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Notes from the Field by Jonathan Lavine
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Stuart Davies and I joined our European team for a week of discussions with key players in the restructuring space across Europe, which I will for the first time go as far as to characterize as in the early phases of a true healing process. Specifically, we met with banks, non-bank financial institutions, regulatory bodies, and government officials in London, Dublin, Madrid and Milan to understand further the situation on the ground in each of these key geographies. Our meetings left us not only with a much better sense of the specific countries and opportunities to come in the corporate, real estate and NPL spaces at a granular level but also with a much better picture of the state of affairs from a pan-European perspective.

Since 2005, our European team, which now stands 32 members strong, has spent a tremendous amount of time in these countries building strategic relationships. Our focus on Northern Europe to date has produced strong returns. We believe our European team was correct to show patience in the pace of their deployment of capital throughout Europe given the complexity, and quite frankly, extreme uncertainty, of the situation. We purposely concentrated on loans and portfolios in Northern European geographies, deploying over $2 billion in approximately 100 investments since 2010, until we had more clarity on the south. This approach is consistent with our historic avoidance of the speculative phase of any market and our old adage of deploying capital only where we feel the expected return is highest. We do not chase lottery tickets in the hopes of a hit.

It will come as no surprise, then, that some of the low hanging fruit is gone, but we must remember it can be defined as “low hanging” solely in hindsight. At the time, when we had dedicated a number of our people to understanding these opportunities, they neither felt nor seemed obvious. The opportunities we have pursued in the UK still have shown themselves better investments. Now, however, we believe the recovery seems to be unfolding in earnest, and the future opportunity set should manifest itself in an abundance of potential investments in Southern Europe.

While we will certainly concede the European situation is by no means fixed, our recent trip reinforced our current hypotheses on the European opportunities likely to play out over the next couple of years. We never subscribed to the thesis that the European Union would crumble or that the Euro would be replaced by the Deutsche Mark and the Franc. We believed that, while dire, the situation was not hopeless as both the will and policy levers existed to help the region through the crisis. Accordingly, we did not short but rather stayed long the stronger northern region.

While the current status is consistent with our view, the speed of the recovery has surprised us. In addition, the process of fixing the financial system, selling non-core assets, and repairing decimated economies is unfolding in a surprisingly orderly manner. Governments across Europe are implementing productive and constructive measures. Whether taking the form of nationalization in the UK, the creation of NAMA in Ireland or SAREB in Spain, centralized points of contact are creating real markets in relevant assets. And yes, a lot of money is now flowing, especially in Ireland and Spain (where we bumped into three of our competitors in the lobby of our hotel!), but one cannot lose sight that the aggregate face value of assets to be sold exceeds €1 trillion. So a wide variety of market participants will be needed to fuel the recovery, and we anticipate those who have developed deep roots in these markets over time will be rewarded. For what it is worth, to date, we have steered clear of many of the situations garnering the most attention from US distressed players anxious to deploy capital in the space – which we felt often transacted at unattractive prices.

As we look to deploy capital in greater scale, (with an even larger European team with an increasingly specialized skill set in NPLs at our disposal), our investigation centers on answering the following questions:

- How much actual good news is priced in, versus what we believe should be?
- What assets remain attractive and what secondary opportunities have been and are being created by the portfolios now in the hands of servicers?
- And most importantly, perhaps the real opportunity involves investing in the future, providing liquidity to mid-size companies creating lending platforms and working with key institutions to get lending going again?

As we have witnessed in the UK, the complexity of the situation belies simplistic characterization of the opportunity set, but it feels like many market participants are more focused on the short term trade rather than the long term investment.

I'd like to share some of our country-specific observations:

<u>Ireland</u>

Clearly Ireland is furthest along in its recovery and is subsequently seeing the best pricing. The joke is that the paradox of the crisis is the best way to fill vacant hotel rooms in Dublin is with investors, bankers and lawyers. Pride is definitely returning to a country that has been humbled by the significant amount of austerity. But, all is not well. Due to the relatively small size of Ireland's economy, the Irish need to remain particularly mindful of avoiding solutions resulting in new problems. We believe the concentration of assets in relatively few hands, with auctions run by a small handful of advisors, could create a mini bubble, or at least result in a correction.

We see the Irish opportunity in:

1. The larger cities in the outer reaches of the country that have not recovered to the extent Dublin has.
2. Consumer/retail sectors that will benefit from the recovery in real estate.
3. Providing new financing to businesses in a market that now has few banks left.

As one banker summarized, Ireland is a market where you need a real view and the ability to deploy capital strategically against that view.

<u>Spain</u>

Spain was perhaps the most interesting place we visited. It is clearly the current area of highest focus for investors, as the creation of SAREB and organized asset sale efforts at the banks have provided orderly and centralized points of contact. We believe it is here the diversity of the opportunity is currently broadest. With an estimated €167 billion of assets (as of 2012), investors must decide whether to focus on real estate, consumer, SME, residential or all of the above. The economy is picking up, or at least bottoming out. GDP has grown, signaling an end to the recession. The Spaniards have begun to close the competitiveness gap and are an exporter once again, which has bolstered national pride. Unit cost of production in Spain is down approximately 25% over the last 5 years.

All of this activity is set against a backdrop of relief, not full recovery. With high unemployment and a fragile political system, this recovery is likely to be more L-shaped than people hope. We saw this in the US and ultimately found it created opportunity for us because L-shaped recoveries can chill the fastest money, not known for patience.

I was most impressed by Spain's ability not to allow lingering issues to prevent it from keeping an eye toward the future. Manufacturers cannot build factories without capital, and hotels need to be clean and fresh for Spain to keep tourism levels at 15% of GDP. It is here we believe that a mix of portfolio purchases and new loan origination will be key components of our investment strategy. Working with banks to reschedule and recapitalize corporate loans as partners may also provide a path to deploy significant capital to benefit from Spain's recovery.

<u>Italy</u>

In our opinion, if Ireland is 60% down the road to recovery and Spain is at 30%, then Italy is at 10%. This is driven by turmoil in their government coupled with the sheer scale of the problem.

As in Ireland and Spain, the process feels orderly, but early. To date, few major sales have occurred, and we sense that institutions remain uncertain as how to best organize their own holdings for sale. The key financial institutions are studying the sales processes in the UK, Ireland and Spain, and very much hope to imitate these best practices. They face the most headwinds vis-à-vis creditor regulations and investor confidence. The process of recovery in Italy is in its nascent stages; accordingly, the most definite thing I can say is we are watching this geography extremely closely and believe we will find an entry point in the coming year.

<u>Conclusion</u>

While we have seen a flurry of activity, and even more drama in the press, we are highly mindful that not a lot of profits in the region have been realized to date outside of investments in the UK and Northern Europe. Just as we approached the opportunity in Northern Europe with our usual mix of diligence and patience, we believe the same approach will lead to success in Southern Europe. While we have gained more confidence in the recovery in Southern Europe, we recognize it will not be a smooth ride back. Therefore, we will maintain our discipline in evaluating opportunities in these jurisdictions and continue to compare them versus potential investments that we are sourcing in Northern Europe, the US and Australia.

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