Sabadell Securities

Sabadell Securities USA, Inc. is a securities broker and investment advisory firm. Sabadell Securities complements and enhances Sabadell's consolidation strategy with a focus on US-resident customers. It provides investment and wealth management services, mainly to personal banking and private banking clients. Its business strategy is based on meeting customers' financial needs by providing advice on capital market investments.

Sabadell Securities is a member of the Financial Industry Regulatory Authority (FINRA) and the Securities Investor Protection Corporation (SIPC). It uses the services of Pershing LLC, a Bank of New York Mellon subsidiary, for clearing, custodian and administrative services.

Asset Transformation

Asset Transformation

Banco Sabadell normalised its balance sheet in 2018 after announcing major sales of institutional portfolios.

Highlights

— Following the sharp reduction in recent years, the Group achieved its main objective of normalising its exposure to non-performing assets in 2018, and has now overcome the period of focusing on this asset class that resulted from the past economic crisis.

— The normalisation of non-performing assets was concentrated particularly in the area of real estate. The priority in 2018 was to make decisive progress in selling non-performing assets to specialised investors, resulting in a number of large transactions that achieved the ambitious targeted reduction in exposure. In 2018, non-performing assets were reduced by over €13,200 million (pro-forma), the largest single reduction since the crisis.

— The sharp reduction in NPAs in 2018 will lead to significant cost savings in future years, estimated at more than €150 million per year.

— In December 2018, it was agreed to sell 80% of real estate subsidiary Solvia, valued at €300 million, resulting in an estimated capital gain of €138 million. This transaction, which is expected to be completed in the first half of 2019, evidences the value created by the Group with this company, one of Spain's leading real estate solutions platforms.

Business overview

The Asset Transformation and Industrial and Real Estate Holdings Department horizontally manages non-performing loan and real estate exposures, as well as establishing and implementing the Group's real estate strategy, which encompasses its real estate subsidiaries, including Solvia and Solvia Desarrollos Inmobiliarios (SDIN).

With regard to non-performing loan and real estate exposures, the Department focuses on implementing the asset transformation strategy and on an integrated approach to the Group's real estate assets with a view to optimising recovery and maximising their value.

Management priorities in 2018

During 2018, Banco Sabadell moved decisively to reduce its non-performing real estate exposure, as a result of which it normalised the Group's real estate exposure during the year after carrying a sizeable volume of non-performing assets that arose from the economic crisis. A number of significant transactions were arranged to sell non-performing assets to specialised investors, completion of which is subject to certain conditions precedent that are expected to be fulfilled in 2019, enabling the Group to achieve the ambitious goal for 2018 of shedding non-performing exposures.

In connection with trends in non-performing loans and residual real estate exposure, the Group continues to deepen and optimise its transformation and management strategy for problem assets, guiding the actions of the Asset Transformation Business Unit, whose main goal is to improve the non-performing asset recovery and transformation processes with a view to maximising their value potential, either by managing them optimally or divesting them, whichever is the best option.

Nevertheless, despite normalising its non-performing exposures, the Bank maintains demanding targets for reducing non-performing exposure in the coming years. The strategy for managing and reducing non-performing assets (NPAs) is designed around three strategic priorities:

1. Constant reduction of NPAs until balances are normalised; major progress was made in this connection in 2018. This was and will continue to be the main goal of the Asset Transformation and Industrial and Real Estate Holdings Department, and it includes: (i) containing and normalising the classification of balances as non-performing, which is vital in order to ensure the future performance of the core business with a cost of risk that is aligned with the Group's risk profile and financial objectives; (ii) accelerating the reduction in the volume of NPAs by seeking solutions for non-performing debt that are adapted to each customer's circumstances and characteristics; and (iii) reducing exposure to foreclosed assets and eliminating the related losses.

   This strategic priority has two facets: an eminently organic approach in the form of ongoing management of existing balances, with a special focus on the oldest ones, seeing to shed the most problematic and least saleable assets, and to sell real estate via the normal channels; and an inorganic approach, involving the sale of portfolios, taking advantage of the liquidity available in the market from institutional investors interested in NPAs because of the Spanish economy's good prospects, the goal being to accelerate the reduction of the exposure to non-core assets in a determined, ambitious way so as to normalise their volumes and leave behind the legacy of the recent economic crisis.

2. Focus on managing non-performing exposures. Banco Sabadell was one of the first Spanish banks to create an NPA workout unit, in 2012: the Asset Transformation and Industrial and Real Estate Holdings Department. It was established to respond to five needs.
   — Globality, understood as segmented management of all problematic and potentially problematic exposures with an end-to-end vision of the process of transforming non-performing assets.
   — Specialisation and segmentation of responsibilities on the basis of processes and portfolios to underpin the management approach, so that each type of NPA is handled in the most appropriate manner and outcomes are optimised.
   — Maximisation of NPA recovery and monetisation, enhancing the efficiency of NPA management processes in terms of time and cost.
   — Multi-channels and transactional capacity. The Group has developed specific channels that afford it considerable transactional capacity to recover its exposure to NPAs.
   — Alignment of the entire organisation in managing and controlling NPAs under the principle of three lines of defence, ensuring the independence of the Asset Transformation and Industrial and Real Estate Holdings Department from the other areas involved in granting the non-performing exposures.

3. Maintenance of solid and sufficient levels of NPA coverage, supported by the capacity to generate future revenues with which to offset potential losses or impairment in this asset class, and robust capital levels with which to absorb any unexpected losses; together, these factors evidence the capacity and solvency of the Group's balance sheet.

These three strategic priorities are translated into six principles for managing NPAs, namely: (i) early action to address problems and avoid classification of assets as NPAs: reducing the volume of assets reclassified as non-performing and in default is vital to normalise these balances. Early action in managing delinquency maximises the recovery and monetisation of NPAs because it minimises the risk of deterioration in credit quality and preserves the quality of the collateral; (ii) segmented management of all non-performing and potentially non-performing exposures (potential delinquency); (iii) large-scale reduction of the non-performing loans and foreclosed assets that have been on the balance sheet the longest, which is particularly important from a management perspective as the range of capacities, solutions and tools require specialised management of the oldest balances as opposed to the more recent defaults and foreclosures; (iv) business intelligence and continuous improvement of the processes. In recent years, the Bank has developed segmentation and prediction capabilities in the recovery process. Business intelligence is also applied to systematise, continuously improve and corporatise processes throughout the recovery cycle, in friendly procedures, judicial procedures and bankruptcies, to enhance recovery efficiency; (v) financial capacity, i.e. not just having sufficient book coverage of the expected loss but also having the capacity to generate future revenues with which to address impairments and robust capital levels with which to absorb any unexpected losses on NPAs; and (vi) a solid system of governance based on three lines of defence, in which, after the first line of defence, featuring the specialised independent workout unit (Asset Transformation and Industrial and Real Estate Holdings Department), and the business units that approved the exposures, there is a second independent line of oversight, comprising the Risk Control and Compliance Departments, followed by a third line of defence, namely Internal Audit, which reviews the adequacy and quality of the entire process.

To implement this strategy, the Asset Transformation and Industrial and Real Estate Holdings Department is structured into various units, each focusing on one stage of the process of recovery, administration, management and transformation of NPAs, having considerable experience and expert knowledge of all areas of the process. This organisation structure, which has evolved over the years to adapt and better respond to the needs and priorities as driven by the established goals, and has proven its suitability, as evidenced by the steady, continuous reduction of the Group's doubtful and non-performing exposures in the last few years, comprises the areas listed below at 2018 year-end, each of which focuses on specific aspects of the process.

The loan loss recovery and default management process involves the following areas:

— Delinquency Prevention and Management Department: its main mission is to implement policies and decisions on the transformation of non-performing exposures, encouraging a mutual approach wherever this is the most suitable way to resolve the specific case, and paying special attention to the social exclusion risks in some of these situations.
— Technical Recoveries Department: manages outsourced collection, bankruptcy and litigation, aimed at optimising the recovery of credit risk through external channels and/or litigation, when friendly negotiation is not sufficient or is not considered to be suitable.
— Corporate Loan Restructuring Department: specialises in dealing with issues surrounding the recovery of corporate, property and developer exposures and focuses on loan restructuring, recovery and loss minimisation within that borrower category.
— Sabadell Real Estate and Institutional Markets: in managing real estate exposure and properties accepted to discharge debts, this unit is in charge of horizontally managing and transforming the Group's real estate exposure with the clear goal of reducing doubtful exposure to non-performing real estate by optimising its value, improving the return on non-problematic real estate exposure, and ensuring the orderly growth of new investment, all focused on portfolio risks and returns. This department also manages the divestment of NPA portfolios through processes aimed at institutional and wholesale investors with perimeters chosen as a function of the needs and policies of the Sabadell Group; accordingly, it was instrumental in the sales of portfolios of NPAs that were among the major achievements of the year, resulting in the normalisation of NPA balances. Its functions also include the analysis, calibration and review of NPA management strategies and models to maximise the efficiency of the recovery processes.
— Business Intelligence, Control and APS Department: this horizontal unit is tasked with optimising and continuously improving the Group's recovery processes and overseeing the management of those processes. Its responsibilities include the development and exploitation of existing information on the Group's various NPAs to facilitate optimum financial decision-making in connection with the various transformation alternatives.

With regard to past-due debt recovery actions in 2018, it is especially important to note ongoing proactive and responsible management of delinquency on mortgages secured by customers' main residences, seeking solutions that avoid litigation and minimise evictions. Consequently, 2,279 dation in payment transactions amounting to €357 million were arranged. As a result of offering housing solutions to customers at risk of social exclusion due to mortgage litigation or dation in payment processes, the Bank has close to 7,300 low-rent homes, including those contributed to the Social Housing Fund, and more than 2,900 homes with affordable rent.

In 2018, €2,740 million of assets were transacted organically, resulting in a positive contribution to the bottom line. However, the deals that really had a distinctive impact in normalising the NPAs on the balance sheet were the sale of four portfolios of non-core assets, mostly real estate assets from non-performing debts, which resulted in an inorganic reduction of NPA exposure by over €10,000 million, whose impact on the bottom line was booked in full in 2018.

Although these transactions were signed during the year, they are subject to certain conditions precedent, mainly the obtainment of certain administrative permits, which are expected to be secured in 2019, consolidating the reduction of NPA exposure to the levels presented on a pro-forma basis in the following figure (G3). Completion of these deals not only culminates the reduction and normalisation of the Group's NPA exposure but also reduces the related costs, leading to savings estimated at over €150 million per year. The contractual closure of the first deal was achieved in December 2018.

The following figure (G3) presents the evolution of the Group's NPA exposure in recent years, detailing the exposure covered by the Asset Protection Scheme (APS), of which only 20% is displayed up to 2017, as 80% was covered by the scheme. The 2018 year-end situation is presented pro-forma, i.e. representing the exposure that would remain if all the significant portfolio sales signed in the year (and expected to be completed in 2019) had actually been completed in 2018. The balance of NPAs was reduced by over €13,200 million in 2018, of which over €10,000 million in organic transactions, which made it possible to normalise that balance. The remaining pro-forma exposure covered by the APS at 2018 year-end was marginal.

Key business data

Net income in 2018 improved substantially with respect to the previous year, as the loss attributed to the Group amounted to -€477.7 million, meaning that the loss contribution halved with respect to the previous year (T11), including a very significant improvement in provisions and impairments in the year.

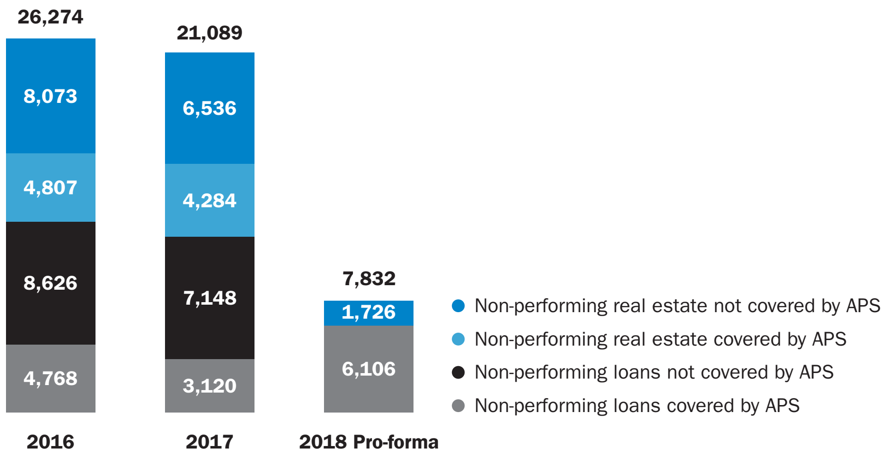
Net interest income in the Asset Transformation Business Unit was negative in the amount of €28.5 million, a notable improvement on the previous year, driven by higher interest recoveries on non-performing balances, the higher margin on performing assets, and lower interest costs.

The gross margin experienced a strong positive change, reaching €96.6 million, as a result of the improvement in net interest income, the positive contribution by trading transactions (which in 2017 included the negative impact of certain sales of portfolios of non-performing loans) and the progress by other products and operating expenses.

Administrative expenses and depreciation and amortisation declined by 14% year-on-year to -€139.8 million, reflecting cost containment and the first savings from the sale of real estate portfolios, which, though due to be formalised and completed in 2019, include agreements under which the buyer bears part of the associated expenses from the date of signature, which was in the third quarter of 2018.

This reduced the operating loss before provisions and impairments to €43.2 million. Provisions and impairments declined significantly year-on-year, to €520 million. This substantial improvement is explained by the extraordinary impairments booked in 2017, which did not recur in 2018, and, above all, by the improvement in credit quality, which resulted in lower impairments, since the figure for 2018 financial year also included -€178 million of marginal impairments to adjust the net value of the portfolios sold in the extraordinary transactions mentioned above to the sale price agreed with the buyers, an impact that will not recur in future years.

In addition to the good income statement performance by the Asset Transformation Business Unit, it also successfully managed its balance sheet, which was reduced significantly in pro-forma terms (considering the effect of the sale of large portfolios). Net loans and advances assigned to this unit declined by 65.5% year-on-year while real estate exposure was reduced by 71.6%.



G3 Non-performing exposures
Data for 100% of APS excl. TSB
(€M)

T11 Key figures — Asset Transformation

€M

	2017	2018	% 18/17
Net interest income	**(52)**	**(28)**	**(45.4)**
Equity-accounted affiliates and dividends	(1)	—	(100.0)
Fees and commissions (net)	2	1	(30.4)
Net income from financial transactions, and exchange differences	(37)	5	—
Other operating income/expense	118	119	0.7
Gross income	**30**	**97**	**220.9**
Administrative expenses and depreciation and amortisation	(163)	(140)	(14.1)
Operating profit/(loss)	**(133)**	**(43)**	**(67.5)**
Provisions and impairments	(1,216)	(520)	(57.2)
Gain/(loss) on disposals	*(14)*	*96*	—
Gain/(loss) on derecognition of assets, etc.	41	—	(100.0)
Profit/(loss) before tax	**(1,307)**	**(563)**	**(56.9)**
Income tax	364	85	(76.5)
Profit/(loss) after tax	**(943)**	**(478)**	**(49.4)**
Non-controlling interest	—	—	—
Net attributable profit	**(943)**	**(478)**	**(49.4)**
Ratios (%)			
ROE (profit / average shareholders' equity)	—	—	—
Cost: income (general administrative expenses / gross income)	—	—	—
NPL ratio (%)	32.2%	33.5%	—
Stage 3 exposure coverage ratio (%)	49.9%	83.4%	—
Assets	**15,384**	**11,907**	**(22.6)**
Loans and advances to customers (net), excluding repos	3,865	1,332	(65.5)
Real estate exposure (net)	3,372	959	(71.6)
Liabilities	**13,728**	**10,791**	**(21.4)**
On-balance sheet customer funds	104	235	126.8
Intercompany funding	12,627	10,315	(18.3)
Assigned capital	**1,656**	**1,116**	**(32.6)**
Off-balance sheet customer funds	**27**	**35**	**32.0**
Other indicators			
Employees	1,018	1,073	5.4
Branches	—	—	—

Solvia continued to perform dynamically and SDIN exceeded its targets in its first year of operation.

Solvia

Solvia, Banco Sabadell's real estate services provider, was very active in 2018. Solvia is one of the main real estate solution platforms, covering a broad range of services: from foreclosure, adaptation and administration to sale of real estate assets. It also provides doubtful loan management and settlement services for some customers.

In December 2018, it was agreed to sell 80% of Solvia to Lindorff Holding Spain, S.A.U., a company owned by the Intrum AB group, with a valuation of over €300 million. Upon completion of this transaction, scheduled for the first half of 2019, the Banco Sabadell Group will recognise an estimated capital gain of €138 million, evidencing the value that the Group has created with this company.

The company continued to develop its business by diversifying its customer portfolio. During the year, it added the portfolios of mutual funds as a result of providing appraisal services for those portfolios in competitive tender processes, and agreements were signed to market additional developments.

In 2018, the range of brokerage services (sale and rental) for individuals and companies continued to grow. Solvia continued to expand its team and, in particular, its own network of agents and consultants for companies, as well as expanding its footprint through the franchise network. At the end of 2018, it had 19 own offices and had signed contracts with 42 franchisees in the main Spanish cities.

The company continued to invest in its marketing capability, enabling it to remain in the lead in terms of brand recognition in 2018.

In 2018, Solvia property sales amounted to €1,439 million and the loan recovery activity which Solvia executes for Sareb remained very dynamic, generating €175 million in liquidity. Solvia marketed 78 real estate developments in the year for its clients, with sales exceeding €130 million.

SDIN

SDIN, a new subsidiary focused on real estate development and on providing services related to development for the Banco Sabadell Group, Sareb and others, was established in 2018; land and sites identified as having specific appreciation potential were transferred to SDIN for development.

In its first year of operation, SDIN established a presence in the most dynamic housing markets in Spain, including Barcelona, Madrid, Seville, Málaga, Valencia and Alicante. It currently has 134 developments under management, comprising 6,364 homes, of which 47 are under construction (2,229 homes) and 50 are at the permit phase (2,369 homes). The others are at the design phase. It also has a bank of zoned and semi-zoned land for 173 future developments. A total of 680 homes were delivered to buyers in 2018.

The new subsidiary has also established itself as a key driver of the developer servicing business and multiplies the scope for gaining volume in this business by signing agreements with new clients. The ReDeS project, a joint venture to acquire, manage and develop homes that currently has 15 developments comprising 873 homes, is a particularly important development.

BS Capital

BS Capital is the department that manages the Banco Sabadell Group's industrial holdings. It focuses on acquiring temporary holdings in companies, with the main goal of maximising the return on investment.

In 2018, it drove the investment cycle in the defined action frameworks for each of the business areas, including notably the closure of three deals for Aurica III FCR (Agrosol Export, Winche Redes Comerciales and Grupo Larrumba), a new investment in a wind energy project in Mexico, and investment in more than 12 digital or technological startups (venture capital and venture debt).

Sabadell Venture Capital is Banco Sabadell's venture capital arm; its main objective is to provide early-stage support (seed capital, series A) to Spanish tech/digital startups that have strong growth potential.

Sabadell Venture Capital operates in the following areas:

- Venture capital: it acquires minority stakes, investing from €200,000 to €2 million per company with the aim of being the startup's financial partner and helping it to grow rapidly in areas such as strategy, internalisation and staff.
- Venture debt: Banco Sabadell was the first bank in Spain to launch a venture debt product. This funding product is aimed at startups to supplement series A capital and avoid diluting the shareholders. Loans amount to between €200,000 and €2 million per company, maturing in an average of 3 years. The debt is remunerated in the form of:
  - Interest payments.
  - Equity.

The portfolio of investees expanded in 2018 to reach 21 equity investments and 8 venture debt deals by year-end.

In its third year of operation, the Venture Capital department positioned itself as one of the leading investors in

Spain, and was recognized as one of the 10 most active corporate investors in Europe in 2018 according to the annual "The state of European Tech 2018" report published by Atomico, one of the world's leading venture capital funds.

Additionally, as part of Banco Sabadell's comprehensive strategy for the health sciences industry, it signed an investment agreement with Sabadell Asabys Health Innovation Investments, which specialises in drug discovery, medical devices and digital technology. It will focus on early-stage investment in biotech, medtech, digital health and innovative services in healthcare with the goal of reaching €60 million.

The department continued to actively manage its investments during the year, having divested PE Ausines, Saria Bioindustries International and Captio Tech; the latter, which focuses on managing personnel expenses using a mobile app, was acquired by its US rival Certify for €25 million, providing Sabadell Venture Capital with a sizeable return; it also advanced with divesting a number of venture capital funds. It also continued to work on formalising, managing and selling holdings acquired in debt restructuring and capitalisation processes. A noteworthy acquisition was Termosolar Borges.