Loan sale market – expert evidence

Correspondence received from three major loan sale advisors giving the market view on discount factors to be applied to NPL (non-performing loan) portfolios

1. Eastdil Secured

NPL Pricing

The pricing & underwriting of non-performing loan portfolios is normally a very extensive process that can take several months to complete. Whilst % discount to asset value has compressed, as the market fundamentals have improved, it's important to take a number of variables into account.

The pricing of loan portfolios is highly dependent on a number of factors, including:

(i) the characteristics of each specific portfolio;
(ii) legal jurisdiction, loan / security documentation and a buyer's practical ability to enforce on the loans;
(iii) the extent to which the underlying assets are generating a cash flow;
(iv) the value of collateral other than property securing the loans;
(v) market depth and liquidity in the underlying property markets;
(vi) availability of loan on loan financing for the portfolio; and
(vii) general market conditions prevailing at the time of sale.

Buyers of NPL portfolios typically take a bottom-up approach to pricing, making assumptions around (a) property values, (b) resolution strategies and (c) resolution timeframe, on an asset-by-asset and borrower connection-by-connection basis. The resulting cash flows are then aggregated and assessed on a leveraged basis, in the context of financing terms that can be secured for the portfolio and the overall timeframe of the investment.

It is therefore generally not feasible or meaningful to assess pricing solely by reference to the par value of the loans or the value of the underlying properties as there are numerous variables to account for.

Having said this, we have seen on a broad brush basis, the loan pricing discount to asset value for granular loan pools in Ireland compress over the past 36 months from +20% to +10% as the underlying market fundamentals have improved. **For Q1/Q2 2014, the average discount to asset value for Irish loan books would have been in the 15% range. Having said this, every portfolio is different, and**

the % discount is completely dependent on the specific valuer's view, and the vintage of the valuation.

Eastdil Secured is a leading loan sale advisor, having advised on over €30 billion in European non-performing loan (NPL) sale transactions since 2013.

2. Lazard

Debt investors typically price NPL portfolios at a discount to so-called recovery value i.e. the value of the underlying collateral. This is because the purchasers of NPL portfolios typically plan on taking ownership of the collateral via some form of enforcement and then selling the collateral to a more natural long term owner. The main component of the return for the purchaser of an NPL portfolio is therefore the difference between the purchase price for the loans and the sale price for the collateral. If a debt investor acquired a loan portfolio at the value of the underlying collateral, he would not generate a return on his capital when he sold the collateral. The return that a debt investor expects to generate from acquiring an NPL portfolio (which manifests itself in the form of a discount to recovery value) is justified by reference to the risk and costs associated with obtaining ownership of the underlying collateral and the time value of money. This is why discounts to recovery value tend to be wider in jurisdictions like Spain and Italy, where the route to asset ownership is lengthier and more uncertain, than in jurisdictions like the UK and Ireland. Larger, more granular loan portfolios secured on assets that are secondary in nature typically trade at wider discounts than loans secured on individual, high quality assets.

It is difficult to define the "typical" discount to recovery value as when NPL portfolios are sold the discount that is normally reported publicly is the discount to par value – which is a function of the original loan underwriting/prevailing market conditions at the time. The purchaser's underwriting assumptions in respect of the value of the underlying collateral are confidential and not publicly disclosed. **However, anecdotally, the discount to recovery value for real estate NPL portfolios in Europe has narrowed over the past five years, as the market has recovered, from c.20% to c.7-12%.** The precise discount will depend on a number of factors at the relevant time including the quality of the real estate (and information relating thereto) and expectations of capital growth, the enforcement strategy, the perceived complexity, costs and certainty of the route to asset ownership and both the liquidity and risk appetite of potential purchasers. Clearly, every situation is different.

3. Cushman & Wakefield

Cushman and Wakefield ("C&W") has provided corporate finance advisory services to the market for over 20 years operating from London, Frankfurt, New York and Washington DC. Our extensive experience covers sell-side, buy-side, valuation and advisory mandates across some of the biggest loan portfolios and most granular collateral sets.

C&W has developed a proven and extensively used loan portfolio pricing model, able to produce accurate indicative value estimates, taking into consideration the quality of individual loans, the quality of the collateral, various portfolio work-out time scales, deal structures, market appetite for the product and how investors approach their own pricing exercise (including their exit strategies, return requirements, and likely financing arrangements).

The pricing of non-performing loan ("NPL") portfolios is complex and the pricing may vary with investors own liquidity and risk appetite as well as prevailing conditions in the global financial markets. NPL portfolios are typically priced at a discount to the value of the underlying collateral, with larger, more granular loan portfolios secured on secondary assets typically trading at wider discounts and taking longer to work-out.

In arriving at a purchase price based upon its proposed discount rate, investors would evaluate a number of key considerations when underwriting a NPL portfolio, including but not limited to:

- **Equity surplus** – Once investors have mapped the cross-collateralisation between loans within a connection, equity surplus can be identified where the collective outstanding principal balance ("OPB") of the cross-collateralised loans is below the collective value of the associated assets.

- **Legal Haircuts** – Investors would need to consider a discount to value to cover certain legal issues including prior charges, the security not being registered, solicitor's undertaking or as they are resting in contract, or missing documentation.

- **Operational costs** – Costs relating to loan servicing, asset management, capex, and working capital would need to be considered in an investor's work-out cash flow.

- **Undrawn Amounts** – Investors would need to consider the effect on the purchase price due to any undrawn amounts which they foresee as future commitments to borrowers.

- **Enforcement and legal costs** – Having developed a work-out strategy, investors would need to consider the associated timings and costs of enforcing or negotiating a deal with the borrowers.

- **Work-out timing** – An investor's exit strategy and resulting cash flow would be highly dependent on the timing to dispose all the collateral taking into consideration market absorption, asset pricing, and asset liquidity. For these reasons, larger, more granular loan portfolios secured on secondary assets typically trade at wider discounts and take longer to work-out.

- **Financing** – The availability and terms of loan-on-loan financing will have a significant effect on an investor's potential returns and hence its offered purchase price.

Due to all the aforementioned reasons, NPL portfolios with these portfolio characteristics and market conditions inevitably trade at a discount to today's price for the individual underlying real estate collateral, **with pricing levels at discounts above 15% below underlying asset value**. The ultimate discount applied will be dependent on the quality of the underlying collateral, loan and security information and borrowers' characteristics as well as investors' own financing and work-out arrangements.