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Fund Focus: Taiyo Pacific Practices ‘Friendly’ Activism

Taiyo Pacific Partners founder Brian Heywood practices a brand of activism he calls ‘friendly’ and says it’s the only brand that works in the country on which he focuses—Japan.

Taiyo, with $2.5 billion in assets under management, is a privately held institutional asset manager specializing in small and mid-cap Asian equities. It was founded in early 2000 when Heywood, who had spent years in Asia—first Japan with JD Power and Associates, then Singapore with UK firm Belron International, then again Japan with Citibank—decided he wanted a change. He called a former JDPA colleague named John Hammond and said, “I’m tired of working at Citibank in Japan making other people rich, let’s figure out something interesting to do.”

The two were “brainstorming” when a mutual friend mentioned that the California Public Employees’ Retirement System had begun a program for managers with a governance-oriented activist style and suggested Taiyo try to convince CalPERS to include Japan in it.

“Everyone in the fund industry that I was talking to said, ‘You’re crazy to go after [CalPERS],’” Heywood told FINalternatives in a recent phone interview. “

By the time they were making their case to the California pension fund, Heywood and Hammond had been joined by a partner with financial management and stock-picking expertise:

“I have a fairly wide network within Japan and put the word out that I wanted to find someone that had small, mid-cap experience and had run a significant portfolio before and about four or five friends said, ‘Oh, you need to talk to Michael King,’” said Heywood.

King, who was running a $1 billion Japanese portfolio for Liberty Wanger Asset Management in Chicago, agreed to join Heywood and Hammond and they began what Heywood terms “the long slog to: 1) get CalPERS to consider Japan and then 2) to get them to consider us.”

In 2003, the “slog” paid off: the $289 billion pension became Taiyo’s first investor, entrusting it with $200 million and a mandate to “employ corporate governance activism to turn around underperforming publicly traded companies in Japan.”

Don’t Say ‘Activist’

Heywood’s approach to investing in Japan is rooted in his years in the country and understanding of the culture.

Brian Heywood

“Activist,” he said, “was kind of a dirty word” when Taiyo launched, “so no one would dare use it.” More to the point, activism, as practiced in the U.S., simply didn’t work in a Japanese context:

“[W]hen you look at activists, in the U.S. there’s two tools that they primarily use,” said Heywood. “One is the greed factor. You go to the management and say, ‘Hey, if you do this, your company will do this and then you’ll make more money because you’ve got stock options and you’ve got stock,’ and you put dollar signs in their eyes.

“On the other hand, there’s the fear, where you say, ‘Listen to us or if you don’t make change we’re going to rattle the cage, we’re going to go to the press, we’re going to fight you on the proxy...those kind

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of tactics."

"[N]either of these work in Japan. Japan is like a great big white blood cell...It's susceptible to outside pressure but outside force it doesn't like. Someone comes in and starts poking it, the whole thing is a giant anti-body, so if you're hostile it reacts against you."

"And on the other hand, this is a country that has a very low differential between the CEO and the average employee pay. Even the CEOs don't live in big fancy houses and if you go to them and say, 'Hey, you're going to get rich,' then they do this, 'Oh, that would be very shameful for me to do anything because I wanted to get rich.'"

Creating Value

Heywood's experience at JDPA, however, suggested "there was a different currency that might actually work" to motivate Japanese management—data analysis.

"[W]e would go in and we would take analysis and...if it was something [management] hadn't seen before and it was somewhat intuitive, you would start to get reactions."

Analysis helps them press their case in the three broad areas on which Taiyo focuses when working to "create value" in a target company.

The first, reputation, involves investor relations and "communicating with the market—and we include in that accurate forecast and accurate disclosure and really being forthright and forthcoming to the market."

Japan, he said, is an under-covered market—far fewer analysts per company than in the U.S., particularly when you get into the mid-, small- and micro-caps. As a result, simply encouraging management to "tell their story" is an easy way to increase value.

The second way is financial: "How does your balance sheet look? How do you manage your cash? How do you manage your payables? Cost of capital decisions...We now spend quite a lot of time in that area."

Taiyo actually runs executive training courses to help managers better understand their own financials. One of their trainees was a man poised to take over a company from his father, the founder. In the course of the training, it became clear the firm was paying companies in five to 10 days but had receivables of 90-120 days, an "incredible backwards cashflow." The son took this information to the father and the father told the son to convince the board, which he did. The move, said Heywood, not only solved the cashflow issue but served notice the son was ready to take over the company. A few years later when the founder died and the son stepped up it was "not a panic moment."

Kurofune

The third way in which a 'friendly activist' can influence a Japanese company, said Heywood, "takes a lot longer and you have to be careful that you're not stepping on people's toes—that's on the business value."

"[T]hat's something that, after we've been in a company for years, and we've been to their factories, and we've been to their overseas operations and we're perhaps on the third president...then we have a different conversation with them."

He cited Taiyo's experience with Topcon, "a really brilliant interesting company" that now has two divisions—one focused on GPS machine control, the other on 3-D optical scanners for the eye. But it used to have two additional divisions that were, in Heywood's characterization, "stinkers."

"They were interesting products that didn't really make money—one of them was really terrible and one of them was just bad...The conversation that we had every year was 'So tell us how you're going to get these two divisions either to profitability or do something with them?'"

About five years ago, said Heywood, the then-Topcon president decided to merge the underperforming divisions to cut their overhead. "We said great, he did that and it was better but it still wasn't able to get to where it needed."

Then came the financial crisis and the senior managing director who would become Topcon's third president approached Taiyo asking for analysis of their competitors—particularly their cost structures.

"I need you to be my kurofune," he told them—a reference to the 'black ships' of U.S. Commodore Matthew Perry that arrived in Uraga Harbor in 1853 and are seen as a symbol of the end of Japanese isolation.

"The western view of that is that it was the superior firepower that was demonstrated and caused panic or fear" that caused Japan to open to the world, said Heywood "but the truth is more

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complicated... There were a bunch of modernizing technocrats who felt like Japan was falling behind and they needed some catalyst to be able to do what needed to be done and then Commodore Perry came in and...they took off...and Japan modernized very rapidly."

"We don't like to call ourselves the kurofune because it has a slight outward pressure connotation but he was basically saying to us, 'Give me the data so I can blame you so I can make the changes I need to make.' We said, 'Okay, we're okay with that. [laughs]'

Beyond Japan

While Heywood sees no shortage of opportunities in Japan, the firm is also beginning to take the lessons learned there and apply them elsewhere in Asia.

"India and Japan are extremely different in many ways but when it comes down to basics there's a lot of similarities within a business context," said Heywood.

The tutorials they've created for training Japanese executives "we can use in India or any country. They're not about Japan, they're about the fundamentals of running a business and especially from a shareholders point of view."

The biggest difference between Japan and India, he said, is that where Japan "lets the idea marinate for a year maybe—or two...in India they are fast, they move much more quickly. Everyone says 'India, it's so slow,' and yes, the bureaucracy is that way but the managers of the companies, the owners of the companies, they're really active and ready to move on ideas, so the engagement is a little bit faster there."

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