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Japan's conservative investors

With Japanese LPs still wary of private equity investing amidst ongoing global economic uncertainty, GPs find it difficult to secure commitments

JAPANESE INVESTORS ARE KNOWN FOR their aversion to risk, but one India-based fund manager didn't appreciate the full extent of this conservatism until he met with a group for the first time.

The GP was summoned by several Japanese investors touring Mumbai a few months ago, but ended up fielding few questions about his business. On the flip side, the LPs were unable to delineate their long-term view of the India market and how they planned on participating in it. It was if their primary their primary objective was just to watch and learn.

"There was the feeling that we couldn't get anything done with them. We would have to spend a lot time in Japan courting them, which would have been a huge undertaking," the GP says. "There are a lot of investors wary of investing in India, but Japanese are even harder."

He decided to focus on other investors and has yet to receive any follow-up calls from the Japanese.

Sources close to Japan's private equity industry find these experiences all too familiar. The typical LP is spooked by the down-and-up momentum of private equity's J-curve because of the long-term commitment they must make to a fund before returns are seen. As a result, they focus more on asset management classes such as hedge funds.

Crack a Japanese LP, though, and you won't regret it: they are said to be among the most loyal in the world, subject to continuing to perform reasonably well. According to one source close to a European GP, although Japanese investors made relatively small allocations – EUR300-400 million ($409-545 million) to their last fund – they had been the most consistent and stable group of participants across multi ple prior funds.

"No one ever thought it was an easy market to get money out of - Japan is not a huge source of capital for anyone really - but it plays a different role," the source tells *AVCJ*. "They're generally quite reliable partners - although the last financial crisis affected banks and insurance companies everywhere - and that's of considerable strategic value in a time of instability. It takes a lot of time for GP's to develop relationships with Japanese LPs and vice versa."

This loyalty applies to foreign GPs in particular. According to Hal Morimoto, managing director at Astoria Consulting Group in Tokyo, investments into domestic fund managers have remained low, with overseas funds attracting nearly 90% of commitments.

Willing participants?

Astoria's data paints a positive picture of Japanese LP activity in the aftermath of the global financial crisis. In a poll conducted in May, the 30 Japanese institutions who responded said their 2011 budgets were up by an average of 38% year-on-year. This represents a marked turnaround on the downward spiral that began in 2008, which saw a 30% drop in budgets, and continued into 2009 and 2010.

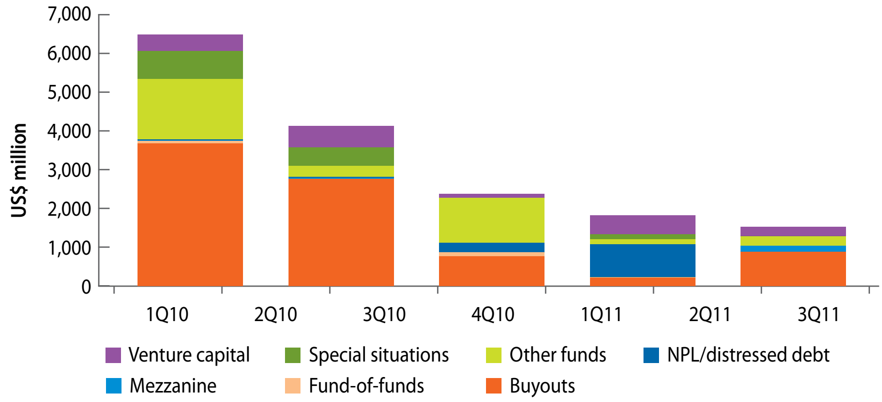
However, sources contacted by *AVCJ* aver that these numbers are not truly indicative of LP behavior: Just because budgets are larger, this doesn't mean LPs are spending them more liberally. Recent volatility in the global economy means that precautions adopted during the crisis remain intact.

There are three main participants in Japan's LP landscape: banks, insurance companies and pension funds. While these investors likewise make up the LP base worldwide, Japanese institutions display unique qualities that streamline the amount of capital flowing into private equity.

Banks, specifically commercial banks, have been the main supporter of domestic funds since the industry's inception 15 years ago. Back then, institutions were flush with capital and unburdened by limitations regarding alternative assets. For funds with 2004, 2005 and 2006 vintages, banks such as Norinchukin Bank, Mitsubishi UFJ, Sumitomo Mitsui and Mizuho Bank played critical capital-providing roles and popularized private equity investing for regional banks later in the decade. All that changed in 2008.

According to Joji Takeuchi, co-founder of private equity LP advisor Brightrust, banks have become more wary in anticipation of the Basel III regulations. Japanese banks suffered from increased capital requirements for alternative assets under Basel II, and its successor will tighten

Japan fundraising, 2007-2011



Source: AVCJ Research

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LPs look East?

JAPANESE LPS make the bulk of their allocations to foreign GPs, but only a small portion of this capital is seemingly spent in Asia.

According to Hal Morimoto, managing director at Astoria Consulting Group, LP interest in emerging market investing has piqued the same way it has for investors globally.

"What they're going after are Asia emerging market investors, and some are looking at Brazil," he says. "Western investors have been looking into these areas for years, but Japanese LPs are maybe two years behind leading LPs in the US and Europe. However, these sorts of investments are beginning to take off."

But Morimoto and others say investment into these geographies is coming at a trickle, and much of Japanese LPs' allocations remains in the West.

"If you look at the total allocation to these emerging markets by Japanese LPs, it's still a very minority portion," says Joji Takeuchi, co-founder of private equity LP advisorBrightrust PE Japan. "Even for US and European LPs, while there has been a lot of money flowing into the emerging economies. I don't think increased allocation to China, Braziland India has brought material changes to their PE portfolio characteristics."

Yuka Hata, director at Nomura Private Equity Capital, says investment in Asia represents a natural progression given the economic climate, but when times are bad, LPs have been less concerned about diversifying their geographies than they have pursuing more liquid assets.

"It's less about LPs changing their appetite for certain geographies and more about their appetite for asset classes," she says. "This could mean distressed, secondaries, infrastructure – these asset classes have a quicker cash flow, which is very much in flavor for Japanese LPs."

investment scope even further. Required to bolster Tier 1 reserves from 2% to 4.5% by 2015, capital costs for investing in private equity will increase.

Takeuchi adds that the collapse of Lehman Brothers and the global financial crisis completely halted foreign banks' leveraged loan activity in Japan. "Japanese banks strengthened their position as the sole provider of liquidity vis-à-vis GPs, and they've realized that they do not need to be private equity LPs to acquire LBO loan business," Takeuchi says.

Sources say that banks are able to re-up their current investments, but allocations for new commitments only become available if they cancel funding to previous commitments, which has been a pattern for at least three years. This doesn't bode well for new funds.

Pension funds on the sidelines

In contrast to most other mature markets, Japanese pension funds account for a very small percentage of private equity funds' capital. According to Astoria's Morimoto, pension funds are 10 times more likely to invest in a hedge fund than in private equity, given the liquidity differentiate. Citing a recent PFA survey, he says 0.5% of pension fund assets are allocated to PE, compared with 5% for hedge funds.

Pension funds are additionally affected by their obligation to provide constant returns to clients, a factor that becomes ever more critical due to the country's rapidly aging population. While insurance companies have large asset bases to liquidate if a day comes when they need fast capital, pension funds have to meet a certain yield thresholds, making the long-term J-curve largely unviable.

"Countries like Japan, Germany and Switzerland are income-loving countries, and they are very bank-centric cultures. It's their nature to be drawn to liquidity," one Japanese investor says. "Especially in the current environment, people will adopt shorter commitment periods."

With other LP categories such as endowments and family offices largely unrepresented in Japan, this leaves insurers as the primary capital provider to GPs – but there are no easy pickings.

First, like banks, insurers are generally have little time for new funds. Second, like pension funds, they suffer from the practice of swapping executives every three years. The idea is to create parity amongst the different groups represented by each pension and insurer, but it isn't conducive to a 3-5 year private equity cycle.

Sources explain that many CIOs are elevated to these positions toward the end of their corporate careers. For pension funds, some are hired from within, and some are hired from banks, trust banks or government agencies. The practice creates little incentive to invest: the executives know they will not see the fruits of their investment; and, if they do invest, they are wary of passing along long-term obligation to their successor. "These executives trend toward instruments which have liquidity and less J-curve such as hedge funds, and then private equity," says Kazushige Kobayashi, managing director at Capital Dynamics.

Experience matters

In this investment climate, it is vital that GPs emphasize their experience when pitching to Japanese LPs. The innate conservatism means it is a genuine challenge for first-time funds to raise capital, but brand-name GPs who have spent years in the market may find more favor. One source suggests that five years' of real investment experience will buy GPs a meeting, and 10 years may lead to an investment.

As a result, Japan's first-movers, such as Advantage Partners, Unison Capital and The Carlyle Group have done well.

Carlyle, for example, opened its Tokyo office in 2000, and launched its first fund, the JPY50 billion ($650 million) domestic buyout fund, Carlyle Japan Partners I, in January 2004. It claimed that nearly 60% – or JPY28 billion – of the fund's commitments came from Japanese institutions. In 2006, Carlyle set a target of JPY215.6 billion for its second Japan, well in excess of the $1 billion raised by Longreach Group for its first fund the same year.

As mentioned earlier, the global financial crisis has brought change, with even established players finding the fundraising environment tougher than before. Carlyle announced in March 2009 that it would reduce the size of Japan Partners II by JPY50 billion to JPY165.6 billion due to the sluggish market for deals.

This has opened the door for funds with alternative investment mandates. Sources say they see a bias toward asset classes that can provide liquidity – notably mezzanine, distressed, direct secondaries and infrastructure-related private equity vehicles. This can be a profitable tip for select funds.

According to AVCJ Research, capital allocated toward turnaround and restructuring projects in Japan has risen from $482 million in 2007 to nearly $4.3 billion in 2010. More than $2.8 billion has been invested in 2011 year-to-date. Meanwhile, between 2008 and 2010, mezzanine and pre-IPO deals rose from $6 million to $24 million.

"Distressed, secondaries, infrastructure – there's a cash flow out of this asset class and they exhibit less of a deep J-curve, as well as more opportunities to come after the crisis," says Yuka Hata, director at Nomura Private Equity Capital. "Even now we can expect to see a lot more distressed again considering the US and European economies."