The European Market and the Deleveraging Opportunity

March 2014

Sankaty ADVISORS

Since Sankaty's inception in 1998, we have spent a considerable amount of time investing in Europe. Given the complexity and uncertainty of the situation, we thought it might be helpful for us to summarize our observations culled from years of regular dialogue with banks, non-bank financial institutions, regulatory bodies, and government officials across Europe. Our European team, based in our London office that opened in 2005 and now stands approximately 30 members strong, has spent a tremendous amount of time in these countries building strategic relationships. Their conversations have left us not only with a much better sense of the specific countries and opportunities to come in the corporate, real estate, and non-performing loan ("NPL") spaces at a granular level, but also with a much better picture of the state of affairs from a pan-European perspective.

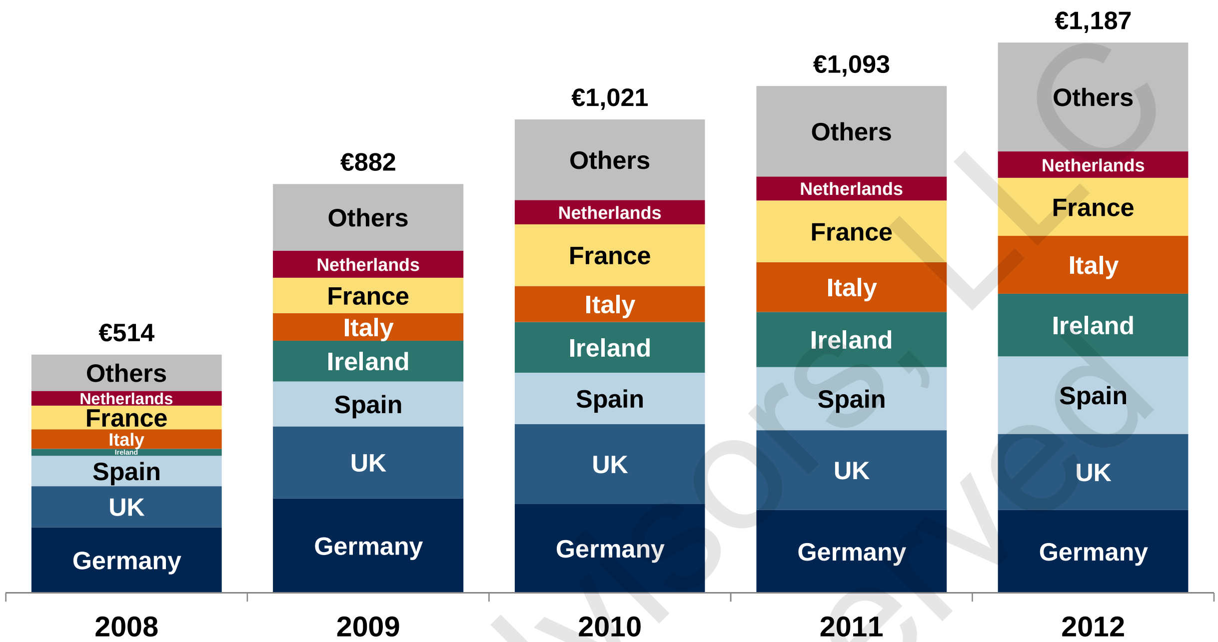
We believe deleveraging by European banks is creating an opportunity that is sizeable, immediately actionable, and provides potential to generate risk-adjusted returns over the long term. As Europe emerges from crisis, governments and regulators are increasingly focused on encouraging banks to acknowledge their problematic balance sheets and to recapitalize them. Faced with either increasing equity or selling assets to deleverage, many banks are choosing the latter. In our view, NPLs are candidates for disposal largely because they are non-core and onerous for banks to hold given their high capital charges, lack of cash flow generation, and operationally intense management requirements. Over the next 7 to 10 years, we believe banks' reduction of assets through deleveraging could total as much as €2.6 trillion. These disposals will be drawn from across asset classes; offering particular opportunity are €1.2 trillion of non-performing loans (NPLs)[1]*, €0.6 trillion commercial real estate (CRE)*[2] *and €0.2 trillion of shipping assets*[3].

Europe's NPL population has expanded significantly since the credit crisis. From 2008 to 2012, the stock of European NPLs has grown at a CAGR of 23% to approximately €1.2 trillion. As a proportion of total loans on banks' balance sheets, NPL stock only continues to rise: from 2011 to 2012, the amount climbed from 6.6% to 7.3%, with a further estimated increase to 8.5% for 2013[4]*. In the years preceding the crisis, overly aggressive lending led to a significant reduction in the credit quality of banks' lending books. The economic downturn negatively impacted borrowers which led to large impairments in the volume of debt that had surged in the run up to the crisis. Protracted recovery processes in a number of jurisdictions have not only further delayed resolution and backed up the pipeline, but have also contributed to new supply.*

[1] PwC, Market Update, 2013
[2] Co-Star Finance
[3] Sankaty estimate based on $500bn financing market (sources: SEAFIN, Bank of America)
[4] PwC Market Update, October 2013

As Europe's Economy Contracted in 2009, its Estimated NPL Stock Rose 72%

2008 – 2012 European NPLs have Grown at a CAGR of 23%



Data as of October 2013. Source: PwC Market Update.

While each region faces its own unique circumstances, the push from governments and regulatory bodies for banks across Europe to deleverage is only growing stronger as the immediate crisis appears to have reached some degree of resolution. We believe given the current state of the European banking system, increased regulation and retrenchment of liquidity (largely through the unwinding of LTRO schemes) will only exacerbate the situation. Banks may have no option but to divest significant assets, and even absent external pressures, they themselves realize that doing so will improve their own business models.

In this paper, we seek to unpack the process of deleveraging in greater detail.

Outline

Political Sentiments and Regulatory Regimes: A Seismic Shift

Forced to provide significant capital to keep the banking system afloat post-crisis, we believe sovereigns and supranational bodies are anxious to see banks begin the process of deleveraging in earnest now that certain markets have stabilized and in some cases, economies are showing signs of growth. Not only do governments recognize the inherent dangers of a banking system dependent on the state – particularly given the size of Europe's banking system relative to its economy - but banks' reduction of assets and repayment of bail out packages can also have political efficacy and serve the broader macro environment.

Europe's banking system is much larger than in other geographies. To put it in perspective, European banks' assets stand at approximately 3.2 times GDP (and approximately 5 times in the UK), whereas the ratio is less than 1:1 in the US[5]. The European banking system has grown disproportionately large relative to its economy, and its deleveraging process has dramatically lagged that of the US (which was much smaller in the first place). The dominance of SMEs over large corporates in many parts of Europe has dictated that most debt finance provided to European companies has come in the form of loans as smaller firms have less access to capital markets compared to large corporates. Consequently in Europe, 85% of debt finance for corporates has come directly from banks, compared to only 25% of corporate lending in the US[6]. Lower levels of securitization also mean that European banks have a significantly higher percentage of loans on their balance sheets. In Europe, outstanding securitized debt stood at €1.7 trillion, compared to €6.7 trillion in the US at Q1 2013[7].

In our view, the state of affairs is somewhat sobering: in 2011, the European Banking Authority (EBA) found that the largest European banks were €242 billion under-capitalized against 2019's requirements (recall 2019 will mark the year of enforcement for Basel III's conservation buffer). In addition, 59% of the cohort also failed Basel III's 3% leverage ratio. The OECD notes that if the Federal Deposit Insurance Corporation's ("FDIC") definition of "well capitalized," (5% on unweighted assets), was adopted as a requirement, the Eurozone's banks would have a shortfall of €400 billion, which represents 4.2% of GDP[8]. Although banks have taken steps to meet upcoming requirements, a number of them may be forced to take action to avoid the need for capital injections or state ownership and, very likely, liquidation.

We see asset disposals in particular as a politically expedient way for sovereigns to recoup cash and to reduce their politically problematic support of the banking sector, while simultaneously lowering their funding costs by reducing their overall levels of indebtedness. In addition to these benefits,

[5] RBS Macro Credit Research, 2013
[6] Credit Suisse, ECB, Federal Reserve, data as of November 30, 2011
[7] AFME Securitisation Data Report Q1 2013. Figures given by collateral value
[8] OECD, 'Deleveraging, Traditional versus Capital Markets Banking…', 2012 pg. 19

working out bad debt – and the enforcement required to extract value - can be politically treacherous for a sovereign. Disposals offer a simple exit. Clearing out old lending also frees up capital for the extension of new credit – a driver of growth that is uniformly popular with electorates. To date, this desire has manifested itself in the creation of bad banks with mandates to dispose of assets and the liquidation of positions held by entities in the wake of government intervention. The full implementation of Basel III, an increasingly demanding capital regime, will further impact deleveraging. The Capital Requirements Directive IV ("CRD IV") and Capital Requirements Regulation ("CRR") are the mechanisms through which Basel III will be transmitted into Europe's banking sector. These may present demanding capital, leverage, and liquidity requirements. Although the precise timeframe is unclear, full implementation is currently expected for 2019. While banks have made adjustments in anticipation, the need to be fully compliant should drive additional assessments of the composition of balance sheets as the deadline draws closer.

In sum, as regulatory requirements become more demanding and liquidity difficulties emerge through the normalization of ECB policy (the regime which spawned LTROs withdrawing), many banks may find that their funding and capital structures are not sustainable and that asset sales are the easiest way out.

We believe the pressures on banks to dispose assets are not all external, however. Banks themselves are keen to change the composition of their balance sheets, partly because legacy assets are less profitable than new lending. As banks seek to pass onto borrowers the increased costs of doing business arising from regulation, spreads have widened against historic levels. The desire to cut down legacy positions and free up capital for new, more profitable lending is providing further incentive to deleverage.

Encouraged by both markets and governments to identify and shed 'non-core' assets, NPLs are candidates for disposal, being by nature 'non-core'. In addition, the capital charges attracted by NPLs (often at a 150% risk weighting) make them onerous to hold. We believe reputational risk attendant on workout and internal fatigue from managing distressed assets each provide additional incentives to dispose, rather than run off.

Faced with either increasing equity or reducing assets to deleverage, many banks are choosing the latter. The context of reduced profitability and limited investor appetite for rights issues makes increasing equity a challenge. Except for the largest banks, equity markets are still closed to a number of financial institutions. With additional capital difficult to raise, many banks are forced to reduce the asset side of their balance sheets instead.

Why the Delay?

Although deleveraging seems like a "cure all", certain realities have left banks in many jurisdictions slow to act. Why is this time different? We believe for the past few years, banks' primary reluctance to dispose of loans has stemmed from their under-provision on bad debt and unwillingness to absorb the subsequent losses that would have occurred upon disposal. Some banks may be starting to generate earnings to cover the P&L impact of portfolio sales. For banks that aren't profitable, capital injections by governments, such as in the UK, and by supranationals have replicated a bump in income, which mitigates the impact of the losses often assumed by banks when disposing of loans.

We also believe that the recent roll out of the European Central Bank's Asset Quality Review ("AQR") will lead to further asset sales from across European jurisdictions by making it harder for banks to hide non-performing loans and forcing them to raise provisions. Previously, definitions of "non-performance" have varied between countries. To date, regimes with laxer definitions have relied on policies of "amend and extend" to disguise non-performing debt on their books. The call to harmonize these definitions is being answered by the AQR, the report for which will be published in 2014. In addition to auditing banks' loan books on a loan-by-loan basis, the AQR will set limits for NPL definition at 90 days past due and assume cross-default across books. The results may widely increase write-downs; accordingly, RBS has predicted a capital shortfall for 15-20 banks on the back of it. Even applying a 43% coverage ratio – well below average European levels – Natixis estimates a provisioning shortfall of €25 billion resulting from the harmonizing of definitions[9]. We believe many banks have avoided selling assets because to do so often meant generating losses. By forcing banks to recognize losses on assets irrespective of whether they are actually sold, the AQR will make disposals themselves less difficult for banks as the marginal loss incurred upon actual sale date will be smaller.

Broadly, the smaller European lenders appear most at risk from consequences of the AQR; regulators may well insist that these banks dispose of non-performing books in favor of assets with lower charges against them. This impetus – and banks' anticipation of it – may provide further deal flow and may in particular bring more SME and CRE NPLs into the market, as these are assets classes to which small European banks' lending is disproportionately exposed.

Markets have reacted favorably to those banks that have been able to articulate strategic direction, to identify assets that do not fit with this strategy, and to dispose of them. Divestment gives clear action now, whereas run-off takes time and can smack of passivity, making management look complacent.

[9] Natixis Sector Note, Europe Outperformance, 30 September 2013

Discerning the Real Opportunity

As banks recommit to their core businesses and geographies, the designation of assets as 'non-core' should provide significant stock for potential sale (i.e., exit from peripheral Europe and CEE). Accordingly, some of the main beneficiaries of the deleveraging process are the NPL markets, particularly those distressed loan portfolios secured against shipping and Commercial Real Estate assets. Although heavily overlapping, it is estimated that together these represent €2 trillion (€1.2 trillion NPL[10], €0.6 trillion CRE[11] and €0.2 trillion shipping[12]). Considered as non-core assets to which banks are overexposed, these assets tick most of the boxes for disposal, and we anticipate them to provide substantial flow into the market.

Of course, the process of asset disposals is highly nuanced not only by county but also by asset type, so we seek to avoid generalizations. The risk-weightings assigned to various asset classes can drive a determination to sell specific types of loans. For example, CRE carries a higher penalty than residential property-backed lending. To provide an example of factors that can have significant impact on what is for sale:

- Because consumer unsecured debt is fully written off at default, once written down sales of these NPLs have shown a profit over book value for banks. For this reason, they are often the first portfolios to be sold.

- CRE and shipping debt is usually written down to collateral value, which is typically often above the amount a buyer will pay. These positions might therefore be loss making upon sale, making banks less eager to shed them.

- More problematic still though are corporate loans, the provisioning for which is often exceptionally soft compared to market value. In addition, the complexities and costs associated with restructuring corporate debt across a distressed lending portfolio increase uncertainty and depress a bidder's price. As a consequence, banks are often least willing to dispose of these assets.

Before providing a county-specific analysis, we specify generally the areas of highest interest to us and our rationale for determining this list. Currently, we are focused on the following areas:

1. **Corporate loan portfolios (secured / unsecured):** In 2013, an estimated €60 billion of corporate loan portfolio sales took place, representing a CAGR from 2010 levels of 76% and

[10] PwC, Market Update, 2013
[11] Co-Star Finance
[12] Sankaty estimate based on $500bn financing market (sources: SEAFIN, Bank of America)

40% of all deals transacted since 2010[13]. We anticipate volume growth to continue and that deals transacted will increase to over €80 billion in 2014[14].

2. **Performing loans:** Frequently the bid-offer gap is too wide for performing loans to interest us. However, at times, the absence of liquidity squeezes the price at which a seller will transact, enabling the buyer to generate attractive returns through the provision of liquidity rather than the assumption of credit risk, such as in Ireland.

3. **<u>Operationally driven real-estate backed loans:</u>** Hotels, student housing, nursing homes and other operational assets where active management can generate additional value, such as data centers, storage facilities, and golf courses, are of particular interest. We look to avoid investing in asset classes where returns are purely a function of capital rate trends, maintaining a contrarian approach to generate uncorrelated returns.

4. **<u>Shipping:</u>** The shipping market cratered as significant oversupply swamped retreating demand during the crisis. Much of this legacy lending is now heavily distressed and trading at deep discounts, which are only exacerbated by the market's natural illiquidity. Since 2007, the significant supply versus demand imbalance in many of the vessel segments has given us reason for caution. However, two factors have changed recently: banks are withdrawing from the market and demand is starting to catch up with supply. The withdrawal by banks from the market leaves a gap, either to fund the construction of new assets or to purchase distressed assets (either hard assets or the loans) which banks as creditor are trying to sell off. Please refer to Appendix A for further color on shipping.

5. **<u>Leasing platforms to capitalize on banks' retrenchments in certain geographies (i.e., Ireland):</u>** The exit from the market (i.e., Ireland) by a number of significant players has left room to provide finance for the Consumer, Auto, Agricultural, and Equipment leasing sectors, which are starving on a lack of credit. Demand for these services exists, and it is only set to increase. Underinvestment in agricultural machinery and equipment during the worst parts of the recession are driving projections for these asset classes that show significant growth in volumes bought and, as the macroeconomic situation improves, exposure to increased consumer spending.

We believe the process of deducing the relative attractiveness of investments is derived from our assessment of four key factors characterizing the opportunity set in each European country: supply, actionability, accessibility, and competition.

[13] PwC, Market Update, 2013
[14] Sankaty estimate

1. **Supply:** Market activity, which varies across Europe, drives interest in our view. Greater supply can indicate a more favourable environment generally and the opportunity to leverage expertise across various deals. We see particularly strong supply in the UK, Ireland, and the Netherlands.

2. **Actionability:** A buyer's ability to extract value is largely a function of the servicing infrastructure, the jurisdiction's friendliness to creditors, and any other legal complications in enforcement. The most actionable countries we see are the UK and the Netherlands.

3. **Accessibility:** Even in markets where a significant supply of portfolios exists and the environment is encouraging to buyers, the ability and willingness of banks to dispose can still present obstacles. The profitability of banks, which we believe is contingent partially on loss absorption as determined by the macro environment, can be a key driver of volume, as can intervention to consolidate and to inject capital into the banking sector by governments (i.e., Ireland, the UK, and Spain).

4. **Competition:** While competition is often more intense in areas of greater supply, heightened activity can also improve leverage terms for deals in tighter markets. Better leverage terms offsets higher prices to some extent.

Geographic Focus

Taking all these factors into consideration, levels of interest in Europe's respective markets are shown in the table below, in which green represents the highest level of interest, red the lowest.

	Secured		Unsecured	
	Commercial*	**Consumer****	**Commercial**	**Consumer*****
UK	🟢	🟡	🟢	🟡
Ireland	🟢	🟢	🟢	🟡
Spain	🟡	🟡	🟢	🔴
Portugal	🟢	🟢	🟢	🟡
Italy	🟢	🟡	🟢	🟡
Germany	🔴	🔴	🟡	🔴
Benelux	🟢	🟡	🟡	🔴
Greece	🟡	🟡	🟡	🔴
CEE	🟡	🔴	🟡	🔴
Nordics	🟡	🔴	🟡	🔴
France	🟡	🔴	🟡	🟡

As of March 2014. Source: Sankaty analysis.
*Includes shipping, aircraft, leasing, CRE, receivables (tax, claims, etc.).
**Includes residential mortgages and auto loans.
***Includes personal loans, credit cards, bank overdrafts.

- **UK:** In our view, the UK portfolio market has been the most active in Europe, with significant flow across all asset classes. Having led the charge to sell off assets, the UK presents both a significant stock of loan portfolios (approximately €164 billion[15]) and an active market in which they are being disposed, with over €40 billion of portfolio sales made since 2010. The potential for appreciation in collateral values may also present opportunity for macro driven upside. Active sales to date, combined with a creditor-friendly jurisdiction, has generated significant competition. In particular, banks developed substantial CRE exposure in the run-up to the crisis, and we believe these assets present opportunity. ***Within***

[15] PwC, Market Update, 2013

CRE, hotels (both full service and limited service) in secondary and tertiary markets are compelling (either branded or independently operated) as are student housing and nursing homes. The asset class is pro-cyclical and stands to benefit from the UK's expected recovery, but the response in its value lags the macro environment, with it yet to pick up.

- **Ireland:** The Irish real estate market, on which the majority of its lending was secured, is presenting a mixed picture, with some stabilisation and even growth in certain areas – notably Dublin – and continued depression in value outside of the capital. Significant volumes of deals are now being pushed into the marketplace (approximately €20 billion since 2008[16]), partly as a result of this calmer property picture. A key driver of this flow is the shape of the banking sector following its wholesale restructuring and the creation of IBRC and NAMA. ***As with the UK, property-backed debt (both CRE and residential), represents potential opportunity, while demanding rigorous due diligence.*** The attractiveness of the market is counterbalanced by a relatively underdeveloped (especially against current requirements) servicing infrastructure, though we've seen improvements. ***Following the withdrawal of many foreign banks from the market during and after the initial crisis, new lending also presents opportunity.*** The disappearance of lending platforms from Ireland has created the opportunity to develop an asset finance platform, offering automotive, agricultural, and equipment finance.

- **Spain:** In our view, Spain is the current area of focus for investors, as the creation of SAREB and organized asset sale efforts at the banks have provided orderly and centralized points of contact. We believe it is here the diversity of the opportunity is currently broadest. With an estimated €167 billion of assets as of 2012[17], investors must decide whether to focus on real estate, consumer, SME, residential, or all of the above. The economy is picking up, or at least bottoming out. GDP has grown, signaling an end to the recession. Spanish industry have begun to close the competitiveness gap and are an exporter once again, which has bolstered national pride. Unit cost of production in Spain is down approximately 25% over the last 5 years. We believe all of this activity is set against a backdrop of relief, not full recovery. With high unemployment and a fragile political system, this recovery is likely to be more L-shaped than people hope. ***It is here we believe that a mix of portfolio purchases and new loan origination will be key components.*** Working with banks to reschedule and recapitalize corporate loans as partners may also provide a path to deploy significant capital to benefit from Spain's recovery.

[16] PwC, Market Update, 2013
[17] PwC

- **Portugal:** Portugal did not witness a housing boom of the same magnitude as in other areas in Europe. Portugal's property market looks as though it is approaching stabilisation, though the wider economy remains in recession. ***We see opportunities in both SME secured/unsecured NPLs***. Although market activity has been relatively muted to date, the government has taken steps to encourage deleveraging, and we believe there will be solid deal flow. That this will be of smaller deal sizes (€50-100 million and lower volumes) compared to portfolios traded elsewhere in Europe will likely reduce competition in this market. Key risks exist in the legal system, liquidity is limited in the Real Estate market, and creditors face delays while seeking to enforce.

- **Italy:** Italy has one of the largest non-core / distressed asset populations in Europe (approximately €281 billion[18]). This presents a potential opportunity, as yet un-tapped due to thinly capitalised banks (something which the government has yet to remedy through intervention at scale). That the number of transactions closed over the course of 2012 and 2013 grew to €4 billion is a positive development. ***We see opportunity across the asset classes in Italy – in its large stock of SME debt, in CRE secured loans and in leasing, as well.*** In addition, new consumer lending will be needed to fill the hole left in the market place following the retrenchment of international lenders in the crisis. The picture as to workout and accessibility is mixed; although the judicial system is cumbersome, impeding resolution for creditors, the servicing infrastructure in the country is mature and well-developed, providing a solid basis for asset management.

- **Netherlands:** We believe the Dutch economy's fundamentals are strong and the government provides a creditor-friendly environment for enforcement. The CRE market remains overvalued, however, with additional value decay anticipated. The residential sector suffers from overleverage, largely due to the fiscal efficiencies of taking out a mortgage in the country. ***We see contrarian opportunities in CRE NPLs and consumer lending.***

- **Other markets.** We see these markets as typically less interesting is due to the fact that the key factors of supply, "actionability," accessibility, and pricing are not generally aligned.

    - **Supply:** This is lacking across a number of geographies, including Belgium, Austria, and the Nordic countries.

    - **Actionability:** Unfavourable environments for extracting value can present through either a jurisdiction which is not creditor-friendly, creating problems for work-out, as in the case of France, or through opacity in loan information, exemplified in the cases

[18] 'The Deloitte Italian NPL Survey: Outlook for 2012-2013'

of Greece and CEE. In Spain, the lack of a strong independent servicing infrastructure and a cumbersome legal system together present complications which, combined with high levels of competition (see below) make the market less attractive.

- **Accessibility:** Many banks in Spain and Greece have not raised sufficient provisions against bad debt – a shortcoming made particularly acute by the continued depression of CRE values. We anticipate that inflated book values will increase losses on disposal and in many cases are preventing deals from taking place.
- **Over-competition:** Even where there is good supply into the loan portfolio market and the environment is sufficiently friendly to creditors, overcrowding in the market reduces its appeal. This has proven problematic in both Spain and Germany, the portfolio market for which has shown relatively limited flow but a large number of buyers, including banks, competing over those portfolios which are disposed.

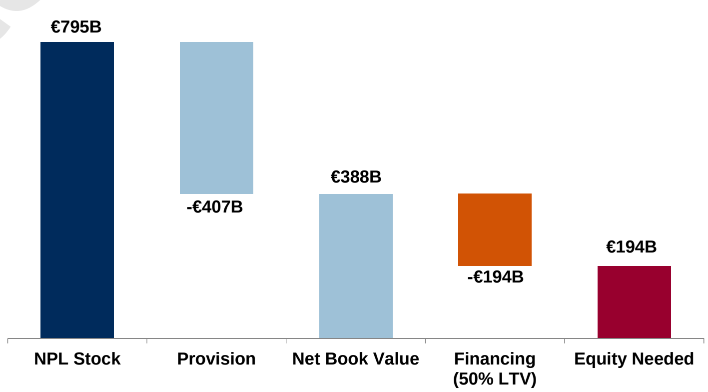
Competition

While we believe the deleveraging process has attracted significant interest from non-bank financial firms, the fact remains that existing equity alone is insufficient to plug the gap of NPLs. We estimate that less than €200 billion of "equity capital" is available to invest in asset disposals from all market participants, including REITS, insurance companies, and alternative asset managers. Many distressed investment funds are focusing on more liquid distressed securities as opposed to NPLs. We also believe that in addition to liquidity constraints, the nature of the assets and the need for extensive infrastructure and skill sets to evaluate them create barriers to entry.

Given the size of the potential market, significant space remains. As mentioned above, it is estimated that European deleveraging will require asset reduction of €2.6 trillion. With regard to likely candidates for sale, we estimate that a total of €2 trillion in NPLs (€1.2 trillion), CRE (€600 billion) and shipping (€200 billion) could be disposed, leaving headroom - even allowing for potential steep discounts and leveraged purchases. In short, given the size of the market, there is more than enough for all, assuming that:

- The aforementioned funds have been raised solely for NPL purposes and no other non-core opportunities.
- There is no further increase in NPL levels (a highly conservative assumption, given current NPL trajectories and the continued financial difficulties in Southern Europe, especially).
- The NPL ratio returns to 2007 levels across Europe through sale.
- That NPL purchases are 60% levered (aggressive gearing and therefore a conservative assumption).

As demonstrated by the chart, of the €1.2 trillion in NPLs across Europe, €795 billion of them are held by Europe's largest 44 banks. We estimate that disposal would require €194 billion[19], even at aggressive financing terms of 50% LTV. When we include banks beyond the largest 44, we estimate that €290 billion[20] of equity will be needed to finance these acquisitions, leaving plenty of headroom in the market.



Source: RBS

[19] RBS
[20] Sankaty analysis.

Conclusion

We believe the process of deleveraging to play out over the next decade. The recoveries that will enable banks to sell NPLs won't all happen at once: muted recoveries across Europe will delay the process in some countries while simultaneously providing new NPL volume as stocks of borrowing continue to deteriorate under unfavorable conditions. Practical difficulties in workout will also lengthen the timeline of market activity; cumbersome judicial systems can make the extraction of value from distressed opportunities a more difficult and time-consuming process, for example. The drawing out of enforcement proceedings is perhaps most notable in Southern Europe, which we anticipate to provide a large proportion of sales. However, even taking these factors into account, we believe there is a sizeable opportunity, and the ramifications of regulatory and political shifts will provide a spate of opportunities for those investors with the specialized skill set and infrastructure in place. For the purposes of this paper, we have sought to portray the opportunity set as generally as possible. However, to succeed in taking advantage of this opportunity, it is imperative for investors to understand the complexity and nuances of the situation.

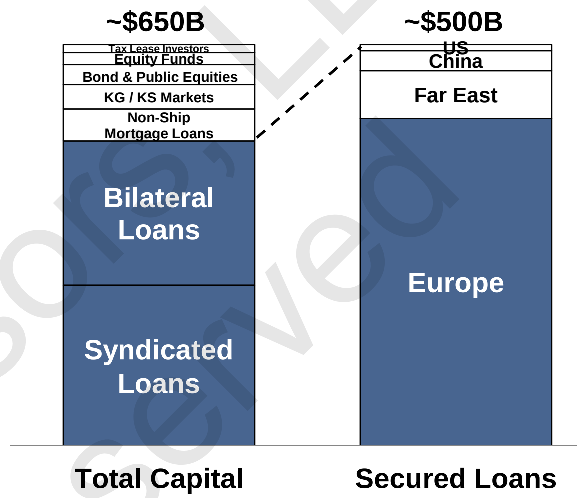
APPENDIX: SHIPPING

There are factors in shipping space that have changed recently: banks are withdrawing from the market and demand is starting to catch up with supply. The withdrawal by banks from the market leaves a gap, either to fund new asset purchases or to purchase distressed assets (either hard assets or the loans) which banks as creditor are trying to sell off.

Background

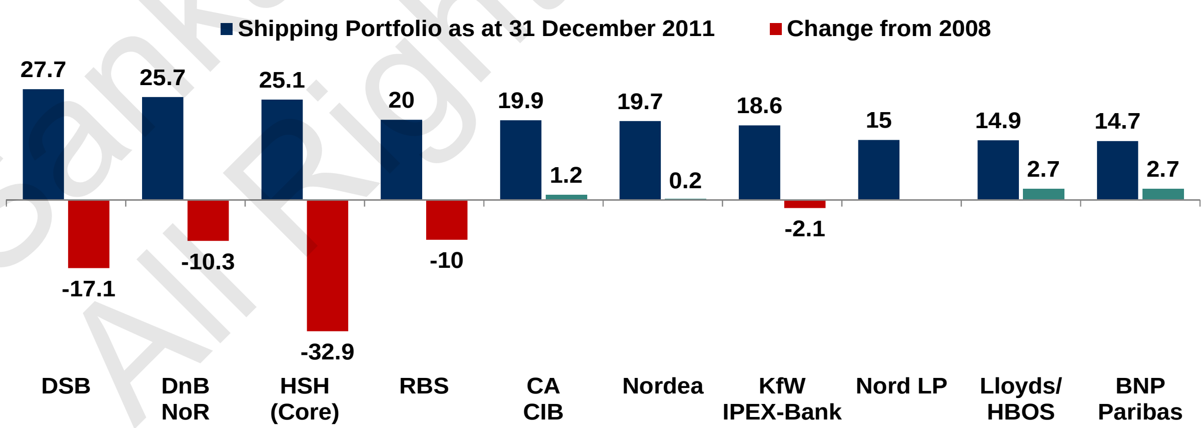
The ship financing market is large: the total secured ship financing market stands at ~$500 billion.[21] Of this, the vast proportion has historically come from Europe (see chart), and the posture which European banks adopt with regard to ship financing is therefore a key driver in the market.

European banks were significant market players: Given the hard assets pledged against these loans, the ability to monetize these assets in the ship resale market and the cyclical nature of the industry, European banks have historically provided very cheap financing and have refrained from taking immediate action against non-performing loans.



Sources: SEAFIN Presentation 2013, Bank of America

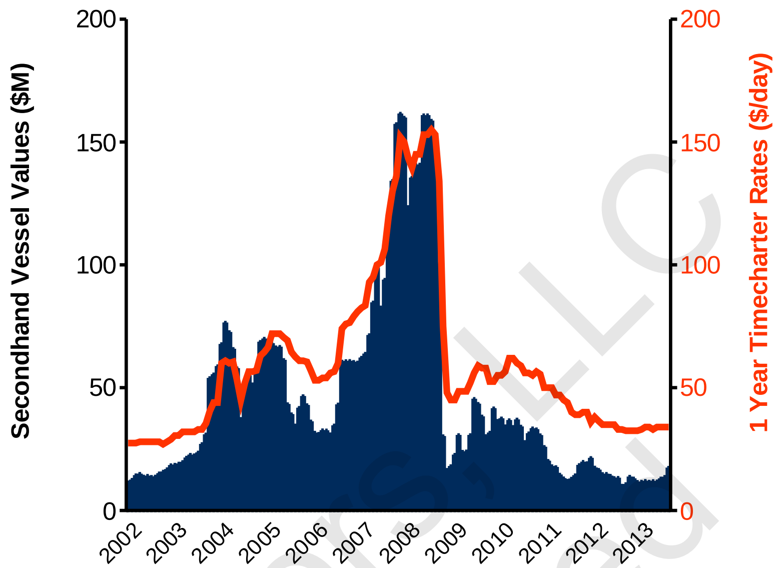
New regulation is changing this, however: The toughening of the capital, liquidity, and leverage restrictions facing Europe's banks through Basel III (transmitted through CRD IV and CRR) has been shown to be a recurring theme in Europe's deleveraging process. As in other markets detailed in this document, we see new regulation and capital requirements leading to retrenchment by banks from the shipping sector. This reduction in exposure to the industry is shown in the table below.



Sources: SEAFIN Presentation 2013. Note: Some banks did not report their portfolios in 2011 and 2008.

21 Sources: SEAFIN Presentation 2013, Bank of America

The market collapsed: A driving force behind the withdrawal of banks from shipping has been the depression of market values following the financial crisis. In the years preceding the crisis, utilization rates, and as a consequence daily charter rates, were very high. Ship owners ordered additional capacity to meet growing demand. However, as the global financial crisis hit, demand growth abruptly disappeared while a significant supply backlog still remained. As the new ships hit the water, it created excess supply which in turn resulted in a drop off in daily rates and asset values. The excess supply was so large that time charter rates fell as much as 90% from their pre-crisis high. Even if we exclude the extreme peak in daily rates and vessel values from 2007-2008, we find that rates fell as much as 60% from their historical 10 year average (excluding peak data).



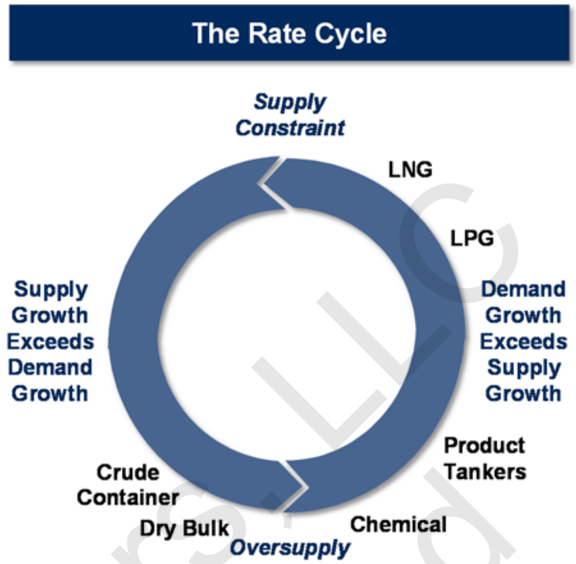
Sources: Clarksons; Values and Rates are shown for a 5 year-old 170-180K DWT Capesize Bulker.

The collapse has led to significant distressed shipping debt. This collapse in value has left many banks with non-performing loans on their books; and, as the fall in ship prices has outpaced the borrower's amortisation schedule, LTV covenants have been breached, in many cases exceeding 100%. Where banks recognize these loans as non-performing, capital requirements increase with risk weighted assets. As a consequence—and as has been repeated throughout this document—banks have been exceptionally reluctant to write down their loan books. In many cases, this has kept the bid-offer spread too wide to trade, withholding some distressed loan flow. Where banks have moved to exercise their charge on the underlying asset, they become forced sellers in the market place, potentially realising substantial losses as part of this process.

Where banks continue to finance shipping, the terms are now more conservative. The reluctance by banks to take new exposure to shipping has led to a significant reduction in the LTVs at which they are prepared to fund. Historically, banks had provided credit at up to 80% LTV. If the ship was on a long-term bare boat charter, then borrowers could get an additional 10% LTV from junior debt. Equity, from the ship owners, would sit behind this. Today, banks provide leverage of only 50-60% LTV. In some instances, there could be junior debt behind the banks at 80% LTV. Junior debt isn't always available so the equity requirement has increased. As a result, owners and others are willing to invite other investors into a Joint Venture structure to share equity ownership.

Demand is starting to catch up with supply. After the retrenchment by banks from the shipping sector as part of their deleveraging, the second driving force behind our interest in the sector is the shift in underlying pricing drivers. New vessel orders have declined and demand is starting to catch up with supply and day rates are showing some signs of recovery.

In general, the lack of financing has trimmed back new vessel orders and economic recovery may help to stimulate demand further, closing the gap somewhat; however an analysis of supply and demand on a sub-sector basis as well as ship size within each sub sector is necessary in order to pick the right asset class.



Types of Opportunities

1. **Providing senior loans on a 1st lien basis.** Historically, these facilities were entirely held by relationship banks that provided funding at L+100bps or less and at 80% LTV. Today, lending occurs at L+350bps for up to 60% LTV, and banks are willing to bring in institutional lenders on syndicated deals. We suspect that as the shipping sector recovers, pricing will continue to tighten for such loans, and it may become less interesting for Sankaty relative to other opportunities to purchase 1st lien debt.

2. **Secondary purchases of distressed debt.** Banks are divesting non-performing loans at a discount to face value. The larger, well-syndicated loans of distressed public companies tend to trade at or above underlying asset value as investors are paying a premium to enter the syndicate and gain access to information. At current trading levels, there are other, more attractive ways to gain exposure to shipping. We have also seen portfolio transactions where banks dispose of multiple syndicated, club and bilateral loans in a pool. Given the complexity created by multiple borrowers in multiple sub-sectors, such portfolio transactions tend to occur at more interesting levels – typically trading at a value that represents 75-80% of underlying asset value and generating a 10-11% unlevered return.

3. **Providing junior financing on a 2nd lien or unsecured basis.** Given the capital gap created by banks' reduction of their leverage from 80% LTV down to 60%, a market has emerged for junior financing. The high-yield market is only accessible to a handful of borrowers, and others look to raise capital in the private debt markets. Depending on the sub-sector, quality of borrower, etc., we see opportunities to deploy capital at a 10-15% interest rate, in some cases with additional upside from participation in equity. The facilities are typically at ~70-

80% LTV. Again, such 2nd liens are covered by hard collateral and at a time when that collateral value is at historic lows.

4. **Purchase of publicly traded common equities**. Many public equities are currently trading above underlying asset value and represent optimism on the part of equity investors that industry conditions will improve faster than what stock prices currently imply. Public equities also appear to demonstrate significant volatility. While the higher valuations and high volatility make the opportunities less attractive, we recognize that such positions are more liquid than most other shipping opportunities, allowing for a better opportunity to exit once the industry is in a better point in the cycle.

5. **Purchase of Hard Assets in a Joint Venture structure.** We have seen several opportunities to partner with an operator to purchase high quality assets and to hold them in a structure that has the patience to wait until we see an industry recovery. We see such opportunities as particularly interesting given where we are in the cycle. As asset values are near historical lows, equity ownership allows one to maximize the upside in an investment from a cyclical recovery. We are particularly focused on finding the right operating partner to bring differentiated value to the joint venture. Such joint venture opportunities can provide 15-25% IRRs depending on the timing and shape of an eventual industry recovery.

Accessibility: Assets are typically held in SPVs that are incorporated in maritime-friendly jurisdictions such as Marshall Islands, Panama, etc. but most of these typical jurisdictions have lender protections similar to those in the US or UK. Further, assets travel, which adds complexity to a repossession process. In order to repossess the asset, one has to take action at the local court where the ship is docked and certain countries tend to have a more efficient process for shipping versus others. As a result one has to be thoughtful about where the ships are expected to travel and what processes exist in those jurisdictions. It is important to know who the equity owner is and whether their behaviour will be commercial in the case of default. Typically ship owners have their loans structured in tranches secured against individual pools of ships and recognize that banking relationships matter over the long term.

Please consider the following:

In this material Sankaty Advisors, LLC and Sankaty Advisors, Ltd., are collectively referred to as "Sankaty Advisors", which are the credit affiliates of Bain Capital, LLC. This presentation expresses the good faith views of the author as of the date indicated and such views are subject to change without notice. The original version of this presentation on the date ascribed within may have been updated or modified for purposes of this posting. Sankaty Advisors has no duty or obligation to update the information contained herein. Further, Sankaty Advisors makes no representation, and it should not be assumed, that past investment performance is an indication of future results. Moreover, wherever there is the potential for profit there is also the possibility of loss.

The opinions and information contained in this presentation is being made available for educational purposes only and should not be used for any other purpose. The information contained herein does not constitute and should not be construed as an offering of advisory services or an offer to sell or solicitation to buy any securities or related financial instruments in any jurisdiction. Certain information contained herein concerning economic trends and performance is based on or derived from information provided by independent third-party sources. Sankaty Advisors believes that the sources from which such information has been obtained are reliable; however, it cannot guarantee the accuracy of such information and has not independently verified the accuracy or completeness of such information or the assumptions on which such information is based.

This presentation, including the information contained herein, may not be copied, reproduced, republished, or posted in whole or in part, in any form without the prior written consent of Sankaty Advisors. Any other person receiving this material should not rely upon its content.