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Markets

U.S. Firms Could Win Lucrative Job of Cleaning Up China's Bad Debt

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- Deal allows U.S. firms to buy bad loans directly from banks
- Lack of experience, need for connections can be challenge

One surprising part of the trade deal struck between U.S. President Donald Trump and Beijing is that U.S. investors won a direct shot at the potentially lucrative job of helping China clean up its heap of bad debt.

China is embracing foreign capital as it grapples with a tide of soured debt. Some estimate it to have topped $1 trillion as the trade war weighed on economic growth and a long crackdown on shadow banking choked off liquidity.

The Communist Party-ruled nation is trying to instill more discipline in the market as corporate defaults have hit records for two straight years and its vast regional banking network struggles to cope. Growing participation by foreign investors could relieve pressure on the mainly state-owned firms that so far have been the front-line in dealing with the bad debt problem. It could also result in a more market-driven pricing of soured borrowings.

U.S. firms including Oaktree Capital Group and Bain Capital Credit have already been pushing into one of the world's biggest distressed debt market. The trade deal will allow financial services companies from the U.S. to apply for licenses to buy non-performing loans, or NPLs, directly from banks, cutting out the middle man they have to go through now.

"China's NPL market is large and growing, and opportunities for deeply discounted investments are enticing foreign firms with NPL experience in other markets," said Brock Silvers, managing director at Adamas Asset Management in Hong Kong.

Gaining access is one thing, but succeeding is another. Top-down run China can be an arbitrary place to do business, and local knowledge and contacts are required in the 1.4 billion person nation. Foreign firms have often grappled with unpredictable courts, fraud and challenges of sourcing bad loans. A web of local enterprises are often closely connected to regional banks and the local government, making it hard to navigate.

The market has grown significantly in recent years. But lack of experience has been an obstacle and many firms that stuck their toe in eventually pulled back because of difficulties in working out bad loans in China's system, according to Benjamin Fanger, a managing partner at ShoreVest Partners, a distressed debt firm.

"Some foreign investors are still continuing to push forward to try to learn and this new agreement opening to direct deals with banks might add more interest again," he said. "But doing Chinese NPLs requires a very significant commitment of time and resources to build up local sourcing, underwriting and servicing/exit capability."

The sheer pace in the buildup in soured debt is proving a potent lure. Bad debt held by commercial banks jumped almost 20% in the first nine months of last year to 2.4 trillion yuan, according to the China Banking and Insurance Regulatory Commission.

Data shows that overseas purchases of bad loan portfolios nearly tripled in 2018 to 30 billion yuan, Savills has said in a report. Active international players include Oaktree, Loan Star, Goldman Sachs, Bain, PAG and CarVal, according to the real estate and research firm. Savills said the overseas investors typically target loan books as large as $100 million, compared with domestic investors who seek to buy small batches of about $30 million. Targeted returns are usually 12-15%, unleveraged, or 17-22%, with leverage.

China's recent financial tightening has also led to opportunities for some foreign investors since some local investors are struggling to conclude deals, according to Savills.

While the trade deal applies to U.S. financial services firms, the government could potentially broaden the scope to include European firms in time, according John Xu, a Shanghai-based partner at Linklaters that advises international funds on buying nonperforming loans.

"The challenge is that there is a quota on the licenses per province, so there may not be sufficient licenses in some of the main provinces," said Xu.

ShoreVest Partners wasted no time in moving ahead and is in talks "with several provincial and municipal governments" about the new agreement and what the first steps would be toward obtaining an asset management company license, according to Fanger, a China bad debt veteran who speaks fluent Mandarin.

But further steps will be needed to tame the unpredictability of the Chinese market.

“If Beijing is to eventually get a handle on China’s over-indebtedness, it will have to allow for a predictable, rule-based nonperforming loan enforcement process,” said Silvers at Adamas in Hong Kong.

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