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Why Private Markets Are Positioned for Significant Growth in Japan

While still in the early stages of alternative investing, investors in Japan are employing their growing experience to target new opportunities in pursuit of diversification

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Founded in 2001, **Capstone Partners** is a leading independent placement agent focused on raising capital for private equity, credit, real assets, and infrastructure firms from around the world.

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Japan is one of the most sophisticated LP markets in Asia, with institutional investors managing over $30tn of assets. Compared to their Western peers, Japan-based LPs are mainly invested in traditional investment asset classes (bonds or listed equities). While some Japanese banks and insurance companies were among the first Asian investors to consider alternative assets in the 1990s, the majority of the LP community is only at the beginning of its journey toward allocating to non-traditional assets. That said, allocations toward private market investment opportunities are growing – even in the face of the economic challenges presented by the pandemic. Closed-end funds are attracting particular attention, having demonstrated their ability to deliver better risk-adjusted returns than hedge funds.

Local LPs Are Growing Their Exposure to Private Market Funds

Under the leadership of several major state-related pools of capital, significant amounts of capital have flowed into the private market space over the past five years. For instance, Japan Post Insurance's three-year plan is to commit $10bn to alternatives by 2021, though this represents only 1.5% of total assets.

Meanwhile, other Japanese institutions have taken a more aggressive approach. A JP Morgan report in 2019 found that Japanese corporate pension plans have increased their average alternatives allocation to 21.3%, up from 12.8% in 2015. However, that same report states that many banks' and insurers' allocations to alternatives were still in the low single digits. Considering the prospective yield of other asset classes, proactive institutions have put in place ambitious investment programs geared toward private equity, private debt, infrastructure, and real estate funds. They have paved the way for more commitments from smaller pension funds, insurance companies, and regional banks that still have limited exposure to alternatives, and that may need to diversify their portfolios in the years to come.

In this context, the proven experience of both local and international gatekeepers for selecting the most attractive fund managers globally should allow more Japanese institutional investors to pursue private funds in their investment program. This is especially true given market risks brought on by COVID-19 that have more recently highlighted the need for more holistic diversification strategies.

Buyout Managers Offer an Attractive Diversification Play on a Global Scale

Together with Australia, Japan is one of only a few economies in Asia-Pacific to allow private equity managers to deploy private money according to the LBO model, which has proven to drive solid cash-on-cash returns to institutional investors.

The Japanese buyout market is considered one of the most attractive on the global stage. The addressable market is huge: Japan hosts over 50,000 companies with more than $25mn in revenues, which is roughly the same as the entire Asian region excluding Japan. Furthermore, compared to other developed markets, the penetration of the private equity industry is still relatively low. Private equity investments in Japan represented 0.23% of GDP on average over the past five years, compared with over 2% in the US and over 1.5% in Australia.

The higher end of the market should remain mainly driven by large carve-out and public-to-private transactions. In April 2019, KKR announced that Japan would be its "highest priority" outside of the US. In March 2020, the Carlyle Group closed its fourth Japan-focused buyout fund at $2.4bn, almost double the size of its last fund. CVC Capital Partners plans to invest 30% ($1.4bn) of its most recent Asian buyout fund in Japan.

The lower end of the market is also expected to grow significantly. Demand for private equity investment from family-owned SMEs is increasing exponentially in the face of succession issues. And only local managers possess the skillset to invest in that segment of the market.

Where in the West a significant proportion of deals are sponsor-to-sponsor transactions, in Japan most are primary investments. As such, GPs can use their hands-on toolkit for creating value without having to rely on stretched financial leverage structures. Furthermore, considering the consistently high proportion of primary transactions where the intrinsic qualities of the buyer are as important as the price, the entry multiples remain below what we have seen in the West in recent years. Compared with a few years ago, a growing proportion of founders/private owners consider private equity transactions as an alternative solution to a traditional sale to a local trade buyer, or to the 'do nothing' scenario. Several former emerging GPs are now established, having built a reputation for being good partners for privately owned companies. In that context, local GPs have a competitive advantage against international platforms, which are mainly interested in large transactions.

At this stage, only a few exits have been completed with international trade buyers. Going forward, we expect to see more well-developed transactions which will likely drive exits for private equity-owned quality firms to both Japanese and international acquirors. Otherwise, exit pricing should remain as discounted as at entry.

The language barrier remains one of the main issues for international investors to do their due diligence on Japan-based lower-middle-market managers. A credible alternative to direct fund investments consists of relying on Asia-focused funds of funds, where a team of Japanese professionals would handle the language and cultural barriers.

Opportunity for Growth for LPs and GPs

Compared to international benchmarks, Japanese institutions still require significant effort to rebalance their assets under management more toward closed-end funds. We expect to see increased appetite from Japanese investors for both domestic and international fund opportunities in the near to medium term. And as more Japanese companies consider private equity as a solution to their capital needs, the buyout market will continue to grow. The low entry multiples provide opportunity for both domestic and international GPs to make solid returns for their LPs.