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China local SOE sales? More risk than opportunity

Photo: Reuters

With nearly $400 billion in debt, China's cities may have to sell assets to raise funds.

ON-THE-GROUND

“Generally speaking, foreign investors don’t have the capability to do onshore due diligence on assets that China's local governments own.” – Benjamin Fanger, Shoreline Capital

FULL BRIEFING

China's mounting local debt may lead to state asset sales, but whether private investors have an appetite for them is an open question, analysts tell Monitor Global Outlook.

Local officials face a record 2.4 trillion yuan ($386.8 billion) of mature debt by the end of 2014 as their income from land sales – a major source of revenue – slide amid a real estate downturn. The sale of holdings in 43.8 trillion yuan ($7 trillion) of locally controlled businesses, which range from roads to power generators, is an option as many local governments struggle to raise funds. Whether they will end up selling these state-owned enterprises (SOEs) depends as much on the property sector as the financial health of higher-level governments.

Investors may see an increase in the sale of SOE shares over the next two to three years as the result of higher financial pressure and Beijing's push to revamp ownership structures, Zhong Liang, a Standard & Poor's analyst, tells MGO. However, investors eyeing local assets will have to deal with significant risks, warns Zhu Ning, a professor of finance at Shanghai Jiao Tong University and a former adviser to Nomura Securities, who says that it is very hard to gauge local officials' assets and liabilities. They may start by getting rid of the worst stuff on their hands.

"Introducing private investors to help local officials is a reform direction," he says. "However, it is not going to be easy."

Also, it might be hard to get a handsome return on local assets, as many SOEs – including electric power, transportation, and financial services firms – operate in sectors subjected to significant regulatory uncertainties, says Ryan Rutkowski, an analyst at the Peterson Institute for International Economics, a think tank based in Washington. The return of local SOEs stood at a paltry 1.7 percent in 2013, even lower than the central government SOEs' 3.4 percent, he adds.

"Until more market mechanisms are introduced to allow these firms to profit, private investors will not be able to generate returns on these assets any better than state-owned firms," he tells MGO. "If governments are selling assets in a fire-sale mode, potential appetite will probably be limited to value investors."

A better way out of the looming debt crisis is asset securitization, says Guan Qingyou, vice president of Minsheng Securities' research institute. Chinese regulators have approved a couple of local government investment vehicles to issue asset-backed securities (ABSs) this year and the market could expand by another 5.3 trillion yuan ($851 billion) by 2015, as local officials are eager to explore this new channel of financing, according to the state-run China Securities Journal.

However, if foreign investors are the target participants, ABSs are unlikely to be a major source of funding, predicts Benjamin Fanger, co-founder and managing director of Shoreline Capital. It may not be easy to classify and rate Chinese local government infrastructure projects into securities that global market participants would understand, says Mr. Fanger.

"Generally speaking, foreign investors don't have the capability to do onshore due diligence on assets that China's local governments own," he says.

Beijing also needs to revise the related laws and streamline a regulatory network including the People’s Bank of China, the China Banking Regulatory Commission, and the China Securities Regulatory Commission to make ABS work better, Rui Yuehua, director of CSRC’s Hubei branch, wrote in a bill during the March parliament meetings.

A good investment opportunity rising from China’s debt overload lies in Chinese banks’ distressed assets, according to Fanger, who says that the banks probably sold twice as many nonperforming loans in 2013 as they did in 2012. Bad loans at China’s top five banks increased by 47 billion yuan ($7.6 billion) in 2013 to 374 billion yuan ($60 billion), as a spending spree starting in 2008 left many sectors with excessive capacity and slower growth amid a cooling economy.

“I see this as a very positive development in China as encouraging the banks to handle the problem as much as they can on their own,” he says.