GLOBAL FUNDS THROUGH AN OFFSHORE LENS 2020

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Introduction/Executive Summary

The investment funds sector globally has experienced significant growth in recent years, despite being confronted by increasing regulatory requirements and a challenging geopolitical and economic landscape.

As a firm with a presence in multiple jurisdictions, we have a global perspective on the investment funds industry, filtered through an offshore lens. In this report, partners across our global practices examine the trends which they observed in 2019 and contemplate the developments they anticipate in the year ahead.

We would like to make it clear from the outset that we started work on this report prior to the COVID-19 pandemic. While we have included comment on this where possible, the fast evolving nature of this crisis means that some contents of this report may be subject to change within a short time of publication.

FUNDRAISING

One inescapable theme of 2019 was the significant fall in the total number of funds closing, with an increase in average fund sizes. And while established managers have been successful in raising funds – often for successor vehicles – smaller or first-time managers have found the landscape rather more challenging. Record levels of dry powder in PE also indicate there is uncertainty around where and how capital should be deployed.

That said, there is broadly a continued appetite for private equity and alternative investments (perhaps with the exception of hedge funds), not least because of ongoing stock market volatility and the low returns to be had from government bonds.

FUND LEVEL FINANCE

The use of subscription line facilities during the commitment/investment period of closed-ended funds is the most prevalent form of fund level finance. The size of facilities being used seems to have remained steady when compared with recent years, demonstrating a measure of stability in this area.

We have seen a substantial increase in the US market in funds using leverage during the commitment/investment period as well as during later stages of the fund's investment period.

Interestingly, diversification of banks in the bilateral markets are allowing for new entrants in the lender space and opportunities for smaller and medium-sized funds.

DOWNSTREAM INVESTMENT AND M&A ACTIVITY

While overall M&A deal flow for 2019 was on a par with previous years – the sixth successive year at over $3tn – it was down on 2018 and there was a significant fall in the second half of the year.

And in contrast to the significant deals done in 2019 – most notably in healthcare, technology and energy, all of which had a particularly strong year – deal flow across our jurisdictions was quite sporadic and volatile, due in part at least to elevated global economic uncertainty, including through Brexit or the US-China trade war.

The 2019 bull market was a curious beast, for it occasionally masqueraded as a bear with the result that we expect a spiky 2020, continuing the decline we saw in the second half of 2019, which will only be exacerbated by the impact of COVID-19.

CREDIT FUNDS

The reduction in bank finance to the SME sector by mainstream banks and the increased appetite for distressed debt opportunities is driving a shift towards credit funds, with investors continuing to seek a reliable income/yield with an appropriate balance of risk and return. This is even the case in regions such as Asia, which has historically been a very bank-financed market.

Corporates that have previously been conservative in their financing structures are now looking to be more opportunistic and are increasingly considering more complex financing arrangements.

RESTRUCTURING AND INSOLVENCY

Broad economic and geopolitical issues are having an impact on businesses around the globe, which has a subsequent knock-on effect on the investment funds industry. While the anticipated rise in restructurings and insolvencies may not yet have materialised, it is certainly an area in which we expect to see increased business in the 12 months to come.

We address all of the above in more detail in the following pages.

SECTION 1

Fundraising – Did Capital Flow in 2019?

As 2019 came to a close, data from Preqin on the state of global private equity (PE) painted a fascinating picture. Most notable was a considerable fall, in recent years, in the number of funds closed offset against a relatively stable aggregate capital raised.

In 2017, 2,398 PE funds closed with an aggregate $628bn capital raised, equating to an average fundraise of just over $261 million. At the end of 2019, 1,316 funds raised an aggregate $595bn – an average of just over $452 million[1].

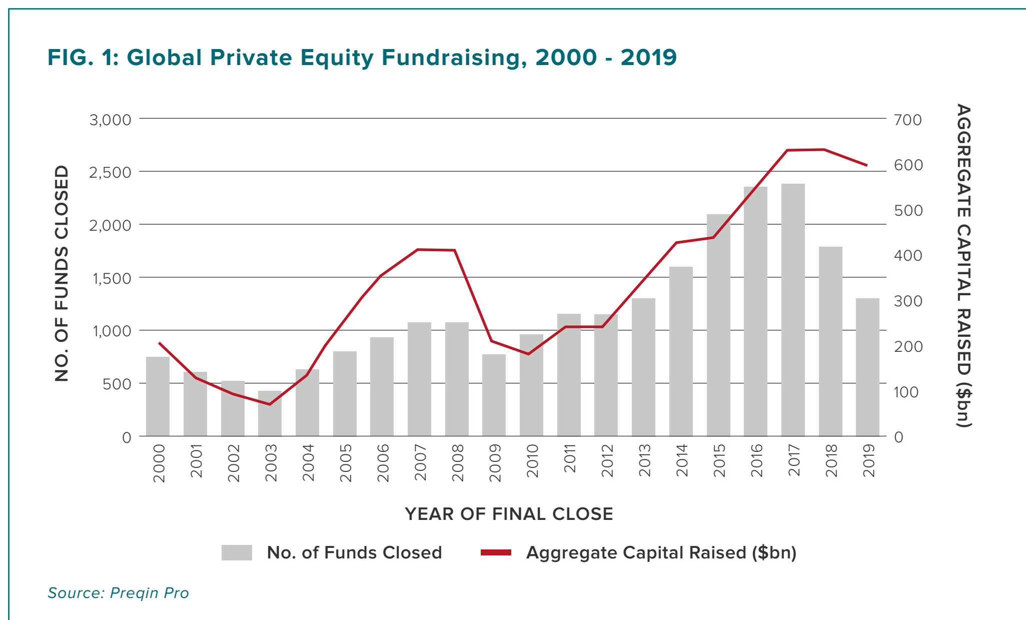
Put simply, while fewer funds closed, the average size was considerably larger. In truth, this came as no surprise to the Mourant funds teams across our jurisdictions as it very much tallied with what we are seeing on a day-to-day basis. On both fundraising numbers and absolute numbers of funds closing, the data shows a clear correlation between wider economic pressure in the early noughties, the period of the global financial crisis and with the beginning of a decline as market conditions began to turn during 2019 and into 2020.

However, it is possible that some significant PE fund raises during the year may have skewed the data slightly. For example, Europe-focussed funds had a strong first half of 2019; most notable among these was KKR raising its biggest ever European fund (€5.8bn) and the Carlyle Group raising €6.4bn for its latest European fund, exceeding its target by nearly €1bn.

Funds domiciled in the Channel Islands saw their share of this trend, with Permira VII raising €11bn and CVC Capital Partners VII raising around €16bn a record for a European fund.

Likewise, in Asia, Warburg Pincus closed a new $4.25bn Cayman fund for China and Southeast Asia in June; the Carlyle Group closed their fifth Asia vehicle of $6.55bn also in June, and it was reported by Reuters in November that KKR is seeking to raise $15bn for its fourth Asia-focused vehicle.

FIG. 1: Global Private Equity Fundraising, 2000 - 2019



Source: Preqin Pro

1. https://docs.preqin.com/reports/2019-Private-Equity-Venture-Capital-Fundraising-Deals-Update.pdf

> “The experience of our fund formation practices has borne this out, with larger fundraises getting away relatively quickly and with high-quality investors, while the mid-market has struggled against target fundraises and timelines.”

DAVID VS. GOLIATH

While this all seems to confirm a long-term trend of successful fundraises for funds at or above €/$2bn, there has been a downward trend for raises of funds below €/$500 million. The experience of our fund formation practices has borne this out, with larger fundraises getting away relatively quickly and with high-quality investors, while the mid-market has struggled against target fundraises and timelines. At the smaller end of the market, we have had positive experiences of niche-focused managers raising funds effectively and quickly.

Our fundraising experience notwithstanding, first-time managers, particularly at the smaller end, have struggled with barriers to entry, which continue to rise. Setting up a fund is an expensive endeavour, and with a relatively long initial period of cash burn before the first trickle of return is received, it is a stiff challenge for first time managers to last the distance from spin-out to sustainable revenue, if not profit.

Numerous other factors are contributing to a challenging environment for smaller managers, not least increased competition owing to high levels of dry powder, leading to limited M&A deals of any quality in the market. Again, however, there seems to be less competition within the lower to mid-size M&A market, which is less visited by the big buyout fund names, thus leaving room for smaller funds to manoeuvre profitably at this level. Increased regulation and geopolitical challenges such as Brexit and the US/China trade war have also had a significant impact: we have seen a rebalancing of focus in Asia away from the dominance of China, increased foreign direct investment into the UK as the British pound weakened during the Brexit process, and generally a stronger appreciation of advisory work as regulatory and governance considerations have come to the fore.

Accordingly, there is rising interest in, and an increasingly important role for, GP financing for smaller managers for working capital purposes, and also using leverage as a strategic tool within larger managers. We have also seen a rise in the number of funds of one established as well as single asset investment club deals, with an investment focus on smaller enterprises that are not on the radar of the bigger players, and where, our clients tell us, price inflation is not considered to be so prevalent.

All the above helps provide context for existing managers continuing to launch (usually larger) successor funds, with investors doubling down on established managers rather than committing capital to newer managers.

CHANGING LANDSCAPE

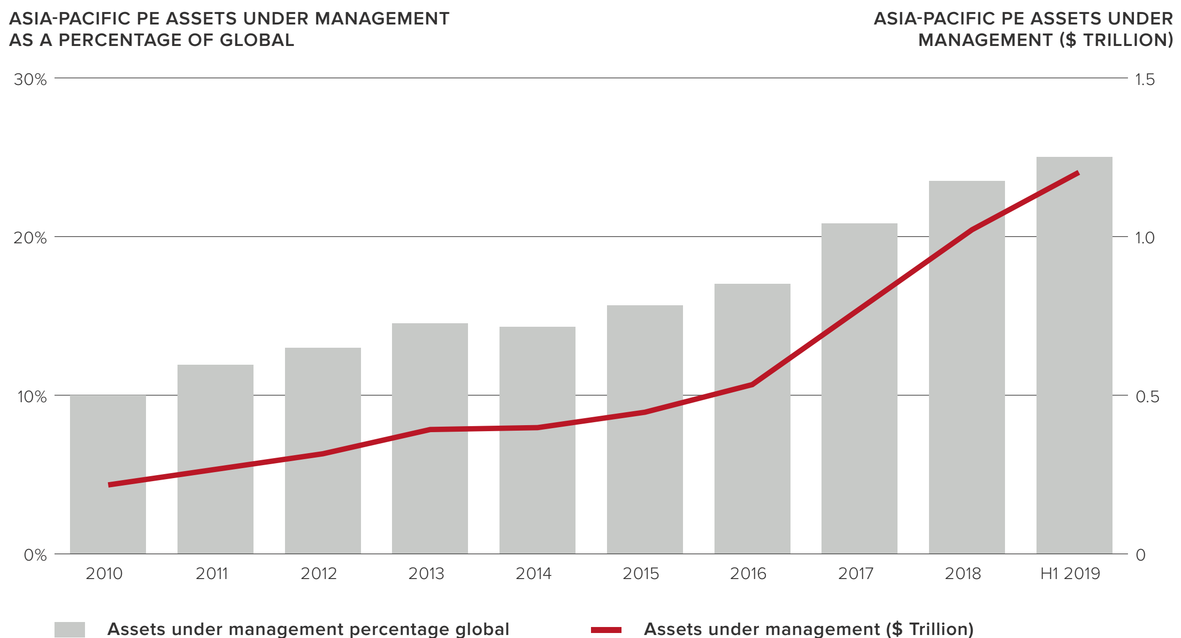
Despite the number of PE fundraises falling while fund sizes have increased, much within PE has actually remained relatively stable. Investment in PE continues to be fuelled by high demand from investors who are looking for better returns than from stock markets and generally low yields on government bonds.

In the Asia Pacific region, funds under management are expanding as a proportion of the global market and at the end of 2018 represented 26% of the funds raised in the global PE market (versus 9% a decade previously) according to Preqin[2]. Indeed, Asia remains the emerging market of choice for private equity investors, with Preqin figures showing that 49% feel China presents the best opportunities in emerging markets[3].

This seems to fly in the face of challenges relating to an economic slowdown in the region and the ongoing US/China trade discussions. Indeed, there is a sense that funds are increasingly treating China as a 'must-have'. In 2019, China came second only to the US in terms of funds closed by country, according to Preqin, and third behind Delaware and the Cayman Islands in terms of funds closed by domicile[4].

Although the current global economic and geopolitical landscape has posed distinct challenges, the time taken to raise funds has remained relatively consistent – on average, a 12 to 18-month period appears to be standard. Larger, more established funds tend to close more quickly, whereas smaller, less established funds may take longer than the average or stall altogether.

FIG. 2: Asia-Pacific now represents a quarter of the global PE market.



Source: Preqin, Dealogic

2. Preqin
3. https://docs.preqin.com/reports/Preqin-Investor-Update-Alternative-Assets-H2-2019.pdf
4. Preqin

THE RISE OF CO-INVESTMENTS AND JOINT VENTURES

We have seen increased popularity of co-investments and joint ventures (JVs) – this reflects a general trend recognised across the industry and in reports such as the McKinsey Global Private Markets Review 2019[5]. As economic uncertainty increases, the use of these structures allows investors to pool capital and market expertise, which allows for innovative collaboration and expansion into different sectors with ultimately less financial risk.

As an example, co-investing and JVs have become extremely popular in the UK real estate market in recent years. Some of this reflects the nature of the investors and the markets they are targeting. For example, pension funds have been keen to invest in the private rented sector (PRS), but lack the expertise themselves to identify, develop and run such investments on an ongoing basis and thus seek to garner investment discipline and experience from joint-venturing with more established real estate investors.

As such, they combine the skills of a developer and manager with the financial resources of a pension fund or other institutional investor.

We are also seeing a general trend towards co-investment alongside blind pool funds in which investors also have a stake.

FIG. 3A: No. of Funds Closed by Country

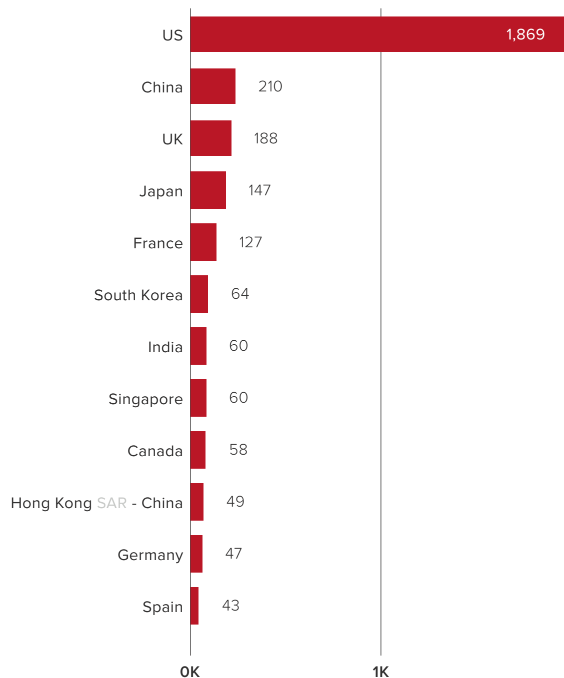
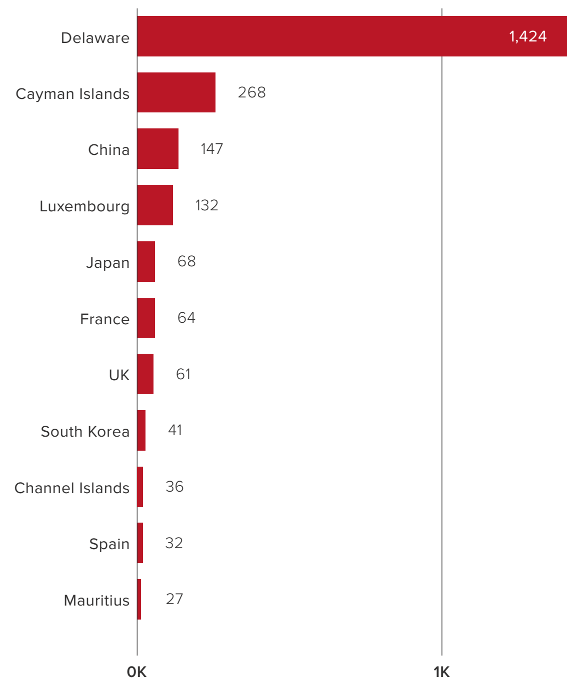


FIG. 3B: No. of Funds Closed by Domicile



Source: Preqin

5. www.mckinsey.com/~/media/McKinsey/Industries/Private%20Equity%20and%20Principal%20Investors/Our%20Insights/Private%20markets%20come%20of%20age/Private-markets-come-of-age-McKinsey-Global-Private-Markets-Review-2019-vF.ashx

THE ROLE OF TECHNOLOGY

Despite the technological advances that have been exploited more widely across global finance sectors, adoption of technology in the funds industry seems to be taking longer to gain traction, particularly when it comes to fundraising.

Governments and regulators in our jurisdictions have acknowledged the importance of embracing financial technologies. Numerous working groups have been established and the process of reviewing the existing regulatory framework with a view to weaving this in is largely underway. For example, recent changes in Guernsey recognise the legal effect of smart contracts. Furthermore, the Guernsey Financial Services Commission is a founding member of the Global Financial Innovation Network (GFIN), a network of international regulators and related organisations committed to supporting financial innovation.

Fund managers are increasingly using portals and data sites to provide documents and information to investors, with e-signature platforms becoming increasingly common as they create a clear document audit trail. And the use of more advanced technology has also been rolled out. In 2019, Northern Trust in Guernsey launched the first ever commercial deployment of blockchain technology for the administration of private equity.

More broadly, some of the larger players are using 'big data' in PE when looking for opportunities to increase return on investment. For instance, by tracking credit card use in relation to certain companies or 'webscraping' for similar information. However, the costs associated with this, and indeed many other areas of technology, mean it is only available to the bigger managers.

It is worthy of note that many fund administrators in Jersey are owned by private equity groups and these owners are looking for opportunities to make these businesses more efficient, resilient and competitive, to which the right technology is key. And although fund administrators continue to invest heavily in technology and IT platforms in order to streamline their services and stay ahead of competitors, it still seems to be relatively early days when it comes to using more advanced technology such as tokenisation in fundraising scenarios.

From our point of view, the major disruption expected from technology – particularly automation and AI – is yet to come.

OTHER NOTABLE TRENDS

Whilst there are common themes across all of our locations, we have identified a number of jurisdictional trends when it comes to fundraising.

In Cayman, there has been an increase in GP-led secondary transactions – including single-asset deals, 'stapled' transactions, preferred equity transactions, and restructurings of groups of funds or assets – allowing managers and investors attempt to manage liquidity in an otherwise illiquid asset class. There has also been a boom in GP minority stakes deals, particularly involving large players, such as Blackstone, raising billions of dollars for 'funds of firms' – vehicles whose purpose is to buy portfolios of GP minority stakes.

Our Guernsey team has noted growth of private capital as a source for PE funds, including club deals, co-investments (as previously highlighted) and funds of one.

There has also been continued investor interest in environmental, social and governance (ESG) funds, as witnessed by the successful $1bn fundraise for the Generation IM Sustainable Solutions Fund III. Arguably, investment in PE is more aligned to this due to its longer holding periods and control over investments than one might find in shorter investment horizon fund styles.

Our Jersey office has seen a growing number of previously captive structures, particularly family offices, opening up to third-party capital to pull resources and compete for assets not previously within their range. And real estate funds and Jersey property unit trusts have had a resurgence following the recent UK Non-Resident Capital Gains Tax legislative changes.

Meanwhile, in Hong Kong, our team identified an increase in US-dollar funds being raised that are targeting investment in Greater China. The rationale behind this is complex and linked to the significant slowdown of domestic PE fundraising in RMB, a consequence of regulatory changes in mainland China.

THE OUTLOOK FOR FUNDRAISING IN 2020

Taking into account all of the above as it relates to fundraising across the sector as a whole, we sense that 2020 is going to pose a number of specific challenges, not least because of the current geopolitical and economic uncertainty and record levels of dry powder – estimated by Preqin to be $2.44tn at the end of June 2019[6]. While this is a lot to contend with in itself, the sudden and unexpected impact of the global COVID-19 pandemic will no doubt test this sector even further. At this stage, we can make no clear conclusions on the further strain this will cause, but we know the sector as a whole is bracing itself for a substantial impact. What seems an obvious opportunity for PE firms however, is the potential to use some of this dry powder, to buy much cheaper companies.

From speaking to managers, we sense there is a feeling that markets may become tougher during the next 12-18 months, so firms may well look to fundraise ahead of any potential downturn. Another view is that fundraising totals may fall a little in order to focus on allocating capital.

On a more positive note, we believe, overall, that fundraising will continue as PE is a long-term growth trend. Now that the Brexit situation in the UK appears to be resolved – although we still can't say for certain what the final impact will be – depending on the impact of COVID-19 dependent, we would expect the trend towards larger funds from established names to continue.

The downturn caused by the impact of COVID-19, at least in the near to medium-term, is likely to create opportunities of a different sort as valuations should come down and opportunistic funds identify good investments. Ultimately cash still needs to be deployed and investors have a strong appetite for alternatives. There is a key question however, on whether banks are prepared to lend.

6. https://www.ft.com/content/2f777656-9854-11e9-9573-ee5cbb98ed36

The COVID-19 Effect

PE has long been used to seeking opportunity in Black Swan events. But by their very nature, Black Swan events are so far beyond normal expectations that even the possibility they might occur is unknown and hence opportunity tends only to follow initial catastrophe.

While it is too early to gauge how significant, and how long-term the disruption of investment opportunity will be as a result of COVID-19 we are starting to see contractual terms tailored to target consequences of market disruption and price swings as a consequence of the virus, as well as steps being taken by counterparties to ensure that transactions are not derailed by practical impediments (see here for further detail on practical steps for BVI and Cayman companies for dealing with COVID-19 disruption).

The initial period of hardship may be felt most keenly by funds that are currently 'on the road', whether for the first time or for a successor fundraise, with COVID-19 travel restrictions applying globally, and much of the world in lock-down as of March 2020 and subsequently with face-to-face meetings being abandoned as a matter of course. That being said, as both funds and investors are motivated to marry capital with opportunity they should find a way to cross any short-term hurdles, perhaps through smarter use of technology. While PE is traditionally seen as a face-to-face industry, innovation must take place in order for firms in this sector to continue with 'business as usual'.

SECTION 2

Fund Level Finance

Considering the broader fundraising landscape as detailed above, we felt it would be of interest to examine not only how funds are being raised but also how they are being deployed, and the role that leverage is playing as part of this process.

TYPES OF FUND FINANCE FACILITIES

The traditional subscription financing (which, at its most basic, is leverage taken at fund-level to bridge the gap between calling upon investors' commitments and receipt by the fund of payment of their capital contributions, secured against the right to call upon, and enforce the payment of, capital commitments from investors) globally had a robust year in 2019. In the US and European markets, the use of bridging finance to ease capital call administration has become mainstream at all levels of the market, from large institutional funds down to small emerging funds.

While subscription financing has accounted for the majority of fund financings we have advised on, in the US market we have seen a substantial increase in funds using leverage during the commitment/investment period – through asset-backed (NAV) facilities – as well as during later stages of the lifecycle of the fund (through hybrid facilities). This has also been a pattern within the European market, which, in many respects, closely mirrors market patterns in the US.

By contrast, we see fewer mid-to-late stage fund financings in Asia, although there has been significant change in the fund finance landscape in the region. While Asia still looks to the more mature US and European markets for structure and best practice, the evolution in the use of capital call facilities, in terms of volume and sophistication of players in the market, has been rapid. The last 12 months exemplify this, as we have seen more complexity and creativity in the financing being offered at fund level – for example, increased interest in umbrella facilities to cover lending for the entire lifecycle of a fund.

An interesting trend which we have seen across the US and Asia has been an increase in financing being provided to the general partner or manager of a fund, typically to finance its own working capital requirements. These working capital loans are usually advanced through management fee facilities, secured by the general partner or manager's right to receive management fees and/or fees actually received.

With general partners under pressure to have 'skin in the game' (in ever-increasing fund sizes), these facilities enable otherwise cash constrained general partners to potentially get their business off the ground, as well as allowing for succession planning at more established general partners, with young portfolio managers funding their ascent into the senior team. In Europe, we see significant demand for this style of fund finance, but the pool of lenders willing to participate in this market have slowed its growth in the region relative to our experience of the US and Asia.

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From an investor perspective, the industry is still getting to grips with investor relations angles on the use of leverage at fund level, and how this impacts performance measures. However, general partners are aware of the need for transparency with their investors and the need for investors to be comfortable with the lending relationship, and so lender branding has been important. LPs not only want to know about leverage disclosures at fund level and the consequential impact on IRR and other metrics, but also how general partners are financing themselves.

For 2020, prior to the onset of COVID-19, we had predicted continuing appetite from investment funds globally to balance debt and equity, in order to put themselves in the strongest position to compete for fewer large M&A deals in the market, and to maximise leverage returns. However, the global onslaught of Covid-19 has somewhat shifted this prediction. There has been speculation as to whether longer-term liquidity crunches may result in LP defaults on capital calls to (among other things) repay finance facilities. While we have not yet seen this in any of our jurisdictions, it is still early days and we are monitoring this closely. We have also become aware that as part of prudent financial planning, to ride the wave of current market unpredictability, some general partners are calling capital from LPs in order to repay subscription lines early to both de-lever and to maximise available dry powder. Indeed, some managers with dry powder available may be looking to take advantage of the market with distressed asset investments, while others will be looking to protect their existing portfolios.

SIZE OF LENDING

In the US market, the size of facilities we have worked on has not changed noticeably in the last few years. Of the matters we advised on in 2019, lender commitments for a newly originated subscription deal averaged approximately $280 million.

By contrast, as fund sizes have grown in Asia, so too has the size of capital-call facilities, and we are seeing continued growth in the number of club and syndicated deals, particularly for funds which have taken out smaller facilities for their second and third funds and are now setting up their subsequent funds.

The size of a subscription facility is typically determined by the size of the fund. In both the US and Asia, facilities for smaller funds are usually bilateral and range between $3 million and $200 million. Banks in this market are often seeking to complement their private wealth business and build relationships with the principals of these types of funds. For medium-sized funds, facilities are typically between $150 million and $300 million; and for large funds with major sponsors, facilities can be up to $1.5billion.

The asset-backed (NAV) facilities which we worked on in 2019 average around $90 million, while hybrid facilities are typically based on a percentage of the outstanding callable capital initially. Once a certain percentage of callable capital has been drawn- down from investors, the amount under the facility transitions to a NAV style availability amount and will typically be capped at a percentage of the value of the funds' assets or cashflows.

The general partner or management facilities we acted on in 2019 are typically based on up to 35% of the management fees receivable annually by the general partner or manager. In 2019, the average size of these facilities in the US that we advised on was around $5 million. That being said, in Asia, we acted on a general partner financing for up to $500 million, reflecting the appetite for larger facilities for mega-funds.

Who is Lending?

In terms of lenders, the Asia-Pacific market is certainly more crowded (and more price-sensitive) than it used to be, with activity centred in Hong Kong, Singapore and Australia. Some banks are offering capital-call facilities on a relationship basis only, while others are focusing on it as one of their key lending products. We have noticed more funds utilising such facilities and openly comparing term sheets to optimise deal terms.

Globally, the diversification of banks in the bilateral market gives great opportunities for the smaller and medium-size funds. Often these bilateral lenders will participate in syndicated deals arranged by the larger agent/arranger banks.

This is also an area in which new entrants are gaining a foothold. Indeed, a significant trend in 2019 was the surge of new entrants in the lender space. This came at the same time as a number of lateral moves of key industry personnel between banks in the US; and moves of personnel from the US to Asia, bringing a wealth of experience and expertise into this evolving fund finance market. The European market has been relatively more stable in terms of personnel movement, but in other respects mirrors the US and Asia.

With the potential for LP liquidity issues amid the economic impact of the Covid-19 crisis, we expect that some managers may look to re-finance existing facilities in order to avoid potential defaults. This opens up opportunities for lenders to either reinforce their existing relationships by showing flexibility and versatility, or for new lending relationships to be won.

SECTION 3

Downstream investment and M&A activity – where is the money going?

Given the locations of our offices and our jurisdictional coverage, our corporate team enjoyed a broad overview of PE deal flow during 2019. Headline M&A deals did not all include offshore elements but many did (particularly in Asia), and trends in the wider market have been paralleled offshore.

Healthcare, technology and energy were amongst the busiest asset classes globally and this was reflected in the transactions we saw. Deal-making in the wider healthcare sector hit $533bn in 2019, up 26% from a year earlier, while M&A in the technology sector reached $529bn, up 4% on the previous year[7].

Total deal values for healthcare, including pharmaceuticals and biotech, exceeded annual totals for the previous 10 years. Notable deals in this sector were Bristol-Myers Squibb's acquisition of Celgene for $74bn and the announced $63bn acquisition of Allergan by AbbVie by way of merger. Underlying life sciences businesses established offshore and operating within, with investment from or in partnership with, these businesses received a boost from these strategic deals. Downstream activity has also been brisk, even if not directly featured within M&A reporting.

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Deal-making in the wider healthcare sector in 2019:

$533bn

26% up from previous year

M&A in the technology sector in 2019:

$529bn

4% up from previous year

7. https://fortune.com/2019/12/31/super-mega-mergers-deals-2019/

Technology, including fintech, saw another active year. Fidelity National Information Services acquired Worldpay Group in a stock-cash deal worth $43bn; Fiserv purchased First Data in a $22bn all-stock transaction; and Global Payments acquired Total System Services in a $21.5bn all-stock deal. Fintech was a driving force in fund and quasi-fund structuring work, with a significant uptick in interest in tokenised and other digitalised fund offerings as well as quasi-fund offerings in the form of ICOs.

The energy sector was more active in 2019 than in recent years and saw the pending acquisition of 70% of the shares of Saudi Basic Industries by Saudi Aramco for approximately $70bn (which is scheduled to close in 2020). Occidental Petroleum also acquired Anadarko Petroleum in a transaction valued at $55bn, including the assumption of Anadarko's debt.

Real estate has also been active and has seen higher investments overall than in recent years. In particular, there is a growing demand for logistics businesses and warehouse/storage solutions due mainly to the increasing role of e-commerce. At the larger end of this sector, Blackstone purchased $18.7bn in industrial warehouses and related infrastructure from GLP in Singapore.

And despite concerns around Brexit, commercial real estate deals in the UK – which are commonly structured through our jurisdictions (especially Jersey, Guernsey and BVI) – saw strong deal flows. Even when market circumstances in the UK may result in real estate assets being less attractive to certain types of investor, the investor pool is sufficiently diverse that UK real estate will often be an attractive asset class for other types of investor, particularly given the relative weakness of sterling in recent times.

The defence sector saw a sizeable transaction in the announced United Technologies agreement to merge its aerospace business with Raytheon in a deal reportedly worth $121bn. Meanwhile, the banking industry saw the largest bank merger since the global financial crisis, with BB&T's merger with SunTrust Banks to form Truist Financial in a transaction valued at $66bn.

Regulated financial services businesses offshore have continued to be a focal point for private equity investors, who have been driving continued consolidation in the offshore fund servicing and broader fiduciary services markets, most notably in the Channel Islands. However, there is increasing likelihood of management exits from these businesses via IPO rather than by private equity acquisition, following a slow burn of ambition sparked by the successful IPO of Sanne Group in 2015.

THE STATE OF DEAL FLOW

It's worth examining the seemingly positive deals above in the context of the broader market, as well as comparing 2019 performance with previous years.

Deal flow has been sporadic and volatile. Elevated global economic uncertainty – not least due to tensions between the US and China, and the unpredictability of US policy actions – clearly slowed activity, particularly in China-influenced Asia.

While relatively strong by historical standards, overall M&A deal flow in 2019 was down 6.9% on 2018, according to Mergermarket – and volume across sectors slowed significantly in the second half of 2019, falling 24.2% compared with the first half[8]. Despite this overall slowdown, the average deal size was larger – this figure rose to around $389 million in 2019, up from $353 million in 2018.

North America, Asia Pacific (excluding Japan), Europe, the Middle East and Africa all saw M&A activity decrease compared with 2018, with a fall in cross-border transaction activity. Likewise, Japan and Latin America saw M&A activity decrease for Q1 to Q3 combined – however, M&A activity for Q3 itself increased as compared to Q3 in 2018.

From a regional perspective, deal-making fell significantly in Greater China, largely as a result of the US/China trade war and a general economic slowdown. As of July 2019, the number of private equity-backed buyout deals and VC deals in Greater China dropped by 30% and 48% respectively. It is perhaps unsurprising, therefore, that investors, particularly PE houses, have been looking for opportunities elsewhere, especially the emerging economies in South East Asia. This is borne out in rising interest on the part of credit funds to participate in this region, as well as narrow-focus funds with niche investment plays focussing on emerging South East Asia.

Thailand, Vietnam and the Philippines have been the partial beneficiaries of China's political and economic situation and there remains significant interest and likely growth in frontier markets in South East Asia, which may be a continued trend for next year. Ultimately, however, China is the world's second largest economy and so will always have an influence on and be a substantial aspect of PE activity in the region.

With regard to UK real estate, while the volume of deals may possibly have been lower this year, there have been a number of very large deals in the market which have offset any lower volume. In addition, from April 2019, non-resident investors in UK commercial real estate have been subject to UK capital gains tax (CGT). As a result, a number of investors have been restructuring their existing structures, often in favour of jurisdictions such as Jersey and Guernsey.

M&A deal flow:

6.9% from previous year

M&A deal size:

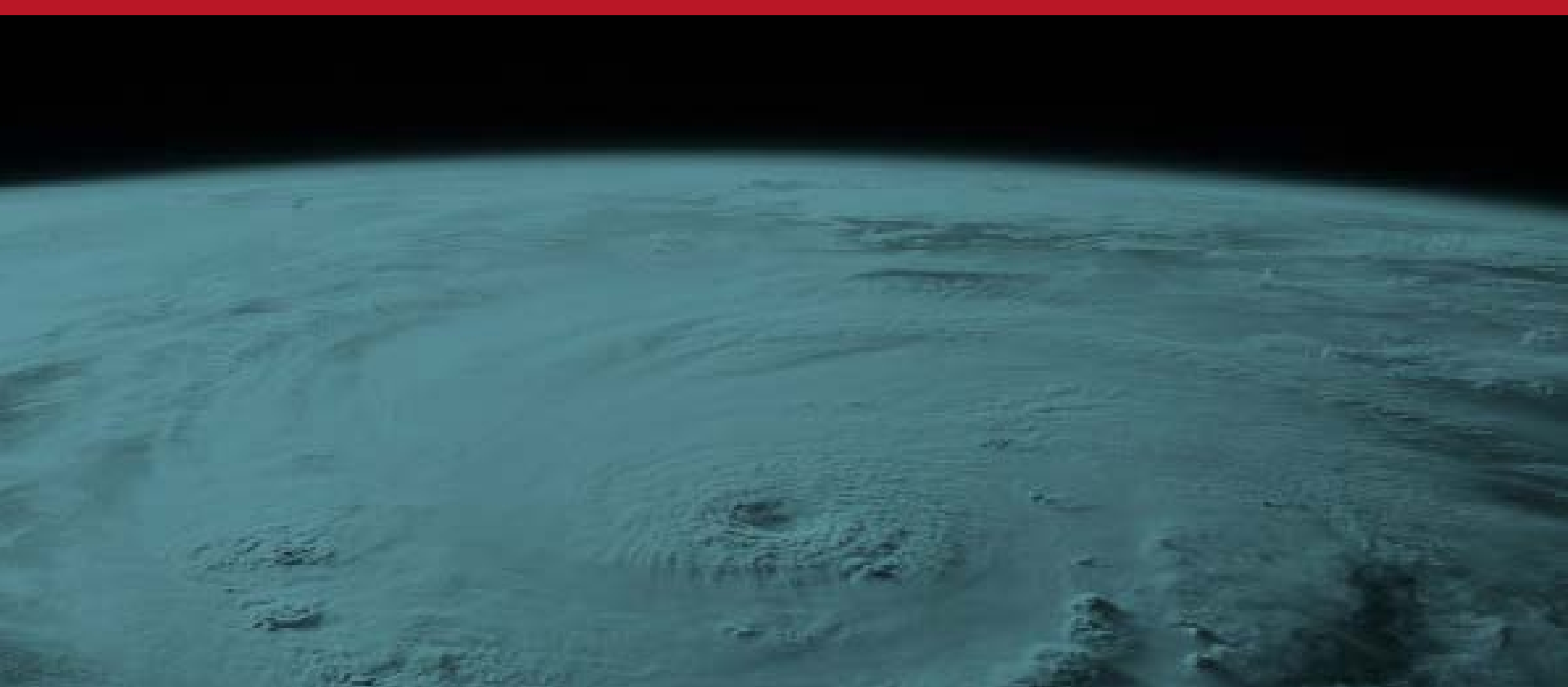
11% from previous year

8. https://www.mergermarket.com/info/ma

THE ROAD AHEAD

We expect 2019's slowdown in M&A activity to continue into 2020. Global economic and political uncertainty, factors such as Brexit, an increase in trade tensions (particularly the possibility of an intensification of US/China trade disputes), COVID-19 and the potential for a global recession, all pose risks to deal flow in 2020.

However, on the flip-side of depressed markets is the prospect of keener pricing terms for good assets, as well as distressed investment opportunities for viable businesses which have weathered these storms poorly.



SECTION 4

Credit Funds – A Phenomenon Here to Stay?

Across our jurisdictions we have seen a number of PE managers raising credit funds for some time. While there are various drivers behind this shift, a key factor has been the withdrawal of bank finance to the SME sector by mainstream banks and the attractiveness of a reliable income/yield for PE managers. From an investor perspective, credit funds have significantly outperformed the key bond benchmarks over recent years.

This is not just a Europe/US phenomenon, we have most certainly seen this shift in Asia as well. In recent years, there has been a significant increase in 'alternative' funding sources within the region, which has historically been a very bank-financed market.

There is now an increased appetite for private debt. To put this into context, some statistics suggest that in 2018, over $96bn of capital was raised in private credit funds which was available to be deployed into Chinese credit opportunities alone.

Credit funds, as a broad church, can be broken down into a variety of structures that are deployed as part of any given investment strategy. We have seen this deployment happen in numerous ways – but most particularly in direct lending, special situations and distressed debt markets.

CREDIT FUND TYPES

In Asia, when credit funds are making investments through direct lending structures, it is typically into 'normal' or non-distressed opportunities. These may be into jurisdictions which are generally regarded as less creditor friendly with less 'robust' legal systems. But the risk appetite of credit funds tends to be of such a nature that with the right security package – often including personal guarantees from the sponsors – they are willing to make the investment.

We have also seen a large volume of credit funds investing in the distressed/special situations space. These are, by their nature, usually 'one-off' value investment situations and often the credit fund will have a particular expertise or familiarity with the underlying industry/asset and jurisdiction involved.

A BROADER APPEAL

It is worth assessing this growth in credit funds in the context of institutional lending and also how they have been received from a regulatory perspective.

There appear to be a number of factors which have given rise to the shift away from more traditional sources of financing/institutional lending. Institutional investors have been looking to diversify their portfolios and seek out newer markets with higher yields. Banks are traditionally cautious about lending activity in these so-called 'high-risk/return' markets.

Linked to the above, corporates that have previously been conservative in their financing structures, most notably in Asia, are now looking to be more opportunistic and are therefore increasingly looking at more complex financing arrangements. Debt and credit funds, more so than banks, are well placed to offer these types of arrangements including mezzanine structures, equity stakes and non-amortising loans.

Furthermore, the changes in the regulatory landscape and mounting non-performing assets all add to banks' increasingly cautious approach to their lending activity.

Lastly, local regulators in markets such as France and Italy, for instance, have seemingly been supportive of measures aimed at loosening SMEs' dependency on bank finance by easing limitations that had previously prevented or heavily restricted non-banks from participating in direct lending activities. The UK regulators, principally the Financial Conduct Authority, have historically raised concerns regarding 'shadow banking', but this seems to have subsided.

SECTION 5

Restructuring and Insolvency – A Continuing Challenge

It comes as no surprise that difficult global macroeconomic conditions have had a significant and often negative impact on businesses around the world across all sectors. Due to these challenging conditions, rising debt levels and the limited ammunition held by central banks, commentators have been predicting a significant rise in restructurings and insolvencies, which in turn will have an impact on the offshore funds sector.

While there are certain global commonalities in this area, there are also differences depending on which region we examine.

> "Although it may be some time before we see the full impact of the Coronavirus on the global economy, this additional threat will likely be too much for many SME businesses to weather."

The predicated wave of insolvencies and restructurings that were expected in 2019 did not materialise by the start of 2020, but there is little doubt that COVID-19 will propel them forward. We are already seeing this is beginning to happen, including with many of our onshore intermediaries telling us that they are increasing capacity in their insolvency and restructuring teams.

In addition, news sources have reported that 2019 saw an increase in US bankruptcy filings for the first time in eight years, and that personal insolvency filings in Canada have recently hit levels not seen since 2009.

From a European perspective, the most substantial impact has come from general economic conditions in the UK, in particular Brexit-related uncertainty and weakening global growth. Investment structures that have exposure to UK and European sectors experiencing ongoing weakness are most exposed. Particular issues have been seen in investment funds that are exposed to UK and European real estate.

Meanwhile, India and South America look likely to see increasing work over the next year or two. And in Asia – particularly in China and the Hong Kong Special Administrative Region – recent geopolitical issues have resulted in an increase in SME defaults, particularly in the retail sector.

With limited investor appetite for rescue via refinancing of this debt, defaults are proceeding into insolvent liquidations. Although it may be some time before we see the full impact of the Coronavirus on the global economy, this additional threat will likely be too much for many SME businesses to weather. Time will tell if weaker balance sheets will result in a noticeable increase in defaults and new, formal Asia-based restructurings.

The other consideration we are monitoring is that traditional institutional lender cautiousness obviously creates opportunities for alternative lenders. It is too soon to tell how such alternative lenders might 'fill the gap' in (re)financings but it is certainly an area to watch as green shoots of practice emerge.

We have also taken notice of the increased appetite (and success) of international financial institutions in taking enforcement action in relation to Chinese-owned assets and, in some cases, 'extracting' assets from China. There is a likelihood of this trend continuing, particularly if financial institutions start publicising these 'successes'.

THE OUTLOOK FOR 2020

We anticipate that work around restructuring and insolvency will continue to become increasingly busy in 2020. Fund managers and directors should ensure that they are well-placed to react quickly and appropriately to any significant macroeconomic shock or liquidity event. A review of the funds' documents from an insolvency/restructuring perspective may help to ensure that all of the necessary tools are available, should they be needed later on.

While the outcome of the recent UK general election will relieve some of the more immediate Brexit-related uncertainty, this is likely to continue to be a factor in 2020 as negotiations on the UK's future relationship with the EU unfold, as will any continued global economic slowdown and trade tensions.

In line with UK and Europe generally, we expect to see increased insolvency and restructuring activity through our Channel Island offices. Guernsey's legislature approved changes to the island's corporate insolvency laws in January 2020. The changes, which are aimed at further modernising those laws, include greater protection for creditors and enhanced powers to officeholders to investigate corporate wrongdoing.

Even amongst COVID-19 it will also be interesting to see how matters develop with the ongoing US/China trade dispute, and the recent rise in Middle Eastern tensions and the resulting impact on oil prices, and what impacts they have on the global economy.

SECTION 6

Summary and Conclusion

The COVID-19 outbreak only serves to show how the unexpected can provide a shock to the capital markets. Stock markets globally have all reported record losses since February (although some have rallied since the announcement of a $2 trillion stimulus package at the end of March), and the threat of a recession for many countries around the world looks imminent, if not inevitable. In the funds space, the world's largest PE manager, Blackstone, warned that the virus 'presents material uncertainty and risk to our and our funds' performance and final results.

"As a firm with a global perspective, we will continue to monitor the broad funds universe closely, with particular regard to the offshore market, and will advise clients on the opportunities and challenges accordingly."

Taking some of the figures in this report at face value, it would be easy to paint a somewhat pessimistic view of the global funds sector – a decrease in the number of funds closed, a record amount of unallocated dry powder, and a slowdown in M&A activity might, on the surface, point to a general downturn.

Yet all of this needs not only to be taken in context, but also in light of what managers and others in the funds industry are saying and experiencing day to day – it's this kind of insight and information that isn't necessarily reflected in hard data.

From speaking to managers, we readily admit there is a feeling that markets may become tougher, and that fundraising totals may fall slightly in order to focus on allocating capital. Indeed, all evidence seems to point to an appetite for alternative investments and that fundraising will continue, although the trend may well keep shifting towards larger funds from established names, complemented by niche players at the smaller end of the market.

Even if there is an imminent downturn, this is likely to create opportunities. Historically the funds sector has been versatile and adaptable and, as the saying goes: 'necessity is the mother of invention'.

As we've already examined, diversification of banks in the bilateral market gives great opportunities for the smaller and medium-size funds when it comes to fund finance. Likewise, credit funds are developing in order to provide institutional investors with broader options than in more traditional markets.

As a firm with a global perspective, we will continue to monitor the broad funds universe closely, with particular regard to the offshore market, and will advise clients on the opportunities and challenges accordingly.

9. https://www.bbc.co.uk/news/business-51639654

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