Private Credit in Asia

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The Alternative Credit Council would like to extend a special thank you to all contributors in this report.

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Foreword

We are delighted to introduce the Alternative Credit Council's (ACC) first research paper focussed solely on non-bank lending in Asia. This work was commissioned as part of the ACC's mandate to support investors' and policymakers' understanding of private credit in Asia.

This publication comes at a time when the global economy is facing unique challenges as it adapts to the COVID-19 pandemic. Investors and investment managers are naturally thinking very carefully about how to navigate the risks that lie ahead across the private credit sector for both individual portfolios and the sector in general. While there is still significant uncertainty over how the pandemic will continue to affect economic activity, several areas also provide reason for cautious optimism.

The decisions already taken by many Asian jurisdictions have mitigated some of the economic impact and provided a framework from which the economy can potentially return to growth faster than in other regions. This will boost confidence among investors and managers to allocate and deploy capital in Asia. The demand for private credit among borrowers and lenders remains strong, with newer business models and a growing e-commerce trade set to become a greater part of the Asian economy. With their speed and flexibility, private credit managers are ready to provide the finance solutions that these businesses will need to expand and thrive.

The benefits of the asset class are increasingly clear across the world — providing borrowers with a much-needed alternative to traditional lenders, offering investors the opportunity to invest in assets with differentiated risk-return profiles and, finally, supporting policymakers' efforts to foster a resilient financial system.

While these benefits are generally recognised, the development of private credit in Asia has historically been steady rather than spectacular. It is our hope that shining a light on the Asian market will support greater awareness of the region's potential and fuel additional investment. In turn, this will improve access to capital for Asian

businesses to invest in essential projects, capital expenditure and meet their working capital requirements. This will support sustained economic growth, job creation and prosperity across the region.

While the broader trends fuelling the growth of non-bank lending — bank retrenchment, growth of private capital, borrower preference for bilateral relationships — will exert a general influence, the developments in the next few years will be crucial for wider adoption of private credit. How the industry responds to these challenges is likely to define the next stage of the market's development while also fortifying investor sentiment towards the asset class in Asia.

This paper provides a roadmap for anyone seeking to understand the direction of travel for private credit in Asia and the road that lies ahead for investment managers and their investors. It is also intended to facilitate a dialogue between investors, policymakers and investment managers on how to support the sustainable growth of private credit in Asia.

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Executive Summary

Strong foundations for growth

The primary drivers of private credit — bank retrenchment, borrower demand for tailored finance solutions and investor appetite for differentiated returns — continue to provide impetus to the asset class in Asia. At the same time, a combination of dedicated Asian private credit managers and multi-strategy firms adding greater focus to private credit is supporting the ability of the asset class to expand in Asia. The adoption of familiar structures and strategies from more developed private credit markets is a further sign that foundations are being laid to support more structured growth of private credit in Asia.

Diverse investor base

Asian private credit managers support inward investment into Asia with 77% of capital raised from non-Asian investors. Our data indicates that 30% of the capital raised by private credit managers comes from North American investors. European, Middle Eastern and UK investors account for 19%, 13% and 12% respectively. Investor profiles are diverse, with pension funds, insurers and sovereign wealth funds providing 41% of the capital allocated to Asian private credit fund managers. Family offices (18%) and high-net-worth individuals (15%) are also significant investors in the region.

Flexible investment mandates

Asian private credit managers combine lending to SMEs and mid-market businesses with a wider spectrum of debt strategies, compared to those in more developed markets. The typical investment objective of these private credit managers is to achieve returns between 13-20% over three to seven years. As the private credit market matures, there is likely to be greater specialisation among private credit managers in the region.

Managing risk

The perception of an "Asian risk premium" among investors is a key challenge for managers when raising capital. This risk premium is largely driven by jurisdictional concerns regarding creditor protection and enforcement rather than the economic opportunities in the region. Many Asian private credit funds also operate in multiple jurisdictions which creates cross-border business, tax, regulatory, legal and enforcement challenges. These complexities can also create an opportunity for relatively higher risk adjusted returns while also acting as a barrier to newer entrants in favour of established managers.

Primacy of relationships

Almost three quarters of respondents originated transactions through relationship channels including direct relationships with a borrower, consultants or existing industry relationships. The diversity of culture, language and business practices between the different Asian countries means that larger networks can be counter-productive while also more expensive to maintain. Therefore, private credit managers tend to prefer more focussed and richer local networks. The vast majority of deals in the region are sponsorless with only 10% of transactions originated through private equity channels.

Fund structuring matters

54% of private credit managers use closed-ended funds with fixed maturity for their investments. A further 21% use open-ended funds that have redemption rights aligned to the underlying tenor of the investment. The introduction of new fund vehicles in both Hong Kong and Singapore has been welcomed by the private credit industry and reforms are likely to support the further growth of these local fund management centres.

ESG and responsible investment

Investors in Asian private credit have the same high expectations regarding ESG as they do across the rest of their portfolio. Sustainability factors and the external impact of investments are now established as a key aspect of risk management and investment due diligence by lenders in the region. Government policy across the region is also encouraging investment in more sustainable business models, technologies and consumption patterns. This is likely to fuel the need for private capital, particularly among SMEs and mid-market firms.

The case for reform

Each jurisdiction in Asia has a different licensing regime for lending, enforcing security and returning cash. Private credit managers are also regulated by the jurisdiction in which they operate. In addition to the inherent complexity this creates, many of the current regulatory frameworks in the region restrict investment by non-bank lenders and do not provide investors with the necessary certainty regarding security and enforcement of their rights. It is our hope that greater investment by private credit firms in jurisdictions with more transparent and dependable enforcement processes will demonstrate the value of this to other jurisdictions, and that over time this will support the case for reform.

Methodology

This report from the ACC, in partnership with Simmons & Simmons and EY, is intended to provide investors, asset managers and policymakers with an overview of the private credit market in Asia.

The ACC collected data via a questionnaire of 28 active private credit asset managers in Asia. The ACC, together with Simmons & Simmons and EY, then conducted 15 open and candid interviews of Asian private credit asset managers. These interviews focussed on three specific areas: (1) a fund's investor base and strategy; (2) origination of transactions, deployment and structure of private debt; and (3) operational aspects of funds involved in private credit.

While the US and European private credit market and industry trends are well documented and understood, this research is the first to look specifically at private credit in Asia.

The resulting report is an indicator of the asset management industry's expectations of the opportunities and challenges of private credit in Asia.

Chapter 1

Overview of Asian Private Credit

As Asian economies look to navigate the impact of COVID-19, private credit will play a key role in supporting the region's economic recovery. Traditionally, bank lending could be relied on for continued growth in Asia, but this is increasingly difficult as banks are facing multiple challenges of their own. Businesses are now reflecting on how their debt finance needs can be met by other types of lenders. Investors are increasingly attracted to the diversified and compelling returns that can be achieved from Asian private credit strategies.

Growth of the private credit market

While this is the first *ACC Private Credit in Asia* report, the development of private credit globally provides an obvious yardstick with which to measure the potential growth opportunity of private credit in Asia.

The *ACC's Financing the Economy* research series has tracked the development of private credit over the past five years. During that period, private credit has grown into a widely adopted capital allocation model, which provides an essential source of finance for the real economy. As the world economy looks to recover from COVID-19, the ability of businesses to access capital remains as important as ever. The longer-term outlook for private credit managers and their ability to provide tailored debt finance solutions to borrowers suggests that private credit in Asia is likely to emerge from the pandemic better positioned than ever before.

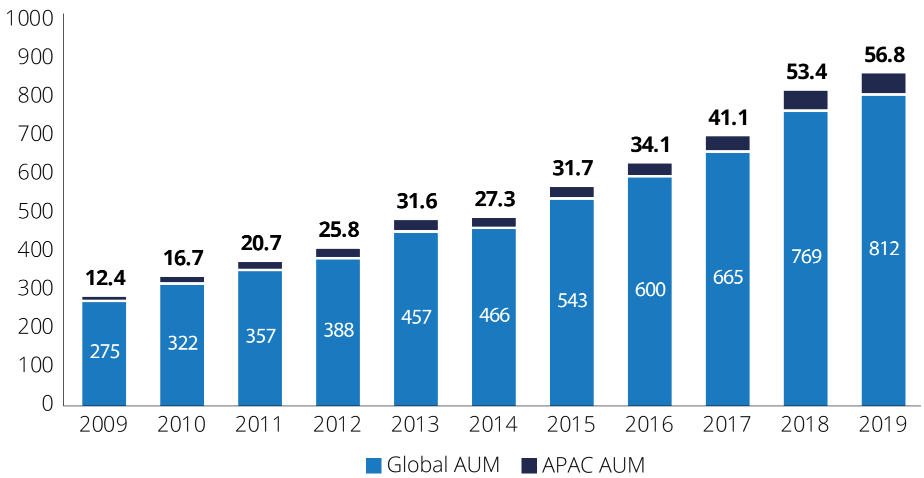
Globally, private credit has enjoyed remarkable and sustained growth, maturing in both size and recognition, with total assets under management (AUM) growing exponentially, reaching a record US$812 billion in June 2019[1]. Even with the impact of COVID-19 in 2020, the global private credit market is on track to grow to US$1 trillion in the near future.[2]

> We believe there is a long-term secular opportunity in Asia-Pacific private credit, driven by a large imbalance in the supply and demand of capital. On the demand side, mid-sized companies in the region continue to grow and require financing to expand. On the supply side, global regulatory pressures led international banks to de-lever, retract from local markets, and repatriate capital back home. In addition, domestic banks are reluctant to offer the flexible capital solutions demanded by mid-sized companies.
>
> **Justin Ferrier**
> Managing Director,
> BlackRock Asia Pacific Credit

[1] Preqin, *2020 Preqin Global Private Equity & Venture Capital Report*. Available from: https://www.preqin.com/insights/global-reports/2020-preqin-global-private-equity-venture-capital-report

[2] AIMA, *ACC sees private credit market reaching $1 trillion by 2020*. Available from: https://www.aima.org/article/acc-sees-private-credit-market-reaching-1-trillion-by-2020.html

Figure 1.1:
Global Private Credit AUM Growth Between 2009 and 2019 (US$ billion)



Source: Preqin Pro

Private credit has grown from a relatively niche means of financing small and medium enterprises (SMEs) and mid-market companies with a limited pool of investors to a globally recognised financing model. The increasing capital allocations from international institutional investors has supported the growth of the market and helped establish private credit as a credible option in the eyes of policymakers and borrowers.

Private credit in Asia is a nascent segment of the global market, but the region is quickly emerging as an opportunity for global fund managers and allocators. Recent research by Preqin further illustrates that Asia-focused private credit AUM has more than doubled from $27 billion in December 2014 to $57 billion in June 2019[3].

Private credit in Asia

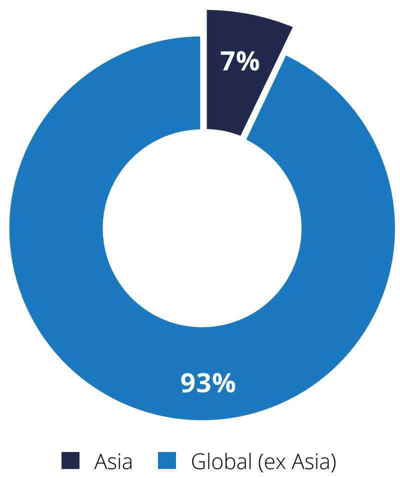
Private credit in Asia initially emerged as an offshoot of the 1997 Asian financial crisis when defaulted Asian high yield bonds were restructured as asset-backed amortising loans. A number of managers then began to engage in opportunistic structured lending.

There is now a more systematic development of the market taking place that involves a mixture of dedicated managers and multi-strategy firms that are increasingly choosing to focus on private credit. The Asian market is gradually adopting the established structures and strategies seen in more developed private credit markets. This shift is viewed as an early sign that foundations are being now laid to support more structured growth of private credit in Asia during the next decade.

Notwithstanding the signs of maturity, respondents still considered allocations to Asia in private credit as "severely underweight". Our data from 2019 pointed to allocations to Asian private credit strategies making up no more than 7% of total global private credit.

There is some evidence this may be changing, with the ACC's Financing the Economy research indicating that one third of managers globally intend to invest more in Asian markets (ex. China and India)[4] over the next three years.

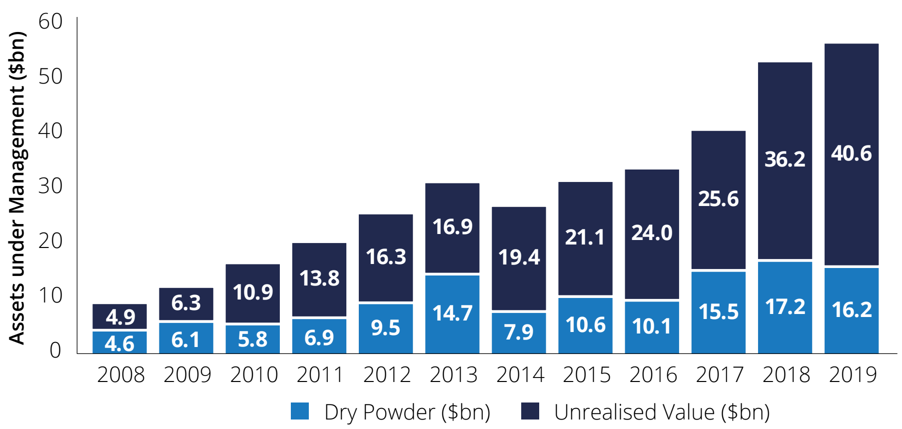
Figure 1.2:
Asian Pacific Share of Global Allocation to Private Credit (by AUM)



Source: Preqin Pro

Figures are as of 2019

Figure 1.3:
Asian Private Credit AUM, 2008 to 2019



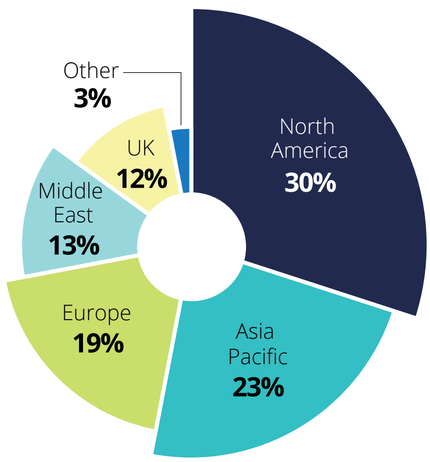
Source: Prequin Pro

[3] Preqin, *2020 Preqin Global Private Equity & Venture Capital Report*
[4] ACC *Financing the Economy 2019*

Typical investors by region and type

Our survey of private credit managers in Asia provides a valuable insight into the investor demographics in the private credit market. North American investors make up the predominant source of capital for private credit funds in Asia (30%), followed by capital from Asian investors (23%), then from European investors (19%).

Figure 1.4:
Source of Capital for Asian Private Credit Funds, by Region

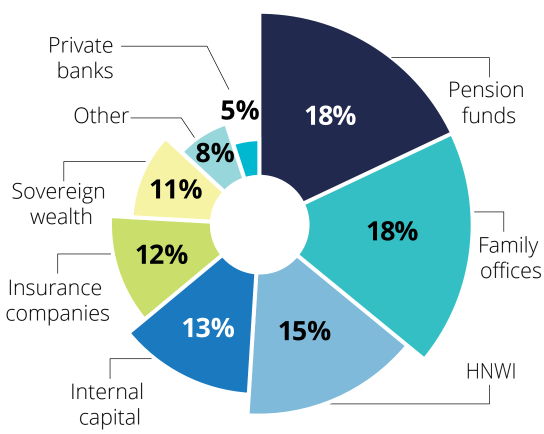


Source: ACC — APAC survey findings

> COVID-19 has accelerated and exacerbated trends that are already manifest in Asia, whether strained liquidity, income inequality, termination of regional trading blocks, continued need for infrastructure, basic goods and services for a growing population. Therefore, comparing Asia to the rest of the world, Asia has long-term growth potential in end user markets.
>
> **Sabita Prakash**
> Managing Director,
> ADM Capital

Our data also indicates that while the greatest proportion of allocations come from institutional investors, family offices and high-net-worth individuals are also prominent investors in Asian private credit managers. This differs from European and US focussed firms whereby institutional investors typically account for the substantial majority of capital allocated[5].

Figure 1.5:
Source of Capital for Asian Private Credit Funds, by Investor



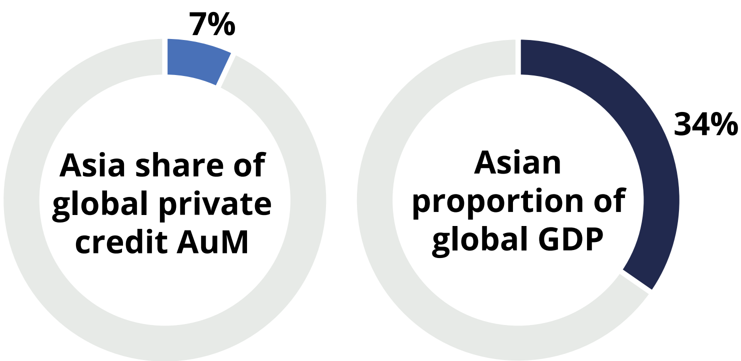
Source: ACC — APAC survey findings

[5] ACC, *Financing the Economy 2018* — Figure 25

The potential of private credit in Asia

The private credit managers interviewed for this research overwhelmingly supported the notion that private credit in Asia provides investors with the opportunity to achieve good returns and diversify their exposure. Respondents to the survey continually cited the relative under-allocation of private credit compared to the potential economic growth that is forecast for Asia more generally. This is something increasingly recognised by investors who see the region's credit markets as inefficient.

Figure 1.6:
Allocation to Asia Private Credit Compared to GDP Output



Source: *International Monetary Fund, World Economic Outlook Database,* October 2019; Prequin Pro

The case can be made that the private credit strategies in the region are significantly underallocated. The Asia Pacific region accounts for roughly one-third of the global GDP output, however receives less than 10% of the capital allocation to private credit strategies.

Asian jurisdictions currently rely on their domestic banking systems to finance economic growth, but there are strong factors challenging this status quo. These include an increasing awareness of the benefits of non-bank financing amongst policymakers and borrowers, particularly in relation to their ability to provide flexible finance solutions. The impact of global regulatory capital requirements for banks has also restricted their ability to serve some lending markets. Collectively, these factors point towards a significant capacity for growth in private credit in the Asia Pacific region.

> We continue to see more and more investors recognising how underweight their portfolios are to the Asian region and the benefit of including an Asian credit strategy as a diversifier.
>
> **Suzanne Ramos**
> Director of Investor Relations and Business Developments, Tor Investment Management

Figure 1.7:
Asia Private Credit Industry

Quotes from our interviewees on the strengths, weaknesses, opportunities and threats (SWOT) for private credit in Asia.

Strengths

"The world is not only about private equity, real estate and bonds. Our investors are eager to invest in different asset classes and private credit in Asia is one of those."

"This asset class provides investors and managers with more diverse exposures outside of US and European concentrations."

"We had early-mover advantage in this currently nascent but growing market."

Weaknesses

"Talent recruitment in Asia, specifically for private credit funds, is very challenging since the market itself is undeveloped and doesn't have the same rigid career path. It is more entrepreneurial."

"Considering different local cultures, languages and business practices, you will definitely encounter a host of different and unexpected difficulties compared to that of the US."

"We believe that local connections are the key to sourcing private credit opportunities in the Asian market, but building relationships takes a long time. There is no broker network and many of those relationships are personal rather than institutional."

Opportunities

"It is a fact that the Asian emerging economies are experiencing steady, higher growth, and they need considerable amounts of investments for their enormous populations."

"The inherent complexities in Asia, when skillfully managed, create unique opportunities for delivering risk premiums while being downside protected."

"Asia has a huge population and so will inevitably need greater capital and that comes from financing SMEs."

"You can see international banks disappearing from local lending markets in Asia for a whole host of reasons."

Threats

"Geographical fragmentation in Asia creates a barrier to scaling private credit funds, unlike the US which is pretty homogenous."

"Just think of diverse requirements, uncertain enforcement regimes, laws and regulations, across different Asian jurisdictions. There are only a few private credit managers who really know all these issues properly."

"Private credit is generally illiquid globally, but in Asia it can be super illiquid. Be mindful of the illiquidity risk premium."

"You have to be prepared to restructure every deal in Asia. There are no easy deals."

Chapter 2

Private Credit and the Asian Opportunity

Over the past three decades, high GDP growth in Asia has fuelled the demand for capital in Asian economies. According to the International Monetary Fund (IMF), Asia-Pacific real GDP has been growing at 4.5% annually as opposed to 1.6% in Europe and 2% in North America in 2019[6]. The demand this creates for credit has encouraged global investors to turn their attention to the Asian private credit market. This thirty-year story of growth in Asia is now facing enormous headwinds as a result of escalating trade tensions between the US and China, coupled with the impact of COVID-19. Despite these challenges, our interviewees cited several reasons why private credit should continue to thrive.

Growing economy and trade

Asian emerging markets such as India, Indonesia, the Philippines and Vietnam will likely require huge amounts of investment to meet the needs of their younger and rapidly expanding populations.

The continued growth in intra-regional trade and capital investments in Asia will inevitably require additional large-scale cross-border financing. Middle-market corporates involved in e-commerce, international trade and supply chains are among the fastest growing business segments in the region. These corporates are more likely than most to see the benefits of private credit in the same way US and European mid-market companies have become accustomed to private credit as a viable funding source.

[6] International Monetary Fund, *Real GDP Growth — Annual percent change*. Available from: https://www.imf.org/external/datamapper/NGDP_RPCH@WEO/OEMDC/ADVEC/WEOWORLD

Growth of middle class and SMEs

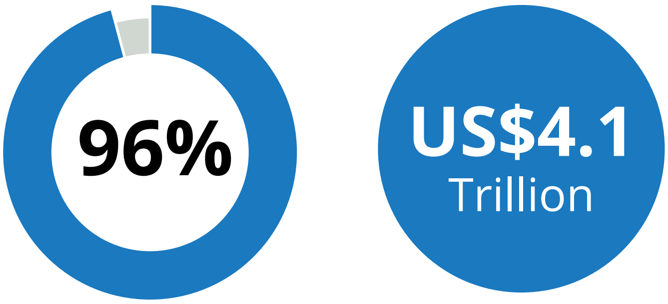
Demand for private credit is also being driven by the growth of the middle class across the region. This is changing consumption patterns which, in turn, is supporting growth in the SME market. Recent research by the Organisation for Economic Cooperation and Development (OECD) estimated that by 2030, China and India will be home to approximately half of the entire global middle class[7]. Further, a recent study commissioned by the Asian Development Bank Institute (ADBI)[8] estimates that SMEs account for more than 96% of Asian businesses and provide two out of three jobs in the region. The expansion of the middle class in the region will create a commensurate need for private credit amongst SMEs seeking finance to support their business growth opportunities.

> The opportunity is created by the mismatch of supply and demand of capital in the APAC region. On the demand side, mid-market companies in the region face a significant funding shortfall. On the supply side, traditional capital providers in the region are unable to bridge this gap due to a rigid financial ecosystem, and complex regulatory environment. Several global banks have significantly scaled back their lending book in the region. Private credit goes some way in meeting this underserved market segment.
>
> **Jiffriy Chandra**
> Managing Partner and CIO,
> TransAsia Private Capital Limited

[7] World Data Lab, Look East instead of West for the future global middle class. Available from: https://oecd-development-matters.org/2019/05/07/look-east-instead-of-west-for-the-future-global-middle-class/

[8] Asian Development Bank Institute, *The Role of SMEs in Asia and their Difficulties in Accessing Finance*. Available from: https://www.adb.org/sites/default/files/publication/474576/adbi-wp911.pdf

Figure 2.1:
Asia Pacific SME Funding Gap



Proportion of Asian businesses that are SMEs

Estimated finance gap for Asian SMEs

The Asia Pacific region needs a developed non traditional financing system. SMEs represents 96% of all enterprises in Asia and are the main engine for employment and GDP growth, however SMEs struggle to source traditional financing. It is estimated that SMEs in the region face a US$4.1 trillion dollar annual funding gap in 2019.

Source: Asia Development Bank, Bank for International Settlements

> Bank finance will not be replaced and while banks are not disappearing any time soon because of their scale and distribution network, their model is changing. Private credit is not looking to compete with bank finance or any other financing. It is offering an alternative when speed, flexibility and adaptability are required.
>
> **Sabita Prakash**
> Managing Director,
> ADM Capital

Infrastructure financing

The Asian Development Bank estimates that the infrastructure investment needs in Asia from 2016 to 2030 will amount to a total of US$26 trillion[9]. The demand for civil infrastructure e.g. power plants, transport, telecommunications and sanitation needed to sustain the economic development of various emerging Asian countries will remain substantial for many years ahead.

While infrastructure investments have traditionally been funded by a mixture of governments, state-owned enterprises and multinational organisations, public financing alone is unlikely to be sufficient to satisfy the region's demands. Significant private debt and equity capital investment will be needed to fill this funding gap.

Digital penetration

Increasing digitalisation in the region, as evidenced by the presence of a vast number of multinational technology companies across Asia, is another noticeable trend fuelling the growing demand for capital. According to a working paper published by the IMF in 2019[10], Asia's share of total

[9] Asian Development Bank, *Meeting Asia's Infrastructure Needs*. Available from: https://www.adb.org/publications/asia-infrastructure-needs

[10] International Monetary Fund, *IMF Working Paper — E-commerce as a Potential Engine for Growth in Asia*. Available from: https://www.imf.org/~/media/Files/Publications/WP/2019/WPIEA2019135.ashx

retail sales via e-commerce (12%) surpasses North America and Western Europe's respective shares of 8%. Further, China's share of e-commerce retail transactions has grown to more than 40%, compared to less than 1% a decade ago. The value of China's e-commerce transactions is today estimated to be larger than the value of those of France, Germany, Japan, the United Kingdom and the United States combined[11].

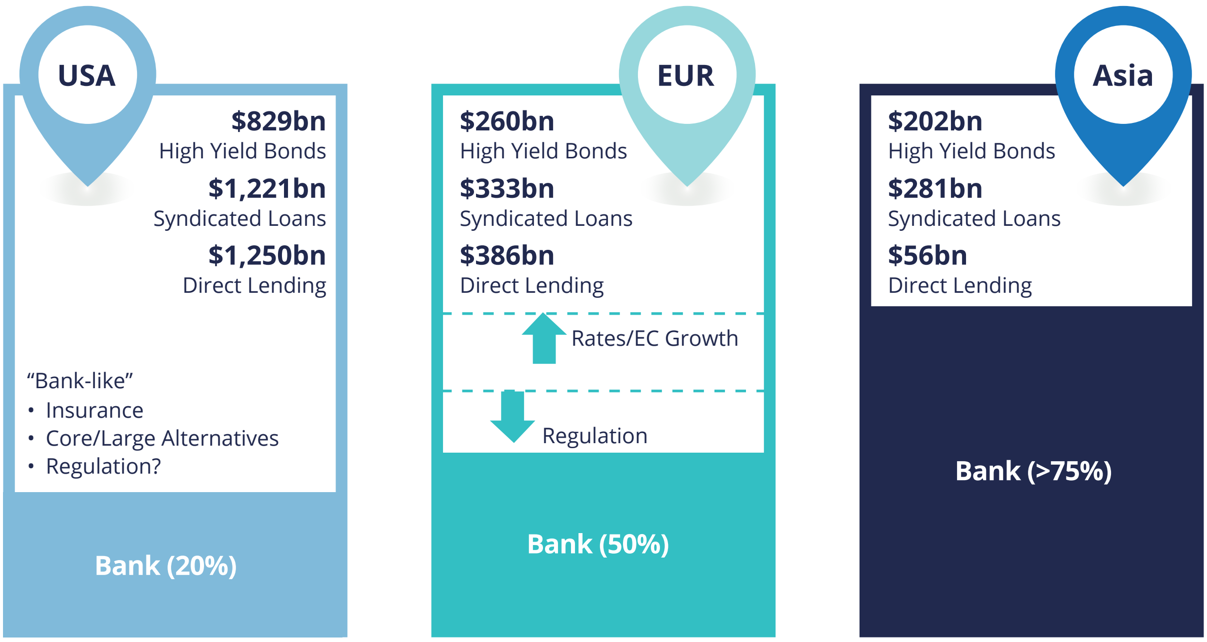
A respondent commented that *"Asia's significant growth in e-sales presents great potential for private credit as an alternative means to provide the massive capital demanded by technology companies. COVID-19, which results in an inevitably huge shift towards e-commerce, will likely accelerate the rising digitalisation trend in Asia, further increasing investment opportunities for private credit fund managers."*

> Private credit has the adaptability to meet these capital demands. The flexibility in negotiating and structuring bespoke bilateral credit solutions makes private credit more of a partnership approach compared to standard bank lending.
>
> **Jiffriy Chandra**
> Managing Partner & CIO,
> TransAsia Private Capital Limited

Bank disintermediation

Regulatory changes such as Basel III, Dodd-Frank and the Volcker Rule have seen some banks reduce their footprint in Asia, repatriating capital back to their home markets or focussing on core business lines. Figure 2.2 illustrates in graphical form what our interviewees highlighted on bank disintermediation trends in Asia.

Figure 2.2:
Bank Disintermediation



Source: StepStone Private Debt, COVID-19 Market Survey May 2020; Reuters, Credit Suisse, Bloomberg; Barclays Asia High Yield Index.

Data as of 2019

[11] McKinsey Global Institute, China's Digital Economy — *A Leading Global Force*. Available from: https://www.mckinsey.com/~/media/mckinsey/featured%20insights/China/Chinas%20digital%20economy%20A%20leading%20global%20force/MGI-Chinas-digital-economy-A-leading-global-force.ashx

As global banks increasingly focus on lending markets that allow them to optimise regulatory capital, compliance and cost-related efficiencies, this can hinder their ability to lend in some markets. Private middle-market corporates and SMEs are now more likely to find that banks are unable to meet their financing needs. For example, many local Asian banks continue to apply prescriptive lending criteria for loans, often linked to real estate collateral rather than cash flow, capex lending or structured receivables financing. This can be inappropriate for many businesses, particularly those seeking growth capital. In contrast, private credit managers can provide more flexible capital solutions, while often deploying capital to borrowers faster than their banking counterparts. This makes them well-placed to cater to the growing demand for credit among mid-sized companies in Asia.

Market access and complexity of private credit in Asia

Access to the Asian private credit market for international capital is gradually becoming easier, however, significant barriers to entry still exist. A common theme emphasised by our interviewees was the fragmented nature of the Asian market. Asia is a diverse region with opportunities sourced through its financial centres e.g. Hong Kong, Singapore and Australia, but with the underlying borrowers and assets derived outside these jurisdictions e.g. China, Indonesia and other ASEAN countries. This dynamic creates inherent challenges for investors that need to be considered against the economic opportunities in the region.

> While the long-term potential opportunity for further investment and allocation into Asian private credit is positive, prospective participants in this developing market need to ensure that they fully understand and appreciate its complexity, and adopt their strategies accordingly.
>
> **Rahul Kotwal**
> Managing Partner,
> Zerobridge

Figure 2.3:
Asia Private Credit Industry

Quotes from our interviewees on the trade off between opportunity and complexity for Asian private credit managers.

Opportunity

"A huge number of opportunities have been created by market inefficiencies to support the financing needs in the emerging economies and the idiosyncrasies of various Asian jurisdictions."

"In Asia, markets are inefficient in fulfilling financing needs, ranging from the growing mid-market firms to the regional and national infrastructure projects. This is when the opportunities for private credit funds are created."

"Jurisdictional idiosyncrasies cannot be ignored, which brings a lot of investment opportunities to private credit managers that know, understand and specialise in those jurisdictions."

Complexity

"Entering into the private credit market in Asia is not easy. You have to spend an extortionate amount to meet numerous requirements, including developing the reach of your business, understanding the structure, enforcement, regulatory and tax regimes, languages, business cultures, local networks and relationships in multiple jurisdictions."

"Getting the right people and getting enough of them to scale the business is a challenge. Managing this strategy is labour intensive and needs employees with specialised knowledge to manage processes of which there are not a lot of market solutions for."

Chapter 3

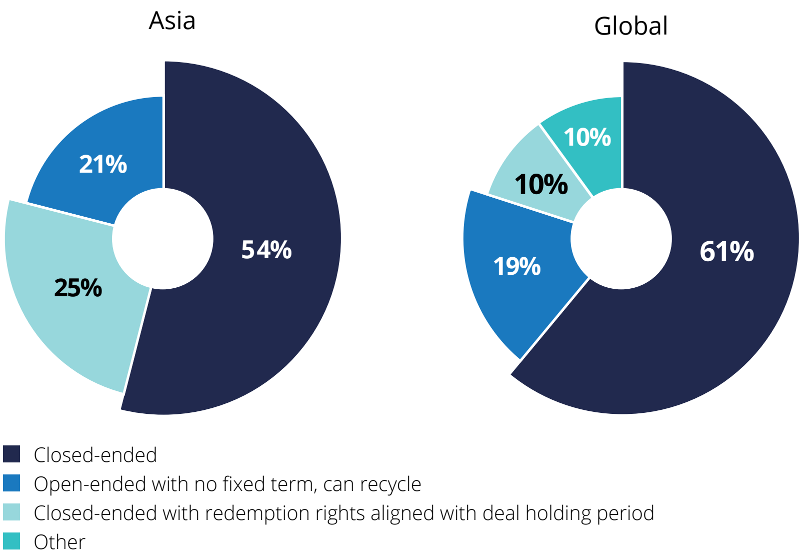
Private Credit Strategies

Nearly all Asia-focused private credit fund managers are based in Hong Kong and Singapore, with almost 40 managers having a presence in the region. Of those, as a measure of the size of their respective firms, AUM tends to sit between US$500 million and US$1.5 billion, though there are some notable exceptions above this level.

Common fund structures

While the types of fund structure being utilised vary, the data from our survey reveals that the choice of fund structure by Asian private credit funds is broadly aligned with that of the global average, with 54% of respondents adopting closed-ended structures with fixed maturity.

Figure 3.1:
Private Credit Fund Structures



Source: ACC — APAC survey findings, ACC Financing the Economy research

The choice of fund structure is often as a result of investor demand and represents a trade-off between an investor's liquidity requirement and tolerance for fund level risks including operational, valuation and liquidity risks. Given that scaling often requires capital from an institutional capital base, it should come as little surprise to see that most funds use a closed-ended or soft closed-ended structure to mitigate those issues.

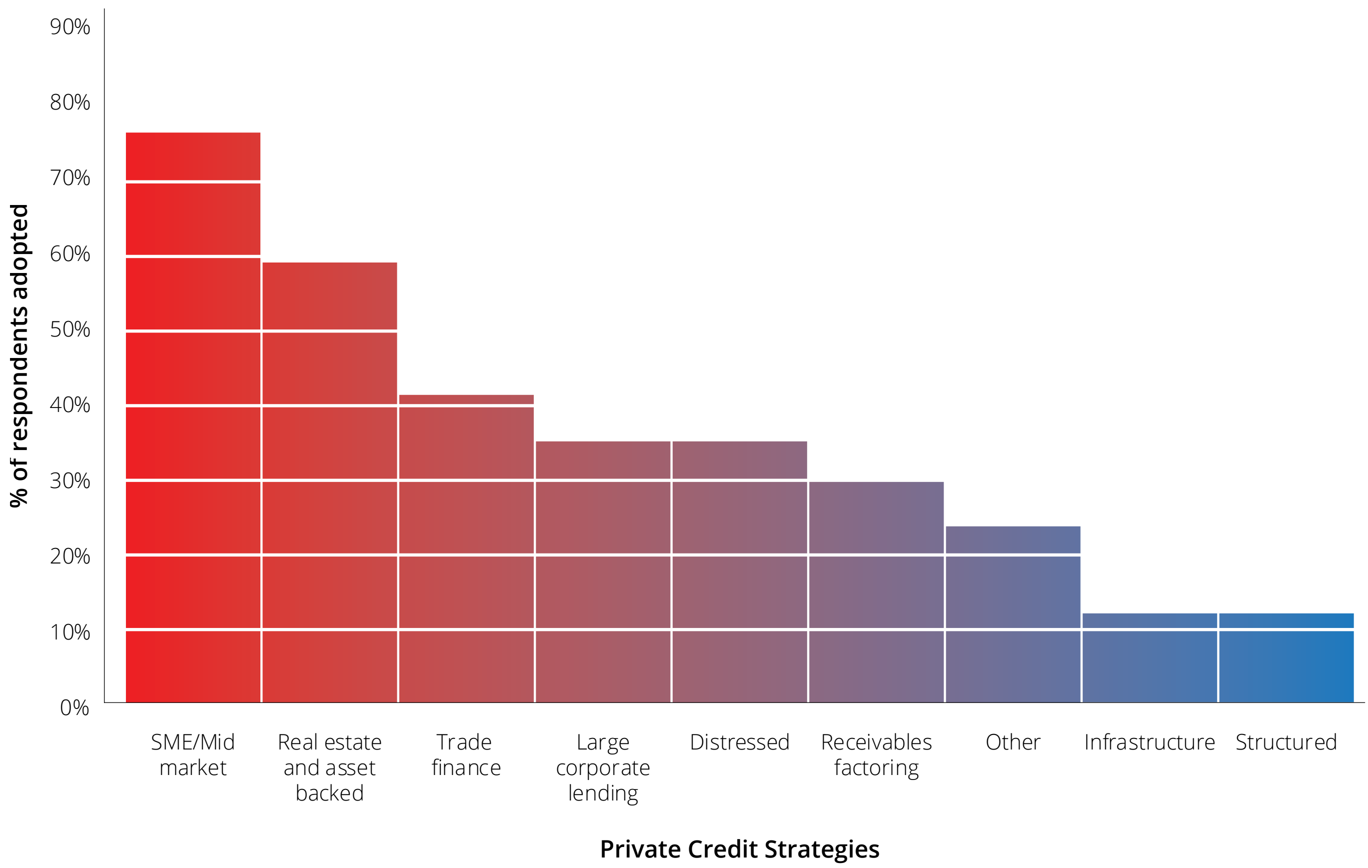
Typical private credit strategies pursued by Asian managers

Fund managers in Asia have traditionally pursued a blended or diversified investment strategy. The majority of private credit managers in Asia tend to focus on special situations or opportunistic lending; that is, involving borrowers that require a non-commoditised finance solution. For example, debt refinancing, project funding shortfall or an immediate requirement for bridge financing. Some managers also specifically invest in non-performing loan portfolios. The typical investment objective of these private credit managers is to achieve returns of 13-20% over three to seven years.

In Asia, the private credit market is both smaller and less delineated than more developed markets. Many of the established credit funds undertake strategies that invest in more than one of the typical subsections of private credit. As a result, they tend to operate more like an opportunistic debt fund that looks at a broad range of debt transactions reliant on event opportunities, borrower relationships and dislocations in the market, rather than focusing on one single sub-strategy.

Responses to our survey demonstrate the diversity of strategies across the sector. The predominant strategy was SME lending and mid-market direct lending as shown in Figure 3.2, however, our research indicates that private credit funds in Asia typically pursue a wider spectrum of debt strategies. The result is that Asian lending strategies can be far more mixed and opportunistic when compared to those in more developed markets. There are, of course, some exceptions and this trend will become less pronounced as the market matures and private credit funds become more specialised.

Figure 3.2:
Asian Private Credit Funds Invest Across a Spectrum of Strategies



Source: ACC — APAC survey findings

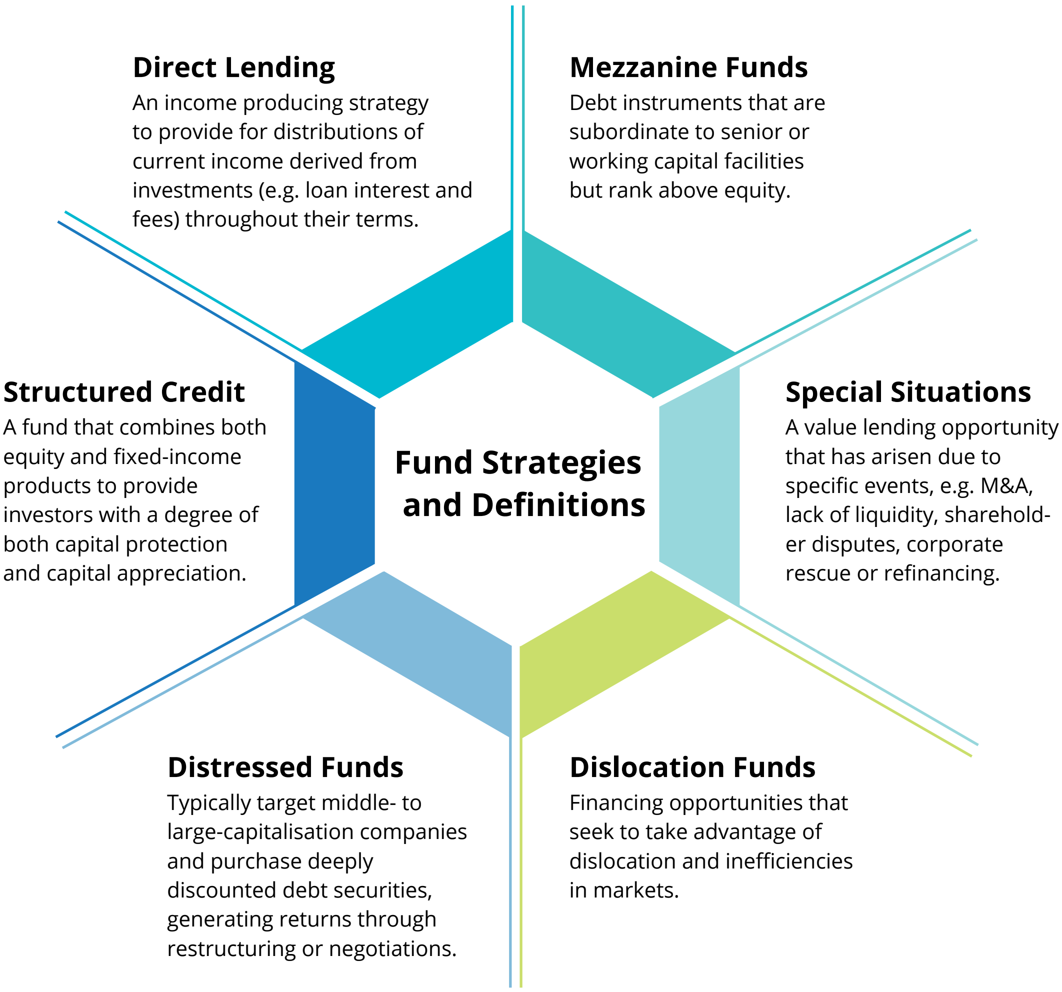
Figures are as of 2019

This approach can make it harder for investors to assess the relative merits of some Asian private credit strategies when compared to others within their broader allocation mix. Asset managers recognise this potential barrier and are addressing this challenge and becoming better equipped at articulating their strategy to meet investors' expectations in respect to benchmarking and comparability.

Diverse strategies, fee structures and target returns

The fee structures of private credit funds in Asia can vary enormously. Being in a smaller and more diverse market, investors have fewer funds that can provide them with a reliable benchmark to appraise performance.

Figure 3.3:
Illustration of Different Private Credit Strategies



In alternative asset management, the fund manager's ability to effectively articulate their investment strategy and risk–return profile is critical in the fund-raising process. For Asian private credit managers, the ability to not only convey this but demystify certain perceptions about private credit in Asia is especially important. Our interviews looked to answer one key question — "what is the real risk premium for private credit in Asia?"

Some managers reported that demystifying the perception of an "Asian risk premium" was a common experience during potential investor meetings. This risk premium is largely driven by jurisdictional concerns regarding creditor protection and enforcement.

While these are valid concerns, there was less awareness of how creditor protection and enforcement risks can be mitigated through appropriate risk management and use of safeguards in deal structuring. Indeed, some private credit funds differentiate themselves and maintain their reputation through their track record and by demonstrating how their risk management systems protect against downside risk.

Some examples given in the interviews included being able to mitigate the key challenge of jurisdiction concerns on perfection of security, enforcement and trapped cash with a combination of legal, structural and operational safeguards. Many of the approaches employed might be unique to Asia, due to the local lending requirements and jurisdictional variations, but nevertheless provide robust downside protection. One example given was the operational control and lines of the chops or seals in relation to companies borrowing in China.

Many managers expressed the view that executing any private credit strategy in Asia is likely to be relatively more challenging than in the US and European markets. Sourcing and origination can be more complex due to the lack of an institutional network and the need to develop local relationships in a geographically and culturally diverse region. Many Asian private credit funds have deals in multiple jurisdictions which creates cross-border business, tax, regulatory, legal and enforcement complexities, thereby making transactions more expensive and time consuming to close. These complexities also create an opportunity for relatively higher risk adjusted returns and, at the same time, can act as a barrier to newer entrants in the favour of the more established managers.

Case Study

Direct Lending to Asian SMEs

Direct lending is by far the most common strategy in Asia. This covers general business working and operational capital, as well as business expansion capital.

Regular business working capital and expansion capital loans are generally high churn, well-collateralised and of shorter duration in nature (between one and four years) compared to traditional special situations, distressed and leveraged loans (between three and seven years).

The returns from such loans are also lower than that usually expected from special situations, distressed or mezzanine strategies, with returns of between 6% and 12%, compared to returns of at least 15%. In terms of scalability however, the majority of respondents commented that the Asian direct lending market should be more easily replicated than other strategies, making it the likeliest engine of further growth for the private credit asset class in Asia.

> It is very rare you would see a fund operate in a significant degree of detail in every Asian market. Therefore, it is key for a fund manager to find its focus, find its sweet spot and be able to stay abreast of changing landscapes. Regulations and opportunities evolve and deals that you may have been able to do two years ago may not exist today.
>
> **Dan Simmons**
> Partner,
> OCP Asia

> Fragmented markets can be difficult to navigate, meaning there are many more risks and variables. But that is why you have to build a robust credit team and loan servicing infrastructure to manage those risks in order to establish a scalable direct lending platform.
>
> **Jiffriy Chandra**
> Managing Partner & CIO,
> TransAsia Private Capital Limited

Case Study

China's NPL market

The People's Republic of China (PRC) has recently taken measures to open up the Non-Performing Loan (NPL) market to foreign investors, by way of reforming (i) the Qualified Foreign Limited Partners (QFLP) programme, which was initially launched to provide a channel for international investors to access the PRC private equity market, and (ii) the asset management company (AMC) licensing system.

In April 2020, the Shanghai Financial Services Office (SFO) published an announcement, expanding the scope of its QFLP programme to cover non-private-equity related investments, including NPLs and convertible bonds. Although this policy change is still to be ratified, it signals the Shanghai government's readiness to accept greater foreign investments by QFLP funds in the NPL market. It is also expected that the QFLP pilot programmes will be rolled out in other cities, including Beijing, Shenzhen and Chongqing, in the near future.

In recent years, AMCs have played a dominant role in the PRC NPL market as only they were entitled to purchase NPLs in bulk directly from commercial banks. AMCs can be classified into two categories, namely national and provincial AMCs, with the former being granted access to a wider spectrum of NPLs. In the past, wholly foreign-owned entities and Sino-foreign joint ventures were banned from obtaining AMC licences (either at the national or provincial level) and were only allowed to invest in NPLs transferred from AMCs to retail investors. The granting of AMC licences to U.S. financial services firms at the provincial level since January, pursuant to the China-US Phase One Trade Deal, demonstrates the increased willingness of China to embrace foreign investors into the PRC NPL market.

> The Chinese government is looking for ways to address non-performing loans and broadening the AMC program is one example of that. For foreign firms, the real barrier to entry is not licensing, but the capability and experience to manage complexities in sourcing, underwriting and servicing.
>
> For example, when it comes to underwriting, you could take two NPL portfolios each with a hundred loans all of which, at face-value, are senior secured but priced totally differently. This is because either the loan documents contain defects, or the underlying collateral may contain the risk for social unrest like firing 100 people from a factory.

Ben Fanger

Managing Partner,
ShoreVest Partners

Chapter 4

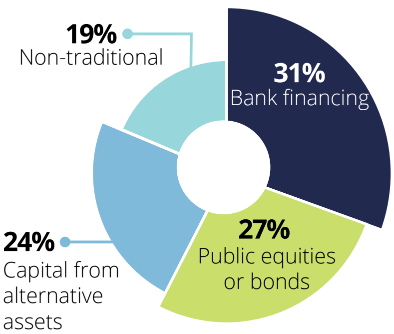
Non-Bank Lending and Borrowing in Asia

It is difficult to comprehensively represent the sheer diversity in borrowers throughout Asia, but there are some identifiable trends. Asia's dependency on raw materials and commodities means there is far more financing required for primary and secondary industries in comparison to other economic regions. Our interviewees noted that the type of borrowers and related lending structures also tend to be less standardised than their US or European counterparts.

Borrower profile

The commoditisation of banks' lending activity has had a negative impact on sectors and borrowers with more specific credit needs. These borrowers are therefore increasingly attracted to the flexible characteristics of private credit — particularly the speed and flexibility they can demonstrate compared to traditional lenders. According to a 2019 survey of SME activity in South East Asia conducted by EY[12], non-traditional financing and capital from alternative assets make up 43% of external sources of capital raised by SMEs. This clearly shows the proposition for borrowers in Asia to utilise private credit solutions is present and growing.

Figure 4.1:
SME Funding — Sources of Funding



Source: EY "Redesigning for the digital economy"

> The pace of business innovation, growth and demand for credit in the mid-market borrower segment shows little signs of slowing.
>
> **Alexander Shaik**
> Partner,
> ADM Capital

[12] EY – Redesign for the digital economy 2019

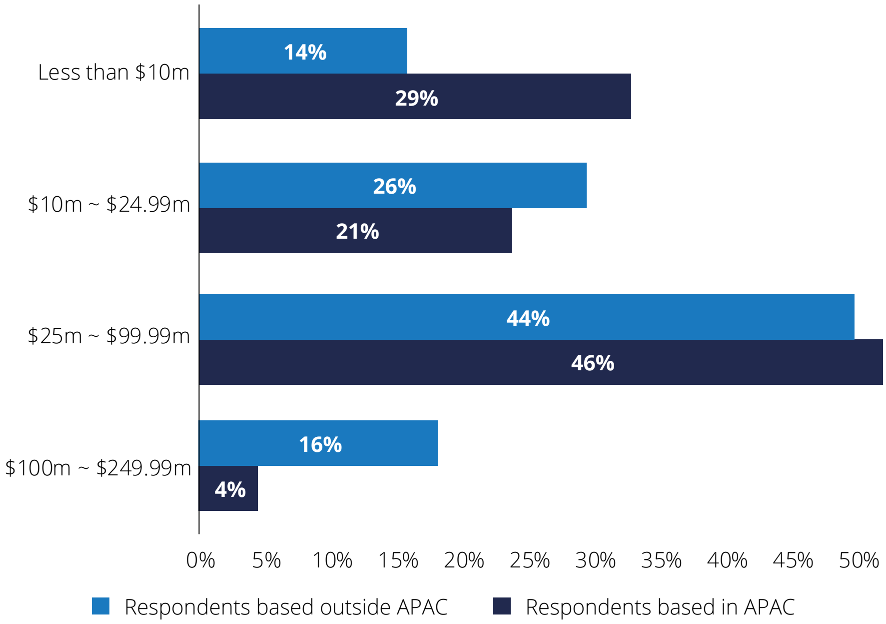
Typical deal ticket size

The spread in deal size observed across the region varies widely. While many survey respondents reported between US$25 million and US$100 million as their typical target loan size, many interviewees commented that their "sweet-spot" was between US$25 million and US$50 million — a range typically considered lower middle to middle market in the US and Europe. Our data suggested a fairly even split between firms targeting loans of this size, and those targeting loan sizes between $10 million to $25 million or $50 million to $100 million.

Very few fund managers reported a target loan size in excess of US$100 million. This can be explained by demand for direct lending in the region being driven by privately held SMEs.

As shown in figure 4.2, this finding is comparable to that of managers from more developed markets, however the key difference exists in the tail ends. The larger sized deals which may arise from special situations or syndicated lending are sparse in Asia, which means Asian private credit managers must rely on sourcing smaller tickets. Asian fund managers emphasised that success in deployment of capital at these levels requires managing more voluminous number of deals which, while being operationally more intense, offers a more diversified portfolio with a greater number of borrowers or exposures across different jurisdictions and sectors.

Figure 4.2:
Typical Target Loan Size



Source: ACC — APAC survey findings

Originating private credit deals in Asia

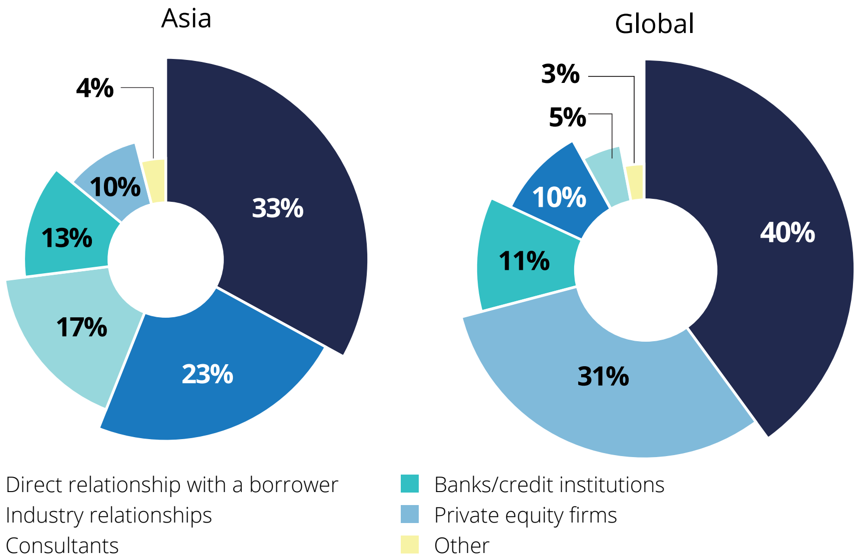
Deal origination was cited as a top priority by all the private credit fund managers interviewed. Many highlighted the difficulty in originating private debt deals in Asia as compared to the US or Europe, with all agreeing that a successful customer relationship programme was key to long term success in the region.

> In today's landscape, one key to sourcing alpha in private credit deals across the Asia Pacific is a long-standing deep historical network of previous borrowers and counterparties. Our 21-year-old network in the region allows ADM Capital to look beyond the typical deals introduced by third party brokers and use our own self-sourced relationships for around 80-90% of our pipeline. Historical relationships also help promote timely repayment of our loans, based on the influence of local business networks surrounding the borrower in encouraging compliance with loan terms.
>
> **Alex Shaik**
> Partner,
> ADM Capital

As figure 4.3 shows, almost three quarters of respondents originated transactions through personal relationship channels, whether that was through direct relationships with a borrower, consultants or other industry relationships.

The diversity of culture, language and business practices between the different Asian countries means that larger networks can be counter-productive while also more expensive to maintain. Therefore, private credit managers tend to prefer more focussed and richer local networks. This creates a significant barrier to entry that has hindered the growth of private credit in Asia - establishing a network inevitably takes time for newer firms or those looking to expand in Asia, and it can also restrict the growth of established managers by limiting their ability to scale their business model.

Figure 4.3:
Origination Channels



Source: ACC — APAC survey findings, ACC Financing the Economy research

Sponsored lending

In more developed markets, most transactions come from well-established and efficient broker networks or via sponsored lending. A loan described as "sponsor led" is a loan to a borrower where a private equity sponsor owns or will own equity in the borrower. It often enables the transaction to be facilitated with greater ease, given the private equity sponsor's relationship with both the borrower and the private credit manager. Globally this is the most common form of private credit. However, our research found that only 10% of respondents in Asia originated deals through private equity channels. Our interviewees indicated that almost all private credit transactions, and certainly those in the middle market SME space, tend to be sponsorless.

> You might have the odd JV because you need a local partnership or local distributor. But the key in Asia is that you need local capacity. You cannot originate remotely. You have got to have a platform on the ground and be able to keep local ties.
>
> **Peter Warbanoff**
> Debt and Restructuring Advisor

> From a sourcing standpoint, opportunities are less institutional in nature when compared to the US or Europe. Asia is much more relationship-based, and execution can be complex when it involves multi-jurisdictional assets and complex situations.
>
> **Dan Simmons**
> Partner,
> OCP Asia

Asian due diligence

Due diligence on target assets was cited by interviewees as one of the most important skillsets for Asian private credit managers. When considering a lending transaction, the private credit manager will typically assess the borrower's credit-worthiness and ability to repay using financial modelling, credit data, on-site due diligence visits and due diligence on the management team.

A combination of remote locations, local language and cultural expectations can make it harder for managers to properly assess the risk associated with an investment. Many companies are family run, have limited accounting track records or may involve complex ownership structures. This means that the due diligence process for each transaction tends to be bespoke, which can mean greater inefficiencies in the lending process. The absence of a standardised process also feeds into a perception of increased risk associated with these investments and, in turn, a greater risk premium is sought by investors.

Lending to borrowers in Asia

How private credit funds structure their debt lending products to borrowers is central to lending in Asia. There are 48 different countries in the region, each with its own legal rules and licensing regimes for lending, enforcing security and returning cash. Private credit managers are also regulated by the jurisdiction in which they operate, and they will also need to understand all applicable rules in the prospective borrower's jurisdiction of incorporation.

This patchwork of regulatory regimes can make it harder for private credit managers to execute a regional strategy, due to the ongoing costs associated with maintaining compliance with all relevant rules and regulations. The typical questions that need to be addressed when lending include:

- can the fund make loans directly to the borrower without triggering any local banking licence requirements?
- what type and form of collateral can the fund take onshore and what is the process for perfection or registration?
- what is the enforcement regime in the jurisdiction of the borrower?
- what are the tax implications and capital control restrictions in the jurisdiction of the borrower?

> Asia is not a bad place to do private credit, there is a lot of demand for it from borrowers. But 1) it is very specialist or niche. You need people who have been doing it for a while with a lot of experience (of which there aren't that many left anymore) and 2) you need the network and not just flying people in from, say the US to deploy their capital.
>
> **Rahul Kotwal**
> Managing Partner, Zerobridge

> It is very difficult to institutionalise regulatory change across the board for Asia. That sort of homogenised market might seem attractive. But conversely, if not being homogenised means there is opportunity and inefficiencies that exist then that is the piece that you have to sell to investors so you can get potentially outsized return for the risk that you are taking.
>
> **Peter Warbanoff**
> Debt and Restructuring Advisor

The necessary licence for different types of lending activities varies extensively across the region. Most licensing regimes, with the exception of Malaysia and South Korea, allow licensed lending activities. In most jurisdictions, however, foreign entities are prohibited from engaging in lending activities without proper structuring or exemptions.

Figure 4.4 provides a snapshot of the regulatory requirements for private credit managers seeking to lend in Asia.

Figure 4.4:
Summary of Lending Restrictions and Regulations for Private Credit Funds in Asia

	Licensing requirements			**Local restrictions**
	Can a non-bank lender make a new loan to a local borrower **without** a banking licence?	Can a non-bank lender engage in cross-border primary lending **without** a licence?*	Can a non-bank lender engage in cross-border secondary market loan activities **without** a licence?	Are funds **free of** other local restrictions (such as FX control and local borrower restrictions) generally?
Australia	Yes	Yes subject to complying with certain exemptions	Yes subject to complying with certain exemptions	Yes
Hong Kong	Yes	No	No	Yes
India	No	Yes	Yes	No
Indonesia	Yes	No	No	No
Japan	No	No	Yes subject to complying with certain exemptions	Yes
Malaysia	Yes	No	No	No
New Zealand	Yes	Yes subject to complying with certain exemptions	Yes	Yes
Philippines	Yes	No	No	No
PRC	Yes	No	Yes	No
Singapore	Yes	No	Yes	Yes
South Korea	Yes	No	Yes	No
Taiwan	No	Yes subject to complying with certain exemptions	Yes subject to complying with certain exemptions	No
Vietnam	Yes	No	No	No

- Yes
- Yes subject to complying with certain exemptions
- No

*Subject to deal structuring and local jurisdictional advice.

> The pretext for anyone investing in Asia is that there is perceived risk. In China for example, this is a risk of enforcement, the complex legal infrastructure and unfamiliarity with the country's laws.
>
> However, Europe is as big and diverse as Asia, and there is definitely a spectrum ranging from lender-friendly jurisdictions to countries with less accommodating regimes. That is similar to Asia as a whole or, indeed, within some Asian countries. You just have to know those jurisdictions, understand them and make sure you fully understand and mitigate the operational risks, as this will give you an edge over other competitors.
>
> **Barry Lau**
> Co-founder & Managing Partner, Adamas Asset Management

Figure 4.5:
Summary of Lending Restrictions and Regulations for Private Credit Funds in Asia

	Overview of private credit market	Local regulator	Licensing regime
Australia	Local barriers to bank funding, including the regulatory regime and rising funding costs, contribute to the development of the private credit market. Private credit has been continuously growing and has played a pivotal role in filling the financing gap.	Australian Securities & Investments Commission	Generally, funds do not require a banking licence to make loans to local borrowers. Funds that wish to offer debt securities or other structured products may have to be vigilant of the specific local rules. Cross-border primary lending and secondary market loan activities will only trigger a licensing requirement to the extent they constitute margin lending.
Hong Kong	The private credit market is very active in Hong Kong. An increasing number of credit funds are basing their credit investment teams in Hong Kong, and focus on transactions involving Asian owners. Credit funds and asset management companies in Hong Kong have also been increasing their portfolio size.	Hong Kong Government (through the Licensing Court, Registrar of Money Lenders (i.e. the Registrar of Companies) and Commissioner of Police)	If a fund is not an institution authorised by the Hong Kong Monetary Authority under the Banking Ordinance ("AI"), it must comply with the Money Lenders Ordinance, which requires any lender (other than an AI) in the business of making loans in Hong Kong to obtain a money lender's licence. Cross-border primary lending and secondary market loan trading may trigger a licensing requirement, but cross-border secondary market loan intermediation will not.
India	"Banking companies" and "non-banking financial companies ("NBFCs")" have been the primary credit providers in India. However, the private credit market in India has been driven by the higher delinquencies and liquidity crunch encountered by bank companies and NBFCs respectively.	The Reserve Bank of India	A fund incorporated in India must obtain a banking licence before offering loans to borrowers in India. An entity which provides loans as its primary business in India have to be registered as either a banking company or an NBFC. Cross-border primary lending and secondary market loan activities will not trigger a licensing requirement.
Indonesia	Commercial banks in Indonesia primarily provide credit for large and well-established corporates, resulting in a financial gap for private credit funds to step in.	Otoritas Jasa Keuangan or Financial Services Authority; Bank Indonesia	A fund generally does not require a banking licence to enter into loan facility agreements, security documents and other ancillary documents with a local borrower in Indonesia. Cross-border primary lending and secondary market loan trading may trigger a licensing requirement, but cross-border secondary market loan intermediation will not.
Japan	The regulatory restrictions on banking and corporate lending, plus the readily available low-cost loans from banks means that the private credit market in Japan is not as active as some of the other Asian jurisdictions.	Japan Financial Services Agency	Lending in the ordinary course of business requires a banking licence under the local law of Japan. It is arguable that one-off loans do not require a licence. Cross-border primary lending may trigger a licensing requirement. A licence is only required for cross-border secondary market loan activities to the extent the loans are securitised.
Malaysia	Corporate lending activities in Malaysia are heavily regulated. The private credit market is limited to the SME market by licensed money lenders (without a banking licence).	Central Bank of Malaysia; Minister of Urban Wellbeing, Housing; Local Government	Funds, which do not carry on any business or activity involving handling cheques or accepting deposits, are not required to obtain a banking licence for making loans to local borrowers in Malaysia. A moneylender's licence will need to be obtained once the making of the loan amounts to carrying on the business of moneylending. Cross-border primary lending and secondary market loan activities may trigger a licensing requirement.
New Zealand	Traditionally, the credit market in New Zealand is dominated by major banks. The private credit market, however, will likely be driven by the recently announced increased regulatory capital requirements for banks.	Financial Markets Authority; Reserve Bank of New Zealand	Generally, fund managers do not need a banking licence to make loans to local borrowers. However, fund managers should be aware of the specific local rules applying to various structures of funds as well as registration requirements. Cross-border primary lending will only trigger a licensing requirement to the extent of peer-to-peer lending. A licence is not required for cross-border secondary market loan activities.

	Overview of private credit market	Local regulator	Licensing regime
Philippines	The regulatory regime for lending activities is not conducive to non-bank lenders and the private credit market in the Philippines remains limited.	Bangko Sentral ng Pilipinas; Securities and Exchange Commission	Where a loan transaction is an isolated transaction and does not form part of other lending transactions to other borrowers located or based in the Philippines, a fund can make a new loan to a borrower incorporated in the Philippines without a banking licence. Cross-border primary lending and secondary market loan activities may trigger a licensing requirement.
PRC	With the continued opening up of the PRC financial markets and the government's commitment to deregulate on foreign debt control, there has been significant growth in the PRC private credit market.	China Banking and Insurance Regulatory Commission; State Administration of Foreign Exchange	Generally, a local establishment and a financial licence issued by the China Banking and Insurance Regulatory Commission are the prerequisites to carrying on a lending business in the PRC. Qualified offshore funds may however make cross-border loans to a PRC borrower, without a local financial licence. Cross-border primary lending may trigger a licensing requirement, but cross-border secondary market loan activities will not.
Singapore	Growth in the Singapore private credit market has been remarkable. Many credit funds have their credit investment teams based in Singapore focusing on transactions involving Asian owners.	Monetary Authority of Singapore	Funds can make a loan to Singapore companies without a banking licence. However, funds pursuing lending business in Singapore are mandated to obtain a moneylender's licence unless they can prove they are lending money in Singapore solely to any one of the following: (i) corporations; (ii) limited liability partnerships; (iii) trustees or trustee-managers of business trusts for the purposes of the business trusts; or (iv) trustees of real estate investment trusts for the purposes of the real estate investment trusts. Cross-border primary lending and secondary market loan activities may trigger a licensing requirement, but cross-border secondary market loan intermediation will not.
South Korea	The private credit market in South Korea has been growing continuously. In particular, there is increased interest in projects (e.g. renewable energy projects following the government's energy policies) which provide a promising opportunity for private credit investors.	Financial Services Commission; Financial Supervisory Service; Ministry of Strategy and Finance; Bank of Korea	Offshore funds are not required to obtain a banking licence for extending cross border loans to Korean borrowers unless they engage in any solicitation activities for the borrowing of loans. In practice, fund managers should exercise caution in the marketing as what constitutes "solicitation activities" is often quite ambiguous. Cross-border primary lending may trigger a licensing requirement, but cross-border secondary market loan activities will not.
Taiwan	The regulatory restrictions on banking and corporate lending plus the readily available low-cost loans from banks means that Taiwan remains a developing market in terms of private credit transactions.	Financial Supervisory Commission; Central Bank of China	Generally, funds which make loans on a commercial basis require a banking business licence. However, offshore fund (without a local establishment in Taiwan) may carry on one-off cross-border lending to a Taiwanese borrower without licence. Cross-border primary lending will only trigger a licensing requirement to the extent they constitute margin lending. A licence is only required for cross-border secondary market loan activities to the extent the loans are securitised.
Vietnam	Private credit is subject to prescriptive statutory and regulatory restrictions and only licensed entities are permitted to lend.	State Bank of Vietnam	An offshore fund is not required to obtain a banking licence to provide a loan to a Vietnamese borrower, but should be mindful of the licensing requirement for carrying out cross-border lending activities. Cross-border primary lending and secondary market loan activities may trigger a licensing requirement.

Enforcement regimes in Asia

Our research indicates that the enforcement regime for security and likelihood of recovering capital from borrowers in default is the single biggest regulatory concern for private credit managers. Without reforms which give private credit managers and their investors greater certainty, it is likely that this factor will hinder the expansion of private credit in the region.

While investors consider insolvency regimes and creditor protection to be the largest barrier to greater investment, private credit managers already operating within Asia see their ability to navigate these challenges as a key differentiator and source of competitive advantage.

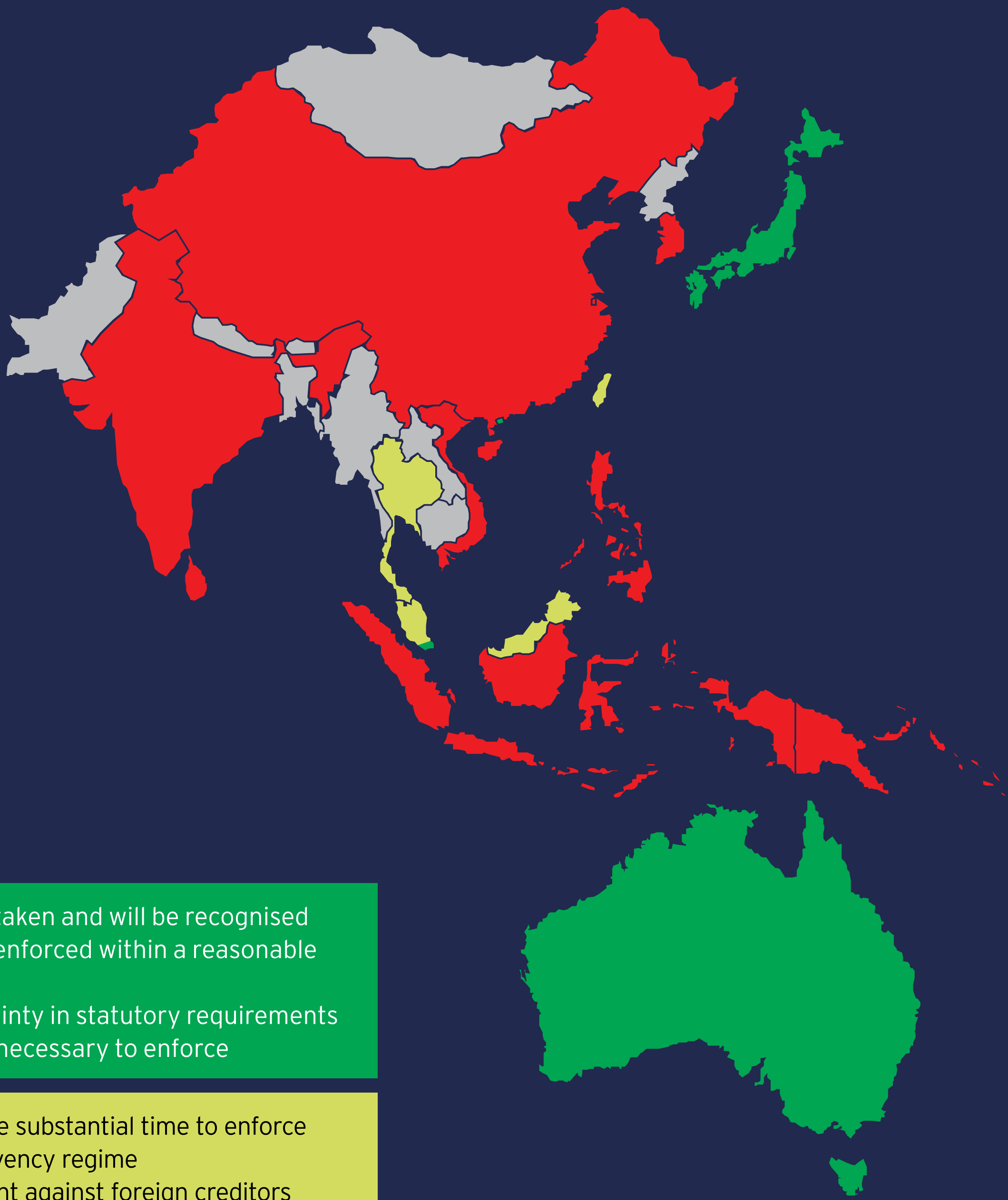
Figure 4.6 shows the level of enforcement certainty in Asia. Jurisdictions such as Australia, Singapore and Hong Kong are seen as more creditor friendly. This means that investors have greater confidence that security will be recognised, that enforcement can occur within a reasonable period and there will be a dependable process around the statutory requirements and procedures that may be present in the jurisdiction. This is typically accompanied by factors such as the presence of an independent judiciary, robust statutory frameworks and accounting standards, healthy corporate governance, positive debtor behaviour and lower political risk.

Jurisdictions such as Indonesia, Vietnam and the Philippines show that a low level of enforcement is a material risk. This means there may be significant delays in enforcement, and legal processes may have debtor or foreign creditor biases, with much depending on the facts of the case or local influences. Such low enforcement levels can be attributable to low judicial independence, weak statutory frameworks, inadequate accounting standards or corporate governance, negative debtor behaviour and high political risk. The risk associated with such jurisdictions usually requires a higher premium and more structured credit profile.

The benefits of operating in such a jurisdiction often means that established private credit managers build up their knowledge and experience in navigating such hurdles. It is our hope that greater investment by private credit firms in jurisdictions with more transparent and dependable enforcement processes will demonstrate the value of this to other jurisdictions and, over time, will highlight the need for meaningful reform.

> The general regulatory environment is becoming more difficult globally and that is a plus and minus point. If you can manoeuvre through these challenges nimbly compared to a bank then that is an attractive proposition.
>
> **Peter Warbanoff**
> Debt and Restructuring Advisor

Figure 4.6:
Overview of Enforcement in Asia



- Security can be taken and will be recognised
- Security can be enforced within a reasonable time period
- Clarity and certainty in statutory requirements and procedures necessary to enforce

- Security may take substantial time to enforce
- Developing insolvency regime
- Possible sentiment against foreign creditors

- Difficult to enforce security
- Significant delays in enforcement
- Rehab process may have debtor bias
- Bias against foreign creditors
- Success in enforcement is highly dependent on local influences

Chapter 5

Operating a Private Credit Firm in Asia

Many Asian private credit funds make investments across multiple jurisdictions and, as a result, effective navigation across a multitude of tax regimes is crucial to meet their investment objectives while maintaining tax neutrality for their investors. This requires tax to be considered at the levels of the management company, the fund and the deal itself. An investment manager can only make an informed decision with respect to any tax matters after adequate consideration of all three. The nature of debt investment means that questions around withholding tax and tax on interest can be central to the return profile of the investment.

Tax and structuring considerations for private credit funds

Many Asian private credit funds' strategies require them to have "boots on the ground" across different tax jurisdictions, therefore, the fund manager's footprint across jurisdictions needs to be carefully managed. From a management company perspective, Hong Kong and Singapore are popular jurisdictions for fund managers to establish their investment teams, finance and back office support functions.

Fund establishment

From a fund formation perspective, key considerations include the location and type of investor, the use of appropriate fund pooling vehicles and the target investment jurisdictions. Traditionally, most Asian private credit funds are established as closed-ended, limited partnership vehicles in a tax neutral jurisdiction.

This trend may change in the future due to increased scrutiny of other fund management centres, combined with the evolution of Hong Kong and Singapore as fund centres in their own right. Both jurisdictions have recently introduced new fund vehicles that seek to support private credit managers. In Hong Kong, the new Private Limited Partnership Fund law will come into effect from 31 August 2020, which enables private funds to be established onshore in a limited partnership form; in Singapore, the new variable capital company (VCC) vehicle was launched in January this year. Since then around 100 VCCs have come to market.

> Changing investor preferences and challenges to traditional fund centres such as the Cayman Islands, along with the development of new fund vehicles and exemption regimes in the key Asian hubs of Hong Kong and Singapore means it is timely to revisit existing thinking on fund structuring.
>
> **Adam Williams**
> Partner,
> Greater China Private Equity Tax Leader
> EY

One key advantage of a Hong Kong or Singapore vehicle is that the use of a legal fund vehicle domiciled in the same jurisdiction where the firm's key business activities are carried out helps to align the legal structure of the firm with commercial substance. This increases the robustness of the fund structure from a tax perspective.

Ongoing taxation

Effective tax planning also requires the Asian private credit fund manager to stay abreast of relevant tax developments on an ongoing basis. In Hong Kong, the uncertain tax treatment of carried interest recognised by closed-ended fund structures has long been a management company issue. The announcement that a tax concession for carried interest will be introduced has broadly been welcomed by industry. The details of the reforms are likely to be released during the course of 2020. It is hoped that any changes will provide the necessary certainty for investors in private credit funds.

Both Hong Kong and Singapore have also expanded their fund exemption rules. In the case of Hong Kong, the Unified Fund Exemption regime came into force effective 1 April 2019. These rules have been a significant improvement for Hong Kong, allowing both onshore and offshore established funds to be exempt from tax in Hong Kong when certain conditions are met.

The one challenge for Hong Kong and private credit, however, is the Inland Revenue Department's interpretation that Hong Kong-sourced interest income is not considered to fall within the exemption (unless it fits within a 5% de-minimis threshold). This contrasts with the Singapore position that will allow an exemption for Singapore-sourced interest income as long as other conditions are met.

In a region where few fund managers have in-house tax professionals in senior operational roles, effective tax risk management and tax planning requires management to lean heavily on their external tax advisors and service providers.Tax matters, when managed effectively, have a meaningful impact on a fund's return profile and, as such, are a key concern when operating a private credit fund in Asia.

Reporting and administration

Private credit managers typically require an institutional grade operational infrastructure that is also flexible enough to meet the needs of a mixed investment strategy. Other areas of complexity arise when a private credit firm is managing multiple funds and legal entities alongside investments in various uniquely structured instruments. Many Asian private credit managers acknowledge the manual nature of their internal and external reporting processes and recognise the need to invest in technology to keep pace with investor expectations.

These challenges are exacerbated by the fact that the surrounding support ecosystem for private credit is still evolving to address the specific needs of credit funds. This is particularly true when it comes to loan portfolio management. The underlying borrower covenants, reporting and scheduled payment dates are often monitored manually and it is difficult to translate this data up for investor reporting requirements. As a result, many Asian private credit funds are currently reliant on manual and in-house processes.

For investor reporting, Asian private credit managers are faced with an increasing reporting burden with investors requesting more detailed and frequent reporting, often on an ad-hoc basis. Certain institutional investors may adopt standardised transparency reporting with very specific reporting parameters. This trend has also been accelerated by COVID-19, with investors seeking more granularity on their portfolios. In the short term, funds may therefore look beyond the reporting capabilities of their service providers and devise their own data strategy to meet raised expectations around reporting.

> Our strategy of sourcing credit opportunities through our senior underwriting professionals or "deal captains" ensures that the best quality deals are getting the most attention, and the deal captain is personally vested in the credit from inception to harvest.
>
> **Chris Mikosh**
> Portfolio Manager, Co-Founder,
> Tor Investment Management

Investments in technology to facilitate compliance with regulatory reporting, fund accounting requirements and meet investor's reporting expectations will therefore be critical to the sector's growth.

Working with the right people

Sourcing and retaining skilled talent to execute an investment strategy is acknowledged as having a significant impact on the growth of private credit firms. A majority of the interviewees for this research agreed that it was difficult to find and retain key organisational and structuring talent in Asia.

The most successful Asian private credit asset managers emphasised the need for their staff to have the capability to take an investment "from start to finish". This covers everything from deal sourcing, structuring and executing those deals and ongoing relationship management. Dedicated managers with client relationship skills were described as pivotal because of the importance of personal networks to deal sourcing. The middle and back office infrastructure is also likely to be relatively labour intensive. As the number of loans being administered by a manager increases, processes and systems need to be scaled commensurately. This leads to operational processes that requires human intervention from those with the right expertise and experience.

Expertise in a particular industry or sector, understanding of the specific risks associated with the loans and financial modelling competence were also highlighted as core skillsets. This allows fund managers to both accurately price credit risk, negotiate favourable terms to protect investors' returns, assess collateral value, monitor financial covenants, understand financial reporting and have a deep understanding of the enforcement regime of the borrower. This tends to be a more multi-disciplinary approach than might be expected in a bank where roles are often more clearly delineated.

Candidates with these specific skillsets are rarer in Asia. Other lenders such as investment or local banks often provide a more defined career path than is ideal for the development of the skills required by private credit managers. Most recently, attracting and retaining talent has become even harder due to the competition from fintech firms and the Asian peer to peer lending market. Culturally, many graduates also display a preference to follow a more institutional career path, rather than the less established route of working for a private credit fund.

> Years ago graduates were attracted to banking, an industry where you made good money and was as interesting as anything around. Now I am not sure you are getting the same talent coming through as most will want to go and work for Alibaba, Tencent, GoJek or some other tech giant.
>
> **Peter Warbanoff**
> Debt and Restructuring Advisor

Chapter 6

ESG and Private Credit

The attitude of debt providers towards sustainable investment and ESG has changed dramatically. This is no longer seen as something which is primarily the domain of the borrower or their equity owners. Sustainability, climate change and social concerns are now considered core risks and objectives by fund managers and their investors.

How private credit addresses ESG and sustainable finance considerations will vary according to a fund's strategy and investor profile. Sustainable investment debt structures can take many forms, from green bonds or ESG linked loans to asset-backed sustainable supply loans or notes. However, an approach to ESG and sustainability considerations will typically involve either:

(i) direct participation in ESG-linked financing and sustainable data and analytics reporting relating directly to those underlying credits; or

(ii) maintaining policies and procedures in relation to a fund's sustainable ambitions and framework. This requirement is not only demanded by investors, but governments and regulators have now implemented a set of standards with which a fund or portfolio must comply.

The range of approaches to ESG investment by asset managers goes beyond the scope of this paper. The drivers, which include demands from end investors, manager recognition of financial benefits, as well as increasing demands of policymakers (especially in Europe), continue to grow. AIMA and Simmons & Simmons recently published a Primer on Responsible Investments that provides a high-level overview of responsible

> The consideration of sustainability factors in finance has moved into centre-stage as lenders, asset managers and their clients increasingly recognise the link between sustainability and financial performance and risk management, as well as becoming more mindful of the external impacts of their capital.
>
> **Lucian Firth**
> Partner,
> Simmons & Simmons

investment, and outlines some of the more common policies adopted by managers. It also seeks to answer some frequently asked questions about responsible investment in the context of funds and outlines a series of AIMA principles for effective regulation in this space.[13]

ESG policies and reporting

Reporting and disclosure requirements for private credit funds in relation to ESG have largely focussed on developing investment policies to capture ESG objectives. A typical policy might consist of the following:

(i) *Investment objectives*: Setting out specific ESG and responsible investment performance targets for its investments. Globally recognised development targets (e.g. the UN Sustainable Development Goals) are often used to inform such standards.

(ii) *Assessment framework*: Assessing potential borrowers against the investment objectives by setting out an assessment criteria guideline and an exclusion list, containing the types of businesses which it categorically does not finance. A widely adopted list is the International Finance Corporation (IFC) Exclusion List[14], which excludes eight types of businesses, such as production or trade in any product or activity

[13] AMIA, *AIMA Responsible Investment Primer*. Available from: https://www.aima.org/resource/aima-responsible-investment-primer.html

[14] International Finance Corporation, *IFC Exclusion List*. Available from: http://www.ifc.org/exclusionlist

deemed illegal under host country laws or regulations or international conventions and agreements, or subject to international bans, and production or trade in tobacco and alcoholic beverages (excluding beer and wine).

(iii) *Reporting*: Explaining the reporting requirements to which borrowers are subject, e.g. specifying that impact screening and reporting will be conducted as requested by the fund or impact investor partners.

Sustainable finance and ESG linked loans

For private credit funds, lending and providing debt products are their core investment activity. There are multiple means by which managers can offer sustainable finance products to their borrowers. Demand for these debt products comes from both investors who need to show their funds are invested appropriately, and also from borrowers who recognise that sustainability can be rewarded with lower interest costs. There are also several popular ESG-linked credits that are often provided by private credit funds to their borrowers.

Sustainability linked loans

Sustainability linked loans can be defined under the Sustainability Linked Loan Principles[15] (SLLPs) (see below) as any types of loan instruments and/or contingent facilities which incentivise the borrower's achievement of ambitious and predetermined sustainability performance objectives. The loan terms are tied to the sustainability performance of borrowers who, as a result, can potentially benefit from a lower interest rate when a specified performance target is achieved.

ESG linked real estate

Buildings account for a substantial share of energy consumption and greenhouse gas emissions. An increasing number of real estate owners and operators have incorporated ESG performance as part of their business strategies, by developing ESG policies and designing buildings with green and sustainable features. This ESG data can be utilised by the lender to encourage sustainable behaviours.

Real Estate Investment Trusts (REITs), in particular, are an integral part of ESG linked real estate investments which often include a leveraged debt element. They own, develop and manage a vast portfolio of commercial and residential buildings e.g. offices, shopping centres, hotels and apartment buildings which are large producers of waste and consumers of energy. A recent research report[16] found that REITs with a more

[15] Loan Market Association, Asia Pacific Loan Market Association, Loan Syndications & Trading Association, *Sustainability Linked Loan Principles*. Available from: https://www.aplma.com/en/gsl/3

[16] Avis Devine, Eva Steiner and Erkan YÖnder, *Decomposing the Value Effects of Sustainable Investment: International Evidence*. Available from: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2920788

sustainable portfolio benefited from higher rental income and lower interest expenses resulting from the sustainable and interest rate linked covenants.

Sustainable Supply Chain Finance (SCF)

The ESG investment trend presents an opportunity for private credit managers, especially in Asia, to embed ESG elements into SCF structures. In particular, sustainable supply chains can be financed by the following mechanisms:

- *Sustainable trade loans:* Sustainable trade loans aim to incentivise suppliers to achieve certain sustainability performance targets (SPTs) specified by the lender in its manufacturing or sourcing of goods, services or activities. The lender provides preferential rates to sustainable suppliers.
- *Buyer-led payable finance programme*: Buyers can integrate ESG considerations into their supply chain, for example, by ranking suppliers according to their sustainability performance. While suppliers sell their receivables income at a discount to SCF providers, they receive preferential terms e.g. favourable lending rates or early financing, for demonstrating strong sustainability performance. Buyers will then pay their invoices on the due date directly to the SCF providers.

Sustainable securitisation

Private credit funds can also participate in the capital markets or collateralised loan obligations via ESG securitisation, which is characterised by the sustainability of the underlying assets and the sustainable use of any proceeds. Sustainable securitisation has become more viable and profitable with the growing types of eligible sustainable assets e.g. loans for hybrid and electric vehicles, loans for solar energy projects, and commercial and residential mortgages for energy efficient properties. Indeed, the OECD estimates that the annual issuance of sustainable asset-backed securities has the potential to reach US$380 billion in the 2031-2035 period[17].

Green bonds

The proceeds of green bonds are exclusively applied to new or existing environmentally friendly projects e.g. sustainable water management, pollution prevention, low-carbon transport and renewable energy.

[17] Organisation for Economic Co-operation and Development, *quantitative framework for analysing potential bond contributions in a low-carbon transition*. Available from: https://www.oecd.org/cgfi/quantitative-framework-bond-contributions-in-a-low-carbon-transition.pdf

Voluntary guidelines for green loans and sustainability linked loans

The Asia Pacific Loan Market Association (APLMA) has recently published two sets of voluntary principles as guidance for green loan and sustainability linked loan market participants.

Green loan principles

In December 2018, the APLMA, along with the Loan Market Association (LMA) and the Loan Syndications and Trading Association (LSTA) issued the Green Loan Principles (GLPs)[19], providing voluntary guidelines for the green loan market to apply on a deal-to-deal basis. Green loans are defined under the GLPs as “any types of loan instrument made available exclusively to finance or re-finance, in whole or in part, new and/or existing eligible green projects”.

The GLPs consists of four core components:

- *Use of proceeds*: The loan proceeds must be utilised for eligible green projects.
- *Process of project evaluation and selection*: A borrower should clearly communicate to its lender its environmental sustainability objectives, the process for determining how its projects fit within the Appendix 1 eligible categories and the related eligibility criteria.
- *Management of proceeds*: The net proceeds of the green loan should be credited to a dedicated account or otherwise tracked by the borrower in an appropriate manner.
- *Reporting*: A borrower should make and keep readily available up-to-date information on the use of proceeds to be renewed annually until fully drawn, and thereafter in the event of material developments.

Sustainability Linked Loan Principles

In March 2019, the APLMA, LMA and LSTA also launched the Sustainability Linked Loan Principles (“SLLPs”) to provide a separate set of voluntary guidelines for sustainability linked loans.

[19] Loan Market Association, Asia Pacific Loan Market Association, Loan Syndications & Trading Association, *Green Loan Principles*. Available from: https://www.aplma.com/en/gsl/2

The four key components of the SLLPs are as follows:

- *Relationship to borrower's overall corporate social responsibility strategy*: A borrower should clearly communicate to its lender its sustainability objectives and how these align with its proposed SPTs.
- *Target setting — measuring the sustainability of the borrower*: Appropriate SPTs, which should be ambitious and meaningful to the borrower's business and tied to a sustainability improvement in relation to a predetermined performance target benchmark, should be negotiated and set between the borrower and the lender for each transaction.
- *Reporting*: A borrower should make and keep readily available up-to-date information relating to their SPTs, with such information to be provided to institutions participating in the loan at least annually.
- *Review*: The need for external review is to be negotiated and agreed between the borrower and the lender on a transaction-by-transaction basis. In the event that no external review is sought, it is strongly recommended that a borrower should demonstrate or develop the internal expertise to validate the calculation of its performance against the SPTs and to thoroughly document such expertise.

ESG, sustainable financing and COVID-19

As well as dealing with the immediate economic and public health impacts of COVID-19, governments around the world are also looking at how the recovery might be used as an opportunity to integrate more sustainable economic models.

Green recovery entails boosting the economy through funding projects which are considered to be more eco-friendly and 'green', thereby creating jobs and opportunities in the market.

Although COVID-19 has taken a toll on the global economy, it has nonetheless increased the focus on sustainable financing projects within governments' plan for post-pandemic economic growth. Government policy across Asia is encouraging investment in more sustainable business models, technologies and consumption patterns. This is likely to fuel the need for private capital, particularly among SMEs and mid-market firms.

> ESG investments consistently outperformed traditional investments during COVID-19 by 3-4% across the globe which reflects better risk management and valuation in ESG products, in particular during market stress. The recent establishment of the Green and Sustainable Finance Cross-Agency Steering Group and the Climate Change Technical Expert Group by the Securities Futures Commission, signified both the HKSAR Government and regulators in Hong Kong are accelerating efforts in developing standards and guidance for addressing climate-rated risks. It is prudent for any investors to take concrete steps toward a fully ESG integrated world.
>
> **Tracy Wong Harris**
>
> Deputy Secretary General,
> The Hong Kong Green Finance Association

Conclusion

Private credit in Asia sits at the edge of an exciting opportunity. International banks are retrenching from the region or reducing their activity in non-core lending markets. Investors are looking to Asia to offer diversification for their portfolio, and provide the returns needed to meet the needs of their underlying beneficiaries. At the same time, SMEs and mid-market businesses in the region are increasingly attracted to lenders who can provide tailored finance solutions.

These trends are extremely favourable for the expansion of private credit in Asia. It is our expectation that the sector will play a greater role in the financing of the region's economy, following a similar trajectory to that seen in Europe over the last decade.

There is no doubt, however, that challenges exist and these will need to be addressed for the sector to realise its potential. Asia is a large region containing multiple jurisdictions, each of which has its own regulatory framework and industry practices. Lending in the region, particularly cross-border, is inherently complex. This makes it harder for businesses to scale processes internally, and for markets to achieve sufficient mass for them to be attractive to investors seeking to deploy larger sums of capital.

Private credit managers, investors and policymakers are now starting to address these challenges and lay foundations to support the next stage of the region's growth. The establishment of new fund vehicles in Asia financial centres, and the adoption of structures and strategies from more developed private credit markets are all encouraging signs.

This report has helped shine a light on the role of private credit in Asia in financing the region's economy and the factors shaping its development. It has also highlighted the value of data to any dialogue between credit fund managers, investors, and policymakers. It is our hope that this paper will provide further impetus to that dialogue and ensure a sustainable future for private credit in Asia.

About us

About ACC

The ACC currently represents over 170 members that manage over $400bn of private credit assets. The ACC is an affiliate of AIMA and is governed by its own board which ultimately reports to the AIMA Council. ACC members provide an important source of funding to the economy, providing finance to mid-market corporates, SMEs, commercial and residential real estate developments, infrastructure as well the trade and receivables business.

The ACC's core objectives are to provide direction on policy and regulatory matters, support wider advocacy and educational efforts, and generate industry research with the view to strengthening the sector's sustainability and wider economic and financial benefits.

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Simmons & Simmons is a leading international law firm, offering access to more than 1000 legal staff in key business and financial centres across Europe, the Middle East and Asia.

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Our immersion in the sector enables us to go beyond technical legal guidance, delivering rounded, actionable strategic advice. It's also informed the development of innovations such as navigator, a leading online subscription service that provides information on global cross-border fund regulation, lending, distribution of funds, portfolio management and tax to subscribers.
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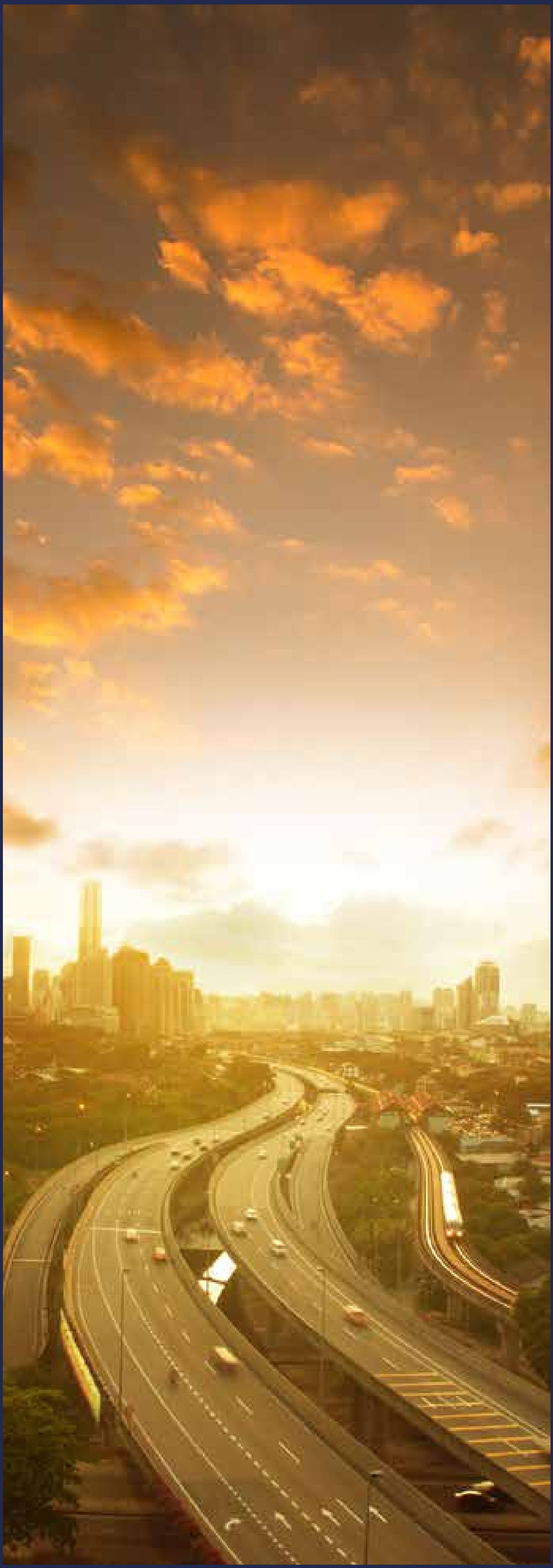

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EY is a global leader in assurance, tax, strategy, transaction and consulting services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

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