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AGG Capital Management

European Banking Sector Dislocation: The Granular Credit Opportunity’

Arrow Credit Opportunities 1

FEATURED AS HAVING ONE OF THE

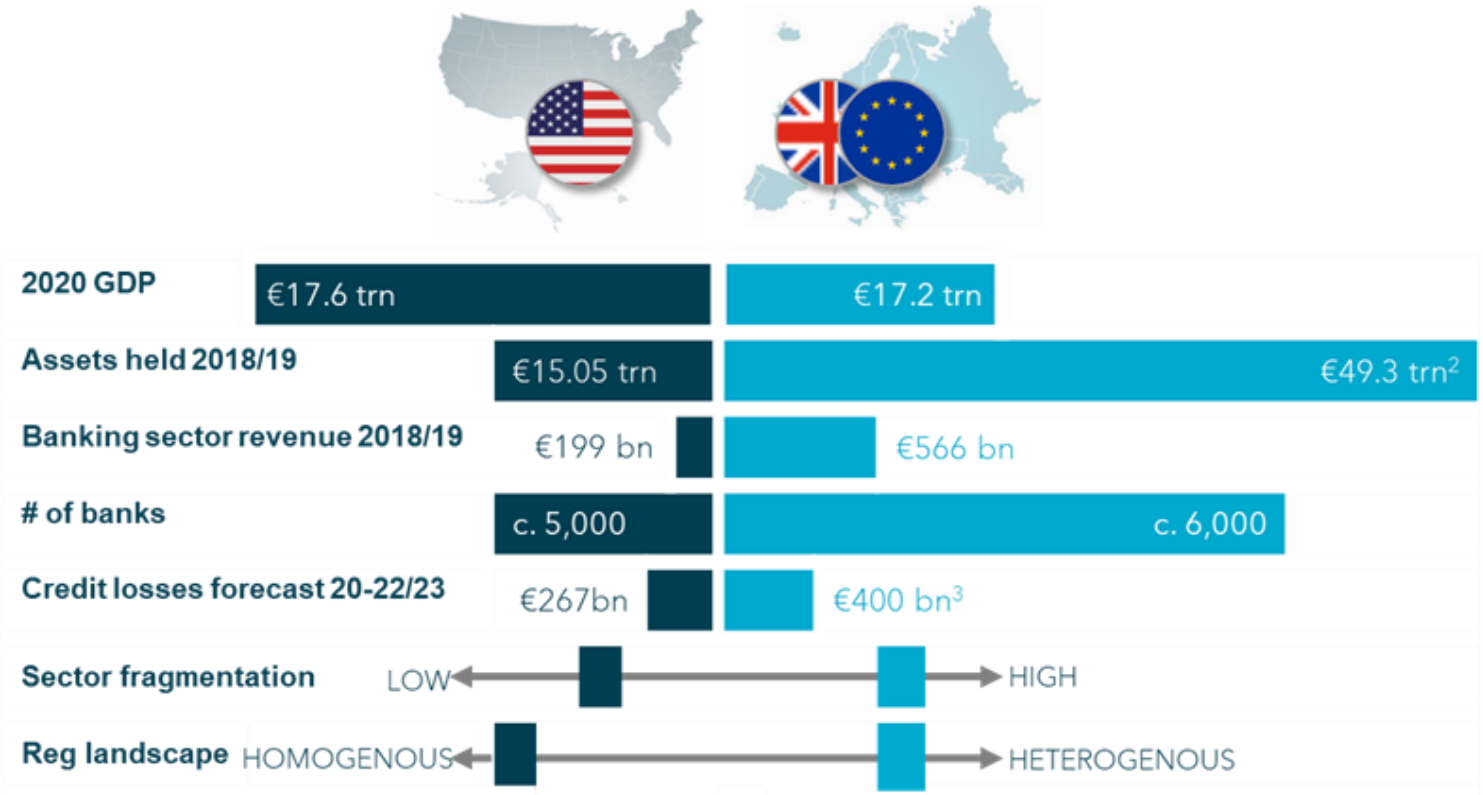
Largest Private Credit Funds closed in 2020

2021 PREQIN GLOBAL PRIVATE DEBT REPORT

preqin

The European banking sector is 2.5x the size of the US market and represents 1/3 of the global banking market. Inefficiencies result in continuous creation of non-core and non-performing credit assets

US vs. Europe Market Analysis[1]



- European bank balance sheets are **interest- vs fee- income heavy** vs US banks
- Inherent characteristic of a straight lending market with limited product range and symptomatic of a **less mature banking system**
- Lack of adequate systems and infrastructure adds to the **local banking challenge**

1. Sources: US Bureau of Economic Analysis, European Banking Federation, Deloitte, Oliver Wyman
2. European Banking Federation Banking Sector Performance
3. EU, UK & Norway. European Banking Authority, Oliver Wyman

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E.U. banks have continued to be margin constrained

E.U. banks are struggling with historically low revenues and profit margins:

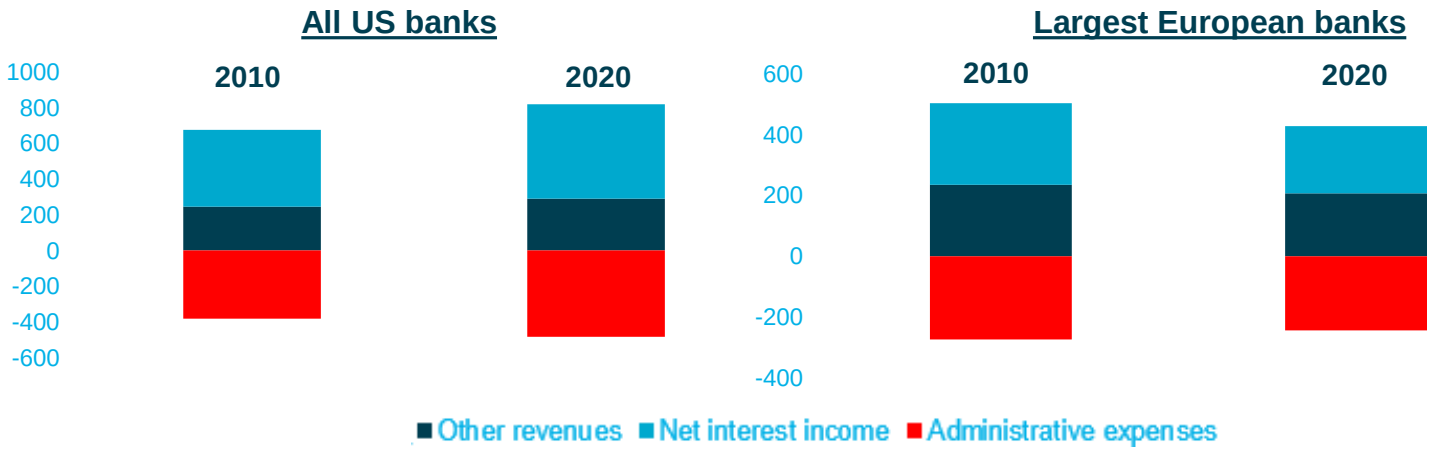
- Limited ability to increase revenues in low nominal growth and low/negative interest rate environment.
- Large non-core and non-performing loan stock, tying up capital, driven increasingly higher by regulation
- Significant cost/operational inefficiencies
- Highly competitive, oversaturated E.U. market

Leading to significantly lower comparative profitability for E.U. banks than U.S. banks:

- E.U. bank net interest margins hit new low of 1.1% in 2020, the lowest on record, compared to 3.1% earned by U.S. banks[2]
- Rate cuts since 2014 have cost E.U. banks an estimated €20bn in charges on their excess deposits[2]
- Average return on equity for the 187 biggest E.U. lenders was 7.2% in 2018, compared with close to 12% for U.S. banks[2]

ECB Deposit rate has fallen below 0% for many years[1]

Declining revenues at European banks vs American banks – 2010-2020[3]



Banks struggling to trade through low profitability – asset sales are required

1. Source: European Central Bank 2020 deposit rate data; 2. Source: FT; 3. Deutsche Bank report: European bank performance in review

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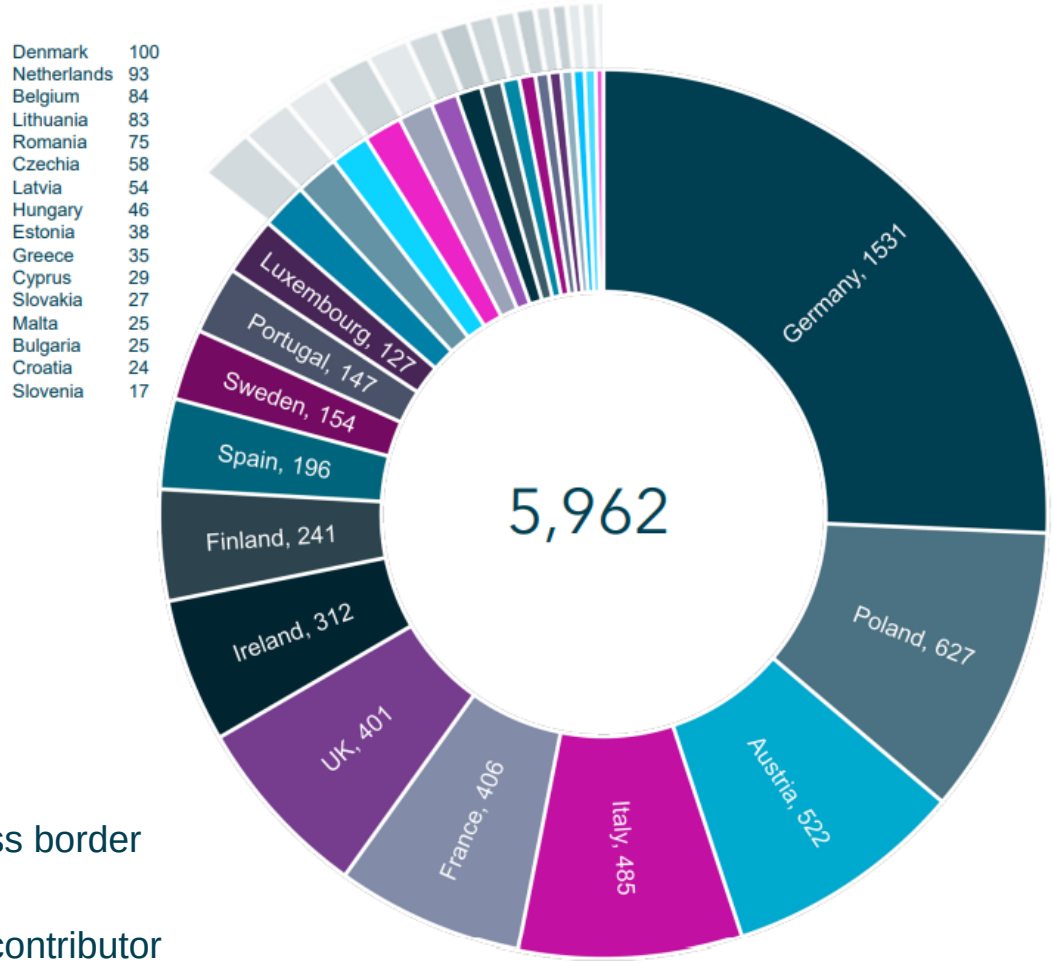
European banks are entrenched in their local markets with limited universal or regional champions – cross border loans and deposits have always been very low

European Banking Country Outlook, Central Case – Market weighted averages (%)[1]

	NPL ratio 2019 - Pre-Covid	NPL ratio 2022 Outlook	Growth factor	Concentration: Scope for in-market consolidation
Sweden	0.6	3	5x	Low
United Kingdom	2.1	6.8	3.2x	Low
Netherlands	2.6	6.5	2.5x	High
France	3.4	8.1	2.4x	Low
Spain	4	8.4	2.1x	Low
Germany	2.2	4.2	1.9x	Medium
Italy	8.9	13.2	1.5x	Low
Portugal	8.3	11.7	1.4x	High
Greece	40.1	47.1	1.2x	Low

European Banks by country (EU28)[2]



- European bank cross border loans to households stand at **c.1%** with cross border deposits at **c. 6%**
- Lack of a **region wide harmonious regulatory framework** has been a contributor

1. European Banking Outlook 2020 (oliverwyman.com)
2. Europe (EU28): number of banks by country, Jan 2020, Statista

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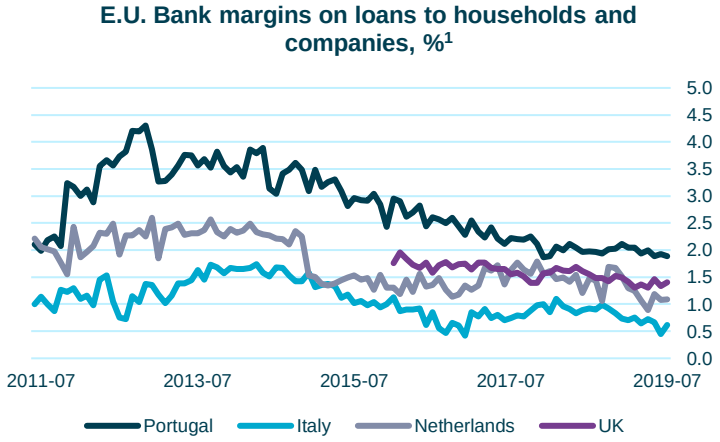
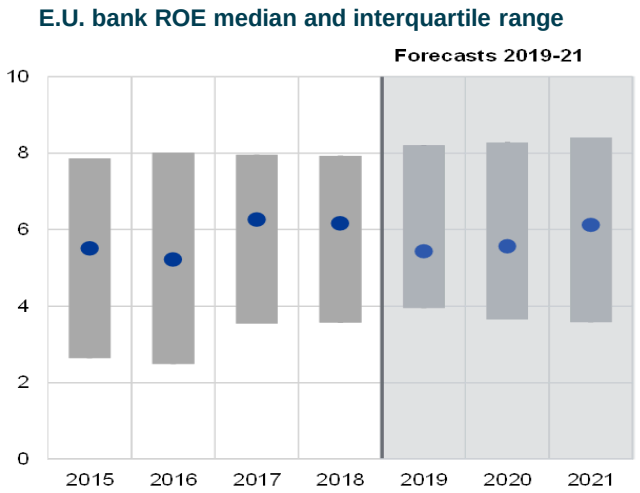
European bank balance sheet deleveraging is critical to addressing capital issues

Ongoing margin pressure



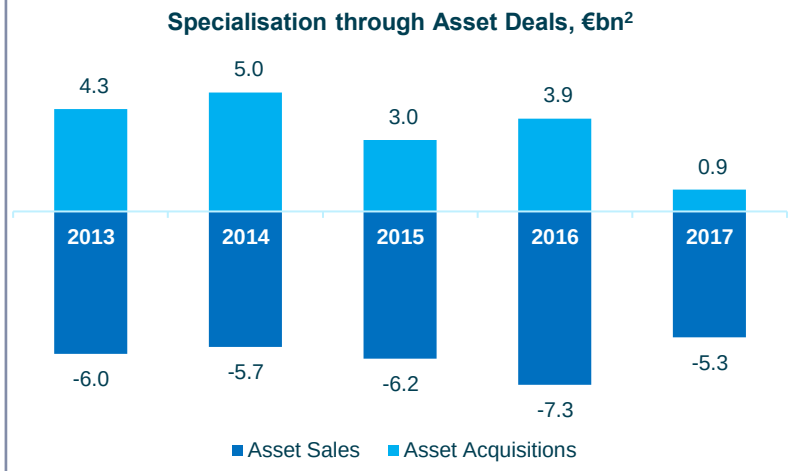
- E.U. bank margins at **historically low levels**, driven by low/negative central bank rates

Historically low return on equity[1]



- Cost pressures further **squeeze margin and ROE**
- Average return on equity for the 187 biggest E.U. lenders was 7.2% in 2018, compared with close to 12% for U.S. banks

Limited alternatives to asset sales



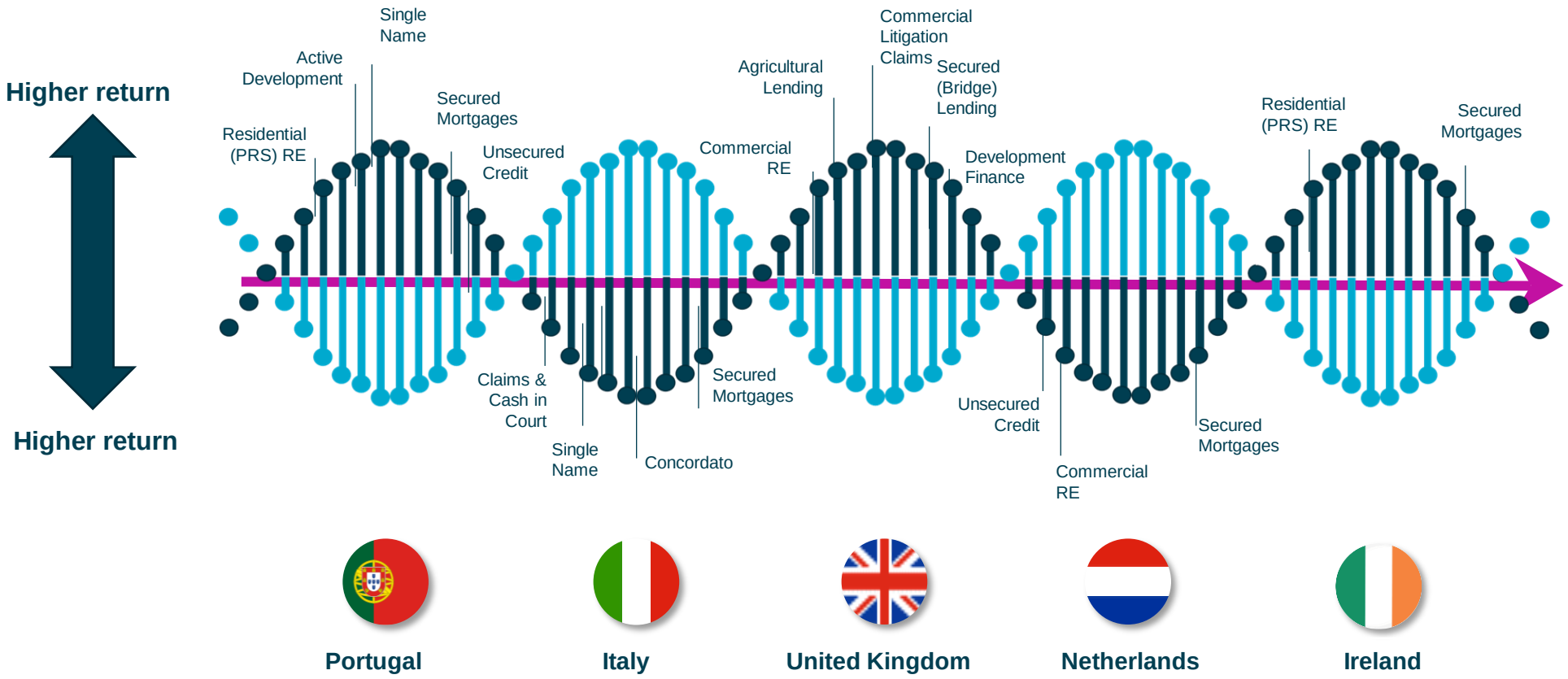
- M&A volumes **halved** since 2010 peak. Further consolidation is needed, which typically **drives further NPL sales**
- Further cost cutting difficult
- **Asset sales key** for banks to boost both profitability and capital

Estimated c.€2trn+ assets need to leave European banks to meet capital ratios and return on capital targets

1. Source: European Central Bank; 2. Source: EBA

As a result European credit is highly granular and deeply local – investors with in-country access have an advantage

Range of returns (gross unlevered IRRs) within high value niches available to local managers



This is the centre of the European banking sector gravity

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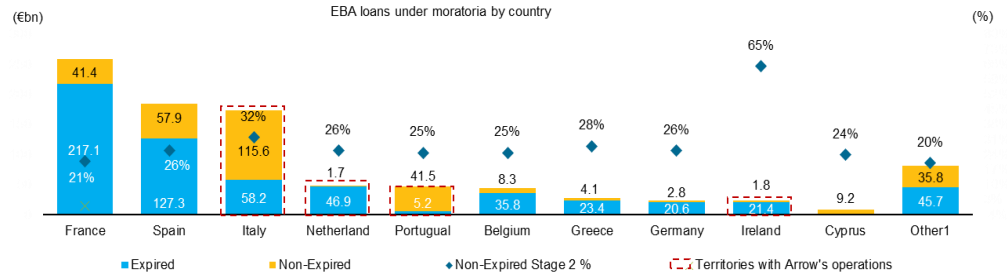
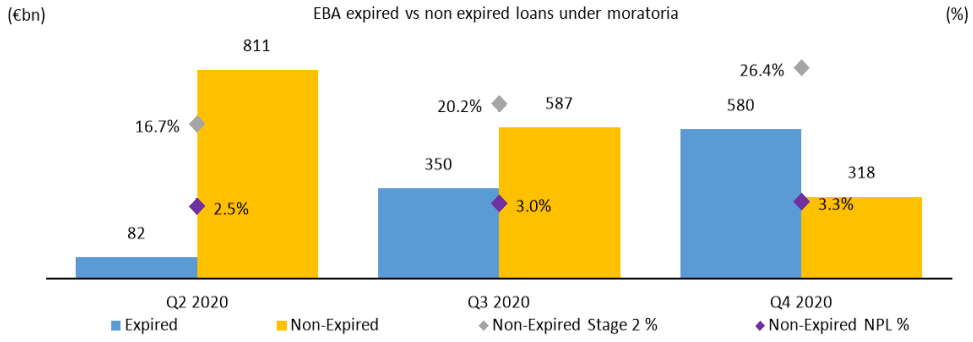
Both the primary and secondary non-performing loan markets are therefore forecast to grow significantly

Primary Market

The feedstock of primary non-performing exposures is growing strongly



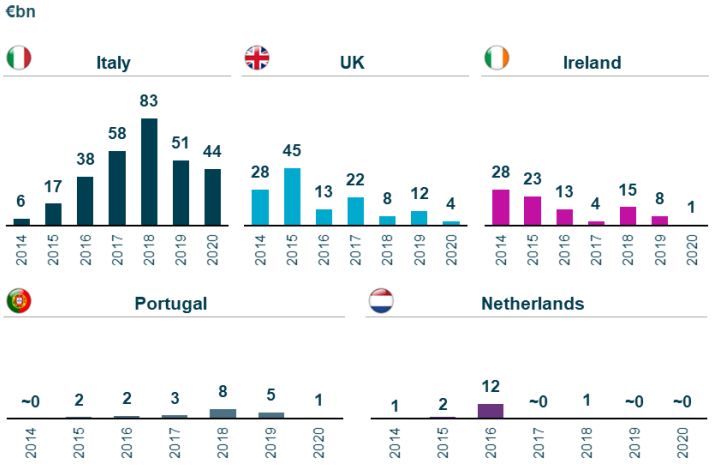


Source: Deloitte, Deleveraging Europe June 2021, Italy: page 12. 2. Q1 2021 EBA Risk Dashboard report, page 39 for Ireland data as of December 2020

Secondary Market

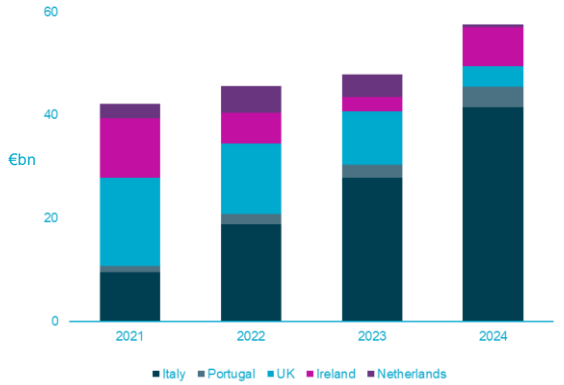
The feedstock of the secondary market is significant

>€500bn of NPLs sales since 2014 suggests large secondary market during life of Fund



Assuming 6yr average hold period and 50% already collected

Estimated secondary sale market in Arrow geographies



Sources: Company data, PwC, Deloitte, KPMG and Debtwire market reports on European NPL market

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COVID-19 related economic dislocation anticipated to lead to a further wave of Non-Performing Loan creation

European NPL and 'Non-core' credit market

- COVID-19 is forecast to increase the European market by over 50% in the next two years[1]
- Italian NPL ratio is expected to surpass the historical peak; peaks in Portugal and Ireland are to be lower than historical highs
- UK NPL ratio could almost double, reaching the peaks of GFC in 2008-09
- Early predictions suggest Italy and France will have ~€350bn NPLs followed by Spain, Greece, Netherlands and Germany

1. Preqin Global Private Debt report 2021

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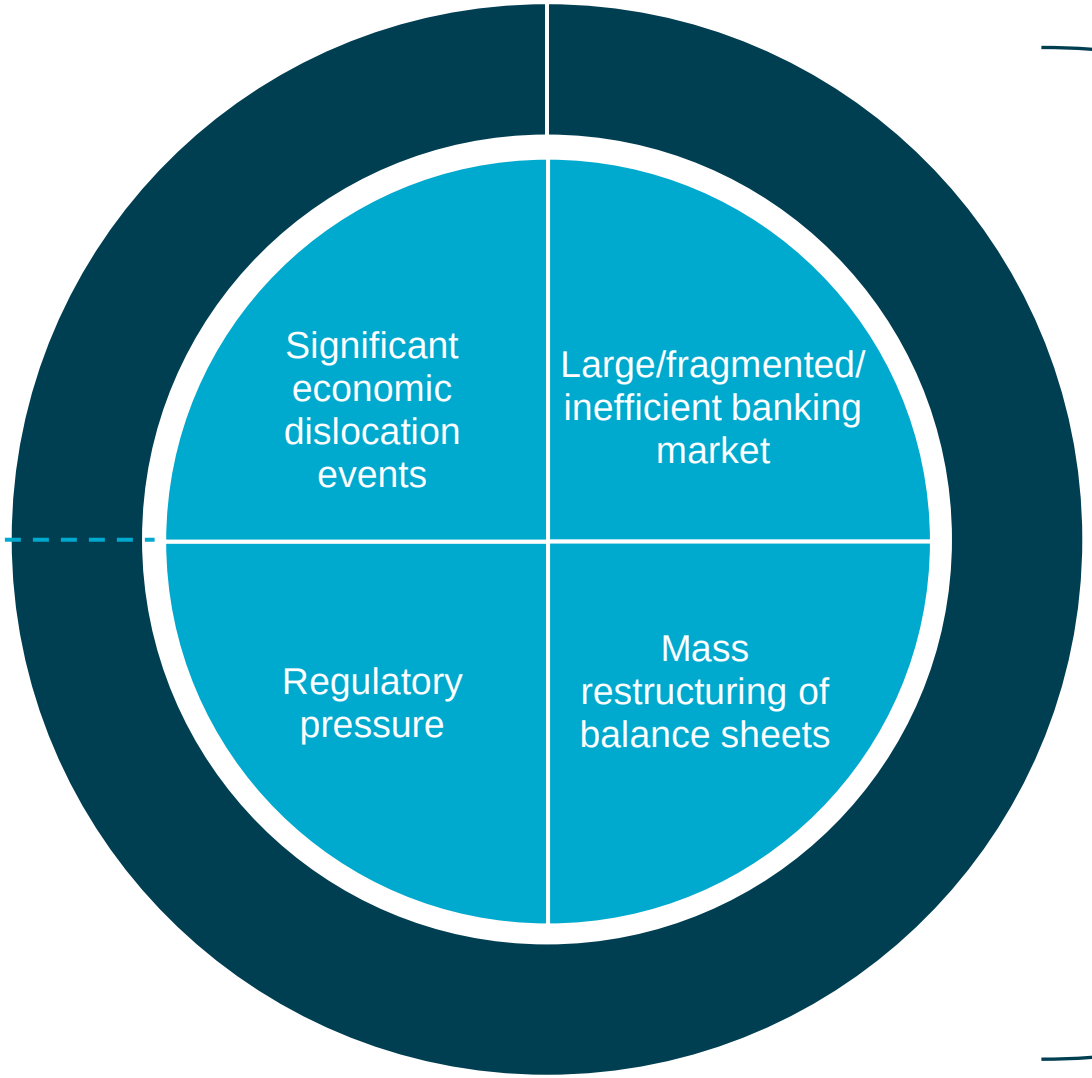
Exciting investment opportunity – €1 trillion + primary market and rapidly growing secondary market of high yielding granular credit assets

Creation of a high yielding granular European credit asset



Creation of typical credit asset has multiple drivers at its core

Local, in-country players **best positioned** to extract full value of assets

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INTERESTS IN THE FUND SHALL NOT BE OFFERED OR SOLD IN ANY JURISDICTION IN WHICH SUCH OFFER, SOLICITATION OR SALE WOULD BE UNLAWFUL UNTIL THE REQUIREMENTS OF THE LAWS OF SUCH JURISDICTION HAVE BEEN SATISFIED.

FUND NOT YET COMMENCED. THE FUND HAS NOT COMMENCED OPERATIONS; IT HAS NO OPERATING AND PERFORMANCE HISTORY. NO REPRESENTATION IS MADE THAT THE FUND WILL OR IS LIKELY TO OFFER INTERESTS AND/OR COMMENCE OPERATIONS, AND IF IT DOES COMMENCE OPERATIONS, TO ACHIEVE ITS OBJECTIVES.

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