EXPERT Q&A

Borrower appetite is increasing just as the banks retreat, creating opportunities to lend through the cycle, says Shane Forster, head of Barings' Asia-Pacific Private Finance Group

Developed APAC private credit: An expanding opportunity set

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Q How have you seen the market and opportunity set evolve in Asia-Pacific over the past decade?

Barings has been on the ground in Asia-Pacific for more than a decade. Already an active investor in private debt in North America and Europe, our team identified parallels in Asia, and saw an opportunity to start investing in attractive private debt deals.

This market was very much bank driven in the early days, so we started investing in and around bank structures, getting exposure to good credits that were less levered than the typical unitranche structures we do today. We were one of the early movers, and the market was initially constrained by capacity.

For private equity firms, our typical borrowers, private debt became an option but the market wasn't deep enough.

In the last five years we have started to see new entrants, consisting primarily of the debt arms of big private equity firms or other specialist players. That has led borrowers to focus on private debt as a real financing option. Meanwhile, the pressure on banks' cost of capital has caused them to retreat and much of the expertise from that industry has migrated to private credit.

At Barings, we are purely focused on developed Asia-Pacific, so the majority of our deals are in Australia, New Zealand, Singapore and Hong Kong, where dealflow remains healthy and we see similar risk-return profiles to the markets in Europe and North America.

As a manager, we remain conservative, focusing on the more defensive, lower-risk sectors that perform through the economic cycle. We have deployed around $1 billion in the last 12 months in this region, roughly five times what we were doing five years ago. Clearly the market is undergoing significant growth, and there is more to come, not least because of the volume

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DISCIPLINE FOR THE LONG RUN

In 25+ years of managing private credit, we have learned that a disciplined approach is key to enduring shocks and capitalizing on longer-term opportunities.

2021 HIGHLIGHTS

REACHED
$34+ B
IN COMMITMENTS ACROSS THE GLOBE

$13.9 B
DEPLOYED CAPITAL

#1
MOST ACTIVE LENDER TO NORTH AMERICAN PRE-OWNED COMPANIES[1]

#2
MOST ACTIVE LENDER TO EUROPEAN PRE-OWNED COMPANIES[1]

CLOSED ON
127
NEW PLATFORMS

EXECUTED
125+
ADD-ON TRANSACTIONS

INVESTED IN COMPANIES IN
14
COUNTRIES &
7
CURRENCIES WITH
110
PRIVATE EQUITY SPONSORS

CLOSED
ESG-FORWARD
UNITRANCHE DEAL IN THE EUROPEAN MIDDLE MARKET IN 2020
12
ADDITIONAL ESG-FORWARD DEALS CLOSED IN 2021, IN BOTH EUROPE AND NORTH AMERICA

1. Sources: Pitchbook for North America, GCA Altium MidCap Monitor, Debtwire rankings for Europe

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of private equity dry powder available for deals.

Can you dive deeper into bank disintermediation – what is pushing them out and what is attracting borrowers to private debt solutions?

The various bank regulations have resulted in more capital costs against sub-investment grade lending for the banks, making that market less attractive. In conjunction, private debt providers have catered to the needs of borrowers, developing the more levered unitranche structure as well as other attractive features.

Private credit competes on flexibility for borrowers, and also offers relatively more pragmatic structures. These deals are usually highly structured with covenants and controls around them, but whereas historically a bank might ask for four financial covenants we now pare that back to just one that constrains the level of leverage in the deal.

Many of our structures include accordion facilities that allow the borrower to operate with a level of certainty and look to make follow-on acquisitions, where banks would require them to go back to the table and renegotiate with more fees. As many private equity strategies are built on acquisitions, these accordions are really attractive.

Finally, direct lenders arguably bring an element of improved customer service to the table. At Barings, for instance, we have investment committees that are part of our private debt teams and can be very responsive both to approving deals and giving feedback during negotiations.

How do you think about relative value vs Europe and North America. Does APAC private debt offer an attractive return premium?

The product we offer our clients is designed to deliver a similar investment experience to what they are accustomed to in those other markets. We are generating a similar return but arguably with a better risk profile given the relatively larger companies we lend to. Given that there isn't really a developed capital markets here, companies look for private debt solutions even as they grow into the ~$100 million-plus EBITDA range.

Furthermore, the size of the economies we are lending to here also means that the credit risk is superior in many cases. A $50 million EBITDA deal in developed Asia-Pacific is more likely to be a market leader, whereas it might be number five or six in its market in the US.

On returns, we really price for similar returns to Europe and the US and this is not surprising given the similarity in loan structures (low leverage and LTVs with covenants) and the reliability of the jurisdictions we lend into. Developed APAC can therefore play an attractive role as a geographical diversifier for global investors who like this senior secured direct lending asset class.

This is particularly true given the macro picture, with APAC clearly a higher growth part of the world with stronger demographics. We feel we have positive tail winds here and can deliver attractive risk-adjusted returns even as we focus on defensive sectors.

In an increasingly complex and challenging world for investors, what is your outlook for Asian private debt?

We feel the tailwinds will result in significant growth for private debt, whether that is driven by overall private equity growth or the substitution of our product for what might historically have been done by the banks.

> *"We remain very conservative, and we like the defensive, lower-risk private debt space"*

The world economy is in a less stable place and we are certainly not immune to those challenges in Asia-Pacific, but for us, our defensive and conservative approach should hold us in good stead as it has through previous challenging cycles.

One beauty of private debt is it is a floating-rate instrument that does benefit from the interest rate increases coming through. At this point, we are maintaining our focus on defensive industries and companies that have a reason to exist through all parts of the credit cycle, pulling back a little on leverage, and tightening a few terms. But we like to be a consistent partner to borrowers through the cycle, so while we might move things at the margin, our outlook remains broadly unchanged.

How would you describe your strategy in the context of the competitive landscape?

When we built this strategy in Asia it was very much a replication of the strategy built over many years in Europe and the US. All our deals are bespoke negotiated transactions, whether on a bilateral basis or in clubs with two or three other private credit strategies.

Our conservative approach has led us to focus on developed APAC where we feel more comfortable with our ability to enforce.

We have a narrow focus on what we would define as more defensive sectors, which can vary by geography but in the context of Asia-Pacific tend to mean a lot of healthcare, education and core services that we feel will perform through the economic cycle. We avoid businesses that are cyclical or have high operating leverage or high fixed costs, which keeps us away from manufacturing and commodities. ■