AUXADI

INSIGHTS

Distressed real estate investments and opportunities in NPLs

Luxembourg and Southern Europe

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1. Post-COVID opportunities in Southern Europe

There's no denying that COVID halted the world however with market activity back on the rise there are a lot of opportunities on the horizon, especially in Southern Europe. The real estate sector and, more specifically, private equity, Real Estate Investment Trusts (REITs), sovereign wealth funds, institutional funds, family offices, and investment service groups were all notably impacted but are now on the lookout for new global investment opportunities.

But, it's not going to be easy. Real estate portfolios with commercial, residential, and hospitality assets are facing a particularly challenging period. As vaccination advances and surpasses 70 % of population, some questions remain: Will bans on international travel and tourism be lifted? How long will hotel occupancies be COVID affected? How long will markets be affected by COVID? How long will construction be affected? These types of questions emphasise the uncertainty that still remains in the real estate sector.

NPL and Non-core Loan Deals by Year

Source: Debtwire NPL Database

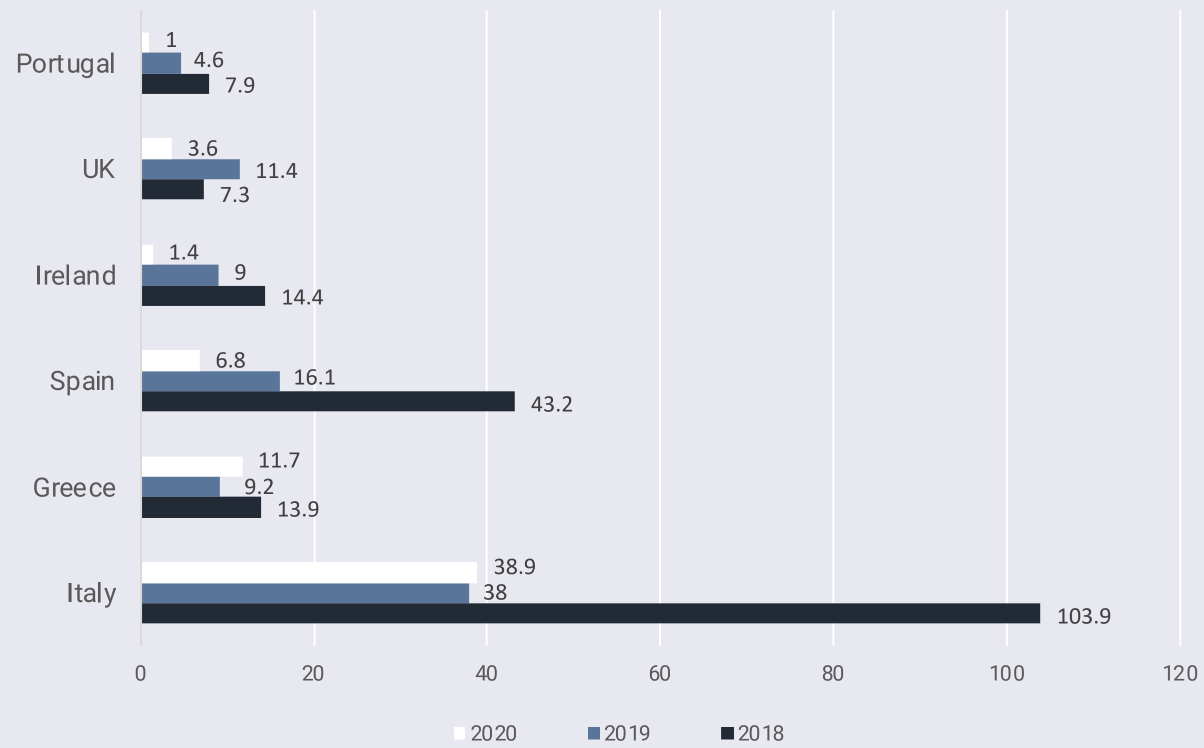
Over the last few years, the real estate sector has been considered a conservative investment. Non-Performing Loans (NPLs) and Real Estate Owned (REOs) opportunities provided optimistic prospects for short- and medium-term investment.

Looking at a post-COVID economy, **NPLs and REOs are an interesting alternative** and could prove to be a cornerstone for professional investment services.

Though acquisitions of NPLs available on banking portfolios have stirred the appetite of European and American investors, it's important to note that this isn't a new trend. NPL transactions have been gaining increasing traction in Europe, especially after the financial crisis. The main expansion was in the Iberian market, between 2016 and 2019, when Gross Domestic Product (GDP) recovery invited a second wave of investors to the market. It's also worth noting the role that Southern European countries play in terms of NPLs. Countries such as Portugal, Spain, Italy, Greece and France are markets where the weight of NPL assets in the portfolio have been historically high; exceeding 10% in most cases, and breaking the 40% barrier in Greece between 1998 and 2019, according to data from NPL Markets.

In this white paper, we present an analysis of the trends taking place in Southern Europe and the opportunities NPLs present for investors, with Luxembourg as the preferred vehicle to structure NPL transactions.

Non-performing loans and non-core sales (EUR bn)



Source: Debtwire

2. An emerging trend from 2008 Global Financial crisis…

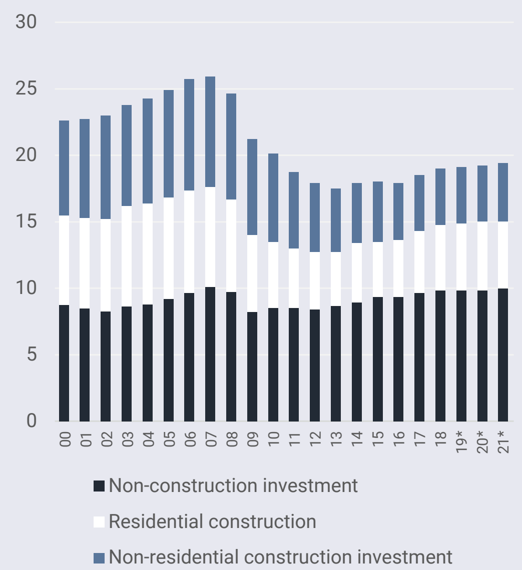
Pre-2011, the Iberian market witnessed major investments in real estate, most of which engendered incredibly high debt. The financing of this debt was mainly absorbed by the local banks with a Loan to Value (LTV) of more than 85%, and in some cases reaching an LTV ratio of 100%. This real estate indebtedness and its concentration in the local financial sector in Spain and Portugal (as well as other close countries like Italy and Greece) were the main reasons for the large number of NPL transactions occurring in the following years.

When the financial crisis hit Southern Europe in 2011/2012, borrowers began to default on their loans, leaving the local banks with a huge volume of NPLs on their balance sheets. To recover their positions and improve liquidity, these local banks were willing to reduce their positions on NPL portfolios. In fact, they didn't have much choice. The expansion of the NPL market in Spain and Portugal since has proven to be an attractive position for investors.

As time has passed, the Iberian market has become more sophisticated, following in the footsteps of other countries, like Ireland for example. Portfolios are packaged according to the type of underlying assets, to attract specifically targeted investors.

Spain - Investment rate %of GDP

Country Report Spain 2020 (European Commission)

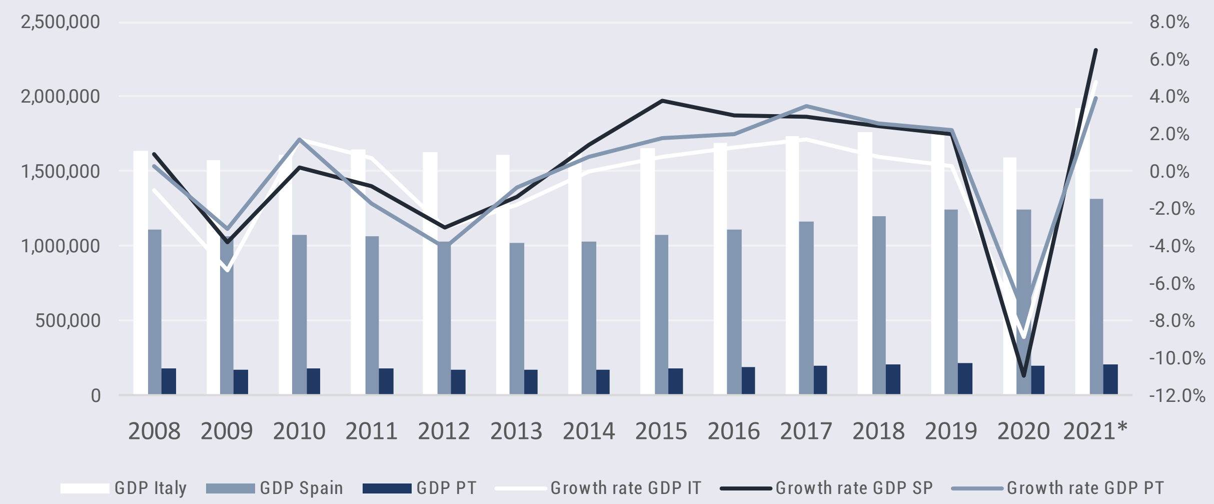


"The expansion of the NPL market in Spain and Portugal since the financial crisis, has proven to be an attractive position for investors."

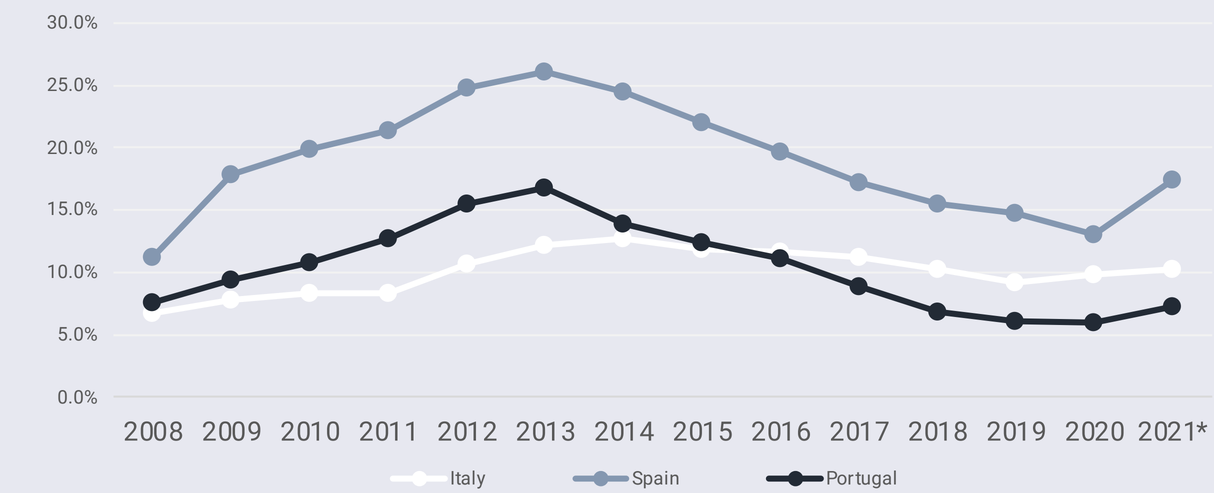
The value of these portfolios depends on the size and characteristics of the debt being sold (for example, the age of the loan, the percentage of secured or unsecured debt, ratio between personal or commercial debt, location, etc.).

In 2017, around €50 billion of NPLs were sold in Spain. 2018 saw a peak, with a record €60 billion in NPL transactions, which decreased to €22 billion in 2019. Portugal, although a smaller market, also had a significant amount of transactions; around €8 billion in both 2018 and 2019. NPLs are even more substantial in Italy, with investment reaching €103 billion in gross book value in 2018, according to data from Debtwire. Greece registered €13.9 billion in the same year.

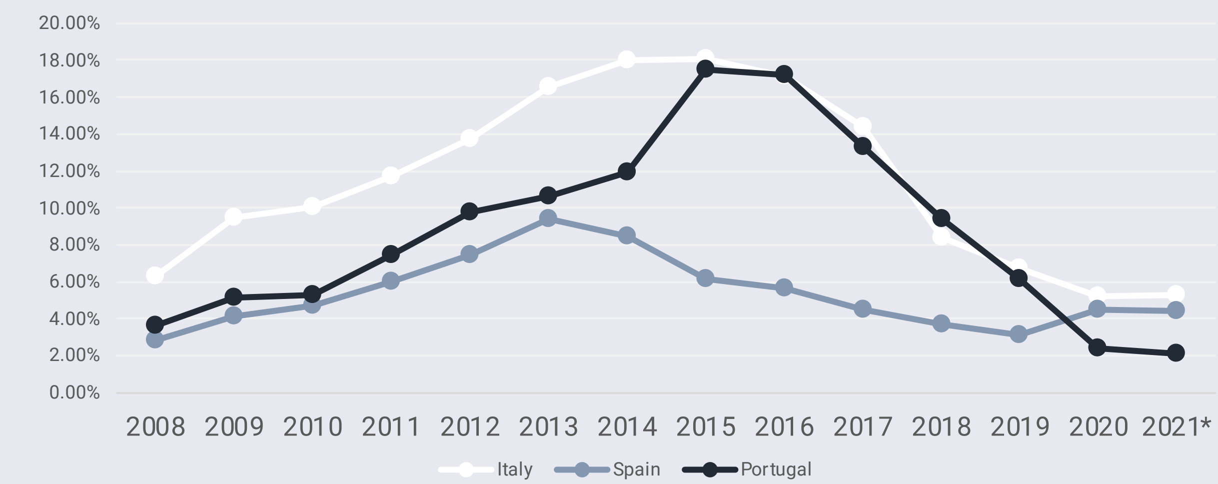
GDP and growth rate GDP



Non-performing loans as percent of all bank loans



Unemployment rate



3. Outlook

All these factors, details, and events predicted a dynamic trend for NPL transactions in 2021, with banks disposing of their most critical assets.

COVID resulted in a significant drop in economic activity in most countries during the months of March, April and May 2020. Some had reduced activity in June, though some reactivated their tourism sector and saw small gains, before the 'second wave' of the virus. Although the situation triggered support measures by both government and central banks worldwide, it has inevitably impacted the growth projections of many economies.

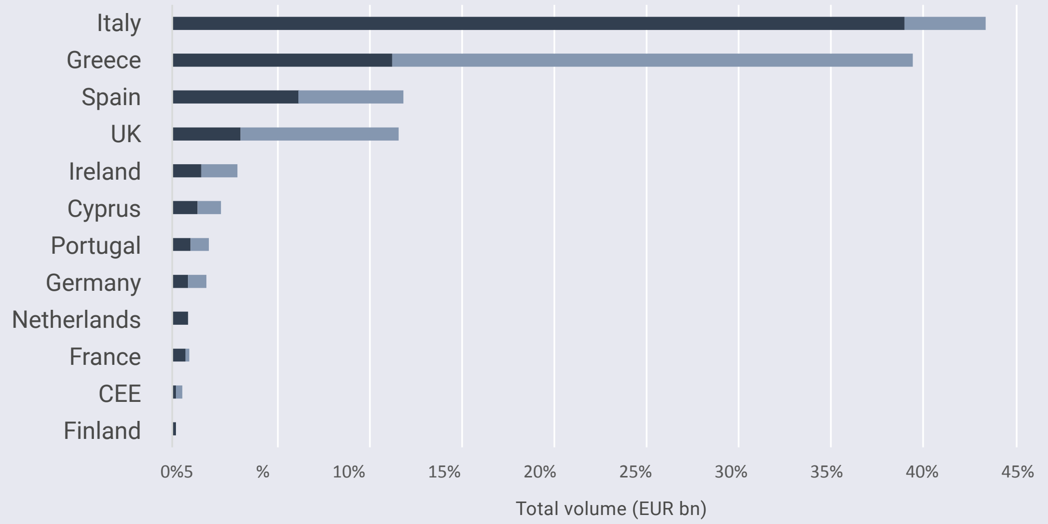
Whilst the true consequences of the pandemic on the real estate sector and NPL activity are yet to be realised, it's encouraging to note that the International Monetary Fund (IMF) predicts a faster recovery than what the industry experienced following the financial crisis.

Bearing in mind that all previous viral pandemics (1918; 1958; 1968; 2002) had a V-shaped economic cycle curve, it's reasonable to believe that the same will happen with COVID. There's also reason to expect that the Iberian market will react with a similar recovery time vis-à-vis their European counterparts, since all are in similar circumstances.

For the real estate sector, the long-awaited normalisation of prices (already considered "quite heated" pre-COVID) should follow when activity resumes. The current slowdown in demand is considered artificial and temporary, and buyers are expected to return to the market, though with more caution – which will impact the pace of price increases.

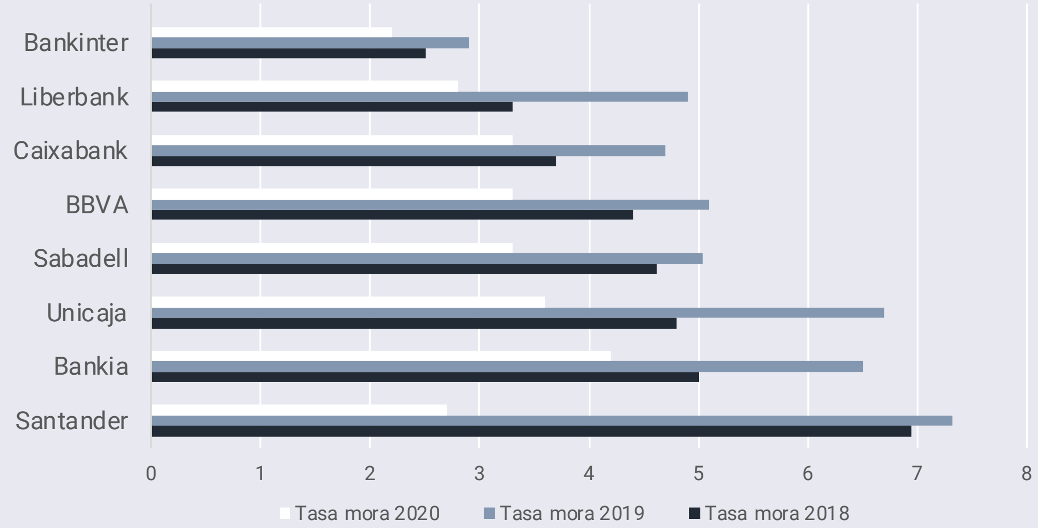
Similarly, NPL transactions will feel the effects of the pandemic, with the postponement of transactions and due diligence because of closures and backlogs in judicial procedures. Many economists and financial advisors predict a strong market response once the current economic slowdown is over.

Ratio of NPLs and opened deals as of Dec. 2020



Source: Debtwire NPL Database

Spanish bank default. Ratio 2018 /19



Source: 'EU-wide transparency exercise Dec 20'

Governments are relying on regulatory measures to support individuals (especially vulnerable ones) impacted by the crisis, mainly by providing moratoriums on loans and lease payments, securing basic supplies, restricting evictions, and suspending judicial proceedings. The expected result of these regulations is a delay (and possible collapse) of proceedings post-crisis. Naturally, this will force investor models to be reviewed thereafter.

For corporations, some governments have focused mainly on extensions to tax payment deadlines and obligations, measures for temporary staff furloughs, and providing credit lines of up to 80% with government agency guarantees. All of which makes them less likely to be part of the NPL portfolios put into the market.

Despite the government measures in response to the pandemic, greater credit risk and defaults are likely to increase the volume of NPL portfolios in the market. Unlike the previous credit crisis, though, it's expected that NPLs from viable businesses will be put into the market due to liquidity, also increasing regular asset transactions.

4. When will normality resume?

Settling in the market will take time, but the industry is starting to reboot as lockdowns ease. The pandemic has invariably affected the functioning of the judicial systems, delaying NPL transaction activity, however, there are at least two key factors that will help speed up recovery.

EU ambassadors confirmed on June 2021 a provisional agreement reached between the Council presidency and the Parliament on a new directive harmonising rules for credit servicers and credit purchasers of non-performing loans issued by credit institutions. The Parliament and the Council are expected to adopt the directive after legal-linguistic revision. After it is signed and published in the Official Journal of the EU, the text will be transposed into national law within 24 months of the date of entry into force. The directive standardises the rules for credit servicers and credit purchasers across the EU and facilitates the sales of non-performing loans, including across national borders, while ensuring that borrowers' rights are not hampered in the process.

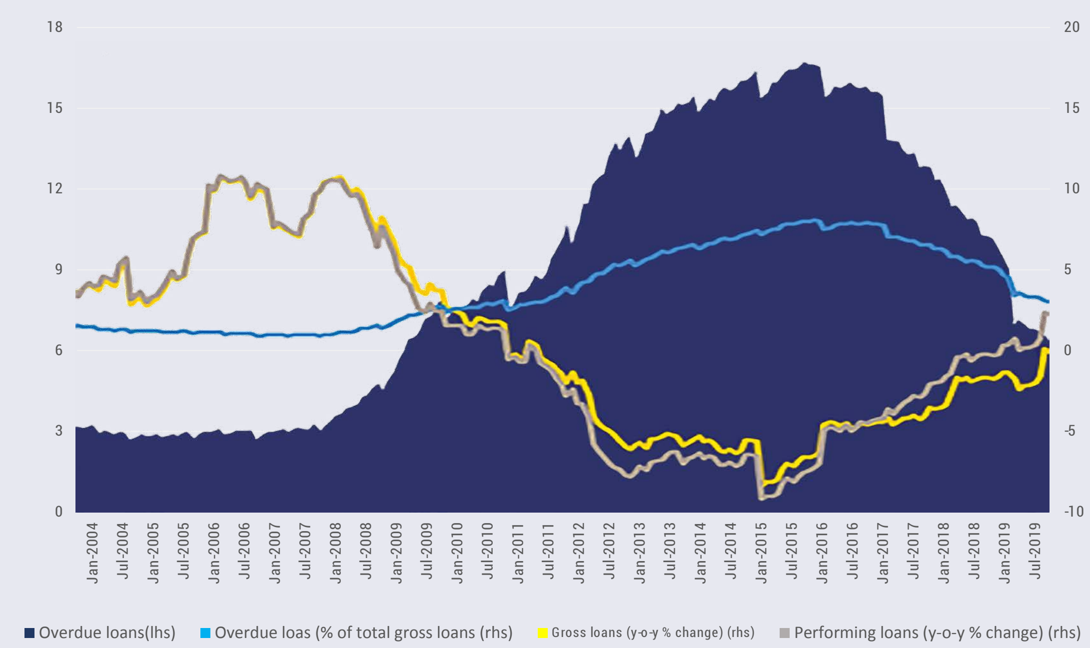
Secondly, given the impossibility to meet the investment KPIs defined by firms, and given the economic situation we're experiencing, it's predicted that banks will get rid of their non-strategic balance sheets – transferring them to more specialised players or those who simply want to offset losses caused by the standstill in the market.

The strategy and opportunity these specialised players will have on the Southern European market (whether from the acquisition of new portfolios or mergers), particularly for Spain and Portugal, are expected to continue structuring through the incorporation of SPVs using Luxembourg holding vehicles.

Indeed, investments in distressed debt are an important market, which has soared over the last decade in Luxembourg, contributing to the Grand Duchy's success as a prime location for the structuring of alternative investments within Europe. Over 85% of the top 30 debt fund managers worldwide are present in Luxembourg.

The country offers an unparalleled breadth of solutions for debt structuring, including debt origination and direct lending. Placed at the geographic heart of Europe, Luxembourg is ideally positioned to help global debt funds deal with the complexity of European financial market rules and regulations (including distribution, global marketing, banking regulations, etc.).

Portugal – Loans performance



Source: Country Report – European Commission

5. Extended structures for NPL acquisition through Luxembourg

Luxembourg's legal framework offers a range of options when it comes to the organisation of distressed debt and asset investments. Structures can be via many different entities, including companies, securitisation vehicles and fund vehicles, or a combination of these.

Sponsors and asset managers benefit from quick setup and flexibility of all these solutions, as most of the structures are based on unregulated companies and funds. These advantages significantly decrease the time and initial investment needed to setup.

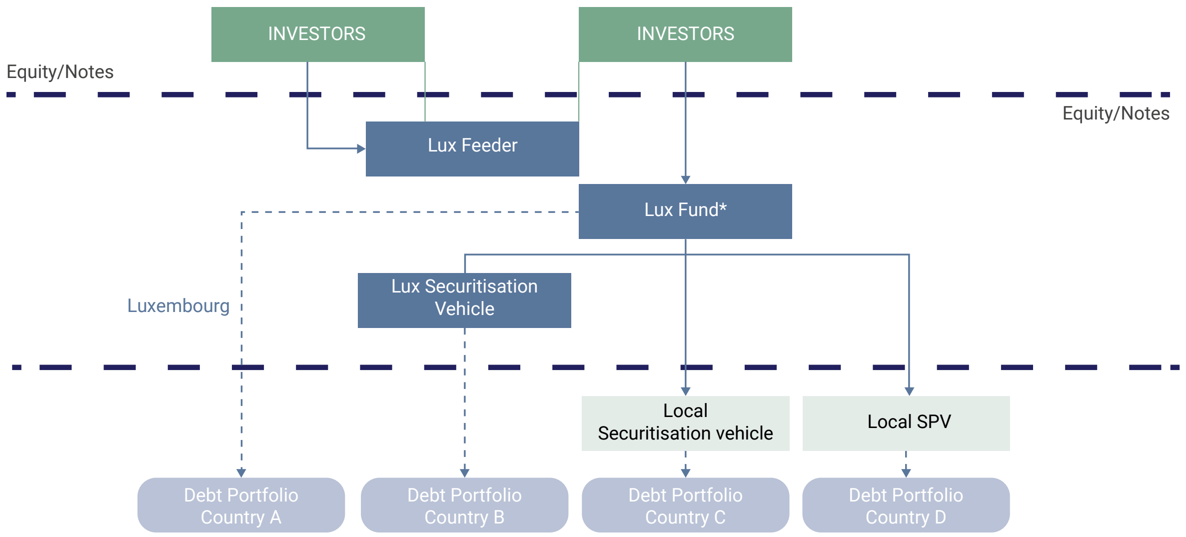
When investments are made via a Luxembourg holding company, the fund usually finances investments largely with debt instruments that bear interest. It's, therefore, important that the Luxembourg company realises an "arm's length" remuneration for its investment activities. Key to running a successful investment structure through Luxembourg is an appropriate determination of an "arm's length" interest rate and the broader subject of transfer pricing research and documentation.

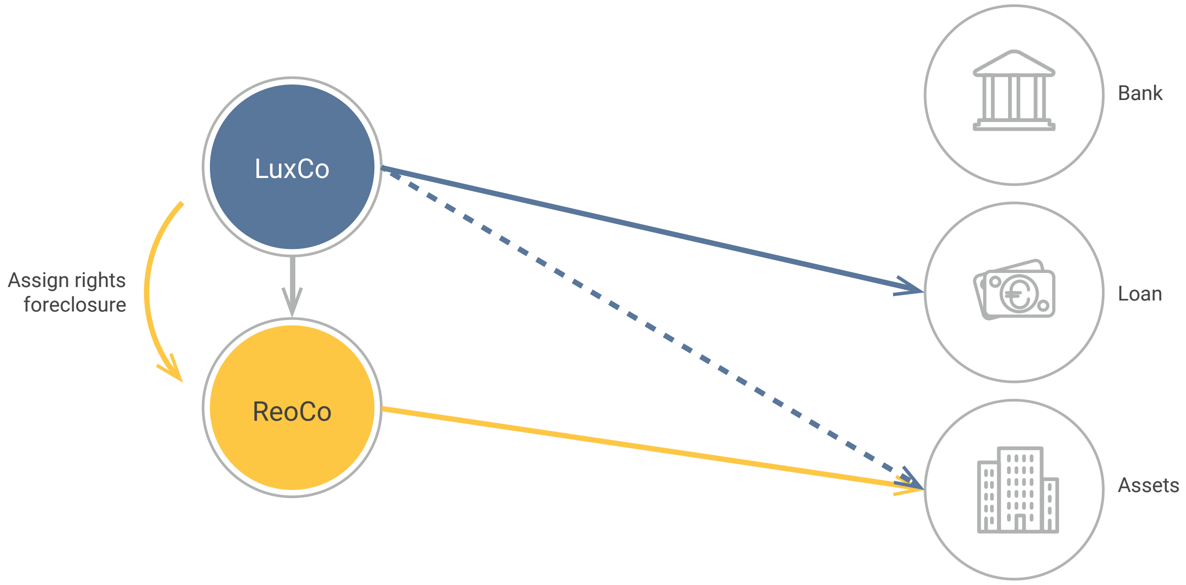
For example, in the case of a Luxembourg securitisation company, securities are issued to investors and the funds subscribed are utilised for underlying investments. The commitments made by the securitisation vehicle to the investors may correspond to the net income derived from the investment portfolio. In other words, the securitisation company doesn't need a taxable income. Debt instruments issued by a securitisation vehicle to its investors are often classified according to the expected investment return and cashflows, therefore different note classes bear different interest rates, and repayment priorities vary depending on the legal documentation.

As from 1 January 2019, Luxembourg Income Tax Law (LITL) limits the deductibility of "exceeding borrowing costs" generally to a maximum of 30 percent of the corporate taxpayers' earnings before interest, taxes, depreciation and amortisation (EBITDA). (LITL Article 168bis)

This interest deduction limitation rule encompasses all interest-bearing debts in its scope, irrespective of whether the debt

Example of a typical debt funds structure





financing is obtained from a related party or a third party. Exceeding borrowing costs up to an amount of €3 million (US$3.442 million) may be deducted without any limitation (which provides a "safe harbour" provision). Corporate taxpayers who can demonstrate that the ratio of equity over total assets is equal to or higher than the equivalent ratio of the group can fully deduct their exceeding borrowing costs (the so-called "escape clause").

One of the extended options has been creating a Securitisation Vehicle (SV) for a distressed debt portfolio located outside of Luxembourg, using a local SV. The key facts related to this are:

- An SV can be used by Alternative Investment Fund Managers (AIFMs) to implement a distressed debt strategy.
- The portfolio can consist of various types of loans and ancillary assets, including: drawn loans, equity stapled to some loans, some undrawn commitments, revolving loans, and cash.
- The SV finances and secures the risk linked to the acquisition of the portfolio, through the issuance of notes and equity subscribed by its shareholder.

Another widely used option is to setup a Luxembourg-based unregulated investment fund; a RAIF-SICAR. The advantage of this particular fund over its competitors is the fact that it's unregulated, easy to setup and, once the risk capital conditions are met, the fund is only subject to annual 0.01% tax on its net assets (it should be noted that investments must be exclusively in risk baring assets, like distressed debt). In terms of investor comfort, the fund initiator has to appoint a local AIFM as well as a depositary bank, independent administrator, and auditor – who make sure the fund meets all the requirements related to investment even though it's unregulated.

A RAIF fund can also be quickly marketed by its AIFM to professional investors in all European Union member states, using the marketing passport.

6. Applying past lessons to the future

Although, as the expression goes, past performance doesn't guarantee future performance, it's true that there are a lot of lessons from the financial crisis in 2008 that we can apply to the current situation. In this case, we can try to predict how the NPL sector will develop.

European Central Bank presented Research Bulletin N. 71, outlining some lessons learned during the 2008 crisis for NPLs.

The document states that "compared with the 2008 crisis, some factors are conducive to NPL resolution this time: banks have higher capital, the forward-looking IFRS 9 accounting standards can help NPL recognition, and COVID was not preceded by a credit boom. However, other factors could make NPL resolution more challenging: government debt is substantially higher, banks are less profitable, and corporate balance sheets are often weak."

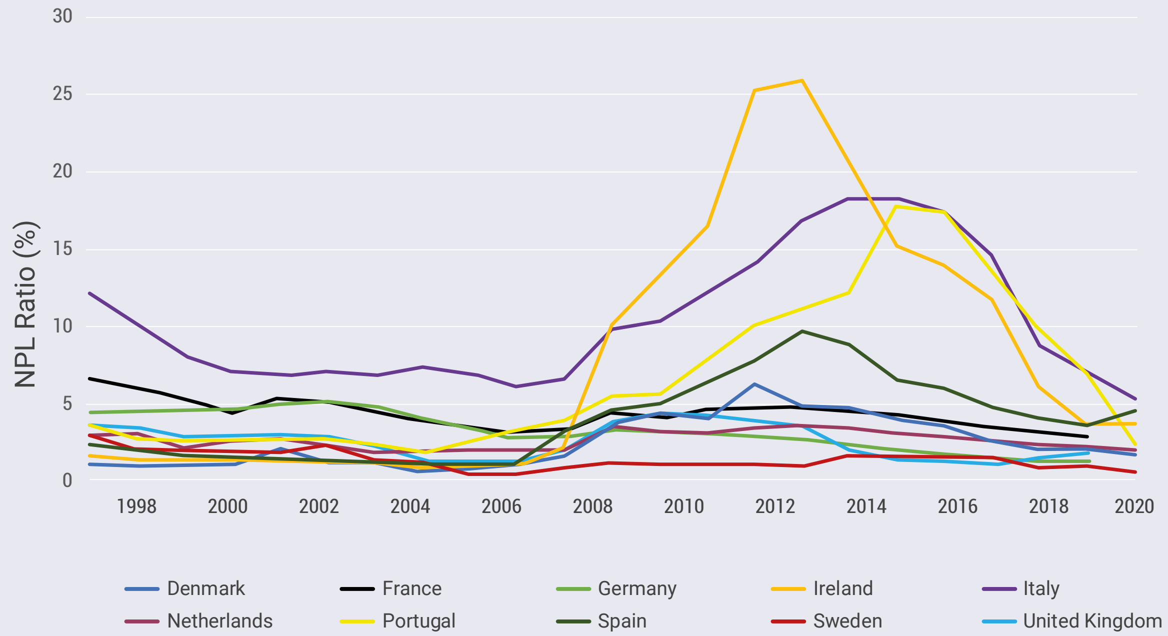
Regardless of the similarities or differences to past situations, the NPL sector will be the one to focus on in the medium term.

ECB Supervisory banking statistics

	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
Number of significant institutions					
Full sample 1)	112	112	110	112	114
Liquidity sample 2)	112	112	110	112	114
Balance sheet composition (EUR billions)					
Total assets	23,991.82	24,430.69	24,357.08	24,193.20	25,218.12
Total liabilities	22,468.31	22,914.68	22,835.86	22,659.39	23,655.17
Equity	1,523.51	1,516.01	1,521.22	1,533.81	1,562.95
Key performance indicators (percentages)					
Return on equity	1.21%	0.01%	2.12%	1.53%	7.21%
Cost-to-income ratio	72.44%	67.61%	65.50%	66.03%	64.69%
Cost of risk	0.66%	0.70%	0.64%	0.67%	0.64%
Capital and leverage ratios (percentages)					
CET 1 ratio (transitional definition)	14.42%	14.89%	15.20%	15.65%	15.49%
Tier 1 ratio (transitional definition)	15.64%	16.13%	16.50%	16.98%	16.77%
Total capital ratio (transitional definition)	18.10%	18.66%	19.04%	19.55%	19.34%
Leverage ratio (transitional definition)	5.36%	5.33%	5.63%	6.01%	5.70%
Leverage ratio (fully phased-in definition)	5.23%	5.16%	5.46%	5.83%	5.56%
Asset quality (percentages)					
Non-performing loans ratio	3.05%	2.94%	2.82%	2.63%	2.54%
Level 1 as a share of total assets 3)	6.97%	7.24%	7.08%	6.77%	7.14%
Level 2 as a share of total assets 3)	15.42%	13.90%	13.65%	13.47%	13.01%
Level 3 as a share of total assets 3)	0.96%	0.87%	0.82%	0.81%	0.82%
Funding (percentages)					
Loan-to-deposit ratio	116.04%	110.81%	108.32%	106.72%	106.07%
Liquidity (percentages)					
Liquidity coverage ratio	146.47%	165.41%	170.83%	171.68%	172.73%

Source: European Central Bank

Historical NPL ratio



About the authors

Rima Yousfan
COO / CFO

Rima is Auxadi's COO and CFO. Her responsibilities include managing operations, leading our team of +350 consultants, ensuring consistency on execution across regions, closely monitoring client satisfaction. Rima holds an Economics degree from the University of Barcelona (2001), received ICAC certification in 2006, and an Executive MBA from *Centro de Estudios Financieros* in 2008. She undertook postgraduate studies in Tax Advice at IE Business School and the LPSF at Harvard Business School in 2010. CPA by AECA. Rima is currently on the board of the PLD Program at Harvard Business School. She speaks English, Spanish, Catalan and French.

David Luksenburg

David Luksenburg has more than 15 years' experience in the corporate and investment funds industry, with particular focus on alternative investments and providing management services to Real Estate, Private Equity and Funds of Funds investors. Working closely with Auxadi, David is co-founder of a Luxembourg corporate services and advisory firm specialised in Alternative Investments, Vehicle, and Technology companies. He was previously the Conducting Officer of a Value Investment management firm in Luxembourg. David has an MBA from HEC-Liège, as well as an INSEAD MBA (2010).

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