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Benjamin Fanger: Ballooning Bad Loans In China Are The Next Great Opportunity

By Staff Writer | July 23, 2014

In this episode of **China Money Podcast**, guest **Benjamin Fanger**, co-founder of Chinese distressed debt investment firm **Shoreline Capital**, talks to our host **Nina Xiang** about the changes he saw in the distressed debt investing space over the past ten years, where he sees future opportunities, and how his firm controls downside risks in a highly specialized investment arena.

Read an excerpt below, but be sure to listen to the full episode in audio. Don't forget to [subscribe](#) to the podcast for free in the iTunes store.

Q: Can you first give us some background on Shoreline Capital?

A: I co-founded Shoreline Capital with my partner, Zhang Xiaolin, in 2004 when we were still studying at the University of Chicago Booth School of Business. Currently, we manage around US\$650 million investing in distressed debt in China, with over 30 people in the company.

Q: And, you are currently raising a third fund with a US\$500 million target?

A: That's correct.

Q: During the past 10 years, how has the distressed debt investment space changed in China?

A: It has changed significantly. Back when we started the firm, it was not clear what would happen in courts if you were trying to enforce debt. Since that time, the legal environment has improved significantly.

The types of investments you can do have also expanded. Ten years ago, there were probably opportunities only in the non-performing loan (NPL) space. Today, there are other types of investments given the decelerating economy.

Q: How has China's legal environment improved, specifically? In 2007, China enacted a new enterprise bankruptcy law, but the new law hasn't been tested that much?

A: I think the more relevant laws for what we do are creditor rights enforcement, not bankruptcy laws. Creditor right enforcement in China has much more predictability nowadays than before.

Let's say if you could do ten things in courts in London or New York to enforce your rights as a creditor, you could only do three things with predictability in China ten years ago. Today, you could probably do four or five.

Q: Can you give an example of the things you can do now but couldn't before?

A: I'll first say some things that a creditor has always been able to do in China. They include doing searches for titles of a borrower's assets, putting liens on those assets, and taking the borrower to court. You could also auction certain types of assets off the borrower, things that are not sensitive in the eyes of the local government.

An example of some new things you can do as a creditor in China is pursuing fraudulent conveyance. In a developed court, if a borrower transfers all its assets to another borrower, creditors can sue that (second) borrower as well. Ten years ago, courts in China were not very familiar with fraudulent conveyance. But today, it's more predictable to pursue this in Chinese courts.

Q: But there are still many things beyond your control. How do you manage that risk?

A: We price those things that we cannot do with predictability in Chinese courts to zero, and give value to the few things that we can do.

But in some cases, Western courts would be less predictable than in China. Let's say I have a borrower who has defaulted on a loan. I have a complete set of loan documents that I have bought from the bad banks in China. If I go through due diligence and find that the borrower owns an office building, but it's not my collateral, then I can go to a court in China and do a pre-trial attachment of that asset and essentially become a secured creditor. In essence, putting a second-lien on that asset.

This is a very predictable process in courts in China. But this process could be quite difficult if there are counter-claims or other complications in courts in developed markets.

Q: Your business initially was to invest in NPLs in China. Can you explain how did it work?

A: We would buy a portfolio of NPLs from the Asset Management Companies (AMCs), or the so-called bad banks, at significant discount to principle value.

Q: At roughly what kind of prices? Say, 50 cents on the dollar?

A: I would never buy NPLs in China for 50 cents on the dollar, at least not for anything I've seen. We would pay much, much more significant discount than that.

For NPLs that derived from loans made in the 1990s, the steep discounts were because lots of those loans were made for policy purposes. But in this next phase of NPLs that derive from loans made around the credit boom in 2009, the prices might be higher because the loans were made to operating businesses, usually with more assets.

Q: What kind of prices are you paying for NPLs now?

A: We purchased a portfolio of NPLs six months ago at less than 20 cents on the dollar.

Q: And this price is still significantly higher than what you paid in the past?

A: Yes. But it's important to understand that prices viewed as a percentage of principal balance aren't what matters. What matters is the purchase price relative to what we can collect at the end of the day.

After we buy the NPLs, the first step is to search for any assets the borrower has, such as real estate, equity stakes or bank accounts. Then, we proceed into the courts to put liens on those assets. Once we bring the borrowers to the

negotiating table, we will discuss some kind of resolution that hopefully doesn't involve auctioning off the assets. Only about 5% of our exits end up in an auction. Usually, someone else would want to buy it, or the borrower would want to settle with us.

Q: There are increasing concerns about China's ballooning debt piles. Where do you see future opportunities for distressed debt investors?

A: First, I'd like to say that China's over-levered in certain sectors such as corporate borrowings and shadow banking sectors, but it's not the same type of credit boom that the U.S. had before the mortgage crisis.

The lending to China's corporations around the year 2009 doubled China's loan book, which created a lot of NPLs that will eventually surface. In the early 2000s, it was estimated that there were half a trillion U.S. dollars of NPLs. Today, NPL estimates in China are around two to six times that number. This is where I see tremendous amount of opportunities going forward.

Q: Where do you see the peak of NPL ratios for Chinese banks during this cycle?

A: The NPL ratio is a misleading indicator, because changes in the denominator can significantly alter the number and it also depends on what gets recognized as non-performing. My estimate for the amount of loans that will likely see difficulty in repayment in China is somewhere north of 10% (of total bank loans).

Q: How much of the NPLs you invested in become noncollectable in the end?

A: Of the thousands of loans we have purchased over the years, very few have ended up realizing no cash collection at all. More importantly, we usually do not see drastic variation from our expected recovery.

Q: Do you find rescue financing providing a good source of deals too?

A: For the three strategies we do, NPLs, rescue financing (or distressed special situations) and non-distressed special situations, it is the first time that I see the drivers for all three alive and well.

The increasing opportunities in rescue financing are due to the current economic slowdown in China. And, in the past year or so, the decline in shadow banking activities and defaults of trust companies are making more companies willing to pay high rates for financing from someone like us.

Overall, I'm cautiously optimistic about the opportunities. We are cautiously investing right now, because China is continuing to decelerate and more loans are coming out as non-performing. In addition, asset quality is likely to decline, and liquidity will increasingly become a problem.

Q: So, how will your pace of investing be compared to past years?

A: We are likely to invest more capital going forward as our deal size is likely to be larger, even if we do the same amount of deals every year. Some of the deals we look at right now are close to US\$100 million. That is too big for our fund to do, but the point is deal size today is much larger than the US\$20 million to US\$30 million four or five years ago.

Q: Which sectors do you see as producing the most distressed debt opportunities?

A: NPLs range across every sector. For special situations financing, we saw the property sector as the most attractive for a couple of years, as China tightened lending in the space. But we really just invest in any sector that desperately needs financing but can't obtain it elsewhere.

The most important thing is that we are an asset-backed financier, so we would not likely lend to service or technology companies, for example.

Q: It reminds me of a comment I read that Chinese banks are essentially pawnshops, as they take little credit risk by issuing mostly collateralized loans.

A: I would say the difference is that the pawnshop actually takes the assets into its hands; while an asset-backed lender only has a document that allows it to go to court, and let the court to auction off the assets.

We have been through hundreds of lawsuits and seen every way a borrower can default its creditors in our NPL business. That's why we try very hard to avoid the courts completely on our other businesses by taking possession of the assets at the outset. Therefore, we've never had a default on our special situations business.

Q: Can you give us an example of a recent investment you did?

A: We purchased an NPL portfolio from a Chinese commercial bank six months ago. It is the first bank-sold NPL deal to a foreign investor that I'm aware of as a result of the government's decision to free up the market and allow the banks to sell to third-party entities, other than the AMCs.

So there are an increasing number of sellers of NPLs in the market, including banks, AMCs, and trust companies.

Another example is a real estate project we financed a couple of years ago. The project is RMB100 million short from completion. The assets were already worth RMB300 million. We found that a big state-owned enterprise (SOE) has signed an agreement to purchase the buildings. So we first transferred the assets into our name in a pre-structured repossession structure. In the end, the project got completed, the SOE purchased the buildings, and we were able to exit.

Q: How was your performance so far?

A: We've never lost money on an investment. We have achieved private equity-level returns. There have been periods of time when it was difficult achieving that kind of returns and the consistency of that return. But fundamentally, we do not pursue higher returns by taking more risk. But rather, we try to focus on achieving private equity returns with senior real estate-backed secured loan risks.

Q: Lastly, what would you say is the biggest difference between distressed debt investing in China and in more developed markets?

A: In China, there are fewer competitors in the space. Also, in more developed markets, you may have to get into complicated bankruptcy or reorganization processes, change management, renegotiate labor contracts, and so on. But in China, you can do more plain vanilla stuff, but it still requires a lot of local experience.