Frontier International

Abundant opportunities in Asian debt but risks remain

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Introduction

Members of Frontier's Debt and Currency team embarked on a virtual Asian research trip in March to revisit a dynamic corner of the global debt markets which is growing quickly, yet remains under-represented in client portfolios.

Meetings were held with a range of managers, covering both liquid credit and private market opportunities considered relevant within both the alternative debt sector, as well as opportunistic strategies suitable for higher return seeking sectors.

This research trip builds on a long history of Asian research at Frontier across multiple asset classes. We focus in this document on two main areas, namely liquid USD Asian domiciled corporate bond markets as well as Asia ex Japan focused private markets. The findings from this trip highlight compelling debt focussed investment ideas that might complement current Asian equity exposure, and help investors take initial steps to formulating a broader Asian investment strategy.

Nam Tran
Senior Consultant

Nam Tran joined Frontier in 2017 as a Consultant, was promoted to Senior Consultant in 2020 and is a member of the Debt and Currency team. Previously Nam worked with NAB in the institutional banking area, undertaking industry and credit analysis in the Resources, Energy and Utilities sectors for ten years. Prior to this, he spent three years with KPMG and the Sarbanes Oxley team at NAB, undertaking financial and operational analysis of clients in the financial services industry, and three years with HSBC in Vietnam in corporate and institutional banking.

Jill Guan
Consultant

Jill Guan joined Frontier as a Consultant in 2021 and is a member of the Debt and Currency team. Jill was previously at Citibank Australia where she provided relationship and credit coverage to institutional clients. She has also spent time in China with Citibank as a credit analyst. Prior to that, she worked at HSBC Australia and ANZ within institutional banking across various client coverage teams. Jill holds a Bachelor of Law and a Bachelor of Commerce from the University of Melbourne.

Paul Chua
Associate

Paul joined Frontier as an Associate in January 2019 and is currently a member of the Debt and Currency team. Prior to joining Frontier, Paul worked as a Performance Analyst in the Performance and Risk Analytics division at National Australia Bank whereby he was involved in calculating and generating performance reports on behalf of superannuation funds, fund managers, university endowments and insurance companies.

Asian bond market strong but under-represented

The Asian corporate bond market has expanded significantly in the past decade to a total size of US$21 trillion as reflected in growth across both dollar and local currency markets. This rapid growth, underpinned by both economic development in the region driving demand for capital and influx of local investor capital, has increasingly attracted attention from non-Asian investors. Despite Asia's role as an economically important region for the world accounting for ~51% of world population and ~37% of the world GDP, global bond indices do not meaningfully reflect the growth in the region. Asian bond markets remain under-represented within both global and emerging market bond indices making global bond investors structurally underweight in Asia.

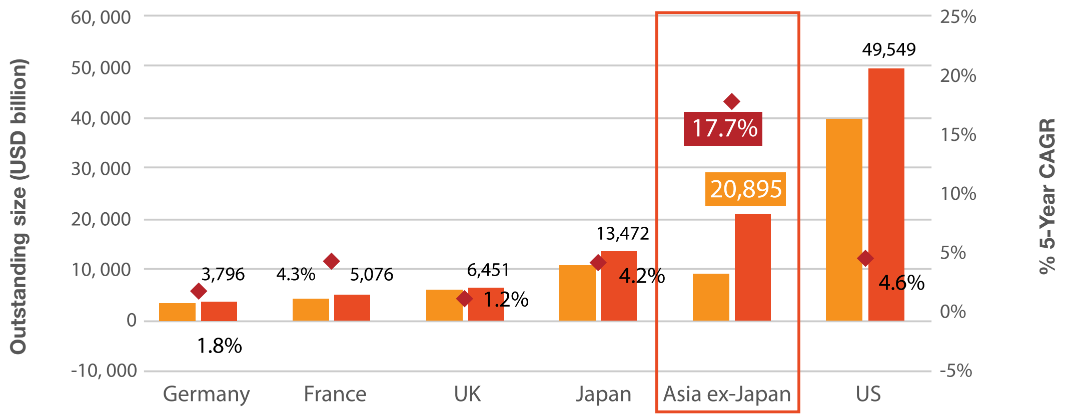
While local currency bond markets dominate the Asian bond market, accounting for ~90% of the secondary market, a range of factors including opaque credit risk; poor relative value; and currency risks give rise to caution when investing in local credit markets. EM sovereign strategies cater well for EMD local currency sovereign markets and these areas, including Chinese onshore government bonds, are the subject of future Frontier research and beyond the scope of this paper.

The Asian USD market is a logical first step with greater clarity and comparability relative to other USD credit markets. Having grown in both depth (now ~US$1.2 trillion) and diversity, comprising of more than 600 issuers from 17 regional economies, it is far from being a niche market. The Asian dollar market has become one of the major sources of funding for Asian corporates and managers believe the growth will continue in line with economic development in the region.

Chart 1: Asian bond market – rapid growth and under-representation in global indices

Global & EM bond indices^

Index name	Asia ex-Japan (Index weight)
FTSE WGBI	3%
Bloomberg barclays global Aggregate bond index	12%
JPMorgan EMBI global	23%



Source: Manulife Investment Management, Bank for International Settlements (BIS), Asian Development Bank, European Central Bank, Bloomberg. Data as at 30June 2020.

Asian credit market: a compelling risk-adjusted asset class

Asian USD credit exposure is often found as a sub component within broad EMD corporate strategies. One notable takeaway from this virtual trip was the lack of direct fund flow into broad EMD corporate strategies, a more targeted Asian approach appears to be preferred.

The Asian credit market categorised by investment grade (IG) and high yield bonds comprises ~65% of the total Asia USD bond market. The remainder is a mix of EMD hard currency sovereign and quasi sovereign issuance. Managers consistently reported better risk-adjusted returns from Asian credit relative to emerging Europe and Latin America. Also notable are the current attractive yields with measured volatility and lower duration particularly relative to US markets.

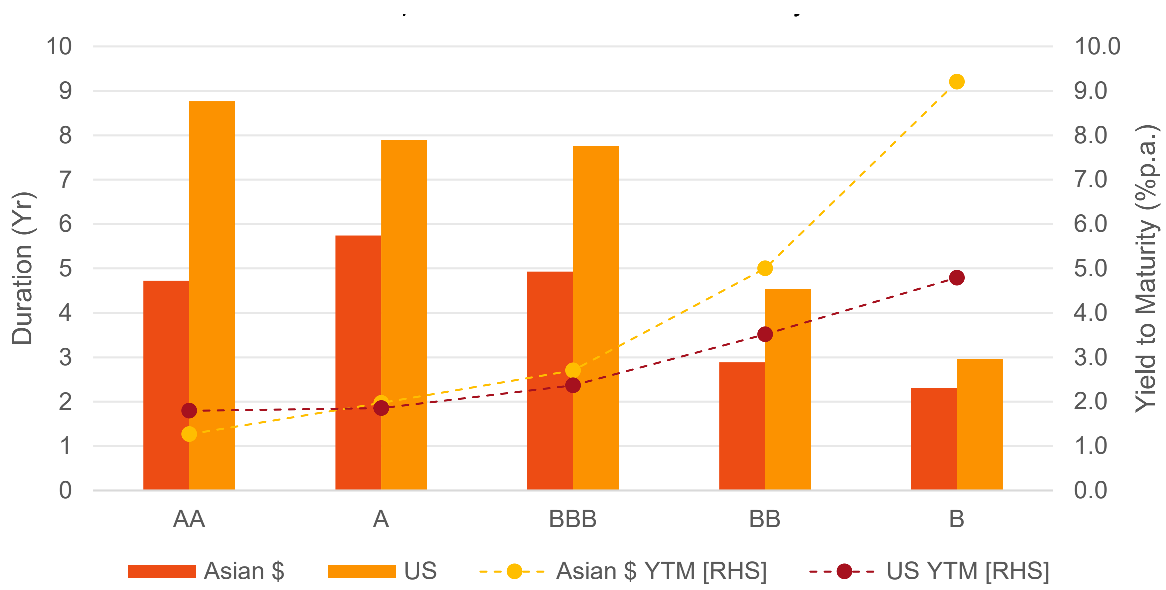
Largely domestic investor base

The investor base within the Asian USD credit market is highly skewed toward local Asian investors largely comprising Asian asset managers and banks. While it is hard to be definitive about the impact of regional funding, managers note this provides a degree of insulation against external shocks and capital repatriation risks, factors well known to global investors in any emerging market debt strategy.

Better relative value and typically shorter duration profile

Asian USD bonds are trading at attractive valuations with lower duration across similar rating bands. While most global credit spreads have contracted to near pre-COVID levels, Asian credit spreads across both IG and high yield have not fully recovered and remain wide relative to historical averages. This provides not only attractive relative value but some yield cushion not evident in developed credit markets.

Chart 2: Less duration than US corporate debt with more attractive yields

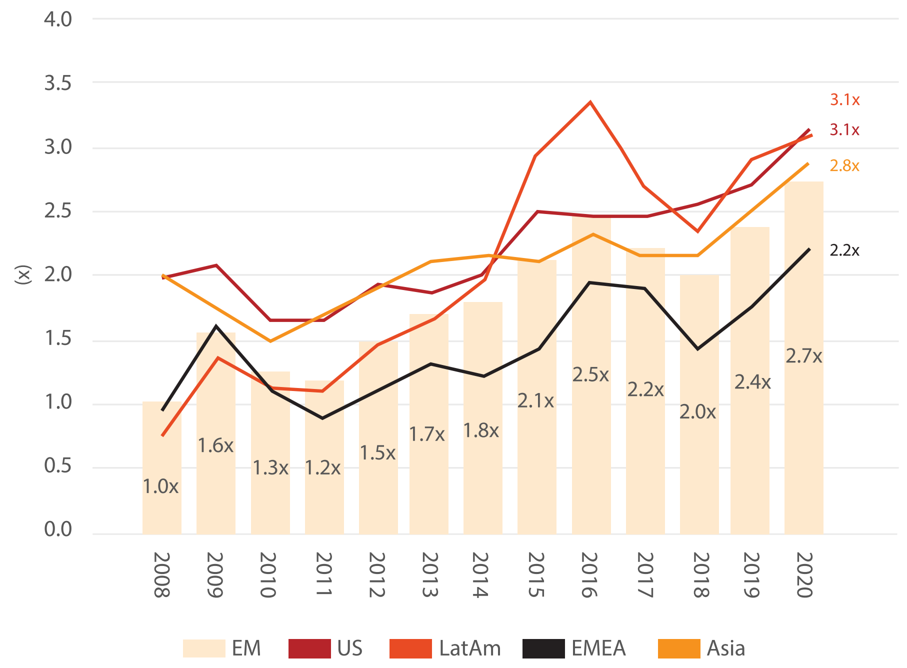


Source: Frontier, Bloomberg. Data as at February 2021

Superior credit quality

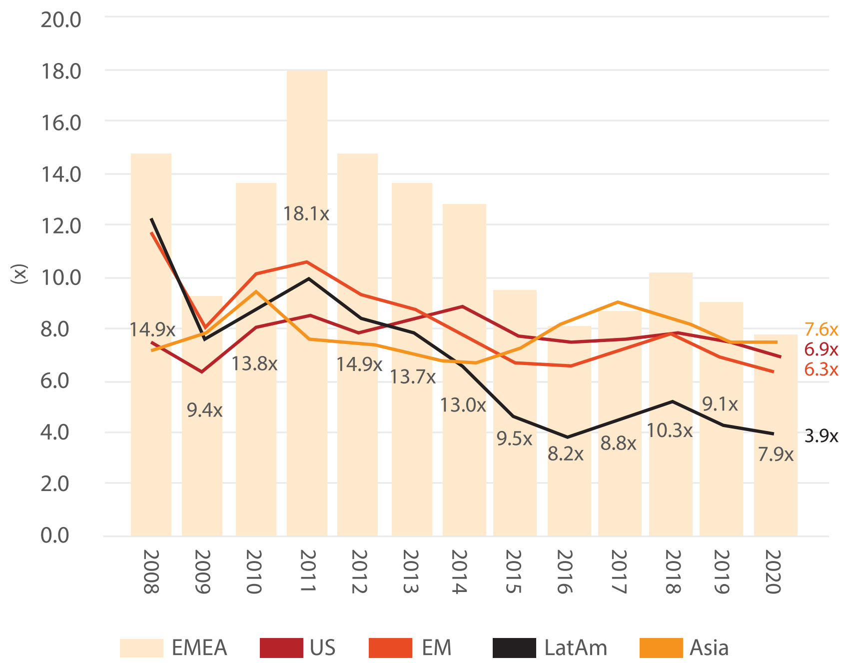
Mangers highlighted the superior credit quality of Asian corporates who have historically displayed lower leverage and higher interest coverage ratio compared to global peers. The strong earnings growth in recent years has supported balance sheet health, debt servicing capacity and improved liquidity profiles which has translated into lower default rates across the region. During COVID-19, IG issuers remained resilient and maintained stable leverage and interest cover ratios. Similarly, while leverage deterioration was more evident across high yield issuers, overall interest cover ratio has shown improvement.

Chart 3: Corporate net leverage (all rating)



Source: Data as of 30 June 2020. BAML, PineBridge Investments

Chart 4: Interest coverage (all rating)

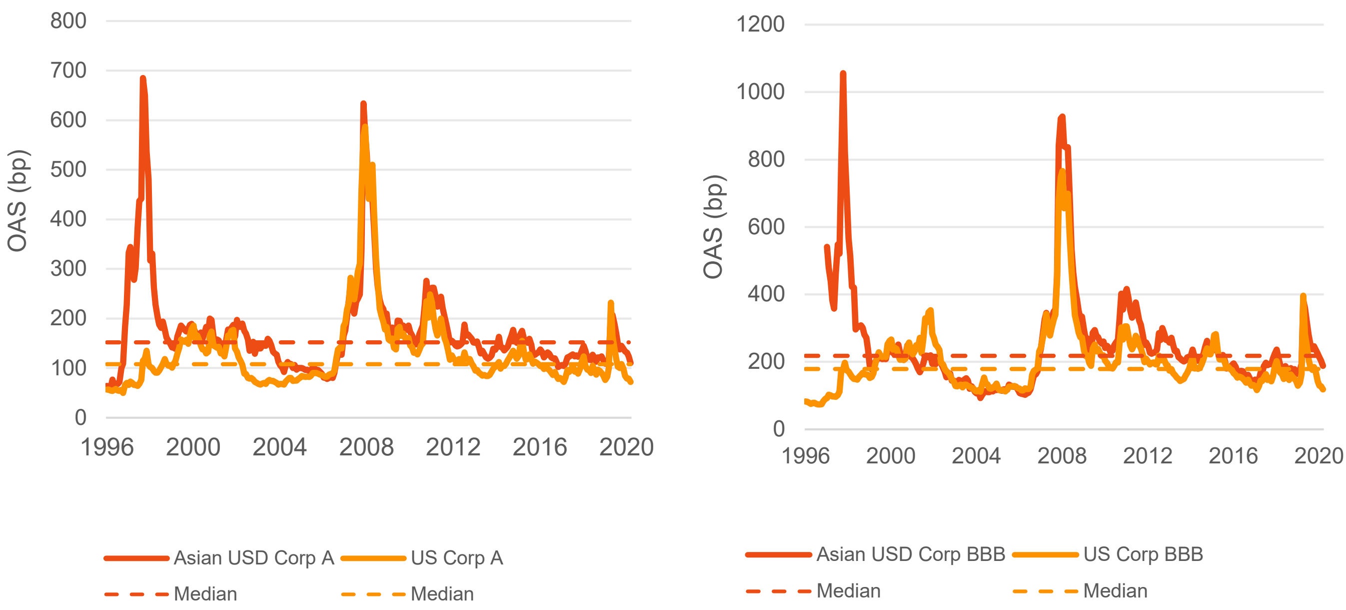


Source: Data as of 30 June 2020. BAML, PineBridge Investments

Focussing on Asian investment grade

In the current environment where duration of global investment grade bonds has lengthened greatly and amount of low and negatively yielding bonds has increased substantially, the lower duration and higher relative spread of Asian IG bonds provides an appealing opportunity. Asian IG bonds have less duration than similarly rated US corporate debt yet typically offer a spread pick-up as shown below.

Chart 5: Spread pick-up vs. similarly rated US corporates



Source: Frontier, Bloomberg. Data as at February 2021

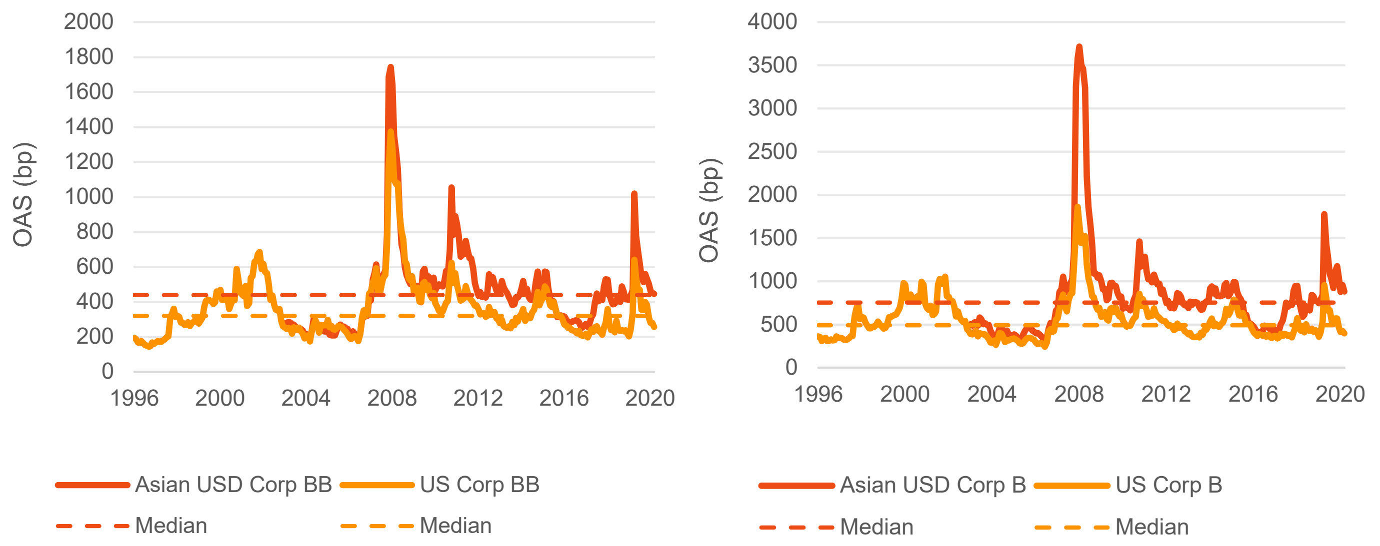
The attractiveness of Asian IG bonds is further supported by the stable outlook of credit fundamentals. The effective early containment of COVID-19 in major Asian economies has allowed the resumption of manufacturing and daily activities, which has alleviated economic disruptions. Together with the faster economic recovery led by China and its spill over effect to the rest of the region through trade and supply chain channels, this provides a favourable environment for stable corporate earnings in Asia. Managers believe the relative credit strength of Asian corporates is sustainable at the back of this favourable macroeconomic backdrop.

Asian high yield

Asian high yield bonds currently offer compelling relative value versus developed market high yield bonds. The performance of Asian high yield bonds in stressed market environments can be volatile and therefore an active approach is preferred. A clear understanding of the market structure and liquidity is also critical.

Consistent with the robust relative value seen in Asian IG, Asian high yield continues to provide an attractive spread premium relative to US high yield. Within Asia high yield, single B rated is showing better relative value over BB providing 350bps premium vs US peers. The additional spread premium, when considered in the context of lower default across Asian high yield names, makes it a more compelling asset class.

Chart 6: Asia BB and Asia B versus similarly rated US bonds

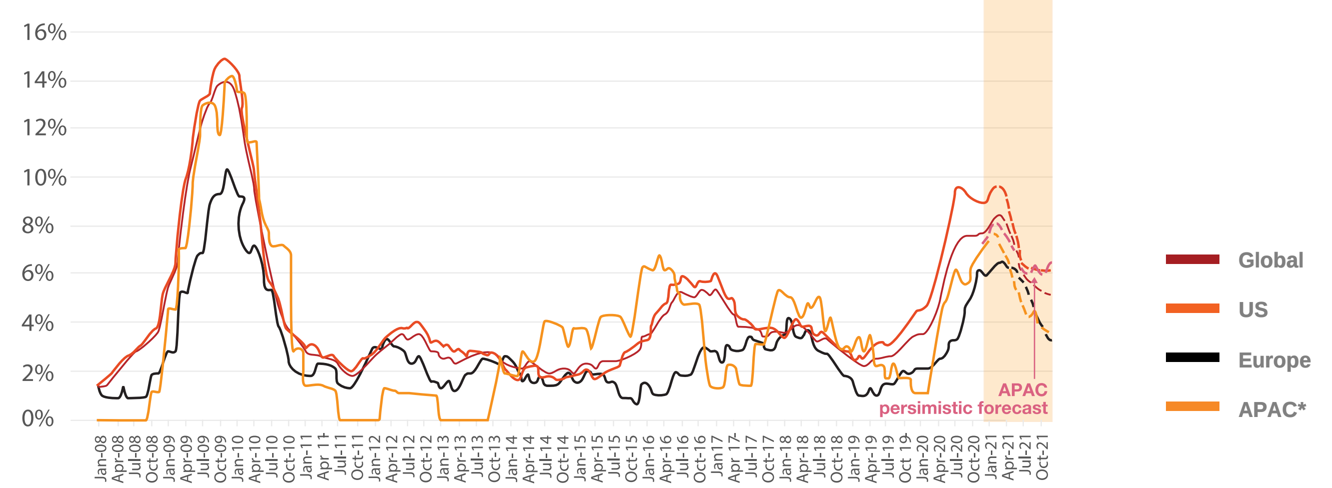


Source: Frontier, Bloomberg. Data as at February 2021

Lower default rate versus developed markets

Managers also commented on the more benign historical default rate amongst Asian high yield issuers relative to global peers. The 12-month trailing default rate for high-yield corporates is at 3.6% compared to 9.0% and 5.9% for US and Europe, respectively, reflecting quicker than expected economic recovery; stronger corporate credit quality; and more favourable bond covenant protection. Moody's Covenant Quality (CQ) scores, which assess the coverage of key credit provisions within bond documentation, notes Asia has the best average CQ score at 2.87, lower than the global average of 3.58. Manager consensus was that default rates are likely to remain at manageable levels going forward supported by the broader economic recovery within Asia and fewer cases of fallen angels.

Chart 7: Expected 12 month trailing corporate default rate %



Sources: Moody's, PineBridge Investments. As of 4 February 2021; *APAC=Asia Pacific.

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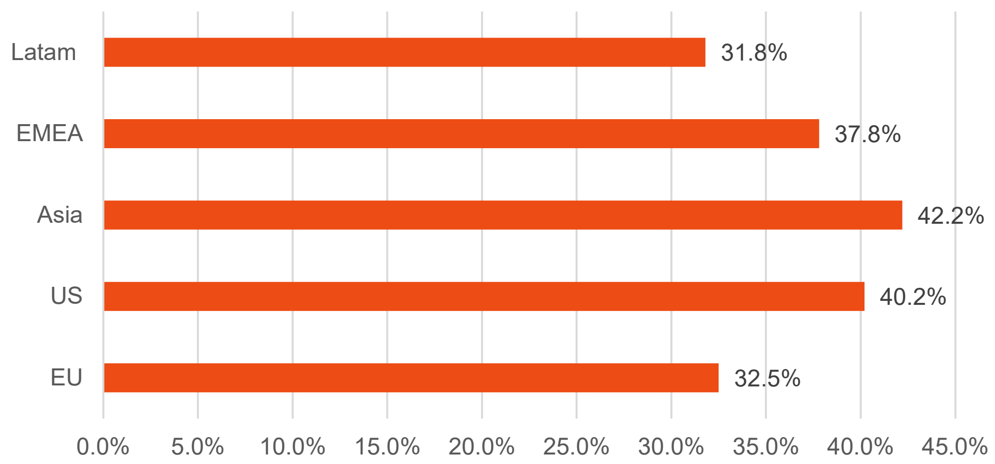
Recovery rates

While manager views on default rates were largely consistent, views on recovery rates were divergent. Some managers noted the potential for better recovery in Asia within high yield given higher concentration of real estate issuance while others highlighted the lack of transparency driven by different bankruptcy frameworks across jurisdictions. This as an area of further due diligence when assessing the recovery rate of Asian companies following default.

Chart 8: High yield recovery rates by region

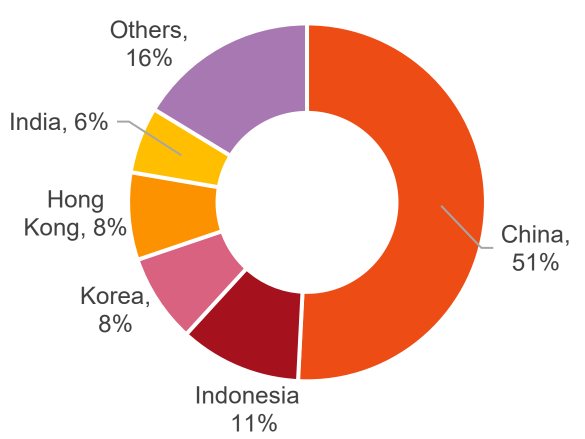


Source: Bank of America Merrill Lynch, as of 30 April 2020

Chinese dominance within Asian credit

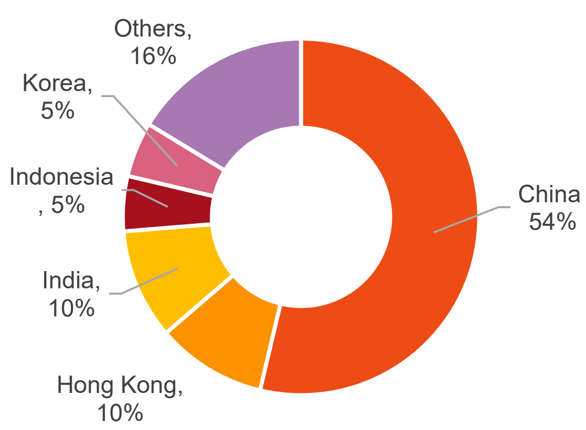
With the rise of China, the geographical composition of issuers within the Asian dollar market has shifted to include an increasing proportion of Chinese issuers who now represent over half of both the Asian credit market and Asian high yield markets. While the total credit market offers a good level of diversification across sectors, Chinese real estate issuers have become a significant part of the high yield market representing ~47% of the J.P. Morgan Asia Credit Non-IG index ("JACI Non-IG") driven by Chinese property companies borrowing heavily offshore in recent years to finance projects.

Chart 9: Asia credit index (IG+HY): China v rest of Asia



Source: Frontier, Bloomberg. JACI as of 31 January 2021

Chart 10: Asia high yield index: China v rest of Asia



Source: Frontier, Bloomberg. JACI as of 31 January 2021

Chinese property sector: another area of opportunity and potential re-rating catalyst

The three red lines policy is a regulatory scheme imposing three criteria designed to help manage Chinese property developer debt dynamics, which has grown rapidly in recent years and poses systematic risks to the economy. The three red lines are 1) liability-to-asset ratio (excluding advance receipts) of less than 70%; 2) net gearing ratio of less than 100%; and 3) cash-to-short-term debt ratio of more than 1x. A cap on debt growth will be placed if the developer breaches any of the ratios.

While the Chinese property sector is often perceived as a high-risk asset, given its cyclicality and idiosyncratic risk, managers held high conviction in the sector citing stable fundamentals supported by recovery in sales post lock down and long-term demand from ongoing urbanisation.

In the view of managers, the changes in prudential policy, including the three red lines policy will force de-leveraging of developers and improve the financial health of the overall sector, providing a foundation for more robust credit fundamentals. Additionally, improved credit metrics are likely to trigger a wave of rating upgrades creating opportunities for managers with local credit research capabilities to make active credit selection.

As China's share of the Asian credit market expands, in-depth understanding of Chinese macroeconomics policies and the regulatory environment have become more pertinent for both managers and investors. Managers investing in China are actively increasing local hires to supplement existing resourcing dedicated to Asian centric strategies.

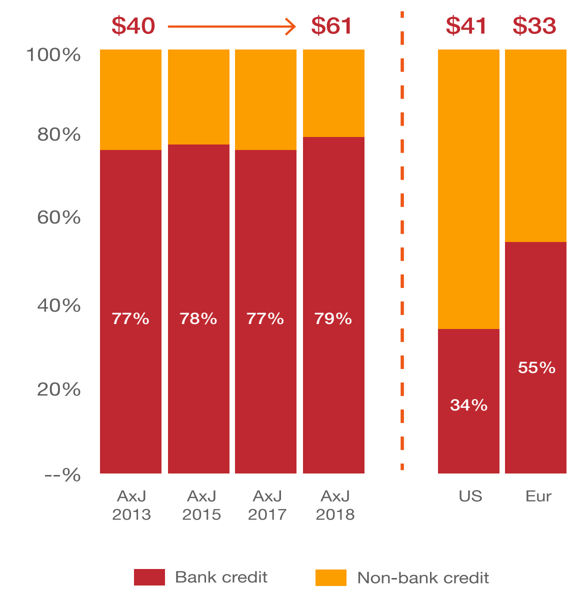
Asian private markets

Asian capital markets are developing quickly, and more sophisticated funding solutions appear to be necessary beyond traditional banking channels. Managers in the Asian private markets at this juncture typically offer broader strategies than developed market peers who are more specialised. A focus on high octane funding solutions is prevalent in Asia, yet it also appears a greater choice in lower risk senior direct lending is occurring as managers look to wrestle further market share from banks, who currently dominate the market, much like in Australia.

Asian private debt

The Asian private debt market can be characterised with an imbalanced supply and demand dynamic. Banks have continued to dominate the market and banks' lending is unable to meet growing demand for flexible, bespoke credit solutions from borrowers, particularly small and medium sized enterprises. In addition, the bond markets in Asia, whilst growing quickly, still cater for much larger entities and remain out of reach of many of these entities who require funding. These factors have resulted in a growing demand for non-bank credit in the region.

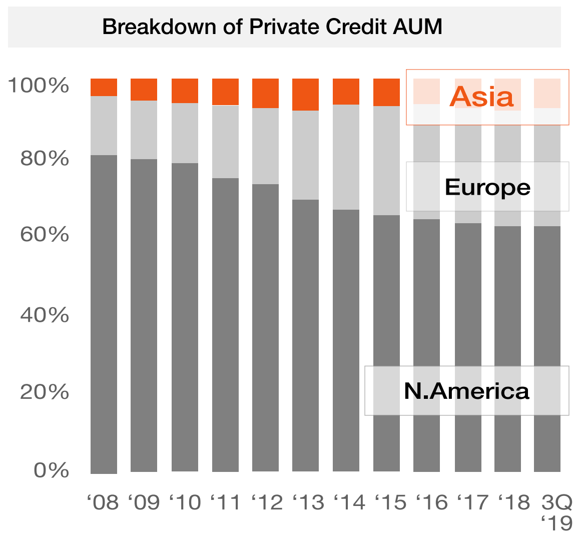
Chart 11: Banks dominating Asia ex Japan markets



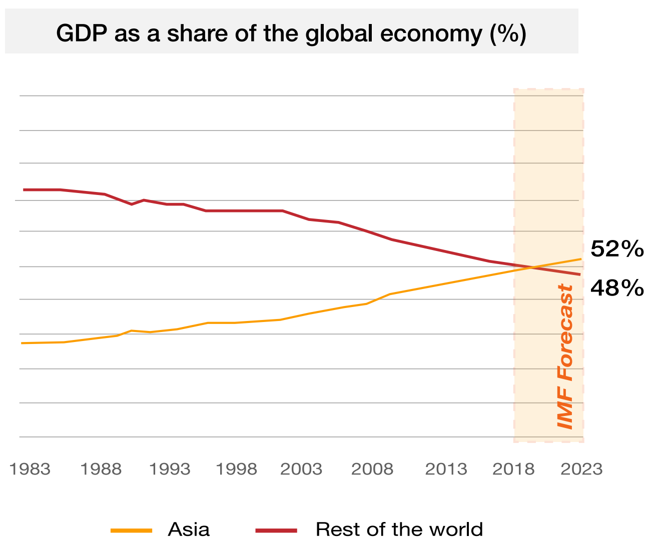
Source: Bank of International Settlements, KKR, data as of March 2019. Market size in USD trillions.

Even though Asia accounts for around half of the world's GDP, the level of capital raising for Asian-focused funds has been much smaller compared to those targeting North American and European markets. This indicates competition among non-bank credit providers is less fierce in Asia and resultant investments may have more attractive risk and return profiles.

Chart 12: Capital raising lower in Asia despite the region's economic importance



Source: Preqin, KKR



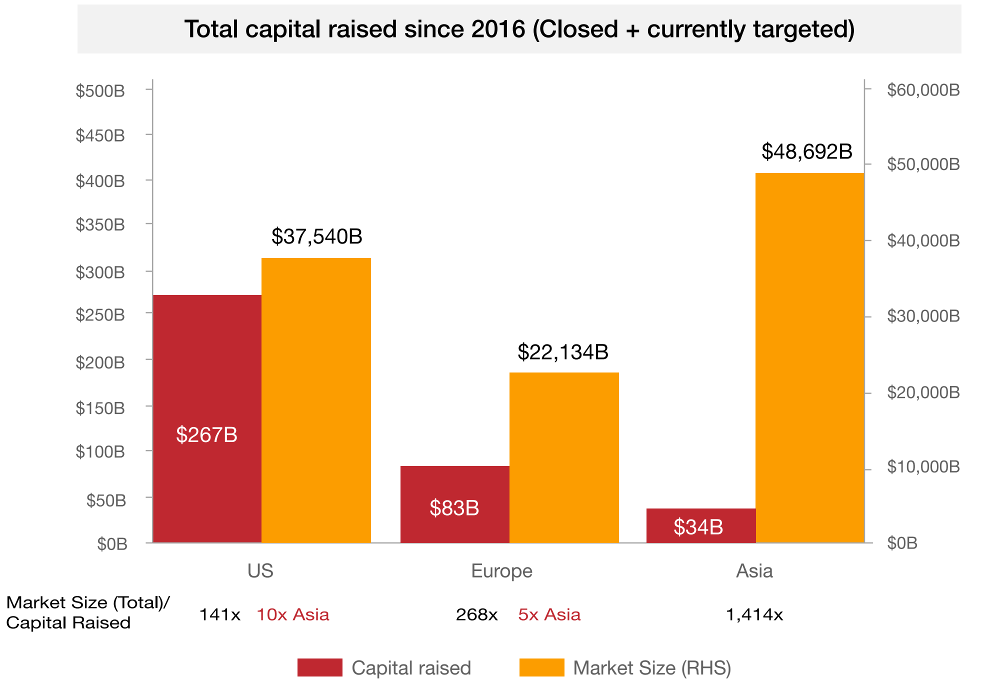
Source: IMF, ICG

Managers believe a key factor in lower capital raising has been the high barriers to entry into the Asian market. The cost and complexity of establishing a viable business and a strong team that can compete effectively with banks in the region is high because Asia comprises a diverse set of countries with varying regulatory regimes, economic development stages, languages, and legal systems.

Distressed credit

Within the broader private debt universe, stressed and distressed credit strategies are worthy of note. According to Preqin data, the majority of distressed and special situation funds raised in the past five years continue to target US and European opportunities. This is particularly evident since the onset of COVID-19.

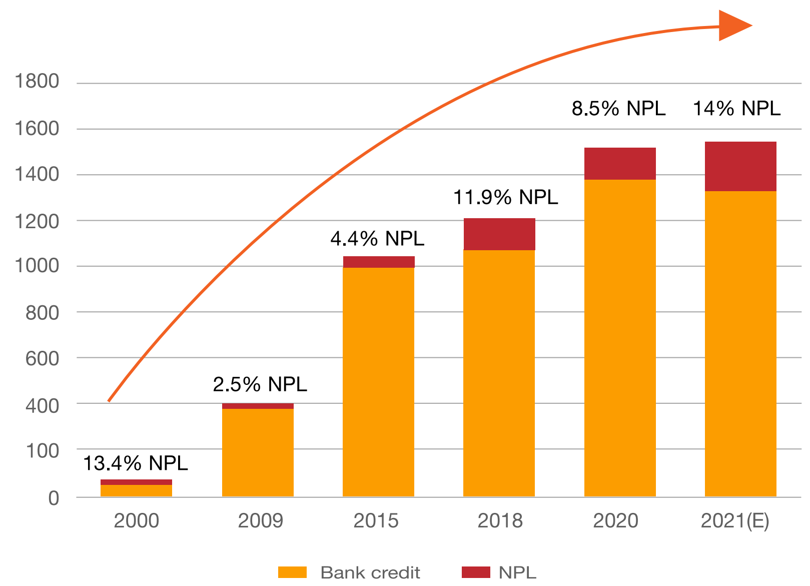
Chart 13: Distressed and special situations funds favouring the US and Europe



Source: Preqin, Bain Capital. Data as at May 2020

Managers highlight that there is a broad range of opportunities for stressed and distressed credit in the region, which has been enhanced by the impact of COVID-19. Non-performing loans (NPLs) in China and India were mentioned as a particular area of interest. The opportunity set in NPLs in the China and India markets is substantial and has been rising significantly in the last seven years. As at 2020, NPLs were estimated at about USD400 billion in China and USD200 billion in India.

Chart 14: : India's non-performing loans (NPLs) growth



Source: China Banking and Insurance Regulatory Commission, S&P Global Market Intelligence. Data in billions Chinese yuan. 1USD=6.59 Yuan as of 24 November 2020. Special mention loans are loans past due.

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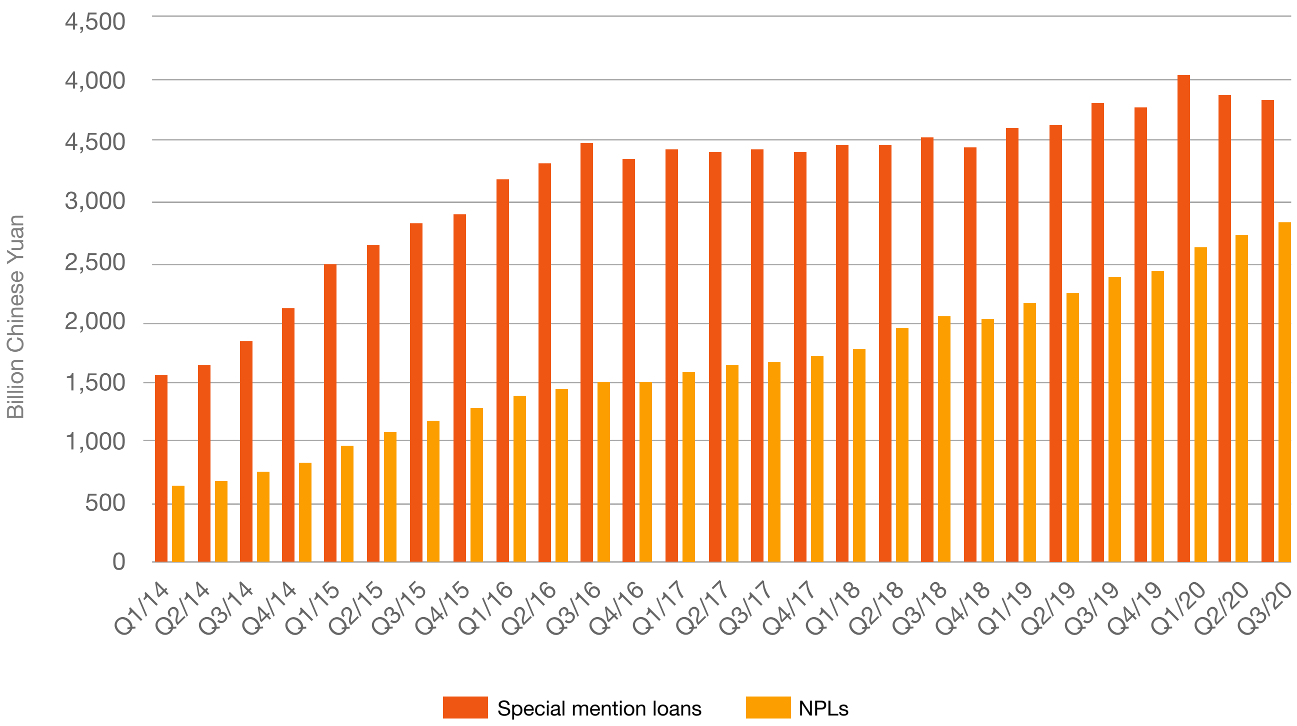
Chart 15: China's past due loans and NPLs



Source: China Banking and Insurance Regulatory Commission, S&P Global Market Intelligence.1USD=6.59 Yuan as of 24 November 2020. Special mention loans are loans past due.

In addition to the increased NPL volumes, managers commented that from a regulatory perspective, both China and India have made strong efforts in improving the NPLs investment process for investors. Improvement includes insolvency reforms and clearer enforcement mechanisms. The large opportunity set and improving investment framework are expected to further enhance the appeal of NPLs investment in the future. That said, we believe investors considering NPLs in China and India should partner with experienced fund managers that possess detailed local market knowledge and proven capability in crucial areas such as NPL servicing and enforcement process.

COVID-19 impact similar to other regions

Performance of private debt has been impacted by COVID-19 although the impact has been quite manageable with limited losses at this juncture. This is consistent with what we have seen in the US, Australia, and Europe.

Feedback from managers on the COVID-19 impact is summarised below.

- Impact varies across managers and strategies.
- Impact has been more extreme on industries directly related to COVID-19 such as travel, hospitality, retail, and commercial real estate.
- The investments strongly impacted by COVID-19 are typically up to 15-20% of total portfolio.
- The managers however are not overly concerned with the impact.

Based on our discussions with managers, COVID-19 has made the private debt landscape more attractive. This is similar to what has been observed in other geographies like the US and Europe.

- COVID-19 has created more complexity and demand for flexible capital solutions has increased. This is likely to favour established managers with strong credentials and expertise in offering flexible solutions.
- Banks have generally retreated or adopted a ‘wait and see’ approach, providing more opportunities for credit fund managers.
- Local banks typically direct their efforts to support large corporations. There appears to be lesser support for small and mid-sized borrowers.
- Certain ‘tourist’ capital has been withdrawn from the region. It is believed there are more opportunities for managers that have identified Asia as a core market and remain committed to raising funds and deploying capital in the region.
- Transactions have better pricing and reduced risk, resulting in enhanced risk-reward.

Implementation considerations for Australian investors

Asian USD credit markets

Active management is pertinent when investing in Asian credit given returns can vary significantly between sectors and credit rating. Managers with established local presence and credit research are preferred to navigate the idiosyncratic risk of different jurisdictions and sectors.

A comfort level around an allocation to China is another key consideration for investors given its regional importance and increasingly higher contribution within Asian credit indices.

A further implementation consideration should include appropriateness of active manager fees. Fees are observed to be generally higher in Asia. We note only a small proportion of managers reported Australian capital invested in their products. This could indicate marketing constraints, lack of investor awareness, or unwillingness by managers to negotiate fees to an Australian fee scale.

Asian private debt

The managers we met with generally adopt a flexible investing approach. For performing credit strategies, the managers can invest across first lien, second lien and subordinated debts. Investments can be a combination of corporate or asset-based lending, and company size can vary significantly. This contrasts with credit strategies in the US or Europe which tend to be specialised in one segment of the market. We believe this is a sensible approach and reflects the Asian private credit market being less developed compared to the US and European markets.

Another common approach among the managers is to invest across a range of countries in Asia. Some managers also include Australia as a core exposure in their strategies which may provide some overlap to existing exposures. Fees are high on performing credit strategies relative to developed market offerings. By comparison, fees on distressed credit are high but in line with strategies focusing on North America and Europe. Investors also need to be aware that currency risks can vary. Most investment vehicles generally have USD as the funding currency, yet they invest regionally. The currency of non-USD investments needs to be considered. Similarly, in terms of illiquidity, investors should be aware that generally vehicles are closed-ended with capital locked-up for five to eight years.

Despite the impact being manageable to date, investors should also carefully assess how COVID-19 may affect future investments.

The final word

Asian bond markets have grown in depth and diversity, yet Australian investors have not fully tapped its potential. The Asian USD bond market was highlighted by managers as a preferred first step and alternative to local currency markets given lower volatility than other EM corporate markets, stable corporate fundamentals, and attractive relative value.

Global EMD fund flow to broad EMD corporate strategies appears to have waned in preference to dedicated regional exposures. Accordingly, we believe there is merit in considering dedicated Asian credit to access its diversification benefits, strong regional active manager skillsets and attractive risk-adjusted returns.

Asian focused private debt strategies can be attractive due to favourable supply and demand dynamics, and we believe this will be a key growth area. Fees however are a key drawback. Asian credit strategies may also include a sizable exposure to Australia, and this needs to be considered by Australian investors.

There is merit in considering an Asian distressed and special situations credit strategy as the opportunity set of non-performing loan opportunities in China and India requires a specialised regional skillset to access. Limited capital raising in the region also suggests lower competition for deals which can be a problematic feature in developed markets.

Frontier will be looking to conduct additional research to further confirm our initial views from this trip and identify effective implementation options for our clients. Please contact us to discuss any of the themes and ideas outlined in this paper as we would be very happy to expand on and discuss this topic further.

Want to learn more?

We hope this paper has generated lots of ideas for your own portfolios. If this is the case, please reach out to Frontier to discuss how we can work with you in this space.

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