DebtX
THE DEBT EXCHANGE

THE LOAN SALE **ADVISOR** Best Practices in Active Portfolio Management

Summer 2014

What's Driving Loan Sale Volume?

2014 is expected to be another big year for loan sales.

So what is the driving force behind the transaction activity?

"The biggest motivator by far is M&A activity," said DebtX President Bill Looney. "When a bank does a strategic transaction, the management team typically faces a number of balance sheet challenges affecting their stock price, capital structure, regulatory status or all of the above. Loan sales are one of the best ways to address those issues quickly and cost-effectively."

In 2013, DebtX sold a record volume of loans and also executed transactions for a record number of sellers. The biggest seller was HUD. DebtX also sold loans for more than 80 banks and financial institutions.

Looney said that after M&A, the need to dispose of legacy non-performing assets and to re-focus on loan origination are likely to be the other reasons for rising loan sale volume in 2014.

From a risk management standpoint, loan sales also help reposition a balance sheet and concentrate on new areas of growth or adjust to changing market conditions.

Two recent transactions by DebtX demonstrate the different benefits of selling.

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Stress Testing: Are You Ready?

The general consensus among banks with less than $10 billion in assets is that at some point stress testing won't just be a "big bank" headache.

But that doesn't mean financial institutions should wait for regulators before evaluating their ability to withstand another market shock.

"DebtX's goal is to help smaller banks show their regulators they are proactive and have a firm grasp of how their portfolios behave under adverse market conditions, so they can avoid being forced to do something painful and expensive," said DebtX Managing Director Will Mercer. "The expectation is that some form of stress testing will be coming sooner rather than later for banks under $10 billion."

Valuable Tool

Annual stress tests have become an important tool for regulators to determine the financial strength of banks if another meltdown occurrs.

The largest banks and financial firms are already subject to a host of stress testing requirements, including those under the Fed's Comprehensive Capital Analysis and Review ("CCAR") and the Dodd-Frank Wall Street Reform Act and Consumer Protection Act Stress Test ("DFAST").

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European Loan Sales Accelerate

2014 is off to a fast start for large and small loan sales in Europe.

Year-to-date through mid-April, there have been €29.8 billion of property-loan sales in Europe, according to The Wall Street Journal. That's slightly less than the €30.3 billion sold during all of 2013. Sales could top €50 billion by the end of the year.

Spain has accounted for a significant amount of the activity. One of the biggest European loan sales is a €6.95 billion portfolio of Spanish home loans, many of which are poorly performing. The loans were originated by Catalunya Banc SA, a regional lender nationalized by the Spanish government.

"In the U.S, most of the large portfolios of non-performing loans have already been sold and cleared, but that's just starting to happen in Europe," said Managing Director Gifford West, head of International Operations & Business Development.

Strategy Mismatch

The largest transactions are grabbing headlines, but the volume of smaller deals has been growing steadily. DebtX has already conducted six transactions in Europe and has two additional sales underway in Ireland and Spain.

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Q&A With Dave LeBlanc, CFA, Managing Director, Capital Markets

Dave has more than 18 years of experience in CRE, loan sale advisory and capital markets. Recently, he sat down with Louis Amaya, host of BlogTalkRadio, for a wide-ranging discussion. An excerpt follows.

Louis Amaya (LA)

What have you seen the whole loan market do in the last few months and in 2013?

David LeBlanc (DL)

I think the residential market is just now starting to blossom. So the commercial market, a couple of years ago, really exploded with predominantly government activity. This goes back to say 2008, 2009, 2010. And as the government activity started to fade, the private market activities started to expand. I think that the residential sector is probably a few years behind the commercial sector. Last year was driven predominantly by government activity, but I think that the government activity is going to be overshadowed this year by the private market activity.

LA That is interesting, so as far as the changes you have seen from last year. Is there anything other than more institutional sellers and government sellers?

DL I think the market can be characterized probably by three things. One is liquidity. Two, transaction velocity and then three, pricing. In terms of liquidity, the market is as liquid as it has ever been. So just in the last couple years, not only do we have billions and billions of dollars of equity capital that has been raised, but financing for these participants is easier than it has been since the financial crisis. So over the last year, we've had increasing prices, increasing access to capital, increasing access to leverage, and increasing transparency, which is frankly driving transaction volume.

LA When you think transparency, what exactly do you mean?

DL There is more transparency in the market today than there has ever been, particularly on a residential sector. So for example, we have a pricing and analytics group, along with the trading group, and we see so many transactions, kind of on a daily, weekly, monthly basis. We can tell you where product is going to trade. It was not so long ago where transactions were so few and far between, if there was a portfolio on the market, you did not really have a lot of clarity about the way the portfolio would clear. That is not the case today. There is very good data available to market participants. That gives you a really good sense of where these portfolios are going to clear. I think that this additional transparency gives market players comfort, more comfort certainly, than a few years ago. More comfort in the market gives you confidence to transact.

LA And who are the buyers and sellers who are most active? Also, if you can tell us, is there room for the smaller investor, someone who maybe just has $20 million to $50 million to play in this space?

DL In terms of the sellers, I think the largest seller of residential whole loans is the FHA and then we are talking about probably the top 10 banks. Those two categories are by far the largest. We do a lot of transactions with smaller banks. Those transactions tend to be smaller. The numbers are a little bit higher, but overall, it does not catch up with the volume of the FHA and the top 10 banks. On the buyers' side are the largest institutional financial players in the world – large hedge funds. Some of the large banks have proprietary capital desks and some of the large private equity firms have allocated capital base. I think when you start getting into smaller funds with $5 to $50 to $100 million under management, they have a difficult time participating in the primary sales. The primary sales tend to be $100 million plus.

LA Are you seeing a lot of fund buyers that historically purchased real estate and now buying NPLs to make that real estate play?

DL Absolutely. Most of them have actually been in the market for a few years. The new participants are the financial buyers migrating into the space in search of a deal, but you are 100% correct. Anybody that is large in the commercial real estate space or in the residential space is at least dipping a toe into the NPL market. The crossover buyer becomes more active in the space as the pricing of commercial real estate goes up, as access to financing improves or any number of other factors.

LA What is your most popular product that you sell through DebtX?

DL Right now, anything with cash flow, followed by anything that is a quality asset in a recovering market. That would be performing commercial real estate and quality single-family real estate loans in a recovering market. Anything where investors think that they can monetize in a fairly short timeline.

LA Are the investors who are buying cash flowing assets buying for hold? I mean are they going to hold it indefinitely? Or are they planning on liquidating? What is the exit strategy for some of these buyers?

DL That is a really good question. On the performing side, it really depends. It used to be that the trade was a bank on one side and a hedge fund or opportunity fund on the other. The way the market works today is that you might have a bank on one side, an opportunity fund in the middle and then two years later, a bank on the other side. So asset values go down, opportunity funds buy the asset, borrower defaults, fund reworks the paper, holds it for a year for some seasoning and then sells it to a bank. In that particular case, the bank might hold to maturity. If it is a performing fund buying the paper, it might be a two-year hold and then they sell to somebody else. The market has changed from predominately a buy-and-hold market to more of a true loan trending market.

LA I am going to guess that demand for a product is pretty high right now.

DL It is off the charts. It is a 100% sell-side constrained market right now. It is a seller's market. I think that the acceleration of some of the sales we saw in fourth quarter of 2013 tells me that many of the sell siders recognized that it is a sellers' market.

What's Driving Loan Sale Volume ?

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Increase Shareholder Value, Raise New Capital

Over the past few years, a Mid-Atlantic bank had made several strategic acquisitions to strengthen its competitive position in Maryland. As part of these transactions, the bank acquired loan portfolios with performing and non-performing loans.

In managing its distressed debt portfolios, the bank wanted to avoid the costs of hiring additional staff to handle the loans in workout. The bank's investment bank, FIG Partners, recommended that it engage with DebtX to sell the loans and sidestep the loan workout process.

Working closely with the bank's management team and FIG Partners, DebtX executed a highly successful loan sale to dispose of the distressed loans. Since its acquisitions, loan sale and subsequent capital raise, the bank has staged a turnaround and its stock has risen significantly.

Improve Capital Ratios

Beginning in 2009, a privately held community bank located in San Francisco and Los Angeles came under scrutiny from regulators. The bank's ratio of classified assets to capital was too high. The bank was pressured to improve the ratio by whatever means necessary.

The bank had a reputation as an active lender with many solid customer relationships they did not want to jeopardize. The bank did not want to stop or reduce new originations to existing or prospective clients. Rather than slowing or eliminating originations and waiting for its balance sheet to improve through natural attrition of current loans, the bank decided to sell some of its loans.

The loans that were chosen for sale were primarily performing, but had high LTV, low DSCR, or were lacking property or guarantor financials. The overriding goal was to improve the ratio of risk-rated assets to capital and satisfy the regulators.

A secondary goal was to align the portfolio more closely to the bank's strategy. The bank chose to use an advisory service to broker the loans. The sale was highly successful, with all loans sold at a premium.

Due to the success of the sale, that bank moved from a state of regulatory crisis to one of holding a stronger balance sheet and a more strategically aligned loan portfolio.

"The positive experience of both these banks demonstrates the power of loan sales to successfully resolve serious balance sheet issues," Looney said.

For more information about loan sales, contact Bill Looney, 617.531.3402, wlooney@debtx.com.

Upcoming Loan Sales

€43.5 Million
Non-performing residential portfolio secured by 338 properties across Spain. The majority of the collateral is located in Andulucia, Cataluna, Comunidad Valenciana, Canarias, and Madrid.
Indicative: May 22, 2014
Final bids: June 12, 2014

$32 Million
High quality seasoned performing CRE loan portfolio. Loans secured by multifamily, retail, industrial and office properties across US with concentrations in Southern CA & Nevada.
Bid: June 17, 2014

$65.9 Million
Residential loan sale containing a conventional non-performing pool, a HAMP delinquent pool and a HAMP restructured pool. Collateral is located throughout the US with a concentration in FL.
Bid: June 17, 2014

$29.9 Million
High-yield performing loan sale secured by CRE located in CT. Collateral includes Class A office, multifamily, retail & parking.
Bid: June 19, 2014

$9.9 Million
Primarily non-performing loan relationships. Secured by 1st liens on single family residences, land, equipment, vehicles, office, retail building & storage facility. Located in NC & GA.
Bid: June 20, 2014

$70 Million
Non-performing loan & REO in Peru. The portfolio includes consumer loans, commercial & residential real estate and REO assets.
Bid : June 23, 2014

$800 Million
Non-performing single family loan sale containing 10 pools across 8 MSA's throughout the U.S.
Bid: June 25, 2014

Innovation. Experience. Results.

Stress Testing: Are You Ready?

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For the largest financial institutions, the tests can cost tens or even hundreds of millions of dollars, as well as thousands of hours of staff time.

The DebtX Solution

"DebtX offers fully outsourced stress testing to smaller banks at a fraction of the cost that big banks pay for CCAR and DFAST," Mercer said.

DebtX uses data aggregated from its 15 years of secondary market loan sales, with particular emphasis on data from the recent crash, to shape the parameters of clients' stress tests. Based on actual market experience, DebtX helps smaller institutions to understand the strengths and weakness of their balance sheet under a variety of scenarios.

Over the past year, DebtX has experienced increased demand for stress tests from government agencies, banks and life insurance companies.

"Larger institutions work with DebtX to execute more complex stress tests that manipulate multiple credit and market factors," Mercer said. "Smaller firms generally need to test two or three simple scenarios to demonstrate to their regulators that they have thoughtfully addressed risk and have an appropriate risk management plan in place."

Multiple Options

DebtX has the flexibility to conduct stress tests in a variety of ways.

In some instances, the stress test parameters are based solely on an institution's internally driven data. In others, the tests are developed collaboratively between DebtX and the institution. Stress tests can also be based solely on DebtX's recommendations and experience from the recent market crisis.

"Given that we lived through the crisis and have that stress testing experience, our financial institutions are very curious to see how well they fare," Mercer said. "The results are always illuminating and always helpful."

European Loan Sales Accelerate

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DebtX has identified three clear trends in the inquiries it has received from sellers in Europe.

First, a growing volume of loan sales is occurring because the seller has changed strategy. A number of large banks have elected to exit countries no longer considered core. A recent example is Danske Bank's sale of a large portion of the bank's Irish loan book.

Second, firms sell as they close out a fund. As an investment vehicle reaches the end of its life, the cost of maintaining the fund begins to overwhelm the assets under management. Depending on the fund's structure, an open sale to a third party is the only means to equitably establish value. A loan sale is a natural solution.

Third, banks are seeking to reduce their reputational risk. The banking industry is under increasing scrutiny throughout Europe. Foreclosing on hospitals, churches and other real estate exposes institutions to unwanted attention from local communities. This concern is magnified when the assets are related to consumer loans.

"Larger deals are being executed for strategic reasons, but an accelerating number of smaller deals are taking place as investors make tactical decisions," West said. "Loan sales are a terrific way to divest of certain assets to free up capital for other purposes."

For more information about DebtX's European loan sale capabilities, contact Gifford West, +1-617.531.3436, gwest@debtx.com.

Upcoming Conferences

SYMMS Advanced Risk & Portfolio Management Bootcamp
August 11-16, 2014
New York University
New York, NY

Thomson Reuters LPC Loan & CLO Conference
September 29, 2014
NY Marriott Marquis
New York, NY

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