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**Zombies Hidden in China Debt Swaps Keep Distressed Funds Wary**

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By Bloomberg News

(Bloomberg) -- Distressed-loan experts are urging caution on China's push to swap corporate debt into equity stakes, amid concern so-called zombie companies are being kept alive by the program.

Zhejiang Oriental Fund Management Co. is among specialist funds that would rather buy loans directly, gaining influence over management and access to collateral, than invest in the swaps. The big three rating companies say the exchanges so far have relieved troubled borrowers and their bankers of loans at par value -- rather than a market rate -- and transferred the burden to China's savers, who invest via insurance plans, pensions and even wealth-management products sold to them by lenders.

"There's a big question mark as to whether the investors can exit at the end," said Denis Zhang, founder of Hangzhou- based Zhejiang Oriental, who said the swaps aren't something that attracts his attention. "Borrowers that need debt-equity swaps must have some kind of problem."

China needs to start cutting corporate debt to unleash its economy and avert a repeat of 1999's tax-funded bank bailout. Yet burdening investors with stakes in companies that should be allowed to fail risks losses down the track that lenders may have to make good, according to Moody's Investors Service. It estimates state-enterprise liabilities reached 120 percent of gross domestic product as of Sept. 30 and warns of deteriorating credit quality, even though banks class only 1.76 percent of their loans as delinquent.

"If you are going to shift your debt into households, you need to be very careful," said Wei Yao, chief China economist at Societe Generale SA in Paris. "They shouldn't allow zombie companies to enter the program."

Under the plan unveiled in October, the State Council said "so-called zombie" companies without hope of survival shouldn't participate. It proposed a market-oriented process involving three groups: borrowers and their lenders; an independent agency to arrange the swap; and the public and their fund managers. While details have been sketchy in the 10 swaps so far – that seek to raise 190 billion yuan ($27.5 billion) -- some look like a means to give imminent defaulters a second chance. "Why would the government intervene to clean up good companies?" said Alicia Garcia Herrero, chief Asia-Pacific economist at Natixis SA in Hong Kong. "It's a no brainer that the debt-to-equity swap is an instrument to clean up banks balance sheets from bad credit."

Eight of the groups involved have debt that averages 150 percent of equity -- higher than the average for Chinese publicly traded companies of 28.5 percent -- and together they lost 236 million yuan in the first nine months, bond prospectuses show.

Shares in the listed flagships of the groups have underperformed. Yunnan Tin Co. lost 29 percent in the past five years including dividends, while Shanxi Coking Co. slumped 22 percent. Wuhan Iron & Steel Co. was the best performer with a 22 percent return, less than half the benchmark Shanghai stock index's 58 percent.

In one deal, China Construction Bank Corp. said its investment-banking arm raised 10 billion yuan from investors to buy good loans from other lenders to Southwest China's Yunnan Tin Group at face value. The debts will be converted into stakes in subsidiaries. The five-year program targets annual returns of between 5 and 15 percent.

Benjamin Fanger, founder of ShoreVest Capital Partners, said he would invest in the schemes only if they had a strong turnaround story and a manager with interests aligned with those of investors.

"The first consideration for whether it makes sense to hold debt or equity is the health of the company and its long-term prospects," he said. "It depends on where we are in this cycle." The last time the state organized a debt-equity swap was during 1999's bailout, and the four state owned asset management companies behind that effort still hold some of the stock they acquired. Huarong Asset Management Co. held 196 of the 281 state-owned enterprise stakes it inherited 16 years later, Haitong Securities Co. estimates.

"People have been trying to work with the AMCs for a long time without success," said Phil Groves, founder and president of DAC Financial Management China Ltd. in Hong Kong, which invests in nonperforming loans and isn't interested in "a blind pool" swap. "Most investors would want to have some input on how those companies are run."

Fitch Ratings raised questions over why the programs bought loans at face value and whether the market would decide conversion prices. Banks may eventually have to "compensate for losses" of WMP clients, said Christine Kuo, a Hong Kong-based senior vice president at Moody's.

The last time China faced financial upheaval in 2013, protests by clients forced banks to bail out trust products they had sold, suggesting they'd stand behind failed investments. Zhang Minghe, manager of CCB's swap program, declined to comment when e-mailed this month.

"Everyone is counting on the creditworthiness of the financial institution," said Zhejiang Oriental's Zhang. "If it's in a troubled industry or a zombie firm itself, the debt-to-equity conversion wouldn't change anything."

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