JUNE 2023

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Fund Finance Association Executive Committee – 2023 APAC Market Update Top Takeaways

Update prepared by Danielle Roman and Lily Miao

The Fund Finance Association Executive Committee hosted the APAC 2023 fund finance update, with market commentators, legal practitioners and lenders giving their views across Hong Kong, Singapore, Australia, Japan, India and the US.

Preqin reported that fundraising in Q1 this year has been low, and a significant chunk raised has been for secondaries. Venture capital fundraising is weaker than private equity, whilst private debt is faring better, showing resilience in 2022 and into 2023. The real estate sector has been the worst hit, falling significantly; while the mega funds that closed in the first half of 2022 are still in deployment phase. Because of the denominator effect and macro-economic factors, investors are still cautious. Whilst APAC has seen a bigger drop than US and Europe, largely due to reluctance to allocate funds to China-focused PE and VC funds, China remains a key market, and still accounts for around 60% AUM for PE and 80% in VC in the region. Meanwhile diversity in APAC (including South-East Asia, India, Korea and Japan) means that the region is likely to be more resilient compared with the US and Europe.

Looking forward to the next 12 months, investors believe their PE portfolios are currently overvalued and expect lower performance; they are adopting a defensive approach. Market conditions present a fantastic opportunity for private debt (which is seen as an alternative to bonds, with better returns than PE). Established fund managers are likely to continue to gain market share and increase in size, possibly leading to some consolidation.

Below we set out the top takeaways from the session, divided by region.

Hong Kong Market

- Fundraising has been slower (and remains difficult for smaller, less experienced fund managers), resulting in fewer facilities. Majority of activity is use of upsizes and accordions but these too are smaller than anticipated with longer time in between. Pricing has not seen the rises that the US has witnessed, and asset valuations have adjusted downwards for China and/or real estate focused funds, which has affected appetite for NAV lines.
- On the plus side, some lenders are extending facilities beyond the investment period, helping managers' liquidity needs and the banks' books, as managers hold assets for longer.
- The exit of certain banks globally in fund finance has opened opportunities for other market players in APAC to step in (including acting in an agency role or as collateral bank), and there remains a gap in the market for another lender to take over SVB's VC and smaller PE clients.
- While the geopolitical tensions should not be understated, there remains pockets of appetite for China from non US investors, and optimism that certain sectors will be able to provide positive returns.

Singapore Market

- Similar to HK, there has been a flight to quality, both on bank and borrower sides. Lenders may ask for tighter terms and are cementing their existing relationships. GPs are equally reassessing their banking connections, showing interest in the credit default swap levels of banks, so creditworthiness of the bank is a key consideration. They are also considering the cost of facilities given rising interest rates, leading some to reduce facility sizes or negotiate for more flexible accordion options.
- The silver lining is that recent events has led to opportunities for new lenders to enter the market, particularly regional banks and US or European banks with a presence in APAC - although lower pricing than the US/Europe remains a challenge for the latter group of entrants into the market.
- The liquidity pressures in the US are not affecting lenders in Singapore (or APAC more generally) as much, and the risk appetite is something that banks intend to manage.
- While there is a current reluctance to allocate to China-focused funds, opportunities in South-East Asia and India remain a key focus for investors.

Australian Market

- The Australia market is backed by strong local banks and some international players, with active participation by credit funds. On the GP side, managers are mainly local, although some global managers have investment teams on the ground. These local managers have deeper relationships with the local banks, who offer more attractive terms in return for cross-selling opportunities.
- As fundraising has slowed, and deals have taken longer to complete, funds needing larger facilities have required more support via club deals. NAV facilities remain the mainstay of the Australian fund finance market, with growing diversity in the lender base (particularly from credit funds) exploring offering NAVs.
- On the investor side, key trends include offshore funds transferring into Australian funds; superfunds funding through equity commitment letters; and innovative FX structures. Superannuation funds have seen a period of consolidation driven by a desire for fee transparency and economies of scale. Whilst such funds have the potential to produce large and creditworthy investors, there will be focus from investors on their investment governance framework, and demand for valuation and reporting at the fund level.
- An interesting new development to watch is a new vehicle called the corporate collective investment vehicle, which is pending certain features being ironed out before introduction to the market.

Japanese Market

- With the Yen still low, Japan has become very attractive for investors looking to diversity from China. The Japanese market consists primarily of private equity and real estate.
- PE: historically, the PE market was relatively small compared to other developed markets, because of its smaller market share and M&A deals dominated by corporate and strategic investors. Since 2016, PE has consistently produced an annual deal flow of around US$12 to US$15 billion. With the take private of Toshiba, this could be a breakthrough year for PE. Japanese corporations have less focused portfolios than their counterparts and less ability to invest specifically into all of their businesses, presenting demand for PE. The aging population and founder succession issue also means that a lot of these businesses will be a big source of private capital inflow.
- Real estate: this has always been a hot area. Japan is one of few countries in APAC with established multi-family offices set up for institutional investors. The rebound in tourism has led to increased attention on the hotel and hospitality sectors.
- The fund finance market in Japan is still in its nascent stage. Many Japanese funds do not use sublines or other fund finance products. One deterrent is the 25/5 rule, whereby capital gains tax is applied on foreign investors owning more than 25% of Japanese companies, or disposing of more than 5% of interests, each within one year. This means that funds cannot cross-collateralise among their parallel funds, so constructing a decent borrowing base is difficult, whilst non-pro rata borrowing could result in certain funds hitting their indebtedness limit sooner than others.

Indian Market

- The introduction of the GIFT city1 in 2015 to facilitate international finance transactions onshore in India has been a welcome development. It is a move by the government and regulators to facilitate local fund managers to set up vehicles in India with offshore benefits (e.g. for legal, regulatory and tax reasons, there will be dispensation allowed as the vehicles will be treated as non-resident). If these structures succeed in attracting foreign investors, foreign banks will follow suit once they are more familiar with the structure.
- The market is still in its infancy, with funds remaining small, and largely for India-based fund managers, but we may see an increase in use as deals prove the structure's bankability.

US Market

- A combination of factors has affected the US credit market, including fast rising interest rates, soaring inflation, tighter working capital requirements, recession concerns, the global political climate and unexpected banking turmoil caused by the collapse of SVB, First Republic Bank and Signature Bank. However, despite the liquidity pressure lenders are staying active and still underwriting in the first half of 2023 – aggregate deal flows observed is similar to the same period in 2021 and 2022.
- Fundraising environment: fundraising is down on average across private capital asset classes and investors are slower to close funds, leading to delayed closing of financings whilst managers wait to receive sufficient LP commitments to satisfy the borrowing base. This has caused some mismatch with the initial economic deal terms based on the target fundraise success and initial facility closing timeline.
- Financing environment: last year saw the end of low interest rates (around 2.5% between 2008 – 2018), rising to 5 – 5.25%. There has been a flight to quality, with investors switching from regional and midsize banks to larger lenders and demand outstrips supply. There is opportunity for new entrants to the fund finance market, especially set up by bankers from collapsed banks. Sublines remain an attractive product for lenders.
- Usage and common terms: North America is the largest private capital market. According to ILPA, 95% of new funds have a subline in place. The majority of facilities no longer have separate credit adjustment spreads – the market has moved towards standardised pricing (mostly SOFR). Facility tenors remain at 1 to 2 years compared with 3 years which is still common in Asia. Pricing has risen to a margin of around 185 - 235 base points, and upfront fees of around 30 - 40 base points.

In summary, notwithstanding market events and challenging macroeconomic conditions, which has caused headwinds in the market, industry leaders in APAC anticipate that fund finance will remain resilient and maintain a steady pace for the balance of 2023, though it is crucial to stay agile and forward-looking.

[1] Gujarat International Fin-Tec City ("**GIFT City**") is being developed as a global financial and IT Services hub on the lines of globally benchmarked financial centres. It includes a Special Economic Zone having the status of an International Finance Services Centre ("**IFSC**"). The IFSC is set up to undertake financial services transactions that are currently carried out outside India by overseas financial institutions and overseas branches / subsidiaries of Indian financial institutions.

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