



Extended Annual Review Report

Project Number: 41918-01
Loan Number: 2367
September 2014

Senior Loan
Eucalypt Mortgages Sdn. Bhd.
(Malaysia)

This is an abbreviated version of the XARR which excludes commercially sensitive and confidential business information that is subject to exceptions to disclosure set forth in ADB's Public Communications Policy 2011.

Asian Development Bank

CURRENCY EQUIVALENT

Currency Unit – ringgit (RM)

| | | At Appraisal | At Project Completion |
|--------|---|---------------------|------------------------------|
| | | 10 September 2007 | 30 September 2009 |
| RM1.00 | – | \$0.1204 | \$0.1355 |
| \$1.00 | – | MYR3.49 | RM3.5099 |

ABBREVIATIONS

| | | |
|-----------|---|--|
| ACAP | – | ACAP Advisory Public or its Malaysian subsidiary (as applicable) |
| ADB | – | Asian Development Bank |
| ADM | – | Asia Debt Management Hong Kong |
| BNM | – | Bank Negara Malaysia |
| EMSB | – | Eucalypt Mortgages Sdn. Bhd. |
| HSBC | – | Hong Kong and Shanghai Banking Corporation |
| NHMFC | – | National Home Mortgage Finance Corporation |
| NPL | – | nonperforming loan |
| Sdn. Bhd. | – | Sendirian Berhad, the Malaysian equivalent of “incorporated” |

NOTE

In this report, "\$" refers to US dollars.

| | |
|-------------------------|---|
| Vice-President | L. Venkatachalam, Private Sector and Cofinancing Operations |
| Director General | T. Freeland, Private Sector Operations Department (PSOD) |
| Director | M. Barrow, Deputy Director General, PSOD, Officer-in-Charge, Private Sector Portfolio Management (PSPM) |
| Team leader | S. Hruschka, Head, Project Administration, PSPM |
| Team member | C. Armedilla, Senior Investment Officer, Private Sector Investment Funds and Special Initiatives |

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BASIC DATA
Senior Secured Loan: Eucalypt Mortgages Sdn. Bhd. (Loan No. 2367 – Malaysia)

| Key Project Data | As per ADB Loan Documents (\$ million) | Actual (\$ million) |
|--|--|-------------------------------|
| Total Project Cost | 10.0 | 10.0 |
| ADB Investment: | | |
| Loan | | |
| Committed | 10.0 | 10.0 |
| Disbursed | 10.0 | 10.0 |
| Key Dates | | |
| | Expected | Actual |
| Concept Clearance Approval | | 11 May 2007 |
| Board Approval | Aug 2007 | 10 Oct 2007 |
| Loan Agreement | | 23 Nov 2007 |
| Loan Effectiveness | | 23 Nov 2007 |
| First Disbursement | | 21 Dec 2007 |
| Months (effectiveness to commercial operations) | | < 1 month |
| Loan Maturity | Mar 2010 | 30 Sep 2009 |
| Financial and Economic Internal Rates of Return (%) | | |
| | Appraisal | XARR |
| Financial Internal Rate of Return (project financial rate of return) | Not mentioned in the RRP | 0 |
| Economic Internal Rate of Return | | |
| Project Administration and Monitoring | | |
| | No. of Missions | No. of Person-Days |
| Fact-Finding | Approximately 2 | |
| Appraisal | Approximately 2 | |
| Project Administration and Monitoring | | |
| XARR Mission | None | |
| Others | None | |

RRP = Report and Recommendation of the President.

EXECUTIVE SUMMARY

The Asian financial crisis of 1997–1998 left the financial systems of several developing member countries of the Asian Development Bank (ADB) with a considerable number of nonperforming loans (NPLs). The Malaysian economy was significantly impacted. In response, in 1998 the Malaysian government established Pengurusan Danaharta Nasional (Danaharta) as a national asset management corporation. Danaharta completed NPL acquisitions in 2000, and up to 2005 focused on recovery from the purchased portfolios.

Danaharta achieved many of its benchmarks, but at its closure in 2005, the banking sector still had a gross NPL rate of 8.9%. As a result, the Government of Malaysia moved to involve the private sector in the next stage of NPL resolution. As part of its Financial Sector Master Plan, in 2005 the government established guidelines defining parameters under which banks could sell NPL portfolios to third parties for resolution (the NPL guidelines).

The NPL guidelines were intended to attract risk capital from third parties not involved in the original lending transactions, and to give banks the alternative of selling NPLs at a discount to a third party or of resolving them in-house. Where experience with resolving a large number of NPLs is limited, banks and the legal system are restrained by a lack of information on the time and legal process required. The sale to a third party, either negotiated bilaterally or through a bidding process, can add valuable information on pricing; and the entry of NPL-experienced risk capital can build experience of financial institutions, legal and tax advisors, and the judicial system. Over time this experience is disseminated through the sector's professional work force. As early as 2005, ADB began to seek an opportunity to support one of the early third-party NPL resolution transactions under the NPL guidelines.

ADB, through its nonsovereign operations, had previously supported government efforts in the region to resolve NPL issues in several private equity funds, lending, and equity transactions, most prominently in the Philippines through two transactions: a loan to Cameron Grandville Asset Management in 2005, and a loan and equity investment supporting resolution of the National Home Mortgage Corporation's portfolio of nonperforming mortgages in 2004.

In October 2007, the ADB Board of Directors approved a nonsovereign loan of up to \$10 million to Eucalypt Mortgages Sdn. Bhd. (EMSB), a special purpose vehicle established to purchase nonperforming mortgages that Hong Kong and Shanghai Banking Corporation Malaysia had extended to about 2,000 borrowers in Malaysia. The transaction was sponsored by Asia Debt Management Hong Kong (ADM), a private equity fund manager specializing in debt management transactions, which contributed \$14 million in subordinated debt for a total purchase price of \$24 million. It acquired loans at a negotiated 35% discount from the outstanding loan principal balance. An experienced loan servicer, ACAP Advisory Public (ACAP), was hired to resolve the portfolio, making ACAP the first commercial NPL servicing platform in the Malaysian market. The ADB loan was repaid in full in September 2009.

The impact of the ADB loan on private sector development and ADB's strategic development objectives met with the project's targets. At the time of the transaction, ADB had not prepared an operational strategy for Malaysia since 1997. However, ADB's strategic goals for private and finance sector development are well aligned with government efforts to support NPL resolution by introducing NPL sales to third parties. The transaction contributed to the early stage of NPL market development to establish valuable information on valuation, time required to resolve NPLs, and servicing techniques, which had been limited in the private sector; and helped establish the first commercial NPL servicing company in the Malaysian market.

The project's business success was evaluated for three financial stakeholders of the transaction. Limited information on stakeholders' business results did not allow for a complete analysis of their financial results, as privileged information was not provided to ADB after the loan was repaid. From anecdotal evidence, resolution of the portfolio likely extended beyond the expected completion date, implying that profitability was positive, but may have been below expectations. Conservatively, business success for the project is deemed to have been somewhat below expectations.

From 2005, when the NPL guidelines were released, to 2010, the gross NPL in the Malaysian finance sector declined from 8.9% to 2.7%, setting free lending limits at financial institutions and reducing banks' impairment cost to the benefit of their borrowers. Danaharta's dissolution as well as the six third-party NPL transactions of which the ADB project is a part, contributed to making NPL-experienced staff available to the market and contributed to the spreading of valuable information and skills. While general economic growth and supportive central bank guidelines were additional factors in the government's success in reducing NPLs, early stage private sector transactions significantly contributed to the outcome and its economic sustainability. The transaction's environmental, social, health, and safety performance and the overall development impact met with the internal parameters of the project.

ADB's pricing was established as a step-up margin (compatible with a single B risk rating) with the support of ADB's pricing committee. Given the lack of comparable transactions, pricing over the single B-yield curve prevailing at the time was used as a proxy for calculating a financial internal rate of return.

ADB conducted market screening and due diligence, and structured the transaction based on accepted market standards. Collection reports after the repayment of the ADB loan would have made the evaluation more robust, but ADB monitored the transaction throughout, based on internal monitoring guidelines. As debt provider, ADB facilitated one of Malaysia's first NPL sale and resolution transactions; and ADB's debt was important in achieving the overall economics of the project. ADB's work quality and role and contribution were deemed to be adequate.

ADB's debt participation succeeded in attracting an experienced debt resolution specialist to the transaction and succeeded in setting up the first commercial NPL servicing platform in the market. This project, and the ones that followed, were instrumental in establishing third-party sales of NPLs as an alternative to in-house resolution, and helped to disseminate valuable skills and information. While this transaction cannot claim more than incremental credit for the Malaysian market's success in resolving its NPL issues, the additionality that early adopters and risk takers bring to markets with nascent NPL resolution skills were noteworthy outcomes from the project. The additionality of ADB's contribution to the transaction and the latter's overall outcome met with the internal parameters set at project inception.