INVESTING

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Few foreign investors positioned for China NPLs

Firms don't have boots on the ground to take advantage of situation

By DOUGLAS APPELL

Benjamin Fanger touted the Chinese court system as being effective for certain collateral claims.

The same regulatory squeeze that's pushed property behemoth China Evergrande Group to the edge of insolvency this year is serving up opportunities for distressed debt investors.

But few foreign investment firms have the boots on the ground needed to take advantage of those opportunities, industry veterans say.

Beijing's "three red lines" policy, introduced in August 2020, effectively throttled the flow of fresh bank loans to China's highly-leveraged real estate developers, leaving a number of them struggling to honor their debts while opening up opportunities for local and foreign credit funds to fill the gap.

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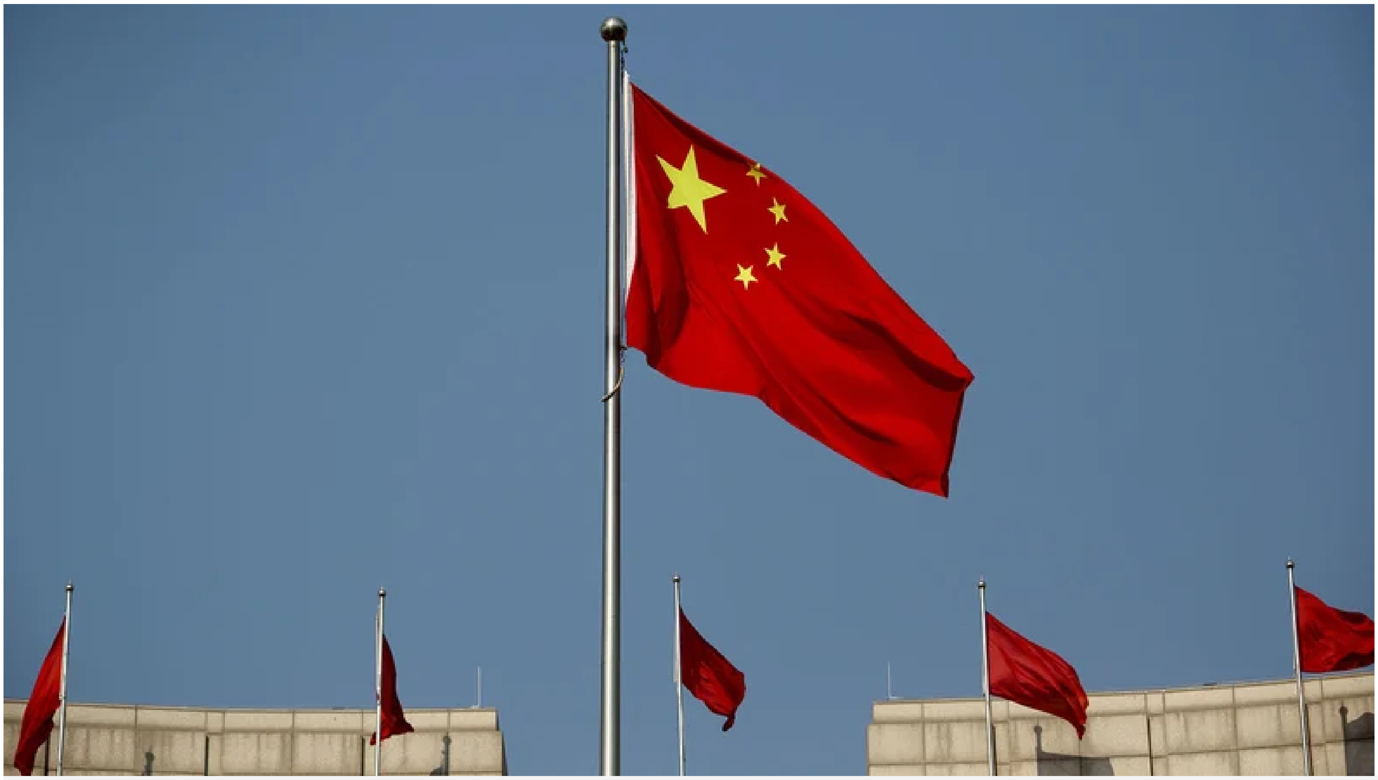
"From a macro point of view, clearly the ingredients are there for a massive opportunity — whether it's non-performing loans" or private credit … but "a number of factors make distressed investing in China incredibly hard to do and do well," said Patrick Cowley, KPMG's Hong Kong-based global head of restructuring services.

To be successful, a firm needs "to be in China with the right resources," with senior management accepting that this is a long-term play and planning accordingly, Mr. Cowley said.

That's proven particularly so with the COVID-19 pandemic making it harder for funds — with billions of dollars of institutional client money scouring the world now in search of double-digit re- turns — to deploy capital when they "can't travel to these places and kick the tires," said a restructuring veteran at a global law firm, who declined to be named.

Even as China's NPLs continued to surge over the past year — the country's banks wrote down or disposed of 3 trillion yuan ($465 billion) in non-performing loans in 2020, roughly double 2017's total, according to official data — one measure of foreign investor activity dropped from an already modest base.



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Purchases fall in 2020

Purchases by foreign investment managers of China loan portfolios — from the handful of bad debt asset management companies China's government launched during the global financial crisis to be the main intermediaries for disposing of NPLs — fell in 2020 to single-digit levels for the first time in three years, said Chen Lau, a Beijing-based partner with PricewaterhouseCoopers.

Portfolio purchases as well as the number of distinct foreign purchasers had been going up yearly but the COVID-19 pandemic interrupted that run, said Mr. Lau, a contributor to PwC's annual report on China NPLs.

Travel restrictions were one reason, as foreign investors, often based in Hong Kong, Singapore or the U.K., were unable to conduct due diligence, such as viewing the real estate collateral backing loans, Mr. Lau said. Likewise, the pandemic introduced uncertainties in areas such as the time needed to pursue collateral claims, with courts in some jurisdictions shutting down at times last year, he said.

Analysts say a handful of foreign investment firms — including Los Angeles-based Oaktree Capital Management and Boston-based Bain Capital LP — have established a local footprint on the mainland, but they've been the exception to the rule.

Both firms declined to comment.

There are very few foreign investment managers with the footprint in China needed to invest with confidence there, said Jonathan Leitch, a Hong Kong-based partner in the restructuring and special situations practice of law firm Hogan Lovells.

In a market where the particulars of the company facing insolvency proceedings often determine how collateral-related claims are handled, it can take time for investors to get the lay of the land, analysts say.

It probably takes years to be able to identify which assets are important enough to a local jurisdiction to make their disposition problematic; for example, if the company involved has enough employees to make its demise a source of social unrest, Mr. Leitch said.

"I think it takes investors a long time to figure out which loans they can make money from and which are just going to give them noise and trouble" — a learning curve that can be accelerated by having "boots on the ground," he said.

Executives with firms that have gone the local route say they've managed to roll with those punches.

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Collateral claims

China's court system works very effectively for collateral claims, "otherwise we wouldn't have been investing in the space for a decade and a half," said Benjamin Fanger, founder and managing partner of ShoreVest Partners, a Guangzhou-based distressed debt and opportunistic credit boutique.

"The most important distinction is really down to the specific loan," Mr. Fanger said.

"If you're trying to enforce the loan where the collateral is just an empty office or a warehouse and nobody's going to be fired, nobody's going to be kicked out of their home, that's something that can be done in 18 to 24 months," he said.

"On the other hand, there are many things that in practice are not enforceable because the government prioritizes social stability" and a bankruptcy would lead to too many people losing their jobs or their homes — a situation where, unsurprisingly, a judge might delay proceedings, Mr. Fanger said.

"It just means that we can't lend to situations like that or use that as collateral and it also means that we wouldn't purchase (those) NPLs," he said.

Evergrande should prove to be a textbook example of that distinction. Market veterans predict Beijing will carefully limit the ripple effects of its debt woes, ensuring that the developments the company pre-sold to millions of customers get completed and their subcontractors paid. "Evergrande itself isn't going to be a big distressed debt story," said Dinny McMahon, Chicago-based author of "China's Great Wall of Debt."

Even so, the current moment is an auspicious one for ShoreVest, with the regulatory environment that caused Evergrande — the second-biggest developer in the country, struggling now to pay down more than $300 billion in outstanding debts — producing "huge opportunities" for both its NPL business and its opportunistic credit business, Mr. Fanger said.

In contrast to the global financial crisis when China's decision to flood the market with cash created a challenging environment for distressed debt investors, this time around Beijing has remained firmly on a derisking and deleveraging path, imposing ever-stricter regulations on banks for recognizing bad loans, Mr. Fanger said.

That's resulted in an environment where returns are higher, said Mr. Fanger, who called the current moment "the best of times" in a 20-year career buying NPLs from banks at steep discounts to underlying collateral value and extending asset-backed loans to corporations in China.

ShoreVest just completed investing its latest fund, which closed at $350 million in institutional money. "Our next fund will be $500 million," with a first close likely to be announced by the end of the year, Mr. Fanger said.

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Government's wishes

Bringing more institutional money to China's credit market — including to distressed debt workouts — is "in line with what the government wants to happen," following its success in dismantling a shadow banking industry where retail investors had backed hundreds of billions of dollars of loans to the real estate sector, Mr. Fanger said.

The government "would much rather have a private credit market in China … backed by pensions, insurance companies, institutional investors, investing through funds that are institutional," he said.

Being on the same side as the government is a point that investors globally could find reassuring after Beijing's decree earlier this year forcing listed after-school-tutoring companies to convert to non-profit institutions, wiping out tens of billions of dollars of market value.

If China's NPL pool is set to continue growing rapidly, market veterans predict foreign manager participation is likely to grow more modestly. One reason: The government — with an eye to financial market stability — is likely to keep a tight grip on the pace of new NPL dispositions, ruling out the kind of market-clearing volatility investors dream of.

In China, "you never get that … big bang moment, where the system is awash with bad loans and prices plummet disproportionately," offering the chance to buy distressed loans at pennies on the dollar, noted Mr. McMahon.

Investors can find plenty of opportunity in China's NPL market but the potential returns pale when stacked up against that "El Dorado" moment looming large in the popular Western imagination, he said.

Meanwhile, overseas distressed debt players will continue to look at the opportunity set on the mainland through the prism of the opportunities available to them in other major markets, and some expect the balance of risks and rewards to become more enticing elsewhere.

In five or 10 years' time, interest rates could rise in developed countries, resulting in more defaults of overleveraged companies there, allowing investors to focus on opportunities in jurisdictions they feel more comfortable with, Mr. Leitch said.

Nonetheless, market veterans concede that continued reforms by China could lower the barriers for foreign investors going forward.

In May, for example, China announced a pilot mutual recognition scheme for insolvency courts in Hong Kong and Shanghai, Xiamen and Shenzhen, including the creation of specialist bankruptcy courts. KPMG's Mr. Cowley called that development a "huge step in the right direction," even if the pace of change is likely to remain gradual.

PwC’s Mr. Lau said Beijing’s commitment to continued financial services and legal practices reforms makes him optimistic the number of foreign players setting up local entities or working with local partners on China NPLs will rebound as the COVID-19 overhang fades.

In July, Warburg Pincus LLC, the New York-based private equity firm, announced it and special situations credit manager Wensheng will establish Wensheng Special Situations Asset Management Co., focused on “single credit real estate special situations investments,” according to a Warburg Pincus news release.

The news release provided no details on the two firm’s respective ownership stakes. Lisa Liang, a Beijing-based spokeswoman for Warburg Pincus, didn’t respond to requests for comment.

ShoreVest's Mr. Fanger predicts a bigger change in focus could be afoot, favoring China's credit markets.

If the focus over the last few decades was on the development of the equity markets in China, "there's a good chance that the next few decades will see the development of the credit markets," Mr. Fanger predicted.