SILVER CREEK
CAPITAL MANAGEMENT

MARKET UPDATE

NPL OPPORTUNITY

NOVEMBER 2018

SUMMARY

Over ten years following the Global Financial Crisis ("GFC"), Silver Creek believes that European Non-Performing Loans ("NPLs") continue to be one of the most attractive risk/reward opportunities in the global credit markets. While the volume of NPL sales has increased tremendously over the past decade, the total market size remains substantial with an excess of €800 billion in NPL balances estimated to still be held on European banks' balance sheets.[1] In addition to NPLs, European banks continue to hold significant balances of other assets that are either sub performing or have been deemed no longer core to the banks' ongoing strategies. An estimated €2 trillion of assets, which include NPLs, sub-performing loans and other assets which have been deemed non-core, need to be cleaned up by European banks.[2] Sales volumes are expected to continue to accelerate as banks undergo significant deleveraging measures to comply with the continued stringent regulatory regime. Furthermore, improved bank profitability is expected to facilitate a faster potential pace of NPL dispositions. Successful investors must possess both the infrastructure to properly analyze the collateral pools, effectively model recoveries on these assets, and have the scale to execute on a wide range of portfolio offerings. We expect solid low-to-mid double-digit IRRs with the quality of the acquired loan/asset pools reflecting the risk being assumed.

ADDRESSING THE "NPL PROBLEM" FOR EUROPEAN BANKS

Despite Europe's improved economic state, the proliferation of NPL balances on European banks' balance sheets continues to negatively impact the financial stability, profitability, and growth of these banks. These NPL exposures have resulted in the following:

- constrained lending opportunities that have forced banks to increase capital reserve balances in order to satisfy increased regulatory requirements;
- banks that are forced to devote tremendous amounts of time and resources to address difficult workout situations, diverting resources from the banks' core activities; and
- increased operating costs and decreased profitability.

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MARKET OPPORTUNITY

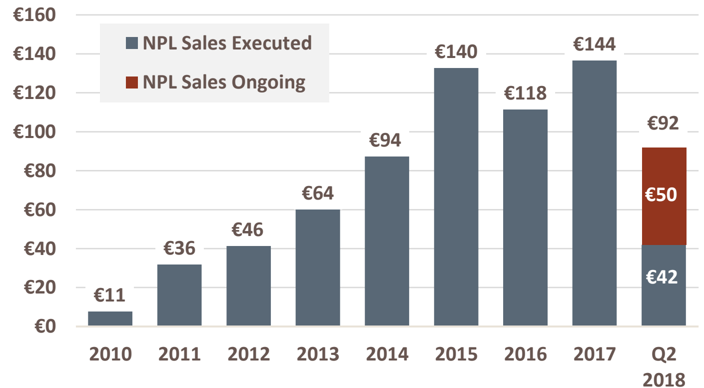
Over €800 billion in NPL balances continue to exist on European bank balance sheets. The balance of NPLs remains high despite increased NPL sales over the past several years. We expect the pace of these sales to continue.

GEOGRAPHIC SUMMARY OF EUROPEAN NPL BALANCES

COUNTRY	2017 NPL BALANCE (€MM)	NPL RATIO
GREECE	101	44.9%
PORTUGAL	31	15.2%
ITALY	187	11.1%
SPAIN	106	7.8%
FRANCE	136	3.1%
GERMANY	50	1.9%
OTHER EU	203	-
TOTAL	813	4.9%

Source: European Banking Association Dashboard as of Q4 2017. 2017 Spanish NPL ratio from CEIC data. Total NPL ratio from ECB Banking Supervision – Supervisory Banking Statistics.

YEARLY EUROPEAN NPL SALES VOLUME



Source: PwC, Deloitte

Early opportunities were predominately in Northwestern European markets with the U.K., Ireland and Germany as key markets. While banks in countries such as the U.K. and Ireland that have already divested a tremendous amount of NPL assets and continue to carry a significant amount of NPL balances (nearly €100 billion[3]) that need to be worked out, this opportunity set has gradually spread throughout Europe over the past several years. As the pressure from regulators continues to mount, the efficiency of the banking systems has improved. As improvements in the legal/bankruptcy frameworks in some Southern European countries have been implemented, the divesture of NPL assets from major banks in Southern Europe should continue to accelerate. Some examples include:

- Italy (€187 billion NPL balance; 11% NPL ratio[4]) – NPL sale velocity in recent years has spiked, resulting from both the increased relevance of major NPL servicing platforms, as well as improved foreclosure enforcement within what is considered a very debtor-friendly legal system. While barriers to entry within the market remain high, the Italian market saw significant NPL mega deals take place throughout 2017 and into Q1 2018.

- Spain (€106 billion; 8% NPL ratio[5]) – Spain has seen significant banking consolidation post-GFC, with the remaining banks actively working out their remaining distressed exposure. This, combined with the establishment of a government owned entity (Sociedad de Gestión de Activos procedentes de la Reestructuración Bancaria, or "SAREB"), that is responsible for the workout of the bad assets transferred from Spain's four nationalized banks has driven the increased supply of NPL sales. Continued deleveraging measures are expected to keep the supply of NPL sales steady.

- Greece (€101 billion; 45% NPL ratio[6]) – Greece's NPL landscape is perhaps the least mature compared to other major Southern European countries. This is particularly problematic for Greek banks given the significant NPL ratio. Nonetheless, NPL volumes in Greece are expected to surge as economic forecasts signal a pattern of GDP growth, with the new political regime reaffirming their commitment to the EU and adherence to the EU's regulatory framework over NPLs.

The three countries highlighted above are among those that have suffered the most from the European sovereign debt crisis over the past few years and for whom the resolution of their NPL balance issue is particularly critical. The NPL opportunity set within these countries remains robust and is expected to escalate over the next few years.

BANK PROFITABILITY

One question investors ask is why the balance of NPLs across Europe remains this high so long after the crisis. The answer is closely related to bank profitability. Banks and their regulators are not likely to push for the recognition of NPLs if it forces the bank to fail its capital tests or forces them into insolvency. This reluctance to make bad situations worse often exacerbated the bid/ask spread

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between where banks held the loans on their balance sheet and where market participants were willing to buy such loans, thus slowing the cleanup of NPLs.

Often times the solution, one evidenced in Europe immediately post-GFC, is to lower rates and allow banks to play the carry trade that would allow them to build up reserves to a point where gradual write-downs would not drive the banks into insolvency. Often this dance takes many years to play out between the banks that own the assets, the regulators, and the buyers of NPLs, as we saw in the U.S. during the savings and loan crisis and we are now seeing in Europe. Now that banks have been able to build up reserves and the bid/ask spreads of NPL portfolios have tightened, we expect NPL sales to accelerate so that banks can finally focus on more profit enhancing initiatives.

Ultimately, banks need to reach a certain level of profitability before they can transact. Bank profitability and NPL sales go hand in hand but the reasons may be a bit counterintuitive. The bid/ask spread for NPLs can be so dramatic that the bank often has to improve its profitability before it can absorb the marks from its NPL book before it can sell. Therefore, as we see improving profitability we also see increasing NPL transactions. As banks sell their NPLs and recycle that capital into performing assets we see profitability continue to improve creating a virtuous circle. Improved profitability allows the banks to sell NPLs and NPL sales drive profitability. This in turn drives increased NPL transactions later in the cycle rather than immediately after a crisis.

- One recent example of the positive impact that aggressive deleveraging measures have had on balance sheets has taken shape in Ireland. Much of the success in Irish NPL dispositions resulted from the establishment of a state supported agency (National Asset Management Agency, or "NAMA"), which was tasked with purchasing and the sale/workout of distressed NPL assets from banks. Since the end of 2017, as NPL ratios within the country have decreased from 10.5% to 7% through Q2 2018, banks have experienced an average ROE increase from 7.1% to 8.4% during this time period.[7]

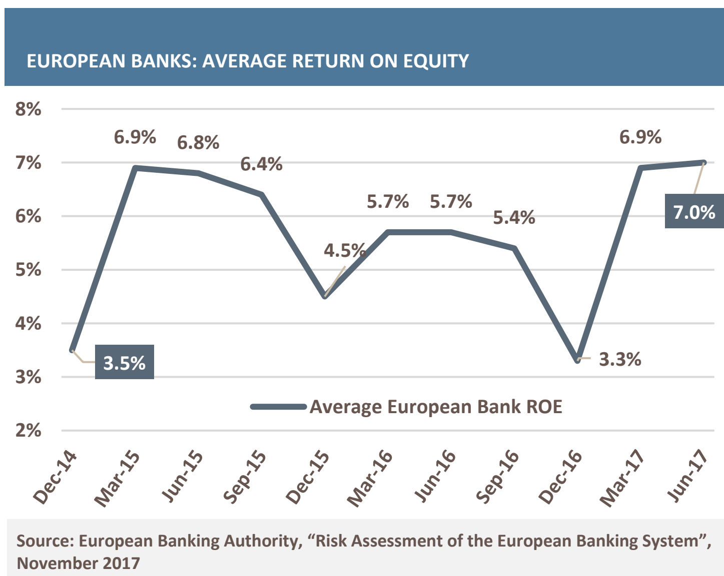
- The European Central Bank ("ECB") expects that replacing NPLs with performing assets could possibly drive 2.5% - 5% increases in the ROE of Southern European banks over a three-year time horizon.[8] As the chart below shows, ROE percentages within Portuguese banks are expected to grow up to 5% in Portugal, 3.5% in Spain, and 2.5% in Italy.[9]

Other statistics reflecting improved earnings against the backdrop of NPL deleveraging include:

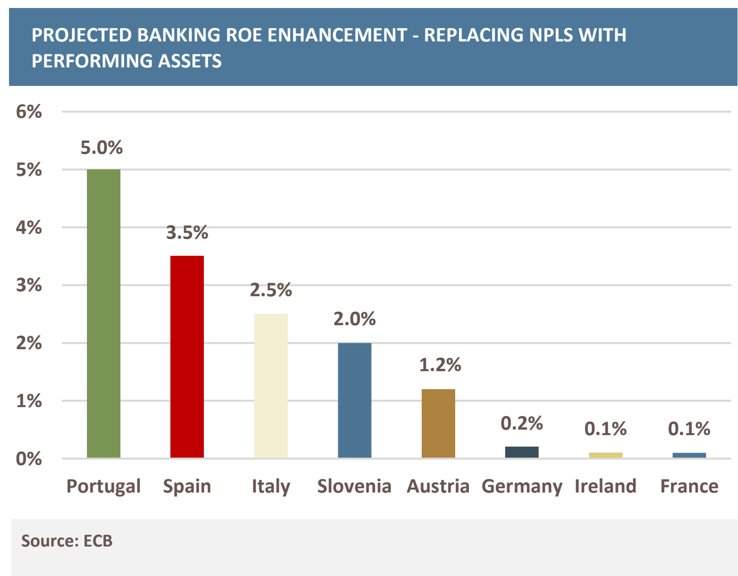
- European bad loan concentration ratios dropping from 4.2% as of Q4 2016 to 3.7% as of Q2 2018;[10]

- The average ROE of European banks improved from 3.5% as of 2014 year end to 7% as of H1 2017;[11] and

- Common Equity Tier 1 ("CET1") ratios increasing from 11.5% as of 2014 year end to 14% as of H1 2017.[12]



Source: European Banking Authority, "Risk Assessment of the European Banking System", November 2017



Source: ECB

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These examples illustrate the powerful impact of the inverse correlation between NPL ratios and banking profitability and how banks are expected to continue the disposition of NPL balances from their balance sheets in order to drive significant profitability in the years ahead.

REGULATORY ENVIRONMENT

The European Commission ("EC") and the ECB have also ratcheted up their regulatory demands for banks to clean up their balance sheets, further expediting NPL asset sales. Banks must understand current regulations while anticipating new regulatory measures. They are further incentivized to address the problem of NPL balances remaining on their books.

- In March 2018, the EC outlined an approach for banks to address their NPL problem. These measures included increased provisioning levels for new loan originations, the development of a secondary market for NPLs with greater enforcement of out-of-court collateral settlements, and a blueprint for EU members to set up Asset Management Corporations ("AMCs") to purchase distressed assets from banks.
- Also in March 2018, the ECB finalized their NPL provisioning guidelines, requiring all new NPLs as of January 1, 2018 to be 100% provisioned at a minimum within two years (unsecured portion) and seven years (secured portion) with no value assigned to collateral after seven years.
- The impact of International Financial Reporting Standard 9, an International Accounting Standards Board guideline that went into effect in January 2018, mandates that banks also recognize expected credit losses rather than just defaults based on available information, and must update impairment losses as necessary. This will require banks to further increase provisioning against the NPL assets on their books and may further incentivize them to dispose of or deal with troubled sub-performing assets.

OTHER NON-CORE ASSETS

In addition to the NPL problem, banks are faced with the task of trying to sell various other non-core assets whose volumes continue to weigh on the asset quality of bank balance sheets. With volumes of non-core assets around €2 trillion (inclusive of NPL balances), this has created another massive buying opportunity for European distressed investors. These non-core assets are performing in most cases but are no longer central to the core strategies of banks. In many cases, entire lines of business owned by banks are in need of disposal as they no longer fit within the strategic priorities of the bank. As such, banks are looking to actively divest these assets in order to focus on more profitable opportunities. Again, with increased banking profitability comes a greater ability to dispose of these non-core assets at a quicker pace. The pressures on European banks to improve profitability within a market heavily impacted by changes in technology, politics, regulation, and banking consolidation are tremendous, particularly in this low interest rate environment.

One example of an interesting non-core asset are unlikely to pay ("UTP") loans. These are loans to borrowers who are currently in a state of temporary financial difficulty that are expected to become re-performing at a later time. It is estimated that €94 billion of UTPs exist on the balance sheets of Italian banks.[13] Regulators have outlined a series of tests and triggers that would cause banks to classify these assets as NPLs rather than UTPs. Given the high level of active management these assets require, as well as the high NPL conversion rates that UTPs historically have, banks are further motivated to work through these assets in a timely manner.

NEW MARKETS

While not yet a particular focus, attractive opportunities in the coming years may arise in nascent NPL markets such as China, Brazil, and India.

- China ($1 - $2 trillion potential NPL volume[14]) - China has seen a tremendous increase in credit and leverage ratios since the GFC, with debt levels increasing from $5 trillion in 2008 to $29 trillion at the end of 2016.[15] Combined with the slowdown in GDP growth, the potential $2 trillion in NPL volume is expected to overwhelm the expected capacity for NPL buyers. Furthermore, the presence of AMCs and other state-owned distressed asset buyers are already making a significant impact in China.
- Brazil ($160 - $200 billion[16]) - The economic recession that Brazil experienced between 2015-2016 led to a softening of the commercial real estate market. This was the catalyst behind a 700% increase in NPL levels between 2010 and 2016.[17] These

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volumes, combined with stringent asset provisioning requirements, regulatory pressure, and strong creditor rights could make the Brazilian NPL opportunity attractive in the near term.

- India ($125 billion[18]) – India's NPL market is unique in that the opportunity has been driven by corporate insolvencies rather than real estate. Recent regulatory changes allowing foreign investments into state sponsored Asset Reconstruction Companies that purchase corporate NPLs, combined with the Insolvency and Bankruptcy Code introduced in late 2016, is expected to drive significant NPL volume in the coming years.

CONCLUSION

Silver Creek's conviction in the NPL opportunity remains as strong as ever. Driven primarily by regulatory scrutiny and the need for banks to take aggressive deleveraging measures in order to enhance profitability, we expect the sale of NPL stockpiles in many geographic regions to accelerate over the coming years. The regulatory, market, and structural impediments that have prevented large scale NPL dispositions in several geographic regions post-GFC have begun to dissipate, further facilitating healthier markets for both buyers and sellers to participate in. We are positioning ourselves to take advantage of opportunities in new markets if they materialize, but are primarily focused on the European opportunity set at hand. This is where we already have the infrastructure in place to take advantage of a significant NPL supply; an opportunity set we view as seemingly unparalleled from a risk/return perspective in the credit market today.

[1]European Banking Authority Risk Dashboard as of Q4 2017
[2]PwC, "Restructuring Europe's Banks", 2017
[3]European Banking Authority Risk Dashboard as of Q4 2017
[4]Ibid
[5]Ibid
[6]Ibid
[7]European Banking Authority Risk Dashboard as of Q2 2018.
[8]ECB, "Resolving Europe's NPL Burden: Challenges and Benefits", February 2017
[9]Ibid
[10]CEIC Data
[11]European Banking Authority Risk Dashboard reports as of Q4 2017, Q3 2016, and Q4 2015
[12]European Banking Authority, "Risk Assessment of the European Banking System", November 2017
[13]PwC, "The Italian Unlikely To Pay Market", May 2018
[14]Fitch, "China's Rebalancing Yet to Address Credit Risks", September 22nd, 2016
[15]Manager commentary
[16]Manager commentary
[17]Manager commentary
[18]Manager commentary

IMPORTANT DISCLOSURES

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