Asset & Wealth Management: Alternatives in Asia

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Content

Alternatives increasingly fund the future

The Asset & Wealth Management (AWM) industry in Asia is at an inflection point with heightening regulations and ever-evolving investor demands providing the key forces driving change. The model where asset managers merely focused on financial gains and performance is no longer the status quo. And this shift is having a revolutionary impact on product design, fee structures, operating models, distribution regimes and asset allocation trends.

There is building consensus from investors that those entrusted to manage their assets professionally can use their influence to play more prominent roles in shaping a better future for the economy and wider society. The alternative asset class is no different and alternative managers are expected to deliver on this front by channelling private capital to investment opportunities which help fund the future. This is ever more important as both economic and social infrastructure investment needs swell, the pension funding gap increases, and sustainable investing gains traction. To put things into perspective, The Asian Development Bank (ADB) estimates that approximately US$1.7 trillion will have to be invested annually in infrastructure across developing Asia through 2030 if the region is to maintain its growth momentum, respond effectively to climate change, eradicate poverty and address other pressing issues[1].

Ongoing rise of alternatives

The alternative asset class has continued to grow steadily in recent years. Allocations to alternatives have been nothing short of remarkable with assets under management (AUM) expected to grow to US$18.9 trillion globally by 2025[2]. Although alternatives is still a smart part of the overall industry, the asset class is expected to grow faster than the total industry over the coming years. There is also the expectation that alternatives will take on much of the alpha mantle for investors, offer attractive risk premia, and provide portfolio resilience and diversification. The alternative asset class in Asia is growing faster than other regions and is expected to reach US$7 trillion by 2025 from US$3.3 trillion in 2020[3].

Tailwinds for the asset class include increasing investor sophistication, robust wealth creation and an enduring rate environment which has dampened the appetite for many traditional assets.

In the U.S. and Europe, lower barriers to access alternatives through innovation and product structuring have provided alternatives an outlet to reach a larger base of investors. Retail investors are able to gain exposure to some alternative investment strategies through liquid retail structures, such as mutual funds or UCITS funds. Asia is yet to follow in this regard but it is envisaged these trends will emerge in the region sooner rather than later.

Accelerating alternatives aspirations for all players

In recent years, traditional asset managers have increasingly looked towards and moved deeper into alternatives, as they look to build a presence in the asset class to offer more choice for their clients. Within Asia, M&A activity by traditional managers to build scale in alternatives have increased and the market for deals has become more competitive. The move to diversify asset classes also highlights the convergence between traditional and alternative managers, as the former increasingly utilizes alternative approaches to generate returns - going beyond the established asset silos of equities and bonds.

Within the alternative asset class, there has been a trend of crossovers between asset managers which highlights the connectivity within alternatives. For example, there has been a trend of increasing allocations of private equity funds to private credit opportunities, growing private equity investment in real estate, and a focus on infrastructure in real asset regeneration. Moreover, there has been an upsurge in collaboration as asset managers seek out partners to provide specialist expertise in a new asset class or to market products through third-party platforms.

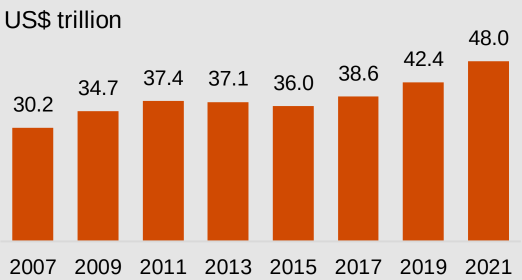
[1] Asian Development Bank - Meeting Asia's Infrastructure Needs
[2] Asset & Wealth Management revolution: The power to shape the future
[3] Asset & Wealth Management 2025: The Asian Awakening

Alternatives increasingly fund the future

Private Credit ramping up

Across the globe, a large shift in dynamics towards the sourcing and lending of capital through alternative providers is happening in a big way. Banks who have been seen as the traditional providers of financing and capital continue to be hampered by regulatory reforms such as Basel III implemented after the Global Financial Crisis (GFC). While the regulatory accord has strengthened capital requirements of banks, it has in turn hindered their ability to lend, especially to small and mid-sized enterprises who are vulnerable to any pullback in the availability of bank credit. This creates an opportunity for alternative asset classes, in particular, private credit to fill the void by financing businesses that are increasingly seeing reduced or no access funding from banks. At US$48 trillion, non-bank lending to the private nonfinancial sector is growing rapidly in advanced economies.

Growth of non-bank lending to the private nonfinancial sector in advanced economies



Source: Bank for International Settlements and PwC analysis

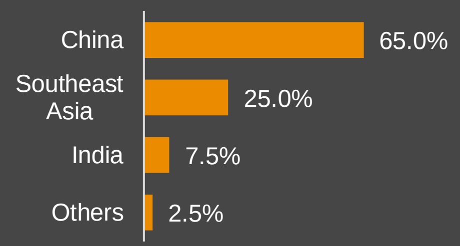
In the context of Asia, home to the majority of the fastest growing economies in the world, ensuring robust and sustainable growth is also a key challenge given the financing gap in economic and social infrastructure, the costs associated with the transition to a green economy, and inadequate pension systems.

With the demand for capital in Asia far outstripping the supply of capital from traditional providers of capital, the role of alternative asset managers in channelling private capital to meet the financing needs of the fast-growing Asian economies cannot be understated.

And with the retrenchment of certain services by banks in the lending space unlikely to go away in the near term, private credit managers are ramping up efforts to raise capital to realise the opportunities that come with providing companies with long-term financing, while tapping the growing appetite from asset owners to increase exposure to high-yielding assets in the region.

With demand for credit likely to remain strong due to positive economic fundamentals of the region, new private credit players will inevitably enter the space. However, with the heterogeneous nature of different markets in the region, the proliferation of new players will be varied in each market as each has its own enforcement and protection mechanisms, regulatory regime, legal infrastructure and tax provisions. In the context of enforcement mechanisms, international investors are still weary given regimes may not be lender friendly in contrast to more established markets such as the U.S. and Europe. This could be a potential sticking point which could delay the ramp up of private credit funds in Asia.

Which of the following geographies do you expect to be the major user of private capital to 2025?



Source: PwC survey

China will require huge amounts of private capital and private credit will be a vital engine to meet the needs of its burgeoning economy which is transitioning from a manufacturing-heavy model to a services-led model.

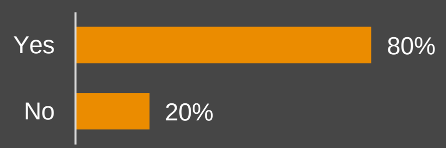
The private credit ecosystem in Asia is undergoing a transformation, mirroring trends in the U.S. and Europe where lenders step in to fill the void and provide capital-starved borrowers a broad suite of alternative funding options and tailored structures.

Alternatives increasingly fund the future

Increasingly, alternative capital is now becoming readily accessible for borrowers looking to utilise flexible funding solutions for working capital needs, M&A, restructuring, trade finance and supply chain finance.

There is a sense of new momentum in the private credit asset class in Asia as new funds in the region are attracting some of the world's most sophisticated and largest investors. Investor profiles are diverse, with endowment funds, sovereign wealth funds, pension funds, insurers, and family offices providing capital to private credit managers in the region. The combination of robust economic growth, the potential for higher risk-adjusted returns vis-à-vis mature markets, and improving covenant protection, makes Asia an attractive prospect for private credit. Moreover, with a less competitive credit market, there is less pressure on pricing for asset managers operating in the space.

Is non-regional capital key to the continued growth of private capital markets in Asia?



Source: PwC survey

Global investors continue to look for assets which can provide differentiated risk-return profiles and private credit in Asia fits this profile. In addition, investors by many metrics are still underweight the region in their portfolios despite the region representing a large share of world GDP.

The role of banks in the context of funding companies is likely to be drastic and the funding shortfall will continue. The funding challenges in the region are enormous and it will require an influx of capital from non-traditional providers to plug the gap. Conditions are ripe for private credit operators to emerge as a significant alternative provider of capital.

China – the new normal

China's total social financing, which is a broad measure of credit and liquidity stood at approximately US$47 trillion as of September 2021, US$29 trillion of which was attributed to lending, including both Renminbi and foreign currency denominated loans[4]. Significant opportunities for international private credit investors lie in corporate borrowing (US$4.5 trillion) particularly to private companies[5]. The financing ecosystem continues to evolve and many international private credit funds are looking to expand into new lending strategies. International players have also become increasingly comfortable with the efficiency and enforcement processes onshore.

Private credit will play a greater role in financing China's development as the country's "common prosperity" drive and crackdown on unregulated lending continues. Ongoing developments will provide an opportunity for the private credit to fill the void left by banks, as risk appetite drops for specific segments of the lending market. Against this backdrop and the continued challenges faced by small and mid-size enterprises to access funding, alternative providers of capital are set to become an even more important part of the financial system in China. Policymakers are actively encouraging a healthier financing mix for a range of sectors and this will provide compelling opportunities for private credit operators. Asian private credit will continue to grow and China will be the core to a regional strategy for most international players.

[4,5] People's Bank of China and PwC analysis

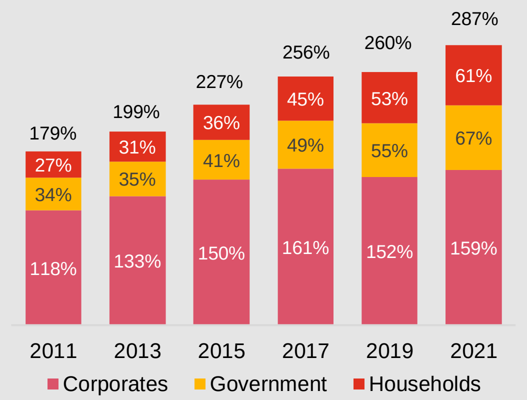
Alternative funding in China

New models emerging

As China's economy continues its transition from a manufacturing-heavy model to a services-led one, small and mid-sized enterprises will play an integral role in accelerating this transformation. Innovative sectors such as 'FinTech', 'PropTech', 'EdTech' and 'CleanTech' to name a few have been significant contributors to economic growth in China. However, small and mid-sized enterprises which operate in these new economy sectors have found it increasingly difficult to access funding. State-owned banks have low appetite to lend to this cohort - and the situation has been further exacerbated with the withdrawal of the onshore shadow banking system in recent years.

Current state of play – Funding growth

Debt as a percentage of GDP



Source: Bank for International Settlements and PwC analysis

While policymakers have actively encouraged banks to increase lending to smaller businesses through various initiatives, wider access to financing is still challenging for small and mid-sized enterprises, in particular those with a short track record. Given this, new investment models are emerging to help fund growth for enterprises shunned by traditional lenders. These models are generally empowered by data analytics designed to bridge the gap between private capital and the country's capital-starved businesses. Moreover, private capital from global capital pools provide opportunities for global investors to share in the growth of China's entrepreneurship development.

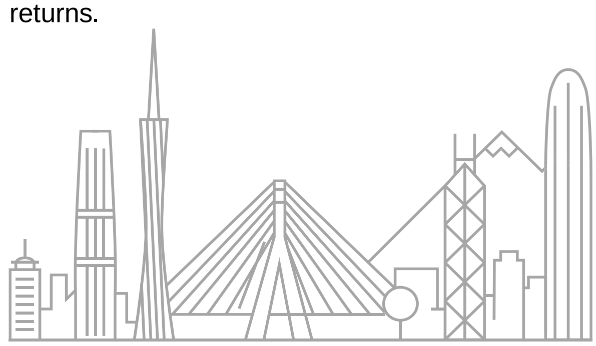
The Greater Bay Area

The Greater Bay Area (GBA) initiative, an ambitious economic development strategy led by Mainland China to transform nine mainland cities and two special administrative regions into a dynamic cluster has clear tailwinds for the financial services industry.

For the asset and wealth management industry, the launch of the Wealth Management Connect (WMC) has provided the necessary building blocks for asset managers, playing the role as product manufacturers, to tap into the burgeoning opportunities in the GBA. At present, the cross-border investment scheme offers opportunities to traditional managers only as the eligible universe is limited to relatively lower risk plain-vanilla products. While this is the current state of the WMC, it is envisaged that other investments products could be permissible in the future – such as private funds.

Pension pressure

Globally, there are mounting challenges for policymakers in regard to devising long-term solutions to offering adequate financial security for retirees. In China, this is no different and its vast population is ageing fast while birth rates remain low - pushing up the dependency ratio and creating imminent challenges The country is expected to have a US$1.5 trillion pension gap emerge over the next five to ten years[6]. In the absence of a meaningful allocation to the alternative asset class which can offer a different risk-return profile to traditional asset classes, the gap will likely widen. Policymakers should consider increasing its alternatives allocation to help provide sustainable returns.



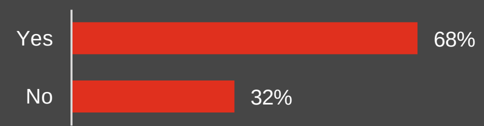
6. China Insurance Industry Association

Shaping sustainable investing

Private capital for public good

Shifting societal values, an increase in sustainability-conscious investors and regulatory imperatives have propelled the topic of ESG to the forefront in financial markets. Asia's alternatives markets have not been exempted from this shift, with ESG triggering an all-encompassing realignment from asset allocation, value creation strategies and performance objectives. Alternative managers are increasingly looking to reflect the sustainability preferences of their clients in their investment portfolios, not only considering ESG risk from a financial perspective but also helping to drive positive impact in the real economy.

Is it possible to generate positive social and environmental impact without sacrificing financial returns?



Source: PwC survey

The belief that delivering positive environmental and societal impact is concessionary to financial returns is shifting. And with ESG risk now a key consideration in the investment and risk management processes of many asset managers, ESG will likely emerge as a value creation lever.

Alternative strategies provide a conducive environment for sustainable investing to flourish and with it, align with the philosophy of ESG conscious investors. Private capital generally has a long investment horizon and accommodates the long term ESG proposition. In the case of private equity, General Partners' (GPs) direct engagement with portfolio companies puts them in a particularly strong position to promote ESG-related initiatives and assist with the transition to a more inclusive and sustainable economy. In this regard, private capital has the inimitable ability to quickly and deeply make an impact, functioning as an accelerant to address concerns in topics ranging from climate change and financial inclusion to poverty alleviation and gender equality.

Private capital and public capital can work in tandem to shape positive outcomes across the region. In recent times, we have witnessed the acceleration of partnerships between public and private players who are leveraging each other's experiences and know-how. Moreover, players can work together to increase awareness and correct misconceptions, smooth out the flow of capital and enhance the transmission mechanism, and educate stakeholders to increase buy-in to address major sustainability targets such as the Sustainable Development Goals (SDGs).

Investing for impact

For some investors, financial returns will remain the sole priority, but the desire to maximise impact solutions has led to the advancement of investing for impact in Asia. Many countries in the region are in desperate need for capital to help alleviate poverty, create domestic jobs, improve livelihoods and upgrade economic and social infrastructure. This presents opportunities for impact investors to direct private capital to enterprises in these countries to further develop and transform for the betterment of livelihoods. While private capital is paramount, real impact is created when both private capital and public capital work together to provide real outcomes to areas of unmet social need, rather than the disparate actions taken so far that have, until now, been used to address broader issues in society.

It is becoming evident that above-market returns can be achieved while simultaneously making a difference in people's lives. One of the core tenets of investing for impact is that the benefit should be defined and measurable, but given the area is an evolving practice, various guidance and best practices have emerged.

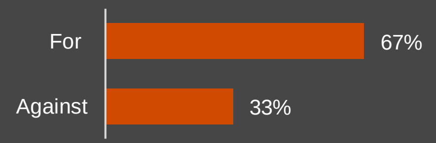
While global capital pools will be the catalytic driver to address deficits across markets in Asia, local talent pools are also essential. For investors looking to deploy funds in emerging and frontier markets to maximise impact and outcomes, having a manager with on-the ground presence is essential to plug the knowledge gaps and information asymmetry which could lead to a misallocation of capital.

The proliferation of Digital Assets

A dilemma for financial advisors

Within the alternative asset's realm, the world of digital assets continues to disrupt the status quo, excite the investment community and appeal to investors given its unique features. The digital assets market is still very much in its infancy, but poised to play a pivotal role in transforming financial markets in the not so distant future. With the digital assets' ecosystem evolving at a rapid pace and interest increasing, at both the retail and institutional level, the asset class is touted to make up a higher portion of an investor's portfolio in the future, given the risk-reward characteristics of digital assets evidently differs from those of other asset classes.

Digital assets are here to stay, and financial advisors should consider an allocation to this asset class in the construction of any well-balanced portfolio for clients.



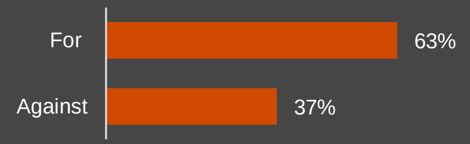
Source: PwC survey

Despite the market volatility associated with digital assets, the asset class can be seen as a means to diversify and enhance the risk-reward profile of an investors portfolio.

Evolving regulatory landscape

As the level of adoption and awareness continues to grow, the asset class has attracted scrutiny from regulators. Currently, the regulatory landscape is uneven and different regulatory bodies in different countries have taken different approaches to regulation. There is yet a clear regulatory framework to emerge but regulators are expected to introduce more regulations that further bolster the regulatory landscape, erring on the side of caution. In Asia, there has been no uniformity, with some countries providing outright bans to the asset class, and others in the process of developing a regulatory framework that takes a more pragmatic stance ensuring it does not stifle innovation.

Regulation and compliance (while bringing legitimacy and access to real capital to cryptocurrencies), are also the bottleneck that will slow down.



Source: PwC survey

As digital assets increasingly become intertwined with financial markets, regulators must ensure they strike a balance between encouraging innovation and providing oversight to safeguard investors' interests.

CBDCs driving innovation

Within the digital asset's arena, central bank digital currency (CBDC) which fundamentally digitize money is touted to be a game-changer in its own right, given its ability to provide citizens and corporates an alternative payment solutions, offering faster and more cost-effective solutions for transactions. Current CBDC designs differ across jurisdictions and a Bank for International Settlements (BIS) study shows that 86% of central banks surveyed are engaged in some type of CBDC exploration[7]. We expect that CBDCs will increasingly need to interact with the existing financial markets ecosystem, allowing capital flows to move faster and improving workflow efficiencies significantly.

CBDCs will be the beginning and pathway to the end of cash in society and that is a good thing.

Source: PwC survey

While CBDCs have demonstrated the potential to revolutionise payments by reducing both transaction speed and cost, the jury is still out on its overall impact in society.

[7] Ready, steady, go? – Results of the third BIS survey on central bank digital currency

Alternatives into the mainstream

Robust growth ahead

Alternatives are playing an increasingly large role in asset allocations as investors continue to seek yield, higher risk-adjusted returns and diversification. Global AUM is expected to grow to US$18.9 trillion by 2025 and Asia will account for much of this growth given the region's strong fundamentals as an investment destination. Within Asia, growth will be broad based, with funds flowing to all alternative asset classes, with the strongest growth expected in the private credit asset class given tailwinds in place.

Historically, alternatives and its suite of investment products have been mainly available for a select cohort of investors - institutional investors and accredited investors. However, in the U.S. and Europe, several forces are in play including greater investor sophistication and product innovation, ushering in new ways to access alternatives through liquid retail structures. Asia is yet to follow in this trend. However, it is likely these trends will emerge in Asia sooner rather than later.

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