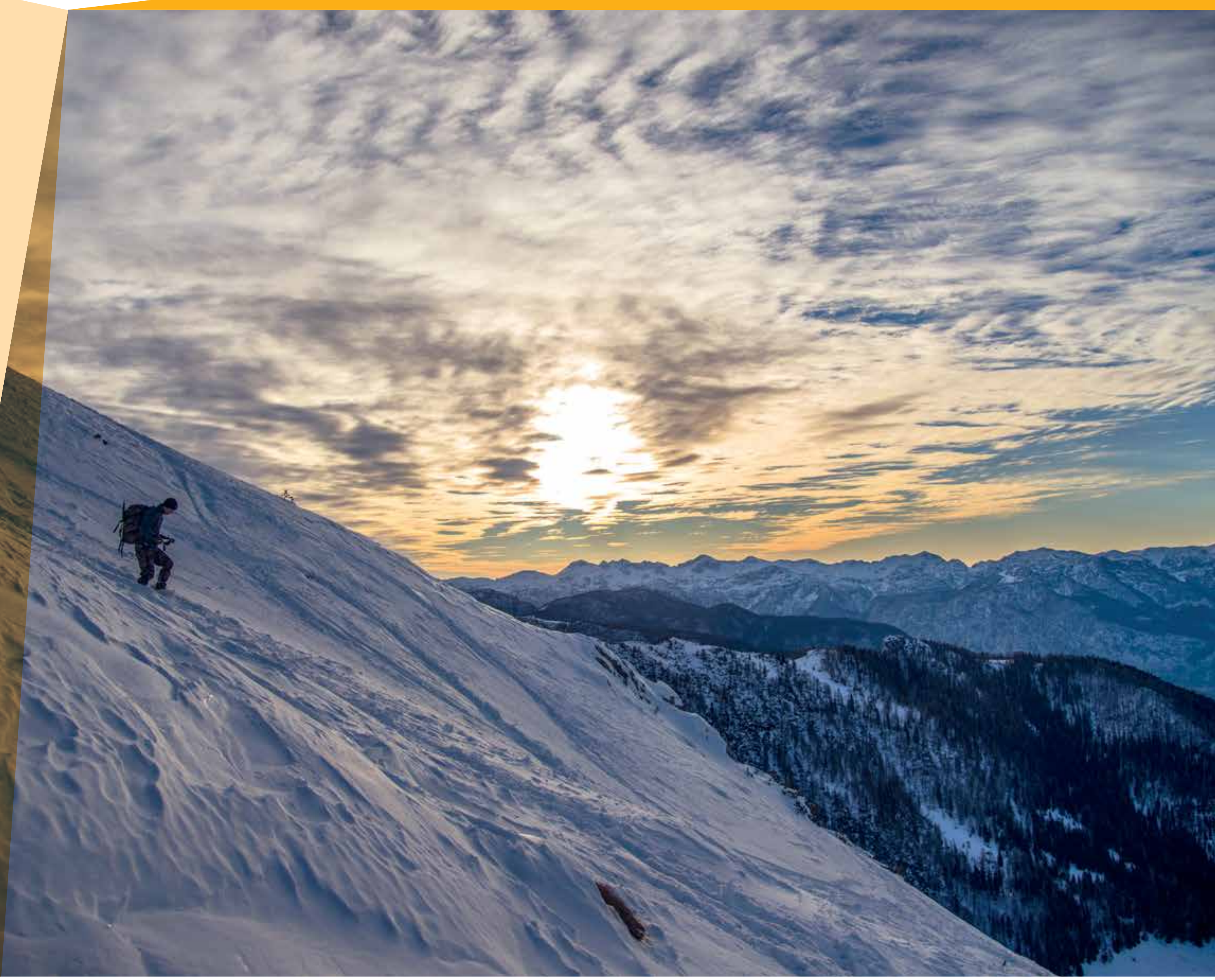
IS EUROPE READY FOR THE NEXT CRISIS?

OLIVER WYMAN RESTRUCTURING REPORT 2018



MARSH GUY CARPENTER MERCER OLIVER WYMAN

MARSH & McLENNAN COMPANIES

SURVEY PARTICIPANTS

IN % OF TOTAL PARTICIPANTS

66%

OF SURVEYED EXPERTS EXPECT A CRISIS WITHIN FOUR YEARS

INTRODUCTION

Dear Reader,

Is the current positive economic climate in Europe preventing us from recognizing a new crisis?

Recent years have seen positive development in most European economies. In particular, countries like Spain, Portugal, or Greece have recovered from the impact of the sovereign debt crisis and show positive GDP growth rates again. Likewise, companies throughout Europe are enjoying growing revenues and profits as well as reduced debt loads. Why then should we talk about a new crisis?

We believe that besides general risks for an economic downturn cycle, certain megatrends – ongoing digitization or growing nationalism – may create a new crisis for the economy or for individual sectors. In addition, political instability in major states within the European Union has become a more common threat over the past years.

So how likely is a crisis, and when should it be expected? How well is the European banking sector prepared to weather such a crisis? And what is the level of preparedness in the corporate sector, generally?

These are the questions we address in this year's Restructuring Report. It is based on an expert survey across Europe, complemented by Oliver Wyman analyses and Points-of-View.

We hope you find it an interesting read.

Sincerely yours,

Lutz Jaede

Dr. Lutz Jaede | Head of Corporate Restructuring

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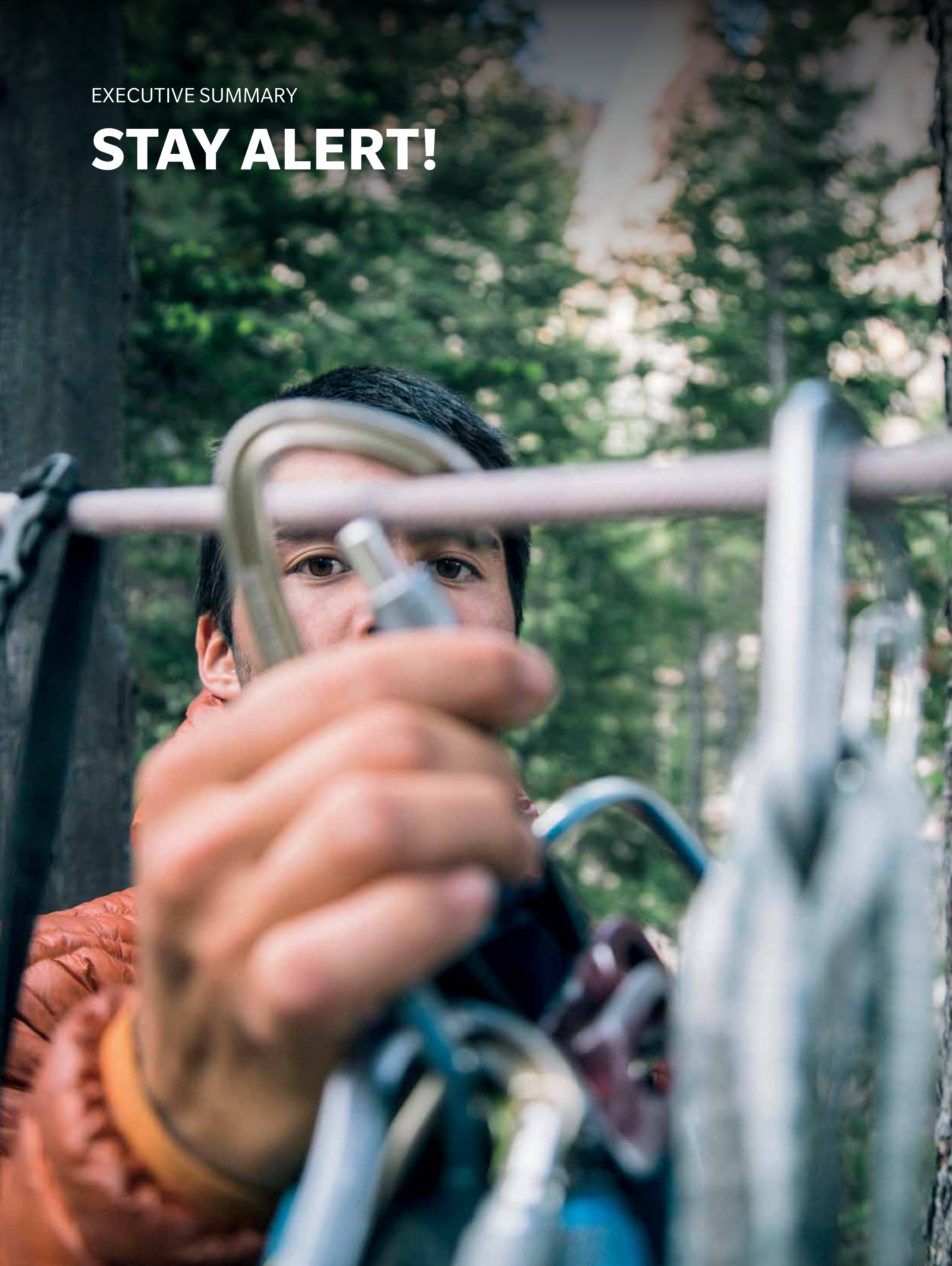
STAY ALERT!



THE MOOD IS GOOD IN EUROPE – BUT A CRISIS MAY COME UNEXPECTEDLY

European economies have recovered from the sovereign debt crisis. GDP growth is at 2.4 percent on average, and several important indicators signal a continued positive business climate for banks and corporates. Consequently, the mood amongst our surveyed companies is generally very good. Even global megatrends, such as digitization and the rise of Asian economies, are seen as opportunities rather than threats. However, experience shows that severe crises always are triggered by unexpected events! This is supported by the fact that 40 percent of the surveyed experts assume more companies will experience crises going forward and two-thirds of the participants expect the next economic downturn to happen within four years.

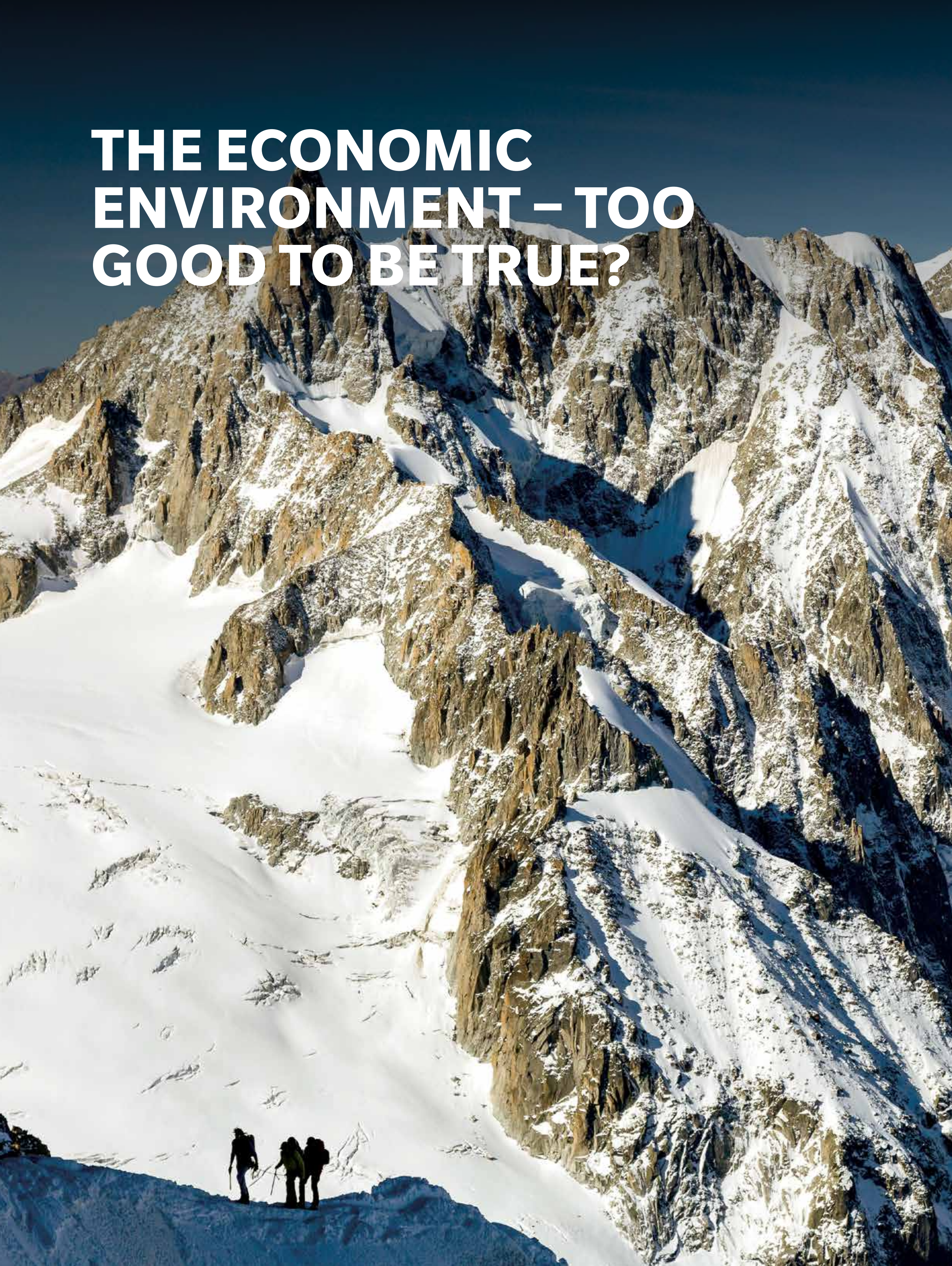
THE BANKING SYSTEM IS STILL VULNERABLE

European banking systems may struggle to absorb the impact of such crises. The non-performing loan (NPL) ratio in Europe still has not come back to pre-crisis levels, especially due to a high NPL load in Greece, Italy, and Iberia. In addition, banks have recently loosened their requirements for new loans: they may thus have loans on their credit books lacking the proper equity base, securitization, covenants, and interest schemes to weather a crisis. On the other hand, banks have become more proactive in the handling of restructuring situations. Stressed loans are monitored more closely, in-house restructuring specialists are involved earlier, and NPLs are sold more often if a successful restructuring does not seem to be likely with the current group of lenders. According to the survey's results, banks feel confident about managing a crisis, but 75 percent of those surveyed have significantly reduced the size of their restructuring/special care units.

CORPORATES MAY BE TOO SHORTSIGHTED

The current positive economic situation has supported a strong development of corporates across Europe. Company revenues have grown above pre-crisis levels in many sectors, partly fueled by stronger infrastructure investments of states and increased private spending for consumer goods – both drivers that may be reversed in a new crisis. In addition, some industries are still performing below pre-crisis levels and EBITDA margins have declined over the past 10 years in many sectors. At the same time, the positive economic development has led to a somewhat shortsighted approach to company steering amongst corporates. Corporates focus more on managing the current performance than on anticipating and preparing for future developments. Also, they should improve the collaboration with their lenders to recognize and avoid crisis, especially with regard to proactive communication in case of extraordinary events.

THE ECONOMIC ENVIRONMENT – TOO GOOD TO BE TRUE?



EUROPE IS BACK ON A GROWTH PATH

The economic situation has improved significantly over the last ten years in the most important economies in Europe. Since 2017, formerly troubled countries like Spain, Italy, or Greece have positive GDP growth rates again. Overall GDP growth is at 2.4 percent, driven by strong growth in Spain, Germany, and France. (See Exhibit 1.) The same positive trend can be observed in other macroeconomic indices, such as the "Economic Sentiment Indicator" which has climbed by 35 percent since 2012.

Exhibit 1: GDP Development: 2012 – 2017

REAL ANNUAL GROWTH (%)

	2012	**2013**	**2014**	**2015**	**2016**	**2017**[*1]
EU-28	-0.4	0.3	1.8	2.3	2.0	2.4
Germany	0.5	0.5	1.9	1.7	1.9	2.2
France	0.2	0.6	0.9	1.1	1.2	1.8
UK	1.5	2.1	3.1	2.3	1.9	1.7
Italy	-2.8	-1.7	0.1	1.0	0.9	1.5
Spain	-2.9	-1.7	1.4	3.4	3.3	3.1
Greece	-7.3	-3.2	0.7	-0.3	-0.2	1.4

< -3%

<0– -3%

>0 – 1%

>1 – 1.5%

>1.5%

*1. Preliminary data for Greece, Spain, Portugal, France
Source: Eurostat (15.3.2018), Oliver Wyman analysis

MEGATRENDS – RISK OR OPPORTUNITY?

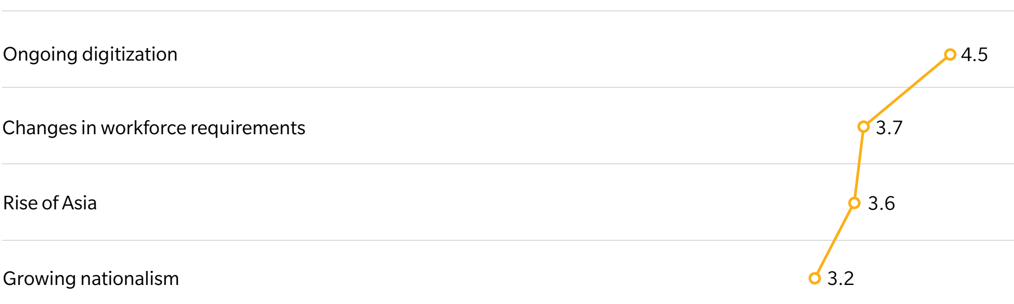
Despite this positive environment, companies constantly need to improve performance. This is supported by the fact that 84 percent of the surveyed managers stated they feel the need to adapt their strategy and business design – mostly due to those "megatrends" that influence and change their markets and competitive environment, sometimes disruptively.

Among megatrends, "digitization" was rated the most important by study participants. "Changes in workforce requirements" was also rated as important, especially with regards to rising importance of knowledge assets, new job profiles, and the lack of skilled workers in Europe. According to the participants' view, the "Rise of Asia" is also important creating new opportunities due to a growing Asian middle class and the emergence of China as the world's biggest end market. "Nationalism" is deemed to be less important by the surveyed experts, and they did not rate this trend as a potential trigger for a new crisis. (See Exhibit 2.)

Taking a closer look at the potential impact of digitization, however, reveals that most of the study participants see it as an opportunity rather than a threat. Digitization of processes, new technologies to mine and exploit data, new sales channels or collaboration platforms, and replacement of hardware related business to service revenues are rated as potential causes for a sector upturn, especially when looking at a long-term view of more than five years.

Exhibit 2: How would you rate the importance of the following megatrends?

AVERAGE PERCEIVED IMPORTANCE (1=NOT IMPORTANT, 5=VERY IMPORTANT)



Source: Oliver Wyman Restructuring Survey 2018

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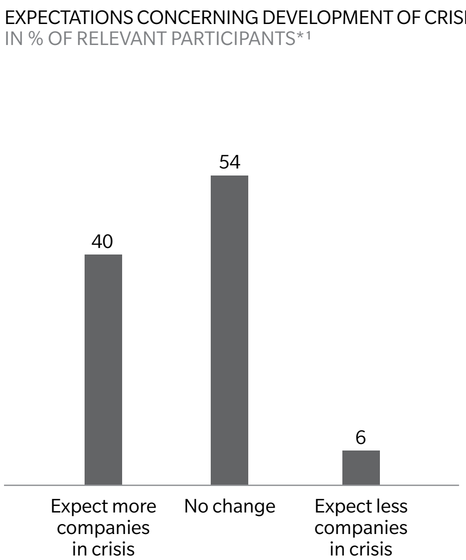
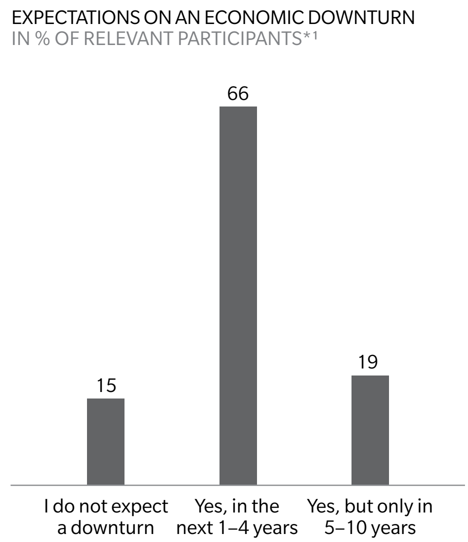
EXPERTS REMAIN SKEPTICAL

Such a positive expectation is clearly biased by the current positive development of many companies. However, experience shows that the most severe crises arrive unexpectedly and that a positive economic environment can undermine attention to early warning signs. Indeed, the experts surveyed – most of them veterans of the restructuring scene – remain skeptical despite the current upswing. Forty percent of the restructuring experts assume that more companies will experience a crisis situation going forward and 66 percent even expect an economic downturn to happen in the next four years. (See Exhibit 3.)

Exhibit 3: Expectations on the economic development





*1. Surveyed banks, investors and family office representatives, restructuring experts and debt servicers
Source: Oliver Wyman Restructuring Survey 2018

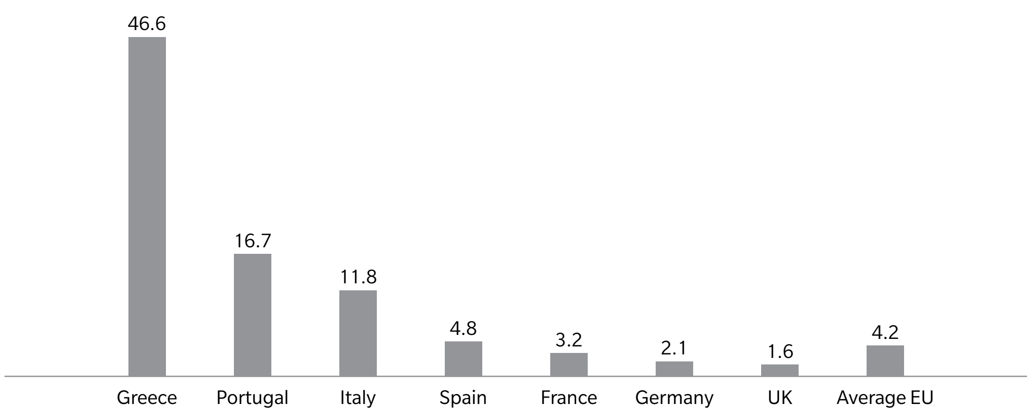
CAN THE BANKING SECTOR DEAL WITH A CRISIS?

DEBT LOAD REMAINS HIGH

Despite the economic recovery, the European banking system still suffers from a heavy burden of problem loans. The overall ratio of "non-performing loans (NPL)" has still not fallen below the pre-crisis level, and some countries still carry double-digit NPL ratios. (See Exhibit 4.) On a global scale, the total debt in relation to the GDP is even higher than its peak during the crisis. (See Exhibit 5.)

Exhibit 4: NPLs in the EU by country (as of September 2017)

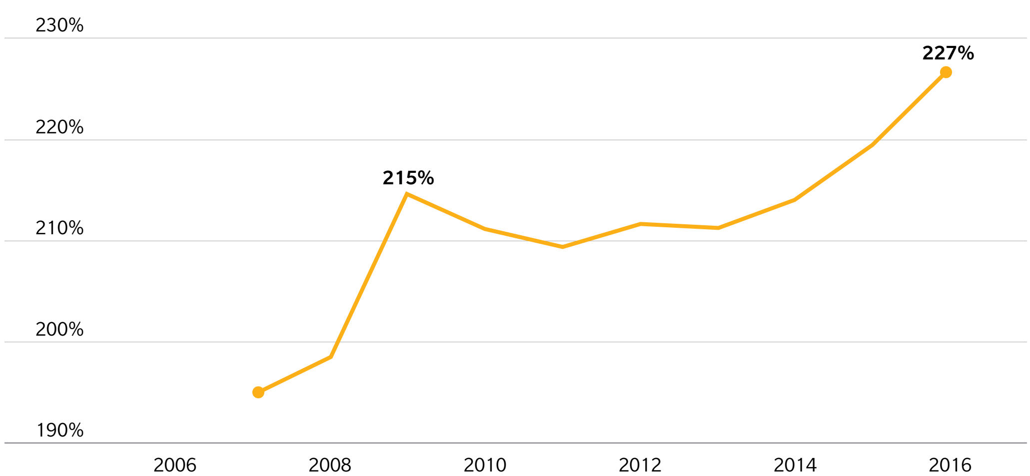
IN % OF GROSS LOANS



Source: Oliver Wyman Restructuring Survey 2017

Exhibit 5: Global Debt*1

IN % OF GDP



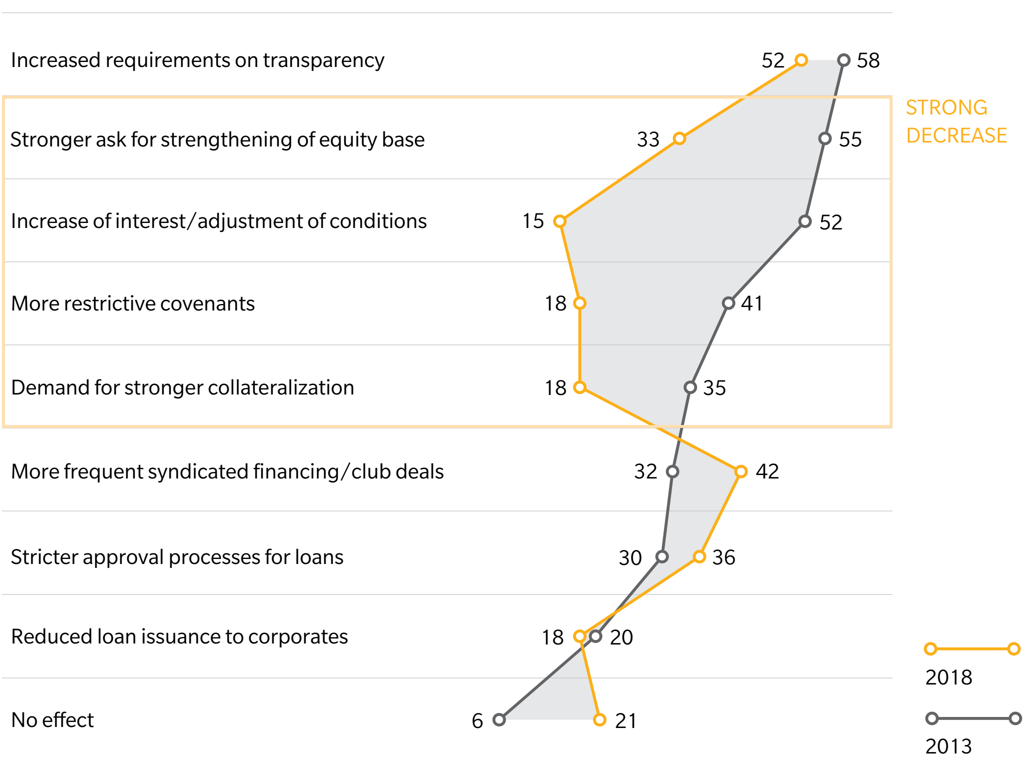
*1. Total public and private debt
Source: IMF

LENDING BEHAVIOR IS MORE BULLISH

Driven by their market's competitive environment, banks have loosened up their requirements to loan issuance. (See Exhibit 6.) In our Restructuring Survey in 2013, we asked banks how they are reacting to tightened regulation on their lending behavior. A significant portion of the banks stated that they would strive for a stronger equity base, increase interest rates, enforce more restrictive covenants, and demand stronger collaterals. Five years later, banks have seemingly abandoned this ambition. Only around one-third of the banks have been asking for a stronger equity base, and less than 20 percent of the participants have tried to establish tighter credit conditions. This change in behavior implies the risk that banks put loans in their credit portfolio that are not sufficiently protected against potential downturn.

Exhibit 6: Changes from megatrends on loan issuance: 2018 vs. 2013*1

IN % OF SURVEYED BANKS, MULTIPLE CHOICE POSSIBLE



*1. Question: How did these challenges change your behaviour when issuing new loans?
Source: Oliver Wyman Restructuring Survey 2018

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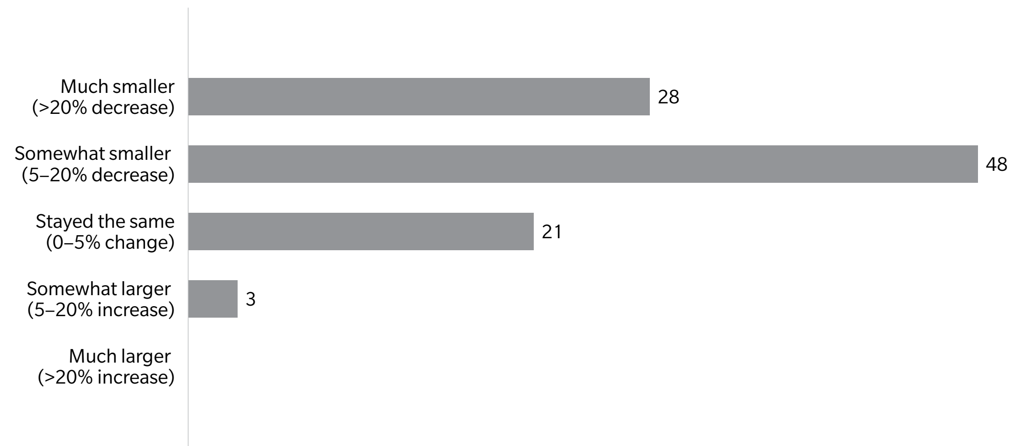
BANKS LET DOWN THEIR DEFENSE BUT STAY CONFIDENT

Due to the improved performance of debtors, many banks have had to deal with fewer restructurings in their credit portfolio over the past five years. This has led to overcapacity and cost pressure in the "restructuring/special care" units of most banks. As a reaction, 75 percent of the surveyed banks have significantly reduced the size of their restructuring teams. (See Exhibit 7.) Still, they feel confident they are ready for a new crisis. (See Exhibit 8.)

Exhibit 7: How did the size of your restructuring/special care unit change over the last five years?

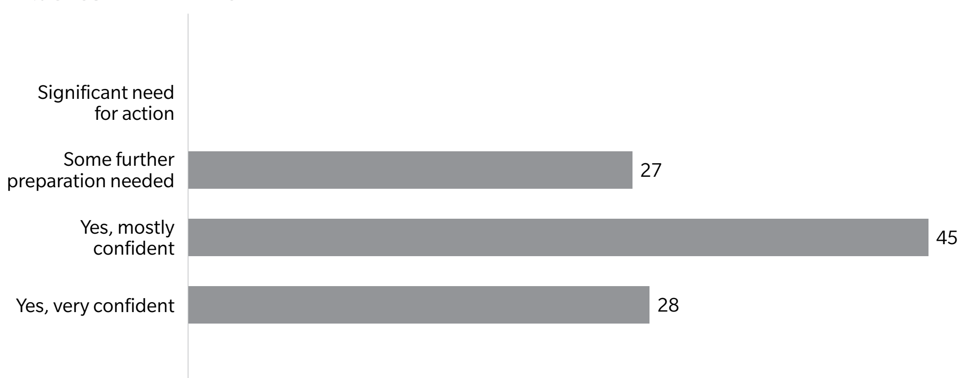
IN % OF SURVEYED BANKS



Source: Oliver Wyman Restructuring Survey 2018

Exhibit 8: Are you confident in the readiness of your restructuring and workout team for the next crisis?

IN % OF SURVEYED BANKS

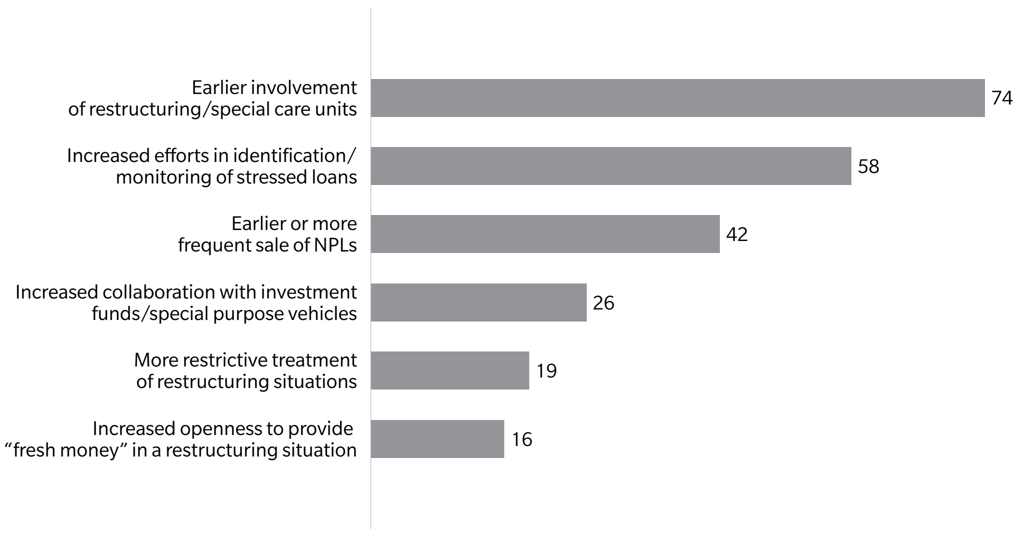


Source: Oliver Wyman Restructuring Survey 2018

This confidence may be due to changes in the approach to restructuring cases over the past years. (See Exhibit 9.) In order to keep the best possible room to maneuver, almost three-quarters of the surveyed banks try to get involved in restructuring situations earlier by monitoring stressed loans more intensively and use their in-house specialists for restructurings earlier. Almost half of the surveyed banks would also consider a sale of a non-performing loan earlier or more frequent than in the past. Using "special purpose vehicles (SPV)" or other means to collaborate with financial investors can be observed primarily in high NPL countries – but is not common yet in countries with low NPL ratios.

Exhibit 9: How has your handling of restructuring cases changed in the last five years?

IN % OF SURVEYED BANKS



Source: Oliver Wyman Restructuring Survey 2018

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ARE CORPORATES SUFFICIENTLY PREPARED?

REVENUES GROW, BUT MARGINS DO NOT

Most key industry sectors in Europe have surpassed pre-crisis levels in terms of revenues. (See Exhibit 10.) In particular, the automotive sector has blossomed due to technology advancement, higher consumer spent for cars, and increased competitiveness of European players. This is especially true of the leading companies in the automotive supplier industry, which for the most part is based in Europe.

On the other hand, the underlying profitability in many sectors (as measured by the EBITDA in percent of revenues) has declined in the past years. This should be a warning signal for many corporates. If growth cannot be turned into higher profitability, it may be a sign that company structures and processes are not mature enough to cope with the increased complexity of the business. Moreover, strong growth at declining margins puts pressure on a company's liquidity: the working capital and CAPEX needed for growth cannot be financed completely out of the operating cash flow if profitability is low.

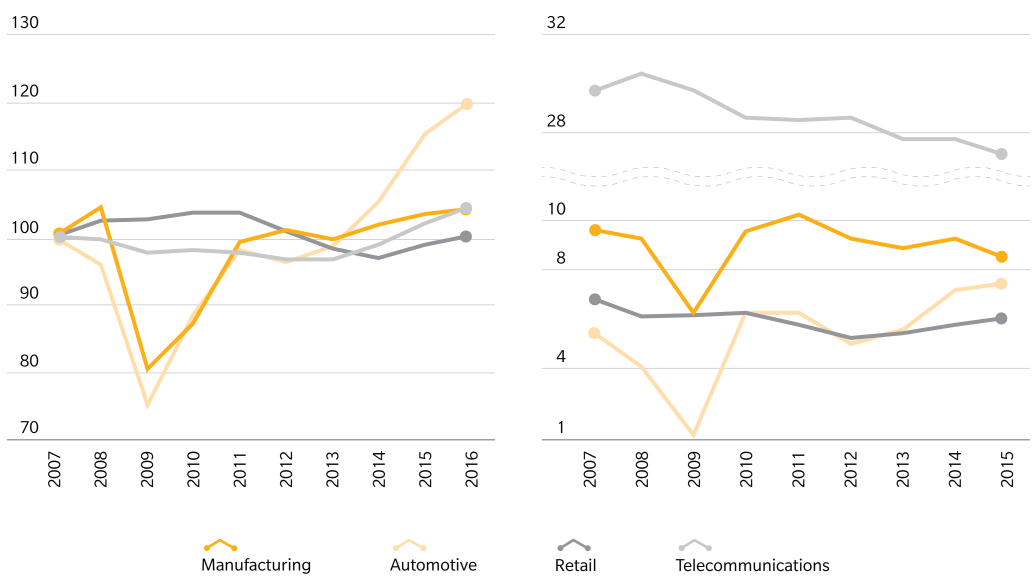
Exhibit 10: Financial performance of key sectors

REVENUE DEVELOPMENT BY SECTOR (EU-28)

INDEX 2005 = 100

EBITDA*1 - MARGIN BY SECTOR (EU-28)

IN % OF REVENUES



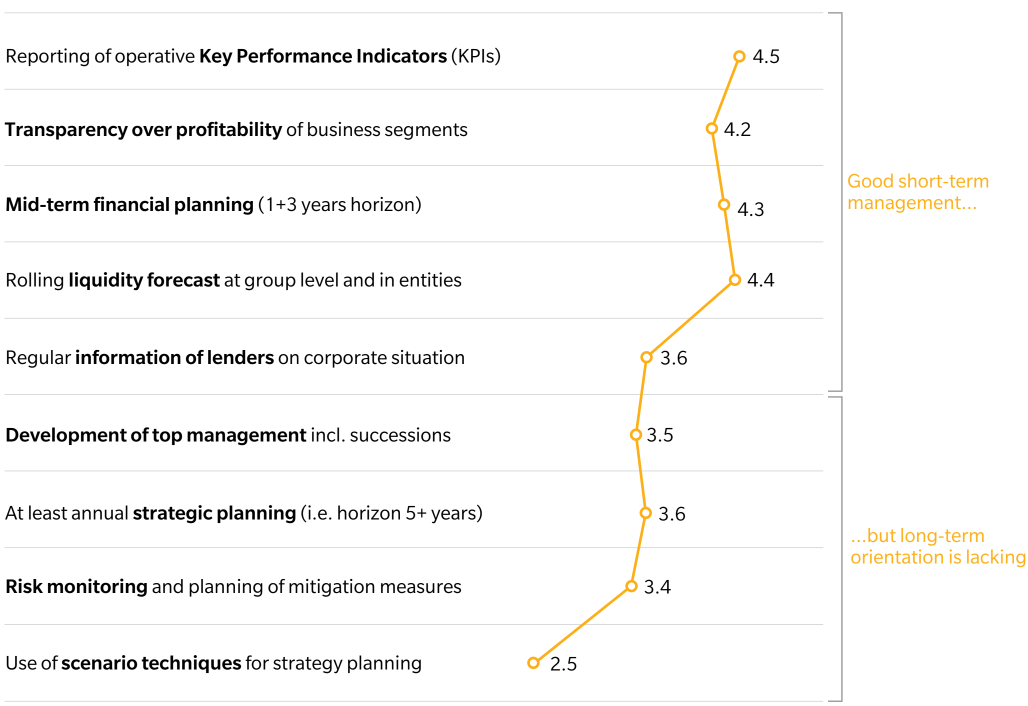
*1. Gross operating surplus, i.e. production value less material and employee costs
Source: Eurostat, Oliver Wyman analysis

SHORTSIGHTED APPROACH TO COMPANY STEERING

The overall capability of companies with regards to steering instruments seems to be good. (See Exhibit 11.) Most of the surveyed managers stated that they have implemented good reporting on profitability and operational performance and that they use a rolling liquidity forecast in combination with a mid-term planning to plan the company's development. These instruments, however, are most appropriate for managing a steady state but do not anticipate major shifts or long-term challenges. A systematic development of the top management team, a strategic planning beyond five years, and a systematic risk management system is much less established. And most of the surveyed companies do not apply scenario techniques to be prepared for disruptive changes to their businesses.

Exhibit 11: What instruments do you have in place in order to prepare for a crisis?

AVERAGE PREPAREDNESS BY INSTRUMENT (1 = NOT PLANNED, 5 = FULLY IMPLEMENTED)



Source: Oliver Wyman Restructuring Survey 2018

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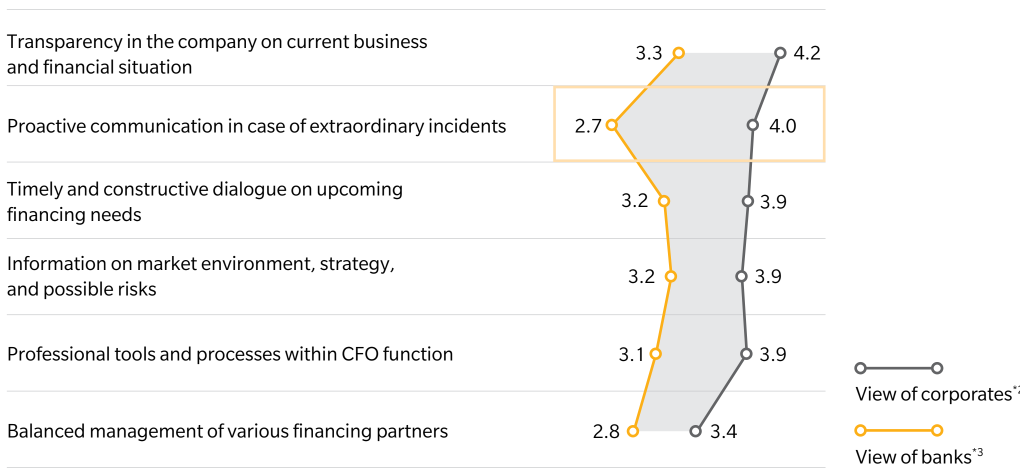
LENDERS AND DEBTORS NEED TO COLLABORATE

In order to avoid a crisis, it is essential that banks and corporates collaborate closely with regards to early identification of a potential crisis event, transparency on a company's situations and performance, timely information on financing needs, and proper management and coordination of different financing partners. Our survey shows that banks are not pleased with the performance of their debtors in these areas. The corporates, however, do not feel a significant need for improvement here. (See Exhibit 12.)

Exhibit 12: Collaboration between banks and corporates to avoid a crisis

PERCEPTION OF SURVEYED PARTICIPANTS*1 (1 = NOT MANAGED, 5 = MANAGED VERY WELL)



*1. Banks and corporates

*2. Question: "How well do you manage the following requirements of a corporate borrower?"

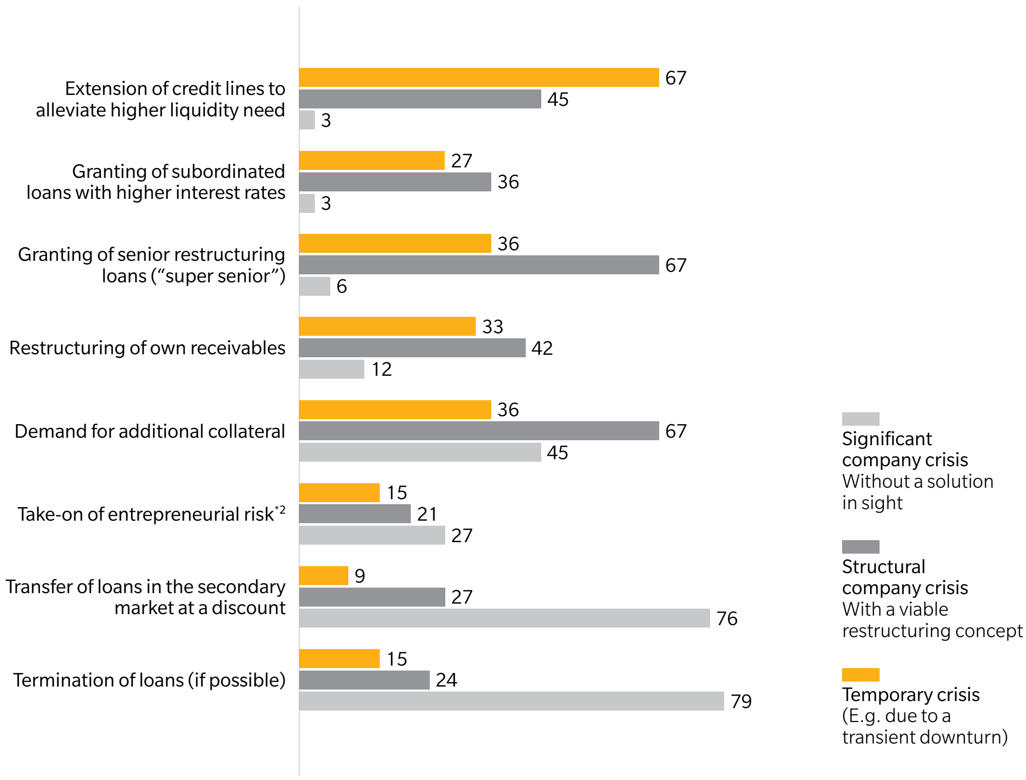
*3. Question: "How well do your debtors manage the following requirements of a corporate borrower?"

Source: Oliver Wyman Restructuring Survey 2018

This applies in particular to proactive communication in case of extraordinary events, which is essential for responding to an emerging crisis in time. Our survey also shows that lenders are ready to support a debtor in crisis as long as they are convinced that the situation can be solved by a viable restructuring plan. (See Exhibit 13.) It is thus critical for a company to address their lenders at the dawn of potential crisis early, proactively, and with a solution in mind.

Exhibit 13: Reactions to different forms of a crisis at a debtor

IN % OF SURVEYED BANKS*1,2, MULTIPLE CHOICE POSSIBLE



*1. Question. For you, what are possible reactions to different forms of a crisis at a debtor?
*2. E.g. participation certificates, debt-equity swaps
Source: Oliver Wyman Restructuring Survey 2018

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BE READY!

THE CURRENT POSITIVE MOOD MAY BE THE SEED FOR A NEW CRISIS

Driven by good economic development, the current mood among study participants is highly positive. Global megatrends are perceived as opportunities rather than risks, and strategy development is higher on the agenda than cost reduction. But severe crisis usually come unexpected and two-thirds of the participants expect downturn in the next few years. Such a new crisis may hit hard if players are fooled by the current positive business environment.

THE EUROPEAN BANKING SYSTEM IS NOT AS ROBUST AS IT MAY SEEM

There are still massive amounts of non-performing loans (NPLs) on the balance sheets of European banks, NPL ratios are still way above the pre-crisis level, and the global debt is higher than ever. At the same time, banks have loosened their requirements when providing new loans and reduced the manpower in their lines of defense. They feel confident in the face of crisis – but we are concerned!

IF YOU DRIVE SHORTSIGHTED, YOU ARE IN DANGER OF MISSING THE CURVE

Many companies are performing well currently. But this may largely be due to a high level of sovereign and public investments and positive consumer spending – which may reverse quickly if the overall mood sours. Many companies lack the right tools to anticipate and simulate the impact of a sudden downturn. In addition, they neglect to keep their lenders informed about their current situation and potential developments. This may make it hard to recognize a crisis in time and to initiate the right measures to avoid it in collaboration with financing partners.

RESTRUCTURING WITH OLIVER WYMAN

Backed by years of experience, Oliver Wyman acts as a trusted adviser to banks, investment funds, and distressed corporates as they take on the challenges of strategic, operational, and financial restructuring.

We support commercial banks by providing solutions for their book of NPLs, leveraging our deep understanding on the financial services industry and world-leading expertise in finance and risk. At the same time, we work with the world's biggest investment funds and advise them on investments into distressed debt and equity.

When working with distressed corporates, we place a priority on developing sustainable restructuring concepts that address the market and the competitive environment, as well as specific factors for achieving operational excellence. Oliver Wyman acts as a coordinator for restructuring processes, an objective expert, and a neutral third party who provides quantitatively supported advice to address the interests of management, shareholders, lenders, and other stakeholders.

OLIVER WYMAN CAPABILITIES	
INDUSTRY EXPERTISE	Deep knowledge on market trends and operational success factors through specialized sector teams
KNOW-HOW	Broad range of capabilities covering NPL transactions, distressed M&A, and corporate restructuring
NETWORK	Excellent network to commercial banks, investment funds (equity and debt), and other restructuring advisers (lawyers, CRO, etc.)
EXECUTION MINDSET	DNA of a "value growth" consultant, aiming at sustainable success

CONTRIBUTION TO RESTRUCTURING PROCESS

FOR BANKS

- Portfolio transparency
- In-house solutions for NPL management
- Outsourcing and sales

FOR INVESTMENT FUNDS

- Due diligence and valuation
- Transaction support

FOR CORPORATES

- Independent business reviews
- Restructuring concepts
- Implementation support

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CONTACTS

Dr. Lutz Jaede
Partner, Head of Corporate Restructuring
Munich
+49 89 93949 440
Lutz.Jaede@oliverwyman.com

Giovanni Viani
Partner, Head of Bank Restructuring
Milano
+39 2 3057 7504
Giovanni.Viani@oliverwyman.com

Pablo Campos
Partner, Head of Corporate Finance and Advisory
Madrid
+34 91 432 8441
Pablo.Campos@oliverwyman.com

Thomas Kautzsch
Partner
Munich
+49 89 93949 460
Thomas.Kautzsch@oliverwyman.com

Dr. Romed Kelp
Partner
Munich
+49 89 93949 485
Romed.Kelp@oliverwyman.com

Dr. Daniel Kronenwett
Partner
Munich
+49 89 93949 591
Daniel.Kronenwett@oliverwyman.com

Dr. Joachim Krotz
Partner
Munich
+49 89 93949 462
Joachim.Krotz@oliverwyman.com

Dr. Moritz Kuentzler
Restructuring Team
Berlin
+49 30 39994 555
Moritz.Kuentzler@oliverwyman.com

Alexander Lis
Partner
New York
+1 646 364 8408
Alexander.Lis@oliverwyman.com

Manuel de Macedo
Restructuring Team
Madrid
+34 91 212 6312
Manuel.deMacedo@oliverwyman.com

Dr. Markus Mentz
Partner
Munich
+49 89 93949 548
Markus.Mentz@oliverwyman.com

Hanna Moukanas
Partner
Paris
+33 1 45023218
Hanna.Moukanas@oliverwyman.com

Rodrigo Pinto Ribeiro
Partner
Madrid
+34 91 2126 305
Rodrigo.PintoRibeiro@oliverwyman.com

Dr. Julian Poetzl
Principal
Munich, Vienna
+49 89 93949 202
Julian.Poetzl@oliverwyman.com

Dimitrios Psarris
Partner
Athens
+44 20 7852 7818
Dimitrios.Psarris@oliverwyman.com

Martin Rauchenwald
Partner
Zurich, Vienna
+41 44 55335 26
Martin.Rauchenwald@oliverwyman.com

Martin Sanchez
Partner
London
+44 20 7852 7625
Martin.Sanchez@oliverwyman.com

Henning Tielker
Principal
Munich
+49 89 93949 776
Henning.Tielker@oliverwyman.com

Vicente Vazquez Bouza
Partner
Madrid
+34 91 432 8456
Vicente.VazquezBouza@oliverwyman.com

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CONTACT

sustainable.restructuring@oliverwyman.com

+49 89 939 49 780

+49 89 939 49 501

www.oliverwyman.com

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