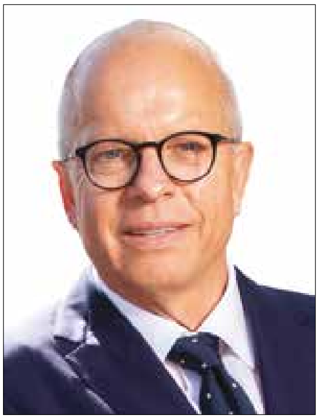
KEYNOTE INTERVIEW

The granular end of the European non-performing loan market is busier than ever, say LCM Partners' co-founder and chief executive Paul Burdell and chief investment officer Adrian Cloake



Private credit 3.0: What does it mean for European NPLs?

Q First, what do you mean by the phrase 'private credit 3.0'?

Paul Burdell: We've been referring to 'private credit 3.0' because it really feels like the market has entered a new phase. Version 1.0 was pre-global financial crisis when private credit was a nascent industry with fairly limited activity. Version 2.0 saw higher growth and new entrants post-GFC when new regulatory legislation put pressure on the banks and the search for yield in a zero interest rate environment led to a dramatic increase in investor demand. Today, private credit feels significant and well established, and yet still small relative to the overall debt markets and with huge potential for growth.

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Bank behaviour has fundamentally changed, and that's generating a large and diverse range of investment opportunities. If the industry can continue to innovate and further penetrate the pension, insurance and wealth distribution channels with appropriately structured investment vehicles, we expect private credit to continue to take market share from other asset classes. The fixed income market is over $100 trillion globally while private credit is just approaching $2 trillion, according to Preqin estimates. You can see why some are forecasting that the asset class has the potential to almost double by 2030.

Q What is an example of bank behaviour changing as it relates to LCM?

Adrian Cloake: Barely a week goes by without a news article reminding us about the new world in which the banks have to operate, whether it's something about branch closures, the latest innovation in significant risk transfer transactions (SRTs) or the more recent green shoots of M&A activity in the sector. That state of flux is most visibly relatable to our asset-backed lending product (SOLO), with so many of the banks having exited the leasing markets which we target. In the final quarter of

Q Given the levels of activity, what is competition like at the granular end of the market?

AC: There is always competition but the supply and demand dynamics have become more favourable today following the increases in interest rates. Our competitors are primarily balance sheet buyers who took full advantage of freely available and low cost leverage when base rates were zero but are inevitably more capital constrained today. Access to the debt capital markets is either no longer an option or it's got much more expensive. Two of the larger leveraged NPL buyers in Europe are currently going through restructuring processes.

PB: It's important to remember that at the granular end of the market your asset management and servicing capabilities are central to the investment thesis. Not only does the servicer actively work out the portfolio but it also looks after all the loan level payment and behavioural data which you use for refining your pricing of new transactions. On top of that, the banks are ultra-sensitive about who they sell to. If you don't have the right servicing capabilities, you won't make it onto the bank buyer panels. There's also a connected point regarding the trend towards forward flow arrangements. The banks want to work with a stable, trusted partner over multiple years. We've been an ever-present operator in the market since 1998 and we don't have any debt on our balance sheet. The banks know we're going to be here for the long term.

2024 alone, Hampshire Trust Bank and ABN AMRO Bank announced they were winding down their activities in UK asset finance.

The impact on our Credit Opportunities (COPS) strategy, which acquires consumer and SME performing (PL), re-performing (RPL) and non-performing loans (NPL), seems more nuanced but is no less significant. Most market commentators assume that the European NPL story has run its course but that couldn't be further from the truth. Banks are now genuinely incentivised to recognise and sell their non-performing exposures as they arise rather than stock-pile them due to the drag on balance sheet efficiency. For us this is most easily illustrated by the number of long term forward flow arrangements we have in place to acquire NPLs on an ongoing basis, typically monthly. Ten years ago we had just a handful of such bank partnerships in place, today we have close to 30 and counting.

PB: We've always positioned ourselves as a solutions provider to the banks and, more than ever, they are receptive to good ideas. If you can offer a solution that can help them drive capital efficiencies or operational cost savings, or preferably both, they're going to listen to what you have to say.

Q Your own activity has increased but what about the European NPL market more generally?

PB: The perception that there's been a slow down in European NPL loan sales hasn't held true for us. 2024 was a record year for our COPS strategy with €1.4 billion of capital deployed into buying loans from banks. Having said that, it's important to distinguish between the larger ticket and granular ends of the market. According to the European Banking Authority (EBA), the stock of EU NPLs stands at just under €400 billion, well down from the €1 trillion of NPL and non-core assets post-GFC as most of the larger-ticket NPL asset sale programmes – many of which via bad banks or other state sponsored schemes – have now been completed. But, at the granular end of the market, there will always be individuals or small businesses that, through no fault of their own, lose their job or a major customer or simply just over-extend themselves, and it's now just too capital inefficient for the banks to hold on to these exposures. And remember it's been a benign environment. Any downturn in the economy and we're only going to get busier.

AC: From a regulatory standpoint, while implementation of Basel 3.1 has been pushed back, the compounding impact of the existing Basel regulations, as well as IFRS 9 and the European Central Bank's time-based provisioning rules for banks, should not be underestimated. We first transacted in France in 2016, for example, but, up until recently, it had been a small market for us because the banks there weren't sellers. They preferred to manage their NPLs in-house but now that's changed. France is a pretty active market today and a growing one where we expect to deploy meaningfully this year. There have also been new types of banking assets coming to market. Using Italy as an example this time, there were €340 billion of government-backed covid-related loans issued to companies from 2020 to 2023 which local institutions are now looking to offload as they default. Given the government guarantee, we like the risk profile of these loans at the right price. But it's a market that is only just starting to get going and the pipeline should be sizeable in the next five years. Overall, we're seeing these same dynamics – markets opening up and new asset types being sold – across our European footprint and that all adds up.

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> **ADRIAN CLOAKE**

Q Aside from the regulatory pressure fuelling NPL sales, are there any other drivers of the increased activity in COPS?

AC: Secondaries are a growing part of our COPS strategy and currently represent around 20 percent of its total deployment. There have been €1.3 trillion of NPL and non-core loan sales in Europe over the last decade, and many of the vehicles that acquired these assets are coming to the end of their respective lives. Secondary transactions naturally play to our strengths as the tails of these portfolios are typically more granular and there's a discrete track record that can be diligenced. The flip-side is that you've got a very knowledgeable seller as well.

PB: We've not mentioned performing loans either. In the past, PLs have been sold because a bank wants to exit a country or product line – because its unprofitable or just lacks scale in the face of increasing capital charges – and we have acquired the run-off, taking over the operational responsibilities as well. That now generally represents around 20-25 percent of what we do in any year.

Going back to our earlier comments around being a solutions provider, we're also seeing increased interest in performing loan forward flows from our partner banks. A bank may want to exit a subscale product line, but they don't want to lose the customer relationship and would like to retain some income stream. In our case, to solve the vendor's capital issue we can purchase the loan shortly after it's been originated and we can then manage the loans and borrowers via our servicing operations to solve the operational issue. It's a neat solution where everyone benefits.

Q In how many European markets do you have a local servicing presence?

PB: We've now got almost 2,000 people operating in 11 countries across our European origination and servicing platform and we're going to continue expanding gradually. For instance, we opened a servicing office in Stockholm towards the end of last year. Sweden is a mature NPL market but one where historically we have struggled to be competitive given the strong presence of the balance sheet NPL buyers who've had to retrench of late.

AC: What's really interesting is that, across all our markets, the servicing landscape is evolving faster than ever. Managing consumer or small business borrowers is all about efficiency as well as delivering excellent customer service and the advent of technologies such as robotic process automation and the various forms of AI means there is huge scope for practical operational improvements in both areas.

But it's equally important to listen to the end customer. Their behaviour is changing rapidly in what's becoming a predominantly digital world. That means making considerable investments in the customer experience. The landline no longer exists and people are less willing to be contacted even by mobile so it's all about digital contact methods and facilitating self-service through online portals. It's quite a big shift but ultimately will bring costs down.

Q What are your expectations for 2025?

PB: Put simply, more of the same. Our pan-European platform is a competitive advantage and we are going to leverage that footprint by continuing to do what we have done for the last 26 years. We are a solutions provider and undoubtedly the banks need our help more than ever. ■