China Debt Dynamics

Private Credit in a Reset World Order

ShoreVest
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Overnight in the US, the world order was reset once again! A regime change in the world's largest economy is no small event, but an epochal shift. Many global leaders are quaking in their boots, regarding what this means for world peace and geopolitics, and whether Europe, antagonized by any tariffs and a threat of a reduced NATO protection, spins into China's orbit. For global economists and investors, they wonder about the outlook for the Fed's independence and rate-setting, debt and fiscal deficits, growth and inflation, tariffs and trade, dollar vs. other currencies and commodities, among a host of other things like climate change. **For us at ShoreVest, for 20 years our China private credit strategy has largely remained uncorrelated with Western market disruptions. But we do question the forward-looking prospects for private credit in the West, especially in the US.**

At the outset, we are still processing the newsflows and are closely following how the political rhetoric translates to actual policies and the implications for private credit. Our leading initial question is whether the "golden age of private credit," as deemed by many US debt managers, does pan out or loses its allure.

It is common knowledge that global private credit has attracted ~$300 billion (2023-Q2 2024: Preqin). This has been driven by US direct lending, despite a forecast of only 7.6% (unlevered) returns in a growing atmosphere of heightened competition between private lenders and banks (and thus narrower risk premiums), and reduced deal flow from private equity sponsors awaiting interest rate cuts to revive a moribund M&A market. With bond yields spiking in the aftermath of the election results on rising fiscal deficit and inflation concerns, it remains to be seen if the wait for an M&A cycle is over anytime soon. With higher for longer interest rates, it bears watching if defaults pick up due to eroding business prospects or pressures on the largely unsecured debt serviceability, especially when many loans have both loose covenants and a syndicate of lenders triggering "lender on lender" violence.

For those US private creditors who have recently made asset-based finance their safe harbor, encouraged by Basel III endgame rules imposing higher capital requirements on banks, it would be interesting to see if the demands on additional capital would be weakened further (Fed already faced pressures from Republican law makers and banking industry to water down the capital requirement) in the wake of less strict regulation expected from the new Trump administration.

Lastly, CRE debt from weaker segments of commercial real estate like office and multi-family housing could be waiting longer for any reprieve from falling interest rates and higher valuations, while facing a $2 trillion (by 2027) wall of maturity.

All in all, global allocators should be closely monitoring how their commitments to the large private debt managers in the US, manifested in their dry powder, would be deployed productively. *Or should they explore greener pastures in non-sponsored asset-backed direct lending in less crowded geographies like China, with a secular growth story notwithstanding the recent developer/property malaise.* With boots on the ground across China's regional markets, ShoreVest constantly fields a flood of uncompetitive opportunities to select from, where ShoreVest provides capital solutions against hard assets at high-teens net IRRs (unlevered). Instead of wondering what regulatory environment the next administration will bring, ShoreVest is able to focus on those credit solutions that meet business outcomes aligned with China's longstanding domestic priorities (e.g. domestic consumption, green projects, etc.) and indispensable role in global business. And due to the lack of competition in the world's second largest economy, ShoreVest is able to demand more margin of safety in the form of first-lien low-LTV positions (rather than the covenant light world faced in US private debt).

Please stay tuned for further insights as we continue to monitor how private credit markets evolve with a paradigm shift in the US and its implications for China private credit.

Our contact details:
Guangzhou International
Commercial Center Suite
1503
No. 235 Tianhe
North Road
Guangzhou, China
510610

inquiries@shorevest.com