

Deleveraging & the Emerging European Non-Bank Finance Industry

June 2015

While the Goldilocks metaphor – the little girl who tasted porridge that was too hot and then too cold until finding one that was just right – is vastly overused, in the context of the European credit opportunity, it may be “just right.” The significant capital that was raised shortly following the Global Financial Crisis was too early as banks were unable and/or unwilling to meaningfully dispose of assets. With significant asset sales occurring today -- €91 billion in European non-performing loan (“NPLs”) sales occurred in 2014 and €100 billion is estimated to transact in 2015ⁱ -- the timing for investors who wait will likely be too late.

While the sale of non-core assets continues, deleveraging means much more than NPL transactions. A nascent non-bank financial company industry is emerging with leasing (aircraft, shipping, equipment, etc) leading the way. Formerly dominated by banks, the European leasing market, the largest leasing market globally, was and is being reshaped by divestitures, including the sale of GE Capital. The origination market, a market that banks have cut €594 billion in lending from since 2008,ⁱⁱ is undergoing significant change while European banks actively pursue accretive partnerships with erstwhile competitors.

In the following pages we outline the evolving regulatory framework and explore how it informs a robust opportunity set, while addressing why Silver Creek believes, in the words of Goldilocks, that the timing is “just right.”

European Bank Profitability & the Evolving Regulatory Environment

The importance of the European banking system cannot be overstated. Controlling approximately 86% of financing versus less than 30% in the U.S., European banks have been the dominant source of credit and overall financing for European companies and consumers (Exhibit 1).ⁱⁱⁱ This dominance, however, appears unsustainable in light of the evolving regulatory environment and mounting profitability concerns. Banks are being forced to restructure operations, rethink business models and pursue creative partnerships.

BANK PROFITABILITY

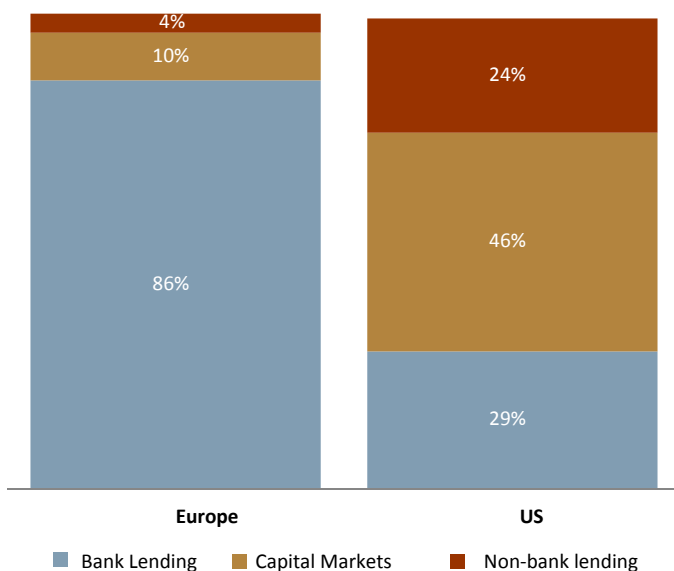
Since 2008 European banks have struggled with profitability. With a higher Cost of Equity ("COE") than Return on Equity ("ROE") since 2008, most banks have found it prohibitively expensive to raise equity (Exhibit 2). Ernst & Young estimates that European banks, on average, would need to reduce costs by 21% while simultaneously growing revenue by 15% in order to achieve their cost of equity.^{iv}

REGULATION

Profitability has been further stymied by an increasingly restrictive regulatory environment. The progression of Basel III (the set of rules established to increase capital requirements, reduce leverage and improve liquidity) is summarized in the below graphic (Exhibit 3).

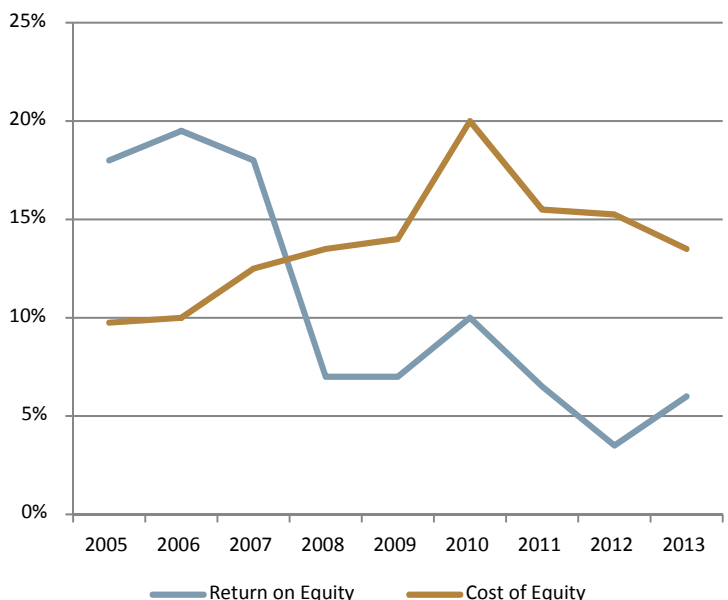
One recent development that has not received much coverage but will likely have a significant impact relates to bank subsidiaries. Under the new regulations which include self-funding requirements, less advantageous capital treatment and in some instances higher risk weightings, all subsidiaries must be self-funding. (Alternatively, banks could consolidate subsidiaries into the parent's balance sheet or apply for separate banking licenses for the subsidiaries).

EXHIBIT 1 – EUROPE/U.S. FINANCING SOURCES

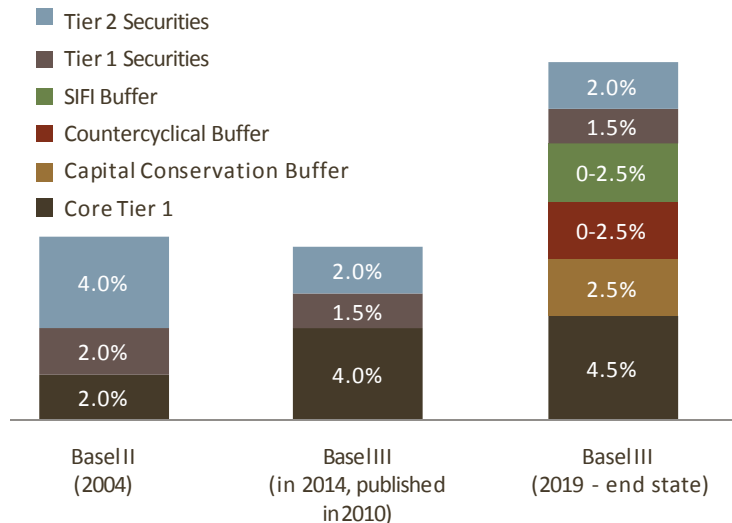


Source: Deutsche Bank

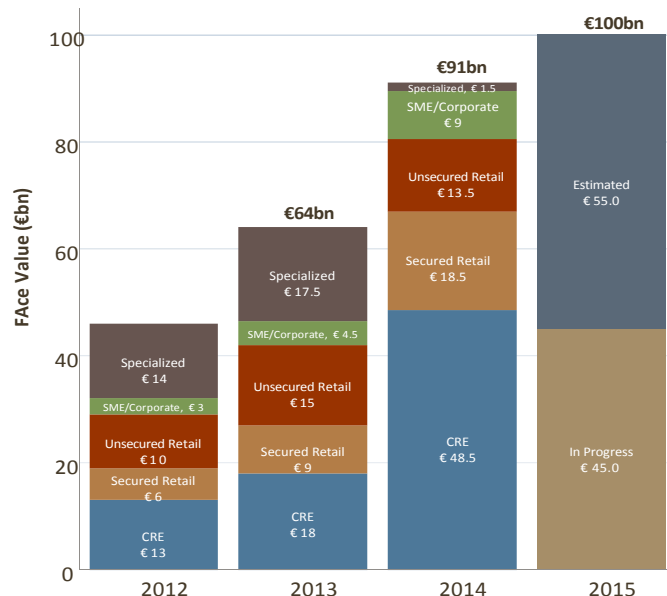
EXHIBIT 2 – EUROPEAN BANKS ROE VS COE



Source: Bloomberg

EXHIBIT 3 – BASEL II/III CAPITAL REQUIREMENTS


Source: Bank of International Settlements, Credit Suisse, PwC

EXHIBIT 4 – NPL PORTFOLIO TRANSACTIONS


Source: PwC

The European Central Bank (“ECB”)–led Asset Quality Review (“AQR”) was also the primary driver of the uptick in non-core asset sales. Released in October 2014, the AQR was a comprehensive year-long assessment of the financial health of the European banking system. Transparent in methodology and broad in reach, the ECB designated highly detailed criteria that banks were required to meet and also instituted uniform definitions across countries. In advance of the AQR release, banks meaningfully responded and strengthened their balance sheets by €203 billion from July 2013 to August 2014 through capital raises and asset sales.^v Market participants attribute the record sales of €91 billion of NPLs in 2014 to the AQR.^{vi}

Rather than representing the culmination, 2014 represents the beginning of meaningful de-leveraging. Banks will need to further sell non-performing assets as well as performing non-core assets to comply with new required capital and liquidity ratios, two of which are highlighted below (Exhibit 5).

THE OPPORTUNITY

Predicting when an opportunity will start is difficult. Recognizing that an opportunity is happening and is likely to continue is not nearly as hard. At the banks, long-awaited asset sales are occurring, and non-bank finance companies are emerging to create new opportunities. We briefly explore both broad categories below.

EMERGENCE OF NON-BANK FINANCE COMPANIES

Since 2008, banks have cut back lending by

EXHIBIT 5 – SAMPLE AQR CAPITAL AND LIQUIDITY RATIOS

Impact of Fully Loading Capital Requirements Directive ("CDR") IV		
Bank	CET1 Ratio - Starting 2013	Fully Loaded Ratio Baseline (2016)*
Allied Irish Banks	14.6%	1.7%
Banco Monte dei Paschi di Siena SpA	7.0%	5.3%
Permanent TSB plc	12.8%	6.3%
Liberbank	7.8%	7.0%
Banco Popolare	7.9%	5.6%
Raiffeisen Zentralbank Oesterreich AG	9.7%	5.6%
Banca Popolare di Minalo	6.9%	6.9%
Banca Popolare di Sondrio	7.4%	7.3%

Liquidity Ratios		
Bank	Country	AQR Adjusted Leverage Ratio (2013)**
Deutsche Bank AG	Germany	2.4%
Banco Popolare	Italy	2.4%
The Bank of New York Mellon SA	Belgium	2.6%
HSBC France	France	2.8%
Banco Monte dei Paschi di Siena SpA	Italy	2.9%

* Pass mark: 8% for baseline scenario

** Pass mark: 3-4% depending on country

Source: ECB and Deloitte

approximately €594 billion^{vii} with lending to small and medium enterprises falling 35% during that period.^{viii} The historically bank-dominated Spanish leasing market alone contracted from €20 billion in 2007 to €3 billion in 2012.^{ix} Non-bank finance companies are stepping in to fill that void, creating opportunities for investors to earn competitive ROE returns plus the possibility of attractive upside through company monetizations.

One particularly attractive sector in the “non bank finance company” category is leasing. The European leasing market is currently dominated by banks with 18 of the top 25 companies owned by banks or bank affiliates (Exhibit 6).^x

Leasing is considered “non-core” and, as such, banks are likely to sell or otherwise creatively partner with non-bank financing companies.

EXHIBIT 6 – RANKING OF TOP EUROPEAN LEASING COMPANIES

Rank	Company Name	Country	Total new business within Europe ('000s €)	Number of new contracts within Europe
1	Societe Generale Leasing Solutions	France	13,961,140	391,341
2	BNP Paribas Laesing Solutions	France	13,402,300	484,572
3	Volkswagen Leasing GmbH	Germany	12,205,747	516,808
4	De Lage Landen International B.V.	Netherlands	10,036,511	278,395
5	Deutsche Leasing	Germany	7,436,400	66,836
6	UniCredit Leasing	Italy	6,857,850	111,121
7	Nordea Finance	Sweden	5,109,309	362,326
8	Alphabet International	Germany	4,780,000	190,000
9	LeasePlan Corporation N.V.	Netherlands	4,775,378	241,827
10	Credit Agricole Leasing & Factoring	France	4,421,734	98,387
11	CM-CIC BAIL	France	3,577,095	108,318
12	DNB Finans	Norway	3,076,198	140,035
13	LBBW Leasing	Germany	2,934,355	38,100
14	RCI Banque	France	2,901,783	227,495
15	ING Lease	Netherlands	2,547,906	21,477
16	NATIXIS LEASE	France	2,787,900	27,964
17	Siemens Fiancial Services GmbH	Germany	2,285,137	
18	Raiffeisen Leasing	Austria	2,210,641	60,667
19	OJSC VEB Leasing	Russian Federation	2,087,821	27,591
20	OJSC VTB Leasing	Russian Federation	1,777,099	23,568
21	Porsche Bank AG	Austria	1,667,890	108,159
22	Mediocredito Italiano - Gruppo ISP	Italy	1,621,037	5,705
23	ABN AMRO Lease N.V.	Netherlands	1,477,985	9,982
24	Catepillar Financial Services	Switzerland	1,308,336	10,829
25	Santander Espana	Spain	1,066,590	25,897

Source: Leaseurope

Such transactions are beginning to occur. Silver Creek has sourced a number of these opportunities. A small sub-set include the following :

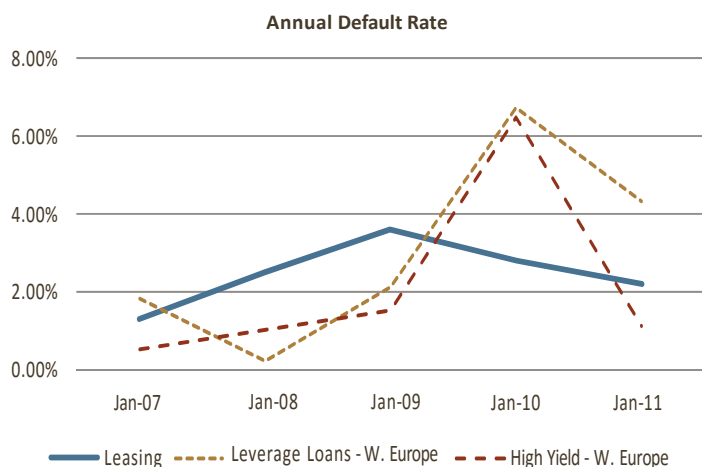
- Spanish bank seeking a partner to acquire a majority interest of a €2 billion auto finance platform;
- Spanish bank spin out of a €300 million per year auto leasing business;
- Italian bank seeking to sell €7 billion leasing business.

Leasing assets can offer attractive return prospects. Given the built-in security frequently afforded by retaining ownership of a physical asset, leases can offer strong down-side protection with lower average default rates than leveraged loans or high yield bonds and recovery rates above 80% (Exhibit 7).^{xi} Moreover, significant upside is available through attractive term financing as well as platform/company equity participation and/or securitization. Assuming the use of attractively priced leverage which is currently available through the European Investment Bank for “High Quality Securitizations”, return expectations could be as high as 18% to 22%.

Middle market direct lending offers another attractive opportunity. While European banks have historically been aggressive in defending their market share in this space, asset managers are taking a larger role. One industry participant estimates

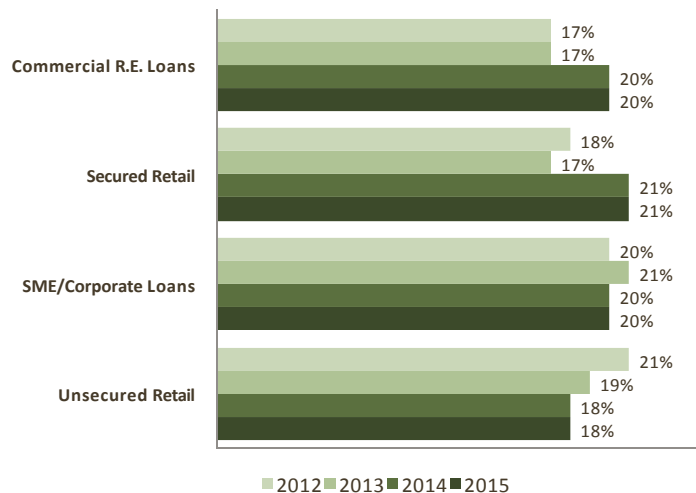
that asset managers will be responsible for €20 to €50 billion of lending in Europe by 2025.^{xii} Currently, Europe offers a premium to the U.S. in terms of spread, while also offering significant higher Original Issuer Discounts (4% upfront fees) as well as equity optionality through warrants.

EXHIBIT 7 – ANNUAL DEFAULT RATE COMPARISON



Source: Deloitte, Leaseurope and Credit Suisse

EXHIBIT 8 – AVERAGE IRR NON-PERFORMING LOAN EXPECTATIONS



Source: 2015 PwC Survey of European market participants

Asset Sales

The scale of the non-core asset opportunity remains massive. PwC estimates that €1.9 trillion in non-core assets remain (€1.05 trillion performing and €850 billion non-performing) and €1.15 trillion in non-performing assets (core plus non-core).^{xiii} Against that background, it is estimated that only €70 billion in equity capital has been raised to address this opportunity set.^{xiv} Given this supply/demand mismatch, it is not surprising that return expectations have not materially changed over the past few years as highlighted below (Exhibit 8).

On a go-forward basis, corporate NPLs are likely to represent a particularly compelling opportunity. As part of the harmonization process under the AQR, €136 billion in new NPLs were identified.^{xv} Corporate NPLs saw the largest uptick (€33.3 billion).^{xvi} Additionally, market participants indicate that banks have provisioned more appropriately for these assets, collapsing bid/ask spreads. Capital markets will set the clearing price for NPL transactions, and given this supply/demand imbalance it would be our expectation that returns will remain robust for several years.

SUMMARY

2014 represented a watershed year for Europe. Following years of tepid asset sales, banks meaningfully sold non-core assets in advance of the highly anticipated AQR. The AQR continues to reverberate and other meaningful regulatory reforms are being implemented, contributing to robust asset sales.

The European opportunity has evolved beyond asset sales with the emergence of a nascent non-bank finance industry. New opportunities, such as those in leasing, are being created. While offering stable cash flows, some of these operationally intensive investments can offer significant upside potential.

While Europe has dominated headlines for years, seemingly few investors have meaningfully profited. The timing now may be “just right.”

About Silver Creek

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With a 20 year history and owned entirely by its employees and founders, Silver Creek manages assets of over \$5 billion with offices in Seattle and New York.^{xvii} Its global investor base incorporates qualified individuals, pension funds, endowments, foundations, insurance companies, and other institutional entities. Silver Creek is registered with the United States Securities and Exchange Commission as an investment adviser.

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ⁱ Source: PwC, Market Update Q4 2014, January 2015

ⁱⁱ Source: Wall Street Journal, “Europe Needs to Stress Lending Instead of Tests,” October 2014

ⁱⁱⁱ Source: Deutsche Bank Research, February 2014 (ECB and FDIC)

^{iv} Source: EY, European Banking Barometer - 2015

^v Source: Comprehensive Assessment: Final Results Press Conference, ECB, October 2014

^{vi} Source: PwC, Market Update Q4 2014, January 2015

^{vii} Source: Wall Street Journal, “Europe Needs to Stress Lending Instead of Tests,” October 2014

^{viii} Source: The Economist, “Don’t Bank on the Banks,” August 2014.

^{ix} Source: Incus

^x Source: Leaseurope, Key Facts and Figures 2013.

^{xi} Source: Deloitte and Leaseurope. September 2014. Implicit Risk Weights for SME Leasing in Europe.

^{xii} Source: Reuters. “In new trend, European fund firms become banks in all but name.” May 2015

^{xiii} Source: PWC, European bank restructuring and debt portfolio conference, March 2015

^{xiv} Source: PWC, 2015 Survey of European market participants

^{xv} Source: PWC, European bank restructuring and debt portfolio conference, March 2015

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