Benefits and Potentials of Crossover Investing
~Sharing Japan's case to benefit the rest of APAC~

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Asset management firms in APAC can learn from front runners in crossover investing in Europe and the United States. In order to share an adoptable framework of crossover investing with asset managers in APAC, this article summarizes an hour-long interview with Mr. Takashi Maruyama, Senior Advisor of FIL Investments (Japan) Limited on crossover investing. Japan-specific examples in this article are provided to help asset managers find their equivalents in the country/region they cover.

In Europe and the United States, asset management firms that invest mainly in listed companies are investing more in unlisted companies both in and outside their countries. For example, T. Row Price invested in Tokyo and Singapore-based Sansan in its Series E in 2018, and Sansan went public in 2019. To seize similar opportunities, Japanese asset management firms are now starting to follow the footsteps of European and American firms. In January 2021, Nomura Holdings, Inc. and SPARX Group Co., Ltd. announced that they had agreed on a strategic partnership to launch an asset management firm investing in unlisted companies.

As an expert in crossover investing, Mr. Maruyama has generously walked us through the benefits of crossover investing and what is required for this kind of investing to become a common practice in Japan. Mr. Maruyama is also a roundtable member of the Japan Securities Dealers Association, a self-regulatory organization serving an interlocutor for the securities industry in Japan. In April 2021, at the fourth session of the "Roundtable Discussion on Revitalizing the Issuance and Secondary Market for Unlisted Stocks," he delivered a presentation on investing in unlisted companies by asset management firms. Based on the interview, this article will focus on crossover investing by publicly offered investment trusts in the following topics.

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Definition of crossover investing

Crossover investing refers to investing in privately-held companies in their pre-IPO stage and continuing to invest in them after they go public. Crossover investing has been practiced in the U.S. and Europe for more than 10 years. There are key differences between a crossover fund and venture capital and private equity funds. Crossover investors are not hands-on investors and do not send executive management to the investee (although a typical contract states that crossover investors have the right to do so). Crossover investors rarely invest from the seed stage but participate in later stage financing and usually continue to hold shares after the IPO.

There are generally two major factors behind why crossover investment has become a common practice. The first factor is that the period leading up to an IPO has become longer, and more companies are entering into their growth phase before the IPOs. The second factor is that new businesses and innovations often come from startups.

Crossover investing workflow

The investment workflow can be roughly divided into the following four steps.

1. Discovering investment-worthy deals

   In order to find attractive startups, in addition to daily research and networking within the industry, at conferences, and with experts, collaborating with major investment banks is imperative. This is because, unlike listed companies, attractive investment opportunities for non-public startups are not open to everyone. What is required of portfolio managers and research analysts here is the ability to discern whether or not to take the time to conduct due diligence afterwards. Since there is less information available on unlisted companies compared to listed companies, it is essential for investors to possess specialized knowledge of the industry and a grasp of business trends.

2. Due Diligence

   Once an attractive company is found, the next step is to conduct due diligence. The core skills required to analyze a business and to conduct valuation are basically the same as those for a listed company. Due diligence also takes into account non-financial factors such as ESG, which have become increasingly important in recent years. Through meetings with the CEO and CFO, the use of funds to be raised, the business strategy, and the future growth story are examined. Usually, companies that are expected to go public within one to two years are the target of investment.

3. Investment Execution

At the time of investment execution, the investor and the investee conclude a contract. A specialized team within the investing company, with the support of lawyers both inside and outside the company, finalizes the terms of the contract and then executes the investment.

4. Monitoring

After the investment is made, the portfolio managers and research analysts monitor the company on an ongoing basis. A separate internal team, independent of the investment team, also monitors the investee company on a daily basis and calculates the market value regularly. External opinions are frequently sought after to check whether the internal market valuation is appropriate.

As explained above, crossover investments require a different level of effort and cost compared to investing in listed stocks.

Benefits for asset managers

According to Mr. Maruyama, there are two key benefits for asset management firms.

1. Providing clients with investment opportunities in the pre-IPO rapid growth stage

As mentioned earlier, the period leading up to an IPO is getting longer. In addition, the number of cases where a company's growth stage is observed before the IPO is increasing. By investing in a company before it goes public, asset managers can take advantage of the rapid growth stage. As a result, the managers make a significant contribution to the performance of the mutual fund when the investee later goes public.

2. Learning about new business trends and apply them to other types of investments

Knowledge on the new business and innovation trends emerging from startups can be widely applied to investments in listed stocks. Portfolio managers and research analysts can benefit from this great learning experience.

Investing in unlisted companies is risky, but it brings benefits to investors.

Benefits for investees

There are two major benefits for companies receiving investment.

1. Publicizing the future potential of the company to other prospective investors

   When long-term investors of listed stocks are listed as shareholders at the time of an IPO, it implies that those investors see a potential and have a certain level of confidence in the company's future, business management capabilities, disclosure standards, etc. Therefore, when crossover investors are on the shareholder list at the time of an IPO, investors who are considering participating in the IPO see it as a positive sign.

2. Stable financial activities are possible

   For start-ups, there is a significant advantage in having long-term investors who can provide funds in a flexible manner when funds are needed and who can respond to the needs of existing shareholders to sell their shares.

In this way, crossover investment brings benefits to both the investor and the investee. However, crossover investing has not become a common practice among Japanese publicly offered investment trusts.

Challenges and solutions for Japanese investment trusts to start crossover investing

There are a variety of reasons why Japanese public investment trusts cannot immediately start crossover investment funds despite their benefits.

1. Restrictions in the Terms and Conditions

   In many cases, Japanese public investment trusts stipulate in their terms and conditions that their investment targets are listed stocks only. In order for such existing public investment trusts to start investing in unlisted stocks, revising the terms and conditions is a requisite. Such revision is considered a “material” change; therefore, a written resolution from the investors (beneficiaries) is required, and the revision needs to be approved by a two-thirds majority of the beneficiary voting rights. If the risks and benefits of investing in unlisted stocks are appropriately explained, the aforementioned concern should be resolved. Nonetheless, the challenge remains.

2. Concerns about the inclusion of illiquid stocks in a portfolio

There are concerns about liquidity, a common issue across the world. For example, in the U.S. there is a regulation that requires illiquid assets to be kept within 15% of the total fund. In order to avoid violating the regulation in the event of sudden asset price fluctuations or sudden large redemptions, the actual percentage of illiquid assets is often 5% or less.

Although the above regulation implies to asset managers that illiquid stocks can be held up to a certain percentage, the secondary market for unlisted stocks is still in its infancy. Since last year, the Japan Securities Dealers Association has been looking into revitalizing the secondary market for unlisted stocks. Mr. Maruyama hopes that this initiative will help solve the liquidity problem.

3. Concerns about fair market value assessment

With regard to the question of whether fair market value can be assessed properly, the focus is on "the maintenance of quoted market prices" and "the assessment system within investment management companies".

Currently, Article 14 of The Investment Trusts Association, Japan, "Regulations Concerning the Valuation and Accounting of Investment Trust Assets" stipulates that unlisted stocks "shall be valued at the quoted market prices provided by Type I Financial Instruments Business Operators*, etc." It is necessary to establish a secondary market where quoted market prices are formed, so that quoted market prices offer a reference for market valuation.

How do overseas investment trusts value unlisted Japanese stocks at market value? As mentioned above, in many investment management firms, a separate internal organization, independent of the investment department, monitors the investees on a daily basis and calculates their market values. Management firms need to establish a system which allows for the prompt valuation of the market value. One method is asking for opinions of third party experts such as accounting firms in an event where there is news that could negatively affect the market value of an investee. If publicly offered investment trusts in Japan are able to adopt a similar system to value unlisted shares at market value, this concern would be closer to being resolved.

Thus, in order for crossover investment to become a common business practice among publicly offered investment trusts in Japan, it will be necessary not only to change the terms and conditions of publicly offered investment trusts but also to improve the market as a whole.

Potentials in crossover investment

Regarding its future potential, crossover investment is expected to create a virtuous cycle, according to Mr. Maruyama. When investment managers, through their corporate research and networks, take risks and invest in growth companies, innovation and the growth of the startups are accelerated. As a result, there will be more opportunities to fund other startups. Due to this virtuous cycle, startups have high expectations for crossover investors.

Author's wish for APAC asset managers in seizing opportunities in their coverage area

I hope Mr. Maruyama's valuable knowledge on creating a virtuous cycle will benefit both crossover investors and investees across APAC. Unavoidable challenges both within the firms and outside the firms, such as explaining and gaining the understanding of customers, require sustained commitment from asset management firms. Although these benefits do not come for free, the Japanese asset management industry as a whole is fortunate to have experts like Mr. Maruyama and other members of the Japan Securities Dealers Association, who graciously share their hard-earned expertise and lead the rest of us. I hope readers in other APAC countries gain insight from Mr. Maruyama and start crossover investing, so the economy of their countries will keep growing with the assistance of asset managers.

Footnotes

* The definition of Type I Financial Instruments Business Operators is found on Japan's Financial Services Agency website:
https://www.fsa.go.jp/en/laws_regulations/faq_on_fiea/section06.html

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Mr. Takashi Maruyama
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Takashi Maruyama joined the Industrial Bank of Japan in 1991 and was an equity and alternative investment Portfolio Manager in the United States. After serving as Head of Japan Equity and Alternative Investment at Nikko Asset Management, he served as Chief Investment Officer, Equity - Japan / Head of Equities - Japan at Fidelity International since 2015. His role centered on strengthening the investment team and evolving the investment process through cross-over investment, ESG integration etc. He assumed his current role as Senior Advisor (in addition to his existing responsibilities as Deputy President and Director) in July 2021.