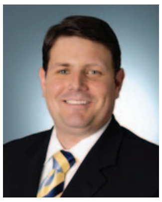
# SECTION 3

## SPECIAL WHITE PAPER

# Investing in Distressed Assets in Europe



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**For the better part of the last two years, the European market has been operating under a cloud of uncertainty; the uncertainty of a European sovereign default, the uncertainty of contagion spread to other economies throughout Europe, the uncertainty of the European Monetary Union viability, the uncertainty of a banking system under Basel III (the increased amount of the capital reserves that banks must hold to absorb potential losses). These uncertainties and others have contributed to an increased interest in distressed investing in Europe.**

### DEFINING THE DISTRESSED INVESTING OPPORTUNITY

Investing in distressed assets is one of the more exciting investment disciplines. These assets are generally defined as having either rates of return in excess of 1,000 basis points above similar tenured risk free assets, or operating under varying degrees of default.

We define attractive distressed investments as requiring the following four characteristics: (1) the investment opportunity is driven by cyclical or episodic dynamics, (2) the value proposition is generally asymmetric, with the asset having more upside potential than downside risk, (3) the asset carries risk that stems from one or more events that create uncertainty, and (4) extracting the value opportunity involves significant process oriented expertise. Although these characteristics generally accompany a spread of 1,000 basis points or more, it is not one of our requirements, particularly in today's environment of historically low interest rates. When you consider the current swap curve as a proxy for the risk free rate, a spread of 1,000 basis points barely equates to a yield of 11 percent.[1] We believe, due to the significant and varied sources of uncertainty, the risk associated with a distressed investment warrants a return well in excess of 1,000 basis points over a risk free rate.

The first characteristic is the opportunity that is driven by cyclical or episodic dynamics. The market generally follows the business cycle; however, business cycles vary across geographies and across time. Therefore, we also believe that the opportunity will likely be episodic by nature, meaning the opportunity will exist for a moment in time due to unforeseen systemic or structural impediments to "business as usual." In the market today, we are experiencing significant changes to the banking regulatory frameworks of both the U.S. and Europe. We are also in a period of a historically active Central Bank both in the U.S. Federal Reserve System and the European Central Bank, both of which are using their respective balance sheets to inject liquidity into lending markets and to stabilize a fragile banking sector. These dynamics have increased market uncertainty and contributed to distressed pricing of assets.

The value proposition of the second characteristic of distressed investing is that the asset is priced at a level that creates a risk adjusted return expectation that is positively asymmetric. This asymmetry provides the buyer with an opportunity to work through the idiosyncratic issues, which is driving the distress but also protects the buyer from any combination of negative events that may or may not be avoidable. One source of asymmetry occurs when the seller of the asset is motivated by a non-economic or structural need to exit the investment. These needs include limits on holding assets below a certain rating category, opportunity cost of capability related to the work out of the asset, and other governing issues, including regulatory necessitated sales to meet certain capital ratios. Quite frequently the sale price declines below the intrinsic value of the asset, which contributes to the asymmetry. Basel III creates a structural need for institutions to work out or sell non-performing assets on a strict timeline rather than on an economically opportunistic basis, which may lead to a longer duration to the opportunity. A key driver of the supply of distressed assets has been a recovery in bank earnings because as earnings have improved, largely due to the low interest rate environment driven by the U.S. and European Central Banks, the equity charge of an asset reserve to a market clearing price has been absorbed and the selling institution remains within regulatory compliance.

Distressed investing is an event driven strategy. The typical events include debt repayments and interest payments, pressures from looming covenant and governance controls, and declining cash flows due to market dynamics and/or supply chain disruptions. This third characteristic provides several decision nodes including buy/sell decisions, reorganisation related decisions, and recapitalization decisions. In Europe, we are currently experiencing new decision nodes or events including the roll out of Basel III, which will begin affecting bank balance sheets during the early summer of 2012, could create an opportunity for well-positioned buyers. The recent pressures on bank stocks have made increasing liquidity and improving regulatory constraints through public or private equity transactions onerous and expensive to the existing shareholders. In

*[1] Source: Euriobor. As of February 17, 2012, the 2 year Euro swap rate was approximately 1.2 percent. We assumed a 2 year to reflect a reasonable period to work out the distressed asset.*

lieu of growing the equity cushion, bank management teams have attempted to shrink their balance sheets through a combination of asset sales at or near reserve value, and most recently, through accessing the ECB's Long Term Refinancing Operation (LTRO). LTRO was established in December 2011 to provide approximately €650 billion of liquidity to the banking sector and is similar to the Troubled Asset Relief Program of the Federal Reserve. The effect of these events is that asset sales have typically been at prices that are less interesting to distressed investors or involve assets that are atypical to the standard fund.

The final characteristic we consider of importance is the process orientation of the work out of the investment. Pre-arranged and pre-packaged bankruptcies or out of court restructurings have historically dominated the distressed investing universe. These types of restructurings involve a number of levers that are pushed in order to create a negotiated resolution. The current asset restructurings have been more largely related to working out non-performing loans including those collateralized by residential and/or commercial real estate assets. Due to the real estate component of the asset, a familiarity with local legal structure and customs is critical. In addition, sensitivity to local norms and social preferences is also extremely important. In evaluating the asset, another important quality is a thorough understanding of local market dynamics. Due to these and other unique qualities necessary to construct a beneficial resolution, many restructurings today must include a measure of localism. The need to have a firm grasp of local dynamics and incorporating that grasp into the analytical and reorganisation processes is unique in the context of history as most distressed investments have involved corporations and syndicated loan reorganisations which tend to be less about the unique local characteristics and more about the country and organisation characteristics.

## CURRENT OUTLOOK

The current market environment is plagued by distressed characteristics. As previously mentioned, the macroeconomic and socio-political environment of Europe has created a huge amount of uncertainty and perceived risk. Additionally, the regulatory reforms of Basel III, which is part of a reaction to regulatory reform following the global financial crisis of 2008 and beyond, present significant hurdles for stressed financial market participants in a period of great uncertainty. The potential for a robust pipeline of distressed opportunities exists.

In order to quantify this potential, Siguler Guff reviewed many analyses of the European market and believes the current market of distressed assets is estimated at €1.5-2.5 trillion, which will be liquidated or sold over the course of the next few years. For example, the Institute for International Finance has recently suggested European banks will need to reduce their balance sheets by 5% or approximately €2 trillion. In a recent research piece, J.P. Morgan estimated the deleveraging potential to be approximately €1,993 billion.[2]

The magnitude of the potential market has attracted significant interest from the investing community. Siguler Guff estimates approximately €15 billion has been raised by funds and allocated from existing pools to attack this opportunity and an additional €15 billion has been targeted by fund managers. From a simple supply-demand perspective, the demand does not appear to be enough to offset the potential supply, which presents a compelling distressed investment thesis as prices should decline.

We, however, have been very cautious to enter into the fray. Although the size of the market may be significant, the poor clarity on the speed with which the banks will sell concerns us as government intervention may relieve pressure to make immediate asset sales. The LTRO affords the financial institutions the ability to raise capital by contributing an asset as collateral to a three year loan at an extremely low interest rate (circa 1% per annum). The proceeds from the loan are then available to lend, a form of quantitative easing. Despite a series of valuation reserves to the assets accepted by the ECB under the LTRO, in effect, the approximately €650 billion facility is akin to a very large buyer of assets at prices well in excess of those desirable to a distressed investor. In addition, a second LTRO is likely in the near future as the ECB continues to grapple with the potential looming Greek government default and the repercussions. A second and larger LTRO could rebalance the supply-demand equation and provide the seller more flexibility, which has a negative effect on a distressed market.

As the banks repay short term (less than one year) funding with three year debt, they are provided a longer runway to work out the assets themselves. Despite the significant programmatic sellers (due to the establishment of bad banks), we believe the speed with which these assets will come to market has slowed. In addition, the runway the banks have received from the ECB provides them more time to earn their reserves, which may create a more organised transaction market that grows over the next few years. The types of assets on the balance sheets of these stressed financial institutions vary and require a greater understanding of local dynamics and more care in the politics of the resolution, which may provide greater desire by the institutions to retain control of the resolution process.

Distress is an adjective that describes a market condition in which, either due to economic conditions or structural limitations, an asset is valued at a significant discount to intrinsic value. Distressed investing today involves a broad array of asset classes and/or types including (1) corporate debt and equity, (2) structured credit transactions, and (3) real estate assets. Within these and other asset classes are significant opportunities to generate equity like returns with positively skewed asymmetric risk-adjusted return profiles. The current market climate in Europe creates many of the characteristics we look for in a distressed market opportunity, but the socio-political climate is clouding the visibility of this opportunity. We are cautiously optimistic about what we perceive to be a significant distressed market in Europe, but remain sensitive to timing. Today, the market is more about "when" and less about "if."

[2] *The Great Bank Deleveraging, JP Morgan European Credit Research, November 4, 2011*