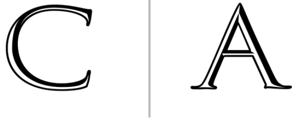


C A M B R I D G E   A S S O C I A T E S   L L C

JAPANESE DISTRESSED INVESTING

2002

Steven Nelson
Bryan Miller
Josie Lewis

Copyright © 2002 by Cambridge Associates LLC. All rights reserved.

This report may not be displayed, reproduced, distributed, transmitted or used to create derivative works in any form, in whole or in portion, by any means, without written permission from Cambridge Associates LLC. Copying of this publication is a violation of federal copyright laws (17 U.S.C. 101 et seq.). Violators of this copyright may be subject to liability for substantial monetary damages. The information and material published in this report are confidential and non-transferable. This means that authorized members may not disclose any information or material derived from this report to third parties, or use information or material from this report, without the prior written authorization of Cambridge Associates LLC. An authorized member may disclose information or material from this report to its staff, trustees, or Investment Committee with the understanding that these individuals will treat it confidentially. Additionally, information from this report may be disclosed if disclosure is required by law or court order, but members are required to provide notice to Cambridge Associates LLC reasonably in advance of such disclosure. This report is provided for informational purposes only. It is not intended to constitute an offer of securities of any of the issuers that are described in the report. This report is provided only to persons that Cambridge Associates LLC believes to be "Accredited Investors" as that term is defined in Regulation D under the Securities Act of 1933. The recipient of this report may not provide it to any other person without the consent of Cambridge Associates LLC. Investors should completely review all Fund offering materials before considering an investment. No part of this report is intended as a recommendation of any firm or any security. Factual information contained herein about investment firms and their returns which has not been independently verified has generally been collected from the firms themselves through the mail. We can neither assure nor accept responsibility for accuracy, but substantial legal liability may apply to misrepresentations of results delivered through the mail. The CA Manager Medians are derived from Cambridge Associates LLC's proprietary database covering investment managers. Cambridge Associates LLC does not necessarily endorse or recommend the managers in this universe. Performance results are generally gross of investment management fees and do not include returns for discontinued managers.

CONTENTS

Abstract 3

Summary 6

Exhibits

1 Price Performance of the Nikkei 225 Index and the Japanese Land Price Index 25
2 Propensity of Japanese Households to Consume 26
3 Business Failures in Japan 27
4 Total Nonperforming and Restructured Loans Held by all Japanese Banks 28

ABSTRACT

1. For institutions with a well-developed alternative assets program, the burgeoning secondary market for distressed assets in Japan presents a promising opportunity, while the increasingly robust track records of established investment managers show that such investments can be effectively implemented. In general, distressed funds focused on Japan are targeting internal rates of return in excess of 20% and although it is premature to judge the success of the 1998 and 1999 vintage year vehicles, many investment managers seem likely to exceed these expectations. With the lion's share of third-party capital raised from 1998 to 2000 having now been committed, no less than seven institutional-quality investment vehicles are currently accepting new capital. The investment strategy and fund size vary dramatically from manager to manager, but all have developed a meaningful presence and demonstrable track record in Japan.

2. In addition to the overriding economic risk of deep, prolonged economic contraction, massive layoffs, and major bank collapses, which would effectively slam shut all exits, investors in distressed Japanese assets incur six primary risks. The most significant is that the Resolution and Collection Corporation (RCC), which was established to facilitate the disposition of nonperforming loans, becomes much more active in the marketplace, effectively nationalizing the process of cleaning up the mess. However, because this would require a substantial infusion of new capital, which would infuriate Japanese taxpayers, we doubt it would be practicable for the RCC to shut out third-party distressed fund managers. A second risk is the stalling out of further reform initiatives, diminishing the banks' incentives to dispose of nonperforming assets, since this would reduce supply. A third risk is increased competition from new investors attracted by the handsome profits existing funds seem able to earn. However, because new investors incur hefty upfront costs and face some daunting barriers to entry, we suspect the ten or so large-scale managers currently active in this market will remain the dominant players. The remaining risks are the possibility that the Japanese could, in desperation, try to inflate and depreciate their way out of the bad debt morass; the risk that government authorities could decide to impose regulatory restraints (or simply moral suasion) to impede the sale of nonperforming loans to third parties; and, finally, the manager-specific risk of a political misstep that results in a given fund being for all intents and purposes barred from distressed security sales.

3. With an estimated US$1.9 trillion in subperforming or nonperforming loans on the books of its financial institutions, Japan is far and away the single largest market for distressed assets the world has ever seen, and even the most shrewd and vigorously implemented reform measures would take several years to fully cleanse the nation's beleaguered financial system. To put the data in perspective: the financial impact of the U.S. savings and loan crisis of the late 1980s never exceeded 8% of GDP,

whereas in Japan, existing bad loans amount to nearly half its forecast 2002 GDP. All but two of the country's 14 major banks posted net losses for the first six months of the fiscal year, together setting aside nearly US$23 billion in additional loan loss reserves. In the month of October alone, more than 1,900 businesses failed—the third highest number of corporate bankruptcies in a single month in post-war Japan. Demand for Japanese exports continues to weaken as the global economic slowdown persists and deflationary pressures at home show no signs of abating. The already gloomy outlook for the world's second largest economy grows worse by the day.

4. According to a recent Ernst & Young report, since distressed assets first began trading hands in Japan in 1997, investors have spent approximately US$30 billion buying loans, business entities, and real estate properties with a face value of approximately US$300 billion. The vast majority of these assets have been acquired by third-party opportunity funds raised by the likes of Cerberus, Goldman Sachs, Lone Star, and Moore Strategic Value Partners. While the principal method of addressing the secondary market in Japan continues to be the bulk purchase of nonperforming loans from banks and nonbank finance companies, foreign investment managers have recently participated in a number of sizeable corporate liquidations and reorganizations.

5. In contrast to many other countries in Asia (except Korea), Japan has a well-defined and relatively clean insolvency regime that provides creditors with substantial protection—as long as one knows how to operate in Japan without stumbling into the minefield of potential cultural gaffes. The principal managers of distressed portfolios have all established their bona fides, and in doing so have cleared a path for the acquisition, management, and profitable exit of distressed assets. Looking forward, we expect they will continue to play a major role in the on-again, off-again progress of structural reform in Japan's financial sector, and in the process generate attractive returns for their investors.

SUMMARY

Introduction

This paper assesses the investment opportunities resulting from a debilitating combination of successive recessions in Japan following the collapse of an asset price bubble and the reluctance of government officials to enact and enforce substantive financial sector reforms. (This study is intended as a supplement to two recent research reports available on demand: *U.S. Distressed Company Investing (March 2001)* and *Global Distressed Investing: Focus on Non-Marketable Strategies and Investment Vehicles (June 2001)*.) The mountain of distressed debt amassed by Japanese financial institutions over the course of the 1990s defies comparison. Official estimates place the sum of all loans to "problem borrowers" by deposit-taking institutions at ¥151 trillion[1] (approximately US$1.3 trillion), but a recent forecast by Goldman Sachs shows the true figure could be as high as ¥237 trillion[2] (US$1.9 trillion).[3] Although their calculations may vary, most analysts are more apt to agree with Goldman Sachs and argue that the current situation is far worse than government figures might lead one to believe.

In the end, this debate is of little consequence: the key point is that an already dire situation is getting worse. Short-term prospects for the world's second largest economy remain bleak as the global slowdown has weakened demand for Japanese exports. Deflationary pressures continue to mount, causing domestic consumers to grip their purse strings ever more tightly. Businesses of every stripe are suffering: in the six months leading up to September 2001, nearly 10,000 Japanese companies filed for bankruptcy, with combined liabilities of over ¥7 trillion[4] (US$58 billion), and analysts estimate the total may reach 20,000 by fiscal year-end March 2002. Not only are small and medium-size enterprises (SMEs) failing at record pace, even companies with household names are folding under the pressure of overwhelming debt burdens. Yet as the bell tolls for literally thousands of firms, Japan's leaders have repeatedly shown themselves unwilling to take the necessary, albeit unpleasant, first steps in what will be a long road to recovery.

[1] This figure was published by the Japanese Democratic Party in April 2001 and subsequently confirmed by the Financial Services Agency (FSA), the regulatory body charged with overseeing the nation's banks. In August, the FSA reported its most recent quarterly estimate of the status of nonperforming loans held by deposit-taking institutions (major banks, regional banks, and credit cooperatives). As of March 31, 2001, the Agency declared that ¥43 trillion, roughly 7% of all outstanding loans made by these institutions, were either nonperforming or had undergone some form of restructuring. The difference between this number and the ¥151 trillion statistic is that the Democratic Party's figure includes "at risk" or "need attention" credits.

[2] To put the Goldman Sachs' estimate in perspective, this figure is nearly half of Japan's 2002 forecast GDP of US$4 trillion.

[3] Unless noted otherwise, the exchange rate used throughout this report is US$1.00 = ¥120.00.

[4] Failures in the construction sector alone totaled 3,029 in the April 2001 to September 2001 period. October 2001 bankruptcy figures show the number of business failures surging 11.7% from a year earlier to 1,911. This total represents the third highest number of corporate bankruptcies in a single month in postwar Japan.

Across Japan, the loan portfolios of financial institutions deteriorate daily. After a decade of neglect, the problem is so severe that a resurgence of the domestic economy will barely serve to stem the tide of *new* nonperforming loans (NPLs). An essential remedy for Japan's beleaguered financial sector is a comprehensive restructuring program that forces the timely disposal of distressed assets, reinforced by effective monetary and fiscal measures to revitalize the economy. Foreign investors with the ability to price, purchase, and service those assets can, and we expect will, play a significant role in this process. To this end, a select group of institutional-quality managers has established a meaningful presence in Japan over the past several years and is already actively involved in the resolution exercise.

Following a brief analysis of how Japanese banks arrived in such dire straits, we address the following questions:

- Is this a good time to initiate or augment an allocation to the distressed asset market in Japan?
- Which of the various strategies being pursued is likely to offer investors the best risk-reward trade-off?
- What risks are inherent in this investment and are they diversifiable?
- Who are the dominant players and what factors are key to their success in the future?

Crisis Preconditions

Creating a Mountain of Bad Debt

Although the sources of the crisis merit a more robust discussion than this report provides,[5] prospective investors should have at least a general understanding of the extraordinary circumstances that spawned more than a trillion dollars of subperforming debt. Two major points in particular are worth emphasizing: first, the current predicament was not caused by a single event (i.e., the collapse of the Japanese asset price bubble in 1990), although rampant speculation in the domestic real estate market throughout the 1980s certainly exacerbated the situation, the ultimate failure was many years in the making. Second, the problem is structural rather than behavioral in nature.

Following the postwar occupation, Japan enjoyed almost 25 years of strong, uninterrupted growth by pursuing a mercantilist economic policy that the United States and European nations tolerated in the interests of maintaining a solid bulwark against communism in Asia. During this time, a heavily regulated

[5] Among numerous examples of more detailed analysis, see Takeo Hoshi and Anil Kashyap, "The Japanese Banking Crisis: Where Did It Come From and How Will It End?" NBER Macroeconomics Annual 1999, National Bureau of Economic Research, 1999, pp. 129-201

financial system drove Japanese businesses seeking external financing into the arms of the nation's banks.[6] Since interest rates were regulated, the banks' pursuit of market share was perfectly aligned with profit maximization,[7] and since savers were afforded few options, banks' coffers swelled with deposits. For over two decades, the traditional deposit-taking and loan-making business boomed, but as the world experienced its first oil shock in the early 1970s, the system began to unravel.

In 1973, oil prices quadrupled overnight and the global economy contracted. In an effort to boost the domestic economy, the Japanese government increased public works spending dramatically, financing the ensuing budget deficits with a flood of new Japanese Government Bonds (JGBs). Whereas prior debt had been sold almost exclusively to local financial institutions, this mass of low-yielding paper was more than the banks could absorb. As a result, the Ministry of Finance had no choice but to launch a secondary JGB market in 1977. With the price of these securities now dictated by the market, interest rate controls slowly crumbled. It was the first step in what proved to be a dreadfully mismanaged deregulation scheme.

Interest rates were now subject to negotiation and the ensuing price competition among banks began to shrink already slim profit margins. At the same time, bond markets, both at home and abroad, gradually loosened issuing requirements and developed a newfound international perspective. Foreign bond issuance became especially appealing to Japanese firms. Not only could they bypass the domestic regulatory authorities, but perhaps more importantly, foreign markets did not require collateral. The result was massive disintermediation: from 1984 to 1991, the fixed income market's share of Japanese corporate financings rose from 3.6% to 24.5%[8] as a substantial number of the banks' most important borrowers broke off their longstanding relationships and migrated to cheaper financing alternatives.

Unlike corporate borrowers, however, Japanese savers were not afforded access to new investment products like money market funds or corporate bonds and therefore continued pouring money into bank savings accounts. Bloated with deposits, barred by the regulators from opening new lines of business, and deserted by their traditional customers, banks opted to expand the higher-yielding segments of their loan portfolios. Most notably, a wave of credit was extended to the real estate industry and to SMEs.

---

[6] The standards set by the Bond Issuance Committee were sufficiently stringent to preclude even the largest and most profitable businesses from tapping the bond market. Regulated commission schedules in the equity markets made initial public offerings exceedingly expensive.

[7] Banks' lending spreads were more or less fixed and the majority of their income was derived from interest earnings. This meant that the number of outstanding loans largely determined the size of their net income. Even as recently as the late 1990s, market share rather than profitability remained the highest priority of senior banking officials.

[8] Genay, Hesna, "The Ownership Structure of Japanese Financial Institutions," 1993, Working Paper Series, Federal Reserve Bank of Chicago.

Cheap and easy financing contributed to soaring property values and additional industrial capacity, which increased the market value of the collateral backing much of this new debt, which in turn enabled borrowers to borrow more, some of which went into additional property purchases, some into more new plant and equipment, and some into the rapidly rising stock market—in short, a classic recipe for an asset bubble.

The Lost Decade

Following his appointment as Governor of the Bank of Japan (BOJ) in 1989, Yasushi Mieno recognized that the taller this house of cards became, the worse its inevitable collapse would be. Consequently, he pricked the bubble by means of consecutive increases in the BOJ's discount rate, with the result that the Nikkei 225, which had risen to a peak of 38,915 at the end of 1989, collapsed to just over 14,000 by the summer of 1992. Property values abruptly followed suit, unraveling 50% and more. Loans to the real estate sector deteriorated at a breathtaking pace and the quality of all real estate-backed securities plummeted. Adding fuel to the fire, the global economy slowed as the United States slipped into recession, further impairing many debtors' ability to meet their obligations. Credit rating agencies responded by downgrading Japanese banks and the global community sat up and took notice.

During the first five years after the equity market meltdown, government officials did virtually nothing to curtail the decaying conditions of the banking system. Lawmakers felt any high-level acknowledgement of the problem would incite panic among the general population and trigger a run on deposits. Furthermore, senior bankers, ever mindful to preserve harmony, were disinclined to recommend drastic measures and determined the most logical plan of action was to simply wait out the downturn, regarding the subperforming loans as call options on the inevitable recovery. In 1995, this scenario looked increasingly plausible, as many excesses of the bubble had been wrung out of the system and the economy was showing signs of sustained improvement. Eager to start paying down its burgeoning debt, however, the government slapped an ill-advised tax on consumers, nipping the nascent recovery in the bud. Since then bad has steadily become worse, despite desperate efforts at fiscal stimulus and an aggressive monetary policy that has pushed down nominal interest rates close to zero. Although these measures may have arrested the economy's decline in recent years, they have failed to spark recovery, with the result that Japan now finds itself in a classic liquidity trap in which monetary policy proves ineffectual at stimulating demand because deflation causes real interest rates to rise even when nominal rates are close to zero.

Swept under many thick rugs of accounting obfuscation,[9] the nonperforming portion of bank loan portfolios mushroomed. An unwavering commitment to dividend payments eroded capital bases, leaving loan loss provisions grossly inadequate. The 1997 Asian financial crisis and subsequent failure

[9] For example, without consolidated accounting, banks could conveniently hide NPLs in subsidiaries, where they were subsidized.

of several large Japanese financial institutions at long last compelled authorities to own up to the gravity of the problem. Less than 12 months later, lawmakers and private citizens alike agreed that an injection of public funds would be necessary to save the banking system. When given the opportunity in March 1998, all major banks applied to receive a portion of the ¥1.8 trillion being offered by the government. This largesse having been quickly exhausted, the government embarked upon a second round of capital infusions in March 1999. These totaled ¥7.5 trillion and came with a far more stringent application process, including the submission of a restructuring plan and agreement to quarterly inspections by the FSA.

Assessing the Investment Opportunities

For investors, the potential opportunity in Japan's economic quagmire is the $1.3 trillion to $1.9 trillion in distressed Japanese debt—a mountain of nonperforming assets far exceeding that in the rest of the world. By comparison, the supply of distressed debt in the United States is estimated at $400 billion[10] with approximately $50 billion "available" capital. Even though other countries in Asia, particularly Korea, Thailand, Indonesia, and China, are carrying dangerously high levels of NPLs in the aftermath of the 1997 Asian financial crisis, the magnitude of their distressed debt is far less than Japan's, estimated at $100 billion, $70 billion, $40 billion, and $400 billion, respectively. Moreover, in contrast to many other countries in Asia (except Korea), Japan has a well-defined and relatively clean insolvency regime that protects creditors. The key questions, then, are whether and how profitably foreign investors might be able to exploit Japan's pressing need to dispose of these distressed assets.

Supply of Distressed Assets

A major challenge in evaluating the opportunity in Japan is developing a reasonable estimate of the potential size of the secondary market. While the current balance of NPLs in the financial system is already huge and an increasing number of "need attention" credits will likely migrate to nonperforming categories over time,[11] it is as yet unclear how much will be made available to third-party investors.

---

[10] Edward Altman, NYU Stern School of Business. As of 12/31/00, market value of distressed and defaulted public and private debt.

[11] Currently, even a number of severely indebted businesses in the weakest sectors of the economy manage to service their loans given the exceedingly low nominal interest rates in Japan. For several reasons, banks have shown a preference for rolling over the debt rather than admitting the borrower has no realistic chance of repaying the principal and labeling it nonperforming. However, migration data published by Japanese banks in May 2001 for the first time shows a high pace of deterioration. During the six months leading up to March 2001, ¥3.4 trillion in loans at major banks previously classified as "need attention" fell into non-accrual status.

Banks

When distressed assets first began changing hands in 1997, the supply came almost exclusively from major long-term credit banks. Driven by government injections of capital, banks disposed of ¥13.6 trillion in NPLs in 1999, the most for any year to date. Since that time, the pace of disposals by banks—major banks in particular—has slowed considerably. There are a number of reasons for this, but the bottom line is that Japanese banks do not have the necessary capital to pursue a large-scale disposal program without risking insolvency. The nearly ¥10 trillion in public funds pumped into the banking system in 1998 and 1999 is gone. Cross-shareholdings in listed firms, which account for a significant portion of bank capital, rest at 16-year lows. Whereas banks had used latent profits in their equity portfolios to help defray loan-loss charges in the past, at current price levels, gains on these holdings have effectively vanished.[12] Further, under new accounting regulations that went into effect in September 2001, banks must mark these holdings to market and deduct unrealized losses from their capital base. Profits remain weak as most banks have yet to move into higher-margin business lines. And finally, if those that accepted public funds in the form of preferred shares fail to pay their dividends in full and on time, they risk nationalization.

Nonbank Financial Institutions

A variety of nonbank finance companies, credit cooperatives, and insurers have stepped up their bad asset disposal programs. Of the three, the deeply troubled life insurance sector has provided the single greatest source of product for foreign investors over the past 18 months. The bankruptcy of Tokyo Mutual in March 2001 brought to seven the total number of failures of mid-sized life insurers over the past four years. Sluggish sales and a marked increase in the number of policy cancellations have only served to magnify the negative spreads[13] draining mutual life insurers' resources.

Resolution and Collection Corporation

A potentially huge supplier of NPLs, and of distressed assets generally, is the Resolution and Collection Corporation (RCC). Formed through a merger of the Housing Loan Administration Corporation and the Resolution and Collection Bank in October 1998, the mandate of the RCC is to purchase bad

[12] Market analysts estimate that every 100-point decline in the Topix Index below a projected break-even level of 1,270 (compared to 1,100 on October 24, 2001) would reduce major banks' Tier-1 capital by roughly ¥2.5 trillion. Official estimates provided by the FSA place the banks' exposure to market risks at two-thirds the levels indicated by analysts.

[13] Many of Japan's life insurers made the fatal mistake of overestimating the performance of their investment portfolios and now face a situation where the return guaranteed to policyholders is outstripping income.

loans from troubled financial institutions. To date, the RCC, which receives its funding from the Deposit Insurance Corporation, has acquired ¥1 trillion of NPLs (based on purchase price). However, only a tiny fraction of this debt has been resold to foreign investors.

Why has the agency avoided selling more of its portfolio? Stated plainly, the RCC is a state collection conduit for which the swift clearance of assets at the best possible price is not a stated objective. The organization is under no obligation to aid in the creation of a secondary market and, in fact, doing so would contradict its aim of servicing distressed assets internally. With that said, some government officials are calling for the agency to follow the example set by the Resolution Trust Corporation in the United States during the early 1990s and divest assets swiftly.

Deeply Troubled Corporations

Lastly, individually negotiated, one-off transactions with distressed companies are also a source of some deal flow for foreign investors. However, this type of transaction generally involves a far greater time commitment and prospective buyers run the risk of losing the deal after investing significant resources in its completion. Additionally, business leaders in Japan, who have spent their entire lives climbing the corporate ladder, tend to have little interest in extensive reorganizations that precipitate job losses, and so proactive restructurings remain rare.

Demand for Distressed Assets

Ernst & Young estimates that since 1997 only about US$30 billion has been invested in Japan's distressed asset market, whereas at least ten times this amount is needed to effect a significant reduction in total distressed debt outstanding. There are now approximately ten major investors involved, some operating solely on a proprietary basis (e.g., Merrill Lynch), but most managing limited partnerships open to third-party investors. Topping the list of purchasers (by amount invested) are Morgan Stanley, Goldman Sachs, and Lone Star. Although there are too few funds with significant maturity to permit the development of meaningful benchmarks, some of the returns achieved thus far appear fully competitive on a risk-reward basis with those of U.S. distressed, U.S. venture capital, and U.S. private equity funds. The table below provides an overview of representative current market participants, with their past capital commitments and current fund sizes.

Representative Fund Managers – Past and Projected Capital Commitments

FIRM	FUND NAME	DATE	FUND SIZE ($ millions)	ALLOCATION TO JAPAN ($ millions)
Cerberus	Cerberus Asia Partners	1999	1,327	1,250
	Cerberus Institutional Partners I	1999	324	87
	Cerberus Institutional Partners II	**Open**	**617**	**205**
Goldman Sachs	GS Special Opportunities (Asia) Fund	1999	1,525	1,037
	Proprietary Capital	N/A	N/A	N/A
Lend Lease	**LL Distressed Debt Fund**	**Open**	**600**	**240**
Lone Star	Lone Star Opportunity Fund	1996	396	61
	Lone Star Fund II	1998	1,228	624
	Lone Star Fund III	2000	2,262	1,357
	Lone Star Fund IV	**Open**	**3,500**	**2,400**
Merrill Lynch	Proprietary Capital	N/A	N/A	N/A
Moore Strategic Value	Moore Japan Restructuring Fund	1999	671	671
	Moore Japan Restructuring Fund II	**2Q 2002**	**750**	**750**
Morgan Stanley	MSREF III	1998	2,120	370
	MSREF IV	**Open**	**3,000**	**1,875**
Salomon Smith Barney	Proprietary Capital	N/A	N/A	N/A
WL Ross	WLR Recovery Fund	1997	200	72
	Asia Recovery Fund	2000	243	134
	WLR Recovery Fund II	**Open**	**400**	**145**

Notes: Data provided to Cambridge Associates by the respective investment managers. For those funds that are not fully invested at this time, "Allocation to Japan" totals reflect the manager's current estimate of final allocations.

Recent Political/Regulatory Developments

In April 2001, Junichiro Koizumi, a pro-reform "maverick" politician, rode a wave of popular support to victory in the race for Prime Minister of Japan. Simultaneously, a major package designed to accelerate bank and corporate reform was unveiled. At the heart of the proposal is the prompt removal of NPLs to bankrupt and near-bankrupt borrowers from major banks' balance sheets within two years, and removal of all newly emerging NPLs within three years of such classification. Any such loans that remained on the banks' books at the end of the allotted time would be sold to the RCC.

The most recent move by the Japanese government came in late October, when it was announced that a supplementary budget of ¥3 trillion would be passed to aid in the clean up of the financial sector. Specifically, the powers of the RCC are to be strengthened. This development is discussed in greater detail below.

Strategies to Capitalize on the Opportunity

The four principal strategies employed by investment managers seeking to capitalize on Japan's need to dispose of NPLs are bulk purchases of NPLs from financial institutions, corporate liquidations, corporate restructurings, and direct purchases of distressed real estate.

Bulk Purchases of NPLs from Financial Institutions

NPL portfolio sales by financial institutions are the cornerstone of most incumbent managers' strategy for addressing the Japanese market. In this type of transaction, the institution (typically with the aid of an advisor) bundles a pool of NPLs to place on the auction block. A standard NPL portfolio may include approximately 75 to 100 loans, with face values ranging from $500,000 to $10 million. The majority of the debt is secured either by real estate properties (most commonly) or commercial obligations, which would include assets such as accounts receivable. Personal guarantees for the unsecured balance are customary and wholly unsecured loans are often included as well.

There are four categories of "classified credit" in Japan. Class I loans are performing credits to stable borrowers. Loans labeled as Class II require "special attention" as the borrower is at risk. Class III and Class IV credits represent loans to near-bankrupt and bankrupt borrowers, respectively. To date, the banks have chosen to sell the worst of the worst, but loans of every category can be represented (as discussed in greater detail below).

Once the asset pool has been shaped, the seller extends invitations to a select group of prospective bidders, generally numbering no more than three or four. Upon selection, each group is afforded on average four weeks to perform an on-site file review, conduct off-site due diligence, price the portfolio, and submit a final bid. Given the size and complexity of the NPL pools, investors regularly underwrite the portfolio based on a statistically significant segment of the overall assets and avoid undertaking a comprehensive, asset-by-asset review. Investors frequently contract with third-party service providers (i.e., accountants and appraisal firms) to augment their analysis. Early on, bulk NPL sales of Class IV credits cleared at five to ten cents on the dollar. More recently, Class II and Class III credits have been added to the pools and prices have increased accordingly.

The successful bidder then takes possession of the assets and initiates the resolution process. Exits come in three forms: voluntary sale of collateral, full or discounted payoff, and forced liquidation (foreclosure). Because of the personal liability attached to most loans, court action is rarely necessary. In such cases where a negotiated settlement is possible, the recovered amount tends to be comparable to or greater than would be obtained through foreclosure and the resolution time faster. In the event court action becomes unavoidable, the Japanese system is decidedly creditor-friendly and works in a predictable, systematic fashion. In practice, the time frame for resolving the average NPL pool has been 12 to 18 months.

Corporate Liquidations

Similar to Chapter 7 proceedings in the United States, and in some respects more efficient, wholesale liquidations of businesses are the second most important avenue for acquiring distressed assets in Japan. Following a filing for protection, the option to force the company into bankruptcy can be exercised promptly, unlike in the United States where protracted litigation between management and creditor is not uncommon. A trustee is appointed to oversee the liquidation, mark the assets to market, develop a workout plan, and present it to creditors. Once the plan is approved, the trustee provides regular written updates and distributes proceeds to creditors.

Investors can approach the liquidation process in one of two ways, with the selection of an entry point largely determined by their appetite for risk. The first option involves positioning oneself as a prime lender to the troubled firm prior to any court action. Assuming the investor is able to acquire a meaningful percentage of the outstanding debt, there exists the opportunity to materially influence the liquidation process. Nevertheless, negotiating a deal that pleases both management and the bankruptcy trustee can often be a delicate dance and there is no guarantee that the plan most attractive to the investor will be implemented. Investors may also gain access to the distressed assets after the bankruptcy proceeding has begun, which allows them to review the adopted liquidation plan and, in a number a cases, limit their risk of loss through claims on cash holdings already built up in the bankruptcy estate.

Transactions of this nature can vary in size from less than US$1 million to several hundred million dollars. The average life of many such investments, given the highly effective legal system, is generally two years.

Corporate Restructurings

Unlike liquidation proceedings, the legal framework and investment opportunities for corporate reorganizations in Japan have lagged those in the United States. However, in April 2001, the new Civil Reconstruction Law took effect, permitting the Japanese equivalent of restructurings under Chapter 11

of the U.S. Bankruptcy Code. With a simplified filing system, protection of vital assets from secured creditors, and more effective implementation of agreed reorganization plans, companies are exercising this option with greater frequency. The fact that incumbent management is allowed to remain in place subsequent to seeking bankruptcy protection (a carrot not previously offered) only adds to corporate enthusiasm for this course of action.

Restructurings come in all shapes and sizes and their relative merit is the subject of some debate. However, the new legislation remains relatively untested leading some investors to hold back, while others have leapt headlong into this corner of the market. Regardless of the current assessments, we would expect foreign participation in these transactions to intensify once the application of the law by Japanese authorities becomes clearer. The likely exits from these investments include asset sales and recapitalizations.

Direct Purchases of Distressed Real Estate

As a result of Japan's difficult and deteriorating economic climate, some businesses have elected to raise much needed capital through the direct sale of real estate holdings. These tend to be discrete deals of considerable size that have a very short fuse. That is, prospective investors are given little time to evaluate the property and must move expeditiously to have any hope of submitting a winning bid. Competition for real estate auctioned off in this manner is stiff, with deals attracting many more bidders than bulk NPL sales conducted by banks, for example. Traditional real estate partnerships, publicly traded real estate investment trusts,[14] and strategic investors may also submit offers. The required hurdle rates for these investors are often lower than those of distressed asset fund managers, and as a result the latter typically find themselves quickly outbid.

Investment Vehicles and Fund Structures

Distressed funds can be divided into two basic groups: *private equity funds*, with three- to five-year or longer lock-up provisions, and *hedge funds*, with annual, quarterly, or monthly redemption options. In each case, the liquidity provisions of the fund should match the liquidity of the underlying portfolio. Private equity funds, with captive capital, can invest in less liquid positions (including early-stage bankruptcies), take "active" positions, and hold more concentrated portfolios. Active distressed investors

[14] REITs are a relatively new type of security in Japan. Thus far, only two trade on the Tokyo Stock Exchange-one established by Mitsubishi Estate Co. and the other by Mitsui Fudosan Co., two of Japan's largest developers. The relationship between the coming wave of REITs and foreign investors in distressed assets is not exclusively adversarial. REITs will help to provide a higher degree of liquidity in the Japanese real estate market and represent yet another path to exiting investments.

often take seats on bankruptcy committees, but are then restricted from trading with outsiders; similarly, they can also take control positions in corporate restructurings. Conversely, managers of hedge fund vehicles tend to focus on more liquid, later-stage bankruptcies, invest passively, or hold more diversified portfolios.

Distressed Investing Strategies in Japan

STRATEGY	TRANSACTION SIZE	TYPE OF EXIT	APPROXIMATE TIME TO EXIT	REPRESENTATIVE MANAGERS
Bulk Purchase of NPLs	Face Values Range from $500k to $10mm Approximately 75 to 100 Loans Per Portfolio	Voluntary Sale Full or Discounted Payoff Forced Liquidation	12 to 18 Months	Cerberus Goldman Sachs Lend Lease Lone Star Moore Strategic Value Morgan Stanley
Corporate Liquidations	From Less Than $1mm to Hundreds of Millions	Trustee Plan Execution	2 Years	Cerberus Goldman Sachs Lend Lease Lone Star Moore Strategic Value Morgan Stanley
Corporate Restructurings	Various	Asset Sales Recapitalizations	Various	Goldman Sachs Morgan Stanley WL Ross
Direct Purchase of Distressed Real Estate	Generally Large	Property Sales REITS	Generally Short	Goldman Sachs Lone Star Moore Strategic Value Morgan Stanley

Key Success Factors

Relationships, Relationships, Relationships

Whatever the strategy, a deep and dependable network of corporate, government, and individual contacts is vital in Japan. Investors have little hope of surviving if they are not fully immersed in the information flow and therefore unable to gauge when and where the next potential acquisition will appear.

Deal origination is time consuming and requires constant attention. For this reason, many funds have created advisory councils populated with former high-ranking Japanese government officials and business leaders to ensure access to boardrooms throughout the nation. However, getting one's foot in the door is only the beginning of the process. In Japan, where preserving social harmony is of the highest priority, investors must take great care to avoid distrust and resentment before, during, and after any negotiations. Winning a single NPL portfolio or restructuring mandate does not generally determine the eventual success of a fund and the adverse consequences of a tarnished reputation may take many years to overcome.[15]

Broad Experience in Valuing Assets

As already mentioned, accurate underwriting of potential acquisitions can be impeded by a lack of reliable data and even when complete data are accessible, Japanese real estate law and loan agreements can prove thorny. For example, several commercial activities in Japan require a property owner to hold a license prior to engaging in specific activities on the premises. An uninformed investor might well take title to such a property without also securing the transfer of the accompanying license. In many cases, the investor cannot independently obtain a license and is therefore left holding an asset of drastically depreciated value. In such an environment, firms with a robust database of proprietary transactions increase their chances of avoiding pricing pitfalls and hold a significant competitive advantage.

Japan's loose categorization of NPLs is another source of potential confusion for uninitiated fund managers. Relying on bank classifications alone to determine the quality of an asset is a serious mistake. Class III and Class IV credits (outstanding loans to nearly-bankrupt and bankrupt borrowers) are generally reserved for SMEs, whose demise is unlikely to damage the industry to which they belong. In reality few, if any, big borrowers have been placed in these deadbeat divisions. Apart from political entanglements, one reason for this is that capital-strapped banks simply cannot afford to be more cautious in their assessment of these large firms. Labeling the debt as Class II, or "in need of attention," only requires the banks to set aside reserves equal to 15% of the loan, whereas loans to near-bankrupt companies necessitate loan loss reserves of 70%. Lax enforcement of debt classification standards is a well-publicized phenomenon and it is doubtful that any institutional-quality manager would place much stock in such vague demarcations when pricing assets.

Deep and Skilled Internal Servicing Operation

For those investors focused primarily on the acquisition and resolution of NPL pools brought to market by Japan's banks, servicing the loans is a critical part of the investment process. As of July 2001, approximately 50 servicers had received licenses from the Minister of Justice. For fund managers, an

[15] At least one foreign fund manager has gone so far as to hire a public relations firm to cleanse its image.

extensive in-house capability is absolutely essential for several reasons. First, input from the servicing team during the underwriting process helps to refine recovery estimates, generating a much higher degree of confidence in proposed pricing. Secondly, bulk NPL sales by the banks tend to occur with great regularity in the January-February and July-August periods, just before semi-annual profit reports are published. As a result, servicing department workloads tend to oscillate from feast to famine, with a deep bench needed at peak periods. Further, quality-control issues can be minimized if the servicing staff is an integral part of the investment fund organization. Properly incentivized teams[16] have repeatedly proven that they can outperform the collection assumptions made at the time of pricing and add meaningful performance gains to the bottom line. Finally, substantial efficiency gains (including those accruing from a fully integrated information technology system) can be achieved when all essential functions—origination, due diligence, pricing, servicing, and portfolio management—are housed under a single roof.

Market Risks

In addition to the overriding economic risk of deep, prolonged economic contraction, massive layoffs, and major bank collapses, which would effectively slam shut all exits, investors in distressed Japanese assets incur six primary risks, discussed below in order of magnitude.

The Resolution and Collection Corporation (RCC)

The most significant current threat to foreign distressed debt investors in Japan is the RCC. Recent political developments referred to above only heighten the probability that this agency will assume a more significant role in the market going forward. Until now, the RCC has been unable to participate directly in the bank-held auctions for bad loans, instead acquiring assets from failed institutions placed into receivership. The new legislation proposed in October casts aside that restriction and permits the agency to purchase NPLs from still-viable banks at "economically reasonable prices." Previously, the prices offered by the RCC were set by its parent corporation and were based rather mechanically on the loan category, with little consideration of the actual current value of the assets. Fund managers are therefore concerned that the RCC may well take a different view from them as to what constitutes a "reasonable" price. The government is reportedly planning to finance a ¥400 billion to ¥500 billion "Corporate-Rebuilding Fund" to be administered by the RCC in the near future.

[16] For example, in an effort to fully align the interest of the servicing organization with that of the fund, Lone Star encourages its employees to take an economic stake in the collection process. That is, staff may make side-by-side commitments to portfolio purchases in amounts as little as US$5,000. This profit-sharing program also helps instill loyalty in a group of employees who are difficult to replace.

Should the RCC begin bidding on NPL pools and prevailing, precedent suggests that it is unlikely to resell these assets to foreign investors since (as noted above) it has no incentive to do so. Currently, the RCC employs over 1,200 individuals and is responsible for generating sufficient income to cover its operating costs. Interest income from its performing assets and the resolution of its distressed assets provide the necessary capital. Therefore, any reduction in the size of its portfolio may necessitate a round of job cutbacks. In addition, assuming that the prices paid by the RCC are in fact above market, any third-party sales would trigger secondary losses that public funds would be forced to absorb—a deeply unpopular alternative.

Stalled Reforms Stifle Supply

There was much hope that structural reforms would at last gain traction when Prime Minister Koizumi took the reins last year. History suggests, however, that Japanese politicians have an uncanny ability to enact seemingly groundbreaking legislation that, in reality, is narrowly applied or sufficiently vague to ensure only sporadic enforcement. A classic example is the most recent edict, discussed above, which calls for all bad loans at the nation's banks to be removed over the coming two years. Not only does the government action solely speak to the nation's largest banks, but it also avoids clarifying critical issues relating to the classification of subperforming debt. Once again, this outwardly direct intervention is filled with loopholes that will again allow deposit-taking institutions to forestall the disposal process. For example, expecting that the RCC will offer a higher price than its foreign counterparts, banks may decide to completely abandon any proactive sales, wait for the prescribed time to expire and sell their distressed assets to the agency. Old habits die hard. The probability of government officials pushing ahead with true reform over the near-term is low.[17]

Increased Competition

Lured by the prospect of relatively attractive returns (net IRRs in excess of 20%), one would assume that serious competitors would be tempted to try and penetrate the market, deploying large amounts of capital in the most attractive deals, and thereby placing downward pressure on IRRs. However, some formidable barriers to entry mitigate this risk. To begin with, any interested party must come to grips with the enormous costs associated with establishing and maintaining an operation in Japan. Although these expenses vary by strategy, all require an on-the-ground presence capable of generating sufficient deal flow, and that comes only at a steep price. Anecdotal evidence suggests that at least two of the investment managers covered in this report spent several million dollars in start-up costs over several

[17] An important reason why bank regulators are reluctant to take decisive action is that those same officials often plan to retire from government service into highly compensated sinecures at the institutions they currently regulate.

years prior to making their first acquisition. Due to the complexity of the business and the importance of bilingual staff, the pool of human resources is limited, and so—even after deciding that the market's potential justifies initial capital outlays—one is faced with the considerable challenge of recruiting a qualified team capable of implementing the investment program. Cultural nuances, unique to Japan, help form the third layer of barriers to entry. Developing a network of contacts and nurturing good business relations are essential to a participant's survival, and both of these exercises require patience and skill. Finally, reliable data can be difficult to come by. Even a minor mistake in pricing an individual asset can cause many months of hard work to vanish. If the bid is unrealistically low, the tightly contested auction will go to a competitor; if the asset is valued too highly, return objectives cannot be met. Without their own proprietary historical data, and the expertise and experience required to analyze them effectively, firms face an uphill battle.

Another factor working to the benefit of incumbent investors is the resurgent distressed market in the United States and, to a lesser extent, Europe. Experienced foreign players who might otherwise search the globe for "special situations" are enthusiastically pursuing more familiar opportunities closer to home.

Fresh competition is more likely to come from domestic players. Given the high-risk, high-return nature of the strategies and the fact that personal and corporate relationships make servicing nonperforming debt an unpleasant experience for native Japanese, local participants have been slow to emerge. At some point, however, resident institutions may be unable to ignore the returns being generated and find ways to justify the perceived disruption to social harmony. A general acceptance by the population that the reform process necessarily involves allowing weak enterprises to fail could help erase any social stigma associated with the debt collection business.

Inflation and Currency Risk

Several economic pundits have asserted that Japan's only escape from its deflationary liquidity trap is by way of policies designed to ensure positive inflation throughout the economy and by providing consumers with additional incentives to spend rather than to save (e.g., measures to lower the exorbitant costs of home ownership). Since various adverse consequences might ensue from inflation targeting—for example, competitive devaluations across Asia, higher debt service costs, and the possibility of stagflation—the government has shown little appetite for such an approach. However, as competing policy options are exhausted and lack of demand emerges as the chief impediment to recovery, the government may increasingly seek to inflate and depreciate its way out of trouble, however surreptitiously. Since loans (nonperforming or otherwise) are denominated in nominal yen, rising inflation would deplete their real value (while perhaps enhancing some borrowers' ability to repay). At the same time, a steadily

depreciating yen could diminish the local currency value of foreign investors' returns on Japanese investments, and although currency exchange risk can be hedged, the cost of hedging may diminish expected returns.[18]

Political Missteps by Investors

The risk of political missteps is particularly difficult to quantify, and yet even the most culturally sensitive foreigners operating in Japan are not immune. The Japanese may see commercially acceptable practices in the Western world as morally reprehensible when applied to their islands. Social and corporate bonds are stronger than one might find elsewhere and the preservation of these bonds is a serious matter. Foreigners must adapt and conduct themselves in a "Japanese" way. One such example of this can be seen in the bank-sponsored NPL auctions. An invitation to participate is much more than a casual offer. Declining to submit a bid on even one occasion effectively bars the would-be investor from any future sales as well. Savvy investors therefore discreetly "bid to lose" and avoid causing offense. By the same token, publicizing one's success and assuming a high profile are liable to trigger resentment rather than admiration.

Regulatory Interference

Unsolicited advice from Japanese regulators has not yet posed a serious problem for foreign investors in the distressed asset market, but there are signs that the authorities would like to exert more pressure in certain circumstances. Corporate restructurings are the area most susceptible to such intrusions. One case in particular has highlighted how difficult it can be for foreigners to run a Japanese business along Western lines. A consortium led by Ripplewood Holdings purchased the failed and nationalized Long-Term Credit Bank of Japan in March 2000. After its rebirth under new management, the reincarnation, Shinsei Bank, promptly adopted Western-style lending practices, cutting off support to shaky borrowers and angering rival Japanese banks. It took little time for the growing complaints to reach the top brass at the FSA. In a transcript from an August 2001 meeting, the Commissioner of the FSA is quoted as saying: "Shinsei should behave in line with other Japanese banks." The Commissioner went on to warn that: "Shinsei should be concerned about its reputation risk, as anything can happen down the road." Pressure on Shinsei to honor traditional Japanese banking practices remains sufficiently high that a board member recently admitted that the organization has extended some credits that do not make sense from an economic perspective.

[18] It should be noted that we do not currently view the currency exposure to be a major problem; in fact, because Japanese interest rates are so much lower than U.S. rates, the forward ¥ exchange is typically fewer ¥ to the US$ than the spot rate, so managers can currently earn a positive spread by hedging their yen commitment back into dollars.

Summary

It has been nearly five years since the Japanese secondary market for distressed assets first opened for business. Despite government officials' persistent faith that the problem could solve itself given ample time, the supply of NPLs and near-bankrupt businesses has continued to grow and now stands at levels immune to every conceivable quick-fix. Even if only a fraction of these assets ultimately "shake out" and become available to foreign fund managers, the absolute figures involved will be substantial. An increase in activity from the RCC is a genuine threat, but mitigated to some extent for the following reason. While the agency is able to generate adequate income to service its operating costs independently, the great sums of capital needed for future purchases inevitably come from the government. That is, a more energetic RCC is wholly dependent upon money supplied by Japanese taxpayers. Given the public outcry likely to result from a third capital injection, whatever the form, that does not offer immediate and measurable results, the RCC must operate on a limited budget or swiftly resolve a great number of assets for cash. Foreign buyers would necessarily play a significant role in the latter option.

The representative investment managers profiled in this study are all firmly established in Japan and have solid long-term track records in the resolution of distressed assets, with many having "cut their teeth" on the U.S. savings and loan crisis of the early 1990s. Because their strategies for participating in the market vary, there is no common risk-reward profile across funds. With that said, the partnerships raised thus far have delivered attractive results with a relatively low correlation to both public markets and other private equity vehicles, broadly defined.

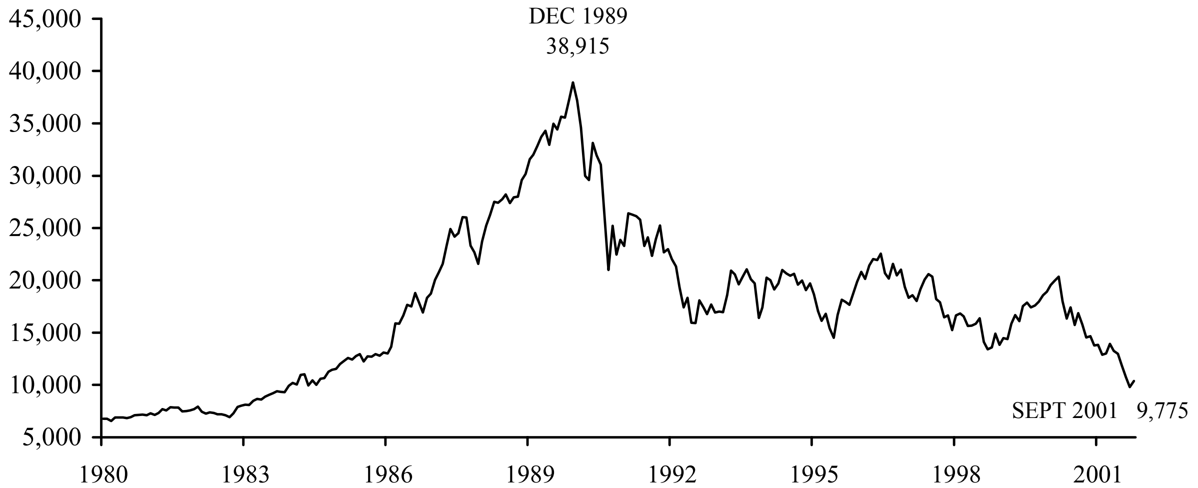
In short, we see Japan's current situation as providing attractive investment opportunities for institutions with well-developed alternative assets programs. Because all involved should benefit from the further development of a robust and active secondary market for distressed assets in Japan, we suspect these investment opportunities will persist for some years, although the specific form they take may shift over time.

EXHIBITS

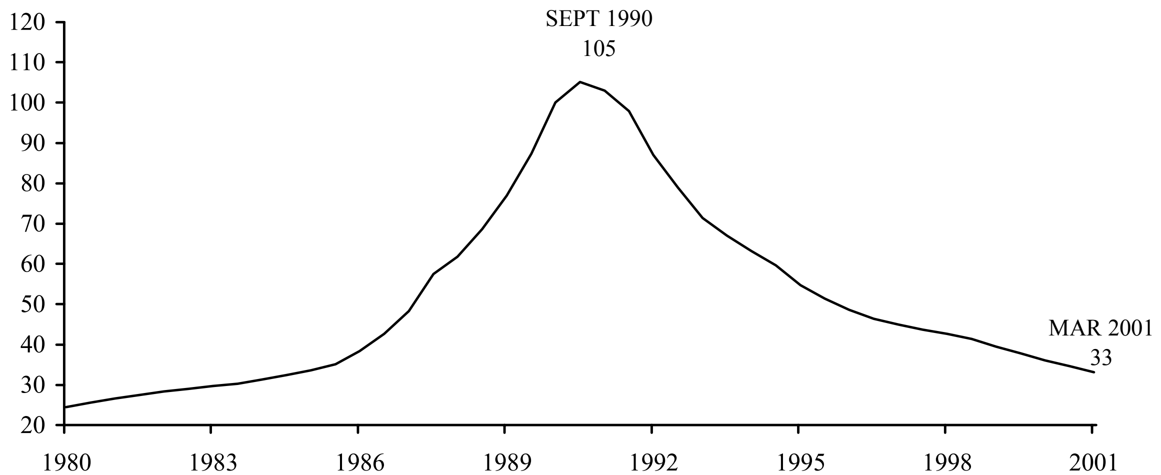
Exhibit 1

PRICE PERFORMANCE OF THE NIKKEI 225 INDEX AND THE JAPANESE LAND PRICE INDEX

Nikkei 225
January 1980 - October 2001



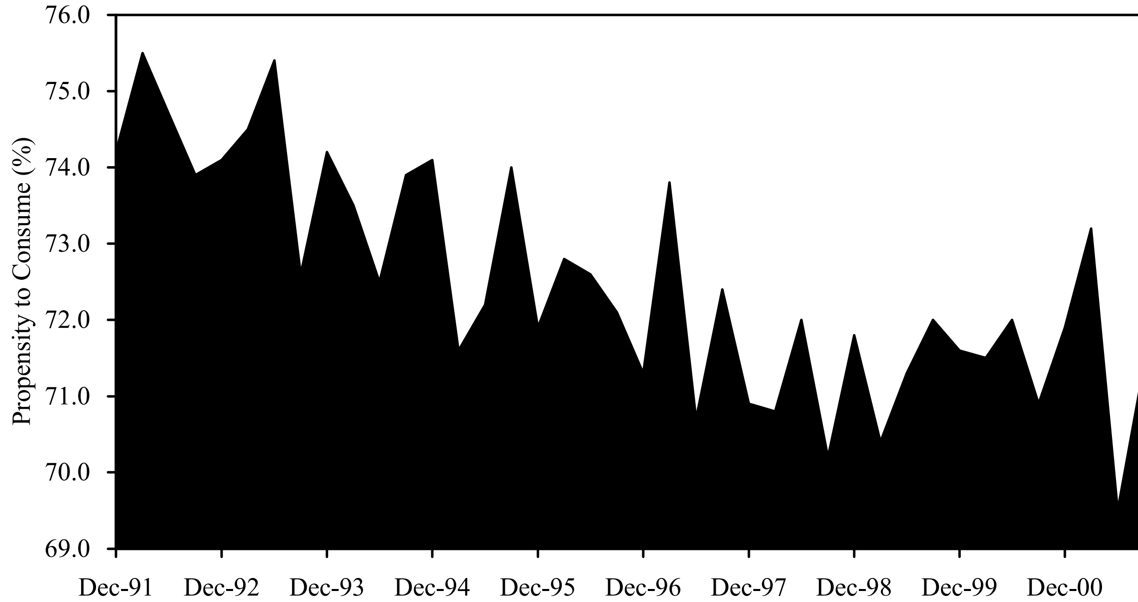
Japanese Land Price Index
March 1980 - March 2001



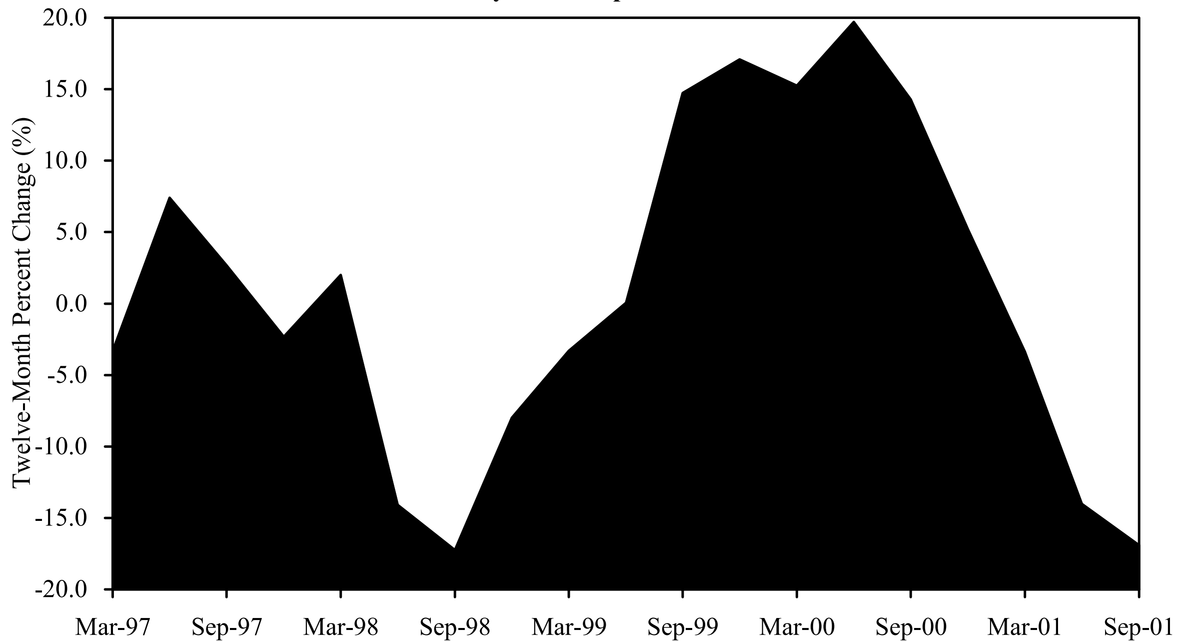
Sources: Bank of Japan and the Japan Real Estate Institute.
Note: The Land Price Index shown above tracks real estate values on a biannual basis for six large cities, including the Tokyo Metropolitan Area, and represents an average of residential, commercial, and industrial properties.

Exhibit 2

PROPENSITY OF JAPANESE HOUSEHOLDS TO CONSUME



JAPANESE EXPORTS OF GOODS AND SERVICES

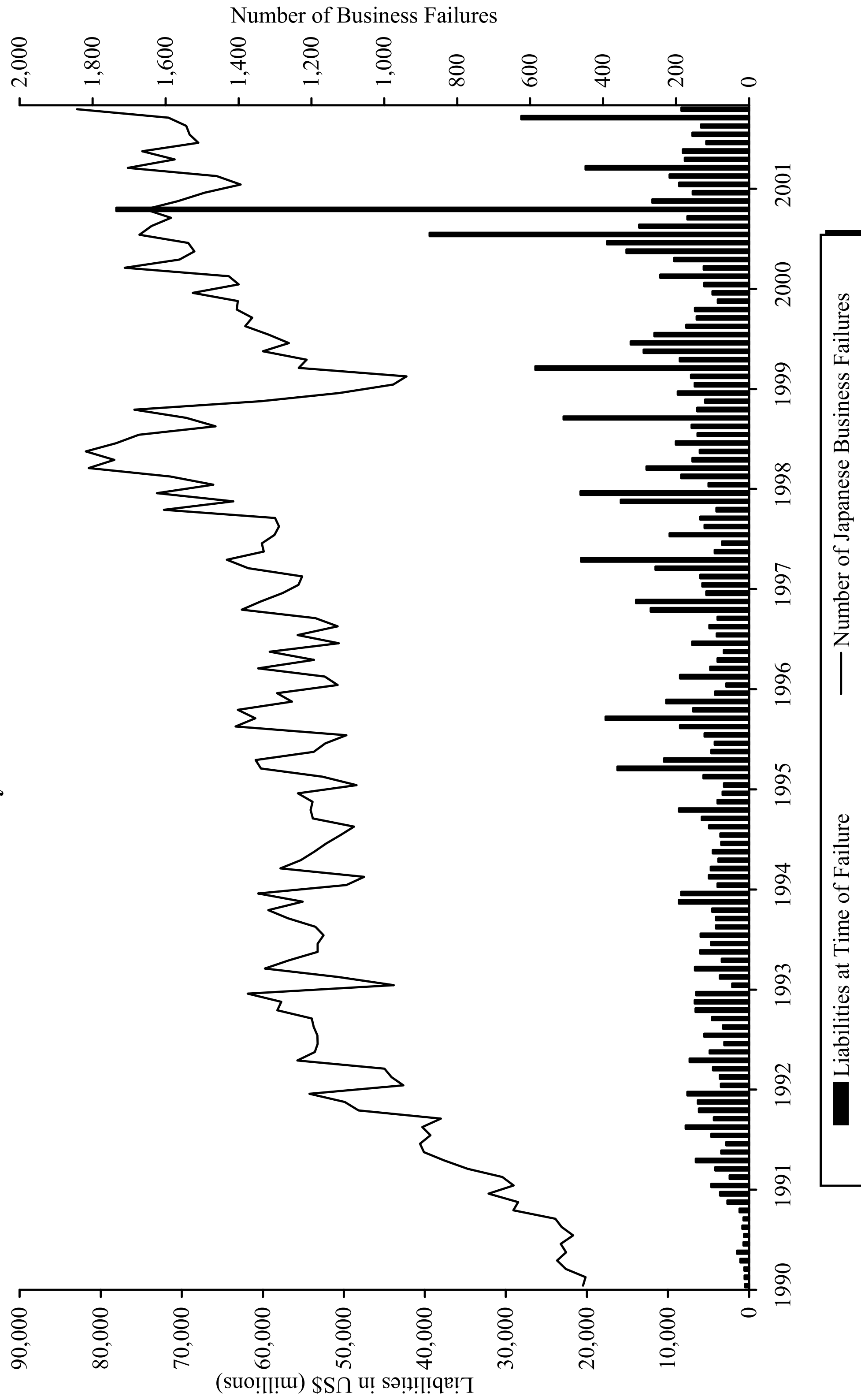


Sources: *Family Income and Expenditure Survey (October 2001)* published by the Ministry of Public Management, Home Affairs, Posts, and Telecommunications and Datastream International.

Exhibit 3

BUSINESS FAILURES IN JAPAN

January 1990 - October 2001

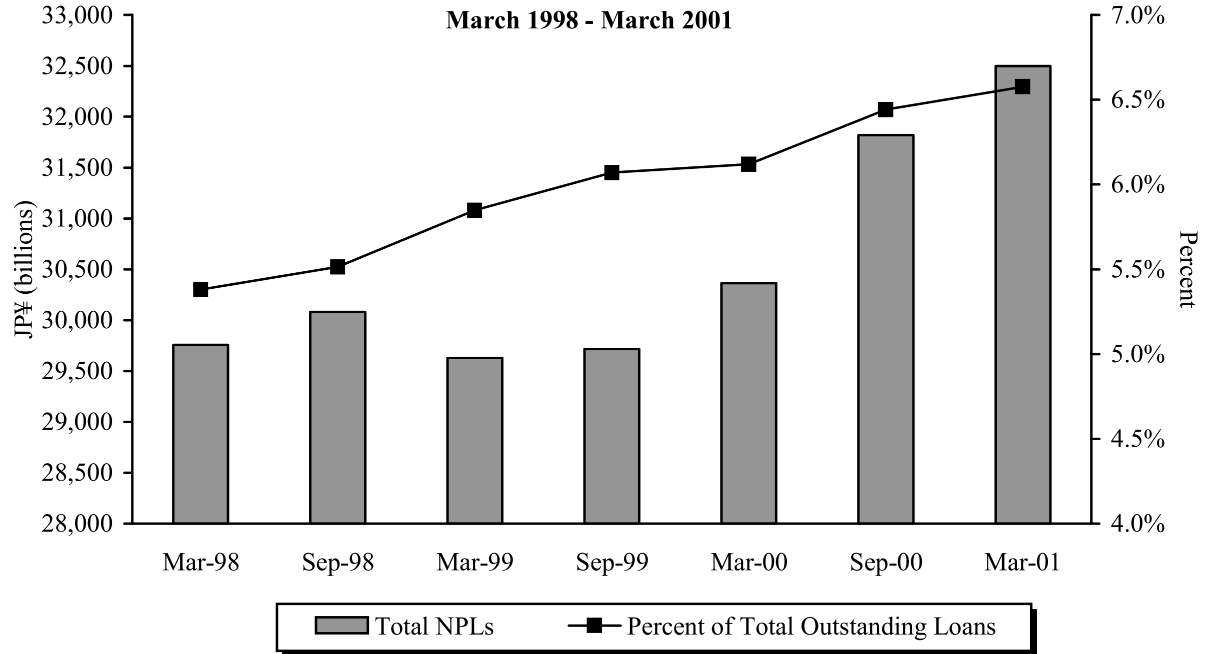


Source: Datastream International.

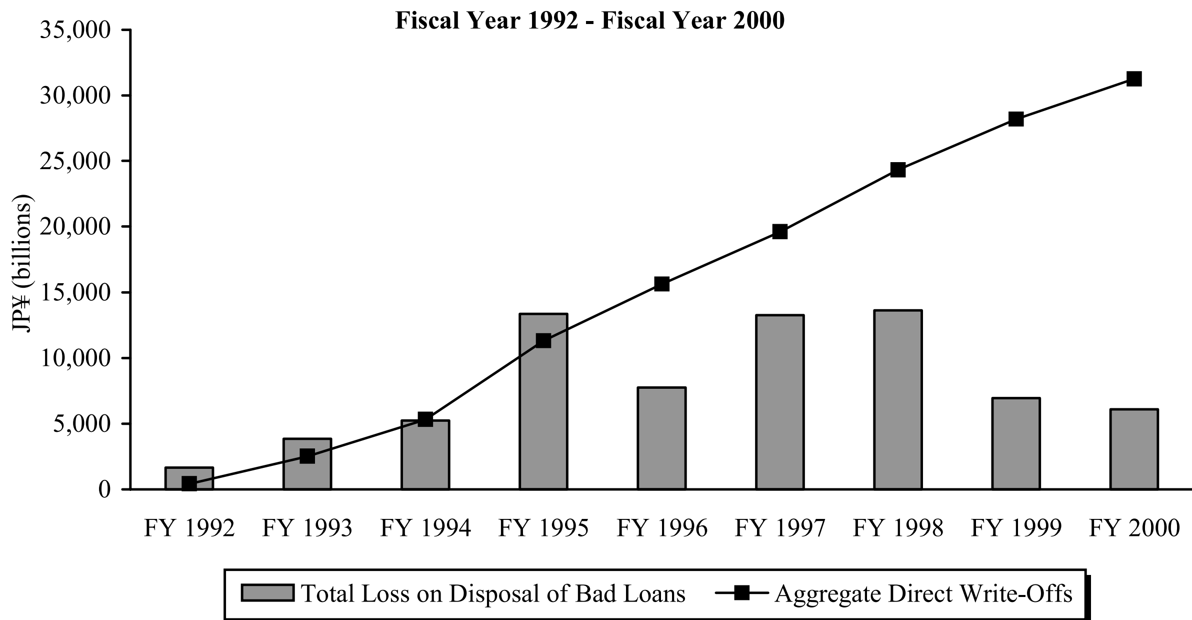
Note: The chart presents monthly data that is not seasonally adjusted.

Exhibit 4

TOTAL NONPERFORMING AND RESTRUCTURED LOANS HELD BY ALL JAPANESE BANKS



TOTAL DIRECT WRITE-OFFS OF NONPERFORMING AND RESTRUCTURED LOANS BY ALL JAPANESE BANKS



Source: Financial Services Agency.