KEYNOTE INTERVIEW

Private markets in Japan continue to accelerate

Active primary fund investing and increasing LP appetite for co-investments, secondaries and direct lending are indicative of Japan's maturing private markets landscape, say Neuberger Berman's Jonathan Shofet and Yoshi Yagisawa

SPONSOR
NEUBERGER BERMAN

Q How does investor appetite for private equity in Japan compare with other major APAC and international markets?

Jonathan Shofet: Long-term global investor demand for PE remains strong. The asset class has performed well over many years and is generally expected to generate attractive relative returns into the future. However, over the past couple of years we have seen differences in demand by geography and investor type, with a subset of LPs having recently pulled back from the market.

While the well-covered numerator and denominator effects are no longer substantially at play, we feel PE demand has been impacted by a lack of distributions due to decreased global M&A. For those investors who had become accustomed to robust and consistent PE distributions, this has become a short-term issue, causing them to delay new commitments.

Overall, we have observed that Japanese institutional investors continue to allocate material capital to the private markets. Neither a lack of current distributions nor the weakened yen over the past two years have meaningfully reduced demand for the asset class, set against strategic objectives to achieve longer-term private markets targets.

The country has been highly engaged with the private markets for many years but numerous public and private institutions remain underweight in the asset class relative to their peers in other major economies. A number of large Japanese investors only launched their private markets programmes during the past five or six years, and certain financial institutions with more mature private markets programmes have only recently started to accelerate those portfolios. As such, we believe that investors in the Japanese LP community have significant appetite and room to grow.

Q How are Japanese LPs accessing the private markets in the current environment?

Yoshi Yagisawa: Over the past decade we have seen a dual approach among Japanese LPs to both go directly into funds and to use fund of funds providers with whom they can meaningfully partner. This has enabled Japanese investors to build relationships more quickly, access best-in-class funds, reduce risk through diversification and better monitor and manage their PE investments. This approach has also enabled Japanese LPs to expand into areas that are harder for them to cover, such as the US and European mid-market.

More recently, we have seen a material ramp up in the use of co-investments and secondaries to drive returns potential, enhance capital efficiency and more proactively target portfolio exposures. These are often viewed as the next evolution of a primary funds-only portfolio, and we believe these strategies will be a growth area for Japanese investors over the next decade.

Private credit appetite is also increasing in Japan given the potential for attractive and consistent yields. Additionally, within primary investments, certain Japanese institutions have started to partner with global fund of funds providers to identify, evaluate, and monitor Japan buyout and venture capital funds, just as they do for overseas funds, both to build strong domestic PE portfolios and to reduce the associated administrative burden.

Q Which areas within the co-investments strategy are generating LP demand?

JS: We see a lot of LP demand for co-underwritten deals, whereby a provider will pair up with a GP to bid on an asset together. This strategy allows the co-underwriter to diligence a potential investment in real time alongside the GP for weeks or months, in contrast to the more abridged and prepackaged diligence process found in a traditional syndicated co-investment. Japanese investors often take comfort in the double layer of diligence conducted by both the GP and co-underwriter, which has the potential to improve investment outcomes.

In addition, there is material LP appetite for co-investment opportunities where a GP owns a company and wants partial liquidity, or is using the proceeds for M&A, but the company might be fully levered. Whereas one would historically use debt to complete these kinds of transactions, these GPs are instead using co-investment equity. These transactions are commonly referred to as "mid-life co-investments" and we're seeing greater LP demand for them.

Co-investments continue to gain popularity because the capital is deployed immediately upon the close of an investment and they are typically done without ongoing management fees and carried interest at the underlying level. This creates capital efficiency within portfolios and the potential for outperformance from fee savings alone.

Finally, we are seeing Japanese LPs focused on targeting specific asset classes, industries and geographies within their PE investment portfolios. Co-investments can allow for greater control over investment exposures versus what may be generated from blind pool fund commitments. For these reasons, we believe co-investments will continue to gain market share in Japan.

Q How are Japanese LPs engaging with GPs?

YY: LP-GP engagement is as strong as it has ever been. The GP community has taken note of the growing private markets appetite in Japan, with a greater number of sophisticated GPs covering the Japanese market both directly and through investment solutions providers. An increasing number of larger GPs have also set up offices in Japan so that they can interact more meaningfully with their Japanese LPs.

We continue to receive a greater number of inbound calls and inquiries from GPs about Japanese investor trends and how to best approach the LP community in Japan. In our minds, to be successful in Japan, GPs need to have a long-term, enduring commitment to the country, and this is best evidenced with dedicated resources and a real presence on the ground.

Q Material PE capital continues to be raised from Japan, but what is your view of Japan as a market for PE investment?

JS: Japan is an attractive market for PE investment. There are particularly interesting opportunities to invest in companies where succession is required, and PE is a great facilitator of that trend. There also opportunities for take-privates of companies that aren't well-suited to being public, and there is substantial activity in the carve-out space, stimulated by a push for greater returns on equity from corporates.

In addition, valuations remain compelling and are characterised by relatively low entry multiples, while debt financing remains relatively inexpensive. In our view, there are a lot of things to like in the Japan market from an investment standpoint.

The growing opportunity set in Japan continues to attract investment from local, global and pan-regional PE firms. Strong local GPs tend to be characterised by experienced teams, differentiated sourcing, well-defined strategies and attractive track records. Global managers tend to be well-resourced and well-positioned for larger transactions. As such, there is an ample supply of choices when building a primary funds programme focused on Japan. We expect the PE ecosystem in Japan to continue to develop and thrive in the coming years.

Q How much demand are you seeing for separately managed accounts and other custom fund capabilities in Japan?

YY: An SMA can be customised based on a variety of investment criteria, structures, reporting requirements and cash management needs. The level of customisation that investors can get through SMAs is difficult to achieve through commingled funds. Japanese investors vary by size, resources and familiarity with the asset class, and they each have their own internal decision-making process, especially when it comes to making fund commitments. Some institutions favour fully-outsourced solutions, while many others are looking for a collaborative process by working with solutions providers.

We spend a lot of time focusing on SMA portfolio construction with our clients in Japan. We have approximately 120 people working in our Tokyo office and talking to clients on a day-to-day basis about their goals and constraints. We also have a six-member New York-based PE Japan coverage team – our "Japan Desk" – who are Japanese or Japanese-speaking professionals that focus on SMA portfolio construction, programme management and client services for Japanese investors. This setup allows us to provide 24-hour client service coverage.

> *"Neither a lack of current distributions nor the weakened yen over the past two years have meaningfully reduced demand for the asset class"*
>
> **JONATHAN SHOFET**

Q How is appetite for direct lending changing?

YY: We certainly see more appetite in the LP community for direct lending, given the highly attractive all-in yields and the materially greater share of the market now held by private credit funds.

A decade ago, a handful of large sophisticated Japanese financial institutions were investing in private credit using SMAs set up with a small number of direct lending managers. Today, we are seeing much broader adoption. Pension funds and other financial institutions are making active use of both SMAs and commingled funds to access the private credit asset class. We are also now seeing LPs set up private credit funds of funds similar to those that have already been seen within PE for many years.

Q How do you expect the secondaries market to develop in Japan?

YY: We feel there is increased acceptance and use of secondaries by Japanese institutions to manage mature PE portfolios. In terms of investing in secondaries, we see continued appetite from Japanese institutions for attractively priced and well-underwritten LP interests and GP-led continuation vehicles.

One recent development is the use of GP-led continuation vehicles within the Japan PE market. Our secondaries business recently completed a multi-asset continuation fund transaction in Japan, which we believe is the first ever GP-led transaction using a continuation vehicle, so we are one of the first movers in this space.

The deal itself was a complex transaction, which took nearly a year to complete – it involved in-depth commercial diligence and complex legal tax structuring. We expect more deals like this will occur in the future as the secondaries market in Japan continues to develop. ■

Jonathan Shofet is global head of the private investment portfolios and co-investments business and Yoshi Yagisawa is a managing director leading the New York-based Japan Desk at Neuberger Berman