Asia presents an untapped but complex opportunity

Direct lending is in its relative infancy in Asia-Pacific, with demand outweighing supply. Managers keen to participate would do well to note the vast differences within individual markets, says Mark Cooper

There is huge potential for direct lending in Asia-Pacific, though its size and heterogeneity mean a regional strategy is hard to implement.

The primary drivers of private debt globally, such as lack of provision by banks, borrower demand for tailored solutions and investor appetite, provide impetus to direct lending in the region. Asia-Pacific also has countries with GDP growth prospects and growing populations, which will generate companies with a need for growth capital.

There is a range of lenders providing mainly senior debt to companies, but the direct lending market is undeveloped and unsaturated compared with those in the US and Europe. Even estimating the size of the market is tough. The Alternative Credit Council estimates the Asian direct lending market to be worth $56 billion, while it is $386 billion in Europe and $1,250 billion in the US. Bank lending, meanwhile, accounts for 75 percent of all lending in Asia, compared with 50 percent in Europe and 20 percent in the US.

"It is difficult to quantify the size of the direct lending market in Asia, but the demand is huge and we haven't scratched the surface of it," says Dan Simmons, partner at Hong Kong-based fund manager OCP Asia. "Demand is significantly outweighing supply and that is why returns are better, even on a risk-adjusted basis, than in North America and Europe."

Banks cannot be replaced

The position of the banks relative to private direct lenders is also different, says Nitish Agarwal, chief investment officer at Singapore-based fund manager Orion Capital Asia: "Direct lending in Asia is complementary to bank lending, it is not a replacement. In North America or Europe, you might get a term sheet from a bank and from a non-bank lender and choose between them.

"Here, we cannot compete directly with the banks and this is a consequence of the return expectations of investors in direct lending strategies. Investors want a premium to their home markets and, by and large, are seeking low teens returns, which takes them out of competition with Asian banks. However, there are pockets where, for regulatory or other reasons, banks are not able to provide funding. In some cases, banks are reluctant to add to their balance sheet."

> *"In some cases, banks are reluctant to add to their balance sheet. In these cases, private lenders can come in"*
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> **NITISH AGARWAL**
> **Orion Capital Asia**

Direct lending returns vary from market to market, depending on the risk and complications of lending. However, most strategies are looking for high single-digit to mid-teens returns, which takes direct lenders out of bank loan territory. Simmons says: "For a lot of private direct lending in Asia the alternative is not bank finance, but equity solutions, perhaps a placement or bringing in a strategic investor."

Lending terms and structures are different to those elsewhere, which reflects less competition among lenders and borrowers' desire for bespoke finance and confidentiality. "Structures in Asia tend to be covenant-heavy and with personal and corporate guarantees, which you see less of in Europe and North America" says Simmons. "In Asia there are a lot of firms with a significant personal or family shareholding."

Direct lenders often say that "there is no Asia-Pacific", as the region is so diverse: each of the 48 countries has its own legal rules and licensing regime for

A selection of closed Asia-based funds

Fund	Head office	Manager	Target size ($bn)	Current size ($bn)	Vintage	Close	Strategy	Sector	Countries
PAG Loan Fund IV	Hong Kong	PAG	0.00	1.50	2019	2020	Senior debt (origination)	Corporate	
Topaz Private Debt II	Japan	Topaz Capital	0.00	0.32	2018	2019	Senior debt (origination)	Corporate	Japan
CDPQ/Piramal Private Credit Joint Venture	India	Piramal Enterprises	0.30	0.30	2020	2020	Senior debt (origination)	Corporate	
R-Bridge Healthcare Fund	Singapore	CBC Group	0.00	0.30	2020	2020	Senior debt (origination)	Corporate	
Tor Asia Credit Opportunity Fund	Hong Kong	Tor Investment Management	0.25	0.26	2018	2019	Senior debt (origination)	Corporate	

Source: Private Debt Investor

lending, enforcing security and returning cash. This makes it hard to generalise about market circumstances and or to develop a truly pan-regional strategy.

"It is a dozen different markets with different languages, different rules and regulations, and different business cultures," says Agarwal. "The resources required to complete a deal and to operate across jurisdictions are significantly higher than what you would need in Europe and the US."

The prime markets for direct lending are India, China, South-East Asia and Australia. The latter is often a first port of call for global lenders that are moving in, because of its familiar legal system and transparency, though the market is relatively underdeveloped.

Japan and South Korea are so far largely untouched by international direct lenders due to the presence of local players. "There are enough domestic liquidity and local securities houses to pick up whatever is left from the domestic bank market" says Agarwal. "So there is less room for private debt investors in those markets."

Australia: All the returns for less risk

Direct lending in Australia offers the transparency and legal structure advantages of Europe and the US, but with far less competition.

"We believe we're probably 20 years behind the US and 10 years behind Europe in direct lending," says Mick Wright-Smith, founding partner at Epsilon Direct Lending, which is raising A$500 million for its maiden fund. "As in those markets, Australian banks are pulling back from anything where there is a need for flexibility or creativity. For mid-market direct lending, we reckon the market is around A$70 billion and that will grow because there's a need for debt from medium-sized companies."

Competition in the US and Europe means much lending is now on a covenant-lite basis. However, Wright-Smith says he has "never seen a covenant-lite deal" in Australia, while borrowers put more equity in every transaction. "The net IRR for direct lending funds in Europe is around 6 percent, which is the target for our fund," he says. "However, we're getting that return for less risk. By way of example, the typical contributed equity for new loans in Europe and US right now is 40 percent, whereas in Australia it averages over 60 percent."

There is interest from both investors and managers and Wright-Smith expects to see an increasing number of international fund managers look to Australia. Meanwhile, the large domestic investor base is "familiar with direct lending and many have invested in European or US credit funds".

Relationships are vital

Direct lenders in Asia need staff who are aware of the cultural and business nuances of the nations where they operate. Personal relationships with borrowers are important and lenders are likely to be originating most of their own transactions.

However, Agarwal says: "The ecosystem and infrastructure is a lot more developed than a decade ago and borrowers' knowledge of private debt is also substantially higher."

Investment in Asia-Pacific direct lending funds has come mainly from outside the region and, although there is still widespread demand for an 'Asia premium', interest is strong.

"Interest from US private and public pensions, endowments and family offices continues to be very strong," says Simmons. "We have seen a significant increase from European institutions as well. US and European private lending is a pretty saturated and developed market."

Investors from within Asia are now more active, says Agarwal: "We have had investment from Korean LPs and Japanese investors, and there is interest from Japanese investors and family offices in Singapore and Hong Kong."

Korea's Public Officials Benefit Association recently invested in its first Asia direct lending strategy, says chief investment officer Dong Hun Jang. "We approach Asia direct lending from a diversification point of view," he says, but notes that funds tend to be smaller and GPs have smaller operations. ■