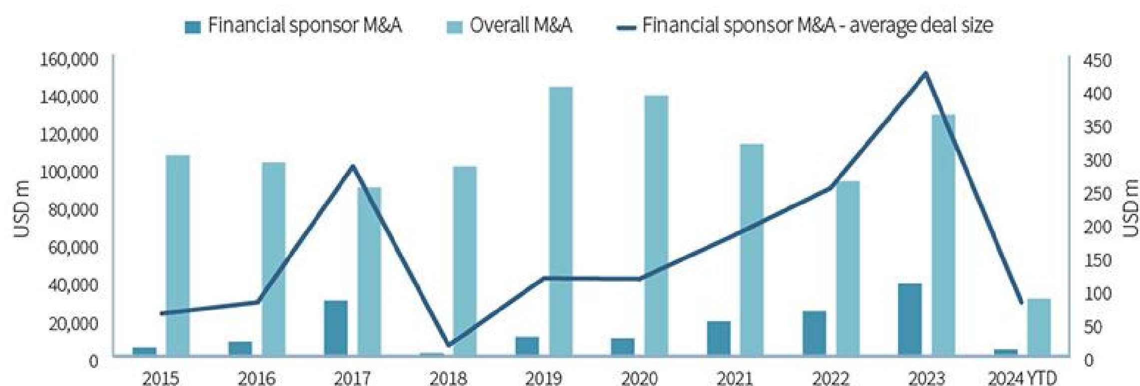
Local lenders enjoy such a low cost of capital – Japan hiked interest rates to 0%-0.1% in March – that foreign debt providers seldom get a look-in. Typically, the three mega banks take the lead on financing and syndicate to the likes of regional banks. MUFG's fund is aimed at financial institutions that can not join a syndicate directly; the fund does it for them and they get exposure as LPs.

MUFG's peers, **Sumitomo Mitsui Banking Corporation** and **Mizuho Bank**, are said to be thinking about establishing similar funds. They are not alone. NSSK, a local middle market private equity firm, is also interested in the idea of a senior debt vehicle as a means of mobilising the 40 regional banks that already participate as LPs in its private equity funds.

"The Ministry of Finance has issued guidance on creating alternative sources of supply for fixed income financing, so many people are exploring it, including us," said Jun Tsusaka, founding managing partner of **NSSK**, adding that these explorations are preliminary. "We have a skunkworks program looking at the possibility of raising a debt fund. This would be a first for a local PE firm."

No one is suggesting that financing a Japanese buyout is difficult right now. Advisors point to specific situations in which banks have been unwilling to lend as much as expected, resulting in private equity firms lowering target valuations for assets or bringing in strategic investors to supplement equity commitments. On a general level, though, debt is relatively cheap and readily available.

Uncertainty begins to creep in when considering longer-term outlooks. Nearly USD 84bn was pumped into Japan buyouts between 2021 and 2023, equal to the total for the preceding 13 years, according to AVCJ Research. During that period, there were 32 deals of USD 500m or more, including 10 of USD 2bn-plus. Prior to this, only about 50 deals had ever crossed the USD 500m threshold.



Source: Dealogic

Over the same three years, Dealogic tracked an increase in the financial sponsor share of overall M&A from 17% to 30%, while the average deal size more than doubled. It has prompted questions as to whether banks have the bandwidth to cope with a steady stream of larger deals.

“Right now, it’s not a limiting factor, but as we see more large-cap transactions, there could be balance sheet constraints,” said Takanobu Hara, a partner at **EQT Private Capital Asia**. “That’s why they are thinking more creatively about a secondary market for LBO loans. With most syndications, debt sits on the balance sheets of regional banks and insurance companies.”

There is a human resources constraint as well, for example when many bidders join an auction, added Atsushi Tatsuguchi, a managing director and head of the M&A advisory group at **Mitsubishi UFJ Morgan Stanley Securities**. He highlighted “a gap in terms of the pace of expansion of the private equity market and the pace of hiring and training by both LBO loan providers and the GP side."

Follow the money

The issue of concentration risk has been flagged by the Japanese government and addressed in a report earlier this year by the Japanese Bankers Association (JBA). The latter observed that the three mega banks were carrying nearly JPY 4trn in buyout loans as of March 2023, twice the 2019 level.

Yet financing a large transaction without these lenders is inconceivable. Offering a rough guideline, Ben Morris, a Tokyo-based partner in the finance group at **Ropes & Gray**, estimated that a single mega bank might cover up to USD 250m. For USD 500m, two would be required, and USD 1bn would need all three. Increased deal activity has already facilitated more syndication to other lenders.

“The LBO market has exploded – investors are looking at Japan that never looked at it before. Senior bank debt remains the preferred option, but the old story about banks taking and holding, that’s gone,” said Clara Shirota, a debt finance and restructuring partner at **White & Case**.

“Even the mega banks need to syndicate, and they do this to smaller banks or the regional banks. We are also seeing some of these smaller or regional banks trying to lead deals as well because they will get more fees.”

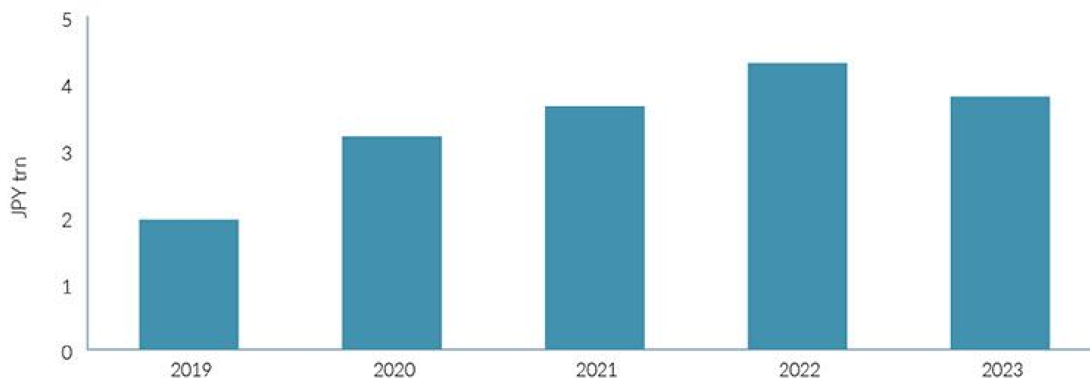
While it is generally agreed that regional banks are becoming more prominent, contrasting accounts emerge as to the nature of their involvement. These are largely influenced by the size and scope of transactions being discussed.

Several advisors observed that for deals involving global private equity firms or a relatively high degree of complexity, there is a preference for mega banks to take the lead on structuring. Elsewhere, some regional banks are making headway. As an

example, Tsusaka pointed to NSSK's acquisition of **Takagi**, a supplier of water purifiers, sprinklers, and faucets, which closed last year.

"It was the first deal of that size [USD 800m] fully financed by regional banks," he said. "Historically, if you required more than USD 200m in debt, you needed a mega bank. But for Takagi, there was USD 550m, entirely underwritten by regional banks. We will see more of that."

This view was echoed by Tatsuguchi of Mitsubishi UFJ Morgan Stanley, who expects regional banks to become "more sophisticated with regard to the loan issuance process and more willing to engage in different situations" as they accumulate experience.



A broader array of participants could also address what some advisors describe as "lowest common denominator terms" when working exclusively with the mega banks. It is not unusual for private equity firms to be quoted rates of 300 basis points over TIBOR (Tokyo Interbank Offered Rate) for senior debt, plus 2%-2.5% in upfront fees. However, pricing has trended upwards in recent years.

"Immediately before COVID was a high point for terms and pricing. Post-COVID, banks took the chance to move risk, increase pricing and tightening terms on the grounds that conditions weren't optimal and they faced challenges in syndication," said Morris of Ropes & Gray.

Financial covenants are much like those seen in Western markets – focusing on the relationship between debt and EBITDA – but Japan is known for its strictness on regular testing. Banks also tend to insist on excess cash sweeps, so that additional balance sheet cash is used to pay down debt, and emphasise the minimum net worth covenant, which places a floor on a company's book value.

Regional banks, on the other hand, are cheaper and more flexible. According to NSSK's Tsusaka, pricing can be up to 100 basis points less than the mega banks with lower upfront fees, while most of his firm's buyout loans do not feature quarterly testing for financial covenants. Moreover, it is possible to negotiate retaining a portion of excess cash flow and limited restrictions on refinancing.

Regional banks have become a significant LP base for many middle-market private equity firms because they want access to LBO financing. It is more lucrative than other forms of lending and strategically relevant – a way for lenders to deepen relationships with companies in their localities.

Mark Chiba, group chairman of **The Longreach Group**, which counts multiple regional banks as LPs, put forward three reasons for their participation: LBO lending, the ability to refer clients to Longreach that might be interested in private equity solutions, and investment returns.

Evolution is afoot in other areas of financing as well. Mezzanine is increasingly an option for deals that require a turn of leverage on top of the 6x EBITDA for senior debt. Gavin Raftery, a partner in the finance and projects group at **Baker McKenzie**, noted there are more mezzanine providers than a few years ago and greater interest in the likes of holdco structures that allow greater flexibility.

While domestic players like **MCo Corporation**, **MCP Partners**, **Fivestar Mezzanine**, and **Topaz Capital** have gained traction, international involvement is limited. One obstacle is an interest rate cap of 15% on facilities of JPY 1m and above.

“It is probably the number one feature preventing greater participation,” said Tsuyoshi Imai, a partner at Ropes & Gray who advises on buyouts. “If you are a US dollar-denominated fund, your cost of capital might be 10%, so that only leaves a small margin to work with. You must come up with other features – an equity kicker or stock option funding – to make it worthwhile.”

The way forward

A lack of investor diversity was cited in the JBA report as one reason for Japan’s LBO loan market failing to achieve an appropriate risk-return balance. Others included the interest rate environment, competitive dynamics among lenders, weak risk analysis, and insufficient checks and balances.

The report envisaged a setup more akin to the US, featuring term loan B (TLB) and high-yield bond facilities in addition to a bank-driven term loan A market, as well as participation by private credit funds, a broader swath of banks and financial institutions, and overseas investors.

The absence of a secondary market for LBO loans represents an obvious and gaping hole. JBA identified implementing an external rating system and ensuring better disclosure of pricing and terms as key priorities. Structural changes are also required to how debt can be transferred – notably around borrower consent – and the ease with which assets can be collateralised.

Last year, the *Financial Times* reported that Japanese government officials and regulators were consulting industry participants on how to jumpstart the high-yield bond market. However, few investors or advisors expect to see much movement on this in the near term.

“There has been talk about it for several years, but Japan has few high-yield issuers,” said Raftery of Baker McKenzie. “There has also been talk about following Australia and tapping the US TLB market more aggressively but given the amount of liquidity in Japan and the pricing levels domestic banks bring to the table, the gap to TLB or high yield is so wide there’s not much incentive to do it.”

NSSK’s Tsusaka described high yield as a long-term ambition, adding that Japan doesn’t even have a corporate bond market of any great depth. He advocates expanding the scope of senior debt provision from banks to private funds and evolving the market from there.

JBA also highlighted the role of LBO loan funds. “By entrusting a certain amount of management and risk analysis to private debt fund, LBOs will become accessible to investors who do not have sufficient resources or knowledge [to assess individual loans independently],” the report said.

This observation was accompanied by assorted caveats: the concept is still in its infancy; it is unclear whether target returns are high enough; quality of information disclosure remains an issue; familiarity with these products among

potential investors is limited; and there is no secondary market.

Industry consultations and investor education initiatives will continue, and there is an expectation that regulators will issue broad guidelines on areas such as analysis and risk management. It might be years before a workable ecosystem is in place, but all stakeholders appear to be aligned on the need to get there.

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