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FUND MANAGER Q&A

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Doing your homework pays in Chinese distressed debt

By **Liz Mak** | 11 August 2008

Ben Fanger, managing director at Shoreline Capital, explains the work behind the firm's \$1.5 billion portfolio of distressed debt in China.

After a couple years of working on distressed asset lawsuits with US firm O'Melveny & Myers, Ben Fanger went to graduate school at the University of Chicago. There he met his future business partner, Zhang Xiaolin, who had a decade's worth of China real-estate development experience under her belt. The timing was good: China had just joined the World Trade Organisation and was trying to rid itself of non-performing portfolios. ▼ advertisement

The pair founded Shoreline Capital and began investing in Chinese distressed assets. Today the firm manages \$1.5 billion of such portfolios.

What is your business about?

Fanger: We do everything from the lawsuits to the restructurings, turnarounds and workouts; all things related to distressed assets.

What are distressed assets in China?

The kinds of assets that are in the portfolios range from any kind. It could be a hotel. It could be a textile manufacturing company. It could be a coal mine. And we have dealt with all of these. We have bought toll roads in provinces that are thousands of miles away from where the loan is located in the borrower's headquarters.

Assets are distressed for a reason. Sometimes borrowers didn't intend for them to become distressed; they were just over-optimistic entrepreneurs who spread themselves between too many projects. Other times there is clear evidence of fraudulent behaviour.

How do you move money into China amid tightening capital controls?

The recent policies relating to capital controls in China do not apply to distressed debt. They apply to real-estate or equity investments. That said, we may be investing in property, in which case we do have to go through the process of forming an onshore entity, as the policy requires. And that process can be time-consuming. It might not get approved.

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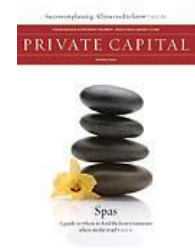
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What is the ideal kind of Chinese distressed asset?

An ideal asset is an asset that is under-priced. I don't care if it is a coal mine. I don't care if it is a hotel or a textile manufacturing plant. If the seller thinks this is an unsecured loan, and there is no hope of collecting whatsoever, the seller is going to price it at zero or one cent on the dollar. If I have different information that makes me think I can collect many times that, then it is an interesting asset for me.

How do you source your deals?

We buy our assets from the asset management companies. We have a database with different contacts from the hundreds of different AMC offices in China. The important thing is not so much about knowing the people at the AMCs, even though that helps. The important thing is to collect a tremendous amount of data on hundreds of thousands of assets from different places across China, and sort through the haystack to find a needle that is the deal that will produce the results that you want.

We have processes for collecting data from all the AMCs and even from the banks before the assets go into the AMCs. We need to keep that data updated. The database tells me, at any given time, what assets the AMCs hold and what portfolios are they inclined to sell.

Is there any problem with information disclosure or the accuracy of the data?

We don't make our investments based on what information an asset manager gives us. They might tell us that 30% of a loan is secured with collateral and that their borrowers are great borrowers. But, at the end of the day, it is our own on-site due diligence that will determine whether we make the investment or not. We visit the borrowers, talk to the security guard, go to the land bureau and conduct title searches, review their equity holdings, and look at the liabilities that they have. We just assume what the seller has given us is not complete.

And how do you exit?

One exit strategy is to get discounted payments from the borrower. So if I have paid 10 cents in the dollar for an asset, I can get them to pay 15 or 20 cents in the dollar to generate a return. The second strategy is to auction or liquidate the borrower's assets in the court. A third is to sell the assets to a strategic buyer. Often there is a buyer who has some relationship with the borrower, or who has some particular reason for being interested in a loan, because he has some localised expertise or interest. Those are potential exits.

Another is equity swap or asset swap, where we take control of the asset for the equity.

How has the pipeline changed for you since China started implementing its credit tightening policies?

The China Banking Regulatory Commission had warned of the possibility that there will be an increasing number of non-performing loans and defaults. But if you look at the figures, the percentage of loans that aren't performing is actually decreasing slightly. However, if you look at the denominator, which is the total number of loans, this is increasing.

But non-performing loans are only a subset of the overall distressed asset

class. Prior to a non-performing loan, you have the developer or the borrower in a situation where they see themselves going to default. And those opportunities are special situations for turnaround investments or equity investments, bridge loans. Once they go into default, then you have non-performing loans. Then you have the court actions and potentially under-priced real estate assets that are getting auctioned off or liquidated.

A lot more developers are approach me and saying that pretty soon they are going to default on their loans and that they need to get some kind of bridge financing soon. A lot more sponsors and companies are experiencing financial distress and that is an anecdotal sign anyway of an increase in potential defaults and non-performing loans.

Does China's legal framework actually recognise your status?

A bankruptcy law came out recently, but prior to that there was a legal action that could be brought to enforce creditor rights. For most people that hear about distress in China, one of the first things that they worry about is, can you enforce your right in court? And the answer to that is: usually you can.

What happens when you can't?

There are situations when you can't. And there are situations that, for whatever reason, there is political pressure for the auctions of the asset not to take place. For instance, one potential portfolio that we looked at had a borrower that was one of the biggest employers in a certain small town. We are not going to expect to be able to foreclose on an asset that employs everybody in the city. You wouldn't even expect that in the United States.

And what happens after the courts?

The part that's more difficult is the enforcement phase, after you have obtained judgment, when you are trying to auction an asset and where people are employed or there are multiple creditors with different interest. This can become very complicated. In these situations we need to be creative to move things along.

Who are your typical investors?

Our biggest investors are top US endowments, and we also have brand name US foundations, pensions and some funds of funds. In Asia, we have Asia-focused funds of funds and high-net-worth family offices from Taiwan. We had Japanese, Singapore and Hong Kong institutional investors talking with us in depth about investing but we just ended up closing the fund before any of them were in.

What has your track record been over the past couple of years?

The typical investor in our asset class hopes for 20% unleveraged IRR (annual number). I've heard of numbers between 17% and 25%. That's what I've heard the expectations are for the typical investors out there. I think we are happy to have beaten what the typical investor hopes to achieve.

Are you looking to raise any additional assets?

We've just finished raising a fund, so we won't be raising another fund this year. Our target was \$150 million and we were oversubscribed. We set the amount to something that we can invest very quickly, and we were very

comfortable with not having to hire additional people to invest it.

However, our next fund could be as early as 2009, and in that fund, we would definitely bring in some Asian investors.

What are the kind of risks investors should beware of?

One significant risk is the policy risk in China. The government can suddenly change its policies and this is something difficult to foresee and something difficult to respond to.

The other risk is legal risk. And if you have a significant amount invested in a single loan, and you are betting on the transparency and the outcome of a single court, on a single judge, then you have a risk there. When we buy portfolios, we diversify that with hundreds of assets. We are never banking on a single court, on a single judge. They are across the board, from different courts, from different provinces.

What's missing in this industry?

Distressed debt investments often involve hiring a local law firm to work out the loans and there are very few local service providers that have a strong track record in working out loans. I think in more developed markets, there are a lot of debt work-out firms that understand all the litigation and the negotiation. There are also very few accounting firms in China that have fund management and fund appraisal experience. But we have relationships with people in Hong Kong and the US that can do this for us.

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