



GERMAN DISTRESSED PROPERTY DEBT: **GRUNDPFANDGESICHERTE KREDITE IN DEUTSCHLAND:** *MINEFIELD OR GOLDMINE* **MINENFELD ODER GOLDMINE?**

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German Distressed Property Debt Highlights

- 1. Distressed debt portfolios in the US have sold for as low as 45% of book value of the unpaid principal balance. The average is closer to 55%. (Lone Star bid close to 70% to win some recent portfolios)**
- 2. US investors in particular stress that France and Italy have provided some sort of state-driven incentives for banks to sell off distressed debt portfolios; considering the size of the German problem, Berlin would do well to consider something similar.**
- 3. No new estimates of the distressed debt potential in Germany; still 3-5% of bank assets measured at nearly E7trillion. Thus Euro 200-350 billion in total.**
- 4. Clear difference between German bankers who see a large distressed debt proportion being unwound internally by creditor institutions, and Anglo-Saxons and Funds who are sceptical that the culture, motivation or know-how exists here. German estimates are that only 20% of total distressed debt will be sold by German banks to third parties.**

5. Seven reasons for selling distressed debt/npl portfolios portfolios: (i) proactive portfolio management, (ii) improvement of bank rating, (iii) limitation of downside risk on asset valuations, (iv) bank liquidity requirement, (v) boost regulatory capital ratios, (vi) cut costs and resource use in internally managing distressed debt/NPLs, (vii) re-focus on core businesses.
6. Probable that German banks increasingly see sense in placing non- or sub-perf debt in a still-consolidated subsidiary specialised for workout/recovery or returning to performing. Then, building these into specialised units that could offer this expertise plus, for example, ABS and private equity consulting to third parties. Once adequate loan loss provisions are formed a deconsolidation can take place from the balance sheet of the parent bank.
7. But banks still well behind on making loan loss provisions for distressed debt books so that this process likely to take 2-3 years at best.
8. Distressed debt portfolio buyers looking for Internal Rate of Return up to 25%. This means high attraction for German banks to do workouts internally. West- and Nord LB's new bank is one example of such a "Workout Bank" (to this term politically incorrect)
9. Advisor spend on a Euro 1 billion distressed debt portfolio likely to be E4-5m. Economy of scale works at this level but is much more questionable at amounts under Euro 500 million. Problem for buyers is to invest on advisors before knowing if they will win a/the portfolio.
10. German legal/tax environment non-conducive to distressed debt sales and should be reformed: (i) separation of loan from lender must be total otherwise lender must still account in P&L under German GAAP, (ii) impact of Basel II on distressed debt assets in 2007 still unclear, (iii) bad loan portfolio selling proceeds should attract VAT though some workarounds exist
11. Real estate collateral values are unlikely to rise in the next 5-10 years. This cannot form basis of the IRR calculation.
12. European distressed debt situation now very different from 10 years ago. Germany now main focus of international capital; much more money chasing portfolios. Seller's market: 'first mover advantage' all on side of vending bank. (easetec: given recent winning bid levels we would agree). 10 years ago 4-5 serious investors in market. Now, 10-15 investors.

- 13.** But IPO market is near-closed, and banks have cut back standard lending sharply so that asset sales are an important source of liquidity in many situations. It is also useful for buyers to approach government organisation that have budget-driven cash requirements. (Berlin's new securitisation of Russian debt receivables, Aries, plus its recent announcement of pension receivables from Post and Telekom)
- 14.** In Germany, most banks take real estate as collateral; even though a loan may be SME in nature. Thus investors must take a view on property prices in almost all distressed debt portfolios; even if commercial debt is mixed in, property often more important to understand than the corporate cash flow. Very different from the United States.
- 15.** More assets coming for sale soon, but smaller portfolios. More supply means that prices for distressed debt portfolios should fall.
- 16.** Distressed debt value in France worth about one-third of Germany, i.e. about Euro 100 billion
- 17.** Frequently, for east German property forced administration may be the only exit from an NPL but the process can take 1.5 - 4 years. If the borrower has filed for insolvency then investor is dealing with the insolvency administrator; it is important that there is good cooperation
- 18.** In the US, insurance companies no longer hold mortgages and banks generally only originate with the end objective of securitising. (thus, higher US ABS issuance this YTD than standard bond issuance)
- 19.** German cooperative banks have pooled distressed debt in BAG Hamm. This is proving to be very confidential about the situation and its needs. But reaching the end of its funding capacity now. Little known publicly about its success in working out.
- 20.** Real estate auction process intransparent. No central documentation; little information release from local courts except partially in regional newspapers. Little or no electronic transmission of information. 6-10,000 court auctions per month offer total value of around Euro 1.5bn in NPLs but part of this is first time or repeat. Total auctioned p.a. is Euro 5-7bn. Recovery rates not published; many court say not legal to do so.
- 21.** German public sector banks, facing loss of government guarantees in July 2005, need to attain a long-term minimum A rating to compete on level playing field with commercial banks; anything lower would be serious competitive disadvantage.