Softly, softly approach has put

Where others have failed, Taiyo made its mark in the Japanese alternatives space through friendly activism and a deep understanding of the culture


Brian Heywood


John Hammond


Michael King

In the early 2000s, Japan seemed to be a prime target for activist investors, but as the decade draws to a close, it is clear that the aggressive style of activism that was successful elsewhere was doomed to fail in Japan. Yoshiaki Murakami's M&A Consulting, TCI, Tower and Sparx, to name but a few, have either retreated entirely or shifted their strategy away from activism. It is against this backdrop that Taiyo Pacific Partners launched its first friendly activist Taiyo Fund in 2003, and since then has launched two more and has gone from strength to strength with total assets under management of over $1.8 billion.

The three funds are all value-oriented, based on concentrated portfolios. The Taiyo Fund holds 12 to 18 positions in Japanese small-caps; the Pearl Fund, launched in 2007, invests further down the market capitalisation chain in 15 to 25 publicly listed micro-caps and private companies; and the Cypress Fund, launched in 2008, invests in up to a dozen mid-cap companies and private enterprises. Private deals account for up to 40% and 35% of the Pearl and Cypress funds' AUM, respectively, although the current level is much lower.

These are not typical hedge funds, but then Taiyo does not have particularly conventional foundations – it was not started by star prop traders or successful long-only managers wanting a slice of hedge fund action. Rather, the idea of running a fund emerged from the desire to harness the willingness of certain parts of Japan's corporate management elite to listen to the advice of outsiders, and their willingness to change.

"My background is in market research and consulting in Japan," says Taiyo co-founder Brian Heywood. "I knew that if you went to senior management with hard data and good analysis then you would get their full attention: they really wanted to know and learn. Even if you were a foreigner, or younger than them, you could go in and have a legitimate conversation with management. The model of a fund was appealing because management didn't need to pay for consulting – you could have a friendly conversation as shareholders instead."

Having lived in Japan for 13 years, followed by a stint in Singapore, Heywood returned to the US, and teamed up with ex-JD Power & Associates man John Hammond. When the idea of developing a fund that would be of interest to the California Public Employees' Retirement System (CalPERS) was mooted, the duo clearly needed to bring in someone with experience of running money in Japan, and Michael King came on board as co-founder in 2001.

Although CalPERS was investing in corporate governance funds in various countries, it took Taiyo three years to convince CalPERS to do the same in Japan, and entrust Taiyo with the job. In the interim, Taiyo ran a paper portfolio, and fielded criticism from other players who said that the only way activist funds could work was to be hostile.

Since then, Taiyo has grown to accommodate a 20-strong investment team, comprising foreigners who, like Heywood and King, are fluent Japanese speakers, and overseas-educated Japanese investment professionals. The team is somewhat larger than other firms with similar AUM, but it is necessary to keep in close contact with the companies Taiyo invests in – they typically meet with companies at various levels between 15 and 25 times a year. "We try to strike a balance between visiting them a lot and being so overbearing that you annoy the management," says Heywood.

By the time companies that are amenable to Taiyo's friendly activism are identified, a lot of research on them has already been done, and Taiyo is only interested in investing in companies that welcome its insight. Once Taiyo becomes a shareholder, the activism typically begins in areas that are as unthreatening as possible, such as investor relations, disclosures and handling an analysts' meeting.

A company that only has a couple of analysts following it once or twice a year may not pay much attention to what would interest outside observers. When the Taiyo team identify what they believe to be a hidden gem, part of the process of unlocking that value is to help the company tell its story. The harder jobs – getting rid of a division, for example, pulling out of a line of business or undergoing a merger – are further down the track.

"You have to have a foundation of trust before the management will have a bigger conversation with you," says Heywood. "We've been investors in some of these companies for five years or more. We've done a lot along the

CV: Brian Heywood (CEO)

Extensive experience working with Japanese boards and management teams.
Member of Investment Committee.
Speaks and writes Japanese fluently.
Education: Graduated from Harvard University in 1991 with an honours degree in Asian Studies

CV: John Hammond (COO)

Helped corporations maximise value through effective use of information, research and strategic analysis.
Member of Investment Committee.
Education: PhD in Econometrics and Economic Policy from The George Washington University in 1977.

CV: Michael King (CIO)

Responsible for screening, analysis, investment selection and portfolio management.
Member of Investment Committee.
Speaks and writes Japanese fluently.
Education: MBA from University of Chicago in 1997.

Taiyo in the activism driving seat

way and we didn't do it by kicking in the door."

The first five years of Taiyo's dealings with Japanese companies were characterised by the heavy lifting of portfolio creation, trust-building with companies and working with management on investor relations, forecast accuracy and capital management. Now the emphasis has shifted to reallocation and active monitoring of the portfolio, and working with companies to create value. Taiyo finds management to be ready and willing to talk about business development, mergers and acquisitions, and co-investment with Taiyo as a partner rather than a shareholder.

"In the early days, there was a lot more handholding and explaining, but as we've begun to develop our relationships, word of mouth has begun to spread," says Heywood.

While the Japan side of the equation has come together nicely, the other side — selling the Japan story to investors — is as tough as ever. Having taken a chance on Japan before, many investors are wary. "A great story that's hard to sell has been our fate all along," laments Heywood.

With China grabbing investor attention, Japan is often seen as a value trap. Taiyo counters this argument by offering access to those companies that are making significant changes in order to ensure their place in the new world order.

For example, while electronics manufacture has shifted to Korea and China, Japan has maintained its position as a supplier of key high-tech components. Japan is also a clear leader in medical technology, and its rapidly ageing population is spurring a quiet revolution in the use of technology and robotics to replace manpower and boost productivity.

While Japan is ahead of China in terms of its ageing population, China's demographic shift is right around the corner, and Japanese firms are poised to capitalise on China's need for innovation in healthcare, innovative nursing and assisted living care and high-end diagnostic and other medical technology. Testing services are another attractive area. Without a local testing agency to secure regulatory approval, the Japanese market for pharmaceuticals and medical devices is closed to foreigners, at a time when demand has never been higher.

Within the management of Japanese firms, there is a shift underway, allowing fresh ideas to blossom, says Heywood. The older generation is giving way to the new, and although some firms are suffering the fate of an incompetent offspring taking the helm, the management of the firms that Taiyo invests in have a very different mindset, not least because foreign ownership now accounts for a quarter to a third of the market, compared to just 15% in 2003, and accounts for more than half of total trading volume, he says.

"You can't ignore foreign investors now, and managers are now looking at things in a different way, also because the cost of capital has changed. Traditionally this was driven by firms' relationship with the banks but, as the banks started to consolidate, their influence on listed companies declined and management no longer has the same access to credit and advice.

"Another internal asset is the generation of Japanese who went overseas to do MBAs in the 1980s and 1990s. They were sent back to the same jobs and couldn't implement what they learned, but now they're in senior management positions and can start to make decisions. For example, they are rising to the challenge, not just of managing overseas staff but also incorporating overseas managers into senior management."

In 2007, Taiyo started to showcase the talent they'd found by bringing them face to face with investors at conferences. It soon became apparent that in addition to meeting investors, company presidents relished the opportunity to meet each other. Since last year this has been done more formally through the Taiyo Club, which hosts two events a year to bring company presidents together to network and learn from each other. This month's meeting, on the theme of leadership, was driven by the presidents themselves — out of 43 eligible to attend, 30 said yes.

"I don't know any foreign fund in Japan that can get that kind of response from the companies they invest in," says Heywood. "As well as giving them a forum to discuss ideas, these events give us an even deeper understanding of their businesses. We're not buying all of Japan, we're buying good companies with good management that can do even better with some investor support."

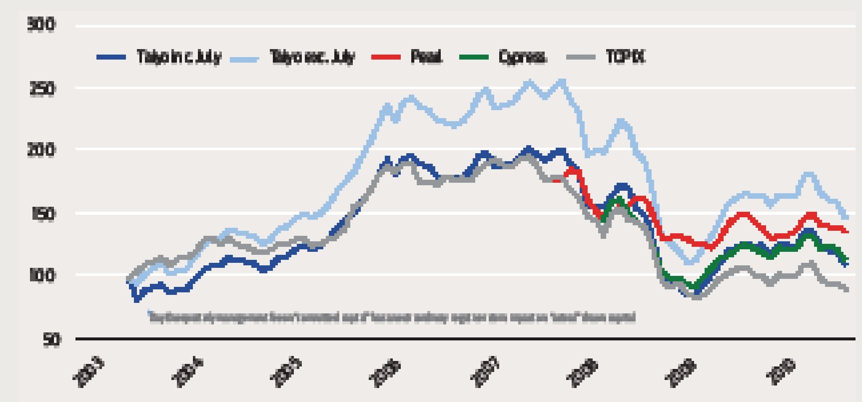
All these positive developments are underway beneath the surface, giving the Taiyo team plenty to be optimistic about, but Heywood concedes that Japan remains a source of pessimism, too, and that is what captures the attention of most investors. Just as money poured into Japan in 2006 then washed back out again, Heywood fears that most investors will stay on the sidelines then rush in with the crowd, rather than getting in now.

It is difficult for investors to break out of their mindset about Japan as a low-growth country that will continue to be eclipsed by the rest of Asia, but they should look beyond the surface, says Heywood. For example, India is becoming more interesting to Japanese firms looking to expand. "Until now the Japanese have grown into China, and India is very foreign to them, but we are seeing a lot more movement into India; it's an interesting market in relation to Japan."

For Taiyo, the next step is to expand its investments in the private equity space. Its friendly activist stance helps Taiyo get access to people, information and trust, says Heywood. "We could be involved in a lot more deals than we are now, but we're taking a relaxed approach at the moment."

Beyond that, other markets that are difficult for Western investors to appreciate or understand are interesting to Taiyo. Just as Japan is seen as too difficult and inaccessible, not least because of the language barrier, there are plenty of other markets that present the same difficulties. "There are markets that are just too foreign for many Western investors," says Heywood. "Long-term, our vision is to be an expert in those markets, just as we are in Japan."

Performance: indexed monthly performance to August 2010



Source: Taiyo Pacific Partners

Taiyo Fund: AT A GLANCE

Inception date: June 2003
Managers: Taiyo Pacific Partners, LP
Office: Monterey, USA
Strategy: Japanese Equity
Assets in strategy: $1,009 million
Administrator: Internal
Prime broker: UBS
Minimum Investment: ¥10,000,000
Open to investment: Yes