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Private lending: The market opportunity in Asia

Sustained rapid growth in the region coupled with a surge in private equity deal volume yields attractive opportunities for investors with flexible structuring capability

Favourable macro-economic backdrop

Asia is expected to represent 52% of global GDP by 2023, a share that has doubled since the turn of the century.¹ Sustained population growth continues to fuel the process of urbanisation across the region as living standards rise. Benefiting from this benign macro-economic backdrop, the appetite for private debt in Asia is showing strength, with increasing demand for flexible capital as local markets grow more sophisticated compounded by a desire from investors for diversification.

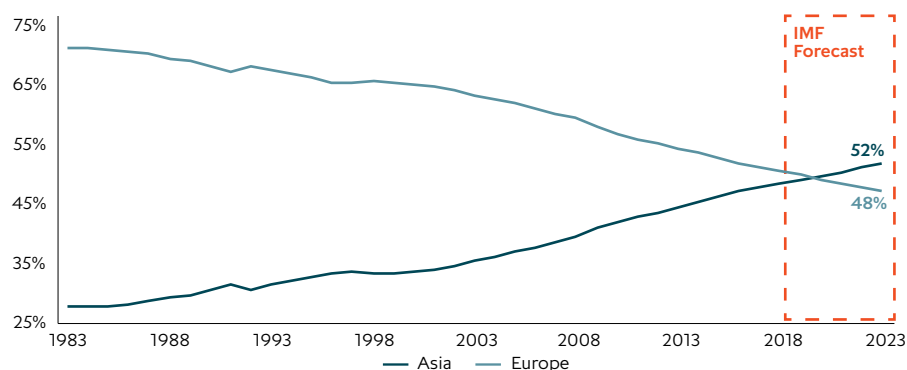
Private debt in the US and Europe, now an asset class in its own right, has seen strong, structural growth in recent years and this trend is set to be mirrored in Asia. As with those more mature markets, certain restrictions enforced following the global financial crisis remain in place, affecting the way in which banks can lend, so there are plenty of opportunities for private lenders to participate both alongside banks or indeed as a replacement. The transition away from bank financing is a seemingly permanent structural shift with institutional private credit filling the vacuum. As financing tools, private debt and private equity are closely aligned and the growth of the private equity market in Asia both in terms of deal volume and dry powder, suggests similar behaviour in the private debt market.

The Asian private debt market enjoys favourable conditions both in terms of supply and demand. That is to say that there are ever-increasing numbers of businesses looking for financing solutions while at the same time, among the ranks of global private debt investors, diversification away from the more mature European and US markets is becoming commonplace.

According to the IMF, annual growth in developing Asia has averaged 8 percent since 2008.² Much-voiced concern over a slow-down in GDP growth requires scrutiny of the relevant figures in context: even at 6% growth, as predicted for the coming decade, this represents more than double the growth rate of the rest of the world.³ The expansion in per capita income over the past two decades and concurrent swelling of the middle class has driven the development of local economies for which higher value-added industry and services-related businesses comprise an increasing share. This transformation and the accompanying waves of technological innovation have yielded exciting opportunities for investors.

The charts on the next page illustrate the trends described above.

Figure 1: Rising proportion of GDP from Asia



Source: International Monetary Fund ('IMF') DataMapper, 2019, UNCTAD definition of Asia. GDP based on Purchase Parity (PPP), share of the world

¹ IMF Datamapper 2019, UNCTAD definition of Asia, GDP based on Purchase Power Parity

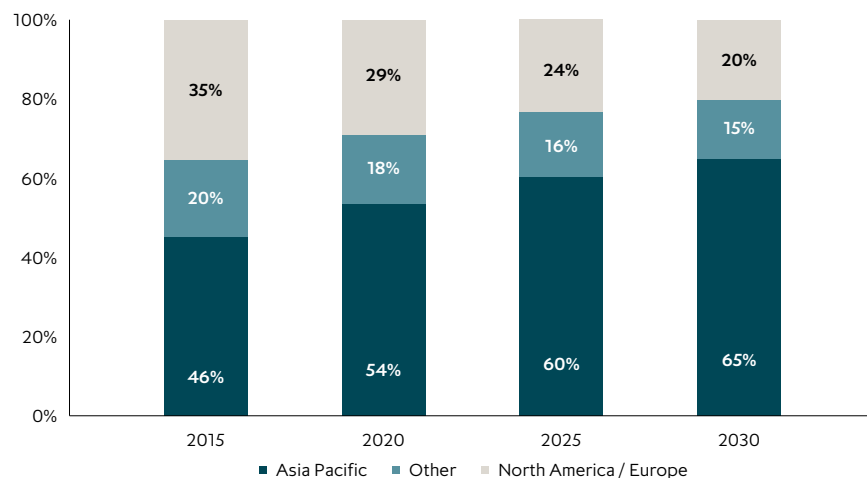
² IMF Regional Economic Outlook: Asia Pacific, Oct 2018

³ IMF Regional Economic Outlook: Asia Pacific, Oct 2018

A growing marketplace

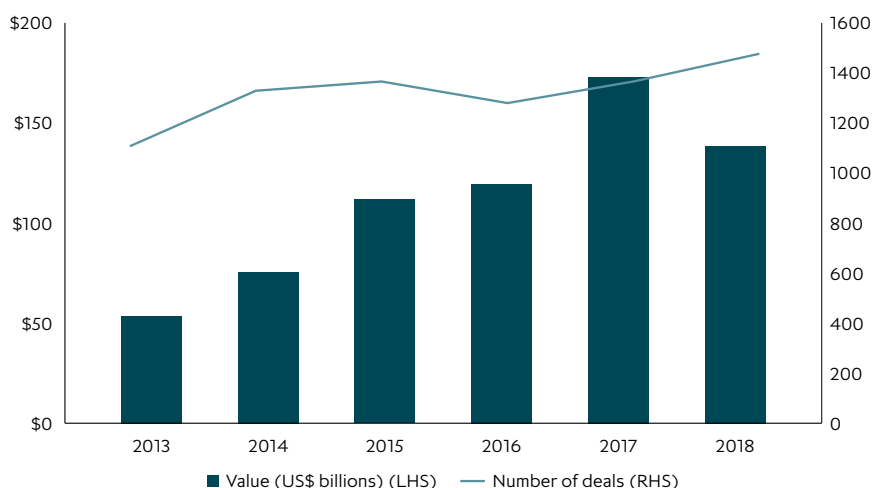
In Figure 3, the number of private equity deals in the Asia-Pacific region has trended upward since 2013. In terms of total value this has also been the case, with the exception of a drop in 2018 after a one-off spike in Chinese deal volumes in 2017. These highs have helped increase assets under management in the Asia-Pacific region to 24% of the global total. The levels of deal volume and assets under management demonstrate increasing activity in the region, creating attractive investment opportunities.

Figure 2: Allocation of the global middle class



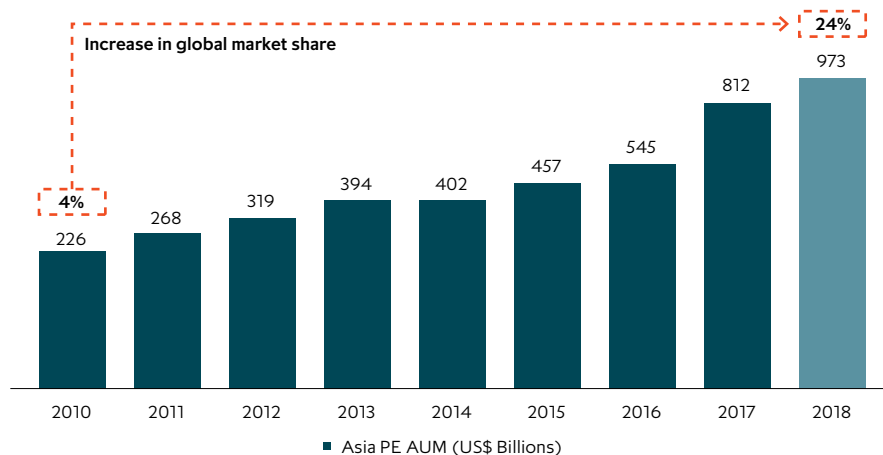
Source: Statista 2019

Figure 3: Deal volume in Asia Pacific



Source: AVCJ, 31 December 2018

Figure 4: PE Assets under management in Asia



Source: Preqin, 31 December 2018

Traditional lenders face challenges

As Asian markets grow and mature, there is increasing demand for flexible capital, and businesses are proving keen to find alternative solutions to what have traditionally been the limited options of debt carrying high cash-pay levels or else the sale of equity and consequent loss of both control and potential upside. A closer look at issues that have acted as a constraint on traditional bank lending in Asia since the global financial crisis highlights the following:

- **Banks struggle to lend across multiple (10+) entities**

For assets held in a variety of structures and across a number of locations, the amount of time and effort required to establish the true EBITDA of a business is such that, given their conservative risk parameters, banks will tend to pass on such opportunities.

- **Bank lending requires liens to be taken over assets**

Banks' conservative risk appetite can lead to an over-reliance on liens taken over physical assets while they struggle to lend against intellectual property or a strong business franchise.

- **Banks continue to cap leverage levels in sponsored buyouts**

In so doing, they limit the total amount of leverage they are willing to lend in a capital structure. With rising enterprise values in Asia; private equity sponsors typically then prefer to pay a premium for subordinated debt and/or second lien in the capital structure, than commit additional equity by way of top-up, thereby diluting their own returns.

The restrictions above give issuers of private debt a competitive advantage when it comes to deals supporting, for example, management-led transactions, capital reorganisations or private equity sponsors financing sponsored leveraged buyouts (LBOs). This is especially the case for those lenders with a combination of both scale and a lengthy local track record. There are now a greater number of 'mega' LBOs in Asia, and a lender able to offer a single subordinated note to private equity partners typically carries the advantage. Likewise with smaller LBOs, buy-out partners tend towards a single incumbent with a proven history of investing in the region.



Dry powder at record levels

The favourable dynamics described above have prompted buoyant activity in Asia's private capital markets and there are currently high levels of un-invested private equity capital ("dry powder") that need to be invested. That figure stands at approximately US\$90bn across the most developed Asia Pacific countries i.e. Hong Kong, Singapore, South Korea, Japan, Australia and New Zealand.⁴ Perhaps against expectations, rather than prompting heightened competition in the market, it is more

often the case that high levels of private equity dry powder in fact drive the LBO market, as well as private lending markets than accompany it. Pressure is on private equity funds and sponsors to keep finding and executing deals, irrespective of macroeconomic fluctuations, and they also need to find ways to return capital to investors. This drives business activity such as private investments, divestments, recapitalisations, initial public offerings and mergers, yielding investment opportunities accordingly.⁵

⁴ Preqin (May 2019)

⁵ World Bank, World Integrated Trade Solution, 2019

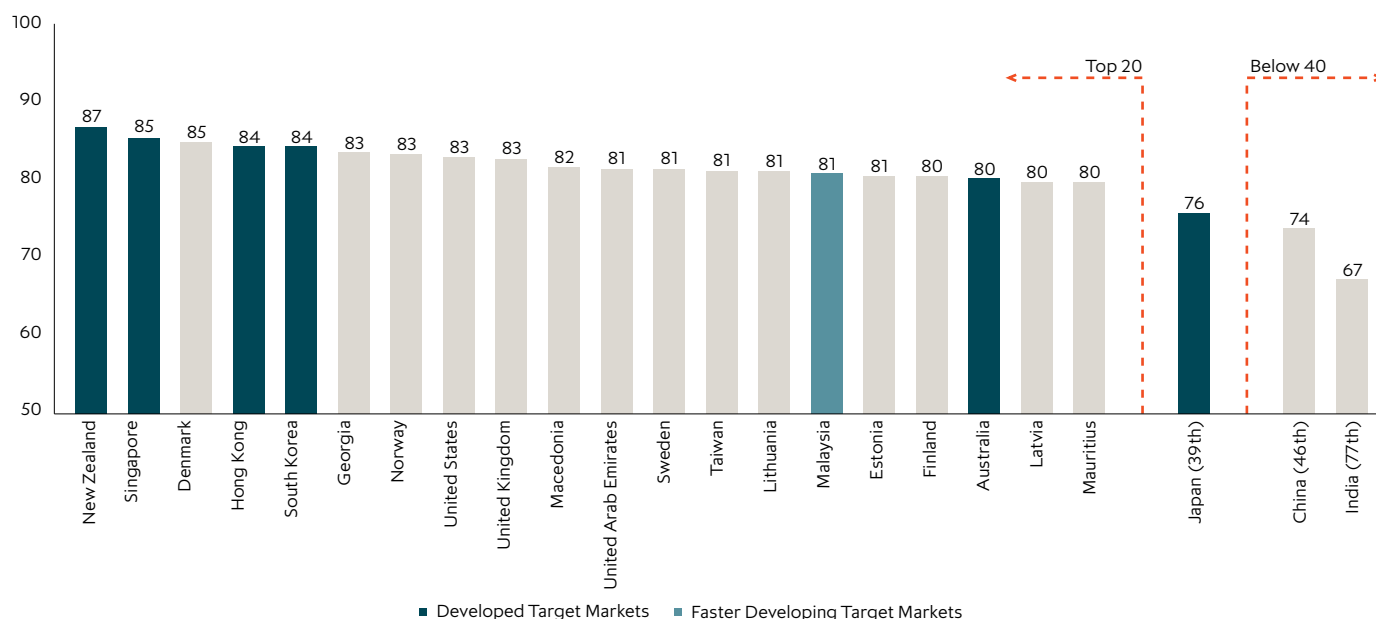
Focus on developed markets

Within the Asia-Pacific region, ICG will continue to focus its primary investment activities in established and developed markets, namely Australia, Hong Kong, New Zealand, Japan, Singapore and South Korea. In so doing, we will continue to benefit from the strong rule of law (including the ability to enforce agreements), regulation and ease of doing business in these selected markets. While ICG will not be investing directly in either China or India, it will be able to capitalise on the tailwinds

generated by the significant growth and development of those two countries. Across its six core countries, China and India account for an average of 30% of exports, a figure that has more than trebled since 2000.

The chart below ranks the top countries globally in terms of ease of doing business, with ICG's targeted markets dominating the top five and featuring prominently throughout the top 20.

Figure 5: Top countries for ease of doing business, ranked from #1 out of a total of #190



Source: World Bank "Doing Business 2019" report

Regulation and corporate governance

A genuinely important dynamic in Asia is the improving regulatory environment. For a period of time Asian regulators were playing catch-up to Western counterparts but today, the global nature of many financial institutions in the Asia Pacific region means that, increasingly, Western standards have been applied, and this has significant repercussions for governance standards.

ICG believes that a stronger regulatory environment is transformational for corporate governance. While improvements are most visible in publicly-listed companies, including better transparency and greater board diversity, these changes are evident too in smaller, privately-held businesses. It is our view that good corporate governance boosts operational efficiency and lowers the likelihood of mismanagement while improving access to and lowering the cost of capital; all ultimately positive for the performance of its investments.

The benefit of local expertise

Drilling deeper into preferences and practices in Asian markets, there are a number of opportunities for private entities to provide bespoke capital solutions that traditional lenders simply do not have the flexibility to engineer. For example, it is particularly common in countries such as Korea and Japan for businesses to feel uncomfortable carrying debt in their capital structure due to the stigma attached to owing someone money.

A provider with the ability to innovate and offer more equity-like structured notes, paying fixed returns, senior in the capital structure, stands to gain under such circumstances. It is increasingly the case that business owners in Asia are focusing on financing packages which allow them either to retain or regain control over their company. A flexible lender is able to respond by structuring an investment with senior capital status which nonetheless leaves majority control positions with management and/or owners.

Case study – Yudo

Overview



Industry

Produces mission critical parts for plastic injection moulding (hot runner systems, “HRS”)



Date of investment

December 2017



Location

Hong Kong



Acquisition cost

US\$203.0
(incl. US\$100.1 co-invest)

Investment rationale

- Globally, Yudo is the leading producer in its industry, has a dominant market position in Asia and manufactures a mission-critical product for a diversified customer base
- Cash generative company with no debt and all capex (relatively low) funded by cashflow
- Distributions on equity are pari-passu but ICG has priority in liquidation, essentially affording a large equity cushion
- The business takes advantage of China growth tailwinds while benefitting from Hong Kong's strong legal and regulatory framework
- The deal involved structuring across 41 different entities, a level of intricacy for which banks had little appetite
- To enable ICG to exit whether or not the business opts for an IPO, ICG has a put option to sell its stake at a fixed return, providing downside protection



Conclusion

ICG's financing flexibility and structuring expertise can be a significant differentiating factor in a stakeholder's selection of its financial partner. The company's longevity as an investor in complex capital structures and in implementing bespoke financing packages for portfolio companies confers a significant advantage when it comes to sourcing and executing investments. The complexity and finesse of its tailor-made solutions simultaneously allow it to meet the particular needs of a portfolio company while also giving it the scope to achieve healthy returns for investors with high levels of downside protection.

By acting as a trusted partner to private equity sponsors, intermediaries, advisors and management teams in the Asia Pacific region for over 18 years, while investing over US\$2.0 billion of capital across three funds and supporting businesses through the global financial crisis, ICG has carved out a track record that includes:

- 75% of value, on average, arising from returns linked to debt instruments, resulting in significant downside protection⁶
- Track record of 1.9x gross MM and 17.2% gross IRR on 14 fully realised transactions⁷
- Realised annualised loss rate of just 0.6% of invested capital, over the 18-year track record⁸

There are very few private lenders with an equivalent track record, local offices in their core target markets and a truly flexible mandate that permits investment throughout the capital structure. With ICG's target markets in the Asia Pacific region benefiting from a supportive macro-economic environment and legal and regulatory frameworks that foster stability and protection, we see ample opportunity to continue to deliver for our investors.

⁶ The returns linked to debt instruments presented are an average across Fund I (80%), Fund II (80%) and forecasted for Fund III (67%), as of 30 June 2019. Returns linked to debt instruments presented are gross and include fees, principal repayment (including warrant proceeds up to their investment cost), cash interest, PIK interest, and value uplift from both detachable warrants and non-warrant variable debt instruments. Fund level MM/IRR gross and net returns as of 30 Sep 2019 are as follows: Fund I (1.85x/15.8% gross and 1.7x/12.5% net), Fund II (1.7x/14.0% gross and 1.4x/8.5% net) and Fund III (1.4x/18.4% gross and 1.4x/15.9% net). Important notes explaining the use of gross performance, net performance, target returns and risk adjusted classification can be found at the end of this document under Notes to Investment Performance.

⁷ ICG Asia Pacific Funds fully realised track record is amalgamated across Fund I (7 investments), Fund II (6 investments) and Fund III (1 investment). Fund level gross and net returns are presented above. Important notes explaining the use of gross performance and net performance can be found at the end of this document under Notes to Investment Performance.

⁸ Loss rate calculated by dividing total US dollars lost, over total US dollars invested, for fully realised investments only. Annualised loss rate is calculated by dividing loss rate, by average hold period of fully realised investments at 4.5 years.

Notes to investment performance

Past performance is not necessarily indicative of future results, and there can be no assurance that the Fund will achieve comparable results or that the Fund will be able to implement its investment strategy, achieve its investment objectives or avoid substantial losses.

The investment decisions and day-to-day operations of investment vehicles managed by ICG that made such investments were made and carried out by persons that were different from those who will be primarily responsible for the investment decisions and operations of the Fund. The composition of the investment committees involved in these investment programs differed substantially from the Investment Committee for the Fund. The information provided herein regarding the investment performance of ICG is therefore provided solely for background purposes and should not be considered as an indication of future performance by the Fund.

Any discussion herein of past or proposed investment opportunities should not be relied upon as any indication of future deal flow. It is expected that ICG, in its discretion, will offer the Fund and other clients investment opportunities, taking into account the investment return, geographic scope, investment strategies, investment size and such other factors as it may deem relevant. Except as specified in the Partnership Agreement, ICG will not be obligated to offer or share any investment opportunity with the Fund and the Fund will not have any priority in respect of investment opportunities provided or created by ICG.

Any gross performance presented herein for investments made in currencies other than USD are calculated and presented based on their historic foreign exchange rates. Gross performance calculated under historical foreign exchange rates use the prevailing foreign exchange rate between USD and the underlying currency at the time of acquisition ("Prevailing Rate"). Following the initial investment, all cash flows received after that initial investment, including value at the stated reporting date, are also converted at the Prevailing Rate. The money multiple ("MM") and internal rate of return ("IRR") reported are based on the USD equivalent at the Prevailing Rate and, accordingly, have not been affected by, nor reflect any gains or losses from, fluctuations in exchange rates, since initial investment.

Any gross IRR and MM ("**Gross Performance**") data presented herein are from date sold or valued using the actual investment cash flows, excluding deductions for the management fee, carried interest and organisational and other expenses, each payable to the general partner and/or manager of such fund in respect of the aggregate performance of such fund, and organisational and other expenses, which in the aggregate were and are expected to be substantial. The effect of these charges on net performance can be expected to be material. Gross IRR and gross MM information is being provided only to certain selected institutional and sophisticated investors on a confidential basis for informational and discussion purposes. Net IRR and net MM ("**Net Performance**") are calculated by applying the management fee, carried interest and organisational and other expenses to the gross IRR and gross MM, respectively. IRR and MM information presented with respect to unrealised investments assume realisation of market values, which may vary materially from the actual proceeds received when the investment is realised, and does not include the reinvestment of dividends. The valuations of unrealised investments are determined on a fair value basis in accordance with ICG's valuation policies and procedures. There can be no assurance that unrealised investments will be realised at the valuations used to calculate the information contained herein, as actual realised returns will depend on, among other factors, future operating results, the value of the assets and market conditions at the time of disposition, any related transaction costs, and the timing and manner of sale, all of which may differ from the assumptions on which the valuations used to calculate the information contained herein are based. Certain market and economic events having a positive impact on performance may not repeat themselves. Past results are not necessarily indicative of future results and no representation is made that results similar to those shown can be achieved. Investments in funds and accounts managed by ICG may lose value. Investment results will fluctuate.

Forecasts and target returns for individual investments, fund sub-sets and funds, together ("**Target Returns**") presented herein are hypothetical in nature, are not a guarantee of future performance and are shown for illustrative, informational purposes only. Such Target Returns are not intended to forecast or predict future events, but rather to indicate the returns that the advisor expects to seek to achieve on an investment. Such Target Returns are based on the advisor's belief about the returns that may be achievable on investments that a fund intends to pursue in light of the experience with similar investments historically, the advisor's view of current market conditions, potential investment opportunities that the advisor is currently or has recently reviewed, availability of financing and certain assumptions about investing conditions and market fluctuation or recovery. There is no guarantee that the facts on which such assumptions are based will materialise as anticipated, that market conditions will not deteriorate or that investment opportunities satisfying a fund's Target Returns will be available. Any changes in such assumptions, market conditions or availability of investments may have a material impact on any Target Returns presented. Actual operating results, asset values, timing and manner of dispositions or other events and resolution of other factors taken into consideration may differ materially from those used to establish Target Returns. There can be no assurance that a fund will be able to implement its investment strategy or achieve its investment objective. Actual returns for each of a fund's investments and for a fund in aggregate may vary significantly from the Target Returns set forth, and any fund may sustain losses. Target Returns and assumptions are inherently uncertain and are subject to numerous significant business, industry, economic, market, regulatory, competitive and financial risks and other uncertainties that are outside of the advisor's control and may adversely affect the performance of any investments. Target Returns on any fund's specific investments are based on models, estimates and assumptions about performance believed to be reasonable under the circumstances. Target IRR are calculated based on assumed proceeds (at exit and any other proceeds received over the course of an investment) and the assumed amount invested, taking into account the timing of flows to calculate the IRR. Target Returns for an individual investment may be greater or less than a fund's overall Target Returns. Gross Target Returns do not include any pro rata deductions for management fees, payable to ICG in respect of the aggregate performance of a fund, and organisational and other expenses, which in the aggregate may be substantial to an investor. Prospective investors are encouraged to contact the representatives of ICG to discuss the procedures and methodologies (including assumptions) used to calculate a fund's Target Returns.

Due to the nature and complexity of the underlying instruments ICG Asia Pacific Funds are invested in, ICG have developed a classification that it feels ties the instruments to their effective economic risk, referred herein as the "**Risk Adjusted Classification**". This **Risk Adjusted Classification** may vary from the legal form of the underlying instrument. ICG believes the Risk Adjusted Classification aligns with both the commercial substance, and, the risk and reward profile of investments and aids a better appreciation of investment exposure. This Risk Adjusted Classification reflects, inter alia, the characteristics of the underlying instruments, interaction between instruments in the investment, position in the deal capital structure and commercial and other contractual return terms from which a fund may benefit.