Vulture Investing

Welcome to the $1.5 Trillion Minefield of Defaulted Chinese Debt

A veteran investor reveals the pitfalls to avoid.

By Denise Wee and Rebecca Choong Wilkins

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It's tough to find a bigger bull on delinquent Chinese debt than Benjamin Fanger. The Mandarin-speaking founder of ShoreVest Partners, a Guangzhou-based asset manager, built his firm around the idea that there's money to be made from the nation's growing pile of distressed credit. He says the opportunity is larger now than at any time in the 15 years since he started analyzing China's nonperforming loans, or NPLs. He predicts it will only get bigger.

Fanger also says the $1.5 trillion-plus market is full of pitfalls. "If you don't have experience, it can be very risky," says the 43-year-old University of Chicago Booth School of Business alum, whose team has purchased more than 15,000 Chinese NPLs since 2004.

Distressed Chinese debt is attracting increased global attention, with defaults soaring even before the coronavirus pandemic and with President Xi Jinping's government peeling back restrictions on international investors. "In an era that could prove to be another global economic crisis, Chinese debt is counterintuitively looking more safe," Fanger says.

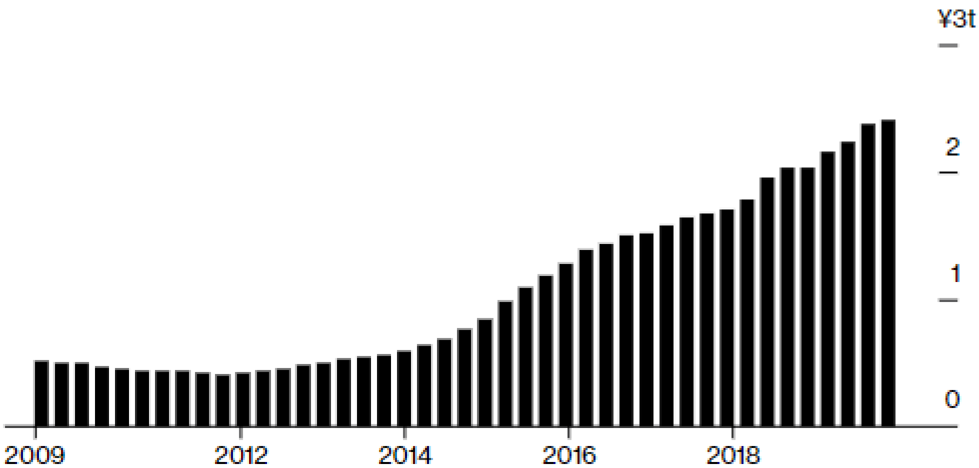
Oaktree Capital Group, the credit-investing behemoth led by Howard Marks, in February opened a wholly owned unit in Beijing to buy NPLs. The potential rewards are juicy. Fanger's team has generated double-digit internal rates of return on all of its NPL portfolios, according to a ShoreVest offering document seen by *Bloomberg Markets.* By comparison, Bloomberg's benchmark index for junk bonds in the U.S. yielded about 6% before a virus-induced spike in late March. In Europe, rates on some corporate bonds are negative.

Global money managers desperate for yield have a growing universe of beaten-down Chinese debt to choose from. The country had $1.5 trillion of NPLs and other stressed assets at the end of 2019, according to PricewaterhouseCoopers. And S&P Global Ratings estimates that past-due loans could jump by $800 billion if the coronavirus epidemic turns into a prolonged health emergency.

Even if China's economy bounces back quickly, delinquencies may continue to rise. The country's ruling Communist Party, which enabled one of the biggest credit booms in world history over the past decade by providing implicit guarantees for corporate borrowers, is now trying to tap the brakes. Policymakers have made it clear that bailouts are no longer a given; even some state-owned companies are defaulting on their bonds.

Default Deluge

Value of China's non-performingloans



Source: China Banking and Insurance Regulatory Commission

But buyer beware. Veterans of distressed investing in the West may find their playbooks of little use in China. So *Bloomberg Markets* asked Fanger, Marks, and other specialists how to navigate the minefield. Below are some of the key takeaways.

Avoid social unrest

This is one of Fanger's guiding principles, and it applies to more than just layoffs and idled factories. When considering real estate debt, for instance, he avoids situations that might force people from their homes. "If a developer got into a cash-flow bind and has contractual purchase and sale agreements with families who think they are buying units, when you go to the court to enforce, the court is likely to delay," he says.

Another tricky area: companies that issued debt to individual savers through asset management products or peer-to-peer lending platforms. "If retail investors invest in mezzanine debt sold through these products and you buy a senior loan, there could be social unrest if retail investors know they are going to be wiped out," Fanger says. The upshot: Think twice before buying that senior loan. While China's government has shown an increased willingness in recent years to let its citizens bear the brunt of poor investment choices, authorities are still loath to make decisions that might send angry people out into the streets.

State support matters

One of the biggest challenges of buying Chinese corporate debt is working out the borrower's ties to the government, says Soo Cheon Lee, chief investment officer at SC Lowy, a credit-focused banking and investment firm. "China is not about the financials, it's about relationships," Lee says. "That's driving a lot of the liquidity available to a company. You really need to understand the local landscape, and it's difficult for foreign players to understand who has that connection or support from the state."

Sometimes a Chinese company will appear to be in dire straits, only to come up with the cash for a debt payment at the last minute, Lee says. "For most of the companies in Asia, we know two weeks before whether they have financing or if they are going to restructure," he says. "I think it's very unique for China to not be able to predict a default."

Some firms are not what they appear to be, Lee says. "If you are truly a state-owned enterprise," he says, "you will continue to get support from the government or state-owned banks. But when we look at companies that claim to be SOEs but aren't really SOEs, we see they're having some difficulties."

Develop local expertise

For CarVal Investors, which oversees about $10 billion in credit and alternative assets, getting comfortable with China meant tapping the local knowledge of Shanghai Wensheng Asset Management, a distressed debt specialist. The two firms have teamed up to purchase two portfolios of NPLs since 2018.

"Today there are domestic investors and servicers that have experience, and that leads to a much better opportunity if you can team with a smart local investor," says Avery Colcord, a Singapore-based managing director at CarVal who's spent about two decades in China. He says the firm would like to buy more NPLs but has taken a cautious approach after "aggressive" bidding by some domestic managers pushed up valuations. At Oaktree, Marks says the firm has also been moving slowly as it builds local expertise. "We're feeling our way and getting used to a new market," he says.

Sweat the details

One major advantage of having a strong local team is that it's more likely to notice the little things that can make or break an investment, says Ron Thompson, managing director of Alvarez & Marsal Asia, who leads the firm's restructuring practice. Property-related deals in particular often require extreme levels of due diligence. "If you have the whole building, it's easier, but if you have just the third floor, you have to figure out who owns everything else," Thompson says.

"You have the third floor, but the elevator might be controlled by the debtor, or the mafia. Will you be able to access the floor? Who else can buy it?"

Savvy borrowers will frequently structure their debt in ways that give them leverage. "For instance, you take a block of land, divide it into five, and deliberately default on the middle piece first," Thompson says. "That's really worth nothing, because there's no access. And then the debtor will buy it back, gradually aggregate it, and they'll only pay market value on the last piece."

Thompson stresses the importance of hiring lawyers who know their way around the domestic court system. While Chinese authorities have pledged to move toward a more efficient and predictable process for dealing with defaults and restructurings, judges in small, poorer provinces are more inclined to help out down-on-their-luck entrepreneurs. "Going more for local insight is critical in China," Thompson says. "There are things you could miss without it."

Liquidity is key

Distressed debt managers in China sometimes overestimate the liquidity of a loan's collateral, says James Dilley, a Hong Kong-based partner at PricewaterhouseCoopers. It's crucial because selling assets is often the only way for creditors to get repaid quickly.

Many distressed situations involve real estate, which requires understanding local property markets. It might be easier, for example, to find buyers for a building in more developed provinces on China's eastern seaboard, such as Jiangsu and Zhejiang, than in less populated inland cities. Some investors have seen their returns suffer because property sales took longer than expected, Dilley says, and "getting that right is key."

Wee and Choong Wilkins are credit market reporters for Bloomberg News in Hong Kong.

Source: https://www.bloomberg.com/news/articles/2020-04-06/defaulted-chinese-debt-is-a-1-5-trillion-minefield