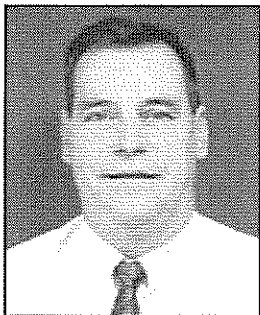


## Asian NPLs & the Internet



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The NPL market in Asia is now in a relatively mature phase compared to regions such as Europe (circa USD 400M of NPLs).

The Asian NPL market totals around USD 1.3 trillion today, way down from the giddy

heights of 1997, although currently only 1% of the market trades annually.

The current trading market is predominated by foreigners in the form of hedge funds, investment banks, and international banks. Local Asian banks are now turning the corner, realizing that there is good money to be made in acquiring NPLs or under-performing loans at a discount. Within a relatively short period of time we can expect local Asian banks to be net buyers of distressed debt, rather than simply sellers.

This article sets out to provide readers with an overview of the changing face of the Asian NPL market, and in particular, will look at Central Banks and their impact on the market; the value of financial advisers; and how the electronic age is impacting on the NPL market.

*"A casual observer might suggest that every secured NPL is up to 30% over-valued."*

### Background

In the early days following the Asian crash, capital in any form was hard to attract, especially foreign capital inflows for investment. Many of the offshore banks were calling in lines of credit to Asian banks. The local currencies depreciated drastically, and for a while there was a distinct feeling that these Asian economies would continue to weaken into bankruptcy. In reality, they were all technically bankrupt, and some remain that way today. With that in mind it is not hard to understand why reform was slow.

Certainly there was a strong Chinese trading influence on most banks throughout the region. The old Chinese methods of doing business were fast coming into conflict with the western concept of good corporate governance. Many of the Asian banks were originally family owned and, whilst having earlier gone public to raise additional capital, they were still being operated as their own private banks. Institutions such as the World Bank and IMF were insisting on change before injecting fresh capital into these economies. Ultimately both sides had to compromise if the NPL problem was ever to be resolved.

### The Asian Market & its Players

With every failure comes opportunity! It wasn't long before the large investment banks saw an opportunity to make large returns by selectively buying NPLs. Back in the late nineties the players were targeting IRR rates of 25% and above. One of the early entrants into the Asian NPL market was

Bangkok Capital Alliance ("BCA"), a joint venture between G E and Goldman Sachs. Their first major foray was a well reported large portfolio acquisition at the FRA auctions. The manner in which they struck the deal meant that only some USD 6M of their own cash was ever outlaid in the acquisition and the returns were extremely high.

One of the problems with the BCA acquisition was that Asian banks were embarrassed by the high returns gained by BCA (and other foreigners) and quickly came to realize that they were minor league players competing in the major league. Foreigners had the skill set and knowledge to acquire a NPL portfolio and achieve large returns. This led to a natural slowing in the NPL market.

Since the Asian crash we have seen the market change dramatically with many new hedge funds evolving (said to be some 500 plus funds in Asia alone), and returns diminishing from those heady days.

With the emergence of these funds and the slowing of NPL sales, there was a glut of capital inflow and limited investment opportunities.

Due to the shortage of attractive NPL investments in recent years, we have seen a number of hedge funds/investment banks target underperforming Asian companies with a mixture of both equity and loan funds. For the most part the loan funds are used to ramp up production whilst the equity is used to repurchase bank debt at a discount.

This will continue to be the prime target market until an economic down cycle occurs or more NPLs come directly to the market.

### Recent NPL Problems

It is fair to say that the NPL market had been relatively inactive until recently. Many of the Asian banks had restructured their NPL portfolios (read as rescheduled) and had ensured that the underlying security values had increased, thereby reducing or clawing back provisions. A casual observer might suggest that every secured NPL is up to 30% over-valued.

This has led to major problems when the bank later wants to sell. Their expectations are based on (predominantly) false security values. Of course, the professional investor automatically applies a similar discount when evaluating the underlying security therefore the parties can rarely agree on a price and the sale falls through.

Alternatively, as we have seen in mainland China, when the foreign investor failed to meet the required reserve, the Chinese banks sold the portfolios to local asset management companies (AMCs).

This has happened on such a regular basis that the foreign investment banks had all but withdrawn from Chinese portfolio sales in recent years. There is a twofold effect every time a portfolio is believed to have not genuinely come to the market. The bidders incur considerable due diligence costs in sending their teams to these markets (USD 250,000-USD 350,000 per portfolio). When invited to bid on the next portfolio, their bid also takes into account previous failed portfolio costs. It is not hard to fathom that this is a downward spiraling problem, i.e. every failed portfolio bid means that the next bid will be discounted further. At that rate it doesn't take too long before being totally priced out of the market

## So what has changed?

There have been three major changes to the NPL market in recent times, i.e.:

- Central banks are now forcing local banks to be proactive in the disposal of NPLs,
- Banks are now appreciating the value of engaging financial advisers, and
- The electronic age has hit

### Central Bank Intervention

Most Asian Central Banks understand that economies cannot grow unless banks improve their balance sheet footings. Post crash, most central Banks tightened NPL classification regulations by ensuring that all loans in default for more than 90 days be reclassified as NPL and provisioned accordingly until the loan returned to performing status. Of course, many of the banks rescheduled debts with a grace period or sub-commercial interest rates, which in turn qualified them to reclassify such loans as performing.

The Central banks in more recent times have attacked the problem from a different angle by further tightening NPL classifications and increasing the capital adequacy ratios for NPLs, thereby impacting on bank growth. This, together with overall improved economic conditions, has led to a resurgence of NPLs sales.

As a testament to the effect of the Central Bank intervention, some USD 7.708 billion in Chinese portfolio sales occurred in the last 7 months of 2005. Apart from a USD 2 billion sale to Great Wall AMC in May 2005, the remainder appeared to be arms-length.

We also saw USD 545 million come to the market in Thailand; USD 469 million in India; and USD 135 million in the Philippines

Upcoming portfolio sales announced for early 2006 include USD 5.65 billion from China as well as smaller portfolios in Thailand and the Philippines

### Financial Advisers

There are a number of factors that cause portfolio sales to fail, including but not limited to:

- Poor standard of underlying information
- Market suspicion, i.e. non arms-length sales
- Unrealistic pricing expectations due to inflated security values

With the market growing exceedingly dubious and frustrated by past sales, many of the sellers now realize they require creditability to enable them to go to the market. The best way to achieve creditability is to outsource the portfolio tender to professional advisers. Once the buyer market realizes that a reputable adviser has been engaged, the confidence level increases dramatically and (specifically) foreign investors are then prepared to invest in the process.

Notable players in the NPL advisory market include Ernst & Young; KPMG; and PwC although there are many other smaller firms actively advising both sellers and buyers.

### The Electronic Age

The third major change for NPLs has been the introduction of the electronic age. In March 2005, e-debtrading.com launched a series of roadshows through Thailand, Singapore and Hong Kong to promote the concept of electronic NPL trading throughout South East Asia. The principals behind e-debtrading.com had been actively involved in Asian restructuring since the 1997 crash and believed the NPL

market had stagnated, with international brokers effectively controlling supply and demand. It should be remembered that the total Asian NPL market is (reportedly) USD 1.3 trillion, of which, only 1% or USD 13 billion (reportedly) trades in any given year.

Until recently, only US based "DebtX" had successfully traded electronically in the NPL market, and that being predominantly North America. The e-debtrading.com principals structured their product with the Asian market in mind and sought to:

- Centralize a fragmented market, thereby opening up supply
- Broaden the potential buyer market to improve demand pricing
- Ensure compliance with (mainly western) corporate governance requirements
- Provide a transparent platform to engender buyer confidence

To ensure an unbiased approach and 'level playing field', e-debtrading.com structured its fees on the face value of debt rather than the final discount value, thus ensuring it had no vested interest in the ultimate sale price.

Of significance, e-debtrading.com has been able to provide a transparent bidding process whilst still maintaining anonymity for buyers and sellers. Registered parties bid under a User ID system and only the successful bidder is introduced to the seller. Thereafter, each party to that transaction will have a change of User ID's for the next trade. E-debtrading.com also undertakes rigorous background checks before registering users to comply with anti-money laundering requirements.

The Asian market has responded warmly to the electronic approach to NPL sales with e-debtrading.com registrations now exceeding 40 of the top international trading banks; investment banks; and hedge funds. By the end of 2006 this is expected to grow to over 100. The recent appointment of M.R.Chatu Mongkol Sonakul (ex Bank of Thailand Governor) as Chairman of e-debtrading.com is also seen as a catalyst in promoting registrations from Asian controlled banks.

The platform commenced trading live in late 2005, listing over USD 88 million of single NPL debts for sale. Of greater significance, the first 7 sales averaged a yield of 6.64% over the seller's reserve. The majority of debts listed have emanated from Indonesia; Thailand; Philippines and Macau, whilst buyers have come from Singapore; Hong Kong; Europe; and the USA. The e-debtrading.com principals are forecasting around USD 400 million in single debt trades on the platform in 2006, together with another USD 500 million in portfolio sales.

In early 2006, e-debtrading.com will also launch new software to reduce the cost and time evaluating portfolios. Sellers will have the option to offer portfolio sales with virtual datarooms, physical datarooms, or a combination of both.

### Summary

The increased presence of the likes of e-debtrading.com and DebtX, together with Central Bank intervention, looks to be the catalyst for a significant increase in NPL trades throughout Asia.

The region has been awash with investment funds for a number of years. As the NPL market opens up we expect to see greater foreign investment in Asia. Additionally, Asian banks are now recognizing that there is a tremendous profit potential and some are already turning from NPL sellers to net NPL buyers.