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Alternative Funds

Japan: Trends and Developments

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Trends and Developments

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Overview

The year 2020 has been one of disruption, challenges and opportunities. While fundraising has so far remained remarkably robust, setting records and generally meeting or exceeding expectations, the twin shocks of the global COVID-19 pandemic and the sudden resignation of Prime Minister Shinzo Abe have created more uncertainty for alternative funds in Japan than at any time since the end of the Global Financial Crisis (GFC). Nonetheless, alternative funds as a whole seem to have planted strong roots over the past decade and appear to be better positioned to weather a crisis than they were in 2007. The challenges faced by the disruptions of 2020 are real, but rather than chilling the entire Japanese alternative funds industry the way the GFC did a little over a decade ago, the current crisis seems more likely to accelerate existing trends towards diversification and a "flight to quality".

Background

Entering 2020, expectations could not have been higher for alternative funds in Japan. At least half a dozen significant buyout funds were publicly reported to be in the market, targeting over USD7.5 billion in commitments. Several real estate and logistics/infrastructure funds were closing in on their hard caps, approaching or clearing the USD2 billion mark. The previous year had been another banner year for venture capital, with financial data company Preqin reporting 597 Japan-based VC funds with total commitments of JPY2.5 trillion at the end of December. The Tokyo Olympics were scheduled to start in July, with over 600,000 foreign visitors expected. Both equities and alternatives were attracting attention from foreign investors, with a 62.8% IRR and 3.6x MoC on 93 exits in 2019, according to Asia Private Equity Review (APER). "Abenomics", the economic policies of Prime Minister Shinzo Abe, had seemingly broken through decades of resistance to M&A, creating opportunities for private equity through legal and tax reforms. Fundraising was buoyed by an influx of commitments from new players, including the Japanese Government Pension Investment Fund (GPIF), with JPY163 trillion in assets (USD1.45 trillion) as of 2017, which had recently revised its long-standing conservative investment guidelines to permit investments in alternative assets; Japanese mega banks; and the newly privatised Japan Post. These changes also attracted the attention of overseas investors, leading KKR co-founder Henry Kravis to remark that Japan had become the global investment company's "highest priority" outside the United States. The future for alternatives looked bright in the land of the rising sun.

The Impact of COVID-19

The worldwide COVID-19 pandemic has adversely impacted commercial activity globally, and Japan has been no exception. Measures taken to contain the initial outbreak in Japan were similar to those taken in other countries, including restrictions on international travel, closures of schools, restaurants, retail stores, offices, businesses and public venues, and the cancellation of public events, including the postponement of the Tokyo Olympics, now tentatively rescheduled for the summer of 2021. The outbreak has disrupted supply chains and adversely impacted a broad range of businesses in Japan, including travel, hospitality, dining, entertainment and other industries that depend on in-person interaction. Consumption is estimated to have declined by 20% in April according to the Bank of Japan, and GDP is estimated to have fallen by 7.8% in April–June from the previous quarter, or 27.8% on an annualised basis, according to the BBC, the biggest decline since figures became available in 1980. These disruptions have made valuations highly uncertain, increased investment risks, and presented unprecedented challenges for managers seeking to raise alternative funds. New investments have been significantly impacted, with buyers and sellers having difficulty agreeing on valuations, muting deployment of capital.

Despite these challenges, fund managers appear to have been remarkably adaptable and resilient. Heeding the lessons from the GFC, private equity firms in Japan seem to have been generally less leveraged than in 2007–2008, minimising exposure to loan defaults and liquidity risks. The rebound in global financial markets also seems to have softened the blow from the initial downturn, and so far there have been no signs of a wave of investor defaults or sell-downs. Conversely, the COVID-19 outbreak appears to have created winners as well as losers, permitting managers who constructed a more diversified portfolio to balance investments in exposed industries with investments in industries that have grown as a result of the disruptions, such as online and e-commerce-related businesses. The disruptions may have also created unique buying opportunities in a market that was seen as promising but over-valued before the COVID-19 outbreak. This seems to apply not just in the buyout sector, but in real estate, distressed and special opportunity investments, as well.

From a fundraising perspective, COVID-19 has been challenging, particularly for sponsors raising capital from non-Japanese investors for the first time. Some investors in fiduciary posi-

tions, such as pension funds, were at least initially limited by policies requiring in-person meetings prior to investing with a sponsor for the first time, and the travel restrictions put in place during the outbreak have effectively reduced the pool of prospective investors. Nonetheless, the industry appears to have adapted through innovation and use of new technologies. New videoconferencing apps and pre-recorded interviews and presentations have become the new normal and have allowed fundraising to continue in the face of these challenges, allowing sponsors to connect with prospective investors.

Alternative fund sponsors have also been concerned, particularly during the initial market downturn in March and April, that investors would cut back their allocations for alternatives and become more selective. In particular, there were concerns that the denominator effect might reduce allocations from Japanese financial institutions that had expanded heavily into alternatives in recent years, some of which had begun facing constraints even prior to the COVID-19 outbreak. Other investors expressed hesitation about permitting managers to make investments during the peak of turbulence in the financial markets. Buoyed by momentum from 2019, however, fundraising remained remarkably resilient, with multiple major buyout and real estate funds successfully reaching their hard caps during 2020, and not infrequently as "one-and-done" fundraisings. The road has not necessarily been easy, though, as the COVID-19 outbreak seems to have made fundraising more difficult even for stronger sponsors. Investors appear to be more cautious than ever in evaluating and negotiating their investments in alternatives, conducting more extensive, probing and time-consuming due diligence and legal reviews of fund documentation. Their caution has also likely led them to become more intransigent on certain terms.

The Resignation of Prime Minister Abe

Prime Minister Abe, who began his second term as prime minister in late September 2012, is generally credited with steering Japan out of the end of the GFC and two decades of deflation. Through his "three arrows" of expansionist monetary policy – increased government spending and legal reforms aimed at stimulating private sector investment to achieve long-term growth – Abe laid a foundation that was hospitable to the expansion of private equity and alternative funds generally. In particular, corporate governance reforms and the introduction of a stewardship code, cuts in corporate tax rates, and other reforms that facilitated M&A transactions paved the way for corporate carve-outs, attracting attention from major global private equity investors. Mr Abe became Japan's longest-serving prime minister in 2020, shortly before he announced his resignation for health reasons. While it is believed that his pro-investment policies are unlikely to change under a new administration, his resignation creates some uncertainty about the ability of future administrations to sustain the pro-investment environment Mr Abe cultivated. With a few notable exceptions, the position of prime minister has largely been a revolving door where the office holders have, more often than not, failed to have any meaningful positive impact on Japan. It remains to be seen whether the leaders who will take Mr Abe's mantle going forward will be as effective in fostering the vitally needed pro-investment reforms in a rapidly ageing society that has historically excelled at preserving harmony and resisting change.

Long-Term Trends in Alternative Funds: Diversification and Flight to Quality

Two key trends that have shaped the development of alternatives in Japan are diversification of the industry and the so-called "flight to quality". To varying degrees, these trends have only been accentuated by the COVID-19 pandemic.

Diversification

The Japanese private equity buyout industry has developed significantly since its inception at the end of the late 1990s. With a few notable exceptions (eg, Softbank), since the GFC, the domestic industry has largely focused on small and mid-cap deals, while the larger deals, including the headline-grabbing corporate carve-out transactions, have been driven by corporates and global private equity firms. This segmentation of the domestic industry was due in large part to the relatively small fund sizes of domestic sponsors, which in turn was largely dictated by investors. After the GFC, Japanese investors expressed a clear preference for smaller funds, believing that the core competencies of domestic firms were in small-cap domestic buyouts, and that domestic sponsors had veered off course in the run-up to the GFC by trying to do larger deals in spaces best occupied by more experienced global buyout firms. This largely shaped the industry for the next decade, with smaller fund sizes and few fundraisings crossing the JPY100 billion threshold. Through 2018, according to APER, average private equity fund sizes in Japan ranged from USD75 million to USD150 million, nearly doubling to USD270 million in 2019. Despite the challenges of 2020, domestic Japanese private equity seems to be breaking out of that mould, with multiple fundraisings eclipsing the USD1 billion mark, and a handful of others closing or expected to reach final closings in close proximity. Moreover, an increasing number of domestic firms have raised their first funds with offshore vehicles for non-Japanese investors. A few domestic firms have expanded their sights beyond Japan, with third country-focused or pan-regional funds, while others have entered new niches domestically, raising regional development-focused funds in areas previously under-served and overlooked by traditional private equity. This differentiation is punctuated by the different sizes, targets, strategies and specialisations emerging in the market.

There is also growing diversification in private equity strategies outside of the buyout space. Real estate funds, and J-REITs in particular, have been a strong part of the alternatives landscape for years, but recent years have seen a wave of large infrastructure and logistics fundraisings. Asia-based logistics operators have recently raised multiple funds exceeding USD1 billion and 2020 saw the closing of a significant USD2.75 billion Japan-focused pan-Asia real estate fund and the seeding of a JPY280 billion (USD2.6 billion) open-ended logistics fund, with the potential to grow to up to USD10 billion in AUM according to Private Equity International. Growth, mezzanine and regional development funds, and minority activist funds, have also contributed to the diversity of alternatives in Japan.

Two alternatives sectors that have not developed, at least to date, have been private credit and hedge funds. Private credit funds may find it more difficult to plant roots in Japan due to competition from traditional banks, who tend to have significant capital available for lending and are able to lend at very low interest rates. There are also relatively few hedge funds in Japan, with industry tracker eVestment reporting that less than 1% of all hedge funds globally have their primary physical location in Japan. This might seem surprising for the world's third-largest economy by GDP, which has sophisticated and well-developed debt and equity markets, and around 3,500 publicly traded companies, but onerous tax and legal regimes, which can make it take over a year to obtain certain licences, have tended to make Singapore and Hong Kong more attractive as a hub for hedge funds in Asia.

Flight to quality

In North America and Europe, the flight to quality, whereby investors flock to fundraisings by stronger, proven sponsors, has tended to polarise the private equity market, leading to the rise of mega-funds and making fundraising more challenging for newer firms and firms without top track records. Historically, this trend has been less pronounced in Japan. There are a number of reasons for this, including the investment strategies employed by Japanese investors in private funds, domestic economic policies, and the generally small number and size of Japanese buyout funds. There are signs, however, that this may be changing, and the recent COVID-19 pandemic may be accelerating that change.

A confluence of factors broadly increased domestic investment in Japanese alternative funds after the GFC. Abenomics promoted investments and generated asset-price inflation, helping to reverse the long deflationary cycle that began after the end of the bubble era in the early 1990s. The revision to GPIF's investment guidelines bolstered Japanese public equity markets and boosted alternative funds generally, with prospects for a substantial allocation to alternatives through domestic and international gatekeepers. Japanese mega-banks began to focus increasingly on alternative investments, and regional banks sought ways to invest in alternatives as opposed to the unprofitable business of lending at negative or near 0% interest rates. Reforms at the newly privatised post office, Japan Post, which sought to make more productive use of its prodigious cash reserves, also injected capital into domestic alternatives. Together, these factors created a vibrant domestic ecosystem for alternative funds. Particularly with many Japanese investors preferring to make smaller investments across a range of funds rather than placing their bets on one or two selectively chosen sponsors, the influx of cash into alternatives has floated many boats, spreading the benefits more evenly across a range of sponsors.

Time and the COVID-19 pandemic may alter these trends. There are signs that Japanese investors are becoming more selective with their portfolios as the economic consequences of outbreak have spread unevenly across Japan's economic landscape, as investors have faced benchmarking and greater scrutiny of performance, and as allocations from financial institutions have been impacted by the denominator effect. As a result, particularly among buyout funds, firms with top performance and disciplined, well-managed fundraises have been able to hit or even increase their hard caps and hold one-and-done fundraisings, while firms outside of that band have had longer, more difficult fundraisings. It would not be surprising to see this trend accentuated by the continuing fallout from the COVID-19 pandemic.

Other Trends: Fund Finance

Like many aspects of alternative investments in Japan, fund finance was slow to arrive and develop compared to North America and Europe. There are a number of reasons for this, including Japan's complex tax and regulatory system, the relatively small size of domestic private equity funds, and the apprehensiveness that domestic LPs have expressed over the use of leverage by domestic sponsors. Despite Japan's complex tax and regulatory regime, some domestic private equity funds have nonetheless been able to implement subscription facilities for bridging drawdowns to make investments. Although developing a facility that serves both onshore and offshore fund platforms of a single fund has proved challenging due to the tax and regulatory constraints, with only a handful of banks able to lend against commitments from both Japanese and international investors, private fund sponsors have been able to put bridge facilities in place that separately serve their onshore and/or offshore platforms. The use of these platforms has been limited, however, as Japanese investors (and in some cases, non-Japanese investors) have initially been resistant to such fund-level borrowing. Addressing the concerns of US tax-exempt investors has also been challenging, particularly for smaller funds, where costs may not always justify the benefits of using blockers. Consequently, borrowing tenor under fund partnership agreements

has tended to be quite short, with many facilities restricting the period for which loans may remain outstanding to no more than 30–90 days, and the purposes for which borrowing is permitted have generally not expanded under private-fund partnership agreements to the extent they have in other markets.

Nonetheless, fund finance seems to serve a clear need for growing domestic sponsors seeking to invest in larger deals. With increased competition for buyout deals from global sponsors and strategic buyers, domestic sponsors who require asset-level debt financing must, increasingly, be able to prove funding certainty and swift execution. Without a subscription facility in place to bridge funding, any delay in putting such asset-level debt financing in place could adversely impact funding certainty and leave a domestic sponsor at a competitive disadvantage. Subscription facilities help bridge these gaps, permitting sponsors to move quickly in competitive situations on larger ticket deals. Although convincing domestic (and, in some cases, overseas) investors of the need and benefits of such financing arrangements has required effort, there appears to be a clear need for such facilities in the market. As the competitive realities and the use of subscription facilities become better understood, it seems likely that they will become more ubiquitous going forward.

Simpson Thacher & Bartlett LLP is a global law firm with more than 1,000 lawyers working across 32 major practice areas and almost every industry sector. Its multidisciplinary private funds practice has advised clients for over 40 years, playing a prominent role in the development of the private funds industry. Working closely with the firm's other practice areas, the private funds team advises many of the world's best-known institutional alternative asset managers, as well as smaller funds and independent boutiques. In addition to comprehensive fund formation advice, the firm provides sponsor and adviser clients with practical solutions to complex regulatory, compliance and enforcement issues, and advises sponsors of private funds worldwide. Simpson Thacher also has substantial experience in M&A transactions involving private investment firms, IPOs of alternative asset managers, credit facilities for funds and managers, and secondary transfers of private fund investments. In Tokyo for over three decades, the firm advises both Japanese and international clients on capital markets, M&A and cross-border private fund formation transactions.

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