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Heretofore unimagined

The world has never seen the likes of China's credit frenzy. From year-end 2008 through the third quarter of 2013, assets on the balance sheets of Chinese banks grew by $15.1 trillion to $24.3 trillion. That growth in assets is greater than today's $14.6 trillion stock of assets at American commercial banks. For further perspective, China's GDP is reported to sum to $8.9 trillion, America's to $16.7 trillion. (U.S. national income data should be taken with a grain of salt; for China's, empty the cellar.) China's bank footings represent 33.1% of world GDP, though China's economic output amounts to just 12.2% of world GDP. In 1994, when Japan had the world on a string, Japanese output peaked at 17.9% of global production; in the same year, Japanese banking assets topped out at 27.3% of world GDP. Nineteen years later, Japan's share of earthly GDP has shrunk to 6.8%, its banking assets to 11.8% of that all-in figure.

All of which will serve to introduce China Cinda Asset Management Co. Ltd. (1359 on the Hong Kong Exchange), a company that—by every outward sign—would seem to be Johnny-on-the-spot. Cinda is in the debt-restructuring and salvage field. It manages distressed assets (72% of pretax profit in the first half of 2013) as well as having fingers in the pies of private equity, insurance, wealth management, securities brokerage and other financial services. It employs 18,259 people. The shares debuted in a Dec. 12 initial public offering that raised $2.5 billion and was 25 times oversubscribed. There are 11.7 billion shares outstanding; the market cap falls just shy of $25 billion; the prospectus runs to 710 pages. In preview, *Grant's* is bearish.

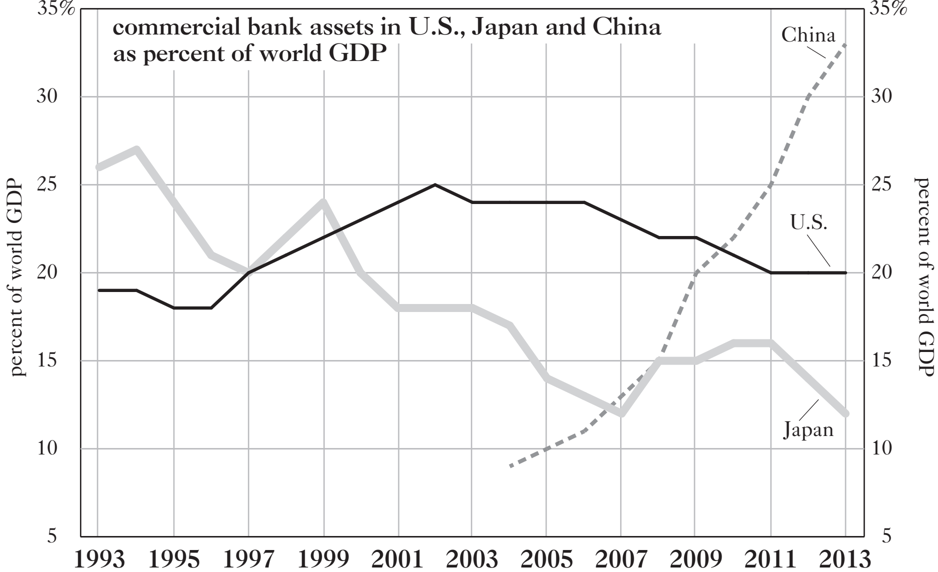
Constant readers will quite correctly feel a sense of déjà vu, as China—and Cinda—have struggled with desperate debts before. Founded in 1999, Cinda was one of the four asset management companies created to relieve Chinese banks of their nonperforming loans. Cinda's special charge was China Construction Bank (*Grant's*, Nov. 4, 2011). We see that Cinda's management has spun a narrative of the corporate history involving three epochs or phases.

During Phase 1, the "policy phase," which spanned 1999 through 2003, Cinda took aboard problem loans from China Construction and China Development Bank. More than generously, Cinda paid 100 cents on the dollar for this debris.

Phase 2, the "transition phase," 2004-2009, featured a change in corporate strategy. Rather than paying par for distressed assets, Cinda got it into its head to pay less than par (or received the Party's permission to do so). Too, the transitioning Cinda went on a diversification drive.

Phase 3, the "commercial phase," beginning in 2010, finds Cinda running a for-profit distress business at the very moment when nonperforming debt must be fairly raining on the People's Republic. A knowledgeable observer of the Chinese banking scene, speaking to colleague Evan Lorenz on condition that he not be named, says

Now, how might this end?



sources: The Bloomberg, IMF, Federal Deposit Insurance Corp, Bank of Japan that a significant part of the growth in bank lending derives from capitalized interest. "Because credit has grown so fast relative to GDP," our source says, "there are de facto nonperforming assets that are not being written down," or, we would add, even acknowledged. "[T]he new credit expansion that you are seeing contains a lot of interest to pay the old debt," our informant continues. "The banking system is keeping itself liquid at the expense of the real economy. That's why you have more and more credit for the same level of activity."

"Whisper it quietly," advised HSBC last month around the time of the IPO, "but Cinda's stock offering represents the first opportunity for overseas investors to buy into China's shadow banking system. Funded by the major banks, Cinda has become something of a shadow lender itself." Plainly, this is not your everyday distressed-debt shop. Neither is China your workaday advanced economy.

Details on Cinda's operations, history and, above all, foibles may or may not present the non-short-selling readers of *Grant's* with an immediately actionable investment idea. (Anyway, even for those who do sell short, Cinda shares are currently a tough borrow.) What it will do instead is provide them with a better understanding of the financial accident-waiting-to-happen called the People's Republic.

If you, like us, are curious about Cinda, you will want to know where it came from—some of the color from management's Phase 1. You will wonder in vain, as Lorenz observes (he having been beguiled the past week with that 710-page prospectus), since the company has released no history prior to 2010. What we do know about Cinda's 2009-era loan purchases is that they were money-losers. It finally fell to the Ministry of Finance to bail out Cinda, the designated bailer-out.

Then again, Lorenz observes, past performance would tell you only so much, since Cinda has changed its M.O. Starting in 2010, the company bought accounts receivable from nonfinancial businesses in addition to taking on assets from commercial banks. Such claims against nonfinancial entities made up 57.1% of distressed-debt assets as of June 30; they amounted to just 5.3% of such assets at year-end 2010.

As we see the situation, Cinda's Phase 3 bears a telling and worrying similarity to "policy" Phase 1. At the start, you will recall, Cinda paid banks par for debts not worth par. It apparently did so at the government's behest. Now, under what management calls its "restructuring model," Cinda is once again paying par for assets that—at this long remove from China, at least—seem not exactly par quality. Why pay par? Quoth Bank of America/Merrill Lynch in a Jan. 15 note: "Cinda believes that these assets are distressed due mainly to short-term liquidity issues, with no fundamental problems." Comments HSBC: "What Cinda is doing here is basically subprime lending—and it views it as a growth engine." Distressed assets managed under this, the "restructuring" technique, increased to 90.2% of total distressed debts on June 30 from 55% in 2011 and 85.7% in 2012.

"Ostensibly," Lorenz relates, "Cinda's nonfinancial distressed-debt business focuses on balances owed by company 'A' to company 'B,' the two corporate entities being separate and distinct. A story in the Dec. 12 editions of *The Wall Street Journal* describes a very different business model. According to the *Journal*, Cinda paid $84 million to Jiangsu Zhongnan Construction Group Co., the would-be builder of China's biggest office tower, 'to buy out debts owed to it by two property developers. . . . Both developers are wholly owned by Zhongnan, making the payout to Zhongnan a loan, rather than a distressed-asset buyout, according to financial professionals.' In other words, Cinda lends to corporations that otherwise struggle to obtain financing from banks through the charade of intercompany receivables."

Ultimately, something tells us, Cin-

China Cinda Asset Management Co. Ltd.
(in rmb. millions, except per-share data)
spot rate: rmb 6.05=$1

	——6 mos. to——				
	6/30/2013	6/30/2012	2012	2011	2010
Total revenues and income	18,669.4	12,209.6	32,335.2	24,382.1	24,260.4
Profit before tax by segment					
Distressed asset mgmt.	3,710.7	2,999.0	6,234.0	7,201.8	7,464.9
Fin. investment and asset mgmt.	1,147.3	800.8	3,284.6	2,488.2	2,332.8
Fin. services	283.7	89.2	164.3	(207.0)	180.3
Elimination	(4.3)	(5.8)	(87.0)	(424.8)	(21.6)
Total profit before tax	5,137.4	3,883.2	9,595.9	9,058.2	9,956.4
Taxes	1,120.4	901.7	2,378.7	2,271.9	2,453.8
Profit after taxes	4,017.0	2,981.5	7,217.2	6,786.3	7,502.6
Non-controlling interests	(47.8)	(3.8)	(89.1)	23.6	103.6
Net income	4,064.8	2,985.3	7,306.3	6,762.8	7,399.0
EPS	0.13	0.11	0.25	0.27	0.32
Cash	29,730.9		42,726.3	27,187.2	33,772.6
Accounts receivable	8,896.3		5,257.3	4,062.5	6,418.2
Distressed debt assets	86,357.1		56,090.4	17,599.6	8,029.9
Debt-for-equity portfolio	43,654.6		48,238.6	50,594.8	52,312.1
Other	114,914.2		102,301.8	73,679.9	50,168.6
Total assets	283,553.0		254,614.4	173,124.0	150,701.4
Borrowing from PBoC	6,872.7		7,053.4	11,310.7	16,464.6
Borrowing from MoF	33,564.3		38,112.3	46,983.8	46,204.8
Borrowings from comm'l banks	104,100.8		76,099.2	25,178.9	7,826.2
Other liabilities	76,269.9		72,464.7	46,807.9	37,704.2
Minority interest	6,382.7		6,111.2	5,029.6	5,476.2
Equity	56,362.6		54,773.6	37,813.1	37,025.3
Total liabilities and equity	283,553.0		254,614.4	173,124.0	150,701.4

source: company reports

da will be a balance-sheet story rather than an earnings story, but the quality of the earnings is already open to question. "While profit grew to rmb. 4 billion ($672 million) in the first half of 2013 from rmb. 3 billion in the first half of 2012," Lorenz points out, "you will see—if you look at note 30 in Cinda's financial statements—that accounts receivable relating to distressed assets grew to rmb. 6.8 billion on June 30 from rmb. 4.2 billion at year-end 2012. Included in accounts receivable are three-year-old claims against China Orient Asset Management Corp., the asset-management company founded in 1999 to clean up Bank of China's problem loans and a claim against China Galaxy Investment Management, an alternative investment company and the former employer of Cinda independent director Li Xikui. Adjusting for these claims, accounts receivable pertaining to distressed debts jumped to rmb. 4.8 billion on June 30 from rmb. 1.9 billion at year-end 2012. This increase is equal to 60% of Cinda's profit before taxes in the first half of last year."

As in America's own credit frolics, fast-growing balance sheets serve both to boost profitability and to flatter asset quality. In Cinda's case, assets registered compound annual growth of 28.8% between 2010 and the first half of 2013. Profitability couldn't keep pace, as return on equity tumbled to 14.6% in the first half of 2013 from 25.5% in 2010.

Funding presents another risk to the would-be adventurer in China's subprime credit markets. "Time was," Lorenz notes, "when Cinda financed its assets through such politically connected conduits as the People's Bank and the Ministry of Finance. These biddable sources—along with stockholders' equity—funded 70% of assets in 2010 and only 37% at mid-year 2013. Borrowings from banks contributed just 5% of funding in 2010, 37% at mid-year 2013. As of June 30, 61% of Cinda's interest-bearing liabilities will reprice or mature in less than a year, no small consideration in these days of off-again, on-again liquidity. As Arthur Kroeber, head of research at GaveKal Dragonomics, observes, Chinese interest rates have doubled in the past six months. In April, the garden-variety money-market rate was quoted at 3%, now it's running at 6% (a liquidity injection by the People's Bank on Tuesday pushed the rate back down to 5.44%). You will recall that, following the China Everbright Bank default in June, overnight Shibor rates lurched to 13.44% [*Grant's*, June 14]. Whither Chinese interest rates? Carl E. Walter, co-author with Fraser J.T. Howie of 'Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise,' makes the point that, for many Chinese borrowers, the demand for credit is inelastic: 'People will pay anything for it.' And Walter adds, 'How are you going to prevent the big state-owned enterprises from getting their chunk of capital?'"

Cinda changes hands at 16.1 times projected 2013 net income and at 12.6 times the 2014 estimate; as a percentage of (guilelessly) estimated year-end book value per share, the stock trades at 194%. Not cheap, is our reading of the facts and figures.

Finally, as Lorenz concludes, "While Cinda may be China's first banking IPO, more are in the pipeline. China Huarong Asset Management Co., the asset-management company founded to scrub Industrial and Commercial Bank of China 15 years ago, is preparing to list. The other two AMCs—China Orient and Great Wall Asset Management Corp.—are expected to follow Huarong." Patience—and, of course, vigilance—would seem advisable.

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