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SPOTLIGHT on East Asian LPs

How rising private equity allocations in China, South Korea and Japan will change the asset class

WITH EXPERTS FROM:

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Slumbering Giants No More?

East Asia has long been a popular, but secondary, fundraising destination, but if current trends continue, it may become an important first stop for seekers of long-term capital.

The most tenured player in the private equity market is Japan, home to a tight-knit community of LPs. Until recently, however, the growth of allocations in Japan and East Asia has been tepid.

Now, as you'll learn in this report, two major Japanese institutions—the Japan Post Bank and the Government Pension Investment Fund (GPIF)— have embraced private equity. The GPIF is estimated to have some $1.3T (that's trillion, with a "t") in assets, and is interested in allocating up to five percent, or $65B, to private equity.

Any LP looking to build a $65B private equity portfolio is going to get attention, of course, but the GPIF example is just one of dozens of large organizations in Japan, South Korea, and China to initiate meaningful allocations to private equity, often after having studied the success and cautionary tales of peers with (slightly) longer tenures in the market.

In this report, we bring you the market intelligence of investors and advisors who have spent years building relationships with East Asian LPs, and who are excited at the events now unfolding in the region. We hope their views are helpful as you think about your own investor base, and make clear that in 10 years, fundraising might look very different than it does today.

Enjoy the report,

David Snow
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With Korea Leading Way, PE Grows in East Asia

Weichou Su
Partner,
StepStone

Limited partners in Japan, South Korea and China are cash-rich and increasingly interested in private equity

Large limited partners in East Asia are increasingly bullish on private equity.

"When we look at the three biggest markets in East Asia—Japan, South Korea and China—we are really seeing growing interest in private equity," says Weichou Su, a partner at StepStone, which helps LPs choose funds for investment and oversees more than $91B in private capital allocations.

Su estimates that large PE firms like KKR, Blackstone and Carlyle now source as much as 30 percent of their money from Asia. "East Asian LPs want exposure to PE funds operating in the U.S.," he explains. "They want access to the U.S. markets. They already have their own array of investments in other asset classes at home."

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South Korea Leads the Way

Although South Korea's economy is not nearly as large as Japan's or China's, the country is the first mover in the East Asian PE market. Su says if you are a GP with any aspirations, you want to be in front of the two large Korean players: Korean Investment Corporation, which is Korea's sovereign wealth fund and has $30B in assets under management (AUM), and the National Pension Service, which has around $430B in AUM.

Below these top-tier investors are significant standalone institutional LPs, like the Korean military and civil servant pensions, insurance companies, and corporate pensions. All of these groups are staffed by professionals well-versed in the PE field, says Su.

Japan has embraced PE only recently. For years, investors here shied away for a number of reasons. The large national pension fund, for example, did not want the media scrutiny that comes with PE investing. But new drivers are influencing LPs to move toward private equity, including negative interest rates, zero economic growth, and limited returns from domestic bonds and fixed income.

Two large Japanese institutions have recently entered the PE market for the first time: GPIF, the $1.5T public pension fund of Japan, and Japan Post Bank, with total assets of about $2.5T. Both have a stated goal of 5 percent allocation to private equity and, together, they dwarf all other players combined.

For the past few years, China Investment Corporation (CIC), with total assets of $814B, has been writing large checks. Recently CIC has been joined by major insurance companies, which are growing more aggressive, and by China's high-net-worth individuals with massive pent-up wealth.

"Until now these wealthy individuals and families were very inward-looking," Su says. "China was the fastest-growing market, so why look anywhere else? But now, with China slowing, they are feeling the pressure to diversify and are beginning to look at private equity."

"There is a tendency to go for the tried and true rather than look for those next-generation players that can have a greater return down the road."

–Weichou Su, StepStone

Asian LPs Learn as They Go

With PE talent more mobile than ever, Asian LPs are finding it easy to hire GPs and transfer knowledge inward. This increases their ability and their comfort level but many LPs still approach PE tentatively. Some LPs follow the herd and construct lackluster portfolios. Others take the path of least resistance, targeting the biggest and least controversial names in the business, which can also diminish returns.

"These LPs want to make decisions that no one can fault them for," Su says. "There is a tendency to go for the tried and true rather than look for those next-generation players that can have a greater return down the road. Internally these are large organizations and very hierarchical, so it's not easy to change the mindset."

While the big PE players—the TPGs and the KKRs of the world—already have their own Asia-focused funds and are set up to meet the growing allocations of East Asian LPs, there is still ample opportunity for mid-tier and small PE groups in the region.

"Even though these firms don't have big names, there are LPs in Asia who are interested in smaller, differentiated GPs," Su says. "There is a growing market for these PE firms among Asian LPs because the market is growing by leaps and bounds." ■

East Asian LPs Learn PE on the Fly—*and Quickly*

Hemal Mirani
Managing Director,
HarbourVest

Private equity commitments from East Asia are rapidly increasing—and LPs are proving to be up to the task

Five years ago, LPs in the region supplied less than 10 percent of private capital. Today, blue chip firms like Carlyle, KKR, and Blackstone source as much as one-third of their money from Japan, Korea, and China.

As the saying goes, you should invest in what you know, and LPs in East Asia have come to know private equity quite well in the past few years by leveraging the experience of those LPs who have gone before them—U.S. funds in particular.

"East Asia has the benefit of seeing PE investing models from the U.S. and Canada, how large institutions in those countries have put together their programs and how they've gotten access to funds," says Hemal Mirani, a managing director in the Hong Kong office of HarbourVest, a global private markets fund-of-funds. "And of course, as institutions get more comfortable with private equity, they grow their allocations."

In recognition of that equation (comfort level = allocation level) HarbourVest has ramped up its East Asia presence. The firm opened its first office in Hong Kong 20 years ago. It expanded into Tokyo in 2010, Beijing in 2012, and Seoul just last year.

HarbourVest also knows that to better partner with Asian LP groups, it needs to have people on the ground in local markets who can deepen relationships.

"We want to make sure investors are engaged," says Mirani. "We'll invite them to listen to an investment committee discussion so they have a better understanding of how we think about risk, how we think about the investment opportunity, how we're thinking about allocations and markets, where we think the best opportunities are."

So far, HarbourVest's education efforts are working. Its clients have grown more sophisticated. Many now reach out to investors in North America to learn about issues like handling operational risk, managing challenges in various asset classes, and getting boards comfortable with the private equity J-curve.

And East Asian LPs are proving to be fast learners. For example, where it took years for North American pension plans to get comfortable with the idea of co-investing, East Asian investors have quickly embraced the concept. "Asian investors want to start doing co-investments almost immediately, along with the fund investments they are doing," says Mirani.

On their end, PE firms are making changes to attract more capital from East Asia investors. Because those investors care a lot about reputation, firms are now thinking more about being good partners. "PE firms are thinking about things like, 'Are we doing the right thing when we come to your country, are we behaving the way these LPs want us to behave?" explains Mirani. "That consciousness has grown as more capital comes from East Asia."

That emphasis on reputation is a primary reason why much of the initial investment from East Asia has flowed to brand-name firms. But once they've invested with a brand name or two, LPs are more willing to go to the next level and add midmarket managers to build a complete program.

"Looking five or 10 years in the future, I think we'll see East Asia continue to increase allocations and attract new entrants," says Mirani. "There is no turning back on this. We will continue to see a lot more interest in private equity and the number of institutions looking to get into the asset class will continue to grow." ■

For Asian LPs, Diversification Now Means **Going Global**

Isamu Sai
Partner,
Adams Street Partners

Ben Hart
Partner and Head of Business Development for Asia,
Adams Street Partners

Yar-Ping Soo
Partner,
Primary Investments Team,
Adams Street Partners

Private equity investors in East Asia are realizing that a globally diversified portfolio is a healthy approach to achieving long-term target returns. Experts from Adams Street explain how these LPs got there.

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Privcap: What evidence do you have from your own interactions with large East Asian investors that the region is becoming a major supplier of capital to global private equity?

Ben Hart: Compared to the U.S. or Europe, Asia remains a smaller portion of global private equity commitments. However, it is clearly the fastest growing. Based on LP feedback and publicly available data, we expect Asian LP allocations to PE to increase by a third between now and 2018. This is driven by both macro environment factors—slower regional and global growth, low interest rates, etc.—as well as an increasing appreciation that PE can be an important part of an investor's portfolio.

Isamu Sai: In Japan, two big names are encouraging the industry. Per publicly available information, Japan Post Bank has started PE investments, and the Government Pension Investment Fund (GPIF) is willing to allocate up to 5 percent of total assets to alternative investments including PE, real estate, and infrastructure. Other public employees' pension funds will likely follow suit. And some of the corporate pension funds are returning to or beginning to make private equity investments.

How have Japan, Korea and China evolved as LP markets?

Hart: Investors in all three markets clearly have an appreciation for real assets, including real estate, infrastructure, etc. Beyond that, I think some of the key factors which drive investment patterns include the availability of domestic alternative investment opportunities, currency controls, and interest rate regimes. The more they can find attractive opportunities at home, the slower they will be to "go abroad". Having said that, I think there is an increasing appreciation among investors in all three markets that a globally diversified portfolio is a healthy approach to achieving long-term target returns.

Many of these programs want to quickly fast forward to the allocation policies, personnel and resources of LPs in the U.S. What are the challenges of entering PE in such a big way?

Yar-Ping Soo: Facing an increasing obligation as its population ages and a low or even negative interest rates environment, these pension funds and sovereign wealth funds need to diversify into a higher return asset class. Private equity is a critical component of the asset allocation. However, rushing into private equity with limited manpower can challenging. Third party providers can in the interim provide the ability to quickly gain access to a wide range of private equity products at the required scale.

What are some missteps that you are advising your East Asian clients to avoid?

Soo: Understandably, a client would want to get to its target allocation in private equity as soon as possible. However, in doing so, one must be cognizant of the cycles that come with investing and ensure that there is proper time, geographic and asset diversification. This will differ for a client just beginning to build their PE portfolio versus one with a mature program.

Looking at the next 10 years, how important an LP market do you expect East Asia to be?

Hart: We believe that East Asian LPs will be a dominant LP force. Many of the region's LPs are allocating to private equity from a low base, but growing very rapidly. Combine that with its AUM size, and a small percentage increase in private equity will be truly needle moving in terms of absolute dollars. As a result, they will represent the fastest growing LP community.

Are these LP institutions effectively learning from each other? Sharing best practices?

Hart: We believe the community in these LP institutions are getting tighter. As the industry matures and experienced PE professionals join these organizations, they are able to tap into their own network to work and collaborate more closely. Sovereign wealth funds are also more comfortable working alongside each other as in the case of GPIF and OMERS' collaboration in infrastructure deals.

Japan has been active in the PE market for so long, why has it taken so long for their largest institutions to dip their toes in PE?

Sai: Regulations to financial institutions, pension scheme change and acccounting rule change might have initially discouraged LPs'. Under negative interest rates environment, investors need to take more risk for return, which we think will change LPs for the next 10 years. We expect many Japanese LPs to follow GPIF's lead as the latter starts to invest in private equity. ■

Click to watch this video at privcap.com

Expert Q&A

What East Asia's LPs are Bringing to the PE Table

The availability of capital from Asia's big institutional investors is expected to grow in the coming five to 10 years. But Mounir Guen of MVision Private Equity Advisers cautions they might have difficulty breaking into the U.S. and Europe where GPs have long-running existing core relationships.

Mounir Guen
CEO,
MVision Private Equity Advisers

Privcap: What is the availability of PE capital from large institutions in East Asia?

Mounir Guen, MVision Private Equity Advisers: If you look at access to private capital from the investors to our private equity community, it's still dominated by North America. Around 55 percent or 60 percent of the capital comes from there. Europe comes in second, around 20 percent to 25 percent.

When we look at assets under management in countries like Taiwan, Japan or Korea, they'll be increasing five times in the next five years. China will be [increasing] 10 times in the next five years. And that's just [AUM] from plan sponsors, whether they're sovereign wealth, pension plans or life insurance companies.

That volume of assets at this particular point is not fully open to private equity. When programs start investing internationally, regulators put in a condition of around 2 percent of assets. So, there are these restrictions. Certain amounts of the available capital are domestically oriented for a number of different reasons, which might vary from currency exchanges to portfolio views to other regulatory requirements on the capital. That will change.

In the future, where do you see Asia as far as contributions to PE?

Guen: In five years, I would very much expect Asia to be between 25 percent and 30 percent of global contribution to private equity, because the investor programs in the United States are mature, [and] it's difficult to get into the program because they have their established core relationships.

The programs, in and of themselves, have been in the asset class such a long time that they have quite a large, natural growth rate from the activities because they are well into their J-curve, whilst the newer institutions have to work through the J-curve. That's why portfolio construction is so crucial and their focus on the kink of the curve is absolutely important because the program has to deploy over three to five years, a consistent amount, and then increase it as their AUM grows and as the portfolio starts returning capital.

What level of interest are you seeing in Asia from general partners?

Guen: Private equity firms—successful ones—are pretty much self-funded these days, and the ability to access them is extremely hard. So, how do you then build the program?

Some general partners have an enlightened view and, every time they come to market, they pay attention to the balance and the geographic diversification and type of investment diversification of their funding base. But most don't.

If their existing [investors] are extremely supportive and they have already three or five investors that were looking at Asia, they might not want to have another 10 Asian investors.

In the last year, I identified a fantastic new investor of substance [in Asia] that could potentially make large commitments, had a very straightforward process, and was a very uncomplicated investor. So, it ticked all the boxes in terms of a wish list. I contacted a U.S. general partner and I contacted a European [GP]. The European said, "We're full." The American said, "Let me meet them."

But that new capital is going to have a bit of a challenge to get the portfolios they're seeking and that's why secondaries could be a very good solution to get access as well as being able—which is harder for new groups to understand—you have to premarket yourselves as an investor. ■