PRIVATE DEBT March 2025

IFM Investors

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The opportunity in Australian private debt markets

Institutional capital provided by pension funds and insurers may benefit from a longer-term view when investing in Australian private debt, a market traditionally dominated by the country's banks.

The Australian lending market is often described as being highly inefficient, as lending is traditionally dominated by an oligopoly of domestic banks, with limited competition from foreign banks and other high net-worth investors.

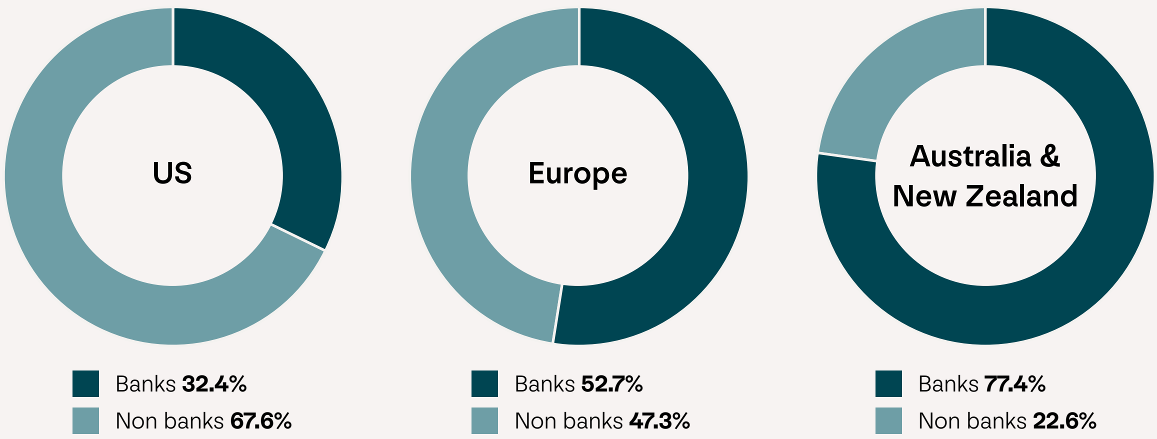
At IFM Investors, we believe this market inefficiency has resulted in the opportunity for investors to capture relatively attractive risk-adjusted returns versus comparable developed market private debt, particularly from reliable lenders who are able to meet capital-starved businesses with bespoke financing solutions. IFM has operated in Australia's private debt market for the past 25 years, and we believe we are well-positioned to partner with institutional investors and help them take advantage of the current shifting investment landscape and opportunity set.

Bank dominance and more favourable terms to lenders

The bank lending dominance in the Australian debt market remains an anomaly compared to North American and European debt markets. This is even more so when you consider that Australia and

FIGURE 1

SHARE OF BANK VERSUS NON-BANK LENDING BY JURISDICTION



Source: Bank of International Settlements December 2022

New Zealand's lending market is largely concentrated amongst just four domestic banks, who collectively cover approximately 75% of its market (see Figure 1).

We believe the result is a highly inefficient market given the supply/demand imbalance between the lender and borrower universe. The power imbalance between borrowers and lenders has led to credit being provided at far more favourable terms to lenders relative to the North American and European lending markets, where the scale is tipped in the opposite direction in the favour of borrowers. We believe this supply and demand dynamic can provide a significant opportunity for institutional investors.

Large-cap corporate lending in Australia is similar to offshore markets, in that it is typically unsecured, but unlike the markets in the US and Europe it does have senior ranking and protection against the ability for another lender to come in with security rights. Most other lending in Australia is generally provided on a fully secured basis with priority ranking over all other creditors. Further, tight lending standards have persisted, with loan structures retaining an extensive set of lender rights and covenant packages. This is contrary to the position within the North American and European markets, where lending standards have loosened significantly over recent years with covenant-lite and non-covenant transactions now the market standard.

Tailwinds accelerating Australian bank disintermediation

Until recently, Australian corporate lending markets had largely resisted the bank disintermediation that had characterised the debt markets of North America and Europe. However, there are now several elements that are shifting the landscape of domestic bank dominance in Australia.

Debt sponsors and borrowers have increasingly sought alternative sources of capital. Borrowers are now giving greater consideration to the value they are receiving from their banking relationships and how they contribute to their plans for growth; including access to tenor and whether they can have an uncomplicated and transparent relationship with no hidden costs. Indeed, many from the upper echelons of Australian business have actively campaigned for superannuation funds to provide more long-term financing – supporters of the push have included the former Prime Minister, Paul Keating.

Increasingly, regulators are also stepping in and this is impacting bank lending. For banks, the cost of corporate lending is currently heavily subsidised by consumer lending businesses, and matched funding requirements have led to rising funding costs. Against this, institutional capital poses fewer

TABLE 1

KEY DIFFERENCES IN GLOBAL PRIVATE DEBT MARKETS

Factor	Australia	North America & Europe
Market structure	• Remains bank-dominated with few other institutional participants • Generally illiquid with minimal trading • Primarily secured, unsecured lending by retail and high net worth clients	• Majority institutional capital • Higher liquidity, increased volatility • Both secured & unsecured lending
Structures & covenants	• 'Cov-Lite'* tends to be restricted to globally syndicated Term Loan B (TLB) market • Minimal to no exclusions from obligor group and assets • Mandatory debt repayment on asset sale is common • Restrictions on higher ranking debt or only without control rights are typical	• Proliferation of 'Cov-Lite' & 'No-Cov'* loans • Exclusion of key subsidiaries and assets from security ring fence • Removal of lender consent on asset sales is common • No or few limits on additional indebtedness

Source: IFM Investors. For illustrative purposes only and is not inclusive of all differences between Australia's private debt market and that of other markets.

*'Cov-lite' and 'No-Cov' are familiar terms in debt markets. They refer to loan agreements that typically do not contain, or have only few, protective covenants for lenders. Such agreements are, as a result, subject to greater risk.

systemic risks. Institutional lenders can also provide capital on an unlevered basis, meaning they are in a better position to absorb downside risks. Even if leverage is utilised, institutional lenders will typically be levered at significantly lower levels than is prevalent across the wider banking system.

Furthermore, institutional capital in the form of pension funds and insurers can take a much longer-term view of risk and return, while bank lenders are typically constrained by the primacy of depositors that expect an immediate call on funds.

Key Differences in Global Private Debt Markets

Table 1 identifies the main differences between the Australian debt markets and those in the US and Europe. The market structure differences mean that the Australian market is substantially less efficient; thus, lenders hold significantly more control and can set more favourable structural and covenant terms.

The differences between these markets are also manifested in pricing. The limited sources of funding means that higher quality credit can offer a significant premium and, has not historically suffered from yield compression and cyclical volatility to the same degree as in the US and Europe.

In our experience, Australian bank loans also tend to offer a significant spread premium over North American and European bank loans of a similar risk profile (see Figure 2).

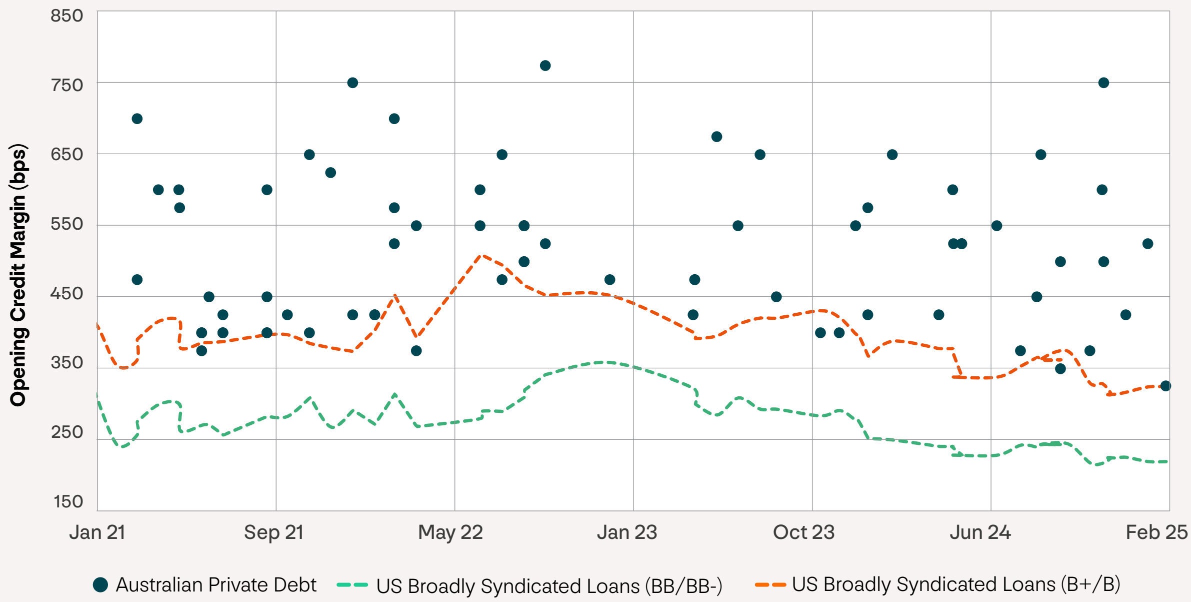
Single B transactions in Australia have typically priced between 500-800bps over floating, whereas the single B markets in the US and Europe currently transact at around 350-450bps over. Mezzanine deals are relatively rare in Australia, but can be employed to finance greenfield property development, or provide private equity portfolio leverage for instance. Our observation over the past year is that these can be priced anywhere from 15% up to 20% for junior ranking debt.

Pricing in Australia has broadly stayed consistent and at a significant premium throughout the past decade, primarily due to the private nature of the lending market and the dominance of banks as providers of loans, meaning borrowers are left with limited options.

The combination of better lending standards and more attractive pricing leads to the potential for relatively attractive risk-adjusted returns from the Australian private debt market. Importantly, we believe the domestic inefficiencies that have bought about these differences, are likely to persist for

FIGURE 2

IFM INVESTORS' EXPERIENCE OF AUSTRALIAN BANK LOAN PRICING



Source: IFM Investors, Bloomberg, Credit Suisse

the foreseeable future. However, the market is not completely immune from the changes witnessed in the US and Europe.

The Term Loan B market has seen greater convergence with the US and European markets over recent years, as these tend to attract a greater portion of foreign institutional investors and reflect the weaker structural developments in those markets.

Historical bank disintermediation globally

For most of the 20th Century, banks generally operated as the intermediaries that enabled and controlled access to corporate lending. However, this 'natural order' was challenged during the latter stages of the century in the US as a new group of capital owners began to grow in prominence. These were insurers, asset managers and pension funds. As the new group emerged, the need for banks as intermediaries became less important. This disruption was accelerated by the Global Financial Crisis (GFC), as banks confronted rising funding costs and increased regulation, particularly in European markets.

Regulators introduced additional capital and matched funding requirements for banks. The latter, in particular, ultimately led to a substantial reduction in cheap, short-term funding, and shifted the banks' business model from their traditional 'asset gathering' approach. As a result, banks in the US and Europe have increasingly acted as arrangers, advisors and distributors, rather than risk takers and providers of capital.

In parallel, maturing capital markets were attracting a broader range of non-bank participants, supported by the growing appetite for income-generating assets from the insurance industry and pension funds.

Sustainable role for institutional investors

For institutional lenders prepared to take a long-term view and absorb the relative illiquidity, the Australian private debt markets can provide an opportunity to become an early beneficiary of bank disintermediation within one of the last remaining bank-dominated developed markets. Indeed, we believe that the opportunities for institutional investors to glean relatively attractive risk-adjusted potential returns from Australian private markets will grow over the coming decade.

Presently, our view is that the Australian private lending environment remains highly inefficient. Ratings agencies only play a nominal role in monitoring the Australian loan market, due to the private nature of the majority of lending activity, which makes it more difficult for some investors to participate. The market is only in the nascent stages of development with few participants with extensive track records. We know from the experience offshore that the disintermediation process can take many years, and we expect this is particularly likely in the Australian context where the market is smaller and liquidity is likely to be more constrained.

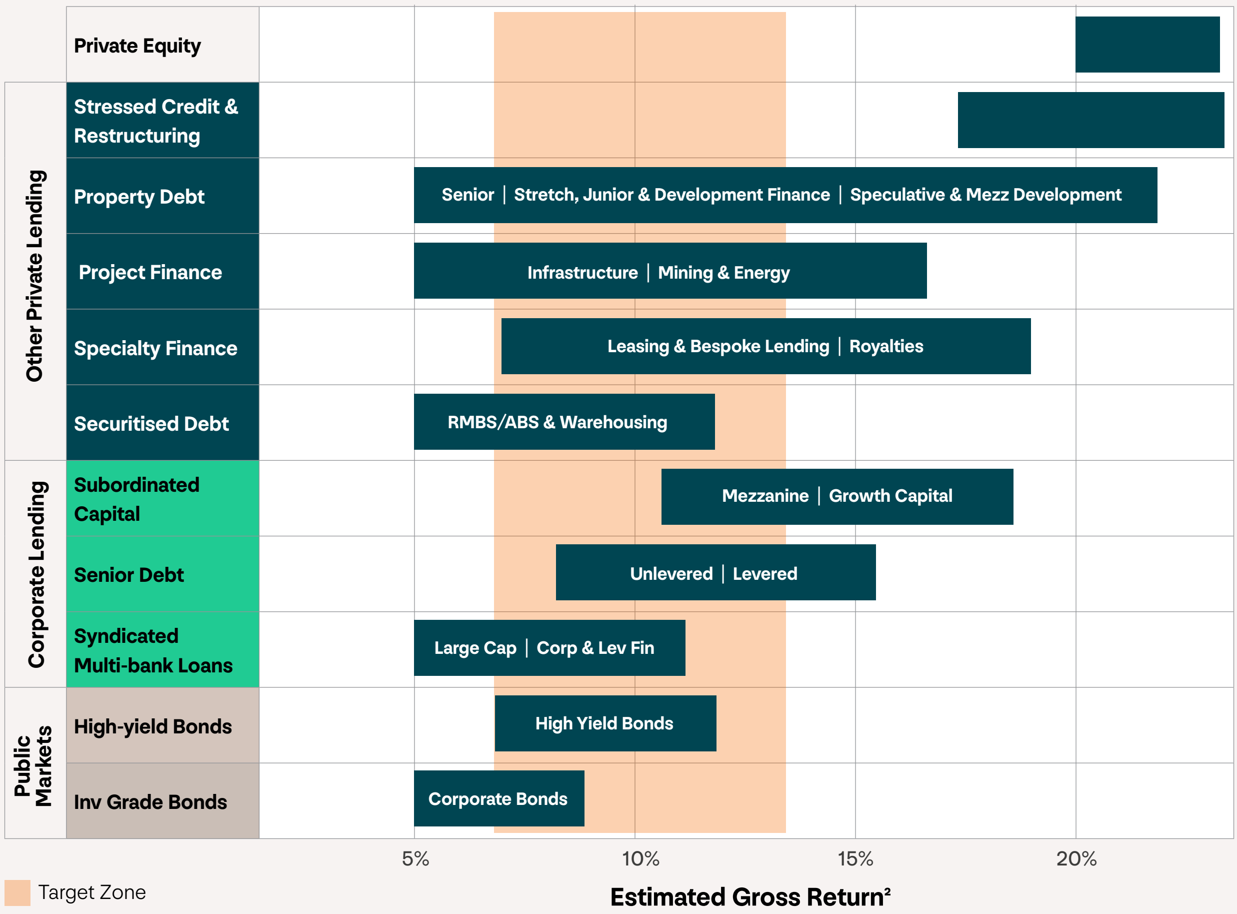
There are other reasons for sophisticated, institutional investors to consider the Australian private lending market. Private lending activities within the Australian economy dwarf the activity in the bond market. In fact, commercial lending as ‘bank loans’ were approximately 14.6x larger than the domestic corporate and asset backed bond universe as at TBC. In addition, the private debt markets are a much better reflection of actual economic activity. The bond markets are almost always a reflection of big issuers and their ability to achieve high grade credit ratings. From a diversification perspective, we believe the opportunities within the private lending environment significantly outweigh those on offer from bond markets.

The private debt sweet spot

We believe that institutional investors can take advantage of the opportunities in Australian private debt. Figure 3 highlights where we believe the Australian private debt ‘sweet spot’ exists. Here, we see opportunity for long-term investors who are prepared to give up the relative illiquidity of this sector to access relatively attractive risk-adjusted potential returns.

FIGURE 3

IFM’S VIEW OF THE PRIVATE DEBT ‘SWEET SPOT’



Source: IFM Investors. For illustrative purposes only. Targets are objectives indicative and is no guarantee that they will be met.

1. Diversification cannot ensure a profit or protect against loss in a declining market. It is a strategy used to help mitigate risk.
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Defining private debt

Private debt in Australia encompasses a broad range of private financing formats. Typically, offering floating rates, it has provided investors with something of an inflation hedge. It is also offered as secured or unsecured loans, which are generally unrated. Liquidity for private debt in Australia is low and generally subject to the agreement's terms.

Table 2 outlines the different private debt formats that we recognise and have participated in over the past 25 years.

TABLE 2

TYPICAL AUSTRALIAN PRIVATE DEBT FORMATS

Debt format	Description
Direct corporate lending	• Borrowing for general corporate purposes in secured or unsecured form • Largest component of the private debt market • General divide between Large Caps vs. Mid-Market & SME borrowers
Leveraged finance	• Typically financing for Private Equity sponsor-owned businesses at higher Debt-To-Equity ratios compared to corporate lending • Recourse and servicing limited to the underlying business – generally secured • Higher proportions of debt than typical corporate businesses • Financing initially supports acquisitions and buyouts but retains higher leverage until Private Equity exit
Property debt	• Targeting commercial, industrial, office and high rise residential • Development financing as well as brownfield property • Credit quality dependent on Loan-to-value ratio • Long tenor potential depending on lease cash flow profile
Speciality finance and asset lending	• Asset-specific financing on a limited recourse basis • Most likely to be off-balance sheet format in Special Purpose Vehicle structures • Always secured against specific assets e.g. aircraft or shipping, trade receivables
Project finance	• Limited life project based lending • Typically infrastructure related with some element of development risk • Fundamental 'value in use' over 'liquidation value

Source: IFM Investors. The table is for illustrative purposes and is not inclusive of all characteristics for each debt format.

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