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Playing doctor

Asia appears to be destined for a spate of corporate restructurings. Although they are studying a wealth of potential investments, distress specialists say the obvious targets are not always the most accessible

FROM JAPANESE ELECTRONICS TO Chinese cleantech to pan-regional shipping, expectations are rife that the trickle of corporate distress in Asia will turn into a flood. With some of the region's largest economies expanding at their slowest pace in years, corporate profits are hurting and rescue might only come in the form of restructuring.

"Given the economic climate in Asia, we foresee an increasing number of corporate defaults in the next 6-12 months and a corresponding spike in restructurings," Mark Austen, CEO of the Asia Securities Industry & Financial Markets Association, told a conference last week.

Global investors are also chasing the trend. Of the 58 distress-focused private equity currently in the market seeking $37.9 billion between them, six are in Asia, according to Preqin. Their fundraising target of $5.4 billion is less than the $6.5 billion committed to eight vehicles last year, but far ahead of the $1.8 billion raised – also by six funds – in 2011.

AVCJ Research, meanwhile, breaks the numbers down by geography: 20 domestic and global vehicles are currently raising capital with a focus in Japan, targeting up to $493 million; India ranks the second with one fund seeking $325 million, while third-placed China has two vehicles chasing $251 million.

For all that these numbers suggest the next wave of restructuring in Asia is highly-anticipated, some industry participants are skeptical as to how big the opportunity really is and how easily it can be accessed by traditional private equity investors, particularly in countries like China, where government policy plays a significant role.

"There may be many potential restructuring opportunities in China as companies face increasing financial stress. However, opportunities involving larger companies are politically sensitive, and are therefore more likely to be handled by local government and state-owned banks," says Tim Gardner, a Hong Kong-based partner at Latham & Watkins.

Even when moving further down the scale to situations that pass beneath the government's radar, there remains the possibility that local players will be better positioned to act. "It is difficult to determine the size of the addressable market, as well as the potential opportunity for international and regional private equity funds," Gardner concludes.

Sinking sun

Suntech Power, once the world's largest solar-panel maker, defaulted on a $541 million offshore convertible bond in March, but investors' ability to enforce and take ownership of the assets was called into question as Chinese creditors forced the company to file for bankruptcy protection locally. It appeared that the domestic banks to whom Suntech owed $2.3 billion would be satisfied first.

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Six months on, the situation was still unresolved and China's relatively recent Bankruptcy Law had yet to be put to a very public test.

However, in November Suntech received a lifeline as the municipal government of Wuxi, where the company's Chinese subsidiary is headquartered, agreed to provide a $150 million bail out. This thwarted a preliminary deal signed by Shunfeng Phtovoltaic International, a Hong Kong-listed solar-cell manufacturer controlled by businessman Kin-Ming Cheng, to buy Suntech's Chinese assets out of bankruptcy for $492 million.

It makes for an instructive example. Given slowing economic growth and credit becoming tighter across Asia, there should be distress situations among private enterprises, particularly small and medium-sized enterprises in emerging markets which typically struggle to source bank financing. Suntech is one of the more high-profile of thousands of cases in which local governments leverage their influence over banks to keep toxic businesses breathing.

A key consideration for the distressed specialists in this respect is the relatively immaturity of the markets in which they are operating. The US loan market is well-leveraged and bankruptcy laws are clearly clarified; by contrast, numerous Asian jurisdictions are still coming to terms with bankruptcy legislation, so taking advantage of a domestic bond default is difficult.

"Distress is really dependent on government policy. If the government wants to sell the distressed debt to foreigners, then they - the debt specialists - have a chance," observes a senior industry professional in the distress space. "If the government discourages foreign investors, it means there is less opportunity. It is pretty black and white".

The China angle

Shoreline Capital, a China-focused special situations investor, is more positive about the prospects for China, specifically the willingness of domestic banks to sell of their non-performing loans (NPLs). The private equity firm closed its second fund at $303 million in March and has already invested almost 75% of the corpus.

"The flow of special situations opportunities has been increasing in the last few years as China's economy decelerates and some companies continue to have difficulty obtaining credit from banks. We are also seeing banks beginning to auction their NPLs. The NPL opportunity is still small but clearly growing," says says Benjamin Fanger, Shoreline's founder.

Rather than structure deals offshore, Shoreline structures investments with a view to securing control of onshore collateral, which could come in the form of property, commodities or holdings of listed equities that can be liquidated. In this context, Fanger sees two types of the special situation opportunities in China beyond NPLs: providing structured finance to stable companies that don't want to raise equity; and putting together rescue packages or bridge capital for firms in deeper distress.

Other industry participants highlight a third possibility – tapping government debt. In recent months, local authorities in China are said to have set up asset management corporations (AMCs) to handle debts run up by local government investment vehicles. These corporations operate as subsidiaries of the big four AMCs – Cinda, Huarong, Oriental and Great Wall – that were originally set up to dispose of NPLs held by the major state-owned banks.

Distress specialists see a significant amount of stressed debt in this space, although there is also a high level of risk because the underlying assets tend not to be companies but rather infrastructure projects, where the local government has run out of cash in part due to central government policies.

"Historically, credit investors in China have looked at companies, not necessarily local government debt. It's still at an early stage of development so I'm not sure about the scale of the opportunity, but how do you do the due diligence on the local government debt?," asks Ivo Naumann, Shanghai-based managing director of advisory firms AlixPartners.

The same concerns about overseas investors foreclosing on onshore assets where there is a strong local government interest still apply.

Alternative sources

Regardless of the target country, credit specialists argue that good restructuring transactions across Asia are actually more sector-driven.

"If you look at the natural resources space, the dramatic decline of earnings to natural resource businesses whether they are in China, Indonesia or Australia, are really interesting," says Rob Petty, CEO and co-founder of Clearwater Capital Partners.

However, the most compelling opportunity Petty sees is still the direct lending space, particularly in China where SMEs contribute more than 60% of GDP and are responsible for 80% of employment but rely on banks for just 4% of their financing needs, instead resorting to the "shadow banking" system.

One industry participant who spoke to AVCJ agreed with the premise of the opportunity set: entrepreneurs are still reluctant to give up equity but they are becoming more willing to borrow and pay a higher yield. However, he stressed that private lending is a niche part of the market and is unlikely to become a significant part because the risks are quite high.

Legal and regulatory frameworks are again the primary risk factor. While first-tier markets like Japan, Hong Kong and Singapore offer comfort, Thailand, the Philippines and Indonesia are generally described as less transparent.

One way to mitigate this risk is to evaluate banks' credit lending and respond accordingly, although Asian lenders' credit performance is rated relatively strong, which suggests fewer opportunities for credit-originated funds compared to Europe, for example.

"Time will tell as to how big the opportunity is in Asia, but clearly credit-originated funds need to be here in the market today and position themselves because it takes time for investors to get to know the market, particularly the late-investment teams," Lindsay Chu, head of Asia Pacific financial sponsors at HSBC.

Their presence also inspires other traditional PE investors to expand platforms in the alternative space, offering more flexibility in their solutions. The expectation is there will be a combination strategies covering PE, real estate and credit funds as special situation funds – indeed, several of the global and large regional players have already adopted this approach.

"Private equity is an important strategy, but there is a need clearly from companies and investors for different types of investment profile," Chu adds. "Investors are looking for different types of investment risks and investment horizons. The fact that these large credit funds are being set up indicates there is an appetite for this type of strategy."

Entrepreneurs: Willing to sell?

When an Asian company requires restructuring to overcome operational difficulties, one of the most pressing questions is this: Is the founder-entrepreneur willing to sell a majority stake to a private equity investor in order to facilitate the transition?

In many parts of the region, entrepreneurs are loath to give up equity in the business they have built from scratch to a third-party investor; a debt-based product, which can be paid down over time, is eminently preferable. Attitudes, however, are changing, says Tim Gardner, a Hong Kong-based partner with Latham & Watkins. More founders are thinking about succession planning and they also have a greater appreciation of the value private equity can bring.

"There will always be entrepreneurs who are open to private equity investors. In addition to the other benefits, they may want to have an internationally recognized institutional investor in their capital structure, which they can leverage when they conduct a trade sale or an IPO," Gardner says.

Moreover, a combination of macroeconomic pressures and intensifying domestic and international competition is pushing entrepreneurs to seek help from private equity firms to revive businesses that are stagnating.

In China, for example, many companies that rose to prominence in a hyper-growth environment are now coming to terms with a more sober reality of rising costs and narrowing margins, where their lack of professional management skills can be brutally exposed.

Even from a pure capital-raising perspective, the IPO market that once made entrepreneurs rich without having to relinquish control of their businesses, is less accommodating. When the current ban on domestic listings is lifted, the market is likely to be more selective in the firms it favors. Selling a majority stake to a private equity investor might be the only option for an entrepreneur in need.

Secondly, in several industries over-capacity issues are rising. Ivo Naumann, managing director at AlixPartners, cites automotives as an industry ripe for consolidation. Car manufacturers have been churning out so many vehicles they are now struggling to sell them. Regardless of the fact that purchases are growing at 8% a year, overcapacity is a problem. The steel and solar industries are in a similar predicament.

"All of these factors are at work in China right now. It opens up a number of opportunities for private equity investors," Naumann says. "They can invest at more reasonable valuations, taking control of some companies they couldn't before. That comes together with the reality of a difficult domestic IPO market."

He adds a kicker to the argument, though: buying majority of a company is not influence a restructuring process. A private equity firm with a minority interest that manages to negotiate preferential rights and power of veto over senior appointments or quite simply identifies the right kind of entrepreneur at the right time, could still effectively control the destiny of its investment.