ADM Capital
1008 ICBC Tower
3 Garden Road
Central
Hong Kong

24/10/2016

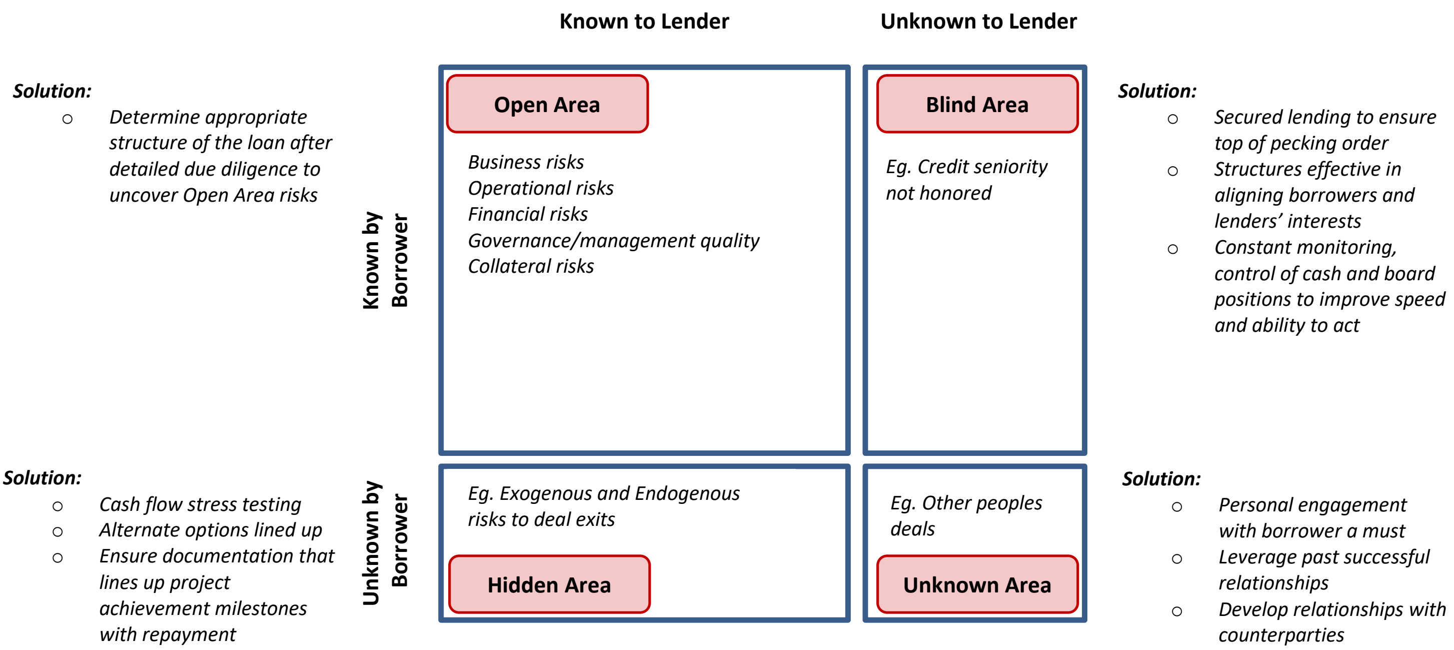
The Concealed Risks in Private Credit Investing

For ADM Capital, our Asian private credit strategy has consistently generated an IRR of 18%+ over the last 5 years. In comparison, Emerging Market high yield bonds have returned a CAGR of 7.1% over the same period. Indeed, in the last 12 years, we have invested in 133 private deals amounting to over USD3.3bn across various countries in the Asia Pacific region, and made our exit from 113 of them, registering ~USD500m in realised gain.

So what is the recipe that has made this strategy pay out so handsomely for us? Ironically, as an asset class, private debt is exposed to its fair share of risks, given that, in general: 1) risks are biased to the downside in all classes of debt given the asymmetry of returns 2) the interplay between the various classes of debt can oftentimes introduce their own set of risks and 3) the fact that these deals are privately placed suggests that information around them is not as readily available as publicly traded instruments. Notwithstanding these issues, we believe that a structured approach to cataloging, understanding, prioritizing and dealing with the various risks facilitates improved ability to generate superior returns in the asset class. Following is one possible approach.

The concept of the “unknown unknowns” was popularised by Donald Rumsfeld in 2002 as he explained the US presence in Iraq, but the concept has its origins much earlier, in the form of the “Johari window” that was initially conceptualised in 1955 by two psychologists to improve communication between people/teams. It’s a four quadrant grid comparing personality traits known by self and by others. Taking the poetic license to translate it into a risk framework, and replacing self with the lender and others by the borrower, this becomes a neat way of identifying known and concealed risks in private credit, as depicted below.

Figure 1: Framework for Considering Private Credit Risk (Sabita Prakash, 2016)



Accordingly, risks known to both borrower and lender are "**Open**" – in this quadrant we would include conventional credit risks that can be uncovered by detailed due diligence and minimised by suitable structuring of the loan.

Risks known to the lender but not their borrower are "**Hidden**" – these would typically include exogenous and endogenous risks that could affect borrower's debt servicing ability. By virtue of our experience as lenders, we have seen how some of these risks catch borrowers unawares but can wipe them out overnight. Eg. The failure to meet or maintain covenants in bond or loan documents, the impact of a bad macro environment on borrowers' ability to refinance their debts, and so on. Setting up communications and collaborating with the borrower to overcome these risks, having a Plan B and Plan C, and so on are some strategies to address these risks.

More pernicious are the "**Blind**" risks: those a lender may be unaware of but are known to their borrower, oftentimes an issue of governance. One typical manifestation of this risk is the non-observance of creditor priority, e.g:

1. Top management/promoters paying high fixed salaries for themselves – another way of dividend upstreaming and getting priority over senior lenders
2. Onshore lenders getting superior access to project assets – therefore important to take a multiplicity of assets as collateral, some offshore as well
3. Leakage of cash to finance other priorities like capex or consultancy fees instead of debt servicing – cash monitoring arrangements can cover this risk
4. Subordination in maturity – if junior loans come due before senior loans

Obviously, the **Unknown Area** risks cannot be mitigated, so diversity of investments in a portfolio are important to ensure risk mitigation.

Conclusion

At the minimum, lenders should convince themselves that Open Area risks are manageable via detailed due diligence of the borrower. Furthermore, by communicating and collaborating with the Borrower in addressing Hidden Area risks, lenders can win borrowers' trust with the hope of reducing Blind Area risks. Strong relationships between the lender and borrower are essential to uncover concealed risks in credit. That said, it remains important to ensure adequate protection against these risks –secured lending with well perfected security to ensure that we are at the top of the pecking order, as well as structures that are effective in aligning promoters' interest alongside lenders to avoid the long drawn, costly and complex process of litigation are key in this regard. Constant monitoring, control of cash and board positions improve our speed and ability to act if needed.

Should you have any questions or like further information, please contact ADM Capital Investor Relations on +852 2536 4567 or email admir@admcap.com.