The Year Ahead for Asia-Pacific Private Credit

KEY HIGHLIGHTS

- 2022 is expected to be another busy year for capital markets, presenting a significant opportunity for Private Credit
- The year will likely be defined by continued economic and political uncertainty around the world, increasing inflationary pressures and accompanying rate hikes, and volatility in historically expensive equity markets
- In this environment, Private Credit is an asset class that should be high on the priority list for managers of long term capital, offering attractive risk adjusted returns, a structural hedge against inflation, and low volatility, steady cash returns

2022 is expected to be a banner year for private credit. In only its first month, the year to date has been defined by continued economic and political uncertainty around the world, increasing inflationary pressures and expectations of significant rate hikes, and volatility in historically expensive equity markets.

Private credit is an asset class that should be high on the priority list for managers of long term capital, offering attractive risk adjusted returns, a structural hedge against inflation, and, in the performing segment where TCP invests, low volatility, steady cash returns.

Investment opportunities in Asia Pacific private credit are compelling. 2021 was a busy year for capital markets with record levels of M&A activity. This in turn drove strong activity levels in financing markets, with in excess of US$50b in M&A financing completed across the Asia-Pacific region (ex-Japan) in 2021. These activity levels are set to continue into 2022 as dealmakers embark on the new year with an abundance of dry powder and no shortage of prospective transactions in the pipeline.

The under penetration of institutional credit in our home markets results in a growing market pie as regulatory pressure is driving a continued reduction in domestic bank appetite to lend to sub investment grade borrowers, as they instead allocate scarce capital to larger, strategic relationships. As a result, borrowers are turning to private credit providers as an alternative source of debt capital offering bespoke, fit for purpose financing structures. This creates a significant opportunity for investors to access a market traditionally the domain of the banks.

2021 was also a big year for TCP. We doubled our FUM to over $750m, expanded the team in Sydney and Hong Kong, and launched Fund II. Deployment activity was strong and the portfolio continued to perform well, with consistent net cash returns of c.6% p.a. achieved.

TCP PRODUCT OFFERS A HEDGE AGAINST INFLATION AND RISING INTEREST RATES

One of the key issues front of mind for global investors currently is inflation and the consequences for interest rates. Australia has experienced a spike in headline inflation in December to 3.5% YoY, significantly exceeding market expectations, with the market now pricing in rate hikes as soon as May, and for the cash rate to exceed 1% by year end.

Traditional fixed income assets are materially exposed to market losses as a result of duration risk. As rates rise, the relative value of future fixed coupon payments declines, negatively impacting the price of the bond and resulting in mark-to-market losses and potential capital loss if sold before maturity. TCP's floating rate product hedges our portfolio against duration risk and associated market-to-market volatility, while providing investors with a growing regular income stream as base rates rise.

A FOCUS ON SECURITY AND LENDER PROTECTIONS IN UNCERTAIN TIMES

As equity markets run hot, so does debt, with leverage levels increasing, terms and conditions becoming more flexible, and pricing tightening. In a rising market where investors are taking outsized risks to chase returns, it is easy to miscalculate the risk-return profile of portfolios. For debt investors maintaining discipline is vital to long term success as, unlike equity markets, upside returns are capped. In such an environment, investors would be wise to approach markets with caution and to carefully select the asset manager with whom they choose to partner.

TCP's investment team has a long track record of structuring investments. Credit investors in senior private credit markets typically benefit from a first ranking security position. That is, in a downside scenario, senior debt will be repaid fully before any remaining funds flow back to equity holders. Unlike bond markets however, investors in private credit are typically able to derive additional protections through structuring of financial covenants which address the specific risks of a particular transaction and provide an early warning signal allowing lenders to take action to protect their position. This is especially true for private credit managers like TCP, which focus on mid-market transactions that benefit from stronger financial covenant protections compared to larger syndicated deals. In an uncertain economic environment, this additional protection can prove critical and allowed us to successfully navigate the effects of COVID.

The impact of COVID-19 on earnings over the past 24 months (both positive and negative) has impacted sectors of the economy in different ways, and the long term structural impact to the economy remains unclear. Whilst we have seen overall spending and consumer confidence bounce back strongly post government enforced lockdowns, the impacts of the Omicron strain are yet to fully play out, and an increasing interest rate environment is likely to impact consumer confidence levels. Furthermore, high levels of government support, coupled with low interest rates, has resulted in a strengthening of corporate balance sheets and continued low default rates. 2022 will see the withdrawal of quantitative easing which, depending on its pace, will materially affect markets. An ability to manage and structure investments for risk through continued volatility is critical.

ESG – A CRITICAL CONSIDERATION

2022 will also be the year when businesses will be required to take real action on ESG. TCP become a UN PRI signatory in 2021 and integrates ESG considerations in all of our investment decisions. It is critical that a deep understanding of a borrower's position is understood, not just directly but throughout the supply chain. The analysis must go beyond industry screens and formal sanctions and delve more deeply into a company's business and strategy, and the ESG implications.

PRIVATE CREDIT A COMPELLING OPPORTUNITY

2022 has brought with it compelling opportunities for private credit given the market backdrop of inflation, withdrawal of government largesse and economic uncertainty around COVID. The continued growth of the Australian and regional private credit market, the floating rate and structural protections inherent in TCP's offerings, and the consistent low volatility cash returns presents an exciting opportunity for investors. Important in allocating capital to private credit is the manager's track record through cycles, as well as their network and ability to originate loans directly. This puts the manager in a position to dictate terms or walk away when investor protections are being diluted. Scale is also important as it provides capacity to extend meaningful loan sizes to borrowers. It also provides investors with diversification in the portfolio, so they do not find themselves overexposed to just a small number of names and sectors. TCP, with one of the most experienced investment teams in the market, offers a fantastic partner as you consider the asset class.

TANARRA CREDIT PARTNERS

Tanarra Credit Partners ("TCP") is an Asia-Pacific Private Credit manager with offices in Melbourne, Sydney, Hong Kong and Wellington. TCP's senior investment team has 100 years of combined global credit markets experience. Since inception in 2017, TCP has grown to manage over A$750 million of investor capital and has successfully demonstrated an ability to originate a diversified portfolio of high-quality loans across its broad professional network.

TCP is the credit vertical of Tanarra Group, an alternative investment platform managing in excess of A$2.5 billion.

TCP AP Fund II is available for commitments, underpinned by cornerstone investments from existing investors. For more information, please contact TCP as provided below.

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