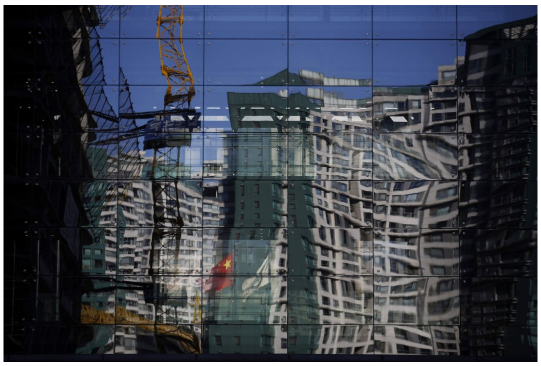
HEARD ON THE STREET

Thick Skins and Local Savvy Needed in China's Bad Debt Markets

Big-name foreign investors are being drawn to Chinese distressed debt. On paper, the market represents a big and profitable opportunity.



The risks of China's distressed-debt market? Property is key. A slump there would mean less value to be gleaned from the collateral behind most of the loans investors are buying. PHOTO: KIM KYUNG-HOON/REUTERS

By Andrew Peaple

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China has a huge pile of bad loans: Therefore, the country's distressed-debt market must represent a great opportunity. That's the logic Howard Marks, co-chairman of Oaktree Capital and other big-name investors are now pursuing. Foreign investors, including Blackstone and Goldman Sachs , have together bought 20 portfolios of bad loans in the past 18 months, according to PwC, investing some $1.5 billion—a "remarkable" pickup in activity, it says.

Mr. Marks and his peers may be right: Those following their lead should be cautious all the same.

The assumption behind the growing enthusiasm is that it is in Beijing's interest to take an enlightened approach. Chinese banks—officially—have some 2 trillion yuan ($287 billion) of nonperforming loans on their books, a figure most assume is much higher. Regulators would prefer to clean this all up gradually via the markets, rather than having to do a one-stop, massive bank recapitalization—or letting the problem fester, Japan-style, for years.

For this to work, foreign investors will be needed. The big Chinese asset-management companies, such as China Huarong, which swallowed up banks' soured loans during the previous cycle a decade ago, have evolved into sprawling financial conglomerates keener to act as market makers by offloading portfolios of bad debts this time round. China's crackdown on shadow banking this year has meantime lowered the domestic competition to buy up these portfolios.

The flood of soured debt, combined with the small number of market players, means plenty of bargains should be on offer. While it's hard to generalize about pricing given the often bespoke nature of deals, PwC reckons most investors expect internal rates in the 15% to 20% range before adding leverage—which is better than has been on offer in markets like Europe. Market participants say the legal backdrop in China has improved for distressed-debt buyers too: Gaining ownership to real-estate collateral typically now takes less than two years, for example, compared with three years to five years in the past.

The risks? The health of China's property market is key. A slump there would mean less value to be gleaned from the collateral behind most of the loans investors are buying—and it may also push the government to tighten capital controls, making it harder for investors to get their money out. And even though court processes have improved, foreign investors in situations where over-indebted companies are cutting jobs run the risk of quickly becoming a convenient boogeyman. China's distressed debt does look a good opportunity—for those with thick skins and a good dollop of local knowledge.

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