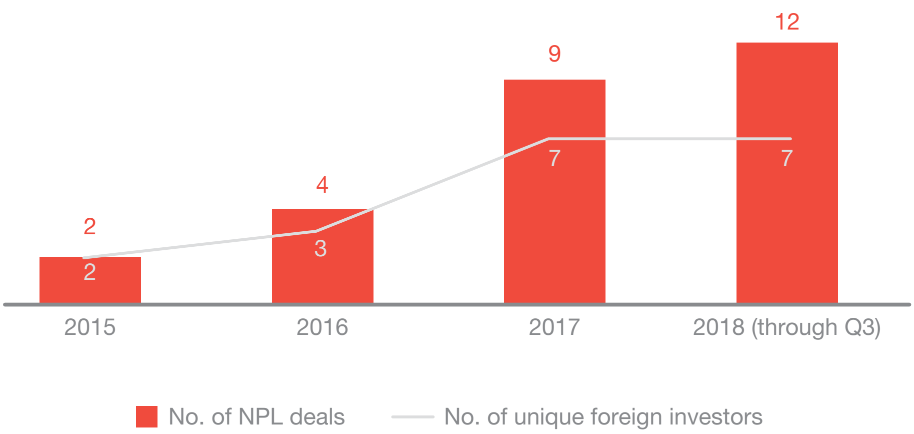
November 2018

2019: A sunnier outlook for international China NPL investors

In our March 2017 report on the Chinese non-performing loan ("NPL") market, we referenced a lack of Western-style political or shareholder pressure to encourage banks to tackle their bad loan problems, a lack of substantial deal flow and the challenges that foreign investors faced in closing deals.

Today we bring you a much brighter outlook: the market has seen a remarkable uptick in sales activity over the last 18 months, with over 20 portfolios sold to foreign investors - including 12 so far in 2018. We estimate foreign banks and funds have invested US$ 1.5 billion during this period and a total of US$ 2.0 billion since this cycle commenced in 2015. While 18 months ago we were cautiously optimistic about the opportunity for investors, today, we believe attractive NPL portfolio investment opportunities will continue to materialise for China distressed debt investors for at least the next 2-3 years as NPLs will continue to accumulate and, importantly, be recognised and sold to the big-4 Asset Management Companies ("AMCs")[1].

Figure 1: China NPL portfolio sales to foreign investors: 2015-2018



[1] Being Huarong, Cinda, Great Wall, and China Orient.

What has changed?

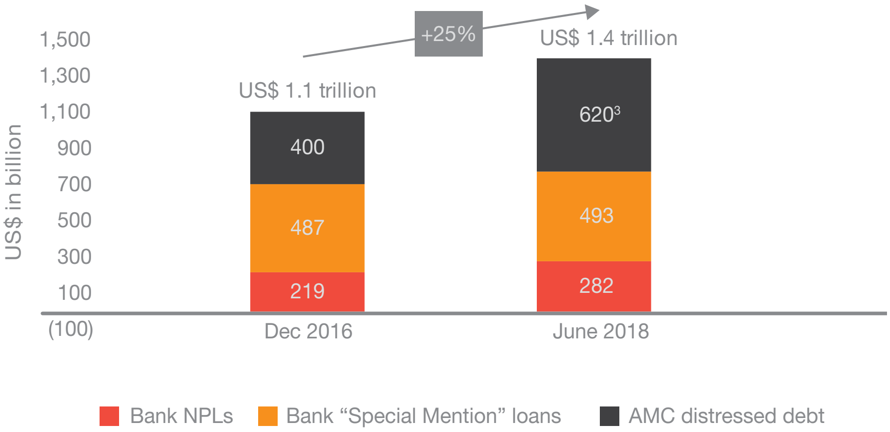
Beijing's attitude towards the shadow banking sector and desire to ensure the nation's banks are healthy so they can withstand any downturn, however slight, is a key factor. Regulator rhetoric has long referenced the importance of a stable financial system, however we have increasingly seen a greater focus on the prevention of circumvention of rules around the disclosure of NPLs.

It's common knowledge that many banks in China were pushing the boundaries in relation to the interpretation of NPL classification rules set by the regulator (although these rules were never meant to be consistent with Western-equivalents — see our December 2015 piece for details). Guo Shuqing, who leads the China Banking and Insurance Regulatory Commission ("CBIRC"), has recognised this and, according to UBS[2], has issued a record number of fines to banks between February 2017 and August 2018. Fines in 2017 increased by 14-fold year-on-year. UBS estimates that at least 65% of the fines were in relation to banks hiding their NPLs. We believe that the pressure exerted by the CBIRC will serve to encourage banks to ultimately recognise more of their bad loans and should lead to a surge in NPL recognition, and ultimately more sales of NPLs to the AMCs.

Rising China NPL levels

China's NPL market is massive and is set to get even bigger. As of June 2018, the country's commercial banks reported nearly RMB 2 trillion (US$ 282 billion) of NPLs on their balance sheets. On top of this was RMB 3.4 trillion (US$ 493 billion) of 'Special Mention' loans (the next regulatory category of loans outside the NPL bucket that are showing signs of stress). We expect many Special Mention loans will ultimately migrate to NPLs — due to the slowing economy (which is being further aggravated by effects of the trade war with the US), the CBIRC pressure on NPL disclosure and a recent regulatory change prohibiting banks from classifying loans as performing if borrower interest repayments are overdue by more than 90 days. When you add in the approximately RMB 4.3 trillion[3] (US$ 620 billion) of NPLs on the books of the AMCs, China's distressed asset market is the world's largest and around 25% larger than the equivalent position at December 2016.

Figure 2: China's pile of distressed assets has grown ~25% over the last 18 months



Source: PwC estimate, analysis of public information
Estimate excludes distressed assets outside the banking and AMC sectors (e.g. P2P loans, trust lending, leasing assets, consumer finance). The June 2018 US$ estimate is based on current foreign exchange rates.

[2] UBS Evidence Lab: Banks behaving badly – What 12,534 bank fines tell us, published on August 30, 2018
[3] PwC estimate of the (notional value of) purchased distressed debt in the Big 4 and Provincial AMCs, based on public information.

What's happening with the AMCs?

Now that banks are recognising more NPLs, the big question is whether the AMCs have the appetite and balance sheet capacity to buy them. The Big-4 AMCs were set up in 1999 in order to acquire and manage the NPLs from China's largest four banks, who were then in the process of modernizing. At that time, buying and selling (or working out) NPLs was the AMCs' only business.

Over the years, however, the AMCs have gravitated away from their core NPL business and have become true financial conglomerates, with direct lending arms and interests in banks, securities, trust and leasing companies. This has caused some China watchers to question whether the AMCs have been over extending themselves and straying from their intended purpose. While to a certain extent the diversification was natural, the AMCs have started to pivot and return to their roots. In April 2018, China Huarong's chairman was detained for alleged economic crimes, causing Beijing to turn its spotlight on the AMCs and their various business activities. This brought to light some of the AMCs more risky businesses such as shadow lending, leveraged financing for China Inc's offshore leveraged M&A activity and equity investing. Not surprisingly, following all the attention, the AMCs' respective chairmen have all come out with proclamations that they would "focus more on bad asset [NPL] investment" going forward. Given this, we expect the AMCs will become much more active NPL buyers in the coming 12-24 months.

Sell, sell, sell!

With the AMCs under scrutiny and returning to their NPL roots, it is no wonder that we have seen a pick-up in sales activity in 2018. Eight foreign investors have acquired over 20 portfolios over the last two years, with Oaktree, Lone Star, Goldman Sachs, Bain, PAG and CarVal all having acquired multiple portfolios. Multiple portfolio purchases indicates that the performance of investors' initial acquisitions are broadly on-track with expectations, so the green light has been given for them to acquire additional portfolios[4]. Our market intelligence indicates all of the foreign investors that have acquired single portfolios to date are actively looking for their second portfolio. We are aware of 2-3 large funds who are actively looking for portfolios but have yet to close on their first deal.

That there are numerous foreign investors acquiring or seeking to acquire NPL portfolios in China is not at all surprising to us – many of the obstacles that deterred investors in the last cycle no longer remain. In our experience, loan files are well maintained and collateral properly registered, making due diligence more efficient. Most of the loans in portfolios are secured by real estate collateral, making underwriting relatively straightforward. China's legal system is quick and predictable[5]. The Big-4 AMCs have plenty of NPLs to sell and are actively courting foreign investors due to their ability to pay. And once a portfolio has been acquired, lenders are beating a path to the investor's door to lend them money to boost their leveraged returns[6]. What's not to like?

[4] Most investors expect multiples of 1.3x – 1.4x which lead to unlevered IRRs in the 15% - 20% range.
[5] Foreclosure on real estate collateral typically takes less than 24 months.
[6] With the NPL market in Europe slowing down, banks who finance NPL portfolio acquisitions are actively seeking new markets, and the China NPL market has conveniently emerged.

A concern for foreign investors earlier in this cycle was competition from domestic investors. However, domestic investors have yet to emerge as significant competition to foreign investors for larger NPL portfolios. One reason for this is that Chinese buyers don't typically have lots of capital at their disposal. This means they need to borrow in order to complete larger deals (most foreign investors are seeking portfolios with an acquisition price in the US$50 - US$150 million range). Given the clampdown on lending in China, not only by banks, but also by shadow lenders (including the AMCs), domestic investors are finding it difficult to raise the necessary funds needed to acquire portfolios, big or small. The relatively lower level of domestic competition for larger NPL portfolios means that the AMCs are being more flexible on their pricing with foreign investors. This is leading to more deals and higher IRRs.

Figure 3: China NPL market transactions: 2nd cycle

Investor	Seller	Location	Year
Oaktree	Great Wall	Shanghai	2015
	Cinda	Fujian	2017
	Huarong	Fujian	2017
	Huarong	Guangdong	2017
	Huarong	Guangdong	2018
	Huarong	Jiangsu	2018
Lone Star	China Orient	Jiangsu	2016
	Cinda	Hubei	2016
	China Orient	Zhejiang	2017
	Cinda	Fujian	2018
	Shanghai AMC	Shanghai	2018
Goldman Sachs	China Orient	Jiangsu	2015
	China Orient	Zhejiang	2016
	Huarong	Tianjin	2017
	Huarong	Jiangsu	2018
	Huarong	Tianjin	2018
PAG	Cinda	Zhejiang	2016
	Cinda	Zhejiang	2017
	Huarong	Jiangsu	2017
	Great Wall	Henan	2018
Bain Credit	Huarong	Jiangsu	2017
	Huarong	Hubei	2018
	Big 4 AMC	Zhejiang	2018
CarVal	Cinda	Shenzhen	2018
	Huarong	Jiangsu	2018
Blackstone	Huarong	Guangdong	2017
LVF Capital	Huarong	Hunan	2018

Sources: Press reports, AMC websites and direct confirmation from investors.

Potential disruptors

While we believe the market will continue to be very active over the next 2-3 years, a real estate down turn could have an impact the level of sales activity. The China NPL market is currently driven by real estate, which underpins 70% - 80% of all loans in most portfolios sold. Should there be a further softening in the property market, portfolio sales could slow as a decrease in property prices would cause the AMCs to sit on their inventory rather than sell loans at minimal profit[7].

[7] For example, take the case of an AMC which buys a loan with a face value of $100 for $60 from a bank as it believes the real estate collateral is worth $80. For such a loan, the AMC could make a profit of $10 if it sold the loan to an investor for $70 (who, in turn, would also make a $10 profit). If, post-acquisition of the loan but pre-sale, the value of the real estate collateral decreases by 10% to $72, the AMC will find it hard to sell to any investor without reducing its sales price significantly, which would reduce or wipe out its profit. Rather than sell at an unacceptably low price, what is more likely is that the AMC would sit on the loan and wait for the market to improve.

Closing a deal — The key things you need to do

Based on our experience of helping investors close NPL transactions in China, we believe there are five factors that all have to occur in order to maximise foreign investors' chances of closing deals and achieving an acceptable return:

Key success factor	Description
Credibility with AMCs	AMCs have to take you seriously—they won't waste their time dealing with you if they aren't sure they you can close deals. So when dealing with first time buyers the AMCs will look for investors that have credentials in other markets (as this tells them they are at least familiar with the asset class) and have a clear mandate to invest into Chinese NPLs. If you can't convince them of this, you won't likely get very far.
Quality of team and advisors	Assembling the right team is critical. Without one, you will waste a lot of time trying to find deals and will almost certainly overpay. If you want to be successful you need to work with people that have done it before, people who have contacts with AMCs and local servicers to source portfolios[8]. And, perhaps most importantly, people who know how to underwrite the loans[9] and have experience dealing with the vagaries of the AMCs.
Educating your Investment Committee in advance	If your IC doesn't "get" China, it will be hard for you to get deals done. Of course every market has its nuances and hard to understand local ways of doing things that need to be understood in order to gage the risk versus the potential reward. We've noticed, however, that often folks from New York and London that sit on ICs can be hyper critical when it comes to China NPL transactions, because, well, "it's China!" It helps if ICs have members that have done deals in China earlier in their careers as they will be a lot more accepting of some of the China specific deal points that are necessary to acquire portfolios[10].
Patience with AMCs	Getting a deal over the line in China is not easy—many things can go wrong and get in the way and slow things down. The business unit head you are dealing with at the AMC may have trouble getting his boss to accept the price he has agreed with you and it may take weeks to sort that out. During roll up you may discover a mistake in your underwriting and need to spend time to 'find' value elsewhere to ensure you make your internal IRR requirements. You may get bogged down in discussions over the deposit amount you should pay when you sign the MOU. Investors that are patient and can roll with the punches will be able to effectively deal with and overcome these types of situations.
Quality of servicer & master servicer	Is doesn't matter how good your underwriting is if you don't have a good servicer with the knowhow to make collections in a timely manner. Finding such servicers is not easy — many are localised with capability in a specific geography. Equally as important is finding a good master servicer. Most likely your servicer will be a local law firm, with little English language capability. That's fine for day-to-day work but it isn't helpful for reporting. Master servicers not only make sure local servicers prepare and stick to recovery plans but also provide FCPA training to the local team and prepare monthly reports for investors on collection progress.

[8] Sourcing suitable portfolios is not easy. Any investor can go to an AMC and get a list of NPLs they are looking to sell. Only those with experience can shape a loan list to form a suitable portfolio. Shaping requires getting the AMC to take out loans you are not interested in (such as loans the AMC paid full value for) and getting them to include new, better value loans from other lists. This requires both an understanding of how the AMCs operate, the person you are dealing with and how to spot valuable loans.

[9] Underwriting loans in China is not rocket science but it does take a deep understanding of the China market. An experienced team is able to identify potential pitfalls in a portfolio and how they may affect pricing. Valuations, recovery, and risk mitigation strategies need to be developed for each key debtor. This requires experience and knowledge of the local environment as well as the network to help provide data to support underwriting assumptions.

[10] There are many local practices in China that take getting used to. For example, the AMCs are extremely rigid in their loan sale and purchase agreements and rarely allow changes such as reps and warranties, but do allow some minor changes to meet foreign investor requirements.

Partnering with PwC

PwC offers complete NPL services for international investors. Our senior team members (see below) are not learning on the job–they have practical experience sourcing portfolios, carrying out pre-acquisition due diligence, doing the hard grind with the AMCs to finalize the deal[11] and hands-on post deal master servicing (making sure the local servicer is doing its job including reporting). Our fee structure is competitive and is aligned with investors as it is results driven.

Please contact any of the individuals below to find out how we may be able to assist you:

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[11] Foreign investors need to be aware of the differences in dealing with a Chinese state-owned counterparty compared to a private commercial counterparty. Besides making money, SOEs need to consider other factors such as current policy and any directions from the Central and/or local governments, etc. The AMCs are SOEs and are tough negotiators, not only on price but also when asked to make changes to their standard and approved MOU and SPA documents. The good news is that the AMCs are willing to allow negotiation on certain terms, which they adamantly refuse to do with local investors.