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With few big deals, private equity moves to be Asia's new banker

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By Stephen Aldred

HONG KONG (Reuters) - In three years, global private equity firm KKR & Co (KKR.N: Quote, Profile, Research, Stock Buzz) has provided over $1.5 billion in loans to companies in India, a business traditionally handled by state-owned and private sector banks.

Encouraged by that success, KKR - which rose to prominence with its hostile $25 billion takeover of U.S. food and tobacco giant RJR Nabisco in 1989 - plans to expand the niche business in China and across Asia.

The move by private equity into lending comes at a time when buyout deals in Asia are few and far between and as traditional banks retreat. Apollo Global Management (APO.N: Quote, Profile, Research, Stock Buzz), KKR and Olympus Capital are raising credit funds as they seek out alternative sources of income. At least $6.6 billion is being raised by 12 funds for investment in Asia, according to Private Equity International and Thomson Reuters data.

At the same time, credit across Asia has grown tight, leaving small businesses and family-owned firms short of capital as the big banks focus their attention on top-tier clients.

The business model adopted by private equity in Asia is very different to that in the United States and Europe, where private equity makes its profits through large buyouts. In Asia, loans as small as $50 million are a growing part of KKR's business as it expands a model developed by its India head, Sanjay Nayar, who was Citigroup's (C.N: Quote, Profile, Research, Stock Buzz) former Asia CEO.

"This country is going to take time to develop into a sophisticated private equity market. There's no point in having a single product strategy," said Nayar.

TARGET: CHINA

Big buyouts are rare in Asia, but the region's millions of small entrepreneurs are starved of capital for businesses from farming to software development. And powerful families that dominate Asia's emerging economies are reluctant to sell stakes in their businesses, but will take a loan.

The next wave of credit funds is expected to target China, where global firms are studying a little-known, but high-risk strategy that would allow them to get money into the mainland to provide high-interest loans to China's cash-starved small- and mid-sized business.

China's 4.3 million SMEs account for 60 percent of GDP and 75 percent of new jobs created in the country, but are forced to use the so-called shadow banking system when they need funds - a market that includes pawn shops, credit guarantee firms and trust companies.

Shoreline Capital, with offices in the United States and China, started by buying non-performing loans (NPLs) in China and added lending when the supply of NPLs dried up in 2009 after China flooded the market with fresh loans during the global financial crisis.

"A lot of private companies were coming to us wanting debt finance," said Ben Fanger, co-founder of Shoreline. "Even though the government was flooding the market with loans it was going predominantly to state-owned enterprises and government projects."

SEEN AS SAVIOUR

Since Nayar joined in 2009, KKR has organized a series of loan syndicates, putting $100 million of its balance sheet into a total of $1.5 billion in loans.

Private equity in India lends through non-bank financial companies (NBFCs), which are more flexible than banks. NBFCs can give loans to buy land, to refinance real estate debt, or for a company to buy out a private equity investor, areas that banks find tough to lend to.

Top private equity funds can make internal return rates, a measure of profitability, of 25 percent, but returns from credit funds can be as low as 9 percent. Private equity firms like the stable income stream though, and see lending as a way to open doors to future buyout deals.

"There are huge opportunities for private equity and private debt in India. Public markets are very shallow, and the banks are undercapitalized," said Nayar.

Now KKR is raising a rupee credit fund of up to $400 million - the Alternative Credit Opportunities Fund-1 - from Indian insurance corporates and high net worth individuals, according to sources with knowledge of the matter. In India, KKR has lent money to large companies such as insurance-to-hospitals group Max India Ltd (MAXI.NS: Quote, Profile, Research, Stock Buzz), as well as to small growing companies.

Shoreline, which has provided credits to local government projects and private companies, takes whole companies or real estate projects as collateral in return for loans with interest rates priced above 20 percent. The borrower gets the asset back if they repay the loan.

Funds like Shoreline see themselves providing a lifeline to SMEs, whose borrowing options have been cut by the credit squeeze. Short-term borrowing costs in China recently jumped when the central bank allowed interbank rates to surge, dealing a further blow to companies in need of cash.

"These companies view us as their saviors," said Shoreline's Fanger.

Shoreline funds make returns of over 20 percent, similar to regular private equity funds. That's attracting others to study the model.

Previously, offshore credit funds have played it safe in China, lending only to the Hong Kong listed arms of Chinese companies, which then funnel the money to subsidiaries in China. But that business model does not tap the SME market, and fails to generate the kind of returns that Shoreline makes.

NOT WITHOUT RISK

While the returns from SME lending are high, so are the risks.

Carlyle, Asian Development Bank ADB.UL, GE Capital (GE.N: Quote, Profile, Research, Stock Buzz) and Citigroup Venture Capital invested more than $100 million in Shenzhen-based loan guarantee company Credit Orienwise. By 2007, the company was one of the biggest of its kind in China, and was being lined up for an IPO.

But the investment unraveled. A Deloitte report from 2008 noted a Credit Orienwise general manager had disappeared, and was suspected of forging documents and using the company seal to grant unauthorized guarantees on third-party loans. The same report noted Credit Orienwise had written down over half of $250 million in loans at the time. Investors never confirmed their losses, and Carlyle still lists the company as an asset.

Fanger said Shoreline decided not to invest in loan guarantee businesses because of problems assessing the risks - yet the fund still faces risks.

A common fraud, said Fanger, is for entrepreneurs to strip pledged assets out of one company and move them to another. Shoreline's experience in suing hundreds of companies allows it to write contracts it can enforce in China's courts.

"When you invest in something you don't understand, you end up having companies defraud you, and poor structures that are not enforceable," he said.

(Editing by Denny Thomas and Ian Geoghegan)