



AUXADI

Distressed Real Estate Investments and Opportunities in NPLs

Luxembourg and
Southern Europe

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1. Post-COVID opportunities in Southern Europe

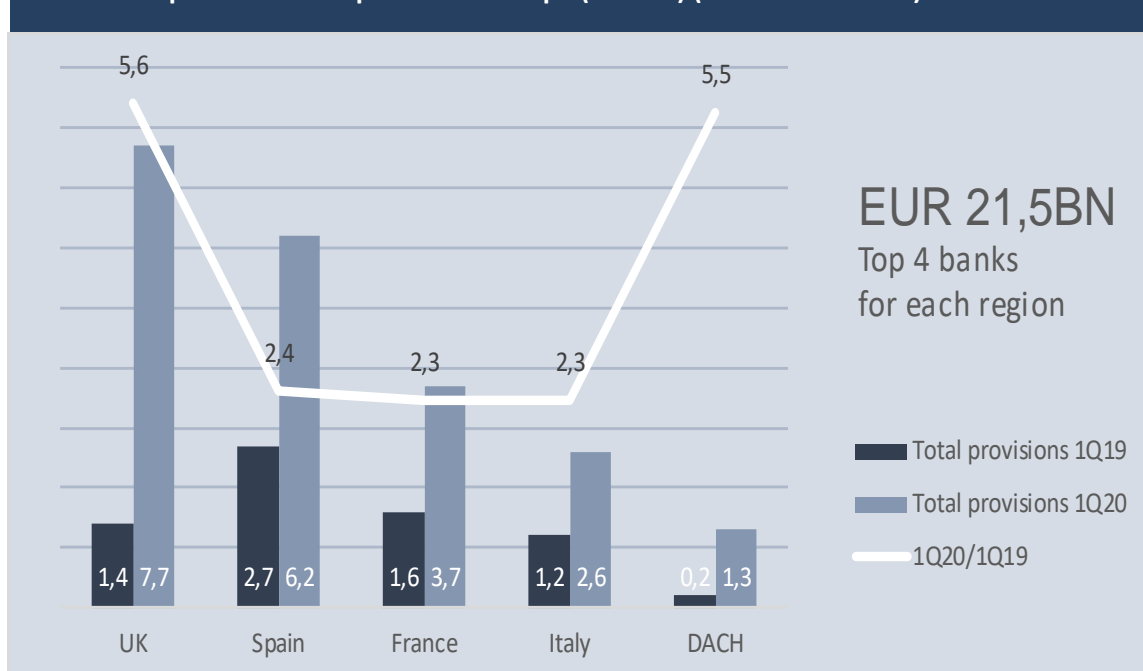
The global crisis caused by Coronavirus has halted the world. The Real Estate sector and, more specifically, private equity activity, REITs, sovereign wealth funds, Institutional and PE funds, family offices, and investment service groups have all been notably impacted by recent events.

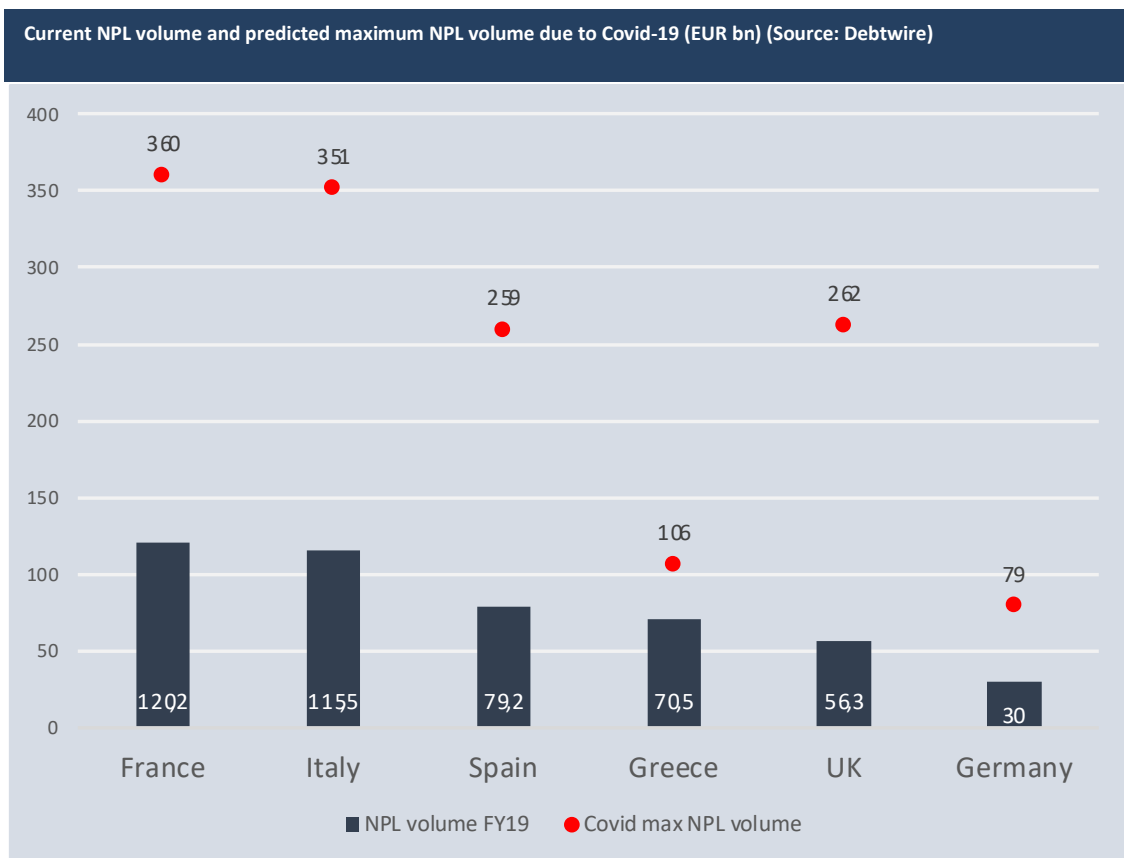
Portfolios containing commercial, residential, and hospitality assets are facing a challenging situation in the coming quarters. Many questions remain to be answered; Will on-site education resume in the fall? Will bans on international travel and tourism be lifted? Will hotel occupancies further be reduced in the coming months? How long will markets be affected by the second wave of COVID? These, and many others, represent the type of uncertainty in the Real Estate sector right now.

During 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. In the current context, when we move towards a post-Coronavirus economy, **NPLs and REOs are an interesting alternative** and could prove to be a cornerstone for professional investment services.

Though recent acquisitions of NPLs available on banking portfolios stirred the appetite of European and American investors, it is important to note that this is not a new trend that has emerged post-COVID-19. NPL transactions have been gaining increasing traction in Europe, especially after the financial crisis; the main expansion being in the Iberian market

Increase in provisions in top banks in Europe (EUR bn) (Source: Debtwire)





between 2016 and 2019, when recovery in GDPs growth *invited* a second wave of investors to the market.

It is 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, Auxadi present an analysis of the trends taking place in Southern Europe and opportunities that NPLs present for investors, with Luxembourg as the preferred vehicle to structure NPL transactions



2. A trend started after the 2008 crisis...

Before 2011, the Iberian market witnessed major investment in real estate, which engendered an 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 the 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 examples of other countries such Ireland. Portfolios are packaged according to the type of underlying assets, to attract specifically targeted investors.

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

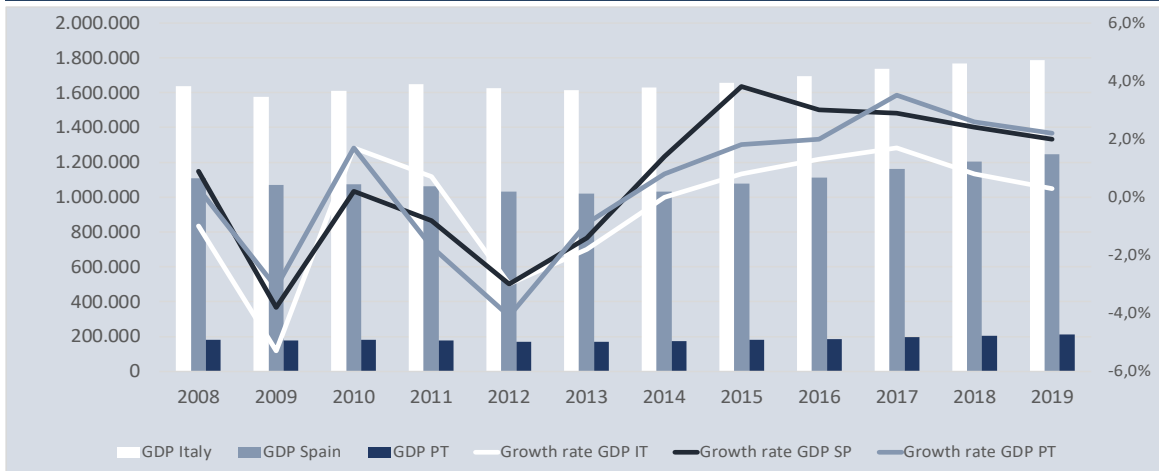
The value of these portfolios depended on the size and characteristics of the debt being sold (for example, the age of the loan, the percentage of secured/unsecured debt, ratio between personal/commercial debt, location, etc.).

In 2017, around €50 billion of NPLs were sold in Spain. 2018 was the peak, with a record €60 billion in NPL transactions, decreasing to €22 billion in 2019. Portugal, although a smaller market, also had a significant amount of transactions, with 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.

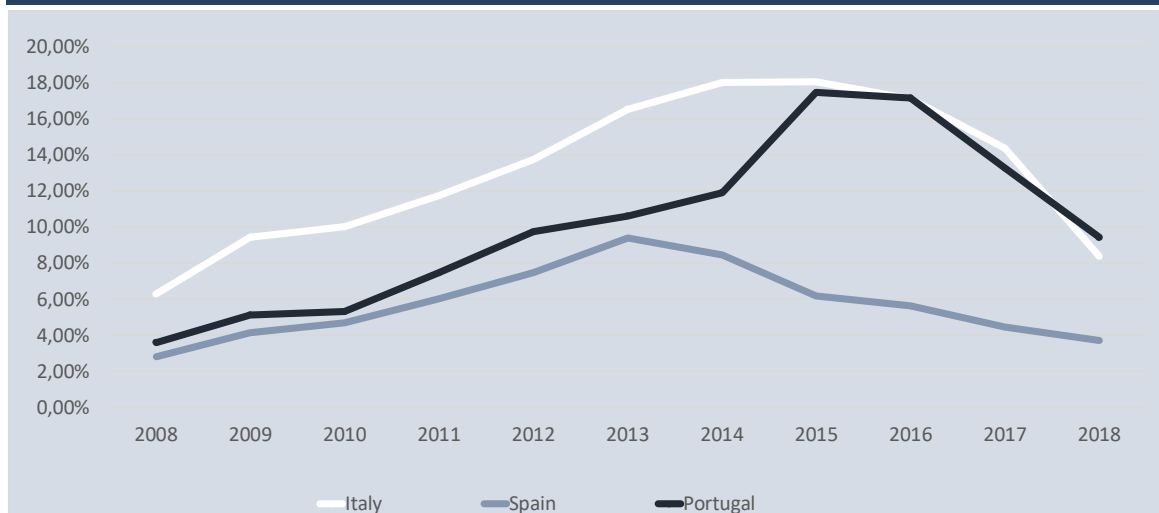




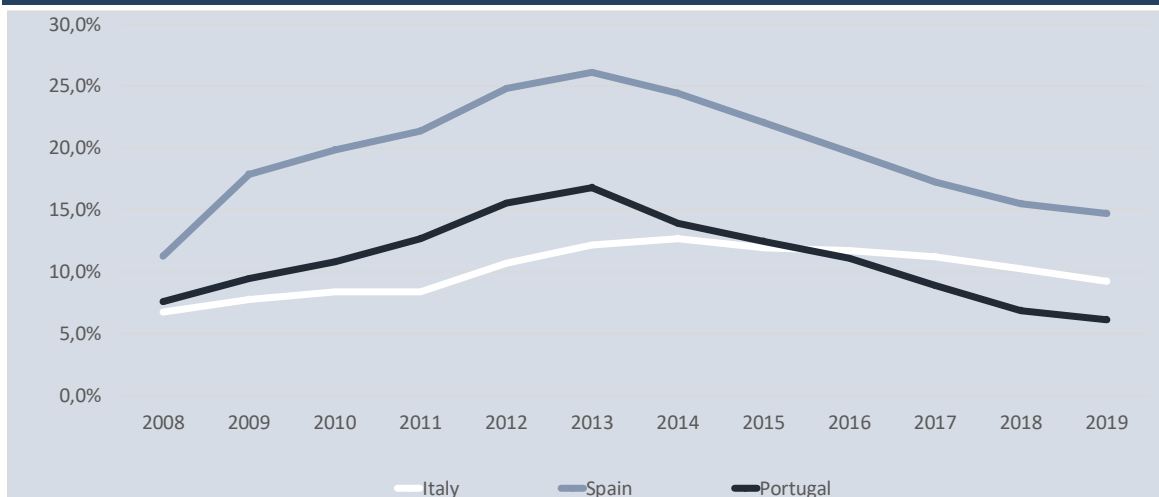
GDP & Growth rate GDP



Non-performing loans as percent of all bank loans



Unemployment rate





3. The outlook for 2020-2021

All these factors, details, and events predicted a dynamic trend for NPL transactions in 2020, with banks disposing of their most critical assets. Then the COVID-19 pandemic halted the world, with a great impact on European countries (Italy and Spain being severely affected) and the USA.

The COVID-19 pandemic caused a hasty fall in economic activity across most countries during the months of March, April and May 2020. June followed for some, though some reactivated their tourism sector and saw some gains before a 'second wave' of the virus again stilled activity. Although the situation triggered support measures by both government and central banks worldwide, it has inevitably impacted the growth projections of many economies.

The International Monetary Fund (IMF) published its forecast for the depth of the

projected recession and its predicted recovery in 2021 (postponed by some to 2022).

The recent pandemic is and will continue to leave its mark on the world economy, with direct consequences also in the Real Estate sector as well as with NPLs, although a faster recovery is expected as forecasted by the IMF in comparison to previous crisis.

Bearing in mind that all previous pandemics (1918; 1958; 1968; 2002) had a V-shaped economic cycle curve, there is a reason to believe that the same will happen with the unprecedented COVID-19 pandemic, if we do not face a second wave. In addition, it may be expected that the Iberian market will react with a similar recovery time vis-à-vis their European counterparts, since all are in similar circumstances.

Projections	Real GDP			Consumer Prices ¹			Current Account Balance ²			Unemployment ³		
	2019	2020	2021	2019	2020	2021	2019	2020	2021	2019	2020	2021
Europe	1.6	-6.6	4.5	3.0	2.0	2.4	2.3	1.6	1.8
Advanced Europe	1.3	-7.3	4.7	1.3	0.5	1.1	2.5	2.0	2.2	6.6	9.2	7.9
Euro Area ^{4,5}	1.2	-7.5	4.7	1.2	0.2	1.0	2.7	2.6	2.7	7.6	10.4	8.9
Germany	0.6	-7.0	5.2	1.3	0.3	1.2	7.1	6.6	6.7	3.2	3.9	3.5
France	1.3	-7.2	4.5	1.3	0.3	0.7	-0.8	-0.7	-0.6	8.5	10.4	10.4
Italy	0.3	-9.1	4.8	0.6	0.2	0.7	3.0	3.1	3.0	10.0	12.7	10.5
Spain	2.0	-8.0	4.3	0.7	-0.3	0.7	2.0	2.2	2.4	14.1	20.8	17.5
Netherlands	1.8	-7.5	3.0	2.7	0.5	1.2	10.9	9.0	9.4	3.4	6.5	5.0
Belgium	1.4	-6.9	4.6	1.2	0.3	1.1	-1.2	-0.7	-1.1	5.4	7.3	6.8
Austria	1.6	-7.0	4.5	1.5	0.4	1.7	2.6	1.9	2.0	4.5	5.5	5.0
Ireland	5.5	-6.8	6.3	0.9	0.4	1.7	-9.5	-6.3	5.3	5.0	12.1	7.9
Portugal	2.2	-8.0	5.0	0.3	-0.2	1.4	-0.1	0.3	-0.4	6.5	13.9	8.7
Greece	1.9	-10.0	5.1	0.5	-0.5	1.0	-2.1	-6.5	3.4	17.3	22.3	19.0
Finland	1.0	-6.0	3.1	1.1	0.9	1.7	-0.1	-3.5	-3.0	6.7	8.3	8.4
Slovak Republic	2.3	-6.2	5.0	2.8	1.1	1.4	-3.2	-3.0	-2.4	5.8	8.0	7.4
Lithuania	3.9	-8.1	8.2	2.2	-0.3	1.7	4.3	6.0	4.5	6.3	8.9	8.1
Slovenia	2.4	-8	5.4	1.6	0.4	1.4	6.6	0.8	3.2	4.6	9.0	6.0

(Table 1 – Macroeconomic forecast for selected European countries for 2020 and 2021. Source: IMF, World Economic Outlook, April 2020)



For the Real Estate sector, the long-awaited normalization of prices (already starting to be considered “quite heated” pre-COVID) should follow when activity resumes. The current slowdown in demand is considered 'artificial' and temporary, so that buyers will return to the market, but more cautiously—impacting the pace of price increases.

Similarly, NPL transactions will feel the effects of COVID-19, with the postponement of transactions and due diligences because of the lockdown of judicial procedures. Many economists and financial advisors predict a strong market response once the current economic slowdown is over.

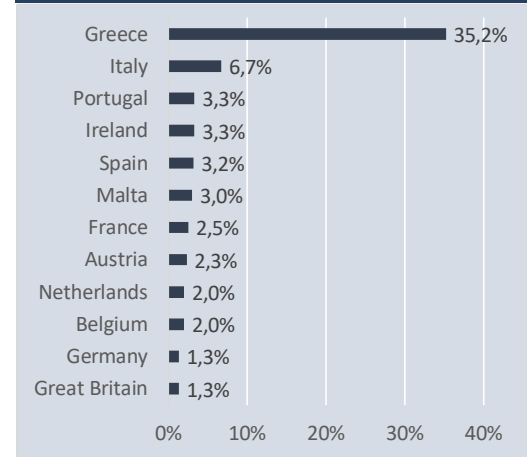
Governments are relying on regulatory measures to support individuals (especially vulnerable ones) impacted by the crisis, mainly by providing moratoriums on loans and lease payments, securing basic supplies, restricting evictions, and suspending judicial proceedings. The expected result of these regulations 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 the delay of tax payments and obligations, measures regarding for temporary lay-offs, and providing credit lines with government agency guarantees of up to 80%. It is less likely to make part of the NPL portfolios put into the market.

Despite the government measures in response to the crisis, greater credit risk and

defaults are likely to increase the volume of NPL portfolios in the market. Though, unlike the previous credit crisis, it is expected that NPLs from viable businesses will be put into the market due to liquidity, also increasing regular asset transactions.

Ratio of non-performing loans and advances (NPLs) in Western Europe as of Dec.2019



Source: NPL Market

Spanish bank default. Ratio 2018 /19



Source: El Confidencial



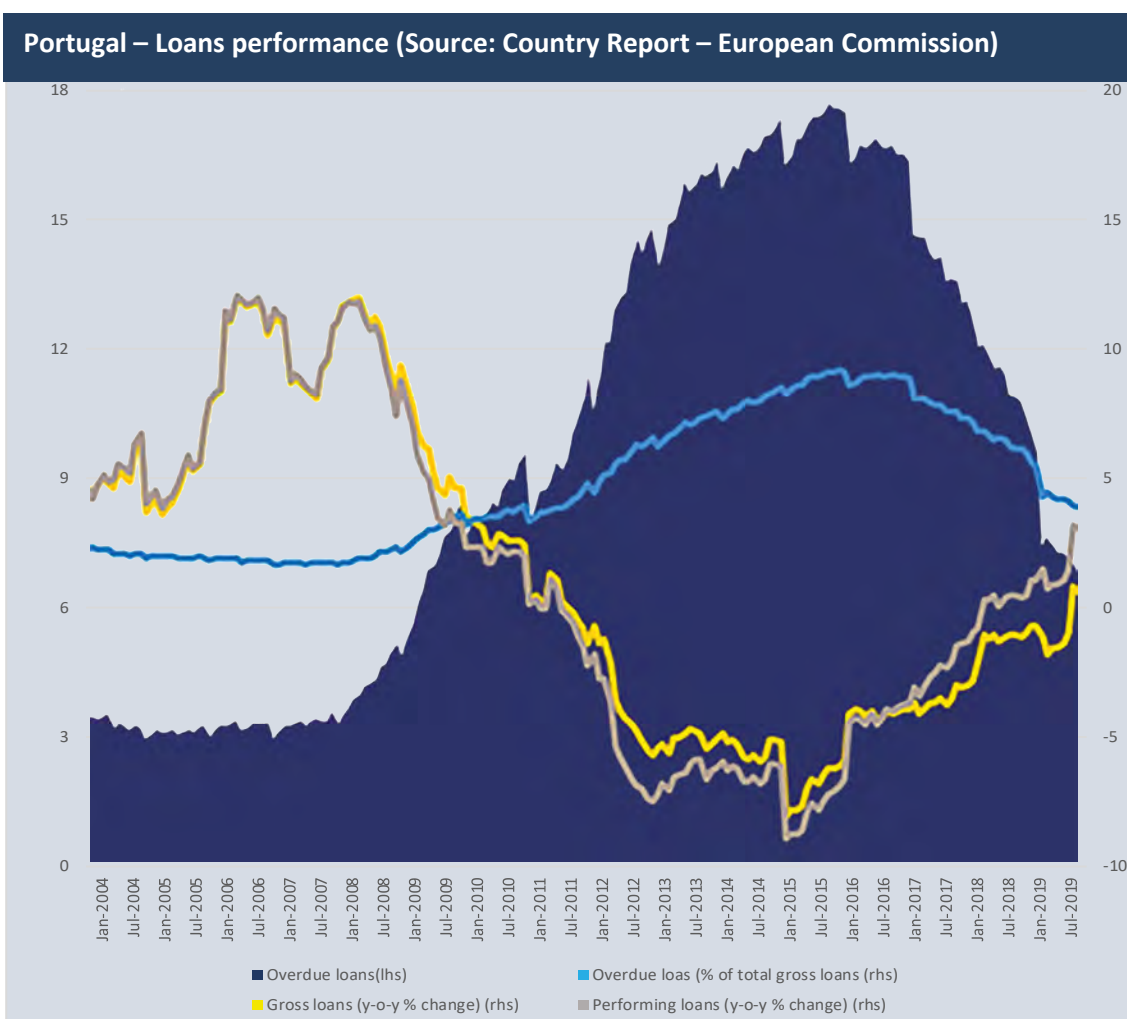


4. When will the uncertainty steady?

A settling in the market will take time, but an improvement is expected before the end of the year. One scenario that has been predicted by Moody's rating scale in its report from April 9, 2020, is how the pandemic will affect the functioning of the judicial systems, thus delaying the recoveries of NPL.

There are, at least, two key-factors that will push this scenario. New European banking regulation for NPLs are expected, where

refinancing loans continue to count as a failure as long as expected revenues decrease by more than 1%. This will result in an accounting classification marking them as prudential failures, and consequently will continue to consume capital resources. It can also be expected that the banks will continue cleaning and relieving their balance sheets, which could lead to increased sales of NPL portfolios.



Source: Debtwire



Secondly, given the impossibility to meet the KPIs defined on the Balance Scorecard for this year, and given the economic situation we are experiencing, it is predicted that banks will get rid of their non-strategic balance sheet—transferring to more specialized players or those who simply want to complement the losses caused by the standstill in the market.

The strategy and opportunity that these specialized players will have on the Southern Europe market (whether from the acquisition of new portfolio or mergers), particularly for Spain and Portugal, will continue to be structured under the incorporation of SPVs through 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 in and through 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.).





5. Extended structures for NPL acquisition through Luxembourg

The local legal framework offers a range of options when it comes to the organization of distressed debt and assets investments. Structures can be via many different Luxembourg vehicles, including companies, securitization vehicles and fund vehicles, or a combination of these.

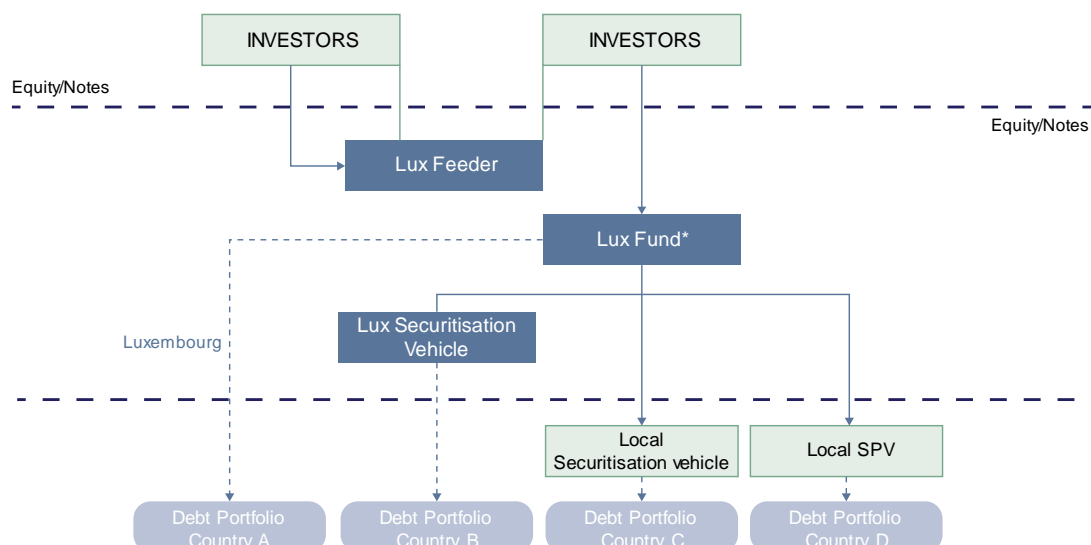
Sponsors and asset managers benefit from quick setup and flexibility of all these solutions, as most of the structures are based on unregulated companies and funds. These advantages significantly decrease the time and initial investment needed to setup such a structure.

When investments are made via a [Luxembourg holding company](#), the fund usually finances investments largely with debt instruments that bear interests. It is important that the Luxembourg company

realizes 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 securitization company](#), securities are issued to investors and the funds subscribed are utilized for underlying investments. The commitments made by the securitization vehicle to the investors may correspond to the net income derived from the investment portfolio. In other words, the securitization company does not need to realize any taxable income. Debt instruments issued by a securitization vehicle to its investors are often classified according to the expected investment

Example of a typical debt funds structure



Source: <https://www.alfi.lu/getattachment/747588d3-a1f0-49a4-b206-d44576e7fac6/alfi-alfi-debt-funds-2018-final.pdf>



return and cashflows, therefore different note classes bear different interest rates, and the repayment priorities vary depending on the legal documentation.

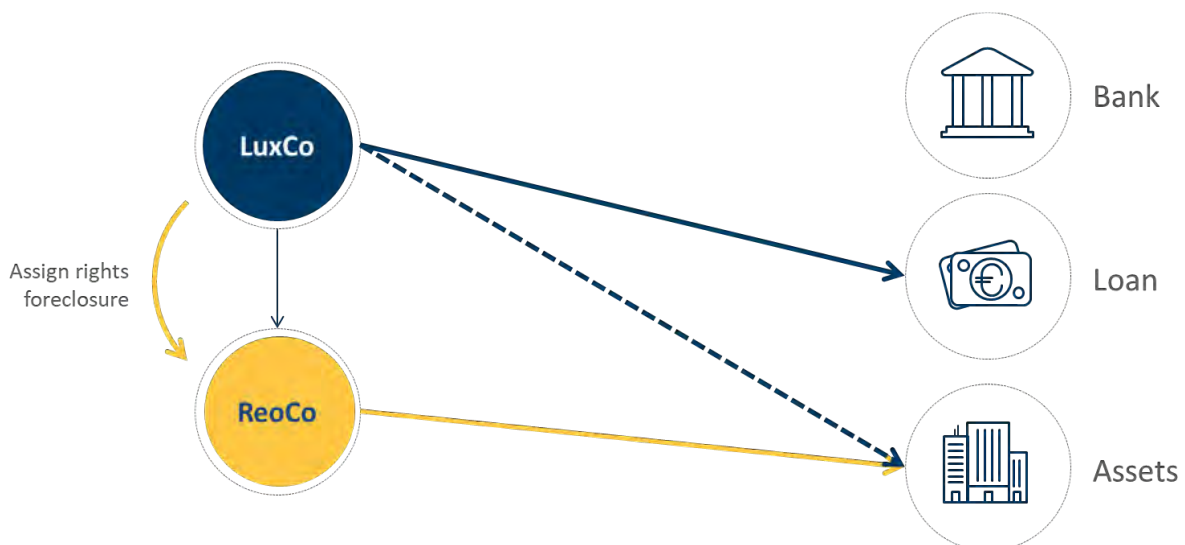
As from January 1, 2019, Luxembourg Income Tax Law ("LITL") limits the deductibility of "exceeding borrowing costs" generally to a maximum of 30 percent of the corporate taxpayers' earnings before interest, taxes, depreciation and amortization ("EBITDA"). (LITL Article 168bis)

The scope of this interest deduction limitation rule encompasses all interest-bearing debts, irrespective of whether the debt financing is obtained from a related party or a third party. Exceeding borrowing costs up to an amount of 3 million euros (US\$3.442 million) may be deducted without any limitation (which provides a 'safe harbor' provision). Corporate taxpayers who can demonstrate that the ratio of their equity over their 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 securitization vehicle for a distressed debt portfolio located outside of Luxembourg, using a local Securitization Vehicle (SV). The key facts related to this are:

- An SV may be used by Alternative Investment Fund Managers to implement a distressed debt strategy.
- The Portfolio consisted 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 financed and secured the risk linked to the acquisition of the Portfolio through the issuance of notes, and equity subscribed by its shareholder.





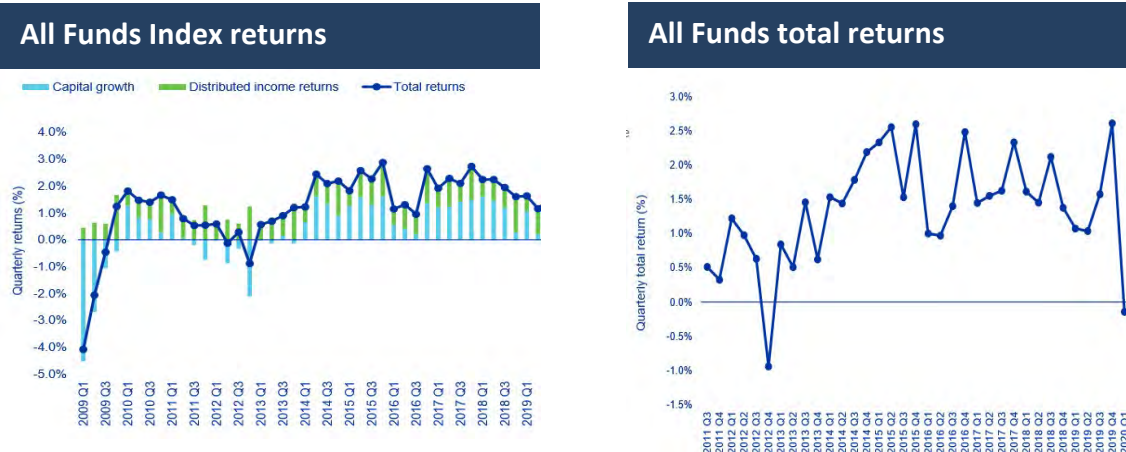
Another widely used option is to setup a Luxembourg-based unregulated investment fund, a RAIF-SICAR. The advantage of this particular investment fund over its competitors is the fact that it is unregulated, easy to setup and once the risk capital conditions are met (investment exclusively in risk bearing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

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

When operating in this sector, it is crucial to make sure that all of the above take into account the Anti-Tax Avoidance Directives, ATAD 1 (implemented in 2019) and ATAD 2 (implemented in 2020), which apply in Luxembourg and other EU countries. These Directives target hybrid (debt/equity) instruments, which are perceived differently between jurisdictions of the borrower and lender.



6. Past lessons—future outlooks



Although, as the expression goes, *past performance does not guarantee future performance*, it is true that there are a lot of lessons that we can consider from the financial crisis in 2008, and apply to the current situation. In this case, we'll try to predict how the NPL sector will develop in the coming months.

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 the COVID-19 crisis 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”.

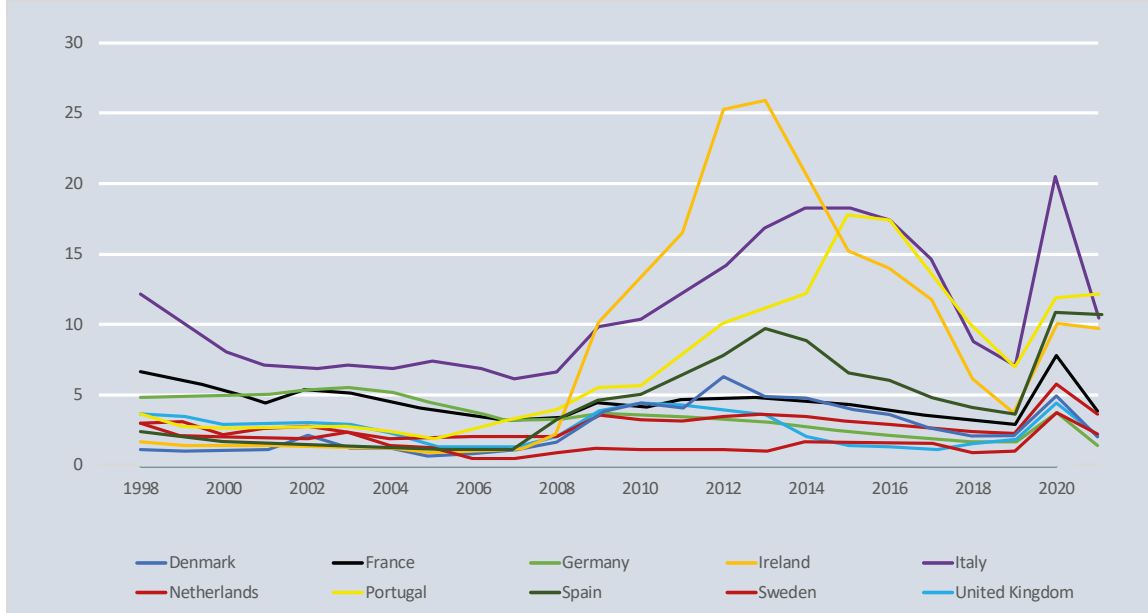
Regardless of the similarities or differences to past situations, the NPL sector will be the one to focus on during the coming months and in the medium term.

Country	Historical Max NPL Ratio (%)	Latest NPL Ratio (%)	UE_lag1 2020	UE_lag1 2021	RGDP 2020	RGDP 2021	COVID Max NPL Ratio (%)	% Increase
Greece	45.57	35.2	17.3	22.328	-9.821	5.333	53	51
Ireland	25.71	3.3	4.992	12.109	-7.886	5.274	9.72	195
Italy	18.06	6.7	9.95	12.7	-8.943	5.048	20.26	202
Luxembourg	0.9	0.74	5.4	7.717	-6.74	2.815	1.83	147
Malta	13	3.21	3.425	5	-4.439	5.54	10.24	219
Netherlands	3.23	1.86	339	6.5	-7.761	2.686	5.37	189
Norway	2	0.8	3.728	13	-6.828	2.335	6.72	740
Portugal	17.48	6.5	6.463	13.94	-7.861	5.187	11.84	82
San Marino	54.05	53.02	7.66	10.314	-12.62	5.078	69.16	30
Spain	9.38	3.16	14.105	20.801	-8.413	3.81	10.56	234
Sweden	2.6	0.58	6.767	10.064	-8.404	4.14	3.42	490
Switzerland	5.2	0.67	2.306	2.725	-7.07	2.546	2.81	319
UK	3.96	1.3	3.825	4.825	-7.041	3.484	4.13	218

Source. NPL Markets



Historical data of NPLs ratio and 2020-2021 forecasts



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Rima heads the Real Estate Division of Auxadi. Her current responsibilities include managing operations, leading our team of 250 consultants and ensuring consistency on execution across regions, and closely monitoring client satisfaction. Rima holds an Economics degree from the University of Barcelona (2001), received ICAC certification in 2006, 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 year's 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 specialized in Alternative Investments Vehicle and Technology companies. He was previously the Conducting Officer of a Value Investment management firm in Luxembourg. David has a master in business administration and finance from HEC-Liège. He also has an INSEAD MBA (2010).



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