

# Advice for the sale of Propertize

NL Financial Investments

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*October 2015*



NL financial investments

## Foreword

In this letter, the Stichting administratiekantoor beheer financiële instellingen acting under the name NLFI advises the Minister of Finance on returning the Propertize shares held by NLFI, to the private sector.

This advisory report is partly based on an intensive and constructive collaboration between NLFI and Propertize. We also owe our gratitude to the Ministry of Finance for providing its opinion on draft versions of this report. While drafting this advisory report, we also exchanged views with Dutch central bank.

In addition, discussions were held with a number of investment banks, financial and legal advisors, market players and other experts who shared their views with us. We are very grateful to all those who helped us produce this document.

NLFI,

October 2015

This is a translation of the original text in Dutch. In case of divergences between the texts, the text of the Dutch version shall prevail.

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## Summary

Since its establishment in 2013, Propertize has taken important steps towards reducing its portfolio of commercial real estate loans and properties. Propertize aims to manage this portfolio down by 2023 as cost-efficiently and cost-effectively as possible. The reduction strategy defined in 2013 was focused on waiting for the property market to recover and in the meantime enabling the Propertize organization to gain a better understanding of and insight into the portfolio and to develop Propertize into an independent organization. Based on an analysis of the market for commercial real estate loans, it can be said that market conditions have changed significantly since 2013, which means that an alternative strategy can be considered at this time.

From a risk perspective, a sale of Propertize in its entirety appears to be an attractive option when compared to the continuation of the current reduction plan. Due to the favourable market conditions, higher-quality credits are rapidly moving out of the portfolio because customers are able to refinance with parties where they can also be serviced for future financing needs— after all, Propertize as a run-off organization cannot by definition offer its customers any perspective for future loans. An additional risk of a dwindling portfolio is that the same problem of future perspective comes into play for Propertize employees as well. The combination of these two factors could lead to a Propertize with a smaller, lower quality portfolio, an unstable base of employees and possibly a higher operational risk (these elements together form a “tail risk”). A sale of Propertize altogether may offer new perspectives for clients and employees alike.

Partly based on research conducted by advisors hired by NLF1, NLF1 concludes that the various preconditions for the possible sale of Propertize are met. The liquidity of the real estate market shows a recovery supported by favourable growth prospects for the Dutch economy and low interest rates. As a consequence of relatively high (real estate) yields in the Netherlands, it currently seems that there is ample liquidity and therefore interest of market players. Finally, Propertize itself is sufficiently ready for sale as a company.

Once the decision has been taken to allow buyers to submit offers, an open and competitive process can be started in the fourth quarter of this year. The goal is to achieve a price that is higher than the initial EUR 0.5 billion capital contribution from the State with as few guarantees and indemnifications as possible. The time schedule is aimed at signing a purchase contract in early 2016.

NLF1 recommends starting the process of selling Propertize along the lines described in this advice following your approval to do so. NLF1 requests that you grant NLF1 power of attorney to execute the strategy on behalf of the State as described in this recommendation to sell the shares of Propertize and perform all the related work as defined in article 3, paragraph 2, under b, sub 2 of the NLF1 Act.

## 1. Introduction

With the nationalization of SNS REAAL NV (“SNS REAAL”) on 1 February 2013, the State owned 100% of SNS REAAL, including all components belonging to the group, which included REAAL NV and SNS Bank NV. In your letter to the House of Representatives on 1 February 2013,<sup>1</sup> you announced that it planned to isolate SNS Property Finance, the real estate branch of SNS Bank from the rest of SNS REAAL. The shares held by the State in SNS REAAL were transferred on 31 December 2013 to Stichting administratiekantoor beheer financiële instellingen<sup>2</sup> (“NLFI”) in exchange for certificates. On the same day, the separation of SNS Property Finance became effective (the name of SNS Property Finance was subsequently renamed Propertize). Since then, NLFI has managed the State’s holdings in SNS REAAL and Propertize BV (“Propertize”) in addition to the State’s holdings in ABN AMRO Group NV and ASR Nederland NV.

In your letter to the House of Representatives on 1 February 2013, you indicated that isolating Property Finance from the rest of SNS REAAL was needed to achieve a break with the past and thus to allow the real estate organization to operate financially and operationally fully independent from SNS REAAL. Propertize was mandated to reduce its portfolio of mortgages and property under its own management in the medium term as cost-efficiently and profitably as possible. With regard to the reduction, it was stipulated that if liquidity returned to the market, Propertize would need to reduce its portfolio as quickly as possible. During the last period, Propertize’s board has implemented this plan. Liquidity in financial markets has now improved, leading to an acceleration of the reduction of the portfolio. Due to the high degree of liquidity, it appears at present that there is an opportunity to sell Propertize as a whole within the foreseeable future.

With this letter, NLFI advises the Minister of Finance on the exit strategy for Propertize. The advice is primarily focused on options for returning the shares held by NLFI in Propertize as a whole to the private sector. This in accordance with NLFI’s legal purpose as laid down in the Trust Office Foundation for the Management of Financial Institutions Act (Wet stichting administratiekantoor beheer financiële instellingen, the NLFI Act).<sup>3</sup> On authorization by the State of the Netherlands, NLFI shall implement this strategy on behalf of the State.

In drawing up this advisory report, NLFI was guided by the statutory description of NLFI’s goals. In discharging its statutory task and in exercising the rights associated with the shares held by NLFI, NLFI has focused primarily on the financial and economic interests of the State, while taking into consideration the interests of the company, its affiliated companies and the employees involved. The advice includes an assessment of NLFI, regarding, among other things, market conditions and the state of readiness of Propertize for an exit. NLFI has partly based its advice with regard to these aspects on the opinions of external advisors<sup>4</sup>.

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<sup>1</sup> Kamerstuk Tweede Kamer der Staten Generaal, vergaderjaar 2012–2013, hoofddossier 33532, nr. 1 (House of Representative, session 2012–2013, main dossier 33532, No. 1).

<sup>2</sup> Stichting administratiekantoor beheer financiële instellingen operates under the name NLFI.

<sup>3</sup> Article 3, second paragraph, section b, at 1° of the NLFI Act.

<sup>4</sup> Advisors to NLFI have, among other things, investigated market conditions and potential interest from buyers, the legal and financial readiness of Propertize and the valuation of Propertize in the current market conditions.

With regard to the sale of Propertize, the decision-making framework for the privatization and empowerment of government services<sup>5</sup> dated 30 October 2012 has been taken into account. The essence of the framework is that the State must be able to act in a way that is both commercially responsible and verifiable. The decision-making framework defines five different phases. Your ministry has indicated that the process is currently in the phase where the decision to privatise is being implemented, i.e. phase four. Since 2013, the reduction of the Propertize portfolio has been put in motion based on your decision of 1 February 2013. The accelerated managing down of the credit and real estate portfolio of Propertize through a one-off sale can also be seen in that light.

## 2. Current situation of Propertize

After the nationalization of SNS REAAL, Propertize was instructed manage down its portfolio of mortgages and property under its own management within ten years (until 2023) in a controlled manner. The objective is to optimise returns and to scale down the risk of the portfolio as quickly as possible – and new risks should be avoided as much as possible. Once liquidity has returned to the market, Propertize should realize the reduction as soon as possible. Expectations about the liquidity in the market, therefore, determine the primary reduction policy of Propertize. Propertize cannot determine its policy based on an interest rate vision or expectations about future increases or decreases.

In the past two years, the credit and real estate portfolio of Propertize has demonstrably been reduced. At year-end 2012, the gross exposure (before the provision for loan losses) of the credit and real estate portfolio of Propertize amounted to EUR 8.2 billion. As of the end of June 2015, this exposure was reduced to EUR 5.9 billion of which EUR 5.6 billion in loans and EUR 0.3 billion in real estate directly owned. After provisions, the credit portfolio of Propertize amounts to EUR 4 billion, of which the vast majority is in the Netherlands with an average LTV (loan to value) of 75%.

Table 1: Gross and net exposure of Propertize<sup>6</sup>

(EUR millions)	2012	2013	2014	2015 H1
Outstanding loans (gross)	7,832	6,702	5,847	5,643
Provisions	(1,217)	(1,786)	(1,625)	(1,665)
<b>Outstanding loans (net)</b>	<b>6,615</b>	<b>4,916</b>	<b>4,222</b>	<b>3,978</b>
Real estate projects	416	810	696	305
<b>Total net exposure</b>	<b>7,031</b>	<b>5,726</b>	<b>4,918</b>	<b>4,283</b>

In total, since June 2012 to June 2015, EUR 1.95 billion was written down on loans and real estate. A total valuation amounting to EUR 2.8 billion was assumed at the nationalization (“mid-point” in the Cushman & Wakefield). The required buffer after taxes is provided to Propertize by SNS Bank in the form of a share premium. The Cushman & Wakefield midpoint was an estimate of the expected depreciation at the time of preparation of analysis compared to the state of the

<sup>5</sup> Parliamentary Research Committee report entitled “Verbinding verbroken?” (Connection broken) dated 30 October 2012 Privatization/Empowerment of Government Services (2012), Eerste Kamer (Dutch Upper House), session 2012-2013, C.A.

<sup>6</sup> On the basis of (semi) annual reports of Propertize

portfolio on 30 June 2012.

As indicated, there have been positive developments in the sector since that time which could positively affect the resulting write down of the portfolio going forward. In its annual report for 2014, Propertize indicated the ambition to reduce losses. To what extent additional write downs are necessary during the term of the loans will have to be determined by potential bidders. This estimate may affect the price that is offered for Propertize.

Table 2: Over Cushman & Wakefield buffer (before tax)<sup>7</sup>

(EUR millions)	Movement	Balance
Cushman & Wakefield buffer 30-6-2012		2,800
Write-downs H2 2012	(776)	
Write-downs 2013	(1,057)	
Write-downs 2014	(102)	
Write-downs H1 2015	(16)	
<b>Total</b>	<b>(1,951)</b>	<b>849</b>

At year-end 2014, the IFRS equity amounted to EUR 1.2 billion, of which a significant part relates to assets earmarked for potential future write downs. At year-end 2014, the reported freely available capital amounted to EUR 527 million.

By the end of 2014, Propertize employed approximately 200 (FTE) employees (internal and external). Since Propertize is an organization being managed down, a social plan was agreed with the trade unions for the employees. Propertize has already made a provision for the costs of the social plan.

#### *Capital expenditures*

Propertize was allocated a EUR 500 million capital injection. This is reflected in table 3. The amounts do not include the State's capital costs (including interest expense) and dividend payments received and other payments or costs.

As of the end of June 2015, the financing with a State guarantee amounted to approximately EUR 3 billion, consisting of EUR 2.6 billion Medium Term Notes (MTN) with different maturities up to 2019 and EUR 0.4 billion in commercial paper of which a significant part will soon be repaid from the proceeds of the portfolio reduction.

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<sup>7</sup> On the basis of (semi) annual reports of Propertize.

Table 3: Overview of capital expenditure by the State of the Netherlands<sup>8</sup>

Description	Date	ABN AMRO	a.s.r.	RFS	SNS REAAL	Propertize	Total
Nationalization Fortis Nederland	okt-2008	€ 12.800 mln	€ 4.000 mln				€ 16.800 mln
Providing core capital SNS REAAL	nov-2008				€ 750 mln		€ 750 mln
Recapitalization ABN AMRO	dec-2008	€ 4.320 mln		€ 2.220 mln			€ 6.540 mln
Sale of Fortis Corporate Insurance	jul-2009		€ (350) mln				€ (350) mln
Mandatory Convertible Note (MCN) I	jul-2009	€ 800 mln					€ 800 mln
Repayment portion core capital	nov-2009				€ (185) mln		€ (185) mln
MCN II and conversion loans to EV	dec-2009	€ 3.150 mln					€ 3.150 mln
Settlement and capitalization RFS	mrt-2010			€ 438 mln			€ 438 mln
Not received coupon payment MCN	apr-2010	€ 103 mln					€ 103 mln
Remaining recapitalization ABN AMRO	jun-2010	€ 490 mln					€ 490 mln
Repatriation of RFS capital	dec-2011			€ (16) mln			€ (16) mln
Expropriation SNS REAAL	mrt-2013				€ 2.200 mln		€ 2.200 mln
Providing bridge financing	mrt-2013				€ 1.100 mln		€ 1.100 mln
Capitalisation Propertize	dec-2013					€ 500 mln	€ 500 mln
Resolution levy SNS REAAL	Mar-Jul 2014				€ (1.000) mln		€ (1.000) mln
Sale of Vivat	jul-2015				€ (0) mln		€ (0) mln
Legal restructuring SNS Bank	sep-2015				€ 0 mln		€ 0 mln
<b>Total expenses</b>		<b>€ 21.663 mln</b>	<b>€ 3.650 mln</b>	<b>€ 2.642 mln</b>	<b>€ 2.865 mln</b>	<b>€ 500 mln</b>	<b>€ 31.320 mln</b>

### 3. Future of Propertize

Based on the analysis of external advisors of NLFI and Propertize itself, NLFI concludes that market conditions have changed significantly since the nationalization in 2013, which is why a different strategy can be considered at this time.

From a risk perspective, the continuation of the reduction in the present setting is less attractive than some alternatives. Due to the favourable market conditions, the reduction will increase but the higher-quality credits will rapidly disappear from the portfolio because these customers are able to refinance with parties where they can also be serviced for future financing needs (by definition, Propertize cannot offer its customers any (re)financing prospects).

An additional risk of a dwindling portfolio is that the same problem of future perspective comes into play for employees. Employee retention is therefore increasingly urgent as the (time) horizon of the business changes.

The combination of these factors can lead to a Propertize with a smaller portfolio of lower quality, an unstable base of employees and possibly a higher operational risk. It is challenging for Propertize in its current form and with its current mandate to adequately manage this tail risk. In fact, a dilemma manifests itself between the requirements of a controlled reduction (risk) and the accelerated reduction when the market offers the opportunity through increased liquidity.

A sale of Propertize in its entirety may offer new perspectives for employees and can reduce other operational risks. The sale of Propertize as a whole is therefore an appropriate option from the perspective of the State if the conditions of sale such as revenue and contractual obligations prove sufficiently attractive.

<sup>8</sup> The proceeds from the sale of Vivat by SNS REAAL Holding was 1 euro. The restructuring of SNS Bank by SNS REAAL Net Holding has no effect on the capital expenditure of the State.

## 4. Preconditions for the sale of Propertize

With regard to the sale of the Propertize shares, applicable preconditions are that the financial sector is stable, that the market has sufficient interest and that the company is ready. The interpretation of these preconditions with regard to the sale of Propertize is explained below.

### *(i) Is the sector stable?*

The macroeconomic conditions in the Netherlands have clearly improved since 2013 and the recovery has continued this year. The interest rates are currently historically low. This has led to a growth in demand for yield by investors that can be found, among others, increased demand for real estate investments and real estate related loan portfolios.

The number and total value of transactions in the real estate (loans) market increased sharply in 2014 and 2015, even though the real estate market seems to show little fundamental signs of recovery in some segments. The increase of liquidity in the market, partly as a result of quantitative easing by the ECB, suggests that this trend will continue.

The property market in the Netherlands has seen a strong increase in transaction volumes in offices, residential, retail and warehouses (logistics): in 2014, the total value of transactions of over EUR 6 billion increased significantly compared to 2013 (EUR 2.4 billion). There are two overarching reasons that can be given for this increase. First, the initial yield (rental income relative to investment) has risen for years to a point where it is of interest for many investors to enter the market. Current yields in the market are not only higher in absolute terms but due to the prolonged decline in interest rates, also relatively. This also makes it attractive for institutional investors with a longer term focus to invest in Dutch real estate. The second reason is the increasing interest of foreign parties in the Dutch market. It should be noted that the recovery of the Dutch property market is particularly evident in real estate of relatively good quality (near centres with high economic activity, good accessibility, modern buildings) and to a lesser extent, in real estate of lower quality.

The “secondary loan market” (buying and selling of existing loans) in Europe has also seen a large increase in transaction volume. In the Netherlands, there have not been enough transactions in loan portfolios to reflect the activity in the market. The total value of transactions in European loan portfolios with real estate as collateral has increased significantly since the beginning of 2014. The total transaction value in 2014 was EUR 80.6 billion, an increase of 156% compared to 2013. In 2014, there were 16 transactions with a transaction volume of over EUR 1 billion. The sharp increase was particularly due to the transfer to the market of large portfolios of loans secured by real estate and real estate appropriated by government agencies, including State-owned “bad banks” or asset managers. Of all providers of loan portfolios in 2014 the Irish IBRC and NAMA, both institutionalized by the Irish government, were the largest providers of loan portfolios (together totalling approximately EUR 29 billion). In 2013 in Ireland and Spain, the government agencies IBRC/NAMA and SAREB were responsible for 59% and 40% of the transaction volume respectively. Private equity investors were the main buyers of European loan portfolios. A private equity party was the buyer in six of the ten largest European transactions.

The transaction volume of European loan portfolios was also high in the first quarter of 2015 with a total value of EUR 12.2 billion. A large part of this volume involves nationalized or government supported institutions and vendors. Based on current transactions, market participants estimate the total transaction value in 2015 between EUR 60-70 billion.

*(ii) Are any parties interested in purchasing Propertize?*

The described developments indicate that the dysfunction present in the market in 2012/2013 has largely disappeared. Among others, it seems that there is currently a lot of interest from different parties to invest in portfolios of loans with Dutch real estate as collateral. This is increasingly the case for larger portfolios than are currently available on the market. Especially with large packages of loans, a number of buyers are seeking an affiliate platform to subsequently manage such loans, where, in some cases, they own a company similar to Propertize elsewhere in Europe and can potentially create synergies in such areas as IT, asset management strategies, financing and personnel. The financing of such relatively large amounts of data will, given the exceptional market conditions, not be an obstacle. Several parties have indicated their interest in Propertize as a whole. Depending on the strategic intentions of the parties, there is also interest in Propertize as a platform for managing other (similar) loan portfolios.

*(iii) Is Propertize ready for sale?*

The readiness of Propertize for a possible sale is to be assessed on the basis of a number of factors which determine whether Propertize can function as an independent company. To assess this, NLF1 has asked various external advisors to examine legal, operational and financial aspects.

Since the split from SNS in 2013, Propertize has disentangled itself entirely and has further established itself as an independent organization in the areas of IT, human resources and risk management. There are no further dependencies with the SNS organization. In the field of IT, Propertize uses three systems for the management of leases, investment financing and project financing. With regard to its personnel, Propertize has built a strong autonomous organization in which a large part of the external FTEs are internalized. Approximately 190 FTEs are currently employed.

Propertize reports under IFRS, publishes detailed reports on the state of the portfolio versus business plan and monitors its own performance in the areas of internal controls, IT and staff. On 9 September 2013, DNB instructed Propertize in the area of controlled and managed business management. For Propertize, this instruction was a reason to intensify the improvement process that it had already started, which led to the introduction of the so-called Propertize Method in 2014. This has been validated by an external party which concluded that the design, existence and operation of the Propertize Method provides sufficient guarantee of controlled and sound business management. In December 2014, DNB informed Propertize that it had fulfilled the instruction.

*(iv) Objective is to recover as much of the State's total investment as possible*

Propertize was allocated a capital injection of EUR 500 million as shown in Table 3. A possible sale of Propertize will be focused at maximising the proceeds from the sale and thus recovering the State's investment as far as possible. Based on research of external advisors, NLF1 expects that

capital expenditures of the State can be recovered.

When evaluating the optimum sale, other factors in addition to the direct proceeds from the sale are relevant, such as contractual terms and how certain it is that the bidder really can finance the bid. These factors should be taken into account.

The price that potential buyers (of the credit portfolios) of Propertize are prepared to pay will depend, among others, on the expected interest income, the ratio of the outstanding loan and the underlying value (LTV), the operating costs associated with implementing and administering the loans in the portfolio and any expected claims from lawsuits as described in the annual report of Propertize. In addition, the method of financing is relevant to the pricing by the buyers and may potential buyers may assign value to the platform, depending on the strategic considerations of the bidder.

The existing State's guarantee on the funding attracted by Propertize may require adjustment at the sale, which can be determined during the sales process and the method of financing preferred by the buyer.

## **5. Design of the sales process**

Following your permission to start the sales process of Propertize, the sale will be carried out via an open, transparent and non-discriminatory process. Parties will be asked to submit bids and will a limited number of bidder will then be allowed to perform due diligence. Propertize has established a data room and made a so-called data tape available, which contains all the information that has been collected from the top 65 relationship complexes with specific loan and property information. This data tape is of sufficient quality to provide buyers with information to make a well-founded bid.

It is important that the process is structured such that the final negotiations can be conducted with multiple parties. When evaluating bids, the quality of the bid (including legal requirements) and the company's opinion will be taken into account, in addition to the proceeds of a sale. NLF1 shall conscientiously respect the advisory rights to which the works council is entitled to pursuant to the Wet op de ondernemingsraden (Works Council Act) subject to the boundaries of good governance relationships as laid down in legislation, regulations and codes.

The goal is to sign a sales contract in early 2016. Thereafter, if necessary, relevant supervisors will be asked to grant approval and the final buyer needs to attract funding and the transaction can be closed in the first half of 2016.

## **6. Recommendation**

Propertize manages down its portfolio of loans and properties under its own management in the medium term as cost-efficiently and profitably as possible. It is the aim to, when market liquidity permits, manage down the portfolio as fast as possible whilst maintaining a manageable risk profile and as such reduce the exposure of the Dutch State.

Given that the demand from the market seems to be driven by liquidity and to a lesser extent based on a permanent or fundamental recovery in a number of segments of the property market, it can be argued that the current demand may decrease based on the back of macroeconomic policies. This applies especially to the ECB's policy of quantitative easing. In addition, the risk of an accelerated decline of the healthy parts of the portfolio of Propertize increases, which, coupled with less desirable staff turnover, can lead to significant losses in the remaining portfolio in the last years of phasing out. It will be challenging for Propertize in its current form and with its current mandate to adequately mitigate this tail risk.

Based on the above developments and research conducted by external advisors, NLFI recommends selling Propertize as a whole. A sale of the Propertize shares held leads to a rapid and complete reduction of the State's interest. The various preconditions for the divestment of financial holdings are currently met in NLFI's view.

NLFI recommends starting the process of selling Propertize along the lines described in this advice, following your approval to do so. NLFI requests that you grant NLFI power of attorney to execute the strategy described in this recommendation to sell the shares of Propertize and perform all the related work as defined in article 3, paragraph 2, under b, sub 2 of the NLFI Act, on behalf of the State<sup>9</sup>.

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<sup>9</sup> Article 3, second paragraph, section b, sub 2 of the NLFI Act states: "to execute on behalf of the State the strategy referred to in part 'b' under (i) and to the extent authorized, to perform activities with a view to managing assets related to the shares and with a view to selling the shares".