Investing in Southern Europe

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Introduction

I. Economic and Political Environment
II. Direct Lending in Southern Europe
III. Specific Issues in Italy – Non Bank Lending
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Economic and Political Environment
Economic Environment – Spain

- Spain’s economy picked up pace in the first quarter of 2015 and recorded the largest expansion in eight years with GDP accelerating towards 3.1% YoY.

- Renewed consumer confidence and robust export growth have turned the country into one of the fastest growing economies in the Eurozone.

Chart 1
Charging ahead
Spain’s economic activity has rebounded, with growth expected to reach 3.1 percent this year, one of the highest rates in the euro area.
(real GDP, index, 2007=100)

Sources: IMF, World Economic Outlook; and IMF staff calculations.
Spain has done its homework to streamline its economy and foster economic recovery and growth

On the public policy side, Spain has made important progress in improving its insolvency framework, in internationalization and in reducing red tape. In addition, various measures were implemented to give more flexibility and dynamism to the labour market, facilitating access to finance and promoting entrepreneurship culture.

Source: The Kingdom of Spain's Economic Policy & Funding – June 2015
Economic Environment – Spain

- Unemployment fell to the lowest level since Q3 2011 in the second quarter, which bodes well for private consumption going forward.
- Since Q2 2010 the private sector has reduced its indebtedness levels by more than €426bn with corporates accounting for €267.3bn of the reduction.

Chart 2: Gradual drop
Jobs are being created, but Spain's unemployment rate at around 22.4 percent is still the second-highest in Europe.

Sources: Instituto Nacional de Estadística; and IMF staff calculations.
Financial Sector

• Spain requested financial assistance from the European Financial Stability Facility in 2012, upon an 18 month recapitalisation and restructuring program. The recapitalisation has resulted in risk premia on external borrowing by Spain’s banks and sovereign down 75% and equity prices up more than 50% during the program period.

• Financial sector reform, fiscal consolidation, and structural reforms, especially in the labour market, have supported the return of confidence, which, in turn, has boosted the rebound in consumption and investment.

• Spain’s banking system has strengthened significantly. Banks’ capital and earnings have increased, asset quality and specific provisioning have improved, and funding and liquidity conditions have become more favorable.

• Operating conditions remain challenging, reflecting profitability pressures and additional loss-absorbing capacity requirements for some banks.
The Spanish private sector went through an extreme adjustment and internal devaluation, rapidly compensating the excesses during boom years

The Spanish private sector adjusted quickly, getting rid of unproductive activities, considerably reducing the weight of the construction sector. Companies also managed to reduce payrolls significantly (wages and staff)

- After years of real estate and internal consumption boom, the Spanish economy went through a radical halt. All sectors faced a decline in value added and employment, especially in the construction sector.

- Increased unemployment and worse economic environment reduced internal consumption, worsening the situation of corporates that depended on the domestic economy.

- Corporates went through a very intense and painful restructuring, leading to massive layoffs and significant wage reductions in most companies.

- The hard adjustment of the 2008-2013 period transformed the Spanish private sector from a relatively uncompetitive economy, too dependent on a booming internal consumption market, to an internationally very competitive economy with a large availability of cheap productive labour.

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Unitary Labor Cost (Base 2008)

Employment in SMEs (Base 100)

Source: European Commission 2014 SBA Fact Sheet
Economic Environment – Portugal

- Portugal is still widely considered to be the biggest credit risk in Europe after Greece, with a registered public debt of over 130% of GDP in 2014.
- Following the financial crisis, Portugal received a bail out of €78 billion in 2011.
- Portugal's unemployment rate dropped to 13.5% in Q1 2015 from a peak of 17.3% in Q1 2013 (Eurostat). This figure does not account for 200,000 people who have left Portugal permanently.
- The Portuguese economy grew a seasonally-adjusted 0.4% over the previous period in Q1 2015.
- Fourth consecutive quarter of growth confirmed the gradual strengthening of the economy observed in 2014.
Financial Sector

Liquidity improved...

Portugal: Banking System Funding, January 2013–January 2015

- Central Bank Funding (billions of euros)
- Loan-to-deposit ratio (percent; RHS)

...but banks continue to operate at a loss.

Portugal: Net Profit and Loss, 2011–14

(Billions of euros)

- Net interest income
- Income from financial operations
- Services and commissions (net)
- Other
- Operational costs
- Provisions and impairments
- Net profit and loss

1 Aggregated data. Loan-to-deposit ratio vis-à-vis non-monetary resident sector.

1 Consolidated data for large banks, excluding ESBG/BES/Novo Banco.
Economic Environment - Italy

- After a long recession, the Italian economy has started its gradual recovery.
- Output projected to grow by 0.6% in 2015 and by 1.5% in 2016.
- Exports expected to continue to support growth, but the recovery will broaden to private consumption.
- Sluggish private investment will be countered by rising public infrastructure spending. Economic growth will result in employment gains and lead to a decrease in the unemployment rate, which will still remain high.

Unemployment levels:
- April 2015: 12.4%
- May 2015: 12.4%
- June 2015: 12.7%
- July 2015: 12%
Direct Lending in Southern Europe
Southern Europe is the most interesting market for direct lending

- This asset class has already consolidated in the US and UK/northern Europe even though direct lending is less needed (and more competitive) in these markets given the numerous available alternatives.

- Southern Europe has a much larger dependency on bank financing. The bank deleveraging process is increasingly leaving a space that will be covered by direct lending and capital markets.

- Banking consolidation has been undertaken in Spain and is expected to take place in Italy. Basel II requirements and expected banking deleveraging is leaving a huge demand for replacement capital.

- Spanish banks’ exposure to corporate credit came down from 31.5% in 2008 to 24% in 2014, but it still has to come down to more suitable levels of 15-20% (compared to European banks’ ~10%). Since recent reduction comes from real estate loans deleveraging (provisions and executions), most future reduction should come from loans to other corporates, leaving a space of at least EUR 50 to EUR 100 billion.

- In Italy, significant opportunities in SME space, a new generation is moving into the financing business.

Bank dependency in SMEs’ overall financing is too large in Southern Europe

Source: European Investment Fund report: “Institutional non-bank lending and the role of Debt Funds”
• Consolidation of the banking system due to the disappearance of Savings Banks and combination of banking institutions
  – Overall entities reduced from 45 to 13. Consolidation expected to continue down to 7-10 entities.

• Spanish corporates deleveraged considerably, from EUR 1 trillion in 2008 to EUR 674 billion. Nevertheless most of this deleveraging corresponds to real estate, though a combination of asset execution, sale of NPL portfolios and asset sales.

• Large pool of loan provisions accounting for 25% of Spanish GDP.

<table>
<thead>
<tr>
<th>Breakup of Spanish Banks’ Assets</th>
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<tbody>
<tr>
<td>(in € billions)</td>
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<tr>
<td>CAGR 2009-2014</td>
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<tr>
<td>----------------------------------</td>
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<tr>
<td>Total Assets</td>
</tr>
<tr>
<td>1. Fixed income portfolios</td>
</tr>
<tr>
<td>(out of which sovereign debt)</td>
</tr>
<tr>
<td>2. Equity portfolio</td>
</tr>
<tr>
<td>3. Interbank credit</td>
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<tr>
<td>4. Other assets</td>
</tr>
<tr>
<td>5. Loans</td>
</tr>
<tr>
<td>5.1. Loans to Public sector</td>
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<tr>
<td>5.2. Loans to non residents</td>
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<tr>
<td>5.3. Loans to Spanish private sector</td>
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<tr>
<td>5.3.1. Households</td>
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<tr>
<td>5.3.1.1. Residential mortgages</td>
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<tr>
<td>5.3.1.2. Other household loans</td>
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<tr>
<td>5.3.2. Corporate credit</td>
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<tr>
<td>5.3.2.1. Real estate loans</td>
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<tr>
<td>5.3.2.2. Other corporate credit</td>
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<tr>
<td>Corporate credit as % of total</td>
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<tr>
<td>of which real estate credit</td>
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<tr>
<td>of which other corporate credit</td>
</tr>
</tbody>
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SMEs are now very competitive but need to restructure and gain scale

SMEs reached a situation where they are operationally very competitive but still lack the scale to be profitable and in some cases need to delever. These SMEs currently depend 100% on bank financing and find no alternative to help them reach a new level.

- There are 2.2 million SMEs in Spain accounting for 65% of GDP, 80% of employment (vs 60% in EU) and an even higher proportion of employment creation. Most SMEs are owned by individuals as opposed to larger corporations (53%).

- Despite the rapid adjustments in operational costs that has led Spanish SMEs to be very competitive, they:
  - Still lack the scale to be profitable, limiting their capacity to export and to lever fixed cost structures. SMEs in Spain have average ROEs of 3-4%. ROAs are closer to that of large companies, however much larger funding costs lead to much lower ROEs.
  - Inherit many cases over levered capital structures. That leads to unfilled orders as lack of restructuring options offered by banks lead to lack of new funding.

- The SME sector has been the most affected by the lack of bank financing in the Spanish economy since the sector was 100% reliant on banks for funding. Banks are not helping restructure the SME debts or offer the additional financing and advice needed to gain scale.
Non-Bank Lending in Italy – Specific Issues
Non-Bank Lending in Italy

• ‘Direct lending’ by alternative credit providers ("ACPs") is currently NOT permissible under Italian law.

• Lending has historically been reserved for banks and financial intermediaries.

• ACPs have historically only been able to lend to Italian corporates through sub-participation or securitisation structures.
Minibonds

• In June 2014 the Italian government enacted a decree to liberalise lending.

• Although the decree generated considerable positive publicity, it has not provided an effective route for ACPs to direct lend into Italy.

• To stimulate non-bank investment into Italian corporates, the Italian government enacted legislation in 2012 for unlisted companies to issue "minibonds".

• What are Italian "minibonds"? Not a technical term. Term is used to refer to debt securities ("bonds") issued pursuant to a package of reforms introduced by Law Decree no. 83 of 22 June 2012 (the so-called Decreto Sviluppo or Development Decree) as amended by Law Decree 179 of 18 October 2013 (the Development Decree bis).
Minibonds – Fiscal regime

• Applicable to commercial paper, bonds and similar securities (but not atypical securities (atipici)).

• Withholding Tax: issuers are no longer required to apply 26% withholding tax on interest if (1) the securities are traded on a regulated market or multilateral trading facility such as ExtraMOT PRO (extends regime previously applicable only to banks and listed companies) OR (2) held by professional investors which are not shareholders and resident in a white-list country.

• Deductibility of Interest: relaxation of limitations on deductibility of interest for corporation tax purposes for unlisted companies as long as securities are traded on a regulated market or multilateral trading facility such as ExtraMOT PRO.

• Deductibility of costs of issuance: fees, costs and expenses of issuing traded minibonds are deductible by the issuing company.
Minibonds – Tax regime applicable to listed minibonds

<table>
<thead>
<tr>
<th>Tax Regime (direct and indirect taxation)</th>
<th>Listed Minibonds (commercial paper, bonds and similar securities)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deductibility of interest for corporation tax purposes due by the borrower/issuer</td>
<td>Yes: subject to certain limits including 30% EBITDA</td>
</tr>
<tr>
<td>Withholding tax on interest</td>
<td>No</td>
</tr>
<tr>
<td>Stamp duty</td>
<td>No: if issued in dematerialised form</td>
</tr>
<tr>
<td>Registration tax</td>
<td>No</td>
</tr>
<tr>
<td>Substitute tax$^1$</td>
<td>0.25%</td>
</tr>
</tbody>
</table>

$^1$Substitute tax is optional and applicable to guaranteed minibonds. Security takers may opt to pay substitute tax on the entire Secured Obligations rather than paying higher tax rates on individual aspects of the security package, such as mortgages.
Costs

- Costs associated with a listing are not significant above a certain minimum issuance threshold (above €1m Euro).
- Listing can be achieved without a third party investment bank.
- We would expect the issuer would need to appoint a calculation agent and an agent to settle the bonds in the clearing system. Costs are again likely to be immaterial.
- Taxes for taking security (see prior note on substitute tax).
- There are likely to be other minor fees such as notarisation costs for security documents (which are the same as for any secured lending transaction in Italy).
Non-Performing Loans
Non-Performing Loans Across Europe

- AQR revealed an additional €135.9 bn of NPL's taking the total exposure of the 130 banks examined to €879.1 bn.
- Much of Europe's NPL's are held by asset management agencies (i.e. bad banks).
- Italy's banks have a significant NPL exposure estimated in the region of €300m.
- Whilst Spain's banks have tried to deal with their NPL portfolios Spain's bad bank, Sociedad de Gestion de Activas Procedentes de la Reestructuracion Bancaria holds €101bn non-core real estate exposure.

Source: IMF staff calculations.
Non-Performing Loans Across Europe

Clear Out
Sales of loan portfolios by country, euros billions

Source: PwC | WSJ.com
Trend of Impaired Loans, NPL and net NPL ratio in Italy

Source: PwC analysis, Bank of Italy Bollettino Statistico (Bollettino I Trimestre 2015, data refer to December 2014) and ABI monthly outlook (March 2015, data refer to December 2014)
Evolution of Insolvency Laws
Market participants have been requesting changes to facilitate debt restructuring for over 5 years. In 2014 there have been 2 relevant amendments with the same objective: avoiding liquidation (not necessarily always consistent with "creditor friendly" approach).

- **RD 4/2014**: new rules for pre-insolvency situations
  - capacity to force dissenting financial creditors
  - leverage on equity-holders
  - enhancing debt for equity swaps
- **RDL 11/2014**: new rules for insolvency situations
  - post-insolvency trading
  - capacity to force dissenting secured creditors
  - concept of classes
What is a "Refinancing Agreement" ("RA") for the purposes of the Spanish Insolvency Act?

- Content of the RA: (i) substantially increase the funds available to the debtor; and/or (ii) amend the terms of the debt that is to be re-negotiated by means of the RA

- Part of a short and mid term viability plan of the debtor

- Majorities → at least 3/5 of the liabilities of the debtor

- Public Deed; and

- Certificate from the debtor’s Auditor stating that the majority needed for the RA’s approval has been met
What are the advantages of a RA vs. other refinancing agreements?

- **Clawback** protection (also achievable by other means – non rescindable acts)

- Capacity to **homologate**

- **Super-seniority** of new money during 2 years.
What is a homologation?: process before a Judge which obtains clawback protection and allows to force dissenting creditors with certain levels of support

When can you homologate a RA?:
(i) subscribed by at least 51% of creditors holding financial debt (excluding commercial and public debt),
(ii) meeting the requirements of a RA described above (except for the 3/5 total liabilities majority)

Classes?
secured/unsecured = valuation of security is (9/10 of the fair value of the underlying asset) – (priority ranking outstanding debt over the same asset)

Fair value: (i) securities: average weighed price negotiated for the securities in one or more regulated markets during the quarter previous to the start of the negotiations of a RA; (ii) real state assets: determined in a report by a homologated valuation entity registered in the Bank of Spain; (iii) other assets: determined by an independent expert
Who and how can you bind through homologation?

— **Unsecured dissident creditors** and secured dissident creditors for the portion of their credits exceeding the security value:

A. If RA approved by at least 60% of financial liabilities of the debtor: (i) stays (5 years max); or (ii) conversion of debt into participative loans (5 years max)

B. RA approved by at least 75% of financial liabilities of the debtor: significant options, including haircuts and debt for equity swaps

— **Secured dissident creditors** for the portion of their credits not exceeding the security value: the effects established above, if approved by the following majorities (calculated on the basis of the proportion of the value of the accepting security over the value of the total assets securing debt):

* 65%: effects in section A above
* 80%: effects in section B above

However, **value of security upon enforcement is preserved** — and in liquidation?
Relevant limitation to homologation: guarantors

Homologating against a debtor does not homologate against a guarantor and joint debtors: dissenting creditors keep claims against guarantors and security granted by third parties

Significant issue when facing group-financings – how to deal with it?

The case of syndicated agreements

– In case of syndicated facilities **75% (or lower if agreed)** can bind the dissenting 25% and thus vote for 100%. Concept is that the other 25% will be "deemed to have agreed"

– Question as to the extent of the drag-along: guarantees/security of subsidiaries?

– New RD 11/2014, although applicable for insolvency process, seems to clarify
How are debt for equity swaps facilitated through RD 4/2014?

- Within the framework of a RA the capital increase can be approved by the general shareholders’ meeting of the debtor by **simple majority**
- Dissident creditors can **choose between debt-equity swap vs haircut** in an amount equivalent to the nominal value of the shares it would have acquired
- Creditors converting debt into equity under the provisions of a RA or any other non-rescindable act shall **not be considered as “specially related” party** to the debtor
- Rebuttable presumption of **guilty insolvency** (board and shareholders) when (i) the debt-equity swap is unreasonably denied (based on independent expert report) frustrating reaching a RA, and (ii) if RA envisages a preferential right of the debtor’s shareholders to acquire the shares/securities when subsequently sold

The issue of international recognition?
Evolution of Insolvency Laws – Spain

How do insolvency restructurings work post RD11/2014?

Can claims be purchased after insolvency? – no longer need to be entity under financial supervision to keep the voting right (but watch out for the timing)

How is a composition of creditors approved?

— At least 50% of the ordinary creditors for haircuts equal to or lower than 50% and stays no longer than 5 years

— 65% of the ordinary creditors for haircuts higher than 50% and stays longer than 5 years, but no longer than 10 years
How is a composition forced on secured/privileged creditors?

— Concept of **valuation**

— New concept of **classes** within the secured/privileged: employment/public/financial/others.

— **Majorities** required per class:
  
  60% for haircuts equal to or lower than 50% and stays no longer than 5 years

  75% for haircuts higher than 50% and stays longer than 5 years, but no longer than 10 years

— Particularities of **syndicated "arrangements"**: 75% to drag the other 25% - to what?

— Value is recognised for secured creditors if company liquidates
• During a 2 year period as from the entry into force of the RD-L 4/2014, credits representing income for the debtor obtained under a RA shall be deemed **100% against the estate.** Security may be preserved by safe harbour. Privilege over non-charged assets.

• After 2 years from the granting of the credits, said credits shall be deemed as 50% privileged and 50% against the estate.

• After insolvency, needs to be agreed with insolvency administration and would be a credit against the estate.

• **No DIP options** to create senior collateral without consent of existing secured creditors (but haircut is now available).

• Some key issues for proper structuring on primary lending deals:
  
  — Law applicable to finance documents
  — Proper security and where it seats in the structure
  — Mitigating risk of clawback of security
  — Avoiding the risk of insolvency in the enforcement process – maintaining the COMI
  — Fast enforcement process and enforceable events of default
  — Change of voting rights in share pledges upon breach
The Italian insolvency law has been reformed many times starting from 2005, the last of which on 27 June 2015.

The new rules have tackled 3 main problems: 1. the lack of competition in in-court restructuring proceedings (concordato preventivo); 2. the hold-out power of small financial creditors in consensual restructurings and 3. the long duration of bankruptcy proceedings.

1. In-court restructurings (concordato preventivo)

To solve the first problem the new rules now allow investors to access the proceedings in the following 2 ways: (i) by submitting a competitive bid for the business/single asset to be sold under the plan filed by the debtor and (ii) by filing an alternative plan, provided the investor holds at least 10% of the overall claims and the plan filed by the debtor does not ensure payment of at least 30% of unsecured claims (40% in the event of a liquidation plan).

The process is the following:

- the restructuring plan is filed by the debtor with the bankruptcy court

- differently from before when the restructuring plan could only be accepted or rejected, creditors holding 10% or more of overall indebtedness can submit an alternative plan, provided that the debtor’s plan offers less than a 30% recovery to unsecured creditors (40% in the event of liquidation plans)
- the alternative plan can incorporate any type of investment, including by way of capital increase.
- the court appointed receiver is required to provide information (under confidentiality) in its possession to enable creditors to make a decision on which plan to vote for.
- creditors vote on all plans and the plan with the highest majority prevails.

2. Consensual restructurings (182bis agreements)

To exclude the hold-out power of small financial creditors the new rules enable now the debtor to force both a standstill arrangement and an out-of-court consensual restructuring agreement (a so called 182bis agreement) on the minority financial creditors, provided that (i) at least 75% of financial creditors have adhered to the restructuring agreement, (ii) the overall indebtedness is composed by more than 50% by financial debts , (iii) the financial creditors have been invited to the negotiations, have had access to information from the debtor and (iv) the practicable alternatives do not offer a better treatment.
3. Bankruptcy proceedings

To accelerate bankruptcy proceedings the new rules:

a) have focused on enhancing trustees’ performance as follows:

(i) trustees are requested to complete liquidation of the estate in 2 years and are entitled to use specialized operators,

(ii) any payment of the trustee’s compensation is subordinated to at least 1 partial distribution to creditors and

(iii) a public national register of appointed trustees is created showing the opening and closing date of each proceedings, the amount of liabilities and the amount of distributions to creditors

b) allow bankruptcy proceedings to be closed regardless of pending litigation (possible proceeds will be distributed to creditors by the trustee who remains in office for the sole purposes of managing litigation)

c) give priority to bankruptcy-related litigation and mandate courts to schedule hearings accordingly.
Deal Activity
Questions