

China NPL Investor Survey 2004

A Survey of the strategies, preferences and expectations of the China non-performing loan foreign investment community



November 2004

connectedthinking*

Table of Contents

	Page
1. Background	1
2. Introduction	2
3. Survey Participants	2
4. Additional Information	3
5. Summary of Key Findings	4 – 5
6. Survey Results and Analysis	
6.1 Analysis of survey respondents	6 – 7
6.2 Investment strategies	8 – 11
6.3 Investment targets, preferences and expectations	11 – 16
6.4 Analysis of resource investment	16 – 19
7. Our NPL Related Services	20

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1. Background

In 1999, the Chinese government started making its first substantive moves to resolve the country's non-performing loan ("NPL") problem that continues to plague its banking system to this day. With NPLs estimated by some market commentators at one half of all loans in the banking system, clearly something had to be done. One of first things the government did was to orchestrate the transfer of approximately US\$170 billion of the big-4 state-owned banks' worst NPLs to four newly established Asset Management Companies ("AMCs"), whose charge was to resolve the NPLs and remit the proceeds back to the government. This had the immediate effect of both improving the NPL ratios of the big-4 banks and spawning a new market for NPL resolution.

China's banking sector reform has flourished in the five years since the transfers, and today hardly a week goes by without bank or government announcements relating to reductions in NPL ratios or planned public listings. But China's banks aren't out of the woods yet, and NPLs remain a significant problem. Unfortunately, not all of the banking system's problem loans were transferred to the AMCs in 1999, and many more remain on the books of China's commercial lenders. Earlier this year another US\$40 billion of NPLs were transferred to Cinda AMC by three banks, and most commentators now peg China's NPL market in the US\$500 billion range, making it the second largest market in Asia after Japan.

The abundant supply of NPLs in China has attracted significant interest from both foreign and domestic investors. Generally, China's domestic investors are far less well capitalised than their foreign rivals, who tend to be banks and funds with long histories of acquiring distressed debt and real estate across the globe. Unfortunately, to date there have been relatively few NPL disposals by the AMCs, especially to foreign investors (China's banks are presently prohibited from disposing of any loans if at a value of less than book value). As the table below indicates, in the past four years, only approximately US\$6.0 billion (face value) of China's NPLs have been sold to foreign investors, a scant fraction of the total.

Summary of China NPL sales to foreign investors: Dec 2001 – Nov 2004

Seller	Investor / Arranger	Transaction Type	Deal Size (OPB) (US\$m)	Completion date / Status
BOC (Cayman)	Citigroup	Open Auction	1,800	December 2003
China Const. Bank	Morgan Stanley	Open Auction	310	May 2004
	Deutsche Bank	Open Auction	203	May 2004
Cinda	Chenery Associates	Negotiated	145	December 2001
China Orient	Chenery Associates*	Negotiated – Harbin	210	December 2002
	Chenery Associates	Negotiated – Yanjiang	217	December 2001
Great Wall	Citigroup	Negotiated	242	Signed – pending approval
Huarong	Goldman Sachs	Open Auction – Huarong I	240	December 2002
	Morgan Stanley**	Open Auction – Huarong I	1,304	December 2002
	Morgan Stanley / GE Comm'l Fin	Closed Auction – Wuhan	215	Signed – pending approval
	Morgan Stanley	Open Auction – Huarong II	125	Signed – pending approval
	Citigroup	Open Auction – Huarong II	131	November 2004
	Lehman Brothers	Open Auction – Huarong II	240	Signed – pending approval
	JP Morgan	Open Auction – Huarong II	220	Signed – pending approval
	UBS AG	Open Auction – Huarong II	185	Signed – pending approval
	Goldman Sachs	Open Auction – Huarong II	229	Signed – pending approval
Total:			6,016	

Note: The data contained herein has been obtained from various sources in the market and may not be all-inclusive. Final deal sizes may vary from those shown.

* Arranged by Chenery Associates. Loans purchased by investors organized by Distressed Assets Consulting.

** Morgan Stanley is the leader of an investor consortium that includes Lehman Brothers, Salomon Smith Barney (now Citigroup), KTH Capital Management Ltd, Zhongjin Fengde and International Finance Corporation.

2. Introduction

We've spent as much time as anyone pontificating on the reasons why the Chinese NPL market has turned out the way it has. As we summed up in our 4th edition of *NPL Asia*, we are now resigned to the fact that the market is what it is — slow and unpredictable, but at the same time active and forward moving. Domestic and foreign investors can get deals done, but they've got to ferret out their own opportunities and work hard to complete them.

But there is no way of getting around what the table on the previous page depicts — that since the establishment of the AMCs there have been very few formal large-scale transactions involving disposals of NPLs to third-party investors, whether foreign or domestic. This apparent lack of activity bucks the trend seen in many other Asian jurisdictions where third-party investors, both foreign and domestic, are seen as a driving force behind the NPL market.

While there are many reasons behind China's apparent slow pace in selling significant quantities of NPLs to foreigners, one thing seems clear: notwithstanding the many meetings and discussions held with the foreign investment community, China's NPL sellers — the AMCs and commercial banks in specific situations — probably still do not have a firm grasp of many of the issues important to the foreign distressed-debt investment community.

We developed our China NPL Investor Survey 2004 with this in mind, and its findings draw out many of these issues. Our next aim is to communicate the survey's results to all interested and involved parties — including China's AMCs, banks and relevant regulatory and government bodies — in the hope that it will help facilitate further meaningful discussions between buyers and sellers, opening the door for additional transactions. Only time will tell if our objectives are met.

3. Survey Participants

PricewaterhouseCoopers Hong Kong/China has had a role in each of the transactions depicted above — and many others as well. As a result, we have long established relationships with both China's NPL sellers and the foreign and domestic investment community. We were thus able to target our survey to parties who are either known to have invested in Chinese NPLs or parties that have expressed a keen desire to do so — essentially, the known "market". In all, this comprised 40 entities, including specialised units within investment banks, distressed debt funds and other commercial entities. All told, 17 of these entities completed survey forms, an impressive 42% response rate. Based on these responses and our market experience, we believe our survey results accurately depict the market as it stands today.

4. Additional Information

Our key findings are summarised in Section 5. Section 6 provides graphical analyses and charts and a more comprehensive commentary on the results, divided into the following parts:

- Analysis of survey respondents
- Investment strategies
- Investment targets, preferences and expectations
- Analysis of resource investment

We welcome your comments on this survey, as well as any suggestions for improvements on future surveys. Please direct your comments to the following partners in the following locations:

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We also invite you to visit our websites at www.pwchk.com and www.pwccn.com to have a look at our firm's various publications including those related to the NPL market in China and throughout Asia (many are listed below for your convenience).

Publication	Date	Content	Link
NPL Asia – Issues 1-4	Oct. 2002 - Sep. 2004	A review of what is happening in the Asian non-performing loanmarket	http://www.pwchk.com/home/eng/nplasia_newsletter.html
Industry Watch	Dec. 2003	Exiting Distressed Investments in China	http://www.pwchk.com/home/eng/indwatch_dec2003.html
Industry Watch	Apr. 2002	Background of PRC NPLs and establishment of China AMCs	http://www.pwchk.com/home/eng/indwatch_apr2002.html

Finally, please see the last page of this survey for the contact details of all of our NPL specialists in cities throughout China.

Note:

We have applied a weighting procedure to quantify certain of the respondents' responses. The purpose of this weighting procedure is to provide a basis for us to quantify each respondent's selection in order of preference, when questions call for an order of preference.

For example, in a 5-option question, where we have asked the respondent to rank its preferences, we have assigned 5 marks for the respondent's first choice; 4 marks for the respondent's second choice and so forth. By aggregating all the respondents' scores for each option, we have derived a composite indicator that shows us the respondents' overall preference for each option.

5. Summary of Key Findings

Our survey respondents:

- Are experienced, well-capitalised, and extremely interested in the China NPL market;
- Are prepared to make multiple China NPL investments of significant amounts each year for several years;
- Are interested in acquiring large and medium sized NPL portfolios concentrated in single locations;
- Would prefer NPLs acquired to be secured by land or real property;
- Expect returns in the 21-30% range per annum;
- Prefer privately negotiated transactions to auctions but are not adverse to sharing a portion of their return with sellers; and
- Are building-up sizable teams to address the China NPL market, often teaming-up with local partners.

But they are concerned by trends indicating:

- An unclear government approval process for proposed transactions;
- Sellers re-negotiating sales terms;
- An unclear approval process within the seller's organisation;
- A lengthy timeframe to complete transactions; and
- A lack of predictable deal flow.

What do these results mean?

In a nutshell, that well-capitalised and experienced NPL investors are itching to make multiple sizable investments in China's NPL market, but are troubled by its lack of defined parameters, consistency and deal flow.

We estimate that foreign investors have approximately US\$10-15 billion earmarked for investment in the Chinese NPL market over the next three years. To put this in context, the general consensus of market observers is that China has in the region of US\$500 billion of NPLs to resolve, and many believe this number is growing. Assuming average proceeds from NPL resolutions in the range of 20%-30%, this implies a recovery value in the region of US\$100-150 billion. Therefore, the US\$10-15 billion of foreign money on the table could take a significant, but not overwhelming, bite out of China's NPL problem.

Our survey results indicate that foreign investors are committed to the China NPL market:

- Nearly all respondents expect to be involved for more than 5 years
- All say that China is a high, if not their top, priority in Asia; and
- The vast majority believe opportunities will increase over the next 1-3 years

Yet few transactions have been completed with foreign investors to date leading to investors having legitimate concerns about the state of the market. We also note that during the three month period between survey completion and today, many of the respondents appear to have changed their tune—in many of our discussions with them their optimism has turned to pessimism over the dearth of opportunities in the market. As a result we believe the biggest issue facing China's NPL sellers today is whether they can modify the current system sufficiently to entice the foreign investment community to stay in the market. Many foreign parties have invested considerable sums preparing an infrastructure for NPL activity in China that has yet to emerge on a consistent basis. History shows that capital flows to regions where consistent transaction flow and profitable investment opportunities can take place. If China cannot produce an environment conducive to such activity, investors will likely move on to other mature markets such as Japan (still Asia's largest NPL market) and Korea, or even to new markets such as Germany and Eastern Europe, where NPL activity has already proven to be more predictable than that presently being demonstrated in China.

In light of this we have to ask the question: Does China need or want the money foreign investors are willing to spend? There are some reasons why the answer to this question might be “no”:

- US\$10-15 billion is relatively small in the context of China’s economy and China certainly doesn’t need the foreign currency;
- The immediate liquidity that would come from quick sales to foreign investors would be at the expense of longer term collection upside;
- There is a risk that when foreign investors begin to collect on the NPLs acquired the status quo of the underlying debtors will be disrupted; and
- There is the issue of job preservation at the AMCs

However, notwithstanding the above reasons, we believe China’s policy makers should and will keep the door open for foreign investment as:

- China can reasonably expect to recover only US\$100-150 billion from resolutions of its NPLs, and while the AMCs can recover a substantial portion of this total from their own collection efforts and from sales to domestic investors, the domestic market can’t reasonably be expected to absorb it all;
- The US\$10-15 billion available for NPL purchases from the foreign investment community could resolve a decent chunk of China’s NPL problem, whilst still leaving the bulk of the sales, and collection upside, with the domestic market—a politically acceptable solution;
- Even if US\$10-15 billion of NPLs were sold to the foreign investment community, the AMCs and the Chinese partners of the foreign investors would likely have extensive involvement in the collection process—again, keeping some value “in-house”;
- The experience to date of foreign investors’ collection methods indicate pragmatic negotiated settlements providing a once-and-for-all resolution for the underlying debtor, in nearly all cases without recourse to the courts or triggering a bankruptcy;
- This relatively fast collection process contrasts with the more politically driven and lengthy collection process typically found at the AMCs and with domestic investors, thus helping to reduce the overall time to clean-up the NPL sector; and
- Foreign involvement in China’s NPL problem also helps to introduce much needed international best practice and expertise into China’s distressed debt sector, effectively serving as a test case for enhancing the development of China’s nascent debt restructuring and workout market.

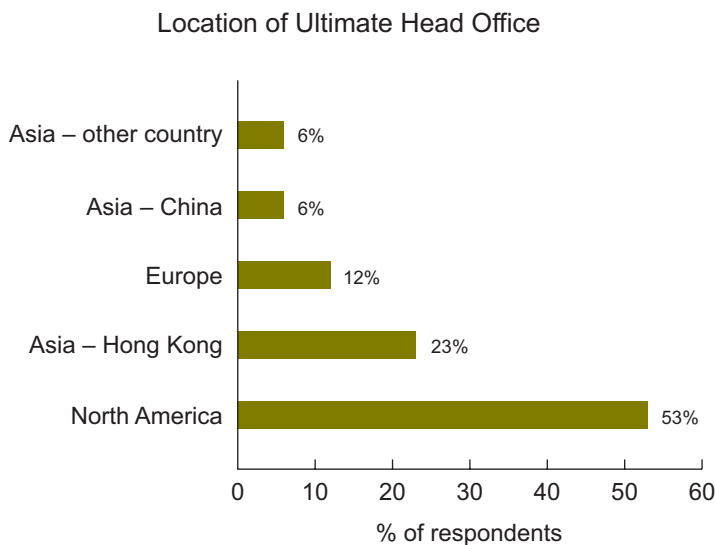
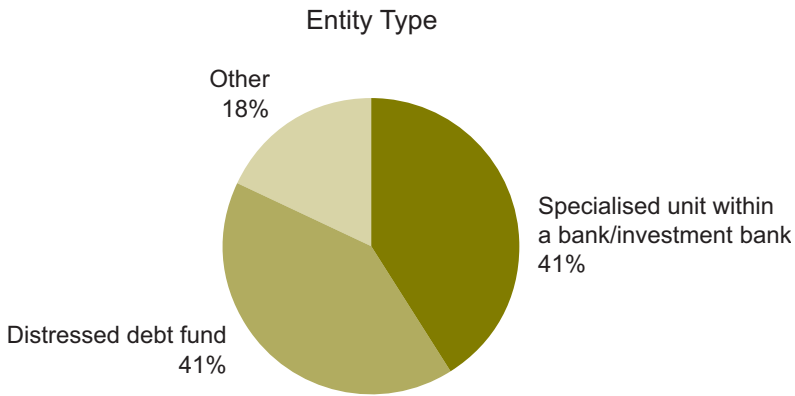
We believe that these benefits outweigh the potential concerns that China’s government officials and regulators may have about the impact of foreign investment in China’s NPLs, and we urge the relevant authorities to consider furthering their efforts to reform the sector to facilitate the market for foreign investment. The National Development and Reform Commission’s recent notice to the AMCs clarifying (and hopefully streamlining) the process for NPL disposals to foreign investors is clearly a step in the right direction.

Alternatively, should China’s NPL sellers continue with their existing disposition approach, we believe there may be a dramatic decline in the expressions of interest from foreign investors. Accordingly, we see 2005-2006 as being critical years for China to address successfully the concerns of the foreign investment community.

Survey Results and Analysis

6.1 Analysis of survey respondents

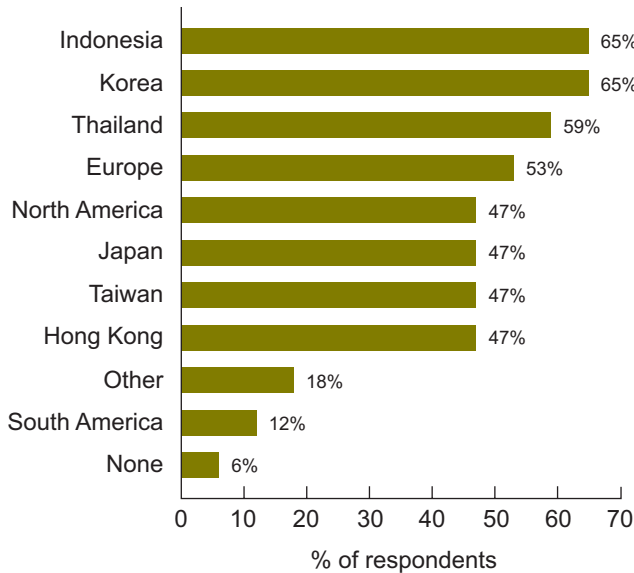
6.1.1 What is your organisation's entity type and where is the location of your organisation's ultimate head office?



- 82% of the survey respondents are either specialised units within banks/ investment banks or distressed debt funds.
- Other survey respondents included an investment company, a merchant bank and a private equity firm.
- 53% of the survey respondents have an ultimate head office in the U.S., with 23% being headquartered in Hong Kong. As most of the banks/investment banks with specialised distressed debt units are U.S. based, this result is not surprising.
- While many of our survey respondents are investment banks that have NPL experience in other countries within Asia, we have seen an increasing presence of small to medium-sized Hong Kong and U.S. based distressed funds entering the market. We have met with many of these funds who are prepared to invest in NPLs covering a wide variety of industries and geographical regions.

6.1.2 What countries/areas (other than China) has your organisation made NPL/ Non-performing Asset (“NPA”) ¹ investments?

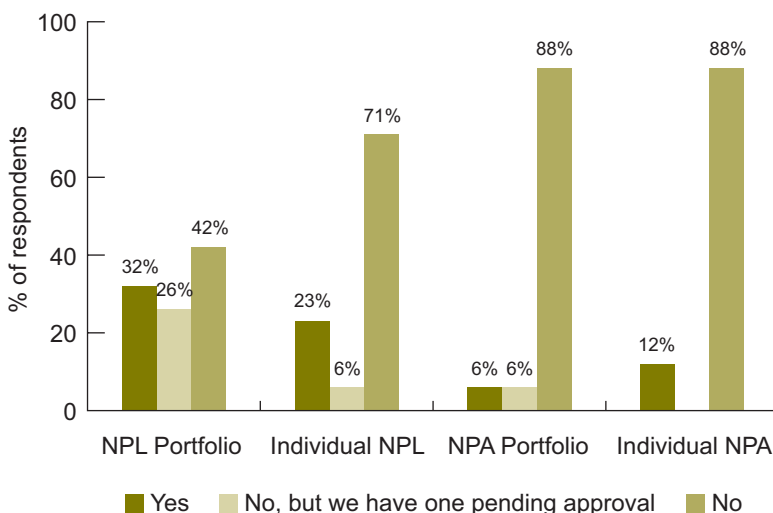
Locations (other than China) with NPL/NPA investments



- 94% of the survey respondents have prior NPL experience in at least one other country or region. 65% have NPL experience in at least one Asian country.
- That the vast majority of the respondents have prior NPL experience does not surprise us. The NPL market as we know it today evolved out of the US Savings and Loan Crisis in the late 1980s. When Thailand devalued its currency in 1997, kicking-off what is now known as the Asian Financial Crisis, many of the experienced NPL players in the US started to consider NPL and other distressed debt opportunities in Asia. The Asian NPL and distressed markets (ex-China and Taiwan) heated-up quite quickly, and many of the US-based operators soon headed east, establishing operations in Thailand, Indonesia, Korea and Japan. During 1998-2002 these markets flourished, as did the fortunes of many distressed debt investors. As luck would have it, just as the inventory of NPLs in these countries started to dwindle, new markets such as Taiwan and China started to show signs of life, and capital has slowly shifted towards these markets, first to Taiwan and more recently to China.

6.1.3 Has your organisation closed any transactions in China involving an (1) NPL portfolio, (2) NPA portfolio, (3) individual NPL or (4) individual NPA?

Transactions closed and/or pending approval

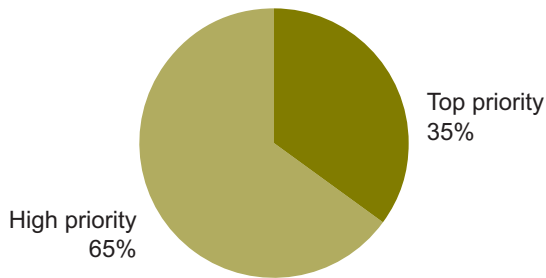


- 58% of the survey respondents have either closed an NPL portfolio transaction or have one pending approvals while the majority of our survey respondents have yet to close a transaction involving an individual NPL or NPA.
- We do not find this result particularly unusual as there have been very few large-scale NPA transactions in the marketplace (China Construction Bank’s settled asset auction being one of the few exceptions). However, this may also be due to difficulties in identifying suitable NPA opportunities and the difficulties and uncertainties inherent in resolving single asset situations. Whilst single asset plays have proven to be good investment opportunities in other Asian markets, a track record for such deals in China has yet to emerge outside of the Hong Kong window company situations of 2000-2003.

¹ A non-performing asset (as distinct from a non-performing loan) is a tangible asset such as a commercial building held on the books of an AMC or bank. Such NPAs are often referred to as "Settled Assets" in China as they were taken in by the financial institution in lieu of payment on a debt owed.

6.2 Investment strategies

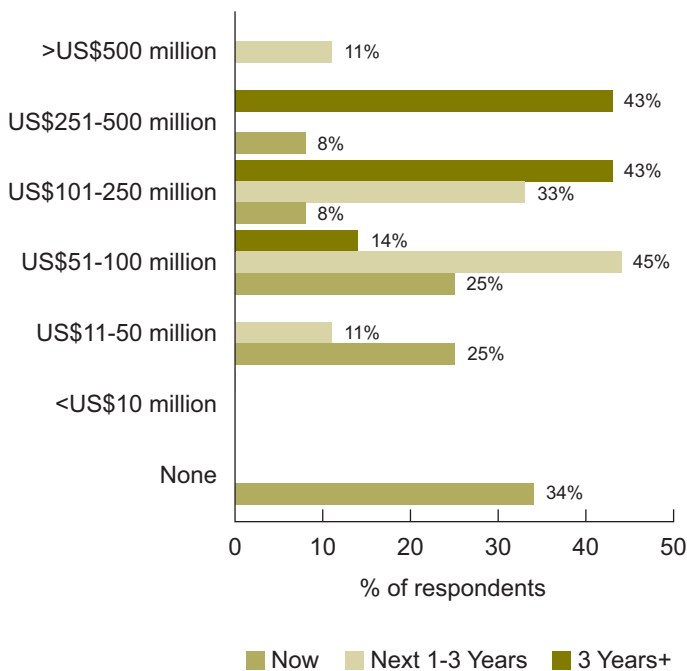
6.2.1 Where does China fit into your organisation's priority with respect to Asian distressed investments?



- All survey respondents indicated that the China NPL market is a high priority with respect to their Asian distressed investments. Indeed, 35% of them reported that the China NPL market is their top priority.
- Investors are interested in the China NPL market for many reasons, chiefly among them, its abundant supply. But China's NPL sellers are actually in danger of losing this investor interest due to a number of factors including the slow pace of disposals, and a lengthy approval process (these and other issues are discussed in greater detail below).

6.2.2 How much capital does your organisation/fund have or plan to have allocated to China NPL/NPA investments?

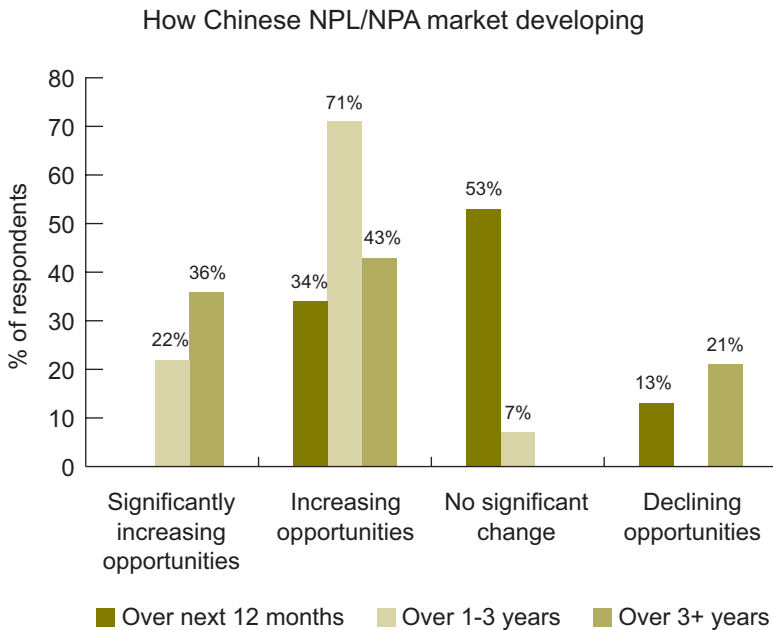
Capital allocated to China NPL/NPA Investments



- 41% of the survey respondents presently have between US\$51-500 million (each) allocated to the China NPL/NPA market, with 16% between US\$101-500 million.
- The survey respondents are expecting investment opportunities to pick up in the next few years with 78% planning to allocate between US\$51 million to US\$250 million while 11% are planning to allocate more than US\$500 million to the market in the coming 3 years. 86% are prepared to invest US\$101 million to US\$500 million in 3 years' time².

² Please see Section 5 for additional commentary in relation to our estimates of the quantum of capital available for investment in the China NPL market.

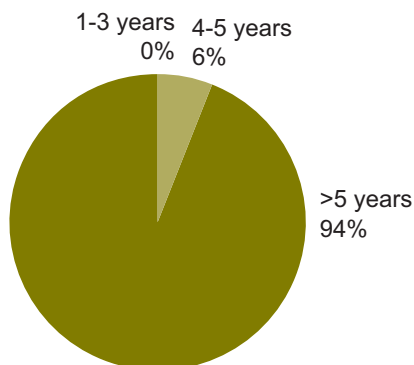
6.2.3 How does your organisation see the Chinese NPL/NPA market developing over the following time frames?



- Approximately one half of the survey respondents (53%) expect the market to have no significant change over the next 12 months. This is likely due to the fact that many of these respondents have been in the China NPL market for three to four years and have grown accustomed to the fickle nature of the market.
- 71% of the survey respondents expect that there will be increasing opportunities in the coming 1 to 3 years and beyond. We believe this optimism is due to the belief that there will be additional opportunities arising out of the AMC's and China's commercial banks. Since they acquired their US\$171 billion of NPLs from the four state-owned banks in late 1999, the four AMC's have disposed of only 38% of their inventory as of March 2004. Meanwhile, the four state-owned banks are under pressure to dispose of their NPLs, clean up balance sheets, recapitalise and get ready for public listing before foreign banks enter the Chinese market under WTO Agreements in 2007. There are thus great expectations that these banks are likely to bring more NPL portfolios to the market in the coming 1 to 3 years in order to fulfill the China Banking Regulatory Commission's requirement that such banks reduce their NPL ratios to below 15% by 2007.

6.2.4 How long does your organisation expect to be in the Chinese NPL/ NPA market?

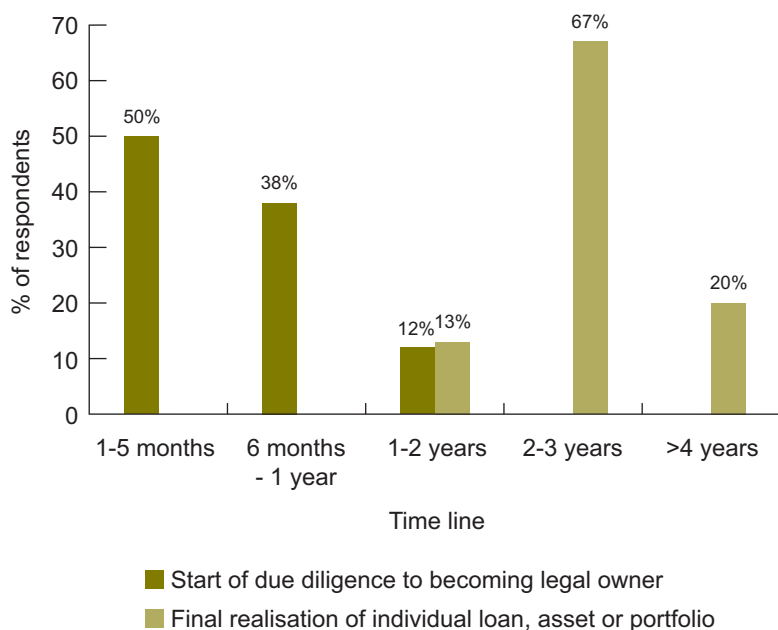
Time expect to be in the Chinese NPL/NPA market



- All survey respondents indicated that they expect themselves to be in the Chinese NPL/ NPA market for more than 4 years and a predominant number of them (94%) expect their involvement to go beyond 5 years.
- This result is not surprising given the current size of the market, the amount investors are prepared to invest and the expectation of additional NPLs becoming identified.

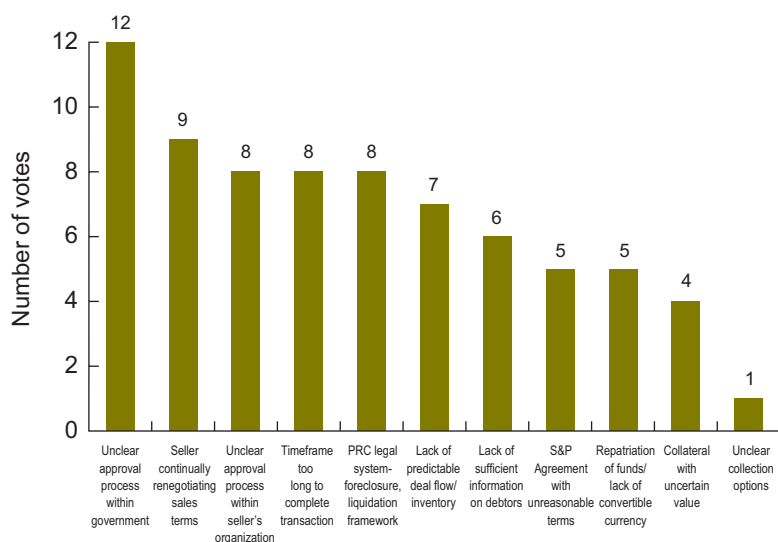
6.2.5 What is your organisation's expected time horizon for most China NPL/NPA investments?

Expected time horizon for most China NPL/NPA Investment



- The vast majority of the survey respondents (88%) indicated that they expect to be able to complete a transaction within one year from the start of due diligence.
- While it is clearly possible to conclude a transaction within this timeframe, our experience indicates that most transactions are actually concluded in about two years. Clearly, then, investors' expectations are at odds with current market practice.
- 67% of the survey respondents expect that individual loans, assets or portfolios acquired can be realised within 2-3 years. Our own experience servicing Chinese NPLs is consistent with our survey respondent's expectations—a target of 2-3 years is a realistic target.

6.2.6 Of the following list, what are your organisation's top 5 concerns relating to the China NPL/NPA market – issues that could keep you from spending resources to investigate the market further and/or making an investment?



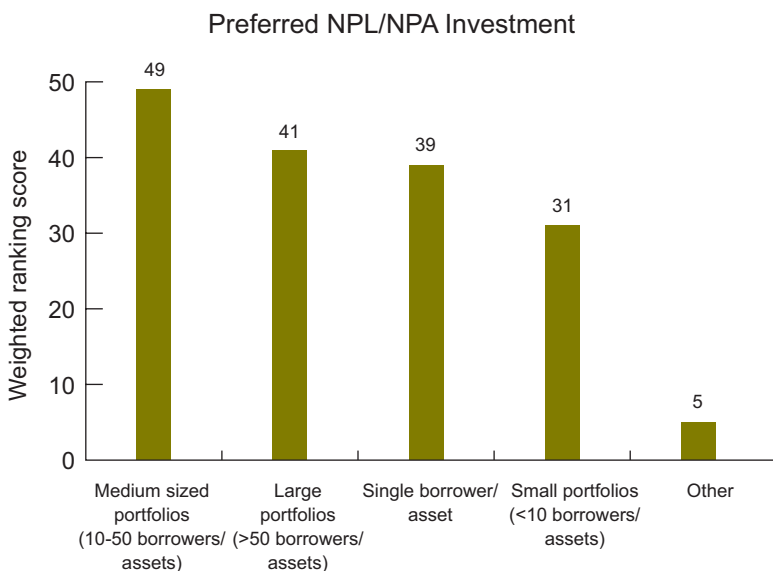
- Investors' top 5 concerns that could keep them away from the Chinese NPL market are:
 1. **Unclear government approval process.** Obtaining the various approvals required to close an NPL transaction in China is notoriously complicated and difficult. Applicants are often required to go through lengthy procedures and numerous layers of government officials, none of which is documented or particularly transparent.
 2. **Sellers continually re-negotiating sales terms.** China's NPL sellers are extremely cautious about pricing, particularly when selling to foreigners. Since the NPLs/NPAs in question are ultimately state assets, no one wants to be on the hook for selling them at perceived under-value. In order to avoid such criticism, frequent changes in pricing are not uncommon, even after they have previously been "agreed".
 3. **Unclear approval process within seller's organization.** Obtaining a clear-cut answer out of an AMC on its internal approval process has proven to be elusive for many of our survey respondents. This is due in part to the political nature of the AMCs, in which

employees can be reluctant to make decisions, and in part to the divide between branch offices and headquarters in Beijing.

4. **Timeframe too long to complete transaction.** This is largely due to (1) the cumbersome and lengthy approval process, and (2) lengthy and often heated discussions over price.
5. **Inadequate PRC legal system.** Over the course of our numerous discussions with prospective investors in the China NPL market, the inadequacies of the PRC legal system are nearly always raised as an area of concern. While in our experience optimal recoveries are had through consensual negotiations, there will always be some cases that will require legal action to be taken. Decent laws and procedures are in place enabling creditors to foreclose on real property. But existing bankruptcy laws are rarely relied upon. A draft new bankruptcy law is expected to be introduced in 2005 that seeks to accommodate the many entities operating in China's new market economy, and this may help to reduce investors' concerns.

6.3 Investment targets, preferences and expectations

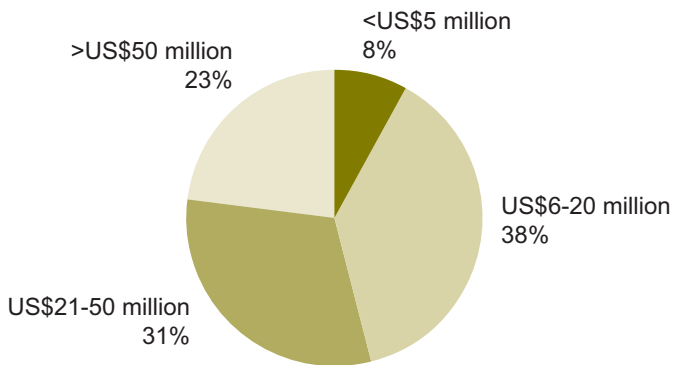
6.3.1 What is your organisation's preferred NPL/NPA investment?



- While 58% of respondents ranked “Large Portfolios” as their most preferred investment, “Medium-sized portfolios” achieved the highest score (49) under our weighted ranking scoring system. Clearly, NPL portfolios are preferred to single asset investments.
- Investors' interest in single assets may be attributed to the perception that there are fewer risks and greater potential for upside with such assets as it is generally easier to get comfortable with the recovery prospects for a single distressed asset than for a portfolio. However, as noted above, our experience indicates that to date investors have found it difficult to identify suitable single distressed asset opportunities.
- Portfolios constituting a mixture of assets, however, often appeal to investors as it enables them to identify hidden value, thereby maximising returns. Our experience indicates that experienced players often opt for large portfolios whereas newcomers are more prone to acquire smaller ones.

6.3.2 What is your preferred investment size (purchase price; not OPB) per China NPL/NPA transaction?

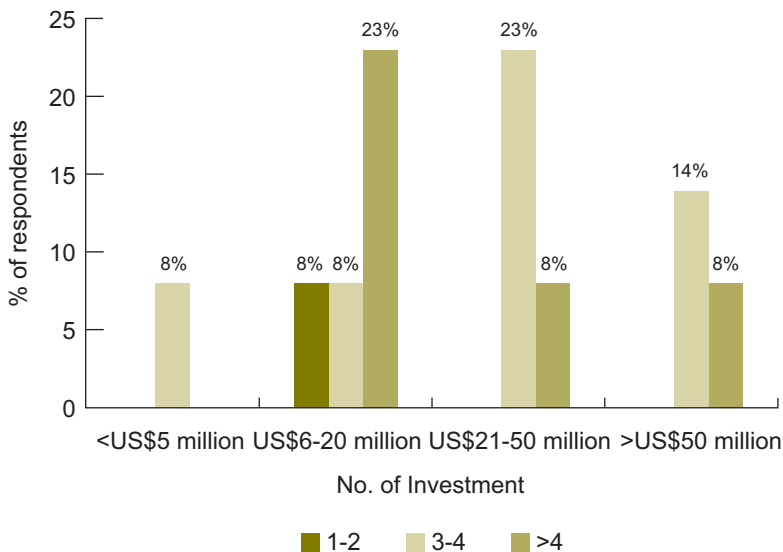
Preferred investment size per China NPL/NPA transaction



- A vast majority of the survey respondents (92%) preferred an investment size of over US\$5 million per China NPL/NPA transaction.
- Among the survey respondents, 38% preferred an investment size of US\$6-20 million, 31% preferred US\$21-50 million while 23% preferred over US\$50 million.
- As borne out from the results of question 6.3.1, to accommodate this investor appetite clearly the demand is for medium and large portfolios.

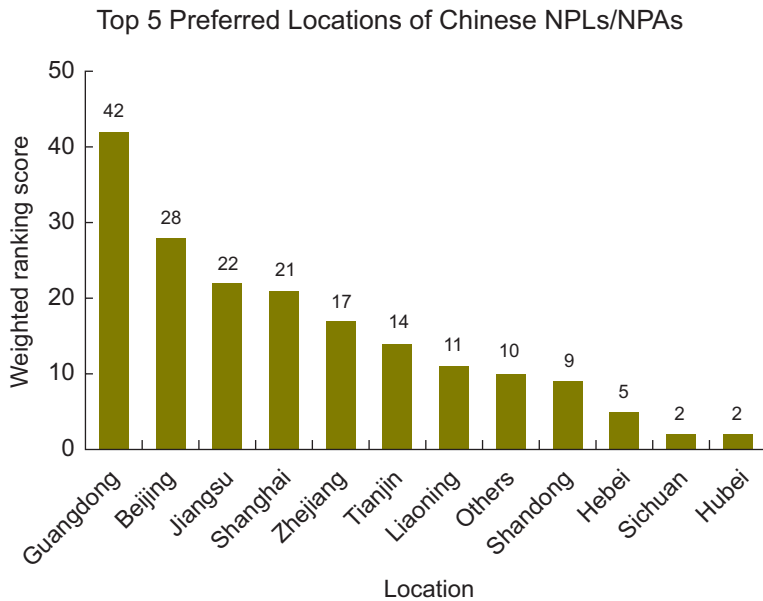
6.3.3 How many investments of the above-indicated size is your organisation prepared to make annually in China for the next 1-2 years?

No. of investments of indicated size prepared to make annually in China for the next 1-2 years



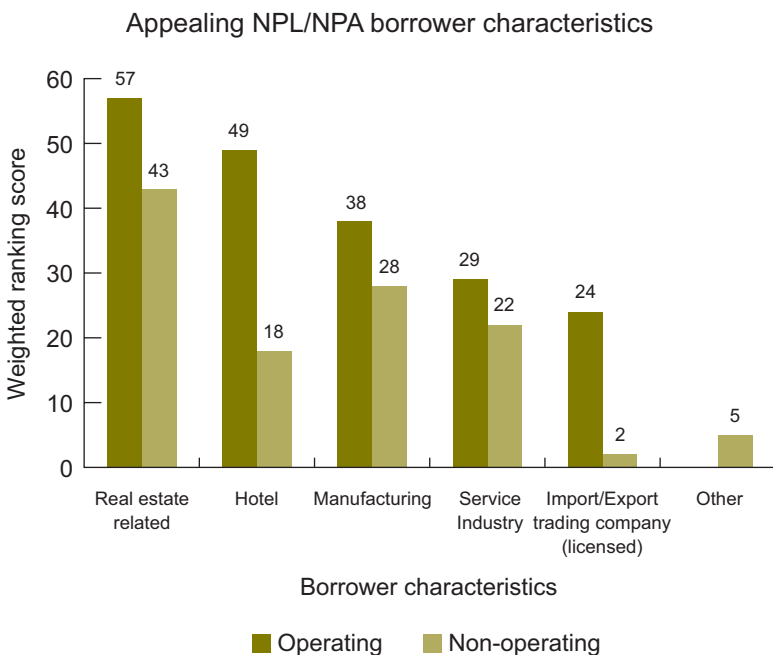
- 23% of our survey respondents are willing to make greater than 4 investments of US\$6-20 million each per year over the next 1-2 years while another 23% are willing to make 3-4 investments each of US\$4-50 million.
- 14% of our survey respondents are willing to make 3-4 investments each of greater than US\$50 million each in the next 1-2 years.
- Clearly, there is significant demand for sizable China NPL transactions.

6.3.4 What are your organisation's top 5 preferred locations of Chinese NPLs/ NPAs?



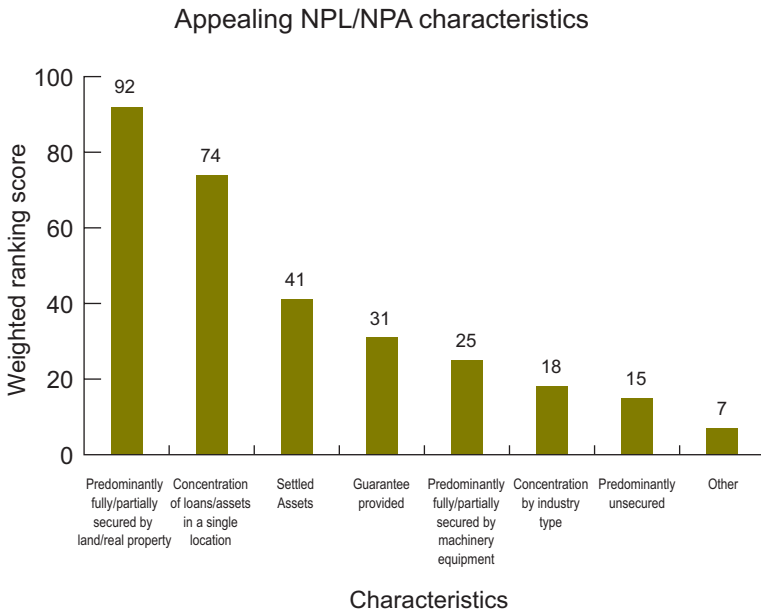
- The five most popular locations for Chinese NPL investment, are:
 - Guangdong
 - Beijing
 - Jiangsu
 - Shanghai
 - Zhejiang
- The result reveals a preference for coastal and more developed locations. As expected, Guangdong province is our survey respondent's most desired location for NPL investment. We believe this is due to a number of factors including the province's close proximity to Hong Kong and its more developed economy.
- Beijing and Shanghai, as the political and business hubs of China, are also desirable locations. The high ranking of Zhejiang and Jiangsu, both of which are not traditional "hot" NPL markets, is not nevertheless surprising as their relatively sophisticated commercial and trading cultures may be their key advantages.

6.3.5 What NPL/ NPA borrower characteristics appeal to your organisation?



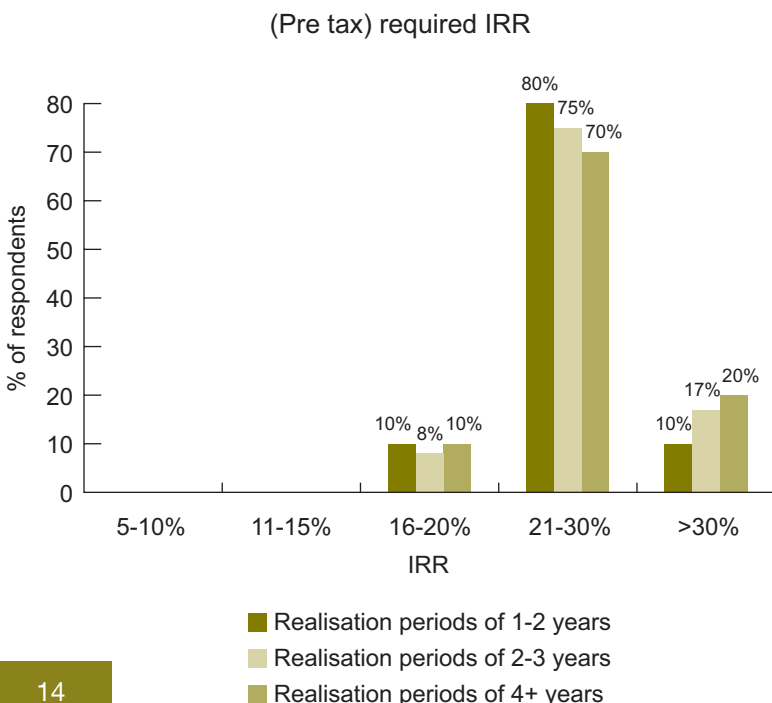
- Most of the survey respondents prefer real estate-related NPLs regardless of their operational status. This may be a reflection of more straight forward pricing of such loans/assets and a perception that these loans/assets are easier to recover.
- Hotels and operating manufacturing companies are also favoured because even if the underlying company becomes dormant, NPLs/NPAs backed by tangible assets are more likely to be realised at a higher values. Access to technologies and industry expertise also makes the manufacturing industry more appealing to NPL investors than the service industry.
- Service companies and import/export trading companies are given lower preference by our survey respondents. This may be due, in part, to the belief that most such companies have fewer underlying tangible assets than manufacturing companies which may undermine the opportunity for investors to achieve optimised returns.

6.3.6 What NPL/ NPA characteristics appeal to your organisation?



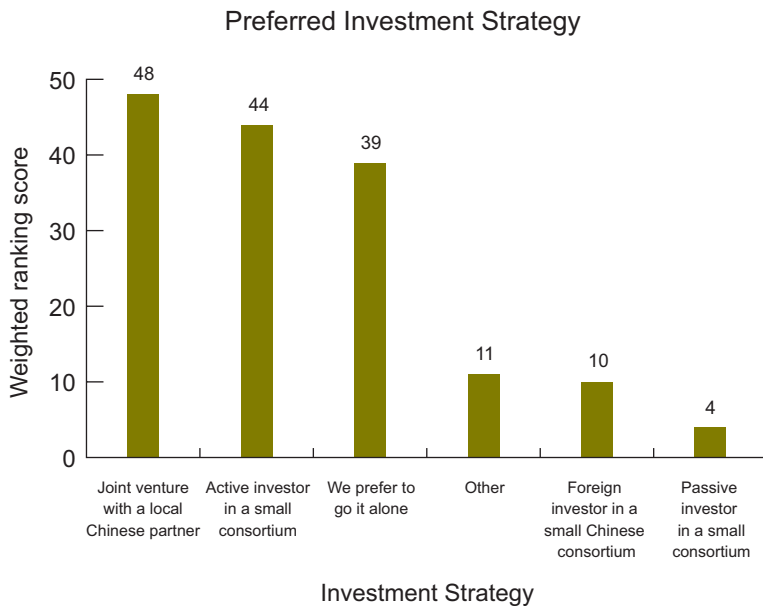
- Our survey respondents’ four most preferred characteristics in an NPL/NPA portfolio, in descending order, are:
 - Predominantly fully/partially secured by land/real property.** While the reason for this may seem obvious—security can be valued and sold—in our experience servicing NPLs in China we rarely see security actually foreclosed upon. Rather, security is used as leverage in settlement negotiations. This pattern is not because foreclosure laws in China are inadequate—they are actually quite clear. It has more to do with finding suitable buyers for the assets subject to security.
 - Concentration of loans/ assets in a single location.** Concentration in one location not only facilitates monitoring and control, but also makes realisation easier and more cost effective for the loan servicer.
 - Settled assets.** Some investors seem to prefer Settled Assets (assets, usually real property, taken by banks in lieu of payment) to NPLs. This may be due to the relatively clear path to realisation—selling the asset. However, many investors are wary of such assets as their title is often unclear and they may have hidden liabilities attached to them, making sales more difficult.
 - Guarantee provided.** Lack of knowledge and information about the underlying guarantor and difficulties in enforcing and securing guarantor assets underscore its relatively lower ranking.

6.3.7 What is your (pre tax) required internal rate of return (“IRR”) for China NPL/NPA investments?



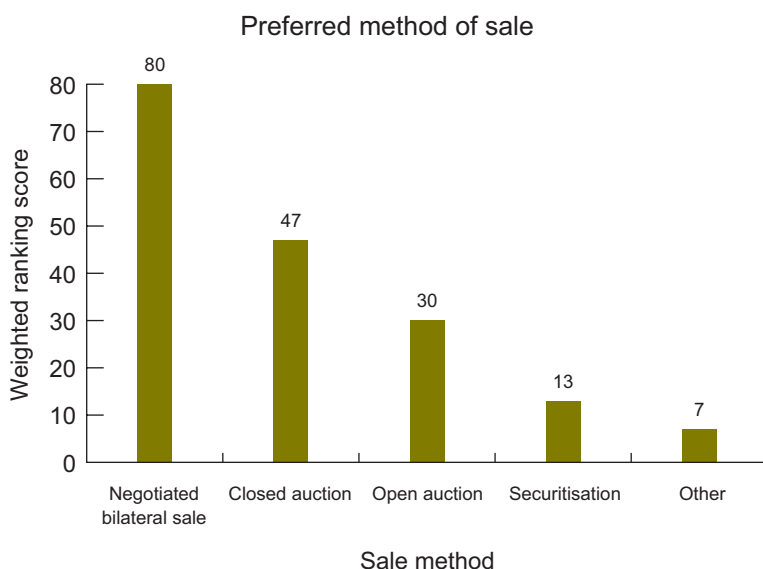
- It is clear that most investors expect an IRR in the 21-30% range, regardless of the realisation period. While IRRs in this range have reportedly been obtained for NPL/NPA investments in other jurisdictions, we suspect it is somewhat higher than what China’s NPL sellers expect and is probably the leading reason behind the prevailing price expectation gap between the parties.

6.3.8 What is your organisation's preferred investment strategy?



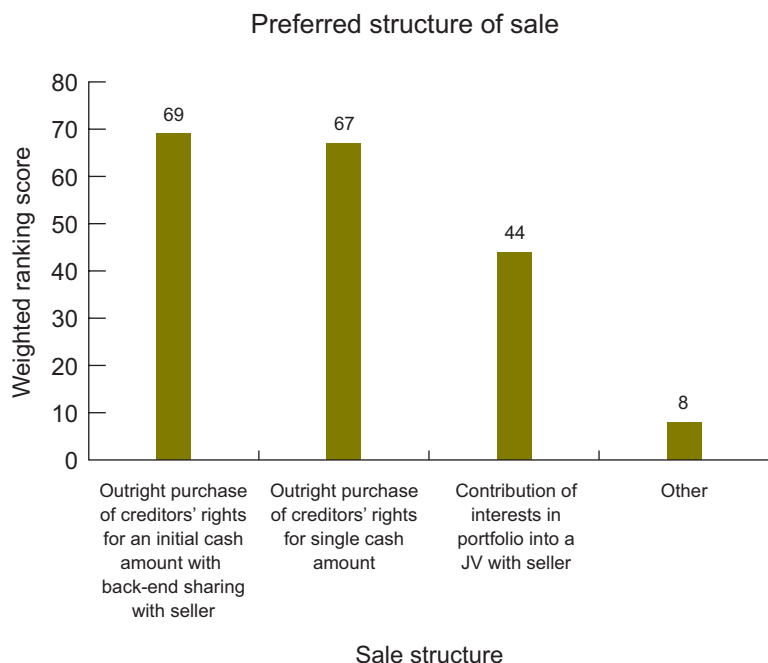
- The most preferred forms of investment in China include: i) joint venture with a local Chinese partner; ii) active investor in a small consortium; and iii) go it alone.
- We are not surprised that our survey respondents prefer to team-up with joint venture partners for their China NPL investments. Many foreign investors have recognized the importance of local expertise in establishing networks and relationships and in dealing with government authorities (especially when seeking approvals), other creditors and labour. In addition, joint venturing can also enable foreign players to gain access to the local market more quickly and cost effectively than going in solo. We have found that joint venturing can also sometimes be a condition of the deal.
- But joint venturing is not without its problems. Structuring is difficult and can require special approvals. Monitoring the joint venture partner remains a thorny issue, particularly when they are responsible for loan servicing.
- In our experience being an active investor in a small consortium is more favored by new market entrants. This approach enables the partners to share risks, capital and knowledge.
- Investors that prefer to go it alone are generally experienced and have their own servicing platforms. Absolute control and discretion in decision-making are the key advantages, and while investors take all the risks, they retain all the rewards.

6.3.9 What is your organization's preferred method for NPL sales?



- Investors' preference for privately negotiated sales is as expected. Such sales allow for more flexibility between the parties and may often (perhaps counter-intuitively) yield the highest price as the investor will consider paying a higher price to the seller if they believe there is a good likelihood the deal will close.
- NPL investors as a rule do not prefer auctions. This is because they require considerable time, effort and cost, and their chances of becoming the winning bidder are reduced due to competition from other bidders.
- That our survey respondents do not prefer securitisations is not unexpected as the fixed returns from securitisations are not likely going to meet their IRR requirements.

6.3.10 What is your organisation's preferred structure for NPL sales?

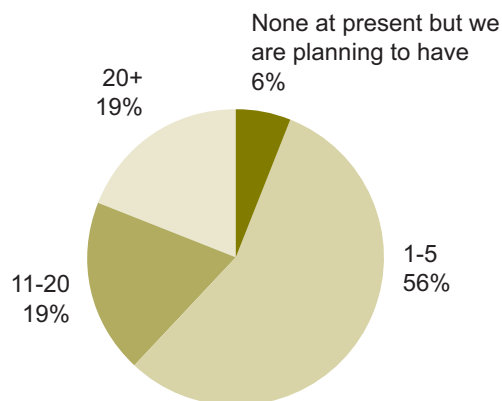


- While our survey respondents' top individual choice for preferred structure for NPL sales was "Outright Purchase with Cash", "Outright Purchase with Back-end Sharing" achieved the highest score (69) under our weighted ranking scoring system. The "Outright Purchase with Cash" approach is usually desired by large investors who can afford to, and do not mind, making a single cash payment in exchange for absolute control and taking all upside. These investors are likely to have built up a local servicing platform and are able to service loans by themselves or with local partners.
- Through back-end sharing, the seller is able to protect itself against charges it is selling at undervalue as it will be able to share in the investor's profits after certain benchmarks are met.
- Our survey respondents find a sale structure involving a contribution of interests in a portfolio into a JV with the seller (the "Huarong I" structure) somewhat less preferable. This could be due to several factors including the lengthy approval process required. However, this structure is not without its benefits. As demonstrated in Huarong I, it allows for ambiguity in relation to selling price/recovery for the seller which may actually increase the transaction's approval prospects.

6.4 Analysis of resource investment

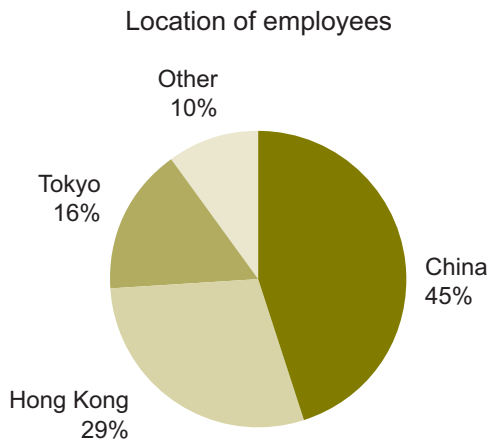
6.4.1 How many employees does your organisation have dedicated or partially dedicated to the China NPL market?

No. of employees dedicated to the China NPL market



- 56% of our survey respondents have between 1-5 employees dedicated to the China NPL market, with 38% having between 11-20+.
- Clearly, a number of entities have invested considerably in an infrastructure for NPL investment. The question is how long can these entities maintain this infrastructure given the dearth of transactions.
- We note at least one well-known NPL investor has withdrawn from the China NPL market, sighting the lack of viable opportunities.

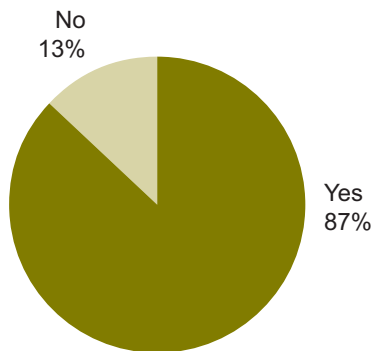
6.4.2 Where are these employees primarily located or where do you plan to locate them?



- A significant portion (45%) of our survey respondents' employees dedicated to the China NPL market are located in China with 29% being located in Hong Kong.
- We suspect our survey respondents that are still basing their China NPL market employees in Tokyo are waiting for the China NPL market to heat up before physically moving them to Hong Kong or China.

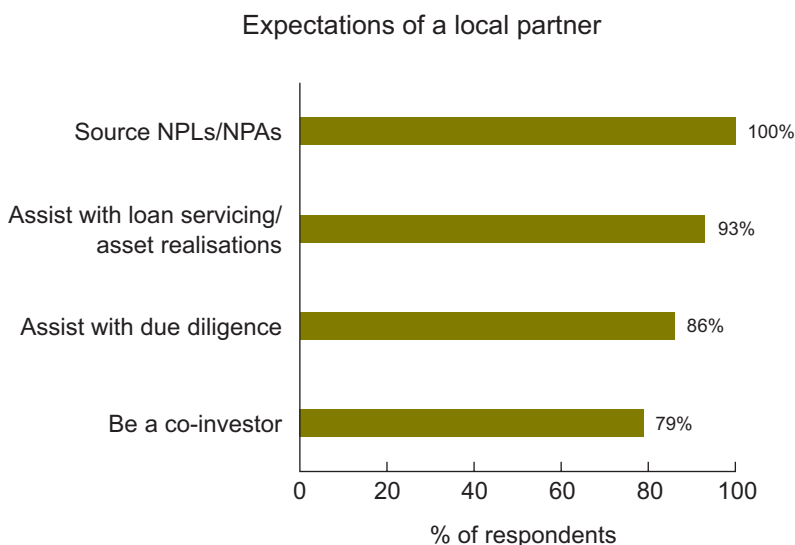
6.4.3 Does your organisation currently have or intend to have a Chinese local partner to assist in NPL/NPA acquisitions?

Currently have or intend to have a Chinese local partner to assist in PNL/NPA acquisitions



- 87% of the survey respondents currently have or intend to have a Chinese local partner to assist in NPL/ NPA acquisitions, manifesting their awareness of the imperative of local knowledge and relationships.

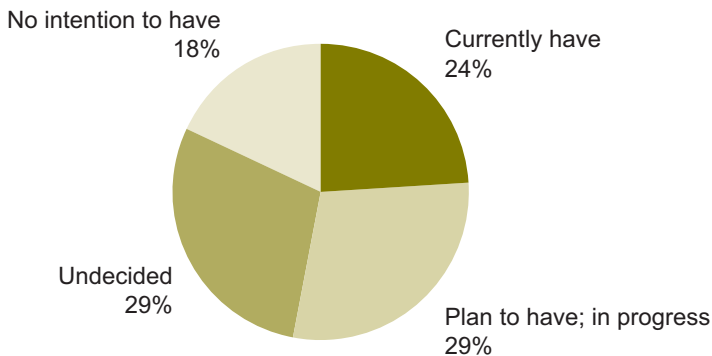
6.4.4 If yes, do you expect your local partner will:



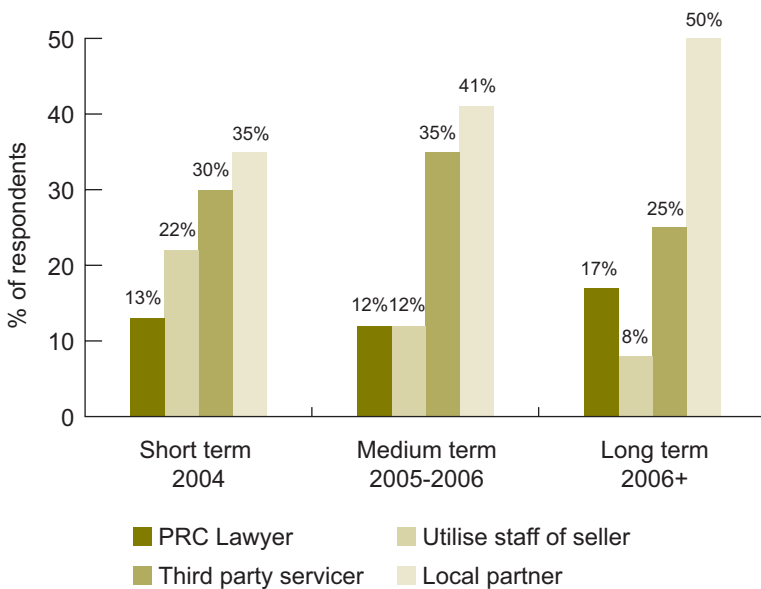
- Based on our survey results, foreign investors are looking for local partners to provide assistance with sourcing deals, servicing and due diligence.
 1. All of our survey respondents expect their local partners to assist with NPL portfolio sourcing. Often the local partner will have contacts/relationships that will facilitate NPL portfolio identification.
 2. Nearly all (93%) of our survey respondents expect loan servicing assistance from their local partner. Again, it is thought that their local connections will enhance the collection process.
 3. 86% of our survey respondents desire their joint venture partners to assist with loan due diligence. Conventional wisdom is that such partners will have "hidden" knowledge about the loans/assets in question which will enable the foreign investor to obtain a clearer view of the loan's/asset's recovery prospects.

6.4.5 Does your organisation currently have or plan to have a servicing platform in China? If not, how does it plan to service/realise investments?

Currently have or plan to have a servicing platform in China

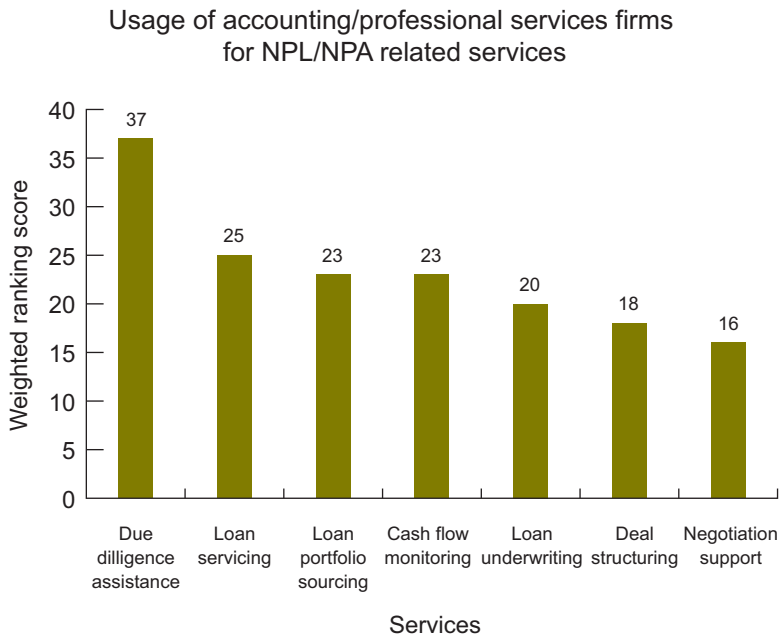


Plans to service/realise investments



- Only 24% of the survey respondents currently have their own servicing teams on the ground in China.
- Nearly 50% of the survey respondents indicated that they have yet to decide on or have no plans for setting up a servicing platform.
- In our experience investors without their own servicing platform prefer to pair up with local partners to realise investments as such partners are thought to have “local” or “inside” knowledge of specific loans/assets.
- In the short to medium-term, our survey respondents are more inclined to look to third parties to assist with loan servicing. These parties could be professional accounting firms or local partners.
- In the shorter term, utilising a self-owned platform is clearly the most convenient approach. However, the cost of keeping staff remains a major issue, in particular under the current sluggish deal environment.
- Reliance on lawyers highlights the unique characteristics of the China NPL market, where lawyers play a key part in loan servicing. It is, therefore, unlikely to find lawyers’ roles being replaced, even in the longer term.
- Utilising staff of the seller is obviously another immediate remedy for inexperienced players lacking knowledge of the legal environment and underlying borrower. This reliance reduces over time as investors gradually accumulate experience and expertise. Based on our discussions with investors, monitoring of the seller’s staff is an issue, and this is often mitigated by utilising a professional accounting firm to provide oversight and project management.

6.4.6 Generally, does your organisation use accounting/ professional services firms for the following NPL/ NPA related services.



- The top 4 most frequently used services rendered from an accounting/ professional services firm are:
 1. Due diligence;
 2. Loan servicing;
 3. Loan portfolio sourcing; and
 4. Cash flow monitoring services
- This reflects foreign investors' acknowledgement of the importance of utilising the expertise and resources of professional accounting firms in the NPL acquisition and resolution process.
- It is interesting to note that loan portfolio sourcing and cash flow monitoring are rated equally important by foreign investors. As forerunners in the China NPL market, some of the large reputable professional accounting firms have built up extensive local networks which will greatly assist them in portfolio sourcing.
- Cash flow monitoring of loan servicers, particularly joint venture partners, remains a popular request, as such monitoring often will be required to obtain investment approvals.

7. Our NPL Related Services

Throughout China, PwC has partners and staff experienced in delivering a complete range of NPL related services, including:

Sell-side services

We act as the lead financial adviser in relation to all facets of NPL sales including complete management of the disposal process:

- **Preparation for sale:** Portfolio review, classification and stratification; Pooling and packaging sub-portfolios to maximise their potential value; Advising on appropriate form of investor review files; Advising on appropriate marketing and disposal strategies; Preparation of confidential information memoranda; Co-ordination and management of third party service providers such as lawyers and Asset Appraisers.
- **Investor sourcing:** Identifying potential investors for bilateral deals or public tenders; Targeting specialist investors for specific sub-portfolios/tranches.
- **Execution/completion of sale:** Management of the entire portfolio sales process; Transaction structuring; Designing appropriate bidding/sales procedures; Overseeing investor contact, including investor invitation and investor qualification; Evaluation of investment proposals; Negotiating detailed terms; Co-ordinating the involvement of legal and other advisers.

Buy-side services

We offer complete advisory services tailored to meet investor requirements:

- Due diligence and negotiation support: portfolio review and valuation.
- Advising on appropriate deal structures for proposed negotiated transactions;
- Advising on accounting/tax implications of proposed structures;
- Advising on the nuances of the Government approval process (if applicable);
- Assisting in the deal completion process, including assistance in securing requisite government approvals;
- Identifying potential portfolio investment opportunities;

Post-deal services

- **Portfolio Management:** Portfolio strategy advice and implementation; Managing the loan collection process; Advising on loan servicing set-up issues; Advising on issues that impact the collection process.

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