中金投X CHINA MONEY NETWORK

NAVIGATING CHINA’S RESTRUCTURING MARKET
RISKS AND OPPORTUNITIES

Foreword

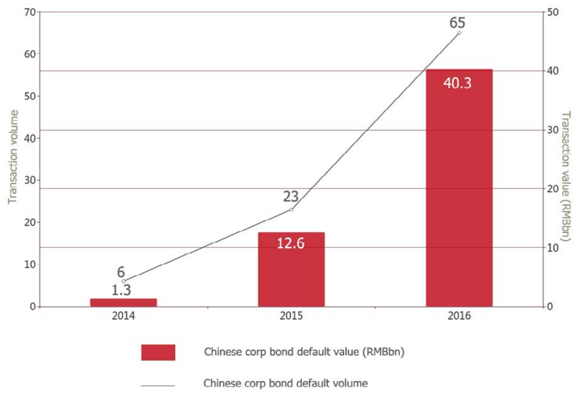
The effort to deleverage China Inc. is underway, and overdue, as China’s credit-to-GDP ratio is clearly unsustainable. This means there are a wider array of opportunities available for foreign investors, who are viewing the Chinese debt restructuring market with increasing optimism. Buying portfolios of non-performing-loans (NPLs) is still the preferred access point to China debt for most foreign investors. However, alternative strategies including investing in single asset situations and restructuring offshore debt of Chinese companies are also on the rise.

A Policy Priority: Reduce Overcapacity and Deleverage

The Chinese government has set “reducing overcapacity and deleveraging” as one of its policy priorities to address systemic risks as its economic growth slows down. Specific measures include slashing excess capacity in heavy industry, reducing the overstock of urban real estate inventory and unwinding corporate debt.

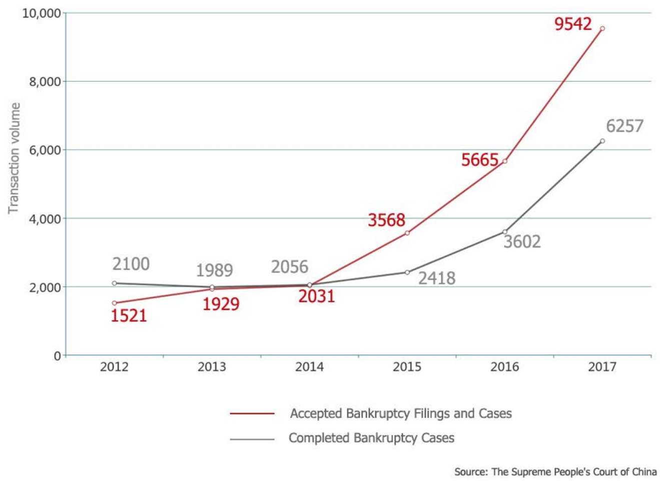
The effort to deleverage China Inc. is long overdue. According to the Bank for International Settlements, the nation’s outstanding debt

Chinese Domestic Corporate Bond Defaults

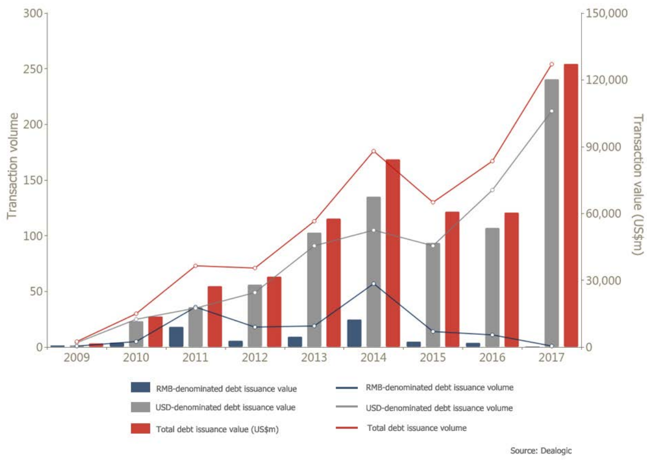


Source: Wind

Bankruptcy cases have rapidly risen in the last 5 years



Total overseas borrowings by Chinese corporations 2009-2017



reached 260% of its gross domestic product at the end of 2016, up from 160% at the end of 2008. Non-financial sector debt has gone from US$6 trillion in 2007 to nearly US$29 trillion today.

Credit should be in line with GDP growth, and China's credit-to-GDP ratio is clearly unsustainable. The International Monetary Fund points out that in 2016 it took four units of credit to raise GDP by one unit in China, compared to 1.3 units of credit a decade ago. As the Chinese economy slows down, non-performing loans should naturally increase.

According to the China Banking Regulatory Commission, NPLs in China totaled RMB1.71 trillion (US$270 billion) as of February 2018, representing a NPL ratio of 1.74%. These official numbers underestimate the real level of "bad debt", as Chinese banks are known to disguise troubled loans, said Jason Bedford, executive director of Asian financials research at UBS. Meanwhile, a total of 55 local asset management companies (AMCs) have been established since 2012, when provincial governments were allowed to set up their own AMCs to compete with the Big Four national AMCs. Numerous newly established local investment houses were also set up to tap into the expected NPL market boom.

At the same time, under the policy directions from Beijing, more "credit events" are taking place. The number of domestic corporate bond defaults has jumped nearly 10 times from 2014 to 2016. In terms of the total value of defaulted bonds, thid has skyrocketed by s multiple of 31 times in the same period.

The number of corporate bankruptcies in China has risen rapidly in recent years as well, with accepted bankruptcy filings by courts more than doubling from 2015 to 2017. The number of completed bankruptcy cases nearly tripled during the same period. This was partly assisted by an increase in the number of specialized bankruptcy courts in China to a high of 97 at the end of 2017 from a low of 5 in 2015.

In 2016 Chinese regulators also issued a policy directive on debt-to-equity conversion transactions as a way to restructure troubled enterprises. There have been over 80 such cases publicly disclosed in China, compared to just a few several years ago.

All these numbers are clear signals that the Chinese government is serious about cleaning up the country's "zombie enterprises" and reducing the corporate debt pile. It also means there are a wider array of opportunities for foreign investors, who are viewing the Chinese special situations market with increasing optimism and are getting into the game with more determination.

A Wider Opportunity Set and Potential Risks

A PwC industry survey in 2016 found that China was viewed as having the most attractive distressed-debt opportunities in Asia Pacific, with around 52% of those surveyed saying the nation offered the best investment opportunities, followed by Japan and India.

An increasing number of investment firms have launched Asia-dedicated U.S. dollar vehicles with China as an investment focus. These include Bain Capital's first Asian credit fund with a US$1 billion target, ShoreVest Capital Partners' fundraising for a debut fund, and Gaw Capital, who is partnering with Chinese property developer Country Garden Group to jointly launch a US$1 billion fund investing in distressed property projects in China. Of course Bain as well as many other funds including Oaktree, Blackstone, Lone Star, KKR and PAG are already in the market.

But despite the expectations, until recently opportunities for foreign investors in China's debt markets following the global financial crisis have been limited. A combination of cheap credit, low interest rates and a steady appreciation in the value of real estate, which makes up 95% of debt collateral, has allowed China's "zombie" companies and indebted SOEs to stagger on unreformed.

That looks set to change. Rising interest rates, notably in the U.S. and Hong Kong, mean Chinese companies of all sizes are finding it harder to access offshore credit. Major conglomerates like China's HNA Group and Dalian Wanda Group who racked up debts for lavish overseas deals are now reversing course to pay down borrowings. That, combined with President Xi Jinping's campaign to curb corporate leverage, including a crackdown on shadow banking and limiting of government financial support to troubled companies, means the pressure is being felt across the economy, from giant state-owned enterprises to small private companies.

The result has already shown a big upswing in restructuring activity, and opportunities for distressed-debt investors and restructuring specialists.

China Money Network sat down with Victor Jong Partner, Advisory Services, PwC

Victor Jong, based in Shanghai, has practiced in the insolvency and corporate reorganization field since 1994. He transferred to PwC's Shanghai office in 2004 to develop the restructuring and insolvency practice in mainland China. He has advised on numerous debt restructurings, distressed investments, receiverships and liquidation assignments in the Greater China region.

CMN: How has the Chinese restructuring market changed in the past few years?

Victor: There used to be very limited debt restructurings in China, as the economy was strong and Chinese companies are very good at kicking their "bad debt" can down the road. As credit tightens, the problem will eventually become too serious to hide under the carpet or ignore. The government is determined to fix the issue, hence banks are becoming more cautious and liquidity is getting tighter. It's harder for companies to roll over their debt nowadays, and local governments are more inclined to let companies go into bankruptcy or distress.

All of these factors have resulted in an increase of in the number distressed cases we are getting involved in, including corporate bankruptcies and out-of-court restructuring cases. Bankruptcies in China, both reorganization and liquidation, reached historical highs last year. We expect the number to grow further in the next few years.

CMN: What kind of cases are you seeing these days?

Victor: Apart from large cross border cases like Mongolian Mining and Pacific Andes, PwC have been involved in a number of high profile restructuring cases that are purely domestic in recent years. For example, we are currently the joint administrator for the bankruptcy reorganization of Huishan Dairy, which has over RMB30 billion of debt in China. We are also involved in the restructuring of Bohai Steel, Dan Dong Port and more recently CEFC Group.

All these cases are very sizeable by international standards but involve primarily PRC banks and bondholders, and so the restructuring solutions have a more Chinese "flavour" involving government support and guidance and/or intervention if necessary. What we have found in each of these cases is that in many instances, this is the first true restructuring for many of the lenders and the learning curve for them is steep.

CMN: What should investors look out for when investing in debt in China?

Victor: Investors considering investing in a Chinese restructuring or enforcement situation need to fully understand the financials and fundamentals business and the options before they take action. China's restructuring laws, foreign exchange controls and tax rules are continually evolving. Concern over social harmony continues to play an outsized role in the Chinese government's decision making in restructuring cases. Having the right partners is the critical first step to minimize risk and maximize returns.

CMN: Where are the key investment opportunities for offshore investors?

Victor: The most mature opportunities are still in the NPL market—buying commercial loans mostly backed by real estate collateral. There have been a lot of precedents in the market and compared to other investment areas, NPLs are generally less sensitive politically and are easier to execute as their transfer to foreign investors means they have already gone through government vetting. The key challenge of investing in NPLs nowadays is finding portfolios that meet investor return requirements and monitoring servicing. To find good portfolios you need to team up with local players like PwC. We have a dedicated NPL team that works full time to source portfolios and help investors close transactions and monitor recoveries post deal.

Buying up most of the debt of large troubled companies and restructuring and turning them around – so called "single asset" investments – is also gaining traction amongst investors. Some investors prefer such investments as they believe they can achieve higher returns through an "invest, fix and sell" approach. Hotels and real estate related projects are often key targets of such investors.

Another opportunity is restructuring offshore debt of companies with assets in China, as acquisitive Chinese corporates piled up offshore borrowings in an unsustainable manner in the past few years. Under the Chinese leadership's policy directives, these conglomerates are rapidly going through an "unwinding" process that could offer attractive investment opportunities for foreign investors.

I believe it is still premature right now for foreign investors to fully participate in Chinese companies' bankruptcy proceedings. Speed is critical in participating in such deals, and foreign exchange controls means investment from foreign investors is less nimble and would seem less attractive. Not to mention having to balance local political dynamics, maintain social stability and other obligations are great challenges for offshore investors.

CMN: What are the key risks for investors in this process?

Victor: Creditors in the US don't have to care too much about people losing their jobs in a restructuring situation. Letting people go is socially acceptable. It is seen as part of the inevitable economic cycle and as a result of market conditions. But in China, this is something investors must watch out for as the government is often very concerned about social stability and this could easily derail a restructuring.

The laws on creditors' rights in China are still developing and there are instances when creditor's rights are not well protected or the

Court just refused to accept certain cases. Accounting fraud is rampant in China and often very difficult to discover, so investors must conduct thorough due diligence before making investment decisions.

So, it is essential to have strong local partners like PwC to minimize risks, to handle government relations and manage dynamics amongst various stakeholders. In terms of foreign exchange controls and tax rules, there are also many landmines that investors need good advisors to help steer them through.

Cautious Optimism

China is entering into an extended credit cycle where there will be increasing levels of bad loans, bond defaults, bankruptcies and restructurings over the next few years. Compared to the last cycle, the Chinese distressed debt market offers a more mature and friendly environment for foreign investors. Investors getting into this market early will enjoy first-mover advantages in their preparedness and execution expertise in the most promising restructuring market in Asia.

About China Money Network

CHINA MONEY NETWORK (CMN) is a leading artificial intelligence-based bilingual platform that tracks China's special situation market, smart investments and technology innovations. Millions of investors rely on CMN as the most trusted source of local media intelligence and data on China's rising business and technology power.

CMN provides a unique way to target deal makers, top decision-makers and business leaders in China and around the world. We are well positioned with our team of experts to uncover forward-looking deal flows not only for our customers in China, but those trying to enter this highly lucrative marketplace.

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