The comeback kid?

Foreign investors should be cautious about China's nonperforming-loan market

by Jack Rodman

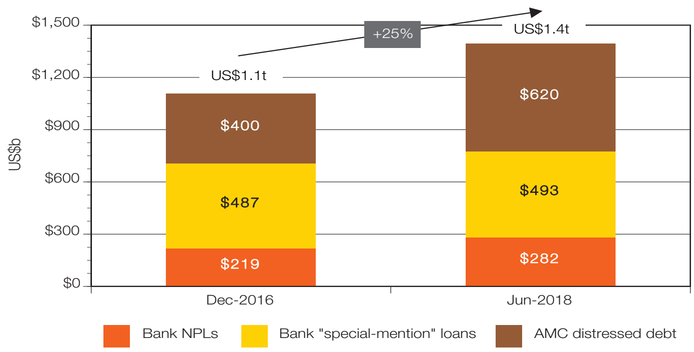
It has been 20 years since China opened its nonperforming-loan market to foreign investors. Like any fad that occasionally makes a comeback, once again it seems pundits are advising foreign investors to take a hard look at investing in Chinese NPLs. Will the nascent NPL market finally make a recovery, and will foreign investors finally get to buy NPLs at market-clearing prices?

This article explores the 2019–2020 opportunity and what's different, if anything, this time around.

With the market opening up and beginning to transact … it should come as no surprise many of the most experienced global NPL investors have set their sights on China.

Jack Rodman
Crosswater Realty Advisors

Growth of distressed assets in China, Dec 2016–June 2018



Note: Estimate excludes distressed assets outside the banking and asset management company sector (eg, peer-to-peer loans, trust lending, leasing assets, consumer finance)
Sources: PwC estimate, public information

Supply side

According to PwC's report, *2019: A sunnier outlook for international China NPL investors,* the amount of "potential" NPLs and distressed assets in China grew approximately 25 percent from December 2016 through June 2018, and is likely to keep growing as the Chinese economy continues to slow.

Total NPLs officially recorded by Chinese banks, including "special-mention loans" — loans that could potentially become NPL — and the amount of asset management company (AMC) distressed-debt purchases, now approaches US$1.4 trillion (see "Growth of distressed assets in China, Dec 2016–June 2018", this page).

Several factors have contributed to this growth, which may also be indicative of market trends: Chinese bank regulators are now forcing banks to report NPLs on all loans 90 days delinquent. In the past, banks were allowed to circumvent this regulation if they felt there was sufficient collateral to prevent any losses on past-due loans. This change brings Chinese banks closer to international standards for classifying NPLs. The China Banking and Insurance Regulatory Commission (CBIRC) has actively increased bank fines for failure to properly classify NPLs, reporting a 14-fold increase year over year, according to UBS Evidence Lab's August 2018 article, *Banks behaving badly – What 12,534 bank fines tell us.*

Compounding the problem is the Big Four AMCs, which were formed in 1999 with the primary objective of buying NPLs from the Big Four banks, have been severely criticised and scrutinised for having "strayed" from their primary "core" business mission of relieving the banking system of NPLs. Most notable is China Huarong Asset Management Co, the NPL industry pioneer that opened the NPL market 20 years ago. Its current chairman, Lai Xiaomin, has been arrested for corruption, according to a 12 October 2018 article in the *Financial*

Times. The probe into the "expanded activities" of these AMCs includes channelling funds to fuel "foreign direct investment of US$220 billion", which peaked in 2016 with trophy-asset purchases — such as the Waldorf Astoria New York in Manhattan — reminiscent of the Japanese overseas investment from 1985 to 1989, when the Japan bubble burst.

The pressure on both asset management companies and shadow banking has resulted in a shortage of funding for China's small- to medium-size enterprises, forcing many to return to China's regulated lenders, who traditionally prefer to lend to large state-owned enterprises.

China NPL market transactions, second cycle

Investor	Seller	Location	Year
Bain Capital Credit	Huarong	Jiangsu	2017
	Huarong	Hubei	2018
	Big 4 AMC	Zhejiang	2018
Blackstone	Huarong	Guangdong	2017
CarVal Investors	Cinda	Shenzhen	2018
	Huarong	Jiangsu	2018
Goldman Sachs	China Orient	Jiangsu	2015
	China Orient	Zhejiang	2016
	Huarong	Tianjin	2017
	Huarong	Jiangsu	2018
	Huarong	Tianjin	2018
Lone Star Funds	China Orient	Jiangsu	2016
	Cinda	Hubei	2016
	China Orient	Zhejiang	2017
	Cinda	Fujian	2018
	Shanghai AMC	Shanghai	2018
LVF Capital	Huarong	Hunan	2018
Oaktree Capital Group	Great Wall	Shanghai	2015
	Cinda	Fujian	2017
	Huarong	Fujian	2017
	Huarong	Guangdong	2017
	Huarong	Guangdong	2018
	Huarong	Jiangsu	2018
PAG	Cinda	Zhejiang	2016
	Cinda	Zhejiang	2017
	Huarong	Jiangsu	2017
	Great Wall	Henan	2018

Source: PwC analysis of press reports, asset management company websites and direct confirmations from investors

Deleveraging

As a result of the AMC expansion into investment banking services and the growth of nonregulated lending — so-called "shadow banking" activities in the form of trusts and wealth management products — Chinese regulators were forced to take a hard line on several of the worst offenders, including:

- HNA Group Co, the parent company of Hainan Airline Holding Co, which bought stakes in Hilton Worldwide Holdings, Deutsche Bank and Swissport;
- Dalian Wanda Group Co, which bought AMC Entertainment, a myriad of hotels, and a US$420 million development site in Beverly Hills, California, United States; and
- Anbang Insurance Group Co, which purchased the Waldorf Astoria New York and made an unsuccessful attempt to buy Starwood Hotels & Resorts Worldwide.

These investors' spending sprees prompted Chinese regulators to remove the chairman of the China Insurance Regulatory Commission, nationalise Anbang, and merge the banking and insurance regulators in an effort to close regulatory loopholes.

Deleveraging is helping to reign in shadow banking, whose assets contracted by 3.6 trillion yuan (US$523 billion) in the first three quarters of 2018, according to Moody's Investors Service, which writes "the sector is now equivalent to 70 percent of China's GDP — still eye-watering, but down from 79 percent [of GDP] at the end of 2017." Shadow banking was a major source of funds for domestic investors' acquisition of nonperforming loans.

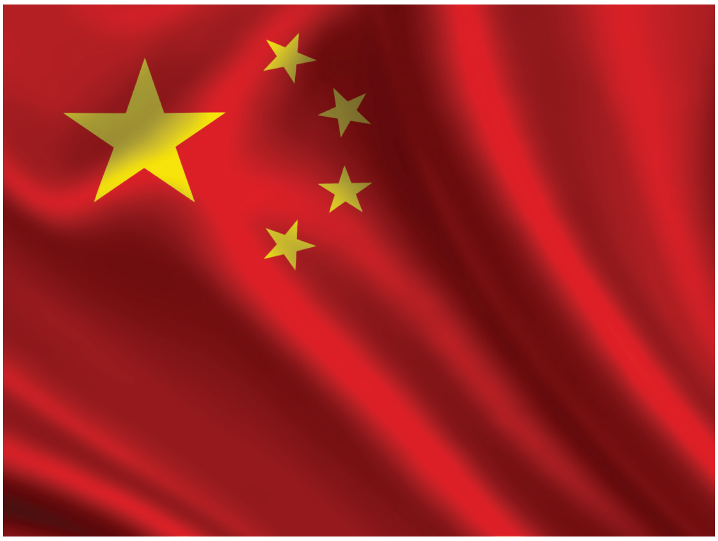
The pressure on both AMCs and shadow banking has resulted in a shortage of funding for China's small- to medium-size enterprises, forcing many to return to China's regulated lenders, who traditionally prefer to lend to large state-owned enterprises.

The result is a slowing economy, exacerbated by trade friction with the United States and a 25 percent drop in the value of the Shanghai Stock Exchange at year-end 2018.

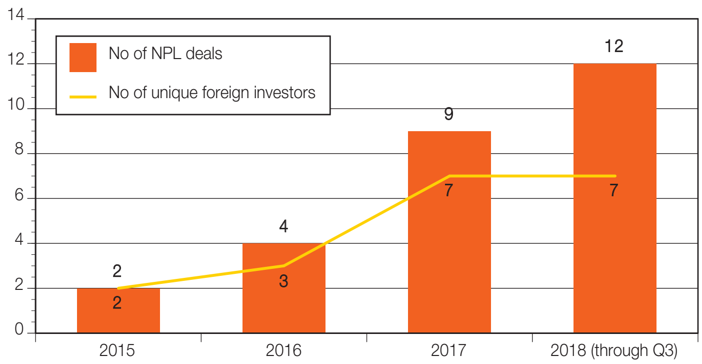
Foreign investment in China's NPL market

Taking all of these factors into consideration, analysts and pundits make a fairly-strong argument that the regulatory changes, combined with a slowing economy, will result in the "best opportunity in 20 years" to invest in Chinese NPLs and distressed debt.

According to PwC, in the "current NPL cycle" from 2015 through third quarter 2018, foreign



China NPL portfolio sales to foreign investors, 2015–2018



Source: PwC analysis of press reports, asset managment company websites and direct confirmations from investors

Risks, challenges and reality: What you need to play the NPL game in China

- Onshore (mainland) presence
- Constant (persistent) contact with the asset management companies
- Master adviser relationship (key local contact)
- Extensive (expensive) due diligence
- Bid strategy and focus (not all NPLs are the same)
- Local servicers, and how to keep them honest
- Working capital, and legal, accounting and tax reporting
- Accept how business in China is done
- Patience and perseverance
- Reality is one win in a good year-long competition

investors have closed at least 27 NPL portfolio deals, with a combined acquisition value of more than US$2 billion. Of these, 21 deals totalling more than $1.5 billion in acquisition value have transacted over the past 18 months (see "China NPL portfolio sales to foreign investors, 2015–2018", at left). With the market opening up and beginning to transact, combined with relatively-strong economies in Western Europe and the United States, it should come as no surprise many of the most experienced global NPL investors have set their sights on China. Some of these investors, such as Goldman Sachs and CarVal Investors, were present and active players in the first cycle back in early 2000s. Some new players have also emerged on the scene, such as Bain Capital Credit, Blackstone and LVF Capital, who were not NPL portfolio players in the early 2000s (see "China NPL market transactions, second cycle", page 6).

According to PwC, and this author's estimate, probably at least a dozen foreign investors are active in the Chinese NPL market, and some have been there for many years. In short, while some argue this is an ideal time to enter the market — with fewer international competitors and domestic investors sidelined — it is still a high-risk, high-return sector, and generally not for the faint of heart. Despite better-quality loans (more real estate collateral) and an improved judicial court system that makes it easier to foreclose on real estate assets, investors need to have patience and a very strong ground game as the rubber meets the road in servicing NPLs and, ultimately, repatriating capital, if they do decide to enter the Chinese NPL market (see "Risks, challenges and reality: What you need to play the NPL game in China", this page).

It is too soon to predict where this story is going to end and when more foreign investors may benefit, according to the PwC report. Even this author, with more than 20 years of NPL experience in China, is not announcing a tsunami of NPLs, or even a return to the heady days of early 2000.

The Chinese government, in dealing with foreign investors across all industries, has not shown much flexibility — or willingness — to adhere to (or adopt) Western practices or international norms when it comes to running the nation's economy. At the end of the day, is it politically acceptable to sell state-owned assets in the form of defaulted bank loans to foreign investors at market-clearing prices? From this perspective, I respectfully remain the "Panda Bear", a moniker hard earned from taking a sceptical view of the Chinese market. ❖

Jack Rodman (rodman.china@gmail.com) is a senior advisor of **Crosswater Realty Advisors,** based in Seattle.