Rocaton

INSIGHTS

The Time Has Come: The European Distressed Opportunity

December 2013

203.621.1700 | **rocaton.com**

EXECUTIVE SUMMARY

For several years, the European debt crisis has inflicted unprecedented stresses on the Continent's economic and financial systems. Yet, while investment strategies oriented towards distressed European credit and real estate have been available throughout this period, broad-based buying opportunities have largely failed to materialize until recently. Now, as conditions have begun to stabilize, significant deleveraging of the European financial system has begun in earnest. In this *Insights,* Rocaton will explore the reasons why the time may be right for investors to consider investments in European distressed credit and real estate, as well as key implementation considerations for such strategies.

Introduction

Europe's financial system and economy were both deeply impacted by the 2008–2009 global financial crisis, which initially began in the U.S. However, most of the European sovereign credit problems that have dominated headlines since 2010 have their roots in a deeper set of (a) structural issues in EU economies and (b) flaws in the design of the European Monetary Union. Specific catalysts for recent financial crises have been varied, from failed construction booms (Spain) to government corruption and outright fraud in economic statistics (Greece), but the end result has largely been the same across the continent: the exposure to a credit bubble of immense proportions. Across many European nations, either consumers, governments, banks or all of the above simply took on too much debt.

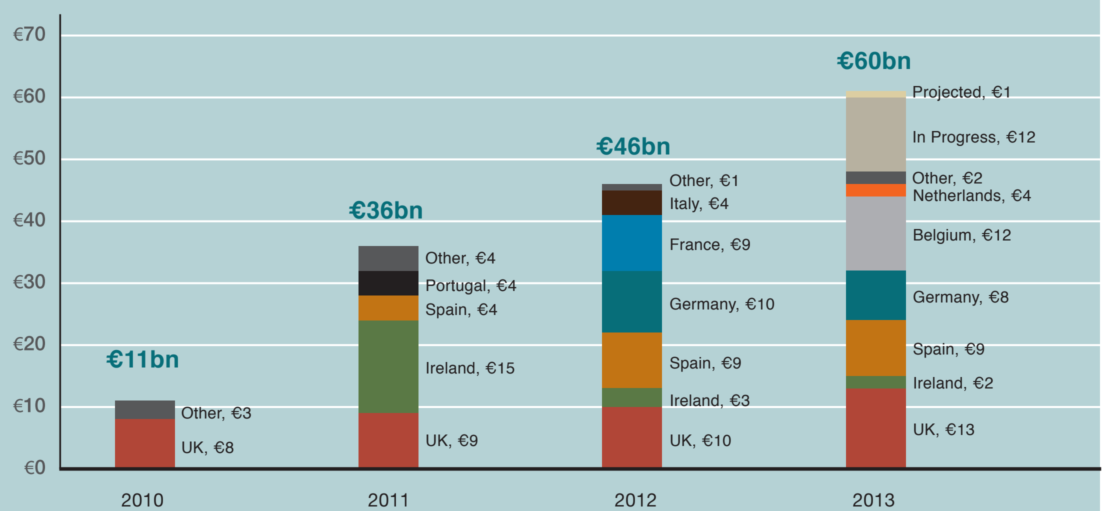
The term "deleveraging" refers to the slow, often painful process of lowering that debt burden, and presently this process is occurring in Europe at both the sovereign level as well as across the EU banking system. With an understanding of the disruptive nature of the deleveraging process, in recent years many distressed debt managers have raised funds focused on Europe, but which then struggled to find compelling opportunities to deploy capital. Yet, with over $3 trillion in expected asset sales from European financial institutions over the next 5 years—including corporate loans, real estate loans and consumer loans—as well as the potential for corporate distressed situations resulting from ongoing economic pressures, the fundamentals appear ripe for a sustained market opportunity in European distressed credit and real estate. In this *Insights*, Rocaton will explore the reasons why the time may be right for investors to consider opportunistic investments in distressed European credit and real estate, as well as outline key implementation considerations for such strategies.

The Basics of European Bank Deleveraging

First, we turn to the large volume of anticipated bank asset sales, a key catalyst for the current European distressed opportunity. A major driver of the expected volume of asset sales is the size of the European financial system, which at approximately $43 trillion in assets or 3.3x GDP is significantly greater than that of the United States (approx. $15 trillion or 0.9x GDP).[1] Moreover, due to poor underwriting practices, certain localized asset bubbles, and recession across most of the region, European bank balance sheets contain large numbers of non-performing loans (NPLs). Analysts estimate that there exists in excess of €1 trillion NPLs across European banks, including Italy (€322 billion), the United Kingdom (€250 billion), and Spain (€180 billion).[2]

In order to regain health and, crucially, to comply with stricter requirements under Basel III rules being fully phased in by 2019, European banks must improve their ratios of equity capital relative to their risk-weighted assets[3]. While there is some uncertainty regarding the amount of deleveraging which will be necessary due to the ongoing implementation of Basel III, the IMF recently estimated that between $2.8 and $4.5 trillion of deleveraging will be required. In order to do this, banks must either raise additional equity capital, organically grow equity through retained earnings, or dispose of assets. Ultimately, some combination of all three measures will likely play a part in the Eurozone banking system's recovery, but it is with respect to asset sales where distressed investment opportunities are most attractive. One of the most effective deleveraging mechanisms for banks is to dispose of high risk-weighted and non-cashflowing assets, such as NPLs. However, large banks are often ill-equipped to engage in such transactions, and are highly averse to selling assets at prices below their current valuations, as such actions have a negative "loss-on-sale" earnings impact.

Chart 1:
EU Loan Portfolio Transactions
(in €billions)



Source: PricewaterhouseCoopers

[1] Federal Deposit Insurance Corporation, European Central Bank, International Monetary Fund.

[2] PricewaterhouseCoopers, Royal Bank of Scotland.

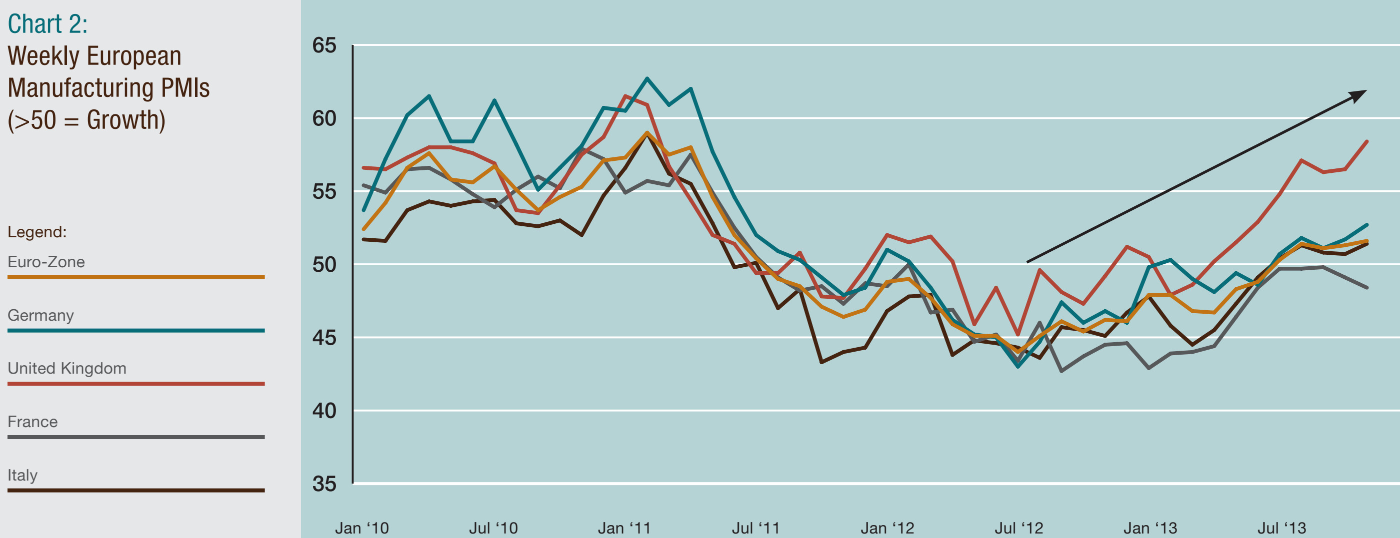
[3] Risk Weighted Assets ("RWA") refers to the banking industry practice of assigning varying weights (0-100%) to assets according to their level of risk, and using this RWA figure in calculating capital ratios. With appropriate risk-weightings, regulatory capital requirements should theoretically be proportional to the riskiness of a bank's assets; however, the 2008-2009 crisis demonstrated that risk-weightings were often flawed, such as in the case of the very low risk weightings on AAA-rated RMBS under Basel II. As such, in addition to increasing capital requirements ("Equity / RWA") Basel III reforms have also made adjustments to risk weightings themselves, effectively inflating RWA. This has exacerbated the level of deleveraging necessary, and is also a key driver of which assets get sold by banks.

Several recent developments have helped to significantly accelerate the sale process across a number of countries within Europe (see Chart 1). In Ireland and Spain, troubled assets from across the banking system have been pooled into "bad banks", which has helped to provide a centralized point from which to liquidate non-performing assets. Furthermore, beyond Basel III implementation, regulatory pressure has been elevated by the recent involvement of the European Central Bank in EU-wide banking supervision. The ECB's first step in the process will be to engage in an Asset Quality Review ("AQR"), which is expected to force more realistic revaluations of NPLs. Finally, as banks have had several years to gradually mark down assets, an increasing proportion are able to transact at market clearing prices without generating a damaging earnings hit. All told, these changes have seen transaction volumes increase from € 11 billion in 2010 to €59 billion completed year-to-date in 2013 (see Chart 1).

Economic & regulatory backdrop: green shoots, but focus on the downside

A challenging feature of deleveraging cycles –for investors and policymakers alike—is the negative economic feedback loop that can result from fiscal austerity measures, tightened bank lending standards, and negative consumer sentiment. As participants in the economy all act to deleverage at the same time, there is an increased risk of deep and prolonged recessionary conditions. This phenomenon has forcefully manifested itself across most Eurozone economies, yet time and measures taken by EU policymakers may have largely stabilized economic activity. In particular, the ECB under Mario Draghi has credibly committed to supporting bond markets and keeping policy rates low, while EU governments have enacted formal budget harmonization rules (the "Fiscal Compact") and an intra-Eurozone bailout mechanism (the "European Stability Mechanism").

Chart 2:
Weekly European Manufacturing PMIs (>50 = Growth)



Source: Bloomberg

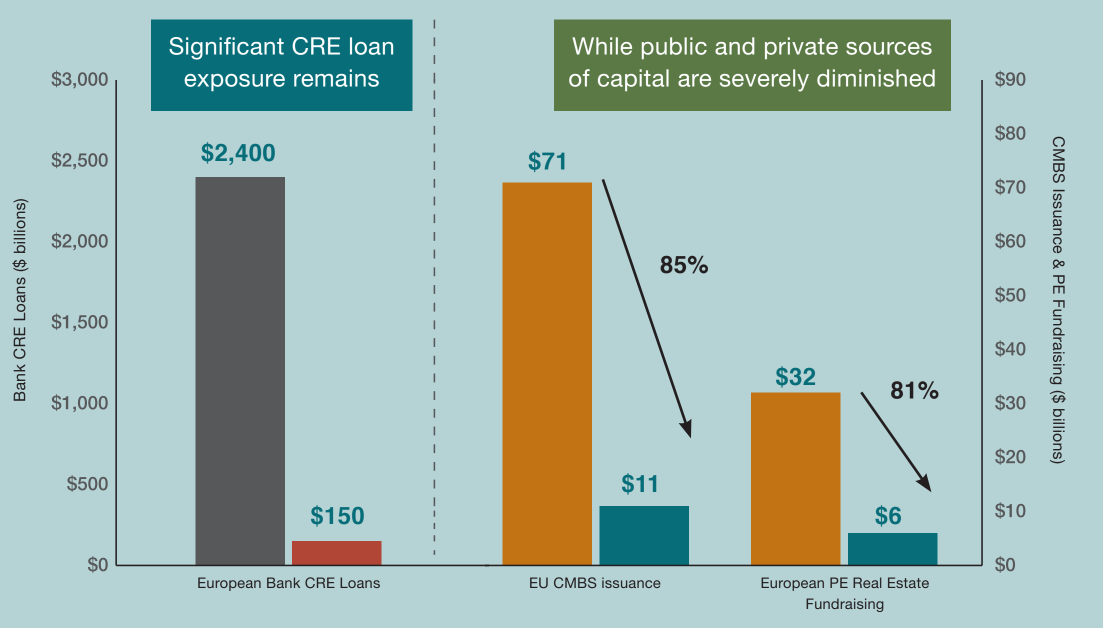
In August 2013, Eurostat announced the official end of the six quarter long Eurozone recession with 0.3% growth in the second quarter of the year. Since this announcement, full year 2013 growth expectations have increased for such key countries as France, the United Kingdom, and Spain while recent manufacturing activity surveys corroborate these trends (Chart 2). Further, on a fundamental level, investors should note that many of the key ingredients of European economic prosperity remain present, including well-developed infrastructure and a large, highly educated workforce. Nevertheless, given the uncertainty on this front, any strategy to capitalize on distress in Europe should be keenly focused on downside protection. Credit oriented strategies with an emphasis on asset protection are one of the best way to approach this dislocation in the market currently.

Away from the banks: the broader opportunity set

While most current information suggests that European bank asset sales will provide the greatest absolute amount of distressed buying opportunities, a number of other sectors of the European financial markets have also been disrupted. Corporate financing markets present opportunities in liquid bond markets, rescue finance, and direct lending. Political developments have driven sharp movements in sovereign rate, FX and credit markets that may be suited towards trading oriented strategies. Finally, with real estate financing activity heavily impaired, capital providers in those markets may be able to realize outsized risk-adjusted returns. Below, we discuss one example of a discrete opportunity: opportunistic real estate.

Chart 3:
European Bank CRE Loans and Real Estate Capital Markets Activity

Legend:
Existing
Deleveraging to date
2007
LTM



Source: Cushman & Wakefield; Morgan Stanley; SFMA; Preqin

Real estate assets require ongoing capital expenditures to maintain and improve occupancy. Similar to the U.S. in 2009-2012, many real estate owners in Europe who are "underwater" on their mortgage have little incentive to further invest in their properties. European banks continue to hold a significant volume of commercial real estate loans (see Chart 3), but are often ill-equipped to effectively manage properties post-foreclosure. Moreover, with challenging fundraising conditions in both public and private markets (see Chart 3), the imbalance of supply/ demand for capital works to the benefit of well-capitalized real estate investors ready to take advantage of the market opportunity. Finally, the distressed real estate market in Europe seems to have opened significantly over the past twelve months as deal flow has improved.

Key Implementation Considerations:

As Rocaton and our clients consider the European distressed credit and real estate opportunity, the following items are dimensions which we are particularly focused on when evaluating specific firms, teams, strategies, and vehicles.

* **Sourcing**: European bank asset sales are frequently conducted bilaterally or via semi-closed auctions with a finite group of market participants. We prefer managers that have demonstrated an ability to generate deal flow via personal networks or business partners.
* **Servicing**: Acquirers of portfolios of consumer, small business, or real estate loans must perform collection and maintenance ("servicing") activities. While well-developed as a stand-alone sector in the United States, the loan servicing industry in Europe is more fragmented and, in many jurisdictions, still largely bank-owned. We prefer managers that have a clear plan for servicing and workout of NPLs acquired. Some GP's may choose to partner with external servicers, while others may have proprietary capabilities.

Investors should give careful consideration to implementation factors

* **Jurisdictions**: Investors should be aware that there is significant variance in legal frameworks across the Eurozone. We prefer managers that have experienced professionals familiar with local norms engaged in portfolio management in selected jurisdictions for their strategy.
* **Liquidity**: European distressed opportunities may target assets with varying degrees of liquidity, however, non-performing assets from European bank asset sales are particularly illiquid. For such strategies, we believe investors should consider private equity style closed-end partnerships.
* **Portfolio Allocation**: For investors with real estate and/or private equity programs and target allocations, these represent the most logical home for European distressed opportunities. The public equity and debt markets also represent a reasonable alternative for those investors not prepared to assume the illiquidity or long lock-up associated with many of the most compelling opportunities.
* **Fees and terms**: Closed end fund structures may vary in length of term, with some shorter life funds targeting 2-3 year investment periods and 4-6 year overall fund lives, while longer funds may entail 3-5 year investment periods and 7-10 year overall fund lives. Investors should expect 1.25-2.0% management fees and 15-20% incentive fees, with hurdles ranging from 6-8%.

Conclusion

The ongoing crisis in European debt markets has created significant disruption in asset prices across the continent. With the commencement of meaningful volumes of bank asset sales, the largest single expected source of distressed buying opportunities appears actionable, while other opportunities may exist across a broader set of strategies. As such, Rocaton suggests that investors consider strategies focused on European distressed credit and opportunistic real estate assets. Rocaton believes that, for investors with the tolerance for long lock-up periods, the returns that these investment strategies target represent a compelling risk-reward trade off and should be considered as a means to improve overall returns in the context of a well-diversified portfolio. In our view, investors should give careful consideration to implementation factors and—given ongoing economic uncertainty—focus on credit oriented strategies with an emphasis on asset protection.