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We're fine, thanks

While China is not technically in a financial crisis or a recession, the sectors of the economy most closely connected with foreign demand – and those related to the investment bubble in real estate – are in trouble. Many foreign firms are looking to shed non-core operations in China while some local companies, particularly those without privileged access to capital, appear desperate for liquidity. Smelling blood in the water, investment sharks have begun to circle.

Both domestic and international players specializing in distressed assets are now looking for opportunities in China, said Michael Harris, chief operating and investment officer at Gao Fei Consulting Services in Beijing. The shark's fin, as it were, is the fundraising going on.

Goldman Sachs has raised US\$1.5 billion for a fund to buy discounted private equity holdings. It is the largest amount ever raised for a fund of this type and demand is driven by expectations of a surge in the number of distressed sellers trying to offload assets. Morgan Stanley has set up a similar fund, worth US\$10 billion fund, and JP Morgan is also looking for a slice of the action.

The easy targets are overextended foreign firms. Today, industry experts estimate there is between US\$200 and US\$300 billion of foreign investor capital stranded in China.

Jack Rodman, president of Global Distressed Solutions (GDS), a Beijing-based real estate and distressed debt specialist, believes the sales will start soon. He offered troubled private equity firms DB Zwirn and Och-Ziff as examples of companies that may have to answer redemption demands from their investors by selling off non-core assets in China. Rodman also believes some textile companies are likely to start unloading.

Profitable subsidiaries of troubled foreign companies may also come on the market as parent firms try to shore up their balance sheets back home – or go into liquidation.

Undistressed

However, those circling Chinese firms may have to circle a little longer, or perhaps indefinitely. Ted Osborn, a business recovery specialist with PricewaterhouseCoopers (PwC) in Hong Kong, pointed out that considering the condition of many Chinese companies, there have been relatively few transactions.

This may be because many domestic companies have found an easier source of cash. "I have the impression that the government is instructing the banks to provide enough liquidity to failing enterprises to keep them afloat," said Dr Bernd-Uwe Stucken, managing partner for Salans law firm in China.

It seems that the stimulus package has produced a mixture of easy credit and policy incentives that are cushioning many of the larger distressed Chinese firms. Consequently, they are able to hold out for a better price, or redeem their own debt. As Rodman points out, Chinese firms that buy back their own debt at a discount can end up sitting all the prettier for it.

Although some of the Hong Kong-listed real estate developers have begun discounting, many of the larger players are resisting – despite static or declining retail property prices and plummeting occupancy rates. "China is the only real estate market on the planet where we haven't seen diminished values reflective of a global downturn," Rodman said.

With no political pressure on banks to call in loans, few firms are putting real estate assets up for sale – at least, not on the private market.

But it is not just Chinese banks pitching in to help. Chinese life insurance companies, recently released from previous legislation that barred them from investing in real estate, are snapping up property. In Beijing alone, Taikang Life Insurance has acquired multiple buildings, while Ping An Insurance has taken over the Prosper Center as well as the Ping An Center, home to the new Westin hotel. China Life Insurance recently took over the China Life building.

These buildings are reportedly selling for roughly RMB 30,000 (US\$4,300) per square meter. In a market where there is over 100 million square feet of empty space, these prices are considered top dollar. "They're buying good buildings," Rodman said. It's just that the buildings are empty.

Though this may appear in some cases to be one state entity helping out another to keep books in the black, there is no hard evidence to suggest collusion between the banks, developers and life insurance companies, Rodman added.

Buyers beware

Real estate aside, it is not necessarily a state-driven story. Stucken's supplementary explanation for the low number of transactions is that, while foreign funds have capital ready to invest, they are still quite picky about where to place their bets. For example, even the most risk-hungry investors are wary of investing in the troubled Chinese export sector because the opportunity for management-driven turnaround is relatively low.

"Their first question is, how is the industry?" Stucken said. "They probably won't buy into the export industry because the problem is not caused by bad management, it's caused by the economic environment."

For now, it seems that distressed asset investors may have no choice but to keep their powder dry. The danger is, of course, that China is saving weak firms in low-value-added sectors at the expense of a deeper economic realignment and other social priorities. After all, the funds being used to buy empty buildings and shore up the finances of inefficient firms are ultimately being paid for by the Chinese taxpayer.

This strategy may work in the short term, Stuckens observes, but it will only postpone resolution of structural problems in China's economy. "Those [problems] will still be on the table afterwards," he said.

Sidebar: Is China on a distressed asset shopping spree?

China's access to currency, when contrasted to foreign firms' cash shortages, has led some to predict a surge in outbound M&A. "The economic crisis has caused many Chinese companies to become predatory, and many are looking to pick up assets on the cheap in other countries," said Ted Osborn, advisory partner with PricewaterhouseCoopers.

Growth in outbound M&A has already clocked a respectable 9.54% increase in 2009 compared to the same period in 2008, although the number of deals declined. Of the US\$22.8 billion in deals announced by April, the most value is going into materials, followed by financials and energy. In terms of distressed assets, Geely, China's largest private automaker, is considering taking Volvo off Ford's hands, and ChinaChem may help Dow Chemical pay off a US\$9.5 billion bridge loan by purchasing a two of its subsidiaries.