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Hippocrates Resolution Process Considerations

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Jefferies International Limited
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Private Sale Process Description

Process Description

Overview

- In order to carry out a private sale of the institution and with the objective of ensuring a competitive process, Hippocrates hired two highly reputable investment bank (Lazard) to assess the potential interest in such transaction of a large universe of candidates around the world, not only national and international banks as well as investment firms with track record of investing in regulated financial institutions.
- As per the document attached as Appendix, Lazard's work was carried out taking into consideration two key aspects, among others:
    a. criticalness to maintain the strictest confidentiality to avoid any disturbance in the day-to-day business of Hippocrates, which would imply having conversations in a “non-deal related” way to avoid leakage of information, but oriented to entering into an acquisition of a Spanish large/ medium-sized bank
    b. maximize the competitiveness of the process to ensure Hippocrates was able to identify the best possible buyer
- Taking into account the abovementioned criteria, Lazard carried out a sounding of the interest of 35 potential bidders (5 national entities, 25 international banks and 4 investment firms), at the highest levels of the institutions supported by its worldwide network. After the dialogue with all potential bidders, the conclusion was that the most interested parties in Hippocrates would be the larger Spanish banks and specifically BBVA and Banco Santander as a result of the lack of interest in buying the institutions shown by international banks or international firms. Price was not a factor in any of them. Following this preliminary sounding analysis, and with the aim of having more competition in the process, JP Morgan, on behalf of Hippocrates, launched a competitive private process focused on the 5 larger Spanish banks. It is important to note that even after the high media coverage of the sale process, none of the previously contacted parties contacted either Lazard or JP Morgan again to show their interest in the transaction or even in understanding the Hippocrates situation.
- We understand that four parties finally showed appetite for the opportunity, signed the NDA and were given access to a complete VDR on the 5th of May, being involved since then in a Due Diligence and Q&A process. However, only two of those parties submitted a Letter of Interest (May 15th – 16th) and remain active in the process as of now.

Procedural Requirements

Sale Process Considerations – Procedural Requirements (BRRD Art.39)

Key Elements

- According to Article 39 of BRRD "…A resolution authority shall market, or make arrangements for the marketing of the assets, rights, liabilities, shares or other instruments of ownership of that institution that the authority intends to transfer."
- In this process, the resolution authority is fully respecting all of the marketing requirements set out in article 39(2) of the BRRD. The process is:
  a. Transparent and not materially misrepresenting the assets, rights, liabilities, etc. that the authority intends to transfer
  b. Not unduly favoring or discriminating between potential purchasers (which shall not prevent the resolution authority from soliciting particular potential purchasers in accordance with article 39(2) second subparagraph).
  c. Free from any conflict of interest
  d. Not conferring any unfair advantage on a potential purchaser
  e. Aiming at maximizing the sale price
- The resolution authority may apply the Sale of Business tool without complying with the requirement to market as laid down before when it determines that compliance with those requirements would be likely to undermine one or more of the resolution objectives and in particular if the following conditions are met:
  1. It considers that there is a material threat to financial stability arising from or aggravated by the failure or likely failure of the institution under resolution; and
  2. It considers that compliance with those requirements would be likely to undermine the effectiveness of the sale of business tool in addressing that threat or achieving the resolution objective

Private Sale Process Qualifying

Process Qualifying – Considered Alternatives

Considerations

- In order to comply with procedural requirements according to BRRD art. 39 the Sale of Business Resolution scheme needs to be a competitive process, free of conflict of interest and needs to aim to maximize value, within the context of maintaining financial stability as described in previous pages, all of which requires a significant marketing effort.
- Due to the need to complete the marketing in a non-standard and extremely short timeframe it is impossible to efficiently and successfully carry out a full marketing process from scratch. Therefore the marketing of the resolution unquestionably must rely on the private sales process marketing carried out.
- We understand that private sale marketing was performed according to M&A (mergers & acquisitions) international market standard practices, taking into consideration all necessary prudency measures needed for the Hippocrates situation.
    - Following market practices, an international, confidential, non-blind and informal market sounding was conducted to obtain preliminary feedback from potentially interested buyers. This is a market practice and feedback is normally accurate
    - The market sounding process was carried out by a credible and recognized financial advisor (Lazard) among the financial services industry at the appropriate seniority levels of the potential buyers
    - Potential parties' selection took into consideration a technically appropriate criteria for Hippocrates circumstances: i) Combination with a large international group, ii) Acquisition of a financial investor, iii) Combinational with a larger national group, iv) merger of equals.
    - In our view selected parties contacted during market sounding efforts meet the criteria regardless OF the final end game, either a private sale of a EU resolution outcome.
    - Despite the extreme confidentiality needed in order to carry out the market sounding process, a wide and complete list of potential buyers were approached.
    - Hippocrates did not receive any pro-active approach from any interested parties. Market participants with moderate or low interest normally would have approached Hippocrates/advisors just to confirm its preliminary views, irrespective of price considerations. Hippocrates did NOT deny invitation to the process to any party
    - All potential buyers that showed interest from the market sounding were formally invited to the process, indicating transaction description, access to VDR, Management and Q&A process.
    - We believe the private sale process terms and conditions presented by Hippocrates were flexible and open to different perimeter structures, not misinterpreting /contradicting the overall resolution scope (business, assets and liabilities).
    - It is also our current understanding that there was no specific reference made to a minimum or reserve price, perimeter or structure restriction to any of the potential buyers that prevented them to study the transaction

Considered Alternatives Debriefing

Alternatives Merits / Weaknesses

Option 1 - contact more bidders than the 5 that had access to the private process

- ✓ Having more bidders into the process would in principle increase the competitiveness of the process, in line with the procedural requirements and objectives (more transparency, no purchasers discrimination, sale price maximization)
- ✓ Some bidders might not have had interest in the private sale process but could have interest in a resolution process
- ✗ Bidders which have not had access to the data-room in the private process and/or that do not have a profound knowledge of the markets and activities in which Hippocrates operates will find it almost impossible to execute a transaction in the short timeframe required by the resolution process
- ✗ Increases probability of leakage from not only the potential buyers, but also its advisors. Any such leak is likely to reduce the success of the Sale of Business Resolution Process as a result of the increase in pace of the retail deposit flight as well as the capacity of Hippocrates to finance itself in the wholesale market, shortening the time available and making it even more difficult for potential buyers to bridge any such liquidity gaps
- ✗ Selection of which new bidders would be itself discriminatory as we would need to support well which new bidders to invite to the process and which not to invite

Option 2 - contact only the 5 bidders that have signed the NDA of the private process

- ✓ Is there real interest from additional buyers? The private process has been publicly acknowledged by Hippocrates and was widely reported by Spanish and international media
- ✓ In addition, it is also public knowledge that Hippocrates has a weak capital position and that a resolution process could be considered if the private sale process was not a success. We would have expected that any interested potential buyers would have reach out to Hippocrates or its advisors, which has not happened
- ✓ Reduces risk of confidentiality leaks
- ✓ Focuses on institutions that are capable of executing the transaction in the short time frame available
- ✓ Provides a clear and objective rationale for selecting the potential bidders

Conclusion

Conclusion

Based on all of the information we have at this stage as described in the previous pages, our conclusions are as follows:

1. The private sale process carried out by Hippocrates with the support of JP Morgan and Lazard followed standard market practices for processes of this nature for a banking institution in the situation Hippocrates is in and the technical criteria for the selection of the potential buyers contacted was appropriate

2. The Sale of Business Process under BRRD article 39 can and should leverage on the private sale process carried out by Hippocrates and its advisors given the very demanding time constraints

3. The private sales process provides strong support to qualify the Sale of Business Process to be carried out (as described below) as being transparent, competitive and non discriminatory

4. Contacting potential buyers that have not signed the NDA and/or that are not intimately familiar with Hippocrates and the market in which it operates at this stage would not add any relevant competition or transparency to the Sale of Business Process and could call into question the non-discriminatory nature of the process and, critically, potentially create catastrophic liquidity tensions to Hippocrates and precipitate other resolution alternatives that would create greater damage to financial stability

5. Given all of the above, we believe the Sale of Business Process restricted to the potential buyers that have signed NDAs and/or that have a profound understanding of Hippocrates and the market in which it operates would be the best way forward

Appendix: Lazard Report - Strategic Alternatives for Hippocrates Assessed

[redacted]

Banco Popular

LAZARD

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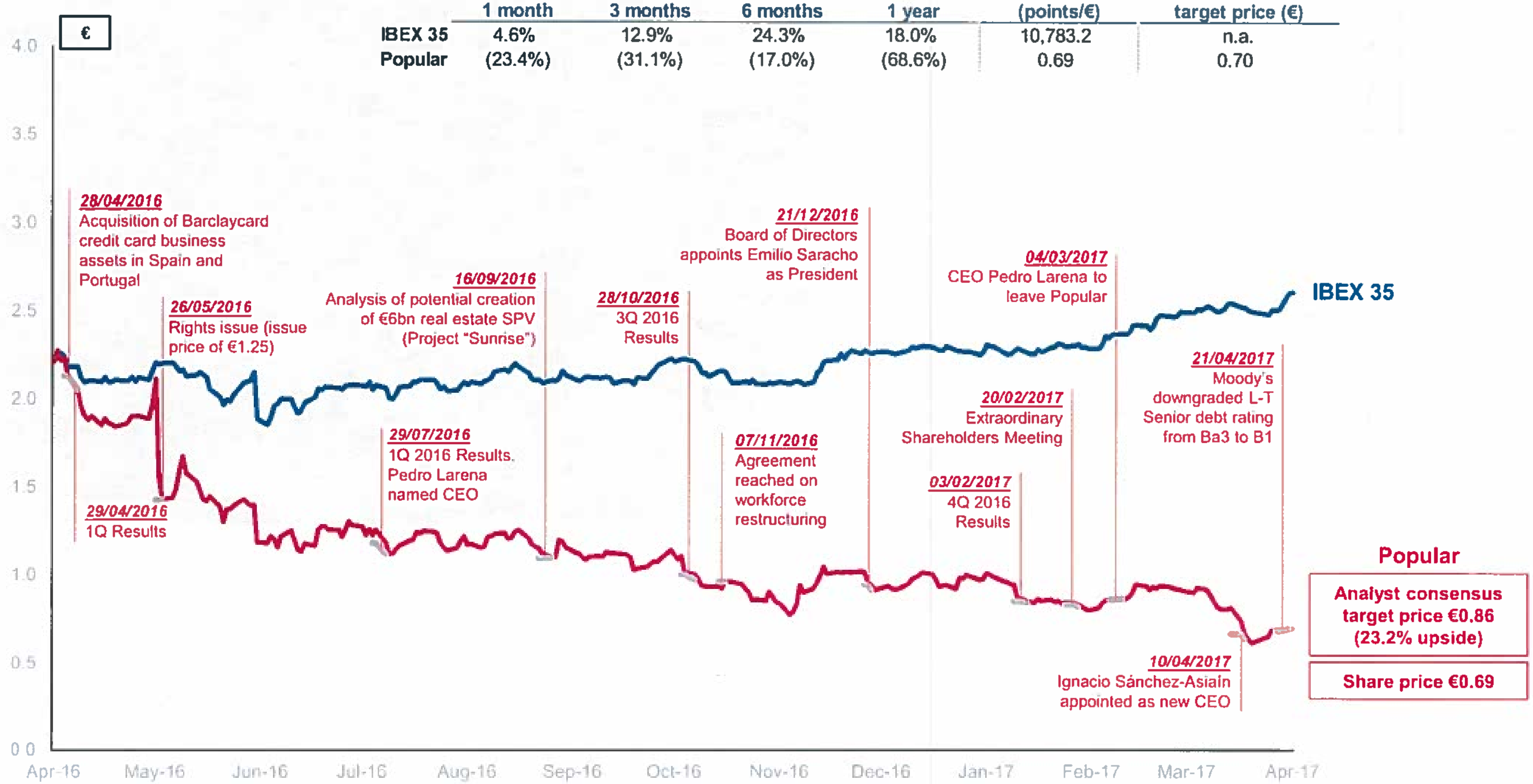
Introduction

- **The purpose of this document is to assess the potential interest of a large universe of banks around the world in the acquisition of Banco Popular**
- **This analysis has taken into account the deep understanding of each of the potential interested bidders that exist across the worldwide office network of Lazard**
- **Our conclusion is that the most interested parties in Banco Popular would be BBVA and Banco Santander, as they would be able to extract more synergies out of the potential integration**
  - We have estimated the net present value of the synergies in c. €4.5bn in case of a transaction with a large Spanish bank such as BBVA or Santander
  - Another factor which would be important in a potential transaction is the ability to manage and underwrite the NPA portfolio of Banco Popular, and we believe these would be better managed by a bank such as BBVA or Santander
- **In our view, the other potential alternatives considered in this document (i.e. integration in other large banking groups, merger of equals, acquisition by a financial sponsor) would deliver less value to Banco Popular's shareholders**
  - This is mainly due to the lack of synergies in case of a new entrant to the Spanish market where there is no large international banking group with a significant presence
  - But also to the fact that in most cases Spain is not part of their core strategic priorities and these groups would not be prepared to pay a strategic premium
- **It should be possible to create enough competitive tension between BBVA and Santander in order to maximize the value for Banco Popular's shareholders**
  - In our view it is critical to maintain the strictest confidentiality to avoid any disturbance in the day-to-day business of Banco Popular
  - An alternative to a corporate transaction would be to maintain the independence and the need to raise additional capital. This alternative should be analyzed and compared with a corporate transaction in the context of value creation to Banco Popular's shareholders

Popular Share Price Performance

	1 month	3 months	6 months	1 year	Current share price (points/€)	Analyst consensus target price (€)
IBEX 35	4.6%	12.9%	24.3%	18.0%	10,783.2	n.a.
Popular	(23.4%)	(31.1%)	(17.0%)	(68.6%)	0.69	0.70



Source: Factset, Bloomberg (25/04/17)

Strategic Alternatives for Banco Popular

Potential Candidates

Alternatives Analyzed → Best Bidders

[redacted]

Comments

A detailed analysis has been made to determine the best alternative for Popular shareholders

- **The analysis has peen performed taking into account the following alternatives:**
  - Combination with a large international group
  - Acquisition / entry of a financial investor
  - Combination with a larger group
  - Merger of equals
- **Our conclusions take into account our deep understanding of each of the bidders across Lazard's worldwide network**

Strategic Alternatives for Banco Popular (cont'd)

Our conclusion is that the most interested parties in Banco Popular would be BBVA and Banco Santander, as they would be able to extract more synergies out of the potential integration and have the ability to manage and underwrite the NPA portfolio

A combination with <u>various international banks</u> has been analyzed

- Limited / no synergies result in a competitive disadvantage vs. large local banks
- Extensive due diligence required, both at Banco Popular and Spanish banking system level
- Regulatory approvals required in not EU
- Lack of experience managing NPAs
- Spain not being a focus area for a number of international banks at the moment

The entry of an <u>international fund</u> has been analyzed

- No synergies attained, result in a competitive disadvantage vs. large local banks
- Good understanding of Spanish NPAs and capacity underwrite these assets
- High returns targeted, resulting in no premium / reduced valuation
- Regulator likely to be more strict vis-à-vis banks
- Portugal, Italy and Greece being the preferred destinations for international funds at the moment

A merger of equals with <u>Banco de Sabadell</u> has been analyzed

- Valuation of Banco Popular would not include a significant premium
- Valuation can only be determined after extensive and complex mutual due diligence, which is more relevant than in case of integration into a much larger entity
- Complexity of resulting corporate governance

[redacted]

A combination with <u>Santander, BBVA and CaixaBank</u> has been analyzed

- Potentially higher premium achieved vis a vis small / mid-sized banks due to increased synergies (significant branch overlap)
- Large entities would require a capital increase which would help carrying out a provisioning effort
- Less complexity on resulting corporate governance
- [redacted]

In addition, transaction results in too large concentration in Span

[redacted]

Analysis of Selected Potential Alternatives

	Santander ☑	BBVA ☑	CaixaBank	Sabadell	Popular
Market Cap	€88bn	€50bn			
Position in Spanish Ranking	Combined entity #1 (€460bn)	Combined entity #1 (€481bn)			
Branch Overlap [1]	76%	67%			
Cost-to-income [2]	54%	63%			
Synergies Potential (% of Target Opex)	● • Achieved 44% in Banesto merger	[redacted]			n.a.
% Popular in Combined Entity	0% premium: 3% 25% premium: 4% 50% premium: 5% 100% premium: 6%	[redacted]			100%
Premium	● • Capacity to pay a significant premium	[redacted]			n.a.
International Fit	● • Leader in Europe, Latam and UK; presence in US and consumer finance	◕ • Leader in South America and presence in the US	◔ • Focus in Spain and Portugal	◔ • Focus in Spain and UK	n.a.

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Note: Data as of 2016 year-end
Source: Publicly available information, SNL Financial
1 % of branches of the target within<1km of the acquiring entity
2 Cost-to-income = total operating expense / total operating income

Analysis of Selected Potential Alternatives (cont'd)

	Santander ☑	BBVA ☑	CaixaBank	Sabadell	Popular
CET 1 FL	10.6%	10.9%			
NPA Coverage (Spain)	58%	[redacted]			
Cost of risk [1]	[illegible]				
ROAE	[illegible]				
Potentially Incompatible JVs	[redacted]		[redacted]		n.a.
Other Potential Concerns	• Brexit impact in UK business				n.a.

Note: Data as of 2016 year-end
1 Annualized loans and credit commitments impairment / Net loans to customers. Verde as reported.
2 Recurrent

Attractive Synergies Generation with Large Domestic Players

As a result of a preliminary analysis, for illustrative purposes and subject to additional due diligence, the combined entity could generate synergies of c.€4.5bn (VAN)

- **The main assumptions of the analysis are: (i) <u>43%</u> operating cost synergies (median of precedent transactions) and (ii) 150% restructuring costs**
  - Similar assumptions can be used for Santander, BBVA and CaixaBank (to be refined based on each player strategy and branch overlap -see appendix-)
  - Santander achieved 44% in Banesto merger [redacted], and [redacted]

Cost Synergies Analysis

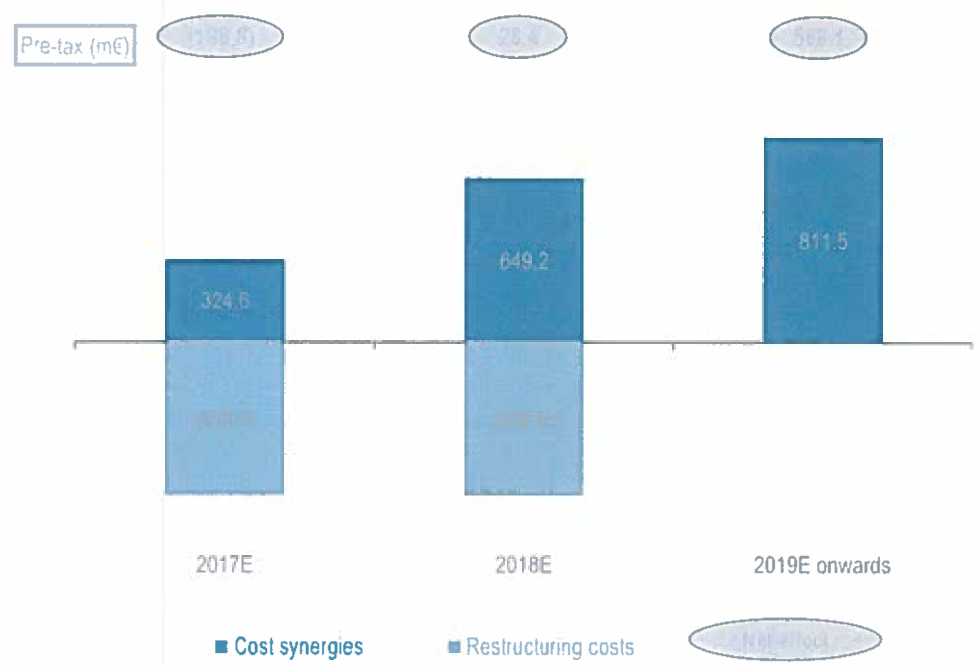
Cost synergies (% of Popular costs) in transactions of the Spanish banking sector[1]	**43%**
Restructuring costs (% of cost synergies fully implemented)	**150%**

Phasing / Assumptions

	2017E	2018E	2019E
Cost synergies	**40%**	**80%**	**100%**
Restructuring costs	**50%**	**50%**	**--**

NPV of cost synergies estimated[3]: €4,537m

Potential Synergies



Source: publicly available information, Lazard estimates
1 Data based on banking transactions in Spain in the last years (see appendix)
2 Includes personnel expenses, other general administrative expenses and amortization
3 NPV as of 31/12/16, assuming a tax rate of 30% and a 10% cost of equity

Assessment of Interest by International Banks in Banco Popular

The following assessment is based in Lazard's deep knowledge of the senior management of each of the institutions mentioned below and it is based on our continued dialogue with their CEOs, CFOs and Heads of M&A

FRANCE

BENELUX

NORDICS

ITALY

GERMANY

[redacted]

Assessment of Interest by International Banks in Banco Popular (cont'd)

UK	[redacted]
US	[redacted]
CANADA	[redacted]
LATAM	[redacted]

Assessment of Interest by Selected Private Equity Firms

Certain private equity funds have the financial strength and knowledge to enter in Banco Popular. However, this route would be more complex than the merger with another bank

- **These financial investor have banking expertise and are capable of underwriting and managing NPAs**
- **A number of these funds have European banking vehicles which could facilitate a transaction**
- **However are focused on high returns (resulting in no premium / reduced valuation) and distressed situations, not usually competing with incumbents**

[redacted]

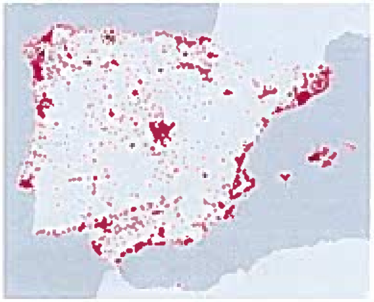
Appendix

Santander/ Popular Branch Overlapping

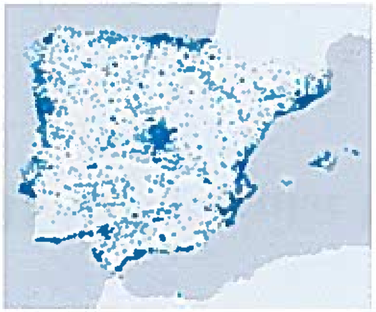
Branch overlapping allows the generation of synergies without damaging the revenue generation capacity

Geographical Presence (2016)

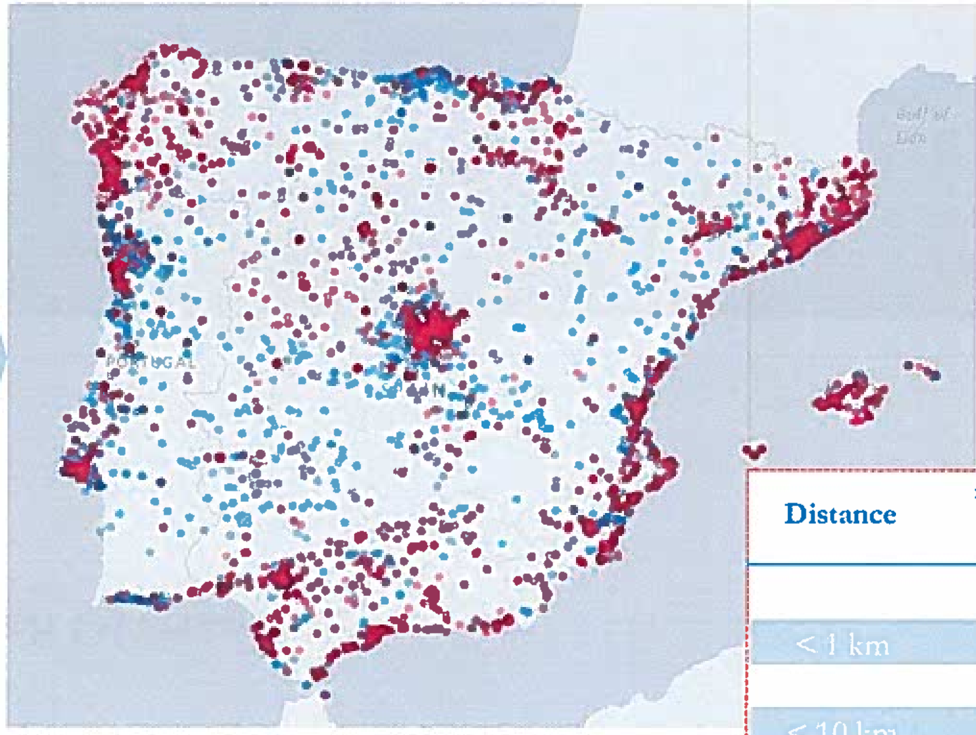
[redacted] Popular



[redacted] Santander



4,732 Santander + Popular



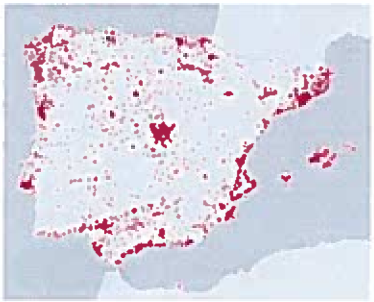
Distance	# Popular Branches	% Popular Branches	% Combined Branches
< 1 km	1,302	75%	28%
< 10 km	1,540	89%	33%

Source: Companies, SNL Financial

BBVA/ Popular Branch Overlapping

Geographical Presence (2016)

[redacted] Popular



[redacted] BBVA

[redacted]

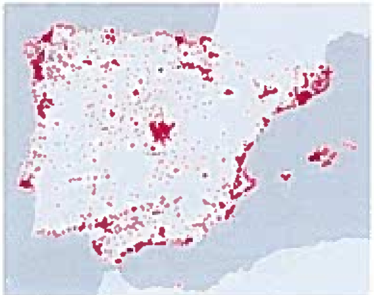
[redacted]

Source: Companies, SNL Financial

CaixaBank/ Popular Branch Overlapping

Geographical Presence (2016)

Popular



[redacted]

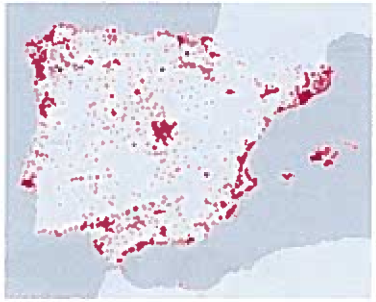
[redacted]

Source: Companies, SNL Financial

Sabadell/ Popular Branch Overlapping

Geographical Presence (2016)

[redacted] Popular



[redacted]

[redacted]

Source: Companies, SNL Financial

Precedent Transactions Synergies

[redacted]

	Announ. Date	Synergies as % of Opex	
		Target	Combined Entity
[redacted]			

Source: *Publicly available information*

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