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World's Biggest Debt Load Lures Distressed Funds to China

By David Yong - Jun 26, 2014

Distressed debt funds are raising cash to seek greater opportunities in China, where Standard & Poor's says corporate borrowing topped the U.S. last year.

Planned commitments to funds investing in Chinese and other Asian troubled assets are set to surpass $2 billion this year, up from $303 million in 2013, data from researcher Preqin Ltd. show. Morningside Group Holdings Ltd. in Hong Kong plans a $103 million vehicle, Preqin said. Guangzhou-based Shoreline Capital Management Ltd. is seeking $500 million for its third distressed-debt fund, according to co-founder Ben Fanger.

China's economic growth has slowed to the least in more than a decade even as companies increased debt to $14.2 trillion as of Dec. 31, surpassing the $13.1 trillion in the U.S., according to a June 15 S&P report. Non-performing loans jumped the most since 2005 in the first quarter and state-owned asset management companies are raising funds to help clean up lenders' balance sheets.

"Now that China is facing slowing growth and the banks are selling bad loans, distressed opportunities have multiplied," said Fanger at Shoreline, which manages about $650 million of assets. "We have begun investing in NPLs again, as well as rescue and bridge financings."

Bad Loans

A person who answered the main line for Morningside yesterday and wouldn't give her name declined to comment, and there was no immediate reply to a question submitted through the firm's website.

Distressed debt funds operating in China face a market dominated by four so-called bad banks that enjoy state backing. The government set up China Cinda Asset Management Co., China Orient Asset Management Corp., Huarong Asset Management Co. and Great Wall Asset Management Corp. in 1999 to help rid the banking industry of 1.4 trillion yuan ($225 billion) of non-performing loans.

Shareholders in Cinda include UBS AG, Credit Suisse Group AG and JPMorgan Chase & Co. The company had 229 billion yuan of distressed assets at the end of 2013, up from 140 billion yuan in 2012, according to its bond prospectus. Some 8.3 billion yuan, or 71 percent, of pretax profit in 2013 was generated from loan restructuring and asset recovery, as well as from debt-to-equity workouts.

China's $586 billion stimulus begun in 2008 to deal with the fallout of the global financial crisis caused a record buildup of debt and inflated property bubbles. That credit boom "sowed the seeds of the NPLs that are now being transferred from the banks balance sheets," Shoreline's Fanger said. The previous cycle of soured lending was after the Asian financial crisis when the bad debt was sold around the time Shoreline was started in 2004, Fanger said.

Economy Cools

Foreign investors that earmarked as much as $10 billion to buy China's bad debt around that time missed out on the opportunity as the government limited purchases, according to a 2006 PwC survey.

Premier Li Keqiang has sought to rein in credit expansion, particularly in the off-balance sheet shadow-banking industry, by tightening lending and curbing real-estate price speculation. He must balance such steps with efforts to meet a 7.5 percent economic growth target, after 7.7 percent expansion in the previous two years, which was the slowest since 1999.

The yuan gained 0.07 percent to 6.2208 per dollar as of 11:27 a.m. in Shanghai, according to China Foreign Exchange Trade System. The currency has weakened 2.7 percent this year, the worst performance among major Asian currencies. China's 10-year government bond yield has declined 51 basis points since Dec. 31 to 4.05 percent.

Debut Default

Nonperforming loans rose by 54 billion yuan in the first quarter to 646.1 billion yuan, the highest since September 2008, the China Banking Regulatory Commission said on May 15. That's 1.04 percent of total lending, up from 1 percent on Dec. 31.

China experienced its first onshore bond default in March, when Shanghai Chaori Solar Energy Science & Technology Co. missed a coupon payment on 1 billion yuan of notes. Premier Li has said that more nonpayments may be inevitable.

Closely held developer Zhejiang Xingrun Real Estate Co. collapsed in the same month under 3.5 billion yuan of debt. China Forestry Holdings Co. defaulted on $180 million of bonds on June 16. The Beijing-based timber producer will extend a plan to buy back its dollar notes to Dec. 24, it said in a June 25 filing.

One-year A+ rated local-currency debentures have lost 10.8 percent this year through yesterday, after rallying 32.2 percent in 2013. The yield averaged 8.3 percent compared with 7 percent last year.

Shoreline Targets

Yields still aren't high enough to reflect potential risks as the economy cools, according to Cheng Peng, head of investments at Beijing-based Genial Flow Asset Management Co.

"Most high-yield bonds were issued by private companies," Cheng said. "We're concerned about their credit fundamentals." Bonds rated A+ or below are deemed junk bonds, Cheng said.

Shoreline expects to fully invest its third fund faster than its first two because there will be more opportunities to buy larger pieces of bad loans from banks now than in 2004, and also lend capital to cash-strapped companies that are still viable, Fanger said.

Credit risk remains the biggest threat to the economy, according to Amy Zhuang, an analyst in Copenhagen at Nordea Markets, a unit of northern Europe's biggest financial group. She met manufacturers in Beijing, Shanghai, Tianjin and Wuxi, and spoke with officials at Bank of China Ltd. and China Banking Regulatory Commission over three weeks in May.

"If China's credit-bubble bursts, it will likely be triggered by rising corporate defaults, not so much from a collapse in the housing market," she said in a phone interview on June 25.

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