

Giving PPIP a chance

April 09, 2009

By Nathan Stovall

They might have some concerns, but a handful of investors commended the government's attempt to tailor the Public-Private Investment Program to the buy side and are relatively optimistic that it could work.

The PPIP has two parts: The legacy loan program and the legacy securities program. The legacy loan program will provide ample leverage to investors — up to 12x investors' equity stake in the transaction — while the legacy securities program provides leverage equal to 4-to-1.

Both programs have received plenty of attention and criticism. Many observers have told us that the program could help narrow the gap between buyers' bids and sellers' asking prices. However, they have also noted that the PPIP will not help investors correctly value assets, at least at first.

Considering the complexity of the issue, Sandler O'Neill & Partners LP held a conference call April 8 with five investors to discuss the PPIP. All five investors said they plan to participate in the PPIP, and they hope it will restart the illiquid market for loan and securities sales.

One of the investors, Lance West, partner and senior managing director at private investment manager Centerbridge Partners, applauded the FDIC and the U.S. Treasury Department for their work on the creation of the PPIP. West, whose firm focused on private equity and distressed debt investments, said on the call that both parties have done a good job listening to the buy side and trying to marry public policy with what will be the best economic solution.

Ben Langorthy, a principal at Centerbridge Partners, added that the Treasury and the FDIC have done a "laudable job" in forming the structure of the PPIP.

West and the other investors do have concerns about doing business with the government and the possibility of Uncle Sam changing the rules of the game. Thomas Kendall, managing member and COO of FiveMile Capital, said he would like to know how the government will begin and end its involvement with the transactions. For instance, he questioned how the government's loan modification programs could impact assets purchased through the PPIP.

Still, Kendall said his largest concern is correctly valuing credits. He noted that leverage and financing will improve liquidity and pricing, but accurately valuing the assets still presents a hurdle.

Those concerns aside, the investors are appreciative of the government's efforts because the secondary market for loans and securities is in such disarray. Jas Khaira, a principal at GSO Capital Partners LP, Blackstone Group LP's distressed debt and credit platform, described the current state of the secondary markets as "idiosyncratic and dysfunctional." Khaira said he has evaluated and considered purchasing a "great deal" of construction and development and acquisition loan portfolios, but he has not completed many transactions due to a large disconnect between bids and asking prices. He said the few

transactions that have occurred in the marketplace were achieved through FDIC-run auctions.

"Hopefully, [the PPIP] will facilitate more transactions and create a more liquid market," Khaira said on the call.

The investors agreed that PPIP would provide leverage in many cases where it has not been readily available. Khaira said some sellers have offered financing on a few deals, but he questioned how valuable leverage is when purchasing nonperforming assets because the real difficulty lies in determining credit risk.

That inability to assess the risk of those assets has made the market for nonperforming paper virtually nonexistent, according to Timothy Clark, senior partner at CarVal Investors LLC. He said the bid/ask spread on that product has simply been too wide for transactions to occur.

The announcement of the PPIP has not closed that gap in the whole loan market yet, Langorthy said. Still, he does expect the program will eventually narrow the bid/ask spread in the marketplace.

"And if that's all it does, it will be successful," Langorthy said.

For his part, Khaira has greater faith in the legacy securities program, which he believes will increase liquidity as well as create markets for distressed securities and support for bids, helping all institutions gain clarity on asset valuations. Khaira said the legacy loan program is "hazier." He believes the government will struggle to force loan sales, and he is not convinced that it is an efficient way to enable banks to dispose of distressed loans.

However, Khaira said if the government desired to create a "closet" Resolution Trust Corp. to dispose of assets of failed or struggling institutions to avoid taking losses like they did with IndyMac Bancorp Inc., then the loan program would certainly be successful in its aim. However, Khaira is skeptical that the program will be successful in meaningfully impacting performing loans.

The investors do not expect the first transaction in the legacy loan program will include severely distressed assets, and they believe that a large bank will be the seller. They said the seller will very likely be one of the big banks that acquired a floundering institution over a matter of days, whether it is Wells Fargo & Co. selling Wachovia Corp. assets or JPMorgan Chase & Co. selling Washington Mutual Inc. or Bear Stearns Cos. LLC paper. They noted that the acquirers in those deals marked down the sellers' loan portfolios significantly at closing, which means the marks on those loans are much closer to current market prices. They further said the buyers completed the due diligence on those transactions so quickly that they likely ended up with assets that they do not want on their books. The investors believe that the first loan sale will likely be a pool of single-family mortgages, since that collateral is the easiest to value.

Khaira said the FDIC and Treasury almost certainly want to kick off the PPIP with a large transaction that grabs headlines and demonstrates that the program is in facilitating deals. No matter how large the deal is, Kendall said the first deal should not look like a sale that

was forced by regulators, because it could undermine the goal of the program.

The investors noted that banks' unwillingness to sell assets could present a hurdle for the PPIP. Banc of America Securities-Merrill Lynch analysts noted in an April 8 report that banks will likely be reluctant to sell assets through the PPIP if they believe the program will "crystallize losses" and impair their capital, requiring them to raise new funds through dilutive share sales. They added that if banks do not play ball, then the program will be a "non-starter."

"The likely unwillingness of the banks to sell assets well below carrying value is understandable. In many cases, carrying value of mortgage and other loans (credit cards, auto loans, and many corporate credits) is so much higher than what a market bid could be

that a sale of most of a bank's toxic assets could seriously deplete capital," the analysts wrote in the report.

Although banks might be hesitant, Kenneth Segal, senior vice president and director of asset finance services at Howe Barnes Hoefler & Arnett, urged them to act and offload distressed assets from their balance sheets. He said in a report released earlier this week that asset valuations will decline further as nonperforming assets rise across the industry and more assets come on the market as banks fail.

"Banks that do not systematically address and dispose of their problem loans will be facing rising levels of impaired investments that will be continually devalued as the hundreds of billions in failed loans and assets are sold into the secondary markets," Segal wrote in the report. *i*