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The coming of age of APAC private credit

Insights from CRISIL GR&RS' closed-group discussion

November 2022

APAC private credit set to capitalise on growth opportunities

CRISIL hosted a closed-group discussion on 'The coming of age of APAC private credit — evolution, opportunities, and challenges' on November 21, 2022.

The panellists comprised Sabita Prakash, MD of Asia Pacific Private Credit, ADM Capital; Sharad Bajpai, Partner and Head of Ares SSG Asset Management, Ares SSG; Piyush Gupta, Head of Private Credit, Investec India; and Piyush Gupta, Director of Funds and Fixed Income Research, CRISIL (India) Research.

Akshat Ruia, Director of Research, CRISIL GR&RS, moderated the discussion.

The insights from the discussion are summarised below.

Theme 1: Strong traction seen in the Asian private debt market

- **Robust underlying economic growth in Asia to drive private debt demand:** Asia's relatively strong underlying economic growth differentiates it from the rest of the world. Its gross domestic product (GDP) is projected to grow around 5% in 2023, compared with 1% for developed economies and 3-4% for emerging market economies in Latin America and Africa. In fact, Asia's share of global GDP is likely to increase to 40-45% over the next decade, from 25-35% in the last decade. According to Asian Development Bank (ADB), emerging Asia will have to spend at least $26 trillion over 2016-26 to provide infrastructure in the region, which highlights huge underlying demand.
- **Supply-side constraints for traditional financiers driving private debt growth:** Funding options continue to be limited despite increased bank financing, fundraising by corporates and investments by institutional investors. Asian small and medium enterprises (SMEs) generate a substantial 30-40% of GDP, but do not find suitable financing — traditional financing channels do not lend beyond well-recognised borrowers. The supply of funding is limited for corporates in Asia-Pacific (APAC), mainly SMEs, and the new economy does not find support from traditional financiers for financing debt. These factors allow private credit operators to step in and capitalize on this opportunity.

Theme 2: No secret sauce to build an APAC-focused franchise

- **Operating successfully in the heterogenous APAC market:** One must look below the hood and try to decipher the characteristics of the markets. APAC is a highly diverse market — it comprises developed countries such as Japan, Australia, Hong Kong, Singapore and Korea; emerging markets such as China, India, Indonesia and Thailand; and frontier markets such as Vietnam and Bangladesh. In these markets, the depth and liquidity, local laws and regulations, ability to create security, foreclosure regime, bankruptcy laws, and various stages of development therein vary widely. The availability of ecosystem for due diligence, investigative agencies, legal and accounting firms, and agency and trust services also varies.
- **Talent pool is critical when operating in APAC**: Given the heterogeneity of the APAC market, global private debt managers need to bank on experienced teams of people who have decades of experience in managing and navigating the APAC market and have effectively created a track record that cannot be emulated easily. The availability of talent in APAC to cultivate this opportunity is getting thinner amid intense competition.
- **Grow organically or by acquiring local/regional 'specialist' managers:** Many global private debt players have scouted around the target region and acquired local/regional managers having infrastructure, talent and experience. The bolt-on acquisition strategy can be implemented quickly. Some global private debt managers have preferred to build an experienced core team. Growing organically can take a long time, and the costs involved in establishing oneself in a market is high. Both the strategies have been successful — the global private debt manager needs to decide which strategy is best suited and easily available.

Theme 3: Evolution of private debt in India and structural opportunity

- **Bank-dominated credit funding in India:** Historically, banks dominated as a credit provider to corporates in India, with a market share of more than 60%. However, over the last decade, post the non-performing loan (NPL) and capital adequacy issues, banks have been risk-averse, especially on the wholesale credit side. While credit growth has picked up since last year, risk-weighted assets to total assets for banks continues to be low at ~58%. India's corporate bond market is under-evolved, and primarily accessible only to AAA- or AA-rated and large-cap corporates.
- **The last decade — a tale of two halves:** Until late-2018, wholesale non-banking financial companies (NBFCs) were chipping away at the market share of banks, by leveraging their books on the back of cheap liquidity and running Asset Liability Management (ALM) gaps to achieve target returns on equity. However, that entire business model broke after the collapse of IL&FS, the largest NBFC in India. On the other hand, credit mutual funds were seeing reasonable growth in assets under management — they were becoming a relevant player in the market and had started underwriting A- or BBB-rated credits until the credit risk funds saga unfolded in 2020. These crises have led to a structural white space being opened up, and alternative investment funds (AIFs) have stepped in to plug the gap and fill into that vacuum. While funding demand has always been strong, supply has been disrupted, particularly after 2018, leading to a structural opportunity for private debt.
- **Direct-lending mid-market performing credit is well suited for Indian markets:** There is a large base of 3,000-4,000 bankable mid-market corporates across manufacturing and services, with a good operating history. The corporate bond market is not available to these companies. The mid-market segment presents a better risk-reward proposition owing to a full covenant suite, lender protection, better historical recovery rates, and a reasonable overall corporate leverage level. Senior secured OpCo-level cash flow lending for growth financing and M&A or HoldCo-based financing for funding equity contributions are something the market participants are looking at.
- **Amid optimism, tread with caution in the near term:** India is a promising market for investment on account of its favourable macros as well as growth potential. However, one needs patience and skills to navigate the market. Given the rise in US interest rates, there has been a flight to safety. There are risks going into 2023, including high energy prices.

Theme 4: Criticality of specialised due diligence and portfolio surveillance in APAC

- **Adoption of a mosaic approach for initial due diligence:** Most of the private debt deals are directly originated and privately negotiated. Given investors do not have access to public information, there is need to adopt a mosaic approach towards research — using a combination of different sources of information. The local intelligence/network provides logical, specific information in terms of due diligence and, at times, helps with governance information. As foreign investors invest across sectors and cannot have presence in all the countries of their investments, they often depend on local relationships/connections such as local due-diligence agencies, alumni, or past borrower companies to understand the market and investee company. Private debt fund managers often combine vendor due diligence with self-commissioned due diligence to avoid any conflict of interest and ensure customisation in order to focus on specific areas to deep dive. Any concerns/risks as an outcome of initial due diligence can be addressed through deal structuring or other means.
- **Correct initial decision-making is critical:** APAC private debt managers are serving a small part of the opportunity set, and hence can cherry pick the credits to underwrite. If the portfolio is constructed right, huge opportunities are available in APAC. Strategies available to Asian private debt managers in case of any deviation in the portfolio are different than those available to the US and European counterparts. In the US or Europe, one can sell the loans, collateral, or hedge position. However, such strategies do not work in the emerging markets in Asia. Hence, private debt managers strive to constitute a portfolio that stands the test of time. The managers perform a detailed sensitivity and downside analysis at the underwriting stage itself, and devise a playbook that can be put into play as part of asset management.

- **Ongoing asset management through the lifecycle of APAC private debt assets:** Ongoing portfolio monitoring/surveillance is essential to sense or identify red flags. Once red flags are identified, private debt managers work with the borrower companies to overcome challenges and take on more structural features. Private debt managers have flexibility in terms of capital to work with their borrowers and chart a new course. This is where private debt markets have a huge advantage over public markets.
- **Take shortcuts in due diligence process at your own peril:** Credit opportunities in APAC come with added complexity around evolving tax laws, enforcement processes, and regulations — a lot of time is spent navigating these nuances. From a risk evaluation perspective, comprehensive due diligence needs to be undertaken across business, operations, finance, governance, etc. Being disciplined with due diligence is critical in underwriting private credit, particularly for the mid-market direct-lending segment. Given the bespoke nature of underwriting, there is no one-shoe-fits-all kind of risk management framework, and the due diligence process for each transaction is typically customised. To make the lending process more efficient, it is important to have an engagement early on with the investee/borrower to ensure no mismatches between the expectations on delivery timeline. It is essential that the investment committee (IC) process is flexible, so that the deal team gets an early steer in an engaging iterative manner from the IC and credit committee — this would ensure the process is streamlined and all the teams are aligned, leading to quick decision-making. Private debt managers are leveraging technology for better data aggregation and improving operational efficiency as part of proactive portfolio management.

Theme 5: Evolution of Indian AIFs and growth outlook

- **Steady growth of Indian AIFs over the last decade:** The Indian AIF industry is 10 years old and at an early stage of growth. In the last 5 years, its growth has accelerated with more than 100 annual registrations of funds across AIF categories, and a compound annual growth rate of 48% in terms of commitments raised. The growth is driven by Category II AIFs, of which private credit funds are part. CRISIL MI&A Research tracks the performance of 36 funds/schemes, starting from vintage year 2017 to 2020. The number of funds has grown steadily over the last 4 years, as the NBFC liquidity crisis and credit risk fund saga meant AIFs became the preferred option for investors to participate in this segment. Across vintage years, the AIFs have returned in the range of 9-16%. While the AIFs of earlier vintage years have returned less than 10%, the recently launched funds have returned 13-17%. Investors have seen healthy distribution over the life of funds. About 85% of funds raised from investors in fiscal 2017 have been returned in the form of distributions, compared with 29% in fiscal 2020. CRISIL MI&A Research also compared the performance of these funds with the benchmark used by mutual funds for their debt funds and concluded that these funds outperformed the benchmarks across vintage years.
- **Advantage of AIFs as a bespoke funding vehicle over credit risk funds:** The product offering through credit risk mutual funds, which are largely open-ended structures, was not appropriate given the nature of underlying investments. AIFs offer flexibility that the issuer has in terms of negotiating the structure with the asset manager, and the asset manager has in terms of defining the overall cash flow over the course of the fund.
- **Things for investors to look at from a risk management perspective in Indian AIFs:** While AIF performance acts as an initial filter; beyond performance, investors need to look at the processes followed by the private debt asset manager in terms of portfolio construction. The right talent and team, with adequate experience in managing a fund or its strategy, are also critical. Given AIFs are typically close-ended structures, with a term of 5-7 years, a team that works through this tenor is required. Beyond that, investors need to look at the overall governance architecture of AIFs, including oversight of the sponsor and the Board on the overall investment process. Given private debt AIF investments are usually at the lower end of the rating spectrum, it is important to have adequate risk controls and ensure those are implemented consistently over the life of the fund.

Theme 6: Headwinds versus tailwinds — turning the tide

- **Battling confluence of headwinds:** The double whammy of interest and inflation, which feed into one another, has impacted the entire world. It is roiling the private debt market in terms of depth and liquidity. Higher discount rates basically lead to lowering valuation and call for the collateral. Market participants are closely watching the movement of interest rates and inflation. Geopolitical tensions and the energy crisis have increased recessionary risk, with half of the Eurozone countries and the UK heading towards a recession. There are high chances of US slipping into a recession in 2023. As Asia has high-growth economies, a significant slowdown in growth is expected; a few economies may slip into recession.

- **Standing tall amid rising default rates — the private debt advantage:** A combination of multiple macro headwinds has elevated the risk of higher default rates over the next 12 months. To combat this, private debt managers have been more disciplined and are picking assets they believe will withstand the test of time. As private debt managers negotiate with borrowers, they have the flexibility to reach some form of understanding, whereby an additional security will be provided in case a term out is needed. Private debt managers have types of strategies available that banks and NBFCs don't. The managers have flexibility in terms of capital, given long-term capital, and have talent and expertise to manage the economic crisis. While default rates would rise, most market participants are confident they can manage the situation and even make some money out of it.
- **Market dislocation — opportunity for private credit in APAC:** Coming out of the Covid-19 pandemic, banks were helped through regulatory advancements and restructuring-related concessions. All the NPLs are still hidden somewhere across the economy. Market participants believe a huge opportunity will emerge over the next 2-3 years across Asia, not only from banks but also from the existing market. Capital markets in APAC have dried up in 2022, with the high yield market down 75-80% in terms of issuances — new equity issuances in Hong Kong, one of the major Asian markets, are down 96%. The drying up of equity and debt markets opens up many sectors for private debt managers. Fund managers with dry powder are looking at this type of markets opportunistically across the region, while being disciplined. Amid any temporary liquidity squeeze, asset managers are happy to hold if the underlying credit is performing well. Asset managers are looking for companies with good demand and stable cash flows to make investments. Given there are tremendous opportunities available in Asia, asset managers can cherry-pick investments as they are 'not takers but makers'. Identifying the macros and companies to invest in, followed by a full-fledged credit analysis, will allow the asset managers to weather the storm.
- **Private debt growth momentum in India to slow down amid global headwinds:** While India is relatively less impacted than the US or Europe, the macro headwinds are bound to impact corporate earnings and the business environment in India. That said, infrastructure-related capex continues to be robust, and the transportation, railways, roads and construction sectors are seeing a trickle-down ripple effect. While some slowdown is expected in growth capex in certain sectors, there are forces that would compensate for some loss of demand for private credit.
- **Rising competition in the Indian private debt space:** While the private debt space is attracting more players, not all the private debt funds, particularly domestic funds, have scale as they are first-time funds. Hence, their ticket writing ability is rather limited at this stage, and they must follow the lead underwriter. The platforms that have in-house origination capabilities will differentiate themselves from standalone funds.

Theme 7: Emerging asset class will be tested in the near term

- **Resilient asset class**: The private debt market in APAC has been emerging since the Asian Financial Crisis (1997), with alternative capital raised to recapitalise distressed high-yield bonds and loans that could not be serviced were worked out over time. Similarly, the Global Financial Crisis also impacted Asia. Since then, APAC has experienced mini 'debt cycles', such as the rise of NPL restructuring in China and India. While APAC economies are likely to perform better than the US and European economies despite difficult macroeconomic conditions, they are not immune to a global financial crisis. The contagion risks for emerging markets, in Asia or elsewhere, are high — these include a more esoteric asset class, lower liquidity, flight to quality by investors, and lower knowledge of markets.

- **Structural protections, covenant discipline, focus on strong cash flows, and hard assets to provide a soft landing:** Given the huge demand for funding, there is room for competing private debt managers. Most of the structures and situations lent to in APAC are idiosyncratic and bespoke, and as there are not many traditional funding options available, the headroom for negotiating covenants is still high. Unlike in the US and Europe, covenant-lite structures are not a regular feature in APAC. There is room for course correction midway through the economic crisis to ensure investments are protected.

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