

News, Special Situations

Andrew Brown: China Committed To Market-Based Solution To Excess Debt Challenge

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China Money Network's Special Situations Team brings you the first of our new "Industry Specialist" series, sitting down with Andrew Brown, partner for Macro and Strategy at ShoreVest Capital Partners, Ltd. Hong Kong to seek his opinions on the growth of China's distressed debt market and the rewards and risks it offers investors in the region.

ShoreVest Partners is an institutional private investment firm specializing in Chinese distressed debt and structured credit. The ShoreVest team has managed US\$1.6 billion of distressed debt-focused capital in China, on behalf of institutional investors including sovereign wealth funds, pension funds, foundations, endowments and family offices from around the globe. In a one-on-one interview with our reporter Yimian Wu, Mr. Brown discusses the investment opportunities arising from China's growing

middle class, the government's efforts to deal with shadow banking, and how distressed debt "bargains" can most easily be found in China's Tier-2 cities.

Stay tuned as China Money Network Special Situations Team continues to uncover and bring you insights from top level investment professionals as part of our "Industry Specialist" series.

Q: What's driving the growth of new distress debt funds in China?

A: One of the largest investment opportunities in the world is here and it is still in a growing phase. We estimate total excess debt in the economy to be over US\$3 trillion. Obviously, it is going to attract investors' interests.

Q: What does the rise in distressed debt funds say about China's economic outlook?

A: The authorities in China are committed to a market-based approach to resolve the excess debt challenges. And part of that approach is for the market to absorb and work-out distressed debts.

At the same time, there are a number of factors that China is focusing on to re-balance the economy to sustain growth, including encouraging domestic consumption, and at least partially through higher consumer leverage. As the industrial economy works through its excess capacity, domestic consumption will grow to help offset the decline in the industrial economy.

Simultaneously, the Belt & Road initiative is profoundly important. The ADB (Asia Development Bank) estimates that between 2017 and 2030, US\$26 trillion in new investment is necessary for the Belt & Road Initiative. That's a significant number and will help stimulate economic activity.

Q: What sectors offer the greatest opportunities in this market?

A: Anything an emerging middle-class family in China will consume. It ranges from consumer electronics, to healthcare, to education, to travel and leisure, and to cosmetics, etc. The purchasing power of an emerging Chinese middle-class is huge, and the items they will consume will do best.

At the same time, it is in China's best interest and is supported by China's authorities to encourage more balanced long-term financial planning by individuals. China is in need of developing a social security net. The focus on developing social security is increase, as an aging demographic, the emergence of a middle-class, and the resultant creation of wealth is driving this need. As a result, Chinese authorities are encouraging insurance, pension reforms, and overall long-term financial planning. We are already seeing mutual funds in China growing significantly. All of these mean the alternative saving

vehicles through the development of insurance, pension planning and mutual funds and the like will be in very high demand.

I am optimistic in sustainable growth in China rather than any significant decline or crash scenario. The overall pace of growth may slow, but it will be more balanced and sustainable.

Q: With more investors chasing distressed assets, do you see a bubble in pricing?

A: In some cities yes. New entrants tend to focus on Tier 1 cities and senior secured collateral. At places like that, there are situations where distressed portfolios are being mispriced as too many investors bid for those assets.

New entrants tend to think that it is lower risk to go to a Tier 1 city with a portfolio with a small number of loans and with senior secured collateral. The problem with that is that everybody can price that easily. There is no information asymmetry. If you have a portfolio in Shanghai and secured by real estate that is easily valued, then people overly bid for that and it becomes unattractive for us.

We prefer to bid on portfolios where there is no other bidder, and the only way you can do that is to have a large sourcing network throughout the country with a long history of doing deals. As a general statement, we tend to find better pricing in second-tier cities at this point.

With 13 years of experience, and reflecting our connections and our sourcing relationships across the entire country, we are still finding very attractive investment opportunities. Our pipeline is providing opportunities that exceed our ability to invest at this point.

Q: Any recent regulatory updates foreign investors should be aware of?

A: An [April circular](#) by the China Banking Regulatory Commission (CBRC) requires banks to reclassify any misclassification on their balance sheets, that is resulting an increased flow of NPL coming to the market.

The regulation came out in April and comes into effect in the end of November. We are seeing an increasing deal flow as we enter the end of the year as a result.

It is clear the regulator is now focusing more on enforcement rather than broad statements.

Q: How would you rank transparency in the Chinese debt market? Is it improving? Can you give an update on China's shadow banking?

A: Yes, transparency will be improved as we move forward, largely driven by regulatory requirements. Especially the CBRC is requiring increased disclosure and importantly, restating any misclassification that has been going on for the past few years.

This April circular by CBRC is to address credit exposures that have been created outside of traditional lending. For example, wealth management products, inter-bank entrusted payments, receivables, trust beneficiary rights, etc.

You will see a decline in shadow banking and more transparency in banks' balance sheets going forward, all of which is good for the market to better price risk.

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