Fund Finance

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Michael C. Mascia

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Fund finance: An 'offshore' perspective

Alex Last, Danielle Roman & Robert Duggan
Mourant Ozannes

Introduction

The private equity funds market, like many aspects of the financial services industry, has become increasingly globalised and complex over recent years. Whether it is General Partners in China looking to raise capital from investors based in the United States, or Europe-based banks lending to Asia-based funds, this global trend looks set to continue as existing players search for new opportunities and new market entrants look to break into the industry.

One thing that is certain is that this growth in cross-border activity and complexity has coincided with an ever-increasing use of fund vehicles established in well-regulated and sophisticated "offshore" finance centres such as the Cayman Islands, Guernsey and Jersey. For example, based on statistics released from the Registrar of Exempted Limited Partnerships in the Cayman Islands, there are over 20,000 exempted limited partnerships registered in the Cayman Islands, more than double the number registered at the end of 2009.

This chapter will explore the role of the leading offshore jurisdictions in the private equity funds market. As part of this, we will discuss the key reasons why offshore vehicles are popular from a sponsor, investor and lender perspective and review findings from a research project commissioned by Mourant Ozannes (in which market participants, including many of the leading global private equity sponsors, were interviewed by independent researchers). We will then examine the key offshore aspects of a typical subscription finance transaction, using a Cayman Islands structure as an example. Finally, we will look at some of the trends we have observed from an offshore perspective in each of the United States, Asia and Europe from our Cayman Islands, Hong Kong and London offices.

Why offshore?

Fund perspective

It is a truism that market participants have a natural tendency to use vehicles in their home jurisdiction where they are familiar with the legal, regulatory and tax regimes. Accordingly, there has to be a tangible benefit to establishing a fund in a third country.

In our experience, there are a number of factors which drive the choice of fund domicile. From a General Partner's (**GP's**) perspective, probably the most important consideration is fundraising. It is crucial that the GP is able to present a fund to market that is established in a jurisdiction which works for, and is familiar to, the target investor audience. This is

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particularly acute for first-time or smaller GPs. The fundraising process can be challenging and highly competitive. GPs do not want to spend time in investor meetings discussing choice of domicile, they want to focus discussions on the investment opportunity. As a result of this, momentum plays a huge part in jurisdictional selection. In order to move away from the tried and tested model, there has to be an incentive to change.

The world's leading fund sponsors have been using jurisdictions such as the Cayman Islands, Guernsey and Jersey as part of their structures for many years. Equally, and probably more importantly, institutional investors have been investing in them. They understand the regulatory and tax treatment of these vehicles in their home jurisdictions, and that their rights as investors will be maintained and protected. The key commercial parties in the industry have developed a clear understanding and confidence in these jurisdictions.

One thing that all of the key jurisdictions mentioned have in common is a sophisticated and stable legal regime based on English common law principles. Equally, each has a highly regarded and well established judicial system. The court of final appeal for the UK overseas territories and Crown dependencies (including the Cayman Islands, Guernsey and Jersey) is the Judicial Committee of the Privy Council in London. This provides a huge amount of legal certainty to market participants.

The importance of the finance industry to the economies of the offshore finance centres means that they are very focused on ensuring that their product offering is at the cutting edge of developments in the market and can respond quickly to change. To this end, the legislation applicable to fund structures in each of these jurisdictions is constantly being adapted and modified to cater to the demands of the end user. For example, the Exempted Limited Partnership Law in the Cayman Islands was overhauled in 2014 to bring it closer into line with the corresponding Delaware legislation and to deal with a number of specific points related to the private funds market.

One of the biggest advantages of an offshore jurisdiction is that it provides neutrality for all parties to the transaction. No-one has home field advantage. This is particularly acute in transactions involving multiple counterparties in multiple jurisdictions with often conflicting legal systems. Investors may be willing to take investment risk in relation to a particular opportunity or in a particular jurisdiction but, in most cases, they are reluctant to take structural risk. Channelling an investment through a vehicle established in a neutral and well-regulated jurisdiction such as the Cayman Islands helps to mitigate this. It provides a platform which is understood and acceptable to all parties to a transaction and, most importantly, enables a huge amount of certainty of outcome.

<u>Lender perspective</u>

It is important to note that private equity funds do not operate in a vacuum. As such, it is not just the GP and limited partner (**LP**) community that has to be comfortable with the domicile of the fund. All commercial counterparties need to be familiar with and understand the consequences of using a particular domicile. In the context of fund finance, establishing a fund in an unfamiliar jurisdiction may, at the extreme end, affect a fund's ability to borrow and, in all cases, is very likely to affect pricing.

In our experience as offshore counsel, from a bank's perspective, the key concerns are the identity and perceived creditworthiness of the LPs, the maintenance of the value of the secured assets (i.e. ensuring that there is no leakage, e.g. through excuse provisions or the use of blocker or feeder vehicles) and, ultimately, its ability to enforce its security upon default. These concerns are significantly mitigated if the transaction is structured through a neutral, creditor-friendly, jurisdiction such as the Cayman Islands.

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Mourant Ozannes' private equity survey

In order to critically assess market trends and opportunities in the private equity industry, we commissioned independent researchers to interview 200 GPs and 60 institutional LPs spread equally across Asia, Europe, North America and the rest of the world. The results were extremely interesting.

Unsurprisingly, the survey revealed that one of the biggest concerns for both GPs and LPs was the ever-changing and complex regulatory landscape. In particular, the EU's Alternative Investment Fund Managers Directive (**AIFMD**) has clearly made it more challenging for GPs to raise funds from EU-based investors.

However, notwithstanding this regulatory headwind, market sentiment was still extremely strong when it came to allocations to funds domiciled offshore. Well over half of the LPs surveyed globally (60%), and 70% of those in North America, in particular, plan to increase or maintain the amount of capital they have invested in private equity funds in offshore locations in the next five years.

The survey also highlighted the increasingly cross-border nature of the industry, with Asia- and Europe-based investors looking to increase allocations to North America over the coming years, and vice versa. In particular, sentiment towards opportunities and the outlook for private equity in Europe (and the UK especially) was very strong.

When asked what the most important factors were when it comes to deciding to make an allocation to a private equity fund, the LPs surveyed highlighted investment strategy as the most important. However, our research indicated that the location of a fund is also firmly on the list of factors that influence LPs investment decisions, with 25% of respondents indicating that this factor sits in their 'Top Three' decision-influencing criteria. Interestingly, when GPs were asked what they thought LPs valued most, a returning investor base came out on top, followed by the reputation of the GP.

One of the frustrations felt by many of the offshore jurisdictions was the tendency by the popular media to try to paint a negative picture of all offshore centres, failing to differentiate between those that have taken a global lead in transparency and regulatory initiatives and those that have clung to an outmoded secrecy model.

The research very clearly supported the analysis above as to why the private equity market uses offshore fund vehicles. From a GP perspective, the top reasons given for using offshore structures were based on the sophistication and robustness of the legal regimes of jurisdictions like the Cayman Islands, Guernsey and Jersey. Respondents focused on the sophistication and quality of the applicable legislation in the relevant offshore jurisdictions. The key factors that the GPs surveyed highlighted were: predictability of law enforcement; speed to market; fund structuring flexibility; a mature dispute resolution environment (including the number and quality of professional services firms operating in the relevant jurisdictions); and tax neutrality.

From an LP perspective, the key drivers were: fund structuring flexibility; clarity of regulation; tax neutrality; a mature dispute resolution environment; and cost.

Leaving aside fundraising, the survey also very clearly highlighted the concerns of both GPs and LPs over rising asset prices and the competition in the market to acquire assets. This was particularly true in North America, where 79% of the GPs surveyed highlighted this as an acute challenge. Just over half of the GPs believed that this was having a negative effect on their relationship with LPs. On the other side of the coin, two thirds of LPs believed this was negatively impacting their view of GPs.

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How does this impact fund finance?

The survey results were interesting from a fund financing perspective for a number of reasons.

Firstly, from a structural perspective, it seems clear that funds will continue to be domiciled in jurisdictions like the Cayman Islands, Guernsey and Jersey (and so lenders will continue to provide finance to vehicles formed in these jurisdictions).

Secondly, given the increasingly globalised fundraising environment, we anticipate that fund structures will only become more complex with the continued use of multiple feeder and alternative investment vehicles (**AIVs**) to cater for the particular tax, legal and regulatory demands of investors in multiple jurisdictions. In our experience, many of the largest fund sponsors are particularly heavy users of AIVs in their fund structures.

Thirdly, a clear theme which came through from the survey was the importance of speed of execution. This is particularly important given high asset prices and competition for deals. With this in mind, it is highly likely that GPs will continue to utilise fund-level financing facilities to execute deals in an expedited manner. Furthermore, we expect that LPs will expect this as they look to their GPs to find and execute the best deals.

Finally, and related to this, we expect the use of net asset value (**NAV**) facilities to increase as GPs look for deals in the secondary market. Over three quarters of the GPs surveyed confirmed that they are looking for deals outside of their normal primary markets to find opportunities to add value as a result of high asset valuations.

Fund level credit facilities: an offshore view

Based on the above analysis, it is clear that offshore structures will continue to play a key role in the private equity market and, as a result, fund finance. With this in mind, it is helpful to look practically at the role offshore legal advisers play when looking at a typical fund finance deal. We note that a separate jurisdiction-by-jurisdiction analysis is set out elsewhere in this book and so we have assumed that a Cayman Islands structure is used for the purposes of the discussion in this section.

The involvement of offshore advisers in a fund finance transaction is derived entirely from the fact that one of the entities involved in the transaction (e.g. the fund vehicle or an AIV) is formed in an offshore jurisdiction. Accordingly, the focus of local counsel is on the law as it affects the relevant vehicle. For example, does the relevant entity have the authority and legal capacity to enter into and perform its obligations under the relevant finance documents as a matter of local law and under its constitutional documents and do the relevant documents create valid, binding and enforceable security in the relevant jurisdiction? Invariably, a lender will look to obtain a "clean" legal opinion from local counsel to confirm this is the case before lending.

As such, the role of offshore counsel differs somewhat from that undertaken by the principal counsel to the parties. While the latter will concern themselves with negotiating the main deal documentation to protect their respective clients' positions and with ensuring that the terms of the documents reflect the commercial understanding between the parties, the role of offshore counsel is essentially twofold: firstly, focusing on the fund borrower itself, its ability to enter into the deal and ensuring it follows the correct procedures in doing so; and secondly, ensuring that legal considerations arising out of the law of the fund's jurisdiction of formation are adequately addressed.

Fund documentation and due diligence

Given that the primary focus of local counsel is on the borrower entity formed in the

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relevant offshore jurisdiction, it follows that a key part of the role is to carefully review the constitutional documents of the relevant entity. In the context of a private equity fund constituted as a limited partnership, this will be the limited partnership agreement (**LPA**).

In particular, counsel will review the LPA to ensure that it permits the fund to avail itself of the relevant credit facility, and for the fund and the GP to grant security over the unfunded capital commitments of the LPs. In addition, counsel will look for, amongst other things, language giving the GP the power to make capital calls to fund bank financing obligations (including after expiration of the investment period), the ability to grant a power of attorney to support the security package, and any provisions which may impose restrictions on borrowing (e.g. relating to duration or purpose). As noted above, counsel will ultimately be expected to issue a "clean" opinion to the effect that the transactions contemplated by the deal documents do not breach the LPA, and so will look for anything which may affect the ability to provide this.

It is now common for LPAs to include provisions expressly permitting the fund to enter into subscription facilities and to grant security over those unfunded capital commitments, but there may be other restrictions or conditions which must be met. For example, advisory committee consent may be required, or there may be restrictions on the maturity or amount (typically expressed as a percentage of aggregate capital commitments) of any permitted indebtedness. In these situations, offshore counsel will raise the restrictions with their instructing counsel or client in order to ensure that appropriate steps are taken or protections built into the documents.

The terms of investor side letters can also impact the deal in a number of ways. Although it is unlikely that the terms of a given side letter will operate to prevent a fund ever entering into a subscription facility, they can dilute the value of the investor's commitment as part of the security package. The ways in which they can do so are almost unlimited. We have seen examples of side letters providing: that an investor is only obliged to fund capital calls made by the GP, rather than by any delegate or attorney; that default remedies under the LPA may only be exercised by the GP; that investors be given extended grace periods to cure funding defaults or before the fund; or that the GP may exercise default remedies, or grant investors additional excuse provisions in certain circumstances. We have also seen side letter terms to the effect that investors need not provide any financial information for the benefit of a financing lender unless such information is already publicly available. In these circumstances, the usual course of action for the lender is to exclude the relevant investor from the facility's borrowing base.

When reviewing the structure, a lender's counsel should also be alive to the potential for leakage if the LPA permits the GP to set up AIVs, blockers or parallel funds. Such provisions can allow the GP to divert investor commitments to these other vehicles. As noted above, in our experience the biggest PE sponsors tend to be very "AIV heavy" in their fund structures.

If the LPA contains such provisions, lenders will want to ensure it also permits the GP to grant security over the undrawn investor commitments to any such vehicles, and the facility documentation should include covenants obliging the fund and the GP to ensure that any investor commitments to these vehicles are added to the security package. The lender will typically expect any legal opinion to also be extended to these AIVs (which are usually also established in offshore jurisdictions).

Finance documents: issues to note

Rather than focusing on the commercial aspects of the transaction documents (which, as noted above, is more the purview of principal counsel), offshore counsel will instead

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concern themselves primarily with aspects of the documentation which may be impacted by local law.

The key offshore jurisdictions are sensitive to the demands of their principal users, including the private equity industry, and aim to meet those demands with user-friendly and practical legislation: as noted above, the Cayman Islands, for example, overhauled its Exempted Limited Partnership Law in 2014 in response to industry feedback.

Because of this, offshore fund vehicles tend to be flexible and their governing legislation accommodating of common industry practice, and it should rarely be necessary for offshore counsel to make substantial comments on a draft loan agreement or security document. The review will mainly concentrate on ensuring that appropriate representations and events of default are included and that customary conditions precedent documents are included and correctly described.

Notification of assignment of call rights: "perfection" and priority

The typical security package will include rights under the fund's LPA, which will be governed by the law of the jurisdiction where the fund is formed and registered. Accordingly, offshore counsel will need to satisfy themselves that any relevant legal requirements for the creation and perfection of this security are satisfied.

For example, lenders and fund sponsors who use Cayman Islands fund structures will know that, in order to secure the priority of the lender's security interest over capital call rights under the LPA, it is necessary to notify investors that those rights have been assigned as part of the security package.

The timing for the dispatch of such notices can frequently be a point of negotiation between lenders eager to safeguard the priority of their security and GPs who are reluctant to disturb investors unnecessarily. Lenders will generally want GPs to send notices upon closing, and to provide lenders with evidence of delivery (since the notice is only effective when received by an investor, rather than upon dispatch), whereas GPs may be unwilling to do this and only to send notices on the next financial reporting date or upon default. Ultimately, this will be determined by the relative negotiation position of the parties.

A lender faced with a GP adopting such a negotiating position might derive some comfort from remembering two things. First, although the sending of notices is frequently described as a "perfection" requirement, from a Cayman Islands law perspective it is not technically so, in the sense that a valid security interest will still have been created at signing even if no notices are sent. Secondly, from a Cayman Islands law perspective, the "priority" of the lender's security interest is its priority only as against *competing* interests in the secured assets. A validly created security interest over capital call rights will still have priority over the claims of a liquidator or unsecured creditor of the fund even if no notices have been sent, and covenants in the main credit agreement prohibiting additional indebtedness and negative pledges in the security documents should ensure that, as a matter of contract, the risk of a competing creditor claiming a security interest over the call rights is minimal.

Offshore legal opinions

An offshore legal opinion should address both the capacity of the fund to enter into the transaction documents and the enforceability of those transaction documents against it.

It has long been market standard in any kind of lending transaction for a borrower's offshore counsel to give opinions to the effect that the borrower is duly formed and registered and in good standing, that it has taken all necessary action under its constitutional documents to authorise its entry into, and to perform its obligations under, the transaction documents,

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and that the obligations of the fund under those transaction documents are legal, valid, binding and enforceable.

In addition to these "standard" opinions, there are a number of additional aspects deriving from the particular features of subscription credit facilities which lenders are increasingly requiring to be addressed in any offshore legal opinion.

Given the importance of the capital call rights to the quality of the credit, lenders will want the offshore opinion to confirm not only that a valid security interest has been created over those rights and that the secured party will have recourse to those assets in priority to any third party (including a liquidator or unsecured creditor of the fund), but also that priority as against competing interests is secured by sending notice of the assignment to the limited partners, and specifically that the form of notice prepared for this purpose (typically included as an exhibit to the credit agreement or security document) will be sufficient to achieve this.

In addition, lenders are now frequently requesting the borrower's offshore counsel (who, in most cases, will have acted on the formation of the borrower vehicle and so will have had input into the drafting of the LPA) to confirm in their opinions that the obligations of the limited partners under the LPA to contribute capital when called are legal, valid, binding and enforceable.

It is also becoming increasingly prevalent for a borrower's offshore counsel to be asked to confirm that the fund's obligations under the transaction documents do not conflict with or breach the terms of any side letter. As noted above, this may not be possible in all circumstances.

Jurisdictional focus

As discussed, the private equity market and, as a result, the fund finance market have become increasingly globalised. Given the role offshore jurisdictions play in this market, we are often well placed to spot trends. In essence, what happens offshore is a mirror of the onshore market.

We have set out briefly below some observations on the market in North America, Asia and Europe from our private equity and fund finance practices in the Cayman Islands, Hong Kong and London.

USA

The offshore jurisdiction we see most used by fund sponsors in North America is the Cayman Islands. In most cases, the offshore Cayman Islands fund complements the corresponding onshore fund of the relevant sponsor which, from our experience, is typically established in Delaware. The Exempted Limited Partnership Law in the Cayman Islands very closely tracks the equivalent Delaware statute.

In addition, the Cayman Islands recently introduced a new LLC regime which, again, largely mirrors the corresponding Delaware legislation. The Cayman LLC will enable US sponsors to easily replicate their onshore LLC vehicles offshore. Aside from fund-level financing, and beyond the scope of this chapter, we also expect the LLC to feature in GP financing transactions, as it lends itself well for GP, carry and management company structuring.

In terms of deal trends, the number of fund financing transactions we have been working on has grown enormously over the last few years. This has covered both typical bridge financing but also increasingly longer-duration deal financing and NAV facilities,

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particularly in a secondary deal context. We expect this to continue. We have a number of large sponsor clients who are increasingly utilising capital call facilities to finance deals and, correspondingly, looking to reduce the number of LP capital calls they make each year.

From a fundraising perspective, the key trend we have seen from an offshore perspective is a flight to quality, with larger sponsors being able to close new funds extremely quickly. The survey confirmed this and also demonstrated that, notwithstanding the challenges of high asset valuations, both the GP and LP community remain positive about the outlook for the private equity market in the United States over the coming years.

Asia

The private equity fund structure we see most commonly used in Asia is the Cayman Islands exempted limited partnership. In fact, in Asia, it is rare to come across an offshore fund domiciled in a jurisdiction other than the Cayman Islands.

There have been a number of large funds raised in Asia over the last couple of years. However, fundraising has been more challenging given the strong performance of funds in mature markets like the United States. The points noted above about the "flight to quality" and competition for deals are equally applicable in Asia.

One trend that we have observed is the launch of various "entrepreneur" funds by GPs spinning out of technology companies rather than traditional investment firms. These have gained traction with global investors, including institutional LPs in the United States. These funds have performed well and so we expect this trend to continue.

In a fund finance context, the subscription facility market is at an earlier stage of development in Asia but we have seen a significant increase in the number of transactions over the last few years. While most of these have tended to be fairly "plain vanilla" subscription lines, the market is growing in sophistication and we have seen a rise over the last 12 months in higher-value syndicated and bespoke capital call facilities. There have also been a number of GP financings. We have observed the trend of GPs "rolling up" and making fewer capital calls. This is particularly noticeable with some of the larger sponsors.

The lender profile in Asia has been evolving as awareness and understanding of capital call facilities has grown. Historically, there were a few US banks offering such facilities to the more established Asia sponsors. However, a shift in strategic focus from local banks in Asia has led to an increased interest from them in this market. Broadly, the lenders we now see in Asia can be split into three categories.

- First, US banks who are actively seeking subscription line opportunities in the Asian market.
- Secondly, UK, Australian and European banks offering such facilities from time to time to key relationship clients or to bring in new target clients as part of their private equity focus.
- Finally, Chinese and other Asian banks, who are newer entrants to the market and are eager to compete by offering cheaper lending with lower interest rates and margins.

We expect the influence of this third category to grow as investment in private equity by Asian-based institutional and sovereign wealth investors also grows. Ultimately, the credit risk on a fund-level financing is the LP base and, inevitably, Asia-based lenders are likely to be more comfortable with Asia-based LPs (with whom they may have a long-standing relationship) than overseas lenders.

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Europe

In the European market, the offshore jurisdictions we see most frequently used for private equity structures are Guernsey and Jersey. This is particularly the case for London-based GPs. Again, the typical fund vehicle for private equity structures in both jurisdictions is the limited partnership.

The fundraising environment in Europe has been dominated by the introduction of the AIFMD. Almost all of the GPs surveyed confirmed that they have found it more challenging to raise funds from investors based in the European Union since the introduction of AIFMD. That said, there have been some very significant fund-raisings over the last few years utilising both Guernsey and Jersey fund vehicles.

From a fund finance perspective, we have seen an increasing use of subscription facilities. Interestingly, as with Asia, the number and influence of US banks in the European market has increased. From an offshore perspective, as the European fund finance market has matured, a key trend has been greater focus from fund formation counsel on the borrowing provisions in LPAs. Typically, LPAs will now contain very clear provisions dealing with subscription facilities and the related security package.

Again, the points noted above in relation to flight to quality, competition for deals and fewer capital calls, are also prevalent in the European market. However, as noted above, our survey demonstrated clearly that both GPs and LPs are very optimistic about the European private equity market and, in particular, the opportunities in the UK over the next five years.

Conclusions

In our view, the above analysis demonstrates that finance centres like the Cayman Islands, Guernsey and Jersey have a key role to play in the private equity funds market and, as a corollary to that, the fund finance market. This is particularly true to the extent that the industry continues to grow and expand across geographical borders.

Ultimately, these offshore jurisdictions are familiar to investors in multiple countries and provide neutrality, political stability and legal certainty to market participants from diverse regions. They are a vital part of the private equity eco-system.

Given the continued growth in the global private equity market, we fully expect that banks and other lenders will find themselves increasingly providing financing to, and taking security over the assets of, borrowers formed in one of these offshore jurisdictions. Equally, we are confident that the jurisdictions themselves will continue to adapt and develop their product offering to remain at the cutting edge of the industry and to ensure that they continue to be attractive to each of the GP, LP and lender communities.

* * *

Endnote

1. Minimum fund size surveyed US$200m.

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Alex Last
Tel: +1 345 814 9243 / Email: alex.last@mourantozannes.com
Alex Last is a corporate partner and specialises in private equity, investment funds and corporate and commercial work. Alex leads the private equity sector group in the Cayman Islands and has many years of experience advising leading private fund sponsors on the structuring and establishment of investment funds, secondary transactions and related deal work. Alex also frequently advises on private equity related corporate and finance matters. He has particular expertise in the context of fund financing.

Robert Duggan
Tel: +44 20 7796 7622 / Email: robert.duggan@mourantozannes.com
Robert Duggan is a Cayman Islands attorney based in London, from where he advises funds and financial institutions on corporate and finance transactions, as well as advising on financial regulatory matters.

Danielle Roman
Tel: +852 3995 5705 / Email: danielle.roman@mourantozannes.com
Danielle Roman is an experienced banking and finance specialist based in the Hong Kong office. Danielle regularly advises major international banks and financial institutions, listed and private corporations, investment funds and leading onshore law firms. She has a particular expertise in respect of fund finance matters.

Mourant Ozannes
94 Solaris Avenue, Camana Bay, PO Box 1348, Grand Cayman, KY1-1108, Cayman Islands
Tel: +1 345 949 4123 / Fax: +1 345 949 4647 / URL: www.mourantozannes.com

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