Investors see return of NPL opportunities in 2H20, with potential price drop — Debtwire Webinar

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Banks and investors across the world are better prepared for the expected new wave of non-performing loans (NPLs) due to the COVID-19 crisis than during the 2008 financial crisis, said panelists involved in NPLs in Europe, the US, China and Europe on *Debtwire*'s live webinar *The New Global NPL Markets*, hosted last Thursday (4 June).

In the face of pandemic lockdown measures, sales of NPLs slowed down in the first half of the year and in Europe are now mostly frozen with just EUR 6.2bn in sales closed since the start of the year, according to the *Debtwire NPL Database*. But the panelists reported that some sales have held up, and that banks continue to face a problem of residual bad loans.

Completing loan sales will become even more relevant as the global coronavirus crisis is likely to cause European NPLs to reverse their downward trend, as reported. Meanwhile, China's commercial banks have overtaken European nations to hold the largest pile of non-performing exposures (NPEs) globally at USD 367.9bn equivalent, according to official figures as of 1Q20.

US bankruptcies

Edward I. Altman, Max L. Heine professor of finance at the Stern School of Business, New York University, predicted defaults and bankruptcies would reach crisis levels in the next two years in the US, and top records in some cases, citing his research, COVID-19 *And The Credit Cycle*.

In 2019, US had reached a new peak of corporate leverage with a non-financial corporate debt to GDP ratio of 47%. This followed the longest benign cycle in the history of modern leveraged finance market, Altman said, but there were "storm clouds on the horizon". Each of the three previous peaks was followed within 12 months by huge default rates in leveraged loans, coincident with a global recession.

Now, the Stern School of Business team forecasts a leveraged loan default rate between 8% and 9% in 2021, as of June 3, much higher than the long term average of 3%, but not reaching levels observed in 2009 (11%), or 2002 (9%).

The team expects large scale bankruptcies to reach particularly high levels. Of companies with liabilities of USD 1bn, there had been 27 bankruptcies this year as of 3 June. Extrapolated for the full year, Altman's team predict 63, the highest ever in the history of the bankruptcy system. For companies with liabilities exceeding USD 100m, they predict 192 bankruptcies in 2020, compared to a record 232 in 2009.

Compared to Europe, the key difference is that there is no moratorium on insolvencies in the US. He predicts the energy sector to be hit hardest, due to the falling price of oil, while retail, leisure

and entertainment will also be hit hard by lockdowns and decreased consumer activity.

European actions

Every country has approached the situation differently, agreed José Brena, global head of distressed asset solutions at UniCredit Group, Italy's largest bank. The two key measures of support for companies in Europe have been through loan moratoria and new lending schemes with direct guarantees from governments, he said. These measures have now peaked, however.

"We are in a lull right now, giving the companies time to settle in and waiting to move to the next stage," he said. "We are in the eye of the storm."

Applications for loan payment moratoria in Italy reached 2.4m for a total value of EUR 260bn, as of 22 May, according to a statement from Italy's ministry of economy and finance. However, Brena said that the number at risk of default is lower, and UniCredit is currently clustering businesses based on this.

While it is premature to specify losses, they are building the bank's resources in preparation. The top four Italian banks set aside EUR 2.6bn in loan loss provisions in 1Q20, compared to EUR 1.2bn in 1Q19, as reported. The top four banks in each of the UK, Spain, France, and DACH, set aside EUR 21.5bn in provisions, up from EUR 7bn in 1Q19, according to *Debtwire*'s analysis.

China's next NPL wave

In China, the new third wave of NPLs will not be as significant as its previous wave, said Ben Fanger, managing director at ShoreVest Capital. Estimates of "real" Chinese NPLs total up to USD 3trn, 10 times the official figure of USD 367.9bn. The estimated total includes "special mention" loans and distressed debt owned by the Asset Management Companies (AMCs).

Deleveraging is still in progess from the second wave , which began around 2015 as a result of a massive increase in lending after the credit crisis. Progress made in regulation, which forced banks to take writedowns and transfer NPLs to bank balance sheets or face fines, will stand the country in good stead, said Fanger. Forebearance means it will take some months for COVID-19 related defaults to be recognised as NPLs, however.

"The fact that China hasn't pulled back on recognition and sale of NPLs is a sign that it's manageable," he said.

A poll of audience members gave insight into market sentiment. There was a clear consensus on where attention would be focused in the next two years, with 62% of the 39 respondents saying Southern Europe, Italy, Spain and Greece. The UK, Germany and France polled at 26%, with the US following at 10% and South America at 6%. No respondents answered China or India.

"Why 0%?" asked ShoreVest's Fanger. "Because the audience is smart."

While China "dwarfs" the rest of the world in terms of transactions, he said, the main participants are local and international investors have yet to get a foothold. There have been immediate special

situations opportunities, but barriers remain. Language remains the biggest difficulty, and local capability is required to cherrypick enforceable loans.

"When there's a global crisis, everyone headquartered in the US or Europe leaves China," he said. "You can't press buttons and make money safely."

New NPL market activity

Asked when NPL portfolio sales will pick up again, 44% of the 48 respondents said 4Q20. The audience was split though, with 40% answering 1H21, and the rest 2H21.

"We never stopped," said UniCredit's Brena. "For us, nothing has changed."

The bank's six-year NPL reduction programme always seeks the best return for a given portfolio between two strategies, disposal and use of a recovery platform, Brena said. Disposals have made up the bulk of the reduction so far. The bank has five portfolio sales planned and ongoing, with a total gross book value (GBV) of circa EUR 6bn, according to the *Debtwire NPL Database*.

While investors generally have hesitated, the bank's core, largely Italian, investors are seeing the situation as an opportunity, said Brena. With less competition, appraisals are realistically lower but the bank won't sell at prices that don't reflect recoveries, he said. The bank remains committed to its previous target of closing its non-core business, by the end of next year, he said. It totaled EUR 8.1bn of NPEs as of 1Q20, according to the bank's earnings report.

"Where we can find meeting of minds, we will dispose," he said.

Continued investor interest has exceeded expectations during the crisis, agreed Bliss Morris, CEO of First Financial Network (FFN), a digital loan sale platform.

"If I was to project the number of transactions we have been able to successfully execute during this time, I really would not think it would have happened," she said.

On FFN, a large US portfolio was sold in mid-March, with pricing holding up. She was involved in preparing another mixed performing and non-performing portfolio for one of the money centre banks in the US. The portfolio was nationwide, but FFN segregated North-Eastern loans as the virus was spreading very quickly in several states. Over 100 companies were cleared to participate, and the only assets where there was a measurable difference were C&I loans secured by soft collateral.

FFN has also accepted an offer for a large asset in Ukraine, where the Deposit Guarantee Fund, the liquidator of failed banks, was reaching the end of its legislated timetable for selling. A seller in Spain did put a sale on hold, however.

Most participants in the webinar survey (63% of the 41 who answered) expected relatively small decreases in price, up to 20%. More substantial reductions of 20%–40% were expected by 27% of respondents, followed by a mere 10% who expected them to stay the same.

NYU Stern School's Altman pointed to historical research which demonstrates an "obvious" truth that there is a negative correlation between defaults and prices, because an increase in supply naturally leads to reduced prices.

Investors, though, have certainly prepared for the opportunity, agreed Altman and Morris. Not only have they built up dry powder" in anticipation of the next crisis, but they are also now in the market raising "huge amounts of capital", said Altman.

Click here to listen to the recording of the webinar.

by Amy Finch

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