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Strategies For Dealing with Distressed Debt in China's Real Estate Sector

Rapid urbanisation is fuelling substantial demand for residential property in China¹. However, the real estate sector's recent financial troubles have exposed developers' over-reliance on debt to fund their projects, leaving offshore bond investors, in particular, to ask if they will ever get repaid and what enforcement strategies are feasible.

Debt restructurings have occurred at a much slower pace than expected. Though some have happened, the danger is that if companies do not move quicker to address their debts, offshore investors will start to look on the Chinese real estate sector as a higher risk than other markets around the world. A majority of Chinese real estate companies only started to issue high-yield bonds, typically with three to five-year maturities, to offshore investors in 2013. The need to redeem or refinance this debt has squeezed the sector in recent years. Those companies that issued another round of bonds with a five-year lifespan in 2017 will come under pressure this year: "Fitch-rated developers have around USD40 billion of offshore public bonds and CNY165 billion of domestic capital market maturing in 2022²."

The resumption of offshore bond sales, which have been off limits to developers since the second half of 2021, has become a critical issue. Developers have had to repay debt with their own cash reserves, but even the strongest cannot do this indefinitely. "The successful return of

stronger developers to the primary cross-border debt market would be a key turning point; and the sooner this happens, the lesser the pain for the sector at large," Fitch said. "The government has made it easier and faster for developers to remit funds from onshore to offshore to repay offshore bond maturities. Remittance channels are likely to remain loose until capital markets normalise."

Policy Response

The government and other policy makers issued new rules and regulations to try to bring order to the real estate market in 2020. Perhaps the most significant were the "2-3-4" Policies – "2" – two land auction regulations in 22 major cities: limiting land auctions to three a year and collectively announcing and auctioning all land for sale³; "3" – "three red lines": limits on the ratios of liabilities to assets, debt to equity and cash to borrowing aimed at reducing real estate developer leverage and regulating liquidity⁴; and "4" – 40% land purchase budget: limiting

¹ FitchRatings' China Property Watch –December2021 Home Sales to Stay Weak on Buyers' Wait-and-See Mood; Underlying Demand Remains Solid: https://1drv.ms/b/s!AkENgIEwy7Uei_tZvPgQtECaOccf6A

² Fitch Ratings 2022 Outlook: China Property Developers: Liquidity Risks to Persist, Return of Confidence Key to Stability: https://1drv.ms/b/s!AkENgIEwy7Uei_tc_c_q6VkiBVzpAw

³ <https://www.asiapropertyawards.com/en/china-restricts-land-portions-in-a-bid-to-end-developers-panic-buying/>

⁴ <https://www.ubs.com/global/en/assetmanagement/insights/thematic-viewpoints/apac-and-emerging/articles/china-three-red-lines.html>

land purchase amounts to 40% of annual contracted sales – to curb developers' risk-taking.

The PBoC and the China Banking and Insurance Regulatory Commission followed up in December 2020, ordering banks to cap their mortgage loans and lending to developers over the next two to four years. State-owned banks are allowed up to 40% in real-estate loans (of which 32.5% can be mortgage loans), for example⁵.

REDD, a financial information provider, reported in January 2022⁶ that policy makers were planning to relax the three red lines to allow developers to exclude debt accrued from acquiring distressed assets.

Restructuring Options

A critical issue facing bondholders hoping to recover their debts, however, is that China has no recent history of successful court-mandated debt restructurings in the real estate sector. According to Bloomberg, since 2018, 27 real estate companies in China have failed to make bond repayments. Only two of them have taken part in court-led restructurings⁷.

“Difficulties can arise if the sector has insufficient experienced restructuring advisers covering financing, business transformation and strategic communications who can provide a comprehensive response as a situation develops.”

One of the first things, if not the first, bondholders should do is identify what they can leverage in times like these to achieve the most optimal outcome under the circumstances. Logically, any security the issuers provided would be the first source of this leverage. This typically comes in the form of pledges of shares in an offshore company (or companies), which usually has indirect ownership of the onshore assets (i.e., the real estate project(s)) of the People's Republic of China (PRC) real estate developer group. Depending on how negotiations between the secured creditor and the issuer progress, it may be necessary to appoint experienced professionals to act as receivers over such shares to enforce the security. The aim of this action would be to assert more pressure on the issuer even if the company, the shares in which are pledged, is not as close to the underlying onshore asset(s) in the group structure as one would like.

At a minimum, the appointment of the receivers will mean the secured lender will:



- Direct access to the affairs, including the books and records, of the relevant company and its assets, including subsidiaries; and



- In a position to have the receivers sell the secured assets to discharge the debt.

The receivers can also strengthen their position if they can exercise the shareholder's powers to replace the directors with their representatives on the boards of the company whose shares are in receivership and its subsidiaries on a layer-by-layer basis under the group structure. This would allow the receivers to act to protect the interests of the secured lender in adverse situations where the issuer tries to dispose of or move the relevant underlying assets out of the group without the secured creditor's consent or engage in any questionable transactions that would harm the value of the security.

Reaching A Successful Outcome

While identifying what to leverage, creditors or offshore bondholders can still opt to pursue a restructuring in parallel at the same time, though they face at least two problems in doing this: structural subordination and insolvency regimes that may not work in the way they hoped. However, working with specialist advisers, they can clear these obstacles if they organise themselves for a negotiated restructuring as early as possible while at the same time, plan for the possibility they may never achieve one.

Tightening housing prices, restrictions on bank loans, private equity and off-balance sheet financing, and upcoming debt maturities are just some of the issues Chinese real estate developers are having to address at the moment. Since the end of 2021, some have made multiple attempts to restructure their offshore debts by conducting liability management exercises to extend repayment dates. Nonetheless, the goal of debt restructuring is a more comprehensive package that provides a long-term solution, rather than a short-term one where none of the individuals in the market is keen to deal with each other unless absolutely necessary. Difficulties can arise if the sector has insufficient experienced restructuring advisers covering financing, business transformation and strategic communications who can provide a comprehensive response as a situation develops.

⁵https://english.www.gov.cn/statecouncil/ministries/202012/31/content_WS5fedca5dc6d0f72576943027.html

⁶<https://www.reuters.com/markets/deals/china-plans-relax-three-red-lines-encourage-state-led-property-ma-redd-2022-01-07/>

⁷<https://www.bloomberquint.com/markets/debt-investors-tested-by-slow-restructuring-evergrande-update>

How We Can Help

FTI Consulting has been retained in many of the most significant international restructurings, working on behalf of various constituents to maximise value, and is well positioned to serve as a financial advisor in large and complex cases. We have a full-suite of restructuring services and a team of dedicated restructuring and real estate experts in Asia, U.S., and the Cayman Islands/British Virgin Islands.



China and Offshore Expertise

We have strong on-the-ground presence in China, including Beijing, Hong Kong, Shanghai, and Shenzhen, including senior experienced restructuring professionals who understand the local market and socio-political environment, know the key players, and are pros in bankruptcy and restructuring. FTI Consulting also operates in the Cayman Islands and the British Virgin Islands often working with entities in distressed situations, including in the context of insolvency, enforcement of debt or security, receivership, stakeholder disputes, litigation or arbitration proceeding.



Industry Expertise

Our professionals bring unique and deep expertise within the commercial real estate sector. We have one of the leading real estate practices in the industry, comprising 150 professionals, with the ability to evaluate and restructure all types of real estate assets, including extensive expertise in multi-unit residential developments and land development across the globe.



Restructuring Expertise

We are involved in the largest and most complex restructurings. Our expertise allows us to quickly assess the situation and assist in terms of liquidity, cash flow analysis, valuation, stakeholder negotiations, contingency planning, and in-court and out-of-court restructuring. Through our diverse experience, we understand the perspectives of all the key stakeholders.



Lender Specialists

Our professionals have extensive experience working with lenders to maximise recoveries. We offer a broad range of strategic and technical skills, hands-on experience with financial modelling and analytics, and negotiating expertise in order to provide decision makers with reasoned and documented analyses regarding all viable alternatives.



Comprehensive Service Offering

FTI Consulting offers global scale and breadth of available resources necessary for undertaking a large and complex assignment, including but not limited to expertise in construction across the globe, real estate and business valuation, litigation, forensic accounting, e-discovery, data and analytics, and strategic communications.



Unmatched Credibility

Engagement constituent groups know and respect our team. Our professional reputation in the marketplace will supplement our client's credibility in key negotiations with all parties involved in the situation.

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