Asset Management and Private Equity 2023 Outlook

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Foreword

Welcome to the Hong Kong Asset Management and Private Equity 2023 Outlook, where we review the major trends and consider the developments that the industry will face in the year ahead.

While most of the world emerged from the Covid pandemic during 2022, the global economy struggled as a result of the impact of the war in Ukraine, soaring inflation and the efforts to control it in many economies. In Hong Kong (SAR), China, the return to normal business operations was constrained by lingering Covid-related restrictions.

So it is hardly surprising that 2022 was a difficult year for the asset management sector, with all asset classes suffering amid the market volatility.

Moving into 2023, however, the outlook is brighter. Hong Kong has been getting back to normal business operations now that most of the pandemic restrictions have been lifted. Meanwhile, the significant easing of Covid restrictions in the Chinese Mainland has removed a major hurdle for asset management activity – particularly private equity. Access to the massive and growing Mainland market is the biggest advantage that Hong Kong has as a global asset management hub, so reopening the border is a major step on the path to a full-scale recovery.

With geopolitical and global economic uncertainty continuing, volatility will remain for the first half of 2023. But there is a general expectation that – assuming no further shocks to the global economy – there will be a return to relative normality in the latter part of the year.

More broadly, there is no doubt about the tremendous potential for asset management in Hong Kong and in Asia. The sector has grown remarkably in the past few years, and the number of asset managers in the city doubled in the 10 years to 2021, according to the Securities and Futures Commission (SFC).

The SFC's latest Asset and Wealth Management Activities Survey paints a relatively bright picture, albeit with figures from 2021. Even amid the Covid-related uncertainty, the sector saw a 2% year-on-year increase in AUM to HK$35,546 billion in 2021, with net fund inflows of HK$2,152 billion, a 6% year-on-year increase. The number of corporations licensed to carry out Type 9 regulated activity also increased by 5% to 1,979 in 2021.

While the numbers for 2022 will almost certainly be weaker, taking a longer term view clearly demonstrates the resilience and growth potential of the sector, and we expect this growth trend to resume in the year ahead.

Hong Kong is also benefitting from the fact that the government is focused on developing the sector and has rolled out a variety of incentives in recent years aimed at making the city a global hub for asset management. These initiatives have been developed with contributions from stakeholders in Hong Kong, so the government has also shown that it is willing to listen to the industry. We hope that further cooperation will help to iron out some of the issues that have arisen in implementing these initiatives, and to ensure that we remain competitive.

Meanwhile, more needs to be done to promote Hong Kong as an asset management hub, so that investors globally know about the advantages of doing business here. With the frameworks in place to support the industry, massive opportunities in China and across Asia, and the "back-to-business" atmosphere in Hong Kong now that restrictions have eased, the time is right for a resumption in asset management activity.

In this Outlook, we identify some of the key sectoral areas of focus for 2023 as well as the broader trends affecting the whole industry. We hope you enjoy the insights from our asset management colleagues, please feel free to get in touch if you would like to discuss any of the trends or topics.

Opportunities and optimism

Easing of Covid restrictions, huge prospects in the Chinese Mainland market and dry powder in the system will boost the asset management sector in the year ahead

As we leave behind a choppy 2022, there are concrete reasons for asset managers to be optimistic about the year ahead. Firstly, the easing of Covid restrictions in both Hong Kong and the Chinese Mainland mean that asset managers can get back to more normal business operations in 2023. This will help to reignite activity in the Chinese Mainland market, which continues to provide unrivalled opportunities for investment and growth.

In addition, the sheer amount of dry powder available means that investment activity stands to rise in the near future. We know that little capital was deployed in 2022 as asset managers took a cautious approach amid the global volatility. In the year ahead, there will be a marked push to deploy some of that dry powder across asset classes.

Many institutional investors have been waiting on the sidelines amid the recent uncertainty, but they are keen to get back into the Mainland market quickly as Covid restrictions ease. Driving this demand is the fact that, for global institutional investors, China is one of the very few markets in the Asia Pacific big enough for large-scale investments. In addition, many large asset owners globally currently have a relatively small exposure to China, so there is a lot of scope for further growth.

Hong Kong-based investment managers will continue to serve not only the market going into the Mainland, but also the growing numbers of Chinese financial institutions that are diversifying and will use Hong Kong as a base.

Hong Kong also acts as headquarters for investing in Southeast Asia: in particular, private lending to SMEs has undergrown huge growth in the past five years. In addition, the Chinese Mainland and Southeast Asia have an ever-growing population of wealthy individuals seeking wealth protection strategies for the long term.

So there are reasons for optimism from a number of quarters. In particular, the outlook for the asset management sector in 2023 will depend to a considerable extent on developments in the Mainland. The end to quarantine and easing of other Covid restrictions have been a promising start to 2023. Assuming that Beijing continues on the path to full reopening, the momentum will carry the asset management sector into a much brighter year ahead.

Challenges and competition

Hong Kong must refine and promote its range of industry incentives as it faces increasingly fierce competition as an asset management hub

While there are many reasons to be optimistic about the asset management sector as we move into 2023, there will also be challenges ahead.

Hong Kong is facing considerable competition as an asset management hub from other jurisdictions. There has been a valid concern that we could slip behind, especially given the city's delay in reopening after Covid. While Hong Kong was still requiring mandatory quarantine, Singapore, for example, was already hosting industry forums and meetings, giving global industry players a clear comparison between the two cities. The ending of most of Hong Kong's travel restrictions has levelled the playing field again, but we still have some catching up to do.

Another issue that may be more important in the longer term is that Hong Kong's support for the asset management industry must be least as attractive as, if not better, than what is on offer in other asset management hubs globally.

Other locations offer a similar range of tax incentives to attract capital and fund managers. However, some of the initiatives that have been rolled out recently in Hong Kong are attractive in theory, but have not delivered the hoped-for results, sometimes due to onerous conditions that need to be satisfied or a lack of clarity on the protocols required.

In another development, there has been a slowdown in deploying capital in and out of the Chinese Mainland in the past few years amid ongoing Covid uncertainty, and investors have been refocusing their attention elsewhere. Japan has been a major beneficiary as it is an attractive market right now given the relatively low cost of borrowing and currency exchange, as well as having a lot of opportunities to deploy capital. Other jurisdictions including South Korea, Australia and India are also attracting investment.

As Covid restrictions have eased in both Hong Kong and the Chinese Mainland, there is justification to be more optimistic about the outlook for 2023. But amid fierce competition, if Hong Kong is to retain its market dominance as an asset management hub, we need to be doing more to review, revise and promote our initiatives and attractiveness.

We need to get the message out that Hong Kong has not just reopened for business travel, but is also a place with free flow of capital and ideas. We would also like to see a government task force set up to assess the city's initiatives to develop the asset management sector, to ensure that we remain competitive and can seize the opportunities ahead.

Tax

Range of tax incentives shows support of the asset management sector, but some may need more refinement before they can fulfil their potential

Hong Kong's status as an asset management hub has long been underpinned by its historically favourable tax environment, with traditional funds not subject to tax in the city. In the past few years, the Hong Kong (SAR) Government has also introduced a number of tax incentives for alternative funds to promote the asset management industry. The success of these in achieving their aim has been mixed, but lessons have been learned about the scope and implementation of such initiatives. It is hoped that they will ultimately be successful in attracting more fund managers to the city – especially given the tough competition from other financial centres around the world.

Launched in 2018, the open-ended funds company (OFC) regime provides fund managers with an alternative to the offshore structure. A tax incentive was also introduced, whereby if the fund met certain conditions, any underlying investment gain derived by the fund would be tax exempt in Hong Kong. However, due to strict conditions, it had limited impact and only a handful of OFCs were established.

In 2019, a Unified Funds Exemption (UFE) was introduced, which applies to both resident and non-resident funds including the OFC. Under the UFE, any investment gain derived by the fund will be tax exempt, subject to certain conditions. The following year, the investment restrictions of the OFC were removed. Due to the economic substance requirements in offshore jurisdictions, more fund managers have become interested in setting up a fund vehicle in a location where the fund managers are based, which has been helpful for the development of OFC.

Then, in 2021, the Government introduced a subsidy scheme for OFCs. The scheme covers 70% of eligible expenses incurred in relation to the incorporation or re-domiciliation of an OFC and paid to Hong Kong-based service providers (capped at HK$1 million). This has further enhanced the interest of fund managers in launching OFC.

Following the introduction of UFE in 2019, the government has further refined the UFE to broaden its application to a wider category of investors and asset classes. The industry is hopeful that the government will continue to take into account how the asset management industry is evolving and that the UFE will continue to be updated to cover typical types of investment, including exempting investment into private credit and debt instruments.

Hong Kong's limited partnership fund (LPF) regime, launched in 2020 to encourage investors to domicile here that would previously have gone to jurisdictions like the Cayman Islands, also got off to a slow start but has picked up recently, and funds launched under the LPF regime are now becoming more substantial.

The carried interest tax concession is another incentive that should benefit the asset management sector, but that contains some hurdles that have prevented full realisation of the benefits. This incentive was a significant lobbying success for the asset management sector, and followed many years of dialogue with the government. However, when the law became effective, fund managers faced a number of practical difficulties fulfilling the requirements for fund structure and documentation, and also had concerns about disclosures that might result.

As a result, fund managers in Hong Kong are still taking a wait-and-see approach to see how the incentive will be applied in practice. Singapore seems to have more clarity in this area in practice whereby carried interest may not be taxable.

The Hong Kong government clearly wants to support the asset management industry and has shown willingness to refine incentives to make them more appealing. Hong Kong needs to update its funds exemption rules, so that fund managers have the certainty they need to continue to manage their investment holdings from Hong Kong or consider domiciling their funds in the city. Such measures will be needed if Hong Kong is to remain competitive on tax, and continue to serve as Asia's leading asset management hub.

Regulatory developments

Tighter requirements around liquidity risk will be one of the key regulatory priorities in the year ahead

Seismic events in recent years have been driving regulatory change as policymakers around the world work to enhance the stability and transparency of markets. While the pandemic, invasion of Ukraine and rising interest rates have affected virtually all businesses, the collapse of family office Archegos in 2021 was a shocking development for the asset management sector in particular.

Liquidity risk management for open-ended funds is a key priority at present. The current regulatory requirements in Hong Kong have been in place for a number of years, so fund managers should already be regularly reviewing the liquidity of the assets in their funds and conducting risk assessments in different scenarios. However, further tightening of these requirements is anticipated in the near future.

On a global level, the Financial Stability Board has been conducting a review of open-ended funds and is expected to make a number of recommendations for regulators, including more clarity on redemption terms, enhanced liquidity management tools, and improving data availability and enhanced stress testing.

In Hong Kong, meanwhile, the Securities and Futures Commission (SFC) has been focusing on liquidity risk in its recent inspections of asset managers. In October 2022, the SFC said that it was closely monitoring liquidity and valuation of SFC-authorised funds, due to the current challenging environment.

Given the ongoing volatility and the likelihood of regulatory changes ahead, Hong Kong asset managers should thoroughly analyse the impact of the recent market volatility on their portfolio holdings and reassess their liquidity risk management framework for all of their funds.

Liquidity risk management is only one of many areas that asset managers must keep on top of. Another major topic is ESG. As sustainability becomes embedded in all areas of business, there will be tighter scrutiny of ESG in investing as policymakers develop frameworks for asset managers. The SFC, for example, has been reviewing fund managers' use of ESG ratings and is preparing guidance for the sector on the use of ESG rating service providers.

Given regulators' need to react to changing circumstances amid global uncertainty, asset managers in Hong Kong should pay particularly close attention to regulatory developments in the year ahead, and ensure that they have the information and tools available to effectively assess risk.

ESG

Regulatory scrutiny, investor demand and global trends are pushing ESG up the agenda, giving asset managers the opportunity to differentiate themselves

A combination of global trends and local developments in Hong Kong mean that ESG matters will continue to be top of the agenda for asset managers in 2023.

In particular, the industry has recently been adopting the SFC's new regulations for the management and disclosure of climate-relate risk as they have started to come into effect. These require fund managers to carry out periodic assessment of how their investments are meeting climate-risk criteria, as well as additional naming and disclosure requirements. The requirements also aim to encourage fund managers to review and manage their carbon footprint on a regular basis, and to find ways to decarbonise their portfolios.

There are two tiers under the new rules, with enhanced requirements for funds of HK$8 billion or more, but essentially all asset managers in Hong Kong will need to comply with the relevant set of rules going forward.

While this has added to the compliance burden, it also gives asset managers an opportunity to differentiate themselves. By having a clear framework and procedures in place they can more easily demonstrate to clients how they can assess climate risk in investments.

There is also an opportunity for asset managers to go beyond climate-related risk management to wider ESG risks based on the same framework. As ESG investing has become more mainstream, many more investors, including major asset owners like pension funds and sovereign wealth funds that have a broad stakeholder group, are showing more interest in the sector.

At the same time, the topic of sustainable investing is becoming broader and is no longer focused on only green companies and activities, like electric cars or solar power. There is also growing awareness of the potential for better returns in the long term and reduced volatility from integrated investing.

These developments are all part of broader global trends. In the EU, for example, 100% of funds need to be ESG complaint. The direction of travel is clear, and asset managers that are ahead of the trend will find this to their advantage in the future as sustainability becomes further embedded in all areas of investment.

Family offices

New incentives on the horizon for family offices will be a boost for the sector and will help Hong Kong to remain competitive

In April 2023, a new incentive to encourage family offices to come to Hong Kong is expected to become law. This is a welcome initiative and should be a major boost in making the city a family office hub, so long as the requirements for operators are not too onerous.

Under the city's current regime, high-net-worth individuals (HNWIs) and family offices would be exposed to tax if they handled their investments and succession planning in Hong Kong – so there was little incentive for them to come here. The proposed profits tax exemption for family office businesses is a positive development as it will give more tax certainty for such investors and should attract more of them to Hong Kong.

However, there is some uncertainty whether this initiative will be enough to attract HNWI investors from the Chinese Mainland and elsewhere in Asia to Hong Kong. One example of a competing jurisdiction is Singapore, which rolled out its family office incentives a few years earlier. Hong Kong needs to ensure that the incentives available are at least as attractive as those in other jurisdictions, and that the conditions attached are not overly complicated or unclear.

The asset management sector has seen other policies in recent years that have not been as successful in attracting investment as had been hoped, partly as a result of complex conditions or a lack of clarity. These include the open-ended funds company regime and the carried interest tax concession. However, some of these measures have since been revised to make them more attractive.

The Hong Kong SAR government has made it clear that it wants to promote the sector, and its actions in support of this have included up a dedicated family office team at InvestHK in 2021, and the upcoming profits tax exemption for family offices is another step in the right direction.

Private equity

Rebound in private equity expected in 2023 as China's Covid restrictions ease and dry powder needs to be deployed

The private equity market in the Chinese Mainland split into diverging paths in the past 12 months, with respect to RMB and dollar funds.

RMB funds have remained relatively buoyant despite the external pressures. This is partly because RMB funds are active in sectors such as the high-tech economy that are benefiting from China's initiatives to become more self-sufficient in technology. We expect that RMB private equity activity should continue into 2023, further boosted by a strong domestic market and continued interest from the wider Asian IPO market.

For dollar funds, on the other hand, the market has been slow due to the global economic slowdown, geopolitical tensions and Covid concerns. However, there is now light at the end of the tunnel as the introduction of a more practical Covid policy in the Mainland is expected to spur a resurgence in activity.

Another reason to expect a rebound in private equity is the fact that dollar funds have a lot of dry powder on hand. Little was deployed in 2022, so fund managers will come under pressure to start making use of this dry powder in the year ahead. As the second biggest economy in the world, China has few rivals in terms of scale and variety of sectors, so will likely remain an extremely attractive target for investment.

Valuations may also have an impact on market activity going forward. China's rapid growth has driven up valuations in recent years, but these are now coming down to more reasonable levels, which could act as another trigger point to encourage investors to return to the market.

In terms of sectors, investors are moving away from cash-burning internet businesses towards more "real" technology areas such as fintech, advanced technology, as well as areas like manufacturing where new technology is upgrading traditional businesses.

Meanwhile, a number of provinces and cities in the Mainland have set up their own investment platforms to support the growth of local industries, which could be an interesting development for the market.

A resurgence in private equity activity will not happen overnight as investors will remain cautious in the short term. But in the second quarter of 2023 and beyond we anticipate that the investment momentum will return strongly.

eMPF

Huge change ahead for MPF service providers as administration of Hong Kong's retirement savings scheme shifts towards the centralised eMPF platform

As the launch of the eMPF platform moves closer, service providers will need to ensure that they are ready for this major shift in Hong Kong's financial market.

The eMPF platform, which will standardise and automate the administration of Hong Kong's mandatory retirement savings fund, is aimed at improving net returns by reducing administration fees paid by the scheme's 4.5 million members. Currently, there are 27 Mandatory Provident Fund (MPF) schemes, operated by 17 scheme sponsors, although the market is dominated by the three biggest players.

Onboarding onto the new platform is expected to be completed by 2025, so service providers should be figuring out the optimal strategies for their business and taking actions now to make sure they are ready for the change.

Three key elements to be Day-1 ready include:

- Employer and employee user journey: Be clear about how these would evolve
- Data: Be ready on the quality of data to be migrated
- System and process: Ensure it is set up to interface with the new eMPF platform

But planning for a successful Day-1 launch is only part of the story, and scheme sponsors must also prepare for a fundamental change in the market. Currently, MPF is a B2B service dealing largely with employers. After the eMPF platform goes live, members will have more visibility of their funds, as well as more freedom to switch providers. Essentially, the market will become more "retail" in structure and the focus will shift from employer to employee. Providers will need to have a clear customer value proposition to differentiate themselves from their competitors.

Scheme operators will also have to find new routes to profit, as administration fees will reduce and there will be pressure to be more cost-effective. Larger firms may be in a better position due to their bargaining power with investment managers, a more recognised brand and an ability to achieve a lower cost of customer acquisition through cross-selling.

Given the huge investment required in moving to the eMPF, market participants will need to decide how important the MPF business is for their group, and some may decide to exit. At the same time, there will be scope for new product development and new players may enter the market. The next few years will be an exciting time for the sector, with opportunities for participants to reshape the retirement savings landscape in the city.

Virtual assets

Hong Kong's standing as a virtual assets hub will be enhanced as recent turmoil in the sector encourages investors to seek well-regulated regimes

The collapse of cryptocurrency exchange FTX in November 2022 was an extraordinary development that will continue to have a huge impact on the global virtual assets industry in the year ahead. Investors will likely be very cautious about such assets in the short term. However, once they return to the market, they will want to invest somewhere with a well-regulated regime, so Hong Kong could ultimately be a beneficiary.

What has become clear is that FTX's demise was a result of exceptionally lax oversight of the business. The company's collapse has highlighted the fact that there are no shortcuts to having strong governance over clients' assets, including where they are being held and how they are being deployed. Investors globally will want to be very sure that adequate governance is being carried out in future.

In recent years, Hong Kong has been rolling out new regulations as part of its plans to become a hub for virtual assets trading. From April 2023, for example, all virtual asset service providers operating in Hong Kong, or that serve clients here, will have to be licenced. This is a timely development, as the recent developments at FTX have validated Hong Kong's approach to scrutiny of the sector. Greater regulatory certainty will help to attract investors back to the market.

There are further moves that the Hong Kong authorities could take to boost the city's attractiveness, such as treating virtual assets as an investment class so they can qualify for tax incentives. For example, virtual assets could be treated as securities, or they could come under the open-ended fund company provision for tax treatment.

Such a development would also encourage investors to be more transparent about their strategies, which would ultimately be good for the city's status as a financial services hub.

Going forward, the regulator will need to find ways to protect the city's broad base of investors while also allowing enough flexibility for sophisticated investors to be more adventurous. This will be a delicate balance, but Hong Kong has a fantastic opportunity to build on the foundation it has already laid to become a successful global virtual assets hub.

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