AUSTRALIAN PRIVATE DEBT MARKET REVIEW 2024: A NEW RECORD MARKET SIZE OF AU$205BN AND IMPACTS OF RECENT REGULATORY CHANGE

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The Australian private debt market is experiencing remarkable growth, in line with global markets, with more companies discovering the diverse and flexible funding solutions available. This growth is further evidenced by the level of new fund raisings being undertaken, the continuous stream of mergers & acquisitions and the influx of talented and experienced professionals transitioning from traditional banking and funds management to private debt management.

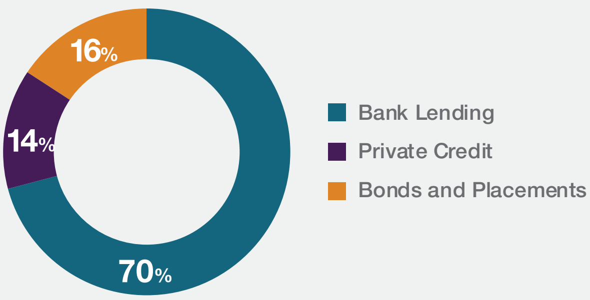
As the market matures, it’s natural for regulators to step in and ensure everything runs smoothly and transparently, minimizing systemic risks. In Australia, this has seen the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), and the Reserve Bank of Australia (RBA) now closely examining financial risk, transparency, and governance within the private debt market. These reviews are likely to lead to initiatives that enhance market transparency and align best practices with those of many long-established institutional private debt managers.

In our report, we provide an overview of the current trends, size and composition of the Australian private debt market and explore three areas of regulatory and industry change impacting the industry.

Australian Private Debt Market Size and Composition Update

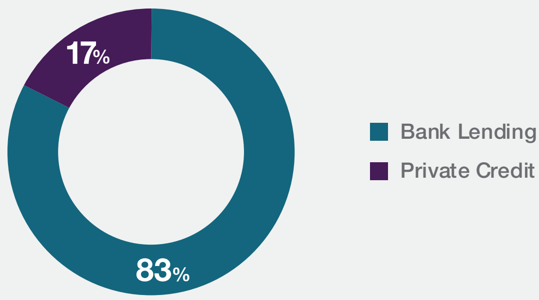
As at the end of 2024, our analysis of the Australian private debt market estimates its size at an impressive AU$205 billion in assets under management (AUM). This figure breaks down into AU$120 billion allocated to business-related lending, which encompasses all private debt mandates except for commercial real estate. This segment represents about 14 percent of the total business and corporate lending markets in Australia. Meanwhile, AU$85 billion is allocated to commercial real estate-related loans, accounting for approximately 17 percent of this lending segment. These insights are illustrated in the charts below.

Australian Corporate Lending Market



Source: A&M data and analysis, APRA, RBA

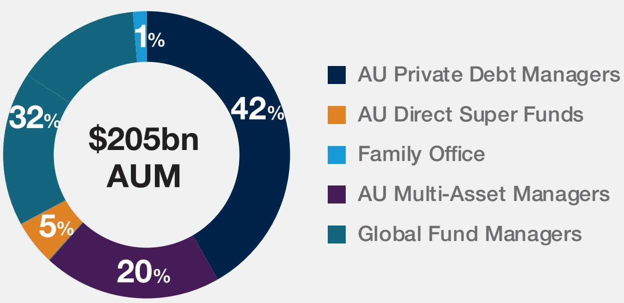
Australian Commercial Real Estate Lending Market



Source: A&M data and analysis, APRA

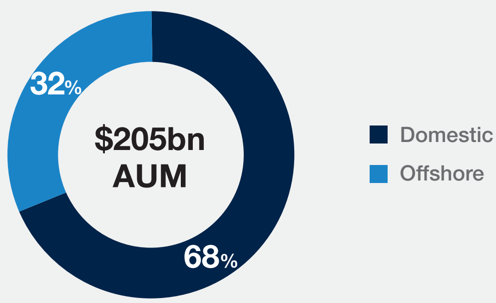
We have further split the private debt manager categories below into manager type and location, based on the data we have collated, to assist in understanding the mix of managers active in the Australian market.

Australian Private Credit Market by Manager Category



Source: A&M data and analysis

Australian Private Credit Market by Manager Location



Source: A&M data and analysis

To gather this data, we've conducted a thorough review of public information sources and engaged in confidential discussions with a diverse range of lenders. Our analysis spans the entire debt risk-return spectrum and targets a wide variety of lending markets, encompassing lending to businesses of different sizes, industry sectors and with a range of funding needs. However, it's important to note that we've excluded commercial bank lending, non-bank lenders financed through warehouse or securitization markets, and investors in public market bonds and securities from our review.

Best Practices in Valuing Private Debt

Private debt managers typically employ established credit market risk rating methodologies and adhere to accepted accounting principles to value their investments. However, these principles allow for flexibility rather than enforcing a uniform approach. With the spotlight on private capital and unlisted investments, there's been a surge of interest from investors and regulators in the transparency, consistency, and reliability of these valuation methods.

Currently, the valuation and impairment of financial assets under the Australian Accounting Standards Board's AASB9 accounting standards primarily follow two approaches:

Impairment Testing: This involves evaluating expected credit losses on assets valued at amortized cost. It's commonly used for funds held to maturity and in less liquid lending classes where external data is scarce. Impairment Testing aligns with AASB9 guidance for assets held to collect contractual cash flows.

Market Pricing: This method assesses the fair market value of assets using observable market data, such as quoted prices for similar transactions. It's suitable for assets held for trading, where the goal is to profit from changes in fair market value, and in segments with ample market data on comparable transactions.

Private debt managers choose one of these approaches for their internal valuations, guided by their external auditors and third-party independent valuation providers. In Australia, where there is a much less liquid secondary loan market and loan market pricing indices are lacking, these external audits and independent assessments offer an enhanced level of objective review on asset values.

Many managers in Australia already leverage independent valuations to improve investor confidence in their lending strategies, portfolio quality, and achieved returns. Regular, externally verified valuations provide crucial insights to internal investment committees and external investors, particularly in identifying stress points and assessing portfolio performance during external risk events, such as the COVID-19 pandemic.

These independent valuations and reviews also aid managers in securing external debt funding, such as back-leverage to boost returns, net asset value (NAV) funding for liquidity, or uncalled capital facilities to manage the timing of investor calls and distributions.

Major Changes to the Deductibility of Interest under Australia's Thin Capitalisation Rules

Australia's recent overhaul of thin capitalisation rules, which restrict interest deductibility, is poised to affect both corporate borrowers and lenders. These changes focus on the deductions permitted for related-party and third-party debt financing. The new rules introduce earnings-based limits on debt deductions, replacing the previous safe harbour and balance sheet-based gearing limits.

For most borrowers, these changes took effect on July 1, 2023. In Australia, thin capitalisation rules typically apply to foreign-owned Australian entities (referred to as 'inward investors') and Australian entities that own foreign entities ('outward investors') if their debt deductions exceed AU$2 million for the income year. However, 'financial entities' that meet a newly defined, narrower criteria can still utilise the old safe harbour and balance sheet-based limits.

The new tax rules provide for three tests that apply in order to limit an entity's debt deductions as summarised in the table below.

Test	Debt deduction limit	Comments
Fixed Ratio Test (default test)	The amount by which net debt deductions exceed 30 percent of 'tax EBITDA'	• Carry-forward denied deductions to later years (temporary difference) • Group entities (≥ 50 percent controlled) can share debt capacity
Group Ratio Test (elective)	The amount by which net debt deductions exceed the group ratio x 'tax EBITDA'	• Group Ratio = net third-party interest expense of the global consolidated group • No carry-forward of denied deductions (permanent difference)
Third-Party Debt Test (elective)	Only debt deductions on qualifying third-party debt	• Carry-forward denied deductions to later years (temporary difference) • Group entities (≥ 50 percent controlled) can share debt capacity

Source: Income Tax Assessment Act 1997

The Fixed Ratio test's reduction in deductions is expected to impact many debt funding arrangements across the market. Another critical aspect to consider is the Third-Party Debt test's limitation on security, which stipulates that external debt qualifies only if secured by Australian assets. This will prompt private debt lenders and banks to rethink how they structure security and debt facilities, potentially leading to the division of debt facilities into Australian and offshore security groups.

Further changes, known as the debt deduction creation rules, will affect corporate borrowers using related-party and cross-border financings to acquire related-party assets or fund distributions. These rules will also deny the amount of interest expense deductible from July 1, 2024, onwards.

Private debt managers must also ensure their governance frameworks align with the Australian Taxation Office's (ATO) Tax Risk Management and Governance Review Guide. This is crucial, as evidenced by the ATO's scrutiny of trustees across various funds, including managed and investment funds, which requires them to furnish detailed information on their tax processes and controls, as well as their understanding of third-party data governance obligations.

These regulatory shifts do, however, present an opportunity for private debt lenders, who generally enjoy greater flexibility than commercial banks in structuring debt facilities and their supporting security. Lenders should stay informed about these recent changes to offer suitable strategies or alternatives, especially when splitting the security structure could alter the risk profile of loans provided to either the Australian or offshore security group.

Funding Opportunities in the Energy Transition and Low Carbon Markets

As global markets rapidly evolve to support a low-carbon economy, it's important to examine how specific regulatory changes are impacting debt markets. Over the past year, we've seen the finalization of the Australian climate-related disclosures standards (AASB S2) and amendments to the Corporations Act 2001, which will require companies to include audited climate statements in their annual reports for periods starting as early as January 1, 2025. With a phased introduction of 'Directors' Liability', companies must also disclose comprehensive transition plans, including funding strategies, to address financially material climate risks and opportunities. This poses new challenges for banks and investors as they assess, monitor, and report on climate-related exposures within their portfolios.

As climate statements increasingly intersect with financial statements and influence decision-making, the emphasis on transition pathways will grow. Globally, transforming the economy to meet climate goals is expected to demand substantial funding—estimated at US$9.2 trillion annually, or about nine percent of global gross domestic product (GDP) according to McKinsey & Co. In addition to more traditional sources of capital this creates an opportunity for private debt lenders to meet the burgeoning demand across all funding channels. As banks retreat from 'brown' and at-risk stranded assets, private debt lenders have the chance to step in and capture these opportunities more frequently.

When engaging in transition financing, private lenders should ensure robust risk management practices, such as thoroughly understanding transition risk exposure and incorporating borrowers' transition plans into their due diligence processes. While the shift towards a low-carbon economy represents a significant structural change in capital allocation, it also presents opportunities. These arise from the substantial funding required for energy transition and climate-related initiatives, as well as from corporates developing transition plans, which may lead to the repositioning of existing business portfolios to ensure continued access to capital on favourable terms.

How A&M Can Help

A&M Debt Advisory helps companies to plan, select, source, negotiate and amend debt facilities across a range of debt markets and funding structures. Debt markets are more sophisticated and more complex than ever before. The A&M Debt Advisory team supports borrowers in navigating those markets and is well-equipped to support its private equity and corporate clients through the economic cycle, providing high value-add advice on debt raising, capital structure optimisation and navigating challenging situations.

A&M also brings operating and management expertise combined with top-tier consulting and specialised industry experience to meet the changing needs of companies and investors. A&M is well-positioned to assist you with specialist tax, environmental, social and governance framework (ESG) and valuation experts in addition to broader offerings around performance improvement, regulatory & risk advisory, disputes & investigations, restructuring & turnaround, digital and corporate M&A services.

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