The First Rule of Holes

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Distressed banks, high unemployment, lack of liquidity, and loss of confidence in the financial system, regulators and government leaders are not new phenomena. As they say in Hollywood: We've seen this movie before !

Despite such clear history the Europeans seemed to have forgotten an old adage: The First Rule of Holes is Stop Digging! The longer it takes for a country, its bankers and its regulators to establish a price floor on its real estate, the deeper the hole becomes and the more endangered the condition of the financial institutions involved. Ironically, substantial capital exists to acquire real estate assets in Spain and other troubled European markets. But it is sophisticated, experienced and, yes, high-yield-seeking capital that has the discipline to not plunge into chaotic markets. It will sit on the sidelines until a price floor for assets is established, markets are poised for stabilization and professional sales processes are in place.

STEP 1: Non-performing Loan Auctions

The bankers and regulators in each and every nation and market where Crosswater's senior advisors have done business uniformly argue, "but we are different". Yes, certain national laws and regulations may be different, but the fundamental economic facts remain constant: the ultimate turning point and recovery in these situations begins when either the government or the banks undertake to dispose of their non-performing loans/assets (NPLs) through a public auction process which draws in foreign investors and new capital.

A notable example is Korea, through its Korea Asset Management Corporation (KAMCO), which began an organized and systematic process to auction portfolios of NPLs ranging from residential mortgages, foreclosed real estate, corporate loans, credit cards and consumer debts in a series of well-publicized transactions using "international financial advisors" and tried and proven processes. This resulted in billions of dollars of new investor capital pouring into the country, prices being stabilized and, eventually, values rising for the remaining assets in the banks' inventories.

The inflow of foreign capital triggers the beginning of a virtuous cycle. Local people and specialists are employed to work on all aspects of the NPL disposition process from initial due diligence to the establishment of systems and procedures to collect and resolve the NPLs acquired. The boost to local employment, along with banks' bolstered capital levels and rising value of NPL portfolios, creates a "multiplier" effect in the economy as new money is invested and spent.

STEP 2: Real Property Investments

An oversupply of real estate has usually been at the root of each and every major financial crisis in the past 40 years. The US Savings and Loan Crisis, Japan Bubble, Asian Financial Crisis and most recently the American subprime loan debacle all had an overabundance of real estate product trading at "speculative" prices as a common denominator. Until the inventories of non-performing loans and foreclosed real estate shrink and property valuations begin to rise, a sustained economic recovery can not begin in earnest.

The second step in each and every crisis has been to open the country's real estate market to foreign investors and to sell portfolios of troubled real estate assets at "market clearing prices". Banks', governments' and developers' inventories of distressed real estate are enormous and need to be brought to the market at prices that will allow the investor to offer to sell, rent or lease property at prices that people in the recovering economy can afford. That does not mean that each and every under- and non-performing asset has to be sold in one fell swoop. Instead a carefully controlled process that feeds selected portfolios into the market creates "new market values", which investors can be confident in.

STEP 3: Operating Platforms and Strategic Equity Stakes

Historically less than 2-3 years from the first NPL sale, the recovery is well underway, investor confidence is restored, and foreign investors shift emphasis from distressed assets, which have been bid-up to values that no longer yield opportunistic returns, to sustainable investment platforms and operating businesses that allow them to remain in the market and capture the benefits of the recovery cycle.

Private Equity and Opportunity Funds have historically led this charge, preferring to enter the market after the banking crisis has passed and the NPL investors have pioneered the market. Not only do the foreign investors take stakes in operating businesses, but in many Asian markets the foreign investors also invested alongside government agencies in recapitalizing the banking system. Again, taking a page from Korea, the TPG/Newbridge investment in Korea First Bank was well received at the time and profitable to both TPG and the government when they exited by selling their stake to Standard Chartered Bank for a handsome profit.

Conclusion

Having lived through multiple real estate cycles and having pioneered the distressed asset markets in Asia we can comfortably say that the rules for Spain and other European nations are not different. The crucial action required is to stop dithering and digging oneself into a hole so deep that it will require a miracle to climb out. Our experience has been that the value of real estate assets "on the books" in deteriorating economic situations – such as Spain -- declines by 10-20% per year – a rate that will produce a pretty deep hole! Until credible, market-clearing prices are established through a professional, transparent, market-based mechanism, provisioning against these losses may require an ever larger and larger shovel.

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