THE WALL STREET JOURNAL.
WSJ.com

FEBRUARY 29, 2012, 11:22 AM ET

# Shoreline Capital's Fanger On China's Coming Debt Crisis

Last week in a Heard On The Street column, our colleague Tom Orlik wrote that a widely anticipated crisis of China's banking system had been delayed in part by China's ability to transfer bad loans held by local government borrowers to other entities, including state-controlled policy banks.

Photo courtesy of Shoreline Capital Management

Benjamin Fanger, co-founder of Shoreline Capital Management

However, Ben Fanger, co-founder and partner of Shoreline Capital Management, has a different take on the situation. Shoreline, which invests in Chinese distressed assets, has been a lonely prophet of China's coming distressed wave, with Fanger's predictions largely unheeded outside of the firm's circles of associates and investors. Now the firm may be gaining a more appreciative audience as it makes the rounds with prospective investors for its latest fund.

According to Fanger, although there are significant problems with loans held by local Chinese government entities, a bigger issue lies in the fact that in China, lending flows to state-owned companies rather than to their often more efficient private counterparts. We caught up with Fanger recently and asked him to expand on his view.

Q: Do you agree with the columnist's conclusion that investors waited for a Chinese banking crisis that never happened?

A: The WSJ article assumes that China need only handle the highly problematic local government infrastructure loans, but in reality far more loans have gone to corporations, many of which will also go bad. The article further suggests that China can handle the nonperforming loan problem by either transferring the loans to wholly government-owned entities, like China Development Bank, or by rolling over loans as they come due. China probably will do this, but it does not come without consequences. The likely corollaries are more inflation and broader economic wealth destruction resulting from the inefficient allocation of capital to low, zero or negative [return-on-investment] projects. If banks are forced to allocate more and more of their lending quota to rolling over bad debt, less is available for growth. So while it is true that the government has the tools to soften the blow to the banks, China has no magic wand to avert the broader loss to its economy.

Q: In your view, is there a crisis in the making in China's banking system? If so, when will it happen, and how bad is it going to be?

A: The seeds of a potential crisis started in 2008. In an effort to fuel growth, China more than doubled its loan book in the two years following the global crisis by increasing loans to both infrastructure and corporations. History tells us that such spikes in lending are almost always followed by a banking crisis, or at least a wave of bad loans that must be cleaned up. It also became clear that much of China's lending was being allocated for policy reasons, not creditworthiness. As concerns about inflation mounted and China slowed credit growth in 2010, banks lent to state-owned enterprises but left private companies and real estate developers starved for cash. Last year analysts estimated that between $1 trillion and $2 trillion of non-performing loans would eventually surface because of this lending glut.

Q: What does this mean for private investors like Shoreline?

A: The two-directional misallocation of lending produces two kinds of opportunities. When the Chinese banks lend too much to low return-on-investment infrastructure and state-owned enterprises, nonperforming loans are created that could eventually be bought and worked out by distressed investors. When banks don't lend enough to private companies, special situations investors can fill the void and demand senior loan-like security for private equity-like returns because the company can't go to the banks for capital. Shoreline invests in both opportunities.

The estimated $1 trillion to $2 trillion of nonperforming loans will probably only trickle out over the next decade, as China attempts to roll over much of the problem. But even if only 10% gets dealt with each year for the next decade, that is a $100 billion to $200 billion flow of nonperforming loans each year, in addition to the $100 billion or more still left from the pre-crisis period.