HKVCA 私投募資

Hong Kong Venture Capital and Private Equity Association

香港創業及私募投資協會

# Private Equity Ideas for Hong Kong ... and Beyond

HKVCA **Journal** Second Issue | Summer | 2015

# Foreword

Hong Kong is a regional private equity hub where over 400 private equity and venture capital firms have established offices over the last two decades. At the end of 2014, firms in Hong Kong had advised on US$110 billion of private equity capital (source: *AVCJ Research*), ranking it second behind only mainland China in Asia.

Private equity and venture capital have also begun to attract increasing public attention with a number of high profile events, including CVC backed Hong Kong Broadband listing on the Hong Kong Stock Exchange; Welab raising $20 million in series A funding from Iconic Capital, Tom Group, Sequoia Capital and Yuri Milner; gazetting of the Hong Kong Government's amendment bill extending the tax exemption for offshore funds to private equity funds; and the proposal to establish a future fund by a consultant group on behalf of the Hong Kong Government that will include private equity and real estate investment strategies.

Of course Hong Kong offers unique advantages including its central geographical position, the depth of private equity managerial talent and the high availability of professional advisory services.

In this, our second issue of the Journal, we will share with our readers some of the advantages of collaborating with private equity and venture capital. We hope to provide strategic insight as well as food for thought for government officials, entrepreneurs and enterprises alike, as we believe, acting together, Hong Kong can continue to strengthen its position as the leading hub for private equity in Asia.

Finally, we want to express our gratitude to all of those who contributed to this second issue of the Journal, and to Messrs. Alain Fontaine, Joseph Ferrigno and T.K. Chiang for their work as editors. We hope that this issue and the issues to come will be a useful platform for the sharing of HKVCA members' stories and ideas, and that they may inspire investors and members of the private equity community worldwide.

**Denis Tse**
**Chairman of Research Committee, HKVCA**

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## HKVCA Journal 2nd Issue: Private Equity Ideas for Hong Kong and Beyond


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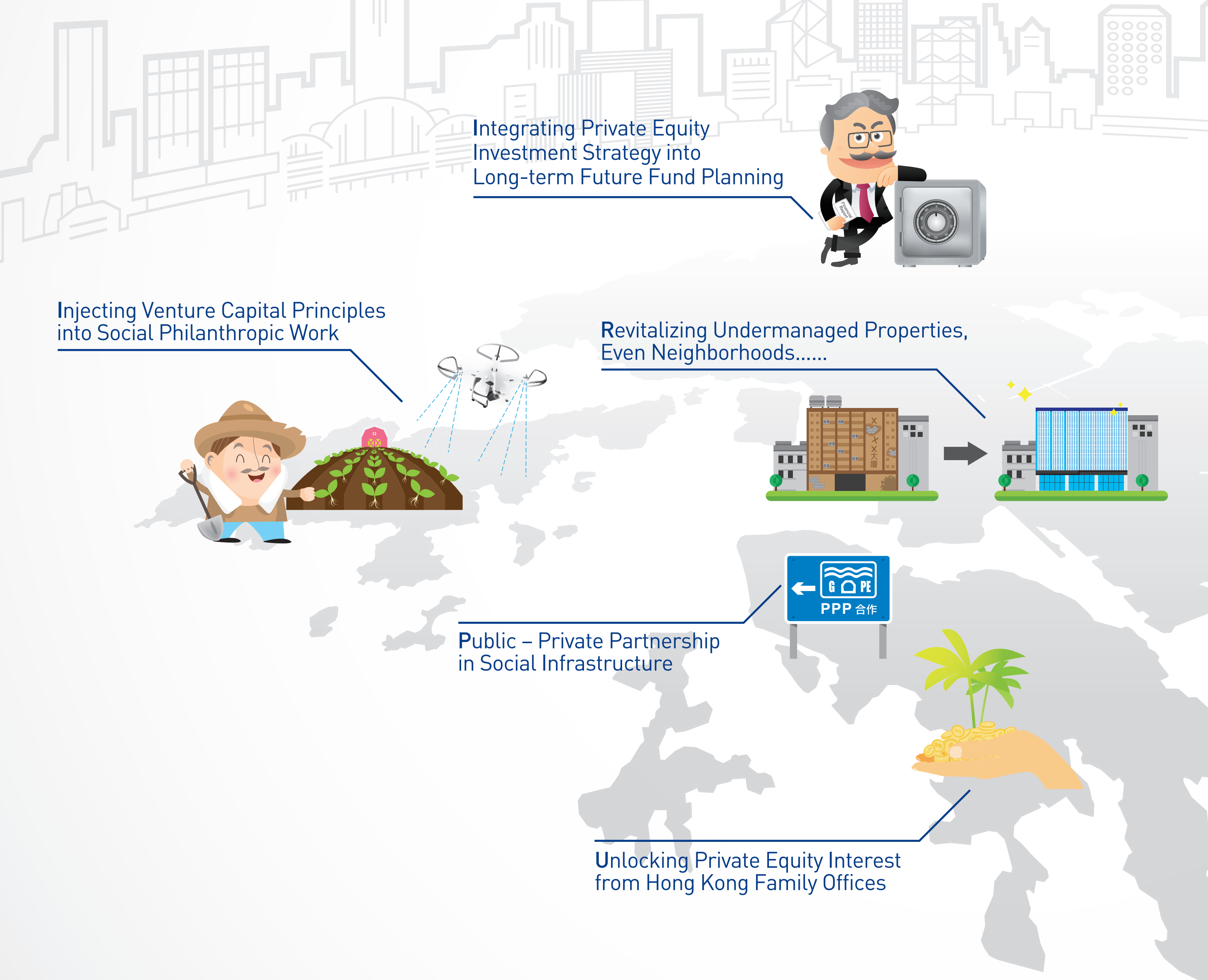
# Mapping the Roles of Private Equity for Hong Kong

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# HKVCA Journal

Second Issue | Summer | 2015

# High Need for More Innovative Ways of Building Infrastructure in Hong Kong

By Conrad Yan, Partner, Campbell Lutyens

Hong Kong has a long-standing and well-deserved reputation as the financial hub of Asia with extraordinary infrastructure. However, the surprisingly simple manner in which Hong Kong's infrastructure projects are currently being conceived, developed and financed means that these projects are not benefitting the society nearly as much as they should and as they did so much in the past. It is time for the city's best minds to focus on this high need.

Infrastructure projects are where finance and engineering capabilities converge and where the fullest possible participation of firms in the private sector can have substantial benefits to the society. In this article, we examine a few local projects and compare and contrast them with similar examples internationally as well as projects developed and financed in Hong Kong in earlier years. In doing so we hope to increase the awareness of the Hong Kong Government and the private sector of much better ways to provide infrastructure services more innovatively and for the best interests of the society.

### Airports

The proposed building of a third runway at Hong Kong International Airport has been a key issue for the Hong Kong Government. Unfortunately, it has become so politicised that no private sector firms or financiers are interested in participating in it. The Airport Authority of Hong Kong announced that the HK$ 141.5 billion cost of construction will be funded primarily by airport users. In Hong Kong's case, 70% of airport users are foreigners, of which a significant proportion are business travellers. It makes a most sense for this group to shoulder the majority of the cost through a HK$180 passenger fee per flight surcharge rather than fund the project through tax revenues. As an example, London's Heathrow Airport financed its Terminal 5 largely on the basis of increased landing charges ahead of construction completion.

There are only essentially two sources of funding for infrastructure - consumers/users or taxpayers. The 'user pays' principle is a key reason why airports around the world have been privatized without much pushback from the public. A recent example is the Japanese government's ambitious airport privatization programme, first announced in 2011. The programme began with the merger of the Kansai International Airport and Osaka-Itami Airport with a consortium comprising Vinci Airports and Orix Corp announcing in May that it would be bidding for the assets. Other Japanese airports where a privatisation process has started, or is being discussed, include airports at Aomori, Takamatsu and Fukuoka. The stated aim of Japan's Ministry of Land, Infrastructure, Transport and Tourism (MLIT) is to privatise all national airports by 2020.

### Tunnels and Bridges

Many infrastructure assets globally are developed and financed through Public Private Partnerships (PPPs) or Build-Operate Transfer (BOT) ventures. Using these methods governments do not provide funding and are not exposed to the significant risks of construction and operation and do not have major roles in building and operating infrastructure facilities. Hong Kong utilized these methods for the development and financing of two of the three harbour tunnels, starting in the 1980's.

The US$ 500 million Eastern Harbour Crossing combined road and rail tunnel was the first successful fully private BOT project in Hong Kong. It was proposed in 1984, the same year that the Sino-British Accord was signed, by construction company, Kumagai Gumi Co. Ltd. of Japan, and the Hong Kong Mass Transit Corporation ("MTRC"). The Hong Kong Government responded correctly to the proposal by requiring international competitive bidding and did not allow MTRC, which was then 100% government-owned, to joint venture with Kumagai Gumi. Kumagai's advisers then proceeded to form an international consortium, which included Kumgai, Hong Kong, British and Mainland Chinese parties. The New Hong Kong Tunnel Consortium successfully developed, fully financed, constructed and operated the tunnels, which opened ahead of schedule in 1989 and on budget at no cost or risk to the Hong Kong Government. Modest tolls were charged and the tunnels greatly stimulated the development of the eastern parts of Hong Kong island and Kowloon. Later, a consortium of Hong Kong companies proposed, financed, built and operate the Western Harbour Crossing, which opened up an efficient western route to the new airport on Lantau Island.

In the wake of the Asian financial crisis of 1998, Hong Kong had the idea of securitising the income streams from some of its infrastructure assets to help plug the impending budget gaps expected over the following years. In May 2004, the government sold HK$6 billion (US$770 million) of securitisation bonds, backed by toll revenues from five tunnels and one bridge to finance other infrastructure assets, with the underlying objective of building a bond market. Hong Kong's financial stability and strength enabled the city to pay for new developments this way.

These and other innovative ways of creating much needed transportation and social infrastructure facilities in Hong Kong should be used more today.

## Social Infrastructure

The rising popularity of PPP structures and other innovative financing arrangements have resulted in their utilization for other types of infrastructure facilities such as schools, hospitals, courtrooms and jailhouses. These social infrastructure projects are being financed this way in many western countries. Although cultural differences and budgetary constraints would have to be taken into account, similar models can work in certain Asian countries. A prime example of this is the Singapore Sports Hub, a state of the art stadium financed through a 25-year PPP agreement with the backing of a consortium led by an infrastructure fund.

The UK was the instigator of applying PPPs for social infrastructure in the 1990's but in more recent years, has lost faith in the model. The procurement benefits of optimal specification of design plus the principle that the beneficiaries of the asset pay for the facility over the course of its useful life, have been lost in the politics of 'excessive' refinancing gains and profiteering for equity owners. Nevertheless, it has been embraced by a number of countries including Norway.

PPP has also become increasingly popular in developing countries as a means of financing social infrastructure. For example, in Turkey the government has chosen to use PPP as a procurement mechanism for a €10 billion programme to deliver 38 new healthcare facilities with 26,000[1] beds. One of the first such projects to reach financial close was the €540 million Adana Integrated Healthcare Campus that closed in December 2014. The project was developed by a PPP specialist fund and contained a number of features to de-risk the project from the investor's perspective. Notably, the Multilateral Investment Guarantee Agency (part of the World Bank Group) guaranteed the investment for a period of 20 years against the risk of transfer restrictions, expropriation and breach of contract by the government, substantially mitigating the political risk associated with the project.

## Utilities and Transportation

A key difference between Hong Kong and Singapore is the historical ownership of utilities. The constant tension between price hikes and minimum profitability is much more complicated in Hong Kong compared to Singapore. In Singapore, many of these assets are owned by the government through an investment company, which aims to provide a balance between private sector efficiency and government social responsibility. In Hong Kong by contrast, most utilities are owned by the private sector and regulated by the government. These utilities are highly sought after as safe growth investments by pension funds and insurance companies from around the world. This is already common in western economies, primarily in the UK, where pension funds have grouped together to buy and build infrastructure projects.

## More Food for Thought

Just as banking systems are designed to intermediate savings and lending to individuals and companies, pension fund savings are well-matched to fund many types of infrastructure facilities. Given the long term stable nature of certain infrastructure facilities, they are natural assets for pension funds. The Hong Kong's Mandatory Provident Fund currently receives 10% of salaries, 5% from employees and 5% from employers. Like the Australian superannuation system, (which now has A$1.8 trillion (US$1.4 trillion) of assets for a population of only 23 million) it is a defined contribution scheme. Privatisation by several states is increasing opportunities for Australian pension funds including the Future Fund of Australia, whose remit is to provide for the pensions of public servants, to own Australian infrastructure. Why not in Hong Kong?

Hong Kong is one of the leading financial centres in Asia and has the highest concentration of financial services and many bright minds. With so many new infrastructure projects needed, it is time for Hong Kong minds to again become more innovative in the way such projects are planned and built. I sincerely hope that Hong Kong will advance its knowledge of innovative private participation in infrastructure development and finance. Mainland China is doing so with the new Asian Infrastructure Investment Bank (AIIB) which is being established to stimulate growth in the developing countries of Asia. Hong Kong can reap big rewards if more time is focused on thinking and acting in innovative ways to build new infrastructure facilities.

**Conrad Yan, *Campbell Lutyens***

Conrad Yan joined Campbell Lutyens as a Partner in 2010. Conrad has experience of developing relationships with and raising general capital, private equity and infrastructure fund commitments from institutional investors and sovereign funds in Asia since 1994. Most recently with Credit Suisse Asset Management where he was a Managing Director and Head of Regional Institutional Distribution, Asia Pacific and prior to that with AIG Investments. Conrad holds a Bachelor of Science degree and an MBA degree from the Leonard N. Stern School of Business, New York University. He is also a CFA charterholder.

[1] Mott MacDonald

# Case Study Interview: Supporting the Next Generation of Hong Kong Entrepreneurs

Interview Simon Loong, CEO, Welab
Xing Liu, Partner, Sequoia Capital

“Welab” marks the debut Hong Kong investment by Silicon Valley venture capital firm Sequoia Capital. The HKVCA had the opportunity to interview both Simon Loong, the founder of the peer-to-peer Hong Kong lender, and Xing Liu, Partner of Sequoia, to get first-person accounts of the investment story and their insights on the prospects of the Hong Kong start-up scene.

By way of background, Sequoia Capital is one of the leading venture capital firms in Silicon Valley, having invested in prominent US companies including WhatsApp, Youtube, and Google at an early stage. Its China team, led by Ctrip founder Neil Shen, is also one of the most aggressive in the country, with its roster including VIPShop, Qihoo, JD, Meituan, Dianping, Jumei, and more recently DJ Innovation.

## Why invest in WeLab?

Sequoia believes that it has spotted disruptive business potential of financial technologies ("fintech") in the China market. The team has evaluated a number of fintech ventures in consumer finance space, and concluded that having the Western-trained financial expertise in consumer finance can be a key advantage.. “Simon and his management team have worked in credit market for decades. We are very impressed by their rich experience and passion to explore the business in mainland China,” said Liu. “Sequoia is delighted to assist them to execute the dream.” Simon concurred by pointing out the importance of having a thorough grasp of how a financial product can be "ported" to and run on the Internet. "Professionals with solid credit backgrounds are comparatively more reliable than generalist entrepreneurs in operating a P2P platform,” Loong said.

Welab knows it has to differentiate itself from the many P2P lending competitors that have mushroomed in the past 3 years to capture the Internet finance wave. It manages to focus and become a prominent lending platform for Chinese university students since last year. The company entered into a distribution partnership with Tom Group and China Post, whose large workforces and networks have the potential to help the company extend its reach to customers in the rural areas. "By strategically collaborating with these Chinese corporate partners," Loong stated, "We manage a platform instead of deploying thousands of staff to carry out credit business in the vast China market."

Loong's ultimate vision is to propel the company toward a "peer-to-peer-to-commerce" (or P2P2C) model, whereby enterprises customers can benefit from the valuable intelligence the company generates from analyzing the consumer behavior "big data" in its network. Through the Welab platform, for example, a company has the potential to offer a customized payment plan for customers according to their behavior-driven credit score.

## Leveraging Sequoia Capital’s Network

Welab is expected to benefit from Sequoia's value-adding approach to innovation and entrepreneurship investing. “We work very closely with the Welab team in recruiting their Mainland China management team, developing core client base, and more importantly, helping them to quickly plug into the mainland business environment,” said Liu. “For instance, Sequoia China has a number of portfolio companies in the e-commerce space and we linked them up to explore launching a range of suitable jointly-marketed products.”

## Challenges and Opportunities for Hong Kong Startups

Loong and Liu discussed the challenges for start-ups in Hong Kong. The most difficult problem is the shortage of talented staff in Hong Kong. Loong acknowledged that it is hard to find the right candidates, even though Welab has established itself as one of the most well-known online lending platforms within two years. “Hong Kong employees prefer working in large companies instead of startups. Mainland Chinese, on the other hand, are happy to explore different opportunities in small-scale firms,” Loong said.

The so-called "Series A gap" is another problem, as entrepreneurs find it tough to raise money after the angel rounds. Compared with other Chinese economic clusters, the level of venture capital activities in Hong Kong is relatively low. “There have not been enough young entrepreneurs in the exciting market segments, such as mobile Internet, online-offline integration, fintech, internet-of-things (IOT), etc., that are targeting the largest market in the world, i.e., Mainland China. Moreover, the entrepreneurial spirit has been dismal. Young people are not plugged into the Mainland Internet community and they do not comprehend the prowess of the 'B.A.T.' (Baidu, Alibaba, Tencent),” Liu said.

Loong pointed out that there is a big difference between the purpose of angel rounds and Series A. Angel investors invest in startups based on a business idea and the entrepreneur's backgrounds and relationships, while Series A investors consider the validation of the business model and plans of overseas expansion. Loong stated, “Hong Kong entrepreneurs find it extremely difficult to raise venture capital money, unless they have a clear business model that can scale up. The lack of well-regarded local venture capital firms further explains the stagnant fundraising environment.”

## Vitality to Entrepreneurship

Liu emphasizes that venture capital investors seek great entrepreneurs. In order to bridge the series A gap, he believes it is time for the government to introduce policies and schemes that are truly conducive to making, or attracting, great entrepreneurs of innovation and technology.


Liu suggested a few ideas on government policies which could attract more ambitious and capable entrepreneurs:

- Firstly, implement incentive schemes to attract mainland Chinese students to establish innovative businesses in Hong Kong;
- Secondly, encourage leading Chinese and global Internet companies to set up operating divisions such as R&D centers and international expansion initiatives, etc.;
- Thirdly, launch "immersion programs" to encourage Hong Kong youths to participate in internships and permanent jobs in leading technology companies and startups in mainland China; and
- Enhance integration with Shenzhen in supporting innovation and technology in order for Hong Kong startups to tap into mainland resources and talents.

Loong believes the Hong Kong entrepreneurial community has a positive vibe. Successful entrepreneurs are keen on assisting local startups and supporting relevant activities. However, Loong is concerned. "If government only injects money without follow-up supports, the Series A gap issue can never be addressed."

## Advice for Local Entrepreneurs

Liu and Loong exude optimism when asked to offer words of advice for local entrepreneurs.

"A quote that I would like to share with other fellow entrepreneurs and always remind my team is: 'Live in the future, then build what's missing'. This is a great piece of inspiring quote by Paul Graham," Loong said.

"Products and services, however innovative, need to address customers' pain points," Liu said, first and foremost. For instance, e-commerce provide convenient platforms for e-shopping which saves customers' time. The impact is much more pronounced when the innovative offering is rolled out in a large and emerging high-growth market.

Both Liu and Loong concur that management experience is a crucial element in establishing a successful venture business.

"Spending time on brand building is also inevitable", Loong advises. If two companies have similar track records, customers usually go for the more reputable service provider."

Finally, Liu advised, "I have a suggestion for local entrepreneurs: go after the opportunities in the Mainland! If Hong Kong entrepreneurs can develop better understanding of the Mainland market and are able to maintain their existing global perspectives, they have abundant opportunities ahead to build a successful venture."

**Simon Loong, *Welab* and Xing Liu, *Sequoia Capital***

Simon Loong is the Founder and CEO of Asia's leading internet finance company WeLab, the operator of WeLend.hk in Hong Kong and Wolaidai.com ( 我来贷 ) in China. Simon has a wealth of financial services experience after working in the banking industry for more than 17 years. An entrepreneur at heart, he founded WeLab in 2012. The company has, since then, sourced more than HK$1 billion in loan applications and 14,000 members through WeLend.hk.

Xing Liu, Partner of Sequoia Capital China. He focuses on investments in consumer and TMT sectors. Prior to joining Sequoia Capital in 2007, Mr. Liu was Vice President in Merrill Lynch (Asia)'s Investment Banking division and had served clients such as Ctrip.com, Home Inns & Hotel Management, Giant Interactive, Digital China and Nepstar Drugstore. Before that, Mr. Liu had worked at Xerox and a Silicon Valley technology start-up, where he was engaged in technological R&D, product development management, strategic planning and management consulting.

# Case Study: Hong Kong Broadband Network – from MBO to IPO

Interview NiQ Lai, Head of Talent, CFO & Co-Owner, Hong Kong Broadband Network
Alvin Lam, Senior Managing Director, CVC Capital Partners

Hong Kong Broadband Network ("HKBN") is an illustrative case study on how private equity fund managers can assist management teams of established businesses in Hong Kong to become owners of their company through management buyouts ("MBOs"), and eventually realize their full value through well-orchestrated IPOs. It is also an example of how businesses that are undercapitalized by being part of a larger group, can unlock their full potential through proper incentives and focused execution.

In May 2012, CVC Capital Partners ("CVC"), a large global private equity manager with over US$71 billion in capital under management, partnered with the management team of HKBN to acquire the entire stake in the telecom division of listed entity CTI Telecom (HK) Limited ("CTI") for HK$5 billion. Having achieved its initial growth projections ahead of plan, HKBN listed on the Hong Kong Stock Exchange ("HKEx") in March 2015 with an enterprise value of HK$12 billion.

The transaction was initially financed 50% with debt. However, within 6 months of the MBO, HKBN issued a bond which funded a dividend recap to refine the capital structure to 2/3 debt and the balance with equity investment from CVC, the HKBN management team and employees, and a few co-investors.

## The Transaction

The catalyst for the MBO was the increasingly diverging visions for the business between Ricky Wong, the founder and controlling shareholder of CTI, and the management of the telecom business. Wong dreamed of building "better content for the Chinese market", whereas the HKBN management remained convinced about the growth prospects of the telecom business – which they proudly referred to as the "Big Fat Dumb Pipe". To achieve this goal, Wong restricted investment in the telecom network to fund the new content business. "The relationship between TV and telecom is similar to that of water and oil," said NiQ Lai, CFO, Head of talent engagement and co-owner of HKBN, "No matter how hard you shake it, they don't mix well."

After three years of exploration, including failed attempts to raise capital through debt issuance and private investment in public equity (PIPE) at the listed company level, Wong decided to sell the telecom business. During those 3 years, HKBN management had several occasions to engage with the CVC team. Although the discussions did not lead to any deal at the time, they created opportunities for the key stakeholders – Wong, the HKBN management team and CVC – to get to know each other and build trust over time. "Throughout various formal and informal processes, we met with 10 private equity firms," Lai said.

Since the deal involved a listed company, confidentiality, speed of execution and deal certainty were critical. As such, once Wong and the management team decided to proceed with the MBO, CVC was invited into exclusive bilateral negotiations. While buyout transactions can typically take 6 months or longer , the HKBN deal was executed in three months after the initial "Sunday hand shake" which formed the basis of a win-win-win scenario among the three parties.

## The 5-Year Plan

Usually 20 or fewer senior management members are involved in a buyout transaction of this size. However, in the HKBN case, the top 100 mangers were invited to co-invest. "William (Yeung, CEO of HKBN), and I are Da-Gong-Jai ( 打工仔 , employees), and we wanted break the wealth creation gap that we had experienced ourselves in the past, hence we pushed to extend the opportunity of value creation to a much wider group," Lai explained.

The co-ownership scheme offered co-owners to invest an average two years of their salaries in the transaction. CVC supported the team's idea. The HKBN management enjoyed the benefits of ownership as the aggregated value of the co-owners' investment increased from HK$180 million to HK$1.2 billion post-IPO, delivering more than a 6x return.

The broad-based co-ownership structure is quite unique in the private equity world. However, the spirit of interest alignment is no different from the classic model of MBO. It mobilized the senior staffs to work collaboratively with the buyout firm to develop a stretched business plan and motivated them to exceed those targets. The private equity firm provided input on major strategic decisions at the board level. However, it gave the HKBN management the autonomy to run the day-to-day business and, indeed, the management excelled and delivered their capability of efficient execution.

The private equity firm worked with the management closely on developing a 5-year plan at the outset and provided additional operational advice along the way. As part of the development process, a team of the firm's telecom experts exchanged technical ideas. A team of debt specialists helped to arrange the initial acquisition financing as well as a new bank loan right before the IPO, and operations team facilitated best practice reviews in areas such as IT and call center operations against other portfolio companies. "Private Equity firms bring significant resources to support the management of each portfolio companies," said Alvin Lam, Senior Management Director in the CVC Asia Operations Team, "they also participate to evaluate investment opportunities, in the case of HKBN, it acquired Y5Zone."

## IPO Within 3 Years

After spinning out from CTI Telecom three years ago, HKBN was relisted on the HKEx in March 2015. From a buyout investor's


*HKBN Board members, Co-Owners and Talents gathered to celebrate a successful IPO at HKEx on 12 March 2015*

perspective, even though trade sales to strategic investors are a more frequent form of exit than IPO, public offerings are sometimes a better option for the shareholders and management team members.

The company did consider potential full or partial exits through strategic sales. In the end, after considering a number of factors, including the financial position of the company, the capital market conditions and the global economic environment, the company and the private equity firm concluded that an IPO was the preferred way to recapitalize the company. A major reason was the readiness of the company for a public listing. HKBN remained highly transparent to external investors during last three years, despite not being a listed company. It conducted a number of proactive non-deal roadshows in order to mingle with hundreds of investors around the world.

The IPO took just a little more than six months from inception to flotation. More importantly, the management outperformed its business plan, in spite of competing in a relatively mature market with already high household broadband penetration. As a result, the company achieved the goal of liquidity sooner than 5 years as per the original plan.

## Lessons for Working With Private Equity Firms

From MBO to IPO, HKBN is a fascinating private equity case in Asia, particularly in Hong Kong. The most interesting aspect of engagement with private equity firms is the opportunity for managers to become owners. Well-versed in this type of transaction, private equity firms can bring structure to both MBO and IPO processes. . This is important in creating a strong alignment of interests and achieving a high level of efficiency in executing the transaction.

The vision of the management team and its ability to clearly articulate the growth opportunity is crucial to attracting private equity firms and facilitating subsequent liquidity events. It is notable that HKBN has grown significantly in the last two years with mid-teens compound annual growth rate ("CAGR") in EBITDA.

"The lesson in dealing with private equity firms is to avoid getting stuck in a negotiation quandary and instead focus on alignment of interest for all key stakeholders," Lai advised.

Finally, Lam said, "Rarely does the final transaction resemble the initial proposal, but typically the result of finding common ground among the various parties."

**NiQ Lai, *HKBN* and**
**Alvin Lam, *CVC Capital Partners***

Ni Quiaque Lai is Head of Talent Engagement and Chief Financial Officer of Hong Kong Broadband Network Limited. NiQ joined HKBN in 2004 and has over 20 years of experience in the telecommunications industry. NiQ is passionate about developing HKBN Talents because he believes if you get the people right, the company will do great. His unique combination of being responsible for 'people and money' gives him a different perspective vs. other executives that focus on just one of these elements.

Alvin Lam is a Senior Managing Director with CVC Capital Partners. Alvin joined CVC in 2005 and is a member of the CVC's Asia Operations Team, based in Hong Kong. Prior to joining CVC, Alvin was a Principal with the Boston Consulting Group's Greater China practice and worked for Philip Morris International in a regional business development role.

# Hong Kong Future Fund - Interview with the Working Group on Long-Term Fiscal Planning

Interview Professor Pak-wai Liu, Research Professor, Institute of Global Economics and Finance, The Chinese University of Hong Kong

The unveiling of a plan to establish a Future Fund in the 2015 Hong Kong Budgetary Address has stirred up excitement among the Hong Kong private equity industry. Recommended by the Working Group on Long-Term Fiscal Planning (the "Working Group"), which is chaired by the Permanent Secretary for Financial Services and the Treasury, Elizabeth Tse, a pool of HK$220 billion is proposed to be allocated from the Land Fund to the Future Fund as an endowment. Half of it will be invested in long-term assets, including private equity and core real estate. A quarter to a third of the annual budget surpluses will be contributed to this Future Fund from time to time.

To understand the Future Fund plan better from a private equity investor's perspective, the HKVCA interviewed one of the Working Group members, Professor Liu Pak-wai, who is the Research Professor at the Institute of Global Economics and Finance in Chinese University of Hong Kong and the former Pro-Vice Chancellor of the university.

The rationale for the establishment of the Future Fund stems from the government's concern of fiscal deficit in the future. Professor Liu observes that "the current demographics of Hong Kong are similar to Japan's a decade ago." He cited studies that debt-to-GDP ratio is positively correlated to an aging population, which causes fear that healthcare expense and social welfare subsidies, compounded by slower economic growth, will put pressure on the fiscal reserves in the long run. The Working Group believes that superior gains from long-term investing may help alleviate the likelihood of an eroding fiscal reserve and that dedicated pool of capital which is safeguarded from near-term withdrawal is likely to better protect fiscal reserves Professor Liu projected that with the current fiscal health, the government will not need to tap into and withdraw from the Future Fund in the next ten years.

The Working Group recommends that the management of the Future Fund be by the HKMA's Exchange Fund Advisory Committee. Not only has the team registered a superior track record in managing its Long-term Growth Portfolio ("LTGP")-- it has achieved an annualized return between 10% and 13% since its inception in 2008, having deployed over HK$90 billion. Professor Liu also acknowledged the realities of political convenience, noting how difficult it would be to get the Legislative Council to approve a new statutory body.

Professor Liu is nonetheless cognizant of the daunting task for the HKMA to manage an additional estimated HK$100 billion for its LTGP in addition to the HK$200 billion already earmarked from the Exchange Reserve Fund. The large size of the assets under management ("AUM") may have an adverse impact on returns.


Moreover, expansion and retention of the investment team, which is expected as a result of the increase in AUM, will also be a challenge. Recent senior staff turnover at the LTGP has been significant.

The Working Group has not made any recommendations with respect to the target returns and allocations for the Future Fund; it would defer to the HKMA LTGP to decide. Professor Liu acknowledges that the Working Group members are not institutional investment experts.

HKVCA believes that in furthering the development of the Future Fund plan, the government may consider tapping into the resident industry leaders from the asset-owner and institutional investor communities already in Hong Kong to join the Working Group on Long-Term Fiscal Planning should it continue to function. In the meantime, politicians and the public should be educated more on the benefits of private equity and other long-term investment strategies.

**Professor Pak-wai Liu,**
***The Chinese University of Hong Kong***

Professor Liu Pak-wai received his AB from Princeton University, and MA and PhD from Stanford University. He is Professor of Economics, Director of the Institute of Global Economics and Finance, and formerly Pro-Vice-Chancellor of The Chinese University of Hong Kong. He was Registrar of the University and Chairman of the Department of Economics. He is currently Co-Director of the Hong Kong Economic Research Centre at The Chinese University of Hong Kong and Vice-President of East Asia Economic Association.

# Regulatory Regime for Hong Kong's Private Equity Industry

By Susan Gordon, Partner, Deacons

Mary Nieto, General Counsel, Financial Services, Deacons

The regulatory regime for the private equity industry in Hong Kong is changing and is expected to result in an improved framework for practitioners. Reforms include an open-ended corporate vehicle and a profits tax exemption.

## Regime overview

**Scope of fund regulation**

Funds in Hong Kong are generally only regulated if they are to be offered to the public, in which case they must be authorised by the Securities and Futures Commission (SFC) and comply with appropriate chapters of the SFC's Code on Unit Trusts and Mutual Funds. Private equity funds do not qualify for SFC authorisation as their closed-ended, long-term nature means they cannot meet the Code's requirement for investors to be able to redeem their interests.

Unless there is an available exemption, it is an offence for a person to issue an advertisement or document that is or contains an invitation to the public to acquire or subscribe for securities, or acquire an interest or participate in a fund. Private equity funds are sold on a private basis pursuant to an exemption from public offering requirements. This exemption allows unauthorised funds to be offered to "professional investors" as set out in the Securities and Futures Ordinance (SFO) and the Securities and Futures (Professional Investor) Rules, which covers investors such as banks; insurance companies; funds; retirement schemes; investment managers; trusts and corporates with at least HK$40 million in assets; and individuals with a portfolio of at least HK$8 million.

Whilst funds themselves are not regulated in Hong Kong except when sold to the public, the managers of the funds, or those marketing the funds in Hong Kong, are regulated if their business activities are covered by the SFC licensing regime.

**Licensing requirements**

Any person who carries on a regulated activity in Hong Kong is required to be licensed to undertake the activity. The SFO stipulates ten types of regulated activity. The SFC is responsible for vetting and granting licences.

Marketing a fund to investors in Hong Kong will generally require a Type 1 (dealing in securities) licence, unless an exemption applies. Schedule 5 of the SFO sets out definitions of the ten types of regulated activity. Type 1 (dealing in securities) is widely drawn and, prima facie, will include the marketing in Hong Kong of interests in a private equity fund, whether structured as a limited partnership or a limited liability company as such interests fall within the definition of securities. For the purposes of the SFO, "securities" is defined to include "interests in any collective investment scheme". "Collective investment scheme" is defined broadly and will capture all common legal structures used for funds, including limited partnerships, companies and trusts.

Careful consideration of deal sourcing and execution should be given as to whether the structure and location of the deal team and its roles in transactions trigger a need for a Type 1 (dealing in securities), Type 4 (advising on securities) or Type 9 (asset management) licence. In 2011, the SFC published an FAQ on Venture Capital Companies. The FAQ notes that securities of a private company established in Hong Kong are excluded from the SFO's definition of "securities". As such, if a private equity manager confines its activities to investments in securities of Hong Kong private companies, the manager does not need to obtain an SFC licence.

A number of international private equity groups have established subsidiaries in Hong Kong which only provide research and make investment recommendations, which are then implemented by the general partner or manager which is located outside of Hong Kong. In such cases, a licence may not be required in Hong Kong as the Hong Kong subsidiary entity may be able to rely on the wholly-owned group advisory exemption. However, where the Hong Kong entity is not a wholly-owned subsidiary, or where its activities go beyond pure research (particularly if it is involved in executing deals or marketing funds) the Hong Kong entity may require a licence to carry on Type 1 (dealing in securities) activity and/or Type 4 (advising on securities) activity.

Where the Hong Kong entity has investment discretion, a Type 9 licence (asset management) is required. It is unusual for private equity managers to hold licences for other types of activity, such as dealing in or advising on futures.

A licensed entity must have at least two responsible officers to supervise each type of regulated activity it undertakes. At least one must be resident in Hong Kong and at least one must be a director of the licensed entity. Responsible officers must be approved by the SFC and must meet qualifying criteria.

Licensed entities must comply with certain financial resources requirements. All employees or representatives who undertake regulated activity must be licensed as representatives of the licensed entity.

When applying for a licence, a large amount of information regarding the applicant's group structure, its directors and substantial shareholders must be provided to the SFC. Any changes to this information must be notified to the SFC. Any new responsible officer must be approved by the SFC before taking up the position. Any new substantial shareholder must be approved by the SFC in advance.


There are extensive reporting requirements in relation to changes affecting the licensed entity or its representatives. Monthly financial resources returns must be filed by a Type 1 (dealing in securities) licensee.

The SFC has a Code of Conduct which applies to all licensed persons. Changes to the provisions of the Code of Conduct relating to professional investors will take effect on 25 March 2016. For professional investors who are individuals, intermediaries will no longer be able to waive certain investor protection provisions, including the requirement to ensure the suitability of a recommendation or solicitation.

The Fund Manager Code of Conduct, also issued by the SFC, applies to persons licensed for Type 9 (asset management) activity.

**Tax**

Profits derived from carrying on a trade, profession or business in Hong Kong, are subject to profits tax. Only profits that arise in or derive from Hong Kong are subject to Hong Kong profits tax. Recently approved amendments to the offshore funds profits tax exemption are discussed below.

There is no capital gains tax. Under the Inland Revenue Ordinance, dividend income is exempt from profits tax if the company distributing the dividends is subject to profits tax.

## Reform

**Open-ended corporate vehicle**

In March 2014, Hong Kong's Financial Services and Treasury Bureau launched a three-month consultation on proposals to introduce a new open-ended corporate structure for collective investment schemes, with limited liability and variable share capital. The concept of a corporate variable capital vehicle, which has seen success in other fund centres, has been advocated for some time by investment management industry groups. The consultation conclusions are pending.

**Profits tax exemption**

In the past, a fund was exempted from profits tax if it was centrally managed and controlled outside Hong Kong and if it only entered into transactions in securities through an SFC licensed entity. The definition of securities did not include transactions in private companies, thus excluding private equity managers from benefitting from the exemption.

To address this issue, and to strengthen Hong Kong's status as a premier international asset management centre, the Hong Kong government proposed in its 2013/2014 budget "to extend the profits tax exemption to include transactions in private companies, which are incorporated or registered outside Hong Kong and do not hold any Hong Kong properties nor carry out any business in Hong Kong". The Hong Kong government published its proposals in the Inland Revenue (Amendment) Bill 2015, which was passed by legislative council on 13 July 2015 and came into effect on 17 July 2015.

The Inland Revenue (Amendment)(No.2) Ordinance 2015 allows offshore private equity funds, whether or not managed by an SFC licensee, to enjoy the profits tax exemption, subject to various conditions. Offshore funds which are not managed by an SFC licensed fund manager will need to be a "Qualifying Fund" as defined. The definition requires the fund at all times after the last subscription acceptance to have at least five investors and for the capital commitments from investors to exceed 90% of the aggregate capital commitments. In addition, the originator and its associates must not receive more than 30% of the net proceeds from the fund's transactions.

Published proposals for the open-ended corporate vehicle remain in their infancy. Meanwhile the passage of the Inland Revenue (Amendment) Bill 2015 is welcomed by the industry as an enhancement to Hong Kong's platform for asset managers.

**Susan Gordon, *Deacons***

Susan Gordon is a consultant of Deacons' financial services practice, which houses the largest investment funds legal team in Hong Kong. She has considerable experience in the establishment of private and retail funds and on advising the industry on regulatory and licensing matters. Susan is a member of the Investment Products and Financial Services Committee at the Law Society of Hong Kong, as well as a member of the Technical Committee of Hong Kong Venture Capital Association.

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# Real Estate Private Equity – Repositioning Hong Kong

By Bastian Wolff, Managing Director, Head Private Real Estate Asia, Partners Group

Hong Kong is one of the most densely populated urban areas in the world, with about 7.2 million people in 2012 over a land mass of 1,104 square kilometers. The shortage of land for development in Hong Kong is the key factor underpinning its high property prices and rents. It is also the driver for Hong Kong's continuous story of urban renewal. With land and property at such a premium, both are too precious to use inefficiently and the repositioning of properties and indeed entire neighborhoods has been a repeated theme in Hong Kong's urban history and one consistently offering attractive opportunities to private real estate investors. One approach in investing in the repositioning thesis has been to develop a deep understanding of the local sub-markets and then partner with those local operators who are able to execute on the strategy and have shown an excellent track record. A few examples are detailed below:

### The Kowloon East story

One Hong Kong neighborhood currently undergoing a transformation is Kowloon East. The story of Hong Kong's success began in the mid-1950s, with the development of the Kowloon East area (comprising of Kwun Tong and Kowloon Bay). Hong Kong metamorphosed into a major Asian industrial city with the influx of labor and capital from the Chinese Mainland to support the sprouting manufacturing businesses. In 1961, there were as few as 100 factories and 15,000 workers in Kwun Tong. By 1970, the number of factories and workers had increased to 800 and 72,300 respectively, and further increased to 7,000 and 200,000, respectively, by 1985.

While the opening up of Mainland China in the early 1980s provided the opportunity for Hong Kong industrialists to relocate labor-intensive production lines to lower-cost operating bases in the Pearl River Delta, it posed a challenge for Kowloon East. The Hong Kong economy proved to be resilient - evolving from a largely manufacturing-based economy to one service-oriented, resulting in much of the industrial real estate stock becoming outdated as areas that were largely industrial have become more commercial.

In view of the decline of Hong Kong's manufacturing industry, and to cater to the new economy, the Hong Kong government introduced an industrial revitalization policy in April 2010 targeting to convert older industrial properties to commercial space and thereby developing Kowloon East into Hong Kong's second Central Business District ("CBD2") after Hong Kong Island. In his 2011/12 Policy Address, the Chief Executive of Hong Kong announced that the city would adopt a "visionary, coordinated and integrated approach" to the development of Kowloon East into a "CBD2" to sustain Hong Kong's economic development. Furthermore, in June 2012, the government opened the Energizing Kowloon East Office ("EKEO") to steer, supervise, oversee, and monitor the development of Kowloon East, with a multi-billion dollar budget allocated for public works and infrastructure through 2023. By the end of December 2014, 69 applications had been approved and executed for wholesale conversion or redevelopment, 40 of them in Kwun Tong and Kowloon Bay. These industrial buildings will be redeveloped or converted into offices, shops and services, and hotels.

What makes Kowloon East attractive for investors and end-users is the wide rental differential compared to the existing CBD in Central/Admiralty, as rental rates in Kowloon East are about one-third of those in Hong Kong's Central. Prospective tenants, including middle and back-office teams at financial institutions, are seeking affordable, yet high-quality office buildings in decentralized districts for possible relocation. For investors, a "buy, fix, and sell" strategy in Kowloon East via a repositioning presents an opportunity to create value in Hong Kong and secure attractive returns for clients. Supporting the attractiveness of repositioning as an investment thesis is the fact that core office and retail property prices appear over-heated, with current yields at historic lows.

### The repositioning theory in practice – Kowloon East Hung To Road

In April 2013, an investor invested in a 13-story building in Kowloon East, Hong Kong. Originally a warehouse, the investor and its operating partner launched the conversion of this industrial building into high specification office space with a gross floor area of 206,255 square feet and a modern and sustainable design with a BEAM Plus rating, a green building label recognized by the Hong Kong Green Building Council. Though rental rates per square foot of office space in Kowloon East are much lower than those in Hong Kong Island, they can be more than three times higher than equivalent rental rates for warehouses or industrial buildings in the area, providing a compelling investment thesis for building conversions like the Hung To Road project. In the first quarter of 2015, the investor sold its investment in the Hung To Road building to a Hong Kong-based property developer, generating an IRR of 45%.

## Other repositioning stories

Kowloon East is a representative example of urban renewal offering opportunities for private equity real estate investors. However, opportunities to invest in a repositioning can be found across Hong Kong and do not necessarily depend on a dramatic shift in the positioning of the entire surrounding neighborhood as the examples below illustrate.

### Nathan Road

In May 2012, a 16-story hotel located along one of Kowloon's prime shopping belts, comprised of 381 hotel rooms as well as retail space on the first four floors, and although well-positioned, an investment group saw the potential to further enhance value through the repositioning of the retail space. At the time of investment, units in the retail space were renting at significant discounts to market rents, allowing bandwidth for upward movement.

### Tsuen Wan

In September 2012, a 15-story commercial building strategically located in the heart of Hong Kong's densely populated Tsuen Wan district was repositioned and rebranded into a modern, vertical retail lifestyle and food and beverage ("F&B") center to capitalize on the high pedestrian flow from middle-income residents, office workers and students in the area. In doing this, the ambition was to capitalize on a significantly under-rented property situated in a bustling neighborhood location; the market rents for retail units in other similar buildings in Tsuen Wan then were achieving three times as much as the property's then average in-place rent. Major building renovation and redevelopment works were completed in January 2014 and the current occupancy stands at 93%.

### Kowloon West

Another example of repositioning took place in March 2015, which involved the acquisition of a four-story neighborhood retail shopping center in a private housing estate located in Kowloon West, Hong Kong. Fully occupied and anchored by a ParknShop store, the diverse tenants mix of this shopping center mainly operates within the non-discretionary consumer sector and enjoys a captive catchment area comprised of four residential projects with over 4,000 units. The acquirer plans to implement a light-scale refurbishment program to modernize the design of the exterior facade as well as the internal common areas, and raise the overall average rental rate of the property to a level in-line with the market.

## Can the repositioning thesis be sustained?

It is probably reasonable to believe that the flow of attractive investment opportunities based on the government policy to promote revitalization and the conversion of old industrial buildings into offices to alleviate the shortage of commercial space in Hong Kong will continue for the next few years. Some 4.8 million square feet in net floor area of class A office space is expected to be completed in Kowloon East by 2019; these revitalized office buildings with good-size floor-plates located close to good transportation links will remain attractive as companies relocating seek contiguous office space and cost savings.

On the demand side, companies are increasingly choosing to build or purchase their own office space. This enables them to build and customize the property to best suit their operational needs, improve their collaboration with facilities management in implementing contingency plans, and hedge against rental volatility. The Stock Connect scheme allowing direct stock trading between Hong Kong and Shanghai launched in November 2014 and the soon-to-be-launched Stock Connect scheme between the Hong Kong and Shenzhen stock exchanges augur well for office demand in Hong Kong. As a result, financial and professional services firms are likely to expand their footprint in Hong Kong, boosted by new firms from mainland China setting up and also by organic expansion by existing companies.

However, there are some headwinds which could impact the repositioning investment thesis. As more firms look to take advantage of the opportunity, more available stock from revitalized former-industrial buildings will come into the market, which may put pressure on the rental increases which are an intrinsic part of the repositioning thesis. Furthermore, the integration of Hong Kong and the Pearl River Delta, supported by better cross-border infrastructure and preferential policies for Hong Kong corporations and professionals, makes the Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone a feasible location for split-office operations. The sheer amount of modern office space available there – some 18 million square meters – would provide more leasing options. Civil movements such as Occupy Central and government efforts to limit Hong Kong visits by mainland Chinese people have taken some momentum out of the demographic trend that was powering the growth in sales at Hong Kong's luxury retail shops, restaurants, and hotels. Annual retail sales in Hong Kong fell for the first time last year since the SARS outbreak in 2003, declining 0.2%, attributed largely to a drop in the luxury segment.

Despite these headwinds, strong repositioning theses can continue to be found in Hong Kong. When the current wave of office-focused repositioning begins to wane as supply meets or surpasses demand, it will be time for another real estate asset class to take precedence. The revitalization policy intended to boost office supply has also intensified the shortage of properties designed for industrial and logistics use, which are needed by retailers and third-party logistics players in Hong Kong. Thus, the story of Hong Kong's transformation which began manufacturing industry in the 1950's will continue to find new opportunities in other sectors in the decades to come.

**Bastian Wolff, *Partners Group***

Bastian Wolff is Partners Group's Head of Private Real Estate in Asia, based in Singapore. He is a member of the firm's private real estate directs and primaries investment committees. He has been with Partners Group since 2006 and has 13 years of industry experience. Prior to joining Partners Group, he worked at Lupus Alpha and CA Chevreux. He holds a master's degree in economics from the University of Wisconsin–Milwaukee and a master's degree in business administration from Justus-Liebig-University, Germany. He is also a CFA charter-holder.

# Family Office – a Viable LP Base for Private Equity Firms

By K O Chia, Director, Grace Financial Ltd

### Introduction

Amongst the many types of institutional limited partners ("LPs"), perhaps the least known are family offices. Yet, family officesare emerging as an important LP base and large fund managers like KKR, Blackstone and Carlyle are paying particular attention to them according to an article in Bloomberg Business dated May 2015. According to the article, it is estimated that family offices and their advisers manage an estimated U.S.$4 trillion and that this amount includes many of the newly rich tech entrepreneurs in Silicon Valley and China, as well as the U.S. mid-western entrepreneurs and the old money in Europe.

What are family offices? Essentially, family offices have emerged when ultra high net worth ("UHNW") with investable assets of >U.S.$30million and high net worth ("HNW") with investable assets of >U.S.$1million) individuals, entrepreneurs and families began to manage their own wealth or the wealth generated from their family businesses in a focused professional way. Increasingly, one sees entrepreneurs and their early employees in the technology sector cashing out their shares, making them the new UHNW and HNW individuals.

Traditionally in the developed economies, it has been common for family offices to manage the family assets over several family generations where the diversified asset base has increased multiple times. Given the asset sizes, a more institutional approach in managing such investments is necessary, which quite often means hiring professional investment managers. It is likely that the family member(s) remain on the boards to set strategic direction with the help of other advisors. However, it is unlikely that the family members will be involved in the day-to-day investments or operations. Such family offices are managed like a financial institution while retaining certain family relationships and values characteristics.

In Asia, the concept of family office is a relatively recent phenomenon. Here family offices are into the second or third generations and the patriarch , the wealth creator, may still be active. Often family members are also more actively involved and therefore their family offices tend to be less institutional. In Asia, the concept and practices of separating the family or personal assets from the treasury of the family business is relatively new.

In the past two decades, family offices have expanded rapidly in Asia, largely driven by the growing economies that created immense wealth which in turn contributed to the growth of UHNW and HNWs in the region. In the 2014 CapGemini/Royal Bank of Canada Wealth Report, the CAGR of Asia's HNW between 2008-2013 was 14%, making it one of the highest growth rates in the world. Significant growth came from Japan and China, followed by Australia and Hong Kong. In the UBS/Campden Wealth Asia Pacific Family Office Survey 2013, it is estimated that there are between 100 to 120 single family offices currently operating in Asia-Pacific. This estimate is based on a mix of quantitative research and anecdotal information as family offices are generally very private and publicity shy.

### Role of the Family Office

The "Family Office" consists of two words. Most of us tend to focus on the word "office" that indicates investments and managing the wealth of the family. But there is also the word "family" where family affairs, family interests and family values take priorities. Therefore a family office plays multiple roles. One of these roles is the gatekeeper to is to help the family to stay out of the limelight. The family office helps to shield, screen and work with a variety of different service providers, that could range from personal chef to legal professionals, from private bankers to investment fund managers, thus ensuring that the required services are provided but in a discreet manner.

While the family office role in investments is significant, it is also important to note that the family office also often manages the family members' personal affairs, such as: managing family trusts, assisting in family governance, participating in the family's philanthropic efforts, mentoring and supporting the family's next generation and other activities. Therefore professionals working in the family office are entrusted with insider information and expected to maintain a high level of confidentiality and integrity.

With respect to investment strategies, most family offices focus on wealth preservation and investing based on estimated risk-adjusted returns. Wealth has already been created and hence the role of the family office is to maintain and grow the wealth steadily and not to lose money. The investment strategy centres around a portfolio approach in asset allocation globally. Each family office has its favorite assets or asset classes. However in general, family offices' investments tend to have more flexibility and have a longer term view. Real assets, like real estate, or businesses that the family is familiar with tend to receive more attention. Depending on the sophistication of the family office, they tend to have a wide range of capabilities. Some have full service investment teams with due diligence capabilities, separate compliance and regulatory teams and sometimes evolve to become multi-family offices. Others tend to prefer to maintain a small staff where most of the heavy lifting work on legal and due diligence is outsourced.

### Family Office Investing In Private Equity

Private wealth management increasingly has an interest in alternative assets and therefore private equity fits well in this asset class. It is also an asset class that has been under-allocated in the past by family offices, but this is now changing. This emerging capital pool helps private equity firms to lessen the dependence on state and corporate pension funds where allocations into the alternative asset class are peaking out. Within the alternative asset class allocation, real estate investments tend to make up a significant portion while private equity investments are of increasing interest.

Breaking into the family offices and wealthy families is not an easy task. It really requires cultivating the relationships with the family office professional managers. As one can imagine, on a daily basis, these family offices are inundated with enquiries and people offering them different services and products. Therefore access to family offices is best done through referrals. An introduction into the family office through a trusted mutual friend of the family, a family office member or other family offices goes a long way to gain attention and validation for the individual or private equity firms.

Decision making processes within the family office and wealthy families vary greatly. Some have put in place more institutional processes led by the hired professional managers doing all the investment processes like due diligence, manager selection and subsequently presentations to the Board or investment committee for final approval. Others are less formal and rely more on outside consultants to assist them in the process to maintain a small staff for investments. Irrespective of the type of family office operations, it is best to get to know the family office first as family offices are more relationship focueds rather than transaction oriented. They value relationships highly and seek and maintain long term partnerships with the managers of their patient capital.

Private equity firms become aware that wealthy families bring more than just money. Family offices bring expertise and knowledge about certain industries, particularly businesses and industries where the family wealth came from. Therefore, they are valuable partner(s) when it comes to buying companies or assisting private equity's firm underlying portfolio companies to scale and reach different geographies. They bring insights into the specific industry, tend to have less considerations for regulatory restrictions and a bigger appetite for risks than other institutional LPs like pensions or endownments. Further tapping into the network reach of family businesses is a significant asset that many private equity firms would highly value.. Many family offices often prefer to invest alongside other family offices so a consortium of these could be a great value-adding investment partner.

Family office investors are very sensitive on management fees. Many of the normal private equity management fee structures of 2% are not something they are wiling to accept so other incentives are required for family offices to participate. Some experienced family offices also have strategies of seeding funds of experienced investment managers so they could play the role of anchor investor and add value to build the funds over a long term period.

Before pitching to any family office, private equity firms need to conduct research and understand the value system of the family office and its family members to evaluate the match in investment philosophy. Increasingly, family offices are also committed to the Environmental, Social and Governance ("ESG") screening framework so it is necessary for private equity fund managers to accept and practice ESG values. Family offices were amongst the early adopters of the ESG framework that is now gaining momentum and acceptance with other institutional LPs.

### Summary

In conclusion, "Family Offices" is a group of LPs that are worth paying attention to, particularly the Asian ones. The growth of such family offices within Asia will continue to be significant over the next decade. Increasingly, established family offices from the developed markets have an increasing interest to learn about the growing Asian market investment opportunities. Towards this end, family offices in the U.S., Europe and the Middle-East are interested to network and partner with Asian family offices. Some have set up off-shore entities in Asia to be closer to the market to more directly feel the pulse of emerging economies and access potentially highly attractive risk-adjusted investment opportunities.

**K O Chia, *Grace Financial***

Mr. KO Chia is Director of Grace Financial Ltd., a Hong Kong based family office, serving as a member of the executive team. He brings 30+ years of diverse international experience as venture capitalist, entrepreneur and corporate executive across Asia, Europe and U.S. Currently he serves as President of the HK Venture Capital & Private Equity Association (HKVCPEA) and Member of Advisory Committee, School of Continuing & Professional Studies at Chinese University of Hong Kong.

# Institutionalising Social Enterprises

By Francis Ngai, Founder & CEO, Social Ventures Hong Kong

### Social investing: the current state of affairs

Social enterprises have made quite a mark recently in terms of raising capital. On the supply side of capital, there is now a growing pool of investors and financial instruments available for social enterprises to tap into. On the demand side, there have been several successful examples of capital-raising by social enterprises from established private equity and venture capital firms (see Table 1). In Asia, the Asian Venture Philanthropy Network (AVPN), a regional funder network with over 200 members, recently concluded its third annual conference, which attracted over 500 participants. This level of turnout serves as a testament to strong interest funders have in Asia's social investing scene.

Yet, social enterprises that have successfully crossed over into the realm of mainstream investing represent an exception, rather than the norm. A vibrant social investing market needs a much larger pool of investable social enterprises for investors to select from, across company sizes, industries, business models and risk / return profiles. To achieve such vibrancy, we envision a stronger role of intermediaries to incubate innovative social enterprises, so that eventually we will reach a virtuous cycle where investments into social enterprises will become as common as seeding technology startups is today.

**Table 1**

| Growing supply of capital ... |
|---|
| • In 2014, BlackRock launched its new BlackRock Impact initiative to explore new ways to scale up impact investing products<br>• Bill Gates invested into Unitus Seed Fund, which provides US$20m seed funding for startups that have the potential to impact those living under $2 a day in India |
| **... for successful social enterprises** |
| • In 2014, Toms Shoes, the canvas shoe company that popularized the "One for One" concept, sold a 50% stake to Bain Capital at a US$625m valuation<br>• d.light, a manufacturer of solar-powered lights, raised a US$11m Round C led by DFJ and other impact investors |

### Paradigm shift: from "social enterprises" to "social startups"

To catalyse this virtuous cycle, it is useful to rethink the term "social enterprises".

As a venture philanthropic organisation, Social Ventures Hong Kong (SVhk) has incubated over 20 social enterprises since our founding in 2007, and has made investments in around half of them. These enterprises aim to address some of the most challenging social issues in Hong Kong – poverty, housing, ageing, education, environment – using innovative solutions through self-sustaining business models.

Reflecting on this experience, we began to think our portfolio companies more as "social startups", rather than social enterprises or ventures, for they indeed had many characteristics usually associated with startups – early-stage, niche, operating in grey areas between established institutions and exploring innovative models to fill existing market gaps. For venture philanthropic organisations, this underlying change in mind-set opens up opportunities to challenge the status quo, while operating leanly, acting collaboratively, and thinking disruptively.

The role of a venture philanthropic organisation is very much similar to that of a venture capital firm. By providing social startups with financial and non-financial resources, a venture philanthropic fund can help social startups to develop the various aspects of their business and simultaneously scale their social impact.

### Bringing more than money to the table

A good venture capital firm brings more than money to the table. It offers industry experience, operational expertise, a broad network of relevant contacts and a range of support services to startups. A startup matched with the right venture capital firm has a much higher chance to survive, scale and succeed. Venture philanthropic organisations take a similar approach in growing social startups, bringing in the 3Cs that are critical to the startup's success: capital, capacity and collaboration.

**Capital – investment or philanthropy?**

There remains a general perception that social startups are needy of government funding and philanthropic support, and very few have figured out viable business models. Increasingly, social startups prefer to rely mainly on private capital and test out innovative business models beyond work integration social enterprises (WISE)[1]. For venture philanthropic organisations and other social investors, while financial sustainability of the startup is important, the principal focus still lies with social and environmental returns.

With new social startup business models springing up, alternative forms of social investments have opened up for a wider pool of co-investors to participate in. An example is affordable housing social realty company, Light Be, which has created a platform that facilitates asset-based impact investments. Through Light Be, apartment owners in Hong Kong can lease their spare apartments

[1] WISE are social enterprises that seek to provide employment to less privileged workers, with the core mission of integrating them into society through work

to needy families, giving these families an opportunity to move out of the poverty cycle over a maximum of 3 years, while maintaining ownership of the apartments and enjoying a stable rental yield.

Venture philanthropic organisations typically adopt the idea of "patient capital" for investments. Acumen Fund describes "patient capital" as investments that "have a high tolerance for risk, have long time horizons, are flexible to meet the needs of entrepreneurs, and unwilling to sacrifice the needs of end customers for the sake of shareholders." Increasingly, public and philanthropic funders are also keen to provide "catalytic first loss capital" for bringing mainstream private resources to the social investing market.

**Capacity – building its people and team**

Capacity building forms the cornerstone of the early stage relationship between the venture philanthropic organisation and social startup. Most successful social startups have received tailored support from their investors to get the business concepts aligned. Tailored support could range from project conceptualisation to back-end business service support. Social investors also provide human resource support for the more labour-intensive aspects of executing pilot projects. Such support is crucial in each social startup's early days, for them to test the target market and further refine their social and business missions.

Activating the network effect is another way venture philanthropic organisations can help social startups overcome the perennial challenge of resource crunch. By connecting social entrepreneurs with the right fit of skill-based volunteers and board members, venture philanthropic organisations empower social startups to benefit tremendously from the team's experience in strategy development, corporate governance, sales and marketing network and industry expertise.

**Collaboration – social investing as a tool for aggregating goods**

A tongue-in-cheek barometer of a social startup's success is its ability to work itself out of business – that is if the social startup is able to create sustainable business and social impact beyond itself for the communities they serve. To that end, rather than adopting a traditional view that focuses on competition with business rivals, venture philanthropic organisations tend to be open to collaborate with other like-minded organisations, utilising a platform approach where investments into social startups serve as catalysts that create a platform for parties from different sectors to further a single social mission.

An example of a platform catalyst in Hong Kong is Green Monday, a social enterprise that originated the concept that everyone can take simple and actionable baby steps to protect the environment, starting from giving meat up for one day each week. With venture philanthropic support, Green Monday has quickly grown from an idea into a social enterprise group consisting of three entities: Green Monday Foundation, a not-for-profit enterprise that focuses on advocacy and education; Green Monday Solutions, a consulting firm that helps corporations to develop green strategies; and Green Monday Ventures, an incubator for green entrepreneurs to start businesses and find investors. Through its work, Green Monday has been able to reach out to all aspects of society for its environmental cause.

## The Business 2.0 way to accelerate growth of social startups

It could be said that venture philanthropy and social startups had a watershed moment with the emergence of impact businesses. Impact businesses are established businesses born out of the Business 2.0 concept of shared value creation espoused by Professor Michael Porter and Mark Kramer of Harvard University. This concept calls for the corporate world to enhance their linkages with the broader society around them by realigning their business philosophy to achieve social and commercial advancement simultaneously across their value chain

Elements underpinning the scaling of a social startup are not unlike that of any other startup, irrespective of business sector or social mission. Venture capital and private equity firms can carve their own niche in the Business 2.0 world by building social startups into investment-ready levels for mainstream – and ultimately public – capital to pick up the torch. Underlying this philosophy is the understanding that any organisation alone will not be able to address the myriad of social and business challenges faced by the world today. During this process, venture capital and private equity can spearhead efforts to institutionalise social startups, alongside government and social sectors, to bring in each's respective areas of expertise and resources, and give legs to this new and sustainable way of doing business.

**Francis Ngai, *Social Ventures Hong Kong***

Mr. Francis Ngai is the Founder and CEO of Social Ventures Hong Kong, Hong Kong's first venture philanthropic organization dedicated to the support and nurture of social innovation. He is also a Board Member of the Asia Venture Philanthropy Network, a regional network with over 200 venture philanthropic member organizations

Mr. Ngai was selected as Ten Outstanding Young Persons in Hong Kong in 2011, a Young Global Leader of the World Economic Forum in 2012 and The Purpose Economy 100 Asia in 2014

# Caught in a Sticky Situation: Advising Private Equity Funds in a Crisis

By Stuart Witchell, Senior Managing Director, FTI Consulting
Nick Gronow, Senior Managing Director, FTI Consulting
Cara O'Brien, Senior Managing Director, FTI Consulting

For private equity firms, doing business in Asia combines both exciting opportunities and a multitude of risks. Notwithstanding the often heated competition for deals, Asia has continued to attract a strong share of private equity investment. However, in continuing to pursue investments in a competitive market, firms may become exposed to high risk situations when allegations of corruption, fraud, misconduct and/or bribery within their portfolio companies come to light in the post-transaction period.

The following are several case studies which highlight some of the common issues and challenges faced by private equity firms operating in Asia and provide some insights into how these risks may be mitigated.

### The Whistle-Blower Trigger

In what had been a somewhat lacklustre year for industry competitors, a Hong Kong-registered healthcare company ("the company") made a name for itself while disclosing healthy and lucrative financial numbers. While this would seem like good news, a global private equity firm ("the PE firm"), which had already invested in the company, started to become concerned by a perceived lack of transparency in the company's financial statements and industry rumours of illicit transactions. However, it was not until a whistle-blower alleged mass kickbacks and corruption involving senior management of the healthcare company that the PE firm realised it was necessary to find out the truth behind the glossy reporting and audited financials.

### First Steps: Peeling Back the Layers

With Asian operations based out of Hong Kong, the PE firm had limited capability to scrutinise the healthcare company's operations based across greater China. It therefore recognised that an investigation would require a carefully synchronized, professional investigation — deft enough to avoid tipping off employees and causing further reputational risk to the firm, yet deep enough to uncover any potential fraudulent practices within. As such, the PE firm decided to engage a professional investigation firm to conduct a discreet investigation into the company's mainland China operations.

The first step was to assess the allegations against the company and management by conducting investigative research in English and Chinese and through in-depth discreet inquiries via contacts at senior government and industrial companies to uncover first-hand information unavailable in the public domain. The initial intelligence-based investigation suggested that senior staff

based in the China operations of the company were notorious in their respective local communities for accepting kickbacks and colluding with local pharmaceutical companies to increase sales. The company's directors were found to have strong and undisclosed connections with local government bureaus, which resulted in authorities having vested interests in their business dealings and therefore turning a blind eye to any questionable behaviour. A forensic accounting team was brought into the investigation and further financial inquiries uncovered that the company was billing for un-rendered services and artificially inflating its revenues.

## The Financial Investigation: Confirming the Numbers Don't Add Up

As with any investigative due diligence undertaking, the financial investigation or review of a PE fund's portfolio company also requires an understanding of the factual position at hand. Only with factual information can the fund manager make informed and reasoned decisions. It is essential that the review be undertaken by an independent party to ensure the legitimacy of the findings.

In this case, where the company faced allegations pertaining to the overstatement of revenue and profit, the financial investigation focused on closely examining any documentation connected to the relevant transactions, as well as areas of the financial accounts impacted by the alleged misstatements, e.g. receivables. The review of invoices drew attention to their simplicity and similarity as well as the absence of any other supporting documentation for the transactions. Big changes had occurred in receivables balances during the accounting period which could not be explained. Also, it was found that significant accounting adjustments to other asset classes seeking to hide accounting manipulations had been made.

Whilst establishing fake or inflated revenue can be difficult, it is much easier to identify fake and misstated debtors. Site visits can be performed, statutory searches can be conducted and transactions can be traced to confirm the legitimacy, or otherwise, of relevant counterparties. The review in this case confirmed the material overstatement of revenue and profit and also the substantial overstatement of other asset classes including not just receivables but other asset items such as prepayments and loan receivables. And this is an important lesson. Wrongdoing is rarely limited to just one issue or line item in the financial accounts, but is usually a more far-reaching and interconnected problem.

Rudimentary audit procedures had not identified the misstatements over many years, which is often the case given audit tests are very specific and routine, so parties with knowledge of what they are doing can work around those tests. As such, investors should never consider an audit to be a substitute for due diligence or some other form of investigative review, or even as a means of protection against financial statement fraud.

Having detected the irregularities and misconduct in the financial statements of their portfolio company, the PE firm needed to also be ready to manage any publicity issues that might arise as a result of these implications.

## Using Communications to Protect the Investment and the PE Firm's Corporate Reputation

To anyone following the news in the last several years, it is clear that an increasing number of global private equity firms based in Hong Kong are facing very public challenges in Asia's emerging markets — challenged deals are becoming a common occurrence. In addition to the well understood financial risks of this situation, there are also reputational risks — not only to portfolio companies but also the PE firm itself.

If communications surrounding the corruption and fraud in their acquired asset were mishandled and the PE firm's reputation was tarnished, this would of course have a wide ranging and lasting impact. Specifically, if the asset was perceived to be beyond repair and considered 'damaged goods,' the PE firm would likely not be able to recoup its investment. Moreover, there would likely be lasting implications on its credibility which it had worked hard to build and this could threaten its ability to operate in the region. Lastly, any reputational damage originating in Asia has the potential to reverberate well beyond the region and could harm perceptions about the global firm as a whole. No investment manager wants to be held responsible for this turn of events.

Once the need for an investigation surfaced, events unfolded quickly and it was important for the firm to put a communications plan in place. In the current market, the risk of an information leak is high so it was important to have various holding statements prepared and at the ready should they be needed. Further, the firm must be prepared for potential proactive disclosures. Because of this, various messaging sessions with the management team were required in order to ensure that all holding documents were well written and accurately portrayed the firm's description of the situation in an appropriate and positive way.

Monitoring for media coverage of the situation is also quite important. Should the news leak in some way in the press it must be identified as quickly as possible and an assessment made if a response is required. Given the potential that the story could be exposed, the firm should be prepared to handle calls which may be received from reporters who would want the firm to explain the background and defend its actions. As part of this, talking points should be prepared in advance.

Letters to key stakeholders — investors, employees, business partners, the financial community should be prepared explaining what are the implications for them now and/or in future.

This particular firm not only survived the investigation without a news leak nor did it suffer any major damage to its reputation. However, not all companies are this fortunate and, therefore, a more aggressive proactive communications strategy may be required to combat negative media coverage, calm nervous employees, and reassure sceptical business partners.


In any event, the PE firm's stakeholders perception of what happened, how they reacted to it, and what this means for the fund's and firm's future cannot be underestimated. It can mean the difference between suffering long-term damage or surviving the event and having the ability to continue to deploy capital in Asia and beyond.

## In Conclusion: Take Action Before It's Too Late

The many complex issues highlighted above demonstrate the extent to which fraud or misconduct can exist in an otherwise seemingly straightforward investment. Furthermore, the disruption, cost, and business impact — both financial and reputational — which could have been avoided had the PE firm embarked upon better pre-transaction due diligence of the healthcare company is also clearly evident.

Such cases are increasingly common within the PE industry, and bring to light the inadequacy of pre-investment due diligence that relies solely on financial information put together and provided by the portfolio company itself or — in an increasing number of instances — by the audit firm whose work has not been sufficient enough to identify misconduct and fraud.

Of course, no company is perfect. But, by focusing resources in an effective, tried and tested way, due diligence can in fact add substantial value to the investment process, highlighting common risk factors and incorporating a thorough analysis of the portfolio company's risk profile. It can help highlight and confirm the target's strengths and identify the target's weaknesses and focus on areas that can be improved or tightened to make the company a better business, and therefore add value for all stakeholders.

Ultimately, as many companies discover too late, the conduct of a comprehensive due diligence process — not just kicking the tires but also looking under the hood — which incorporates both investigative and financial focused due diligence is not just advised, it is sometimes indispensable and may pay for itself.

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- **Private Equity Fundamentals Course**
  September and October 2015

- **HKVCA Wine Tasting**
  23 November 2015

- **HKVCA Young Professionals Beerpong Competition**
  November 2015

- **HKVCA Christmas Cocktail**
  10 December 2015

- **HKVCA Gala Dinner**
  19 January 2016

- **HKVCA 6th Asia Private Equity Forum**
  20 January 2016

- **HKVCA Annual Golf Day**
  4 March 2016

- **HKVCA Venture Capital Forum**
  11 March 2016

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