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Asia overview: a dynamic and diverse market

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Introduction

Composed of 48 countries recognised by the United Nations and a handful of other countries and autonomous territories, covering about 30% of the earth's total land area and home to approximately 60% of the global population, Asia is the world's largest, most populous and diverse continent. Three Asian countries – China, India and Indonesia – are the first, second and fourth-most populous countries in the world. Five Asian countries rank in the top 20 largest economies in the world. According to the World Bank, in 2015, China's GDP ranked second in the world, at approximately US$11trn, which was behind the first-ranked United States at around US$18trn. Japan came in third at approximately US$4.1trn, India seventh at around US$2.1trn, followed by South Korea and Indonesia ranking at 11th and 16th, respectively.

Despite the geographical, demographic and economic dominance of the continent, Asia's private equity market is still proportionally small. According to Preqin, private equity and venture capital funds raised US$335bn globally in 2015, but only US$46.7bn in Asia, which amounts to only about 14% of the global share. After a slower start in 2016, fundraising in Asia recovered in the second half of the year, ending with approximately $50bn of fresh capital, according to Asia Private Equity. With respect to M&A activity, the aggregate M&A transactions announced in 2016 in Asia, according to Dealogic, were valued at US$799.3bn, constituting approximately 21.7% of global M&A activity. Ex-Japan Asia's M&A activity fell 28% year-on-year, a steeper drop-off than the 15% global decline. In a survey conducted by Preqin Fund Manager Survey in June 2016, Asia-based fund managers have identified fundraising and the exit environment to be the two key challenges in the industry in the subsequent 12 months.

Much of the complexity of the Asian private equity market stems from the region's diversity. There is no common language, religion, currency or legal system unifying the region. Further, Asian countries are in various stages of economic growth and development, with vastly differing demographic profiles. China and Japan dominate the investor base for fundraising, while other Asian countries offer opportunity for deploying capital. The risk-return profile of investing in Japan is vastly different from India and Southeast Asia. As a recognition of the complexity of the Asian private equity market, sponsors are raising an increasing number of Pan-Asia funds. For example, in 2013 KKR & Co raised KKR Asia II, a US$6bn Pan-Asia fund, which is the largest fund focused on Asia or any Asian country. KKR is reportedly raising its third Asia fund, with an increased target of US$7bn. In 2015, RRJ Capital raised US$4.5bn with a focus on China and Southeast Asia; Baring

Private Equity Asia raised US$3.9bn to invest in companies in Asia as well as non-Asian companies with growth plans in Asia; and PAG Asia Capital closed its second Pan-Asia private equity buyout fund at US$3.6bn. These funds were very large by Asian standards, and were among the largest funds raised globally in 2015.

The increase in the number, sophistication and competitiveness of private equity funds in Asia have given rise to an increase in the utilisation of capital call facilities (also known as subscription facilities), a form of credit facility made available to a fund, which is typically secured by: (i) the unfunded capital commitments of the fund's investors; (ii) the fund's rights to call capital and receive capital contributions; and (iii) the fund's bank account into which capital contributions are deposited.

This article will first take a high-level overview of the private equity market in China, Japan, India, South Korea and Southeast Asia. It will then introduce how capital call facilities have been utilised in Asia, and the issues to be considered during negotiation of those facilities.

Overview of the private equity market in Asia

China has been the dominant power in the region. According to Preqin, 27% of investors in Asia are based in China, followed by 25% in Japan, 10% in each of South Korea and Hong Kong, and 9% in India. China and Japan combined hold 73% of the US$34trn in assets under management held by Asia-based limited partners. On the deal-making front, out of the US$125bn Asia-Pacific private equity deals recorded in 2015 by Bain & Company, China accounted for about half of the share at US$69bn.

Many factors, including, for example, China's five-month freeze on initial public offerings in 2015, the plunge of the Shanghai index by as much as 25% in January 2016, and slowing GDP growth have made investors more cautious about China. In addition, intensifying domestic competition has influenced China-based funds to explore outbound or to raise Pan-Asia funds. Japan, on the other hand, is enjoying a period of rejuvenated private equity activity after several years of stagnation, as governmental policy has led to ample supply of capital into private equity funds and increased appetite for private equity buyers. Activities in India and South Korea, despite each potentially facing certain near-term challenges, are expected to remain stable. Lastly, more and more investors are excited about the potential in Southeast Asia, especially against the backdrop of a slowdown of the Chinese economy.

<u>China</u>

Aggregate capital fundraising for Greater China (China, Hong Kong, Macau and Taiwan) for 2014 and 2015 reached US$32.4bn and $33.8bn respectively, according to Preqin, but as of August 2016, only US$11.7bn had been raised for 2016, but fundraising is reported to have recovered in the second half of the year, largely driven by an infusion of capital in a handful of RMB funds. The PRC government has been trying to expand the sources of capital. For example in 2015, the China Insurance Regulatory Commission began permitting Chinese private insurers to invest in PRC private equity funds. As reported by Private Equity International ("PEI"), China Life is expected to invest up to 5% of its 2.4 trillion yuan (US$357bn) of assets under management in buyouts and co-investment opportunities in 2017.

Nonetheless, gone are the days where private equity investors could rely on double-digit GDP growth for successful investment programs. Private equity investment in China declined in 2016 to $47bn, about a one-third decline from 2015, according to the Asian Venture Capital Journal. The Chinese private equity market has reached a level of maturity where limited partners can be deliberate about their investment choices. Funds with lacklustre historical performance are struggling to fundraise (even some of the most well-established sponsors), while funds sponsored by firms that have consistently performed strongly across multiple cycles are oversubscribed. As noted in Bain & Company's Global Private Equity Report, internet deals in China accounted for 40% of total deal value in 2015, which is a six-fold increase from the average over the previous five years. In comparison, deal value declined in most traditional industries, which disproportionately harmed long-established sponsors that had not adapted to the change in industry trends.

The other notable development in the Chinese private equity market has been the increase in outbound acquisitions. With intensifying competition and high valuation of quality assets, funds are seeking to make investments outside of their home country in order to diversify and differentiate their portfolios. According to Mergermarket, in the first half of 2016, China-based funds invested US$7.4bn in Europe and North America, exceeding the US$5.8bn invested in 2015. For example, Hong Kong-based PAG Asia Capital and Apex Technology acquired US printer manufacturer Lexmark for US$3.6bn. Chinese buyers are said to have a competitive advantage because they can provide a target with access to the Chinese consumer market. Outbound investments, however, face hurdles as they are subject to regulatory challenges from countries such as the US, Canada and Australia, all of which have formal review processes for foreign investors. For example, the Committee on Foreign Investment in the United States recently blocked Dutch company Philips' plan to sell an 80% stake in the lighting and lighting components business based in California to a Chinese consortium, GO Scale Capital, due to unspecified national security concerns. Outbound investment initiatives also face pressure within China. In November 2016, the Chinese State Administration of Foreign Exchange (SAFE) increased the restrictions on moving RMB out of China, making it nearly impossible to execute outbound deals for RMB fund sponsors who don't otherwise have USD sourced funds.

Although these pressures have triggered turmoil in the Chinese private equity space, some view this as an opportunity for private equity funds to move away from making minority investments and instead take more companies private. According to Bain & Company, the value of buyouts in 2015 was five times higher than the annual average from 2010 to 2014. Further, Carlyle's US$3.7bn take-private deal of China's Focus Media in 2013 illustrates that leveraged buy-outs are possible in China. The current environment in China is forcing Chinese private equity funds to evolve to best manage the uncertainty of the economy, decrease dependence on China and differentiate themselves from other competitors.

Japan

Japan, with an economy that is a little shy of half the size of the Chinese economy, possesses unrealised potential for private equity activity as Japan's private equity market is still small relative to its economy. 2016 is expected to be one of the best fundraising years for Japan-based funds in a decade. In addition, 2016 M&A activity in Japan remained the same as in 2015, with the aggregate value of announced transactions amounting to US$89.4bn. This stands in sharp contrast to the rest of Asia and the world, which declined by 15% and 28% respectively. Abenomics, the economic policy advocated by Prime Minister Shinzo Abe since December 2012 with a focus on fiscal stimulus, monetary easing and structural reforms, combined with entry into the private equity market by new investors, have improved prospects for private equity in the minds of both investors and companies.

The Bank of Japan's monetary easing and lowering of interest rates, ultimately below zero, boosted the Japanese equity markets. The more lasting effect, however, may be that Japanese private equity funds have become more attractive to investors. The Government Pension

Investment Fund of Japan, the world's largest pension investor, announced that it would allocate up to 5% of its assets in alternative investments, including private equity. Recently privatised Japan Post Bank and Japan Post Insurance have made similar announcements. PEI reported that these three institutions combined could potentially steer over US$3trn towards private equity investments. In addition, Japanese mega-banks, regional banks and corporate pensions have begun investing in private equity funds. One unique phenomenon in the Japanese private equity landscape, primarily driven by the investment philosophy of diversification of the Japanese limited partners, has been that a larger number of sponsors are raising smaller funds, generally in the US$250m to US$500m range.

Receptivity towards private equity has gradually become more positive, possibly due to demographic shifts and changes in the regulatory environment as well as potential synergies offered by private equity investments in Japanese companies. According to the Small and Medium Enterprise Agency, there are approximately 3.8 million small to medium-sized companies in Japan. Because of the aging and declining population in Japan[1], many of these companies are struggling with succession planning and/or looking to expand internationally to offset declining domestic consumer demand. Some companies increasingly view private equity firms as potential allies who can help these companies improve their capabilities, continue their legacy, better reach new markets and take the business to new levels beyond what some founders might have imagined possible.

Initiatives such as the amendment of the Companies Act and the implementation of the new Stewardship Code, among others, were enacted with the intention of enticing: (a) companies to appoint independent directors to their boards, provide more transparent disclosure and strive for better return on equity; and (b) institutional investors to more actively engage with the companies in which they invest for medium-to long-term growth. The new policies are intended to induce management and top executives of Japanese public companies, which have for years been conservative, to think more strategically and innovatively, in order to help such companies become more successful and profitable. This had led to a trend of divestitures of non-core operations by public companies and thereby has created an opportunity for private equity funds to acquire such non-core assets.

With such relatively small rates of private equity/M&A penetration, these changes signify that the Japanese private equity market has untapped sources of capital and an increasing pipeline of attractive investment opportunities, which position the market for continuing growth over at least the next year. Bain & Company, in its Asia-Pacific Private Equity Report 2016, noted the outlook on Japan to be positive.

<u>India</u>

Because fundraising has been challenging for India-based funds, the Indian private equity market has largely been dominated by a relatively small number of global or regional private equity players. According to Live Mint News, Amicus Capital Partners was reported to have raised its first US$90m (out of its target US$200m) as of December 2016, the first time that an inaugural Indian fund succeeded in fundraising since Kedaara Capital Advisors Ltd. raised its US$540m debut fund in November 2013. Offshore funds also face near-term challenges due to the amendment of the India-Mauritius tax treaty which comes into effect on April 1, 2017. The amendment also impacts the India-Singapore tax treaty, as the treatment of capital gains is linked to the India-Mauritius treaty. Investments in India have often been made via Mauritius and/or Singapore to benefit from the applicable treaty network. The amendment, which is applicable to any new investments made after April 1, 2017, will make such capital gains taxable in India, resulting in decreased attractiveness of existing structures and forcing private equity firms to consider alternative tax-efficient structures to invest in India.

On the deal-making front, private equity investments into India have been robust – in 2015, aggregate deal value reached US$22.9bn, surpassing the 2007 peak levels of US$17.1bn, according to Bain & Company. Vikram Hosangady, head of deal advisory and private equity in KPMG India, is quoted in Live Mint News that "sentiment on deal street remains strong and the recent passing of the goods and service tax regulations… and the insolvency law adds to the optimism that the government is keen to push through reforms". Successful exits of Indian investments in 2016 are also encouraging signs. KKR's sale of Alliance Tire Group to Yokohama Rubber Co., a Japanese strategic buyer, in the summer of 2016, marked the largest exit from an Indian company by a private equity fund. KKR also agreed to sell a stake in Gland Pharma Limited to Shanghai Fosun Pharmaceutical (Group) Co., Ltd., a Hong Kong-listed unit of Fosun International Ltd. Fosun has also been reported to start a private equity business in India. These exits are also noteworthy from the cross-border Pan-Asian angle since the new buyers are Asian companies looking to make investments into India.

South Korea

The Korean fundraising market has fluctuated in the last few years, with a steady decline in the number of funds closed per year. The KOSPI, the Korea Composite Stock Price Index, has also remained in a range between 1,800 and 2,150 in the last five years, and recent turmoil surrounding the South Korean presidency casts uncertainty on the economy in the near term. Regulatory reforms are being carried out, however, to stimulate activities of private equity funds – the Financial Investment Services and Capital Markets Act was amended in 2015, and in June 2016, the Financial Services Commission, the country's financial regulator, proposed to open up the private equity market to retail investors, which would expand sources of capital. It is also worth noting that Asia's biggest-ever leveraged buyout deal, announced in September 2015, was the US$6.1bn acquisition of Homeplus, the South Korean business of Tesco Plc, by a consortium led by MBK Partners.

Southeast Asia

According to the 2016 Global Limited Partners Survey conducted by the Emerging Market Private Equity Association, Southeast Asia ranks as the most attractive emerging market for private equity investment over the next 12 months, topping India. The same survey indicated that 34% of limited partners intend to begin or expand their investment in Southeast Asia in the next few years. Investors are paying particular attention to Indonesia, which has a population of approximately 250 million (ranking fourth-largest in the world), increased urbanisation, a rising middle class and growing access to technology (it is the third largest online market in Asia behind China and India, according to PEI).

KKR, alongside Warburg Pincus, Farallon Capital Management and Capital Group Private Markets, invested in a US$550m funding round for GO-JEK, an Indonesian motorbike taxi service application company in August 2016. Most of the investments in Indonesia are still minority interests and buy-outs remain rare in Indonesia. This is due to a number of factors, such as the necessity to navigate through complex and evolving regulations, a desire to maintain a local partner, corruption concerns and difficulty accessing the Indonesian debt market. In addition, fundraising efforts in Indonesia have been hampered by the small pool of funds available domestically, and the disadvantageous regulatory environment. As a result, fundraising for funds investing in Indonesia has taken place outside of Indonesia.

Private equity activity in Southeast Asia is likely to experience notable growth, and Bain & Company has characterised Southeast Asia as one of two markets in Asia with a positive outlook for the next two to three years. Investment strategy within Southeast Asia, however, will need to be tailored by country. Quoted in PEI, Ming Lu, KKR's head of private equity in Asia, described KKR's "strategy for Singapore – where buyout opportunities exist and the capital markets are sophisticated – is different from [their] approach in Indonesia, which offers exciting opportunities related to urbanisation, a rising middle class and shifting consumption trends."

Role of capital call facilities

As the Asian private equity market becomes more sophisticated, competitive and global, Asian sponsors have generally been eager to utilise capital call facilities or subscription facilities. Capital call facilities are most frequently used to: (i) bridge or smooth out investor capital calls; (ii) obtain loans, issue letters of credit or provide other credit support for portfolio companies at cheaper rates than may be available at the portfolio level; (iii) enhance the fund's internal rate of return; (iv) reduce the spread between gross and net performance metrics with low-cost financing; and (v) improve competitiveness *vis-à-vis* strategic buyers. These facilities may be sized based on a borrowing base where investors are categorised in accordance with their credit ratings (and different advance rates are applied depending on the rating) or based on a coverage test where availability under the credit facility is capped at a certain percentage (such as 50%) of the aggregate uncalled capital commitments of investors.

Subscription facilities entered into by Asian funds are relatively straightforward but they need to be tailored to address the investor and lender expectations in the Asian private equity markets. For example, Asian subscription facilities tend to be short-term (no longer than one year), as limited partners in Asia do not like indebtedness to be outstanding for a prolonged period. Additionally, although fund sizes are getting larger, Prequin has reported that average fund size among Asia-focused private equity funds has not grown significantly, averaging US$298m in 2015. As lenders will typically offer a credit facility that is 10–20% of the aggregate capital commitment of investors, fund facilities for funds shy of US$1bn in capital commitments are typically bilateral facilities, often provided by a relationship bank as part of the package of services it offers to the private equity sponsor.

Given the diversity of the Asian private equity market, and the growth of global and Pan-Asian funds, the providers of these facilities are expanding. Also, the complexity of these facilities increases as they shift from bilateral deals to those with multi-lender syndicates. While negotiating these fund facilities, sponsors should be mindful of factors such as fund structures and banks' review of limited partnership agreements, especially as the sponsors move beyond working with a small number of relationship banks. Additionally, by the time private equity sponsors are raising their second or third fund, they are increasingly interested in a capital call facility. As a result, subscription facilities are becoming a staple product that financial institutions must provide to remain competitive.

<u>Fund structure</u>

In a typical Asia-focused private equity fund structure, the primary fund vehicle (i.e., the entity that aggregates investors) is frequently a limited partnership that is formed in the Cayman Islands. Such a limited partnership would have a general partner controlled by the sponsor and investors which are limited partners. The fund structure is relatively straightforward, and the limited partnership would be the borrower under the capital call facility.

There may also be a parallel fund vehicle, which has a separate pool of investors from the main fund but is controlled by the same sponsor and co-invests in the same investments as the main fund in a lock-step *pro rata* basis. Often sponsors want the parallel fund to have the same access to a capital call facility as the main fund. In some cases, the lenders request that the main fund guarantee the parallel fund's obligations under the facility (and *vice versa*). Alternatively, lenders may request that the main fund and parallel fund be jointly and severally liable for the obligations under the capital call facility. However, if a parallel fund (which may have a smaller pool of capital commitments) is liable for the obligations of the larger main fund, the assets of the parallel fund may not be sufficient to cover the main fund's obligations. Moreover, any such guarantee or joint and several obligation could cause the smaller, parallel fund to be in violation of its partnership agreement debt covenant, or in the worst case scenario, depending on the relative sizes of the fund vehicles and the size of the main fund's borrowing, the small parallel fund could be rendered insolvent. To address these concerns, sponsors will insist on incorporating savings language into the loan documents, so that the liability of the smaller fund is capped at an amount that would not violate its limited partnership agreement or render the parallel fund insolvent. Another solution may be for the main fund and the parallel fund to be severally liable for their respective credit agreement obligations, but to cross-collateralise their obligations such that the obligations under the credit facility are secured by the uncalled capital of both funds. This cross-collateralisation is a feature commonly seen in the United States.

Fund structures are not always as straightforward, however. Japan, for example, has complex tax rules affecting Japanese and non-Japanese investors differently, leading sponsors to structure funds with two or more independently managed fund vehicles investing in parallel in the same investment opportunities. Depending on the size of the non-Japanese investor group, multiple parallel funds may be needed to minimise the exposure of non-Japanese investors to Japanese tax risks. The independence necessary for each fund vehicle complicates the ability for the fund vehicles to be jointly and severally liable or to be cross-collateralised within a credit facility. Consultation with Japanese tax advisors is key for any Japanese funds to enter into fund facilities.

"Bankable" limited partnership agreements

Subscription facility lenders diligence the limited partnership agreement of the fund borrower to ensure that the partnership agreement permits borrowings, and the pledge to the lenders of the right to call capital from investors. Side letters, which tailor the limited partnership agreement for specific investors, are common in Asia. Lenders are particularly focused on provisions in these letters that deal with sovereign immunity and confidentiality. Sovereign immunity is the judicial doctrine whereby states, governments and government-affiliated entities cannot be sued without their consent. If an investor has sovereign immunity, lenders may be concerned about their ability to enforce a capital call following a default under the capital call facility, since they would be prohibited from bringing an enforcement action against a sovereign investor in court proceedings. As a result, lenders may have difficulty realising a portion of their collateral. Since state-government funds or pension funds are frequent investors in Asian private equity funds, this issue comes up frequently. Some lenders in Asia have become comfortable with lending against the capital commitments of sovereign investors, especially if they have a good history of funding capital calls, while others require such investors to waive their immunity (if possible) or be removed from the borrowing base calculation in the credit agreement.

Certain investor side letters may also restrict the ability of the general partner to disclose the identity of such investor. Without knowing the identity of an investor, lenders may not be able to contact such investor when exercising remedies and calling capital. Depending on the percentage of such confidential investors, certain lending institutions will not participate in a facility for a fund that has confidential investors. Other providers may simply be unwilling to lend against the capital commitments of these investors (although their commitments would still be considered collateral). As a result, the commitments of such limited partners would be excluded from the borrowing base, and the overall borrowing capacity of the fund would thereby be reduced. Fund borrowers ought to be aware of these provisions in side letters, and endeavour to limit these ineligible investors compared to the overall investor pool supporting the capital call facility, as significant exclusions from the borrowing base could affect the viability of the capital call facility.

Prior to the initial closing of a fund, it is advisable for fund borrowers to share, on a confidential basis, drafts of their limited partnership agreements (and side letters) with potential lenders, or to fund finance counsel to ensure that the agreements are "bankable" from a fund financing perspective, as a subsequent amendment is extremely onerous both from an investor-relations standpoint and lender-negotiation dynamics.

Growth of global and pan-Asia funds

Increases in fund sizes, driven in part by the rise of global and Pan-Asian funds, have resulted in the sponsors' desire to have larger capital call facilities which can no longer be supported bilaterally by one financial institution. A multi-lender deal creates opportunities for other financial institutions to compete for a sponsor's business.

A facility with multiple lenders also imposes additional legal complexities. For example, a security agent would typically need to be appointed, which would hold the security interest in the collateral on behalf of all the lenders and would be the representative of these lenders should enforcement ever be necessary. Certain countries, however, do not have the practice of granting security interest to a trustee or agent, and instead require that each lender be the pledgee of collateral. These concerns may be alleviated by setting up funds in jurisdictions such as the Cayman Islands, but sponsors also need to ensure that other collateral (such as the bank account) is located in a jurisdiction with secured transaction rules that permit creation and perfection of a lien in favour of an agent for the lenders.

A larger, syndicated, multi-year credit facility also increases the concern that a lender may want to reduce its exposure during the life of the facility by assigning or participating out its interest in the credit facility to another financial institution. The fund borrower's consent right over such assignment or participation becomes critical because sponsors are sensitive about keeping information regarding the fund and its limited partners confidential, especially from any competitors. The sponsors' desire to control the composition of its lending group needs to be balanced with the flexibility and protection that the lenders customarily want in a large, multi-year credit facility.

Conclusion

The extent of the impact of global events (such as the health of China's economy, withdrawal of the United Kingdom from the European Union, the new U.S. presidency and currency fluctuation) on the Asian private equity market all remain to be seen, but the fundamental growth story of Asia remains intact. According to the Asian Development Bank, GDP in the region is expected to grow 5.7% in 2016 and 2017, contributing to 60% of the global growth in the next two years. Given the relatively limited penetration of private equity in Asia *vis-à-vis* the overall economy, private equity activity in Asia has inherent opportunity to expand. Preqin has reported that as of August 2016, US$110bn of dry power (the amount of capital that is available for investment) exists among Asia-based private equity and venture capital firms. Sixty-eight per cent (68%) of the Asia-based firms responded to the Preqin Fund Manager Survey that they expect to deploy more capital compared to the previous year, and 77% of the general partners plan to launch new funds before the end of 2017.

The dynamic Asian private equity market will continue to remain diverse within the region and will also continue to evolve. To be successful, funds will need to be nimble to these differences and changes. Capital call facilities may be one way for sponsors to remain competitive and to differentiate themselves from others. Sponsors who are interested in entering into fund facilities should consult their legal and tax advisors early on in the fundraising process to ensure that the fund structure and limited partnership agreement are financeable. With growing sophistication of the sponsors, investors and lending institutions, better appreciation for the many uses of these facilities and larger fund sizes, the fund finance practice in Asia is destined to grow in the next few years.

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* * *

Endnote

1. According to the The World Factbook by the US Central Intelligence Agency, the Japanese population is set to have declined in 2016. Over one-quarter of the population is over 65 years old and the median age is 46.9 years old, which is the second-highest in the world (https://www.cia.gov/Library/publications/the-world-factbook/geos/ja.html).

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