

GUEST ARTICLE

Setting the scene

Offshore funds lawyer Arwel Lewis looks at the trends that emerged in 2010 and predicts which will carry forward to 2011.

As a resurgent private equity sector swings into 2011, the Asian region will remain increasingly important to the global private equity industry, both as a result of Asia's increasingly central role in global financial growth and the continued focus of global funds towards emerging markets such as China and elsewhere in the ASEAN region.

The search for yield and a growing comfort with the risks in emerging markets will see further private equity money invested in emerging markets during 2011, having already increased by over 100 percent during 2010. Asian investors will also have a greater significance globally, a trend noted by the recently raised \$15 billion Blackstone Group buyout fund, which was notable for



Lewis: LPs wield more power in current climate

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the participation of Asian investors. Around 20 percent of the new fund's commitments have come from China and East Asia, according to reports at the time of the close.

One of the most significant trends in Asia of the past 12 months has been the pace at which RMB funds have been established by leading global names, such as The Carlyle Group, KKR, Blackstone and Morgan Stanley. As private equity activity surges in China, industry players have formed RMB funds both to gain greater and faster access to opportunities in China, as well to unlock

cash reserves held by Chinese investors and companies.

As a result of these developments, which are extremely important in terms of driving the private equity industry forward in Asia, deal allocation will be a key trend to watch in 2011 as China sees greater investment from both onshore funds and RMB funds. Private equity houses will need to take into account the rights of all types of investors in terms of providing access to particular opportunities, however, the strength of

the current market in China suggests that there is room for all participants. RMB funds are particularly suited to deals based in China, making sense to tap into that liquidity, while offshore funds are favoured for foreign capital aimed at supporting expansion and international growth objectives.

Recent developments which look set to allow international capital to participate in RMB funds, could also go some way to dealing with the potential conflicts surrounding deal allocation. The changes will also increase investment opportunities for overseas investors and provide new avenues of capital for RMB funds. Local pilot programmes for Qualified Foreign Limited Partners (QFLP) are expected to allow international institutional investors that meet certain criteria to invest as limited partners or shareholders in RMB funds.

The favourable climate for outbound M&A, particularly due to exchange rate movements, points to continued activity for Chinese portfolio companies in buyout funds to acquire expertise or market share from undervalued US or European companies at opportune levels. Enterprise values of target assets are considerably lower than they were in 2008 and may not remain so for some time, plus Chinese companies are holding greater levels of cash, however, managers will need to remain vigilant of the potential integration issues that cross-border M&A presents.

Private equity funds may also have the opportunity in 2011 and beyond to acquire assets that were previously targeted by the investment banks, following the wave of regulatory changes

in 2010. The Volker Rule and the Dodd-Frank Act, which limit ownership of private equity business or require greater costs for holding them, have prompted a flurry of deals by investment banks, such as HSBC, Citigroup and Barclays to spin out their private equity units. For the industry in 2011, this activity is likely to result in greater opportunities in the secondary market, as the main players find easier and greater access to deals with ready made portfolios from funds and managers with track records. Overall the spin outs will also likely result in greater competition and activity in the market, with banks potentially looking to start their own internal proprietary investment trading desks to look at similar investments to those previously housed in the spun out funds.

Offshore focus

This expected increase in activity will follow on from the positive recent developments in the market which Walkers has seen in Asia, where there has been a significant uptick in private equity work. Fund formation has rebounded strongly since the financial crisis and fundraisings which had previously stalled are now closing. With downstream investments, activity has been growing in pre-IPO equity and debt financing, as well as mergers and schemes of arrangement. Additionally, clients have taken advantage of the merger regimes in the Cayman Islands and British Virgin Islands which allow statutory mergers where one or more entities can be merged into, or consolidated with existing or new entities.

Overall, the global regulatory landscape has shifted to encompass a greater appreciation of private equity as an asset class, particularly with the requirement for previously exempt managers to register with the Securities and Exchange Commission in the US. This increased awareness of private equity has also been evident regionally with new taxation legislation in China affecting inbound investment. Circular 698 results in a capital gains tax of 10 percent for a transfer of shares in an offshore holding company

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which is located in a jurisdiction which has an effective tax rate below 12.5 percent or does not tax residents on overseas income. Based on our clients’ experience, the certainty brought by tax rulings on Circular 698 has been welcomed, and the costs are being factored into financial models and it is not expected to provide a great deal of concern to LPs, who will remain focused on the overall investment strategy and the quality of investments.

Investor attitudes have also changed over the past twelve months and further changes are expected as investor expectations increase in terms of information flow and for a greater alignment of interests with GPs. Investors are wielding a greater degree of power in the current climate and, understandably, larger investors are seeking the most attractive deals. Certain of these changes, which developed out of the tighter fundraising environment in 2008 and 2009, follow the best practice guidelines of the Institutional Limited Partners Association’s Private Equity Principles, covering issues such as management fees, provisions for clawbacks and offsets of fees.

On one side, investors are demanding greater reporting from their GPs in terms of more detailed and more frequent reports on the portfolio of investments, as well as more information on the method used to calculate the Net Asset Value. Investors that sit on investment committees are also seeking a greater say in potential investments. Consent or veto rights have become more common for investors, however, it is important to maintain a delicate balance from a Cayman Islands law perspective, particularly as investors who actively participate in the conduct of a Cayman fund’s business could potentially lose their shield of limited liability.

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even up to as high as 100 percent, while also likely to be far more common within deal documentation this year are the use of clawbacks, where GPs are required to repay carried interest distributions if subsequent performance disappoints. Alongside this development will be the greater use of escrow accounts for carried interest distributions.

Side letters, which played an important role in helping managers negotiate the difficult post-crisis market conditions are likely to remain in vogue and GPs will need to ensure that the terms of such side letters are not breached. By maintaining a register of side letters and tracking the terms closely, GPs can look to keep side letters given to different parties consistent.

For all the anticipated increased activity, challenges will still remain in 2011, with intense competition for good deals, as well as credit constraints and debt financing still not freely available. With such a high degree of competition at the moment, GPs have found they are being selected on the basis of what else they can bring to the table in addition to hard cash. This factor has made good market contacts and strong business acumen even more important differentiators. While there is certainly a greater appetite for lending, credit constraints do still exist and lending is still nowhere near pre-crisis levels. Nevertheless, we hope that Asia’s continued emergence as the driver for global growth will see 2011 being a positive year for the private equity industry in the region. ■

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