UPDATE

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APAC Fund Finance Symposium 2023 Top Takeaways

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The Fund Finance Association hosted its 5th Annual APAC Fund Finance Symposium on 12 October 2023. Mourant was proud to be a Gold sponsor for this landmark symposium. Our thanks to the Fund Finance Association and the APAC fund finance community.

2023 has been a challenging year, but the APAC fund finance community continues to demonstrate resilience and ingenuity. Keynote speaker, Robert Swan, the first person in history to walk to the North and South Poles, reflected our industry's sentiments as he spoke about hope, collaboration, trust, and innovation.

These top takeaways summarise the panel discussions as experts reflected on 2023 and their hopes for what lies ahead.

1 Financial Stability - The Recent Banking Turmoil and Lessons for APAC

Impact of March Madness

- The APAC region was less affected by the March banking crisis compared to the US due to (i) regulators in APAC monitoring the situation from the start; and (ii) diversified banking relationships.
- After the collapse of Silicon Valley Bank (**SVB**), funds and Venture Capital (**VCs**) started diversifying their banking relationships, benefiting local players and creating opportunities for other banks to fill the void.

Current Fund Finance Market

- In the US, demand for fund finance exceeds supply, allowing banks to charge higher interest rates. In Asia, the situation is reversed, with the cost of funds historically being cheaper than in the US.
- All funds, including mega managers, are experiencing longer fundraising cycles, leading to more extensions and longer draws on credit lines.
- Lenders are becoming more selective, focusing on their 'sweet spot', and developing strategies tailored to specific types of sponsors. This diversity among lenders creates varying experiences of the current market based on their approach.

Appetite for Fund Financing

- Fund financing remains highly active compared to other types of lending, indicating continued investor interest and demand.
- Limited Partners (**LPs**) are increasingly exploring the use of secondaries markets, with a 10% increase in the use of continuation vehicles in the US. In Asia, there is a greater supply of sub-line money compared to NAV money.
- Historically, sponsors have achieved their Internal Rate of Return (**IRR**) targets by utilising debt. However, Asian sponsors face challenges in borrowing due to fewer buyout deals, making it harder to realise expected returns.

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2 The Evolving Landscape – Transformative Trends in Lending

The Current Market

- With slow fundraising and high interest rates, sponsors are more cautious and are considering whether it makes sense to use fund finance facilities. In the US/Europe, demand for fund finance outpaces supply due to bank capital adequacy requirements, while in APAC supply is increasing with new entrants into the market, particularly Asian banks and US/European banks looking to become active in Asia.

Use of Rated Products

- There is increased use of credit ratings (often privately) in the US/Europe to decrease or distribute risk weighted assets. From a sponsor perspective, having a rating can increase the efficiency of the execution process and obtain more flexible pricing or larger commitments from lenders.

Bank Appetite for Fund Finance

- The current prime rate has limited borrowing incentives for funds with a similar hurdle rate. However, Asia retains a pricing advantage above the US, so some US/EMEA sponsors have come to Asia to borrow.
- Lenders are monitoring the usage of loans and consider factors such as draw down on the lines, term length, whether borrowers will call capital to repay debt at current interest rates and whether General Partners (GPs) are achieving their IRR.
- In APAC, some credit funds have utilised NAV facilities, however, PE shows less usage. The CLO market is very developed in the US but still nascent in Asia (these are popular as banks can offload/distribute their exposure).
- In other trends in APAC, there has been growing utilisation of subscription lines by SMAs; increased requests from open-ended funds for financing; and continued demand for management/GP lines, as well as some hybrid facilities. There is demand for NAV, but it is challenging to evaluate assets in the portfolio.

Alternative Lenders

- Banks dominate fund finance in APAC, with limited activity from alternative lenders. Reasons for limited fund finance engagement from private credit funds include perceived competition from sponsors, lack of ancillary banking services, knowledge on how to underwrite, and the fragmented nature of a multi-jurisdictional region. With alternative lenders making up only 25% of the Asia market (compared with 80% in the US market), there is significant room for private credit to expand.

3 Beyond Traditional: Alternative Financing Strategies in APAC's Fund Finance

The Significance of Net Asset Value (NAV) Facilities in the Changing Landscape

- The NAV facility market in the US/Europe is well-established and complex, while in Asia, it is still emerging. There is growing interest in NAV facilities among Asian GPs who seek to optimise funds and increase liquidity, however, they are cautious about financing costs in the current macro environment.
- Previously, NAV facilities were commonly used for bolt-on acquisitions or follow-on investments during periods of increased exit opportunities and investment activity. Over the past year, NAV facilities have become more of a defensive tool. They are now used to address challenges like debt covenants or to provide distributions to investors in a challenging exit environment.
- Hybrid facilities are gaining popularity in APAC, allowing lenders to support the fund's lifecycle, catering to the relationship-driven nature of lending.

Documentation: The Limited Partnership Agreement (LPA) and Collateral

- LPAs are increasingly tailored to reflect the fund's strategic focus and intended financing arrangements, reducing the need for retrospective amendments.
- There is a drive towards collateral lite for NAV financings in the US. However, lenders in APAC take a more conservative approach with a robust collateral package including equity pledges when they can be obtained.

Future Outlook for Hong Kong

- The Hong Kong government's focus is on ESG, fintech, and AI initiatives. The collapse of SVB resulted in a loss of an important source of funding for venture capitalists in these sectors. The government, through HKIC (Hong Kong Investment Corporation), has committed HK$6.2 billion to support initiatives in these areas. China-based companies are seeking international expansion and are turning to Hong Kong as a source of capital and access to international markets.

4 Navigating Complexity in FF Documentation

Complexity in Fund Structures and Finance Documentation

- There has been a shift from 'plain vanilla' fund structures to more complex ones with parallel and alternative investment vehicles. This has resulted in more complex security packages with additional obligors and increased need for cascading security.
- While there may be desire in the market to standardise fund finance documentation, given the complexity and uniqueness of fund structures, it would be difficult to achieve a true standardisation.
- When negotiating fund finance documentation, the relationship between lenders and sponsors is crucial and requires a balancing act. Lenders need to consider hairline triggers (which should be exclusion events) and real events impacting the facility and leading to an event of default. Meanwhile, sponsors need to consider information which needs to be shared with lenders.
- Following the banking crisis, facility agreements have increasingly included defaulting lender provisions. Lawyers are also addressing ways to enable transfer of administrative or agent roles to mitigate practical issues where there is a default by one of these entities.

ESG Considerations

- ESG provisions in fund documentation can be purpose-driven or linked to key performance indicators (KPIs) with margin adjustments. The complexity in ESG is not in the documentation, but on agreeing the KPIs, reporting requirements and the ramifications for not achieving KPIs. This is a challenge in APAC where there is no uniform standardisation.

Challenges and Considerations in SMA Deals

- Security package and sovereign immunity issues pose challenges in SMA (Separately Managed Account) deals. Understanding the investor's track record is crucial for lenders. Lenders may require comfort letters or statements of fact particularly when dealing with a special purpose vehicle investor. Transfer provisions are also important, especially if the investor intends to transfer to affiliates.

Trends in Due Diligence Documents

- More investors are seeking to add confidentiality provisions into side letters, resulting in heavily redacted documents. Lenders should ascertain the agreed terms and rationale for redactions within side letters. Additional protections may be necessary, such as excluding an investor or adding additional representations. Fund counsel may provide a compendium of provisions, and it can be useful to include a representation that the compendium contains all relevant information.

5 Shaping the Future: Opportunities in APAC's investment fund landscape

Geographical considerations

- China: While fundraising and exists have slowed, it is inevitable that China's market is cyclical, with periods of contraction and consolidation. Currently, USD fundraising for China has slowed, and there are questions about where this capital will come from. Meanwhile, there has been increasing popularity of funds denominated in Chinese currency (RMB) and a trend of Chinese businesses expanding beyond their domestic markets.
- India: While traditionally a domestic market, investors are recognising the significant population and ongoing economic growth in India. The emergence of GIFT City (Gujarat International Finance Tec-City) is a potential investment hub.
- Japan: This is a market which has been performing well in private equity and venture capital. Much of this follows opportunities arising from generational changes in business ownership in Japan. The key

challenge for fund finance will be understanding the complexities and regulatory issues related to onshore/offshore structuring in Japan.

- Australia: Investors are interested in infrastructure in Australia. It is key to understand the regulatory landscape for non-Australian fund managers looking to invest in the region.

Shifting Markets in APAC

- With China's influence receding, market participants are recognising Asia as a fragmented and diverse market with various assets and sectors. This realisation is beneficial for Asia's maturation, as it dispels the notion of a homogenous market. Managers are increasingly flexible and nimble in reallocating capital to reduce exposure to China, if necessary, while remaining ready to pivot back when conditions improve.
- Middle Eastern investors are becoming more active and engaged in conversations with lenders. They demand greater due diligence and may shape the terms of fund finance transactions. This increased involvement may also lead to a rise in Islamic financing options.
- Secondaries are still relatively new in APAC, but are increasingly becoming a pivotal source of liquidity, particularly for GP continuation funds. There is a strong emphasis on high-quality assets and sponsors.
- All stakeholders, including investment committees, are highly engaged in ESG, while regulators are increasingly putting parameters around sustainable investing and mitigating greenwashing. For managers with prior experience in ESG, particularly with infrastructure or energy funds, are well-positioned to thrive in this evolving landscape.

Fund Domicile

- Cayman Islands remains the preferred jurisdiction for funds, with an increase of 3,800 private investment funds over the past 3 years, bringing the total to 16,500 registered private funds in the Cayman Islands.
- There is also a notable presence of fund administration activities in Luxembourg, Singapore, and Hong Kong. Healthy competition between Hong Kong and Singapore has emerged, with significant wealth flowing into Singapore.

Democratisation of Private Equity

- GPs are increasingly looking to the private wealth sector as a source of capital. This shift entails moving from a small number of large LPs to a larger pool of LPs with smaller commitments. Managers who can effectively leverage technology to manage and nurture these relationships will have a competitive advantage. As more quasi-retail money enters the space, regulatory scrutiny may increase, and managers who can navigate this evolving regulatory landscape will be better positioned for success.

6 GP/LP Panel

GP Investment Strategy

- Private Equity GPs are actively seeking proprietary investment opportunities, particularly in early-stage ventures. They prioritise situations where they can establish a close relationship with the company's management and add unique value. Given the current environment, characterised by uncertainties such as geopolitical and market volatility, GPs adopt a more 'hands-on' approach and are focusing on identifying companies that demonstrate resilience against global trends.
- Given today's challenging markets, GPs place significant emphasis on analysing 3 to 5 year exit solutions for their investments.
- From an LP perspective, spinoffs are viewed positively. They offer incentives for management, attract external talent, and revitalise organisations. An LP may consider acquiring stakes in spinoffs, either as a GP stake or an LP stake, which can present interesting investment opportunities.

Private Credit

- Private credit is currently a hot topic and is gaining traction in the APAC region. Private credit lenders require a high degree of conviction in the underlying assets and seek higher returns with a significantly larger equity buffer. Smaller businesses benefit from private credit financing, as it provides a valuable source of financing to overcome liquidity challenges.

- The private credit market in APAC differs from Europe or the US due to various factors, such as currencies and sovereign ratings.

Regional Discussion

- India: Over the past decade, India experienced stagnated credit growth due to non-performing loans and an asset-liability mismatch within the banking system. However, recent developments indicate robust credit growth, especially in sectors like manufacturing and commercial real estate. There is strong demand for lending and credit in India, driven by the need for infrastructure development and financing for small and medium-sized enterprises.
- China: China continues to be an attractive market for direct investments. The Chinese government's focus on technology and innovation has created opportunities for GPs to invest in sectors such as biotech, artificial intelligence, and clean energy. GPs are also exploring opportunities in China's consumer market, driven by the rising middle-class and increasing urbanisation.
- SE Asia: The Southeast Asian market, including countries like Indonesia, Malaysia, Thailand, and Vietnam, offers significant growth potential and GPs are drawn to the region.

Plant a Tree

Robert Swan spoke about The Tropical Regen Project, which is a reforestation effort to preserve the world's oldest rainforest in Queensland, Australia, led by Robert's son, Barney Swan's, NGO ClimateForce. For more information about planting a tree with ClimateForce, please go to the ClimateForce Tropical Regen Project website www.TropicalRegen.org.

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