Research appears to indicate an increasing desire by investors and asset allocators for exposure to the private markets, as many are beginning to seek out low correlated and reliable income streams in the face of a late market cycle. To this end, an asset class in the private space which has been seeing increasing interest is that of private credit. While the US and Europe have been the traditional bastions of alternative credit, both in terms of investment capital and opportunity set, the scene here in Asia is fast coming of age and deserves a seat at the table too. Asia is still amongst the fastest growing regions in the world and the need to finance this growth will be severely challenged in coming years amid rising rates and the unwinding of QE.

In this first edition of Fullerton Insights for 2019, we share our experience investing in Asian alternative credits and the opportunity set we see unfolding here in the region. With an average of 24 years of experience investing in the global capital markets, Fullerton's Alternatives Team is aptly positioned to capitalise on the current late cycle as we exploit the rising need for private credit in the region.

Alternative Credit in Asia

As global markets begin 2019 making amends for a bygone year that saw volatility hit levels not seen since fears of a China slowdown spooked global markets in 2015[1], much has been written about the shift in portfolio allocations away from traditional investments towards less liquid, alternative asset classes[2]. To this end, private markets are increasingly seen by many as a means of navigating the inherent challenges faced by the global economy in this current period of transition, amid the realities of quantitative tightening, geopolitical tensions and trade anxiety. Time-tested investment principles such as diversification, low correlation, superior risk-adjusted returns and reliable income streams, are once again returning to the fore.

One particular segment in the private markets which has been attracting attention of late is private credit.
Surveys conducted by HFM *Insights* in November and December 2018 reveal that institutions are exhibiting an appetite for credit (managed accounts and/or co-investments)[3]. This should come as no surprise to the keen observer, given that performance across the private credit sector has demonstrated strong yield relative to other asset classes.

The Nuts and Bolts

Private credit is non-publicly traded credit which is provided to borrowers on a bilaterally negotiated basis. Such credit can take the form of a loan, bond, note or private security. In terms of implementation, distressed debt, direct lending, mezzanine financing and structured financing, are among some of the well-known strategies which employ the use of private credit.

The growth in this asset class can be attributed to the strong demand from borrowers in light of the withdrawal of banking activity from the lending markets. On the supply side, it appears that alternative providers of private credit are now a source of more comprehensive, tailored solutions in the lending market. As such, there are now more flexible, better structured alternatives to traditional lenders in the marketplace. It is worth noting however that the onset of such flexibility and refinement has not compromised the focus on lending standards and commitment to robust due diligence.

[1] The CBOE Volatility Index hit a high of 37.32 in February 2018, just shy of the 40.74 reached in August 2015.
[2] In its report "The Future of Alternatives", Preqin surveyed more than 120 institutional investors in June 2018, of which 84% planned to increase their allocation to alternatives over the next five years.
[3] HFM Insights, "Winning New Business 2019", January 2019

The Opportunity in Asia

The US is traditionally recognised as the largest provider of capital for private credit firms, while Europe has been a key source of opportunities for alternative lenders in recent years. While the private credit scene here in Asia is relatively younger, it is nonetheless approaching adolescence.

According to research published by the Alternative Credit Council and Dechert LLP, the Asia Pacific houses the largest base of private credit managers, outside the US and Europe/UK[4]. Additionally, it is also worth noting that data from Eurekahedge shows that assets managed via fixed income strategic mandates in Asia (which would include the likes of distressed debt) amounted to some US$24.5 billion at the end of July 2018[5].

From our observations, such growth here in Asia has been catalysed by a broad-based deleveraging effort, led primarily by the region's largest economy, China. Credit growth in the country has slowed considerably in the last couple of years as Chinese authorities come down hard on domestic sources of alternative funding like wealth management products and peer-to-peer lending.

While the aforementioned developments are positive for China's economic fundamentals over the longer term, they however present a funding gap that needs to be bridged[6]. To this end, we have seen pockets of opportunities surfacing in recent years, in sectors such as healthcare and logistics.

Elsewhere in the region, Australian home prices have experienced decades of appreciation, placing the Australian residential property market amongst the least affordable in the world. As housing and its related industries add up to almost a quarter of the Australian GDP, any continued decline in property prices is likely to lead to potential opportunities for alternative credit. We are at the early stages of such developments and are monitoring the situation closely.

The above scenarios present a rich source of ideas for alternative credit, which traditional bank lending cannot access, thus providing an opportunity for those who can put forth a funding solution for the right price and proper collateral base.

2015: A Defining Moment

With an average of 24 years of experience investing in the global capital markets, Fullerton's Alternatives Team first began investing in Asian credit hedge fund strategies in 2004. We then progressed towards making credit co-investments back in April 2015. Here are some notable deals we have been involved in:

1. Distressed High Yield Credit in Greater China: A leading Chinese real estate developer ("the Developer") in Shenzhen, China, with a high quality land bank and a strong franchise in urban redevelopment, had its projects frozen following the resignation of its Chairman. This event breached the Developer's bank covenant loan and the Developer subsequently also missed payment on bond coupons. This led to a huge sell-off of the Developer's bonds.

Thereafter, a white knight announced that it would buy out the Chairman's stake in the Developer, contingent on debt restructuring with creditors. While the bonds traded back up, they were subsequently sold off, due to the potential for severe haircuts as well as the uncertainty of the transaction being completed. We, along with our co-investment partner, saw an opportunity to accumulate the aforementioned bonds at an attractive price and proceeded to acquire a blocking stake.

We saw the Developer possessing a valuable franchise in Shenzhen, with the ability to extend its bank loans and potentially even find a strong equity partner. We then set out to work closely with the bond holders' steering committee and negotiated for a better restructuring outcome.

2. Senior Secured Loan in Hong Kong: A couple of PE investors ("the Borrowers") were looking to buy out a leading Hong Kong telecom operator ("the

[4] The Alternative Credit Council, Dechert LLP, "Financing the Economy 2018", November 2018

[5] Eurekahedge, "The Eurekahedge Report September 2018"

[6] In the article "China's private sector struggles for funding as growth slows" by Tom Mitchell, Xinning Liu and Gabriel Wildau, published on 21 January 2019, The Financial Times reported on the challenges faced by private sector companies in their search for funding in China.

Target") from its parent. The Borrowers were attracted to the Target on a number of key fronts: a fixed infrastructure which was focused on the enterprise telecom market, a predictable and recurring revenue stream, stable operating expenses and significant physical assets.

The Borrowers are prominent players in the Leveraged Buyout market, with a good track record to show for, particularly in structuring successful investment exits. We believed they had the ability to run the Target properly and had a clear strategy to enhance the Target's value post acquisition.

Half of the Borrowers' purchase was to be made via senior and mezzanine debt, with the remaining funded by equity. Together with our co-investment partner, we provided a mezzanine loan to the Borrowers, with an upfront fee. Key terms included cash interest payment and payment-in-kind interest payable at maturity.

The mezzanine loan provided a good yield pickup, with equity downside protection. We eventually sold our position to another fund manager.

3. Senior Secured Loan in Mongolia: On the back of falling washed hard coking coal (WHCC) prices, a Mongolian producer/exporter of WHCC had its cash depleted, which in turn led to it defaulting on its debt. A workout team of a bank holding this debt was looking to clear its exposure.

The coal producer subsequently shed its debt aggressively and extended any remaining debt maturity. It also cut cash costs, enabling it to withstand the volatility in coal prices. With the recovery in coking coal prices, we assessed the coal producer to be well positioned for profitability.

As the sector was out of favour and the bank had already positioned for its exposure, it was willing to sell its position out of its non-performing book at reasonably attractive levels. We bought a piece of a senior secured loan, after assessing the repayment schedule and ability to be safe – with a cash flow sweep that gave payment priority, principal and interest of the loan were secure even under stressed scenarios.

Our Edge

Leveraging on Fullerton's cross-asset class capabilities employed in the management of more than US$30 billion in assets (as at December 2018), a proprietary network of best-in-class money managers, and deep industry relationships built over the course of various market cycles and a handful of financial crises, our Alternatives team is ready to take the next step in the field of private credit investing.

Asia is still amongst the fastest growing regions in the world and the need to finance this growth will be severely challenged in coming years amid rising rates and the unwinding of QE.

With the upcoming launch of our Asia Alternative Credit capability, we are aptly positioned to capitalise on the current late cycle as we exploit the rising need for private credit in the region. The opportunity to harness the significant illiquidity premia of private debt, with a yield pick-up over high yield bonds and low correlation to global macro factors, beckons.

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Source: HFM Global and Allocator [7]

[7] *Please refer to our website for full listing of awards. Past performance of the Manager is not indicative of future performance.*

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