KEYNOTE INTERVIEW

How is the private debt market in the Asia-Pacific region evolving?

With banks retrenching from lending to middle-market companies in various Asia-Pacific jurisdictions, there may now be an opportunity for investors to benefit. We asked Andrew Tan, head of Asia-Pacific private debt at Muzinich & Co., about the pace of change in this evolving market

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Q How is the private debt market in the Asia-Pacific region evolving?

If you look at Europe and the US, private non-bank lending has taken up an increasingly large portion of lending and the Asia-Pacific region is following that trend.

After the global financial crisis, we saw regulators clamp down on bank capital adequacy ratio requirements. Basel III formed a big part of that. As a consequence, banks were forced to put aside larger amounts of capital when lending to smaller companies, than when lending to larger companies. So, while larger companies received a lot of attention, we have seen that fast-growing middle-market companies have been somewhat starved of capital.

Although bank lending is dominant in the Asia-Pacific region, accounting for around 91 percent of all loans in Asia-Pacific, according to an ANZ report, only about 20 percent of loans are disbursed to small and medium-sized enterprises. This is despite these companies accounting for around 40-60 percent of GDP, according to the Asian Development Bank. The International Finance Corporation estimates there will be a funding gap in the Asian middle market in excess of $2 trillion in the years to come and that has to be filled somehow. We think that private debt can ultimately be the solution.

Within the Asia-Pacific region, we are already seeing banks dealing with an increase in the cost of funding and an increase in non-performing loan assets. With this in mind, we are expecting to see an acceleration in the pull back of bank-based lending.

Q What are the regional trends which you see

Q What is your interpretation of impact investing and is private debt compatible with broader ESG approaches?

People often talk about impact investing and how they can help their local community. We believe that you only have to look in your own backyard to know that there are a lot of companies that are underserved in this region. For businesses with good cashflows and EBITDA between $5 million and $50 million we believe there are opportunities to make an impact.

Environmental, social and corporate governance comes in layers. People think of ESG as environmental or social, but they often forget about the governance aspect. Muzinich signed up to the UN-backed Principles for Responsible Investment in 2010 as ESG is something that we take very seriously. From our perspective, there are certain no-fly zones such as gambling, vice-related sectors, tobacco, alcohol and firearms, for example.

At the next level down, before we get involved with a company, we consider their impact on the environment and whether they are doing anything harmful. If the answer is a straight no, we also consider whether they are doing anything to reinforce that fact. We consider how we might be able to help a company influence their ESG outcomes, we look at the governance that they currently have in place and explore how this can be better enhanced.

as material to the growth of this market?

Since the last financial crisis in 2008, we have already seen private credit grow in terms of assets. In Asia, we have a growing population and an expanding middle class that is demanding ever more products and services. SMEs will need to be able to cater for this demand, but the banks are not lending enough. I believe it will be private debt that steps in to make up for this funding gap.

Q Where do you see the investment opportunity?

We see investment opportunities in the Asia-Pacific private debt middle market with a focus on creditworthy companies that seek to generate high recurring income, and capital appreciation potential in geographies across Asia-Pacific including Australia, China, Hong Kong, Singapore and Indonesia. We consider the middle market to be companies with between $5 million and $50 million of EBITDA and we are looking at creditworthy companies, those with a minimum of three years' operating history and with audited financials.

Q Where do you see investment demand for private debt strategies in Asia-Pacific coming from? What kind of investors are particularly keen?

Some investors may be more familiar with the traditional private equity model – 10-year lock-ups with a back-ended expected return in excess of 20 percent. But recent years have shown that, in some instances, that expectation hasn't been met. I have met with people who have been disappointed with their private equity choices. It's a function of the J-curve in private equity. You can be losing money in the first few years without an income and you are effectively betting on portfolio probability for success.

At the other end of the spectrum, you have another set of investors that say they want to go for a very liquid market strategy in the public bond market. They think that because a market is public that it must be liquid, but the Asia-Pacific high-yield market, for instance, is not as liquid as it is perceived to be so when you need the liquidity the most in times of volatility, it potentially isn't there.

In private debt, we are focused on secured loans. We control the amount of collateral coverage that we have, and we also may have top-up mechanisms if the collateral coverage deteriorates. Financial covenants in private debt transactions tend to be stronger than public bonds. At the minimum you will have

"As an asset class within a portfolio, Asia-Pacific private debt could provide a diverse set of opportunities for investors"

debt to EBITDA and minimum debt service coverage, oftentimes we also include minimum EBITDA requirements and/or restrictions on capex spending.

Q How would you rate the quality of due diligence in Asia-Pacific private debt compared with the bond market?

From a governance perspective, private debt lends itself to full "front-to-back" due diligence. In addition to internal team due diligence, we will often get third parties to supplement due diligence and help provide an independent viewpoint.

Q Looking at the return profile of middle-market private debt in Asia-Pacific, how does it compare with bonds and private equity then?

We believe there is a place for public bonds within investors' portfolios as they serve different investor needs and risk profiles. In private equity, there is a long wait for returns which can sometimes disappoint. With private debt, you are looking at a typically five-year time horizon where you are able to help structure downside protection by establishing a credit floor as part of the debt package. You could secure a cash return from the first quarter that capital is invested. As an asset class within a portfolio, Asia-Pacific private debt will seek to provide a source of alternative alpha from the US and Europe.

Q How has the Asia-Pacific landscape changed in the past 20 years. Would you say that the private debt market has become more sophisticated?

Since the last financial crisis in 2008, there has been more case law that has developed in the past 10 to 12 years to lean on. For example, in China, in addition to the Enterprise Bankruptcy Law of the People's Republic of China, the courts have upheld that the priority of secured creditors should take precedent over security granted to a mainland Chinese company just prior to the commencement of bankruptcy proceedings. This is an important milestone for both offshore and onshore creditors who take security from mainland Chinese counterparties. A more well-defined timeline under bankruptcy proceedings has been put into place. In India, we've seen the establishment of the National Company Law Tribunal under the 2013 Companies Act. There has been progress in Asia-Pacific from a standpoint of bankruptcy regimes and due process.

"The Asia-Pacific market has developed from a standpoint of creditor rights, bankruptcy regimes and due process"

In developed markets, Australia is one of the best jurisdictions in the world for senior secured lenders. If there is a default, you can go through a receivership process to take control of the company. Singapore, Hong Kong, Japan and Korea are also great jurisdictions in terms of their protections, with a clear rule of law. Those jurisdictions are fantastic because they have the right frameworks in place. Developing markets like China, India and Indonesia have no doubt come a long way. They have the laws in place, but the practical approach might be where experience goes a long way. In these jurisdictions, we believe that you need investment professionals that have the experience of turnarounds to navigate the Chinese court system, Indonesia PKPU (restructuring) process or India's NCLT insolvency regime.

Q What other experience do you consider to be important in this market in order to achieve your investment goals?

Our senior team members in Asia-Pacific have distressed debt and turnaround experience. That said, we are not discussing buying into distressed debt at this point, but we think this experience is important should the companies invested in ever face a situation where things don't work out according to plan. That way the team already has the experience to know what needs to be done and how to go about doing it to help turn things around for the company. I would say that is a big differentiating factor.

Having a global team allows for more inter-market, cross-border potential in terms of transactions. We benefit from the intellectual DNA of the firm's best practices as well as the connectivity, context and knowledge of local team members that are on the ground.

We believe not many global firms target middle-market lending in Asia-Pacific. In our experience, these firms are focused on really big deals and by extension larger companies. Furthermore, we have not seen many global firms like Muzinich that specifically seek out the middle market in this region. We believe that having local experience is really important in Asia-Pacific. We already have people on the ground in Australia, Hong Kong and Singapore and our expectation is for the team to grow again further next year, building out in the jurisdictions that matter to us and our clients. ■