CLIFFORD CHANCE

BELT AND ROAD PRIVATE INVESTMENT FUNDS

– THOUGHT LEADERSHIP

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BELT AND ROAD: HURRY TO EMBRACE BELT AND ROAD PRIVATE FUNDS?

When the Belt and Road Initiative (BRI) was first announced in 2013, no one in the private sector was really sure what it meant and what opportunities would become available. Now there is a much clearer picture and we are seeing a significant degree of interest in BRI-related financial commitments, investments and projects.

What have we seen?

In private funds, there has been a noticeable increase in fund formation activity where funds' investment objectives are linked to BRI. Examples include: Silk Road Fund, Sino-Central and Eastern European Fund, China-Central and Eastern European Fund, China-ASEAN Investment Cooperation Fund, China-ASEAN Maritime Cooperation Fund, China UAE Joint Investment Fund, China-Eurasia Economic Cooperation Fund, China-Africa Development Fund, and the China Latin America Industrial Cooperation Investment Fund.

Here are some of our observations:

1. Current BRI initiatives are mostly being led by Chinese state-owned banks, policy banks and governmental bodies. Relatively speaking, it appears that private capital is currently less enthusiastic about investing in "BRI focused" funds, and is very much adopting a "wait and see" approach at this stage. This might be due to a higher risk premium being required to encourage private capital to invest in BRI countries, many of which are generally considered to be sub-investment grade.
2. In terms of structure, although many of these funds are structured as traditional closed-ended blind pool private funds, it is quite common for these transactions to be structured as club deals with significant capital commitments from each co-sponsor. Shareholders of the general partner/manager (Manager) of the fund are often also investors (and sometimes the only investors) in the fund. Increasingly, we have seen Managers established as joint ventures between Chinese state-owned/policy banks or Chinese-backed investment cooperation funds (Chinese SOEs) and foreign investors/sponsors.
3. Aside from blind pool funds, we have also seen a marked increase in the formation of single asset funds which invest in pre-identified BRI-related portfolio assets, with a limited number of investors. There seems to be a wide belief that, by attaching the "BRI" label, this will more likely secure funding from Chinese SOEs and backing from the relevant Chinese regulatory bodies.

Where are we heading?

Will BRI become or remain an interest for international private fund managers? The answer is a definite yes; provided that the government-led projects prove successful.

Need for private capital

BRI will no doubt present many opportunities; however, financing currently remains a challenge. While existing Chinese government-backed banks and investment cooperation funds (including Asian Infrastructure Investment Bank and the Silk Road Fund) have extended funding to BRI investments, the amount remains very small relative to funding requirements.

According to the Asian Development Bank, government reforms could only bridge up to 40 per cent of the financing gap, while the remainder needs to be filled by the private sector. Filling this funding gap will require more private international capital; mere government/state investment is not sufficient. China's increased measures to tackle shadow banking (including the recent ban on China investment funds from making loan investments) could further increase this funding gap.

However, in order to fill this funding gap, changes are needed in the way in which international private investors perceive risks in many of the emerging markets in the BRI countries. There also needs to be transparency on costs and returns to attract these investors. Fund economics are important – beating the hurdle and ensuring that there is the potential for a decent distribution of carry is key to the success of an investment fund and hereby attracting more private capital.

International collaboration and good corporate governance

We expect to see more collaboration between Chinese SOEs and foreign investors/sponsors to capitalise on the potential and opportunities arising from BRI. Through cooperation arrangements with Chinese SOEs, foreign parties can gain access to "Chinese elements" (for example, financing from Chinese institutions; cooperation opportunities with Chinese equipment manufacturing, engineering, procurement, construction (EPC) contracting, operations and maintenance services and other types of enterprises; potential Chinese buyers in a portfolio sale, etc) while Chinese SOEs can gain access to the technology and/or knowledge of local conditions which the foreign parties can often offer. Cultivating a good corporate governance culture is vital to this collaboration, and will make BRI investments more palatable.

What are the possible challenges faced by private fund managers?

- **Difficulty in defining the investment strategy of a fund:** One of the challenges for Managers is the difficulty in defining the investment strategy of a fund (which has an impact on co-investments, follow-on investments, non-competes and successor projects), for example the geographic scope and asset classes of permissible investments under the fund documentation. How should one define BRI? Should the geographic scope be limited to the jurisdictions which fall under BRI on closing? What are the permissible investment asset classes? Investors may want certainty on a fund's investment parameters on day one, but what falls within BRI will likely change over the term of the fund.
- **Choice of fund domicile:** Generally speaking, it remains the case that Chinese parties tend to have a strong preference for establishing private funds in traditional offshore centres. However, increasingly there seems to be a preference on the part of European parties and multinational conglomerates to "onshoring" funds. Therefore, reaching an agreement on the fund domicile at the structuring stage may not be straightforward, and different investor considerations will need to be taken into consideration.
- **Potential trigger of merger filings in China:** As it is quite common that BRI-focused funds tend to be managed by a joint venture Manager (owned by two or more controlling shareholders, with at least one Chinese SOE that will likely have significant turnover in China), merger filing in China may be required. If a merger filing is required, closing cannot take place (i.e. the fund cannot be capitalised) until merger filing approval has been given.

Hong Kong/Greater Bay Area – a key link to the BRI initiative?

With Hong Kong's unique strengths, including preferential access to the massive China market (Shanghai Stock Connect, Shenzhen Stock Connect, Bond Connect and China Interbank Bond Market) and robust legal system, together with its strategic location and membership of AIIB, Hong Kong is well-placed to play the role of "super-connector" for BRI.

Furthermore, with the development of the Guangdong—Hong Kong—Macao Greater Bay Area, and Hong Kong's efforts to develop an up-to-date legal structure for closed-ended private funds, this will help promote and solidify Hong Kong as a crucial link to the BRI initiative.

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