Silver Linings from Ireland's Financial Clouds

The lessons of the on-going financial crisis have been hard-learnt globally and Ireland is no different.

Our problems arose primarily as a consequence of the largely self-developed property bubble, due to rapidly increasing prices, fuelled by the availability of cheap credit in the context of light regulation. One of the tools which has been utilised to try to recognise the scale of the problem and kick-start the economy, particularly the real estate industry, is the sale of distressed assets and loans.

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When speaking of "distressed assets" what is generally being dealt with is a "distressed loan". An asset is worth what it realises in the marketplace. If the loans and the associated security instruments are sold, as distinct from the asset itself, then the purchaser gets recourse to the underlying asset through enforcing the loan and the underlying security. The borrower may be unable to repay the loan and therefore the loan is distressed. If an asset is sold for less than it was bought for, then it is not in itself distressed but overvalued in the context of funding that has been put in place with respect to it.

1. Sales

The disposal of assets, by lenders directly, by receivers at the instigation of lenders and by borrowers has manifested itself in a number of ways including through:

a) Loan Portfolios

Once it became apparent that certain of the banking entities operating in Ireland were looking to divest themselves of their distressed assets, an immediate market opened up for investors, who saw an opportunity to pick up valuable assets at competitive prices in order to hold these and wait for the property markets to improve, or enhance the management of the debt and then realise a profit through renegotiated loan deals or improved borrower performance.

The Irish Bank Resolution Corporation (IBRC) is in liquidation in accordance with the Irish Bank Resolution Corporation Act 2013. This legislation requires that the Special Liquidator of IBRC seeks purchasers before selling the remaining assets on the IBRC balance sheet to the National Asset Management Agency (NAMA) as purchaser of last resort.

NAMA has already taken control of 12,000 real estate loans from the banks, valued at €74 billion, according to its Annual Report and Financial Statements 2012.

Meanwhile, Lloyds Banking Group sold a portfolio known as Project Prince to Kennedy Wilson Europe and Deutsche Bank for a reported €61 million. Project Pittlane, a more complex loan portfolio valued at €2.2 billion was sold to Apollo Global Management and CarVal in September 2012 at a reported 75-90% discount.

b) Individual Assets

We have seen a growing trend of the sale of specific assets, usually by receivers. Recent transactions in which we acted include:

i. representing banks providing debt finance to Kennedy Wilson for the purchase of the Alliance Building in Dublin

ii. advising DTZ and Bank of Ireland in respect of the sale of office premises

iii. representing bank consortium on the sale of the former Bank of Ireland corporate headquarters on Baggot Street

iv. advising various UK advisors relating to sales and purchases for non-Irish clients.

2. Deal Structure

There have been recent legislative changes in Ireland which facilitate the acquisition and retention of assets through tax-efficient vehicles and holding structures. The typical structures are:

a) Section 110 vehicles
Section 110 of the Taxes Consolidation Act, 1997 permits qualifying Irish resident special purpose vehicles (SPVs) to engage in an extensive range of financial and leasing transactions in a tax-neutral manner. A section 110 SPV is normally utilised in securitisation transactions.

An Irish tax-resident company may elect under section 110 of the Taxes Consolidation Act, 1997 to have expenses that would not otherwise be deductible set against its income so that effectively, the profit subject to Irish tax at 25%, is negligible. This entity benefits from Ireland's tax treaties on a worldwide basis. As most profit-participating interest payable to investors is deductible, taxable profits in a section 110 company are typically nominal.

Certain conditions must be met to benefit from this treatment, including that the company must be Irish tax resident, have qualifying assets of a market value of not less than €10,000,000 on the day on which the assets are first acquired, must transact business on an arm's length basis, with the exception of the profit-participating loan note, and must elect for section 110 treatment with the Revenue Commissioners.

b) Qualifying Investor Alternative Investment Funds ("QIF")
The general investment and borrowing restrictions imposed by the Central Bank on investment funds are avoided by structuring the fund as a QIF.

A QIF can pursue investment strategies including short selling, significant borrowings and leverage, derivatives and investments in other funds, without restriction. Similarly, the limits on the level of investment in any given market or securities which apply to all other types of funds in Ireland do not apply to a QIF.

Accordingly, QIFs are particularly suitable for sale to sophisticated investors such as high net worth individuals and institutions and are very suited to the acquisition and management of distressed assets.

To qualify as a QIF, a fund must:

- impose a minimum subscription requirement of at least €100,000 per investor;
- be marketed solely to qualifying investors who meet criteria set out in the Markets in Financial Instruments Directive (MiFID), be successfully appraised by an EU credit institution, MiFID firm or a UCITS management company, or who have certified that they are an informed investor.

The QIF is tax-exempt on its income and gains and has the ability to pay tax-free returns to investors without incidence of Irish tax.

c) Real Estate Investment Trust ("REIT")
The Finance Act, 2013 introduced the concept of Real Estate Investment Trusts (REITs) into Irish legislation for the first time. These investment vehicles are used in more than 30 jurisdictions worldwide and their introduction here is aimed at enhancing and improving the levels of real estate investment in Ireland by bringing fresh capital into the Irish real estate market. Subject to a REIT meeting particular conditions, certain tax exemptions are available to REITs in respect of incoming chargeable gains derived from exploitation of a property rental business. The first Irish REIT, Green Reit plc was launched in July 2013.

3. Trends

Over the last year and a half, transaction volumes and frequency have increased significantly in the real estate market.

Not all distressed assets sales relate to real estate assets. Many do, but there are others which also form the basis of a properly constructed distressed asset purchase transactions.

Given all that has occurred with respect to the State's finances, it will have come as no surprise that part of the arrangements with the Troika involve the on-going disposal of certain State assets.

Among the assets up for sale are Bord Gáis Energy, Aer Lingus, Irish Life and reportedly, the preference shareholding that the State has in Bank of Ireland. We await with interest for further developments in the sale of distressed assets in Ireland. ■