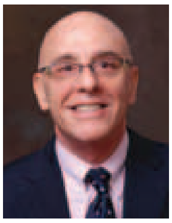
Rules is rules

And the first rule of holes is: stop digging!

by Jack Rodman

In 2011, Crosswater met with senior officials at the Bank of Spain and the newly-formed SAREB (Spain's version of a central bad bank for restructuring and distressed loan sales) to share "international best practices" on how best to "kick-start" the Spanish real estate market. We offered many internationally-proven practices gained from having worked the distressed markets for more than 25 years in the United States, Asia and Europe.

As the subtitle for this article states … the first rule of holes is to stop digging! Former US Resolution Trust Corp chairman William Seidman, who presided over the most successful government-led effort to "restore confidence" and start the US real estate market on the road to recovery following the devastating savings and loan crisis in the late 1980s (where 757 savings and loans were closed and taken over by the government), told sceptical banks and an even more sceptical US Congress that "your first loss is your best loss" and that there is no "recovery" without a resolution of the distressed asset overhang!



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While it took Spain two more years to figure this out and get started, today global distressed asset investors look at Spain and Ireland as "model" countries for having "kick-started" their economies by aggressively marketing their significant amount of nonperforming loans to foreign investors.

Spain's success in 2014 was so strong that many experienced international distressed investors migrated to Italy in hopes of early bargains there, as prices in Spain increased so rapidly that investors could not pay current market value and earn the "outsized" returns that they had promised investors in their funds.

Stress test outs the laggards

The European Central Bank's recently-completed asset quality review or stress test indicated that European banks still had a significant way to go to adequately provision for loan loss reserves for NPLs remaining on their books. The ECB's stress test included 130 participating banks and found that an additional €135.9 billion of performing loans needed to be reclassified as "nonperforming exposures", increasing bad loans from €743.1 billion to €879.1 billion as of the end of 2013. Of the €135.9 billion increase, approximately 40 percent were real estate–related loans. The single largest component was attributed to commercial real estate loans, followed by land and residential loans.

Current estimates for the amount of NPLs in European banks exceed $1 trillion (€870 billion) and local asset managers and investors estimate the real amount of distressed assets requiring resolution at closer to $2.5 trillion (€2.2 trillion). Regardless of the precise amount, it is clear that it is a very large problem and that banks are loathe to "set the plough low" in estimating the current FMV or transactional value of large NPL portfolios for fear of triggering secondary losses after years of heavy losses from consistent write-downs due to a flagging economy. In fact, the ECB study indicated that 25 of 130 banks had a capital shortfall resulting from the stress test.

Learning the lesson

The lesson that the Italians should learn is that Spain had to sell only a tiny fraction of the total estimated NPLs in Spain to see the market value for these assets increase two to three times within one to two years. The result was that, while the first few investors may have captured "low-hanging fruit" and made good purchases at fire sale prices, for the remaining assets on the bank books prices increased materially as a result of the successful initiative. As Seidman so aptly advised: "Your first loss is your best loss". Looking back, pretty much the same arguments can also be made for the UK and Irish markets.

However, having just returned from a series of meetings in Milan, the Italians seem to be affected by a contagious NPL disease (a common ailment) heard over and over as we moved to "kick-start" the real estate markets around the world. Italy is different!

It is amazing to us that, after conducting distressed asset sales around the world in countries whose loans are written in local languages (Japanese, Thai, Korean, Chinese, etc), Italy would think that its situation is somewhat "different" than everyone else who has experienced the same circumstances for pretty much the same reasons. Excess liquidity, an overheated real estate market, lax regulations, budget deficits and an almost universal view that real estate as an asset class can only go up in value!

What is not different in Italy is that the lagging economy has resulted in unemployment of 13.4 percent and youth unemployment of 43.9 percent. The government seems to be ineffective in writing a hard prescription for rehabilitation. Banks would prefer to "pretend and extend" rather than take a hard mark-to-market, delaying the inevitable losses in favour of "death by a thousand cuts" over time as assets continue to deteriorate in a stagnant economy.

Loan files in Italy are considered incomplete, lacking current information about the borrower and collateral, and the judicial system is deemed to be inefficient and favouring the debtor. So, what else is new?

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Many real estate assets and small businesses that are in default are owned by a few wealthy families in each region that are powerful and under no pressure to dispose of assets and prefer to fend off any efforts by banks to foreclose or settle assets at a loss. The central bank appears to be ineffective and slow to react, not accepting the seriousness and depth of the problem on economic growth.

In retrospect, there is nothing "different" from the Italian economy, banking system or judicial system that was not present in other foreign markets experiencing a financial crisis for the past two decades that cannot be overcome with a confident and strong leader.

From one opportunity to another

We would like to offer the following takeaways from our recent analysis of the European and Italian distressed debt markets:

1. Those who are thinking that the "trickle" of NPL transactions will turn into a tsunami will be greatly disappointed. Our experience is that the "trickle" might increase to a steady "stream" over time, but rarely becomes a tsunami overwhelming the distressed debt investment community.

2. One reason is that there are only a handful of highly experienced, well capitalised international investors working these markets (most notably Fortress, Apollo, Lone Star, Cerberus) who have established an early "beachhead" in these markets that give them a competitive advantage. Typically, large investment funds do not want to enter a market by purchasing less than $150 million to $200 million (investment value, €131 million to €174 million) of distressed loans, as economies of scale dictate that they need critical mass to justify establishing a presence and a servicing platform. Most large NPL portfolios are underwritten for three to five years (with two annual extensions), which requires that they continue to invest and feed the dragon.

3. At the onset of loan sales, investors are seeking a deep discount that will often cause the seller (bank or government-controlled asset management company, ie. SAREB) to incur secondary losses. Large sales trigger a re-capitalisation event by the banks that can go to the capital markets having begun the "recovery process", thus restoring shareholder and market confidence. Once additional investors smell blood in the market (a successful loan sale), it brings more "opportunistic" investors who are often willing to bid slightly higher prices to "win" a seat at the table. This process has repeated itself over and over from market to market.

4. As prices become too "frothy", as they have in Ireland and Spain, investors move on to new markets (Italy, Portugal, Greece, etc) where early sales at deep discounts are anticipated.

5. There is a "herd mentality" and estimates of the numbers of distressed asset investors increased last year from 30 to more than 200. A good rule is to be at the "head of the herd" or at the tail-end of the herd, in both cases to avoid getting trampled. Know your strengths and weaknesses, and position yourself accordingly. Patience, commitment and hard work will eventually pay off.

6. The beauty of this system is that over a relatively short time, as the early investors (so-called "wholesalers" or financial intermediaries) move on to more "opportunistic" markets, local demand picks up along with the economy, and we begin to see the economic recovery and "trickle-down effect" of getting these deteriorating assets back into the private sector at a price that contributes to economic recovery and sustained growth.

In conclusion, Europe will present attractive distressed asset opportunities for many years to come. We have witnessed "opportunistic" investing in NPL portfolios in foreign lands emerge from a "one-time event" to a recurring institutional asset class attracting billions of dollars, as global investors have successfully deployed capital and made money in these assets over time. As said earlier, there is no reason that this time round should be any different than last time round: different country, different language and different judicial system, but the same old issues and problems to be overcome by smart, diligent distressed asset investors. ❖

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