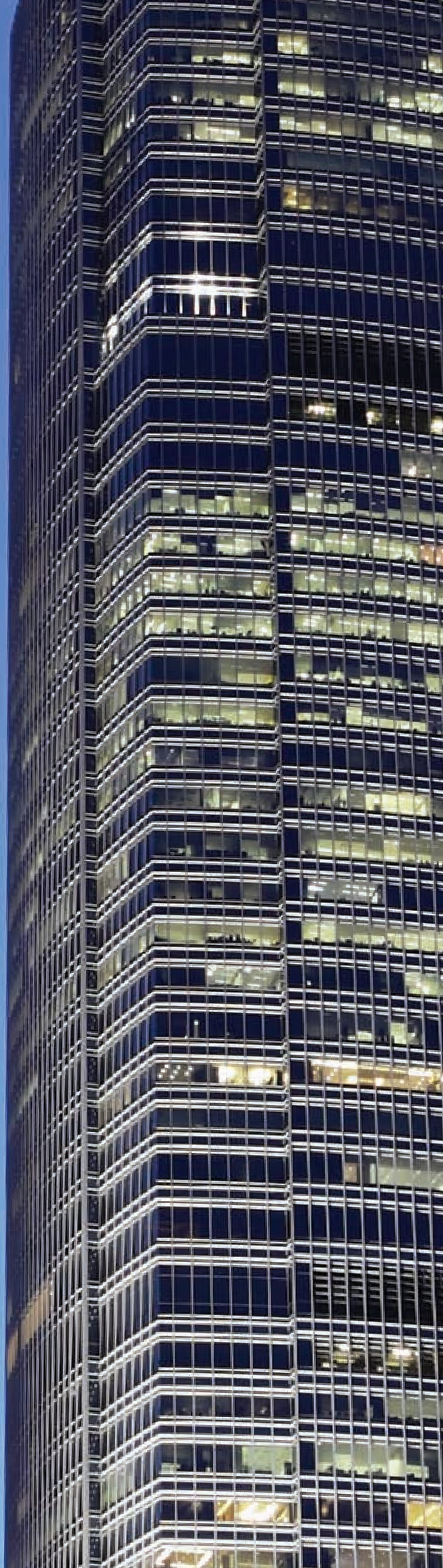
Aiming high: satellite offices get investment funds closer to the action



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In today's low-yield environment, institutional investors are keeping a close eye on their portfolio composition, internal capabilities and technology demands, as well as tradeoffs between asset management fees and internal costs. This ongoing review is steering many institutional investors to conclude they can gain higher returns by boosting their direct investments and by increasing their internal capabilities accordingly.[1]

[1] For insights on the challenges that arise when expanding the scope of in-house investment-related activities, including insourcing certain investment capabilities to directly and actively manage aspects of portfolios, please see *Direct investing debate*. This KPMG International paper provokes debate and comments for institutional investors as they consider a move toward increased in-house activity.

Deciding to build or expand a direct investment program triggers a range of questions, one of the more important being whether to set up one or more satellite offices. There are no one-size-fits-all answers. Every organization has unique characteristics and capabilities, and these must be understood and analyzed to assess the potential benefits and challenges of expanding operations geographically. Investors also need to consider whether expansion is within their means and aligns with their broader goals.

This article explores some of the more important questions to think about when establishing offices closer to key markets.

The evolution continues

"More and more, we are seeing clients consider an expansion of offices to provide greater exposure to a particular market — improved insight, deal flow and market connectivity — and to provide strategic advantage in an increasingly crowded and competitive market. We help clients as they make these decisions and as they implement them."

David M. Neuenhaus,
Global Head of Sovereign Wealth and Pension Funds, Tax, KPMG International

Institutional investors are major players in international financial markets, and their impact is intensifying. Since 2007, the Sovereign Wealth Fund Institute says, the combined assets of sovereign wealth funds have doubled to more than 7.2 trillion US dollars (USD), and they are expected to reach 20 trillion USD by 2030.[2] And, the Willis Towers Watson *2018 Global Pension Assets Study* reports that global institutional pension fund assets in 22 major markets weighed in at more than 40 trillion USD.[3] As allocations to alternative investments and foreign investments grow, institutional investors continue to evolve as direct investors. Day-to-day portfolio management is now integral to many investors' roles.

This presents challenges when the investor is located far away from the markets where investments are held — access to data, market relationships and deal flows are crucial to success. As activities expand, the need to find ways to be front and center of deal flow and investment opportunities becomes more urgent. Competition for deals can be significant, and proximity to the action and ready access to information can make all the difference.

That's why many institutional investors are growing their global footprint by establishing foreign offices in strategic locations — to source and monitor deals, develop local relationships and help execute transactions. Having the right people in place with local market knowledge and relationships can support better deal flow, transaction evaluation and post-deal monitoring. Familiarity with the local government, politics, people, legal and tax advisors, regulatory environment and customs deepens investors' understanding of the terrain and improves their ability to compete in the market.

Some investors have gone beyond setting up foreign offices, organizing regional hubs that cover investment and operational needs for multiple markets. This approach can promote superior monitoring of the regional and local political environment, especially in emerging markets.

[2] Sovereign Wealth Fund Institute
[3] Willis Towers Watson *2018 Global Pension Assets Study*

Factors to consider

Many factors come into play when deciding whether and how to set up a foreign office. These include:

- the purpose of the foreign office and functions that it will perform
- deal approval processes — whether centralized or distributed
- staffing — whether local or expatriate
- the impact on the institution's culture and governance
- potential legal, tax, and regulatory issues that can arise in the new location.

Some factors are jurisdiction-specific, such as restrictions on the types of entities allowed. Other factors influence the choice of entity and resultant tax treatment of the foreign office. The choice of entity itself is a key decision that drives other consequences, such as permanent establishment risk and transfer pricing.

Some key questions that institutional investors should consider, among others, are as follows.

What is our purpose in setting up a foreign office?

Funds need to strike a careful balance when determining the purpose of a foreign office since this can affect not only its effectiveness but also its impact on existing policies and procedures.

Many institutional investors open foreign offices to establish a presence in an investment hub, close to markets where they have significant assets or markets that are central to their portfolio strategy. Sometimes, the purpose may be more opportunistic, for example, to gain proximity to fund managers located in London, New York or other high-value locations.

In other cases, nonfinancial centers may be selected to improve the flow of economic and other key data to the home office.

In all cases, the ability to initiate and deepen relationships with deal originators over the investment lifecycle opens access to more transactions. A foreign office can also give investors an edge by helping identify local partners and specialized knowledge that can help identify investments.

What is the foreign office's intended function?

Defining the intended function of the foreign office will help institutional investors implement the appropriate operational models and processes in the new location. Questions to think about include, but are not limited to:

— Will the foreign office house front office staff only?

— Is the team expected to grow over the years?

— Will the foreign office focus on investment?

— Will the foreign office operate independently from the main office?

Foreign offices of institutional investors are typically restricted to investment advisory and management activities, unless the office also acts as an investment platform. The foreign office's services may include, but are not limited to:

— researching and identifying investment opportunities in the region

— initial screening and diligence

— making recommendations to investment committees and/or board

— monitoring assets across their lifecycle.

What impact will the foreign office have on the investment fund's culture?

Having overseas staff can affect a fund's institutional culture. Establishing clear reporting lines and grants of authority, and maintaining a common corporate culture across all offices can be critical. Home office professionals are often seconded to the foreign offices to export the corporate culture and promote high ethical standards in the new location. However, the foreign office's success equally depends on tapping local talent that understands the market.

Finding the right local team to align with existing organizational resources is not easy. Many investors are constrained in the compensation that they can pay, challenging their ability to attract and retain talent. Competing successfully in foreign markets for investment talent, particularly for a new market entrant, requires the ability to offer competitive compensation packages.

"Our biggest challenge is human capital. Aligning a local team with existing organizational resources is not always easy."

Head of Tax,
Middle Eastern Sovereign Wealth Fund

What is the appropriate choice of legal entity?

An important component of establishing a foreign office is choosing the correct structure — for example, whether to operate as a representative office or an onshore incorporated entity. This analysis needs to address a variety of tax and non-tax considerations, including:

— the office's intended function

— tax and legal requirements in the jurisdiction

— for an incorporated entity, the compensation arrangement that will be put in place in light of home and local country transfer pricing requirements.

Regulatory restrictions may affect the scope of activities that could be carried on in the country, influencing whether the foreign office is set up as a representative office or wholly-owned subsidiary. It is also important to determine whether sovereign immunity or other preferential tax treatment is available.

What are the local rules for permanent establishments and transfer pricing?

Before establishing a foreign office, managing permanent establishment and transfer pricing risk is imperative. The rules defining what creates a taxable presence can vary dramatically by jurisdiction — and they are not always clear. It is especially important to develop protocols for senior executives sent abroad to help determine their activities in the new location do not create a permanent establishment for the fund. The fund may need to restrict who can sit on boards of portfolio companies or remain on boards of the head office fund. Country-specific concepts of what creates a taxable presence and local requirements on how to set and disclose transfer prices must be considered and discussed with advisors in that country.

"It is a challenge to establish protocols, especially for senior executives sent abroad, to be sure that they do not create a taxable presence for the fund."

Tax manager, Canadian pension fund

Further, the relationship between the foreign office and head office should be documented and regularly reviewed and updated to reflect changes in both local and head office transfer pricing requirements. Many institutional investors set up foreign offices as limited service providers to the home office, with the foreign office receiving reasonable fees for the services provided and risks assumed. In other cases, head offices provide advisory services to foreign offices that do not have the investment professionals with the appropriate experience for a specific asset class or transaction. Over time, personnel and operating models tend to evolve such that the transfer pricing methodology may need monitoring or updating and in any event will typically vary by country.

Will the foreign office have decision-making authority?

Certain foreign offices act as investment advisors to the main office, only making recommendations on potential investments. Other institutional investors authorize foreign office staff to make investments or take part in investment decisions. The approval process can have important consequences not only on the fund's policies and procedures but also on the taxation of the foreign office.

What are some of the other practical considerations that may need to be addressed?

In addition to these questions, there are many practical considerations to review. For example, establishing the new foreign office may entail significant start-up costs that the main office may need to finance (e.g. deposits on leases). Some countries set restrictions on the initial capital structure. Employee training, entity financial reporting and internal compliance requirements present additional challenges. Also, information technology and the infrastructure network, including cyber-security, of the office must also be considered.

New horizons, new opportunities

In summary, expanding offices beyond the home jurisdiction is a significant undertaking. It opens more exposure to new opportunities and creates a strategic advantage in an increasingly crowded and competitive market. But it also raises risks due to the complexities of operating on a multijurisdictional scale. Before setting course for such a journey, institutional investors need to carefully consider the potential benefits and risks of establishing a foreign office.

Case study

A pension fund decided to establish an overseas office and hire investment professionals (both internally and externally) for several investment groups over time. The hired investment professionals were not members of the home office investment committees and did not have authority to sign or otherwise bind the home office to investment opportunities. Investment professionals from the head office would also work in the foreign office from time to time.

The investment professionals' activities would include:

- researching general investment opportunities in the region
- sourcing specific potential investment opportunities
- analyzing identified investment opportunities
- discussing investment terms with other parties
- monitoring completed investments.

KPMG professionals analyzed from a tax perspective, alternative legal entity options for the foreign office, including creating a new subsidiary or a representative office of the home office fund. The tax-based analysis considered a wide variety of potential issues, including:

- local legal restrictions
- transfer pricing requirements
- local and home office tax implications and compliance requirements
- dual-hatted executives
- independent agent issues
- impact on existing policies and procedures
- approval authorities
- availability of tax exemptions and access to preferential tax regimes
- permanent establishment risks
- local corporate formalities
- human resource requirements.

After assessing these considerations in view of the fund's business objectives, establishing a subsidiary in the foreign jurisdiction was determined as the appropriate approach. KPMG professionals then worked with the fund to set up the legal entity and put in place policies and procedures that helped determine that the new foreign subsidiary would be respected as an independent agent of the fund and that local and home country transfer pricing and compliance requirements would be met. This included assistance with drafting clear operating guidelines for the foreign subsidiary.

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