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Distressed Debt in China? Ain't Seen Nothing, DAC Says

By David Yong - Nov 20, 2014

(Corrects title in fourth paragraph.)

Bad debts in China are well underestimated because authorities persist in propping up weak companies and bailing out local investors, according to DAC Management LLC.

The Chicago-based asset management and advisory firm, which focuses on distressed credit and special situations in China, says the worst is yet to come, and that means lots of opportunities for the world's biggest distressed debt traders.

Nonperforming loans at Chinese banks jumped by the most since 2005 in the third quarter to 766.9 billion yuan ($125.3 billion), official statistics released earlier this month showed. The People's Bank of China has injected 769.5 billion yuan into its banking system over the past two months to support an economy growing at the slowest pace in more than a decade.

"They keep reporting such a low number for so many years, there's only one way it can go -- up," DAC founder Philip Groves said in an interview in Hong Kong yesterday. "We've yet to see it because if you look at corporate defaults, they keep getting covered by the government. At some point, they can't cover every single one."

DAC manages about $400 million of its own and clients' money onshore in China. It first bought Chinese bad loans in December 2001 from China Orient Asset Management Corp., one of four asset management companies created by the government to buy, repackage and onsell soured debt, Groves said.

Sporadic Activity

While China's bad loan ratio is relatively small versus other countries in Asia -- soured loans are equivalent to 1.16 percent of total advances compared with 3.88 percent in Vietnam and 0.86 percent in South Korea -- their total is still in an order of magnitude greater than the funds raised by distressed investors, Groves said.

There hasn't been enough capital to soak up the nonperforming debt and much ends up being reabsorbed by the government, he said. That's why distressed activity in China has been "sporadic" over the past 10 years and why some large investors aren't participating. "It never became a market where you could put a billion dollars to work in a year," Groves said. "But if the wave of bad debt comes, and there are things to buy, the money will follow."

China's three other asset management companies are China Cinda Asset Management Co., the biggest bad loans manager, China Great Wall Asset Management Corp. and China Huarong Asset Management Corp. The four were established in 1999 in an attempt to rid banks of some 1.4 trillion yuan in soured loans.

Government Rescues

Oaktree Capital Group LLC, the world's biggest distressed debt investor, joined with China Cinda in November 2013 to tap what it said were "unique opportunities" in the country's real estate market. Debt buyers at Nomura Holdings Inc. and Bank of America Corp. said they'll be paying more attention to Chinese developers in 2015.

Closely held developer Zhejiang Xingrun Real Estate Co. collapsed in March while Haixin Iron & Steel Group, an unlisted Chinese steelmaker in Shanxi province that halted production because of a capital shortage, started bankruptcy proceedings earlier this month, making it the largest mill in the nation to enter the procedure.

Many other companies however have been the subject of government rescues. Huatong Road & Bridge Group Co. averted failure in July thanks to funds from local governments and bond underwriters. And Shanghai Chaori Solar Energy Science & Technology Co., the only company to have defaulted in China's $4.2 trillion onshore bond market, got the money to repay investors from a state-backed asset manager in October.

Extending Loans

"In China, we see a lot of opportunities out there, especially among Chinese banks," Hanson Wong, Hong Kong-based chief executive officer of Belos Capital (Asia) Ltd. said in an interview. "They are facing some difficulty right now, they cannot keep extending their loans time and time again."

If more companies are allowed to fail, competition for nonperforming loans will intensify and the likes of Oaktree, Lone Star Capital Management Inc. and Cerberus Capital Management LP could build a meaningful presence in China, DAC's Groves said.

Syndicated loan facilities in China are already a record $46.4 billion this year, according to data compiled by Bloomberg. In Hong Kong, the total $60.6 billion thus far is approaching the record $63.9 billion in all of 2013.

KPMG LLP doubled headcount at its China restructuring practice after Premier Li Keqiang unveiled measures last December aimed at excising nonperforming assets at state-owned companies to boost their returns, Eddie Middleton, KPMG's Asia-Pacific division chief, said in Hong Kong yesterday.

Difficult Situations

According to Middleton, using a bankruptcy process is becoming more common in bank and state-owned enterprises' responses to difficult situations, whereas that wasn't the case even two to five years ago in China.

DAC employs about 50 people in China and has acquired more than 25 billion yuan of bad debts since it first bought the soured loans from China Orient in 2001, Groves said.

"When you see restructuring advisers getting hired by state-owned enterprises and Big Four accounting firms helping banks to get rid of distressed assets, you know it's coming," he said.

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