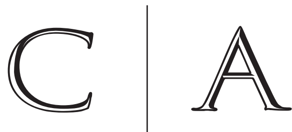

CAMBRIDGE ASSOCIATES LLC

ASIA EX JAPAN DISTRESSED INVESTING

2004

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ABSTRACT

1. The Asia ex Japan distressed debt market is complex, heterogeneous, and inefficient. However, these characteristics mean that investors equipped with the necessary resources can reasonably aim to earn double-digit returns in what has increasingly become a single-digit world. In addition to the potential returns, distressed debt also brings diversification benefits since returns are driven more by company-specific factors rather than by broad market movements.

2. The underlying source of return for this asset class is the large pool of nonperforming loans (NPLs) left in the wake of the Asian financial crisis of 1997-98, a substantial part of which remains unresolved. Although China was relatively unscathed by the crisis, China also has a large pool of NPLs as a result of decades of politically directed lending.

3. In general, the profusion of unresolved Asian NPLs results from a confluence of factors:

   - A culture of government policy-directed lending or relationship-based lending as opposed to lending based on objective assessments of borrowers' creditworthiness;
   - Weak banking regulatory regimes that permitted rampant lending without regard to the economic consequences;
   - Poor corporate governance and transparency;
   - Poor legal framework for the adjudication of creditors' rights; and
   - Weak mechanisms for the enforcement of legal judgments.

4. Because cheap money was readily available in the years preceding the crisis, many Asian companies with viable business models made the mistake of taking on more debt—especially US$-denominated debt—than they could support when their local currencies devalued and the business climate soured. Investing in such debt may provide a backdoor to effective control of these companies, which is especially useful in Asia where many of the better firms are still held by founding families reluctant to cede control regardless of the economic circumstances.

5. Where there are creditors strongly motivated to off-load debt at a reasonable loss, rather than attempting to get the highest price they can, opportunistic "vulture" investors may find tempting carrion. These creditors often come in the form of government sanctioned (public or private) asset management companies whose function is to take substantial chunks of NPLs off the banks' books at a discount so that the banks can resume their regular role in the economy with reasonably clean balance sheets. Other such creditors are those that have reached the end of their tether and who are not prepared to stay the course of a debt restructuring process with their debtors.

6. The attraction of the distressed debt market in Asia ex Japan lies in the complex inefficiencies that result in attractive risk premia. However, to earn these risk premia rather than lose their shirts, investors must maneuver safely through the following reefs:

   - Political risks—with whom debtors have influence may prove more important than to whom they are indebted;
   - Weak regulatory environment, inadequate legal framework for resolution of credit disputes, and unclear bankruptcy laws and procedures;
   - Weak mechanisms for enforcing legal judgments in creditors' favor;
   - Lack of accounting, financial, and management transparency at indebted companies;
   - Lack of pricing transparency; and
   - Volatile foreign exchange and inflation rates.

7. Since a unique combination of skills is required to exploit this investment space successfully, manager selection is critically important. At the least, investors should expect prospective managers to possess:

   - Valuation expertise;
   - Credit analysis and risk management skills;
   - Management and financial expertise;
   - Knowledge of and the ability to manage legal processes;
   - Macroeconomic acumen;
   - Good local network; and
   - Extraordinary patience.

8. Distressed debt investing is cyclical. In many of the Asian countries worst hit by the crisis, the economic outlook and legal infrastructure have improved substantially, enhancing the attractiveness of this sub-asset class. Although the number of opportunities declines as economic conditions improve, the quality of those opportunities tends to be higher and we would still rate Asian ex Japan distressed debt as relatively attractive on a risk/reward basis.

SUMMARY

The Birth of the Asian Distressed Debt Market

Those unfamiliar with Asia often view it as one integrated and somewhat homogenous region. Nothing could be further from the truth. From one country to the next, the landscapes, languages, lifestyles, and cultures are profoundly different. However, as the Asian financial crisis of 1997-98 so cruelly demonstrated, there are substantial economic linkages across the continent. While the effects of the crisis were felt more severely in Thailand, South Korea, Malaysia, and Indonesia, no Asian country was unaffected, except perhaps, Japan, which was already mired in its own debilitating deflation.[1]

As is so often the case, the core of the crisis was overinvestment resulting from excessive optimism and an infusion of cheap capital. Much of the excess liquidity poured into property speculation, inflating a real estate bubble, while the propensity of most Asian countries to peg their exchange rates to the US$ (either explicitly or de facto) meant that domestic assets were increasingly encumbered with US$-denominated liabilities. At the same time, domestic banks in many Asian countries were closely linked to the government of the day, creating moral hazards that encouraged lending practices that tested the frontiers of prudence. As in all bouts of euphoria, few were circumspect enough to see the storm clouds gathering.

Thailand was the first domino to fall. Thailand's average cumulative GDP growth rate, which was in excess of 9% per annum in the years 1987-96, increasingly attracted foreign capital and with US$ loan rates substantially less than those in the domestic market, both foreign and domestic investors preferred to borrow in dollars, secure in the knowledge that the US$/baht exchange rate was fixed. Meanwhile, a weak domestic banking regime was ill-equipped to exercise prudential regulation of an increasingly manic borrowing spree and massive inflows of foreign capital drove Thailand's current account deficit to unprecedented and unsustainable proportions. When speculators, smelling blood, finally targeted the overvalued baht, the government had no option but to break the peg and allow the currency to float (i.e., drop like a rock). Overnight, US$-denominated debts ballooned, triggering mass defaults. Bank balance sheets bulged with nonperforming loans (NPLs) as the property bubble burst and the Thai government was left scrambling for funds to finance its deficit.

As Thailand sneezed, the "financial flu" spread rapidly, and the same scenario played out in Indonesia, the Philippines, South Korea, and Malaysia. In each of these countries, the currency plummeted, not so much as a result of speculation, but as a result of panic selling by domestic debtors with foreign currency exposure desperately trying to hedge their burgeoning liabilities. Liquidity dried up across the region and foreign capital was pulled out of Asia as quickly as it had rushed in. As in Thailand, domestic banks across the region found themselves saddled with mountains of NPLs as a result of their imprudent lending practices, some of which were government directed.

In the bond market, the spectacular collapse of Peregrine Investments Holdings, a Hong Kong investment bank, jump-started a distressed bond market in Asia. In the mid-1990s, Peregrine's credo was that Asian equities were dead, and their place taken by corporate debt. The company thrived, becoming the

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[1] This report focuses on Asian distressed debt ex Japan, since we regard Japan as a significant, separate case. For insight into the distressed debt scene in Japan, please refer to our 2002 report, *Japanese Distressed Investing.*

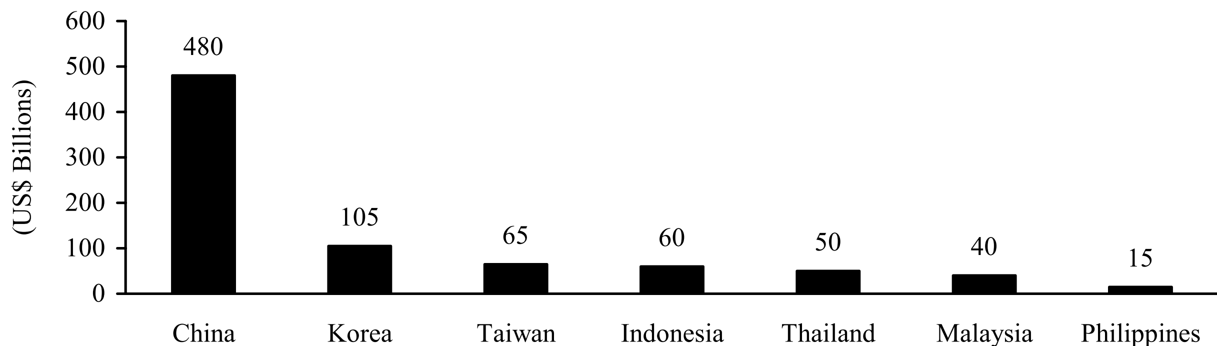
largest player in the Asian fixed income world in the space of just over three years. By 1997, the fixed income unit accounted for 45% of Peregrine's surging profits, boosted by "high-octane" credit and foreign exchange bets.

This highly leveraged business model completely unraveled when Peregrine found itself stranded with (among other illiquid investments) close to US$270 million (amounting to about one-third of its shareholders' funds) of US$-denominated promissory notes issued by an Indonesian taxi company, whose default was assured by the collapse of the Indonesian *rupiah* in January 1998. Despite its high profile, Peregrine was unable to secure any lifeline financing from the Hong Kong authorities as it did not pose any significant systemic risk to the financial system.

For a while, Peregrine's demise spawned a pool of distressed debt securities attracting "vulture" investors. However, this proved a flash in the pan, as Asian corporations soon reverted to more traditional bank loans for their funding needs. It is only of late that we are beginning to see a handful of companies returning to a bond market that is still relatively underdeveloped and dominated by sovereign and quasi-governmental issues. As a result, the distressed bond market in Asia constitutes only a small fraction of the Asian distressed debt market.

The largest part of the market consists of bank NPLs, which continue to fester like an abscess that has yet to be fully drained. Based on Ernst & Young estimates, at its peak, Asian (ex Japan) distressed debt totaled about US$815 billion.

Peak Levels of Distressed Debt Since 1997



Source: Ernst & Young.

The Asian countries that accumulated substantial NPLs in their financial system shared the following common characteristics:

- A culture of government policy-directed lending or relationship-based lending as opposed to lending based on fundamental credit analysis.[2]
- Weak banking regulation, where rampant loan generation remained unchecked.
- Poor corporate governance and transparency.
- Poor legal framework for the efficient enforcement of creditors' rights.

The NPL Problem

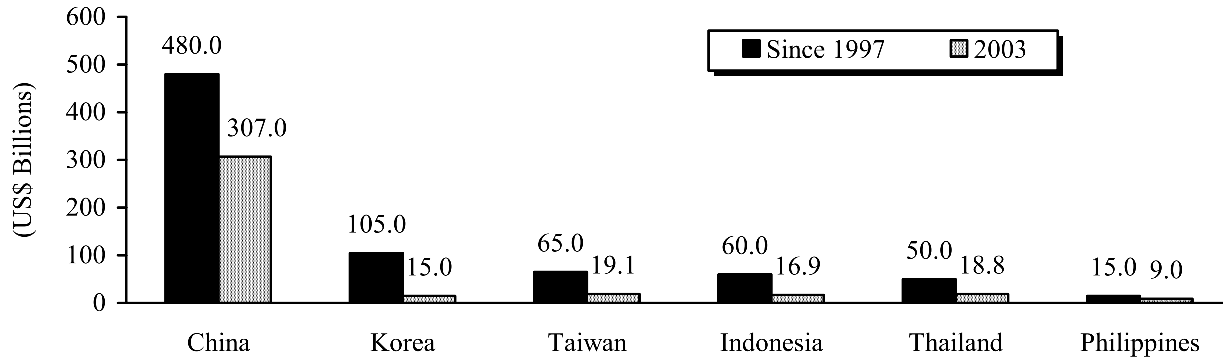
As long as NPLs persist, some companies that should be allowed to die will continue to be sustained through policy-directed debt rescheduling, leading to misallocation of resources. Also, as the level of their NPLs increase, banks tend to become more risk averse and smaller domestic enterprises, viewed as more risky, are denied access to growth capital, further stifling the domestic economy.

So why is it taking so long to resolve outstanding NPLs? For a start, not all these debts are being auctioned off at the same time due to the banks' need to preserve their capital adequacy ratios. Secondly, with the collusion of regulatory authorities, banks have often sought to avoid categorizing some NPLs as such in order to maintain a pretense of solvency. Instead, many state-controlled banks have frequently lent more money to deadbeat borrowers (often at the government's direction) so that these companies (many of them also state-owned enterprises) can meet interest payments and thus avoid technical default. The hope has been that improving economic conditions will help resuscitate these zombies. In fact, this approach serves only to exacerbate the problem; nevertheless, it means that the disposal of NPLs in some countries (especially China) will remain a long, drawn-out process, requiring constant government approval.

To be fair, the situation today is no longer as bleak as it was six years ago and the various countries listed above have had varying degrees of success in resolving the NPLs in their financial system through a combination of debt write-offs, sales, and reschedulings. Thus, a recent estimate of NPLs across Asia indicates significant reductions in the NPL levels in several countries. China also announced recently that it would streamline the approval process for direct sales of NPLs by Asset Management Companies to foreign investors, cutting down on the number of approvals required with a view to speeding up NPL sales.

[2] Government-directed lending was certainly the proximate cause of the massive buildup of NPLs in China, where state-owned banks lent at the direction of government officials—often to further political rather than purely economic purposes.

Peak Levels of Distressed Debt Since 1997 versus 2003



Source: Ernst & Young.
Notes: Data for 2004 for Malaysia not provided. Data for 2004 exclude unresolved NPLs held by AMCs.

The Aftermath

Asset Management Companies. After the initial shock of the crisis, one country after another set up Asset Management Companies (AMCs), or entities with similar sounding names, to provide banks and other financial institutions with a mechanism for off-loading their NPLs. (These AMCs are identified at the start of the respective country reviews that follow.)

The purpose of the AMCs is to get the loans off the banks' balance sheets, so that their lending capacity is no longer impaired. Seeking to avoid too large a hit to their reserves, the banks themselves often prefer to roll over NPLs rather than dispose of them at prices sufficiently attractive to potential investors. In addition, an AMC is also able to aggregate loans from several small creditors to enhance its bargaining power with borrowers during the loan restructuring process. AMCs buy the NPLs (often under government sponsorship) with a hope of repackaging or securitizing them for sale to private investors.

South Korea and Malaysia. (Korean Asset Management Corporation [KAMCO] and Pengurusan Danaharta Nasional Berhad.) Countries that have been more resolute in their task of reducing NPL ratios in their financial system have been rewarded. For example, South Korea and Malaysia have dealt with the problem decisively, realizing that the longer it took to resolve, the more the implicit cost on the economy would mount. Instead of auctioning off some of the NPLs it had taken over from the crippled Korean financial institutions, KAMCO worked with foreign investors like Lehman Brothers Holdings Inc., Morgan Stanley, and Colony Capital to form joint ventures focused on restructuring the loans. In fact, KAMCO has been so effective that it has successfully marketed its services overseas as a distressed debt management consultant. Unfortunately, the South Korea banking system just became mired in a fresh mound of NPLs, this time from consumer credits extended by one of the major credit card issuers, LG Card Co., which is now in financial distress. As of the end of 2003, 19 banks in South Korea had $26.5 billion of bad loans on their books, representing an almost 23% increase over the 2002 figure.

Taiwan. (Taiwan Asset Management Company.) Taiwan has been the most active NPL market in Asia outside of Japan and at the end of 2003 the average NPL/total loans ratio of its domestic banks was down to a manageable rate of 4.3%. A strong legal framework that supports creditors' rights, the introduction of tax holidays for gains arising from the realization of real estate loan collateral, and a slew of other measures implemented soon after the Asian financial crisis have all contributed to the success of its NPL resolution program. In addition, laws to govern loan securitization were enacted in 2002.

Indonesia. (Indonesia Bank Restructuring Agency [IBRA].) In Indonesia the disposition of distressed loans and other distressed assets started slowly, but has picked up over the last nine months. IBRA has enjoyed a degree of success in its disposal of NPLs, with a recovery rate of 28%. As a result, the banks' NPL ratio has been significantly reduced to well below 10% of total loans. Indonesia differs from some other countries in that its problem has not been government policy-directed lending as much as the banks' history of lending to related family businesses and political allies. From the perspective of foreign investors, however, Indonesia's attraction as a distressed debt market is dimmed by its incredibly slow and unpredictable legal infrastructure. For instance, the debt restructuring of Asia Pulp and Paper, which stopped debt payments in March 2001 with a total debt of US$13.9 billion, is ongoing to this date.

Thailand. (Financial Sector Restructuring Authority and Thai Asset Management Corporation [TAMC].) At the other end of the spectrum are China and Thailand, both of which have dithered for years in the resolution of their NPL problems. In Thailand, a framework for corporate debt restructuring was only introduced in 1998 as an alternative to liquidation. Similarly, new bankruptcy and foreclosure laws were only passed in March 1999 after much wrangling in the legislature by interest-conflicted politicians. A bankruptcy court was also set up that year. During the darkest hours of the financial crisis, Krung Thai Bank, the second largest commercial bank in Thailand, had bad loans estimated to be as high as 84% of its total loans. Like the banks in many of the other Asian countries, it had been used as an instrument by the government for policy-directed lending.

Like Indonesia, Thailand suffers from a weak legal infrastructure. For example, it took the Thai courts more than two years to rule (in March 2004) that Thai Petrochemical Industry was insolvent, although the company had long since stopped servicing its debt of about US$3 billion. Only then was the reorganization process set in motion.

Distressed assets transferred to the TAMC have now come close to a resolution. The *Bangkok Post* reported on 2 September 2004 that the TAMC had completed debt restructuring for 753.3 billion baht worth of dud assets, which makes up 96.7% of its original portfolio since it was established in 2001. However, corporate governance and disclosures in Thailand still leave much to be desired. For example, analysts were all shocked by Krung Thai Bank's revelation last July that its NPLs had risen by more than US$1 billion during the second quarter of 2004 alone and by more than 70% since the start of the year. This cast grave doubts over the degree of transparency in government-run institutions and raised suspicions that policy-directed lending has far from ceased.

China. (Four AMCs were formed to deal with the NPLs of its big four banks. Huarong is an affiliate of Industrial and Commercial Bank of China [ICBC], Orient is an affiliate of Bank of China [BOC], Cinda is an affiliate of China Construction Bank [CCB], and Great Wall is an affiliate of the Agricultural Bank of China [ABC].) Today, China is the largest and probably the most promising Asian distressed debt market outside Japan. Of late, the resolution of NPLs in the large state-owned banks has taken on a new sense of urgency. To prepare the big four Chinese state-owned banks for public listing and competition with foreign banks by 2007, when China's banking sector is opened to foreign competition under WTO requirements, China has given its banks up to the end of 2006 to reduce their NPL/total loans ratio to less than 15%. They seem to be on track as the ratio stood at 15.6% at the end of June 2004 and is likely to be even lower now after the sale of $33.7 billion in NPLs by the BOC and CCB to Cinda (one of the AMCs) at the end of July. However, if these banks hope to secure a foreign public listing, they would need to bring the ratio below 10% and closer to 8% to meet international standards. To jump-start the process, China withdrew up to $45 billion from its foreign exchange reserves and injected $22.5 billion each into BOC and CCB in December 2003, thus enabling these banks to write off part of their NPLs. Since BOC and CCB are targeting public listings of their shares in 2005 or—at the latest—2006, they are eager to reduce their NPL/total loan ratios and have succeeded in driving these down to 5.46% and 3.08%, respectively (if one accepts official estimates). With this development, Standard and Poor's duly upgraded BOC and CCB's long- and short-term foreign currency counterparty credit ratings. Many expect that in due course similar capital injections will be made into the remaining two largest state-owned banks, ICBC and ABC. However, such US$ capital injections could quickly lose their impact should the yuan be revalued upwards, since the banks' NPLs are still yuan-based, and the banks' vulnerability in this regard is certainly one reason for China's stoic resistance to any calls for a speedy currency revaluation.

Official estimates put China's NPL/total loans ratio at 20.4% for 2003, an improvement over 2002's figure of 26.1%. Official figures at the end of September 2004 put the NPL ratio as low as 13.4%. Some observers have expressed a concern that this reduction has been achieved more through an increase in new loans than through a reduction of NPLs—although there is no denying that the absolute value of NPLs has also fallen. Based on Ernst & Young's estimate, the four big state-owned banks still account for US$235 billion (or 57% of total NPLs) as of December 2003. Some unofficial estimates have put the figure as high as US$420 billion. In addition, Ernst & Young further estimates that US$107 billion of NPLs remain on the books of the AMCs. The officially reported figure is US$103 billion. To date, the debt recovery rate of the AMCs is in the region of 20%.

Even based on official figures, the four AMCs combined have disposed of less than 40% of the total NPLs sitting in their books. After significant lull, NPL sales are beginning to flow again—and the US$33.7 billion recently transferred from BOC and CCB to Cinda suggests that the pace will soon pick up. For example, Lehman Brothers Holdings, Inc. was reported to have agreed to buy US$240 million of NPLs from Huarong last July, and in August UBS AG, a new entrant into the China distressed debt market, reputedly finalized a deal to purchase a portfolio of NPLs worth US$185 million from Huarong.

At the same time, more foreign expertise is being sought to deal with the problem. Huarong has signed a cooperative agreement with KAMCO to work on the securitization of its NPLs. And in June of

2003, ICBC, the largest domestic lender in China, signed a Memorandum of Understanding with Goldman Sachs to dispose of NPLs amounting to RMB10 billion and to set up a joint venture to deal with its NPLs. Similarly, CCB worked with Morgan Stanley to dispose of RMB4.3 billion of its NPLs and in June of this year Newbridge Capital became the first foreign investor allowed to appoint the majority of the directors on the board of a Chinese bank, Shenzhen Development Bank, even though as a foreign investor it could only acquire the maximum permitted 20% stake in the bank. If foreign expertise is to be injected to improve the management of Chinese banks, this is certainly a step in the right direction.

However, credit-blind bank lending at the branch level has been difficult to curtail partly due to poor accessibility to credit data and the difficulties of supervising a large network of branch offices where many of the branches are so far flung from the bank's central office. Bank credit rose 21% in the first quarter of 2004 and, in the same period, fixed investment rose 43%. Loans poured into the property development, automobile, steel, aluminum, and cement industries, threatening overheating in those sectors and prompting the government to curtail further lending. Nevertheless, the breakneck pace of fixed asset investment as a whole remains unabated, rising 31.1% year-on-year, over the first seven months of 2004. One can only wonder how large a pool of NPLs is being incubated at this moment, from the new loans to finance what, as in Thailand's case, could be an imminent overcapacity overhang. We do know, however, that the China Banking Regulatory Commission reported recently that they expect another 40 billion yuan (US$4.8 billion) of new NPLs by the second half of 2005. Given the past propensity of government NPL estimates to be on the low side, this new pool could be substantially larger.

Strategies and Challenges

Opportunities

While distressed investing technically encompasses the purchase of distressed debt (both private loans and tradable debt securities), distressed securities, and other distressed assets, this report focuses only on investment in Asian ex Japan distressed debt. In addition, while there is no unequivocal definition of what constitutes "distressed debt," a company's debt can safely be termed "distressed" if it is trading at 60 cents to 70 cents to the dollar. A bond is technically in distressed territory if either it is trading at greater than 800 basis points (bps) to 1,200 bps over Treasuries or its yield exceeds 20%. The issuers would typically either have defaulted on their debt obligations or have filed for the equivalent of U.S. Chapter 11 bankruptcy protection. In Asia, as elsewhere, distressed opportunities abound when the following factors are present.

Eager and ready sellers. The presence of nonfinancially motivated sellers eager to rid themselves of their investments in nonperforming debt is a catalyst to the distressed debt market. In Asia, examples include AMCs who have taken over the NPLs of national banks and who have mandates from their government sponsors to clear the NPLs within a certain time frame. Banks themselves may be prepared to sell their NPLs if their net book value of the loans (i.e., the original face value minus provisions made) is less than the price offered to them on the market. This is because they are likely to be more concerned with cleaning up their balance sheet than the intrinsic worth of the loans. Provisions made for such loans tend to

be based on internal bank standard methodology rather than on a fundamental bottom-up credit analysis of the borrower. Hence, the net book value of a loan on a bank's financial books can deviate sufficiently from its intrinsic value to allow distressed debt investors to earn a spread. "Exhausted" foreign investors who wish to exit their investments in Asia altogether after a bad experience could also be noneconomically driven sellers.

Underperforming companies due to weak management. Private equity investors would ordinarily view these as buyout targets, gain equity control, and consequently management control with a view to turning the company around before selling it off at a handsome profit. However, in Asia, where many companies are family grown and control jealously guarded, wresting such control from the incumbent family may prove an insurmountable challenge. However, if distressed debt investors can identify badly run but otherwise viable companies that are suffering financial distress, they may be able to gain backdoor access to a controlling stake by buying the debt on the open market (where it would typically sell at a substantial discount to face value). The investor then controls the debt restructuring process, which could include an attractive debt for equity swap. Having relieved the company of its debt burden, and improved the management and corporate governance, the investor can either work toward a complete turnaround before selling out or can cash out earlier by selling its stake in the company to a strategic investor. Such backdoor acquisition of control has proven to be more successful in some countries than others. For instance, in Thailand, controlling shareholders have been known to fight tooth and nail with creditors to retain control of the debtor company, which they had run to the ground in the first place.

Underperforming companies due to overleveraged balance sheet. In such cases, the distressed debt investor can again purchase the debt at a discount with a view to either selling the debt back to the company at a profit, or to swapping the debt for equity and riding the fortunes of the company as it benefits from a stronger balance sheet. The availability of cheap foreign currency financing in the years preceding the Asian financial crisis spawned many such good companies with bad balance sheets.

Rewards

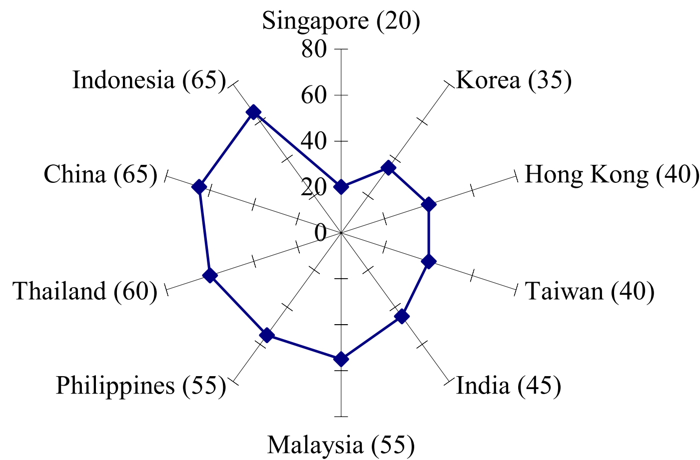
The attraction of distressed debt investing in Asia stems from several factors. First, the Asian debt markets are highly inefficient, being under researched and poorly understood. Consequently, extraordinary returns are possible for those equipped to exploit this market inefficiency. Secondly, the illiquidity and low price transparency of the Asian distressed debt market, coupled with the inherent risk in resolving problem debt in jurisdictions with inadequate legal frameworks, command attractive risk premiums. On the other hand, from a credit perspective, it has been said that debt prior to default can actually be more risky than the same debt after default if one factors in the deep discount at which the issues generally trade after all the bad news has been released.

Risks

Nevertheless, investing in distressed Asian debt is not without risk, even for experienced players. In addition to the inherent risks of low-quality assets, common to distressed investing across the world, several loom larger in Asia than elsewhere.

Political risks. Political structures and processes in Asia are not always as transparent as one would like, and stability in government policies is not always a given. However attractive an investment may appear to be at the outset, the assessment could change with unpredictable government regulations and policies. Some Asian governments have also been known to interfere in what would appear to be private debt restructuring negotiations.

Political Risk Index (July 2004)
Note: Risk level (100=worst)

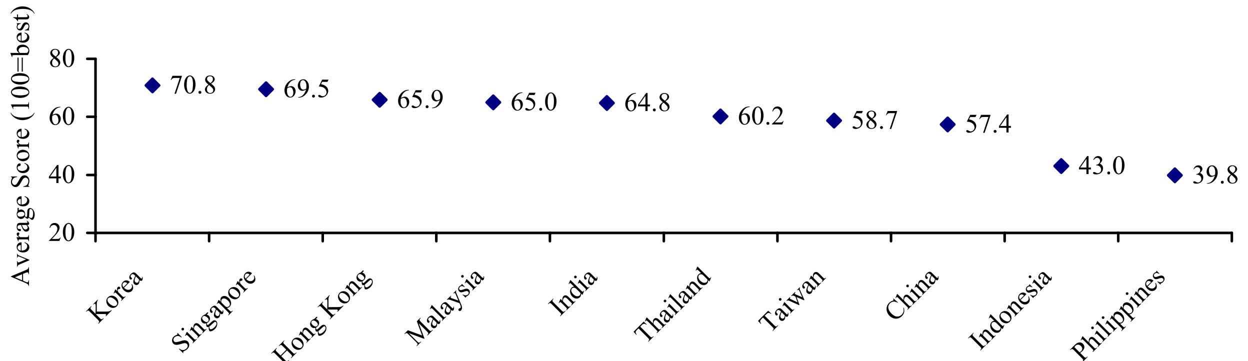


Source: Economist Intelligence Unit.

Weak regulatory environment and unclear bankruptcy laws and procedures. Many Asian countries have only recently adopted laws to affect corporate reorganizations in the context of debt restructuring. China is still in the process of putting such a legal framework in place. Moreover, the courts are often inefficient and slow. As bankruptcy and liquidation proceedings drag on, anticipated rates of return from distressed debt investing can be severely eroded. In addition, even if a creditor wins a legal judgment, some jurisdictions have little or no mechanism for the enforcement of these rights. In other cases, such means of enforcement as they exist are new and untested or so fraught with loopholes that debtors can give their creditors the run-around for an indefinite period of time. In China, for example, asset transfers are still being carried out at less than arm's-length prices between listed subsidiaries and their unlisted state-owned parents, so that creditors may find themselves holding an empty bag when they lay claim to corporate assets. Enforcement of judgments against state-owned debtors can also be bogged down by extraneous considerations such as the potential laying-off of thousands of state employees in the process.

Lack of management transparency. Corporate governance is still poor in most Asian countries. For instance, a 2002 survey conducted by the China Securities Regulatory Commission found that one in ten listed companies had doctored their accounts. In January this year, the Ministry of Finance reported that 152 firms that it surveyed had misstated their profits by a combined amount of 2.9 billion yuan. Distressed debt investors negotiating with debtor companies should never assume that incumbent management will deal with them honestly or fairly.

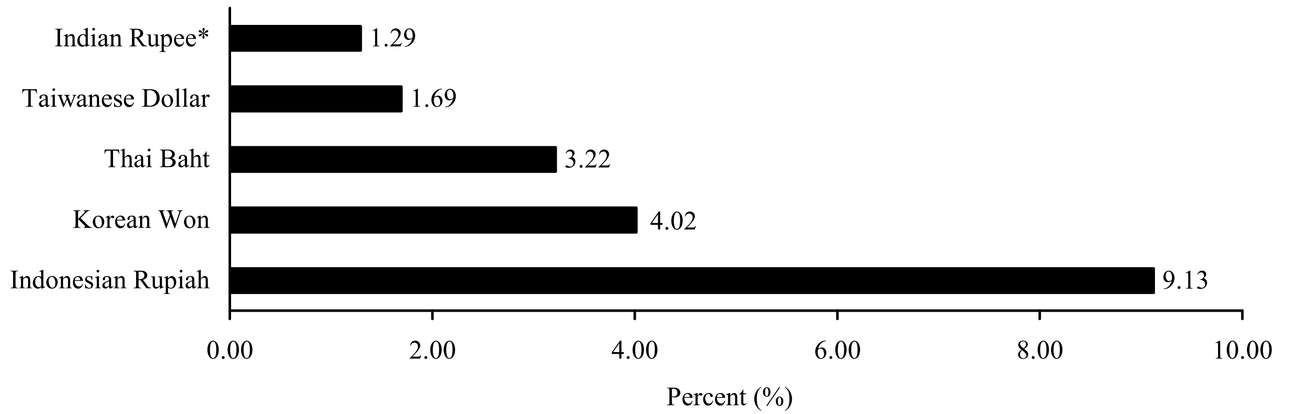
Corporate Governance Index (2002)



Source: CLSA Emerging Markets.

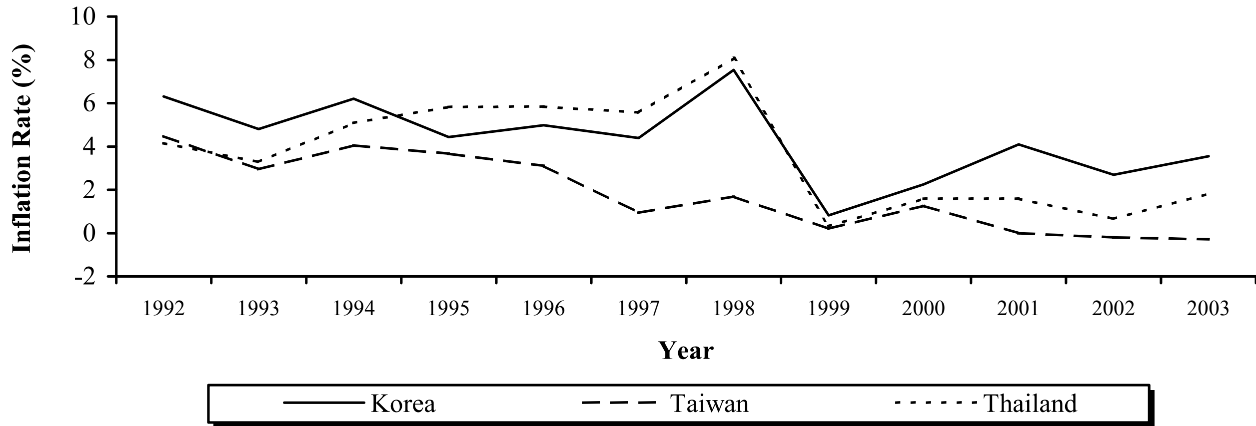
Volatile foreign exchange rates and inflation. For US$ investors, foreign exchange rates could throw them either a life vest or a millstone since the historical volatility of some Asian currencies against the US$ has been high. With many predicting a secular depreciation of the US$ against major Asian currencies, returns from investments in local currency debt could be rewarding. On the other hand, as many Asian countries emerge from recession and register robust economic growth, inflation could re-emerge as the predominant concern, thereby eroding local currency real returns. It should be noted, however, that investors now have far more tools at their disposal to hedge currency exposure risk than was the case a decade ago, and so this risk can be managed to a greater extent than was possible in the past.

Standard Deviation of U.S. Dollar Valuation in Asian Currencies
(Based on monthly data from January 1985 to July 2004)



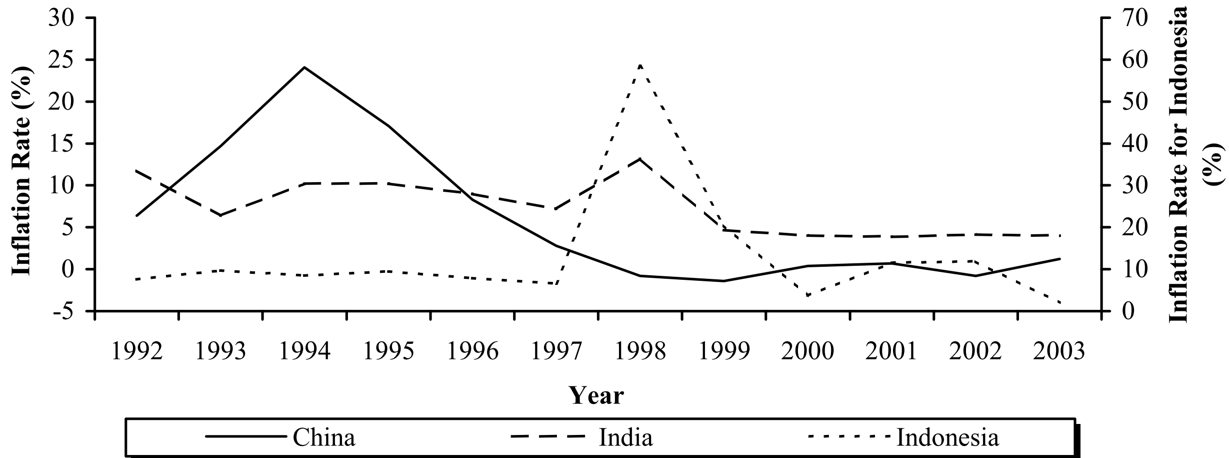
Source: Cambridge Associates LLC.
Note: US$ is pegged to the RMB at the rate of US$1:RMB8.28.
*Data for Indian rupee are based on monthly data from January 1994 to July 2004.

Annual Rates of Inflation (Korea, Taiwan, Thailand)



Source: Asian Development Bank.

Annual Rates of Inflation (China, India, Indonesia)



Source: Asian Development Bank.

Strategies

Distressed funds can be broadly classified into two categories. The first consists of those that seek control of a debtor company through a debt restructuring process. These hope to work out the financial problems of the debtor and turn it around before selling either the debt or equity (from a debt-equity swap) at a profit. These "active" funds are normally structured more like private equity partnerships with a minimum three- to five-year lock-up. In the second category are the more "passive" funds, which are structured more like hedge funds with a shorter investment holding period and offer relatively greater liquidity than the "active" funds. These funds try to exploit mispricings of corporate securities relative to intrinsic value or relative to the debt of similar companies. In the Appendix, we have summarized the key features of distressed debt hedge fund and private equity structure types of managers that are currently active in this market.

For a more detailed description of the various strategies typically employed by distressed investment managers, please refer to our *Global Distressed Investing: Focus on Non-Marketable Strategies and Investment Vehicles* (2001).

Skill-Set

Both distressed investing in general and investing specifically in Asian distressed debt require specialized skills.

Valuation Expertise. Investors need to be able to distinguish badly run companies from companies that are victims of fraud. Although the introduction of the International Financial Reporting Standards (IFRS) has created a set of uniform standards, assessing the financial health of Asian companies remains

challenging because the degree of compliance with these new standards varies considerably from country to country. At the present moment, Singapore, Hong Kong, and the Philippines are the closest to compliance with IFRS, with their standards taken almost verbatim from the IFRS. In addition to these accounting issues, investors must also be able to evaluate and project the post-restructuring value of the company and the contingent breakup value of the firm's assets should the restructuring fail.

Credit analysis and risk management skills. Investors need to be able to conduct fundamental credit analysis on borrowers to assess the premium commensurate with the credit risk. As in all investments, it is critical that the investor not overpay for the debt on offer and have the expertise to manage the downside risk. This task is made even more difficult by the lack of reliable and publicly available credit data in most of these countries. The investor must also be able to differentiate between borrowers who have a genuine desire to work out their debt problems in good faith and those simply seeking an additional line of credit. For instance, apart from an *ability* to commit to some form of repayment of the debt, the borrower must also be *willing* to do so, which is by no means the same thing—the assumption that a borrower necessarily intends to repay a loan does not hold true in Asia and (as noted above) creditors are often unable to enforce their claims, even in situations western investors might perceive as cut and dried. The better the investor understands the borrower, the higher the likelihood of a profitable outcome. Due diligence exercises are often more time consuming and labor intensive than in developed markets.

Management and financial expertise. Investors planning to reinvigorate a distressed company must first be able to identify the cause of the borrower's distress and possess the expertise needed to resolve the problem. Experience in Asian or at least emerging markets corporate workouts and mergers and acquisitions would be a distinct advantage.

Understanding and management of legal processes. Apart from corporate finance skills, distressed debt investors must also be well versed in the diverse legal processes of corporate restructurings, liquidations, and collateral enforceability in the various Asian jurisdictions. This includes negotiation skills—and a recognition that Asian negotiations often follow a different logic from those in Europe or the United States—and the ability to estimate the time frame within which legal issues will be resolved.

Macroeconomic acumen. Investors should also have a firm grasp of each country's socioeconomic policies, since these affect industry-wide trends; the attitude of governmental authorities to distressed debt workouts, bankruptcies, and the resolution of bank NPL problems; and the prospect of recovery for distressed companies in general.

Good local network. The legal and investment structure of many Asian countries is still in the process of maturing. In some cases, like China, new policies and regulations are being promulgated weekly and on-the-ground expertise is needed to monitor the pulse of the shifting regulatory environment. In addition, foreign investors need a good local network of advisers, entrepreneurs, corporate borrowers, and domestic and foreign banks to ensure a reliable deal flow. This is particularly critical in the distressed debt market where lenders saddled with such debts are not predisposed to publicly soliciting offers for their dirty laundry.

Patience. Due to poor debt enforcement and recovery mechanisms in many Asian countries, creditors' patience is likely to be tested by recalcitrant debtors attempting to drag out liquidation proceedings in a war of attrition designed to secure favorable debt resolution terms. Under unfavorable conditions, exhausted creditors might agree to a lower recovery rate, accept local currency repayment against a foreign currency debt, or even swap the debt for equity in the debtor. The flipside of this predicament is the very beauty of Asian distressed debt investing—few investors have both the requisite expertise and the necessary patience, and so those who do have been able to earn annual returns in the order of 15% to 20% (and in certain cases, even higher) in recent years.

Conclusion

Although it would be unrealistic to expect to earn annual returns as high as those earned in the wake of the Asian economic crisis (30+%), the Asian distressed market remains relatively attractive on a risk/reward basis.

- The economies of most Asian countries are enjoying robust growth again. Asia ex Japan has outpaced the rest of the world in GDP growth over the last two years and this is likely to continue at least for the next few years. It has also become less reliant on trade with partners outside the region and so less vulnerable to foreign capital flows.

- Banking regulations have been substantially improved in many of the countries hit by the Asian financial crisis.

- Banking systems in Asian countries have recuperated substantially. Their NPL/total loan ratios have steadily improved, allowing banks to resume lending to spur economic growth. In addition, most countries have accumulated substantial foreign exchange reserves: UBS predicts that Asian foreign currency reserves will grow by US$50 billion a month over the second half of 2004 alone.

- New laws and regulations have been passed in many Asian countries to strengthen creditors' rights and to provide a framework for corporate debt restructuring as an alternative to liquidation.

- As regional economies improve, the number of distressed opportunities is projected to fall, but optimists among fund managers point out that in such an environment the quality of companies in distress also improves. The argument is that the worst companies would long have failed during the recent lean years and the trick now is to identify underperforming companies with viable business models. The real problem managers wrestle with is pricing, as competition for good deals increases and management of distressed companies regard an improving economy as a lifeline that may save them from sinking. The upside is that diverse exit opportunities are likely to be more readily available in a bullish environment.

In addition, a country's distressed debt cycle runs counter to that of the economy as a whole. An improving economic environment provides opportunities to harvest investments made in earlier, weaker periods. Following any economic upturn, there will be a future season for "planting" as far as distressed debt managers are concerned. In Asia, in particular, the stream of distressed debt could rise again in coming years as many companies in Asia have taken advantage of low interest rates to issue lower-than-investment-grade foreign currency bonds. Moreover, undisciplined bank lending persists, particularly in Thailand and China, which could further supplement the future stream of distressed debt. In the Philippines, the level of NPLs has also been on the rise. Finally, overinvestment in fixed assets in China could well erode profit margins, sending some aggressively expanding companies into financial distress.

From a total portfolio perspective, a modest allocation to reasonably priced Asian distressed assets has the additional value of diversification since the correlations of returns with those of developed markets debt and equity are likely to be low. As with distressed investing in general, returns are driven more by company-specific events than by broad market movements. In other words, both the risks and the returns tend to be more idiosyncratic than systematic.

APPENDIX

Appendix

CHARACTERISTICS OF ASIA EX JAPAN DISTRESSED DEBT FUNDS

	Hedge Funds	Private Equity
Firm Background	Key players tend to have been founded in the last eight years.	Key players fall into two main groups: those that have been in this market since the early 1990s and those that were established closer to the year 2000.
Most Recent Fund Size ($mm)	Representative sizes of most recent funds of the key players are in the US$100 million to US$400 million range.	Recent fund sizes vary substantially. Many are in the US$150 million to US$500 million target range. However, there are a few mega-funds that aim to raise more than US$1 billion.
Distressed Strategy	Generally, these funds tend to invest in a combination of publicly traded and privately held securities. Some focus primarily on single credits, while others invest in a combination of single credits and entire portfolios of debt. Most invest in US$ debt and local currency debt to varying degrees. Typical investments include bank debt, public debt, public equity, busted convertibles, privately negotiated direct loans to companies, and property assets.	Funds distinguish themselves geographically into those that do not confine themselves to Asian distressed debt, those that confine themselves to significant distressed debt investments in Asia including Japan, and those that invest only in Asia ex Japan. In certain cases, the focus can be very specific, such as exclusively China or Greater China distressed debt. At one end of the spectrum are funds that deal only in single credits and at the other end are funds that primarily purchase whole portfolios of distressed debt. Funds also distinguish themselves between those that aim to take a control position in the debt of a company and try to actively influence the debt restructuring process and those that do not. Of the latter, the funds tend to focus on senior secured post-restructuring debt.
Use of Leverage	Some funds do not employ leverage at all. Others set a limit to leverage based on a percentage of gross asset value (e.g., 75%) or net asset value (e.g., 25%).	There is no typical level of leverage employed. Among those surveyed, this can range from no use of leverage to the higher of 100% of total commitments or 50% of net asset value.
Investment Vehicle and Terms	Fees are typically 1.5% to 2% management fee + 20% to 25% performance fee with high watermark. Some funds require a one-year lock-up. Quarterly redemptions are common with 14- to 90-day redemption notices.	Typically structured as limited partnerships with a five- to ten-year lifespan and possible extensions of up to two years.