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Hurdles limit Chinese NPL trades to small group of international investors so far; includes PAG, Oaktree, GS

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Non-performing loan (NPL) sales in China could be a massive opportunity for international distressed investors but so far just a handful of transactions involving non-domestic players have materialized this year despite a concerted effort by regulators to expand the buyer pool.

Among the early buyers are Asia-focused alternative asset manager PAG, Los Angeles-based Oaktree Capital Management and Goldman Sachs, but their exposure so far is relatively limited, according to numerous market sources. Other firms, including KKR and Avenue Capital Group, have touted the opportunities in cashing in on the growing pool of bad debt but have yet to invest, in part because pricing is often too rich and few foreign firms have an adequate presence on the ground to manage the diverse pools of credits. Domestic investors are also front-running whatever opportunities there are, a challenge that didn’t exist during China’s first major NPL sell-off a decade ago, two domestic, three international distressed debt investors and an advisory source all said.

Amid the slowing economy, Chinese regulators earlier this year began urging domestic banks to step up their NPL disposals. Industry players estimated that the potential scale of the market—NPLs and special mentioned loans that banks need to get rid of—could be upwards of CNY 10trn (USD 1.5trn), more than twice the official figures.

As of end-June, loans marked as non performing by Chinese banks climbed to CNY 1.4trn, and special mentioned loans—a ranking before moving down to NPLs—was CNY 3.3trn, according to a 10 August disclosure by Chinese banking regulator CBRC. Five Chinese national banks have so far launched seven non-performing asset-backed securitization products with a total amount of only CNY 7.4bn, according to disclosures on interbank bond market. Meanwhile, the first two trust products of earnings rights transfer of two regional banks’ non-performing assets sold in September with a total size of merely CNY 574m, according to Chinese media.

“Interest in Chinese NPLs is huge, but the bridge [to connect capital and assets] is human, which is not built up yet,” said Benjamin Fanger, the erstwhile founding partner of longtime Chinese NPLs investor Shoreline Capital, who this month formally launched his new distressed debt and structured credit platform, ShoreVest Partners.

Manpower and funding

One of the biggest challenges related to Chinese NPLs for international investors is simply staffing up a local team with the right skillsets, backgrounds and resources, according to the domestic investors, the first international investor and the advisory source.

Prior experience comes at a premium. Professionals who worked for the big four AMCs during the first round of Chinese NPL disposals between 1999-2005 have moved on to more straightforward investments, such as private equity, while local service providers with workout experience prefer to raise their own capital pools to invest in NPLs rather than assist international investors just to earn a commission fee, they said.

Apart from the need for experienced local manpower, international distressed debt investors—especially those with investment committees in New York or London—have expressed difficulty understanding Chinese legal documents on hundreds-to-thousands of claims typically featured in a NPL portfolio, Fanger said.

“Every distressed situation has its own challenge,” said James Feng, founder of Poseidon Capital Group, a Beijing-based investment management firm focused on distressed and special situation investment opportunities in China.

“For example, how do you go about changing land title usage? How do you transition illegal construction to legal? How can you turnaround a suspended construction project to a cash-generating property?” he said. “While AMCs also lack this type of expertise, they can partner with local developers who know the properties inside out.”

What international players do bring to the table is a sophisticated understanding of distressed investing—from due diligence to pricing—and the ability to raise large amounts of capital from global institutions willing to ride the cycle, Fanger said.

On the other hand, domestic firms with the skills and manpower to manage NPL portfolios are reliant on pools of domestic high-net-worth capital seeking a quick turnaround and have so far struggled to raise longer-term capital better matched to the non-performing assets' liquidity, according to Wu Ge, managing partner of Dove Capital, a Shanghai-based special-situation investment firm.

Narrowing the gap

Despite Chinese policy-makers stepping up their pressure on banks to deal with problem loans, it will likely take more time for banks to become comfortable selling larger NPLs or accepting lower prices, said the first and the second international investors and two internet platform runners involved in the sector. Larger transaction sizes should stoke more interest from international investors.

“For foreign investors, the bigger a portfolio the more likely you may find gold in trash,” said the first international investor, noting NPL bulk sales above CNY 10bn are still rare.

Chinese regulators recently began allowing provinces to set up additional AMCs to help increase competition by scrapping restrictions that gave the big four national AMCs oligarchic control to transfer/onsell bad loans, according to Chinese media in late October. In addition, the minimum NPL portfolio size has been shrunk to three claims, from 10, and local AMCs are now permitted to onsell the assets.

The policy change highlights Beijing’s determination to encourage more buyers to participate and to speed up NPL disposals, the second international investor said.

The policy will only make it easier for smaller domestic players to get into the game. Already, local asset-managers and regional high-net worth clubs formed by lawyers and collection-services providers are buying small portfolios or even single names, often exploiting their first-hand knowledge about the debtors, said all the sources.

“Everyone is jumping in,” the first international investor said.

by Zhou Ping

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