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Rising reward and declining risk boost appetite for Asian private debt

Treabhor Mac Eochaidh, head of debt services at MUFG Investor Services, says improving legal and tax frameworks are driving investor interest in Asian credit.

As the hunt for yield steers investors towards different markets and regions, Asia-Pacific has emerged as the next big growth area for private debt. Until recently, investors had approached the region with caution, as they recognised its significant potential for both yield and volatility. Lately, however, they have become more reassured by the steps many Asian markets have taken to protect investors by shoring up legal frameworks and tax transparency.

Consequently, asset managers have expanded their presence in the region beyond established markets such as Australia and Hong Kong to launch operations and invest in funds in more frontier corners like Indonesia, Vietnam and Cambodia. Investors have identified prospects in strategies that involve real estate infrastructure loans, special situations and mezzanine debt in these countries. They also see promise in some distressed debt opportunities in India and China.

Fundraising falling, yet opportunities abound

Private debt markets across the globe continue to remain popular among investors owing to the reliable income, diversification and downside protection that the asset class generally promises. However, fundraising in the space struggled throughout last year, according to Private Debt Investor's Fundraising Reports, amid widespread uncertainty about how geopolitics and trade policy would affect the global economy and interest rates. Fundraising numbers for 2019 slipped to their lowest level in four years.

Even so, Asia-Pacific, starting from a low base, shows substantial room for growth. Investors recognising this potential have tiptoed into the region. Behind the trend, asset managers have noticed that returns in more established markets, such as the US and Europe, have begun to plateau in some sectors, making investments in Asia-Pacific more attractive.

Meanwhile, Asian banks that had mostly escaped the more damaging effects of the global financial crisis over the past decade are now hearing calls for additional capital requirements. As these institutions slowly deleverage to meet the new constraints, direct lending and other private debt opportunities have emerged to fill the gaps by offering loans ranging mostly between US$25 million and US$100 million, thereby generating robust yields.

Where investors are finding the yield

Investors are finding success using different strategies, such as real estate infrastructure loans and some special situations, despite varying levels of risk across the region. Asset managers spy considerable yield potential in infrastructure loans, as countries in South-East Asia have sizeable construction needs, even amid underdeveloped regulatory and legal structures and light enforcement.

Ample real estate construction and debt issuance in Vietnam, for instance, has introduced direct-lending opportunities for investors. In response, asset managers have been pushing regulators there to tighten rules and protections. Cambodia, with its proximity to China, has also seen activity in the infrastructure loan space.

Asset allocators have shown some interest in Australia and India for special situations, which involve making private-placement loans to distressed companies whose valuations investors expect will rise. The allure should only increase as regulations strengthen and investors feel more effectively shielded from the risks.

As banks tighten their capital deployment, the mezzanine sector has also grown. Here, lenders are allocating to debt funds that provide higher yield, but which have less protection and claim to a company's assets should borrowers default.

Indian banks, for example, hold many non-performing loans with several tranches of investors. The covenants, or protections, are strongest in the senior-most A and B tranches.

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But the mezzanine level lying beneath those tranches commands higher yields for its more risk-tolerant investors: at about 6 percent, compared with the 3 percent that investors in the A and B tranches receive. Still, some asset managers hedge their bets by buying the A- and B-level debt alongside the mezzanine-level debt.

Investing where 37 percent of the world lives

Investors have discovered many distressed-debt opportunities in India and China. After years of unprecedented growth, China's banking sector has seen a lot of distressed debt accumulate. Even though only a small portion of Chinese banks' loans have entered the distressed space, it nevertheless represents a large number with substantial yield potential for investors.

In recent years, the Chinese government has lowered barriers to foreign investors in its effort to help banks offload their distressed loans. But, even here, the banks try to keep the higher tranches and seek to offload the less-protected, riskier debt on to yield-hungry investors.

State-owned Indian banks hold large numbers of NPLs, opening up the market to high-yield opportunities for foreign investors. Similarly to China, the state wants companies and investors to take the riskiest tranches of these loans off its hands.

But though investors remain cagey about India's weak legal infrastructure and cumbersome bureaucracy, they are still opening offices there. Many find the country's NPL ratio – 15 percent, compared with 4 percent throughout the rest of the region – too appealing to ignore.

As interest rates hover around historic lows across developed markets, demand has grown for higher-yielding private debt investments issued in less-developed markets, such as Asia-Pacific. Investors recognise how some debt instruments in the region offer yields not seen for several years in equivalent US and European assets. Meanwhile, demand across Asia-Pacific for loans to fund real estate and infrastructure projects should continue to be robust.

Conditions remain ripe for healthy returns in private debt across Asia-Pacific over the next five years. But investors chasing these attractive yields need to do their research, ensure they are properly protected and choose their assets – and markets – carefully before they embark.

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