THE LAST WORD

SHORELINE CAPITAL

Opportunity knocks in the East

Shoreline Capital is one of just a few investors in China specialising in NPLs. Co-founder **Benjamin Fanger** talks to **Anna Devine** about changes in the region and the firm's oversubscribed third fund

Q This time last year, I understood that just a trickle of NPLs were coming to market. Has that picture changed materially?

Yes. The credit boom of 2009 to 2010 included a lot of loans that eventually wouldn't be paid back by corporate borrowers and now many have come due. In the last NPL cycle 10 years ago, the government took the losses, but this time, it is mostly directing the banks to handle it themselves.

There is quite significant flow now. But it is not flow that just anybody could come and invest in. A lot of these companies are in default, many of which have pretty serious problems. So unless you are a specialist in non-performing loans in China and you've been in thousands of lawsuits in China, like Shoreline has, in my opinion it's a very bad idea to try to invest in it.

Q Some senior secured products are alleged to carry equity-like risks. What's your view?

I'll give you an example of something that is worse than equity – let's say you have an operating company in China who needs capital and its parent company is in Hong Kong. Along comes an offshore lender who doesn't have experience or presence in China, or an understanding of how to get a financing at the operating company level onshore. So the lender writes a loan to the parent company in Hong Kong. In the documents, the company purports to pledge all the operating assets onshore, provides personal guarantees on loan and gives the lender certain debt covenants. But in reality that loan is worse than equity because you won't be able enforce it at the operating company level. By contrast, if you had equity in the parent company or better yet the operating company, at least you are one step closer to the operating assets, from a management perspective and a corporate governance perspective. So in this case, certainly equity onshore would be better than that debt at the holding company level.

Whether debt carries equity-like risks, as you say, depends on the structure that is being used, whether it's onshore or offshore, who has their hands on the assets and also whether the investor has any experience in Chinese courts enforcing debt. We've been in thousands of lawsuits enforcing distressed debt and have generally found the courts very useful. So something's working with both the legal system in China and the debt structures we have invested in.

Q What kind of deals are you seeing now?

This year we invested most of Fund III into almost 1,000 corporate non-performing loans across several coastal provinces, and the assets in general have somewhere between 65 and 85 percent senior secured loans, depending on the portfolio. They are much more secured and far higher quality than portfolios we were investing in during the last cycle. That being said, they are still non-performing loans, so they still have hair on them and situations that need to be worked on.

Q Are you doing lending other than buying non-performing loans?

This year what we find to be the most attractive opportunity is buying non-performing loans. I think the most risky of [lending in China today] ironically is non-distressed direct lending because there are trust companies, the P2P lenders, the wealth management product vehicles, the banks, all of these people competing with you. And so you might only be able to charge 12 percent or less, with less collateral coverage.

Q What kind of investors committed to your third fund?

Investors in Fund III include endowments, foundations, ultra-high-net worth family offices, sovereign wealth funds, corporate and public pension funds, and insurance companies from various countries.

[That's different from Fund I, which] had mostly just a few endowments and foundations that were really just looking for a very niche player in a space that nobody else could access.

Q Can you give us an idea of the kinds of returns you are targeting?

I would like to achieve the typical private equity target of 25 percent gross IRR. This can be achieved during times when there is distress in the system and banks selling distressed debt. But at other times when there aren't a lot of NPLs coming out, and China is not experiencing a lot of distress, it's much harder to get those kinds of returns through a credit strategy. ■

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