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PE Type Unit Trusts for Japanese Investors and Managers Seeking Allocations

Japanese institutional investors have been allocating increasing amounts to alternative asset classes, including private equity, venture capital, infrastructure and private debt (collectively "Private Equity") for some time now in the search of yield[1]. However, with returns on domestic investments, particularly bonds, continuing to be hit by chronically low-interest rates, this is a trend that has been gathering pace. For example, in FY2020, Japanese life assurers increased their holdings in 'other' securities, i.e. securities other than conventional equities and bonds, including fund investments, by 27%[2].

PE Type Unit Trusts

This increased interest in Private Equity by Japanese life insurers, banks and other institutional investors has seen the rapid increase in the use of the 'private equity type' unit trust (the "PE Type Unit Trust"). The PE Type Unit Trust is a Cayman Islands unit trust (the preferred investment vehicle for many Japanese investors) that incorporates some characteristics of a private equity fund, including a capital call feature and defaulting investor provisions. PE Type Unit Trusts typically invest in Private Equity through one or more Cayman Islands companies that are incorporated with limited liability (each an "Investment Subsidiary").

Some investor benefits of using the PE Type Unit Trust structure to obtain exposure to Private Equity include but are not limited to:

(a) Investor familiarity – the Cayman Islands unit trust is already one of the most popular investment vehicles used by Japanese investors for seeking exposure to more complex strategies.

(b) Tax advantages – it is usually possible to obtain securities investment trust tax status in Japan (see below).

(c) Off-balance sheet - the PE Type Unit Trust is treated for accounting purposes as an off-balance sheet vehicle, meaning no consolidation of accounts is required.

(d) JPY Hedging - many Japanese investors wish to hedge any non-JPY currency exposure arising from making non-JPY denominated Private Equity investments. JPY hedging is more difficult when using a limited partnership ("LP") structure, given gains / losses arising from Private Equity investments are not recognised until the relevant investment has been realised, which may be many years after the investment has been made. By contrast, in a PE Type Unit Trust structure, , both realised and unrealised gains are distributable and there is a current net asset value that can be used for the purposes of calculating the non-JPY exposure that is to be hedged.

[1] https://maples.com/fr-ca/knowledge-centre/2018/11/japans-increasing-attraction-to-alternative-investments

[2] https://www.nri.com/en/knowledge/publication/fis/jamb

(e) J-Curve - the J-Curve effect (the historical tendency of private equity funds to deliver negative returns in early years and investment gains in the outlying years as the portfolios of companies mature) often results in early realised losses for investors in an LP structure, especially when a private equity program is in its infancy. In a PE Type Unit Trust structure, while realised losses may result in lower net asset values and possibly fewer distributions, investors need not recognise realised losses to the same extent as with using an LP structure. The J-Curve effect would show up only as a lower net asset value per unit figure, with losses not being realised unless and until any redemptions are made. If no redemptions are made, investors will not need to recognise realised losses, a drastically different experience to using an LP structure.

Use of Investment Subsidiaries

As noted above, PE Type Unit Trusts typically invest through one or more Investment Subsidiaries. One advantage to investing through an Investment Subsidiary, from the trustee's perspective, is the trustee is protected from unintended potential personal liability that might otherwise arise from making commitments to underlying private equity funds. Given a Cayman Islands unit trust does not have a separate legal personality, when the Cayman Islands unit trust commits a capital amount to an underlying private equity fund, it is actually the trustee (the legal owner of the assets) that makes the commitment. The trustee is then liable to pay all of that commitment, even if the end Japanese investors default on their commitment to the trustee. From the trustee's perspective, this would be problematic. The Investment Subsidiary provides a solution to this issue since it is the Investment Subsidiary (and not the trustee) who makes the commitment to the underlying private equity fund.

Another advantage of investing through an Investment Subsidiary is the shares in the Investment Subsidiary are regarded as "Securities" within the meaning of the Financial Instruments and Exchange Act (Act No. 25 of 1948) of Japan, meaning the PE Type Unit Trust can obtain securities investment trust status.

Irish PE Type Unit Trusts

Recently, some Japanese promoters have begun to replicate the PE Type Unit Trust structure using Irish vehicles. While Japanese investors have found that an Irish unit trust structured as a qualifying investor alternative investment fund (QIAIF) can accommodate the range of European alternative investments they are seeking to allocate capital towards, it is noticeable that this structure has been adopted for Japanese investors who are seeking exposure to European infrastructure, particularly infrastructure debt in the form of loans, bonds, swaps and notes.

Conclusion

The PE Type Unit Trust not only provides a solution for Japanese investors; it is also providing opportunities for Asian, US and European investment managers who are increasingly tapping new opportunities to manage allocations to Private Equity from some of Japan's largest investors.

The Maples Group can provide legal advice and fund services to the full range of such structures described in this article. If you have any questions on the PE Type Unit Trust, please contact the persons below or your usual Maples Group contact.

This article is not intended to constitute, nor should it be relied upon, as individual legal advice. The choice of structure will often be determined by many factors, including the investor's circumstances.

About the Author

Nick Harrold is a partner in the Hong Kong Funds & Investment Management team at Maples and Calder, the Maples Group's law firm. He specialises in all aspects of investment funds, advising an international client base, with a particular focus on advising clients who wish to target the Japanese market. He is recommended by Legal 500 Asia Pacific as a standout funds specialist who has the "ability to quickly understand very complicated structures" and whose "strength lies in his ability to apply legal principles to some of the most complex, novel and challenging commercial issues". He is also recognised as "client-friendly, innovative and commercial" and having an "in-depth knowledge" of the Japanese market.

Hong Kong

Nick Harrold
+852 3690 7403
nick.harrold@maples.com

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