Investor eager to take banks' shaky loans

Recovery Partners

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Alex Jurshevski, chief executive and portfolio manager at Recovery Partners LLP, is convinced he's found a stellar investment opportunity where others only see bewildering complexity and risk.

He is trying to raise at least $500-million over the next three years to buy distressed or unwanted loans from banks and other financial institutions. Spurred by new global regulations in 2006, the banks will be itching to sell certain assets to avoid putting up more capital to offset risk, he predicts. Mr. Jurshevski and his team are aiming buy some of these cast-offs, restructure them, and sell them to banks or other investors.

It's a potentially massive market, with an estimated US$700-billion to US$1-trillion in assets coming up for grabs in Europe and North America. In Canada, $20-billion to $40-billion in assets may be discarded by banks, Mr. Jurshevski predicts, perhaps more. If even a fraction of the Canadian banks' $1.7-trillion in assets are deemed undesirable and sold off, it will create a sizeable niche for Recovery Partners and others targeting this virgin territory.

"You don't have to make heroic assumptions to identify this is a business opportunity for some people," Mr. Jurshevski said. "Banks will now have to look at reallocating where they are using their capital under the new rules."

There are already hedge funds and vulture funds buying distressed debt, but they are typically looking for quick trading opportunities or buy senior debt to gain control of a company.

Recovery Partners, however, is focused on turnaround situations. Mr. Jurshevski is primarily looking for portfolios of commercial loans made to companies that are struggling.

"It's our job to determine which businesses are viable," said Chris Gilmore, managing director and credit specialist. "If it's a dog, you shoot it in the street."

When it comes to turnarounds, loan workouts and restructuring, Mr. Jurshevski appears to have plenty of experience, much of it gained a long way from Bay Street.

In the early 1990s, Mr. Jurshevski was working in Tokyo, running the Asian capital markets unit of Canadian Imperial Bank of Commerce when a headhunter from KPMG LLP called with an unexpected opportunity.

By 1992, New Zealand's government had a serious problem: more than US$35-billion in debt, of which more than 60% was denominated in foreign currencies. Taxpayers were dangerously exposed, since New Zealand's debt swelled as the value of these currencies increased relative to the Kiwi. The risk couldn't be fully hedged because it was too large for the foreign-exchange market to absorb. At the same time, it created a vicious circle where the government couldn't forecast how much it need to service its debt, which made New Zealand more risky in the eyes of investors and increased its borrowing costs.

Between 1991 and 1992, for instance, New Zealand's dollar dropped about 11%, adding more than US$3-billion -- equivalent to roughly 8% of its GDP -- to its already crushing debt. Rating agencies swiftly

downgraded the country's credit rating.

It was the ultimate turnaround opportunity, so Mr. Jurshevski, a Canadian, could not say no. He was hired in 1993 to run the country's debt management office, and to advise the finance minister on how to get New Zealand out of a very deep hole.

"My entire career has been spent either starting new businesses or fixing businesses that are messed up," he said.

By the fall of 1996, New Zealand's foreign-currency debt was paid off, prompting then-Prime Minister Jim Bolger to proclaim, "the albatross that has been around our necks for 139 years has finally been plucked and cooked."

Mr. Jurshevski is not modest about his contribution to New Zealand's marked turnaround: "I managed the transition of New Zealand from international basket-case borrower to darling of institutional and hedge fund investors," he said.

He is equally confident that Recovery Partners will be a major success story. Under the new set of rules, called the Basel II Capital Accord, the banks will be favouring less risky retail assets over higher-volatility institutional loans. For instance, Toronto-Dominion Bank, under the direction of CEO Ed Clark, has sold or otherwise disposed of $10-billion in corporate loans since 2002, freeing up capital for expansion in retail banking, most notably the acquisition of a majority stake in Banknorth.

Recovery Partners is looking for smaller commercial loans, not syndicated corporate loans, but other banks are following TD's lead in lowering risk and favouring retail over institutional or wholesale business.

So far, Recovery Partners has secured the financial backing of three investment funds, two in the U.S. and one in Europe so it's ready to buy portfolios. But it is actively trying to raise money from big Canadian investors, such as Ontario Teachers Pension Plan and the CPP Investment Board. Like most pension funds, they are looking for so-called alternative investments to reduce their exposure to the equity and bond markets and generate large enough returns to meet their long-term obligations. From that standpoint, it looks like Mr. Jurshevski's timing with this fund is fortuitous.

At the moment, however, the banks don't feel much pressure to rid themselves of assets. Interest rates are still low, and credit quality is excellent, with few loan defaults.

"It's important to note that not everyone is seeing things the way we are," Mr. Jurshevski said. "The market generally has not understood the importance and significance of Basel II."

The banks haven't disclosed much information on the actual impact of the new capital rules, and it hasn't received much attention from the Street because researching such regulations is a surefire cure for insomnia.

At the same time, there is little, if any, trading of bank loans in Canada due to a number of barriers, from inconsistent documentation to a lack of willing buyers.

But the credit cycle will take a turn for the worse, as it always does, Mr. Gilmore said. And coupled with the capital rules, large loan sales are inevitable. As the banks sort through the rules and figure where they could take a hit to their capital, they will further shift their product mixes from higher volatility, higher risk assets, including commercial loan portfolios, to lower-risk pursuits.

"It's like the market wants blue dresses this year and all of the sudden the market wants red dresses, so you're not going to make blue dresses any more, you're going to make red dresses and whatever blue dresses you have in inventory, you want to get out of," is how Mr. Jurshevski explained the change.

By the middle of 2005, Recovery Partners is gunning to have $100-million under management.

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