BARINGS

PRIVATE CREDIT

Developed APAC: Capitalizing on a Compelling Growth Story

CONVERSATIONS

The developed APAC direct lending market is relatively nascent compared to the U.S. and Europe but offers similar risk and return characteristics—with the added benefit of diversification and access to a compelling global growth opportunity.

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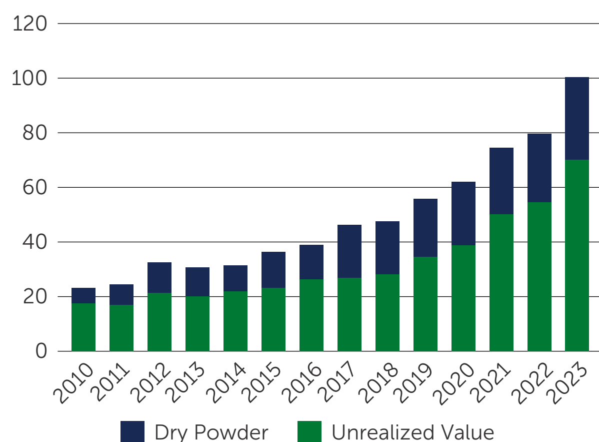
How has the APAC direct lending market changed over the last decade, and what are the key drivers and dynamics behind this evolution?

Shane Forster: The Asia Pacific (APAC) direct lending landscape has undergone a considerable transformation over the past decade, and particularly over the last four or five years. This evolution is partly due to the growth of the APAC middle market, which has accelerated the funding needs of APAC-based businesses and increased the demand for innovative, flexible and efficient financing solutions.

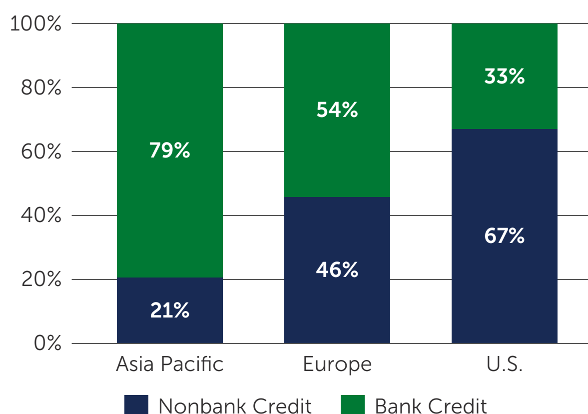
At the same time, banks—the traditional source of middle market funding—have been tightening their lending criteria and scaling back, similar to what we have seen in the U.S. and Europe. Largely a result of regulatory changes across the region, particularly in Australia and New Zealand, banks' retreat has effectively starved capital-intensive areas, such as leveraged loans, of lending. As a result, a new wave of institutional lenders has stepped in to fill the gap. This is evident from the meaningful rise in APAC-based private credit AUM, which has grown at a rate of nearly 30% over the last five years **(Figure 1)**. Additionally, while APAC non-bank lending share continues to grow, it still lags the U.S. and Europe—suggesting a continued opportunity going forward **(Figure 2)**.

Figure 1: Asia Pacific Private Credit AUM has Grown Significantly



Source: Preqin. As of October 2024.

Figure 2: Developed APAC Non-Bank Lending Share has Room to Grow



Source: Bank of International Settlements. As of June 30, 2023.

Justin Hooley: I would add that, historically, funds in APAC tended to look primarily at special situations and opportunistic credit. Over the last few years, as more international private equity (PE) sponsors have entered the market, this has shifted toward traditional senior direct lending. In many cases, these sponsors have experience in the U.S. and European direct lending markets and are looking for the familiar benefits—like more flexible structures and speed and certainty of execution—that non-banks can offer. This shift is evident from the record amount of dedicated private equity capital that sponsors in the region have raised, with dry powder currently exceeding $650 billion.[1] And we expect this trend to continue as more funds targeting the growing private debt market are raised, and as banks continue to shrink their leverage teams.

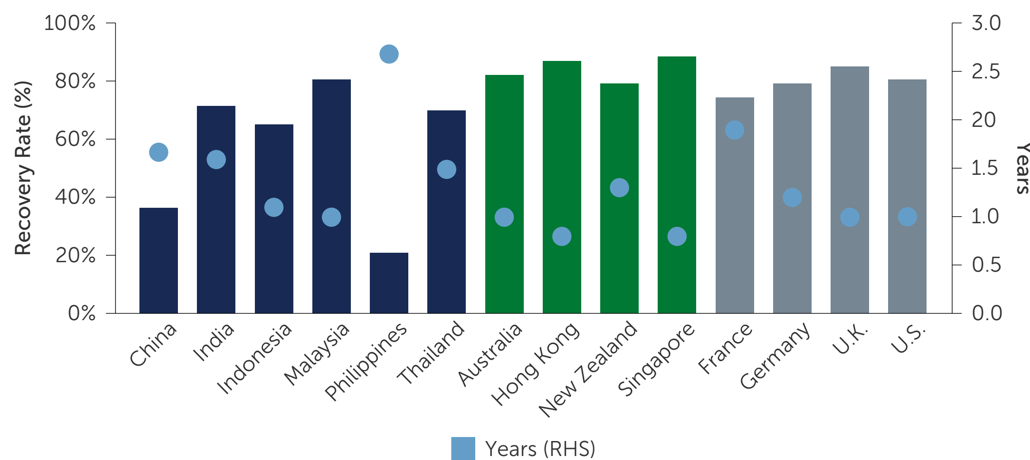
1. Source: Preqin; Bain & Company. Asia Pacific Private Equity Report 2024. As of December 2023.

The APAC direct lending landscape is far from homogenous. Where do you see the most value, and are there any areas where you don't invest?

Justin Hooley: The majority of our investments are in developed APAC—specifically, Australia, New Zealand, Singapore and Hong Kong. These economies exhibit similar risk and return profiles as what we would expect to see from a core direct lending strategy in the U.S. and Europe, with the added benefit of diversification and access to a compelling global growth opportunity. Australia and New Zealand, for instance, have well-developed financial systems and a stable economy, making them attractive markets for private credit. Singapore and Hong Kong, with their younger and rapidly growing economies, offer dynamic and diverse markets for private credit investments.

Importantly, the regulations and bankruptcy laws in these countries are comparable to those in other developed markets. This leads us to have confidence in the ability of senior secured lenders to engage in enforcement proceedings that are reliable and transparent. Additionally, the sovereign credit ratings in these regions are similar to, and in some cases better than, those in the U.S. and Europe **(Figure 3)**.[2]

Figure 3: Developed APAC Offers Attractive Insolvency Resolution Regimes



Source: The World Bank—IBRD 'Doing Business—Resolving Insolvency most recent data collection project completed in May 2019.

Shane Forster: It is also worth noting that we do not invest directly in emerging economies like China, India, and Indonesia. By focusing on developed economies, we're able to gain indirect exposure to the economic growth potential of the broader region with less idiosyncratic jurisdictional risk. As an example, Australia and New Zealand, in addition to having their own vibrant domestic economies, are strongly connected to the economic growth in China and India via trade (i.e. commodities). Ultimately, this conservative approach, among other factors, has led to zero losses across senior investments made in developed APAC since our platform's inception in 2011.

2. Source: The World Bank—IBRD "Doing Business—Revolving Insolvency." Most recent data collection project completed in May 2019.

"Demand for non-bank financing is strong, particularly in Australia and New Zealand, on the back of increased private equity activity from international and local PE sponsors."

While Japan and South Korea meet the criteria for developed APAC, we see less value in these countries currently given that banks still have a dominant share of lending and the potential opportunities for institutional non-bank lenders tend to be less attractive. That said, we continue to monitor the developments in these markets.

What are some of the other key characteristics of the developed APAC market, and how do those compare to the U.S. and Europe?

Shane Forster: The developed APAC direct lending market is still relatively nascent compared to the U.S. and Europe, but it offers similar risk and return characteristics. Because these regions are smaller in size and less developed from a capital markets perspective, the companies in the middle market tend to be first or second in their fields and often have dominant market share. EBITDA profiles, typically in the range of $15 to $100+ million, are similar to the U.S. and Europe. Leverage levels tend to be consistent with transactions in those markets as well, if not slightly lower in some cases. And pricing has historically been less volatile—while non-bank lenders are a growing presence, there are still fewer participants chasing deals relative to the U.S. and European markets. Finally, I would note that documentation is relatively conservative. Maintenance covenants and other structural protections exist in almost all transactions, particularly in the middle market space.

Justin Hooley: In terms of the characteristics of the market, I would also note that middle market companies in developed APAC have remained largely healthy, particularly in the sectors where we concentrate. Defensive sectors like education and health care have fared particularly well, with companies exhibiting consistent corporate profits and strong interest coverage. Companies in these sectors also tend to have high cash flows and low capital expenditures, and demand tends to be less discretionary or price sensitive and therefore less impacted by changing economic conditions.

What makes the opportunity in developed APAC so compelling for investors today?

Shane Forster: The current opportunity in APAC direct lending is rooted in the region's growth story. In addition to benefitting from strong economic growth historically, demand for non-bank financing is strong, particularly in Australia and New Zealand, on the back of increased private equity activity from international and local PE sponsors. Hong Kong and Singapore are in their earlier stages of growth in terms of private debt markets, but offer significant runway for development.

The increase in non-bank lenders has also helped expand the breadth and depth of the market. Five or six years ago, we were one of the earlier participants in the market. As other large international managers and funds have come in over the last few years, supply has increased, leading to what today is a more efficient market with a much deeper opportunity set.

Justin Hooley: I would echo Shane—prior to the market's growth both in size and number of deals, it arguably wasn't deep enough to build standalone diversified portfolios. Rather, it was better-suited as a means of adding geographical diversification to a broader global allocation. But the landscape has evolved, and while the market is more competitive today than it was a decade ago, managers are also better-positioned to present PE sponsors with more viable solutions, and to more meaningfully fill that gap left by banks. Investors' appetite for private credit generally, and direct lending specifically, has increased as well. As the narrative and understanding around these markets continues to grow, particularly among overseas sponsors and investors, we think the opportunity will persist.

What should investors look for in a manager when considering APAC private credit?

Shane Forster: It is important for investors to partner with managers that have a strong track record and history of successfully navigating the complexities of the APAC private credit market—including a demonstrated ability to generate attractive risk-adjusted returns, manage risks effectively, and deliver consistent performance over time. Deep, local expertise is also important. The APAC region is diverse, and managers with a thorough understanding of each market's unique dynamics and regulatory environment will be well-positioned.

Justin Hooley: Strong and longstanding relationships with local borrowers and intermediaries are also essential. Today, many of the top PE firms prefer to work with fewer lenders—often only with one or two. The ability to underwrite and structure an entire transaction is key. In some cases, smaller or less experienced managers, particularly those that cannot provide as much of the capital structure that is being sought, are missing out on deals, especially those that are higher-quality and involve tier-one assets and sponsors. This can have significant implications for portfolio performance, underscoring the important role that scale and relationships play when it comes to sourcing the most attractive opportunities.

Increasingly, managers are also being asked how they handle workouts and maintain origination while navigating challenges. We have seen a few cross-jurisdictional restructurings, in which APAC managers needed to have insight into, and an understanding of, situations unfolding in the U.S. or Europe. A large, global presence can make a big difference when it comes to managing these scenarios. Managers that can provide tailored solutions that support companies' long-term growth trajectories—even as financing needs evolve and change—also look well-positioned. In cases like I just described, financing needs could feasibly extend beyond senior direct leveraged buyout lending to areas like capital solutions. Ultimately, lenders with the breadth to support these requirements are in a good position to serve as strategic partners to sponsors and source the most attractive opportunities for investors.

Source: Barings. As of September 30, 2024.

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**As of September 30, 2024*

24-3943467