

White Paper

Reaping rewards from non-performing asset purchase

Debt sale is booming, but hedge funds need to be smart about how, when and what they purchase

The growth and increased maturity of the UK debt sale market is creating opportunities for hedge funds to take a more structured approach to investing in non-performing assets. The market is continuing to grow with 70% annual growth in volume sold to an estimated £6 billion of face value consumer debt this year. This is creating a range of opportunities to invest capital, and risk management is becoming easier through better access to data and a developing resale market that provides liquidity. However, non-performing assets in the UK are still a relatively unique asset class and there are a number of key considerations that need to be weighed when entering the market.

With UK consumer borrowing at an all time high of over £1.1 trillion and bad debt becoming an increasing problem for high street banks, just as in the US, debt sale has emerged as a key tool for generating returns from non-performing portfolios. The market is growing exponentially as more and more creditors recognise its potential for releasing value from delinquent portfolios, with the growth being driven by new sellers, new asset classes (including non-financial services debt) and debt being sold earlier in the credit lifecycle.

Market growth is expected to further accelerate towards the end of this year, stimulated further by the emergence of a secondary resale market. This is a key development in the maturity of the market that will increase liquidity, provide a hedge against and encourage the emergence of specialist purchasers. In the US, over 50% of the volume of debt sold is through the secondary market. The UK has an existing stock with nearly £15 billion debt sold in the last six to eight years.

As the volume of debt sold grows, it is attracting new capital into the market. Traditionally the market has been funded by a mix of private equity and bank funds backing existing purchasers and collection agencies. Increasingly investors are acquiring outright or in partnership and, as in the US, hedge funds are looking at the market in search of strong returns with increasingly better understood risk profiles. Hedge funds are beginning to put their own capital at risk through buying portfolios directly and contracting to service providers to deliver liquidation performance. So what do they need to do to be successful?

There are three important factors that need to be considered to be successful at debt sale:

- Access to portfolios for purchase. Because every deal is not going to be a match for either timing, price or risk profile and because each deal is relatively small, it is important to review a large number of portfolios.
- An effective pricing model. With so many sales, an effective pricing framework that allows portfolios to be quickly evaluated is essential.

- Consistent servicing to deliver liquidation. Ultimately these assets are only worth as much as can be collected. While a resale market will provide other liquidation options, establishing effective and consistent servicing is critical.

Access to portfolios

Access to portfolio sales is of primary consideration. This involves either developing relationships with creditors, or working through sales side market brokers. In the UK today, 40-45% of the market is professionally brokered through increasingly standardised processes. Another 40-45% is tied up through annually renewed forward flow deals which are typically managed by the creditor's procurement departments. These flows are typically fresher debt and therefore see both higher prices and strong competition. The remaining 10-15% is sold direct, typically as one-off sales and represents opportunities to take a business / deal development approach.

It is also important to understand the sales process, which is increasingly transactional and standardised vs. negotiated. This standardisation has enabled purchasers to understand and build acquisition plans and processes around these sales. However, it also means that 'off-market' deals that can yield higher returns are fewer and typically more complex.

Pricing model

The pricing/performance model needs to balance risk management with efficiency and practicality. While debt is increasingly being sold with richer due diligence information and more detailed data files, an effective pricing model based on historic and forecast performance of comparatives is typically required. Because average deal sizes tend to be small, it is important to have a model that allows for proper risk management without resulting in excessive costs for participating in portfolio bidding. Working with a servicing partner is a good place to start for funds unfamiliar with non-performing assets. Price is not always obviously 'rational' and is driven by a number of factors including fundamental economic value, perceived risk, competition, purchaser operational requirements (where they have captive servicing platforms) and business plan/growth targets. Hedge funds need to know when to buy versus when to 'sit on the fence'. Finally, purchaser selection is important for sellers and typically takes into account not just the price but also final terms and the increasingly simplicity of the post sale relationship.

In our experience, the pricing model has been very difficult for hedge funds. Their appetite for data and comparatives is tremendous and without an effective framework for limiting pricing analysis this can easily go into overkill mode which makes bidding time consuming and expensive. Avoid the need to analyse and go after every deal. Build a framework model around fundamentals, understand market pricing and pursue deals where pricing levels stay with the ranges justified by the basic model.

Servicing

The key to a successful investment and good returns is effective servicing. For hedge funds looking at the market, there are a range of options available from partnering with existing providers (e.g. debt collection agencies), acquiring a captive provider, creating a panel of collection agencies, or working with a managed service provider who already have established agency panels.

For hedge funds, the right deals can have significant upsides and the downside and risks can be mitigated, especially as the resale market develops and matures in the UK. The key is identifying a servicing provider that will enable them to buy where appropriate and having access to servicing on an 'as needed' basis, rather than investing in and buying a servicing provider themselves. Partnering or working with a managed service provider is an ideal solution for incrementally testing the market and provides the best framework for buying only when the deals match versus investing in operational capability. Alternatively, hedge funds can also get involved in the debt sale market by acting purely as a funding source for purchasers, although this can often be more complicated and difficult to control than buying directly.

As the debt sale market continues to grow and mature, hedge funds should have a view on the role of non-performing asset classes in their overall portfolios, and understand how to access these assets if there is a fit. While returns are lower than they once were, the risks are easier to manage. As the market grows, new asset types are being sold, from telecom and utility debt to mortgage shortfall, local government debt and increasingly insolvency debt. New asset types will always represent potential value purchasing opportunities for sophisticated purchasers until they are more widely understood by the market. With the tremendous growth of personal insolvencies, particularly Individual Voluntary Agreements (IVAs) and their relatively high cash-flows, these assets are potentially one of the most interesting places for hedge funds to explore as they look to enter the market.

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