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China Baby-Formula Maker Buying Arsenic Debt Shows Trust Risks
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By Shai Oster

Oct. 7 (Bloomberg) -- A Chinese baby-formula maker selling imported Australian milk to safety-conscious parents invested in the risky debt of lead, arsenic and cadmium refiners, seeking higher returns for its cash.

The uncollateralized investment, sold by a middleman known as a trust, promises to pay Ausnutria Dairy Corp. about double China's benchmark savings rate. It's an example of how companies are undermining government efforts to cool lending that has led to soaring property prices and inflation of 6.2 percent, near a three-year high.

Chinese trusts, investment vehicles once championed by Deng Xiaoping, are part of a shadow-banking system that now accounts for about 50 percent of all loans in the country, according to Fitch Ratings Ltd. They gained prominence after the central bank increased the amount of deposits banks have to keep on hand, limiting what they can lend. Ausnutria is typical of businesses investing in trusts, which make loans at rates as high as 25 percent, spreading the risk of a potential credit crisis.

"When companies neglect their core business and start speculating in hot sectors they know nothing about, it's a sure sign the market is out of whack," said Patrick Chovanec, an associate professor at Tsinghua University's School of Economics and Management in Beijing who has advised private-equity funds.

Metals, Wine

More loosely regulated than banks because they don't hold deposits, trusts have attracted 3.7 trillion yuan ($582 billion) from investors with promises of high returns. At first, they bought debt from banks seeking to move it off balance sheet.
They now invest in everything from metals refining to real estate, even bottles of fine wine. They're also making loans, circumventing restrictions on lending between individuals and companies. Western banks including Edinburgh-based Royal Bank of Scotland Group Plc, London-based Barclays Plc and Morgan Stanley in New York, as well as large Chinese companies such as China National Petroleum Corp., have bought stakes in trusts.

Firms listed in Shanghai and Shenzhen have announced at least 100 trust loans this year through September totaling almost 23 billion yuan, according to Bloomberg calculations based on data supplied by Shanghai-based Wind Information Co.
The average interest rate was 12 percent.

Ausnutria, which expects a return of about 6 percent on its investment after fees and doesn't hold any collateral against a default, according to company filings, said in an e-mail that the deal is "in the interest of the company's shareholders."

'No Regulations'

Lending by non-bank institutions such as trusts, leasing companies and pawnshops, which accounted for 4 percent of loans in China in 2002, according to estimates by Barclays Plc, could rise to 55 percent of the total next year, Fitch estimated in a July report. The ratings firm said all lending in 2011 will increase to 18 trillion yuan from 16.5 trillion yuan in 2010.

"Trusts are facilitating the movements of assets off the balance sheets of banks -- there are no regulations on where it can go," said Charlene Chu, a Fitch analyst in Beijing who co- wrote the report. "When there aren't enough guidelines, who knows what's going into this stuff?"

The shadow-banking credit boom could lead to a new pile of bad debt. Almost half the money managed by trusts is invested in infrastructure and real estate projects, according to figures from the China Trustee Association, an industry group. Local governments had 10.7 trillion yuan in debt borrowed through financing vehicles at the end of last year, according to a June report by China's National Audit Office. Nearly a third of those entities are losing money, according to a study by Beijing-based analysts Zhang Xu at Guosen Securities Co. and Qiao Wei of China Asset Management Co.

'Domino Effect'

Regulators have tried to curb a real estate boom by raising down payments on home loans and limiting purchases of housing in some cities including Shanghai, where prices have almost quadrupled in the past decade. Trust loans to developers increased 150 percent to 605 billion yuan in June from 235 billion yuan in March 2010, after a clampdown on bank lending, according to a report by UBS AG.

The true figure is probably much higher, said Du Jinsong, a Credit Suisse Group AG analyst in Hong Kong, because trusts are bundling new real estate loans with other financing to get around orders from regulators. That leaves trusts vulnerable to defaults by developers under government pressure to ratchet down property prices, which could have a ripple effect on other parts of China's informal lending system.

"If trusts aren't going to be sustainable, they'll also stop lending to other industries," said Du. "It could be the beginning of a domino effect for the whole shadow-financing system in China."

Debt Ratio Rising

Lending is rising faster than China's economy is expanding. The proportion of China's total debt to gross domestic product, taking into account corporate, local government and household borrowing, increased to 188 percent in the first half of 2011 from 146 percent in 2008, according to analysts at Morgan Stanley. That's an indication borrowers aren't paying off loans as quickly as they're getting them.

"This points to a potentially significant rise in loan delinquencies," Chu wrote in the Fitch report.

The China Banking Regulatory Commission, which oversees trusts, has issued regulations to slow their growth, raising the capital they're required to keep on hand relative to assets under management. Last year trusts were told to report on risks in their 2011 financial statements. The CBRC didn't reply to phone calls or e-mails seeking comment.

Premier Wen Jiabao called for greater oversight of non-bank loans, including collateral and capital requirements, in order to prevent risks from spreading, the official Xinhua News Agency reported Oct. 5.

Ausnutria Deal

The structure of Ausnutria's deal is common to many trust arrangements. The company, based in the southern Chinese city of Changsha, is the country's 13th-biggest pediatric-formula retailer by market share, according to London-based researcher Euromonitor International. Founded in 2003, Ausnutria listed in Hong Kong six years later.

Sales of imported baby milk have climbed since 2008, after domestic formula tainted with the chemical melamine killed at least six children, and could reach 62 billion yuan by the end of this year, according to Euromonitor projections.

In April, Ausnutria invested 200 million yuan in Yunnan International Trust Co., according to regulatory filings. The trust, based in Kunming, the capital of Yunnan province, and one-quarter owned by the local government's finance department, used the money to buy four loans from China Merchants Bank Co., the country's sixth-largest lender by market value.

Two of the loans are to Hunan Nonferrous Metals Corp., a subsidiary of state-owned China Minmetals Corp. that refines lead, cadmium and arsenic. The other loans are to Chenzhou Diamond Tungsten Products Co. and Hunan Bismuth Industry Co.

No Collateral

After paying 1.5 million yuan in fees to Yunnan International, Ausnutria expects to earn at least 11 million yuan, the company said in filings. In March, Ausnutria netted 10 million yuan after buying loans of Hunan Provincial Expressway Construction and Development Co. in a similar deal with Hunan Trust and Investment Co., the company said.

The returns aren't guaranteed, and Ausnutria doesn't hold any collateral, according to filings. That raises the question of who's liable if a borrower defaults and the trust can't deliver returns to clients. Hunan Nonferrous borrowed money from China Merchants and has no financing arrangements with trusts or Ausnutria, Janice Liu, a spokeswoman for the metals company, said in an e-mail.

Parallels to 1907

Ausnutria conducted "a thorough study on the terms of the agreement and assessed the benefits and risks arising from the transaction prior to the investment," Karl Cheung, a spokesman for the company, wrote in an e-mail to Bloomberg. He said the deal "is in the interest of the company's shareholders." He declined further comment.

Executives at China Merchants didn't respond to phone calls, and no one answered the phones at Yunnan International.

The rise of trusts in China has parallels to the role they played in the U.S. bank panic of 1907, said Ellis Tallman, an economics professor at Oberlin College in Ohio and a former Federal Reserve Bank of Atlanta vice president.

"Historically, there is always a tendency for innovation around financial regulations to get financing to rapidly appreciating assets," Tallman said.

Second Life

This is a second life for trusts in China, which trace their origins to 1979, when the government, led at the time by Deng, founded China International Trust and Investment Corp. to attract foreign investment. By the 1990s, there were about 1,000 trusts owned by local governments that speculated in real estate using foreign money.

After Guangdong International Trust & Investment Corp. defaulted on a $200 million bond in 1999 -- the first Chinese company to do so since the Communist revolution of 1949 -- Beijing unwound the businesses, and they mostly lay dormant until reforms in 2007. About 60 have been relicensed.

One of the reconstituted trusts, Suzhou Trust Co., was built on the rubble of an investment company owned by the government of Suzhou, an eastern Chinese city. In 2008, Lenovo Group Ltd., maker of ThinkPad laptops, and RBS, Europe's seventh-largest bank by market value, bought a 30 percent stake in the restructured trust from the city.

"The investment in Suzhou Trust allows RBS to expand into China's non-banking financial-services sector and broadened our presence in the world's fastest-growing economy," Sherry Liu, chairman and chief executive officer of RBS's China operations said in an e-mail.

Spokesmen for Barclays and Morgan Stanley declined to comment on their trust investments.

Swelling Deposits

In their revived form, trusts can't take deposits or invest their own money. Instead, they're supposed to act like asset managers for companies and affluent individuals.

The trusts are tapping companies flush with cash following the government's stimulus lending program, which helped the economy expand 25 percent over two years beginning in 2008. Bank deposits swelled more than twice as fast during the same period, by 53 percent, according to the International Monetary Fund.

After China's regulator imposed lending quotas in 2010, banks started pitching private wealth-management products such the ones being offered by trusts to investors, offering better returns than the government's 3.5 percent benchmark deposit rate. In some cases, banks distributed loans repackaged by trusts directly to private-banking clients, promising rates of return of as much as 25 percent in text messages, according to trust executives.

More Millionaires

"Offers at 12 percent or 13 percent were common last year," said Winston Ni, an entrepreneur in Shanghai who bought a 3 million-yuan stake in a trust that promised a 9 percent yield backed by a mall in Tianjin, a city 70 miles (113 kilometers) southeast of Beijing.

The number of Chinese having more than 10 million yuan in investible assets will reach 585,000 this year, almost twice as many as in 2008 when the stimulus started, according to a study by consulting firm Bain & Co.

"If you limit what banks can do, there's still demand for loans," said Zhang Liwen, president of Suzhou Trust, sitting in an office on the second floor of a cement-and-glass building on a leafy street in Suzhou, 50 miles west of Shanghai. “The market still needs capital.”

Zhang presides over an empire that grew to 15.7 billion yuan in assets under management in 2010 from 11 billion yuan in 2009. By mid-2011, the fund added another 7.5 billion yuan, as affluent Chinese and other institutions invested in his products, including loans to businesses.

Liquidity Worries

Last year, Zhang invested 48.9 percent of Suzhou Trust’s funds in infrastructure, mostly bonds issued by financing vehicles set up by local governments that pay between 7 percent and 10 percent. The trust has since reduced its infrastructure investments and raised its holdings of real estate debt to one- third of the total, Zhang said.

Government restrictions make him worry about liquidity, he said. His firm has run stress tests looking at the impact of a 50 percent drop in the value of its real estate holdings.

There are signs the real estate market is already cooling. While new-home prices rose in August in all 70 cities monitored by the government, sales volume is falling in Beijing and Shanghai, according to SouFun Holdings Ltd., China’s biggest real estate website, which tracks 20 cities.

Hungry for cash, some developers are borrowing at 12 percent to 25 percent, higher than the benchmark lending rate of 6.56 percent, according to regulatory filings. Trusts thrive because the government’s low interest rates discourage banks from lending to the private sector, Tsinghua’s Chovanec said.

Wuhan Towers

Founder BEA Trust Co., a trust set up by Hong Kong-based Bank of East Asia Ltd. and Founder Group, owner of one of China’s largest computer makers, has raised 40 billion yuan and is lending to real estate developer Wuhan Central Business District City Construction Development Co. at 12 percent. The company is building luxury apartment towers in Wuhan, the capital of Hubei province. The units, fitted with Siemens appliances and Kohler bathroom fixtures, went on sale in August.

“Medium-sized property developers appear to have borrowed heavily for short-term and bridge loans,” said Il Houng Lee, the IMF’s senior representative in China. “Property developers’ strains could hit trusts.”

Chilling Effect

Shares in Chinese developers plunged in Hong Kong trading for two days last month on concern that tightened access to loans will force them to cut prices. Greentown China Holdings Ltd., a builder in the eastern province of Zhejiang, has fallen 37 percent since Sept. 21 amid reports by Credit Suisse analysts that the banking regulator was looking into trusts that had loaned the developer 5 billion yuan.

Greentown, based in Hangzhou, said it has no trouble financing its loans and that the company hasn’t been questioned by the regulator.

“Our reliance on trust loans is not that heavy,” Simon Fung, chief financial officer, said in a phone interview.

Any sign of weakness in China’s real estate market could have a chilling effect on trusts and their investors, said Jason Bedford, a manager at KPMG LLP in Beijing.

“Imagine that you have a real estate product and suddenly the real estate markets start to plummet,” Bedford said. “What was a liquid product suddenly becomes very illiquid as investors pull out and can’t be replaced.”

Bank analysts, including Michael Werner at Sanford C. Bernstein & Co. in Hong Kong, are concerned that a mismatch between trust loans and investments could exacerbate damage if declines in real estate volumes spread. Loans are often for two years or more, while investments are usually for one year.

‘Wealth Destruction’

“It will cause a significant amount of wealth destruction,” Werner said. “The party goes on until someone turns on the lights and you can’t roll over these assets. There will be wealth destruction. The question is how much.”

There is no sense of panic at the headquarters of Noah Holdings Ltd. in the Pudong section of Shanghai, where customers sip coffee and browse glossy brochures while sitting on leather and chrome sofas.

The firm, listed on the New York Stock Exchange, was founded in 2005 by two former private bankers at Xiangcai Securities, a brokerage in Changsha, where Ausnutria is also based. It offers wealth-management products including those issued by trusts to clients who the company says invested an average of $1.3 million last year. On Noah’s website is a quotation from Chairman and CEO Wang Jingbo: “The world revolves around money, and it makes its own rules.”

“Right now is a period of innovation,” Shang Yan Chuang, head of investor relations, said in an interview. “We’re looking for innovation with controlled risk.”

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