The Great Chinese Bank Sale

by Jonathan Anderson

THE HEDGE-FUND MANAGER sitting across the table shuts his eyes in frustration and slaps his palm to his forehead. "What on earth are they thinking? This is Latin America all over again. Everybody jumps in on a whim, and then they spend a decade digging themselves out. Plus they lose a truckload of our money in the process. This time is no different."

The place is New York, in one of the countless hedge-fund offices populating east midtown. The time is mid-June 2005, and the reference is to Bank of America's announcement that it would purchase a 9% stake in the P.R.C.'s China Construction Bank for the princely sum of $3 billion—making it the most expensive banking acquisition (or, for that matter, any acquisition) in China's history.

To see what the fuss is about, remember that for most of China's postwar history it had pointedly ignored foreign banks; and for their part, foreign banks paid precious little attention to China. Of course, global financial institutions and banks were nominally invited to the "China party," but they weren't even seated in the same room as the main participants. Their foreign branches were limited to one or two per bank, and then only for foreign-currency business; as a result, even after 20 years of greenfield development, the 200-odd foreign commercial banks active in the mainland still accounted for a paltry 1% of total loans and deposits, and a total capital commitment of no more than a few billion dollars.

The same applied for acquisitions of existing institutions. The government began cautiously allowing foreigners to buy minority shares in domestic commercial banks in the late 1990s—but only for isolated transactions in smaller niche players such as Shanghai Pudong Development

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Bank, Xi'an City Commercial Bank or Minsheng Bank. As late as the end of 2003, accumulated foreign equity stakes in Chinese banking institutions barely exceeded $500 million, or 0.3% of the estimated total value of mainland bank capital.

This strategy made a lot of sense for China. The government's main priority was to protect the stability of big state-owned commercial banks, of which the five largest—the Industrial and Commercial Bank of China, the Agricultural Bank of China, the China Construction Bank, the Bank of China and the Bank of Communications (BOCOM)—control more than 60% of the country's loans and deposits. For the most part, these banks were technically insolvent, with a crushing burden of bad loans reflecting decades of lending to poorly run state-owned enterprises and ill-advised projects, and simply could not withstand the shock of being forced to compete on an equal basis with experienced foreign institutions.

Strange as it sounds, this strategy actually made a lot of sense for foreign banks as well. As much as overseas players grumbled about their lack of access, it was hard to imagine any serious institution actually putting down money to buy shares in one of China's bankrupt state-owned behemoths if offered the chance. And, although most banks would have been happy to enter the mainland market under their own flag, government restrictions in fact saved them from getting caught up in the disastrous bubble (and ensuing bust) that overwhelmed the mainland banking system in the 1990s.

All that changed radically beginning in 2003. In March of that year, Premier Zhu Rongji—who almost single-handedly managed macroeconomic affairs for more than half a decade—formally stepped down from his position as head of China's civil government, turning over the reins to incoming Premier Wen Jiabao and a new team of senior ministers. During the Zhu administration, official policy toward large state commercial banks was simple: no free lunch, and no privatization. The government performed an initial cleanup in 1998-99, removing more than 12% of outstanding loans from state banks' books, but from then on banks would have to learn to be better lenders, grow their own way out of their problems, and maybe then China could open its market to foreign investment and competition.

A Different Tack

BY THE TIME the Wen government was coming to power, however, two points had become clear. First, better accounting practices showed that the size of the problem was much bigger than previously imagined, with many independent estimates pointing to a remaining nonperforming loans ratio of 40% or more. And second, efforts to encourage state banks to "grow their way out of the problem" were leading to another bubble. By the end of 2002, banks were caught up in a wave of speculative lending to property developers as well as redundant industrial and infrastructure projects, and the authorities were increasingly worried about macroeconomic stability.

This situation called for a radically dif-

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ferent tack—and sure enough, by the end of 2003, the government had effectively made a full 180-degree turnaround on banking policy. The first element of the new strategy was a massive injection of state funds to clean up banks' balance sheets; the People's Bank of China alone has already spent over $100 billion on recapitalization and bad loan write-downs over the past 18 months, with more still coming from banks' own profits and government tax breaks. Official NPL ratios have dropped precipitously as banks have literally written off everything they can find.

And then came the sell-off. During the course of 2003, the authorities made it clear to state commercial banks that instead of being coddled at home, they were going to be pushed out the door. Suddenly large banks found themselves incorporating, with a newly minted board of directors and supervisors. Suddenly every bank had a preparatory listing committee. And suddenly the government was advertising high and low for foreign "strategic investors" to come in and take a sizeable stake, prior to the banks going public.

That was all foreign institutions needed to hear—and indeed, the response has been truly staggering. From that paltry half-billion dollar cumulative outlay going into 2004, overseas investors committed an additional $18 billion to the Chinese banking system in the past 12 months alone.

The ball got rolling in late 2004, when HSBC bought a 19.9% stake in BOCOM for a total cost of $2.25 billion. This year, the megatransactions have come rolling in like an avalanche: Bank of America announced its $3 billion investment in CCB in June; one month later, a consortium led by the Royal Bank of Scotland agreed to take a 10% share in BOC for $3.1 billion; not to be outdone, Singapore's Temasek took a similar stake for the same price (UBS is also reported to be buying a smaller share for $500 million); Temasek also committed $2.5 billion to invest in CCB; and last month, a Goldman Sachs-led group signed an agreement to lay down $3 billion for a 10% share of ICBC.

This is by no means the end of the story, as the market is still rife with reports of new transactions. And the above figures don't even include the bulk of the proceeds from overseas equity listings. BOCOM already issued $1.9 billion worth of shares on the Hong Kong stock exchange last month, and over the next year we expect another $20 billion in initial public offerings for CCB, BOC and ICBC.

At this pace, by the close of 2007 foreign banks and other foreign investors could conceivably control more than one-sixth of the entire Chinese banking system. It seems the only brake on the process is the 25% ceiling on cumulative foreign ownership of individual banks—a restriction likely to be eased in the near future.

Disaster…or Euphoria?

NEEDLESS TO SAY, this sudden turnaround has inspired radically different interpretations. According to the press announcements of the overseas banks themselves, this is one of the greatest investment opportunities of the new century: a chance to enter a financial market with $4 trillion in assets, and what's more, a market that is growing at double-digit rates with no slowdown in sight. Chinese per-capita income is only $1,500, and consumers are just beginning their love affair with mortgage and credit card debt; imagine what riches lie ahead over the next decades as incomes double and double again.

For more cynical observers, of course, this is just the latest in a long string of disastrous banking follies. Perhaps the most engaging read of the past year was Tim Clissold's *Mr. China*, a story of two private equity entrepreneurs who collected hundreds of millions of dollars from global investors in order to buy into the "greatest growth story of the century" and transform the Chinese corporate landscape in the process, but ended up pissing away most of the funds down the black hole of mainland economic reality.

So it will be with the banks. According to detractors, Chinese banking problems have simply been glossed over through state bailouts and creative accounting. Nothing has changed in the economy, as civil servants still dutifully shovel money into moribund state enterprises with no regard for repayment prospects. Once the next downturn hits, banks will face a tidal wave of new bad loans, and the foreign giants will be forced to write down tens of billions of dollars in worthless investments in the process.

Not a Great Growth Story

SO WHICH IS IT? A once-in-a-lifetime opportunity, or a pending disaster? In fact, neither. The truth of the matter is that China's financial system is neither an explosive minefield nor a beckoning gold mine, but rather a profoundly middle-of-the-road investment option.

On the one hand, the banking system is clearly not going to collapse—not now, and not in the foreseeable future. Large state banks may have been insolvent, but they have always been very liquid, propped up by China's enormous national savings rate as well as the lack of alternative financial assets. And with the government now busy vacuuming up nonperforming assets and throwing in new capital, insolvency is no longer even an issue; with the exception of ABC, the state banks are solidly back in black (and we should soon see a bailout and restructuring program for ABC as well).

But won't banks get right back into trouble in the coming years, with a flood of new NPLs overwhelming the system? The short answer is no, and the common view that banks are unreconstructed dinosaurs turns out to be a myth. In a recent detailed study of the banking system, UBS found that the banking environment has changed radically over the past 10 years, with better regulation and supervision, better macroeconomic policy making, better internal controls and better borrowers. This does not mean that Chinese banks are now making fully sound lending decisions. Indeed, the one area where large banks have not changed over the past decade is their 100% state ownership, and this is the

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root of many continued problems. However, it does guarantee that the magnitude of new NPL flows will be much more manageable than in the past.

On the other hand, Chinese banks are hardly the greatest growth story of the 21st century. The plain truth is that—glaringly alone among poor developing countries—China is already significantly overbanked. Just look at the numbers: Commercial bank deposits account for nearly 200% of GDP, and loans in the banking system currently stand at 130% of GDP. This makes China a near world-record holder; of all major economies across the globe, only Taiwan and Hong Kong have higher banking ratios, and the average for the developed world is much, much lower.

What accounts for these huge numbers? It's really very simple. For two decades mainland firms have had no other source of outside financing, and mainland households have had no place else to put their savings. But this could change quickly. As China's nascent equity, bond and property markets mature, we expect a steady deleveraging on the part of companies, and a steady diversification on the part of Chinese savers. So while consumer banking is a promising development area, corporate lending isn't. We're not saying that the banking system can't grow at all—but at some point, it will begin to grow much slower than GDP.

Moreover, the profits earned by Chinese banks on that growth are far from impressive. Last year, global banking institutions recorded a 1.2% overall return on assets, while the figure for Chinese banks was 0.4%. The rate of return on equity was closer (11% compared to 16%, respectively), but only because mainland institutions have lower capital adequacy. Of course, Chinese banks will gradually learn to generate more fee-based income, but keep in mind that margins on regular lending operations are currently propped up at artificially high levels because of state-controlled deposit rates. Once these are decontrolled (which should happen fairly soon), deposit rates will rise, putting further pressure on profitability. The only way for China's large banks to show high rates of earnings growth will be to cut costs aggressively, a fairly unlikely outcome for the foreseeable future.

Still "Win-Win"

SO WHERE DO we end up? Even after bringing euphoric expectations back down to reality, the bottom line is that buying into the Chinese banking system is still a "win-win" proposition. China does benefit from having foreign investors buy in, and foreign investors benefit from being there.

The gains for China are easy to see. The government has done everything it can for banks—except to privatize them. And as long as senior management is made up of civil servants with a mandate to support official policy, banks will never be fully market-oriented institutions. What China needs to make financial-system reform and restructuring "stick" is to get the state out of the business of running banks.

The key question is where to find new owners. The authorities could easily list state banks on the domestic Shanghai and Shenzhen equity markets, but China's short-term retail investors have done a notoriously poor job of providing outside governance to date. Simply handing banks over, Russian-style, to the current management presents similar problems (not to mention the risk of escalating social tensions).

The answer is to turn to foreign investors, just as China has done consistently over the past five years when deciding how to reform large state enterprises in other sectors. In this sense, the Chinese authorities are now following what we might call the "PetroChina model," named after one of the first large mainland SOEs to be listed abroad. In this model, the purpose of selling to foreigners is never to get money; indeed, most large state firms were already awash with cash when they went to the market, just as the large state banks are awash with recapitalization funds today.

Instead, the government found that overseas investors provided a "one-stop shop" for enterprise reforms. Global management consultants, human resources and investment banking firms took the reins of the restructuring process, identifying and stripping off unproductive assets, clarifying pension liabilities, carrying out audits, and redefining governance responsibilities. Once the listings were complete, state firms also inherited a professional investor base intent on scrutinizing accounts and management decisions. In most cases, the result has been better-managed, more profitable and transparent companies, and this is exactly what China is now hoping to achieve by selling off stakes in the large banks.

What do foreign investors get? We already showed that China's overbanked financial system is not the world-beating growth story it is often made out to be—but this is exactly why foreign banks are better off pursuing an acquisition and restructuring strategy than trying to do new greenfield investment. And, ironically, with their nationwide branch networks and consumer databases, the large state commercial banks are probably ideally placed to compete in banking segments that will provide growth opportunities going forward, such as mortgage and credit card lending.

So there are perfectly valid reasons for overseas banks to be investing in their Chinese counterparts, as long as they are not overpaying for the assets, which brings us to the final issue of price. Based on market information, the average price-to-book value ratio for the recent multibillion dollar BOC, CCB and ICBC transactions was a very moderate 1.2—well below the 1.9 ratio commanded by large global banks, not to mention ratios in excess of two for smaller, promising high-growth plays. In other words, foreign investors don't seem to be wearing rose-colored glasses; they paid pretty much what you would expect them to pay for a stable, low-growth, low-margin business. And when all is said and done, this gives confidence that the Chinese "gold rush" won't leave a deserted, desolate ghost town.