ShoreVest 新岸資本

White Paper

Understanding Chinese Distressed Debt Investment

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Even as one of the most compelling opportunity sets in the world, Chinese distressed debt investment remains less understood. In this white paper, ShoreVest seeks to give an overview of this asset class and highlight the intricate know-how that makes it a successful investment.

The Opportunity

The current distressed opportunity in China essentially comes in two categories: (1) purchasing non-performing loans (NPLs) sold by the banking system and (2) what we call "special situations," which is essentially structured financings that provide bridging or rescue capital to companies that are having some form of distress or difficulty accessing bank lending.

On the NPL side, estimates of the total market are usually US$1.5 trillion or more. For example, in a report earlier this year, PwC estimated that as of mid-2019, there were US$1.5 trillion worth of bad loans in China's banking system. They arrived at the figure by combining the official level of NPLs with special mention loans. That places the NPL ratio at about 4.75%. Other estimates put the figure significantly higher. Based on interviews with banks, a researcher at Tsinghua University's National Finance Research Center last year estimated that the NPL ratio for large state-owned commercial banks was between 5% and 8%, between 8% and 12% for joint stock banks, between 10% and 15% for city commercial banks, and between 20% and 30% for rural financial institutions.[1] That would put the NPL ratio for the banking system as a whole somewhere between 8.2% and 12.4%, or between $2.6 trillion and $3.9 trillion. The difference between the PwC and Tsinghua estimates highlights how difficult it is to assess the true scale of China's NPLs.

More important than the overall estimate of NPLs in the system is the question of exactly how many loans are actually getting written off and disposed by the banks. According to data disclosed by the CBIRC, in the four years from 2016 to the end of 2019, Chinese banks disposed of 6.4 trillion yuan ($914.3 billion) worth of NPLs, a figure that includes write-offs, debt-to-equity swaps, and the transfer of NPLs to third parties. That's equivalent to about 4.9% of the total volume of outstanding loans at the end of the period. This is largely due to a series of regulations, implemented by China since 2017, to force banks to accurately recognize and dispose of their NPLs.

At ShoreVest, we have found the best risk/return approach to investing in Chinese NPLs is to focus on senior loans secured by real estate and price at steep enough discounts to create significant value. The process involves actively sourcing portfolios that allow us to sift through hundreds of opportunities to find those with a very high margin of safety. By "margin of safety," we mean the difference between the price we pay and the underlying collateral value. The challenge, however, is that often the more attractively priced portfolios include hundreds or even thousands of loans in them, so due diligence and especially working out the loans requires a significant onshore platform and many years of experience

[1] Yang Xiaohai, "如何化解不良资产"堰塞湖"," (How to Resolve the "Railings Dam" of NPLs) *FT Chinese*, October 8, 2019, http://big5.ftchinese.com/story/001084431?adchannelID=&full=y&archive.

On the special situations side, in recent years as China's economy decelerated and the scale of the shadow banking system waned, companies who could not access bank loans are now forced to come to groups such as ShoreVest who provide alternative bridge financing. Over the last few years we have seen the cost of capital that Chinese companies are willing to pay increasing as their options become more limited. This year, as companies face the effects of COVID-19 and a continued deceleration of the economy, we are seeing many companies in need of rescue financing. Such financings are often backed by real estate, but they can also be secured by public or private equity in companies.

Expected Yield and Time Horizon

The yield on an NPL portfolio is generally viewed in terms of its IRR (because most loans are not currently paying interest, so the cash recovery comes from servicing or workouts). Because every NPL portfolio is bound to have some bad apples, it's vital to be able to identify the apples that are rotten on the inside and kick them out of the portfolio. Hence, IRRs on these portfolios depend entirely on who is underwriting the portfolio and thereafter, who is working it out. Many inexperienced investors that have entered the market end up losing money on their first portfolios, or at least taking many more years to work them out than originally expected. There are two reasons this occurs. First, an inexperienced investor will unwittingly include some bad apples in the portfolio, such as a loan that looks senior secured on the surface but may not be enforceable at all due to underlying issues. Second, an inexperienced investor is unlikely to be able to navigate the intricacies of the Chinese courts or the complications with negotiating workouts or selling loans to local buyers.

For experienced investors such as ShoreVest, we can expect to target unlevered net IRRs in the teens for portfolios primarily underwritten to senior secured loans. Regarding investment horizon, we generally have some cash generated in the first year and the recoveries continue thereafter until the end of year three (give or take). So the horizon is usually significantly shorter than a typical private equity investment. The return profile and time horizon for special situations or bridge financings are similar to NPLs.

Competition/Dynamics Among Distressed Asset Managers

Because of the barriers to entry, competition is muted. On the sell side, deal flow is highly fragmented, with sellers being hundreds of local offices of asset management companies ("AMCs") and banks all across China. This is in contrast to some markets in Europe, where auctions tend to be more centralized and sourcing deals and information is much easier. So sourcing the best opportunities in China is difficult if an investor does not have an established network of hundreds of local touchpoints across the country, and a reputation in the space for being able to execute effectively.

On the buy side, the vast majority of buyers are local players, who often write smaller checks and who primarily have an interest in NPLs from only a particular region. The newly set-up local AMCs are an example of this – generally they are limited to purchasing loans from banks only within a particular province. Foreign distressed debt firms have been highly interested in the space in the last few years, and while they can write larger checks, they are generally limited in terms of experience, sourcing, and servicing capability. This has meant that even with their first deals done, it will be some years before the foreign newcomers have any significant experience resolving whole portfolios. As a result, foreigners still constitute a tiny segment of the overall market.

Challenges for Foreign Investors

The barriers to buying an NPL portfolio in China are relatively low, but the barriers to successfully sourcing one with a high margin of safety and then ultimately recovering the cash are high. Sellers want confidence that the buyer will be able to get the deal done, because most selling AMCs have a mandate to sell as much as possible, as fast as possible. Where a foreign firm's decision-making process involves various approvals needed across different countries, it is difficult for a seller who urgently needs to resolve a portfolio to place significant confidence in such a buyer.

While at least half a dozen different foreign groups have purchased their first few portfolios in recent years, we have heard in the market that many are already experiencing difficulties with exits. This can arise not just from mistakes in underwriting, but also in the inclination of foreign firms to entirely outsource the servicing to local groups with whom they have limited working history. Where an external local servicer is used, it is essential that a buyer have a robust internal team with actual Chinese NPL workout experience overseeing the servicer on a daily basis. Few foreign firms are staffed with much more than Hong Kong based foreigners and many of the primary decision-makers don't speak or read Chinese. This creates a plethora of potential hazards in both judgment and operational efficiency, which are key to the workout process.

The Difference Between Distressed Debt in China and Other Markets

Our understanding is that when compared to North America and Europe, China's sale of NPLs is greater in volume, but also much more fragmented in sourcing deals or information. Therefore, accessing the space at scale requires a robust local platform with many touchpoints across the country.

When compared to other recently developed markets such as India, China's system has a more predictable regulatory and legal process for buying and working out NPLs, because the government has been resolute in its implementation of court and banking regulations that encourage both the accurate recognition of NPLs and a legal environment where they can be worked out efficiently.

China also is unique in that national regulations that are directed toward the resolution of NPLs can be very fast and effective at forcing the recognition and sale of NPLs. Since 2017, a series of government policies, such as Circular 46 and, more recently the requirement that banks now recognize any loan past 90 days overdue as non-performing, have greatly catalysed the flow of opportunities into the market. Also, presumably due to concerns around conflicts of interest, China does not allow its banks to work out loans directly with borrowers at a discount to outstanding principal, so the loans must be sold by the bank before a borrower can settle at a discount.

Enforcing Creditors' Right in China

China benefits from a national regulatory and legal system (as opposed to various state-level laws that govern debt collections in the US). Provincial or other local governments might try to influence the process, but generally speaking, courts will adhere to the nation-wide rules on how enforcement of distressed assets is handled.

The litigation process and the courts' willingness to enforce creditors' rights has significantly improved over the past decade. Fifteen years ago, the process could take as long as five or six years. Today, although there can be significant variation depending on the loan, the process for full enforcement is supposed to (and often does) take somewhere between 18 to 36 months. The variation in timelines is usually due to particular issues with a given loan, or difficulty finding a buyer for the collateral, so it is important that an NPL investor identify these issues before purchase.

One very important hidden issue that inexperienced investors overlook is that in cases where there is a large bankruptcy of a company whose liquidation could create major job losses or other sources of social unrest, local or national government involvement is likely to ensure stability. These are the kinds of loans we kick out of a portfolio before purchasing it.

The risks that have been associated with China's legal system are more a misunderstanding than the reality. With that said, there is enough idiosyncrasy in the Chinese laws that warrant an experienced local team when it comes to investing in Chinese distressed debt.

Exit Strategies

Most distressed debt opportunities in China involve a variety of exit options, including negotiating with a debtor for partial repayment, seeking payment from a loan's guarantors, finding third parties willing to buy a loan, selling a loan's underlying collateral, taking possession of loan collateral and generating revenue by leasing it or selling it later. In this sense, it is now possible to employ a "loan-to-own" real estate focused strategy in the NPL space.

While the availability of any one of the exit channels will vary depending on the individual loan, China does generally have a robust market for underlying real estate collateral (depending on type and locality) and a market for sales of individual loans or sub-portfolios. However, an essential question determining whether a loan or collateral can be exited is: What was the entry price? If an NPL investor's entry price involved significant value or margin of safety, the investor will have more flexibility to choose between an exit channel and exit type. If the investor overpaid, then no profitable exit will be available.

Servicing experience is also vital to the exit process. Also, in other more developed markets around the world, investors have found that owning a proprietary servicing data system and a captive national servicer allow the investor to manage servicing more effectively. In China, these kinds of tools are generally only owned by the most experienced platforms.

Types of Investors

Investors who allocate capital to funds that invest in Chinese distressed assets, include a broad range of investors from around the world, including sovereign wealth funds, pension funds, insurance companies, endowments, foundations, and a variety of others.

Generally investors view the China distressed opportunity as one that provides them several desirable return characteristics: (1) downside protection in the form of real estate collateral, (2) IRRs that are generally higher than other debt strategies outside China, (3) speed of cash recovery that is generally faster than other private equity funds, (4) a risk/return profile that is uncorrelated with other major markets the investors are heavily exposed to, and (5) a source of alpha, given that the space requires significant work in both sourcing and exits.

Investors are also cognizant of the unique risks presented by investing in Chinese distressed debt, but manage this risk through partnering with a manager with a long history and experience in this area. Counterintuitively, buying an NPL portfolio in China where the collateral is worth three times the investment cost could arguably be viewed as safer than a senior loan in the United States where the loan-to-value is over 80%, assuming the firm has the relevant experience with Chinese NPLs. This is due to the margin of safety and diversification across loans that such a low priced NPL portfolio provides.

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