Private Credit in Asia Pacific

Navigating the region

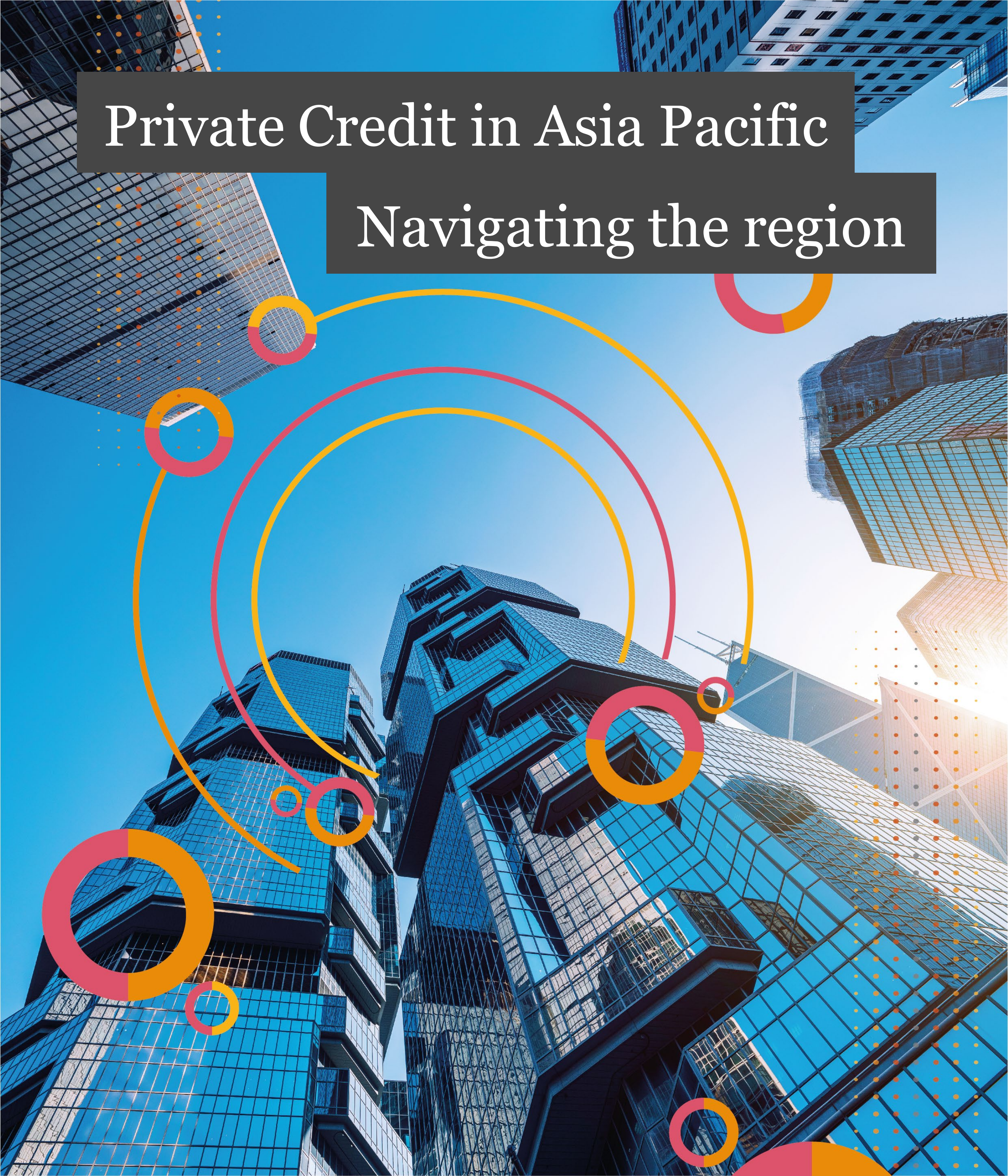


Table of contents

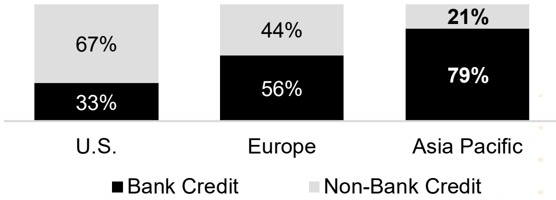
Shifting lending dynamics

Over the past decade, private credit has grown significantly in the global sphere, forming a major pillar for business financing. This growth is in large part a crowding out effect of increasing regulatory capital requirements on banks since the global financial crisis (GFC) that have encouraged other institutions to enter the lending space and offer banking-type products, in addition to the increasing demand from businesses for an alternative source of financing outside of traditional borrowing and lending channels.

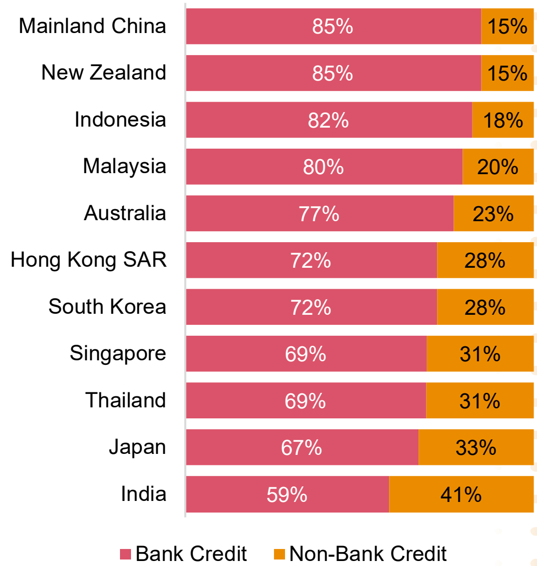
There are a number of unique advantages private credit solutions offer to borrowers and investors. Private lenders work with the specific needs of borrowers, providing flexibility, speed and certainty of execution. In turn, asset managers and investors are provided with portfolio diversification, attractive risk-return profiles and higher yields compared to the traditional fixed income asset class. The array of investment strategies are vast, ranging from distressed debt, special situations, direct lending, mezzanine debt and infrastructure debt. This allows private credit portfolios to be customised to a wide range of investment objectives.

In Asia Pacific, bank lending has historically been and remains the dominant source of funding, making up close to 80% of the market, higher than both Europe and the U.S Particularly for larger companies, the banking system continues to serve the region's borrowing needs well. The Asian banking system has ample capital and the resulting crowding out effect of Basel regime has been minimal. Nevertheless, some Asian banks may have less appetite to meet new credit demand and are keen to dispose of distressed credit. This presents a big opportunity for investors interested in private credit in Asia Pacific.

Bank funded and non-bank funded credit split



Asia Pacific bank funded and non-bank funded credit split



Source: Bank for International Settlements (as of June 2023) and PwC analysis

The influx of private capital has complemented bank lending and provided financing alternatives for underserved borrowers. For some businesses, using a combination of funding options may be required to meet their capital needs for a range of purposes.

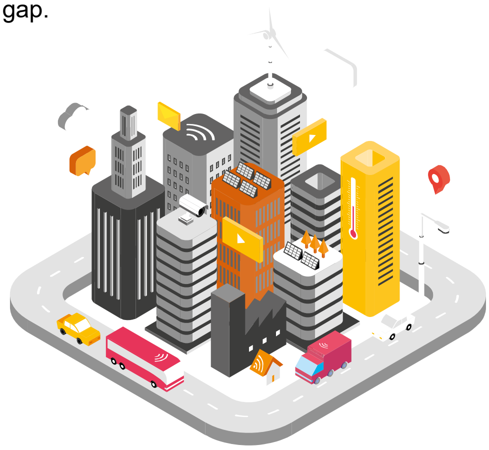
- **Organic business growth**
- **Project financing**
- **Acquisition growth**
- **Trade financing**
- **Debt financing**
- **Current debt restructuring**

Shifting lending dynamics

Asia Pacific did not see the equivalent step-change with private credit following the GFC like in Europe and the U.S. where the rise was underpinned by a blend of supply-demand market imbalances in credit and participation of non-bank lenders coming to the fore. In addition, the use of a single functional currency in Europe and the U.S makes investing and doing business more efficient compared to Asia Pacific. For instance, asset managers operating a USD denominated fund and investing in credit opportunities across Asia Pacific would see frictions related to currency mismatches and vulnerabilities to foreign exchange risk.

While the private credit market in Asia Pacific is still small compared to the U.S. and Europe, it has been growing steadily and demonstrates tremendous growth potential for investors. This is illustrated by several large fund raises in the region and global asset managers building up their local presence and teams.

With the demand for capital in Asia Pacific far outstripping the supply of capital from traditional providers of capital, the role of alternative financing in channeling private capital to meet the funding challenges of the fast-growing Asian economies is pivotal. Some of these challenges include helping climate risk issues such as navigating the net zero transition, accelerating financial inclusion, eradicating poverty, financing much-needed infrastructure against the backdrop of dynamic growth in populations, and addressing the pension funding gap.



- Meeting climate mitigation and adaptation needs in emerging and developing Asia requires investment of at least **USD1.1 trillion** annually.
- Developing Asia will need to invest **USD13.8 trillion** in infrastructure from 2023 to 2030 to sustain economic growth, reduce poverty and respond to climate change.

Source: International Monetary Fund (IMF) and Asia Development Bank (ADB)

Traditional avenues of lending and private lending are collectively fulfilling the range of funding needs of different borrower types in the economy and driving long-term investment opportunities in Asia Pacific. Moreover, the supply-demand dynamics varies from different countries and institutions.

Banks in Asia Pacific …

… In general, tend to have higher capital adequacy ratios (CAR) than banks in Europe and the U.S.

… Tend to value relationship capital with business contacts more so than other parts of the world.

… May be state-owned which influences how lending is provided i.e. to ‘national champions’.

Demand and supply drivers of private credit in Asia Pacific

The demand and supply drivers of private credit can vary depending on the specific country and market conditions. However, some common drivers include the following:

Demand drivers

Small and Medium Enterprises (SMEs)

Forming the backbone of many economies across Asia Pacific, SMEs have been fuelling the rising demand for private credit in the region. Due to their size and lack of collateral, SMEs often suffer from higher transaction costs when securing bank financing. As a result, SMEs are increasingly turning to private credit providers, which have more flexible lending criteria and are less constrained by regulatory requirements. Moreover, post-Covid, many jurisdictions are gradually exiting from earlier credit support measures for SMEs, hence these borrowers may represent a source of demand in the private credit space.

Early stage startups and venture capital

This cohort in Asia Pacific has also generated demand in private credit funds as players want to avoid raising equity capital at discounts to their valuations.

Family-owned companies

Private credit can be used as transitional capital for family-owned companies undergoing structural and generational ownership changes.

Buyout deals and activity

Private credit serves as an attractive alternative to bank lending for financing buyout deals. As Asia Pacific's buyout market matures, private credit is increasingly becoming an alternative financing source, outside of traditional borrowing and lending channels to carry out buyouts.

Supply drivers

Increased allocations to private credit

Investor interest into alternative asset classes have been gaining traction and the growing pool of wealth globally further exacerbate allocations to private investments. Investors across the board are increasing allocations in private markets and specifically to private credit. Private credit provide investors lower volatility, portfolio diversification, attractive risk-return profiles and flexibility to negotiate customised lender protection.

A change in status quo for traditional capital providers

Regulatory capital requirements have caused many international, regional and domestic banks to tighten lending standards and be more selective. Private credit managers provide flexible capital solutions quickly to cater for underserved businesses.

Current state of play and trends to watch out for

Banks refining their business model

The growth of private markets presents both challenges and opportunities for banks. As private credit managers expand their presence, they will likely compete with banks for lending opportunities in certain segments, in particular those which are key fee generators. This increasing competition will put pressure on banks to revisit their way of operating to remain fit for purpose. With this, the originate-to-distribute model has come to the fore, as more banks utilise the model to manage risks associated with liquidity, solvency and leverage. This preference to originate loans and then distribute to other parties and investors in the secondary market enables banks to reduce certain risk exposures by no longer holding the assets on their balance sheets to maturity, while still earning fee income from originating the loans.

Banks can also view the growth of private markets as an opportunity for collaboration in Asia Pacific. For instance, some regional banks may choose to partner with private credit managers to offer a broader range of financing options to their client base. This collaboration can also help banks expand their product offerings and reach new client segments. Moreover, the main source of leverage for private credit funds continue to be banks. Private credit funds often use leverage as part of their investment strategy to amplify potential returns for their investors. Leverage can be used to invest in a larger number of deals or to increase the size of their investments in individual deals. In short, banks can treat private credit players as frenemies rather than adversaries, and there are various synergies which can be realised through different avenues.

Boutique managers coming to the fore

In Asia Pacific, there is a host of boutique asset managers, a diverse group of nimble specialists, operating in alternative investment strategies such as private equity, hedge funds, real estate and infrastructure, that are also looking to expand into private credit. Many boutique managers in Asia Pacific are already well established with strong reputations, serving sophisticated institutional investors such as pension funds, insurance companies and endowments, and often possessing a proven record of outperforming in their niche areas.

With private markets increasingly top of mind for institutional investors searching for higher returns and diversification, more boutique managers are exploring the possibility of adding the asset class in their product suite. In short, boutiques are expanding into this space to meet the growing demand from investors. As an asset class, private credit offers investors an attractive risk-return profile, higher yields compared to the traditional fixed income asset class, diversification benefits and may allow access to niche sectors that are not readily available in public markets. Moreover, investments are less susceptible to market volatility as they avoid the daily price fluctuations seen in public markets. Despite the allure of private credit, there are inherent risks, including credit risks that investors should be cautious of.

Current state of play and trends to watch out for

Untapped opportunities in ASEAN

The Association of Southeast Asian Nations (ASEAN) is home to many of the fastest growing economies in the world and ensuring sustainable economic growth is a key challenge. The region faces a multifaceted and interlinked challenge – how can countries sustain economic development against the backdrop of traditional providers of capital not always providing access to the flexible capital to allow corporates to grow, innovate and refinance. With this, many public and private enterprises have turned to private credit markets.

While the public markets have developed significantly in the past couple of decades, the breadth and depth of the institutional lending markets may not always be sufficient for a dynamic economic cluster, home to a rich tapestry of companies seeking capital for a variety of purposes including organic business growth, project financing, acquisition growth, trade financing, refinancing or current debt restructuring. Public debt markets can be volatile and lack liquidly, as a result, companies have a dearth of options beyond issuing equity, which can be expensive.

Across ASEAN, many corporates have strong balance sheets and prospects, however, they are severely underbanked hence require creative alternative capital solutions, often cross-border solutions to achieve their strategic goals. High quality and performing corporates with large amounts of debt approaching maturity are also tapping the segment for refinancing that may not be available through public markets. These companies often require even more tailored and complex financing solutions and given idiosyncrasies in local markets, this has the potential to provide investors with attractive risk premiums. Investing in private credit in the region can offer a premium over similar deals in other parts of the world, in part because the supply of private capital is lower in ASEAN.

Corporates are becoming larger and more diverse geographically, and this will naturally result in the demand for different types of capital increasing. The demand for private capital is very strong in the region and there is a relatively thin amount of private credit that is currently dedicated to ASEAN, hence the return premiums observed.

Many corporates in the region are family-owned and are now exploring generational changes in ownership or a transition to an institutional model with professional management. This generally requires transitional capital and private credit can be a useful source of capital for businesses to take the next step in their development. Private credit firms looking to engage should understand family-owned business dynamics and assess capital solutions which can be tailored to enable value creating next steps. The credit landscape in ASEAN is extremely diverse, more so than any other region globally. Corporates need partners who can understand the local context and who can provide bespoke capital.

Long-term thematic trends, coupled with secular trends are accretive to support the continued growth of private credit in the region. However, diversity, from culture, language and business principles, pose a challenge for asset managers looking to capture the entirety of the opportunity set in ASEAN. It may be more effective to focus on specific industries or pockets within the region. Moreover, with the heterogeneous nature of different markets in the region, each country has its own enforcement and protection mechanisms, regulatory regime, legal infrastructure and tax provisions. International investors may be wary given enforcement mechanisms may not be as lender friendly in contrast to more established markets such as the U.S. and Europe. Legal systems in ASEAN vary from jurisdiction, with some adopting common law and others using civil law, and some adopting a combination of the aforementioned.

High level private credit lifecycle and kickstarting your journey

Private credit continues to grow in importance both as a source of capital for borrowers and as an investment opportunity for investors. With positive economic fundamentals, new private credit players will inevitably enter the space and fulfil the burgeoning credit needs of Asia Pacific.

When considering setting up a private credit fund, there are several key fundamentals to keep in mind and consider. Setting up and running a private credit fund can be seamless, but new entrants need to be aware of the unique operational aspects compared to other asset classes.

Fund structuring	Asset managers look for structures known for their efficiency of establishment, cost effectiveness and flexibility. For private credit managers, the closed-ended structure is generally preferred from an operational perspective but there are other considerations such as tax, regulatory requirements and investor preferences.
Capital and fund raising	Clearly articulating the unique selling points of the fund and highlighting the investment strategy, track record, expertise of the team, and potential returns is essential when developing the value proposition. The buildout of a strong investor relations team is important to manage relationships and to highlight the unique differentiators of the fund from competitors.
Pre-investment and sourcing	One of the most important factors in sourcing attractive opportunities is whether the manager is perceived by an investee company to provide attractive commercials or can accommodate borrowers whose credit metrics make them ineligible for a bank loan. A differentiated platform for deal sourcing is also essential given the competitive market and building a strong network of industry professionals can provide access to opportunities.
Due diligence	Once potential investment opportunities are identified, due diligence should be carried out thoroughly and this involves analysing the financials, assessing the creditworthiness, evaluating collateral, and conducting legal, tax and regulatory reviews. A meticulous due diligence process helps identify potential risks (and also rewards) associated with the investment opportunity.
Investment management	Following the due diligence step is assessing the risk-return profile of the opportunity and determining whether it aligns with their overall investment strategy and objectives. Once a decision is made to invest, the team would work with borrowers to structure the terms of the loan or credit facility which includes the loan amount, interest rate, repayment terms, covenants, and any other relevant terms and conditions.
Exit strategy and refinancing	A unique feature of private credit is that a shorter investment period allows investors to redeploy their capital allocations more frequently. Given this, managers develop exit strategies for their investments and this may involve refinancing, selling the investment or holding until maturity. The specific process and timing of the exit will vary depending on the objectives of the manager and the borrower's circumstances.

Fundamentals for private credit managers to consider

Risks in private credit

While the nature of credit risk exposures associated with private credit is similar to those of mainstream credit, other risk dimensions may play out differently. For instance, unlike traditional banks which are highly leveraged and subject to high inherent liquidity risk, private credit tends to be less susceptible to liquidity risk. Likewise, interest rate risk tends to be lower in the absence of high leverage.

Owing to the significantly different risk profiles between traditional banks and private credit managers, the latter may have more room to take on credit exposures that the former does not favour. With this, private credit managers should look to implement adequate risk management frameworks in order to identify, capture, measure, monitor and manage all types of risks appropriately, including the following.

Credit risk	**Regulatory risk**
Market risk	**Legal risk**
Liquidity risk	**Concentration risk**
Operational risk	**Deployment risk**

Deployment risk stems from most private credit funds having a shorter investment period, as compared to a private equity fund. In particular, special situation credit funds focused on short-term dislocations and opportunities in the market may have even shorter investment periods. Overall, credit managers may feel the need to deploy and redeploy their capital more rapidly and frequently (as compared to private equity managers), given they are remunerated by management fees based on invested capital, rather than committed capital.

For managers to best insulate themselves from a myriad of potential risks and gain a competitive edge, a robust risk management framework to protect assets, enhance investor confidence and comply with relevant laws and regulations is essential. It allows private credit managers to focus on their core investment strategy while mitigating potential risks.

Enhancing risk-resiliency creates an environment where portfolio managers have the confidence to make informed decisions based on a solid foundation of robust risk management practices. Moreover, monitoring market and economic conditions and regulatory developments is paramount for assessing the myriad of potential risks which can impact the portfolio. This includes analysing interest rate trends, macroeconomic indicators and industry-specific dynamics.

Currently, the closed-end structure is the most widely used vehicle for private credit strategies. However, asset managers are starting to explore alternative structures, such as the open-end structure (which allow for greater flexibility in subscriptions and redemptions for investors). While the open-end structure has yet to gain prominence, it is a trend worth watching out for. The open-ended structure could attract a broader investor base and contribute to fund growth. However, open-end funds require careful and timely execution of liquidity management tools such as redemption gates and swing pricing.

Fundamentals for private credit managers to consider

Portfolio monitoring

Portfolio monitoring is the process of tracking and evaluating the performance of a portfolio of investments. The process involves monitoring various aspects, including individual investments, risk exposure and overall performance.

Regular monitoring enables managers to assess the health and performance of their investment portfolio and by tracking key performance indicators, they can take timely actions to mitigate risks.

Monitoring the investment performance of individual investments includes tracking factors such as interest payments, principal repayments, and any potential defaults or credit events. Regularly reviewing the financial health of the underlying borrowers is essential to assess their ongoing viability.

Assessing and managing risk involves evaluating risk factors associated with private credit investments. Monitoring credit rating and financial ratios can help identify potential risks and the appropriate actions to mitigate them.

Diversification of the portfolio ensures that risk is appropriately spread across different borrowers, industries and geographies. Frequently reviewing the portfolio composition and analysing concentration risk can help identify potential vulnerabilities and portfolio rebalancing needs.

Keeping abreast of compliance and regulatory requirements ensures adherence with relevant laws and regulations. Regular documentation of compliance activities is also essential.

Reporting and communication with investors providing timely and accurate information on portfolio performance, risk exposure and any significant developments is crucial for transparency and decision-making.

Valuations are often based on estimates and assumptions and they can be subject to various uncertainties given investments are typically illiquid and may not have readily available market prices. A lack of transparency of valuations can increase the chance of an abrupt reassessment of risks and potential falls in value.

No time like the present

The market structure of global finance is changing and private credit is playing a pivotal role. As banks continue to face capital pressures, private credit serves as an important source of funding for underserved business segments and a powerful complement to traditional capital providers.

While the fragmented nature of Asia Pacific's economy creates risks, uncertainties and barriers in scaling private credit funds, on the flip side, the inherent complexities of the region's economy presents unique opportunities for asset managers and investors. The steady and rapid growth of emerging economies and intra-regional trade in Asia Pacific will inevitably require greater amounts of capital and cross-border financing.

Given the fast and dynamic growth of the private credit market, the need to identify, monitor and mitigate potential risks is crucial. Private credit managers must implement robust governance and risk management practices in their investment frameworks and decisions.

Furthermore, they must exercise rigorous self-regulation and risk discipline to ensure that investors are sufficiently protected. These best practices are essential for asset managers to create robust investment strategies and gain a competitive edge in the market. The outlook for private credit continues to evolve with triggers, such as changes in the macroeconomic and interest rate environment, leading to windows of opportunity opening and closing quickly.

The growth of private credit tells us something important about today's ever-evolving financial markets. It is more than just another option for funding and is a response to the market's needs and the constant change in economic dynamics. Against this backdrop, it is important to note that while private credit is deemed a well-positioned asset class to provide financing for a range of funding needs, banks are not expected to disappear, and that both providers of capital are complementary to one another.

Marie-Anne Kong
Hong Kong Asset & Wealth Management Leader
PwC Hong Kong
+852 2289 2707
marie-anne.kong@hk.pwc.com

Rex Ho
Asia Pacific Financial Services Tax Leader and
Hong Kong Asset & Wealth Management Tax Leader
PwC Hong Kong
+852 2289 3026
rex.ho@hk.pwc.com

Julie Chan
Hong Kong Asset & Wealth Management
Consulting Leader
PwC Hong Kong
+852 2289 2432
julie.py.chan@hk.pwc.com

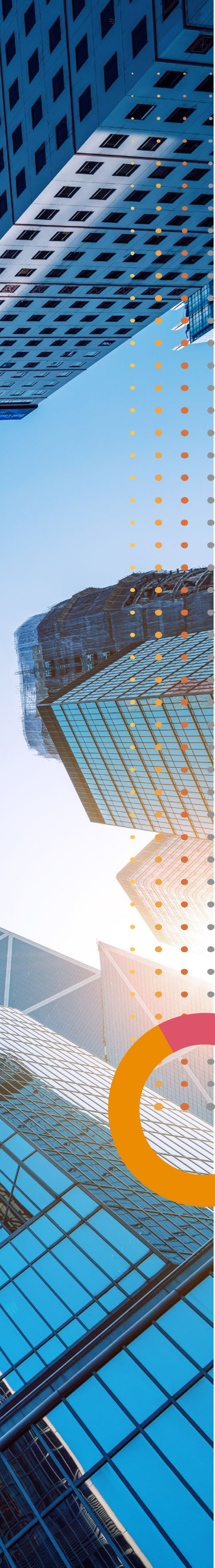
David Brown
Global Corporate Finance Leader
PwC Hong Kong
+852 2289 2400
d.brown@hk.pwc.com

Nick Atkinson
Asia Pacific Debt & Capital Advisory Leader
PwC Hong Kong
+852 2289 1834
nick.atkinson@hk.pwc.com

Henry Cheng
Senior Advisor, Financial Services
PwC Hong Kong
+852 2289 8208
henry.f.cheng@hk.pwc.com

Editorial

Christopher Jim
Senior Manager
Asset and Wealth Management Intelligence
+852 2289 2635
christopher.hy.jim@hk.pwc.com



www.pwchk.com