The European Distressed Opportunity

January 2012

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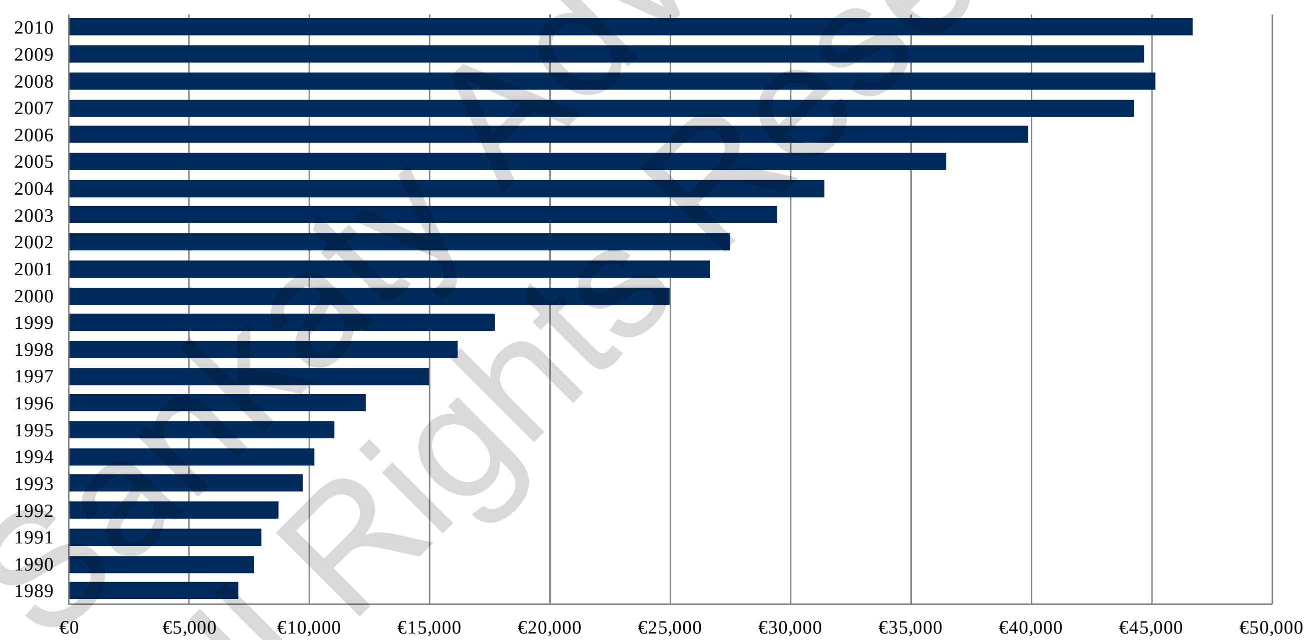
I. Introduction

Distressed situations in Europe have become increasingly compelling and the opportunity for distressed investors to deploy capital in Europe will continue to grow over the next several years. The primary catalysts of this opportunity are regulatory changes, the looming European maturity wall and the dearth of buyers set against a backdrop of significant sovereign debt issues and their ramifications for the Euro. Put simply, the longer these catalysts remain unresolved, the more marked the imbalance in the supply of assets for sale and the demand for them. While one sees similar issues playing out in the U.S., they are more pronounced in Europe where banks have significantly more distressed balance sheets and market volatility, and economic uncertainty are heightened.

In this paper, we draw upon the experiences of our 15 European investment professionals, augmented by our 73-person U.S. investment team, to explore the nuances of these catalysts and the opportunities they are likely to create for distressed debt investors. Through 2010 and 2011, Sankaty Advisors has seen a steady flow of opportunities to acquire single-name assets and portfolios from European banks and institutions, which has resulted in a large number of attractive investments. In the years preceding the financial crisis, European banks accumulated record amounts of assets. Driven by a strong economy, a benign regulatory environment and the growth of the derivatives and securitization markets, assets on their balance sheets grew from €18 trillion in 1999 to €45 trillion in 2008.[1]

Figure 1: Evolution of Bank Assets in Europe (€B)[1]

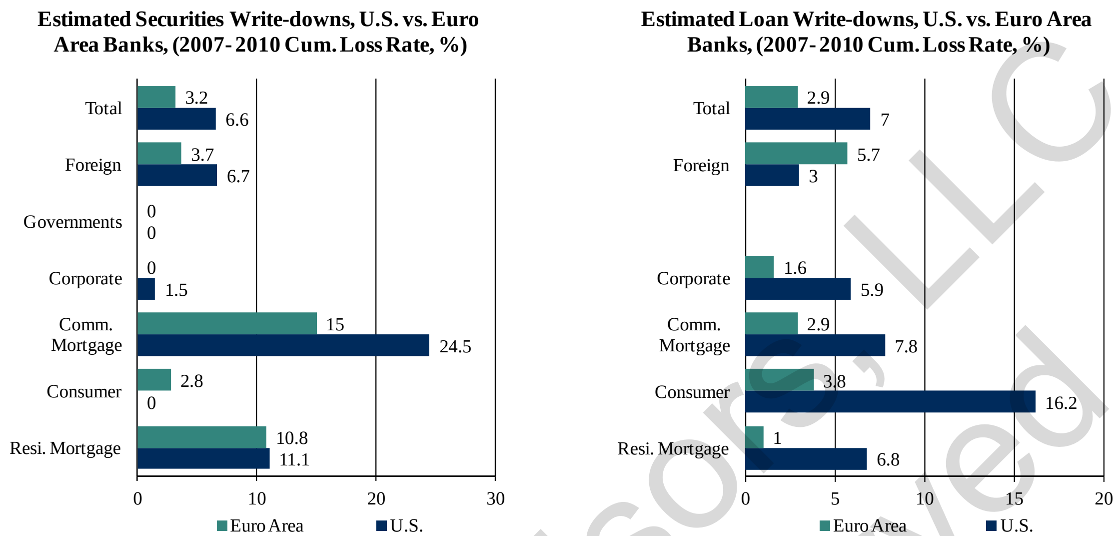


During the financial crisis from 2008-2009, the banking industry lacked the capital required to absorb the severe losses experienced and liquidity in the system was clearly insufficient. Numerous banks scrambled to stay afloat by raising additional equity, receiving bailouts from governments and central banks, selling assets, and, as a last resort in a select few cases, filing for bankruptcy.

[1] European Banking Statistics 2009 (European Banking Federation, 2010).

While many banks muddled through the crisis, the problems are far from resolved. Figure 2 demonstrates that U.S. banks have written off substantially more assets than their European counterparts.

Figure 2: U.S. Bank Write-downs versus Europe Banks[2]



Deleveraging bank balance sheets through asset sales has become a focal point for regulators anxious to create a more stable and resilient banking system. Indeed, it is estimated that major European banks have pledged to sell or run down approximately €1.7 trillion of assets over the coming years.[3] We have seen extensive asset sales in the U.K. and Ireland, and they are now beginning in Spain and non-core books in Germany. Over the last 24 months, we have purchased $800 million from banks and other financial institutions in Europe.

Even if European banks are slow to de-lever – and in this paper, we identify reasons why many of them might be incentivized to postpone asset sales – our experience investing in Europe since 1998 shows that if one has the necessary relationships, the investment skill set and an appropriate time horizon, a number of opportunities to invest in stressed and distressed European credit exist. Over the last three years, leveraged loans have become an increasingly large source of financing relative to bonds in the European high-yield market. Since 2008, the European high-yield market has doubled in size due primarily to retail demand. Market technicals are currently challenging and have featured a significant decline in demand from both institutional buyers and banks. CLOs have not returned in force to the leveraged loan market and retail investors, who began flocking to higher yielding credit in 2008, have proven unreliable in the face of market volatility. The fickle behavior of retail investors, for example, allowed us to buy a number of attractive companies at distressed prices in the secondary markets in the third and fourth quarters of 2011.

While the maturity wall no longer makes regular headlines, it remains a pressing concern, particularly in Europe where many companies on the cusp have postponed addressing their stressed capital structures over the last two years.

While "amend and extend" has proven an effective strategy for many European companies, a day of reckoning will come for many of them. We estimate that at least 10% of loans and bonds maturing between 2011 and 2015 will face difficulties refinancing, which puts the size of the investment opportunity at €30-€40 billion. Our specific analysis suggests that the maturity wall is more concentrated in the next few years, even though market

[2] Source: ECB, Banca d'Italia, Banco de España, Banque De France, Bloomberg, Barclays Capital.
[3] Deleveraging in the European Financial Sector (Deloitte, 2011).

expectations are somewhat longer dated. Many European companies will ultimately need more permanent solutions, especially given the weak outlook for European growth and the disappearance of the traditional buyer base. Compounding the problem, Basel III and other regulatory changes have made it more challenging for banks to participate in leveraged loans going forward. This will lead to restructurings and rescue financings in many of the situations we are following today, and many European companies will have to turn to less traditional providers of financing for help. Our dedicated middle market and restructuring teams and portfolio operations group allow us to offer solutions to companies facing challenges. These types of capital solutions have been a core part of our business since 2002.

In this paper we will look at the nature of these asset sales, the differences among regions and institutions, and our outlook for the timing of these sales in the coming years. We will also share our analysis of the European maturity wall and why we believe it is likely to lead to opportunities earlier than it might appear. And finally, we will offer our take on the challenging technicals of the European credit markets and the heightened macro and sovereign risks.

II. Catalysts for Opportunity

A. Bank Deleveraging

i. Rationale

European banks are reducing the size of their balance sheets through asset sales for three primary reasons:

1) To boost capital ratios: this is increasingly relevant as the more stringent Basel III regulatory requirements are phased in over the coming years,
2) To prepay interbank or central bank funding in order to reduce dependence on short-term funding and improve loan to deposit ratios, and
3) To meet political pressures to sell assets, particularly those considered non-core.

Improving Capital Buffers for Regulatory Reasons

One of the three pillars of the Basel Accord, which was agreed upon in 1988 to regulate the banking industry, is capital requirements.[4] Due to the banking industry's systemic importance and vulnerability to contagion, regulators require that banks maintain sufficient capital to absorb impairments on their loans without impacting senior debt holders and depositors. The centerpiece of regulating capital requirements are the Tier One Capital Ratio and Total Capital Ratio:

$$\text{Tier One Capital Ratio} = \frac{\text{Shareholder Equity} + \text{Shareholder Reserves (Tier One Capital)}}{\text{Risk-Weighted Assets}}$$

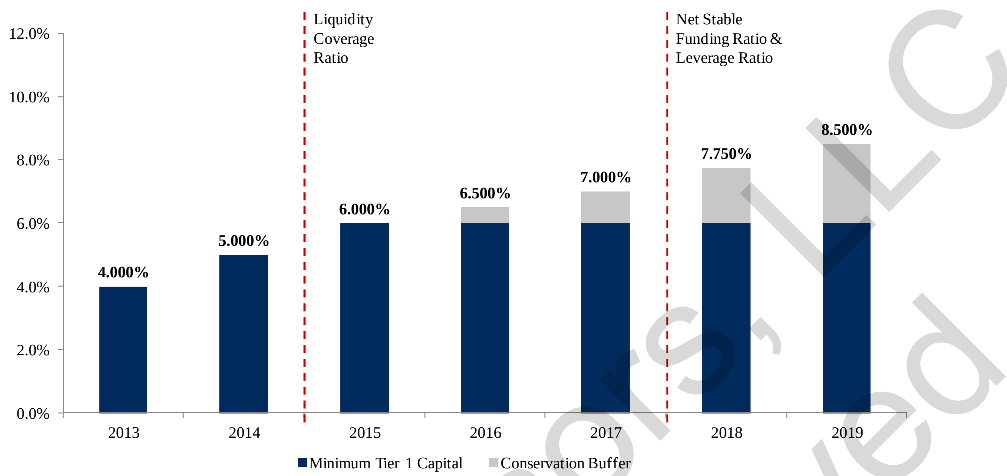
$$\text{Total Capital Ratio} = \frac{\text{Tier One Capital} + \text{Subordinated Debt}}{\text{Risk-Weighted Assets}}$$

The current rules that regulate global banks' capital requirements, Basel II, suffer from a number of shortcomings, including insufficient capital, an over reliance on internal risk estimates (which were often flawed in the first place), and a lack of liquidity safeguards. Basel II is to be replaced by a new set of more stringent rules, Basel III, that seek to address these issues through stricter capital and liquidity requirements. Basel III will be phased in progressively from 2013 to 2018, although most banks are seeking to be compliant multiple

[4] International Convergence of Capital Measurement and Capital Standards (BIS, 1988).

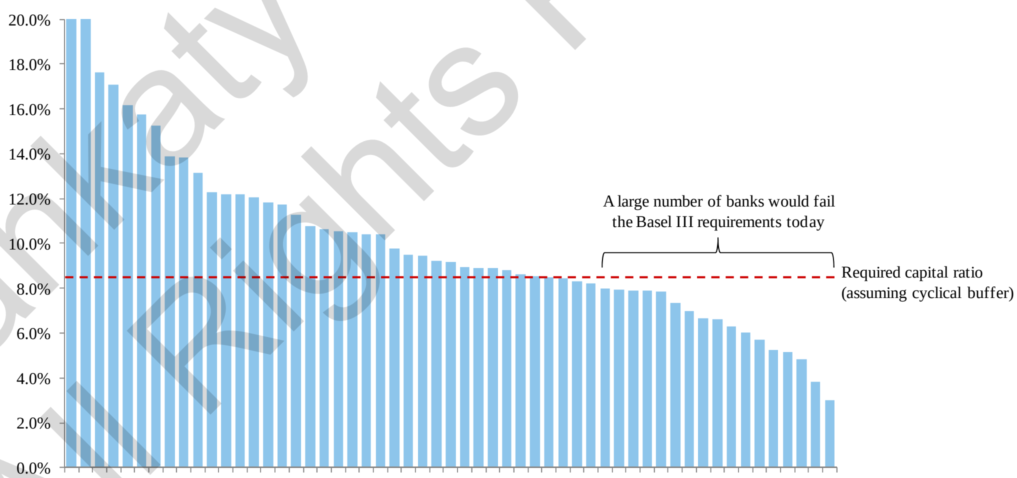
years in advance. On top of the global regulation from Basel III, national regulators may overlay stricter regulation on banks within their own countries, although there are discussions to include a ceiling on the capital ratio requirement.

Figure 3: Phase in Arrangements for Basel III Regulation[5]



Based on the capital ratios of 55 of the biggest European banks at the end of 2010, 16 are below the 8.5% Tier 1 Capital Ratio required by the start of 2019, which includes the counter cyclical buffer of 2.5%.[6,7] The number of non-compliant banks would increase significantly if individual country regulators opt to increase requirements further. Moreover, these capital ratios are based on reported asset values, which may be overstated. For instance, a Greek sovereign default could lead to a sizable reduction in some banks' capital ratios.

Figure 4: 2010 Capital Ratios for Major European Banks[6]



There are four methods to boost capital ratios:

1) **Raise new capital from investors:** Banks could raise new common equity or other forms of regulatory capital.
2) **Raise new capital from governments:** Banks could receive capital injections from their governments.

[5] Basel Committee on Banking Supervision (June 2011).
[6] Bloomberg, Company Reports, Citigroup.

3) **Retain earnings:** Banks could grow their common equity by retaining earnings, including potentially reducing or stopping dividends.
4) **Reduce asset base:** Selling assets and using the proceeds used to pay down liabilities (or running assets off if they can be refinanced or paid down).

When a bank considers the optimum strategy to improve its capital ratios, it must take into account a number of key factors. Absent political influences, which we discuss later in the paper, the main factors banks must account for are as follows:

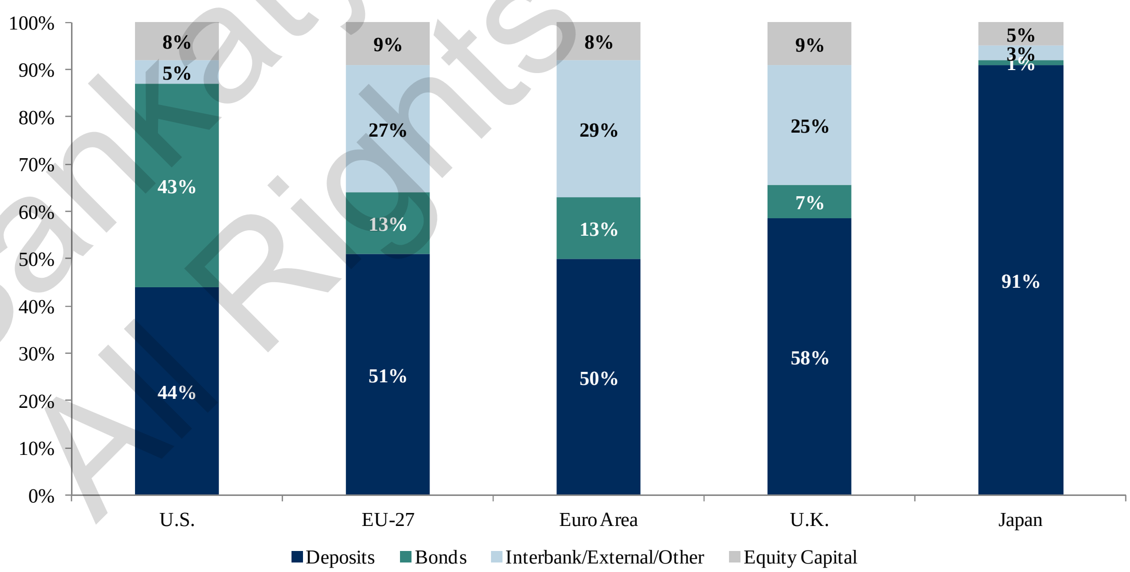
- **Market:** Liquidity of the assets, the current asset prices and access to capital markets.
- **Operational:** The various strategies require significant human capital and time to implement.
- **Impact on the return on equity:** Boosting capital ratios and hence lowering leverage would subsequently lead to a reduction in the return on equity (depending on the price received for the sale).

Improving Funding Positions

In the years prior to the financial crisis, many banks became increasingly dependent on funding from the interbank market (short-term debt from other financial institutions). The interbank market offered very low interest rates and almost unlimited liquidity, without significant differentiation on price to reflect credit quality. It thus allowed banks to expand their balance sheets beyond the constraints that would traditionally have been exerted by their deposit base.

Following the large losses from subprime mortgage lending, the leverage in the banking system and the uncertainty as to who ultimately held the impaired assets, confidence in the banking system declined, and the liquidity in the interbank market collapsed. This ultimately led to the failures of Lehman Brothers and Bear Stearns. Many other banks would have collapsed had central banks not stepped in to replace the short-term funding.

Figure 5: Reliance on Interbank Funding (% of Total Funding) at the Start of 2010[7]



[7] U.S. Fed, ECB, BoJ, BoE, Citigroup.

Today many banks still depend heavily on short-term funding from the interbank market or central banks, particularly in Europe. These banks and regulators are focused on improving the funding base. Indeed, Basel III will introduce liquidity and funding requirements through its Liquidity Coverage Ratio ("LCR") and Net Stable Funding Ratio ("NSFR").[8] This regulation is mainly designed so banks would be able to maintain liquidity if the interbank market were to seize up for a certain period of time. The LCR is the ratio of high-quality liquid assets to short-term liquidity needs under a specified stress scenario, and NSFR is the proportion of long-term assets which are funded by long-term, stable funding.

A bank can reduce its dependence on the interbank market in several ways:

- Increase the amount of deposits,
- Issue longer term bonds, and
- Sell assets.

While a bank likely benefits from a reduction in its reliance on interbank funding, each option means the risk of reducing the return on equity:

- While deposits are viewed as more stable than interbank funding, their costs can be high. This is the case particularly if banks have suffered serious reputational damage (e.g. several Irish banks). Moreover, when multiple banks in a market are looking to increase the amount of deposits, aggressive competition for those deposits can drive up the cost of deposits for all banks. We witnessed this phenomenon in Spain.
- The cost of longer term debt/bonds can be high, particularly if the bank or government has a damaged reputation or the bank and government have been downgraded by ratings agencies.
- Selling assets will likely reduce a bank's return on equity and divesting lower priced assets can cause further reductions of capital ratios.

Strategic and Political Reasons

A number of banks have isolated strategically non-core assets. The types of strategic non-core assets include:

- Assets which are geographically distant from a bank's core activities. For example, AIB divested its Polish business in 2010 and plans to dispose of a large amount of its U.K. assets in 2012, and a number of European banks are winding down their activities in Australia.
- Business units that were not closely related to core activities of a bank. For example, RBS sold its payment systems business, RBS WorldPay, in 2010.

In many cases, underlying political reasons drive divestments of foreign assets. Governments are trying to encourage and, in some cases, mandating, increases in lending to local businesses.[9] As a result, if a bank is reducing assets, it is politically much more attractive to do so in foreign countries rather than where the bank is headquartered. This becomes a bigger factor for banks that have received government funding.

ii. The Opportunity

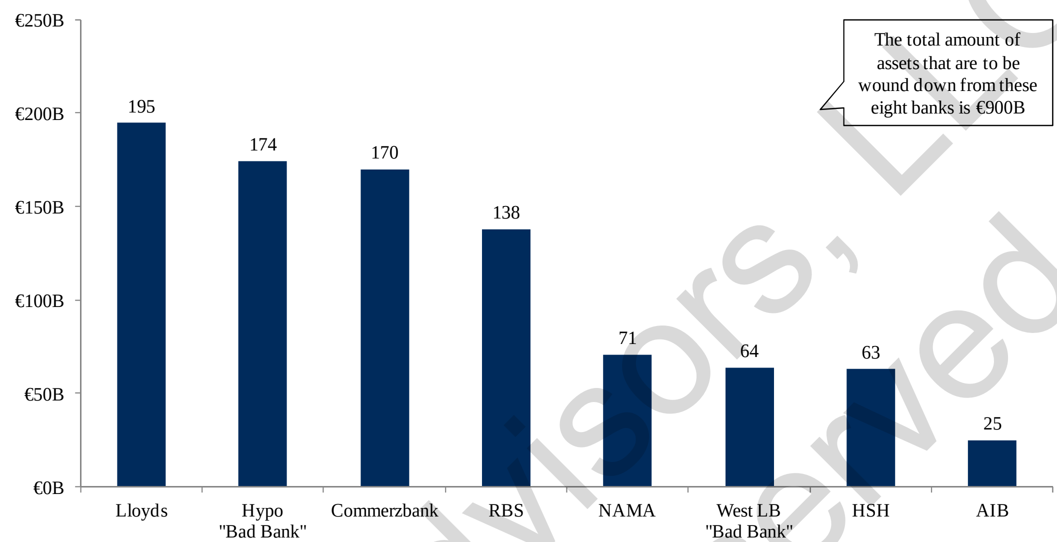
1. <u>The Size</u>

European banks have an estimated €1.7 trillion of non-core assets, which includes both non-performing loans (loans for which banks have created loss provisions) and performing assets that are no longer core to the

[8] Basel III: A global regulatory framework for more resilient banks and banking systems (BIS, June 2011).
[9] Such as Project Merlin in the U.K., which put in place soft targets for U.K. banks to lend to SMEs.

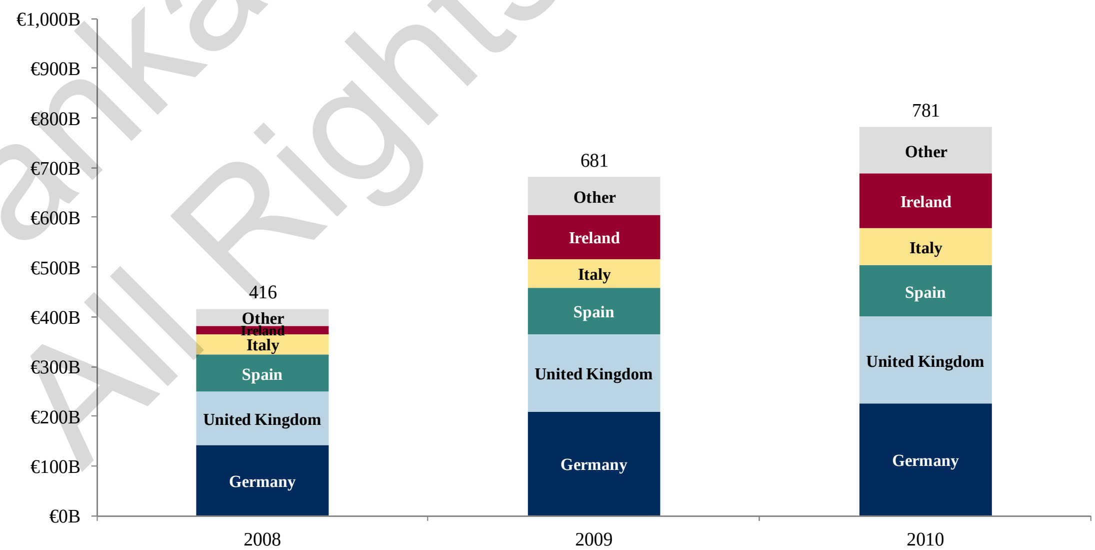
business.[10] These non-core assets have been earmarked by banks for sale or run down (have been refinanced by other institutions). A number of prominent European banks have formally announced asset sale programs, some of which have been underway for several years. These assets include both non-core and distressed assets. Some banks have publicly outlined the asset reduction targets. We include eight banks below that have outlined approximately €900 billion of assets to be wound down from the end of 2010.

Figure 6: Non-Core Loans on Select European Banks' Balance Sheets as of December 2010[11]



The amount of non-performing loans (NPLs) in Europe is a good proxy for the stressed or distressed assets in the European banking system. NPLs are estimated to have reached approximately €800 billion at the end of 2010, growing significantly over the last three years (see chart below). Most banks that have broken out their non-core assets have included a high portion of NPLs.

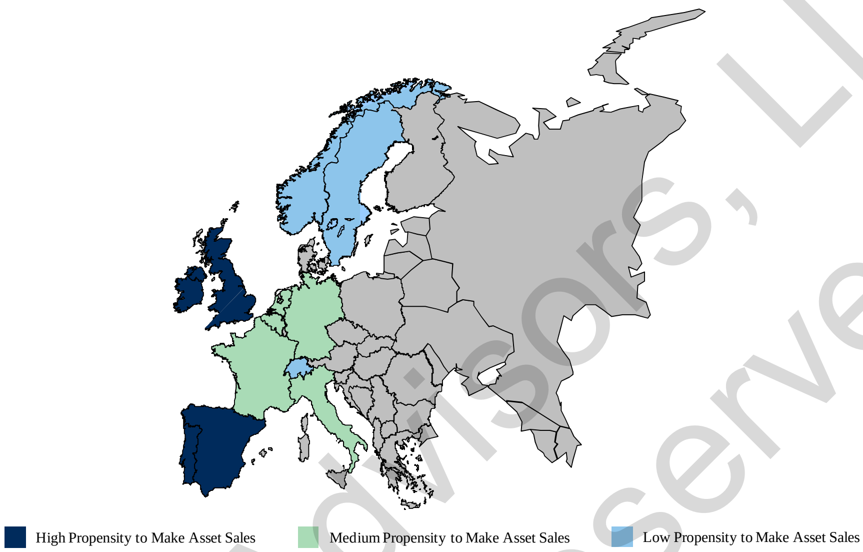
Figure 7: Non-Performing Loans on European Banks' Balance Sheets[12]



[10] Deloitte estimates.
[11] Company financials, some are more recent estimates than December 2010.
[12] European outlook for non core and non performing loan portfolios (PwC, April 2011).

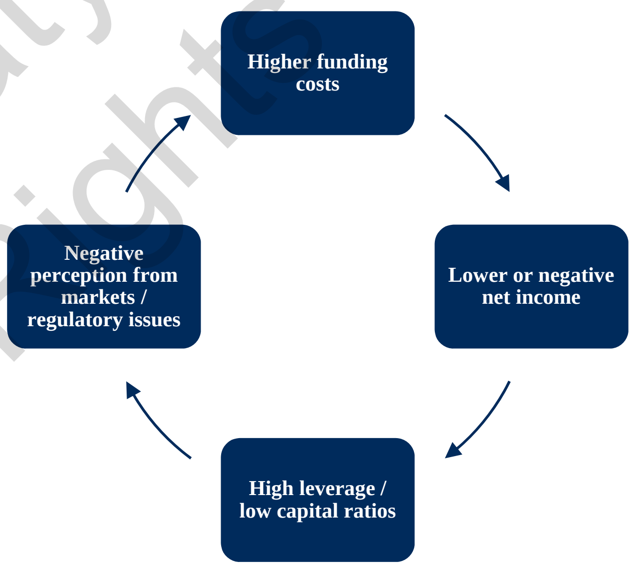
2. Geography

Certain countries are much more likely to have banks that are selling assets than others depending on the country's banking system, economy, and political strategy. As mentioned above, political strategy is often a very important influence on a bank's decision to make asset sales. For instance, Italy's government pushed its banks towards raising new equity in early 2011 rather than divesting assets. In contrast, the U.K. government has pushed the partially nationalized banks in the U.K. towards divestments. The Spanish government is currently focused on capitalizing and nationalizing its regional banks before likely forcing them to make asset sales.



3. Stressed Banks Versus Non-Stressed Banks

We consider a number of banks across Europe stressed. Many of these stressed banks are in a negative reinforcing cycle of high funding costs and low earnings, a cycle only exacerbated by continuing impairments.



In order to break this cycle, banks must typically (i) receive capital injections and/or (ii) make, or pledge to make, asset sales, thereby de-levering the bank and restoring confidence. Indeed, the majority of stressed banks have indicated that asset sales are a core part of their strategy to return to stability.[13] Capital injections from governments are often contingent partially on a bank's pledge to make asset sales (e.g. Lloyds, RBS, AIB).

Stressed banks typically have some or all of the following characteristics:

- High dependence on short-term funding, particularly central bank funding
- Low amounts of deposits relative to their loan book (deposits may even be declining as a percent of loans)
- Recently received government capital injections
- Bonds that trade below face value
- High leverage and low capital ratios
- High exposure to challenged sectors, such as real estate, and/or difficult economies
- Recent history of sizable impairments relative to their book value

Examples of stressed banks include Irish banks, Spanish Cajas, and Greek banks.

Banks that have a more stable funding base are less likely to pursue asset sales; however, some of the aforementioned reasons for selling still apply even to more robust banks, such as for regulatory reasons.

4. Types of Assets for Sale

We estimate that approximately 40% of the estimated €1.7 trillion of non-core assets are corporate assets.[14] The remaining assets are mostly related to property, consumer debt, and government bonds.

Many of the non-core assets have the following characteristics:

- **Higher risk assets:** The higher risk the asset (as defined under Basel II/III), the greater the amount of regulatory capital that is required to hold it on the balance sheet.[15] This high-risk weighting is driven by a number of factors, including its category and its credit rating.
- **Impaired assets:** A bank is more likely to sell a loan below par if the loan has an impairment charge against it. Otherwise, the sale of the loan below par would force the bank to record an impairment charge on it through its P&L.
- **Long duration assets:** Long-term loans in areas such as project finance, shipping and aviation often generate income lower than today's funding costs associated with these loans for the banks.
- **Strategically non-core**: Loans that fall into jurisdictions or sectors in which banks may be reducing activities.

In addition, we find that most banks reduce exposure in their more liquid assets first and follow with sales in their less liquid assets.[16]

5. Timeframe

We categorize banks with regard to the expected timing of assets sales in the following way:

[13] Lloyds, RBS, AIB, Anglo Irish Bank, HSH Nordbank, West LB, Hypo Real Estate, amongst others.
[14] Sankaty analysis: based on average NPL breakdown of 10 large European banks. Corporate sector includes project finance and asset back finance, such as infrastructure assets and shipping..
[15] Basel III: A global regulatory framework for more resilient banks and banking systems (BIS, June 2011).
[16] RBS presentations (2009-2011), PwC.

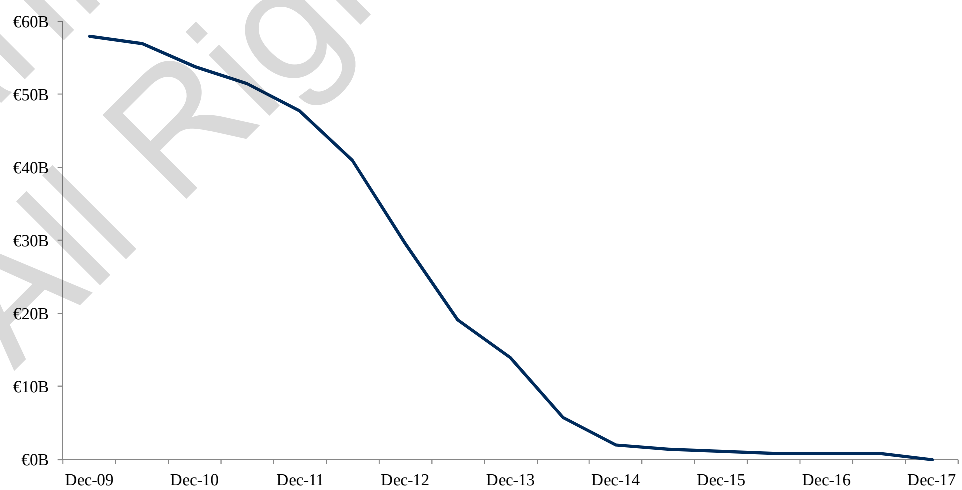
	Public Asset Sale Targets	Public Non-Core Divisions But No Timing Targets	Ad Hoc Sales
Timing	For the banks that have communicated their targets publicly, the expected timing is that the majority of non-core assets will have been sold or run down by 2013-2014.	Other banks have broken out non-core assets and have indicated that their asset sale process will be continuous. These banks are likely to have internal targets in line with those banks that have communicated their targets.	The speed of the group making ad hoc sales is likely to be slower, although there are a number of catalysts: ▪ Changes in political strategy ▪ Basel III regulation starts to come into effect by 2013 ▪ Sovereign restructuring(s) ▪ Bank stress tests ▪ Ratings downgrades ▪ The maturity wall
Examples	▪ RBS ▪ Lloyds ▪ AIB ▪ NAMA ▪ Anglo Irish Bank	▪ West LB 'bad bank' ▪ HRE 'bad bank' ▪ Bank of Ireland ▪ HSH Nordbank	▪ Santander ▪ Intesa Sanpaolo ▪ Barclays

B. European Maturity Wall

Many European companies on the cusp of bankruptcy have postponed addressing their stressed capital structures over the last two years and will ultimately need more permanent solutions, especially given the weak outlook for European growth. This will lead to restructurings and rescue financings in many of the situations we are following today. European companies have been less likely to have dealt with looming maturities than their U.S. counterparts, and low interest rates have allowed many companies to postpone addressing their capital structures. When the time comes when they can no longer "kick the can down the road," capital from banks and CLOs will likely be scarcer than ever.

During 2006 and 2007, CLOs accounted for 35-40% of the total buying power in the European leveraged loan market. These 2006 and 2007 deals account for the large majority of refinancing requirement over the 2013 to 2015 period.

Figure 8: European CLO Reinvestment Capacity[17]

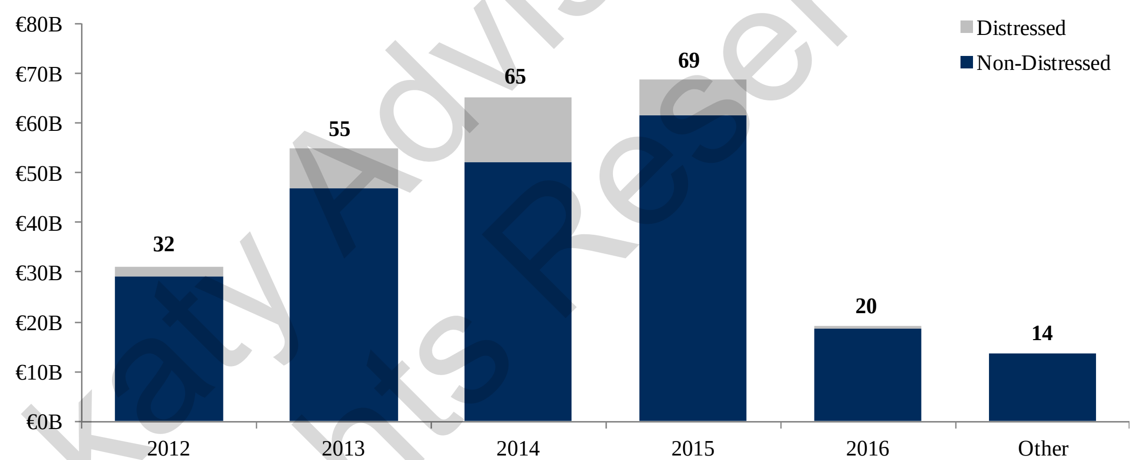


[17]J.P. Morgan CDO Research Intex. Based on 174 European CLO transactions. Sample represents approximately 80% of European CLOs.

We therefore expect that over the next 24 months, many issuers will struggle to refinance their obligations for a number of reasons, including over-levered businesses, declining industries, and a limited appetite for refinancing lower-rated issuers. Furthermore, over the past few months, with the exodus of retail buyers from the high-yield market, we have already begun to see a significant shift in the supply/demand picture in the credit markets. The issuer friendly market we saw earlier this year was short-lived and has left positions hung on bank balance sheets and the market closed for the moment given volatility. The strength of the market, the relative quality, and leverage of deals down over the past 12 months will likely result in a large stressed and distressed opportunity.

We believe this distressed opportunity will become increasingly pronounced, potentially as early as the second half of 2012. We estimate that at least 10% of loans and bonds maturing between 2011 and 2015 will face difficulties refinancing, which puts the size of the investment opportunity at €30-€40 billion. While many investors do not expect maturities to peak until 2014—with a relatively long tail of refinancing into 2015 and 2016—our analysis suggests that the maturity wall is more concentrated in the earlier period. This accelerated maturity wall will be driven by companies' need to refinance all of their senior debt as soon as their first tranche comes due. In addition, companies tend to refinance debt at least 6 to 12 months ahead of its maturity, bringing the maturity wall even closer than many expect.

Figure 9: Distressed Loans by First Structure Maturity[18]



	2012	2013	2014	2015	2016	Other
Distressed	€2B	€8B	€13B	€7B	€1B	€0B
Non-distressed	€30B	€47B	€52B	€62B	€19B	€14B

Sponsored Leverage Buy Outs (LBOs)

The vast majority of currently outstanding European LBOs were financed with senior secured term loans maturing in the 2013-2015 timeframe. Since the covenants of these loans typically step down over the life of the facility, even mildly positive growth will not prevent issues with covenants for many companies. Accordingly, the companies and their owners will need to rely on refinancing, new issuances, or flexibility from existing creditors to amend covenants or to extend maturities. Although the markets were accommodating at the start of 2011, they are no longer. We believe many existing creditors, including CLOs with maturity issues of their own

[18] Credit Suisse leveraged loan index, LCD universal pricing file, Sankaty analysis (June 2011). Maturity wall data principally relates to syndicated corporate loan deals. Used for sourcing purposes only and indicative. Spreads are to maturity and reflect weighted structure average. Distressed defined a structure spread >1000bps. Total outstandings are displayed in the year of first structure maturity.

and banks facing Basel III and other liquidity issues, will find it difficult to accommodate these requests in 2012 and beyond.

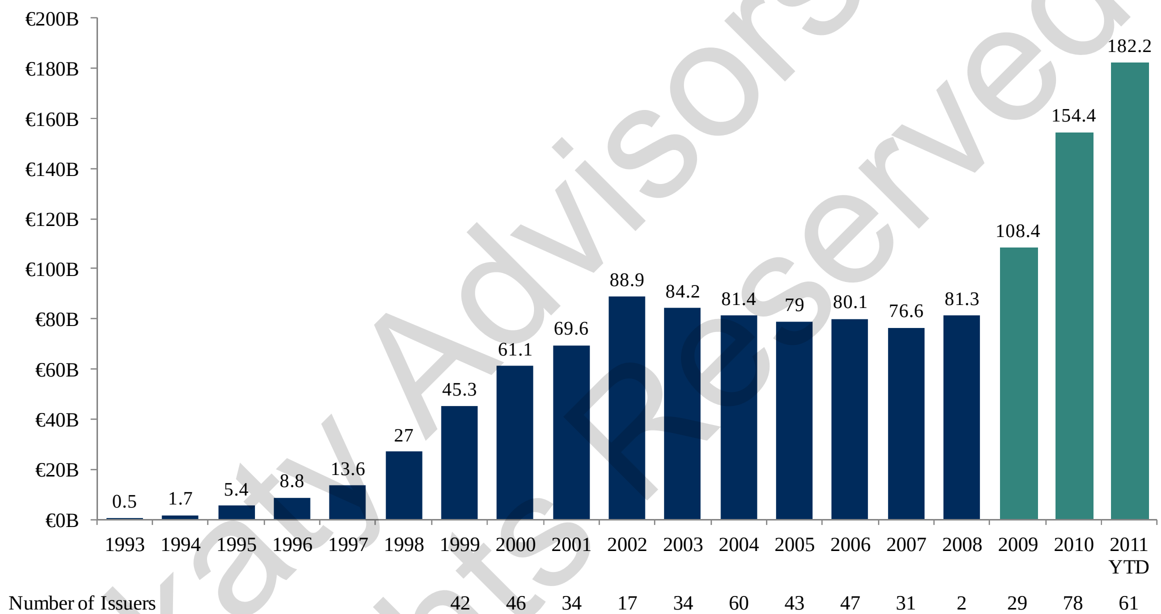
Levered Corporates (non-sponsored)

Europe does not have a large universe of public, non-sponsored, levered corporates; however, a number of non-sponsored companies with highly levered capital structures are held by local European banks. These companies typically have less access to capital, and as banks reduce lending, institutional investors will be required to step in to fill the gap. We have reviewed a number of such opportunities throughout Europe and continue to see significant flow from trading desks and financial advisors.

C. Technicals

Largely backed by retail demand, the European high-yield market has doubled in size since 2008.

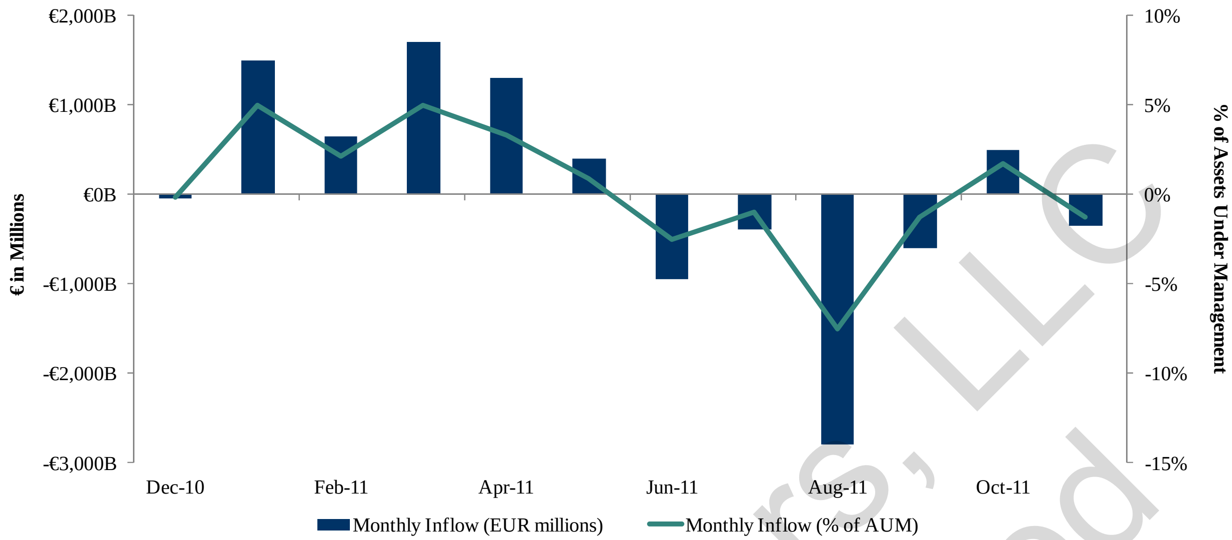
Figure 10: Western European High-Yield Bond Market Size[19]



Bonds have replaced leveraged loans as a main source of financing. These large retail inflows have supported market growth; however, as sentiment turns, significant outflows are putting pressure on the market. Since early 2011, we have been conveying our concerns regarding the stability and funding dynamic in the high-yield market. The growth of institutional retail high-yield funds, driven primarily by "tourist" capital seeking yield in a low-rate environment, has reversed, and their exodus from the market has helped to drive further volatility when the macro situation caused price movements. Retail outflows have already impacted the market, leading to liquid stressed and distressed opportunities in the second half of 2011.

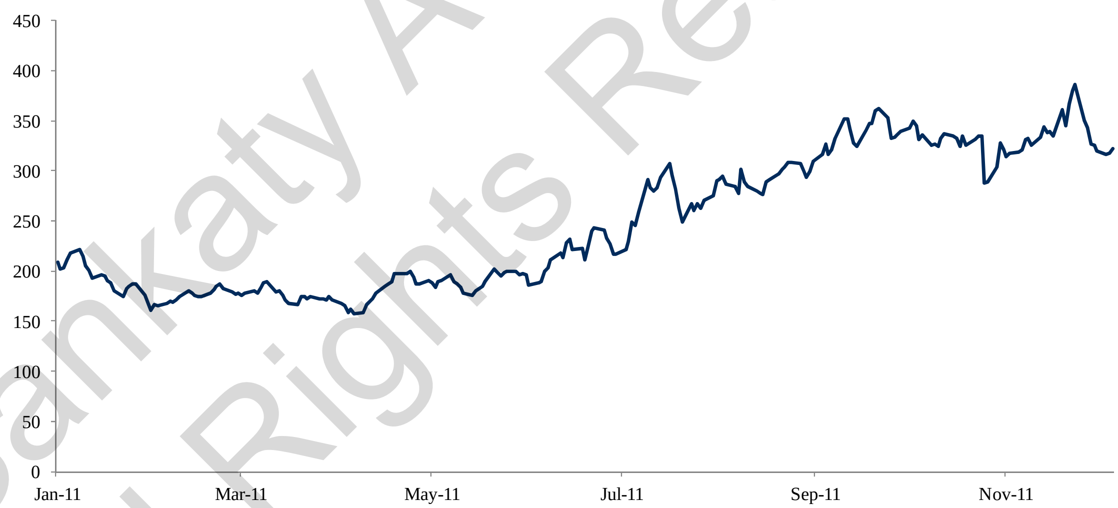
[19] Credit Suisse, J.P. Morgan. Includes non-investment grade straight corporate debt of issuers with assets located in or revenues derived from Western Europe, or the bond is denominated in a Western European currency. Floating-rate and convertible bonds and preferred stock are not included.

Figure 11: Monthly European High-Yield Fund Flows for Last 12 Months[20]



The recent pricing declines, in turn, are leading banks to expedite their disposal programs. The recent dislocation also means that high-yield markets will be less likely to refinance riskier issuers. That this imbalance of supply and demand is occurring across a backdrop of European sovereign concerns only exacerbates the problem.

Figure 12: Western Europe 5-year SOVX Index (bps)[21]



This volatility, particularly when combined with weak growth, will be a further cause for distressed opportunities.

[20] J.P. Morgan, Bloomberg.
[21] Bloomberg.

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