JUNE 2024

REPORT

Bridging the APAC Funding Gap:

Changing Private Finance Landscape

EXECUTIVE SUMMARY

1. With APAC economies contributing to nearly two-thirds of global GDP growth, the region presents lucrative investment opportunities.

2. Private finance emerges as a promising asset class in APAC, offering an alternative to traditional bank funding.

3. Assets under management in private credit have surged nearly 30-fold over two decades, underscoring the region's economic dynamism.

4. APAC offers premium returns compared to Western markets, with a 50 to 100 basis points premium for direct lending transactions.

5. The surge in Islamic finance growth in APAC, particularly in Southeast Asia, adds another dimension to investment opportunities.

6. Despite a slowdown in fundraising activities, private credit in APAC remains resilient, offering stability amidst market volatility.

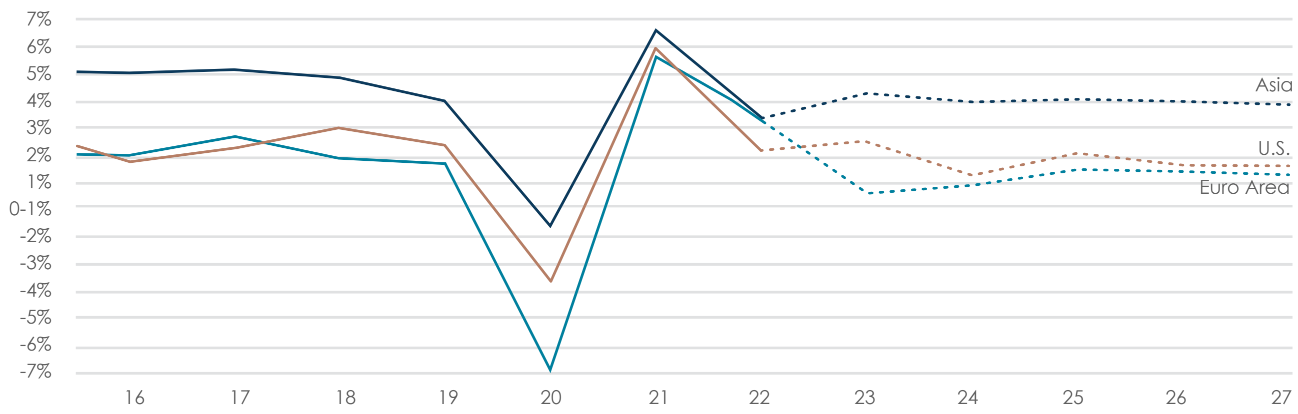
7. Leveraging private credit in APAC presents a strategic opportunity for portfolio diversification and potential long-term returns.

PRIVATE FINANCE IN APAC: WHY GLOBAL INVESTORS NEED TO LOOK EAST

Investors aiming to diversify their portfolios and maximize returns have traditionally focused on equities and government bonds in emerging markets. Yet, one frequently overlooked asset class is private finance or private credit, particularly in the Asia-Pacific (APAC) region. To put this into perspective, economies in the APAC region contribute to nearly two-thirds of the world's real GDP growth and are anticipated to account for about 50% of global capital expenditure investments in the near term. According to KKR's report titled 'Private Credit in Asia Pacific,' the region's GDP growth over the next five years is expected to surpass that of Europe and the United States by more than 2%.

Contribution to Global Growth by Region

Data retrieved as of November 8, 2023. KKR Global Macro & Asset Allocation (GMMA) estimates for United States, Euro area, and China. IMF estimates for other APAC countries, nominal GDP-weighted. Sources: Haver, IMG, KKR GMAA analysis



For maturing businesses in the region this outlook holds potential for significant growth. However, these small and medium-size enterprises (SMEs) often struggle to access the necessary capital for expansion and evolution. The current environment of high interest rates has led to increased borrowing costs, complicating debt servicing for these businesses. Banks often prioritize larger corporate clients, leaving SMEs in developing East Asia and the Pacific with unmet annual financing needs totalling $2.39 trillion, as reported by the World Bank.

In response, private finance is emerging as a compelling alternative to traditional bank funding. Over the last two decades, the private credit market in the APAC region has experienced steady growth. As reported by risk consultancy Control Risks, the assets under management in private credit have surged nearly 30-fold, from $3.2 billion in 2000 to over $90 billion by early 2024. This growth underscores the region's economic dynamism and the rising demand for alternative lending solutions. Moreover, incorporating private credit from the APAC region into an investment portfolio offers considerable diversification benefits, providing exposure to a wide range of economies, from emerging to mature markets.

PRIVATE FINANCE OPPORTUNITIES: APAC VS WESTERN MARKETS

While private financing options in the APAC region carry certain risks, such as evolving legal frameworks and the possibility of regulatory changes, these challenges are navigated effectively by organizations with a deep understanding of the local contexts. It is also crucial to recognize that the supply of credit does not meet the increasing demand for capital in this region. This imbalance between demand and supply means private lenders often encounter less competition and can set more favorable terms, allowing them a degree of control over operations to safeguard their investments.

So, what rewards can investors anticipate for taking on these higher risks? According to KKR, the APAC region generally offers a 50 to 100 basis points premium above what is typically seen in the United States and Europe for direct lending transactions. For capital solutions, the premium over the US and Europe ranges more widely, between 300 to 500 basis points.

APAC: EXPLORING OPPORTUNITIES IN ISLAMIC FINANCE

The APAC region, particularly Southeast Asia, is also experiencing a surge in Islamic finance growth. This sector, valued at $2.5 trillion and spanning 80 countries, has been predominantly concentrated in just 10 countries, which hold 95% of the global Shariah-compliant assets. These countries include the GCC nations, Iran, Turkey, Bangladesh, and Malaysia.

The 2019 State of Global Islamic Economy report by Arab News predicted that Shariah-compliant assets would reach $3.5 trillion by this year. Although up-to-date figures on this growth are scarce, this forecast highlights the significant opportunities for investors interested in Shariah-compliant assets, especially in Muslim-majority countries within the APAC region.

Currently, the APAC region accounts for nearly 25% of the global Islamic finance market, with Malaysia being a major player. In Indonesia, despite its Muslim-majority population, Islamic finance is still in its early stages with Shariah-compliant assets making up only 8% of the country's total banking assets in 2020. However, the country is making strides to expand its sector, including a strategic roadmap and the anticipated merger of three Islamic financiers, which is set to create one of the largest Shariah-compliant banks worldwide.

THE TWO-FOLD OPPORTUNITY FOR INVESTORS

Investors interested in Shariah-compliant assets in the APAC region face a dual challenge. On one side, there is a significant opportunity to tap into the growing demand for alternative financing. On the other, options for Islamic finance are somewhat limited.

Sidra Capital, a Saudi-based asset management firm, acknowledges this gap and is introducing innovative solutions to bridge the gap. Its Singapore-based Sidra Asian Opportunities Investment I VCC focuses on commodity trade finance transactions across Asia and offers semi-annual income distributions. Key features of the fund include a target net return of 10 percent in USD, adherence to Shariah principles, low volatility, and minimal credit risk, supported by fully funded Letters of Credit (LCs) from investment-grade banks. This also allows investors the benefit of portfolio diversification.

According to Sidra Capital, "Despite its huge potential, Shariah-compliant private credit in Asia remains low key and almost invisible, overshadowed by Islamic financial institutions. However due t o regulatory-imposed limitations for FI's including single customer limits, sectorial limits, and a risk-weighted assets regime, credit consumers are increasingly being forced to turn to private markets to raise much needed funding. Sidra Capital as part of its APAC expansion plan also aims to bridge the gap between excess capital from the Middle Eastern region and the demand for funding by credit consumers in the region."

Sidra Capital adds, "From our perspective, Southeast Asia is a ripe market to be exploited by Shariah-compliant private credit providers, where the legal framework for Islamic financing exists alongside conventional banking which is robustly regulated by the authorities. Traditional credit consumers are also more receptive to alternative funding avenues due to cultural familiarity with this product."

NAVIGATING A SLOW FUNDRAISING PACE

The private finance ecosystem is not without challenges. The past year has seen a notable drop in the amount of capital raised amidst the economic headwinds in the APAC region. This has led to a marked decrease in both the capital raised and the number of funds compared to the preceding two years. The fund count dropped in 2023 to just 12 funds, far below the 33 funds in 2021 and 23 funds in 2022. This trend suggests a deceleration in private credit fundraising activities within the region. It should be noted that the drop in fundraising is not limited to the APAC region. According to investment data company Preqin, global private debt fundraising has slipped back to pre-pandemic levels, amid ongoing uncertainty about base rates. In the first quarter of 2024 managers across the private debt arena raised $30.6 billion. That is roughly 14 percent below the average of $35.8 billion seen over every first quarter since 2017.

Conclusion: Investor Confidence Robust Despite Challenges

Preqin's survey reveals that despite the decline in fundraising, investors show a higher satisfaction with private debt compared to other alternative asset classes. Investor sentiment indicates that private credit in Asia is displaying significant resilience, maintaining its balance amidst traditional banking pullbacks and widespread market fluctuations. The report suggests that the slowdown in fundraising might be short-lived, with opportunities to recover later in the year. The inherent appeal of private credit is enhanced by its floating-rate feature, providing a tactical advantage in a landscape of rising interest rates.

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