Why the Future of Private Capital Lies in the East

As Asia-Pacific takes its place leading the growth of global private markets, a regulatory arms race between jurisdictions is playing out where expert navigation is key

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Harneys is a global offshore law firm with one of the largest global advisory networks. With locations in major financial centers across Asia, the Caribbean, Europe and the Americas the firm provides expert services of the highest quality to clients in their own languages and time zones. **Maggie Kwok** is the Head of Harneys' Funds and Regulatory practice group in Asia. She has a broad range of experience spanning fund formation, downstream investments, capital markets, and corporate finance. Her practice has a particular focus on formation, structuring, and maintenance of various types of open-ended and closed-ended funds including private equity and hedge funds.

The Dragon has risen. China has solidified its presence on the world stage, carving out a dominant economic position among other nations. Its success is the culmination of strategic, well-organized initiatives first orchestrated by Deng Xiaoping some 40 years ago. Asia-Pacific has benefited directly from this, and close regional integration has created one of the most important hubs of global commerce. While the pandemic added a great deal of turbulence to the mix, it also acted as a catalyst for tilting the economic center of gravity from the West to the East.

The global alternative investment industry has followed a similar trajectory. Indeed, Asia-Pacific leads the growth of the industry globally. Private capital industry assets under management (AUM) have expanded more than eightfold in the past decade to reach approximately $1.6tn as of September 2020, Preqin data shows. Almost 73% of private capital fund managers based in Asia-Pacific are operating out of China, Hong Kong, Japan, and Korea.

As capital continues to flow eastward, a few key themes have emerged:

- **Dry powder:** Asia-Pacific-based private equity and venture capital dry powder has increased by 453% in the past decade, reaching a record high of almost $326bn as of September 2020. This correlates directly with an increase in allocations to the asset class, alongside private debt and real estate.
- **Asset class diversification:** GPs in Asia-Pacific have been expanding the breadth and depth of their investment strategies to remain competitive. In particular, private equity firms have extended their offerings to include private debt and real estate, as well as integrating ESG into their investment philosophy.
- **Innovation:** China's desire to become the world's

most important force for innovation by 2035 and to out-innovate Silicon Valley by 2025 are driving rapid growth in sectors such as biomedicine, robotics, artificial intelligence, and alternative car technologies, all of which have benefited from the COVID-19 catalyst. Aggregate venture-backed deals in China over the past five years alone have surpassed $395bn in value.

- **Private debt:** Asia-Pacific-based private debt AUM more than doubled from $28bn in 2017 to $59bn in 2020, as funding needs for Asian businesses accelerated after banks tightened their lending requirements and governments withdrew from liquidity programs.
- **Digitalization:** Aging populations have accelerated digitalization trends and consumer behavior has shifted to adopt technology with an appetite unequalled elsewhere in the world. This has changed the opportunities available to investors and created new business models for the industry to embrace.

Competition Heats up among Regulators

To maintain a firm grip on the rapidly expanding private market in Asia-Pacific, the asset management space has been a hotbed for competition between various financial jurisdictions. Offshore leaders such as the Cayman Islands, which dominates approximately 70% of the private funds market, and the British Virgin Islands have been front runners in the global initiative to modernize their fund regimes – namely the Private Funds (PF) regime and the Private Investment Fund regime, respectively. At the same time, regulators in Asia have been keeping the local market on its toes. Hong Kong, for example, introduced the Limited Partnership Fund (LPF) regime to attract private equity and venture capital funds, while Singapore launched the variable capital company (VCC) framework with a generous supporting grant scheme.

While institutional and sophisticated LPs have continued to elect the Cayman Islands as their primary choice of jurisdiction – especially so following recent developments regarding the PF regime which provide greater surety and transparency – some Hong Kong- and Singapore-based GPs have pivoted toward 'onshoring' their fund activities. For those targeting purely local LPs, the LPF regime and the VCC framework have been important options to consider. Rather than being competitors, jurisdictions do co-exist and can complement one another. Classic examples include the parallel Cayman Islands, Delaware, and Luxembourg/Dublin options when GPs are targeting investors in multiple regions.

Creating the Right Legal Platform

Regardless of jurisdiction, GPs are expected to strike a balance between the interests of LPs and the expectations of authorities. As part of this exercise, Asian GPs have often considered allowing a single GP entity (the Common GP) to act as the GP of more than one fund, as in the Cayman context. It is crucial that a Common GP is aware of the potential adverse factors when making a decision in light of its unlimited liability in relation to all funds. It must also consider its title to the assets of each fund and the rights of funds held in a statutory trust. This can be problematic, particularly when one of its funds becomes insolvent – what happens when liquidators are appointed over the Common GP and, in such capacity, also have management control over the solvent funds? Or what if a lender wishes to take security over shares in the Common GP? Many questions like these need to be deeply considered.

Another interesting phenomenon in this part of the world is the concept of co-GPs. Although traditionally more common among Chinese state-owned entities, we have seen more Asia-based managers in different regions join forces, particularly between China and Japan. Although there is no restriction on a Cayman partnership having more than one GP, provided one is a 'qualifying GP,' care must be taken to ensure their respective roles, duties, and obligations are clearly spelt out in the documents.

Maintaining a Global Lead

Asia-Pacific will continue to solidify its lead in driving global growth in alternatives over the next five years. Preqin forecasts AUM to grow from $1.6tn in 2019 to almost $5tn in 2025, at a world-beating CAGR of 25.2%, which is more than twice the forecasted growth rate of 9.8% for global private markets. With deflationary pressures and returns on traditional investments expected to be anaemic, global LPs will be on the hunt for opportunities that can offer diversification benefits to portfolios, particularly on the back of recent market volatility. As such, increased allocations to private equity, private debt, real estate, and infrastructure should not come as a surprise. At the end of the day, this new era of 'slowbalization' will continue to showcase Asia-Pacific as the prime hunting ground for golden opportunities.