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Expert Views

Structuring Winning Bids: European NPL Portfolio Transactions

*Editor's note: Below is the latest in Reorg Research's Expert Views series: a white paper written by **David J. Karp**, **Sonya Van de Graaff** and **Anthony Lombardi** of **Schulte Roth & Zabel LLP** on the uptick in activity in the European non-performing loan market. Here is a link to the pdf with the full article including footnotes: http://reorg-research.com/pdf/SRZ%20White%20Paper.pdf*

Over the past five years investment funds have built up a war chest of funds available for European distressed investments, including non-performing loans ("NPLs"). While investors and sellers have been at odds in the past as investors bid fire-sale prices and banks refused to mark to reality, deals have more recently started to flow, as evidenced by the approximately €64 billion worth of loans sold last year and the €80 billion expected to be sold in 2014.

2014 Sees Market Opportunities Finally Shaking Out

A wide range of factors are driving the increase in NPL sales, including: (1) stricter capital requirements via the European Banking Authority stress tests; (2) the European Central Bank asset reviews; and (3) the impending Basel III capital requirements (while not fully implemented until 2019, banks are already moving to comply with Basel III for more conservative capital base and tier one ratios). These factors have led to a strategic shift by banks toward reducing their holdings of risky assets and exposure to certain sectors, and/or to address the internal fatigue resulting from carrying non-core assets. In addition to NPL sales, the creation of "bad banks" has helped to speed up the disposition process by allowing banks to place non-core assets into the bad banks so that they are off their own balance sheets.

Enhanced competition from the buy side has increased deal flow and encouraged sellers (who, in general, have until now defied predictions and resisted coming to market) to finally offer up their NPL assets for sale, while leaving stakeholders at lower levels of the capital structure struggling to retain value.

Certain common issues are emerging in connection with NPL auctions and sales that potential investors need to be aware of in order to make a quick and effective assessment of an opportunity before deciding whether it is worthwhile to drill down into the details and push toward a successful bid.

Getting Ahead of the Game

Price May Not Be Decisive

Identifying the reasons behind a seller's decision to come to the market may assist an investor in preparing a bid and being responsive to non-pricing factors that may be important to a seller.

Banks are bringing a broad mix of assets to market. They are not just "standard" NPLs but also include sales of non-core assets which may not necessarily be non-performing. The reasons include not only objectively ascertainable reasons, such as the need to offload expensive risk-weighted assets (e.g., property, shipping, structured products and less-than-investment-grade-rated corporates), but also reasons that are particular to the selling bank in question and which may not be objectively ascertainable or publicly known.

We are also seeing more whole "non-core" business units in banks shutting down. This offers investors looking to enter into a specific asset class or business area significant purchasing opportunities, as they may be able to purchase an operational business unit with both the relevant expertise and infrastructure already in place. Examples include Lloyds Banking Group selling off its Trustee Savings Banks branches, the Royal Bank of Scotland PLC shedding its aviation and project finance businesses, German banks divesting their shipping portfolios, and the Irish and Spanish banks selling off their real estate loans. Another potential area for investment may be in Italy where Italian banks appear to be getting more serious about disposing of their NPL or non-core assets in light of their much publicized attempts to create bad banks with the assistance of investment funds outside of Italy.

Servicing

Sellers may want a clean exit from the loans and may want to transition servicing quickly. If investors cannot demonstrate clear relevant servicing or management experience in a certain asset category, they should be prepared to join forces with a reputable partner who is an expert in the industry. Expect the seller to be concerned about the quality of the servicer and the prospective servicing criteria for the asset. Investors who cannot satisfy a seller's concerns may struggle to be invited to subsequent rounds.

Reputation

When selling to a fund that could be perceived as a vulture fund, reputational issues will be of concern, and the seller will want to be assured that an investor can be a socially responsible steward of the business. This means being prepared to respond to requests and in many instances providing contractual assurances around any follow-on asset sales, servicing plans or other business plans that could impact the local economy. If an NPL includes potential control through a loan-to-own strategy, a seller may also be concerned about employee-retention issues, plans for existing management and details of any turnaround strategy.

Structuring of the Purchase Price

While compliance with Basel III is still years away, in many instances banks have not yet been forced to mark assets down. As a consequence, internal policies and pressure (and pride) has resulted in a hesitancy to do so. If the bank has not marked the asset down, then a sale at a significant discount to par may be difficult to accept. There are, however, ways of softening the purchase price so as to avoid the seller's having to book a significant loss. For example, deferred consideration might be attractive if the seller retains involvement with the asset (e.g., by way of vendor servicing) or other forms of risk sharing such as minority ownership in the purchasing vehicle or mechanisms for the asset to remain on or return to the bank's balance sheet depending on various performance scenarios.

Granular or Portfolio Pricing

The seller may value transparent pricing on each name regardless of relative size in the portfolio. This may be the case if the seller is fronting the sale where, behind the scenes, there are other position owners. Of course there are benefits to a buyer in providing one price for the entire portfolio without transparency on price indications for each name, but often behind the scenes a sale decision is being made by a board with divergent and potentially competing interests. Therefore, the more an investor can engage in the pricing process with the seller and be seen to be a partner, the better.

Local Presence

Successful investors know they need to look beyond their London desk sales' contacts to source deals. In many cases, a local physical presence, even if by way of a joint venture partner, is a must. Being on the ground may be vital in order to be first in line when an opportunity arises; therefore, investors should form strong relationships with players in the market who have the ability to source and direct deals in the relevant local market.

Analyzing the Portfolio

Diligencing a portfolio opportunity can involve significant time and expense commitments for potential investors. Once this high-level threshold decision has been made, investors need to decide early on whether their diligence will be front-loaded or postponed until after the commercial deal has been reached. There are pros and cons on each side, which are often linked to the manner in which the NPL sale is being structured.

For example if the sale terms are to be agreed as a debt trade on Loan Market Association ("LMA") terms, investors should be especially cautious because the LMA operates on a mandatory settlement basis. This means that a trade will become binding upon oral or written agreement on material terms. As a consequence, an investor will be required to settle the purchase by either assignment, participation or an alternative settlement method (e.g., by way of total return swap). Mandatory settlement may be appropriate where an investor is buying into an isolated credit agreement but could be problematic when buying into a portfolio of multiple loans. For example, a seller may not be prepared to enter into a participation with the investor but could be left with little choice if an assignment cannot be perfected. While investors can attempt to negotiate additional terms at the time of trade, including terms that enable them to walk away, this approach needs to be dealt with on a case-by-case basis in portfolio transactions, as a derivative structure (i.e., an LMA participation) may not work for a seller who is looking to shut down a business or discontinue operations. The risk for investors is that if no due diligence is undertaken up front and a serious impairment (which can lead to a defect in or devaluation of the unique inventory being purchased) is discovered at a later stage of the process, the buyer may still be required to settle the trade.

Due Diligence Check List

The Jurisdiction

Europe consists of 26 different jurisdictions, each of which has its own insolvency laws and security enforcement challenges. Many local laws have recently been revised (including Spain's and the Netherlands') and while in many cases they have moved towards more creditor friendly regimes, they are being tested and enforcement is not uniform. In addition, "soft" issues and business culture in each region must be considered and respected.

Examples of local trading requirements include banking licence requirements, security perfection requirements and security transfer requirements. Investors must be prepared to spend time and money resolving these risks or risk investment failure. In many cases an investor will be buying distressed loans with a view to either selling the underlying assets or undertaking a restructuring. Given these scenarios, a prospective buyer needs to be fully aware of the risks involved and satisfy itself that any bespoke registration or perfection requirements have been complied with. Some common issues that need to be considered follow.

Banking License Requirements

Investors need to be attuned to the bespoke banking law requirements across Europe. In some of the major jurisdictions (including France, Germany and Italy), there are bespoke banking license requirements that may prevent an investor from holding the paper directly. This is particularly the case where an investor will be buying either a revolving facility and/or further drawdowns are permitted under the terms of the facility agreement. If an investor cannot hold a banking license directly, it will need to look to partner with an established local operator who already holds the required license. As stressed above, the importance of having a local presence or a wide network of credible local investor partners cannot be overstated.

Bespoke Security Transfer Requirements

In Spain, particular care should be taken to confirm that security and perfection over real estate has been granted. If this is the case, each piece of security granted will need to be perfected in accordance with the individual local Spanish Public Registries. In circumstances where the security is granted in multiple local Spanish Public Registries this can be very time consuming and costly for a buyer, as each registry may have different fee structures and have different time frames and local processes for finalizing registration. Furthermore, in certain European jurisdictions the security trust concept is not recognized. For example, the trust concept is not recognized in Spain. A security agent can be appointed to help administer and act as a common representative to assist the creditors in taking certain common actions in relation to the security. However, the security itself must be in favor of each creditor under the loan. Similar processes exist in Germany, Poland and Portugal.

Therefore, a buyer will need to ensure: (1) that the seller has taken all the required steps to perfect its security correctly; (2) that the security is capable of being assigned; and (3) what perfection steps (including time frames) a buyer will need to take to ensure that it: (a) retains the benefit of the security; and (b) does not harm its ranking in the waterfall of creditors. Investors cannot count on their sellers or a trustee having perfected the security correctly. General trade documentation (including the LMA standard terms) will not provide protection. Therefore care will need to be taken to understand perfection issues, and an investor may want to obtain specific representations from the seller that perfection has occurred. (Finally, in some jurisdictions, specific notification formalities such as hussiering or notorization are required.)

Voting Restrictions

In certain circumstances, specific borrowers in an NPL portfolio may be in or about to go into an insolvency process. In such scenarios an investor will want to retain control of any formal or informal process in order to maintain asset value. Therefore, the ability to vote in relation to a proposed turnaround plan or statutory process may be essential. Investors should ensure that they are aware of their voting rights on a sale of a distressed loan, as in some jurisdictions voting rights are not transferable.

Restructuring an NPL

Investors adopting a restructuring strategy for the NPL portfolio will need to consider the relevant insolvency regime, including restrictions on enforcement against collateral. It cannot be assumed that techniques taken for granted under a U.S. Chapter 11 bankruptcy will apply (e.g., neither DIP lending nor credit bidding is possible in various jurisdictions (such as the United Kingdom)). Also, rather than knowing how to open/commence an insolvency proceeding, it may be more important to know how the opening of an insolvency proceeding can be avoided, so as to allow a restructuring to be agreed upon and implemented.

Control Position

An analysis of the degree of control the investment will allow an investor to exercise in a restructuring will be important in assessing the value of the position being offered for sale. In particular, any bespoke voting requirements should be considered.

Is the Asset "In the Money"?

In some jurisdictions, only those parts of the capital structure that are at or above the fulcrum security will have a vote in a formal restructuring situation (including in an English scheme of arrangement). On the other hand, in some jurisdictions, out-of-the-money classes have been able to effectively force through out-of-court restructurings given that their position could only have been extinguished through an in-court proceeding that everyone wanted to avoid. In particular, the continued influence of the (out-of-the-money) majority shareholder in family owned businesses outside of a formal insolvency proceeding should not be underestimated.

Can the Relevant Insolvency Regime Be Changed?

If the insolvency regime of the debtor is not ideal or is worryingly untested, consider whether it is possible to move the situation to a more creditor-friendly jurisdiction, whether by way of center of main interest (COMI) shift or otherwise. Eligibility for entering a primary insolvency process in the European Union (including the United Kingdom) is based on the COMI. Factors used to determine the COMI include:

- Location of the debtor's business premises, production sites and warehouses;
- Place of work of the debtor's employees;
- Location of the debtor's bank accounts used for payments to creditors; and
- Choice of law in contracts with creditors.

COMI shifting to the United Kingdom has the additional benefit of the availability of the Companies Act scheme of arrangement (U.K.) process. Recent cases show the willingness of the English courts to push the boundaries of foreign situations that are amenable to an English Companies Act scheme process.

The growing availability of the U.K. scheme of arrangement as an option for restructuring a foreign company will be useful as a negotiation tool in avoiding local value-destructive formal insolvency filings that do not sufficiently cater for a rescue.

Intercreditor Issues

In particular, in a multi-layered capital structure, the rights as against creditors in different classes will need to be analyzed to determine whether other classes of creditors have a right to hold up a restructuring or impede an enforcement scenario. Bear in mind that what may appear at first sight to be different classes of creditors for voting purposes may in fact be determined by the court to be a single class.

Transfer Restrictions

European credit agreements often contain transfer restriction provisions, the most common of which are: (1) borrower consent/consultation rights; (2) minimum hold and transfer amounts; (3) restrictions on transfers to specific entities (including funds); and (4) restrictions of transfers to competitors of the borrower. The transfer provisions of the loans being sold by way of auction will need to be carefully considered in order to identify any obstacles to the transfer being affected, as this could be a negotiation tool for determining the price.

The most common restriction to be aware of is borrower consent to a transfer and in some instances to a participation. This is a particular issue in Europe at the moment as European borrowers and sponsors are concerned about perceived "aggressive" investment funds buying into their debt, either directly or via participations. As a result, when European borrowers receive a request for an investment fund to become a lender, via a secondary market transfer, they are increasingly using their consent rights to deny the request and maintain control of who their lenders are. In many cases, the credit agreement requires the borrower not to unreasonably withhold consent to the transfer; but what constitutes "consent being unreasonably withheld" is an unsettled point of English contract law, which governs many credit agreements across Europe.

Conclusion

Due to the nature and size of the NPL market in Europe, the potential and opportunity for the purchasing of NPLs is growing. However, it is clear from the amounts that have been raised to invest in these opportunities that competition will be strong. To get ahead of the game it is going to be crucial to plug into why that asset is being sold and any bespoke local issues that may arise.

This article does not purport to review all of the factors that may arise in the context of portfolio asset bids, but it does highlight some of the main issues to consider in deciding whether or not it is worthwhile to throw one's hat in the ring, and for investors who make that initial decision, it provides a way to approach tackling the various issues that will inevitably arise.

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