Cross-Border Issue

HKVCA **Journal**

Sixth Issue | Spring | 2019

HKVCA Journal | 6th Issue

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FOREWORD

THE CROSS-BORDER ISSUE

At time of this publication, China and the United States have not resolved their tariff negotiations. We want this issue of the HKVCA Journal to come out in a period of enormous uncertainties to remind us that our industry is not foreign to – and in fact embraces – big regional macro shockwaves, and good-old-fashion investment approach still prevails.

In this issue, our contributors provide insights to the countries that are having the most controversies with China cross-border investments: namely, the United States, for which our CFIUS expert offers his ideas to Chinese/Hong Kong investors on continued market access; Germany, where we have found a voice of rationality from our peer venture capital association; and Israel, in which case we have invited a Chinese portfolio manager that pioneered a cross-border investment program there to convey what matter most in managing multi-country volatilities.

We also should not forget Japan in the current US-China dynamics. The country in 2018 surpassed China in outbound M&A volume for the first time in five years. We asked a seasoned cross-border Japan private equity manager to share how his strategy is uniquely positioned in the current environment.

Finally, looking back home, with our last quarter's GDP growth halved as a result of the US-China trade friction, our discussion with the largest technology landlord in Hong Kong offers glimpse of hope that, despite its vulnerabilities as an open economy, Hong Kong can capitalize on companies' needs (and especially our technology portfolio companies' needs) in re-aligning their production supply chain.

We really hope you would find useful perspectives in the timely issue.

Denis Tse
Chairman, HKVCA Research Committee

HKVCA Mission Statement

The HKVCA's mission is to stimulate a vibrant venture capital and private equity industry in Asia while promoting the role of member firms in value creation, innovation and economic development.

The HKVCA provides a forum for networking and experience sharing for its members, promotes industry professional ethics, international best practices and standards, and represents the views of its members before governmental and other relevant bodies.

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Macro Headwinds on the Horizon

Interview with H. Chin Chou, Morgan Stanley Asia

Investors have to presume that there will be unanticipated macro volatility, says H. Chin Chou, and the recent trade tensions are a reminder that we cannot take things for granted.

The HKVCA chairman, Mr H. Chin Chou, is the Chief Executive Officer of Morgan Stanley Private Equity Asia and a Managing Director of Morgan Stanley based in Hong Kong. Today, the firm has as many investment professionals in private equity in Asia as it does in the US. Asia in general, and China in particular, have become valuable investment destinations for the US' sixth largest bank by total assets.

Chou points to the dominance of China and Hong Kong in IPOs as an example of collaborative capital. "Hong Kong was the largest IPO market in six of the last 10 years. You cannot create such a successful IPO market with international investors unless you're open to international capital. "

"A decade ago there might have been a question about who would win in China, local funds or international funds. The answer today is clear: there are strong local funds and strong international funds and we work with each other and we compete against each other. Sometimes the local fund has an advantage, but in other cases it's the international fund. "

"We have worked with entrepreneurs in China for many years and found that some prefer to have an international firm like ourselves to invest in their business because we offer access to and a deep understanding of business, markets and governments all around the world. But at the same time, some entrepreneurs in China are more comfortable with local funds. The reality is that local and international funds will co-exist, and our continued existence will depend more upon our investment judgement and our investment acumen and value add, rather than whether we are foreign or local."

That coexistence is particularly noteworthy as the US-China trade tensions continue into 2019. Having previously gone on record stating that the rhetoric regarding tariffs was resulting in some weakness in the region's capital markets, with hindsight Chou now calls it a "a dislocation" in traditional capital markets.

"The trade dispute is another reminder that we cannot always take things for granted. For example, from the time that the Chinese renminbi was not freely tradeable until 2015, it consistently appreciated. But it wouldn't have been appropriate to presume that it would always remain strong. In August 2015 it started to weaken as it responded to market forces, and today is weaker than it was three years ago."

"Likewise, with respect to trade, it is dangerous to assume that it will always grow and proliferate. What the trade dispute has shown is that countries have sovereignty over their products and markets and at times they will respond due to either growing domestic political pressure or foreign exchange markets, or to other circumstances," he says.

"But the issues revolving around the trade dispute have been both topical and important with respect to our funds and our investment perspective. The first thing I would say is that you have to presume that there will be macro volatility. Think about the past 20-plus years. We had the Asian financial crisis in the late 1990s, the internet bubble in 1999-2000, 9/11, SARS in Hong Kong and elsewhere in the early 2000s, the

global financial crisis and Greece blowing up and impacting the emerging markets."

"Any robust investment strategy has to presume that there will be macro headwinds, headwinds that are, by definition, unanticipated, just like the trade dispute. So, firms should think carefully about the type of business they are buying, the price being paid, and the capital structure in which they are operating that business."

"That said, trade friction very rarely impacts a GP's portfolio directly – I would estimate that the vast majority of China investments are focused on domestic income growth, rather than export growth. The broader question is about the indirect impact of trade friction. Clearly, the capital markets have been more difficult, more volatile, and that has led to more challenging exits, particularly in China where there are just two main exit methods, IPO and trade sale. "

"The first impact of increased trade tensions was clearly capital market volatility, not just in Hong Kong's Hang Seng Index, but across Asian markets. Secondly, we are beginning to see the impact of the dispute on China's overall economy. The third quarter of 2018 saw a slow-down and I believe that the second half of the year will have been slower still from an operating perspective than the first half. All the data isn't yet available so it's premature to make any firm conclusions on the impact on China's domestic economy. But clearly, we are feeling it - we are seeing anecdotal evidence that there are more headwinds today than a year ago."

As to whether trade tensions are wholly responsible for China's slowdown, Chou is sanguine. "Frankly it could be sentiment itself. In some instances, poor performing equity markets lead to a self-fulfilling prophecy in terms of a slowing economy. But I continue to be a believer in the secular growth opportunities in China. We were witness here in Hong Kong and elsewhere to an economy that in 2000 was at about US$1,500 per capita income and then from 2000 to 2019 saw that income increase to about US$10,000. That US$8,500 per capita increment resulted in about US$10 trillion of extra economic output."

"Driving that growth has been a level of entrepreneurialism that is astounding. The reality is in the past 15-20 years there have been two major economies that have grown in size - the US and China, and it's no surprise that these two countries are the most entrepreneurial economies in the world. While the media may talk about the differences between China and the US, at least economically these are the only two countries that have grown in any magnitude compared to, for example, the EU or Latin America."

"Ultimately, as long as China remains committed to an entrepreneurial, market economy, then I feel reasonably confident that it can overcome what are very normal economic cycles. For all of us investing in China, our aspirations in terms of macro overlay are clear: assuming China grows from US$10,000 per capita income to say US$15,000-$16,000 per capita income, that US$6,000 increment is US$8 trillion of additional economic output. That US$15,000-16,000 per capita income would compare to Malaysia and is still lower than Poland and other similar economies, so I believe it's achievable."

"The largest e-commerce firms in the world 10 years ago were all American. Today, half of them are American and half are Chinese. The development of companies like Alibaba, Baidu, Tencent and others is phenomenal and, not surprisingly, PE and VC funds and others were able to create access for their clients into these businesses as they were private companies."

"Given the growth, I am not surprised that e-commerce has dominated the last few years of investing in China. But I believe that valuations did get head of themselves and going forward we will likely see more classic PE increase its percentage of private capital investing, with of course e-commerce remaining a large part of the China investment environment."

"For classic PE managers like us, we tend to be more excited about businesses that generate current year earnings or operating cash flow. The metric EV/EBITDA or valuation to EBITDA is important and the vast majority of the PE money continues to do what it has always done, which is to buy businesses with historical earnings and, hopefully, operate them better, change capital structures and position exits to the benefit of our investors."

As to the future for GPs fundraisings just as quantitative tightening starts to bite, Chou says that one of the big risks in investing in emerging markets is currency, particularly if a firm is managing international - dollar-denominated - funds.

"We don't have the benefit of investing, for example, in the Euro markets where the Euro is easy to hedge or the yen market where it is easy to hedge. It is more challenging to hedge the renminbi or the Korean won, and almost impossible to hedge cost effectively the Indian rupee. We saw that in Turkey and in other emerging markets. I'm not sure that is directly related to quantitative easing. From a currency perspective we tend to hedge currency because we never know where the renminbi or the yen or the Korean Won will be three to five years from now when we exit the transaction. We believe hedging is a reasonable risk mitigation tool. It's expensive, but it's a reasonable cost to bear."

"But having invested in Asia for more than 20 years, I can say that the consistency of growth in the international investor base seeking to invest in Asia has surprised me. Investors who may not have previously invested in Asian private equity are now doing so, some with large allocations. Almost every international LP that I meet now has an Asian team whose job it is to develop their Asian strategy and to interview and consider Asian GPs."

"Asia has now overtaken Europe in terms of new funds being raised. We are seeing an increasing proportion of capital flowing into private asset classes. Interest rates remain low. Pension funds are struggling to hit their overall rate of return targets on their assets. As a result, we're seeing more and more pension funds increasing their allocation to non-liquid alternative assets. And Asia is benefiting from that trend."

Professional private equity managers never take things for granted. In order to outperform , managing their portfolio well for the long run is a solution to counter macro headwinds.

H. Chin Chou, Morgan Stanley Asia

H. Chin Chou is the Chief Executive Officer of Morgan Stanley Private Equity Asia and a Managing Director of Morgan Stanley. He is based in Hong Kong. Mr. Chou also serves on the Firm's Asia Pacific Executive Committee, which is comprised of the Firm's senior business leaders within the Asia Pacific region.

Mr. Chou joined Morgan Stanley in 1987 in New York and has spent 29 years at Morgan Stanley, with the past 25 years in Asia. Mr. Chou has lead MSPE Asia's four private equity funds to date: the $330mm MSGEM Fund (1999), the $525mm Asia Fund II (2005), the $1.5bn Asia Fund III (2007) and the current Asia Fund IV. Mr. Chou was also part of Morgan Stanley's Private Equity Group in New York in the late 1980s. He was previously a Director of CTCI, eAccess, ECVision, HTL, Hyundai Rotem, ITest, Landmark, Ssangyong Corporation and YesAsia. Mr. Chou holds a B.A., magna cum laude, from the University of Pennsylvania and an M.B.A. with Distinction from Harvard Business School.

An Overview of Recent CFIUS Developments

Brian Curran and Zachary Alvarez, Hogan Lovells

What Hong Kong and Chinese Venture Capitalists Need to Know

With the enactment of the Foreign Investment Risk Review Modernization Act ("FIRRMA") in August 2018, the landscape concerning national security reviews conducted by the Committee on Foreign Investment in the United States ("CFIUS") dramatically changed. Now parties to any foreign investment in a U.S. business must consider whether they are legally obligated to submit a filing to CFIUS. Moreover, FIRRMA expanded CFIUS's jurisdiction significantly, giving CFIUS the power to review even non-controlling investments in U.S. critical technology and critical infrastructure companies and U.S. companies that hold sensitive personal data of U.S. citizens. Although FIRRMA will increase the regulatory burden for many foreign investors active in the U.S. market, as described in further detail below, certain FIRRMA provisions and certain CFIUS developments create opportunities for Hong Kong and Chinese venture capitalists.

I. Introduction

Prior to the enactment of FIRRMA, CFIUS's mandate was quite broad, but FIRRMA broadened it further. Under the Defense Production Act of 1950 ("DPA"), as amended by FIRRMA, CFIUS's jurisdiction now extends to a broader array of transactions that are known as "covered transactions." As described below, other FIRRMA provisions that will expand CFIUS's jurisdiction further are not yet in effect.[1] Therefore, it has become increasingly important for foreign investors to understand the current and evolving CFIUS landscape in order to ensure that they comply with new legal requirements and minimize regulatory risks.

II. "Covered transactions" currently Subject to CFIUS Review

a. **Transactions that result in foreign control.** Prior to and after the enactment of FIRRMA, CFIUS has jurisdiction over "any merger, acquisition, or takeover . . . by or with any foreign person which could result in foreign control. . ." of a U.S. business. In other words, CFIUS jurisdiction is triggered if there is an acquisition of or an investment in a U.S. entity that results in foreign "control" of that U.S. entity. The CFIUS regulations define control as "the power, direct or indirect, . . . to determine, direct, or decide important matters affecting" the U.S. business.[2] CFIUS has interpreted "control" broadly, particularly with respect to Hong Kong or Chinese investments in U.S. businesses. For example, in some cases, CFIUS has considered investments of approximately a 10 percent equity and voting interest by a Chinese investor in a U.S. business and the appointment of a board observer to be a "covered transaction."

[1] Many FIRRMA provisions will not become effective until 18 months after the date of the enactment of FIRRMA (February 13, 2020) or 30 days after publication in the Federal Register of a determination by the Secretary of the Treasury that the regulations, organizational structure, personnel, and other resources necessary to administer the new provisions are in place.

2 31 C.F.R. § 800.204.

b. **Investments covered by CFIUS's pilot program.**
In October 2018, CFIUS released interim rules establishing a pilot program that took effect on November 10, 2018. The pilot program expands CFIUS's jurisdiction to non-controlling foreign investments in a U.S. business that meet these criteria:
- The U.S. business is a pilot program U.S. business, meaning that it is a U.S. business that:
  - "produces, designs, tests, manufactures, fabricates, or develops" critical technology that is used in the business's activity in a pilot program industry; or
  - designs such technology for use in such an industry; and
- The investment affords the foreign investor:
  - access to "material non-public technical information" in the possession of the U.S. business that relates to certain critical infrastructure or critical technologies;
  - membership or observer rights on the board of directors of a U.S. business, or the right to "nominate" an individual to the board; or
  - any involvement, except through the voting of shares, in substantive decision-making of the U.S. business relating to critical technologies (collectively "Active Investor Rights").

The pilot program includes 27 pilot program industries (listed in Appendix 1), which include, among others, aerospace/defense, biotech, batteries, telecommunications, nuclear power, and semiconductors. Critical technologies include many items subject to the Export Administration Regulations ("EAR"), all defense articles and defense services subject to the International Traffic in Arms Regulations, and others.[3]

For non-controlling foreign investments in a pilot program U.S. business in which the foreign investor acquires one of the Active Investor Rights and for any controlling investment in a pilot program U.S. business, the parties to the transaction are legally obligated to file with CFIUS a declaration (short-form CFIUS filing). Parties that are required to submit a mandatory declaration, but that fail to do so, may face steep penalties – up to the value of the transaction.

c. **Changes in the rights of foreign investor.**
FIRRMA has expanded CFIUS's jurisdiction to cover a change in the rights of a foreign investor in a U.S. business if that change could result in foreign control of the U.S. business.[4]

[3] The pilot program only applies the expansion of FIRRMA's jurisdiction to a subset of critical technologies. FIRRMA ultimately will give CFIUS the authority to review any foreign non-controlling investment if (i) the foreign investor acquires the Active Investor Rights and (ii) the U.S. business (a) owns, operates, manufactures, supplies or services critical infrastructure; (b) produces, designs tests, manufactures, fabricates or develops one or more critical technologies; or (c) maintains or collects sensitive personal data of U.S. citizens that may be exploited in a manner that threatens national security (collectively, "other investments").

[4] FIRRMA also ultimately will expand CFIUS's jurisdiction to include any change in the rights of a foreign investor in a U.S. business if that change could result in a non-controlling investment in a U.S. business that meets the criteria of "other investments" described in footnote 3. Moreover, CFIUS's jurisdiction also ultimately will be expanded to cover certain purchases by or leases to foreign persons of real estate that is located in the U.S., is within or part of a port, or is near sensitive U.S. Government national security installations. Again, these particular jurisdiction-expanding provisions are not yet in effect.

d. **Evasion.**
FIRRMA expanded CFIUS's jurisdiction to cover transactions, transfers, agreements, and arrangements that are designed or intended to evade or circumvent CFIUS's review.

III. FIRRMA Investment Fund Exemption

The CFIUS pilot program includes an exemption, drawn directly from FIRRMA,[5] for indirect investments in a U.S. business by a foreign person through an investment fund that affords the foreign person membership as a limited partner ("LP") or equivalent on an advisory or committee of the fund if:

- The fund is managed exclusively by a general partner ("GP");
- The GP is not a foreign person;
- The foreign LP advisory committee/board cannot approve, disapprove, or otherwise control investment decisions of the fund or GP decisions related to entities in which the fund is invested;
- The foreign LP does not otherwise (a) control the fund or the GP or (b) unilaterally dismiss, prevent the dismissal of, select, or determine the compensation of the GP; and
- The foreign LP does not have access to "material nonpublic technical information"[6] as a result of such participation on the LP advisory committee/board.

Thus, if a foreign LP invests indirectly through a U.S.-controlled investment fund that is taking a non-controlling stake in a U.S. critical technology company and meets the criteria above, the foreign LP's investment effectively is not subject to CFIUS's review.

IV. An Evolving Landscape

Because many of FIRRMA's key provisions are not yet in effect and because no FIRRMA regulations have been promulgated, many CFIUS changes are on the horizon.

a. **Further expansion of CFIUS's jurisdiction**
As noted above in footnotes 3 and 4, no later than February 13, 2020, FIRRMA will further expand CFIUS's jurisdiction to include:

- Certain transactions with foreign persons involving real estate in close proximity to air or maritime ports, military installations, or other sensitive national security facilities;

- Any "other investments" regarding critical infrastructure or personal data of U.S. citizens; and
- Changes to the rights of a foreign investor in a U.S. business if a change would result in an investment in a U.S. business involving critical infrastructure or sensitive personal data of U.S. citizens.

b. **More mandatory filing requirements**
FIRRMA allows CFIUS to determine which types of transactions will require the submission of a mandatory declaration. So far, CFIUS mandated filings only through the CFIUS pilot program, but it will expand the types of transaction subject to mandatory declarations with the promulgation of the final FIRRMA regulations. FIRRMA mandates the submission of declarations for any transaction that involves the direct or indirect acquisition by a foreign person of a "substantial interest" in a U.S. business engaged in critical technologies, critical infrastructure, or sensitive personal data of U.S. citizens if a foreign government has a "substantial interest" in the foreign person. FIRRMA delegates to CFIUS the authority to define what will constitute a "substantial interest," but the statute does clarify that an investment that is less than a 10 percent voting interest is not a "substantial interest."

c. **Expansion of technologies that constitute "critical technologies"**
FIRRMA added to the definition of "critical technologies" a new subcategory called "emerging and foundational technologies." These technologies have not yet been identified, but in November 2018 the U.S. Department of Commerce's Bureau of Industry and Security ("BIS") issued an

[5] The investment fund exemption in FIRRMA applies to any "other investment" described in footnote 3, whereas the investment fund exemption in the CFIUS pilot program is limited to the scope of the program (i.e., certain foreign investments in critical technologies).
[6] Material nonpublic technical information is information, not including financial information, that is not available in the public domain and is necessary to design, fabricate, develop, test, produce, or manufacture critical technologies.

advanced notice of proposed rulemaking and provided a list of representative categories of technologies that might be identified as emerging technologies, such as biotechnology, artificial intelligence, microprocessor technology, and robotics. BIS has not issued a proposed rule yet.

V. CFIUS Outlook for Hong Kong and Chinese Venture Capital

CFIUS scrutiny of investments from Hong Kong and China remains high, particularly in cutting-edge technologies, such as artificial intelligence, robotics, semiconductors, cybersecurity, and data analytics. A reversal of this trend is unlikely, but a few developments still present opportunities for Hong Kong and Chinese venture capitalists:

- Many foreign investments are not subject to the CFIUS pilot program and therefore do not require a filing with CFIUS. Some of our foreign investor clients, for example, have decided to take a consistent approach of not acquiring the Active Investor Rights in their investments, thereby taking a passive role in their investments. Other foreign investments are not subject to the pilot program because the U.S. business is not involved with critical technologies.
- For some Hong Kong and Chinese investors, the FIRRMA investment fund exemption may present a significant opportunity. The exemption essentially allows Hong Kong and Chinese investors to invest in U.S. early stage cutting-edge technology companies, albeit through a U.S. fund, and reap the financial benefits of those investments.
- CFIUS has begun to show a greater willingness to address its national security concerns on the basis of mitigation measures (i.e., restrictions) that maintain a passive role for the foreign investor. In limited cases, CFIUS has begun to clear transactions on the basis of mitigation that employs third parties to secure data or otherwise shield the foreign investor from the U.S. business.

We also offer a few tips for managing CFIUS risk in 2019:

- Engage CFIUS counsel at the planning stages of your investments to assist you in assessing risk and to keep you up to date on CFIUS trends (i.e., CFIUS areas of focus based on ongoing cases) and regulatory developments (e.g., new FIRRMA regulations)
- Consider whether any of your investments in U.S. businesses might be eligible for the FIRRMA investment fund exemption
- Review the 27 CFIUS pilot program industries to determine whether you intend to invest in these industries
- Determine at an early stage whether the U.S. business is developing critical technologies
- Engage export controls counsel (preferably also your CFIUS counsel) to assist you in vetting the representations of the U.S. business as to whether it develops critical technologies or is connected with one of the 27 pilot program industries
- Consider whether co-investors increase or decrease your CFIUS risk

Brian Curran, Hogan Lovells

Having spent 10 years as a Defense Intelligence Agency analyst with a TS/SCI clearance, Brian Curran retains his keen interest in national security issues. Today, Brian uses that experience every day at Hogan Lovells to represent foreign multinationals and investors in national security reviews before CFIUS, including companies based in China, Israel, Singapore, Japan, France, Spain, Luxembourg, the Netherlands, Germany, Canada, and the United Kingdom. Brian has a deep understanding of complex matters involving export controls, economic sanctions, and CFIUS reviews.

For more details on CFIUS,
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China and Germany: Trading Partners or Competitors?

Ulrike Hinrichs and Martin Bolits, Germany Private Equity and Venture Capital Association (BVK)

The role of Chinese investors has been the subject of heated debates in Germany since at least 2016, when the Chinese conglomerate, Midea, tendered its bid to buy the Augsburg-based robotics manufacturer, Kuka. According to a study by EY, over USD 36 billion was invested in Germany across 144 transactions between early 2016 and mid-2018 alone. And although the rate of Chinese direct investment has since fallen, “Made in Germany” companies and technologies continue to be in great demand in China. Investment projects in key technologies of the future, as was the case with Kuka, or in infrastructure-related companies such as the high-voltage grid operator, 50Hertz, are vigorously fuelling the debate about the purpose of Chinese investments. In the case of the specialist machine manufacturer, Leifeld, the German Federal Ministry of Economic Affairs unambiguously indicated that it would block the purchase by Yantai Taihai Corporation because the potential use of the technology provided by the Westphalian company’s products in the Chinese investor’s nuclear business was classified as critical. In the end, the Chinese company withdrew its offer. The German government also took an active role in the case of 50Hertz and came to the aid of the Belgian shareholder with a loan from the German development bank, KfW. The acquisition option for the State Grid Corporation of China was therefore no longer an issue. Even though German-Chinese trade relations are of high importance for Germany, the rise in Chinese investment activity has recently amplified calls to tighten controls on foreign investors in Germany. It is feared that expertise will be moved abroad or that more and more important infrastructure companies will be controlled from the Far East.

Tightening of Investment Controls

Shortly before Christmas, on 19 December, the cabinet in Berlin responded by adopting the 12th Ordinance Amending the German Foreign Trade Ordinance (Außenwirtschaftsverordnung), which amended the rules for investing in Germany. This is quite the balancing act for the government: on the one hand, it wants Germany to remain an attractive investment location and Chinese investors to be among those allowed to invest in German companies of course, but, on the other hand, it wants to have tighter controls and stricter screening regimes in place to be able to prohibit investment in cases of doubt in future in the event that a foreign investor makes a state-funded investment in security-relevant companies and infrastructure.

Until now, the German Federal Ministry of Economic Affairs was able to screen all new acquisitions where the foreign investor was set to acquire at least 25 % of the voting rights in the German company. The criterion for this was whether the investment in question posed a threat to the public order or essential security interests of Germany and its citizens. This will basically remain as it was; however, the threshold for screening will change, lowering from 25 % to 10 % for sectors that are defined as being particularly critical. Companies that need to be screened include companies that operate critical technology and infrastructure for the supply of energy or water or for telecommunications, or companies in the

defence or security technology sector. Investments in the key technologies of the future are also affected, such as cloud computing and software companies, where these technologies are applied to critical infrastructure. Media enterprises that contribute to the shaping of public opinion have been newly added to this list. If a foreign investor is set to acquire 10 % of the voting rights in a broadcasting service, for example, the government can screen the investment and block it.

What Does this Mean for Foreign Investors?

In general, we can expect to see more sector-specific and cross-sectoral screenings of investment projects in the future. Not simply due to the fact that media companies represent a new category, but more because a lowering of the screening threshold will automatically lead to more notifications of impending acquisitions and therefore more screenings. In this way, the German government intends to ensure that it can intervene in sensitive transactions at an earlier stage than it does now. This will mainly affect foreign investors wishing to invest in critical infrastructure or security-relevant companies. Other investors, who invest in the broad spectrum of German companies outside of these categories, will not be affected by the investment screening provisions any more than they are now. This is because the general screening threshold, as it is known, will remain at 25 %, which sends out a strong message that direct investments in Germany from foreign investors are still welcome going forward. Following the cabinet's decision, Germany's economy minister, Peter Altmaier, stressed: "Companies like to invest in Germany and it should stay that way."

BVK Critical of the Tougher Stance

As an advocate of German venture capital and private equity firms and those investing in Germany, the German Private Equity and Venture Capital Association (BVK) is critical of the proposals to amend the German Foreign Trade Ordinance (Außenwirtschaftsverordnung). The regulation, which has now been passed, increases the number of barriers to investment and negatively affects transaction security and the speed of acquisition processes. Plus, let us not forget that the German legislature already tightened investment controls back in 2017. A 10 % threshold is therefore especially unnecessary because there is no way that a share of 10 % could influence company management decisions as a blocking minority. This would only be possible with 25 % or more of a company's voting rights. However, political decisions are not made for purely financial reasons; they are also made to safeguard essential national interests. We hope that a balance can be achieved on a sustained basis between more controls and the preservation of an attractive environment for foreign investors who wish to invest in Germany as a centre of commerce and industry. The topic of investment screening will continue to be relevant for foreign investors. Germany, France and Italy have proposed a European initiative to Brussels suggesting that state-funded direct investments be screened and blocked at the level of EU law in the future.

From Valued Trading Partner to Demanding Competitor?

All of this must be viewed in the broader context of the complex economic relations between China and Germany. The debate is not limited to the subject of Chinese direct investment. It is a fact that China has become an economic powerhouse and can no longer be referred to as the "workbench" of western industrial nations. Ambitious initiatives such as "Made in China 2025" and "One Belt, One Road" have gained a lot of attention in Germany. Although German companies were able to raise or maintain their export rates, unlike other industrial nations, after the global financial and economic crisis at the end of the last decade thanks to the country's prudent reform and crisis policies, the perceived competitive pressure from the Far East is currently rising. German entrepreneurs feel that Chinese rivals are muscling in on global markets with powerful technology and services. At the same time, there is an increasing perception of systemic competition, as the Federation of German Industries (BDI) recently named it in its call for a comprehensive China strategy from the European Union. Germany, like many other western industrial nations, has a liberal and open market economy that makes social needs a priority. China's economy, in contrast, is more heavily controlled by the state. This means the Chinese state is not just a regulator, it actively shapes the market and creates the conditions for strong economic growth. Platform companies, such as Alibaba, Tencent and Baidu, were able to grow rapidly and become global

champions in this environment and are now known to more than just the German venture capital industry. This competitive environment can also stimulate German companies to boost the level of investment they make in their own products and services, which enjoy a good reputation around the world. More demands than ever before are being placed on the German government to provide German companies and their financial backers with the right economic and fiscal framework to ensure that Germany retains its capacity for innovation and is technologically and therefore economically successful in future areas such as artificial intelligence and electromobility. At least the German government is now at last trying to introduce a tax-based research and development subsidy in Germany.

Above all, China represents an opportunity for Germany. Germany continues to be the most important trading partner in Europe, and in 2015 alone, the amount of German direct investments in Asia's largest national economy was almost EUR 70 billion. China is still very much valued as a production location, supplier and sales market. Nevertheless, trading is not always easy for German companies in China. Complaints are often made about the numerous restrictions and discriminations compared with Chinese companies, and there is no reciprocity in areas such as the financial sector. There is a consensus in Germany and the European Union that this disparity should continue to be dismantled and that fair competitive conditions could substantially improve the quality of the bilateral economic relations for both sides.

China and the German Private Equity Sector

Chinese investors play an increasingly important role in the German private equity industry, primarily on the side of the buyer. According to an analysis by BVK, a total of 27 companies have been sold to Chinese buyers since 2011. Only two of the acquired companies were financed by venture capital and most exits involved SMEs. During this period, 2016 has been the year with the highest number of exits to date (eight). It can be more than just sensible for both private equity firms and financed companies to involve a Chinese investor, for example, to tap into the huge consumer and sales market in China and use it as a basis for further expansion into Asia.

Chinese investors do not often get involved in deals, although some investments such as the engagement of a Chinese investor group in the Munich-based machinery manufacturer, KraussMaffei, did receive a lot of press attention. According to publicly available information, the German private equity sector recorded a total of eight deals involving Chinese investment in the last three years, including in the venture capital segment. This is how Tencent, along with German and other foreign investors, invested in fintech bank N26. Recently, the Berlin-based start-up company GoEuro was able to obtain a new round of financing of USD 150 million from various investors including the Chinese private equity firm, Hillhouse Capital. These investments do not result in any reservations in the German private equity industry. On the contrary: Chinese investment management firms are valued sparring partners if their own portfolio companies are to grow in

Recent China-backed Private Equity/Venture Capital Deals in Germany

Year	Private equity and venture capital firm or other investors	Company	Industry sector	Deal segment
2017	China Renaissance Capital Investment (CRCI), Zhengzhou Coal Mining Machinery (ZMJ)	Bosch Robert Starter Motors Generators	Automotive	Buyout
2016	AGIC Capital, China National Chemical, Guoxin International Investment Corp.	KraussMaffei Group GmbH	Machine engineering	Buyout
2016	Hillhouse Capital Group (China)	Gimborn Holding GmbH	Consumer goods / Pet food	Buyout
2018	Beautiful Mind Capital (China)	Cordenka-Gruppe	Industrial goods / Textiles	Buyout
2017	Atomico, Obvious Ventures, Tencent Holdings (China), LGT	Lilium GmbH	Mobility / Aviation	Venture Capital
2018	Allianz X, Tencent Holdings (China), Greyhound Capital	N26 GmbH (ehem. Number26)	Fintech / Bank	Venture Capital
2018	Hillhouse Capital Group (China) / Temasek (Singapore) / Kinnevik AB (Sweden)	GoEuro Corp.	Mobility / Search Tech	Venture Capital
2019	Insight Venture Partners, GIC, Earlybird Venture Capital, Allianz X, Tencent Holdings (China), Greyhound Capital	N26 GmbH (ehem. Number26)	Fintech / Bank	Venture Capital

Source: BVK research 2019 (press releases and publicly accessible information)

Asia. Market access, which can be complicated at times, and the disadvantages to venture capital- or private equity-backed companies are viewed more critically if these firms are planning a growth strategy in China.

The debate over the role of Chinese direct investments in some areas of the German economy and the recently adopted amendments to the German Foreign Trade Ordinance (Außenwirtschaftsverordnung) should not deter foreign investors from working closely with Germany. Confidence must be built. The German private equity sector offers Chinese investors an opportunity to do just that and can help to build bridges. This is particularly successful if Chinese investors – like other foreign investors – cooperate with German private equity managers and are present with an office in the German market, for example. In addition, Chinese institutional and professional private investors can invest in German private equity funds. In this way, they participate in the returns of technologically strong German companies while at the same time developing German entrepreneurship in cooperation with local private equity and venture capital firms. Ultimately, this has a positive effect on entrepreneurs and employees alike throughout Germany.

BVK

The German Private Equity and Venture Capital Association (BVK) is the Berlin-based association of private equity and venture capital firms across all market segments (seed capital, venture capital, growth, small/mid/large buyouts) operating in Germany. Founded in 1989, BVK has more than 200 investing members (Limited and General Partners) and provides access to more than 1,600 professionals operating in the German-speaking private equity landscape. More information at www.bvkap.de

Japan: a Safe Harbor in a Volatile Time?

Interview with Mark Chiba, The Longreach Group

As the winds of the China-US trade war continue to blow, Japan may offer investors the best opportunity

In April last year, as the US and China sparred over trade and the US prepared to slap tariffs on Chinese products, the smart money in Asia was on the world's third largest economy, Japan. A direct impact wasn't yet expected, and most industry gurus were pointing to the opportunities that the trade war might present to Japan's economy, rather than any potential adversity.

Almost a year later, however, and there is some disquiet. Japan is a supply chain superpower and a major exporter to both the US and China, deeply entwined in complex global supply chains. Economic data and the yen are beginning to show the strain. The yen, the best performer among its group of 10 peers last year, has begun to lose its appeal as risk appetite returns. Recent reports on machinery export orders and vehicle sales have come in on the downside.

So, is the trade war an opportunity for Japan, or is it going to cause a sustained economic downturn? Mark Chiba, Group Chairman and Partner of private equity firm The Longreach Group, based in Tokyo and Hong Kong, says that Japan should look at the opportunities:

"Japan potentially can position in a US-China trade war in a smart way. It can be a bit of a safe harbor in that China will want Japan on-side, and so Japanese companies with good products, good technology, consumer or industrial, have an opportunity in China and, more broadly, South-East Asia."

"Ultimately, the trade war as a tariff war will be settled. The bigger issue – and opportunity for Japan - is intellectual property. China is going to find it much harder to source intellectual property acquisitions in the US and Europe, and that could spell opportunity for Japanese companies looking for buyers in China – though I suspect Japan will also be careful with its technology. It is already relatively fully integrated into the US defense and aerospace technology systems. But in areas of non-defense industrial technology, software, gaming and other non-controversial technology areas, China will continue to be an acquirer."

According to Chiba, there are mid-market deals, consumer and industrial businesses that are not regulated, including more high-end manufacturing such as precision instruments. As an example, Chiba cites one of its companies that is a bridal jewelry business retailing wedding and engagement rings. It has successfully expanded from Japan to China, which now accounts for about 30% of total sales.

"That's a consumer-facing business where middle-class Chinese couples want to have a Western-styled wedding and are adopting diamond jewelry. The product is stylish, trustworthy, with elegant Japanese design, and it's pitched to that middle-class target area. Another example is a coffee business that we bought last year and that is attracting strong growth from Chinese and Asian tourists in Japan. We could also potentially expand this business into mainland China."

"We stay away from very regulated assets or high-profile assets but buying companies that we can expand into China is part of our strategy. What we try and do is simple: we try and buy

under-managed businesses at a reasonable valuation and bring in strong management and value creation, which releases efficiencies to make them more profitable. We then redirect them strategically to growth. That growth could be global but very often it's focused in Asia, and often in China."

Chiba says Longreach looks at Japan as a risk-managed way to approach China. "If we buy a company in Japan with a US-style controlled buyout, we have control. We pay a reasonable valuation, we have our own management team, we have full exit freedom, we have no regulatory problems and no capital repatriation issues. But we can get that company to expand into China, into Asia, so we get growth exposure but off a Japan platform, which can be a good proxy play."

The Success of Abenomics

Part of Japan's success in the past five years, and the rise of its private equity industry, has been so-called Abenomics, the economic model implemented by Prime Minister Shinzo Abe. According to Chiba, what Abenomics has done is put an end to persistent deflation, through its policy mix and by increasing confidence in investment as well as encouraging trade flows and in-bound tourism.

"If you walk around Tokyo or any major Japanese city, even a tourist destination like Hokkaido, it is busier than before and there's an affluent middle-class Asian tourist boom. And then, when we talk to Japanese companies, unlike five years ago, they are actively divesting non-core businesses and looking for growth, particularly in Asia. They might be narrowing their business lines, but they are going more global: they are looking for growth.

"This is due both to a psychological change as well as a change in the monetary and fiscal policy environment. Basically, Japan is now a stable investment environment, there's more confidence. Growth is low but politically it's stable and wealth is well distributed. If you compare it to the problems in the US or in Europe, Japan is nicely boring. It's a stable platform for investment."

That's not to say that Japan has no economic woes. The government needs to build the revenue base to address a budget deficit and there will be an increase in the consumption - sales – tax rate from the current 8% to 10% in October 2019. Chiba agrees that an increase in more indirect tax would help address the deficit. But he points out that Japanese households have plenty of cash to cover the domestic debt overhang, so a debt crisis is unlikely. And the 2019 tax increase is already factored into consumers' expectations.

The Challenges of Being a Foreign Firm in Japan

Longreach is an independent firm with both US dollar and yen funds. About 60% of its capital

comes in dollars and the remainder in yen. Among its investors in Japan are the major pension fund, the largest banks, life insurance companies, and funds of funds. It has strong sovereign wealth fund capital from Asia and elite founds and endowment investor capital from the US. Chiba says Longreach is identified in Japan as an independent local firm but with distinctive cross-border execution capabilities and networks.

"As for foreign private equity firms in Japan, they are very active in the big caps space: Japan has almost become a must-do market for big cap funds and buyouts. I think that in the mid cap space - average cheque size of about US$100 million – it's a mix of domestic firms and foreign players with local teams, plus a very few firms that are independent but also cross-border, doing deals that take Japanese companies into Asia."

Which brings us back to the trade war conversation and where opportunities lie. "Protectionism is basically a disaster," Chiba says. "Look at Australia. It was a declining economy in turmoil, with high budget deficits, until it unilaterally threw off protectionism and embraced free trade in the 1980s. Globalization has created enormous wealth - the clear problem is it's not equally distributed. It's the people who have been hurt by globalization who are fighting back. Inequality has created a backlash that is understandable but risks making everybody poorer."

"I am still hopeful that we will work through it and that there might be a more centrist, more balanced political approach as people see that populism, protectionism are an economic disaster. If it continues, everybody will be a loser, but I'm hopeful that we are past the worst of it. I think China will soften its behaviour and be less aggressive in its IT theft and trade policies. Now that they are the owners of significant intellectual property themselves, they have a vested interest in the system. If you look back at history, all rising powers essentially at first took technology from the previous great powers and then moved forward with a new level of indigenous innovation. China is just doing what other rising powers have done."

Mark Chiba, The Longreach Group

Mark Chiba is Group Chairman and Partner of The Longreach Group and is based in Hong Kong. He is responsible for senior relationship-driven deal sourcing across Longreach's sector and geographic focus, with a special focus on financial services sector investments, and on building the firm's general partner capabilities, capital base and global networks. As Group Chairman and Partner, Mark has had senior origination and execution roles in various investments, including the acquisition of 25% of McDonald's Holdings Company (Japan), Ltd, the management buyout of CYBIRD, the control investment in EnTie Commercial Bank, and the control buyout investments of Primo Japan and Wendy's First Kitchen. Mark also serves on investee company boards and works closely with Longreach's investment professionals and company management teams across the portfolio to help drive value creation and exits.

Managing Cross-Border Investments Amid Trade Tension

Interview with Shengyan Fan and John Chan, China Everbright

CEL Global Investment Fund, a USD 539 million fund, is led by Shengyan Fan and John Chan, both managing directors of China Everbright Limited (stockcode: 165HK) mergers and acquisitions department, which has overseen the group's outbound investment business since 2013. It was at the behest of Fan and Chan that Everbright first decided to establish a standalone private equity fund for investing in advanced manufacturing and high-tech companies, and they have now managed these cross-border investments since 2016.

In addition to the CEL Global Investment Fund, their team also manages the CEL Catalyst China Israel Fund, a dedicated private equity fund aimed at investing in innovative Israeli companies with a global expansion strategy, particularly for ventures looking to expand into China. They concurred that obstacles are encountered by cross-border investment platforms due to tariff issues.

Dealing with Tariff Issues

Tariffs have become a major battlefield in the US-China trade war. Most Chinese and US products have been touched by the issue and the impact on exports has been predictable. While Fan agrees that new tariffs have had a knock-on effect for both Chinese and US companies, she is grateful their existing portfolio does not include companies involved in sensitive industries nor products hit by the new tariffs. Moreover, the manufacturing plants owned by the funds are located in both Europe and the US, which means they can allocate exports taking into account the location of the clients.

Chan emphasized that supply chain architecture is vital in managing the fund's portfolio. Private equity firms have to lead existing investors in mobilizing resources to deal with risk. There is a comparative advantage when investors manage several plants in different countries, because should political issues arise, those companies can shift their production line from, for example, the US to Europe, or vice versa. This flexibility offers a degree of stability in the supply chain, so the portfolio is able to maintain revenue despite trade tensions. Managing such policy change is fundamental to portfolio management, Chan noted, and structural diversification acts as an effective solution to tackle the issue.

The fund's portfolio companies also diversify their research and development across various countries. They work with investors in designing a structure that helps manage tariff issues.

While some degree of resilience is required to manage the risk in changing national policies or disputes between countries, diversification itself does also happen quite naturally, and so in many ways investors may be unable to prevent it.

Both Fan and Chan believe that tariffs must also be dealt with proactively and that fund managers must deal effectively with the various regulators as well as different government agencies. Every country has its own rules with respect to acquisitions and sensitive industries. As sophisticated investors, private equity firms need to follow the law and handle regulations wisely. For instance, some jurisdictions require foreign investors to be transparent and file particular

documentation for investments in some sectors, such as intellectual property related to high-tech and data intelligence. Indeed, some countries even block such acquisitions.

Fan suggested that a private equity fund manager has to maintain a good relationship with the regulatory authorities. Indeed, the alignment of their portfolio companies and value creation are their stated goals and therefore, failure to cooperate with the governmental authorities would jeopardize their acquired companies and threaten the value creation.

The third component of the risk management strategy is experience. A professional fund manager usually begin looking for investment opportunities well ahead of fundraising. An experienced investor continuously build its pipeline and always manages to create valuable relationships with the market participants beyond the life cycles of its various funds. Market knowledge and experience also help to recognize market momentum and the best time for exits.

Moreover, analyzing the various markets and evaluating the market segments are necessary. Cross-border investment professionals have developed considerable experience dealing with high-tech and advanced technologies that require complicated deal diligence and an acute awareness of economic cycles. This creates a comparative advantage when responding to market change.

Finally, Fan and Chan are quick to highlight the importance of identifying economic cycles at both the macro and micro level, within companies and within industries. Private equity firms have to be aware of the market sentiment as well as the economic environment in order to pursue fundraising, investment and liquidity. In addition to GDP numbers, price indexes and currency rates, a prudent manager also tracks PMI data, which is a key indicator for the manufacturing industry and a useful benchmark for measuring economies across countries.

At the micro-level, private equity investors must regularly review their portfolios. Chan stated that industry peers have to study market data related to industrial demand and other market insights in order to be on top of industrial cycles. In addition, team members should keep an eye out for the latest innovations and the potential for disruptive technologies that may allow them to add more value to their supply chain. Of course, such data is also useful for recognizing market trends and designing longer term investment strategies.

Divestment Issues

Protectionism seems to be growing around the world with some countries implementing rules and/or policies prohibiting foreign inbound investment, in particular from China. The United States, Germany and other European countries have grown leery of foreign acquisition or interest in domestic high-tech companies. Private equity and venture capital activities are obviously being impacted, creating obstacles to liquidity in portfolios focused on US and European companies.

Some projects may get the green light from local governments to divest to other Chinese investors, but these investors may lack the knowledge and be unfamiliar with the potential of some of these companies. They may underestimate the enterprise values as well as the intrinsic values of the investees due to inexperience in the target industry.

In addition, some investors have a very specific strategy in terms of acquisitions. For instance, some Chinese investors use outbound investment as a channel for global expansion of the entire group. The company owners or other significant shareholders are reluctant to sell their assets to them, because these investors may not be able to help with the companies' development.

Key to Tackling the Issues

The current tensions between the US and China have created chaos and difficulties for private equity investors and their portfolio companies. However, astute investors may be able to gain a comparative advantage or avoid the dispute entirely if they are able to diversify their supply chains and are adequately equipped with the right industrial knowledge and experience.

Shengyan Fan, China Everbright

Ms. Fan Shengyan is responsible for CEL's private equity investment funds that invest in overseas market. Ms. Fan has 18 years' experience in direct investment, capital raising and investment banking serving corporate clients in Greater China region as well as multinationals.

John Chan, China Everbright

Mr. Chan is responsible for developing the principal investment portfolio and strategic initiatives for CEL. Mr. Chan is also Managing Partner of CEL Catalyst China Israel Fund and serves on the Investment Committee and Board of Directors of the General Partner. Mr. Chan has 18 years of experience working with regional and international financial institutions and investment banks.

US-China Trade War: Likely Impacts on the Private Equity Industry

Richard Martin, IMA Asia and Ivan Cheah, Centric Advisors

The US-China trade war is creating turmoil for trans-Pacific supply chains, running from manufacturers in China (including US owned) to retailers in the US. But with turmoil also comes opportunity for some.

One of the opportunities may be buying assets in China. You could say that this is apparent at the headline level, as one of President Trump's goals is to force China to ease restrictions on foreign investment. China has been moving in that direction for over a year, with foreign companies ranging from BASF to UBS announcing major deals based on 100% or majority foreign ownership in 2018.

Yet, who does well in a period of turmoil often depends on a broader reading of the environment, as there's always more than one trend playing out, and it's the interplay – often in unexpected ways – between two or more trends that creates opportunities.

One of the local trends playing out in China today is a rapid escalation in financial stress, particularly for private sector firms, which have always had to scramble for finance. While that opportunity is driven by local issues, companies who might buy assets from these firms will need to keep an eye on the trade war, as the direction that it takes in 2019 will determine the value of some businesses in China.

Last November, IMA Asia examined the interplay between these trends in debates in Shanghai, Hong Kong and Singapore with members of the China and Asia CEO Forums. The debates brought together around 100 CEOs for Western MNCs with substantial operations in China. Ivan Cheah of Centric Advisers also joined one of our Shanghai debates to help us explore one of the local trends playing out in China, the pledge share debacle.

The trade war outlook

We expect the current US-China trade dispute to lead to a deal, with enough agreed by March 1, 2019 to avoid an escalation. While their public comments and negotiating tactics naturally don't reveal it, both sides are certain to be aware of the damage that would be done to their economies by escalation.

Applying a 25% tariff to some US$250bn in annual exports from China to the US (about half of the total) would swing China into sharp deflation, which would undermine profits and make debt management – a key challenge for China - difficult. In the US, it would trigger a jump in producer price inflation, which would push the US Fed to more rate hikes than otherwise, and that would undercut US growth in 2019.

Moreover, the political/policy alignment is better than it might seem. While President Trump has talked about trade issues for decades, he is first and foremost a deal maker. We expect him to step away from the ideological warriors in his team to back negotiators like Treasury Secretary Mnuchin. On China's side, the US demands for better intellectual property (IP) protection and more openings for foreign investors are, at the end of the day, going to help China in its next phase of growth. So, there's scope for a deal.

If this scenario plays out, it removes one of the big risks in China's outlook. China's

rising global engagement is central to the next phase of its growth. Take that away with a trade war escalation and the long-term growth opportunity in China takes a big hit. Leave it on track and it's worth looking at China assets.

China is Hurting as 2018 Closes

A second trend apparent in China in 2018 is weaker growth. The main cause is an overshoot in the massive reform programs launched by President Xi Jinping. Reform almost always has a short-term cost to growth, yet the severity of the 2018 downturn appears to have been unexpected by Beijing. After remarkable success in reflating China's growth in 2017 (pushing current GDP growth to 11.2% from 7.9% in 2016), Beijing felt it could deliver similar growth in 2018. Yet by Q3'18, it was clear that both real and current growth were cratering. Sales of cars (-11%yoy for the July-Nov 2018) and cement (-8.6%yoy in Q3'18), two classic volume or real measures of growth, were the weakest on record, while nominal growth in fixed asset investment also hit a record low in August before edging up to 5.9% yoy for the year-to-date measure.

Linked to the slump in growth was a collapse in China's stock markets, with the Shanghai Composite down 16% by end-September (and by 23% by 14th December). The fall has been bigger than in most other emerging markets, which have also struggled with capital outflows following an end to global quantitative easing. The stock markets fall in China saw the PE ratio for A shares drop from 18.2 in December 2017 to 13.0 in November 2018, while B shares saw a halving in their PE ratio from 22.5 to 10.9. That suggests a buying opportunity while also limiting the capacity of local buyers to tap the stock market for funds to drive their own acquisition strategies.

Yet the opportunity is bigger than implied by a sharp fall in PE ratios. To understand why, one needs to focus on the pledged share debacle.

China's Pledge Share Debacle

Every entrepreneur in China wants to be the next Jack Ma. The goal is stratospheric growth and that requires stratospheric funding. Against the odds, that is possible in China, which is one of the ways in which China differs from other emerging markets. Yet it is a high-risk scramble, with rules bent and common sense ignored, at least by the risk-adverse standards of Western markets.

Pledged shares as an avenue for funding sprang into prominence in 2015, with some 8,000 loans made to owners of listed firms, almost double the number of 2014. In some cases, loans were made to 100% of the value of the pledged stock. Beijing applied a series of curbs to such high-risk loans in 2017, yet by the end of that year trouble was on the horizon.

Trouble hit in 2018 as the stock market fell and financial institutions that had lent against pledged stock started to unload the stock to limit their losses. At this point, the future of China's listed private sector firms was on the line. Out of a universe of more than 3,700 stocks, more than 3,000 experienced a one-day limit-

down drop. More than 900 went limit-down for two days in a row, while 400 were limit-down three days in a row, and 129 were limit down four days in a row.

The scale of the risk to the stock market was considerable. By mid-2018, Bloomberg reported that Rmb4.2 trillion (US$613bn) in stock was pledged against loans, about 11% of the total market capitalisation.

What Happens Next?

By October, Beijing had slowed the collapse by instructing state-owned financial institutions to halt their sale of pledged stock. However, there's no resolution plan on the table yet. The government has proposed debt for equity swaps, but few such deals have taken place. A lender is always going to be in a preferred position to an equity owner in times of crisis, so there is little incentive to undertake an equity swap. Tax leniency has been suggested to local governments. This may help somewhat, but really doesn't cut to the essence of the problem, the distress of major shareholders.

Analysis on the 600 most pledged stocks by Ivan Cheah's team shows that three quarters are pledged over the amount of the largest shareholder's stake, which is a strong indication that the shareholder has probably pledged most of his shares. The average stock has 47% of its shares pledged as collateral.

This crisis extends to nearly every single industry category, from advertising to wholesale distributors, and nearly everything in between. The largest affected sector by market cap is real estate, perennially over levered at the company level and at the shareholder level. The chemical sector is another highly pledged group. Companies in most categories are over pledged, again, meaning more shares are pledged than are owned by their controlling shareholders, which suggests that the controlling shareholder has pledged his entire stake.

Some of the names are quite recognizable. Lots of auto parts companies, environmental, chemical, and consumer products companies. China Oceanwide, for example, which owns the US insurance company Genworth Financial. Jifeng Interior which owns the German company Grammar. Teamsun which owns the US software company Grid Dynamics. There's even a luxury travel operator, Abercrombie & Kent, owned by Zhonghong Stocks.

Will anyone come to the rescue? Private equity is one possibility. According to Preqin, which tracks private equity capital flows, there is approximately US$246bn of so-called "dry powder" in Asia-focused funds. But much of this is earmarked for venture capital, and not all of it is allocated specifically to China.

SOEs are another likely place where privately-held companies or some of their prized assets might end up. SOEs are in a better position to take care of company liabilities and employees. Tencent and Alibaba might also be an option for any tech-related firms, as these two giants have tens of billions of dollars ready to make investments.

Finally, there are the global multinationals, many of which have struggled for years to gain market share in China. It is quite possible and likely that deals can be struck between Chinese pledged-share companies and these global multinationals. Not only can multinationals provide cash and management expertise, they can also provide access to global markets and supply chains.

Richard Martin, IMA Asia

Richard Martin has helped companies assess Asian markets for 38 years. He is the founder of the Asia and China CEO Forums, which form the largest peer group network for Asia CEOs. He is also the editor of the Asia Pacific Executive Brief and the Asia Forecast Book. He started work in in Hong Kong with Business International in 1981.

How Geopolitical Pressures are Driving Tax Policy Changes that Impact the Fund Industry in Hong Kong

Malcolm Prebble, KPMG

Over recent years, geopolitical pressures have had a growing impact on global tax policy as developed nations look to protect their tax base. Recently, there have been two new developments which are likely to have a significant impact on the Hong Kong funds industry. Both developments are driven by European Union (EU) concerns around profit shifting and harmful tax practices and have resulted in new legislation being introduced by the governments of the Hong Kong S.A.R., the British Virgin Islands (BVI) and the Cayman Islands. The examples are:

– The introduction of the new comprehensive Hong Kong funds tax exemption; and
– The introduction of new economic substance requirements in the BVI and the Cayman Islands.

The first instance is a good example of the Hong Kong government using new legislation to not only address EU concerns over the fairness of existing tax exemptions available in Hong Kong, but at the same time make positive changes that should help to promote the asset management industry in Hong Kong. In contrast, the changes introduced by the BVI and the Cayman Islands have created a degree of uncertainty for both the fund organisations themselves and the Hong Kong corporates which have for many years used Cayman Island and BVI entities in their funds or corporate group structures.

Hong Kong's new funds tax exemption

The Hong Kong government introduced draft legislation in December 2018 containing a new comprehensive tax exemption for funds. The new exemption represents a significant step forward and should contribute to the Government's long stated objective of further developing the asset and wealth management industries in Hong Kong.

The legislation seeks to address some of the concerns raised by the EU Council in relation to Hong Kong's existing offshore funds exemption. The draft legislation addresses the ring-fencing features of the Hong Kong tax regime for privately offered offshore funds and enhances the competitiveness of our tax regime by creating a level playing field for all funds operating in Hong Kong.

Under the draft legislation, all funds operating in Hong Kong, regardless of their structure, location of central management and control, or size, can enjoy the profits tax exemption for their transactions in specified assets subject to meeting certain conditions. A fund can enjoy the funds tax exemption for its investment in both overseas and local private companies. This significantly reduces the current tax uncertainty faced by PE funds. This represents another step taken by the Hong Kong Government to counter the Base Erosion Profit Shifting measures while ensuring that Hong Kong remains competitive as a funds

management centre regionally and globally.

A notable and very significant change is the removal of tainting provisions that have applied to the previous iterations of the fund exemptions. This means that if a fund now has a particular portfolio investment that does not satisfy the qualifying conditions, it will no longer preclude the fund from relying on the exemption for all other investments. This is a big step forward and should allow fund organisations to bring more of their key investment management activities onshore without running the risk of not being able to rely on the exemption for all investments as a result of inadvertently making one non-qualifying investment.

Another key feature of the exemption is to combine separate exemptions for non-resident persons (including offshore funds) and an exemption for open-ended fund companies (OFCs) incorporated in Hong Kong. The existing non-resident person's exemption remains in place for persons other than funds. This is a welcome development as there was a real concern about the impact on the wider wealth management industry from a proposed repeal of this exemption. The new legislation repeals the OFC profits tax exemption in full and incorporates OFCs into the new comprehensive private fund tax exemption. In doing so, the onerous qualifying conditions for the OFC tax exemption have fallen away which is a positive move. However, in practice, regulatory aspects may still continue to limit the use of OFCs.

A further welcomed move is that the initial proposal to codify the taxation (or at least partial taxation) in Hong Kong of carried interest has not been included in the draft legislation due to significant lobbying from the PE industry.

The new exemptions are quite broad and apply to both resident and non-resident funds, transactions undertaken by SPEs established by those funds, and most types of investments typically contemplated by PE or other forms of alternative funds. However, there are typical limitations where, for example, the underlying investments are in Hong Kong property. In addition, there are some limitations for investments in businesses with significant trading assets unless these investments are held for at least two years.

The wide range of potential funds that could seek to rely on the exemption is certainly a positive move and an improvement on the status quo. The specific inclusion of Sovereign Wealth Funds within the 'fund' definition is a good example of this as is the potential ability for pension funds and other forms of single investor funds like Family Offices to rely on the exemption.

The broad nature of the new exemption will provide opportunities for funds with operations in Hong Kong to simplify their current operating protocols and undertake more investment related activities in Hong Kong. This is a positive step and is something that the fund industry has been seeking for some time. It should also make it easier for funds looking to establish new operations in Hong Kong. This could also bring potential opportunities for funds to invest in new asset classes in Hong Kong (such as infrastructure assets) without the risk of additional tax on the investment returns received by the fund.

We believe that the proposed legislative changes can provide a significant boost to the funds industry in Hong Kong and help to put it on a level playing field with other leading fund centres in terms of the quality of tax exemptions provided to funds. However, there are still some remaining issues that the Hong Kong government should address so that funds can obtain sufficient comfort and certainty to rely on the new exemption.

Cayman Islands and BVI Economic Substance Requirements

In response to the EU Code of Conduct Group which assessed the tax policies in a number of jurisdictions, both the BVI and Cayman Islands have introduced new legislation imposing economic substance requirements on certain entities established in each jurisdiction. This is as a result of both countries being included in a list of jurisdictions by the Codie of Conduct Group that needed to address concerns about economic substance.

In each jurisdiction, the new legislation imposes an economic substance test on banking, insurance, fund management and shipping companies, as well as on entities functioning as headquarters or distribution and service centers, and businesses engaged in financing and leasing or holding intellectual property.

Under the new Cayman legislation, companies active in the relevant fields will pass the economic substance test if they conduct core income-generating activities in the Cayman; incur an adequate amount of operating expenditure; have a physical presence locally; and have an adequate number of full-time staff locally.

The relevant entities are required to make an annual declaration with the Tax Authority as to confirm if they have conducted any relevant activities in the preceding financial period.

As the new legislation has been introduced without guidance (this is expected to be issued in March or soon afterwards), there is some uncertainty amongst practitioners as to the practical impact on fund structures.

As many readers will be aware, Cayman Islands limited partnerships are the fund vehicle of choice for many Asia focused funds. In addition, Cayman Island companies are frequently used for the General partner and fund manager of a Cayman Island fund while Cayman Island and BVI companies are commonly used by a fund to hold investments made by the fund. In most instances, the fund organisations have little or no substance in either the Cayman Islands or the BVI.

Importantly, the new legislation contains an exemption for investment funds established in the Cayman Islands, as well as Cayman Island SPVs used by a fund to hold investments. In addition, many fund managers should not be subject to the economic substance requirements based on the current drafting of the legislation. However, we understand that following discussions with the EU, some amendments may be made to the legislation and the pending guidance could also have an impact on how the new legislation should be interpreted. As such, this is an aspect that should be monitored by fund organisations over the forthcoming months to determine whether any changes should be made to existing fund / fund management structures.

It should also be noted that the changes could potentially have a greater impact on Hong Kong corporate group structures which commonly utilise both Cayman Island and BVI companies to act as group holding companies or to carry on an operating business in Hong Kong.

Conclusion

It is clear that geopolitical pressures and volatility have and will continue to shape future tax policies regionally and globally. It is important that companies continue to monitor the changes in tax policies that may affect their fund structures and operating models and be flexible to adapt to these changes.

The introduction of the new Hong Kong funds tax exemption and the BVI and Cayman Islands economic substance requirements are examples of how governments are responding to and managing geopolitical risks. This is a trend that will likely continue in the near future.

Malcolm Prebble, KPMG

Malcolm has extensive experience in advising on regional merger and acquisitions projects including a number of tax due diligence and structuring projects for acquisitions by fund organizations and other professional investors.

Malcolm has also assisted a number of organizations with the establishment of new funds focused on investments in the Asia Pacific region, or reviewing existing fund structures to recommend improvements to mitigate tax risks for the fund, sponsors and/or carried interest participants.

“Innovated, Designed and Made in Hong Kong” as a Strategy

Interview with Dr. HL Yiu, Head of Advanced Manufacturing, Hong Kong Science & Technology Parks Corporation

With the United States imposing tariffs on 6,000 Chinese imports since July 2018, there has been a more accelerated trend of companies diversifying away from sole dependence on China as the manufacturing base. HKVCA spoke to Dr. HL Yiu, Head of Advanced Manufacturing at Hong Kong Science & Technology Parks Corporation (HKSTP) to understand the real-world dynamics of manufacturing migration from Mainland China, and the opportunities it holds for Hong Kong from the perspective of private equity investment.

Dr. Yiu’s main role is leading HKSTP to build an advanced manufacturing hub in Hong Kong and attract advanced manufacturers worldwide to establish presence at industrial estates. According to Dr. Yiu, manufacturers have been contemplating restructure of their China operations for some time. “There is a phenomenon whereby end-customers have required their manufacturing partners to restructure their supply chains to mitigate risks since the last couple of years. It is not simply for the reason of tariffs.” Cambodia, Vietnam and Myanmar have been consistently the top three destinations for manufacturers wanting to move their China production according to surveys done by the Standard Chartered Research in 2016 and 2017. The monthly manufacturing wages in these target locations are not only cheaper than China but the respective government policies are also more appealing. Vietnam, Indonesia and Cambodia provided some incentives for the foreign direct investments. For instance, Vietnam implemented tax exemption for high tech and labor-intensive industries or projects for the first four years and a 50% deduction on tax for four to nine subsequent years.

With the introduction of US tariffs on Chinese imports, manufacturers are even more tempted to swiftly migrate at least part of their production lines away from China, not least as a way for tariff mitigation. If the manufacturer moves sufficient production processes out to a new jurisdiction that would make the finished goods being shipped to the US qualified to have a different industry code from the semi-finished goods shipped from Mainland China, such finished goods would then qualify to have the new jurisdiction as their origin of production and be exempted from the US tariff.

The HKSAR is treated as a separate jurisdiction by the US with respect to the China tariff issue. However, while the China-US trade war is a catalyst, Dr. Yiu sees that some China-based manufacturers are considering to move to Hong Kong and most of them are driven by more than labor cost considerations. He cited a Hong Kong Productivity Council (HKPC) report that as early as 2016, there were over 25% of the Hong Kong founded China-based manufacturers considering to move portions of their operations back to Hong Kong. Dr. Yiu noted that Hong Kong cannot compete on wages and rentals for traditional factory set-up, but Hong Kong has its advantages to

attract high-tech advanced manufacturers. He thinks that Hong Kong has several advantages, namely intellectual property (IP) protection, logistics, and more recently, R&D commercialization through collaboration between companies and local universities. Dr. Yiu believes that there are strong enough precedents like DJI and Sensetime (which were founded and nurtured by Hong Kong-based professors), to convince commercial enterprises that can be effective to develop strong relationships with local universities and move certain key research activities to Hong Kong. He particularly sees China-based technology-driven manufacturing companies founded by Hong Kong entrepreneurs becoming more ready and eager to move back to Hong Kong amid the current China-US tariff shake-out. With smart manufacturing technologies, Dr. Yiu is optimistic that just a few of these "returning" enterprises with advanced technology will be impactful enough to kickstart the technology manufacturing landscape in Hong Kong.

Government Measures

The Hong Kong Government has announced an allocation of HK$2 billion for launching a "Re-Industrialization Funding Scheme" to subsidize manufacturers, on a matching basis, to set up smart production lines in Hong Kong. The aim of the scheme is to encourage the industries to engage in high-end production by capitalizing on innovation and technology (I&T), as well as the application of smart technologies in production processes. Dr. Yiu believes that such scheme will have a positive impact for encouraging some manufacturing companies to move across the border.

HKSTP plans to develop specialised multi-storey industrial buildings for rental to multiple users in the Tai Po Industrial Estate and the Tseung Kwan O Industrial Estate in order to facilitate the operations of precision manufacturing and advanced manufacturing companies. The Precision Manufacturing Centre (PMC) is currently fully occupied, and it is a manufacturing base for companies to work on for product employing advanced or precision process.

The Advanced Manufacturing Centre (AMC) in Tseung Kwan O is a 1 million square feet workspace which aims to open in 2021-2022. It is a pioneer program for fostering smart production and advanced manufacturing with artificial intelligence, robotics and automated workflow in Hong Kong. The idea is to develop a multi-tenant facility to maximize the value of the property and provide high level of efficiency. With over 6 meters of ceiling height, which is perfect for installing robotics and other large-scale machinery for smart production, the initiative has proved to be hugely popular, with

an already very strong inquiry pipeline before the commencement of application.

Dr. Yiu commented: "The supply of land for manufacturing was extremely low in the past but we recognized the demand for moving the advanced manufacturing to Hong Kong. Therefore, AMC is a pilot project to ease the supply issue to meet the pent-up demand." In her 2018 Policy Address, the Chief Executive Carrie Lam has recommended deploying an additional HK$2 billion for HKSTP to seek suitable land in industrial estates for building manufacturing facilities for the advanced manufacturing sector.

Dr. Yiu cites a number of live examples of advanced manufacturing and smart production in Hong Kong. For instance, Novetex Factory has the first-ever "Garment-to-Garment" (G2G) recycled retail shop in Hong Kong. The advanced manufacturer located in the PMC provides a one-stop-shop concept for garment recycling to reuse the textiles for mixed fibers products. The technology was developed in collaboration with HKRITA (The Hong Kong Research Institute of Textiles and Apparel).

Dr. Yiu concedes that with the gradual increase of advanced manufacturing operations to be located in Hong Kong, we need to address the talent supply issue. In this respect, the HKPC actively offers upgrading smart manufacturing training courses for workers in manufacturing industry in collaboration with the Vocational Training Council. Dr. Yiu stated that it is important to enrich and equip workers or engineers with up-to-date industry-specific professional knowledge and the ability to develop multiple skills, which would be key to attract advanced manufacturing companies to set up factories here.

Dr. HL Yiu, Hong Kong Science and Technology Parks Corporation

Dr. Yiu is currently the head of advanced manufacturing of the Hong Kong Science and Technology Parks Corporation. Dr. Yiu has a wealth of technical and management experience in the field of information technology, computing, telecommunications, integrated circuit design, new product development, sales and business development. Dr. Yiu has worked in various departments of the Motorola Semiconductor Hong Kong for fifteen years. He also has experience in start-up companies.

Dr. Yiu graduated from Hong Kong Polytechnic University with Bachelor of Electronic Engineering. He has Master degrees in Electronic Engineering of The Hong Kong Polytechnic University, EMBA and MSc Finance of the Chinese University of Hong Kong. He also has Doctor of Business Administration degree of The Hong Kong Polytechnic University. He is currently a fellow of the Hong Kong Institution of Engineers (HKIE).

Hong Kong Private Equity and Venture Capital Data

HKVCA Research

By Value (US$ million)

	2010	2011	2012	2013	2014	2015	2016	2017	2018
PE Investment	$ 1,918	$ 1,668	$ 1793	$ 1,175	$ 7,546	$ 5,747	$ 3,698	$ 13,877	$ 3,678
VC + Technology Investment	$ 91	$ 98	$ 80	$ 22	$ 159	$ 433	$ 559	$ 1,262	$ 2,287

By Volume

	2010	2011	2012	2013	2014	2015	2016	2017	2018
PE Investment	25	23	21	14	20	19	20	19	17
VC + Technology Investment	8	15	15	16	41	41	29	42	42

Top Three Private Equity Transactions in 2018

Top Three Venture Capital and Technology Transactions in 2018

Appendix:
List of CFIUS Pilot Program Industries

Aircraft Manufacturing
NAICS Code: 336411

Aircraft Engine and Engine Parts Manufacturing
NAICS Code: 336412

Alumina Refining and Primary Aluminum Production
NAICS Code: 331313

Ball and Roller Bearing Manufacturing
NAICS Code: 332991

Computer Storage Device Manufacturing
NAICS Code: 334112

Electronic Computer Manufacturing
NAICS Code: 334111

Guided Missile and Space Vehicle Manufacturing
NAICS Code: 336414

Guided Missile and Space Vehicle Propulsion Unit and Propulsion Unit Parts Manufacturing
NAICS Code: 336415

Military Armored Vehicle, Tank, and Tank Component Manufacturing
NAICS Code: 336992

Nuclear Electric Power Generation
NAICS Code: 221113

Optical Instrument and Lens Manufacturing
NAICS Code: 333314

Other Basic Inorganic Chemical Manufacturing
NAICS Code: 325180

Other Guided Missile and Space Vehicle Parts and Auxiliary Equipment Manufacturing
NAICS Code: 336419

Petrochemical Manufacturing
NAICS Code: 325110

Powder Metallurgy Part Manufacturing
NAICS Code: 332117

Power, Distribution, and Specialty Transformer Manufacturing
NAICS Code: 335311

Primary Battery Manufacturing
NAICS Code: 335912

Radio and Television Broadcasting and Wireless Communications Equipment Manufacturing
NAICS Code: 334220

Research and Development in Nanotechnology
NAICS Code: 541713

Research and Development in Biotechnology (except Nanobiotechnology)
NAICS Code: 541714

Secondary Smelting and Alloying of Aluminum
NAICS Code: 331314

Search, Detection, Navigation, Guidance, Aeronautical, and Nautical System and Instrument Manufacturing
NAICS Code: 334511

Semiconductor and Related Device Manufacturing
NAICS Code: 334413

Semiconductor Machinery Manufacturing
NAICS Code: 333242

Storage Battery Manufacturing
NAICS Code: 335911

Telephone Apparatus Manufacturing
NAICS Code: 334210

Turbine and Turbine Generator Set Units Manufacturing
NAICS Code: 333611

Membership Benefits

HKVCA 私投募資
Hong Kong Venture Capital and Private Equity Association
香港創業及私募投資協會

Deal Flow
项目对接

Have unrivaled access to government and business players in Hong Kong, mainland China and across the Asia region.

Networking
人脉网络

Take advantage of extensive opportunities to connect with all sectors of the private equity and venture capital community. Benefit from significantly reduced rates for HKVCA events where members network and have access to key players in the industry at the local, regional and international level.

Skills Upgrade
技能提升

Upgrade professional skills and acquire cutting edge, up-to-date knowledge of the latest trends, deals, and market and regulatory changes.

Representation
行业代表

Use the Association to showcase your specialist expertise, increase your profile and become more involved within the industry, with opportunities to join special interest groups and sit on industry-related committees.

Effectiveness
功效优化

The HKVCA is a family, helping to maximize multi purposes most effectively. The diversity of our member base provides the opportunity to connect with all the various market participants through a singular, unique platform.

Standards
专业规范

Be involved in setting standards and creating benchmarks that help raise the profile of the venture capital and private equity industry.

Ecosystem
生态系统

By leveraging ecosystems, companies can deliver complex solutions while still maintaining corporate focus. The HKVCA is a key part of the private equity ecosystem, built on the interaction of limited partners, general partners, services providers, target companies and government units.

Information Exchange
信息交流

Enjoy exclusive access to the membership directory and keep up with all the latest industry and local investor news. Exchange information and share experiences with industry players who possess common interests and goals.

Resources
资源分享

Receive feedback on questions and queries from informed members and have access to industry research and information.

Dedicated to private equity & venture capital. Dedicated to your success.

Our Private Equity & Venture Capital practice across the Asia Pacific region offers:

- Deal origination and introductions
- Pre-deal commercial due diligence
- Transaction execution and due diligence
- Post-deal integration, 'hands-on' support
- Operational transformation & portfolio value creation
- Exit readiness and sales strategies

Contact us to find out how KPMG can help you succeed:

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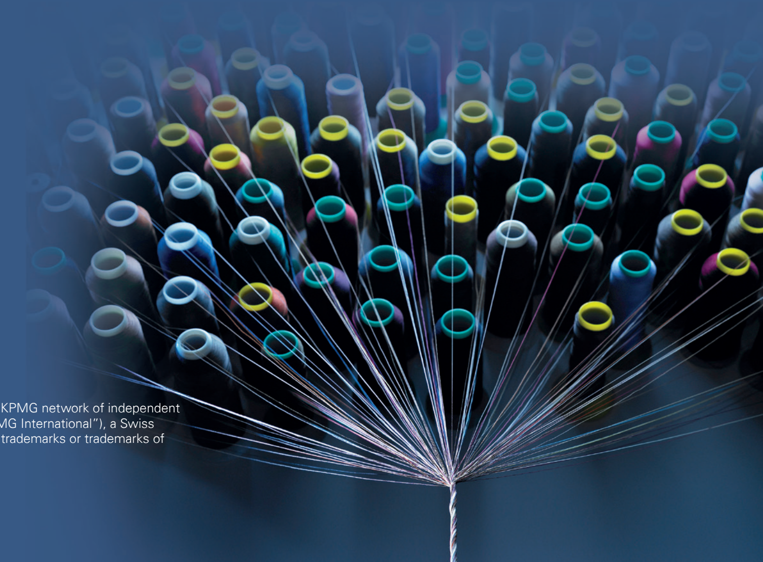

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