

Two approaches to the art of the loan sale: loan sales are not M&A

BY GIFFORD S. WEST

The barriers to liquidity for sales of illiquid loans have all but collapsed in the US and are collapsing in Europe and an increasing number of Asian countries. This fundamental shift in liquidity is being driven by a growing volume of loan sales being executed for both individual and portfolios of non-performing and performing loans. In this new era of liquidity, US banks are auctioning individual loans with face values as little as \$500,000 and as large as hundreds of millions of dollars. In Europe, sales of large portfolios of non-performing loans by German and Italian banks are becoming commonplace. These sales are playing an important role in restructuring the balance sheets of financial institutions worldwide.

The expanding number of loan sales, powered by efficient new trading exchanges, is creating significant new opportunities for asset management. By bringing liquidity to assets previously thought illiquid, institutions are increasing profitability, reducing risk and spending more time on productive pursuits, such as making additional loans, instead of on workouts. Moreover, many of the traditional loan sale functions that previously absorbed a significant amount of management time and expense are no longer necessary because online pricing, due diligence, trading and closing have streamlined the process dramatically.

As banks explore this liquidity for the first time, it's essential that sellers understand the two competing deal approaches. These are: 1) The negotiation intensive M&A style and; 2) The streamlined auction process. The M&A approach is management intensive, and its success (from the seller's perspective) is heavily dependent on the negotiation skills of the deal team. The auction approach depends on the ability of the bank to deliver data clearly and generate a critical mass of bids.

Five myths drive banks towards the M&A approach. The purpose of this article is to identify these myths and help sellers understand that, under most circumstances, the more productive approach to selling loans is through competitive auctions.

Myth 1: "A bilateral sale is faster, more discrete, and leads to a better price"

In almost every instance, sellers of smaller portfolios realise higher proceeds on better terms through a sealed bid exercise. Bilateral sales, while arguably more discreet, result in inferior terms.

Sellers adopt the bilateral approach because they frequently believe that the buyers are obvious, their bids will be similar, and that the art of the deal is in negotiating the Asset Sale Agreement. The seller may pride itself on its negotiation skills. On first assessment, the bilateral approach

seems like the obvious one.

For very large sales, the universe of buyers may be obvious. But as the projected proceed level goes below the \$100m level, the universe expands, and the best buyers may not be clear-cut. The buyers that have been featured in recent deals may be swamped by the logistics of handling their existing deal flow, and may be more discriminating. Buyers that have been shut out may be more aggressive.

Similarly, bids on any one NPL transaction tend to have a wide standard deviation. Valuation assumptions vary, different buyers have different strategic objectives, and access to relevant third party information may not be widespread. A wider net, within reason, is likely to result in higher proceeds.

NPL buyers negotiate Asset Sale Agreements on NPLs for a living. Most banks execute a NPL sale on an extremely infrequent basis. In a bilateral sale, the best terms the seller will see are on the day they receive the initial bid. From that moment on, the terms will degrade as the buyer runs down the clock and positions for better terms. While most issues are relatively obvious, the nuances are likely to be won by the buyer. Ultimately, if the seller becomes frustrated by the terms that are emerging, there is no cover bid to revert to.

Finally, a properly managed sealed bid can be executed with a high level of discretion. The publicity of recent sales has been driven largely by their extreme size and management's decision to make public announcements.

Myth 2: "Buyers care how the selling institution values a portfolio"

The truth is that NPL investors consider valuation one of their key capabilities. Regardless of the analysis provided by the selling institutions, they will conduct their own bottom up analysis. At the margin, the seller's case for valuation may sway the bid.

More likely, the buyer will use the valuation framework as points of leverage in the negotiation. By attacking the assumptions underlying the valuation, they will attempt to drive down the expected bid. The seller's valuation framework can also be used as a point of leverage in seeking onerous representations and warranties.

Sellers should value portfolios as a means of establishing the minimum acceptable price. They should guard this number and not reveal it to buyers beyond wide ranges.

By contrast, the traditional M&A approach is to invest significant effort in building the case for the valuation of the loan portfolio. The logic ►►

supporting this approach is that by building as compelling and complete an analysis of the portfolio, the buyer will be swayed and use the bank's framework as the basis for its bid. Preparing this analysis is expensive and time intensive. In the end, most buyers simply don't buy it.

Myth 3: "Due diligence preparation can be overdone"

In fact, professional preparation of due diligence material will always be recovered through higher bids. Selling institutions that have a reputation for complete and well organised due diligence processes will, as a rule, get more, cleaner, higher bids.

Frequently, the M&A approach to due diligence is to focus on analysis and negotiation at the expense of the preparation of basic due diligence material. While road show presentations may incorporate beautiful Powerpoint presentations, due diligence material may be left in boxes of printouts with nominal thought to preparation. The neglect of the due diligence material is not intentional; it is just assumed that money spent on preparation of this material will not be recovered in the bidding process. Investment is better spent on a powerful roadshow to institutional investors.

Because NPL investors see valuation as a core competence, the easier they can review the underlying data, the faster they can build their models. The more portfolios they can review, the more bids they make. Conversely, if they are going to need to hire external advisors to review due diligence material because it has been poorly prepared, they are less likely to bid.

Myth 4: "Omitting data can lead to a higher bid"

In fact, if NPL investors perceive that part of the file has been purged, they will make the worst possible assumption. Bids will be most certainly be lower. In addition, the seller is not always the best judge of what is good versus bad material; a long and argumentative series of correspondence with the borrower might be seen to demonstrate a litigious borrower or potential that the borrower is open to dialogue. Finally, intentionally withholding data may have legal ramifications in the long term. With a few exceptions, all data should be included in the due diligence material.

Contrast this to "Caveat Emptor," which is one approach to the preparation of due diligence material. This approach argues that the least information possible should be provided and that that information which is provided should be positive. The supporting logic is that buyers will understate negative factors because they have not been flagged and over emphasise positive factors. Because NPL investors review files for a living, they have a high sensitivity to the completeness of a file.

Myth 5: "Representations & warranties are a necessity to getting a deal done"

There are only two representations and warranties that a seller should enter into a loan sale willing to make:

- We own the loan
- We have the right to sell the loan.

Representation and warranties in a negotiated sale are part of the currency

As banks look at smaller sales and as tax and regulatory issues become resolved, sellers should use the syndicated loan market as their model

used for negotiation. The logic to the seller is that these can be used to sweeten the deal or resurrect a deal that looks like it might be on its death legs.

The range of reps and warranties that a seller makes directly reflects the negotiating leverage and experience of the seller. In a bilateral sale, the seller's leverage diminishes from the moment the bid is received. The seller has an increasing amount invested in making the deal; internal deadlines are approaching, management become impatient with closing the deal before quarter end. Reps and warranties are a valuable tool for the buyer to gain additional return on the investment at no cost.

In short, the negotiation intense approach to loan sales has its place: very large sales where entire lines of business (potentially including staff) are a good example. Similarly, if sales include complex tax and regulatory aspects, a more complex approach may have its place.

As banks look at smaller sales and as tax and regulatory issues become resolved, sellers should use the syndicated loan market as their model: straightforward auctions, standard documents, and minimal representations and warranties. Transparency and a level playing field will ultimately yield the highest net proceeds in a sale. ■

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