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The beauty and the beast of China's non-performing loans

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Chinese debt offers a huge opportunity for investors – provided they can find the information needed to take advantage.

Everything comes at a cost, and some would say that the cost of China's 4 trillion yuan stimulus package in 2009 is the mounting debt problem the country sees today.

The debt-to-GDP ratio rocketed to 282 percent in 2014, while the non-performing loan (NPL) ratio of the country's commercial banking sector has grown to 1.6 percent, reaching 1,186 billion yuan, according to the China Banking Regulatory Commission.

"We saw a large amount of NPL sales in the first wave back in the early 2000s, but it is nowhere near the size of today. It is four times larger now," says Benjamin Fanger, founder of US-based fund manager Shoreline Capital.

With the huge supply of NPLs, many foreign investors have started to show interest in a market that has barely been tapped since 2008. But while interest is one thing, inadequate information in the market means opportunities are limited to the courageous.

"For many years, it has been quite lonely for us. You can imagine before 2008, people who invest in China thought we were crazy because it was so easy to invest in real estate or growth equity and make easy returns," says Fanger, who has spent over 20 years in the country and is fluent in both spoken and written Chinese.

Shoreline is one of just a few investors in China which has been specialising in NPLs since 2004 and it invested more than $700 million in the space last year.

The NPL market has been quiet in recent years and the NPL ratio remained below 1 percent until 2013-14. Even the four big asset management companies set up by the Chinese government in early 2000 to handle NPLs have transformed from "bad banks" into multi-strategy financial companies.

However, the market has begun to see state-owned enterprise defaults and some corporates are suffering from over-leverage after the credit binge of 2009.

The percentage of Chinese-listed companies that cannot cover their interest payments with revenues has increased from 8 percent in 2010 to 18.5 percent in 2015, according to Natixis research.

This has made the banks uneasy and measures such as NPL securitisations and debt-to-equity swaps have been suggested by the government as a way of easing the pressure on balance sheets.

NPL sales are the fastest way for banks to offload their problematic loans, yet few successful transactions have been seen thus far.

"I would say the biggest challenge for NPLs is to price them accurately. Every loan in China has a different story, different collateral coverage and a different set of collateral documents that may or may not be enforceable," Fanger tells PDI.

Unlike investing in listed companies, where investors have plenty of research and reports from different institutions at their fingertips, the market for NPLs is more obscure.

The situation is further complicated by the local culture where most documents are in Chinese and investors are dealing with local SMEs with limited access to their accounts. To price the deal correctly, investors need to have their own view and a profound understanding of the Chinese market.

"Both the beauty and the beast of the NPLs in China is the low level of transparency," says Eddie Hui, managing director, PAG, the Asian alternative investment management firm. "Only with that, can you have the opportunity to make big money."

Compared with the first wave of NPLs, some overseas investors have accumulated more experience in the Chinese market and certainly have a better idea of what they can do with the loans or the related collateral.

Asset managers such as PAG, which set up its first office in Shanghai in 2007 and now employs over 70 people in China, are showing an interest in the Chinese NPL opportunity.

But even the enthusiasts recognise the difficulties in areas such as pricing.

"Pricing can be an issue even if you have found a 'perfect' portfolio, because the banks' reserve price can often be significantly higher than what investors want to pay," says James Dilley, a senior manager at PWC.

Investors and banks have very different commercial considerations. For the banks, selling a NPL means they have to recognise their loss. They are only willing to take this step when their balance sheets are under tremendous pressure. Even then, they will want to minimise the haircut.

For investors, with stated return requirements and an aim to maximise profits, their offer price will frequently be too aggressive for the banks to accept.

In addition, Chinese banks have to evaluate the political risk associated with the sale of NPLs. If an NPL sold to a foreign investor generates a large return, the bank will be perceived to be giving away state-owned assets on the cheap. Consequently, the banks are reluctant to sell NPLs to foreign investors at a large discount.

"Another challenge lies on the legal process of the transaction, if you look at an NPL, it looks nice, but whether you can put out your hands to grab it would be another problem," says Hui.

Howard Lam, partner at international law firm Latham and Watkins, sees other problems.

"For overseas investors, foreign exchange rate control poses a problem for the flow of their capital. The process of setting up an RMB platform to purchase the asset and get profit out of the country will be a very complicated procedure," he says.

Notably, regulations in China were tightened in the second half of 2015 to restrict investments in overseas stock markets and limit banks' foreign exchange operations to reduce outbound investment. This has lowered liquidity for foreign investors wanting to invest in the Chinese market.

"You need to have at least a medium-term of view as to whether you are willing to deploy a significant amount of time and resources in the Chinese market," says Hui.

"If you really want to get into this market, you need a sizeable and well-established platform with at least 10 to 20 people. When you are dealing with a credit investment of 100 million, you can ask one or two colleagues to handle it. But it doesn't work when you have hundreds of loans coupling with hundreds more documents."

Fanger's Shoreline started with eight people and has grown to more than 50 people today. The wider team includes trusted law firms and other relationships in the market.

Investors have to be careful with the various outsourcing services in China and new entrants may find it difficult to obtain the best service quality.

"Knowing the market and people well and being able to check their quality of work is important. We started off doing everything ourselves and got first-hand experience. Only after that can you determine whether the service providers are giving you a reliable resource," Fanger cautions.

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