ShoreVest 新岸資本

China Debt Dynamics

Stricter Controls Crimping Local Funding

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Regulatory enforcement is creating tighter onshore RMB funding conditions

As we have written in previous articles, while the Chinese authorities continue to implement their "de-leveraging" and "de-risking" campaign in the Chinese economy, regulators have transitioned from *creating* new regulations to *enforcing* those regulations that are in place. This is now creating a ripple effect of reducing the access to new onshore RMB funding (as we have written before in previous China Debt Dynamics).

We are beginning to see tangible evidence of this development in several important forms, including: (1) further additional fines and penalties on financial institutions for breaches of prohibited accounting practices under Circular 46 (see "CBRC Stepping-Up Enforcement"), including the recent fine on Noah for mis-selling investment products; (2) the reduction in activity by RMB-funded NPL investment firms (i.e., both a reduction in fund-raising activity as well as a reduction in deal participation), and; (3) the recent suspension of several high-profile onshore, RMB-denominated bond issuances by several well-known property developers.

Additional fines for accounting breaches and/or taking undue financial risk – there have now been over 3,000 fines and penalties on banks and financial institutions since the audit findings in November 2017 as required by Circular 46, including 477 so far in 2018 totaling RMB3.2 billion (US $491
million). The recent reprimand and fine by the HK SFC on the Chinese wealth management firm, Noah Holdings, for breaking the rules on the sale of investment products (including KYC and due diligence matters which resulted in selling unsuitable investment products to clients), further highlights the authorities' continued enforcement and resolve to de-risk the financial system. We believe there are still more penalties to come given the significance of accounting breaches we believe that have yet to be exposed and addressed by the China Banking and Insurance Regulatory Commission (CBIRC);

RMB-backed NPL investment firms are under pressure – funding pressures are not only in the property development space, or in the over-leveraged corporates space more generally (e.g., HNA's recent funding challenges), but also in the local RMB-funded NPL space as well. In 2015 and 2016, there was a large increase in the number of RMB-funded NPL investment platforms being established, which were often times marketed to retail investors as wealth management substitution products with relatively high guaranteed coupon interest payments. But now with the crackdown by authorities on predatory and risky practices in the wealth management industry, we are witnessing local RMB-funded

new fund management companies established to raise RMB to invest in NPLs have essentially been halted during the past year, presumably because of concerns arising out of such groups raising money from less-sophisticated retail investors.

This is creating opportunities for ShoreVest as these local competitors ease away from the market, thereby reducing participation by less-sophisticated participants which were, shall we say, less prudent on pricing NPL portfolios than institutional platforms. We also note that this dynamic so far has not impacted downstream buyers of our sub-portfolio tranches, most of whom are smaller platforms with self-funded equity.

Importantly, this fall-off in demand is happening at a time when the supply of NPL portfolios coming to the market is increasing as a result of regulatory developments (see Circular 46 article). The net result is an overall improvement in pricing dynamics in the Chinese NPL market from the perspective of an institutional buyer with long term experience and capital.

Recent suspension of property developer bond issuance – This tightening on "non-standard" credit sources (i.e., wealth management products, entrusted loans, etc) has led to an increase in bond defaults this year, thereby affecting overall investor demand for bonds issued by highly leveraged companies. As an example, according to a recent report by Caixin, five listed property developers have recently withdrawn their planned domestic bond issuances totaling almost $6 billion just since the end of May.

Importantly, these suspensions came literally days after the listed company, Beijing Orient Landscape & Environment Co. Ltd, was only able to raise a mere 5% of its intended RMB1 billion in new bond issuance. This undoubtedly has tempered expectations by other Chinese property developers who likely would be concerned that any failed bond issuance of their own would draw scrutiny and skepticism over their balance sheet strength and bring concern over potential funding stress. Indeed, Chinese property developers are among the most leveraged globally. According to Caixin, the average debt-to-assets ratio of Chinese developers has now reached a record high of almost 80%, making them quite exposed to any disruptions in funding availability.

As a result, the timing of this regulatory-driven deleveraging campaign is creating a market dynamic whereby the supply of bonds coming to the onshore market is outstripping investor demand, exposing funding risks in the sector. The cracks are now beginning to occur - during the first five months of 2018, 15 companies defaulted on their bond maturities, involving RMB12.9 billion (US$2 billion), which is an increase of 34% versus the same period last year. And the number of defaults looks set to go even higher given that among the thirty-four listed developers on the A-share market, there is RMB81 billion (US$13 billion) of onshore bonds maturing in 2018, two-thirds of which mature in the second half of this year (RMB55.4 billion; US$9 billion. Source: Caixin). Indeed, funding strategies that rely on refinancing maturing debt as a source of repayment at a time when authorities are tightening credit conditions remain particularly at risk.

Will this force developers to sell-off inventory and affect collateral values? – The tighter funding environment raises the question of whether developers will be forced to sell inventory to raise cash in order to repay maturing bonds and deleverage their balance sheets, causing a drop in property prices as a result. This is certainly a possibility, but if it were to occur, it would not be a bad thing in our view. As property prices across China continue to rise (up 4.7% YoY in May, marking the 32nd straight month of growth), we believe an increase in supply is needed and is a desired outcome of the deleveraging campaign.

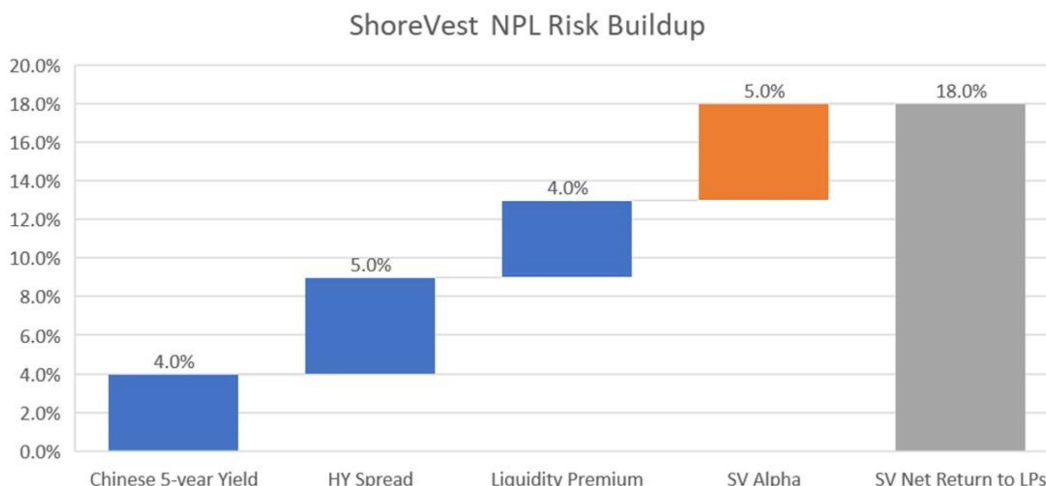
While of course we at ShoreVest watch these developments attentively, we would note that an overall moderation in the pace of growth in property prices, or even a managed decline in property prices, would be welcomed and in the best interest of the long-term health of the economy.

Having said that, and although we assign a low probability to it, should property prices drop meaningfully as a result of China's deleveraging campaign, we believe ShoreVest's strategy is well-protected through our underwriting approach, one which prices in already significant discounts to real asset market values.

There are three important topics for investors to consider in this context:

1. **Hierarchy and pricing** - when ShoreVest underwrites and prices an NPL portfolio, we create a significant margin of safety. Core to our strategy is taking senior secured positions at steep discounts to the underlying collateral value. Using a loan secured by a single piece of collateral as an example, we do this by taking the liquidation value of the collateral, which is discounted from market value (independently verified through a third-party appraiser we engage) by 20-60%, and assigning that value as the gross recovery. Fees and transaction costs are then taken out of the gross recovery value to arrive at a net recovery value, which is then placed as a terminal value out into the future. We then discount this back to present value using fairly high discount rates to achieve our targeted IRRs (see below). This combination of discounting from market value to achieve a rapid sale, and for the time value of money, means that property prices would have to drop signficiantly across the board before our margin of safety erodes to break-even, which is a magnitude to which we assign a low probability given the importance of property values to the Chinese economy;
2. **Diversified portfolio** - ShoreVest constructs NPL portfolios to have anywhere from a few dozen loans to as many as 1,000+ loans. This means that within a given fund, we end up having thousands of loans across many different geographies and underlying collateral types, thereby providing a significant level of diversification rather than having concentrated exposures. Meaning that if property prices were to decline in a particular geography or asset-type, the impact on the overall fund would be diluted;
3. **ShoreVest portfolios are arguably lower risk than China HY bonds** - we view Chinese developer bonds as riskier than our strategy for three primary reasons: (a) a High-Yield (HY) bond is a single credit risk and by definition is not as well diversified as an NPL fund; (b) our strategy does not involve development risk; rather our loans are generally secured by completed buildings and land that we price at liquidation value, not development value (as described above), and; (c) property developers employ asset level leverage in the form of bank loans (the very same type of bank loans that we purchase) that are senior to the claims of the HY bondholder.

As shown below, the risk build-up to the lower end of our targeted returns (net, unlevered, offshore IRR to LPs) allows for meaningful alpha in an asset class that is growing rapidly and is uncorrelated to most any other asset class.



So, as Chinese regulators continue to focus on enforcing existing regulations, and authorities continue their “de-leveraging” and “de-risking” campaign, pressures on local RMB-funding are bound to continue for some time to come. And during this time, it is therefore likely that we will continue to see local RMB-funded distressed asset investors continue to fall by the wayside.

This creates an improved investment environment and a unique timing opportunity for institutional platforms with long-term funding, particularly those with over a decade of experience navigating the space locally. ShoreVest remains well-positioned to capture this opportunity in an efficient, scalable, and institutional fashion.

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