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MAXIMISING VALUE OF NON-PERFORMING ASSETS

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The Role of Policy and Incentives in Maximizing Value of Distressed Assets

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VALUE OF DISTRESSED ASSETS

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This paper has been prepared as an attempt to address the question of public policy as it relates to the value of distressed assets. The Asian financial crisis, as we all know, resulted in large amounts of nonperforming corporate loans, many of which ultimately wound up in the hands of the government. Though many of these distressed loans have since been sold and/or restructured, the policy issues they left behind are with us still. The question remains: how should the public sector go about dealing with systemic economic collapse within the corporate sector?

The panel discussion for which this paper was prepared couches the question in terms of maximizing the value of distressed assets. This particular articulation of the issue raises a host of public policy questions and, it can be argued, carries with it a series of implicit assumptions which must be examined one-by-one. This paper is largely devoted to examining these assumptions and, in its final section, it suggests various policy options for consideration.

Maximizing the Value of WHOSE Assets?

The most fundamental question to be addressed in dealing with the panel topic is, assuming that the public sector has a role in the business of value maximization, in whose hands must distressed assets be imbued with maximum value? This is, in fact, more than a merely rhetorical question. In our experience in Indonesia, we have seen three main players actively involved with distressed assets, and their interests frequently diverge wildly.

The first candidate for value maximization is, of course, the existing owners of overindebted corporations. This interest group will obviously desire to retain their ownership and control over said assets, which represent a future stream of income to them. Consequently, the value of the assets in the hands of this group will be maximized by policies (formal and informal) which permit current owners to retain control. In this regard, the interests of the existing owners will obviously differ from the second key group of stakeholders, which are the lenders (both original and through the secondary market), who hold claims against the distressed assets. With respect to this group, value will be maximized by policies which permit lenders to seize corporate assets quickly and inexpensively, and which permit a vibrant secondary market for distressed assets to be sold. As we have seen, the consequential effect of such policies are increased secondary market prices for distressed assets, and it is assumed that it is this group, with its emphasis on asset price and portability, that is referred to in this panel topic when distressed asset value maximization is discussed.

In addition to original owners and lenders, there is a third interest group inevitably involved in the asset value equation – namely, the government of the emerging economy in question (and, assuming the government represents the interests of its electorate, the people of the economy themselves). With respect to this interest group there are two, perhaps conflicting considerations. On one hand, the interests of the government will be maximized to the extent that seized assets can be sold for top dollar. This of course implies the use of policies that increase the market value of distressed assets and, in this regard, the interests of the government are not that much different than those of common creditors. As discussed below, however, an interesting side issue arises here, in that the timing of government asset sales can have an arguable impact on recovery. Quick asset sales dumping large quantities of corporate assets onto an already depressed market may work to further depress prices, while a more measured, cautious disposal strategy can arguably avoid the "buy high – sell low" syndrome seemingly built into the boom and bust corporate cycle.

This more cautious approach is, however, at odds with the second consideration facing emerging market governments. In addition to the interest of the government in maximizing the value of its own assets, it will also have an interest in seeing a robust, vibrant corporate sector which maximizes tax revenue and employment for its citizens. With respect to this consideration, much more concern is placed on the rapid disposal of corporate assets and policies to ensure that they wind up in the hands of those most able to put them to productive use. There may, of course, be nationalistic arguments involved, with objections being expressed that rapid asset sales may result in a wholesale transfer of corporate assets to foreign concerns, and more discussion on this topic will appear below. But returning to the original issue, to the extent that the goal of the emerging market government is to foster long-term economic growth, the proper response would seem encompass policies encouraging quick transfer of corporate assets in a manner consistent with macro stability.

Maximizing Value Over What Time Frame?

Closely related to the previous question of whose asset values are to be maximized is the issue of the time frame over which value is to be measured. As discussed in the preceding paragraphs, a certain tension exists between relatively rapid asset disposals (which arguably contribute to long-term corporate health at the expense of short term government recovery) and the slower approach that advises the government to hold distressed assets until their price recovers (thus increasing short-term recovery at the arguable expense of long-term corporate sector health).

Although a definitive policy position on these issues is beyond the scope of this paper, it can be suggested that while a tension between the two approaches certainly exists, there is in fact less inconsistency between them than there might at first seem. Even if a rapid divestment approach is followed, there are few who could credibly argue that assets should be disposed at such a pace as to deny buyers sufficient time to fully assess their value (or otherwise restrict the ability of the government to take adequate marketing steps). This, of course, will inevitably take time. Similarly, there may well be a significant number of assets in need of stabilization prior to sale. Such stabilization may involve the process of wresting control from existing management (a process that the public sector can arguably manage more effectively in emerging markets than can the private sector). Alternatively, the stabilization process may simply involve short-term financial and operational measures, such as securing short-term working capital lines to ensure that suppliers and employees are paid. In either case, it will take time to stabilize the assets in question, such that the “fire sale” scenario feared by those taking the wait-and-see approach is less likely to materialize.

From the wait-and-see perspective, it is unlikely that any could rationally argue for an indefinite ownership over effectively nationalized corporate assets. Although there is ample evidence that too rapid divestment can, indeed, create market instability and encourage rent seeking, there is a similar wealth of evidence demonstrating that the private sector can, in general, operate most corporate concerns much more efficiently than can the public sector. In this light, the wait-and-see approach should be viewed less as an attempt to maximize government asset recovery by sitting on assets indefinitely, and more of a naked attempt to maximize government recovery over the short term.

Thus, the issue of short-term versus long-term asset value maximization is, in fact, less of a choice between two conflicting options as it is a process of assessing the probable “present value” of any particular divestment regime. Various assumptions must be made regarding the likely recovery to the government as a result of asset sales, the disruptions caused by the sales, and the long-term impact of quick versus slow divestment in terms of overall corporate health. Based on how these factors are assessed, the scheduling of divestment can be undertaken. Those arguing for all-or-nothing “sell fast” or “go slow” approaches, it is suggested, are likely doing so based either on ideological concerns or from a desire to benefit their own specific interests. On the other hand, a well-reasoned, prudent distressed asset divestment scheme is likely to fall somewhere between the two extremes.

Recommendations: Let the Markets Work, but Watch them Closely

As promised at the outset, this paper will now turn to practical considerations in connection with the asset-value maximization topic. As discussed above, we must begin our practical analysis by answering two key questions: 1) whose interests are we to maximize through public policy, and 2) over what time frame are we to act? For the government of an emerging market economy, there can be only one answer to the first question: the government must act to maximize asset prices solely to benefit the interests of its citizens. This, of course, is largely uncontroversial, as no special interest group would ever admit that the proper role of government is to maximize its own interests. Rather, the controversy arises where debtor and creditor interest groups seek to identify their own interests with those of the common citizen.

In this regard, owners of distressed corporate concerns (who may be seeking to retrieve their assets from the government or who may be arguing in favor of policies that will otherwise allow them to hold on to their companies) will raise nationalistic objections to the supposed fire-sale of national assets. On the other hand, international investors will point to the purported benefits of FDI, and will argue that systems allowing for quick asset disposal will encourage future trade and investment and will bring expertise into the country. However, as discussed below, neither of these arguments is completely persuasive.

As to the investor argument, it is certainly the case that investment-friendly policies encourage additional investment, and it is also probable that long-term FDI is beneficial to the growth of an emerging economy. However, the jury is simply still out on the effects of short-term FDI (including, if one study is to be believed, bank lending). As such, arguments that fire-sale divestment regimes are justified by FDI concerns are simply not credible when advanced by those providing the sort of FDI that is of uncertain value in the first instance. On the other hand, the concerns of long-term investors should be taken seriously, and should be factored into any divestment strategy. However, given the longer-term nature of such investors' return horizons, it is unlikely that such investors will be much interested in seeing fire-sale divestments taking place.

On the other hand, the arguments inevitably raised by the owners of distressed corporate assets are similarly suspect. There is no obvious reason why most assets must be owned by local businessmen, and to the extent that there is such a reason, it does not justify a conclusion that the *same* businessmen should continue to control precious corporate assets. Bringing in new entrepreneurial talent and technical expertise, be it domestic or foreign, helps to ensure that asset values are maximized and that companies are run as profitably as possible, and it is the position of this paper that it is this argument, more than all the others, which carries with it the definitive policy recommendations for the public sector to follow.

The creative destruction of the capital markets are, in point of fact, essential to ensuring crisis situations are not repeated. Only by ensuring over the long run that entrepreneurial success is rewarded and failure is punished can the real sector be made internationally competitive. Under circumstances where limited corporate assets remain locked within tightly-controlled family dynasties regardless of entrepreneurial merit, other (local) entrepreneurs are denied opportunities to compete and the health of the entire economy suffers.

Of course, seizing and dumping corporate assets in too quick a fashion, without the opportunity to stabilize and market the assets being sold, is not an optimal solution. As discussed elsewhere, the costs and benefits of various timing approaches must be weighed, but this argument does not justify an indefinite nationalization of distressed assets. In answering the second question posed above, this is neither a strictly short-term nor a long-term approach, but rather one which balances the immediate concerns of the day with longer-term issues of growth and economic health.

At this point, the reader may still be unsatisfied. It is fine to argue that the government must plan divestment programs to maximize the long-term health of its economy, but it is quite another thing to

specify how policy is to accomplish this. Isn't, as has been suggested above, the solution to encourage policies that allow for ownership over corporate assets to be transferred more readily in the event of default, so as to permit new entrepreneurial talent and initiatives to be introduced?

The answer is, of course, yes. In the final analysis, the creative destruction of the markets is best encouraged by policies that encourage quick, efficient transfer of ownership over corporate assets where existing management has failed to perform. This requires efficiently and transparently operating insolvency systems, and government policies (including asset divestment policies) that send the signal to the markets that the cost of entrepreneurial failure is a loss of control, so that assets can be recycled for the next entrepreneur in line to take their turn. This process must, of course, be carefully coordinated in the event of systemic economic failure so that the markets are not distorted, but in the end, the process must proceed.

Conclusion: But What About the Rest of Us?

As a concluding matter, a final question must be answered. What does any of the above have to do with the value of distressed assets? Of course, policies that encourage the quick transfer of ownership will maximize the market value of distressed assets and to the extent the government or local banks hold such distressed assets, they will be beneficiaries. But in this regard, it must be mentioned that this is only a secondary effect of the policy. There is no reason, in fact, that the government ought to be concerned over the value of distressed assets as an end in itself. Policy should be, as discussed above, inwardly focused on the best interests of the citizenry, and it should be oriented toward the long-term health of the economy. Creditors and investors who benefit from higher secondary debt prices should count themselves fortunate regarding this policy focus, but they should not mislead themselves that they are the intended beneficiaries of government policy.