ShoreVest
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China Debt Dynamics

Revisiting Risk and Returns

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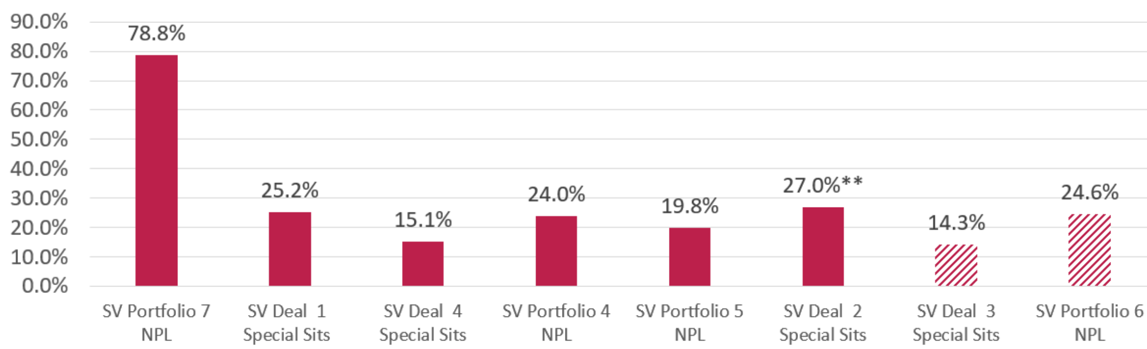
Prior to the many recent world-changing events, 18 months ago, in China Debt Dynamics ("CDD") Vol 5, Issue 2, we posited that ShoreVest's asset-backed private credit strategy in China presents global allocators with a uniquely downside-protected, uncorrelated opportunity. In summary, we made the following points:

1) Bigger Market / Less Competition: "Driving [Chinese asset-backed private credit's] unique risk/return profile are three overarching factors: (1) the volume of debt in the market, (2) forecasted growth in volume of opportunities, and (3) the lack of competitors, especially relative to developed markets." (CDD 5.2, p 2.)
2) Better Downside Protection: "Chinese asset-backed private credit generally affords far more margin of safety than is typically found in the West. For instance, Chinese private credit funds often target LTVs in the range of 30-50%, whereas leverage levels in the West are much higher." (CDD 5.2, p 3.) A few months later, we pointed out in our CDD on Evergrande here that when compared to unsecured offshore bonds, first-lien asset-backed private credit of the type ShoreVest participates in has far superior protections.
3) Higher Unlevered Returns: We also shared a range of data points showing that Chinese private debt offers higher returns (target range 12-16% IRR net unlevered) than those historically found in comparably secured private debt products elsewhere in the world.

Now with 18 months of hindsight, how correct were these assessments? And in particular, how correct were they during a period of many destabilizing events? To name a few: a global pandemic, a sell-off of US equities, inflation, war in Europe, COVID-zero lock-downs in China, and Beijing's aggressive de-leveraging and resulting property developer distress. If there was ever a time to test ShoreVest's claim that our strategy provides a superior downside protected, uncorrelated opportunity, it would be a period of crisis like the last 18 months.

Instead of being a period of greater stress for ShoreVest, our investments have continued to generate: (1) Steady cash recovery; (2) Higher returns; (3) No losses. Of the eight investments made by ShoreVest in the last three years, six are already exited (note, two of which have installments to be made) and the last two are partially exited. The range of realized IRRs on these deals is from 14% to almost 80% IRR (see table below). All during the last few years of tremendous crisis.

ShoreVest's Recent 3-Year Deal Performance

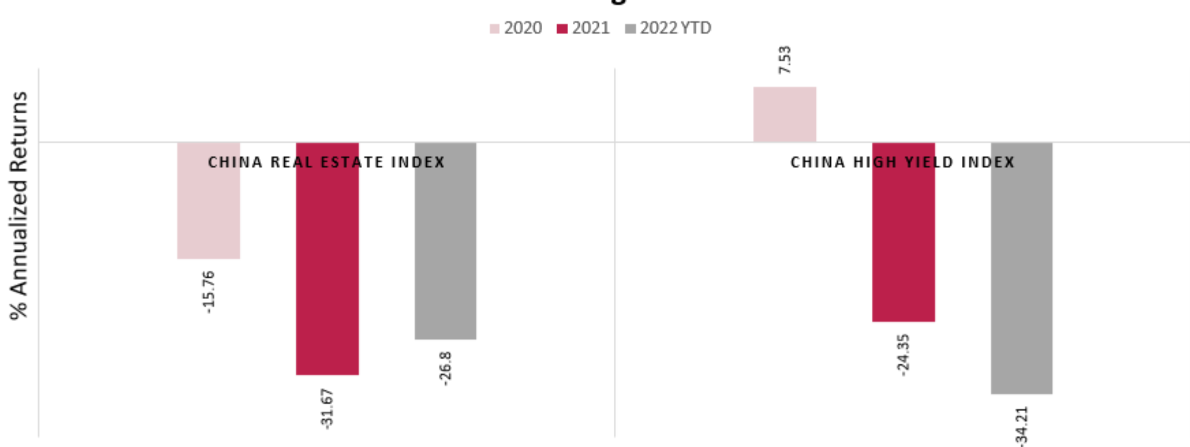


Deal Year	2021	2020	2021	2020	2020	2021	2021	2020
Deal Level Net Multiple	1.65x	1.41x	1.18x	1.16x	1.53x	2.43x	1.27x	1.34x
Status	Fully Exited	Fully Exited	Fully Exited	Fully Exited	Fully Exited*	Fully Exited*	Partially Exited	Partially Exited

Data is as of July 31, 2022 unless stated otherwise.
* There are remaining installments to be paid. The IRR for this deal is as of Oct 2022.
** The option value would increase the SV Deal 2 Special Sits IRR to 40.9%.

The returns above might seem counterintuitive, given the bleak headlines on Chinese property and bonds. For instance, China property and high yield indices have fallen significantly in recent years (see table below). So some might ask: If real estate and credit indices are down, wouldn't ShoreVest's asset-backed credit strategy be under pressure? But as we have explained before, ShoreVest focuses on lending with first liens on completed buildings as collateral (as opposed to taking development risk or buying offshore unsecured credits, such as bonds). We think the returns shared above illustrate how relatively uncorrelated we are to the property developer bond and equity performance shown below.

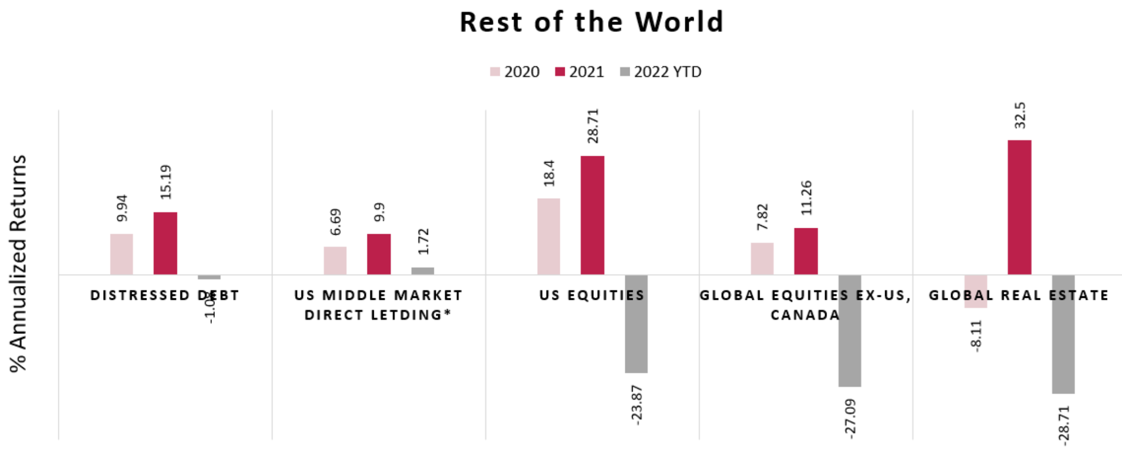
China Real Estate and High Yield Performance



Source: China Real Estate represented by MSCI China Real Estate Index, China High Yield represented JPM Asia Credit China High Yield Index

* YTD for all indices is Aug 31, 2022

Looking beyond China, ShoreVest's returns were realized not just during China's woes, but in a time with many more problems facing the world at large. The table below shows how other markets have suffered (including both distressed debt and middle market lending indices, which have largely underperformed this year relative to prior years).



Source: Distressed Debt is represented by Eurekahedge Distressed Debt HF Index, US Middle Market Direct Lending represented by Cliffwater Direct Lending -CDLI-S Index, US Equities represented by S&P 500 Index, Global Equities Ex-US and Canada represented by MSCI EAFE, Global Real Estate is represented by S&P Global REIT

* YTD for all indices is Sept 30, 2022 except Cliffwater which is June 30, 2022

Based on ShoreVest's recent performance in realized exits (not unrealized marks), the points we made 18 months ago would seem to hold true. The strategy is uniquely downside-protected and uncorrelated. This should not be too surprising as we look back on ShoreVest's nearly two-decade track record, in which the team generated a range of 8-18% net unlevered returns across all vintages through events such as the GFC, a global pandemic, multiple points of extreme volatility in markets, changes in political leadership, China's property developer implosion, and so forth.

But will this opportunity continue?

Market Continues to Grow

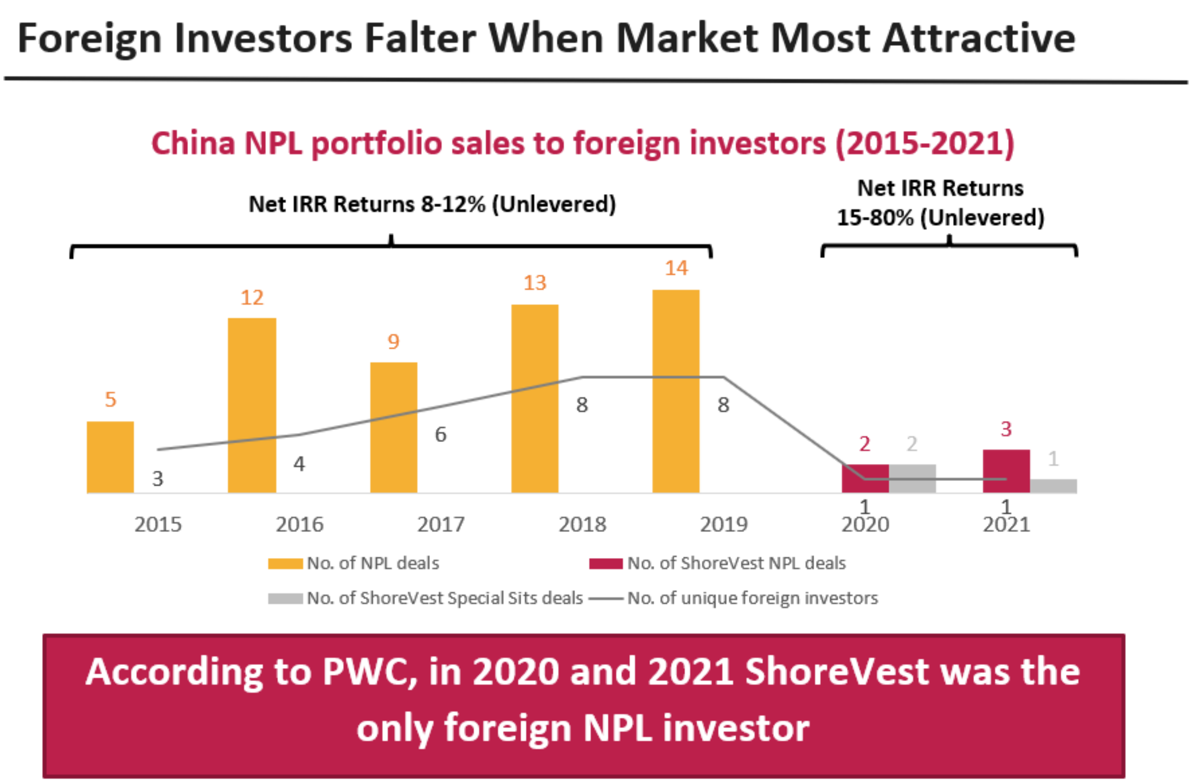
One of Beijing's primary goals is to maintain stability. An important part of financial system stability (and therefore social stability) is to keep banks healthy. So Beijing has made clear its policy focus is on de-risking and de-leveraging, increasing the pace of NPL disposals. Chinese NPL disposals in 2022 are set to continue the 2020/2021 RMB 3+ trillion record-breaking levels, indicating Beijing's resolve to clean up and take the pain now, rather than kick the can down the road.

Source: CBIRC, local media

Aside from NPLs, the continuing opportunity in asset-backed lending and special situations comes from a market with fewer credit options for companies. One primary competing source of credit was historically the shadow banking system. According to the CBIRC, the shadow banking sector shrunk by $4.3 trillion by the end of H1 this year, from its estimated peak of $13 trillion in 2017. This, together with the fact that China has been imposing more constraints on the commercial banks, has allowed ShoreVest to demand higher cost of capital and better collateral coverage.

Fewer Competitors

Another reason for our assessment that China's private credit markets would outperform developed markets was significantly lower levels of competition. Both the NPL and asset-backed special situations markets lack strong foreign institutional competition. From PWC and ShoreVest data, we saw no activity by foreign firms in China's NPL space in 2020 and 2021; years which had much higher returns than the previous years when foreigners were doing their first deals in the space. Foreign firms typically have foreign-based ICs and senior management, which has been an inhibitor to sourcing and executing deals, particularly with NPL opportunities.



Sources: PwC "The Chinese NPL Market in 2020" (published in 2020), PWC Partner, ShoreVest Partners

Room to Grow

Supportive regulatory policies from the CBIRC to continue to de-risk and de-lever have already created an opportunity that is set to persist for years to come. But an additional reason for the space's likely future growth is just how little non-bank credit had penetrated China's overall credit market to begin with.

Private Credit Has Room to Grow

Percentage of credit to corporates from non-bank channels

Source: Bank of International Settlements. Accurate as of Q3 2021.

China's private credit markets are clearly underserved relative to developed markets. As the country's currently inefficient credit markets mature into a more diverse allocation and pricing of credit risk, the space is bound to grow.

We believe ShoreVest's performance during the recent years of crisis is telling and confirms what we said 18 months ago. The strategy is uniquely downside-protected and uncorrelated. In this growing market, we aim to continue producing a compelling risk/return option for globally diversified portfolios.

ShoreVest Management

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