Chinese hot pot

Questionable remedies remain for China's cooling economy

by Jack Rodman

As Chinese celebrate the Lunar New Year, they often gather around a "hot pot": a pot of boiling water into which you throw vegetables, cabbage, onions, mushrooms, tofu, rice noodles and then thin strips of beef and lamb, which everyone dips into savoury sauces and devours. There is always "something for everyone" in a Chinese hot pot. China and its ruling party are looking into their collective hot pot. Some of the ingredients are more pleasant looking than others, and the resulting flavour could be anyone's guess.

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Shadow banking

The accumulation of massive amounts of risky debt are finally moving from the shadows into the sunlight and the figures are staggering. So-called shadow lending by lightly regulated finance entities and Chinese banks doubled from 2010 to 2012 to reach 36 trillion yuan (US$5.93 trillion), according to J.P. Morgan Chase & Co. At the end of 2013, Chinese banks alone accounted for 11 trillion yuan (US$1.81 trillion) of the total, reports Standard Chartered Bank.

What is most alarming is that the majority of this lending sponsored by the banks is off balance sheet via trusts and wealth management products, which the banks sold to their high-net-worth customers. These products offer interest rates far greater than standard deposit rates and are guaranteed — or assumed to be guaranteed — by the banks. The first signs of defaults have started to occur, and several high-profile cases involving an arm of Ping An Insurance Co and the Industrial and Commercial Bank of China (the world's largest bank) have focused attention on whether the banks will make good on these products or allow investors to take the loss. So far, financial intermediaries have stepped up to pay off disgruntled investors to avoid a loss of confidence in these products. But how long they can or will do this remains to be seen.

Nonperforming loans

China's banks reported 563.6 billion yuan (US$92.8 billion) in nonperforming loans as at September 2013, up 38 percent from two years ago. While still less than 1 percent of total loans outstanding, many analysts believe NPLs will increase further as a result of the rapid increase in lending during China's economic stimulus from 2009 to 2012.

The Chinese asset management companies that were formed to take NPLs off the banks' books back in 1999–2000 are coming to market. The first to do so was China Cinda Asset Management Co, which completed its Hong Kong listing with a raise of US$2.5 billion in December 2013. Oaktree Capital Group, Och-Ziff Capital Management Group and the Abu Dhabi Investment Authority are reported to be cornerstone investors.

China Huarong Asset Management Co (ICBC's bad bank) is planning to follow suit some time in 2014. In addition, China's government is gearing up for a spike in NPLs and has authorised "over-the-counter" asset exchanges as well as allowing local provinces to set up their own "bad banks" (state-owned institutions) that can take over NPLs that threaten banks' stability and ability to continue lending.

A billion here and a billion there …

China's National Audit Office reported that, as at mid-year 2013, the amount of debt and guarantees issued by local governments had rocketed 67 percent from 2010 to 17.9 trillion yuan (US$2.95 billion). The majority of this money was borrowed from the banks and invested in long-term development and infrastructure projects during China's recent economic stimulus programme. At one point, it was estimated by regulators that as few as 25 percent of the projects could produce cashflow to service their outstanding debts. Local governments and banks have "institutionalised" rolling over these loans to keep them from defaulting and ending up as NPLs on the banks' books. More than half of these loans will mature during 2014, and it is likely that many of these loans will find their way into the newly-formed asset management companies.

China's real estate markets

So far, China's commercial real estate markets remain relatively robust. Despite huge increases in supply across first- and second-tier cities in China, rates and occupancy have been stable, dispelling the predictions by many analysts of an impending glut. Even more surprising is that cap rates for prime, grade A office and retail properties are now trading from 3.5 percent to 4.0 percent with few quality properties available for investment. International investors from sovereign wealth funds to opportunistic investors are aggressively competing when a new listing comes to market, keeping prices at record-setting valuations. Investors argue that even with diminished growth prospects (ie, 7 percent GDP growth), major Chinese cities such as Beijing and Shanghai offer more potential than the United States, Europe or other

emerging markets. New, well-capitalised investment funds focused on China continue to be formed, and there does not appear to be any shortage of foreign capital trying to get a foothold in China, especially for quality office and retail properties.

Recently, Li Ka Shing (Cheung Kong Group), regarded as one of the smartest and wealthiest investors in Asia, sold the Oriental Financial Plaza in Shanghai, two premium office towers comprising more than 90,000 total square metres. Most of the recent buyers in Shanghai have been large state-owned enterprises acquiring properties at record prices for self-use. New austerity measures may, however, reduce SOEs' appetite for "trophy buildings" as the new government of President Xi Jinping redirects the economy away from conspicuous consumption and corruption. It will be interesting to see how the market responds if there is a pull-back in SOE interest and if established players such as Li continue to dispose of assets.

Shanghai pilot free-trade zone

The big news in Shanghai at the end of 2013 was the announcement that the government has targeted Shanghai to become a global financial centre comparable to Tokyo, London and New York City. To help the Shanghai government accomplish this goal, plans were drawn for the creation of the China (Shanghai) Pilot Free Trade Zone. It is unclear how the free-trade zone will work or who will be allowed to operate within the free-trade zone as well as what benefits are to be derived. The general consensus is that it will probably be positive for the overall Shanghai economy. In addition, the government has announced that a new Shanghai Securities Exchange and Shanghai Futures Exchange will be developed in the Zhu Yuan business district of Pudong in an attempt to bring renewed life to the Shanghai Stock Exchange, which has been one of the worst-performing stock indices in recent years. Local investors have shied away from investing in the Shanghai Stock Exchange in favour of buying residential property or WMPs because they believe the stock exchange is controlled by the government and subject to corruption and insider trading.

The SEC versus China Inc

As a former Big 4 accountant, I would be remiss not to mention the unfolding of the "Accounting War", a standoff between the US Securities and Exchange Commission and the Government of China. The SEC has been investigating dozens of US-listed Chinese enterprises for allegations of malfeasance and shoddy accounting practices. The SEC has subpoenaed the audit work papers of the US Big 4 accounting firm affiliates in China. Chinese officials have not allowed the SEC access to these work papers, arguing that it would divulge "state secrets". The SEC has responded by refusing to allow Chinese enterprises to continue to list on US security exchanges. It will be fun to see who blinks first.

New anti-corruption measures

If I were a political cartoonist, I would depict President Xi riding in like the Lone Ranger on a white stallion to welcome in the Year of the Horse. A number of new anti-corruption measures are being implemented in China with comical results. For example, many five-star luxury hotels have downgraded themselves to four stars so they can still capture government business and banquets.

The good news for sharks is that shark fin soup, an expensive delicacy, is now on the government's list of "no-no's", along with "hairy crabs" and gifts of expensive watches, extravagant moon cake packages with fine wines and gold bars, and officials driving luxury foreign automobiles. In January 2014, *China Daily* announced that "naked officials", civil servants whose family members have migrated overseas, will not be promoted as a means of discouraging corrupt officials from fleeing overseas. The new regulations call on government officials to lead a "frugal life".

A number of headwinds and crosscurrents make it difficult to foresee how well China will ride out the Year of the Horse. It may be one interesting hot pot. ❖

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