China tipped to see more NPL deal flow

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Bad debts accumulated by China's state banks have been targeted by distressed asset investors for about a decade, with mixed results. The high-profile auctions of the mid-2000s that attracted the likes of Avenue Capital and Mellon are no more. Foreign investors are enjoying the most success on the fringes, pursuing assets on a smaller scale in lesser known areas.

The four asset management corporations (AMCs) set up to handle bad debts emanating from the Big Four state banks, still have about $100 billion in legacy assets on their books, much of it from 10 years ago. Although sales of these non-performing loans (NPLs) has slowed markedly in recent years, Ben Fanger, co-founder of Shoreline Capital, thinks the deals could start to flow again.

"At the end of last year and early this year we received calls from AMC branch managers offering to sell loans," Fanger says.

The implication is that the AMCs, which were only set up to divest NPLs and therefore slowed progress for fear that they might divest themselves out of a job, are about to receive another tranche of assets from the banks. Given the explosion in credit growth in China since late 2008, this is hardly surprising.

Banks have employed various measures to minimize the impact of mounting exposure to NPLs on their balance sheets - even transferring assets to trust companies before the regulator stepped in and ordered an end to the practice. According to Fanger, one of the Shoreline partners was told by government officials that Beijing would employ a multi-pronged approach to the rising debt pile, which would include some assets being transferred to AMCs.

Even if NPL deal flow doesn't come from the AMCs in the volumes expected, the wider environment of credit tightening in China creates opportunities for distressed investors. While state-owned enterprises (SOEs) generally have little trouble getting bank loans, many in the private sector are by all accounts capital starved. If they are unwilling to sell equity in their companies, a shorter-term special situations solution might be the best option.

"The SMEs are having a hard landing but the SOEs are enjoying a soft landing," says Fraser Howie, a managing director at CLSA who recently co-authored a book that highlights the inefficiencies of China's financial sector.

Shoreline invests in a combination of NPLs and special situations opportunities, which account for 40% and 60%, respectively, of its $178 million first fund. The private equity firm is currently in the market for a second vehicle, with a target of $400 million. It typically acquires portfolios of NPLs at $10-40 million, paying on average as little as $0.05 on the dollar per asset.

Although many of the proprietary trading desks and hedge funds that were in the market in 2005-2007 have now gone, Fanger admits that distressed assets are generating more interest among foreign investors. "In the last six months we have seen increasing interest in private debt situations such as special situations and NPLs," he says.

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