Guest Article

A New Era of Chinese Institutional Investment in U.S. Private Equity Funds: Considerations for Sponsors and Investors

A New Era

Stephen Schwarzman's well-publicized 2014 trip to China to meet with Chinese institutional investors heralded the beginning of a new era of Chinese institutional investment in U.S. private equity funds. Mr. Schwarzman, the CEO and co-founder of leading private equity firm The Blackstone Group, is widely reported to be bullish on China's economic potential and is seeking to forge a stronger relationship between China and the U.S. He has contributed $100 million of his own money to Schwarzman Scholars, a Rhodes Scholarship-style international scholarship program that will launch later in 2016, through which U.S. students will study at Tsinghua University in Beijing.[1] Given that Chinese institutional investors have become major investors in many U.S. private equity funds, including those managed by The Blackstone Group, Mr. Schwarzman knows firsthand the value of a stronger U.S.-China relationship.

It is no secret that Chinese institutional investors have massive amounts of capital to deploy. In response to the Chinese government's recent policy change encouraging Chinese companies to invest overseas, and faced with limited opportunities for profitable domestic investments, Chinese institutional investors are diversifying their holdings by investing part of their capital overseas, with a number of them making substantial investments in U.S. private equity funds. As a result, U.S. private equity sponsors are increasingly focusing their fundraising efforts on Chinese institutional investors.

This article discusses some of the factors driving increased investment by Chinese institutional investors in U.S. private equity funds and summarizes some of the key process considerations and deal terms for such investments.

Newly Liberalized Chinese Insurance Company Regulations Result in Substantial U.S. Private Equity Investment

Over the past several years, the People's Republic of China ("PRC") has eased regulations that previously prevented Chinese life insurance companies from making direct investments in the U.S. For example, in October 2015, the China Insurance Regulatory Commission ("CIRC") enacted regulations easing restrictions on private equity investments by Chinese life insurance companies, raising the ceiling on such investments from 10% of an insurer's portfolio to 30%.[2] This followed the CIRC's doubling of allowable private equity investments by Chinese insurers from 5% to 10% in 2012.[3] Because the Chinese insurance sector has a total asset value of more than 10 trillion Chinese yuan (approximately $1.497 trillion, at current

[1] See: "Blackstone CEO Stumps at Stanford for His Scholarship Program," *Fortune*, November 19, 2014, available at: http://fortune.com/2014/11/19/stephen-schwarzman-stanford-scholarship/.
[2] See: "LP interview: China Reinsurance," *Asian Venture Capital Journal*, May 7, 2014, available at: http://www.avcj.com/avcj/interview/2343405/lp-interview-china-reinsurance.
[3] See: China to let insurers boost private equity investment: draft rules, *Business Insurance*, July 24, 2012, available at: http://www.businessinsurance.com/article/20120724/NEWS04/120729966?tags= %7C73%7C76%7C306

exchange rates),[4] these regulatory changes have made more than 3 trillion Chinese yuan (approximately $449.13 billion) potentially available for investment in private equity funds.

The result has been a massive increase in investment by Chinese institutional investors in U.S. private equity funds. Since October 2012, when Chinese insurers were first allowed to invest in foreign private equity funds, a number of preeminent U.S. private equity firms — including Kohlberg Kravis Roberts, Texas Pacific Group and The Blackstone Group — have received substantial investments from investors such as China Life Insurance Co., Ltd., the largest Chinese life insurance company; China Reinsurance (Group) Corp.; and China Investment Corp., the PRC's sovereign wealth fund.[5]

Process Considerations and Key Deal Terms

When making limited partner (LP) investments in U.S. private equity funds, Chinese institutional investors typically engage experienced international private equity lawyers to perform due diligence on the funds, advise them on current market terms for such investments and assist them with negotiating the investment documents. It is particularly important for counsel representing such investors to have substantial experience not just with private equity investments generally, but also with the unique issues often encountered in such Chinese investments specifically.

Some process considerations and key deal terms particular to investments by Chinese institutional investors in U.S. private equity funds are discussed below.

PRC Capital/English-Speaking Investment Management Teams

Although the invested capital comes from the PRC, in many cases the investment management teams of Chinese institutional investors handling outbound investments have worked for major U.S. or European private equity funds. Team members typically are fluent in English, well educated and quite sophisticated in investment transactions, although they might not be familiar with all the nuances of U.S. private equity investments. As a result, language-related constraints (e.g., the translation of investment documents, issues lists, memoranda and other deal documents into the investor's language) that sometimes arise in cross-border investments are less common.

Co-Investment Opportunities

Consistent with to the trend among U.S. LP investors to seek co-investment rights — which allow investment in portfolio companies alongside the U.S. private equity funds often on a reduced or "no fee" basis — Chinese institutional investors also are increasingly seeking such rights when making LP investments in U.S. private equity funds. In addition to their more advantageous economics, co-investments enable Chinese institutional investors to deploy large amounts of capital and leverage their relationships in certain industries, sectors and geographies.

Educational Opportunities

Chinese institutional investors have sought out investments in U.S. private equity funds not only to earn a financial return, but also to learn how U.S. private equity firms conduct their businesses. Investors that have not previously made substantial U.S. private equity investments often focus on obtaining certain educational benefits, including the following:

- **A Seat on the LPAC.** Chinese institutional investors can obtain a seat on the private equity fund's limited partner advisory committee ("LPAC"), which can give them greater insight into the day-to-day operations of the fund.
- **Structured Training.** Chinese institutional investors can obtain the right for members of their investment teams to participate in structured training programs conducted by the U.S. private equity sponsors. U.S. private equity sponsors are often eager to build relationships with Chinese investors in this manner and the parties sometimes enter into reciprocal arrangements in which U.S. private equity sponsor's investment team members learn about Chinese business and investment practices at while working at the investor's offices in China.
- **Meetings with Portfolio Managers.** Chinese institutional investors can obtain the right discuss fund operations with the U.S. private equity sponsor's portfolio managers and other investment team members, either in person or via conference call.

"Excuse" and "Exclusion" Provisions

"Excuse" and "exclusion" provisions in private equity investment documents are extremely important for Chinese institutional investors making investments in U.S. private equity funds. Sometimes these provisions need to be clarified and/or modified via the side letter entered into by the parties.

Excuse provisions allow LP investors to be excused from making a capital contribution to the private equity fund in connection with a specific portfolio company investment if such a capital contribution would result in a violation of law applicable to the LP investor. Excuse provisions are important to LP investors because of the severe consequences that typically result when an LP investor fails to make a capital contribution (e.g., elimination of the LP investor's voting rights and ability to participate in subsequent investments and/or forfeiture

[4] See: "China: Regulator Allows Insurers to Set Up Private Funds," *Asia Insurance Review*, September 14, 2015, available at: http://www.asiainsurancereview.com/News/View-NewsLetter-Article?id=33782&Type=eDaily.
[5] See: "China Life Invests $250m in TPG," *Finance Asia*, August 7, 2014, available at: http://www.financeasia.com/News/389251, china-life-invests-250m-in-tpg.aspx.

or forced sale of the LP investor's interest in the fund at a substantial discount). Exclusion provisions allow the private equity fund to exclude an LP investor from participating in a portfolio company investment if the investor's inclusion would result in a violation of applicable law or otherwise adversely affect the fund.

The well known series of rejections by the Committee on Foreign Investment in the United States ("CFIUS") of proposed acquisitions by Chinese investors of U.S. companies[6] make clear that this is a real issue for U.S. private equity sponsors accepting LP investments from Chinese investors. In an effort to avoid delayed approval from — or outright denial by — CFIUS, private equity sponsors sometimes seek to exclude Chinese investors from participating in portfolio company investments that have national security implications. For their part, Chinese institutional investors often want assurance that exclusion provisions will be exercised by private equity sponsors in a fair and reasonable manner.

Both the relaxation of PRC laws governing overseas investments and the liberalization of Chinese insurance regulatory requirements are relatively recent occurrences and these requirements will continue to evolve. Consequently, Chinese investors in U.S. private equity investments often seek to have excuse provisions apply to not only existing laws, but also to laws enacted in the future. Private equity fund investment documents, however, typically provide that only existing laws at the time of the capital commitment can be the subject of an excuse application, so this modification is typically made via the side letter entered into by the parties.

The Effect of PRC Laws and Restrictions on Capital Contributions

China has very strict foreign exchange control laws and restrictions on monetary transfers outside the country, which can be problematic for Chinese institutional investors making investments in U.S. private equity funds. As a result, Chinese institutional investors need to plan ahead to help ensure that their funds will be available to make capital contributions in a timely manner. This is important because failure by an LP investor to fund a capital contribution within the required time period can result in the adverse consequences discussed above.

PRC foreign exchange control laws and monetary transfer restrictions can be particularly problematic when there is only a short amount of time from the time at which a capital call is made by the private equity fund and the deadline by which the LP investors must make their capital contributions. As a result, Chinese institutional investors sometimes include provisions in their side letters that either extend the deadline by which a capital contribution is required to be funded by the investor after the capital call is made by the fund or extend the "grace period" after the deadline before the private equity fund issues a notice of default to the investor.

Limits on Fund Investments in Certain Industries

Chinese institutional investors making investments in U.S. private equity funds may be subject to limitations under Chinese laws, regulatory requirements and internal governance policies that limit their ability to invest in private equity funds that make portfolio company investments in certain industries. For example, Chinese banks are sometimes limited in their ability to invest in other banks, either directly or through private equity funds and other investment vehicles in which they invest. To avoid violating those limitations, such Chinese institutional investors typically include provisions in their side letters restricting the fund's ability to make investments in the applicable industries.

Conclusion

The time is right for Chinese institutional investors and U.S. private equity sponsors to deepen and expand their relationships, to their mutual benefit. Please don't hesitate to contact the authors of this article with any questions concerning the matters discussed herein.

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[6] Two recent examples of proposed acquisitions of U.S. companies by Chinese investors that were terminated on CFIUS grounds are as follows. On January 22, 2016, the proposed acquisition by a consortium led by China's GO Scale Capital of Philips Electronics' Lumileds division was terminated after concerns about the acquisition were raised by CFIUS. Three weeks later, on February 16, 2016, Fairchild Semiconductor declined a takeover offer from China Resources Microelectronics Ltd. and Hua Capital, to instead accept an offer from U.S.-based ON Semiconductor, based on CFIUS concerns.