

# Distressed Debt in Germany, Austria and Switzerland – the banks' perspective

Trend study results

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A.

The end of the crisis or a  
never-ending crisis? An  
economic crossroads for  
Germany



# The German patient: signs of lasting improvements are not in sight

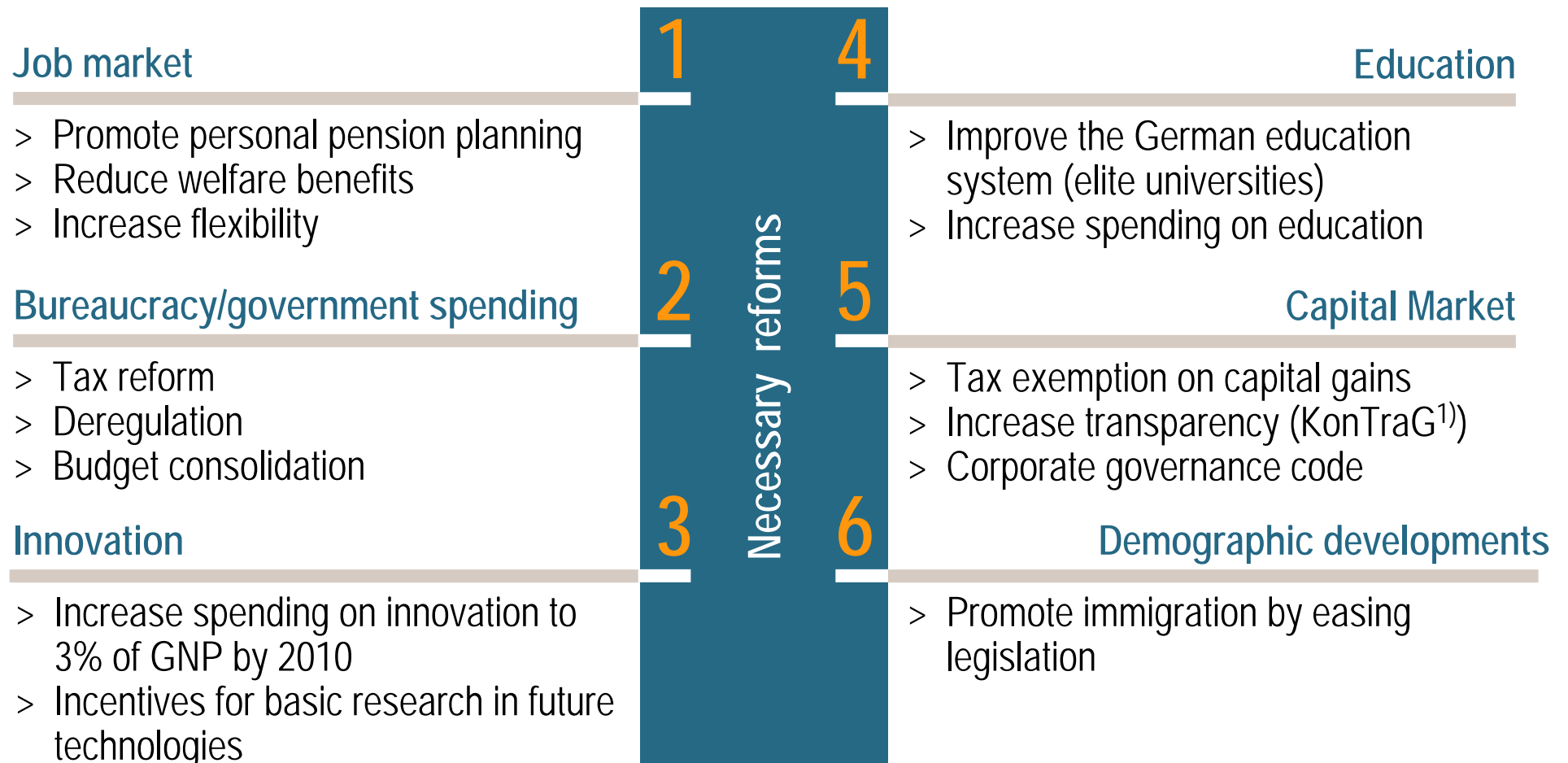
## ECONOMIC ENVIRONMENT

- 1. Hardly any growth:**  
Annual avg. GDP of 0.7% from 2001 to 2004, Germany is the tailight in Europe
- 2. Employment drops:** Unemployment rate in 2004 >10%, (above than the EU avg.); shadow economy at 16.4% of GDP (2004)
- 3. Prosperity falls:**  
Per capita GDP of EUR 24,000; below the EU-15 average
- 4. Competitiveness drops:** Share of global exports at 9.4% (2004), previously 12.3% (1990); foreign direct investments at USD 11.3 bn < EU avg.
- 5. Waning innovation:**  
Annual drop in the number of patents in Germany since 1998, on average by 2%
- 6. National debt soars:**  
EUR 1.4 trillion in 2004 EUR (63% of GDP), new debt alone in 2004: EUR 69.2 bn

## There are many different **causes** for this development

- > **Shrinking and aging population** combined with low immigration
- > Sluggish attempts to **eliminate bureaucracy** and **high public sector share in GNP**
- > **High labor costs**, high cost of **unemployment** and a **very inflexible job market**
- > **Only a sluggish shift** toward a service economy and knowledge society ("Pisa Study")
- > **Few** foreign capital investments and poor output-to-capital ratio

# Uncertain political situation: Will initial reform initiatives really be implemented or abandoned/delayed?



# The **light** at the end of the tunnel is still very dull – Will it get dark again because of political uncertainties?

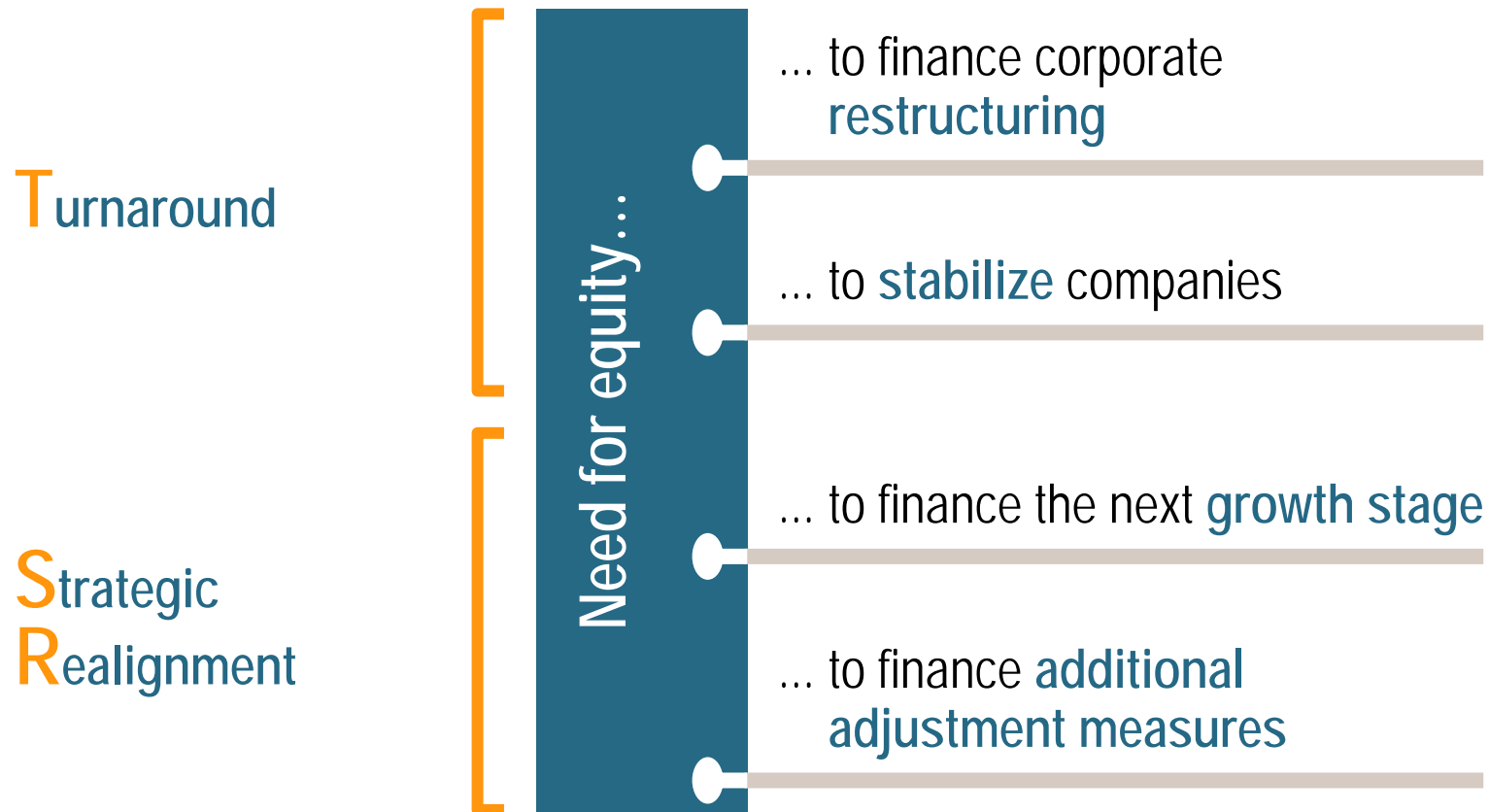


- > In 2005, finally the **reversal** of the **insolvency hype trend** in Germany (first drop since 99 (-3%))
- > **Exports** provide some **economic stimulation**
- > Increasing **business profits** (DAX 100)
- > **Indications of an economic recovery** in 2005 Q2 (+1.5% vs. same quarter in prior year)
- > Increase in **economic growth** expected as of 2006



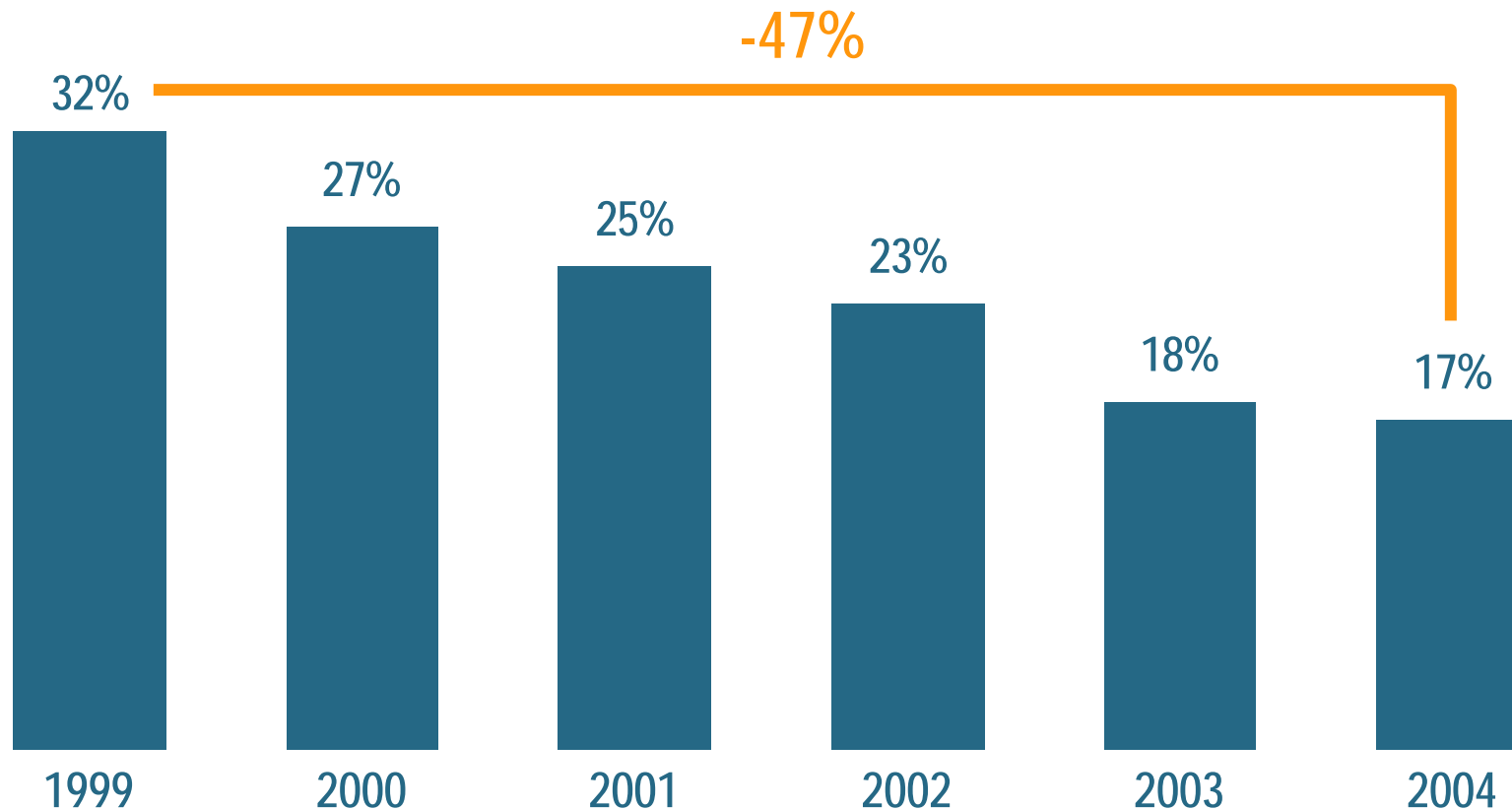
- > **Political uncertainties** following the Bundestag elections
- > Rising **prices of raw materials**
- > **Domestic** as well as **foreign demand too weak**
- > Main economic institutes **predict slow economic growth (IMF)** in the coming years

# Grow or go: The need for equity to provide stabilization and new direction is currently still very high



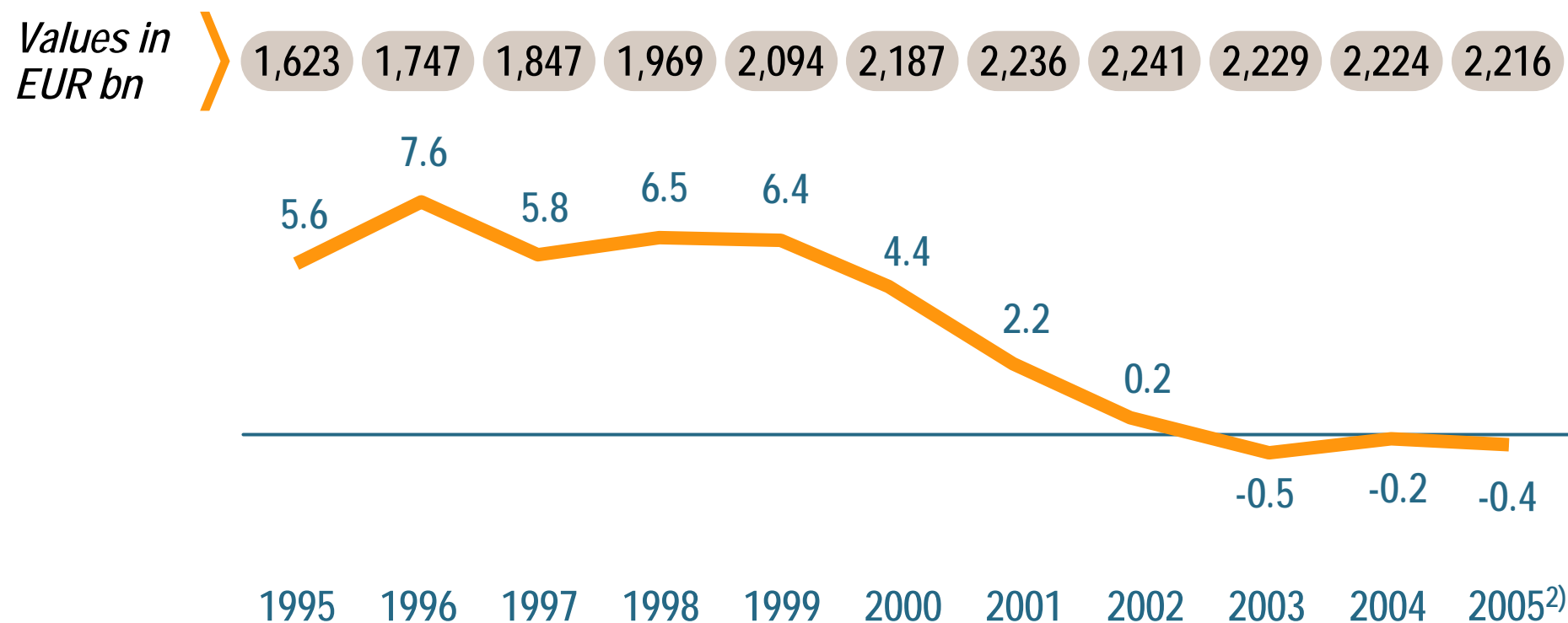
# However, these needs can not be sufficiently covered by current shareholders...

Equity ratio development at German companies from 1999-2004 [%]



## ... and banks continue to hold back in extending new loans

Book credit development of German banks toward German companies and private individuals<sup>1)</sup>, 1995-2005<sup>2)</sup> [%]



1) Year-end figures

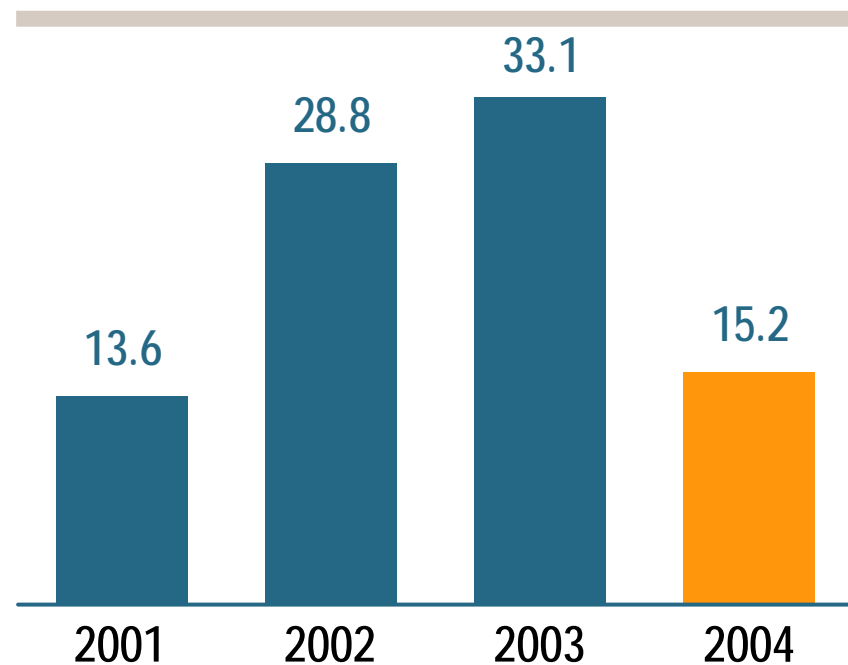
2) YTD

Source: Deutsche Bundesbank

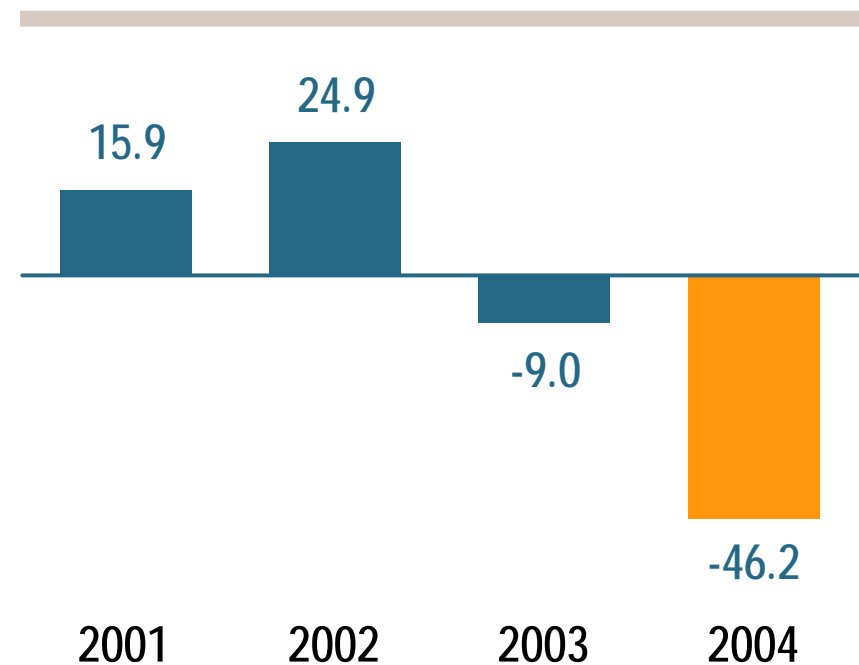
# Thus far, foreign investments are very reserved

Foreign capital flows toward Germany [EUR bn]

Venture capital and profits plowed back



Credit transactions



## Key question: What will the structure of corporate financing in Germany look like in the future?

### Baseline



- > High need for corporate **financing** and **equity** after five crisis years
- > Banks are increasingly hesitant to **provide capital** (especially during crises)
- > **Foreign investors** are **waiting things out**

### Questions



- > Paradigm shift:  
What will the structure of **corporate financing** in Germany look like in the **future**?
- > Useful animal or pest:  
What role do **external financial investors** play?
- > Quo vadis: Does Germany need to change its way of **thinking**?

B.

Results of the Survey



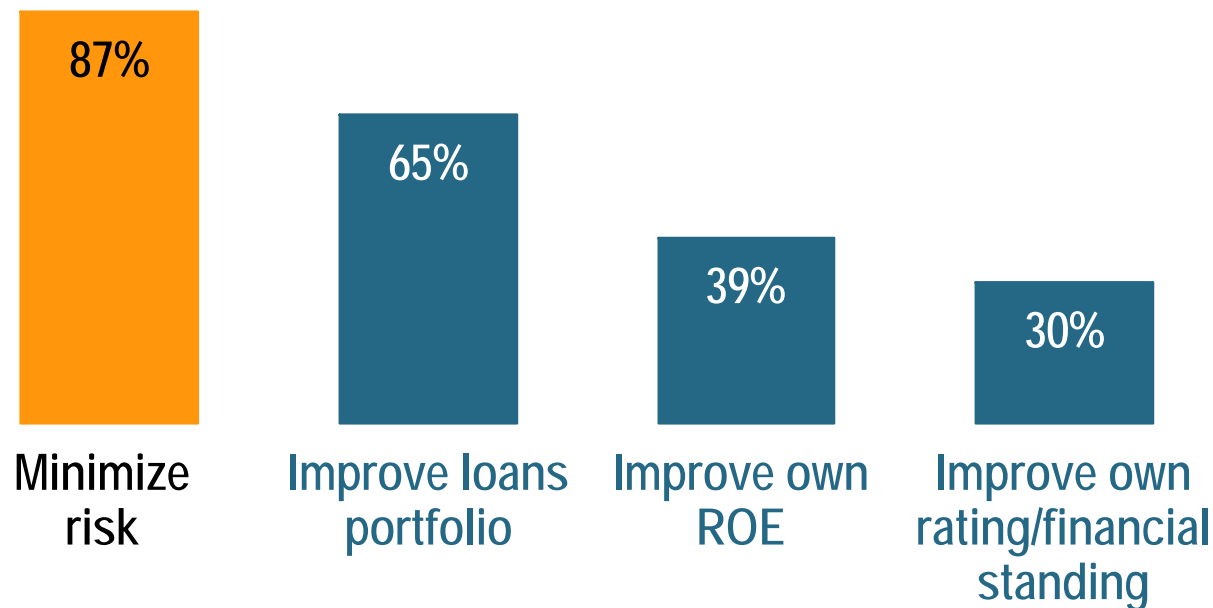
## The **Survey results** can be summarized into seven core points

### STUDY RESULTS

1. Banks see themselves as inexperienced, although they have been selling distressed debts for years
2. Banks are (still?) handling business in a largely opportunistic manner and are prepared to accept considerable price discounts
3. Nevertheless, classical restructuring and full repayment of nominal volumes is by far the preferred solution
4. The distressed debt markets for corporate and mortgage loans each have a nominal volume of > EUR 100 bn
5. Transaction volumes will increase considerably in coming years and will settle at approx. EUR 20-25 bn
6. The market will move away from portfolios and toward single name transactions
7. Without a bank license , investors will not be able to conduct business in Germany, Austria and Switzerland

# Most banks sell distressed debt to **reduce** their **risks**

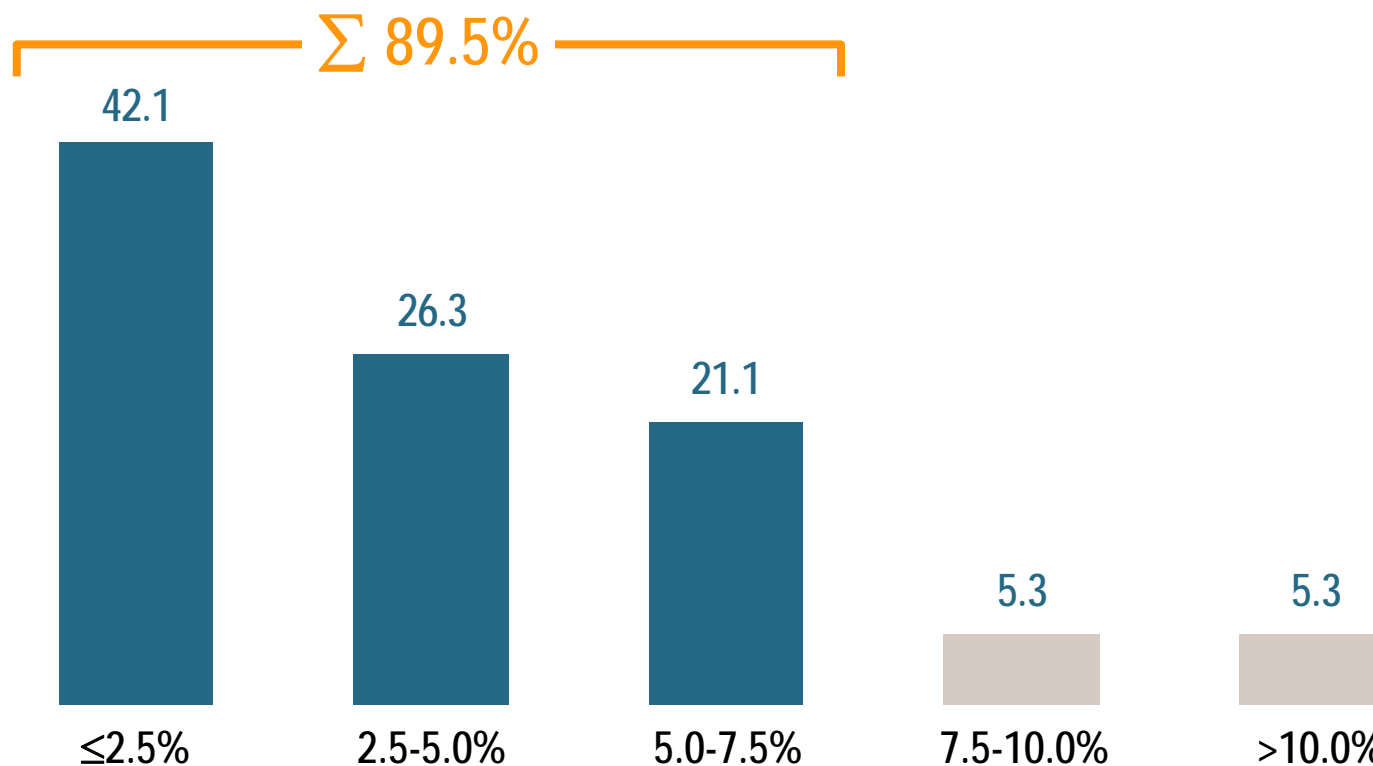
Reasons for selling distressed debt<sup>1)</sup>



1) Multiple mentioning of reasons possible

The **share** of distressed debt in 90% of the respondents' overall credit portfolio ranges from **0-7.5%**

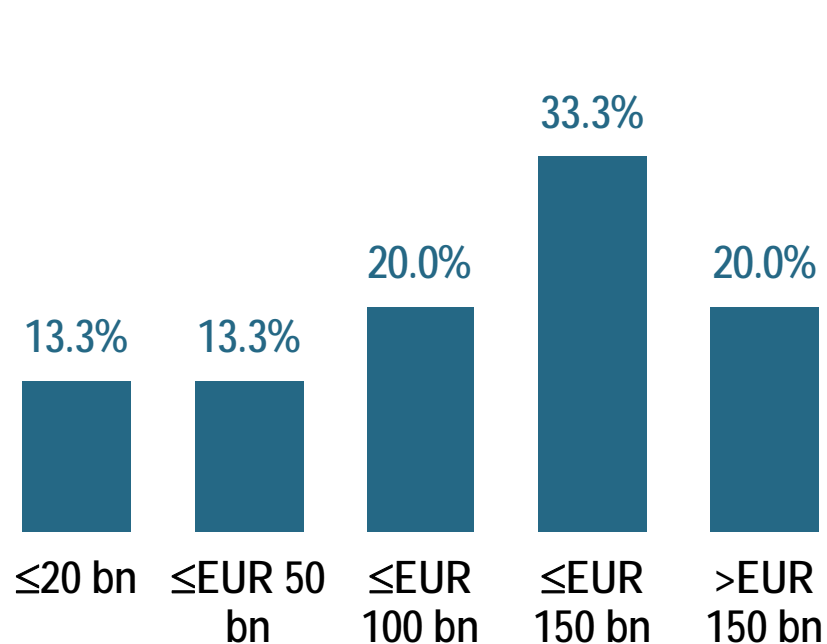
Share of distressed debt in nominal value [%]



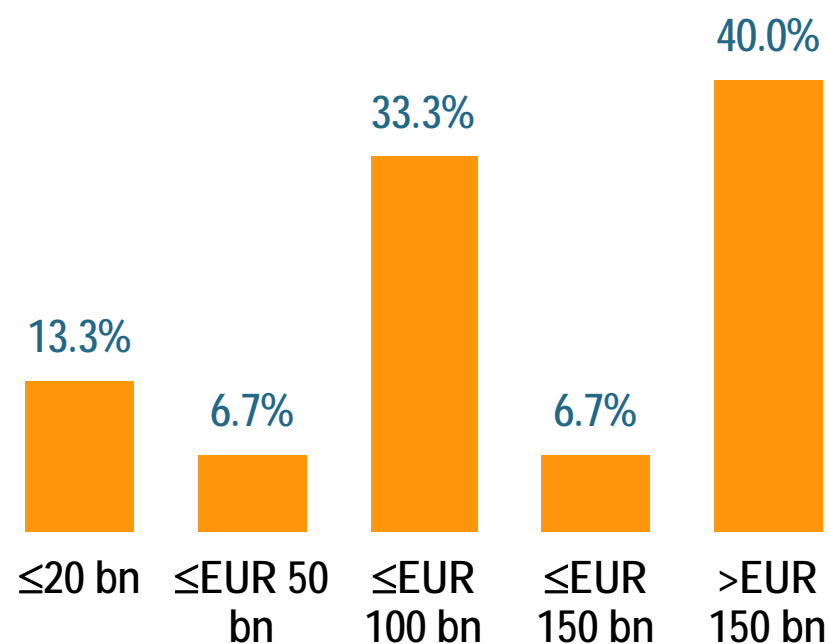
# Nominal value exceeds EUR 100 bn each for Corporates and Real Estates

Estimated nominal value of distressed debt in 2005 [EUR bn]

## CORPORATE LOANS

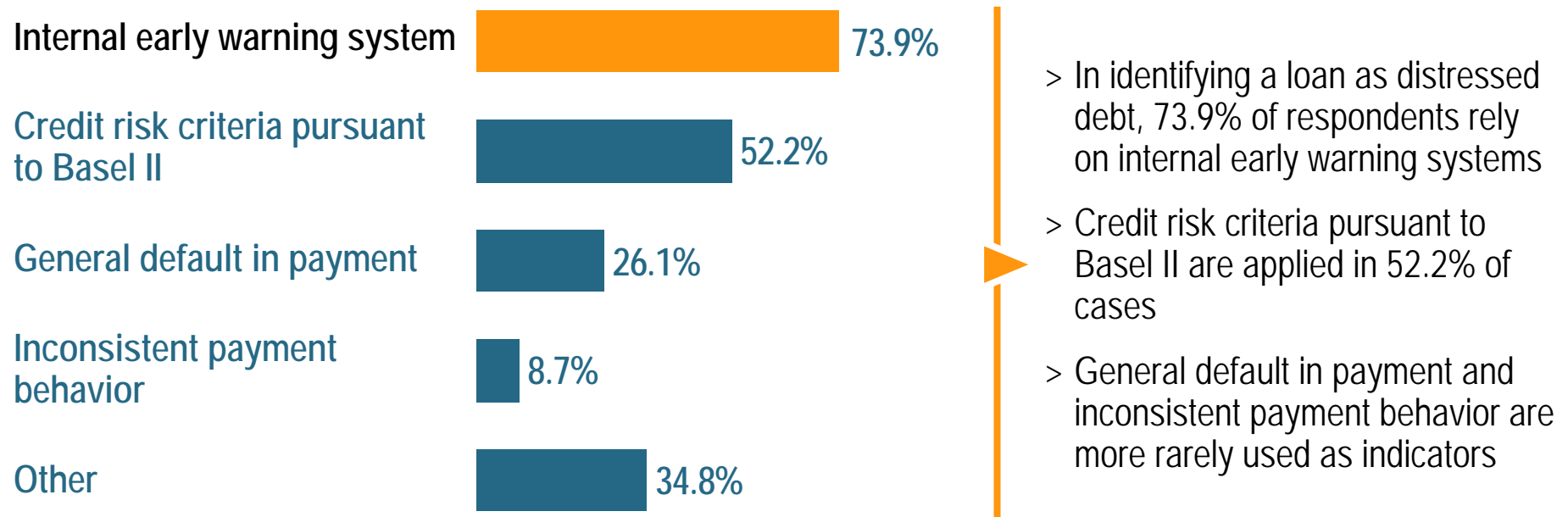


## MORTGAGE/REAL ESTATE LOANS



# To identify a loan as distressed debt, most respondents rely on their internal **early warning systems**

Mechanisms to identify credit as distressed debt [% of banks]<sup>1)</sup>

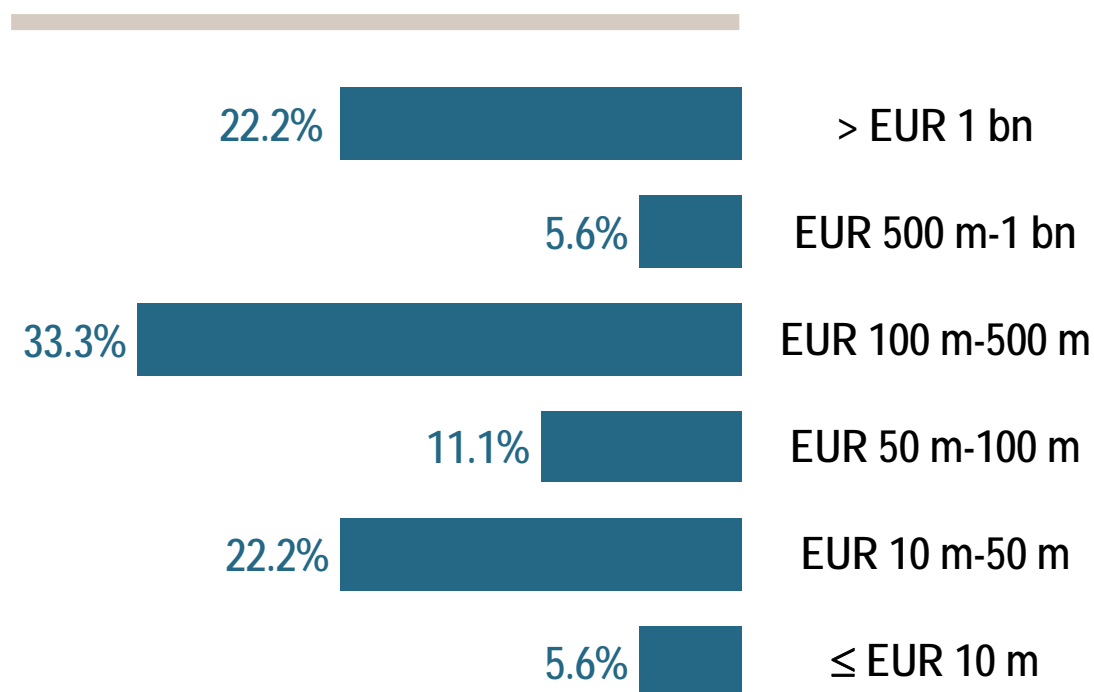


1) Multiple answers possible

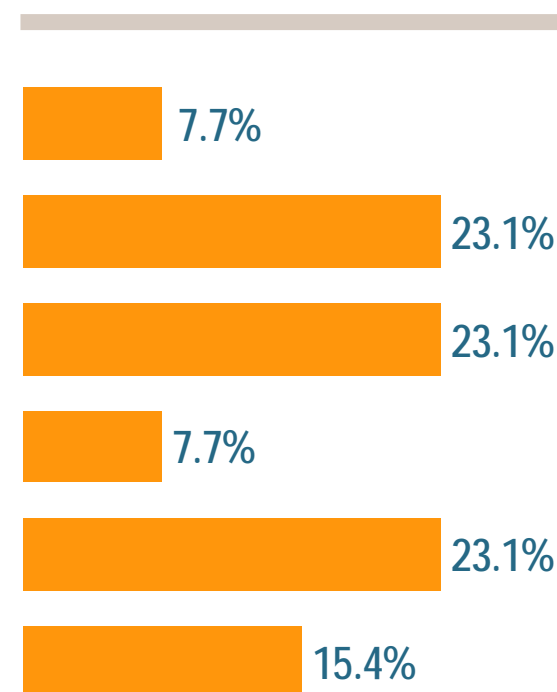
# Most transactions are above EUR 100 m – corporate loans are generally over EUR 1 bn

Nominal volume of respondents' distressed debt transactions in 2003/04 [%]

## CORPORATE LOANS

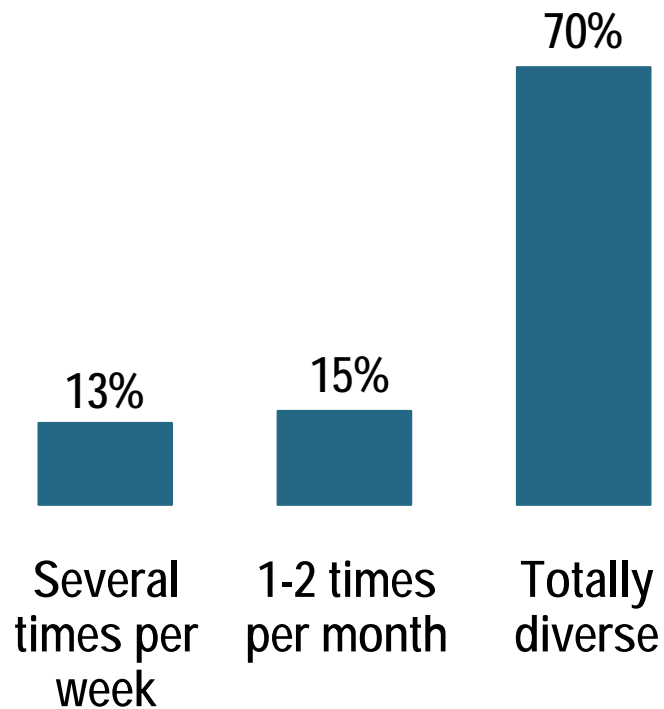


## MORTGAGE/REAL ESTATE LOANS

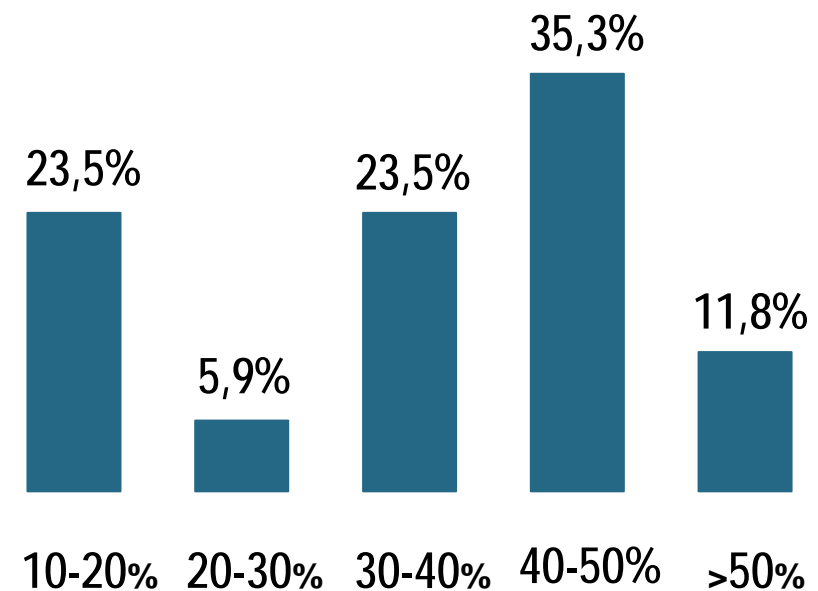


# Significant discounts up to 40% and more are not unusual

## Transaction frequency



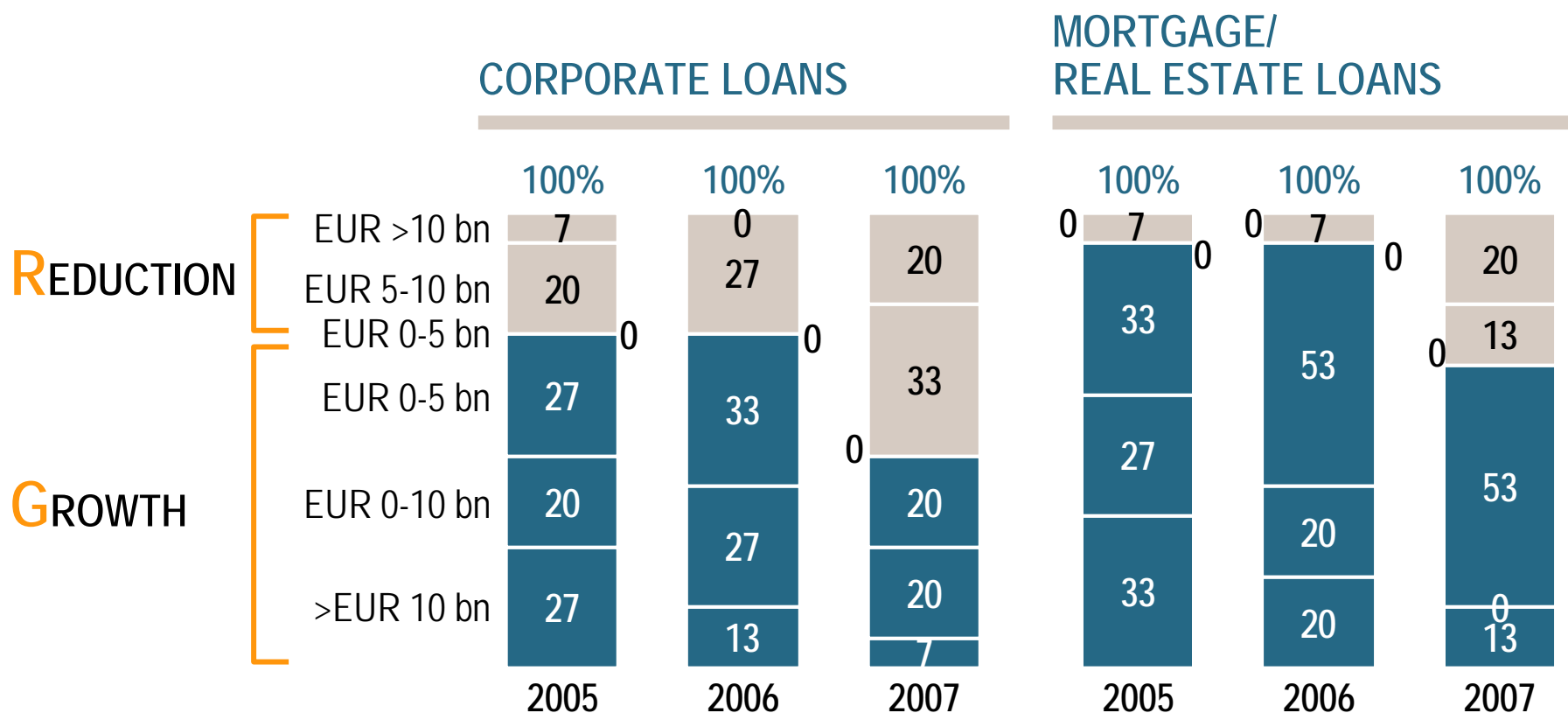
## Discount on nominal value<sup>1)</sup>



1) For transactions carried out in 2003 and 2004

# Strong growth expected for 2005 and 2006 – cooling down in 2007 expected

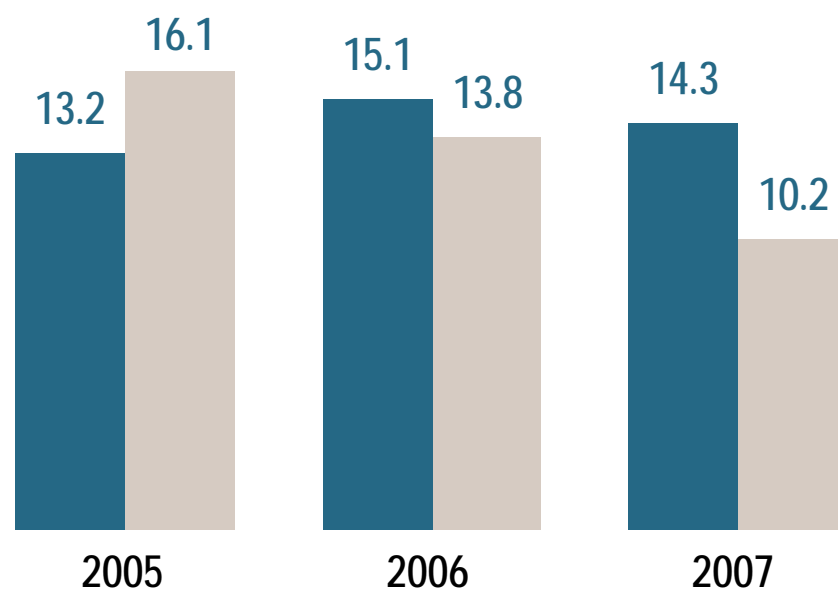
Development of distressed debt volumes [%]



# For the next two years, respondents forecast an annual **transaction volume** between EUR 10-16 bn each

## Transaction volumes and types

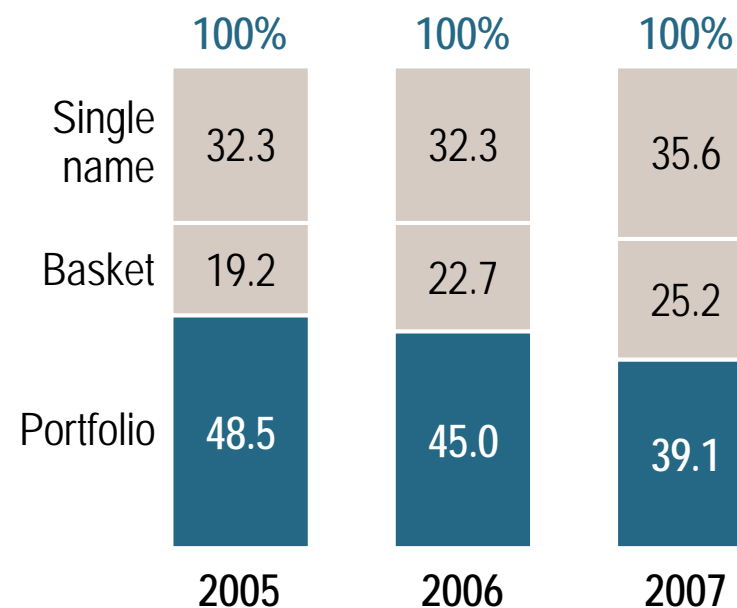
EXPECTED TRANSACTION VOLUME [EUR bn]<sup>1)</sup>



■ Corporate loans    ■ Mortgage/real estate loans

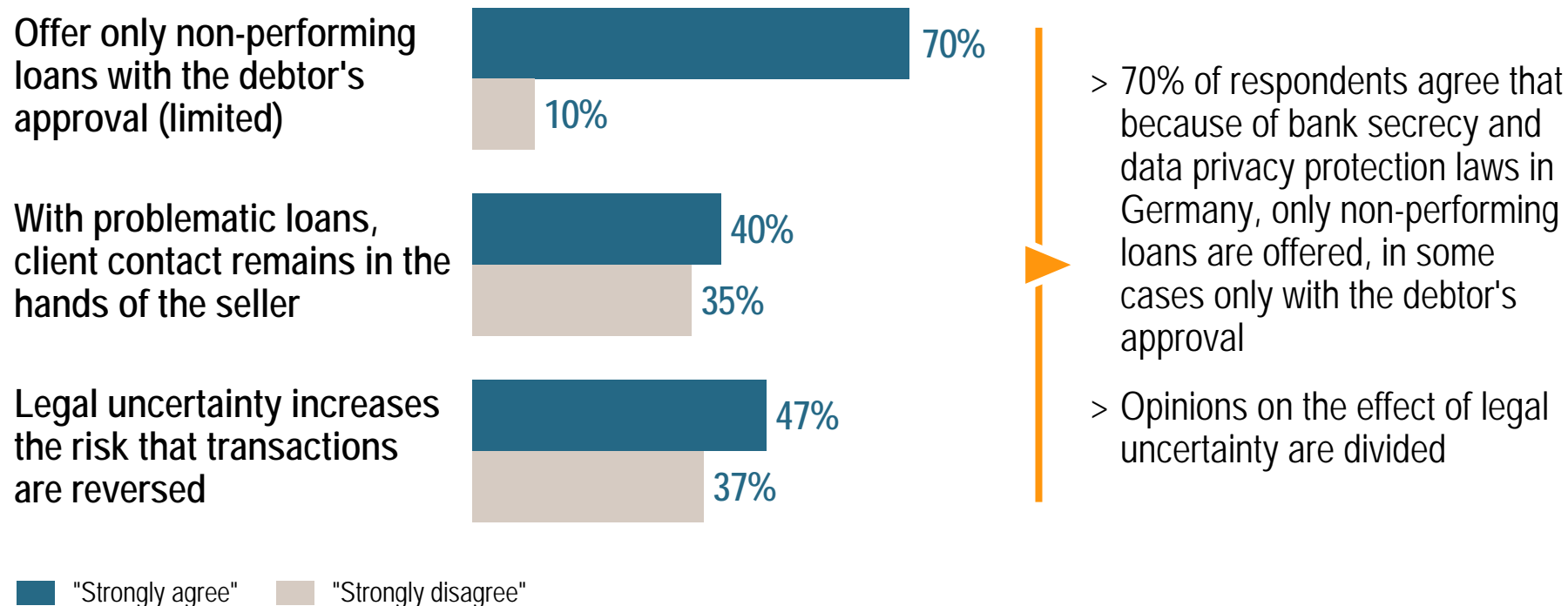
1) Average

EXPECTED TRANSACTION TYPES [%]<sup>1)</sup>



# Banking secrecy and data privacy protection are seen as barriers to trading activities

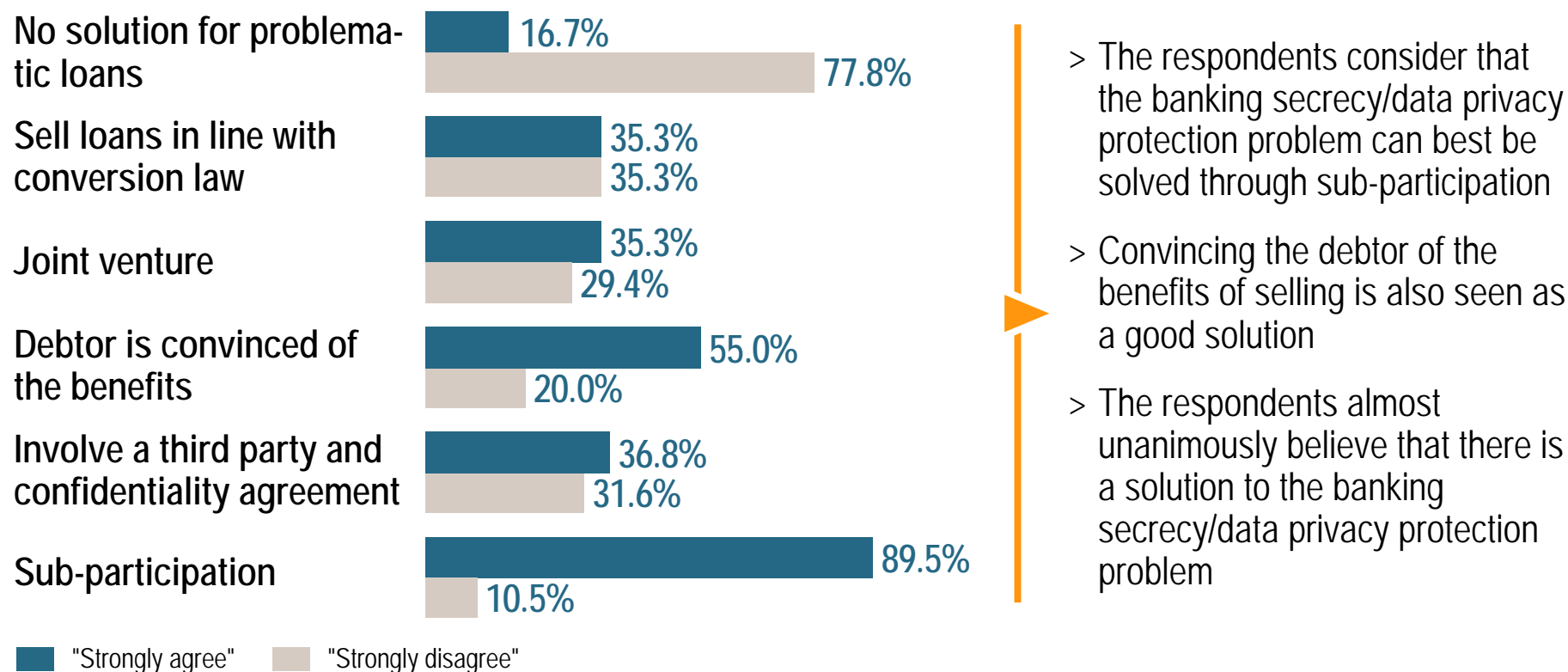
Problems with transactions for loans that the lender has not terminated due to bank secrecy and data privacy protection<sup>1)</sup>



1) Only "strongly agree" and "strongly disagree" are represented. "Don't know" has not been included here

# Sub-participation is seen as the best way to solve the banking secrecy/data privacy problem

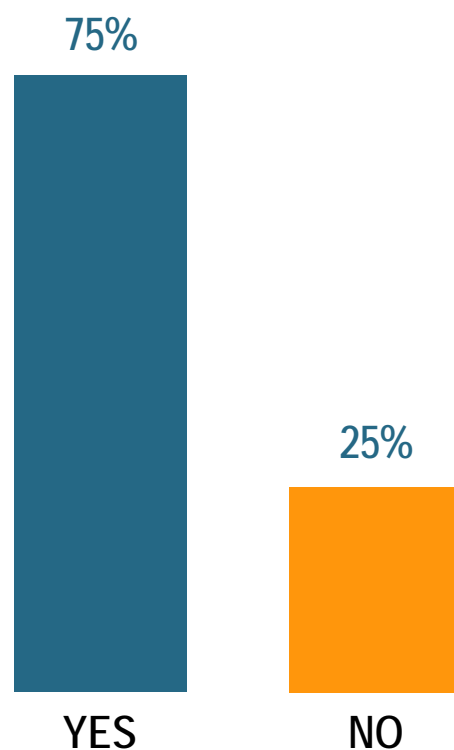
Ways of dealing with problems (bank secrecy/data privacy protection)<sup>1)</sup>



1) Only "strongly agree" and "strongly disagree" are represented. "Don't know" has not been included here

## 75% of respondents see long-term **problems** for investors who are **not licensed banks**

Long-term problems for investors who are not licensed banks



### REASONS

- > Bank license is necessary to buy loan commitments that have not been terminated
- > No fresh capital/cash in cases of capital reorganization
- > Not possible to take over servicing for problem clients
- > Problems with loans that have not been terminated
- > Not possible to enter balance settlement agreements (cash collateral, guarantee credits)
- > Risk of misuse of unregistered creditor positions

C.

Contacts & Backups



# Contacts

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## SWITZERLAND

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### **Beatrix Morath**

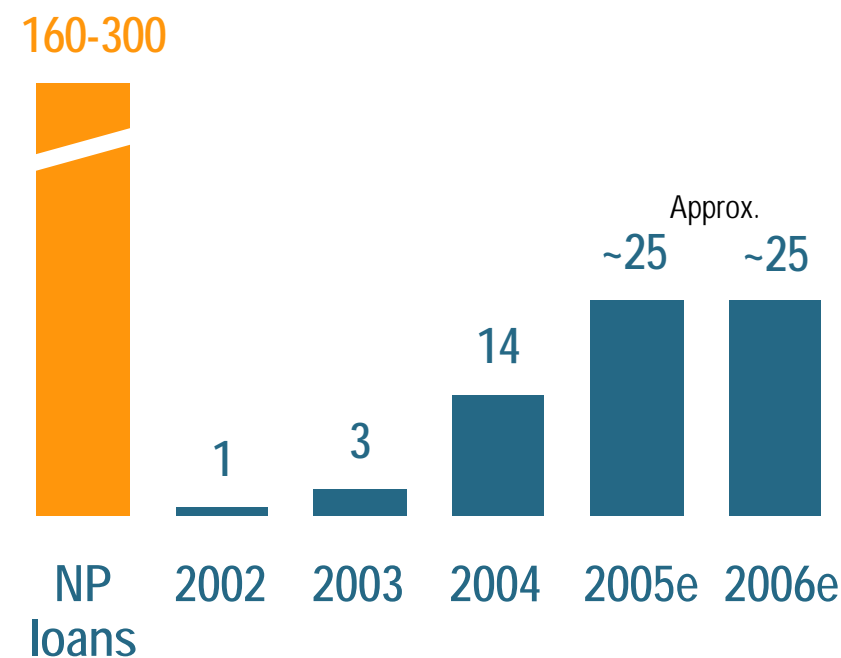
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# Private equity and distressed debt market in Germany still has development potential

Private equity market  
(investments/GDP) [%]



Distressed debt market  
[EUR bn]



*Nominal value of the transactions*

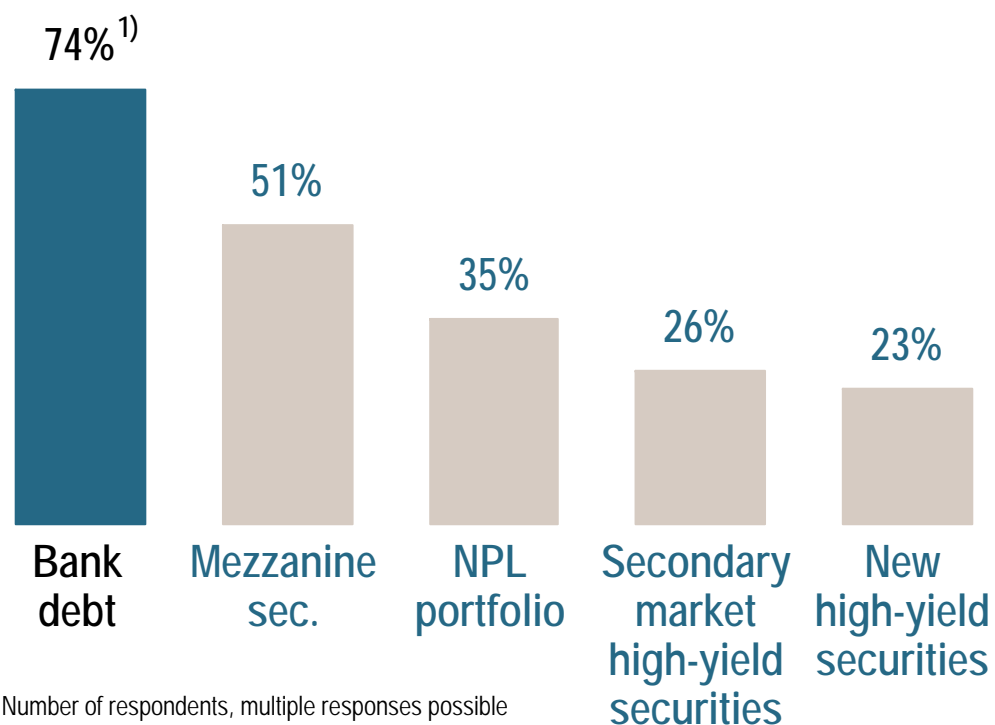
# Buyers of non-performing loans are mainly US investors

## NPL transactions in Germany

| Buyer                      | Seller/target            | Date           | Volume                  |
|----------------------------|--------------------------|----------------|-------------------------|
| WestLB/NordLB/Shinsei Bank | Initially own loans      | June 2005      | Initially EUR 400 m     |
| Lone Star                  | Aareal Bank              | June 2005      | EUR 690 m               |
| Lone Star                  | Mitteleurop. Handelsbank | June 2005      | As transaction platform |
| Lone Star/Merrill Lynch    | Dresdner Bank            | June 2005      | EUR 1,400 m             |
| Goldman Sachs              | Delmora                  | May 2005       | EUR 2,100 m             |
| Goldman Sachs              | Commerzbank              | February 2005  | EUR 350 m               |
| Lone Star                  | Dresdner Bank            | October 2004   | EUR 1,200 m             |
| Morgan Stanley/Citigroup   | Hypo Real Estate         | October 2004   | EUR 394 m               |
| Lone Star                  | Hypo Real Estate         | September 2004 | EUR 3,600 m             |
| Lone Star/JP Morgan        | Hypo Real Estate         | December 2003  | EUR 490 m               |
| Deutsche Bank              | Dresdner Bank            | May 2003       | EUR 511 m               |

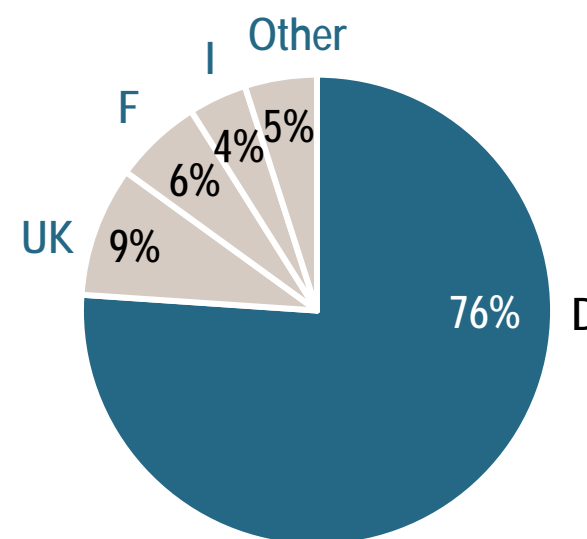
# Germany is considered attractive – Investment opportunities are especially expected in bank debt

## Attractiveness of DD investment according to type



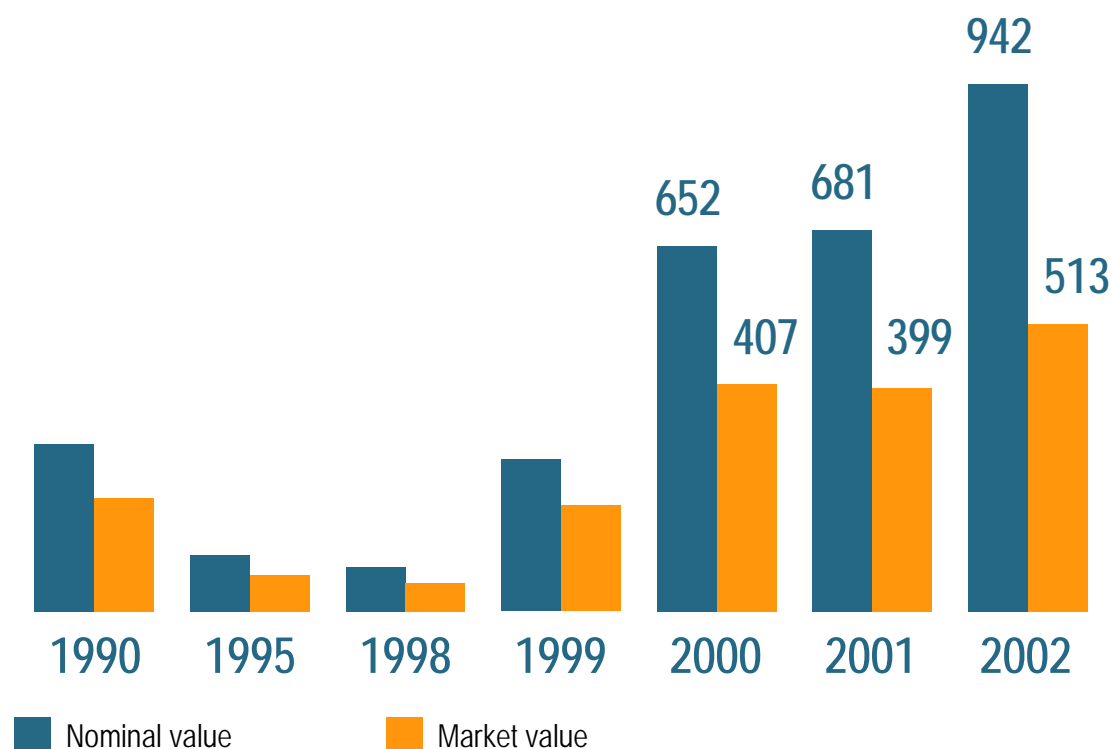
1) Number of respondents, multiple responses possible

## Country attractiveness for DD investments



# Especially secondary markets for acquiring debt capital from crisis companies is considerably more advanced

## Market volume for defaulted and distressed debt [USD bn]

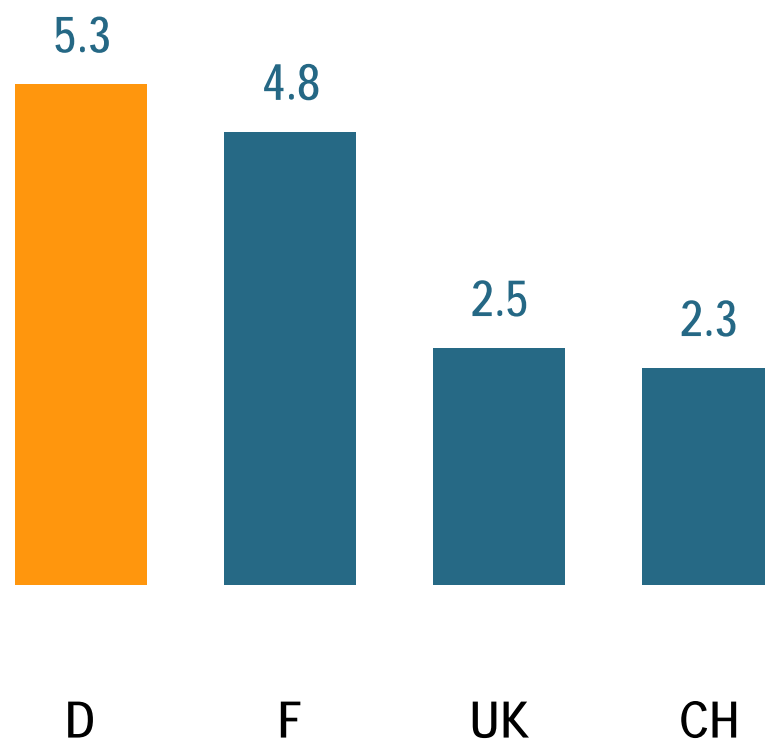


## Indicators for the level of development

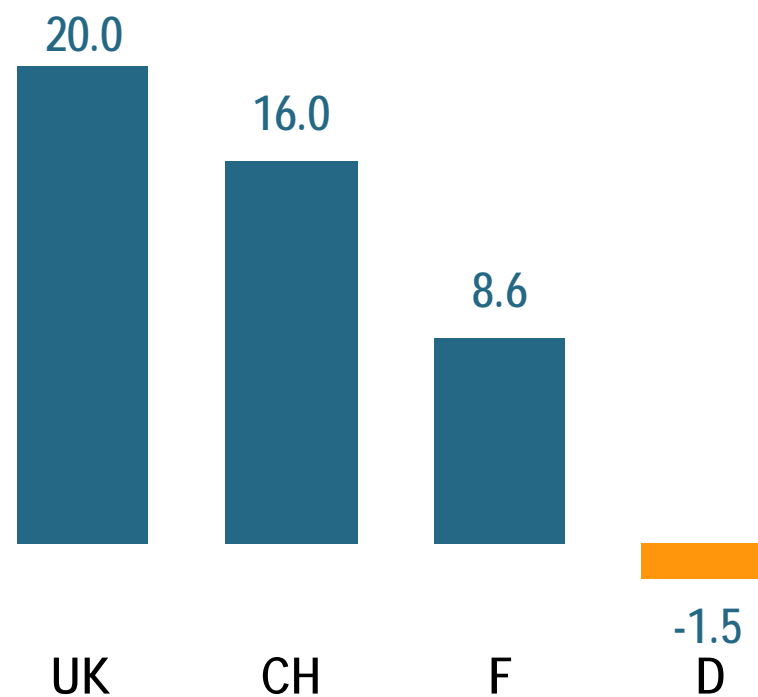
- > Return indices for measuring the performance of distressed debt investing – Altman-NYU Salomon Center Index for Defaulted Bonds and Bank Loans
- > Regular publishing of default rates
- > Detailed information on individual receivables
- > Combination of offering and demand on various markets

# Clear correlation between share of non-performing loans and profitability

Non-performing loans as a percentage of the entire loan volume<sup>1)</sup> [%]



Banks' return on equity<sup>1)</sup> [%]



1) Information as of 2003

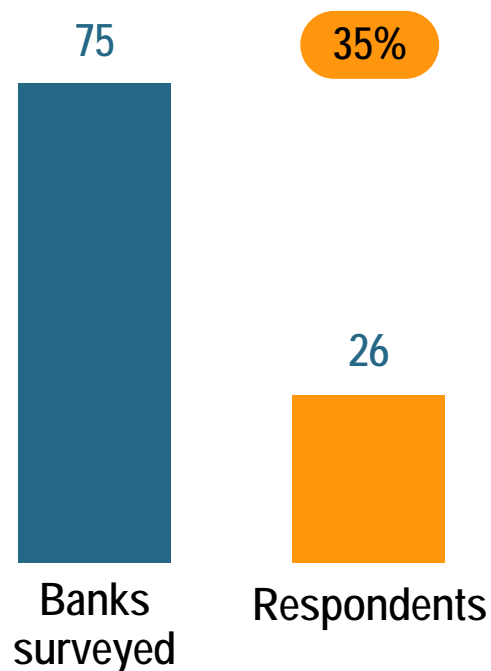
## Survey Details

- > In 2005, Roland Berger Strategy Consultants conducted the study "Distressed debt –the banks' perspective" in Germany, Austria, and Switzerland
- > Seventy-five banks in Germany, Austria and Switzerland were sent questionnaires. Thirty-six percent, or 26 banks, responded
- > The study focused on
  - The current market status for distressed debt in Germany, Austria and Switzerland
  - General conditions of the distressed debt market in Germany, Austria and Switzerland
  - Transaction processing and costs

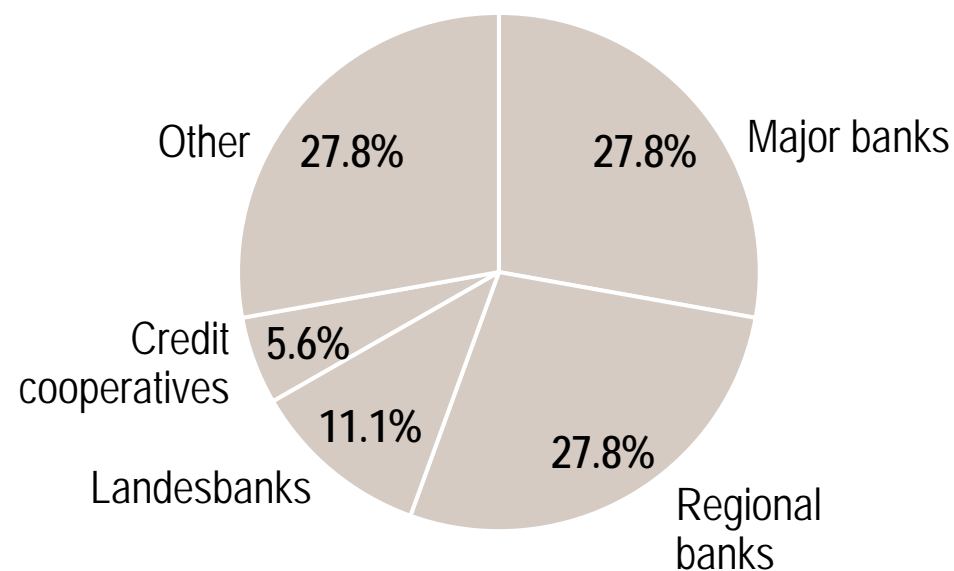
# Thirty-five percent of surveyed banks responded – banks from different segments participated

"Distressed debt" study overview

NUMBER OF BANKS SURVEYED



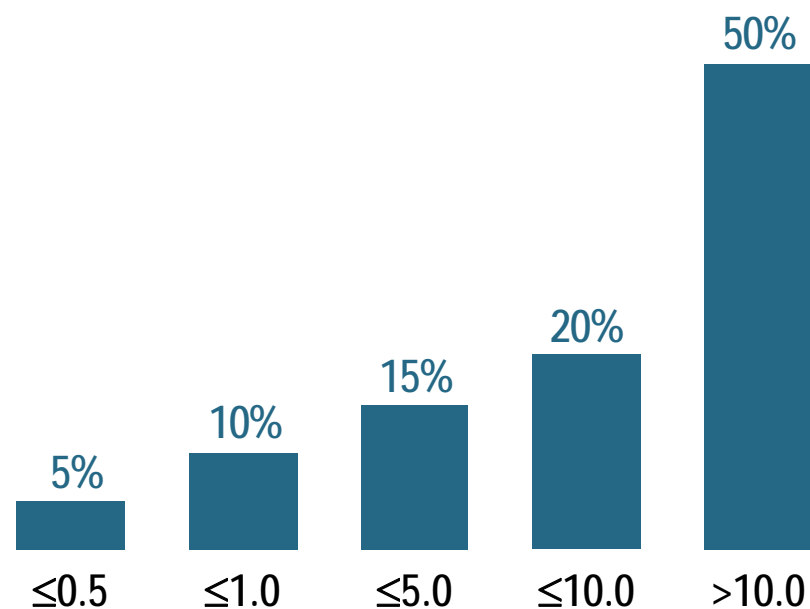
BANKS BY SEGMENT [%]



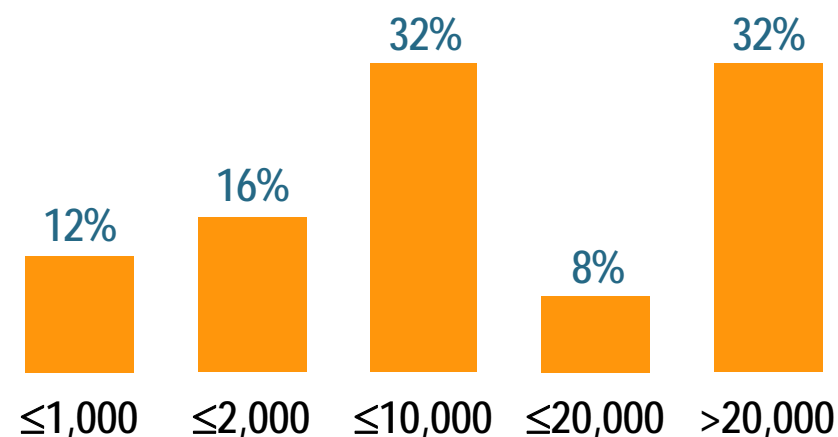
# The study included both major and mid-sized banks

Size of banks included in the study

BY ANNUAL NEW CREDIT VOLUME [EUR bn]



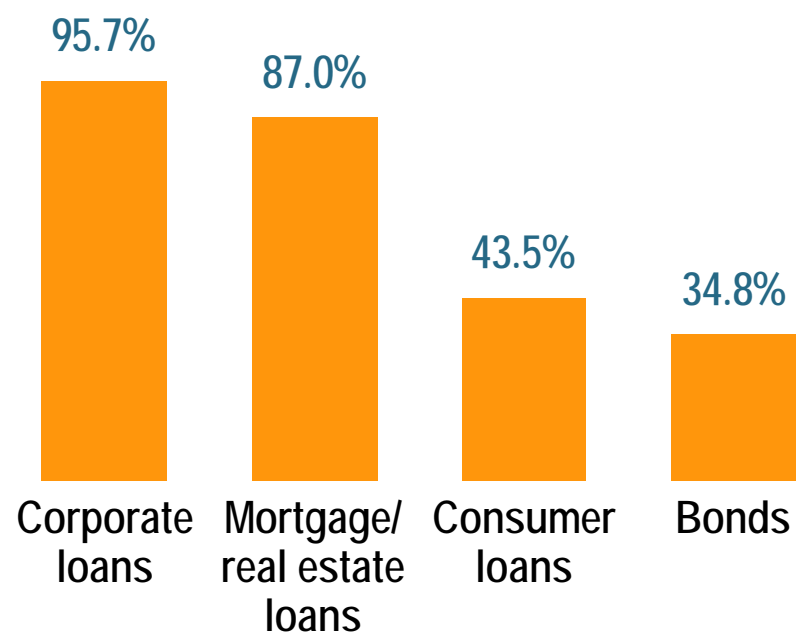
BY NUMBER OF EMPLOYEES



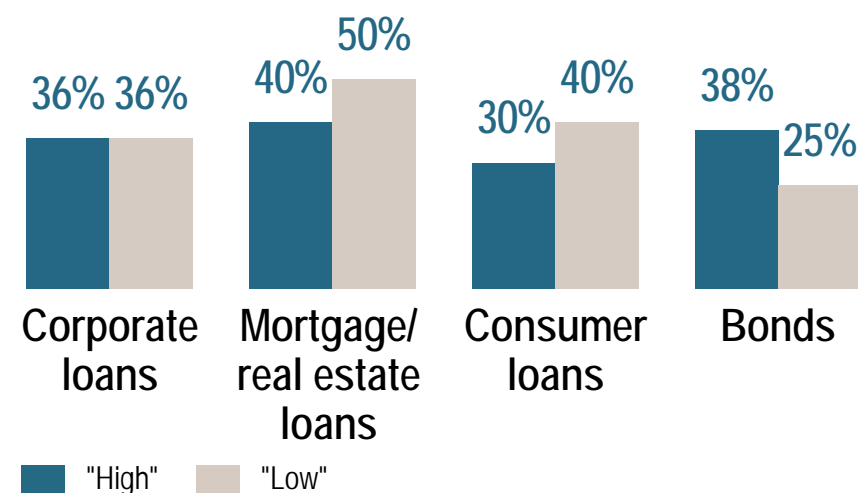
# Banks focus on corporate loans and mortgage/real estate loans

Types of distressed debt and transaction volumes

ACTIVITY BY DISTRESSED DEBT TYPE<sup>1)</sup>



TRANSACTION VOLUME<sup>2)</sup>

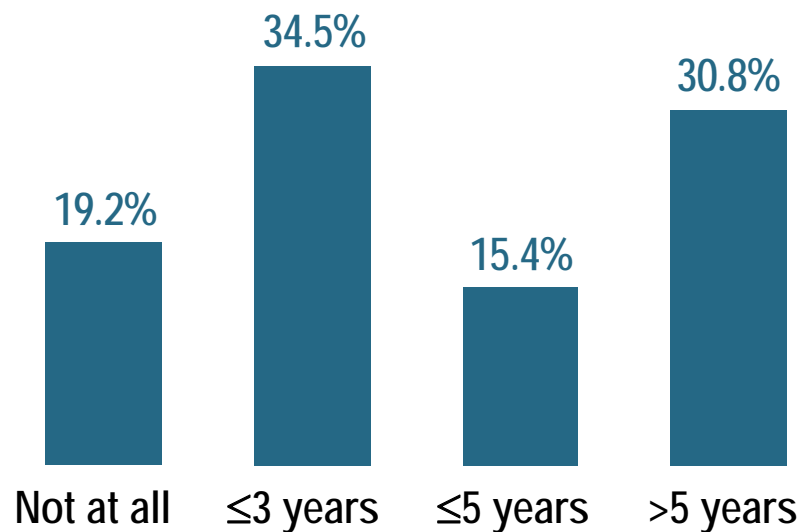


1) Multiple answers possible    2) Only "high" and "low" are represented. The mid-range is not included here

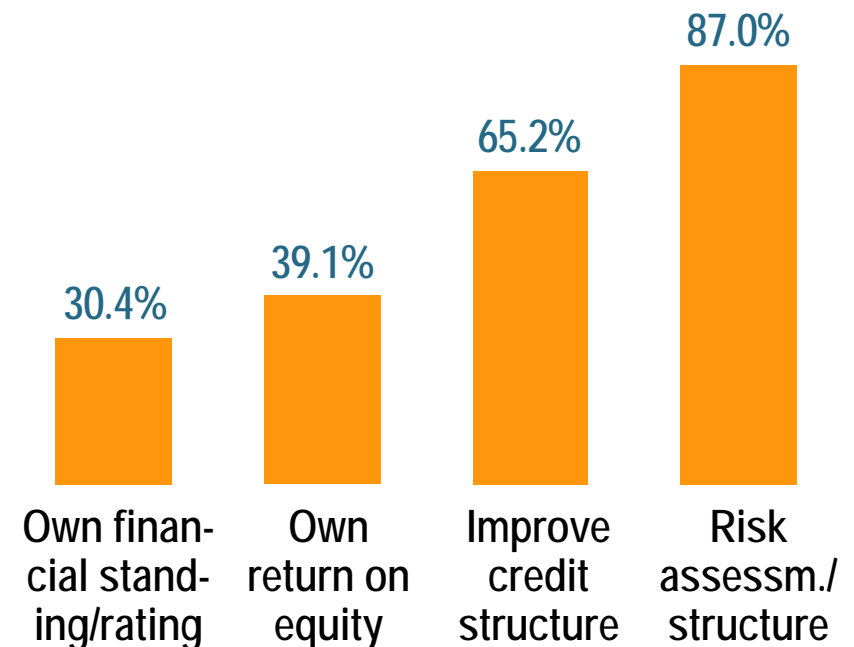
# 31% of banks surveyed have been active in the distressed debt segment over 5 years

## German banks in distressed debt segment

### INVOLVED IN THE DISTRESSED DEBT SEGMENT FOR ...



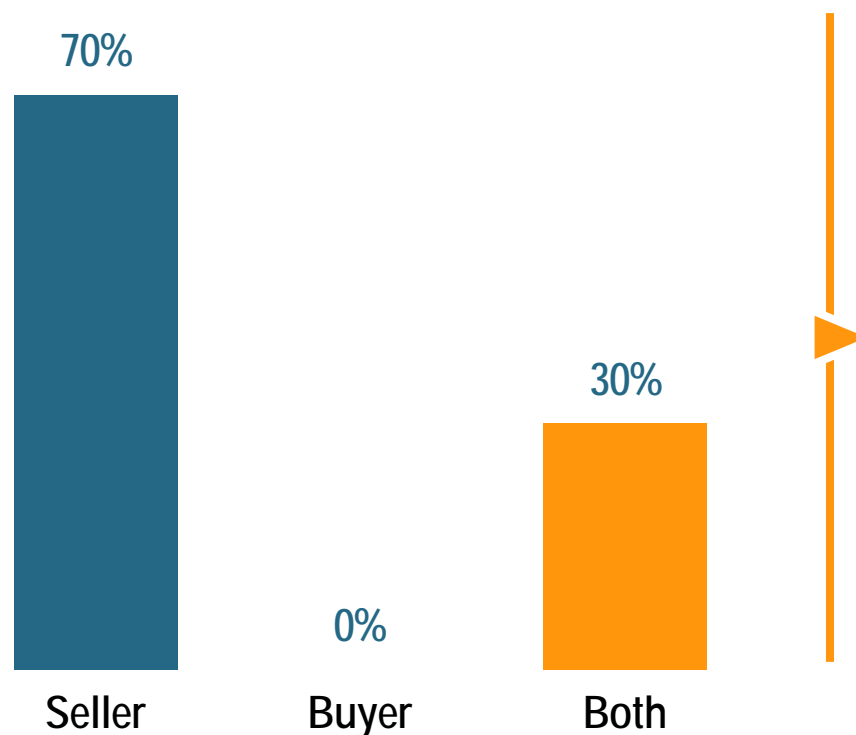
### REASONS FOR INVOLVEMENT IN DISTRESSED DEBT<sup>1)</sup>



1) Multiple answers possible

## 70% of respondents are only active in sales, while a mere 30% are active as "dealers"

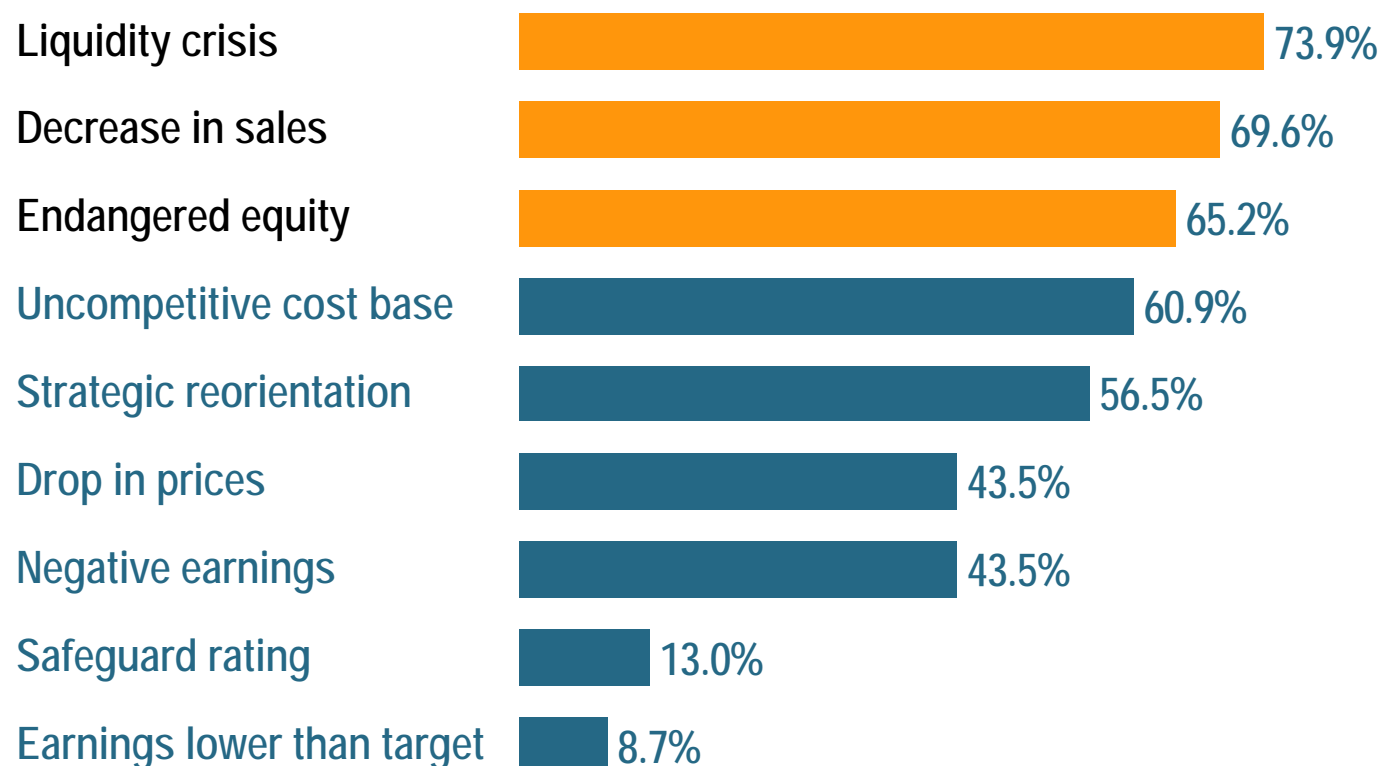
### Activities in distressed debt segment



- > 70% of respondents are only active in sales – these banks are therefore mainly interested in cleaning up their credit portfolio
- > 30% of respondents are active as "dealers", meaning that they are both buyers and sellers. In addition to cleaning up their credit portfolios, these banks also want to earn money through trading in credit commitments
- > There are no pure buyers among the respondents

# Banks identify liquidity crisis, sales decreases and endangered equity as the most common reasons

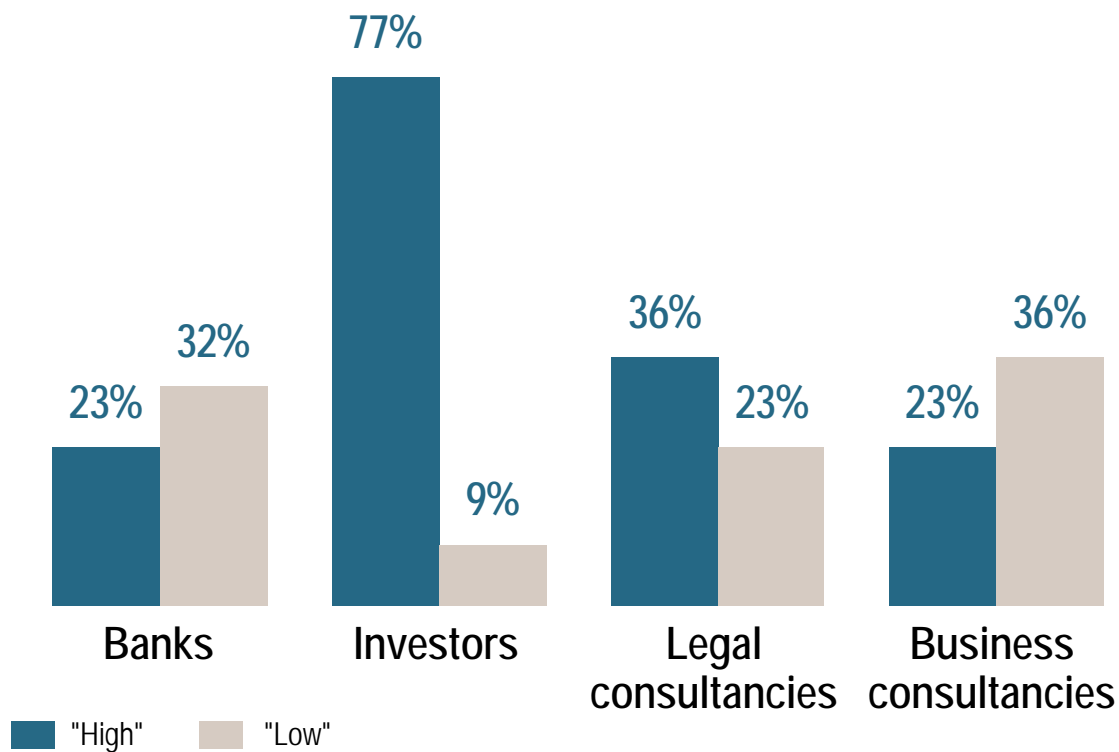
Reasons for distressed debt from banks' perspective [% of banks]<sup>1)</sup>



1) Multiple answers possible

# Investors are seen as being the most experienced players in the market

Experience of market players<sup>1)</sup>



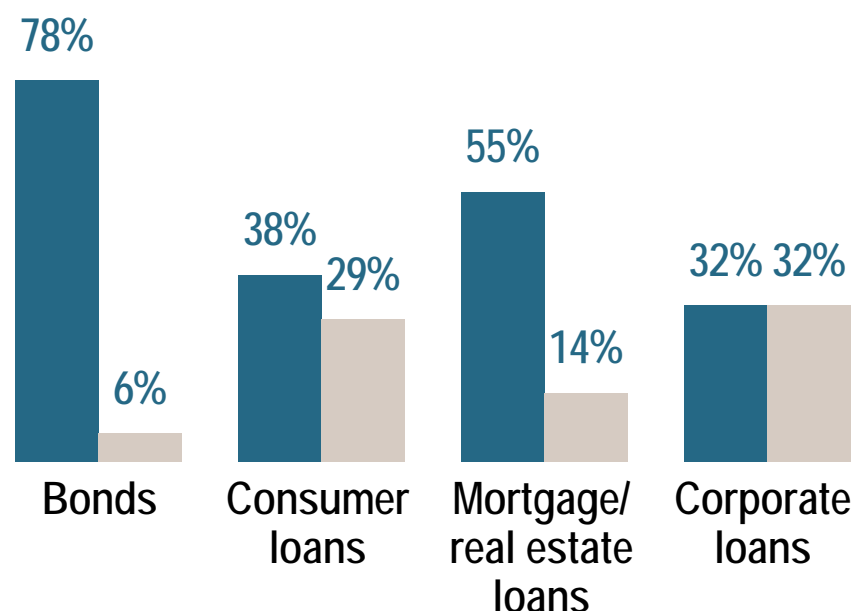
- > In the distressed debt market, **investors** are seen as being **the most experienced**
- > **Banks** see themselves as rather **inexperienced** in the market
- > **Legal consultancies** are seen as relatively experienced

1) Only "high" and "low" are represented. The mid-range is not included here.

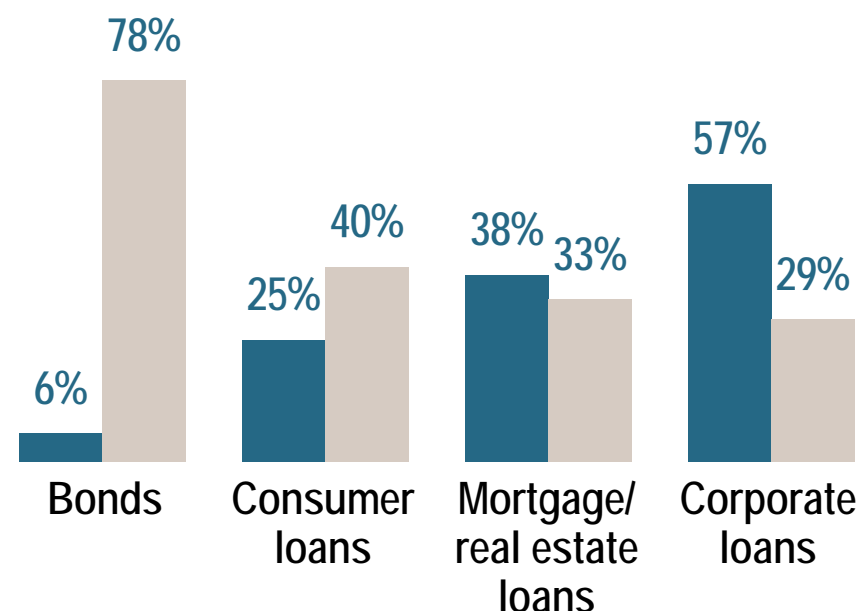
# Banks have the least experience and the most difficulties with corporate loan transactions

Experience and difficulties with transactions<sup>1)</sup>

## EXPERIENCE WITH TRANSACTIONS



## DIFFICULTIES WITH TRANSACTIONS



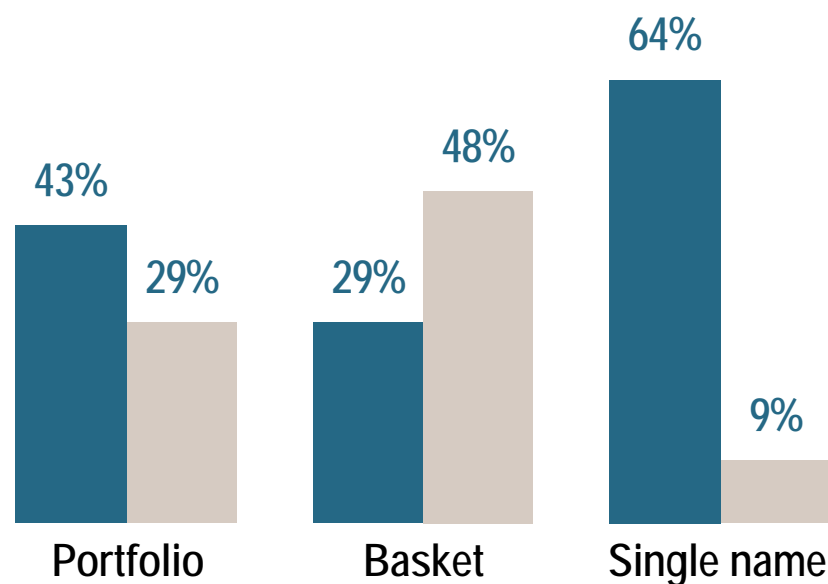
■ "High" ■ "Low"

1) Only "high" and "low" are represented. The mid-range is not included here

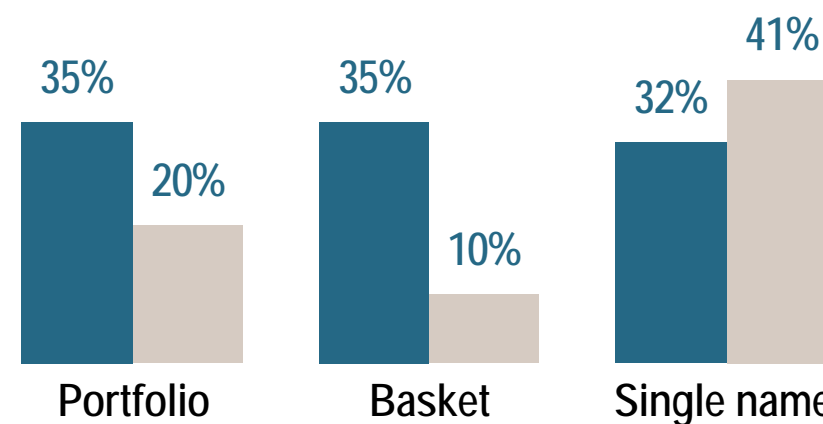
# Most experience is with single name transactions – which are also seen as the least problematic

Experience and difficulties with transactions<sup>1)</sup>

## EXPERIENCE WITH TRANSACTIONS



## DIFFICULTIES WITH TRANSACTIONS



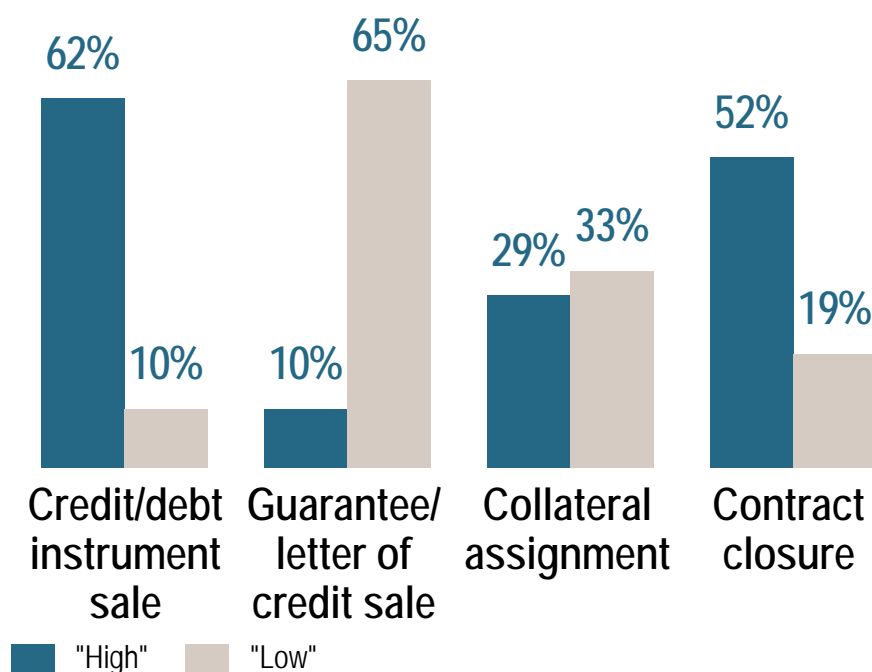
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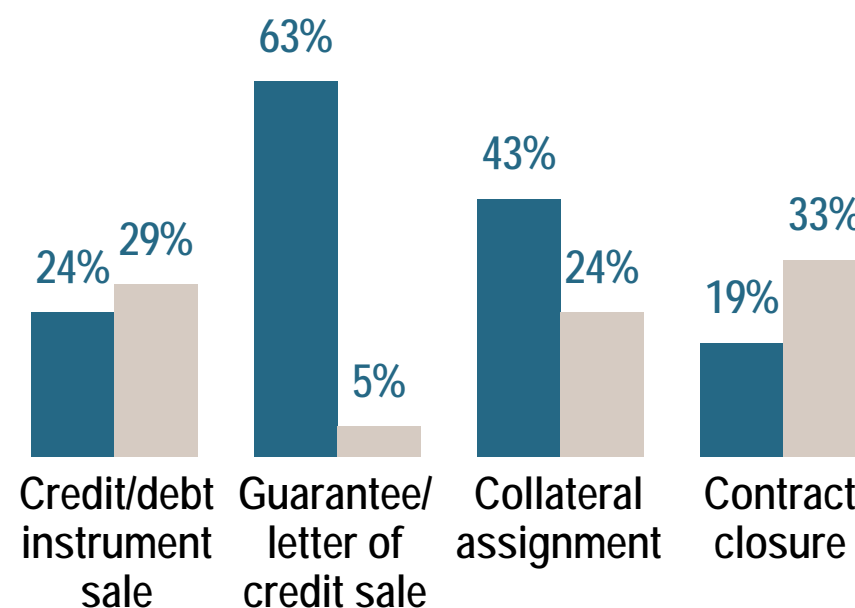
# Banks have little experience with guarantee and letter of credit transactions

Experience and difficulties with transactions<sup>1)</sup>

## EXPERIENCE WITH TRANSACTIONS



## DIFFICULTIES WITH TRANSACTIONS

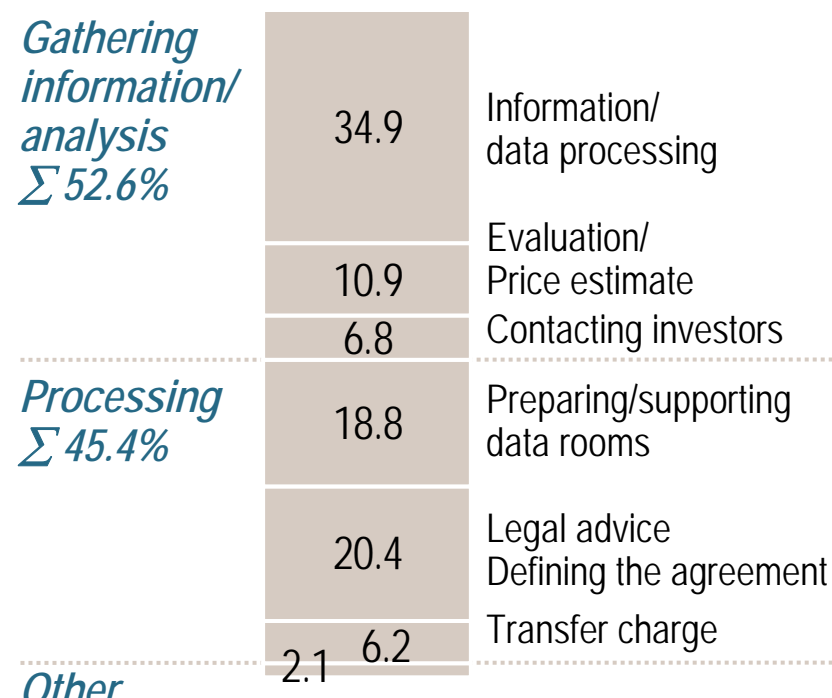


1) Only "high" and "low" are represented. The mid-range is not included here

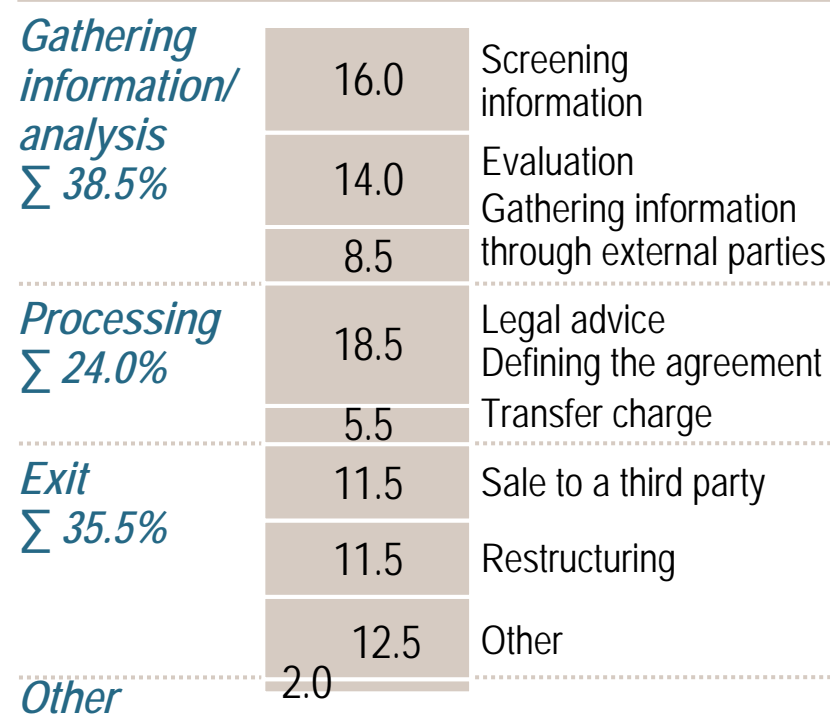
# From the seller's perspective, expenses related to data processing make up the biggest cost block

Share of main cost blocks of total transaction costs<sup>1)</sup> [%]

## FROM THE SELLER'S PERSPECTIVE



## FROM THE BUYER'S PERSPECTIVE

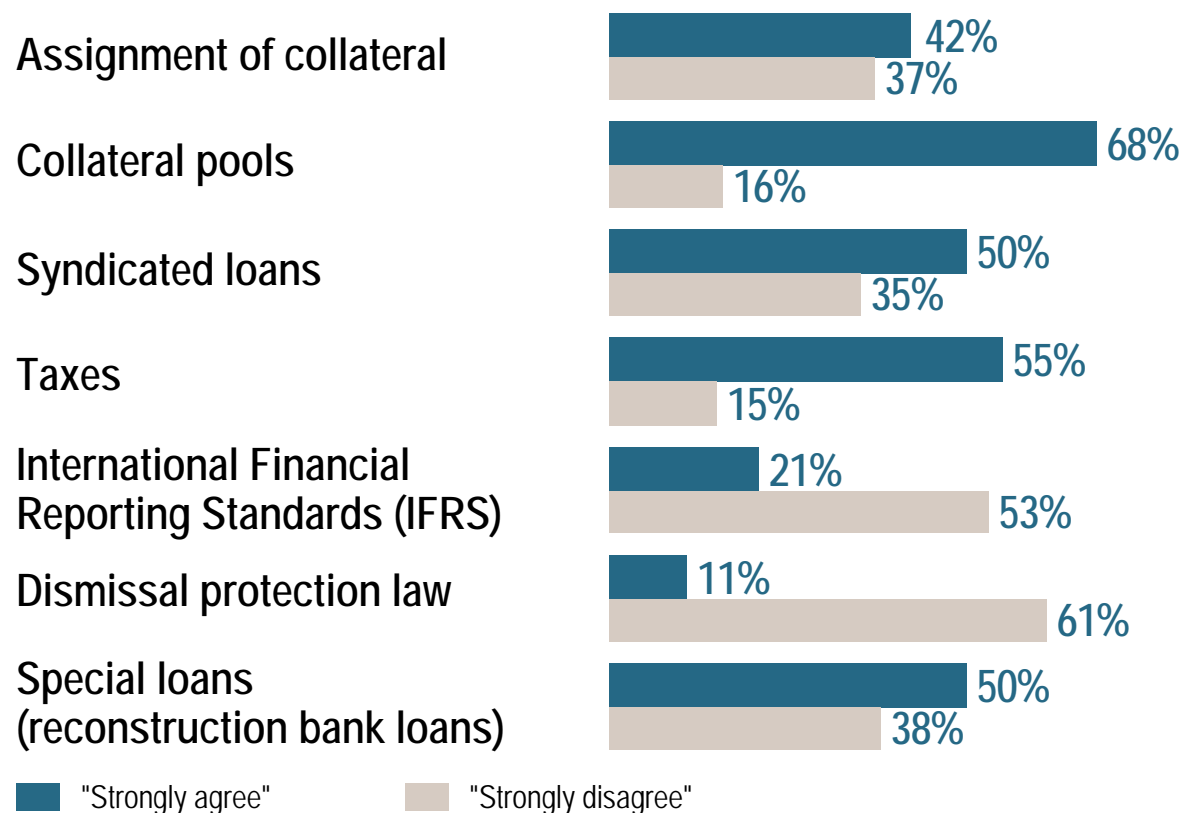


1) Average

Source: Roland Berger

# Collateral pools and taxes have a huge impact on distressed debt investing

## Legal regulations that impact distressed debt investing<sup>1)</sup>

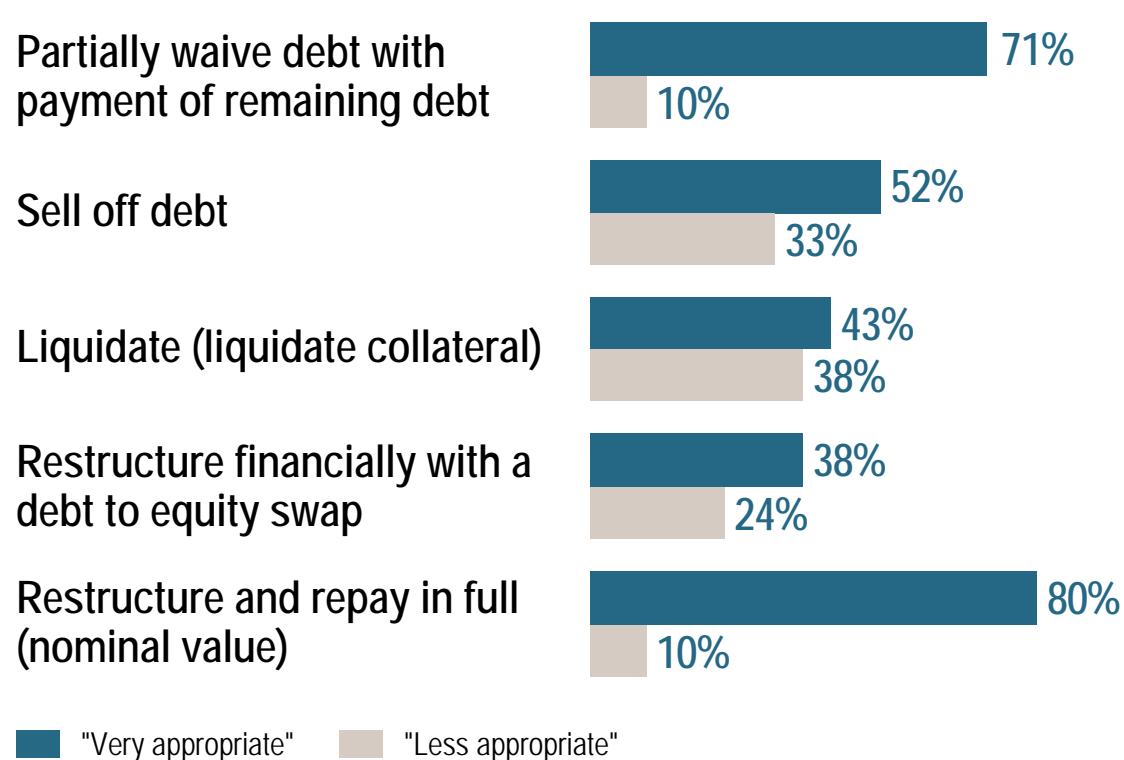


- > According to banks, collateral pools and taxes have a huge influence on distressed debt investing
- > Special loans, syndicated loans and collateral assignments are also influential factors
- > Dismissal protection laws and IFRS bare no influence

1) Only "strongly agree" and "strongly disagree" are represented. "Don't know" is not included here.

# Respondents see restructuring and complete debt repayment as the best exit strategy

## Appropriateness of exit strategies<sup>1)</sup>

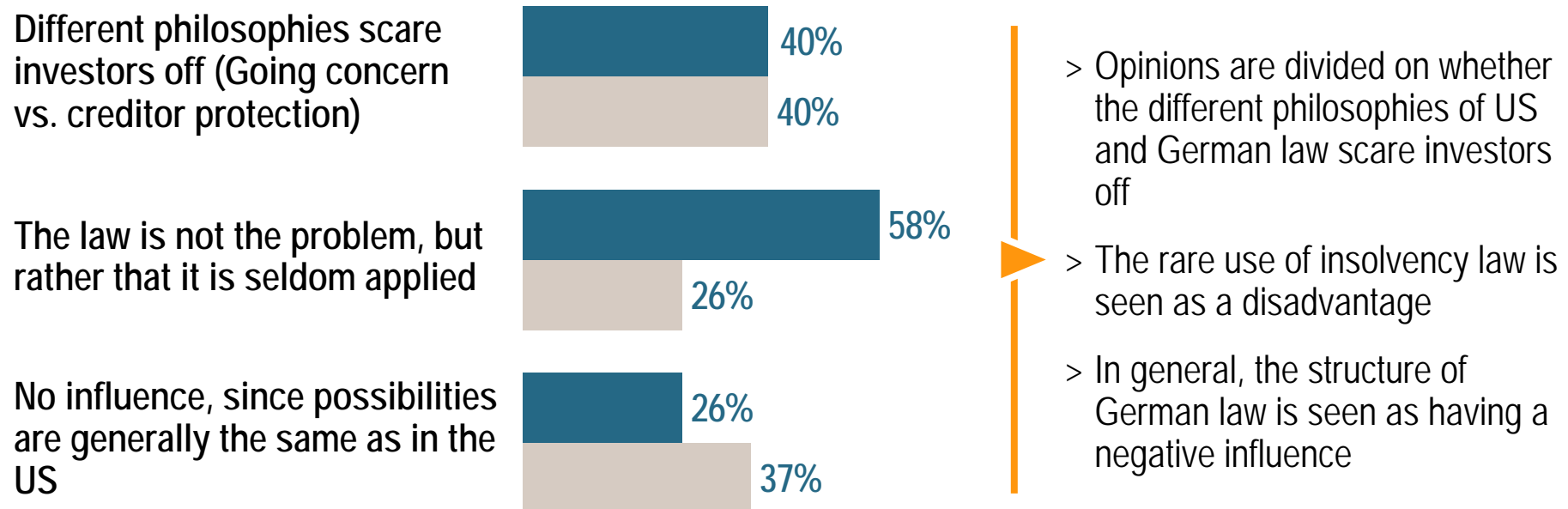


- > Respondents see corporate restructuring and full debt repayment as the ideal exit strategy
- > They consider partially waiving the remaining debt to be appropriate as well
- > Liquidation followed by a liquidation of collateral is seen as the least appropriate strategy
- > Selling off the debt and financial restructuring is seen as only moderately appropriate

1) Only "very appropriate" and "less appropriate" are represented. "Moderately appropriate" not included here.

# The rare use of insolvency law is seen as a disadvantage

Disadvantages due to insolvency law compared with the US<sup>1)</sup>



■ "Strongly agree"      ■ "Strongly disagree"

1) Only "high" and "low" are represented. The mid-range is not included here