DIRECT LENDING TAKES OFF IN ASIA-PACIFIC: FIVE KEY TAKEAWAYS

Asia's private debt market has gained increased investor attention in recent years. While private debt fundraising peaked in 2019 before a hiatus during the COVID-19 pandemic, direct lending dry powder levels are now steadily on the rise, with an estimated US$1.9 trillion globally as of October 2021.[1]

In addition, companies seeking to diversify their funding sources are showing a pent-up demand for capital. As economic conditions improve, these factors should continue to fuel growth in this nascent asset class in the Asia-Pacific region.
At a discussion hosted by Latham & Watkins partner Howard Lam at the 2021 Debtwire Asia-Pacific Forum, panelists analyzed the direct lending landscape in the region, including the drivers behind its growth and the opportunities and challenges that direct lending presents for those active in the space.

This article offers five key takeaways from the panelists' discussion:

1 ALTERNATIVE FUNDING OPTIONS AND STRUCTURES FILL A GAP

Many factors are driving the growth of direct lending in the region, with demand for capital far outstripping supply from more traditional finance sources. The dominance of bank lending has been challenged in recent years, particularly as banks had to repair balance sheets following the global financial crisis and respond to increased regulatory pressures. As a result, small- and medium-sized enterprises (SMEs) and mid-market borrowers often face difficulties in accessing finance. According to the Asian Development Bank, the annual funding gap for Asia-Pacific SMEs was almost US$4.1 trillion in 2019.[2]

Direct lending has been able to fill this gap by providing SMEs, mid-market corporates, and financial sponsors with a broad suite of alternative funding options and structures, ranging from supply chain finance and general working capital to financing for operational improvements and acquisition financing.

2 THE FAST AND FLEXIBLE APPROACH HAS APPEAL…

Unlike more traditional forms of finance, private debt managers often provide faster credit approval processes and can generally offer greater flexibility, with tailored structures that suit the specific needs of borrowers. At the same time, private debt managers can offer a range of risk/return options for investors with varying appetites.

Amortizing senior secured loan tranches at fixed prices may not always be suitable for growing mid-market companies that need to reinvest cash into the business or for financial sponsors trying to maximize returns for investors. Private debt managers can offer alternative bespoke structures that include equity kickers, bullet repayments, payment-in-kind (PIK) notes, and other subordinated capital. Many borrowers in emerging Asia-Pacific markets have shown a willingness to pay a higher price in return for this fast decision-making and flexibility.

[1] Preqin, 2021
[2] Asian Development Bank and Bank for International Settlements; Alternative Credit Council (ACC). Private Credit in Asia, 2020

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…BUT SECURING A BALANCED STRUCTURE IS KEY

Parties considering a direct lending arrangement need to be mindful of getting the right structure up front. The relationship between the lender/borrower or the lender/sponsor therefore becomes crucial, particularly in early-stage commercial negotiations.

Direct lending in the region is largely focused on first lien secured capital with strong covenant protection. As such, parties must balance ensuring an efficient structure and access to liquidity with the need for sufficient protection for lenders.

Increased use of technology will assist in striking this balance. Developments in technology have provided lenders with both access to and the ability to process vast amounts of company data and financials in a short time frame. Greater transparency on emerging companies allows for more efficient due diligence of borrowers and facilitates the negotiation of meaningful covenant protections.

4

DIVERSE LEGAL FRAMEWORKS PRESENT CHALLENGES FOR BOTH LENDERS AND BORROWERS

As with any nascent sector, there are always challenges, particularly in a region such as the Asia-Pacific, which has diverse legal frameworks and licensing regimes for lending, taking, and enforcing security, repayment, and arranging fees, etc. Many of the laws and regulations governing lending in the region were formulated decades ago and have not kept pace with the growth of alternative financing sources. Lenders and borrowers alike need to be mindful of these challenges and consider what options are available when issues arise, including which Asian jurisdictions have the most robust enforcement regimes.

A 2019 case considered by the Australian Takeovers Panel illustrates the complexities of direct lending. The Takeovers Panel looked at whether a lending and security arrangement that also included an equity kicker fell within money lending exemptions.[3] Although the Takeovers Panel did not make a final determination on the issue, the case was a cautionary tale for participants in the direct lending market, who must take into account legal complexities across the region when structuring alternative credit arrangements.

5

ESG CONSIDERATIONS ARE INCREASINGLY IMPORTANT

Market participants in the direct lending space should not overlook environmental, social, and governance (ESG) considerations, particularly as ESG requirements are becoming increasingly important to managers and investors across the region.

The tenors of direct lending loans are typically short, at only two to three years, which may limit the ESG requirements lenders can impose. Nevertheless, private debt managers still have opportunities to ensure accountability against ESG measures and create a meaningful impact, as borrowers are often willing to comply with ESG requirements in order to access potential funding.

In Summary

Direct lending has considerable growth potential and is likely to play an increasing role in the Asian financing landscape in the years ahead. Direct lending can open up alternative finance routes for SMEs and mid-market borrowers, while providing greater flexibility for different investment appetites. However, as with all financing arrangements, lenders and borrowers need to be mindful of the risks, conduct due diligence, and ensure appropriate legal protections are in place.

Contacts

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[3] Debtwire, OCP Asia's regulatory sanction in Donaco highlights risks for private lenders in Australia 2020