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China

Huarong chief warns of bubble in China's distressed debt market

Lai Xiaomin says onslaught of inexperienced investors has pushed asset prices up 10%

A bubble in real estate has led to a steady flow of bad debt in China © Bloomberg

YESTERDAY by: Don Weinland in Hong Kong

Bubbles in credit and real estate have led to a steady flow of bad debt in China for years. But now a bubble is forming in the market for the bad loans themselves, says the chairman of China's largest state-controlled "bad bank".

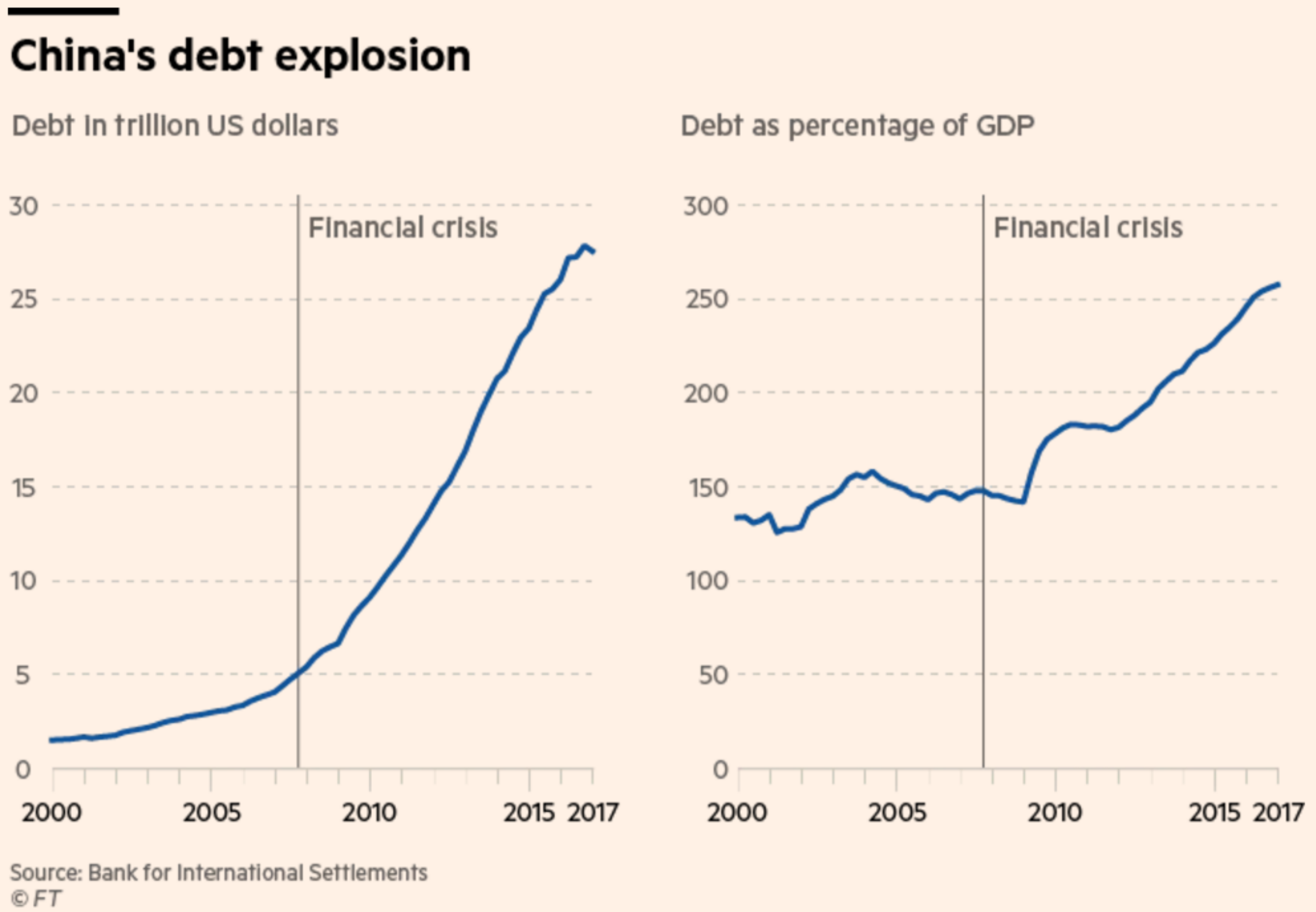
Banks in China are dealing with an onslaught of non-performing loans that have resulted from poor risk controls and years of loose monetary policy. Investors estimate that China's stock of bad debt has risen to $3tn this year, in step with a decelerating economy. One prominent analyst said recently that the figure could be as high as $6.8tn.

As the pool of bad assets rises, so too has the number of Chinese investors willing to chase after bad debt portfolios.

But many of the newcomers had little experience investing in distressed debt and were pushing up prices for the assets at auctions, said Lai Xiaomin, chairman of China Huarong Asset Management, and a deputy to the 12th National People's Congress.

Inexperienced investors presented the risk of creating new losses while also failing to resolve troubled loans, he said.

"There is a bubble in the price of bad assets... There are more investors driving up the price through competition," Mr Lai told the Financial Times. "If you don't understand the market for bad assets or asset restructuring and merging, for non-professionals there is big risk. Not only will you not make money, you will also lose money."



Over the past three years, competition from new investors had pushed the price up by at least 10 per cent, he said, calling for more regulatory oversight of the market.

Some of the overpricing in the market was likely to have come as new funds rushed to get their first deals done, seeking to prove to investors they understood the market, said Benjamin Fanger, managing partner at Guangzhou-based distressed debt investor ShoreVest.

Regulators have loosened controls on the investors that can buy distressed assets, causing a swift increase in the number of buyers.

“Somewhat under the radar, there has been a significant proliferation in the number of small-to-medium-sized funds chasing these assets,” Jason Bedford, an analyst at UBS wrote in a report earlier this year.

The influx of new buyers had mainly been seen in large cities as they attempted to get in on highly publicised auctions, he said. The less obvious and more complicated deals — particularly outside of China’s biggest cities — were often left untouched.

“In first tier cities like Shanghai, Shenzhen and Guangzhou, we do see new, inexperienced entrants buying their first NPL portfolios in what seem to be prices that don’t account for the time or risks in workouts,” Mr Fanger said. “Some new investors assume they’ll be able to get full appraised value for underlying collateral and this is a faulty assumption.”

ShoreVest is one of a handful of foreign investors buying distressed debt in China, although the number has increased this year. US-based Lone Star and Bain Capital, as well as Hong Kong’s PAG, started Chinese distressed debt investing during the past year.

China has experienced steady deregulation in how distressed debt is bought and sold since the industry was launched 18 years ago.

Huarong, along with three other centrally controlled asset managers, was created by the ministry of finance in 1999 to absorb perilously high levels of bad debt from China’s largest commercial banks. At the time, the government directed banks to transfer $1.4tn to the four groups.

Since then, the asset managers have greatly expanded their businesses in China and globally, operating more like investment banks than bad debt investors. Huarong went public in Hong Kong in late 2015.

Huarong sells about 70 per cent of the distressed assets it buys and attempts to restructure about 30 per cent, according to Mr Lai. This positions the group as a broker of bad debt, which would benefit from having the maximum number of investors.

Source: https://www.ft.com/content/c5cde11c-8bb8-11e7-9084-d0c17942ba93