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‘Opportunity of a lifetime’ for distress investors as companies from HNA to China’s LVMH flounder and bad debts balloon

Bulk of China’s coronavirus-related NPLs to hit market in 2021-22, says debt investor ShoreVest

Buy quality and look before you leap, says junk bond king Michael Milken

Topic | Central Banks

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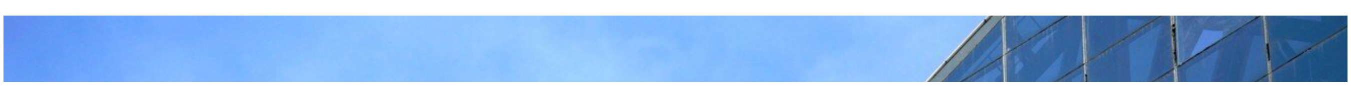
Peking University Founder Group, controlled by China's most prestigious university, was unceremoniously advertised for sale on a national website for failed companies this month. The bankrupt group will meet creditors on April 30.

Other once marquee Chinese companies are in talks with holders of their debt as the coronavirus pandemic ravages the world's second-largest economy.

Conglomerate HNA hurriedly convened a meeting with its yuan-denominated bond investors while credit rating agency Moody's downgraded Shandong Ruyi, the country's answer to LVMH, to deep junk in March, saying its debt-fuelled acquisition binge on global fashion brands made refinancing of debt due this year doubtful.

Chinese companies' pain as they grapple with the most dramatic slump in global demand since the Great Depression has created an opening for a small band of investors to provide emergency funds, buy soured loans and hoover up debt at cents on the dollar.



HNA battles with creditors for breathing space to restructure. Photo: Reuters

Los-Angeles-headquartered Oaktree, Boston-based Bain Capital, China's Citic Capital and others have amassed funds and assembled specialist debt teams for just such a calamity. Such investors have raised US$10.6 billion over the last two years, said data provider Preqin.

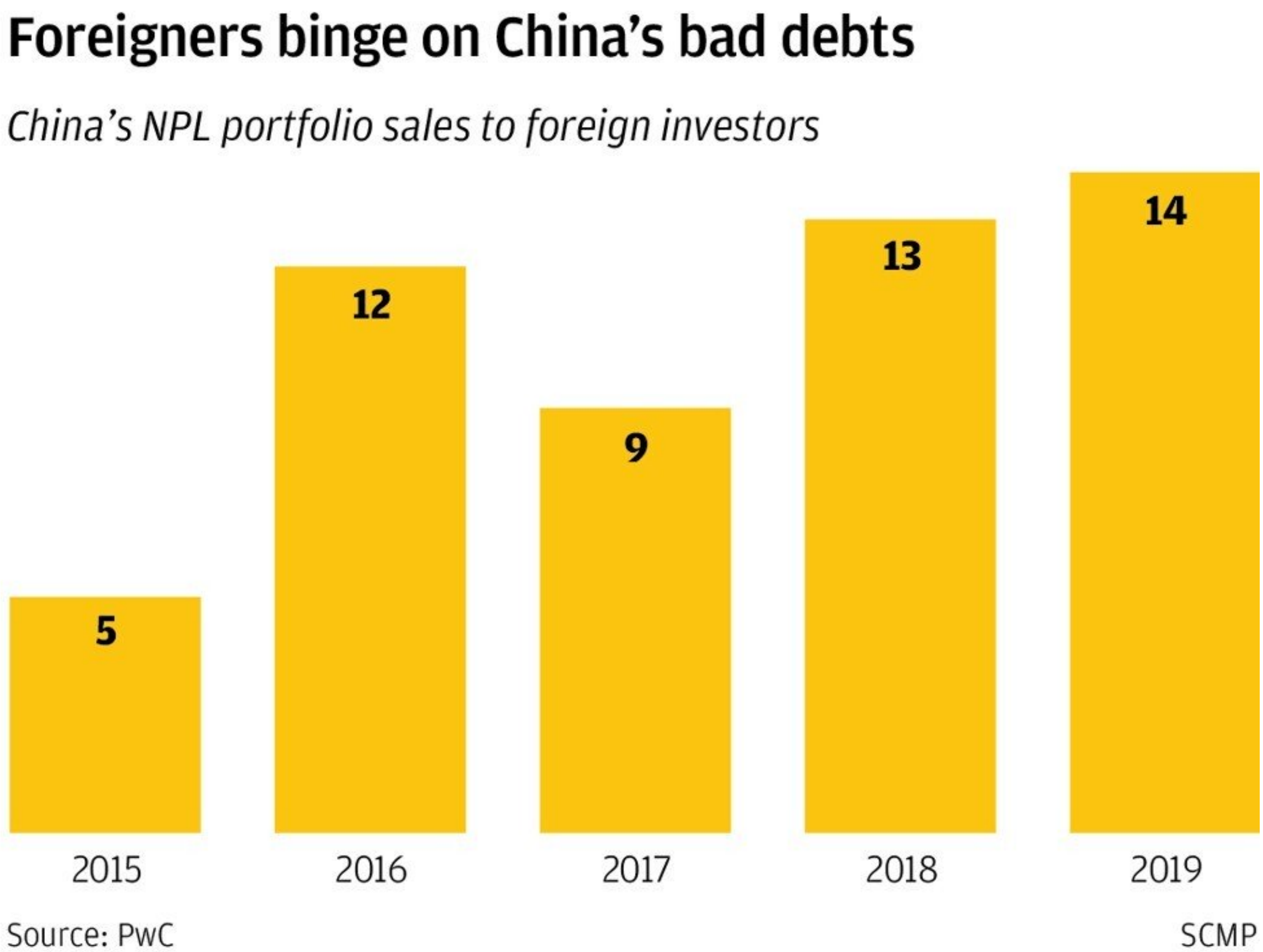
"We are drinking from a fire hose," said Benjamin Fanger, a veteran distressed debt investor in China and founder of ShoreVest Partners.

Even more money is likely to pour into the asset class from yield-hungry investors as global interest rates languish around zero. Some distressed asset managers said they are looking at returns in the mid-teens this year.

Bank Julius Baer is looking to add to the firm's stable of distressed fund managers while Emmanuel Roman, CEO of the world's largest fixed-income investor PIMCO agreed: "It will be a good asset class."

As China's economy shrank for the first time since 1976, nearly half a million Chinese firms closed in the first three months of this year, corporate registration data shows.

Californian Fanger said the last few months have presented the biggest opportunity for rescue financing he has witnessed in his career, who started as a legal assistant on the first foreign-owned non-performing loan (NPLs) in 2002.



China has been laying the foundations for a distressed debt market in recent years by opening up to overseas investors and forcing its banks to recognise soured loans festering on their books.

In another step forward, the US-China trade deal in January allowed US firms to apply for a provincial asset management company (AMC) licence to acquire NPLs directly from Chinese banks instead of via local intermediaries. ShoreVest, for one, is talking with government officials about applying. To better seize the opportunity in China, Oaktree, one of the world's largest distressed debt investors, established a wholly owned entity in Beijing in February.

"This is an opportunity of a lifetime" for clients looking at rescue financing, said Ron Thompson at turnaround specialist Alvarez & Marsal. Investors can ask for more collateral, higher yields and seize the chance to invest in quality companies, he said.

China's biggest private broadband provider Dr Peng Telecom & Media Group is in discussions with investors in its US-dollar bond due June 2020. It has appointed Alvarez & Marsal and Latham & Watkins as advisers, according to a Singapore Exchange filing.

"We're really busy," said Hong Kong-based Thompson, who is building a team focused on financial restructuring and insolvencies. Thompson declined to comment on specific cases.

Shandong Ruyi racked up debts after an acquisition spree on brands including Bally. Photo: Bloomberg

To be sure, the coronavirus pandemic has upended the rules of engagement this year. Courts are flooded with bankruptcy cases, preventing some creditors from pressing their claims. Local money managers, who do not need permits for moving money onshore, can move faster at cheaper rates than most foreign funds.

“I expect money to show up to finance corporates at relatively modest rates in China,” said Juan Delgado-Moreira, vice-chairman and head of Asia at investment manager Hamilton Lane.

Travel restrictions are preventing investors from investigating companies even as financial shenanigans proliferate.

“Good people do dumb things when they are desperate,” said Fanger. ShoreVest conducts background checks but also secures hard assets as collateral.

Old hands warn investors with severe “fear of missing out” to bide their time.

“The question is ‘are these good assets, good companies that were fine but have the wrong capital structure at the wrong time because of the coronavirus?’,” said Michael Milken, the doyen of junk bond investing, speaking on an April 17 conference call.

Michael Milken urges credit investors to hold out for quality companies. Photo: AP Photo

Beijing, like governments all around the world, is helping crippled companies to protect its financial system and minimise social unrest. China's banks pumped more than US$1 trillion into the economy in the first quarter of the year while the central bank has made targeted rate cuts.

Beijing is actively discouraging state-owned banks from taking aggressive action on loans, such as downgrading debt, cutting credit limits or foreclosing on assets, said industry sources and banking regulators.

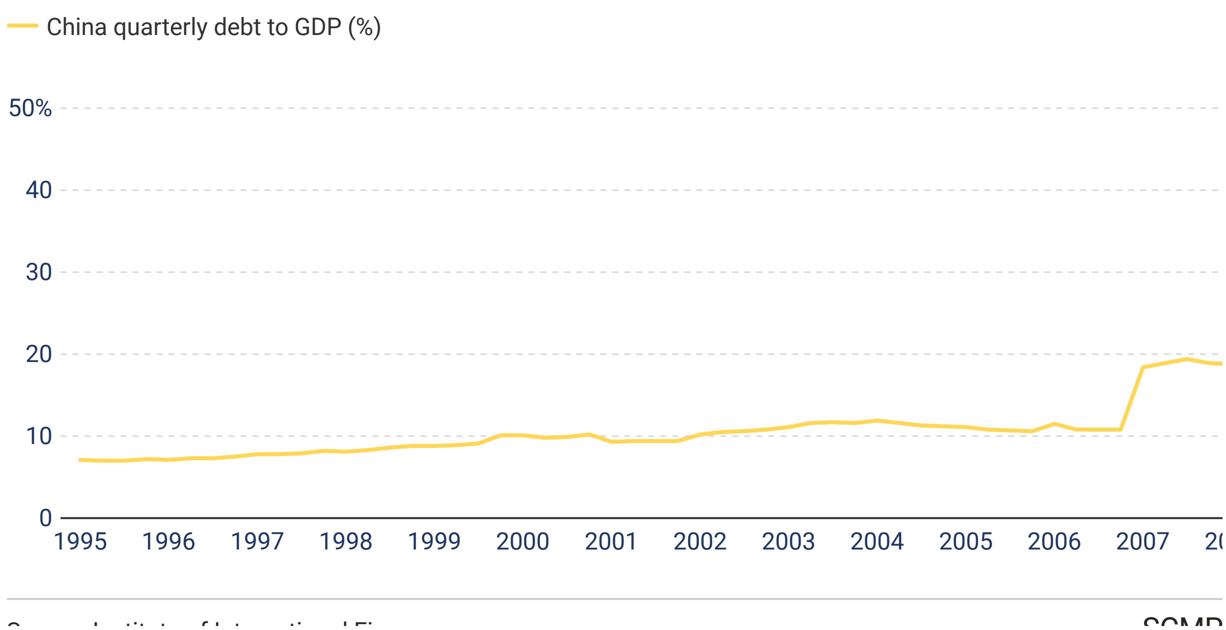
"A principal haircut for big state-owned banks in China, Taiwan or Korea remains a hard sell, even if mathematically it's the smart thing to do," said Thompson.

For NPL investors, such forbearance means a delay in coronavirus-related NPLs hitting the market. Once the government lifts restrictions, banks still have to make a call on which companies will survive and workout the default. By law, banks have 90 days before they even have to recognise an NPL.

"We see Covid-19-related NPLs surfacing in 2021-22," said Fanger. In the meantime, pricing has softened on China's existing mountain of bad debt, which Fanger said could be far higher than PwC's estimate of US$1.5 trillion as of June.

China's debt addiction

The world's second-largest economy's growing reliance on debt to fuel economic growth since 1995



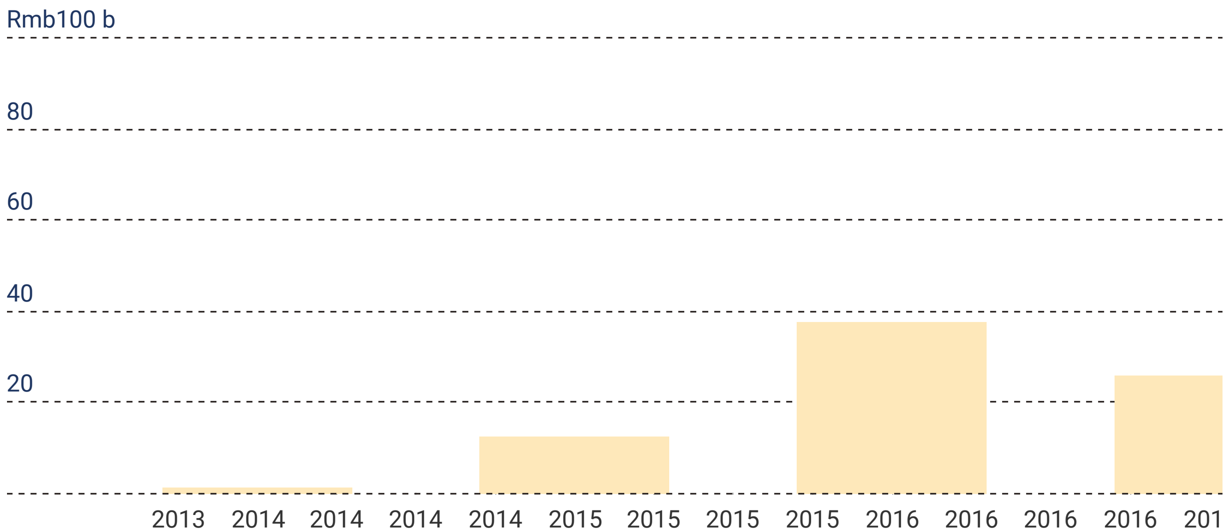
Chinese banks' NPL ratio rose to 2.04 per cent at the end of March, up 0.06 percentage point from December, the China Banking and Insurance Regulatory Commission said on Wednesday.

On rescue finance, known as special situations in the arcane language of credit, investors are wary of ploughing capital into high-profile and politically sensitive firms. Property developers who contribute to local government budgets and often have a large number of retail shareholders are particularly risky, they say.

"Large developers may be too big to fail, but smaller developers risk a sudden cessation of government support or the imposition of bureaucratic mandates," said Brock Silvers at Hong Kong-based private credit firm Adamas Asset Management.

Bond defaults mushroom in China

Principal amount of defaulted bonds by Chinese issuers onshore*



*Incremental defaults only **2020, January and February only

Source: Fitch Ratings, Wind

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Some investors are pushing ahead. New York-headquartered Blackstone is in talks to take private Chinese developer Soho China, according to one person familiar with the matter. A spokeswoman for Blackstone declined to comment.

If investors take companies to court to get their money back they may not be able to get a hearing this year.

Chinese courts are knocking back cases from creditors, slowing the review of bankruptcies in courts to 1,770 in February and March, from 2,160 filings in January, according to the national enterprise bankruptcy information disclosure platform.

“With this shock to the system, it will be very hard to file new cases,” said Thompson, who has been working in Asia for around 30 years, mostly dealing in financial distress.

Howard Marks, co-founder of Oaktree. Photo: Bloomberg

Skilful managers are navigating the minefield of China’s corporate distress and sticking to smaller companies in less politically sensitive sectors.

Many are hopeful that China will continue to open up to foreign investors and refrain from the massive stimulus it unleashed in 2009 that kept zombie companies alive. So far, China's rescue package amounts to roughly 3 per cent of GDP, conservative compared to Japan's bazooka of about 20 per cent.

The dismantling of the state-controlled Peking Founder Group is a sign that Beijing is willing to let some prestigious companies fail and develop the market further.

After a creditor started court proceedings in February, 10 million yuan (US$1 million) of bonds issued by the business arm of Peking University traded cross-border on April 17 via China's interbank market, the first deal of its kind, according to a unit of China's central bank.

"China's desperate need for foreign capital is only increasing," said Adamas' Silvers.

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