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SHOW ME THE MONEY

EUROPEAN BANK NPLs (NON-PERFORMING LOANS)

The European NPL market is benefiting from strong demand originating from a narrow pool of buyers and abundant liquidity. As we witness regime change in global monetary conditions, what strategies should you adopt to be resilient to volatility?

> European NPL stock alone stands at around €900 billion with non-core asset stock aggregating an additional approximate €1.1 trillion.

Concerns around high non-performing loans (NPLs) at eurozone banks have persisted so long that one might be excused for thinking all aspects of NPLs have been covered by market commentators. However, framing the value of NPLs across different asset classes and countries remains a relative conundrum. The stock of NPLs and non-core assets at European banks remains stubbornly high, albeit with material variances across EU countries. European NPL stock alone stands around €900 billion with non-core asset stock aggregating an additional approximate €1.1 trillion.

In this paper, we attempt to consider factors impacting the forward-looking valuation of NPLs, including (i) the steps that European banks might take to mitigate against diminished or more selective buyer appetite in the future, (ii) how these banks might reduce their counterparty dependency through accelerating access to a broader and larger secondary market, and (iii) key ingredients for forging an ecosystem that prioritises standardisation and resilience to macro stress.

Sources: IMF, ECB

Valuation, Rising Rates, and Monetary Policy Considerations

Eurozone NPLs require new valuation considerations, which has implications for large holders of NPLs—and banks in particular. This view stems from the belief that pricing NPLs based on absolute value can be misleading. This approach fails to take into account time-varying risk premia based on dynamic drivers of portfolio value. Determinants of the value need to go beyond expected cash flows, yield-enhancing strategies, and timeliness of recoveries. We also need to factor in capital availability and buyside behaviour, particularly in a rising rate environment.

Empirical evidence shows that *ex-ante* real interest rates are not constant. Asset returns and valuations share some of this cyclicality. Humans by nature are prone to fits of optimism, pessimism, greed, and fear. To quote Charles Dudley Warner, "there is no such thing as absolute value in this world. You can only estimate what a thing is worth to you."

One of the biggest surprises for 2018 may involve higher inflation triggering faster-than-expected tightening of monetary conditions. As per the IMF, we are already witnessing the "broadest synchronised global growth upsurge since 2010." Thus, a sustained period of global growth, aided by new US tax cuts, may change investor consensus as early as Q2 2018.

The return of the EU banking crisis, which began in 2011, necessitated a focus on changing legal and insolvency regimes across eurozone countries. Investors needed to get comfortable with the direction of fundamental legal and standardisation reforms that would illuminate opaque data and expedite recovery, resulting in higher pricing. However, much of the due diligence and assumptions undertaken by investors had the backdrop of low interest rates and relaxed monetary policies.

An accelerated adjustment to monetary policy paired with risk premium decline from a peak could trigger downside volatility. This may result in various impulses throughout the eurozone NPL market, perhaps including unintended consequences for all asset classes, including consumer exposures, concentrated real estate, shipping loans, and midsize corporates. Consequently, one needs to be mindful of resulting incentives for both buyers and sellers of such NPLs, as monetary policy cycle is a related explanation for financial assets' procyclical behaviour.

This scenario provides a different perspective for viewing current and future developments. It brings to the fore unique features of the eurozone NPL market, notably the significant concentration of NPL portfolios among a few large buyers and abundant (albeit temporary) monetary-enabled liquidity.

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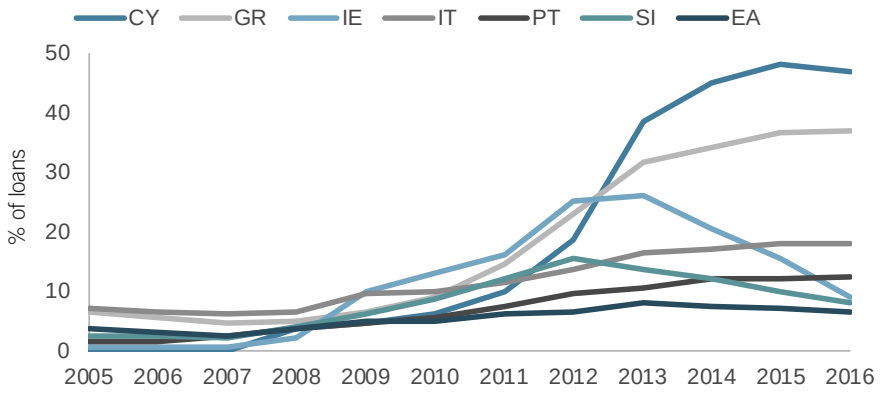
>
> —Charles Dudley Warner

NPL Market 101 – Revisiting Key Characterisitics of the Eurozone Market

Europe continues to suffer from a fragmented and inefficient NPL market with limited NPL sales in relation to the overall aggregate stock. There has been a significant uptick in volumes and transactions over the past few years, notably in Spain, Italy, and Ireland. Still, in relative terms, and as widely quoted in the industry, this deleveraging process has a significant way to go before stock of such loans become manageable. The ingrained structural illiquidity in European NPL and non-core markets cannot be pinpointed to one or two factors, though clearly some attributes have a higher weighting.

NPL resolution in the euro area has been slow



Source: ECB

To this end, the European Central Bank (ECB) has accurately diagnosed the condition that plagues the market and coined a term for this situation: "oligopsony."

Oligopsony can be defined as a situation where lower trading prices are the result of

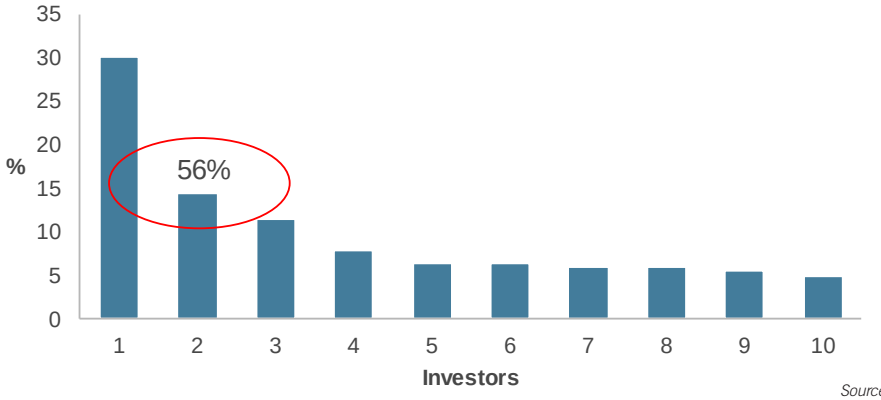
- The market being dominated by a few buyers (buyside control)
- A concentration of market power in the hands of few (bargaining power)

> This principle states that market prices not only reflect expectations of future outcomes but also shape economic outcomes through a feedback loop.

Concentration of Buyers

The chart below illustrates this point forcefully with just the top three buyers accounting for more than half of market share.

Market share for the top ten buyers in European loan portfolio sales 2015–2017



Source: ECB/EBA

Furthermore, the slide below from a recent UniCredit presentation to investors confirms this point. It shows active participants in Italy. The names highlighted here, with the exception of a few, are the same handful of investors seen in many transactions across other European jurisdictions.

	Investors With Servicing Platforms/Banks in Italy		Investors That Participated in NPL Projects in Italy and Europe		
Equity Investors	Apollo	Arrow	Algebris	AnaCap	Ares Management
	Bain	Banca Ifis	Bayview	Blackstone	CarVal
	Centerbridge	Elliot	Cerberus	CRC	Deutsche Bank
	Fonspa	Fortress	Goldman Sachs	King Street	KKR
	Lone Star	Oaktree	KRUK Group	Macquarie	Marathon
			Och-Ziff	PIMCO	TPG
Financing Providers	BAML	Citi	Credit Suisse	Deutsche Bank	Goldman Sachs
	J.P. Morgan	Morgan Stanley	Nomura	RBS	
Services	CAF	Cerved	FBS	Finanziaria Internazionale	Fire
	Guber	Italfondiario	NPL SpA	Prelios	Zenith Services

Source: Unicredit

Concentration of NPL stock in the hands of a few risks creating feedback loops if default correlation risk is underpriced. In the event that embedded leverage around portfolios is disguised, it could amplify market moves in line with Soros' reflexivity principle. This principle states that market prices not only reflect expectations of future outcomes but also shape economic outcomes through a feedback loop. As such, one might argue that in a current somewhat Goldilocks scenario of rampant investor demand and abundant liquidity, selling banks should encourage processes and structures that allow broader investor participation. These could be implemented through fund vehicle solutions, securitisation, and participation

> In order to build a more resilient and diverse buyer ecosystem, in the next phase of the cycle holders of NPLs—particularly banks—need to make an equally concerted effort to widen investor participation and create infrastructure and conditions that encourage investors of different stripes to participate in their programmes.

of passive investors through stapling third-party independent servicing. Crowdedness raises liquidation risks resulting from amplified moves or buyer strike, making the return stream more negatively skewed. The severity of impact could be better understood by requiring improved disclosure on the use of embedded leverage and/or financing at the back end for some of these portfolios, coupled with evaluating the robustness of risk sharing structures under the new, more volatile IFRS 9 accounting regime.

Monetary conditions still encourage abundant liquidity, and various European jurisdictions have made progress in legal and insolvency reforms. In order to build a more resilient and diverse buyer ecosystem, in the next phase of the cycle holders of NPLs—particularly banks—need to make an equally concerted effort to widen investor participation and create infrastructure and conditions that encourage investors of different stripes to participate in their programmes.

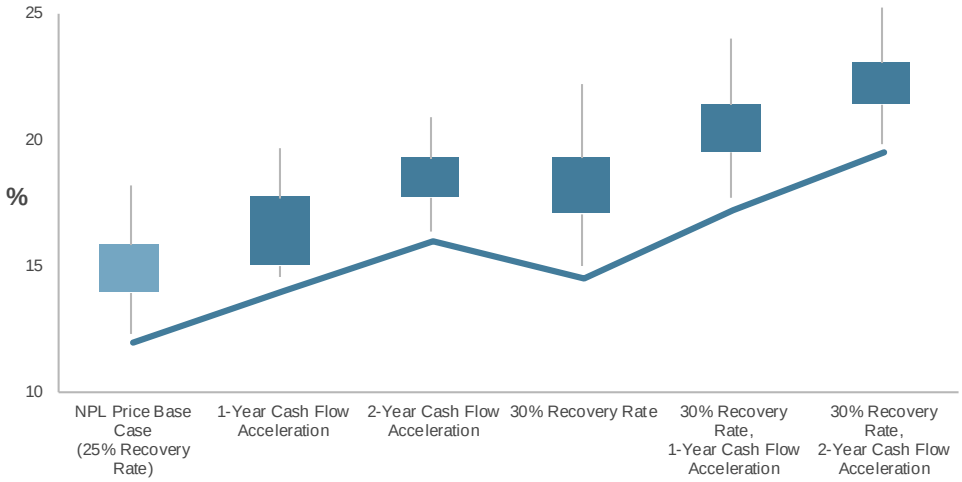
A larger number of, and greater diversity among, investors able to gain comfort with underwriting processes and asset quality results in a better and more resilient deleveraging channel. In such a scenario, a banking institution could still carry on implementing its deleveraging targets even if market dynamics force larger buyers to trim their holdings or sit on the sideline as monetary conditions tighten and new valuation considerations arise.

Time to Enforcement and Recovery

Another important factor commonly highlighted as impacting NPL turnover has been the long period to enforcement coupled with information inefficiency around collateral. Security enforcement and restructuring challenges in the context of insolvency regime have been a major drag on investors' expected return. Unsurprisingly, this has impacted pricing for such exposures.

The illustration below shows the meaningful sensitivity for NPL prices to discount rate, recovery rate, and cash flow horizon. The price range is further impacted if accounting for funding cost for different investor capital pools, collateral valuations, enforceability, and ongoing operating expenses (including servicing and workout capabilities).

NPL prices in each scenario assume a 10%–25% range of discount rates and a given recovery rate



The ranges highlighted above in our illustration are reinforced when comparing recovery time and cost between various jurisdictions. In the table below, the difference between UK and Greece in terms of time to enforcing contracts and recovery rate is a multiple of 3.6 times and 2.5 times, respectively. Clearly, some of this data will suffer from a lag effect, as there has been much progress in Greece in recent quarters—and we are hopeful of more positive improvements in the future. Nonetheless, it draws a sharp contrast between the underlying differences and scope for improvement.

> The ability of smaller, midsize, or passive investors who do not have scale to access the NPL market are reliant on independent servicers for each asset class and geography.

JURISDICTION	ENFORCING CONTRACTS		INSOLVENCY PROCEEDINGS		
	TIME (days)	COST (% of claim)	RECOVERY RATE (cents in the dollar)	TIME (years)	COST (% of estate)
UK	437	45.7	85.2	1	6
Ireland	650	26.9	85.8	0.4	9
Germany	499	14.4	80.6	1.2	8
Italy	1120	23.1	64.6	1.8	22
Greece	**1580**	**14.4**	**33.6**	**3.5**	**9**

Source: The World Bank, http://www.doingbusiness.org/data – The most recent round of data collection was completed in June 2017.

Backing Independent Servicers

Recent growth in capacity of independent servicers could also contribute to improved solutions for European NPLs. The market is reliant on greater trust between sellers and buyers. Rightly or wrongly, captive servicers at banks may not be viewed as fully independent. Use of independent servicers can therefore help bridge some of this dynamic while opening opportunities to a broader investor pool and achieving a better balance between buyer and seller pricing power. A further benefit of independent servicers might be their ability to also perform a role in facilitating various structured solutions. The ability of smaller, midsize, or passive investors who do not have scale to access the NPL market are reliant on independent servicers for each asset class and geography.

Deploying Multiple Options and Routes

The areas we have outlined to help resolve the large NPL stock throughout Europe must be coupled with a new toolkit to accelerate bank deleveraging. Fully utilizing alternative channels to straight sales creates pricing tension and can act as a disciplining force for prospective buyers, as a given portfolio will have alternatives for disposal.

The chart on the next page highlights some of the commonly used tools by banks, some of which can be pursued simultaneously. As we have seen in recent transactions, this deleveraging can also be facilitated with banks holding some of the newly issued notes or tranches from such structured solutions.

On Balance Sheet

Internal Workout

- Workout by originating bank; includes various restructuring options

Asset Protection Scheme

- Risk-sharing agreement to limit further losses; usually state-backed
- Usually short horizon; potential losses large but with low probability

Securitisation

- An alternative to outright sale

Asset Management Companies

- Complete separation of asset from originating bank; often state-backed
- Usually long horizon; larger losses typically already realised

Direct Sales

- Assets sold directly to investors where sufficient liquid markets exist
- NPL transaction platform

Off Balance Sheet

The options listed above are all aimed at repackaging financial risk, allowing investors to meet their specific needs that are unattainable through conventional routes.

It is important to recognise the existence of a diverse investor base that is increasingly comfortable with bespoke solutions. Such investors range from endowments and sovereign wealth funds to financial sponsors and structured credit players. Use of structured finance techniques, coupled with appropriate investor matching, can help lower cost of capital through a more surgical division of illiquidity premia between investors and the selling bank. This approach is even more relevant because the macro backdrop in the fixed income universe is about to normalise. A return to normality with less liquidity will result in plurality of views and preference on leverage, duration, and yield. Sizing each transaction and its parameters to the appropriate investor base, and coordinating such processes, becomes critical. Hence, in our view a robustly functioning market needs to embody alternative features and options to spread risk across investors that are resilient to changes in economic conditions.

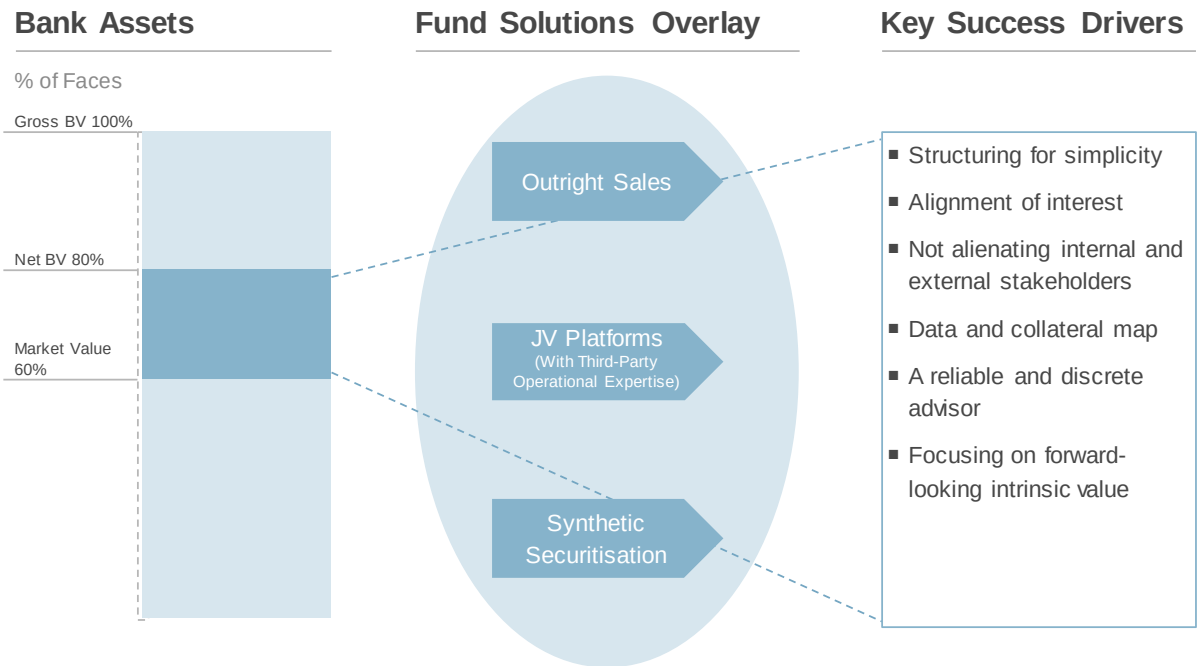
Conclusion

It is clear that market opacity and inefficiency is too costly for many investors, as was reinforced by recent recommendations from the ECB. This issue needs to be resolved in order to broaden investor participation, because only a handful of large investors can absorb such costs, thereby creating significant barriers to entry.

As discussed, these recommendations need to be complemented with more debtor rights reforms and the transfer of some of these rights to creditors through an ongoing upgrade of insolvency regimes. A multipronged approach is the best mitigant against the so-called oligopsony that results in lower prices and the elimination of price competition.

A broadening of tools and solutions, such as the use of fund overlay solutions, would accelerate the achievement of successful outcomes. It would result in attracting more investors to the marketplace, creating deeper and broader liquidity and narrowing bid-offer spreads.

The ingredients required for implementing a successful and resilient deleveraging programme are many. We have identified six broad drivers that have been effective for our clients when undertaking such transactions. It is important to note that these are not exhaustive but rather represent the highest weighting in bridging the gap between book value and market value when undertaking NPL or non-core asset transactions.



Ultimately, it is interdependency of these factors, aligned with the need to reflect moderate flexibility for each institution and its idiosyncrasies, that will generate effective outcomes. The aim of matching the appropriate investors and banks, and helping determine the right format or route for deleveraging, is best achieved in a deeper and broader NPL market.

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ABOUT HOULIHAN LOKEY

Houlihan Lokey (NYSE:HLI) is a global investment bank with expertise in mergers and acquisitions, capital markets, financial restructuring, valuation, and strategic consulting. The firm serves corporations, institutions, and governments worldwide with offices in the United States, Europe, the Middle East, and the Asia-Pacific region. Independent advice and intellectual rigor are hallmarks of the firm's commitment to client success across its advisory services. Houlihan Lokey is ranked as the No. 1 M&A advisor for all U.S. transactions, the No. 1 global restructuring advisor, and the No. 1 global M&A fairness opinion advisor over the past 20 years, according to Thomson Reuters. For more information, please visit www.HL.com.