UPDATE

Evolving landscape of LP financing in Asia: Trends, challenges and innovations

Update prepared by Danielle Roman and Simon Lawrenson (Hong Kong).

In this article, Danielle Roman and Simon Lawrenson, partners based in the Hong Kong office of Mourant, explore recent trends, evolving structures, preferred financing instruments, and the impact of economic conditions on LP financing in Asia. Danielle is head of the firm's Asia Banking and Finance team, and Simon is the global co-practice leader for the firm's Corporate and Finance team.

Financial challenges from volatile equity markets, a real estate crisis in China and high US dollar interest rates have prompted transformations in the landscape of limited partner (LP) financing in Asia. High net worth (HNW) individuals are increasingly exploring ways to leverage existing assets, primarily driven by the need for liquidity, higher margins and a desire to proactively manage and diversify their portfolios amid lackluster performances in the public markets. Fund managers, meanwhile, increasingly look for financing options to exploit opportunities in the secondaries market or fund their own contributions into continuation funds.

Recent trends in LP financing

Private equity is now witnessing the emergence of the secondaries market. Secondaries transactions allow LPs to sell their partnership interests to other investors, providing an exit or rebalancing opportunity for a traditionally illiquid asset without waiting for the fund's typical life cycle to complete. This presents an attractive opportunity for individual and institutional LP-investors to access private equity markets and to purchase private equity assets at a potentially discounted price. This has also led to opportunities for lenders to leverage their investment fund client portfolio, offering financing options to LP-investors secured against their client's LP interests in the underlying fund(s).

General partner (GP)-led secondaries funds have also grown as a means for GPs to hold onto assets longer, using continuation funds as an alternative to traditional exits amidst macroeconomic and geopolitical uncertainty and volatility. Lenders have been able to offer financing options to fund managers to support their stake into such continuation funds.

The other significant trend has been the rise of individual investors in private equity, as wealthy individuals are drawn to alternative investments to diversify their portfolio and seek greater returns than traditional, currently under-performing asset classes. Private equity has been using innovative fund structures and technology to provide greater access to smaller entities and HNW individuals to the industry (the 'democratisation' of private markets).

In a difficult fundraising environment, GPs of all sizes are pursuing strategies to raise capital, including individual capital. Sophisticated private banks have responded by offering debt financing solutions to support their HNW clients with such investments. Indeed, in some cases, private banks are leveraging and cross selling their proprietary asset management platforms to distribute alternative investments to their clients (and offering financing options so support this). This strategic move by leading international lenders reflects the industry's adaptability to challenging economic climates, the evolution of the fund solution products in Asia and a focus on long-term value creation.

Evolution of LP financing structures

LP financing structures have evolved to meet changing market needs. Lenders now utilise a variety of approaches and are willing to finance a broader spectrum of fund investments, from vanilla bilateral loans collateralized against LP interests, to fund manager's special limited partnership interests, or even debt-equity structures.

There has also been a rise in lending against HNW investor interests in hedge funds through the securing of redeemable shares, adding a further layer of complexity and risk. The bespoke nature of these structures reflects the need for lenders to demonstrate understanding and flexibility in dealing with diverse assets.

Relationship-lending continues to play a crucial role, particularly in the Asia markets, so there is a willingness and desire from lenders to offer client-driven (rather than product-driven) solutions. With competition fierce within the market, lenders have been seeking to diversify and differentiate themselves, seeking to offer bespoke products to their clients that others cannot.

Preferred security instruments

The choice of security instrument depends on how the underlying fund interests are held. Security is typically granted over the LP interest in the underlying fund, or it could be over a fund manager's special limited partnership interests in the fund. For a bank's proprietary fund, security is often aligned with custody, while security over hedge fund interests see share security with added considerations relating to redemptions and valuations.

The incorporation of robust protection mechanisms in the security agreements becomes crucial to safeguard lenders during unpredictable market events. High interest rates and delayed or poor returns mean that lenders are closely watching LP liquidity and any early warning signs of default.

Fund documentation and new financing tools

Fund documents, particularly in the context of hedge funds, may lack express provisions that contemplate the financing and securing of those interests by fund investors. Collaboration between investment fund lawyers and banking and finance colleagues at fund formation stage is essential to ensuring sufficient flexibility is hard-wired into the fund documentation to accommodate a fund's financing needs throughout its lifecycle, as well as to support its investors who wish to take on financing.

As fund structures and the leveraging used at multiple levels of fund structures become more complex, new consideration needs to be given, by lenders and funds alike, as to how these layers interplay with each other.

Impact of economic conditions

LP financing is likely to continue to grow as the private wealth sector and family offices further tap private equity opportunities amidst sluggish and uncertain public equity markets.

Meanwhile, we are likely to see more banks offer this product as they look to protect and grow their private wealth management platforms and seek greater returns whilst traditional corporate lending and sponsor driven activity remains depressed. For some, this means extending flexibility in LP (as well as other 'alternatives') financing and using this as a differentiator.

Technology, innovation and ESG considerations

Lenders have been using their own internal rating systems on investors and are increasingly using technology to determine their lending appetite for a particular client. Rating agencies can also provide credit ratings for most institutional investors to support lenders in their decision-making.

Environmental, social and governance (ESG) considerations, particularly sustainability-linked loans, are becoming increasingly important to investors. A growing number believe ESG factors can impact the performance of their portfolios and can enhance profitability or value over time. The challenges are in determining the KPIs, ongoing reporting requirements and the ramifications for failing to hit KPIs.

The evolving market – Asia

LP financing is undergoing a dynamic growth and shift in Asia, driven by evolving market conditions, economic uncertainties and the need for innovative solutions for both institutional fund and HNW clients. As LPs, banks, and fund managers adapt to these changes, the industry is likely to witness continued evolution, with a focus on flexibility, risk mitigation, long-term relationship building and sustainable financing practices.

As technology continues to advance and ESG considerations become more integral, LP financing is poised to become even more sophisticated, providing tailored solutions to meet the diverse needs of investors in an ever-changing financial landscape.

Contacts

Claire Fulton
Partner
Mourant Ozannes (Hong Kong) LLP
+852 3995 5728
claire.fulton@mourant.com

Danielle Roman
Partner
Mourant Ozannes (Hong Kong) LLP
+852 3995 5705
danielle.roman@mourant.com

Simon Lawrenson
Partner
Mourant Ozannes (Hong Kong) LLP
+852 3995 5707
simon.lawrenson@mourant.com

This update is only intended to give a summary and general overview of the subject matter. It is not intended to be comprehensive and does not constitute, and should not be taken to be, legal advice. If you would like legal advice or further information on any issue raised by this update, please get in touch with one of your usual contacts. You can find out more about us, and access our legal and regulatory notices at mourant.com. © 2024 MOURANT ALL RIGHTS RESERVED