

## EUROCASTLE, A CONTRARIAN OPPORTUNITY IN ITALIAN LOAN SERVICING



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Uncertainty over asset values is what plagues the Italian banking system. Since 2008, the stock of gross non-performing exposures has quadrupled and now stands at EUR 360 bn. One way or another, the banks have to tackle the NPL issue in a way that neither breaches EU state aid rules, nor crucially exposes Italian households to losses via bail-in of subordinated debt.

### Stressing the banks

In an eventful week for European banks, the European Banking Authority (EBA) released its latest EU-wide stress tests on July 29th. Moments before the EBA release, *Monte Dei Paschi* (MPS) announced its strategy to deal with its large stock of non-performing loans (NPLs). While comprehensive, the plan to clean up its balance sheet via a complex disposal of EUR 9bn of NPLs in conjunction with a EUR 5bn capital raise is ambitious to say the least. It relies on a significant number of factors falling into place for it to be successful, and management's admission to there being no plan B doesn't reassure. The -15% decline in MPS' share price last week suggests the situation has not yet been solved and the transaction is not due to complete until the end of 2016 (after the Italian referendum), which adds to the uncertainty. Stress in the Italian banking system continues to rise and hinges on the outcome of the complex MPS plan. The coming months could be critical in determining whether Italy and potentially Europe can avoid another banking crisis.

### Italian NPLs continue to rise

Uncertainty over asset values is what plagues the Italian banking system. Since 2008, the stock of gross non-performing exposures has quadrupled and now stands at EUR 360bn. While Italian banks continue to cling to the belief that their coverage ratios are adequate due to the value of the collateral underlying the loans, the market is far from convinced. Applying the same conditions as the MPS deal would crystallise a capital shortfall of EUR 20bn across the Italian banks. Rumours have begun to circulate that *Unicredit* could come to the market to raise more capital at the beginning of next year. One way or another, the banks have to tackle the NPL issue in a way that neither breaches EU state aid rules, nor crucially exposes Italian households to losses via bail-in of subordinated debt.

### The opportunity in loan servicing

While the banks struggle under mounting NPLs, some businesses are making the most of the difficult situation. Debt purchasing businesses and loan

servicers are ideally placed to hunt for opportunities. While a number of mainly US private equity companies are patiently waiting on the sidelines for NPLs to come to the markets at distressed prices, businesses like *Eurocastle* and *Cerved* are uniquely positioning themselves to service these loans. *Eurocastle*, an Amsterdam-listed vehicle, has been increasing its exposure to the Italian loan servicing industry in recent years. It announced last month that one of its key investments, *doBank*, had acquired the second largest servicer (*Italfondiaro*). In combining the two businesses, *Eurocastle* is now invested in the leading loan servicing and recovery platform in Italy. The proposed MPS NPL deal points to the opportunity for independent loan servicers. Underpinning its planned disposal of NPLs is a government guarantee of the senior tranche of the securitisation (known as GACS). Of MPS's EUR 9bn planned disposal of NPLs, it expects EUR 6bn to be securitised and sold as senior notes with a GACS guarantee. To access GACS, Italian banks will have to outsource collections to highly rated 3rd party servicers, of which *doBank* is the largest. If the MPS deal is successful, this could be the template for the other banks to sell their NPLs. If this plays out, then *Eurocastle* could benefit as the largest independent servicer. All eyes will be on how the MPS situation plays out later this year. Whatever the solution is to the NPL crisis, the loan servicers will eventually have to play a key role in collected out this enormous stock of bad loans.

As contrarian stock-pickers we look for opportunities in crisis. We are monitoring the situation in Italy closely and identifying stocks that could benefit from the current NPL predicament in Italy and its potential solution. *Eurocastle* is a good illustrative example of how we implement our contrarian approach in practice.

