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THE AMCS' DEBT-FOR-EQUITY SWAPS: OPPORTUNITIES FOR FOREIGN CAPITAL?

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Since the establishment of a financial asset-management company (AMC) for each of China's four commercial state-owned banks two years ago, analysts have commented a great deal on their formation and effect, the loan transfers designed to clear China's banks of nonperforming debt, and subsequent debt-for-equity swaps (*see The CBR*, July-August 2000, p. 22). There has been relatively little discussion, however, about what the AMC project means for foreign strategic or private equity investors and the potential involvement of foreign capital in the reform of China's state-owned enterprises (SOEs).

Foreign investors now have the opportunity to buy into SOEs directly by purchasing from AMCs the equity created via the debt-for-equity swaps. Certainly the AMCs—Changcheng, Dongfang, Huarong, and Xinda—and parts of the Chinese government want foreign investors to know about and understand this opportunity. Xinda announced in April 2001 that it had prepared "between 140 and 150 projects" for "overseas participation." In June 2001, Xinda and Huarong AMCs set out on international road shows—with Deloitte & Touche LLP and Ernst & Young LLP in tow—seeking to interest foreign parties in distressed Chinese debt for sale or the equity swapped for the debt. And all this is a prelude to "auctions" of such debt (or equity) to international buyers.

AMCs: Background and Implementation

Two years ago, the Ministry of Finance (MOF) established and capitalized one AMC for each of China's four major commercial banks to clear up the banks' balance sheets and move nonperforming loans to other—seemingly unrelated—balance sheets (*see box* p. 58). Thus the Xinda (for the China Construction Bank), Huarong (for the Industrial and Commercial Bank of China), Dongfang (for the Bank of China), and Changcheng (for the Agricultural Bank of China) AMCs came into being—formally unrelated to the banks that sponsored them but staffed almost entirely by former personnel of the sponsoring banks. According to MOF's plan, the AMCs purchase the bad debt of the respective banks with 10-year bonds. (These bonds carry a soft guarantee from MOF, and thus may amount to a program of deferred recapitalization of the banks by MOF—recapitalization being necessary at the end of 10 years unless the AMCs can offload the interests they have acquired and dedicate those proceeds as purchase price consideration owed to the selling banks.)

The AMCs, now proud owners of significant books of bad debt, may swap the bad debt—with State Economic and Trade Commission (SETC) approval—for equity in the nonperforming SOE borrowers. (In reality this may be all they can do, as forced liquidations seem impossible in the Chinese political context, and the institutional basis for proper bankruptcy proceedings in China is weak.) Thus, as if by magic, the banks clear their books of significant amounts of bad debt, the borrowers eliminate oppressive loan obligations to lenders, and the AMCs (or purchasers of the swapped-for equity)

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become concerned shareholders in the former SOE borrowers able to implement governance, operational, and financial reforms. These reforms, in theory, include hard measures like downsizing and real demands for equity returns.

On November 1, 2000, the State Council promulgated the Regulations on Financial Asset-Management Companies (AMC Regulations), formally writing into law the AMC program and related transactions and ceding control of the AMCs to the joint supervision of the People's Bank of China and the China Securities Regulatory Commission (CSRC).

A recent review of the AMCs' websites and the Chinese press reveals that the AMCs have in fact been busy—they have been purchasing nonperforming loans since September 1999 and have swapped some for equity interests. By the end of 2000, Huarong had bought ¥505.6 billion ($61.1 billion) in nonperforming loans and completed 333 debt-for-equity swaps, Xinda had bought ¥370 billion ($44.7 billion) in loans and completed 168 swaps, Dongfang had bought ¥266.5 billion ($32.2 billion) in loans and completed 65 swaps, and Changcheng had bought ¥345.8 billion ($41.8 billion) in loans and completed 21 swaps.

Loan-transfer Problems

Several significant problems with the loan-transfer program and the hoped-for debt-for-equity swaps are important to mention in a discussion of the potential for foreign strategic investment.

First, the banks have transferred nonperforming loans to AMCs strictly at face value, without any discount to take account of the real, or market, value of doubtful or uncollectible loans. (Herein lies one looming difficulty if any of the AMCs seek to sell the loans themselves, either individually or as part of a portfolio of nonperforming debt. Few buyers will purchase the loans, or securities backed by such loans, at anything close to face value.) The valuation of any subsequent debt-for-equity swap is presumably tied to the unrealistic face value of the original loan. This in turn will affect the valuation of that same equity interest when the AMC seeks to sell it to a third party.

Second, in theory at least, AMCs or subsequent purchasers of equity will, as equity holders, be able to exert a reforming influence on the SOE. This assumption may prove false. Many of the original loans were a result of political or policy pressure: a bank, as a weak actor, allocated funds to an SOE or enterprise within a ministry system without much bargaining power or influence. The AMC that replaces the bank, as lender or (post-swap) as shareholder, is unlikely to have much more influence or power in the SOE—probably less, in fact. Anecdotal evidence suggests that the original management of the SOE—which often remains firmly in place—will be resistant to pressures for transparent governance or real returns on equity. Even a majority equity stake in the SOE does not necessarily translate into stronger management influence.

Legal Basis for Foreign Participation

Article 21 of the AMC Regulations allows the transfer of newly swapped-for SOE equity stakes held by AMCs to foreign investors. The relevant part of the article states, "Enterprise equity held by AMCs may be transferred to domestic and *overseas* investors according to related regulations..." (emphasis added).

The legal basis for these transfers of share interests has been in place since 1995, with the promulgation of the Tentative Provisions on Several Questions Concerning the Establishment of Foreign-Invested Companies Limited by Shares (FICLS Provisions) by the Ministry of Foreign Trade and Economic Cooperation (MOFTEC). The FICLS Provisions allow for the foreign purchase of *unlisted* equity in private Chinese companies limited by shares (CLSs) formed under the Company Law, as distinguished from the foreign purchase of publicly listed shares issued by Chinese CLSs (such as B shares listed on domestic exchanges, or H and N shares listed on foreign exchanges).

Another critical piece of the puzzle is a CSRC notice entitled Regarding the Question of Listing and Liquidity of Unlisted Foreign Capital Shares of Domestic Foreign Capital Share (B Share) Issuers, which was issued November 30, 2000 and is retroactive to September 1, 2000. This notice allows foreign investors that hold unlisted shares in Chinese CLSs—whether by private investment in a FICLS or by conversion of a Sino-foreign equity joint venture into an FICLS or a CLS that has issued public shares—to apply to CSRC and MOFTEC to have these shareholdings converted into B shares within three years of the initial investment. B shares are PRC-exchange listed shares traded in foreign currency and can be bought and sold by Chinese and foreign investors. More recently, MOFTEC and CSRC teamed up again in a June 2001 notice to provide the legal basis for FIEs to issue A and B shares (after the FIE issuers are converted into CLSs). These notices provide essential liquidity to certain kinds of foreign capital and also, in theory, complete a happy circle for foreign investors who may consider becoming SOE investors: the AMC Regulations and the FICLS Provisions offer the *way in* and the CSRC and MOFTEC notices offer the *way out*.

The Reality So Far

To date, it appears that only one AMC has consummated a transaction with foreign investors, although the transaction as reported did not conform exactly to the principles set forth in the AMC Regulations. In this case, announced by Xinda on April 21, 2001, Alliant Energy International Ltd. and Transpacific Capital Corp. reportedly signed an agreement in March 2000 to buy most of the ¥173 million ($21 million) debt of Bengbu Thermal Plant that China Construction Bank had transferred to Xinda in 1999. In April 2001, Bengbu Thermal Plant contributed all of its valuable hard assets, including land-use rights, buildings, and other facilities, to a new Sino-foreign equity joint venture. The $21 million debt purchased by the foreign parties for $14 million was converted into a 70-percent interest in the equity (registered capital) of the new joint venture.

This of course does not resemble the direct purchase of swapped-for equity discussed here, but it does indicate a method by which foreign participants can pay less than face value for bad debt, obtain real governance input and control over good assets, and insulate investment in new entities from predecessor liabilities.

The Business Rationale

Foreign investors now have the opportunity to own equity in China's most significant, albeit money-losing, SOEs and the sprawling enterprise and distribution systems that many SOEs still govern. This opportunity may be enticing to old-line strategic investors, such as multinationals that are tied to a specific product line and are eager to participate in a network of productive factories and a presumably nationwide supply-and-distribution network. It may also be interesting to private equity or venture capital investors who believe that their participation can reform and revitalize an enterprise while attaining a necessary—and profitable—short- or medium-term exit.

The Business Drawbacks

As enticing as the opportunity may be for foreign investors, these types of transactions raise significant potential business issues:

- **Due diligence and transparency**. The proposed foreign purchaser of AMC-held equity may be unable to perform real due diligence on the SOE, or the SOE may be unable to produce information (business, legal, or financial) that is stable, transparent, and reliable. Many SOEs have operated for years not as commercial enterprises but as government departments. The difficulty in understanding their historical operations and future business is enormous.

- **Valuation**. Foreign purchasers may have difficulty valuing the equity stake for sale because of problems related to the provenance of the equity. The AMC, which has been forced to purchase debt at face value, presumably uses the same value to swap its nonperforming loan for equity in the SOE issuer. Whatever the process used, that valuation can have very little to do with the valuation a foreign purchaser may put on the equity interest, or even the methods for valuation. Foreign investors and AMC sellers will thus likely have difficulty reaching agreement on price—one party is buying in a perceived market while the other party is selling an asset created and valued by command.

- **Control and governance**. The size of nonperforming loans converted into equity may prove equally limiting, as they will only very rarely translate into an amount of equity in the SOE issuer that might confer significant governance powers on the purchaser, whether foreign or Chinese. In addition, as stated above, the former managers and stakeholders in the SOE will likely remain in the enterprise and thus be able to frustrate the plans and ambitions of any new stakeholder.

China's Banking Crisis and the AMCs

Until the early 1980s, only one domestically oriented bank existed in China: the People's Bank of China (PBOC). In the early to mid-1980s, the PRC government created new banking institutions from the assets and network of PBOC, namely the Agricultural Bank of China, the China Construction Bank, and the Industrial and Commercial Bank of China. PBOC was then remade into the nation's central banking institution. Along with the Bank of China, which long had a monopoly over foreign exchange and trade-credits business, these banks operated through the late 1980s and 1990s as China's major banking institutions, accounting for about three-quarters of all lending activity in the PRC.

Unfortunately, these banks continued to act as funnels for government allocations of capital to SOEs, most often through transactions that looked like loans but were indistinguishable from policy (not credit)-based donations of capital. Fully four-fifths of all bank lending in China has been and continues to be to SOEs. Given the quality of the borrowers and the lack of real credit analysis prior to lending, many of these loans were subsequently revealed to be underperforming, or nonperforming, leading to a potential crisis in China's banking sector.

After a limited program of bank recapitalization (of around $30 billion) in the mid 1990s, and then the onset of the Asian financial crisis in 1997-98, the notion of clearing bad debt from the books of China's major banks and providing relief to China's SOE borrowers was conceived and implemented beginning in late 1999 and 2000. Some analysts see the program as tailored to "prettifying" the banks for public listings in the next two to five years (via better capital/assets ratios and a reduction in recorded nonperforming debt), rather than to saving SOEs from their burden of debt or putting them on the path to real reform.

Despite the initiation of this program and the transfer of more than ¥1.4 trillion ($170 billion, or 15 percent of GDP) in nonperforming loans to AMCs, recent information from PBOC indicates that as much as 25 percent of aggregate bank lending is nonperforming. Indeed, Liu Mingkang, president of the Bank of China—which is generally thought to have China's best portfolio—said in May 2001 that as much as 30 percent of bank loans are nonperforming. Worse, three-fifths of *new* bank loans are reportedly to non-creditworthy SOE borrowers, thus potentially perpetuating the very problem that the AMCs were designed to remedy.

- **Enterprise recovery plans**. Last, regardless of the difficulties understanding the business and activities of an SOE prior to its conversion into an entity that can issue equity, one thing is almost certain: the enterprise was failing and could neither repay nor service its bank debt. Accordingly, any proposed purchaser must have a recovery plan to turn the failing enterprise around.

Thus, the foreign purchaser may face a situation in which it purchases the overvalued equity of a fairly opaque and ill-understood enterprise with a history of failure, and all for a minority equity interest with little power to turn around the SOE. Or the purchaser will have the dubious privilege of sitting alongside the prior management, which often maintains the controlling stake in the SOE and has no incentive to pay any attention to the new stakeholder.

Legal and Contractual Difficulties

If the business considerations seem daunting, the legal and contractual issues may seem more so. As with any acquisition of stock or assets, the acquisition of equity in SOEs involves a number of critical issues, including those related to government regulation and industrial policy, foreign exchange, approval, legal transparency and enforceability, valuation of state assets, control, balance sheet and purchase price, identification and containment of liabilities, suppliers, customers, and co-investors.

The types of transactions contemplated here may also present more specific problems. For instance, it seems certain that AMCs themselves will gain no contractual protections (representations, warranties, and indemnities) directly from the SOE upon the initial debt-for-equity swap. As a result, AMCs are unlikely to be willing or able to give any representation, warranty, or indemnity protections to foreign or Chinese purchasers of such equity. The conversion of an SOE into a CLS, in preparation for the private issuance of shares to an AMC, is a complex task and often obscures real value, operations, and liabilities inherent in the SOE and its assets and properties. Chinese law lacks clear principles on successor liability, yet it seems safe to say that the owners of stock in a CLS that is a recently converted SOE will not, merely by virtue of the conversion, be able to avoid responsibility for the operations of the former SOE and its personnel and affiliates.

A second set of problems involves the key vehicle for the foreign purchaser's potential interest in the SOE. The PRC Company Law describes a CLS that is in many ways deficient or difficult to use and lacks minority rights protections or mechanisms to ensure proper governance. The Company Law also forbids or constrains certain critical technical mechanisms that would mitigate the risks inherent in holding a minority position (such as preferred share capital, class voting rights, and supermajority voting). It even appears that any rights gained by the imposition of sophisticated articles of association on the SOE issuer will be unavailable, as the CSRC's Recommended Articles of Association for A- and B-Share Issuers—now generally imposed on FICLSs—strip minority shareholders (or specific types of shareholders, such as foreign shareholders) of any significant rights.

Third, aside from the limitations inherent in the CLS form, the FICLS sub-form requires MOFTEC approval, regardless of the size of investment or the "total investment" of the SOE issuer. FICLSs also involve significant illiquidity—shares in FICLSs may not be transferred, under any circumstances, for three years from the formation of the FICLS, and then only with MOFTEC approval. Of course, these liquidity constraints were eased considerably, in theory, by the November 2000 CSRC

notice and the recent MOFTEC notice that allows FICLSs to issue A and B shares, which together allow at least an eventual exit into the B-share markets.

Worth the Risk

The creation of AMCs and the authorizing legislation for AMCs, when coupled with pre-existing regulation of private purchases of equity in CLSs, provide a significant new set of opportunities for foreign strategic and private equity investors interested in direct participation in China's SOEs. Nevertheless, actual investment may be constrained in the short term because of unrealistic SOE equity valuation, weak or unavailable contractual protections for investors, and deficient legal forms through which participants must hold equity interests. This need not be the case. These deals are feasible for investors that have a strong interest in a given sector and a full understanding of pricing and valuation (and the ability to negotiate a realistic value with AMC sellers), and can apply extra efforts to produce strong governance mechanisms and legal protections regarding prior operations. Indeed, for such investors, these transactions may become an important new mode of participation in the reforming Chinese economy.

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Conversions of foreign debt into equity investments in the debtor countries, called debt-equity swaps accounted for $12.5 billion of this amount. Through this technique, investors purchase part of a countrys debt from a creditor bank at a substantial discount and exchange the debt for local currency, bonds, or state-owned equity shares from the debtor government debt of less developed c ountries.Â No debt relief should be extended under the new Brady Plan unless an LDC is aggressively seeking to attract foreign capital and its own citizens flight capital through an active debt-equity program. No capital relief is assumed for Germany, since net NPLs are below their historical average. Note: The sample comprises 22 European countries (14 euro area, six non-euro EU, and two non-EU countries). Results for Cyprus are not shown for formatting reasons. The whiskers indicate the results for capital relief for a +/â€“5 percentage point deviation from the 5 percent haircut assumption. B. NPLs and corporate debt overhang.Â Other tools were used less often, with only about a third of surveyed countries employing debt-for-equity swaps and less than 40 percent using performance-based write-offs (the latter could be partly due to tax disincentivesâ€"see below). 28. Debt enforcement and foreclosure vary considerably across countries in speed and rate of recovery.