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China debt 'could prompt $7.7 trillion asset sale'

Privatization of state groups might draw foreign investors, says Citi

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Hazy sky covering Pudong district in Shanghai. (Photo by Kenji Kawase)

HONG KONG -- China's mounting bad debts might constitute a nightmare for Beijing as it tries to ensure more stable growth. But they are also fueling an emerging market that could be worth at least $3 trillion for foreign buyers of distressed assets.

Key sources feeding the growth of this market are state-owned enterprises, privatization of which is necessary to put China back on a sustainable growth path, according to Citigroup's chief China economist Li-Gang Liu.

Andrew Brown, partner for macro and strategy at ShoreVest, second left; and Allen Wang, TIH Investment Management CEO, left, at a conference in Hong Kong on June 1. (Photo by Joyce Ho)

Liu believes the process, if carried out seriously, will unleash 52 trillion yuan ($7.7 trillion) of assets into the market, assuming state ownership were to be sold down to between 40% and 50% in exchange for fresh funds needed for debt repayment.

"More than half of the funds could be supplied by China's own savings. The remaining [funding] probably will have to rely on foreign investors," said Liu, speaking at a Thursday conference in Hong Kong organized by market intelligence provider Debtwire. He noted that China's saving ratio currently stood at 47% of the country's gross domestic product.

"China will have to either open up its equity and capital markets for foreign participation ... or continue with the old ways to allow their enterprises to list in Hong Kong, Singapore, New York and elsewhere," he added.

Liu's theory is based on the belief that China's state-owned enterprises, struggling with declining profitability, will have difficulties in resolving their huge debts, which amounted to 65% of GDP in 2016. He estimated that the country's implied non-performing loan ratio was as high as 8.5%, with 41% of its bank loans concentrated in sectors plagued by excess capacity, such as steel, chemicals, mining, and oil and gas.

"If the government were to use [SOE's] future earnings to honor their debts, there is a great risk that China will follow the Japanese path to have at least five to 10 years of very sluggish economic growth," said Liu. He noted that the current credit down cycle was different from previous ones over a decade ago, when Chinese banks could resolve their soured loans through initial public offerings, amid rosy prospect of earnings growth that outstripped the level of GDP increases.

Andrew Brown, partner for macro and strategy at specialized investment firm ShoreVest, also suggested that China's distressed debt market could be worth at least $3.1 trillion, based on the Bank for International Settlements' calculation that the country's excess credit -- credit that is not producing economic growth -- stood at 30.1% of its $11 trillion economy.

Misclassified credits

"That does not even touch on the topic of how the banks have misclassified credits into various types of receivable instruments or wealth management products or interbank entrusted payments -- I can go on and on," said Brown. "That adds a significant amount to this."

Although the opportunities created out of credit misallocation were huge, the market is still underdeveloped, noted Brown, who characterized it as being largely "local," with "short-dated funding pools" buying small packages of non-performing loans.

"What we are seeing is that [deals are] predominantly done by smaller pools of capital that can only buy $10 million portfolios, even $5 million portfolios," said Brown, adding that their funding pools entertained just two to three years of lock-up, as the sources of funding were mainly from high-net-worth individuals or borrowings. This timescale was less than that usually required to resolve non-performing loans.

Allen Wang, chief executive of Singapore-listed TIH Investment Management, believed that a lot of effort should be put into aligning the interests of all participants in a deal, as there was no infrastructure deterring middlemen from fleecing.

But he also said the operating environment of China's distressed asset market had improved compared to the previous cycle, in which collateral was of low quality, and local judges lacked the knowledge to settle commercial disputes.

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