BTG Global Advisory

EUROPEAN INSIGHT

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The NPL Market – Europe 2015

In the first of a series of updates on the capital markets sector, BTG Global Advisory compares non-performing loan portfolios across Europe and looks at what should be expected in 2015.

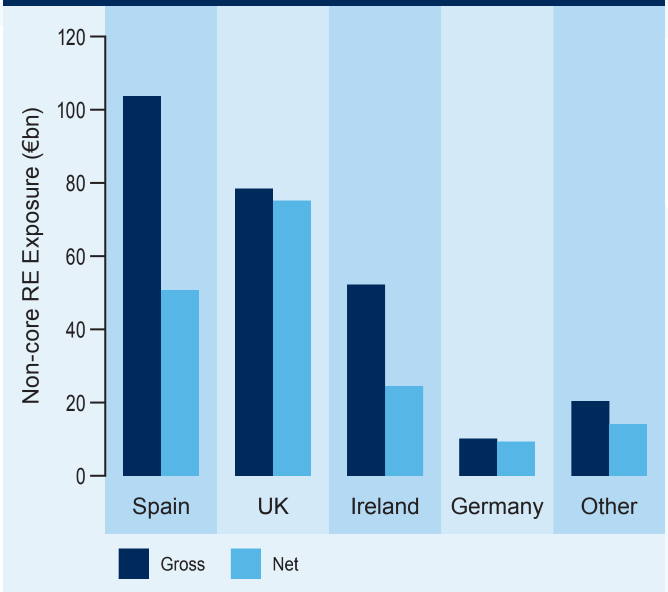
The completion of the ECB's comprehensive assessment and asset quality review (AQR) stress tests in October 2014 revealed an additional €135.9bn non-performing loans on eurozone bank balance sheets – bringing the total held by the 130 banks examined during the exercise to €879.1bn. The findings only fuel anticipation of perhaps the most long-awaited trade in Europe since the crisis: the sale of non-performing loan (NPL) portfolios by European banks as they deliver.

The sale of non-performing commercial real estate portfolios has dominated the market in Europe to date. This asset class has accounted for the majority of such assets in the jurisdictions that have been the busiest so far – the UK, Ireland, Spain and Germany. Banks in the UK and Ireland are well advanced in the sale of such assets and the pace of activity has accelerated this year. In Ireland, for example, while asset sales stood at €2bn for the whole of 2013, towards the end of 2014 €27bn of NPLs had been sold. The significant rise in activity is largely accounted for by the €20bn liquidation of the Irish Bank Resolution Corporation (IBRC).

In Spain, the sale of a €5bn portfolio of performing and non-performing debt by Commerzbank unit Eurohypo earlier this year has similarly driven an increase in activity. But there is still a very long way to go.

Much of the supply that is now anticipated in Europe is presently held in asset management agencies (or bad banks) throughout the region. According to Cushman & Wakefield, European bad banks held a total of €264bn non-core real estate assets in Q3 2014 which represents a net total of €173bn after loan loss provisions. This represents 45% of total non-core real estate exposure across Europe.

AMA Non-Core Real Estate Exposure (€BN)



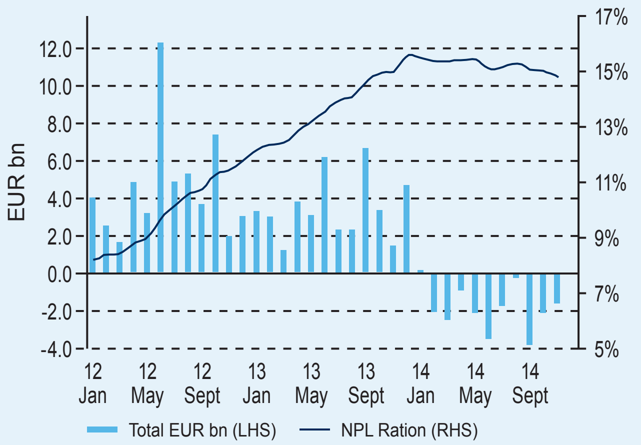
Source: C&W Corporate Finance

The largest bad bank is Ireland's NAMA, which still has €57.2bn of non-core real estate exposure having delivered by €16.2bn since launch in 2009. The UK's UKAR and Germany's EAA have both sold 35% of their portfolios since launch, but still hold €70bn and €10.4bn of assets respectively.

Spain, however, holds nearly 40% of the total gross non-core real estate exposure in Europe, with its bad bank, Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (SAREB), holding €101bn on its books, having only delivered by 5% by the third quarter of 2014 since launch in 2012.

While activity levels in Ireland and the UK have probably peaked, attention is now turning to other countries. The volume of assets now under Sareb's stewardship, together with more active selling by foreign and local banks, means that Spain is viewed as the jurisdiction offering most potential today. Banks in Spain have closed nearly 40 deals over the last two years and by mid-2014 one-third of portfolio sale deals being negotiated in the European market were Spanish. But a lot of the activity in this market has so far been concentrated in the most easily monetisable assets, such as performing Corporate Real Estate loans that have been well provisioned for. The total stock of wholesale NPLs in Spain is €135bn, which is a huge drag on the banking system; €36bn of those NPLs sit on the balance sheets of Spain's largest six banks and will prove a much tougher challenge to move.

Net NPL Formation – Spanish Banks
Adjusted by the SAREB Transfer



Source: Bank of Spain, Nomura research

In terms of potential, Italy might be the most interesting market in Europe for NPL portfolio sales, but turning that potential into reality will be a daunting task. The country is estimated to have €300bn impaired loans in the banking system and Italian banks have started to improve their provisioning against them – largely in anticipation of the AQR this year. However, without additional measures that were taken in 2014, up to nine Italian banks would have failed the AQR tests, so there is an urgent need for the country to begin to effectively address this problem.

Another jurisdiction in which practical outcomes might not live up to potential is Germany, which has seen just €18bn of NPL disposals in the last three years. These have predominantly been the result of non-German banks selling German assets (such as Lloyds, IBRC and Nationwide) or German banks selling non-German assets (Eurohypo). Although the percentage of NPLs on German bank balance sheets ranges from as low as 2% to as high as 37%, the incidence of German banks selling German NPLs has so far been minimal. Indeed, despite attempts to chip away at the problem, €70bn underperforming shipping loans remain at Germany's six largest banks. *(See table on page 3)*

A key determinant in a bank's desire and ability to sell its NPLs is the extent to which it has provisioned for them. Many banks in Europe are now getting to the stage where they are fully provisioned against their NPLs and this should translate into greater deal volumes. However, other important factors that will determine volumes of business include the capital constraints of the individual bank, how depressed its return on equity (ROE) is and how elevated its levels of NPLs are.

There is no shortage of investor appetite for distressed loan sales – indeed, many funds have been waiting years to take advantage of this opportunity. Given the predominance of jumbo portfolio sales at the early stages of this cycle, it has been the large US private equity buyers that have dominated the market to date. An analysis by Cushman & Wakefield of the largest buyers of bad bank commercial real estate assets between 2012 and 2014 reveals that 33% of these loans were bought by US-based Lone Star Funds, 17% by US-based Cerberus Asset Management and 10% by US-based CarVal Asset Management. However, the banks have also been active in the market with Deutsche Bank involved in 7% of purchases and JP Morgan 6%. There have been significant economies of scale to be had by these large buyers. An important element in this is servicing provision. Some buyers have captive servicing providers, but for smaller players finding a local partner with servicing capabilities can be a limiting factor. The sale of jumbo portfolios continues to be the preferred route for most banks, not least because it enables a mix of performing and non-performing assets to be sold together. But as these deals provide pricing visibility for the rest of the market the pace of smaller portfolio sales is expected to pick up.

By the third quarter of 2014 73% of the total original gross commercial real estate exposure transferred to the national bad banks across Europe had still to be addressed, and investors should exercise some caution in estimating the volumes of assets that could be put up for sale in the coming months. European banks still have access to historically cheap funding from the ECB and are now being actively encouraged to address their capital positions using alternative means such as securitisation. Nevertheless, with provisioning at much healthier levels than has been the case in the past, the market should now expect a growing number of sales – both large and small – from banks across the region.

German Shipping Lenders
(Ranked by Shipping Exposure, in EUR billion)

Name of Bank	Standalone Bank Financial Strength Rating (BFSR)	Baseline Credit Assessment	Outlook on BFSR	Deposit Rating	Outlook on Long-Term Rating	Shipping Exposure (in EUR billion)	Tier 1 Capital (in EUR billion)	Shipping Exposure / Tier 1 Capital
HSH Nordbank AG	E	caa2	Stable	Baa3	Stable	28.6	7.0	4.1x
Commerzbank AG	D+	ba1	Stable	Baa1	Stable	18.9	27.2	0.7x
Norddeutsche Landesbank GZ (NORD/LB)**	D	ba2	Negative	A3	Negative	18.3	8.5	2.2x
Kreditanstalt fuer Wiederaufbau (KfW)**	n/a	n/a	n/a	Aaa	Negative	14.2	19.8	0.7x
DZ BANK AG**	C-	baa2	Stable	A1	Stable	11.9	12.2	1.0x
DVB Bank S.E.	D-	ba3	Stable	Baa1	Stable	11.9	1.2	9.6x
UniCredit Bank AGC	C-	baa2	Negative	A3	Negative	8.1	19.5	0.4x
Landesbank Hessen-Thueringen GZ*	D+	baa3	Stable	A2	Stable	7.4	7.0	1.1x
Bremer Landesbank Kreditanstalt Oldenburg GZ (BremerLB)	D	ba2	Review-Down	A3	Review-Down	7.0	1.5	4.5x
KfW IPEX-Bank GmbH	D+	baa3	Stable	Aa3	Negative	6.3	3.2	2.0x
DekaBank Deutsche Girozentrale*	C-	baa2	Stable	A1	Stable	5.2	3.3	1.6x

Note: Shipping exposure and Tier 1 capital as of year-end 2012 (latest date for which comparable information is available).

* *Shipping exposure for DekaBank and Landesbank Hessen-Thueringen indicates exposure to transport sector.*

** *Consolidated figures for NORD/LB (including Bremer Landesbank), DZ BANK (shipping exposure represents DVB Bank data only) and KfW (sipping exposure includes the bank's promotional business and KfW IPEX-Bank's own accounts).*

Source: Moody's Banking Financial Metrics, company annual reports