May 17, 2009
VOL 26 NO 20

www.tribune.ie
TribuneBusiness

Bill Nowlan - Interest roll-ups are a major threat to Nama

Last week in this newspaper I wrote about five key strategic actions that need to be taken by Nama in fulfilling its role as asset manager for what will be one of the largest single property portfolios in the world.

Two other matters have been exercising my mind during this week. The first is the impact of compound interest (or interest rolls-ups) on the overall Nama project. The second relates to the ability of Nama to actually sell property in huge volumes in a market place that is currently almost non-existent.

Legendary tycoon and philanthropist John D Rockefeller described compound interest as the "eighth wonder of the world". By this he meant that if interest is rolled up on a loan the value of the loan will double over a very short space of time - dependent on the interest rate.

The Rule of 72 gives us a quick but reliable ready-reckoner to calculate the period of time, at a given interest rate, it takes to double the amount of the original loan. At 10% the loan doubles in just over seven years: at 7% it doubles in just over 10 years and at 5% it doubles in just over 14 years.

Most of Nama 's loans will not be paying interest and therefore the capital debt on Nama 's books will be growing by the amount of the unpaid interest. This process is known as rolling up. In normal times the period for which a project can roll up interest and still remain profitable is a key viability test used by developers and financiers. For example, a newly completed office building should be able to remain viable for a period of about three years. If it remained vacant and non-income producing after three years, it would become loss making.

This test is equally applicable to Nama. The viability of many of the projects it inherits will be already underwater and to leave them rolling up for another two to five or even 10 years will push their book cost well below the price that Nama paid the banks for the loans – be it a 5%, 15% or even a 30% discount on the loans' face value.

If Nama starts its job with assets for disposal of €50bn and succeeds in selling €5bn in year one, then at the end of that year it will still have €47.5bn of assets for disposal (€45bn of remaining assets, plus the rolled up interest of €2.5bn).

If they sell another €5bn in year two, they will then still have almost €45bn to recoup after taking account of roll-up. So in two years they will have sold €10bn, but effectively will have made little headway in the original task. No wonder Rockefeller called compound interest the eighth wonder of the world.

This brings me to the second point which is the capacity of the Irish market to buy the assets from Nama in what is nicely termed "an orderly disposal".

What will be the reality of the market and the economic environment over the next few years? To sell €5bn in current or likely market conditions in 2010 or 2011 and every year thereafter is quite an 'ask' of even the best of asset managers. To sell less than €5bn in a year would mean that Nama would be going backwards when the effect of compound interest was included.

Possibly the hope is that the economy and property market improve in the medium term and we get back to market turnover closer to 2004 or 2005, but this is putting a lot of faith in a significant improvement in the economy.

It also ignores the depressing effect of Nama continually feeding properties into the market under forced sale conditions for up to 10 years or longer. This makes me believe that focusing on 2002 turnover volume for a long time is quite realistic - and maybe optimistic.

Part of the answer may be that some of the properties are in overseas locations and particularly in the UK where the market is bigger and can absorb assets early on. Part may be that there are properties that will have no value above agricultural value and should be written off on day one which should be allowed for in Nama's negotiations with the banks.

But the concept of selling most of the properties and getting all the money back over 10 or 15 years is more than challenging if one remembers the impact of compound interest. It might be doable if interest roll up was stopped but not if interest accrues, as it will by virtue of the taxpayer having to pay interest on the Nama bonds. Thus looking at the impact of compound interest and the overall size capacity of the market to buy buildings puts the scale of the problem facing NAMA into real focus.

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