CHINA INVESTMENT - 2019

SPOTLIGHT

Savills Research

China Non-Performing Loan Market

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第一太平戴维斯

Preface

China has witnessed a lending boom ever since the Global Financial Crisis (GFC) in 2008. Companies and the country have become reliant on access to ever-larger amounts of credit for sustained growth. While overall debt levels may be on a par with the US or the UK (non-financial sector credit to GDP currently stands at roughly 260%), it is the pace of growth over the last decade that is staggering. Chinese debt to GDP has grown by more than 110 ppts since 2007, compared to 20-45 ppts in the UK & US over the same period.

The government, concerned about systemic risks to the economy if debt levels were to continue to rise unchecked, has taken dramatic steps to curb the informal lending (shadow banking) sector, increase transparency and regulatory oversight of financial markets and local government finances, and slow the overall growth in debt. The slowing of credit growth, in addition to ongoing global trade tensions, has exacerbated the structural slowdown in the economy that was already impacting corporate cash flow and profits.

The inability of corporates (both developers and others) to service debt or roll over maturing debt commitments has led to a rise in bankruptcies, defaults and non-performing loans in recent years. Most loans are typically secured against property, unlike in other markets, as they are comparatively easy to value and seen as a relatively secure store of worth. The rise in defaults, and consequently the increasing volumes of NPLs, therefore represents a substantial opportunity for investors to access a range of the real estate assets at a discount to market pricing.

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China NPL Market Size

China's outstanding aggregate financing number totalled RMB219 trillion by September 2019, up by 10% year-on-year (YoY) according to PBOC data, of which local currency loans made up 68.2% (RMB149 trillion). Chinese commercial banks typically classify loans into normal, special-mention, substandard, doubtful and loss, with the three latter ones considered non-performing loans (NPLs).

Chinese commercial banks held a total of RMB2.37 trillion of NPLs by September 2019, according to the China Banking and Insurance Regulatory Commission (CBIRC), up from RMB2.0 trillion as of the end of 2018; special-mention loans totalled RMB3.8 trillion by September 2019 up from RMB3.4 trillion as of the end of 2018. NPL ratios for commercial banks ranged between 0.83% (foreign banks) to 4.00% (rural banks). According to China's National Audit Office (NAO), NPL ratios exceeded 20% in 12 commercial banks by YE2018, while some even had ratios higher than 40%.

Table 1: Classification Of Five Types Of Commercial Loans

Normal Loan	Borrower is able to honour the terms of the contract; there is no sufficient reason to suspect that the principal and interest cannot be repaid in full on time.
Special-Mention Loan	The borrower is currently able to repay the principal and interest of the debt; however, there may be some factors that may have an adverse effect on the ability to repay in full.
Substandard Loan	The borrower's ability to service the loans is in question. The borrower cannot depend on their normal business revenues to pay back the principal and interest, so losses may ensue, even when guarantees are invoked. The loss of principal and interest of such loans is generally not expected to exceed 60%.
Doubtful Loan	The borrower cannot pay back the principal and interest in full and significant losses will be incurred, even when guarantees are invoked. The loss of principal and interest of such loans is generally not expected to exceed 90%
Loss Loan	The principal and interest of loans cannot be recovered, or only a small portion can be recovered after taking all possible measures and resorting to necessary legal procedures. The loss of principal and interest of such loans is expected to be more than 90%.

Source PBOC; Savills Research

Figure 1: Commercial Bank Loan Breakdown By Quality, 2014 to Q3/2019

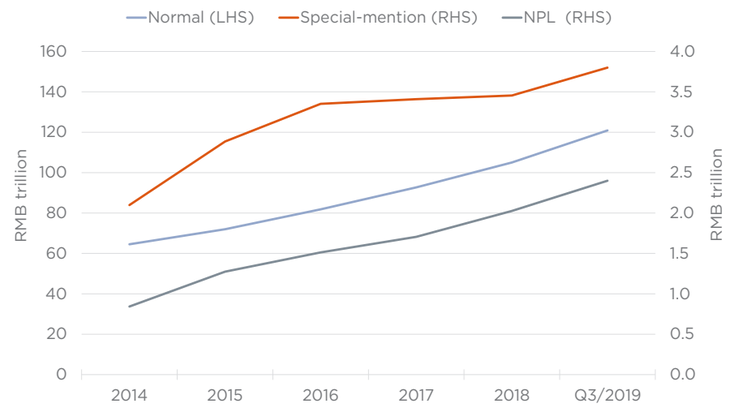


Figure 2: NPL Ratios By Issuing Institution

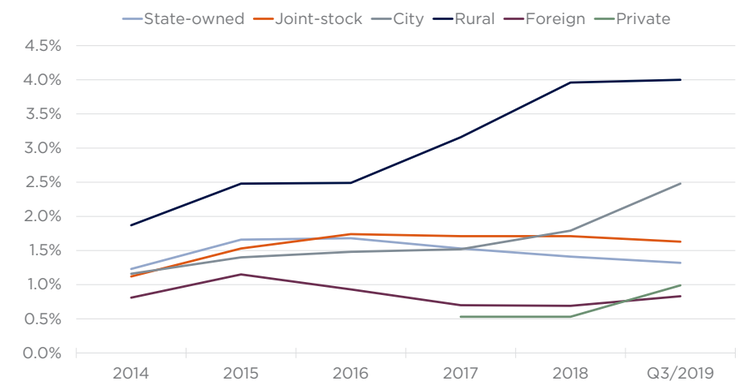
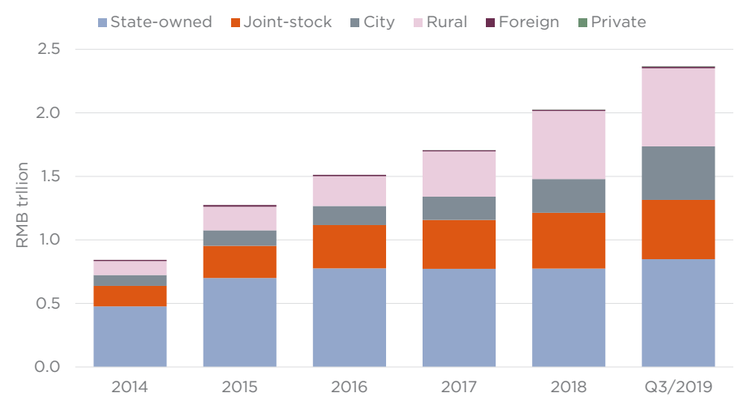


Figure 3: NPL Breakdown By Bank Types，2014 to Q3/2019



Source CBIRC; Savills Research

China NPL Market Progress

National AMCs Emerge

The first wave of NPL disposals followed the Asian Financial Crisis of 1997. Four national Asset Management Companies (AMCs) were established to purchase bad loans from financial institutions that had seen NPL ratios rise to more than 20%. During the first cycle, even though the market saw strong interest from international investors, the opaque Chinese legal system, currency controls, and a reluctance on the part of Chinese courts to allow foreign investors to restructure businesses where jobs were at stake all created substantial obstacles for international buyers.

Regional AMCs Join The Fray

The latest wave of NPLs began in 2015 and saw the growth of regional AMCs. A total of 50-60 regional AMCs were created to support sales and facilitate online auction processes, over-the-counter trades and securitisation projects. Local AMCs are often seen as being more active than national AMCs in acquiring NPLs from local commercial banks as they tend to have stronger connections with the local market. In 2016, the government started allowing local AMCs to transfer NPLs to entities outside their home provinces.

International Investors Tap The Market

In June 2017, the State Administration of Foreign Exchange (SAFE) launched a pilot program in Shenzhen for cross-border NPL disposals. The program was extended and enhanced in May 2018, allowing AMCs and commercial banks to sell NPLs to foreign investors via a private sale process, rather than the customary court-administered process (provided that certain criteria were fulfilled). The Shenzhen Qianhai Financial Assets Exchange (SQFAE) was also established in Shenzhen to help streamline and accelerate sales processes while reducing transaction costs for international investors. The platform facilitates all aspects of cross-border NPL transactions, including NPL payments, settlement, notarisation and documentation, as well as tax payments.

Rigorous Reporting Requirements

China's NPL level has long been viewed as underestimated by the rest of the world with some analyst estimating ratios could be as high as 20%. Chinese commercial banks have been known to "hide" loans that are overdue by 90 days under the special-mention loan category, stating that there might still be a chance of repayment in the future. However, Beijing started to tighten NPL reporting standards and push towards accurate NPL recognition by banks from 2018.

In February 2018, a regulation was introduced saying that loans that are overdue by more than 90 days would have to be downgraded to NPL status. The CBIRC has given city and rural commercial banks until the end of 2019 to reclassify all overdue loans while some of its local branches required banks to comply even earlier. In 2019, some local banks were encouraged to classify loans more than 60 days overdue as NPLs. Joint-stock banks, city commercial banks and rural commercial banks will be the most impacted by these changes (China has more than 1,300 rural commercial banks and 134 city commercial banks). Since 2H/2018, an increasing number of small rural banks have reported a big rise in their NPL ratios.

Table 2: List Of Four National AMCs

Name	Primary State-Owned Commercial Banks
China Cinda Asset Management Co., Ltd.	China Construction Bank and China Development Bank
China Great Wall Asset Management Corporation	Agricultural Bank of China
China Huarong Asset Management Co., Ltd.	Industrial and Commercial Bank of China
China Orient Asset Management Corporation	Bank of China

Source Savills Research

NPL Market Transactions

The NPL market has proliferated in recent years and the majority of NPLs, close to 70% of them, are secured against real estate. While some buyers may go directly to banks, most will buy NPLs from AMCs with buyers often allowed to tailor portfolios by geography or asset class. All the loans are from commercial banks, and most of the borrowers will be private SMEs.

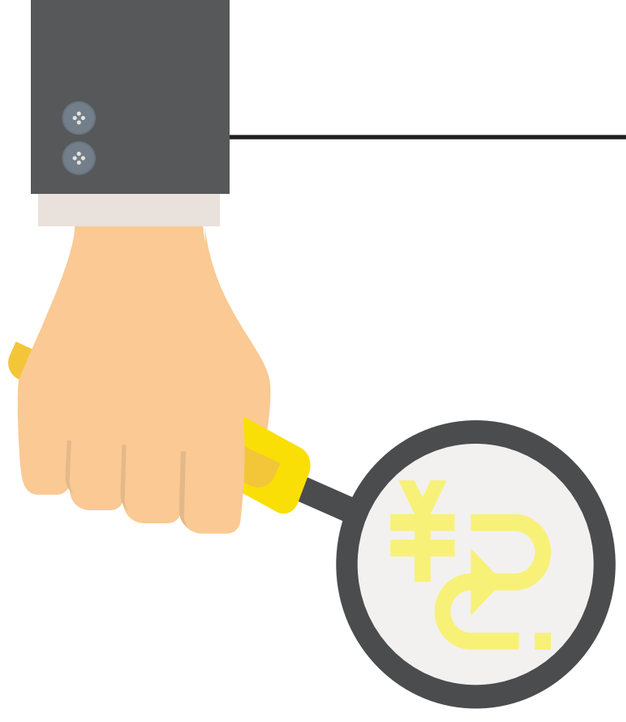
International investors have proven quite active in the market, with SQFAE data showing that overseas purchases of bad loan portfolios nearly tripled in 2018 to RMB30 billion. Active international players include Oaktree, Loan Star, Goldman Sachs, Bain, PAG and CarVal. Aside from NPL portfolio investments, several investors have also been targeting single credit investments.

After buying the NPL portfolio, investors look to generate a 1.25-1.40 multiple of the purchase price by selling on the collateral or debt either individually or as a whole. Other investors seeking higher returns of up to 2.0 times the purchase price may target single credit investment or attempt to obtain creditor's ownership rights to the mortgaged property, potentially repositioning or adding value to the underlying asset. The second option is not without risks, with additional costs/fees/taxes, and requires investors to hold the debt assets on their books for longer, thereby reducing the IRR and exposing them to the possibility of asset deflation.

Table 3: List Of International Investors' Acquisitions, 2015 to 2018

Investor Name	Number of NPL Portfolios
Oaktree (橡树资本)	6
Lone Star (孤星资本)	5
Goldman Sachs (高盛)	5
PAG (太盟投资)	4
Bain Credit (贝恩资本)	3
CarVal	2
Blackstone (黑石)	1
LVF Capital	1

Source PwC China; Savills Research



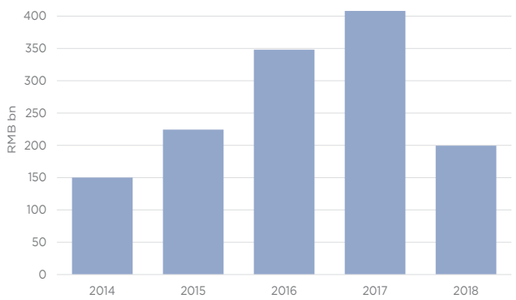
Falling Prices

NPL prices have fluctuated significantly in recent years. Portfolios were valued at roughly 30% of their book value in 2014-2016, then rose to 50% or even as high as 80% in 2017 as the economy picked up and the rise of local AMCs created greater competition for loan books. Values began falling in 2018, as the supply of bad loans continued to increase and as AMCs found financing more difficult to obtain, with many finding it difficult to sell on the NPLs fast enough. Additionally, China's national banking regulator introduced rules in late 2017 that required the four national AMCs to adopt a more strict capital adequacy ratio, which further restricted their appetite until they were able to sell down the bad loans or raise fresh capital.

China Huarong Asset Management, one of the big four, bought just RMB199.4 billion of NPLs in 2018, less than half of the RMB408 billion it had acquired in 2017. The lack of appetite from some of the biggest bad-debt buyers at a time when commercial banks were actively looking to clear their balance sheets forced many of the banks to offer steeper discounts on subsequent loan portfolios.

Domestic bad-loan investors have, in the past, used a considerable amount of leverage to buy portfolios. However, getting access to capital is significantly more difficult now. At the same time, falling values have made it difficult for investors to achieve a quick turnaround of their assets, threatening liquidity issues and increasing the risk of losses.

Figure 4: Huarong's Acquisition Of NPLs, 2014 to 2018



Source Huarong; Savills Research

International Investors' NPL Appetite

International investors, with more experience, will typically look to acquire loan books of around US$100 million, compared to domestic investors who look for smaller lump sums of around US$20-30 million. Targeted returns are usually 12-15% (unleveraged) and 17-22% (with 50-60% leverage).

The recent financial tightening has meant that local investors have struggled to conclude deals, whereas better capitalised international purchasers who have access to other pools of credit have more opportunities. International purchasers also have a range of different strategies and some are more flexible on situation-specific strategies. While both domestic and international buyers will prefer quick turnarounds to reduce risk and increase IRRs, some international buyers can hold on to assets longer if they feel that there might be more upside potential.

Direct Lending Market

Chinese developers are finding it difficult to access financing; while larger developers may still be able to get credit lines from banks, tap equity markets or issue bonds, many of the smaller developers, who used to turn to the shadow banking sector in times of need, have been left out in the cold. International investors are looking to step into the fray, providing these developers with a much-needed lifeline as long as the developer is creditworthy enough or has good enough collateral against default. Returns can be attractive, in the mid-to-high teens, given the last stage in the credit cycle, and for international funds, China offers some more geographical and currency diversification. According to PwC, over US$9 billion of capital was raised in private credit funds targeting Chinese credit opportunities (not specifically developers) in 2018—the highest on record. A further US$6 billion was raised in the first half of 2019.

Some investors, such as Infrared NF, have extended loans to smaller developers whose properties are normally located in second-and third-tier cities as part of their opportunistic strategy. In February 2019, CapitaLand had a US$556 million first close of its China real estate debt fund (CREDO 1 China); the fund has a target of US$750 million and will invest in offshore US dollar-denominated subordinated instruments for real estate in Hong Kong and China's first-and second-tier cities. It targets loans and securities of commercial, retail, residential, logistics, and industrial assets.

While the deleveraging campaign is expected to be long term, developers will eventually adjust strategies including selling non-core assets and curbing aggressive growth of new development pipeline; as such, the window for investors to achieve mid-to-high teen IRRs could be limited.

Table 4: Summary Of Private Credit Strategies In China

Strategy	Opportunities	Structure	Indicative net IRR available
Direct or Mezzanine Lending	Providing offshore financing to Chinese real estate groups	Offshore	Mid-teens, depending on security package. Can be higher if borrower is stressed
	Onshore RMB financing to Chinese corporates	Onshore	Mid-to-high teens (onshore, gross yield). Can be higher if borrower is stressed
Special Situation/ Distressed	Partnerships or JVs with Chinese investment groups; investing in onshore special situation/ distressed Chinese bonds	Depends on the structure of the partner	Typically, a strategic investment to access other credit opportunities
	Investing in onshore special situation/distressed Chinese bonds	Onshore	Funds are underwriting to returns of 25%+
Distressed	Single credit investments (real estate backed)	Onshore	Funds are underwiring to returns of 20%+
	NPL portfolios	Offshore	15%+

Source PwC China; Savills Research

Challenges

As with most things, the key challenge is pricing. Investors prefer loan books secured by first-and second-tier city assets as these are in comparatively transparent and liquid markets. However, it is difficult to find any portfolios at a big enough discount to market to justify the risks. This is especially true for international investors who will benchmark risk-weighted returns in China against other markets, some of which also generate 15%+ IRRs. Additionally, a lot of deal sourcing and processing rely on relationships which could be more problematic for international investors.

As mentioned above, many commercial bank loans in China are secured against real estate—by some estimates as much as 70-90%, indicating that much of the value of NPLs is dependent upon the value of the underlying real estate asset. China's commercial real estate markets tend to be more speculative than other countries with many investment deals having negative yield spreads and investors looking for continued value growth to hit targeted IRRs.

In illiquid markets (typically lower-tier cities), an accurate yield-derived valuation can prove challenging and is often at odds with comparable sales transactions, while sales-comparable valuations can prove unrealistically high if investment sentiment deteriorates. At the same time, the slower economy has resulted in weaker demand for commercial real estate and new supply continues to be added to the market, resulting in weaker fundamentals that underpin valuations in the higher-tier cities. This would likely deter some investors while making others more conservative.

Despite recent policies that look to open the market to international investors and promote the sale of NPLs, potential regulatory uncertainty could also concern some investors. Additionally, alternative channels for disposal such as ABSs secured by NPLs (allowed in 2016), while relatively niche in scale, could create increased competition.

While challenges exist, the sheer scale of the Chinese market and its growth potential mean that, for global investors, it is very hard to ignore. Meanwhile, as we have seen so many times in the past, market conditions, regulations and the competitive landscape can change very quickly in China, and investors should be ready to seize upon these opportunities when they appear.

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