Han Kun's 2019 Data Analysis Report for Fund Formation Projects

September 2020

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LPACN

TABLE OF CONTENTS

Part 1: Introduction

Every year, Han Kun represents numerous private fund managers ("**GP**") and institutional investors ("**LP**") in raising investment funds and advises on matters throughout the entire fund lifecycle—from its fundraising and operations to management and liquidation. Han Kun is one of the first law firms with investment fund practice group in China to provide legal services to GPs and LPs in connection with the fundraising and operations for both onshore and offshore investment funds and is among the first to establish a team dedicated to the practice. Members of our investment funds team are located in Han Kun's offices in Beijing, Shanghai, Shenzhen and Hong Kong. Han Kun's investment funds practice features local experience, global vision, and cutting-edge legal services. Members of our team have exceptional legal education backgrounds and substantial experience in advising on fund formation and related matters, a majority of whom have extensive experience in working with international institutions and advising on cross-border transactions.

As a fully integrated law firm, Han Kun is able to provide legal services to clients by leveraging resources across all of our offices and practice areas. We are able to pool our wisdom, experience and resources across all the firm's practices to efficiently and effectively assist our clients with every deal, by leveraging on the firm's management system featuring strict practice area divisions, close cooperation across different practices, professional management and resource sharing systems. Han Kun is able to deploy lawyers and resources from across all our firm at any time if clients so require or it is necessary for to meet the needs of a project. Han Kun fully understands the issues that arise throughout the investment fund lifecycle and provides clients with a full range of legal services from diverse perspectives, utilizing firmwide resources based upon our in-depth understanding of investment funds. In addition to fundraising-related services, Han Kun also provides other investment fund-related legal services, such as dispute resolution, taxation, foreign exchange settlement, labor, intellectual property rights, onshore and offshore listing projects, and structuring investment funds.

In 2019, Han Kun was deeply involved in hundreds of onshore and offshore private fund formation projects and provided comprehensive legal services for the funds following their establishment. We have prepared this report with the objective to offer a broad view of the 2019 private fund industry, which hopefully also provides a reference for industry practitioners in the industry, based on projects with which we have been involved in 2019 and related data.[1]

[1] This report only covers fund formation projects on which Han Kun has advised, excluding fund investment projects. In addition, this report only references statistics from fund formation projects Han Kun participated in to closing (including initial and subsequent closings), not all fund formation projects on which we advised during 2019.

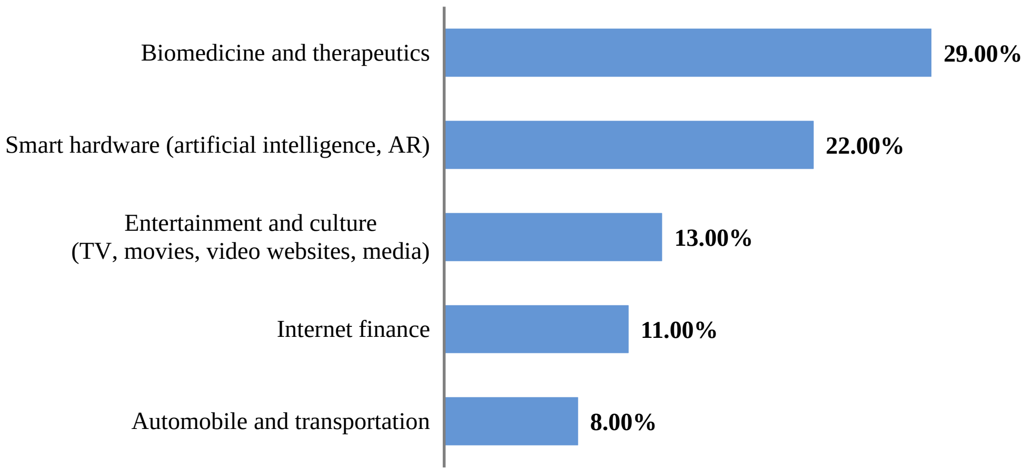
Part 2: 2019 Fund Formation Projects Overview

Fund formation projects on which we advised in 2019 presented the following characteristics:

Fund Investment Industry

Private funds closed in 2019 have the following focused investment industries: biomedicine and therapeutics (29%), smart hardware (22%), entertainment and culture (13%), internet finance (11%), and automobile and transportation (8%). According to our data, more than 50% of funds were invested in the biomedicine and therapeutics and smart hardware industries, which signifies the popularity of these two industries in the 2019 investment market. Other than these five top industries, other popular industries included TMT, corporate services, education and training, catering and food, real estate, energy, and social media.

Fund Investment Industries



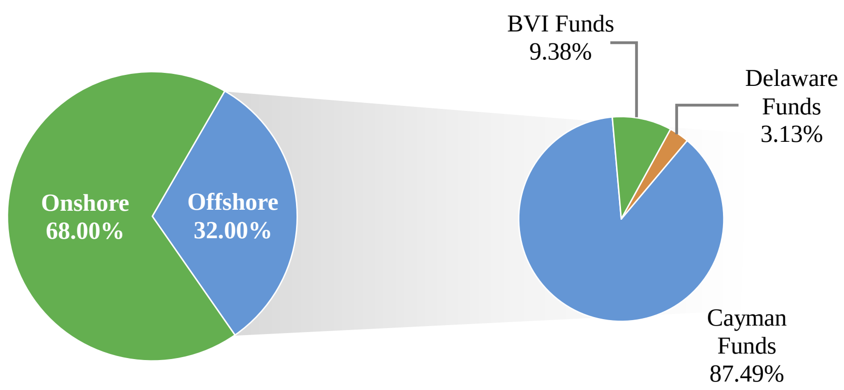
Fund Domiciles

- **<u>Notable gap between the number of onshore funds and offshore funds</u>**. In 2019, the number of onshore funds that completed closing was twice that of offshore funds.[2] According to our data, considerable number of onshore funds have completed closings in 2019. China's tightened control over the asset management industry has slowed the pace of fundraising for onshore funds and decreased the number of onshore funds. Relatively smaller number of offshore funds closed in 2019. We think it is in part due to the vintage year of the funds we represented, and in part due to the global geo-political environment and the business environment which has generally slowed down the pace of fundraising for offshore funds. We noticed that first-time offshore fund managers based in China generally face more stringent screening requirements from European and American institutional investors.

[2] Note: It should be noted that the data here only indicate the proportion of onshore and offshore funds among all funds, but not the actual numbers of those fund types.

■ **Popular domiciles for offshore funds remain unchanged.** In recent years, many entities established in popular low-tax locations have faced challenges due to further implementation of global tax information transparency and exchange systems and the European Union exerting pressure on low-tax countries by promulgating the "list of non-cooperative jurisdictions for tax purposes." At the same time, many countries and regions have begun to improve their legal entity structures and promulgated preferential tax policies with the intention of attracting overseas investment funds. These factors have provided offshore funds with more choices with respect to domicile for establishment. However, according to our data, offshore funds that closed were primarily concentrated in the traditional hot spots for fund establishment, including the Cayman Islands, the British Virgin Islands, and the U.S. state of Delaware. It remains to be seen whether this trend will be altered by preferential policies implemented in Hong Kong, Singapore, and other jurisdictions. Meanwhile, we note that the U.S. Securities and Exchange Commission (SEC) published the latest Private Fund Statistics report for the third quarter of 2019,[3] which shows that 56% of private equity funds are registered in the United States, 30.1% are registered in the Cayman Islands, 2.3% are registered in the United Kingdom, 1.1% are registered in Canada, 0.9% are registered in Bermuda, and the remaining 9.6% are registered in other jurisdictions.

Fund Domiciles



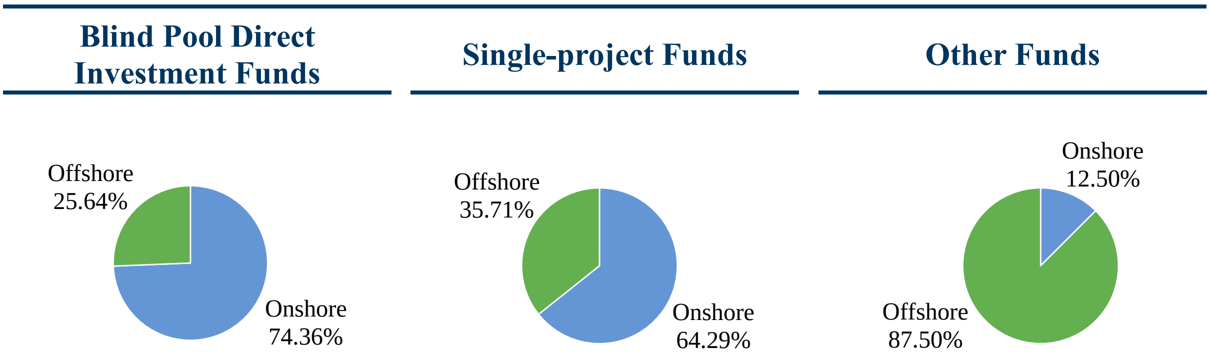
Types of Funds

In terms of fund types, over one third of single-project funds were established overseas, which was 10% higher than blind pool direct investment funds established overseas. This could have been because (i) a considerable portion of target projects have overseas structures, so establishing funds overseas would facilitate acquiring foreign capital, or (ii) offshore funds and entities are more quickly established than onshore funds, which favors the fast establishment

[3] Note: This report is based on SEC's statistics on filing forms collected from SEC-registered Advisors, SEC exempt reporting advisers, and state-registered investment advisers. See details at https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2019-q3.pdf.

of single-project funds overseas and the commencement of investment. In terms of funds other than blind pool direct investment funds and single-project funds,[4] the number of these funds established overseas also far exceed those established onshore. We do not rule out as a possible reason the prudential attitudes of PRC regulatory authorities toward the supervision of other types of private investment funds. For example, the China Securities Regulatory Commission ("**CSRC**") and the Asset Management Association of China currently impose different degrees of restrictions on arrangements for debt funds, leverage strategies, etc. In contrast, offshore funds have greater flexibility in terms of investment methods, funding routes, and structural designs.

Fund Types



[4] Note: Blind pool direct investment funds mentioned in this report refer to blind pool direct equity investment funds. Other funds include funds of funds, real estate funds, and hedge funds.

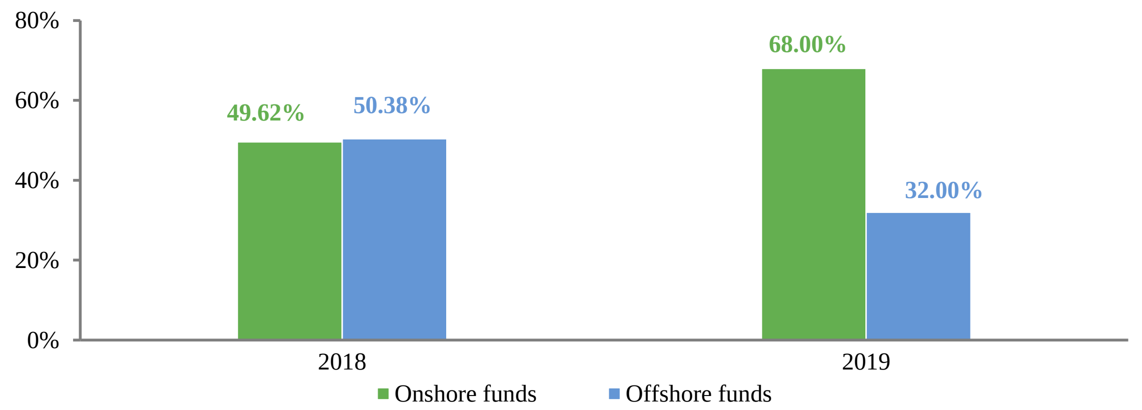
Part 3: Side-by-Side Comparison of 2018 and 2019 Data

Fund Domiciles

■ Significant change in the ratio of onshore funds to offshore funds

In comparing the data in 2018 and 2019, we observe a significant change in the number of onshore funds to offshore funds. In 2018, the number of onshore funds and offshore funds was roughly the same, but in 2019 the number of onshore funds exceeded offshore funds. In our view, this change increase in onshore funds relative to offshore funds resulted from many potential factors (including the vitality of onshore and offshore capital markets, the invested enterprises' acceptance of RMB and foreign currency investment, and differences in investment attitudes and expectations between domestic and foreign investors, etc.).

Fund Domiciles



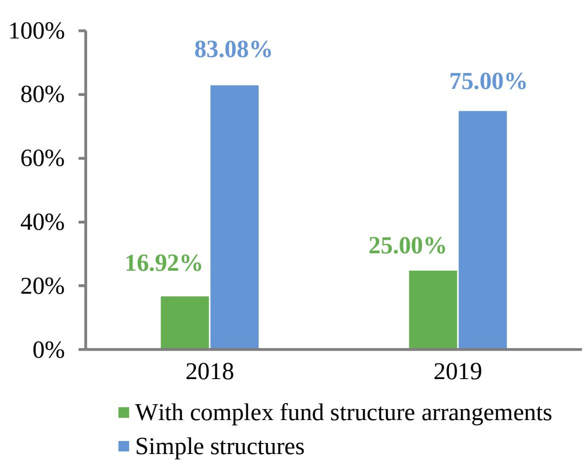
Fund Structures

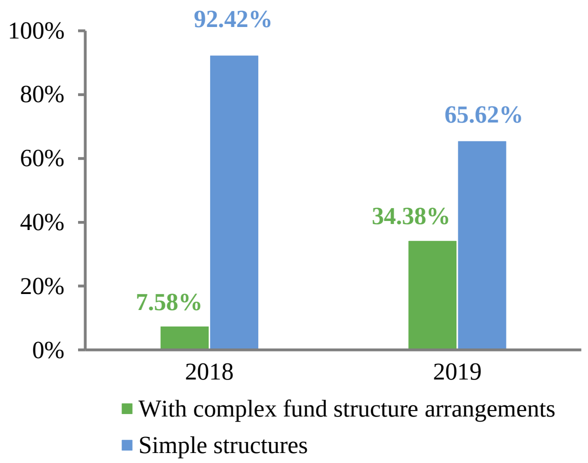
■ More funds exhibit complex fund structure arrangements

To satisfy various fundraising and investment requirements, private funds may adopt a variety of fund structures, including parallel fund structures, umbrella fund structures, feeder fund structures, and other mixed complex structures. The proportion of investment funds with complex fund structure arrangements increased in 2019 compared to 2018, both onshore and offshore, indicating a significant increase in market acceptance of complex fund structures. We observe the composition of fund investors was more diverse in the past year and it became increasingly common for investors with various backgrounds co-exist in a single fund. Some funds have admitted investments from several government-guided funds from different regions. With further opening up of foreign-invested enterprises' capital settlement funds used for domestic equity investment, more funds began to admit foreign-invested investors. Correspondingly, more investment funds intended to adopt more complex fund structure arrangements to meet the needs of investors from diverse backgrounds.

Fund Structures

Onshore Funds	Offshore Funds





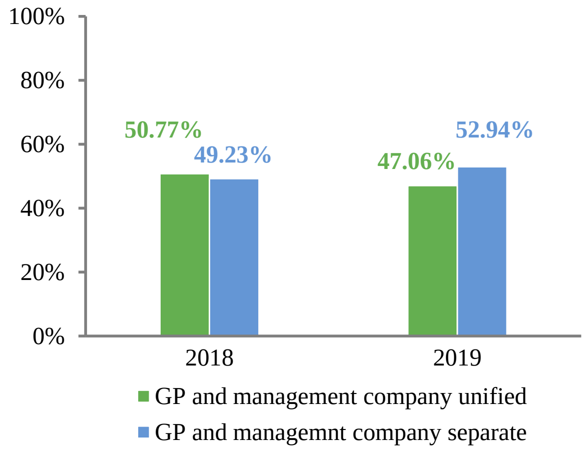
■ **Onshore funds and offshore funds diverge when choosing whether to separate or unify the GP and Management Company**

Regarding whether the same entity or different entities serves as the Management Company and GP, there was no significant change among onshore funds from 2018 to 2019 between the two options. We note the ratio of onshore funds choosing the GP-Management Company–separate structure increased by 3.71%, signifying a slight improvement in market acceptance of the GP-Management Company–separate structure. Generally speaking, the reasons for onshore funds to choose the GP-Management Company–separate structure are primarily to meet the risk isolation needs of the Management Company, which may concurrently manage multiple funds, and to facilitate fund management and operation, etc.

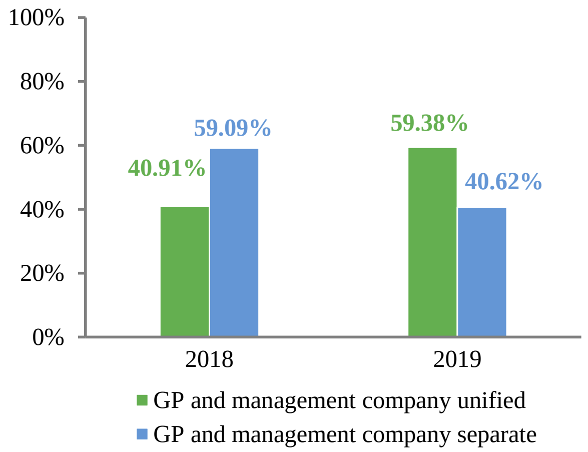
As for offshore funds, the proportion of offshore funds that chose the GP- Management Company-unified structure significantly increased by 18.47% from 2018 to 2019, which may primarily have resulted from compliance and cost control considerations. According to the current relevant laws and regulations of the Cayman Islands, where separate entities serve as the GP and the Management Company, the Management Company is required to register with the Cayman Islands Monetary Authority and may also need to meet further substantive economic requirements. However, these compliance requirements do not apply to GPs which themselves manage funds (that is, GPs which manage funds and are separate from a Management Company) as long as certain preconditions are met.

GP and Management Company: Unified or Separate Structure

Onshore Funds



Offshore Funds

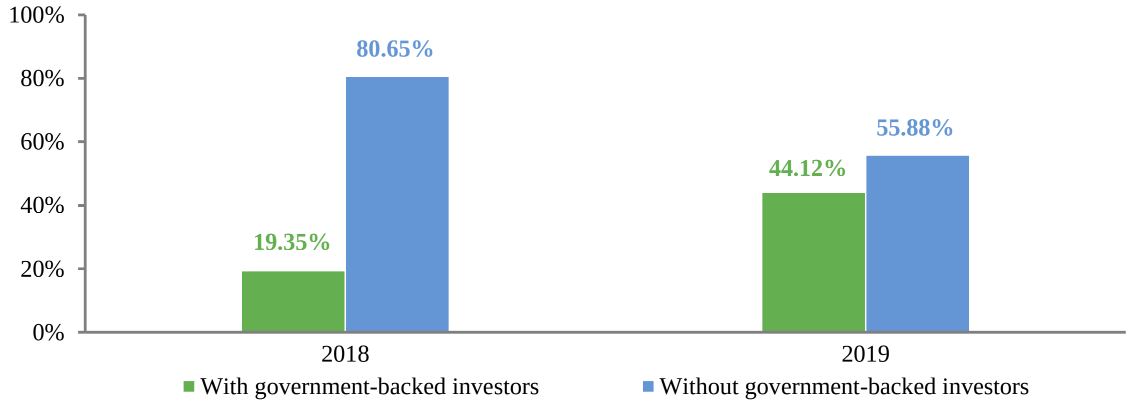


Composition of Onshore Fund Investors

■ Significant increase in the proportion of government-backed investors

We observe from our 2019 data that the proportion of onshore funds with government-backed investor participation increased significantly to 44.12%, an increase of 24.77% compared with 2018. We note the number and scale of government-guided funds expanded year over year, and there are also other state-owned investors that grew increasingly active in the private funds field. Nonetheless, there is still a great amount of private capital and offshore capital actively participating in the private fund market and playing an important role in facilitating fundraising for private funds.

Composition of Investors (Onshore Funds)

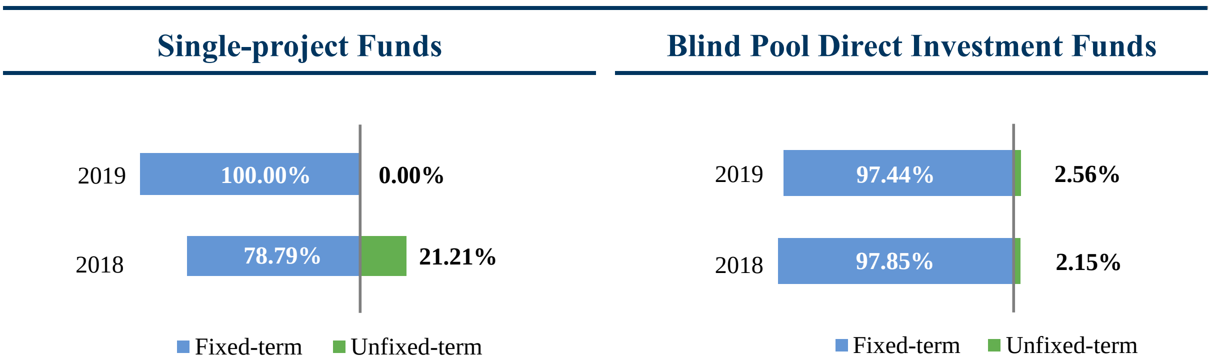


Fund Terms

■ Terms of blind pool direct investment funds tended to be longer

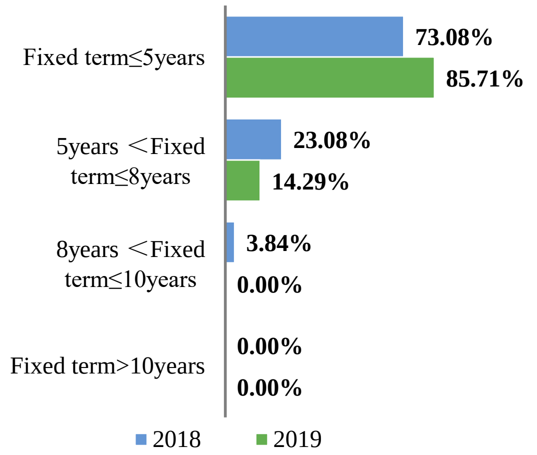
We observe a divergence in the fund terms of single-project funds and blind pool direct investment funds. The terms of single-project funds tended to be shorter. Specifically, none of the single-project funds we advised in 2019 were unfixed-term funds (i.e. funds that have no fixed fund term pre-set in the fund documents); and among fixed-term single-project funds, those with fixed terms of less than five years increased by 12.63% compared with 2018. In contrast, the terms of most blind pool direct investment funds tended to be longer. Specifically, blind pool direct investment funds without fixed terms increased by 0.41% compared with 2018; and among fixed-term blind pool direct investment funds, those with fixed terms of between five and eight years increased by 15.92%. The extension of fund terms for blind pool direct investment funds may have been due to the influence of current government policies which encourage the establishment of long-term equity investment funds. Based on our observations, the trend toward longer fund terms was particularly pronounced among venture capital funds, as evidenced by the increase in the number of venture capital funds with terms ranging from five to eight years and from eight to ten years. In particular, from a venture capital fund policy perspective, CSRC has clearly stipulated that venture capital funds must have terms of not less than seven years to be entitled to preferential tax treatment under the *Circular on Tax Policies for Venture Capital Enterprises and Individual Angel Investors* (Caishui [2018] No. 55), which indicates the great influence that policy orientation has on the fund terms. In addition, a significant number of equity investment funds have adjusted their expectations for holding and exit periods for their investments, and more investors have endorsed long-term investment strategies.

Fund Terms

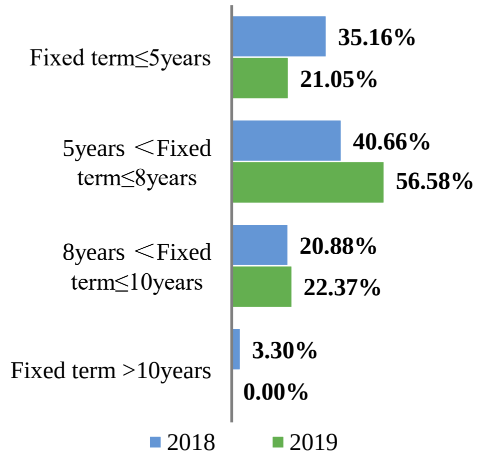


Fund Terms (Fixed)

Single-project Funds



Blind Pool Direct Investment Funds



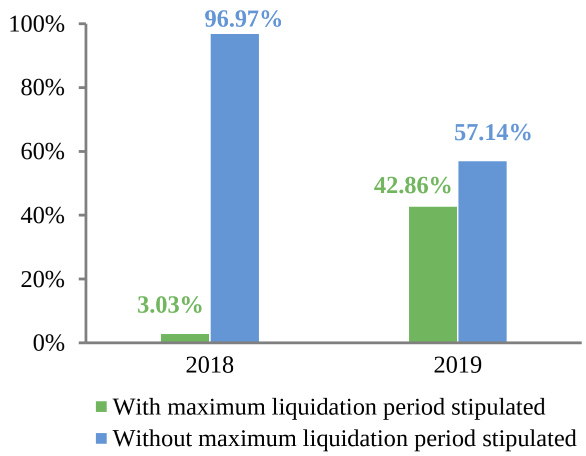
Liquidation Periods

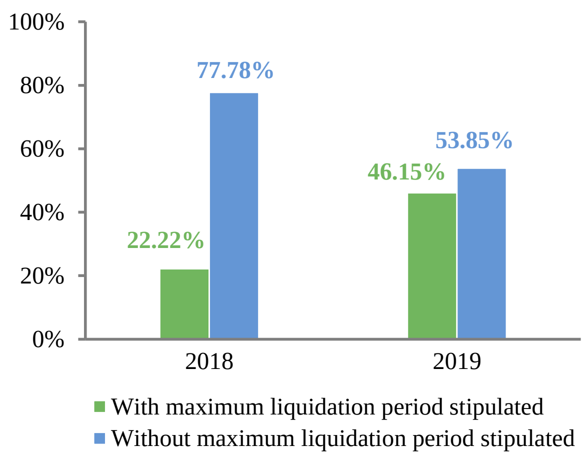
■ **More funds began to pay attention to liquidation periods**

In recent years, many private investment funds have gradually entered into their investment exit and liquidation periods. In the process of assisting our clients with liquidation issues, we have encountered various obstacles and restrictions that have affected fund liquidations. For example, some local administrations for market regulation require limited partnerships to be removed from the registers of shareholders of portfolio companies and to complete such registrations before the limited partnerships are dissolved. In practice, however, this registration procedure requires the cooperation of portfolio companies and other shareholders, which means successful registration necessarily depends on the cooperation of relevant parties. Some local regulatory authorities also require limited partnerships to conduct tax filings and verifications prior to tax clearance procedures, which may be greatly affected by the complexity of a fund's financials. Throughout the entire liquidation process, there are usually complicated interests at play between the Management Company and investors (e.g. investors usually expect the Management Company to handle the liquidation matters more actively and therefore would tend to limit the exit and liquidation period). According to our 2019 data, the number of funds clearly specifying a maximum liquidation period saw a significant increase compared with 2018 for both single-project funds and blind pooled direct investment funds, evidencing the fact that funds have increasingly begun to pay attention to liquidation period arrangements and to conduct relevant discussions and planning with investors in the early stages of fundraising.

Liquidation Period Clauses

Single-project Funds	Blind Pool Direct Investment Funds





Fundraising Periods

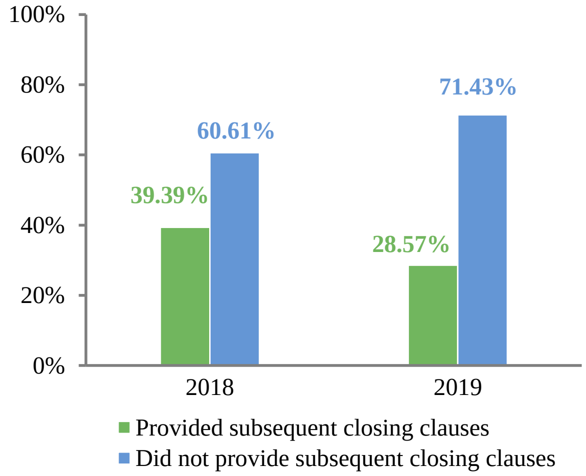
- **Extended Fundraising Periods for Blind Pool Direct Investment Funds**

With respect to blind pool direct investment funds, the proportion of funds with subsequent closing arrangements exceeded 70% both in 2018 and 2019. While the 2019 data indicate a lengthening of fundraising periods, signifying the market generally expects longer time for fundraising.

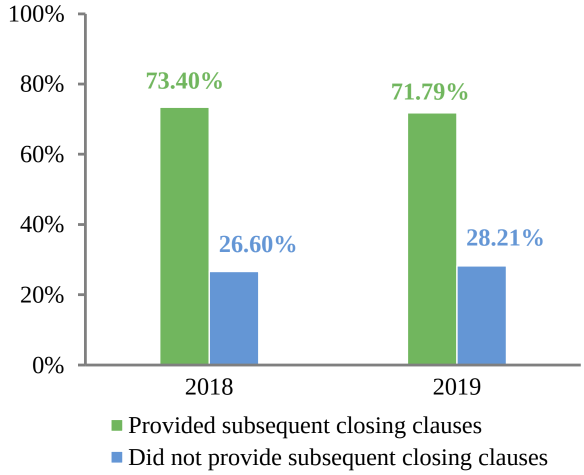
As far as single-project funds are concerned, the number of funds with only one closing arrangement saw a significant increase of 10.82% compared with 2018. According to our observations, most current single-project funds are more inclined to complete fundraisings and investments at a fast pace because they typically focus on popular portfolio projects.

Subsequent Closing Clauses

Single-project Funds

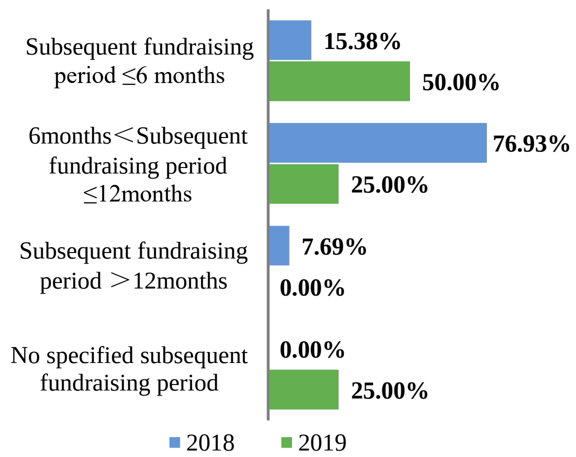


Blind Pool Direct Investment Funds

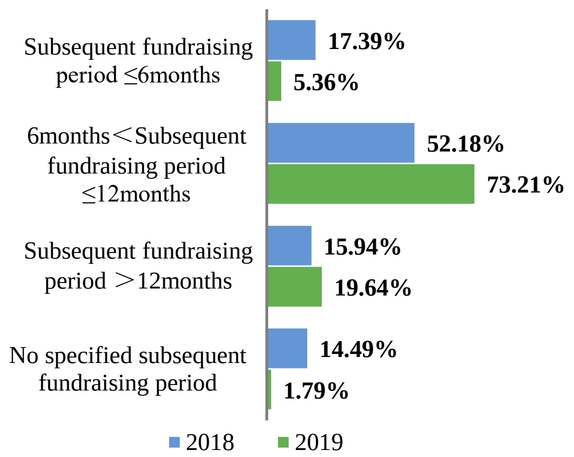


Fundraising Periods

Single-project Funds



Blind Pool Direct Investment Funds



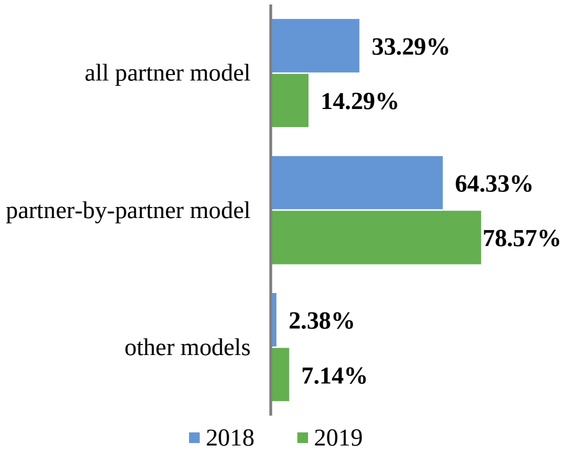
Distribution Mechanisms

- **Increase in the number of funds making distributions partner-by-partner or by deal**

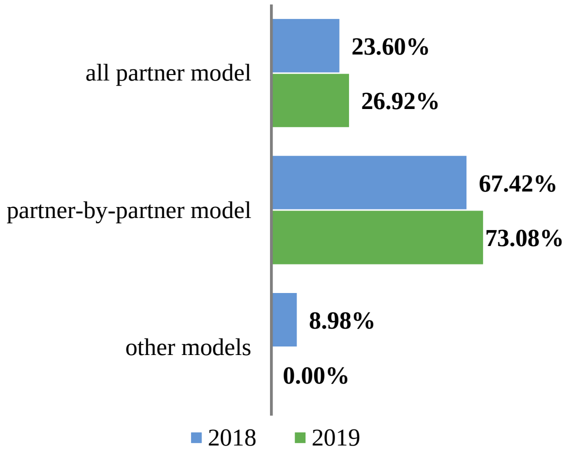
In term of distribution mechanisms, the 2019 data indicate an increase in the number of both fund types adopting partner-by-partner distribution mechanisms and by deal distribution mechanisms compared to 2018 for both single-project funds and blind pool direct investment funds, indicating that market has gradually increased for these two distribution mechanism types.

Distribution Mechanisms

Single-project Funds

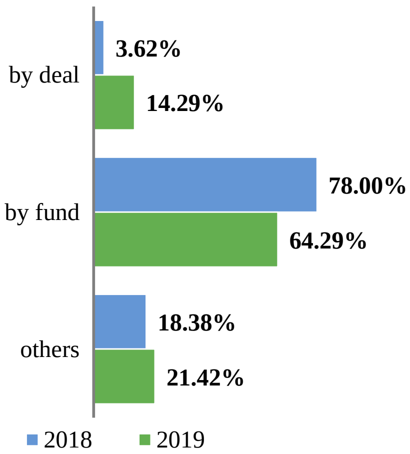


Blind Pool Direct Investment Funds

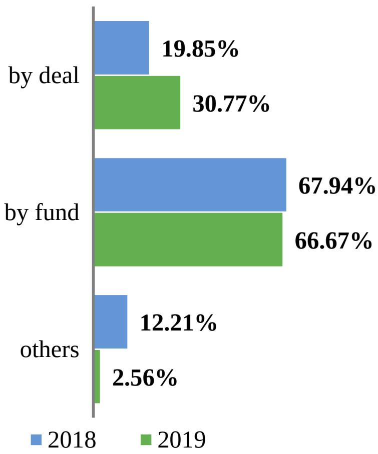


Capital Return Models

Single-project Funds



Blind Pool Direct Investment Funds



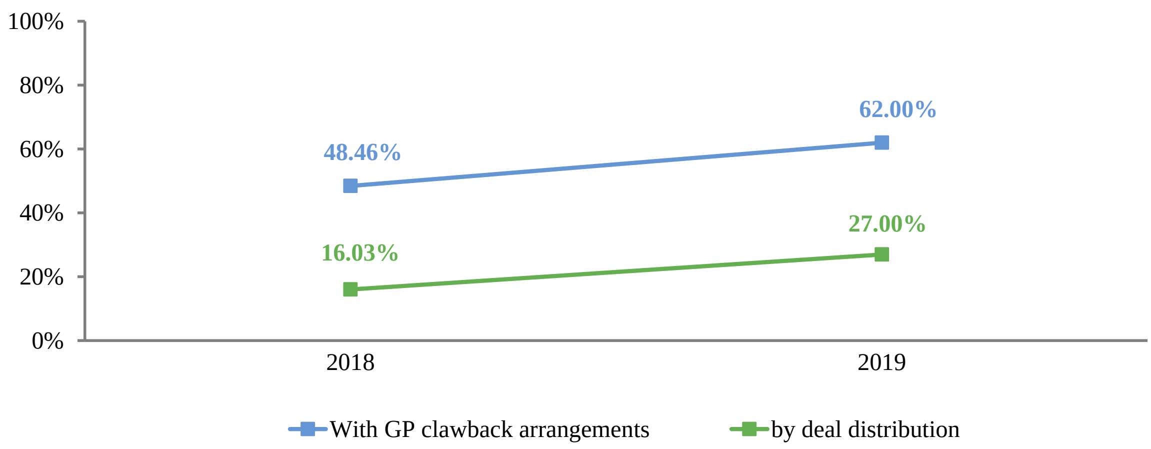
General Partner Clawback Clauses

- **General partner clawback clauses became increasingly common due to the broad application of by deal distribution models**

The distribution mechanism a fund adopts typically determines whether it adopts a general partner clawback clause. Generally, the possibility for general partner clawback is lower in funds with by-fund distribution mechanisms because investors receive returns on investment based on their capital contributions before the fund distributes carried interests to the

GP/Management Company. In contrast, general partner clawback clauses are more sensible for funds that adopt by deal distribution mechanisms because distributions will be made during the fund term, and carried interests calculated, based on the returns of each disposed portfolio investment, which means the GP/Management Company may receive a portion of its carried interest before investors fully receive back their capital contributions. According to our 2019 data, more funds adopted general partner clawback clauses, an increase of 13.54% compared to 2018, due to the wider adoption of by deal distribution mechanisms. In practice, general partner clawback clauses are typically subject to certain restrictions (e.g., a relatively common restriction is that "the clawback amount shall be less the taxes and fees that have been paid by the GP/Management Company and its direct or indirect beneficial owners").

General Partner Clawback Clauses

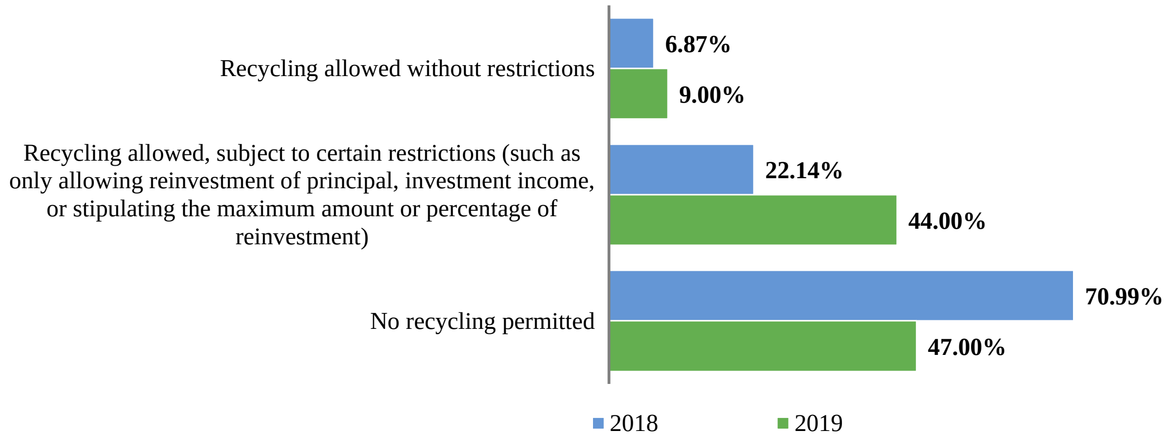


Recycling

■ More funds allowed recycling, subject to certain restrictions

As indicated by our 2019 data, more funds permitted reinvestment, an increase of 23.99% comparing to 2018. However, at the same time, more funds (an increase of 21.86%) set certain restrictions on reinvestments, including allowing recycling only for investment principal, investment income, or stipulating the maximum amount or percentage of re-investment.

Recycling



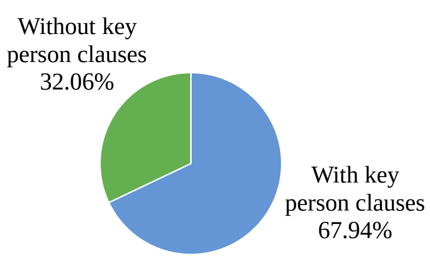
Key Persons

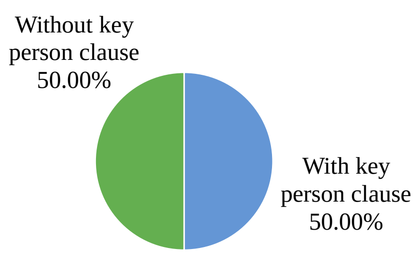
■ Fewer Key Person Clauses

The level of dependence investors have on specific core team members can be observed based on whether the fund contract contains a key person clause and the binding effect of such clauses. According to our 2019 data, the number of funds that chose not to adopt any key person clauses showed a significant increase of 17.94% compared to 2018, which we believe may be related to the emergence of private equity institutions with more institutional background shareholders and more single-project funds in the reporting year.

Existence of Key Person Clauses

2018	2019





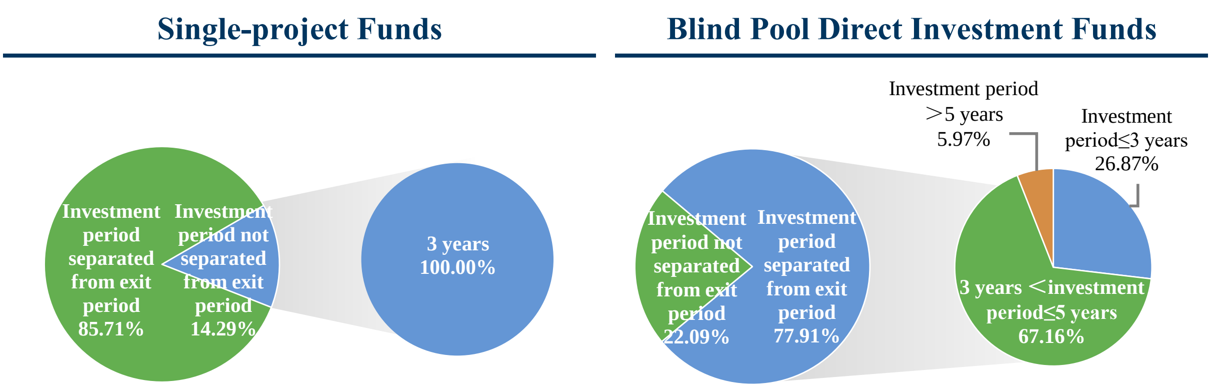
Part 4: Analysis of Other Key Fund Terms in 2019

In addition to those provisions mentioned above that differed significantly between our 2018 and 2019 data, we have further organized and analyzed the data of other key terms in formation projects.

Investment Periods

In general, most single-project funds tend to not separate the investment period from the exit period, because single-project funds typically target a specific project with a known financing stage. Nonetheless, there are a small proportion of single-project funds which stipulate a fixed investment period due to considerations such as the investors' expectations for the investment period and the actual operations of the portfolio company. Most blind pool direct investment funds, which tend to invest in multiple projects during the fund term, generally stipulate an investment period with the view to roughly ascertain the investment pace and progress. Based on our 2019 data, 67.16% of blind pool funds stipulated an investment period ranging from three to five years.

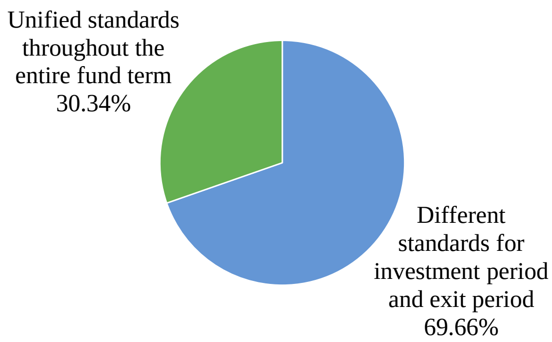
Investment Periods



Management Fee Calculation Methods

Management fees are the primary financing source for Management Companies' daily operations. In establishing private funds, it is common practice for the investment period to serve as a basis for calculating management fees, with different charging standards applying before and after the investment period, which considers the extent of a Management Company's involvement in managing a fund before and after the investment period. Based on our 2019 data, nearly 70% of funds follow this convention by distinguishing the management fee charging standards between the investment and exit periods. However, it is worth noting that more than 30% of funds chose to implement unified management fee charging standards throughout the fund term, of which 75% of single-project funds and 19.44% of blind pool funds chose to implement unified management fee charging standards throughout the fund term.

Management Fee Calculation Methods

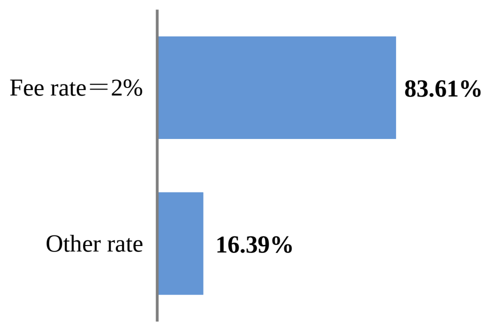


Management Fee Rates

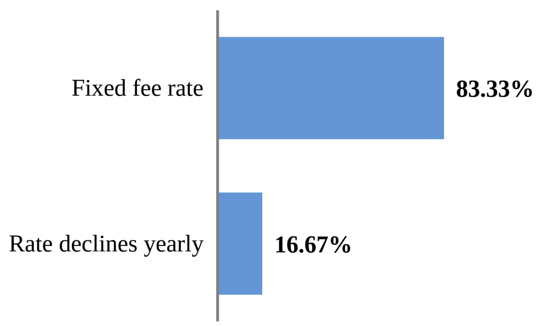
In terms of management fee rates, the prevailing market rate applicable to the investment period is generally 2% for funds that charge management fees according to different standards during the investment and exit periods. When the investment period expires, the Management Company will generally reduce its management fee in various ways, either by fixing the management fee rate while reducing the calculation base or by fixing the management fee calculation base while reducing the management fee rate. Compared with the fixed-rate reduced-base method, the fixed-base reduced-rate method is more convenient for the Management Company in early stage budgeting. Based on our 2019 data, only 16.67% of funds chose the fixed-base reduced-rate method, whereas most funds chose the fixed-rate reduced-base method.

Different Management Fee Standards for Investment and Exit Periods

Investment Period

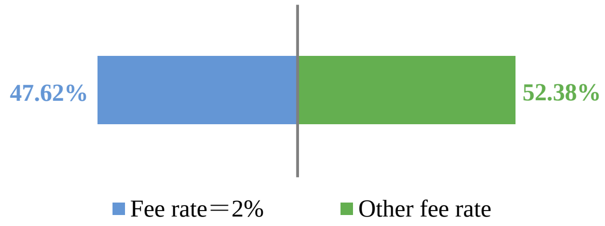


Exit Period



With respect to funds that did not separate investment and exit periods, excluding non-management fee samples in our data, more than half of the funds did not choose to adopt the prevailing 2% fee charging rate.

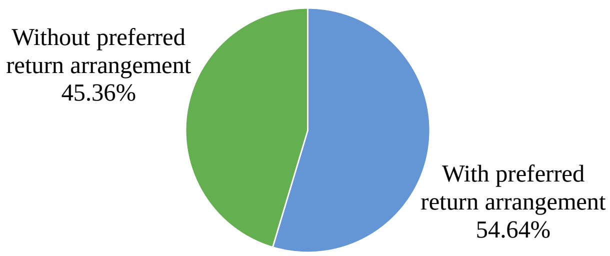
Unified Management Fee Standards for Investment and Exit Periods



Preferred Returns

Preferred returns refer to hurdle return mechanisms GPs set up for the purpose of delaying the collection of carried interests and reducing the possibility of GP clawbacks. Based on our 2019 data, we notice little difference between the number of funds with preferred return arrangements and those without, with the latter slightly exceeding former. In particular, 58.82% of onshore funds had preferred return arrangements while the proportion of offshore funds that had preferred return arrangements was 40.63%, slightly lower than onshore funds. We understand this is mainly because investors generally expect onshore funds to have preferred return arrangements. In terms of the annualized interest rate for preferred returns, we observe that the annualized rates generally range from 5%/year to 8%/year.

Preferred Return

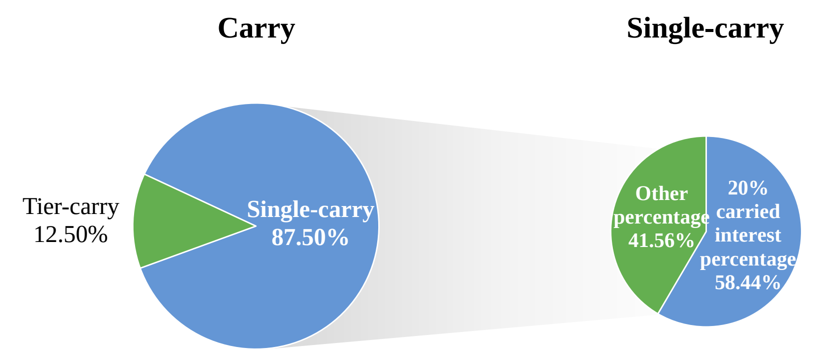


Carried Interests

Carried interests are an important incentive for GP/Management Companies. Generally, the carried interest distribution ratio for VC/PE funds is 20%. However, based on the data we have collected, it is worth noting that there is currently a considerable proportion (nearly 41.56% in 2019) of funds in the market that do not choose the 2/8 carried interest incentive arrangement but are attempting to explore other incentive methods.

As far as venture capital funds are concerned, returns distributed to Management Companies at exit are likely higher than for PE funds, because venture capital funds are earlier to enter the investment stage and their investment principal is generally lower in the early stages. Therefore, in order to have a better incentive effect for GP/Management Companies, there are a considerable number of venture capital funds that choose to adopt tier-carry arrangements, which set different carried interest percentages corresponding to different income levels—the higher the investment fund return, the higher the carried interest distribution percentage. Based on our 2019 data, we observe that 12.5% of funds adopted a tier-carry arrangement, while the remaining continued to adopt a simple single-carry model.

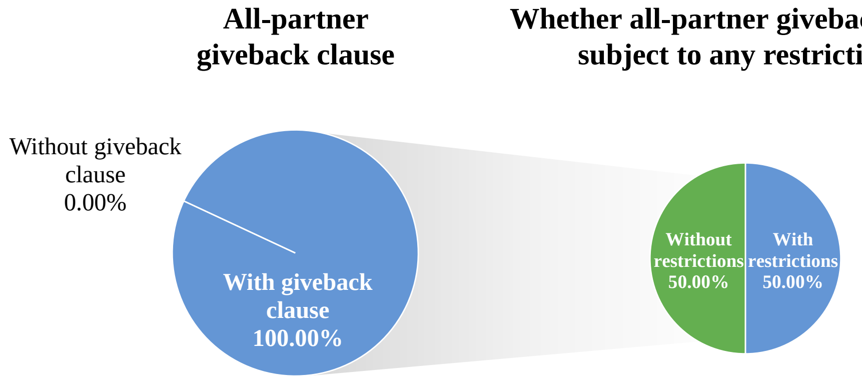
Carried Interests



All-Partner Giveback Clauses

"All-partner giveback" clauses apply in circumstances where the fund assets are insufficient to cover the fund's external debts and liabilities, in which case all partners must return to the fund the proceeds distributed to satisfy the fund's obligation to pay off the fund's external debts. Based on our 2019 data, all funds, without exception, adopted all-partner giveback clauses, among which half of the clauses were not subject to any restrictions while the other half were subject to certain restrictions. Common giveback restrictions include restrictions on the giveback amount and the maximum period of giveback obligations, etc.

All-Partner Giveback Clause

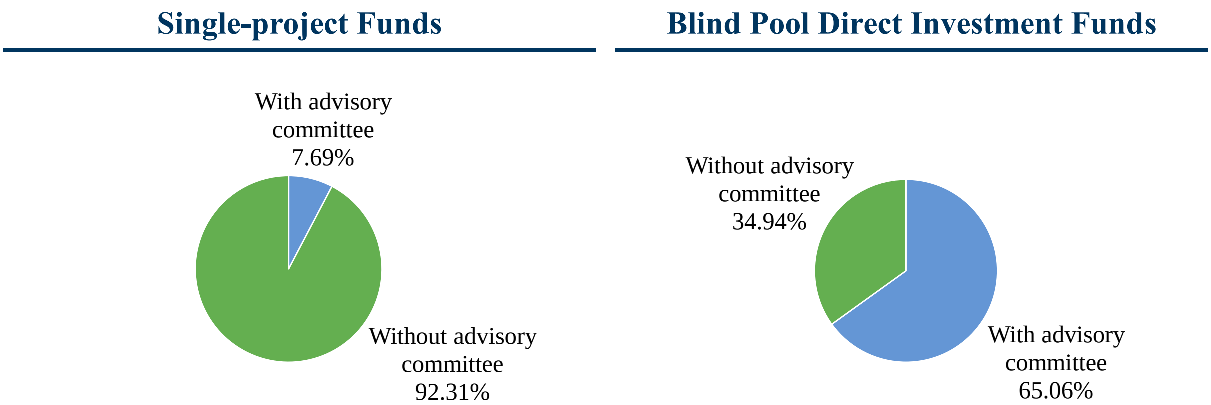


Advisory Committees

The Advisory Committee is an important organization within funds. The Institutional Limited

Partners Association ("**ILPA**") issued in June 2019 its latest guidelines the ILPA guidelines (version 3.0). In this guidance, from the perspective of LPs, ILPA recommends funds to form an advisory committee, whose function is mainly to supervise and review the fund's related-party transactions and conflicts of interest. Generally, it is rather rare for single-project funds to form an advisory committee, considering funds typically target specific projects and may disclose more specific information regarding each project. In contrast, most blind pool direct investment funds form an advisory committee as part of the fund's decision-making mechanism.

Advisory Committees

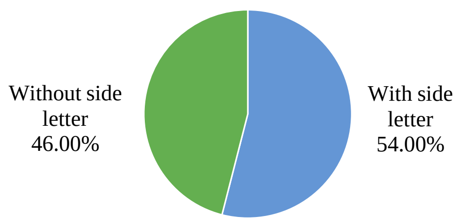


Side Letters

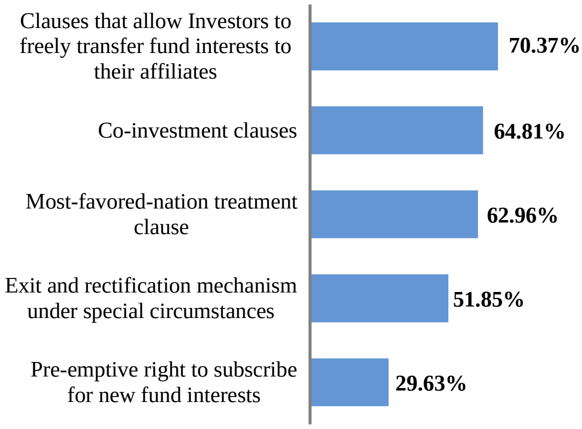
Side letters refer to unilateral arrangements reached by and among an investor and the GP/Management Company, which typically stipulate certain special requests by the investor. However, in practice, a certain number of GP/Management Companies tend to adopt a "non-discriminatory" attitude toward investors, refusing to reach side letter/unilateral agreements with any investors. Based on our data, more than half of GP/Management Companies hold a positive attitude toward side letters. Below, we list the common rights contained in side letters and their respective frequency of occurrence.

Side Letters

Existence of Side Letters



Common Side Letter Terms



Disclaimer

This report should not be relied on as legal advice or regarded as a substitute for detailed advice in individual cases. If you have further questions or need professional legal services or support, please feel free to contact us.

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