PRIVATE EQUITY international

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Fundraising

Land of the raising fund

Japanese pension funds and other institutional investors are slowly discovering, not always for the first time, the attractions of private equity as an asset class. For GPs looking to tap new sources of capital, starting to build relationships now should prove lucrative in the future.

To date, Japanese financial institutions have played a rather modest role as providers of capital to international private equity firms. Alternative assets have long been attracting attention from Japanese investors. But this has mainly been to the benefit of hedge funds holding out the promise of greater liquidity while demanding less specialist knowledge from the investor. According to a source familiar with Japan investment flows, over 300 Japanese institutional investors invested in hedge fund products in 2001 alone, committing some $13.5bn between them, whilst less than 30 institutions contributed to private equity funds in the same year.

There is nevertheless a relatively long history of Japanese involvement in the asset class. Several banks and insurance companies began to move into private equity in the late 1980s, investing in US and European general partnerships either through funds of funds or directly from local offices in New York and London. But this initial foray came to a halt in the 1990s after the world's second largest economy fell into a recession that it has been struggling to emerge from ever since. For a period in the 1990s, it was secondary buyers of limited partner interests more than fundraisers who considered Japan an attractive place for doing business.

Looking for yield

This is now changing though. Japan's institutions, whose efforts to generate returns have long been frustrated by ultra-low interest rates, a depressed domestic public equity market and the poor performance of Japanese Government Bonds, are looking for better yield internationally. Although the preference is very much for 'income today' as opposed to long-term exposure, the limited choice of high-yielding domestic assets and private equity's global recognition as a higher yielding asset class mean that a growing number of Japanese investors are considering to step up their allocations or, where they have not already done so, set up a private equity programme for the first time.

Life companies including Daiwa, Nippon, Yasuda and Tokyo Marine are all already active investors in private equity funds. Among the banks with an exposure to the asset class are Norinchukin and Mizuho, which has long invested in private equity and, after a period of keeping a lower profile, is now looking to increase its commitments. Trust banks such as Sumitomo are investing, as are the big trading companies including Mitsui, Itochu and Mitsubishi, which has also formed an alliance with Pacific Corporate Group to operate a fund of funds joint venture where its role is understood to be mainly that of a placement agent. Other trust banks are thought to be mulling similar plans.

The most telling change, however, dating back to the late 1990s, is that public and private pension schemes, which between them control trillions of Yen in capital, are for the first time looking to become more visible in private equity. "Japanese pension fund investment in the asset class is still in its infancy, but there are signs that more funds are beginning to be active," says James Moore of the private equity funds group at UBS Warburg, which like Merrill Lynch and CSFB operates a private equity fund placement business out of Tokyo. Wayne Harber of Hamilton Lane, which has been doing business in Japan as a gatekeeper and fund of fund manager for years, agrees: "Public pensions and government-related entities haven't taken the plunge yet, but many are studying the nuances of the asset class at the moment."

In the private sector, corporate pension fund assets are also attracting attention. In line with recently enacted legislation (see boxed item accompanying this article), numerous corporate pension fund managers are turning to a fund run by the government where they hand over their assets for investment (daiko-henjo). As a result, whereas in the past individual corporate pension funds did not have enough of a risk buffer to invest in high-return strategies such as private equity, the pooled assets afford the government fund enough, and increasingly more, critical mass to invest in alternative assets. “Everyone is talking about this money,” says an investment manager at a major Japanese financial institution. “They say they are just studying for now, but they will probably become a major limited partner in the coming years.”

Obstacles

Nevertheless it is still early days for pension fund assets held both publicly and privately to move into private equity, and it would be wrong to expect a sudden stampede into the asset class any time soon. Mizuho Securities estimates that Japanese pension fund investment in private equity accounts for less than 1 per cent of pension fund assets as at July 2002.

There are various reasons for the pension community’s relative lack of prominence within the asset class. One important obstacle it that unlike other financial institutions in Japan, pensions are not allowed to invest directly in limited partnerships, having to use the trust banks as trustees instead. Under Japanese regulations a trustee has the same fiduciary duty as the pension fund it represents, so that investment decisions require the consent of both parties. Furthermore, Japanese pension managers may not be used to the accounting standards that GPs apply, run to a different fiscal calendar or apply reporting standards that differ from that of a partnership.

There is also a lack of knowledge about private equity investment practices and products. According to a recent survey by the Pension Fund Association in Japan, 86 per cent of the funds themselves state they lack sufficient relevant knowledge, and while 43 per cent need to improve their investment stance, they say they do not have any specific measures in mind.

Historically, there has also been the currency risk. “Japanese investors know that if the exchange rate goes against them, top quartile performance can be reversed into a bottom quartile result,” says Mounir Guen at MVision, whose placement team pay regular visits to Japan.

Other frequently cited hurdles include the language barrier, the fact that subdued public markets are reducing the amount of capital available for new investment and, most importantly, trustees’ current reluctance to make any allocation decisions for the future prior to having some comfort that the investments they have made since 1998 are indeed performing.

“Current performance is the biggest issue for investors at the moment, and many are busy nurturing their positions,” says a Tokyo-based observer. “Many of the newcomers haven’t seen any returns yet. If the assets perform, they will increase their allocations and others will follow. If not, it could well be a turn-off.” The focus on returns is also a reason why many institutions are extremely tough when doing due diligence on domestic managers. Japan’s home-grown general partner scene, the formation of which began in 1999, is too young as of yet to be able to demonstrate the kind of track record that their international counterparts can show for themselves.

Forge those relationships now

International GPs and placement agents alike are nevertheless adamant that now is the time to grow relationships with the Japanese buyside while beginning to cultivate new ones. The complexity and seeming “otherness” of the Japanese financial system mean that foreign money managers are often finding it difficult to get close to institutions that are looking to enter the asset class for the first time.

A key rule for general partners looking to establish a franchise in Tokyo is to be alive to the local appetite for regular communication. Relationship management is taken very seriously: “Some larger investors are currently keen to minimise the number of relationships with foreign GPs to be able to monitor them better, which in turn is likely to boost individual ticket size,” notes Tanya Race, who manages MVision’s presence in Japan.

In terms of forging new relationships, for a new investor to make an investment decision takes more than one presentation - and an annual visit even post-closure will be much appreciated. “Raising capital from a new Japanese institution takes determination and a lot of work,” says Paul F. Denning, the San Francisco-based placement agent. “You have to be prepared to follow it through. But jet-lagged travellers will always be met with great interest.” Time to get on a plane.

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Japan's investment institutions

To the untrained eye, the number and diversity of Japan's institutional investors can seem bewildering. As a starting point though, and with the invaluable help of Mizuho Securities*, here's a snapshot of Japan's institutional investment institutions.

Pension fund managers

The pension system in Japan consists of three pillars: public pensions managed by the state, corporate pensions managed by companies, and personal pensions.

Public pensions consist of: the National Pension (Basic Pension) which covers all members of society, Employee's Pension Insurance which covers workers in the private-sector, and the Mutual Aid Associations which cover public servants.

The pension funds of public institutions fall into the category of Mutual Aid Association Pension Funds and due to the large size of the public sector accounts for one of the largest investor groups in Japan. Mutual Aid Associations for government employees are divided mainly according to the types of occupations, and for the municipality employees mainly according to the sections of the municipalities. Key Associations are:

- The Pension Fund Association for Local Government Officials (Chikoren) with reported assets of Y11,991bn as at March 1999;
- The Federation of National Public Service and Affiliated Personnel Mutual Aid Associations (Kokkoren) with reported assets of Y8,135bn as at March 1999;
- The Mutual Aid Association of Public School Teachers Pension Fund (Koritsu Gakko) with reported assets of Y7,086bn as at March 1999.

A new defined-benefits corporate pension law (also known as the Corporate Pension Law became effective 1 April 2002. The current amendments that defined benefits corporate pensions which can be separated into employees' pension funds and qualifying retirement pension funds will be split into 3 systems being (1) the existing Employees' Pension plan, (2) contract type pension and (3) fund type pension. In principle, investment management of these funds is to be handled by trust companies, life insurance companies and investment advisory companies but the funds may also invest by themselves.

Trust Banks

Japan's trust banks provide long-term loan and equity capital to companies and also provide conventional banking services and asset management services including pension management and trusteeship (see accompanying article). Some became especially mired in the property market crash and construction sector meltdown. After a series of mergers there are now four key trust banks: Mitsubishi Trust & Banking; Mitsui Trust Holdings; Mizuho Trust & Banking and Sumitomo Trust & Banking.

City Banks

These leviathans of the Japanese financial system have regrouped and restructured as problem loans and a deflating economy pushed several to the brink. Here are the key players both by their former and current identities:

- Asahi Bank (now part of Daiwa Bank Holdings Group);
- Bank of Tokyo-Mitsubishi;
- Dai-Ichi Kangyo Bank (Regrouped as Mizuho Bank and Mizuho Corporate Bank);
- Daiwa Bank (now part of Daiwa Bank Holdings Group);
- Fuji Bank (Regrouped as Mizuho Bank and Mizuho Corporate Bank);
- Sanwa Bank (now UFJ Bank);
- Sumitomo Mitsui Bank;
- Tokai Bank (now UFJ Bank).

Life Insurance Companies

These are often massive life insurance providers with increasingly active and diverse investment strategies. The leading firms here are: Daido Life, Dai-Ichi Mutual Life, Nippon Life, Sony Life, Sumitomo Life, Tokyo Marine Life and Yasuda Life.

Non-Life Insurance Companies

These provide a huge range of insurance products other than life policies. For a company list see the Non-Life Insurance Institute of Japan:
http://www.sonposoken.or.jp/links_e/index.html

Investment Trusts

There are numerous international asset management firms as well as units within domestic financial institutions, particularly securities firms such as Nomura, Nikko and Daiwa (the big three) that are offering unit trust products to Japanese retail investors. For a full listing see:
http://www.mizuho-sc.com/english/ebond/institutions/trusts/members.html

* see also http://www.mizuho-sc.com/english/ebond/