No stranger to distress

ShoreVest tells WiC about the changing face of bad debt investing in China

Last year the Chinese banks disposed of an estimated Rmb1.75 trillion ($258 billion) of soured loans – a value roughly the size of Vietnam's economy. While the size of the disposals sheds light on the scale of the challenge facing the country's banking system, it also represents an opportunity for specialist investors to profit. From a dedicated platform in Guangzhou, ShoreVest Capital Partners has been investing in China's distressed assets and structured credits for 15 years. WiC spoke to its founder and managing partner Benjamin Fanger for more on the nitty-gritty of distressed debt investment in China, including the rise of online auction platforms, the impact of the recent Sino-US trade deal, and changing rules that have helped to create a more favourable environment for resolving debt disputes in court.

Benjamin Fanger: has 15 years experience of buying Chinese NPLs

How big is China's distressed debt market?

The current distressed opportunity in China essentially comes in two categories: one, purchasing non-performing loans (NPLs) sold by the banking system; and second 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 $1.5 trillion or more. For example, in a report last month, PwC estimated that as of mid-2019, there were $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 Centre estimated last year 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.

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 highlight 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 are actually getting written off and disposed of by the banks. According to data disclosed by the CBIRC, in the four years from 2016 to the end of 2019, the Chinese banks disposed of Rmb6.4 trillion ($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 recognise, and then dispose of, their NPLs.

For ShoreVest, NPLs in China are largely a real estate-backed play because usually we are only underwriting significant value to NPLs that are senior loans, secured by real estate. Our approach to the NPL opportunity is to source hundreds of opportunities and sift through them 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. Also, because a portfolio large enough to be priced attractively usually has hundreds of loans in it, pricing and especially working out the loans requires a significant onshore platform and many years of experience.

On the special situations side: as China's economy has decelerated and the scale of the shadow banking system has waned, companies who can't access bank loans are forced to come to groups such as ShoreVest for alternative bridge financing. Over the last few years we have seen the cost of capital that companies are willing to pay increasing as their options become more limited. This year, as firms face the effects of Covid-19 and a continued deceleration of the economy, we are seeing more 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.

Do you have a preference for the size of the loan books that you are looking to acquire?
ShoreVest prefers NPL portfolios that are too complicated for newcomers to underwrite. This often means that the loan books have hundreds or even thousands of borrowers in them, so the work in sourcing and constructing these portfolios is significant.

It involves first sifting through hundreds of portfolios with hundreds of different borrowers for candidates that meet not just our return targets, but also our requirements as to the level of collateral coverage or "margin of safety." 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.

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). But resolution of a portfolio requires a safe pair of hands. Hence, IRRs depend entirely on who is underwriting the portfolio and, thereafter, who is working it out.

Many inexperienced investors that come into 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 happens. 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 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 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 generally significantly shorter than a typical private equity investment.

The return profile and time horizon for special situations or bridge financings are similar to NPLs.


Factories resume work

Photo: Reuters

How would you describe the competitive dynamics between foreign and local distressed debt asset managers in China?
The market isn't crowded. On the sell side, it is actually highly fragmented, with the 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 centralised 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 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 cheques and who primarily have an interest in NPLs from a particular region. The newly set-up local AMCs are an example of this – generally they are limited to purchasing loans from banks within a particular province.

Foreign distressed debt firms have been highly interested in the space over the last few years but while they can write larger cheques, 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 foreign newcomers have significant experience resolving whole portfolios. As a result, foreign firms still constitute a tiny segment of the overall market.

What are the key challenges for overseas NPL 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 requires various approvals across different countries, it is difficult for a seller who urgently needs to resolve a portfolio to put significant confidence in such a buyer.

While at least half a dozen different foreign groups have purchased their first portfolios in recent years, we have heard 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 outsource the servicing of the deals to local groups with whom they have limited working history.

Photo: Reuters

China's Supreme Court: made key decision on NPL auctions in 2017

Where an external servicer is used, it is essential that a buyer has a robust internal team with actual workout experience in Chinese NPLs actually overseeing the servicer on a daily basis. Few foreign firms are staffed with much more than Hong Kong-based executives and many of the primary decisionmakers don't even speak or read Chinese. This creates a plethora of potential hazards in both judgment and operational efficiency, which are key to the workout process.

Can you share your experience of working with provincial governments over recovering distressed assets?
Compared with the United States, China benefits from a national regulatory and legal system (as opposed to various state-level laws that govern debt collections). Provincial or other local governments might try to influence the process, but generally courts will adhere to the national rules on how enforcement of distressed assets is handled. Of course, 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 more likely. But we generally do not include such loans in the portfolios that we purchase.

How have court decisions in China evolved to enable more efficient resolution of distressed asset situations?
The litigation process and the courts' willingness to enforce creditors' rights has significantly improved over the past decade. Fifteen years ago, when I was first involved in enforcing NPLs in the Chinese courts, the process could take as long as five or six years. Today, although there can be significant variations depending on the type of loans, the process for full enforcement is supposed to take somewhere between 18 to 36 months (and it often does).

The variation in timelines is often due to particular issues with a given loan, or difficulty finding a buyer for the collateral, so it is important that an NPL investor identifies these issues before purchase.

When a court decides in our favour, it orders the collateral asset to be sold at auction. Traditionally that was done on consignment at open-cry auctions that were conducted locally. However, the system was open to abuse, with insiders often able to use thinly attended, poorly publicised auctions to pick up assets cheaply.

In 2017, the Supreme People's Court declared that all auctions must include an online auction or at least an online notice. These online auctions have a higher rate of success than traditional consignment auctions and they generate higher bids. Today, most judicial auctions of collateral are conducted on Alibaba's Taobao platform, and to a lesser extent on JD.com. Over the past few years Taobao alone has conducted hundreds of thousands of judicial auctions.

The auctions allow creditors to receive the proceeds of collateral sales – up to the value of the outstanding debts – without ever taking possession of the assets. However, if an asset fails to sell at auction twice (the reserve price at the second auction is typically set at a 20% discount to the first), the creditor has the right to take possession of the asset and count the reserve price against the value of the outstanding debt.

This "deed-in-lieu" arrangement rounds out the NPL disposal methods available to ShoreVest. In addition to negotiating with a debtor for partial repayment, seeking payment from a loan's guarantors, finding third parties willing to buy a loan, and selling a loan's underlying collateral, we can take possession of loan collateral and generate 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.

How is China's distressed debt market different from those elsewhere?

Our understanding is that in comparison to North America and Europe, China's sale of NPLs is greater in volume but much more fragmented in terms of sourcing deals and information. Accessing the market at scale requires a robust local platform with many touchpoints across the country.

Taobao: auctions bad loans too

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. China is unique in that the national regulations that are directed toward the resolution of NPLs can be very fast and effective at forcing the recognition and sale of the loans. Since 2017, a series of government policies such as Circular 46, and more recently the requirement that banks recognise any loan past 90 days overdue as non-performing, have catalysed the flow of opportunities into the market.

Also, presumably due to concerns about 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.

Have the online auction platforms been useful for the process of portfolio construction as well?

We almost always source NPL opportunities directly within the offices of the sellers. While online auctions of NPLs are common, our understanding is that at least in the case of portfolio sales (as opposed to single loan sales), the online element is usually more of an auction notice than an actual channel through which an NPL buyer presses "buy" without even visiting the seller. This is due to the fact that each of these portfolios is highly complicated and involves gathering reams of information from the seller and the local real estate market, legal documents and new appraisals, and opinions from law firms, none of which is available online.

Are there enough exit channels for bad debt investments?

Most distressed debt opportunities in China involve a variety of exit options, including settlements with borrowers or guarantors, sales of loans to third parties, debt/asset or debt/equity swaps, and court enforcement of collateral.

ShoreVest's team has extensive experience with each of these strategies and has been involved in thousands of debt-enforcement lawsuits over our 15-year history in this space. The availability of any one of the exit channels depends on the individual loan but 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 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. ShoreVest owns proprietary servicing technology and a captive national servicer, which allow us to manage the servicing more effectively. Because any one of our funds will usually have over a thousand loans or borrowers in it, the operational aspect of managing the exit process is intensive. If investors don't have this operational capability, then resolution will be delayed.

Who are your LPs (limited partners)?

Our investors include institutions from all over the world. They are generally sovereign wealth funds, pension funds, insurance companies, foundations and a variety of other LPs you would typically find in a reputable private equity fund.

Our investors view the China distressed opportunity as one that provides them several desirable characteristics: first, downside protection in the form of real estate collateral; second, IRRs that are generally higher than other debt strategies outside China; third, speed of cash recovery that is generally faster than other private equity funds; fourth, returns and risks that are uncorrelated with other major markets they are exposed to; and fifth, a source of alpha, given that the space requires significant work in both sourcing and exits.

Our investors understand the unique risks presented by investing in Chinese distressed debt, but are they are more comfortable when they know the assets are being managed by an institutional team with more than 15 years of experience in the market. Counterintuitively, buying an NPL portfolio in China where the collateral is worth three times your investment cost can 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.

How has the trade deal between the US and China affected your opportunities?

The trade deal does create an additional channel for US firms (ShoreVest included, as we are partly US-based) to purchase NPLs from the banks. Under the agreement, China committed to allowing US financial services firms to acquire NPLs directly from lenders. Rather than acquire the bank NPLs from AMCs at a mandatory mark-up – as is currently required – investors with the appropriate licence will be able to buy NPLs directly from the source.

ShoreVest is already in discussions with several local governments on the steps that will be necessary for the firm to get such an AMC licence.

While this is a positive development, it bears noting that the ability to buy directly from banks has never been the primary gating factor [i.e. constraint] for foreign firms hoping to invest in Chinese NPLs. For many years, overseas investors have been allowed to purchase NPLs from AMCs (or source them from banks and then buy the portfolio once an AMC purchases it). The primary gating factor has actually been experience, operating ability and networks for sourcing and servicing the NPLs. Hence, while this new development is promising, it does not resolve the primary challenges for many foreign firms in the NPL market.

What's your outlook for China's economy, and especially its banking sector?

With the global economic impact of the Covid-19 outbreak, it is difficult to see how any economy would have a wholly positive outlook for the months and years ahead. In addition, China's economy had already been decelerating for some years and the banking system is saddled with a massive amount of NPLs. That said, China has proven adept at responding to crises in a measured and effective way on many occasions in the past, and we believe that it will be able to navigate its way through the current crisis.

Furthermore, with China's recent bailouts of its financial institutions, it is clear that where necessary to avoid a systemic crisis, the government will step in to maintain stability.

Therefore, our medium-to-long-term view for China's economy and banking sector is still generally positive, even though significant short-term stress is inevitable. ■