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Distressed Funds Find Treasure in China's Mounting Bad Debts

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By Bloomberg News

(Bloomberg) -- The specter of more soured assets piling up in China is turning into a sweet spot for distressed debt investors seeking fat returns.

China Huarong Asset Management Co., the nation's largest bad bank by assets, expects cash returns of above 20 percent from distressed debt sales in this non-performing loan disposal cycle versus about 17 percent in the last clean-up a decade ago.

Guangzhou-based fund ShoreVest Capital Partners Ltd. Predicts the next three years to be a sweet spot for bad debt investment in China due as many lenders look to sell. KPMG China says now is the best time to buy as asset prices and returns will improve once the economy stabilizes.

While large U.S. distressed managers worry about not having enough bad debts to buy, investors looking at China are finding themselves busy amid a growing pile of soured assets. Non-performing loans at the country's lenders have doubled to 1.5 trillion yuan ($218 billion) in two years through 2016.

ShoreVest estimates the country to have about $3 trillion in distressed debt including account receivables, with the volume still growing. "There is a confluence of factors that is making NPL investments attractive now, it's perfect timing," said Andrew Brown, partner for macro and strategy at ShoreVest, which was founded in 2016 and is in the process of raising its first fund.

"Banks are being encouraged to dispose NPLs after taking significant provision in the past two years." Chinese banks' total loan loss provisions surged by 712.4 billion yuan in 2015-2016, from an increase of 499 billion yuan in the previous two years, according to official data.

Prices of NPLs sold by banks are competitive for buyers and "I do think it is a buyer's market today," said Simon Gleave, head of financial services at KPMG China, who has 17 years of experience in the NPL business in the country. "The asset management companies are clearly market-price focused. It's a good time to look at investments in China's bad debt market now because if economic growth stabilizes and asset prices pick up, returns would improve."

While China is targeting economic growth of about 6.5 percent this year, compared with an expansion of 6.7 percent in 2016, data this month showed growth on a firm footing after industrial output and fixed-asset investment topped estimates for the first two months of 2017. Premier Li Keqiang said earlier this month more market- and law-based methods will be used as China works to address the problems of zombie enterprises, encourage mergers, restructuring and bankruptcy liquidations.

At least eight onshore bonds have defaulted this year following 29 failures in 2016, which more than quadrupled from 2015. DCL Investment, a Beijing-based distressed debt fund, says the huge incoming supply offers a good window of opportunity. It looks at both non-performing bank loans and defaulted bonds. Its strategy is to take a lead role in the defaulter's bond restructuring. The firm plans to raise more than 10 billion yuan within the next five years, its president Zheng Hualing says.

Investors in the bad debt space are facing more competition in the past year. Local governments have set up asset management firms to deal with regional debt, while banks have more channels to resolve NPLs, including bad loan securitization and debt-to- equity swaps, says Steven Xu, a financial services partner at EY.

"There is increasing competition but the pie is big enough and we need more participants," said Brown from ShoreVest. "Our pipeline is still increasing meaningfully. It's rapidly growing."

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