

---

From the Hong Kong Securities Institute  
July/August 2009



## Finding Treasure in China's Distressed Debt

---

Following the financial tsunami, buyers of distressed debt expected to see many opportunities for bargains to emerge. However, there are many risks involved that should not be overlooked.

At a conference on distressed debt held in Hong Kong earlier this year, the general consensus largely to the Central Government's four-trillion yuan stimulus package and the approximately seven trillion yuan injected into the money supply from expected. The Chinese economy has been quite resilient to the challenge of the global economic downturn following last year's financial crisis, thanks to the loans issued by China's banks during the first half of the year.

"We thought there would be an avalanche [of distressed debt opportunities]," says Handel Lee, a partner of the law firm King & Wood. "But because of the amount of money that is now flowing into the Chinese economy this year ... many of the projects that were having significant funding issues are still holding on. Distressed opportunities have not presented themselves as what originally people thought."

At the end of June this year, outstanding bad loans totaled 518.1 billion yuan, down 42.2 billion from the beginning of the year, according to the China Banking Regulatory Commission. China's commercial banks combined non-performing loan (NPL) ratio fell to 1.77% by June's end, down 0.65 percentage points from the start of 2009.

However, more buying opportunities are expected to surface in China in the near future, according to some experienced investors. They say the large increase in lending will be the cause for two reasons. Firstly, there will always be a certain proportion of bad loans that will result from new lending. Secondly, the massive increase in the money supply from this lending is tipped to increase the inflation rate, which should lead to a rise in interest rates or other tightening measures. In this case, company and project owners will find it more difficult to repay their loans.

"I would estimate these types of booming loan growth years will create another US\$50-100 million of NPLs per year. And the NPLs will rear their ugly heads when interest rates start to rise and/or the Central Government tightens liquidity," says Tom Holland, the managing director of the investment firm Cube Capital HK.

### Clear of Competitors

Also, many foreign investors have been withdrawing from China's distressed debt market after the global financial tsunami, leaving more room for those who have access to funds and are still interested in this market. Lehman Brothers, the United States investment bank which collapsed last September, was a large investor in China's distressed debt market. Other troubled foreign investors have scaled back their operations in China to focus on their domestic markets.

"It is a relatively low time for competition," says Phil Groves, the president of DAC Management. "A lot of traditional distressed debt buyers are either not investing now or have closed up their Asian shops and have gone. Many funds have left Asia because of the crisis last year."

Buyers need not necessarily wait until an economic slowdown in China for an increase in the supply of distressed debt. Holland says his firm has been finding good opportunities when purchasing debts from foreign investors who want to exit the market this year.

"From our standpoint, it is pretty exciting now. There is a lack of demand because it is very difficult for people to gear up to do this business, as well as a burgeoning supply," Holland says. "The secondary market is interesting because we are seeing a lot of players who want to sell their portfolios; primarily foreign investors and some global investment banks. Everything is getting reined in and China is a non-core strategy for them."

### A Risky Market

Except for the extremely lucky, doing your homework always pays when investing, and that is clearly the case with distressed debt in China. There are some deep traps for the unwary. For instance, scams are relatively common.

"The same types of things that some Chinese joint venture partners try on their foreign joint partners have been tried on creditors," Groves says. "You always hear stories about Chinese joint venture partners starting up side businesses across the street [to compete with the jointly-owned company]. Or having a lot of off-balance sheet assets that are difficult to find. None of it is particularly creative, but because it is harder to find out information sometimes they can do it without being detected."

Performing proper due diligence before purchasing distressed debts in China is usually more time-consuming than in other markets because the required information is often not easily accessible. Carrying out even a simple land title search can be difficult, Groves says.

"In the US, if you want to see if a piece of property is mortgaged to somebody, you can do a title search online. In China, you have got to show up at the local land bureau and do it by hand. And that is if they let you in the door," Groves says. "If not, you have to find an attorney who practices in that city and has a good relationship with the bureau to do it."

### Finding a Good Partner

Cube Capital's Holland says having a good relationship with the local service provider has been the key to his firm's success when investing in China. One of his firm's specialties is in buying pools of NPLs domestically, so having a competent and reliable local partner who assists in identifying investment opportunities, liaises with the courts and manages the relationships with the local asset management corporations (which sell Chinese banks' NPLs) is crucial.

Before entering China in 2006, Holland and his colleagues studied others' forays into this market to see what did and did not work.

"We were seeing there were a lot of people that were struggling in the market," he says. "Trying to understand why people were having issues, we found that a lot of it was due to their servicing arrangements. Some people were trying to do it in-house, others were paying auditors, accounting firms or legal firms on a fee basis to work things out. We saw incentive schemes that were clearly not aligned."

Cube Capital's approach has been to establish an exclusive, long-term relationship with their local service provider in China. They insist the local firm co-invests with Cube Capital in every deal they complete.

"The key to aligning the interests in the partnership is that we co-invest in every portfolio. Additionally, the servicing relationship is structured so they don't get their incentive until we get our money back, and we have people on the ground in the partnership to control the cashflow and assets," Holland says.

### Using the Courts

Another challenge for many foreign investors is that due to China's regulations, many are restricted from having direct ownership of assets on the Mainland. If a creditor defaults or a business becomes bankrupt, foreign lenders in many cases have limited recourse to extract their money.

However, Lee says his firm has had some success using litigation tactics when acting for foreign investors who have pursued the assets of failed companies and their directors through the courts.

"Many investors are afraid of China," Lee says. "They believe China's courts are corrupt, and so on. But it is not necessarily the case. We are trying to tell people to utilise the PRC court system to your advantage. Staying away from them is detrimental to your financial interests."

Nevertheless, whenever legal issues could be involved when buying distressed debts, many foreign investors choose to be creditors to companies and projects in the major cities where the courts are more reliable. Holland is one.

"We focus on the commercial centres because the courts there work better. They are more commercially, rather than politically, orientated," he says. "When we are running these legal strategies, we concentrate primarily on Beijing and Shanghai."

### The groups tasked with selling off China's bad debts face a challenge in keeping investors interested

December 31 was significant for China's financial industry. This was the day when the first wave of bad loans from the Big Four state banks - US\$170 billion taken off their books in 1999 - was supposed to be cleared.

The deadline wasn't met but the work of the asset management corporations (AMCs) set up to manage the non-performing loans (NPLs) was not the embarrassing underperformance expected this time last year after much foot-dragging over sales.

PricewaterhouseCoopers estimates that there was US\$30 billion of the 1999 loans remaining by mid-2006, with a few sales pending. NPL sales to foreigners, US\$12 billion before November 2005 from a total of US\$90 billion, had nearly doubled by February 2006. There are few official statistics on the four AMCs - Cinda, Great Wall, Oriental and Huarong - but one or two may have more or less rid themselves of the 1999 offerings.

"Things have speeded up in the last year, making significantly more dispersals than in the previous three years," said Ted Osborn, head of PwC's business recovery services practice in Hong Kong. "The question is: will this continue into 2007?"

Foreign investors appear confident that it will.

Phil Groves, president of DAC, which specializes in distressed opportunities and has bought a number of NPL portfolios, says that sales only really started in 2001 and the market is taking time to mature.

"Back then the regulations weren't clear but they have become clearer in the last two years," he said. "Approvals are faster and the structures being used now are much simpler."

With a more transparent and sophisticated system, a steady flow of NPL auctions is expected. And there is plenty of bad debt up for grabs.

According to the banking regulator, there was approximately US\$160 billion in NPLs held by China's commercial banks at the end of September. PwC has calculated that another US\$153 billion has been transferred since the 1999 batch.

A Fitch Ratings report in May put the total number of NPLs at US\$403 billion with another US\$271 billion in problem loans lurking on the banks' books. Another report by Ernst & Young, later withdrawn, claimed China's full NPL exposure was US\$911 billion.

### Changing faces

Despite this consistent supply, the foreign parties interested in buying Chinese bad debt have changed considerably.

Those involved in the first NPL sale to foreigners - a 2001 Huarong auction that saw a US\$1.3 billion portfolio picked up by Goldman Sachs and a Morgan Stanley-led consortium - are now rarely to be seen on the buyer lists. In recent years, it is the likes of Mellon and Cargill that have come to the fore.

"This year we've seen more sales but prices have been higher," said Osborn.

The AMCs received interest-free loans from the central bank to cover the transfer of the 1999 NPLs, which were taken at 50-100% of their face value but sold for as little as 5-10%.

However, interest is charged on loans made to facilitate the transfer of US\$150 billion in NPLs in 2004 and 2005. Having already paid over the odds for the bad debts, the AMCs have tried to charge investors more in order to cover their costs.

"The AMCs are forced to buy at US\$0.30 on the dollar and don't want to sell at less than that," said Osborn. "You need to be able to collect US\$0.30 but is there enough profit in there that someone will want to buy it?"

### Changing faces

Now, foreign players may have other investment options with better returns. The books of debt-ridden companies often tell only half the story so investors have to put staff on the ground to carry out due diligence before purchase and service the debt afterwards. Local knowledge can uncover hidden assets that can be used as leverage, but it can be costly.

"Some of the early players didn't view it this way but it's a people intensive market," said Groves, pointing out that DAC has 45 people in China.

---

A PwC survey in December of foreign investors in the NPL market found 89% of respondents expect to acquire NPLs in the next 12 months but two-thirds also plan to invest in individual distressed loans. Real estate, private equity and high-yield lending are also popular.

DAC's preferred means of dealing with NPLs is through restructuring not foreclosure. For example, by buying up the debt and injecting capital into the assets, the company found itself in possession of a five-star hotel in northern China.

"There are lots of real estate opportunities where the builder is in the middle of the project and unable to get local backing so goes looking for a partner," Groves said.

In an increasingly open economy, it is easier for investors to seek out distressed opportunities on their own and implement restructuring plans in exchange for equity. Coming in before loans turn sour could prove more lucrative than waiting for NPLs to drop off the end.

With so much competition, the pressure is now on the AMCs to keep foreign players interested.

[http://www.chinaeconomicreview.com/cer/info/Dealing\\_in\\_debt.html](http://www.chinaeconomicreview.com/cer/info/Dealing_in_debt.html)