HOW TO AVOID THE PITFALLS IN PRIVATE CREDIT

Steer clear of mezzanine in Asia and China NPL funds, says Hamilton Lane. The ideal credit portfolio is a blend of special situations and direct lending

By **Alison Tudor-Ackroyd**

Private markets investor Hamilton Lane sees traps lying in wait for the herd of institutional investors rushing to buy private debt instruments.

There is too much cash waiting to be deployed into distressed debt in China while mezzanine in Asia is too risky for the slim reward the product offers, Juan Delgado-Moreira, a managing director at the Pennsylvania-headquartered firm, told *FinanceAsia* in an interview.

His advice is to pick fund managers who can source complex special situations or have found a lucrative way of lending directly to Asia's rising middle class or to smaller, privately owned companies struggling to secure a loan from a bank.

In short, investors need to be highly selective as they ponder the growing array of private credit funds on offer.

"The explosion of different types of credit in Asia is happening in front of us. There is more special [situations], there is more direct lending, more mezz," Hong Kong-based Delgado-Moreira said.

Asset owners are switching out of publicly traded fixed income markets into private credit at a time when more than $7 trillion of sovereign bonds offer yields below zero. Private credit funds are promising these yield-hungry investors higher returns for unearthing deals outside of publicly traded markets.

That has crushed the premium investors usually expect as a form of hazard pay for backing riskier companies. "Now when you allocate to credit in Asia you are much more focused on the absolute return than on the spread to developed markets," Delgado-Moreira said.

The migration is global but across the Asia-Pacific region many conservative funds are switching out of traditional asset classes for the first time and the movement is snowballing. In mid-2016 AsianInvestor surveyed the top-300 institutional investors headquartered here and found that 60% of these pension funds and insurers planned to raise their allocations to alternatives within a year, up from 37% in the previous year's survey.

> **"Special sits is the credit strategy par excellence"**
> – Juan Delgado-Moreira, Hamilton Lane

Private credit is one of those alternative strategies.

"It [private credit] is the fastest-growing area where we need to answer to our clients," said Delgado-Moreira, outpacing buyouts or growth strategies. "Around four years ago we were seeing only about 90 funds a year, today we see over 140 funds a year, just in credit."

Hamilton Lane advises investors on allocating about $320 billion into private markets globally. In credit, Hamilton Lane has advised on $15 billion worth of investments and manages $4 billion itself.

ALWAYS THE BRIDESMAID

One investment strategy dominates investor choices in credit right now: distressed debt. In a typical credit portfolio, investors have allocated 38% to distressed debt, according to alternative assets data provider Preqin.

At 134% of GDP, China's corporate debt ratio is the highest among large economies globally, according to credit rating agency Standard & Poor's. So the betting is on non-performing loans rising.

To meet this demand from investors, fund managers are rapidly raising capital to buy non-performing loans in China. Bain Capital, KKR, Hong Kong-based PAG, and Baring Private Equity Asia are all in the market raising funds to invest in NPLs in Asia.

However, as yet there are slim pickings and there is no guarantee that there will ever be a full-blown bad debt crisis in China, where the state continues to dominate the economy. Instead it may happen in the European fashion, with a trickle of NPLs over time.

China also has asset management companies in place to absorb toxic loans from its biggest commercial banks: Cinda, Huarong, Great Wall and Orient. And these so-called bad banks have enough spare capacity still to be lending out their balance sheets to healthier, growing companies.

So there is lack of deal flow, increasing the pressure to put money to work before investors lose patience and increasing the potential for ill-judged investments.

DON'T MEZZ AROUND

Among the more risky credit investments in Asia is mezzanine, said Delgado-Moreira.

Mezzanine has appeared more frequently of late across Asia Pacific region. It was used to help finance the joint acquisition of Wharf T&T by private equity firms TPG

Juan Delgado-Moreira

The buyout of Korea's Homeplus used mezzanine

Capital and MBK Partners for HK$9.5 billion ($1.22 billion), as well as Permira's purchase of business services firm Tricor.

A mix of debt and equity, it tends to appear in developed markets in Asia in the most highly priced deals as an incremental point of leverage.

"Beware of mezzanine positions in Asia," said Delgado-Moreira. "You are in the danger zone."

Investors are attracted to the instrument because it promises a bit more return than the senior debt in a buyout. South Korea's National Pension Service provided the mezzanine finance in private equity firm MBK Partners' purchase of Tesco's Korean discount retail chain Homeplus.

In many markets across Asia banks are keen to offer leverage finance as it pays a bit more interest compared with straight loans. There is less investor protection too compared with the US.

"Mezzanine is best played where capital supply is constrained," Delgado-Moreira said.

SPECIAL SITUATIONS

Some private credit strategies have better risk-return tradeoffs than others.

"My ideal portfolio construction in credit straddles direct lending in some markets and special [situations] in others," Delgado-Moreira said.

Special situation funds look to help companies over the hump during say a liqudiity crunch and make a handsome profit for their investors at the same time. Direct lending funds, as the name suggest, act almost like a bank, extending loans directly to borrowers.

In China special situation funds have been helping refinance developers, whose buildings perhaps have taken longer to sell than expected or where the borrower needs more capital to grow but is considered a bad risk by banks.

"Special sits is the credit strategy par excellence because you do need to find a borrower in a certain amount of stress, but [which] has an underlying quality, and there needs to be a bit of a mess as well," Delgado-Moreira said.

Elsewhere Aion Capital Partners, a joint venture between ICICI Venture and Apollo Global Management, has had some success in India, backing companies across their capital structure in the form of equity, debt or hybrid instruments.

DIRECT LENDING

The retreat of banks across the region in the wake of the global financial crisis left many borrowers without access to credit. And the banks that remain often favour large, often state-owned enterprises. In China, the region's dominant economy, SOEs produce one-fifth of economic output while taking out 40% of bank loans, according to S&P research.

So fund managers have been stepping into the breach, such as Asia-based SSG Capital Management and Minneapolis, Minnesota-headquartered Värde Partners, and lending directly to borrowers.

That includes China's swelling middle class ranks who increasingly want to own their own home but struggle to secure a mortgage and have to resort to expensive short-term consumer finance lenders.

"It's easier for a Chinese worker to get margin finance to open a brokerage account than to get a mortgage," Delgado-Moreira said.

As a result, some funds are stepping in to lend directly to consumers in China at rates that are cheaper than in the shadow banking sector.

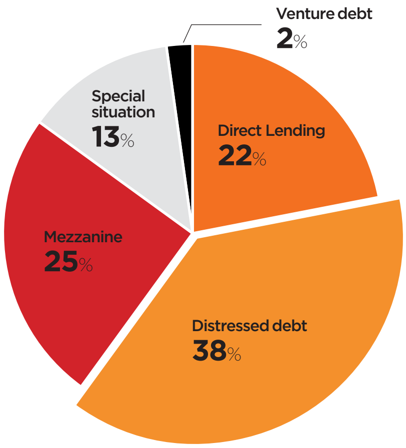
The trend looking forward is that global managers are moving more resources to Asia to invest directly in credit themselves.

Hamilton Lane has been encouraging global managers to think of Asia as a much more diverse and fertile ground, and to build teams in the region.

Some are heeding the call. The Canada Pension Plan Investment Board for one is bulking up its Asia credit team as a long-term play on the fast-developing debt markets in the region, people familiar with the moves said.

"Don't just wait at the gates of China for distress," Delgado-Moreira said. **FA**

THE TYPICAL PRIVATE DEBT PORTFOLIO



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