PRIVATE EQUITY
ANALYST

Distressed Investors Wary of Riding China's Bad Loan Wave

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When **Oaktree Capital Group** unveiled a joint venture with **China Cinda Asset Management Co** . – one of the "bad banks" the Chinese government established in late 2013 as the official conduit for nonperforming loan deals – Oaktree said in a news release that the partnership would provide "a unique opportunity to participate in China's distressed debt markets."

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Business Caution

Almost two years later, however, the venture has yet to make its first investment, even as problem loans have piled up on Chinese banks' balance sheets. However, in July, Oaktree did have some success with a separate debt investor, Shoreline Capital Management, which teamed up with the Los Angeles firm to buy a portfolio of nonperforming loans for a total of $168 million.

Oaktree declined to comment for this article.

Oaktree's experience highlights the challenges facing global credit investors that look to capitalize on opportunities presented by slower economic growth and a surge in problem loans in China. Although active investors in the distressed debt of U.S. and European companies, firms such as Oaktree and **Goldman Sachs** Group Inc.'s special situations group have been slow to capitalize on the emerging distressed debt wave in China. The Chinese government's caution in opening up the market to foreign investors has made it less appealing, analysts say. Foreigners may also find Chinese bankruptcy laws and debt collection processes hard to navigate.

A SLEEPING GIANT

The total volume of China's nonperforming loans hit a new high since the global financial crisis in 2008. According to the **China Banking Regulatory Commission** , as of March 31, Chinese banks reported 982.5 billion yuan ($154 billion) in problem loans, up from CNY646.1 billion a year earlier and the highest level since the third quarter of 2008. The percentage of total outstanding loan volume that was nonperforming has also risen steadily since the first quarter of 2012, even as overall bank lending has increased, according to official statistics.

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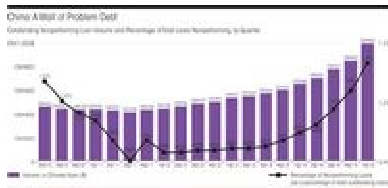


China - A Wall of Problem Debt
Credit analysts and investors say the actual amount of problem loans is likely much higher than stated in official statistics, if what are known as "special mention" loans are included, said Qiang Liao, a Beijing-based senior analyst with Standard & Poor's Ratings Services. Special mention loans are technically performing loans and have a lower default risk than problem loans, but could become problematic if the Chinese economy worsens, said Mr. Liao.

S&Pestimates that nonperforming and special mention loans combined account for 5% to 6% of total outstanding loan volume, compared with a nonperforming loan ratio of 1.39%, as reported by the Chinese government for the first quarter of this year, said Mr. Liao.

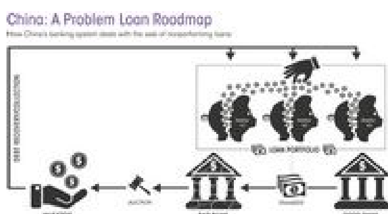
Robert Petty , co-founder and managing partner of Asia-focused credit firm Clearwater Capital Partners, agreed. "Every bank the world over makes judgment calls as to what loans fall into the substandard category," said Mr. Petty. "We think a more realistic ratio is 5%."

Investors and analysts say they expect nonperforming loan volume to continue growing. The loose monetary policy adopted by the Chinese government after 2008 has led to overcapacity in such sectors as manufacturing and mining, said Christopher Lee, S&P'smanaging director of corporate ratings for the Asia-Pacific region. That overcapacity, in turn, has reduced the profitability of some borrowers, many of which are state-owned enterprises.

"The companies have not been able to reform and have relied on banks" for financing, said Mr. Lee. "Overall, the picture is one that's very challenging."

Mr. Liao said that it takes time for problem loans to materialize and added that the current problem loan cycle began to emerge in the second half of 2013, when China's economic expansion began to slow. This time around, he said, more defaults are coming from larger companies, compared with the small- and midsize businesses that dominated defaults before 2013.

The pace of investing by global credit firms hasn't caught up with the opportunity set. Firms such as **Goldman Sachs** ' s special situations group that bought problem loans in China in the late 1990s and early 2000s aren't as active this time around. A Goldman Sachs spokesman declined to comment.



China - A Problem Loan Roadmap
The Chinese government hasn't made the process particularly welcoming because of what Mr. Liao calls "market access restrictions." In the late 1990s, the Chinese government set up asset management companies including Cinda as "bad banks" to take nonperforming loans off of the balance sheets of "good banks." The bad banks then auctioned off loan portfolios to investors such as **Goldman Sachs** .

About 15 years later, the asset management companies are still virtually the sole conduit for deal flow because investors, foreign and Chinese alike, aren't allowed to transact with banks directly, analysts and investors say.

More recently, China has expanded the number of asset management companies that can handle such loans, allowing each province to establish a local asset management outlet, Mr. Liao said. However, the provincial "bad bank" can only take loans off of the balance sheet of "good banks" in that province.

The cautious approach was a result of the Chinese government's experience during last distressed cycle, in the 1990s

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and early 2000s, during which the government determined some sales were conducted too hastily, further depressing asset prices, Mr. Liao said.
Ben Fanger, co-founder and partner of Shoreline, estimates that this time around, the total amount of nonperforming loans is more than four times the amount during the last cycle – only a sliver of which will be available to investors.

"The barriers to entry for foreign private equity or distressed debt firms [are] high," Mr. Fanger wrote in an email. For one, deal sourcing requires a "far reaching and diverse network of contacts" within financial institutions around China, he wrote. For another, the ability to underwrite risk requires experience in assessing the liquidation value of a company and in determining "what recourse is actually actionable in a Chinese court," according to Mr. Fanger.

Lastly, he wrote, exiting investments requires experience dealing with bankruptcy courts, identifying co-investors, and negotiating with borrowers and guarantors, among other things.

"Such sourcing, underwriting and workout abilities are difficult to obtain without many years of experience investing in bad debt in China," according to Mr. Fanger.

Mr. Petty of Clearwater seconded that view. "It's not a question of how big the market is," he said. "It's a question of buying good portfolios at the right price. The [asset management companies] get first choice and other purchasers end up with lower quality assets."

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