Fund Finance

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Michael C. Mascia

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Overview of the fundraising and fund finance market in Asia

Nicholas Davies, Appleby &
Maggie Ng, Linklaters

The Fund Finance Association's inaugural Asia-Pacific fund finance symposium was held in Hong Kong in June 2017. If the number of attendees is a barometer of interest in the fund finance product within Asia then that interest is significant, with nearly 300 attendees and 30 sponsors for the inaugural event.

That level of interest is borne out in the significant number of enquiries that we have received from sponsors, banks and intermediaries throughout the region over the last couple of years. There is clearly significant interest in the product, but what are we seeing in the region in practice and how do we expect that to develop in the coming year?

Overview of the private capital fundraising market in Asia

General market trends

While the lion's share of global growth in private capital investment is today driven by Asia, its burgeoning private equity market is still relatively small. Over the last decade, the amount of capital raised by funds with a focus on investments and businesses in the Asia-Pacific region accounts for approximately 14% of the US$5.9 trillion raised globally.

It is difficult to predict whether we are seeing an upward trend of private capital fundraising in Asia in the short to medium term. Asia has enjoyed a not-insignificant share of the total amount of private capital raised globally, despite the fact that in the first half of 2017 there was a steady decline in the absolute capital raised by closed-ended private capital funds in Asia. North America and Europe's private equity markets are now rebounding from a regular cadence of macro tremors that rattled their economies, and are regaining near-historic levels of fundraising. However, Asia's private equity and venture capital industry continued to represent less than 10% of global capital raised as at the end of the first half of 2017. The volume of deals carried out by private equity funds has also dropped from the high point for Asia private equity exits in 2014, when US$67.4 billion in proceeds were derived from approximately 700 transactions, to approximately US$44.7 billion generated from 400 deals in 2016.

The results from a recent survey conducted by Preqin have shown that despite over 50% of Asia-based fund managers indicating a real concern in fundraising activity in the first half of 2017, the same fund managers maintain an optimistic view on the potential of private capital in Asia for the second half of 2017. There appears to still be appetite from Asia-

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based investors to contribute capital to private funds and a number of the global private equity houses are continuing to undertake (or have undertaken) concentrated fundraising efforts in Asia in the second half of 2017. For example, KKR closed its Asia Fund III in June 2017, which had raised US$9.3 billion and as such represents the largest private equity fund dedicated to investing in the region. Previously, the largest pan-Asian fund was also held by KKR at US$6 billion in July 2013, then the largest pool of private equity capital ever raised for deployment in Asia.

Notwithstanding the relatively positive outlook on fundraising activity in the private equity space, Asia also faces some challenges that might hinder growth in this area (especially with new entrants to the market). Given the region's diversity, with huge variations in demographics, stages of economic development, investor appetite and sophistication, many funds have found it difficult to infiltrate and appeal to the regional investor base. In Asia, the largest concentration of private equity investors is located in the PRC and Japan (approximately 27% of investors are based in the PRC and 24% reside in Japan). South Korea, Hong Kong and India follow closely behind with investors based in those jurisdictions making up an aggregate of approximately 30% of the total Asia-based investors.

Overall, the general sentiment in the market is one of caution and risk-aversion as regards investment allocations. This is largely due to the fact that Asian private equity is still relatively unproven and Asia-focused funds have not consistently demonstrated the ability to deliver strong positive returns to investors. This could also relate to the culture of Asian investors where, generally, such investors tend to be risk-averse, and will often target established global private equity firms based on their brand, require relatively extensive due diligence, an understanding of the investment strategy of the fund, and a demonstrable track record from the fund sponsor. As a result, larger pan-Asian funds continue to grow in size, while first-time funds experience greater difficulty in identifying investors and sizing up. This is notable from the fact that six pan-Asian funds – Baring Private Equity Asia, RRJ Capital, Bain Capital Private Equity, PAG, MBK Partners and KKR – all raised funds in 2015 with aggregate commitments larger than earlier fundraisings, with KKR experiencing the largest jump (approximately 60%) from Fund II in July 2013 to Fund III in June 2017. These funds have the reputation, standing, network and track record to expand into different jurisdictions and are better placed to leverage local expertise, develop relationships to source new deals and to establish presence in new markets to widen their coverage into new sectors and economies.

The apparent advantage that pan-Asian or larger reputable funds have does not mean that there is no place for smaller or new funds with an Asian focus. Many founders of smaller or new Asian funds are bankers that have developed a significant degree of sophistication (and a network of investor contacts) through their international banking careers. The level of sophistication of such smaller or new private equity funds in Asia means that, whilst they do not necessarily compete for diverse multi-jurisdictional and multi-sector portfolios, they are able to focus on specific sector preferences and develop deeper industry insights to appeal to specific segments of the Asia-focused investor base. Mekong Enterprise Fund III is a good example of this: the fund was established in 2015 by Mekong Capital to focus solely on consumer-driven segments in Vietnam, after the country's economic downturn between 2011 and 2012.

Other specialised infrastructure or real estate funds that focus on investments around the region demonstrate that there is room for new and niche funds in an increasingly competitive environment. Those at the forefront include several sovereign wealth funds,

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followed closely by Asian pension funds and insurance companies. This specialisation strategy is long-standing in the US. While this strategy is less entrenched in Asia, there has been a proliferation of firms such as Mekong Capital that operate a sector preference, signalling a new development in the Asian private equity and venture capital markets. This sector-focused strategy is consistent with the general approach and culture of the relatively risk-averse Asia-based investors that desire low risk and steady returns. As such, Asia-based investors are keen to invest in funds run by specialised fund managers who are equipped with a solid understanding of their sector and more adept at pushing for favourable investment terms. Industry-specific focused funds also benefit from the growth in global interest in infrastructure investment and the political drive for infrastructure development around the Asian region. With Japan's Government Pension Investment Fund promulgating an infrastructure plan in April 2017 to focus its investments on brownfield projects in developed markets and China's sprawling One Belt One Road initiative providing the framework, it is highly likely that more Asia-based investors will seek to support such sector-specific funds and accelerate growth in the Asian infrastructure sector.

Type of funds

There are various fund structures used in the Asian region, determined largely by tax considerations (both for the fund itself and for the target investor base). Asia-focused private fund vehicles tend to be close-ended and established as Cayman Islands Exempted Limited Partnerships (**ELPs**), comprising at least one general partner (controlled by the sponsor), with the investors subscribing for limited partnership interests in the ELP. A Cayman ELP fund structure ensures tax neutrality – that is to say, no additional taxation will be incurred at the fund level (in addition to tax due downstream with respect to the fund's investments and upstream on returns paid by the fund to its partners) – and is generally considered a transparent structure for tax purposes. The Cayman Islands legal system is based on English common law – and originally on English corporate and partnership law – but with significant legislative developments to bring into play 'best in class' provisions seen in Delaware, Canada and elsewhere. This provides a flexible legal framework with appropriate regulatory oversight that is well understood by international investors and designed specifically for the conduct of cross-border fundraising and investment. The Cayman Islands are also at the forefront in developing new products for use by the global investment community, with the recent introduction of limited liability companies (again, heavily based on the well-used and understood Delaware model, but with additional flexibility) likely to prove popular for the structuring of certain private funds in Asia, and in particular for their general partner and investment management arrangements, and underlying investment portfolios. Based on statistics from the Registrar of Exempted Limited Partnerships in the Cayman Islands, approximately 20,000 ELPs were registered in the Cayman Islands by the close of 2016, representing a 12% increase from 2015.

In North Asia, it is rare to see an offshore fund that is domiciled in a jurisdiction other than Cayman. However, it should be noted that, in Asia more generally, funds may be domiciled in other jurisdictions such as BVI, Luxembourg, Singapore or Mauritius (and with US feeder funds often established in Delaware). Frequently, this is driven by a requirement for the fund in question to benefit from relevant double taxation agreement (**DTA**) provisions. This was illustrated in the wake of the Lone Star Fund's protracted arbitration proceedings, which brought to light the lack of DTA protection between South Korea and the Cayman Islands, such that a significant portion of proceeds from its sale of Korea Exchange Bank were to be withheld to cover capital gains tax to Korean authorities. The nature of investments and location of assets in which Asian funds invest, and the

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availability of appropriate DTAs to mitigate potential double taxation consequences, have seen jurisdictions like Singapore and Mauritius increasingly becoming viable options for fund establishment, in particular where Southeast Asian markets (such as Indonesia or India) are the funds' investment focus. The Japanese market continues to frequently utilise the unit trust structure (whether Japanese, particularly for the domestic market, or Cayman for international fundraising).

Cayman, as a tax neutral jurisdiction, does not have a network of DTAs (there being no tax at the Cayman end to offset on a double-taxation avoidance basis). However, the range of products on offer, the regulatory approach and flexible legal framework, and the familiarity of the Cayman offering, suggest that the Cayman Islands will continue its reign as the jurisdiction of choice for Asia-based investors, albeit with increased use of alternative jurisdictions, or a combination of other jurisdictions, where relevant.

The Asian fund finance market

The fund finance market in Asia has evolved over the last couple of years and now represents an increasingly key market for global fund finance houses. Although the size of the market – estimated to comprise approximately US$50 billion in aggregate commitments – is smaller than its counterparts in the US or in Europe, the potential for growth in Asia is significant. As discussed above, the private fund market represents an underweight proportion of the global market given the economic potential of the region, so the potential for growth in fundraising (and, alongside it, fund finance) is clear. In addition, it is estimated that not even 50% of the raised funds currently active in Asia make use of fund finance facilities. It is a product that is increasingly marketed in the region and is used significantly by the global and large regional players, but has not yet penetrated the Asian private fund market in the same manner as in the US or in Europe.

The fund finance product offering in Asia remains very much the subscription line facility at present. We have not yet seen any significant execution volume in downstream net asset value (**NAV**) or hybrid subscription / NAV facilities in Asia. There is limited use of general partner or investment manager facilities, though these tend to be small in size, limited in tenor and tailored to the specifics of the borrower fund in question.

Leveraged financing of downstream fund investments is ubiquitous, but outside the scope of this chapter.

Asian subscription line facilities

As elsewhere, the subscription line facilities offered in Asia are largely intended for short-term borrowing in order to bridge or smooth out investor capital calls, provide additional credit support for downstream investments or portfolio companies, and to allow the fund to consummate strategic investments without delay. Virtually every subscription line facility written in Asia is secured over the uncalled capital commitments made to the fund by its investors; it is increasingly rare to find an unsecured fund finance facility of any nature in the Asian region.

Larger facilities are typically written under English or US (New York or California) law, with the security package enforceable as a matter of Cayman law and priority of the security assured through written notice to the fund's investors. In these respects, the capital call facilities on offer in Asia look and feel very similar to those available in the US and European market, with the 'convergence to the mean' in the global fund finance space very much applying to the market for big-ticket facilities in Asia.

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There is a large volume of smaller facilities in the region often governed by Hong Kong or Singapore law where that is the preference of the local lender(s) or borrower (and otherwise frequently by the laws of the home market of the lender). These mostly bilateral facilities are provided by niche fund finance houses and written under facility documentation used in their home markets (for example, niche US west coast fund finance houses providing facilities in Asia governed by their largely standard, California law-governed, subscription facility documentation). Here, one might see more divergence in covenants, tenor or use of proceeds – and so less of a 'convergence to the mean' than the 'big-ticket' market – though for the most part, the security package tends to be as robust as that provided in support of larger subscription line facilities in the region.

Lenders

The Asian finance market remains very much relationship-based, with bilateral facilities (typically in the US$200–US$750 million range) offered as part of a bank's wider corporate or private wealth offering. Larger facilities – and in particular, those provided to the Asia-focused funds of global or large regional private equity sponsors – are often arranged by global or core regional (Australian, Hong Kong, Japanese or Singaporean) financial institutions that make structuring or credit decisions centrally, and are frequently syndicated among that group. For these reasons, they tend to mirror to a significant extent the subscription line facilities on offer in the US and European markets, further fuelling the 'convergence to the mean' we are seeing globally.

The key players in the 'smaller-ticket', sector-specific fund finance market remain largely west coast US and certain European banks, though we are starting to see increased activity by Chinese and Asian regional banks in this space.

Borrowers

The borrowing base comprises largely close-ended, private funds, ranging from single entity funds through master-feeder, umbrella, co-invest and consortium arrangements. For the most part, these entities will be established as Cayman Islands ELPs as discussed above.

It is very common for the Asia-focused funds of global or large regional private equity sponsors to employ a subscription line facility in their borrowing strategy. Historically, the fund finance product has been less frequently utilised by the smaller regional and single-country funds, which is likely to be caused by a combination of the lack of profile of the product (especially where banking facilities are provided by local banks) and its potential benefits to a borrower fund. This is changing, especially as the larger Chinese and other regional banks start deploying the fund finance product.

Defaults

Although there has been an uptick in defaults in recent years – though largely technical defaults, such as breaching notification covenants, rather than payment or other fundamental defaults – for the most part, the product has remained remarkably stable. A key factor in this track record is the conservative approach to investor base risk-weighted due diligence (including full reviews of any side letters that the fund has entered into with its investors) in calculating an appropriate loan to uncalled capital value ratio, as well as the robust covenant package typically included in the facility documentation.

What is the outlook for 2018 and beyond?

Absent any global or regional negative macro-economic or political events, the increasing size of the Asian private fund market – and the relative lack of penetration of the fund

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finance product throughout the Asian fund universe currently – suggests that the Asian fund finance market will continue to expand.

Although Chinese banks have participated in a number of fund finance transactions over the last couple of years, we are seeing a marked increase in interest in the product from these (and other regional and international) institutions recently. We anticipate that, as that interest and product understanding develops, we will see an uptick in the penetration of subscription line facilities, particularly to Chinese banks' local and regional private funds clients. In addition, it is likely that there will be increased demand for NAV and hybrid products in line with the increasing size and sophistication of many funds active in the Asian market (and as we have seen in the US and Europe).

As the volume and sophistication of fund finance facilities increases in the Asia-Pacific region, and competition amongst financial institutions seeking fund finance business grows (particularly with the entry of Chinese banks to the market), we are likely to see much more divergence in structure, terms, approach to security, due diligence and pricing on offer in the market. This ultimately suggests a larger and more innovative, dynamic fund finance market developing in Asia in the coming years.

* * *

Endnotes

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Nicholas Davies
Tel: +852 2905 5769 / Email: ndavies@applebyglobal.com
Nicholas Davies is a Partner based in Appleby's Hong Kong office with extensive experience advising on a broad range of finance and corporate transactions. His finance practice focuses primarily on debt and equity capital markets, structured finance and derivatives, fund finance, Islamic finance, and acquisition and leveraged finance. Nick also advises on all aspects of private equity and other private fund work, mergers and acquisitions, joint venture arrangements, corporate governance matters and regulatory advice, particularly in relation to international sanctions.
Nick has been rated in various legal directories for both his offshore and onshore work, with *Legal 500* noting that he 'provides excellent advice and is easy to work with'; IFLR ranking him as a 'rising star'; and *Who's Who Legal* commenting that 'the "impressive" Nicholas Davies offers "expert advice" combined with "substantial understanding and experience" of the commercial, legal and cultural issues associated with completing transactions in this area'.

Maggie Ng
Tel: +852 2901 5184 / Email: maggie.ng@linklaters.com
Maggie Ng is a Managing Associate at Linklaters, Hong Kong. She represents international banks and financial institutions and a variety of alternative credit providers including credit funds and asset management companies as arrangers, lenders, investors and borrowers on a range of financing transactions. Her practice focuses on structured lending and includes fund financing, syndicated and bilateral secured and unsecured corporate, acquisition, pre-IPO and real estate loans, equity-backed financing and sponsor-backed mezzanine investment structures as well as mezzanine financings provided by asset management and credit fund houses.

Appleby/Linklaters

Appleby, 2206-19 Jardine House, 1 Connaught Place, Central, Hong Kong. Tel: +852 2523 8123
URL: www.applebyglobal.com

Linklaters, 10th Floor, Alexandra House, 18 Chater Rd, Hong Kong. Tel: +852 2842 4888 /
Fax: +852 2810 8133 / URL: www.linklaters.com

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