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Industry Q&A: Benjamin Fanger

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Benjamin Fanger, co-founder and MD of China-focused distressed investment fund Shoreline Capital Management, speaks to AVCJ's Christina Kautzky

Q: Can you talk a bit about your strategy as a distressed investor?

A: Shoreline can be called a distressed investor, but it would be more accurate to say we invest in the inefficiencies that result from misallocation of capital in China. Many good Chinese companies can't get funding; this produces high yield opportunities for structured asset-backed financings. Conversely, often bad companies do get funding; this results in non-performing loans (NPLs) and distressed asset sales. Shoreline invests in both of these "too little capital" and "too much capital" kinds of inefficiencies.

An example of "too much capital" is the NPLs in China's banking system. In addition to the hundreds of billions of dollars of NPLs that existed prior to the global economic crisis, China's flood of new lending in 2009 (which doubled 2008's new lending) will undoubtedly produce significantly more NPLs over time. The last time the Chinese government forced a wave of policy lending was in the late 1990s when a quarter of all loans went bad. If just 10% of last year's new lending went bad, $150 billion of new NPLs would surface.

An example of "too little capital" is where Chinese stimulus lending has favored large infrastructure and state-owned enterprises that employ many people while making credit harder to obtain for foreign-invested entities or mid-size companies. Because of this inefficiency, and because of our understanding of the legal enforceability of structures, we have been able to structure high yield convertible notes to mid-size companies in China.

We find below-the-radar opportunities where our return hurdles can be met without assuming best-case outcomes. For NPLs, we focus on exits with minimal court involvement; for other secondaries, we invest in CBs and pre-IPO loans that are available at a substantial discount. In all situations, we work to obtain equity returns with secured credit-type protections.

Q: Where does your deal flow come from?

A: The market of distressed investment opportunities in China is sizable, but impossible to navigate without a highly experienced onshore team. Shoreline Capital's sourcing strategy employs a network of on-the-ground professionals who are able to leverage our connections within the banking, private equity and real estate industries to source investments in lower-profile local deals. We aggregate as much of this information as possible into our proprietary database of hundreds of billions of dollars of loans and other assets. Shoreline Capital also has an experienced team to price and dispose of these assets.

Q: Everyone talks about China in terms of the growth story, so what tends to be the distressed story?

A: Besides capital inefficiencies, another trend is assets that require more on-the-ground legal knowledge and experience than multinational growth investors generally possess. Capital inefficiencies are the common theme among the sources of our investments. A second common theme would be assets that require more on-the-ground legal knowledge and experience than multinational growth investors generally possess.

Misallocations of capital and information asymmetries produce "distressed" or value investment opportunities in all phases of an economic cycle, especially in an emerging economy. In the current environment, we would never touch core real estate properties or the public Chinese stock market, because these assets have been the target of growth-oriented capital, which has provided a flood of liquidity. However, in areas where good private companies lack funding or face simple legal issues we know how to resolve, then situational value opportunities with higher spreads emerge. Also, there are opportunities where banks or investments funds need to write off or write down loans or bonds. These present opportunities where the credits are so illiquid that only an onshore team like Shoreline's could understand and work out the situation.

Q: What skills are required to be a good distressed investor, and are they different from those necessary to be a good traditional private equity investor?

Good growth-oriented private equity investors have a knack for picking the horse and rider. Since our investments focus on situational opportunities and not directional market plays, I like to think we pick (or structure) the entire track.

Distressed investments in China require that a foreign firm possess three core competencies in order to succeed: (1) the ability to source a large number of assets and apply experience to find favorably priced portfolios, (2) local expertise in execution and exit from distressed debt investments, and (3) experience engaging in cross-border distressed debt investments, including understanding structuring, repatriation, tax and other aspects of investing in China. Shoreline Capital was one of the first foreign investors in this area and because we avoided the temptation to overprice assets we did not understand; we are one of the few left standing now.

Q: "Distressed" is a rather scary word - do you think the idea of the risk associated with what you do is sometimes falsely inflated based on perception?

A: While a word like "distressed" is perhaps scarier than a word like "venture," I would bet my house that the volatility of returns among venture funds in China has been much more horrific than that of distressed investors. The best venture fund probably made insanely lucrative returns, but the worst funds certainly went to zero. Distressed funds, on the other hand, rarely make more than two or three times their money on a deal, but also rarely drop anywhere near zero. The reason for this is that we price investments based on real assets and actual cash flows, rather than an anticipation of future growth potential. We also do not generally leverage our investments. An uninformed, inexperienced investor in Chinese distressed assets will almost undoubtedly be surprised by legal risks or liabilities he did not see at the outset. But a competent and prudent Chinese distressed investor finds those risks ex ante and prices them into a structure that is enforceable both onshore and offshore.

Q: What does 2010 hold for Shoreline?

A: Now that China's stimulus is easing off, we hope 2010 will be the beginning of a steady flow of distressed debt opportunities for onshore, experienced teams like ours.

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