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Preying on China's Distress

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Global advisory firms are beginning to allocate more resources to China in a bet that slowing economic growth and tighter credit conditions will lead to a rise in restructuring opportunities.

Slowing growth and mounting debt burdens are creating an environment that is, in theory, ripe for turnaround specialists and distressed debt investors. A number have been adding senior staff in China, a market that remains largely untapped relative to the rest of Asia.

Investors, however, warn that restructuring specialists may find doing business in China a lot more difficult than they anticipated.

AlixPartners has doubled the size of its team in Asia to about 70 in the last two years. **Alvarez & Marsal** appointed *Yansong Xue* and *Bing Liu* as directors in Beijing this month. Both firms plan to continue expanding in China and elsewhere in Asia.

"Most of our work is done when you have a leveraged Chinese company with some kind of private-equity firm backing it and it's in default," said Ivo Naumann, managing director, AlixPartners, Shanghai. "We are engaged by equity owners and creditors to help with leadership in the process, and are often brought in as an interim manager."

Turnaround shops, however, are also targeting the underperforming China operations of multinational corporations.

"For many Western companies, five or 10 years ago, you just had to be in China irrespective of profitability, and that was fine when you were making a lot of money in Europe and the US, but it's not working now," Naumann said.

Chinese growth has slowed in nine of the past 10 quarters, and data last week showed that the country's production lost momentum for the third straight month.

At the same time, companies are facing a tougher time accessing financing as regulators force banks to reform their risk management and rein in off-balance-sheet lending. A liquidity squeeze in China's money markets has pushed up the cost of bonds, and no domestic IPO has priced since October 2012.

Refinancing pressures in China have rarely led to the kind of restructuring or turnaround opportunities that are common in the US and Europe. No domestic bond issue has defaulted, while local politics and laws related to restructuring have often frustrated international investors, adding to general linguistic and cultural differences.

Advisers, however, believe the renewed focus on reform under Premier Li Keqiang will lead to more opportunities for conventional workouts.

Predator and saviour

Many on China's long list of PE-backed companies are already feeling the pressure, they say.

Over the past decade, the market for Chinese PE has grown rapidly, only to decrease just as rapidly as the local PE markets offered few exit opportunities. PE investments in China are on pace to reach US$6.4bn for the full year 2013 – that is a 64.2% decline from the 2011 peak. *(See Chart.)*

This ebb in new investments means fund managers are spending more time on existing portfolios.

"[R]unning a private equity fund has become much more of a value-add business in that funds now have to manage their portfolio companies," said Oliver Stratton, co-head of Alvarez & Marsal Asia, a turnaround firm. "They're not only investors, and they can't be passive. So, they're thinking, 'we actually have to grow earnings now and fix up the balance sheet'."

What is more, foreign firms have not always committed the necessary local resources – or had the patience – to address the full scope of the market. The effect is a missed business opportunity.

"Broadly speaking, there is an almost-unimaginably huge money-making opportunity available for turnaround/restructuring firms to act as predator and saviour for PE portfolios in China," said Peter Fuhrman, chairman and CEO of **China First Capital**, an international investment bank focusing on China.

"But – and it's a very big but – there really are few if any firms with that capability, experience, focus. It is, therefore, a great example of why often the best and easiest opportunities to make money in China are overlooked or not acted upon."

Meanwhile, in part because China's bank loan market is opaque, potential investors have had to go to greater lengths to get basic information on local assets. On a few occasions, investors have called on risk consultancies to vet PRC loans and the parties backing them.

"We don't help clients source investments, but we see growing demand to investigate non-performing loans in China," said Tadashi Kageyama, senior managing director at Kroll Advisory Solutions in Hong Kong. "Interest in these assets should grow after the liquidity squeeze this year."

Out of court

The Chinese court system, and the way it deals with bankruptcy, can be both a benefit and a hurdle to restructurings. Turnaround specialists said that judges were often quick to liquidate a defaulted firm, rather than engage in a lengthier workout process that could have benefits for debtors and creditors.

“China has a modern bankruptcy code that’s fine and as good as in Europe,” said AlixPartners’ Naumann. “It’s just that the courts and creditors have limited experience in executing it. Their intentions are good, but, in mainland China, a judge’s performance is often measured by the number of cases decided. So, for a judge to engage in a lengthy and highly complex turnaround process, it is challenging. This may sometimes lead to a situation where a liquidation is given priority over a turnaround process.”

As a result, sources said, PE-backed companies – their managers, debtors and creditors – often wanted to settle things out of court. That is where restructuring firms can come in to turn things around.

Yet, to be a relative success in this market is probably going to take a bigger commitment than firms have demonstrated in the recent past. Not a lot of money has been made in China restructuring relative to the rest of the world, sources say.

“It is not particularly difficult for foreign or domestic firms to make money in China, but why no turnaround firms? It starts from simple, humble, unsexy things like none of these guys have real offices in China with significant Chinese-speaking teams with experience in fixing what’s broken inside a Chinese company,” CFC’s Fuhrman said. “They will quickly gravitate to better-paying jobs in PE or investment banking.

“Without teams, you can’t do squat.”