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INSIGHTS

EUROPEAN SECTOR OUTLOOK

The pandemic, perils and
the paradigm shifts

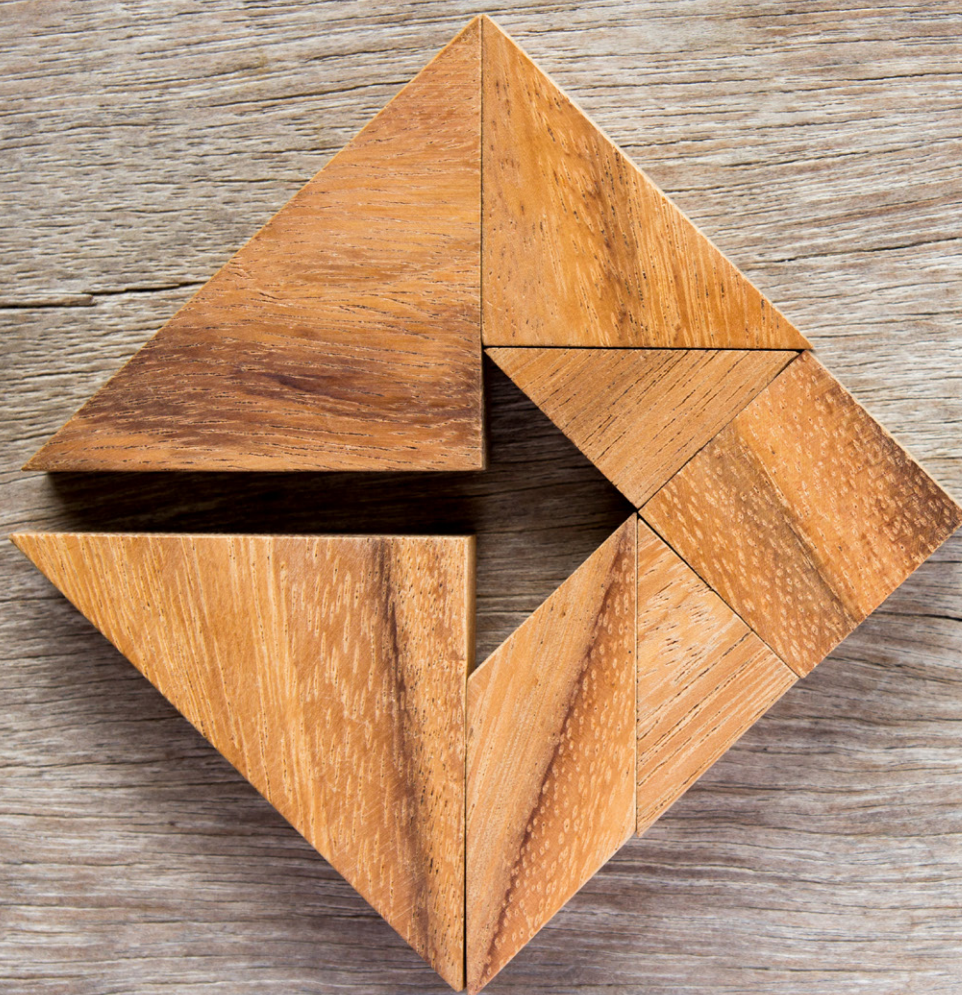
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The pandemic has affected all sectors globally, changing operating practices significantly. From global food supply chains to financial powerhouses, the impact has been astonishing, especially in Europe, once the epicentre of the pandemic. As the region recovers from the latest peak in infections, although still vulnerable to subsequent waves, this insight paper looks at how strategic priorities and procedures have changed by sector, and at the shift in the lending space supporting these sectors.



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1. Executive summary

The pandemic-affected global macroeconomic backdrop is highlighting aspects of sectors we have never seen before, testing their core trade models and making them rethink their commercial practices and changed business direction. From the asset-backed and collateral-heavy sectors such as real estate, international transportation and clean energy to “servicified” sectors such as telecommunications and financial institutions, the year 2020 saw major changes to their operations. Against this backdrop, it is interesting to evaluate the strength and position of these sectors in Europe, to see how the world’s most advanced continent in terms of trade is weathering daunting macroeconomic externalities. In this insight paper, we take a look at six of the leading sectors: real estate, transport and logistics, telecommunications and technologies, clean energy, financial institutions, and food and agriculture. We will consider how they fared during Europe’s first wave, how they restructured their dynamics, and their crisis-resistant commercial practices and provide our perspective on the near-term outlook for each.

The real estate sector saw interest move to the logistics and warehousing realty space from the traditional office and hospitality property space. While

this structural change was a result of pandemic-driven consumption patterns, we believe it marks a turning point in the property business. The transport and logistics sector saw its marine, air and land transport subsectors plateau simultaneously, but recovery stories have largely been mixed. The marine transport subsector, with its use of different types of vessels, capitalised on the unique opportunities that arose amid the peak of the pandemic in mid-2020 and is now using its global capacity effectively as international trade normalises. The air transport subsector, however, which is more passenger-driven, is likely several years away from reaching pre-pandemic levels due to the changing restrictions on global travel and tourism. In Europe’s telecommunications sector, the pandemic amplified the need for rigorous customer engagement, highlighting the significance of network consolidation, digitalisation and implementing cybersecurity best practices. The clean energy sector gained prominence as the global community increasingly accepted its importance and sustainability discussions gained traction, although a number of phased construction projects were suspended.

Operations of financial institutions (FIs) were characterised by

fiscal flexibility of the respective sovereigns and the quantitative easing necessitated by severe financial strain. The lending business thrived, while lenders acknowledged the need for robust cost structures amid record-low interest rate regimes and thin profit spreads. Moreover, with the relaxation of bank capital requirements [risk-weighted asset (RWA) base reductions], the focus on risk control is increased. The food and agriculture sector, which pioneered tech-driven agronomy practices even before the pandemic, strengthened further due to the need to reduce reliance on mass labour and shift to mechanised processes.

We focus on Europe because many of the sectors we consider in this paper originated in the region, their trade was amplified in the age of colonialism, and the region still controls their trade. Moreover, Europe has historically innovated trade practices, shaping the direction for the rest of the world. Its pioneering in trade should be carefully observed, especially in times such as the present. While it is premature to comment on the performance of all sectors amid the pandemic, analysing the effect on trade of the initial shock would help formulate an insightful and informed outlook for the near to medium term.

2. Detailed sector outlook

2.1. REAL ESTATE: LOGISTICS AND RESIDENTIAL EMERGE THE WINNERS

Europe's real estate sector faced many challenges amid the pandemic. The hospitality subsector was affected by the travel restrictions and adverse economic conditions, and office real estate faced uncertainty due to the work-from-home (WFH) arrangement. Nevertheless, the sector generated satisfactory returns in a low interest rate market¹, which particularly benefitted residential real estate.

Increased dependence on e-commerce proved favourable for logistics real estate, at the expense of retail real estate.

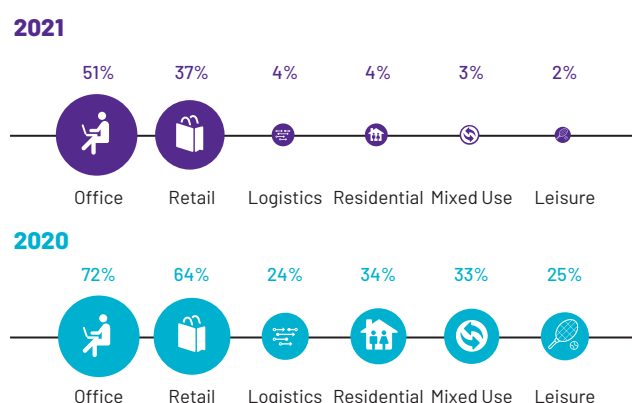
Accelerated restructuring of real estate subsectors: The pandemic has fast-tracked emerging trends in real estate, revolutionising

the way in which we live and work. With constant lockdowns and social-distancing restrictions, remote working has become the norm, helping businesses worldwide operate as usual. We expect companies to look at incorporating a more hybrid work environment after the situation normalises. This would increase uncertainty of demand for office real estate, especially co-working spaces, which were unutilised amid social-distancing restrictions.

Dependence on e-commerce boosted the transition from physical to online shopping. This is likely to result in a tangible restructuring of both retail and logistics real estate, shifting demand to warehousing space from physical retail stores.

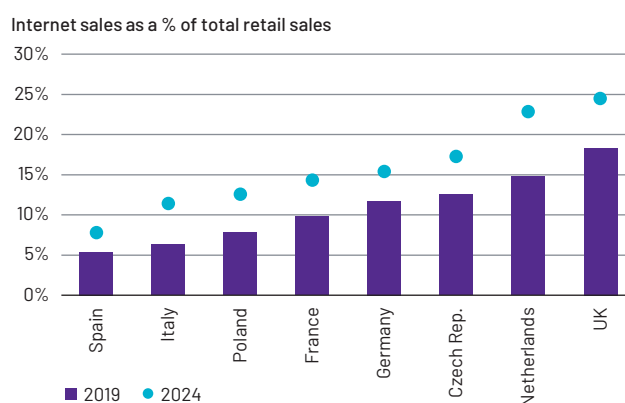


Figure 1: Forecast repurposing of buildings in Europe



Source: PwC: Emerging Trends in Real Estate – Europe 2021

Figure 2: Expected penetration of e-commerce



Source: CBRE: 2021 EMEA Real Estate Market Outlook

¹ <https://www.pwc.com/gx/en/industries/financial-services/asset-management/emerging-trends-real-estate/europe-2021.html>

The emergence of property technology (proptech): The key driver of these trends is increased digitalisation and reliance on technology. Data centres are now a niche subsector in real estate. We expect increasing demand for space to establish data centres and communication towers to keep pace with increasing dependence on technology. The crisis has also proliferated proptech initiatives

such as building information modelling and 3D printing, which could be used to further drive innovation in real estate.

Sustainability at the core of new developments: Climate change remains a major concern in Europe and across the world, and environmental, social and governance (ESG) initiatives are being undertaken to mitigate its

effects. The real estate sector, too, has a vital role to play in combatting environmental degradation, especially in terms of limiting its carbon footprint and promoting energy efficiency. A number of intelligent and green buildings – focusing on de-carbonisation and eco-friendly energy consumption – are being built in Europe. “The Edge” building in Amsterdam is an example.

Figure 3: The Edge building in Amsterdam

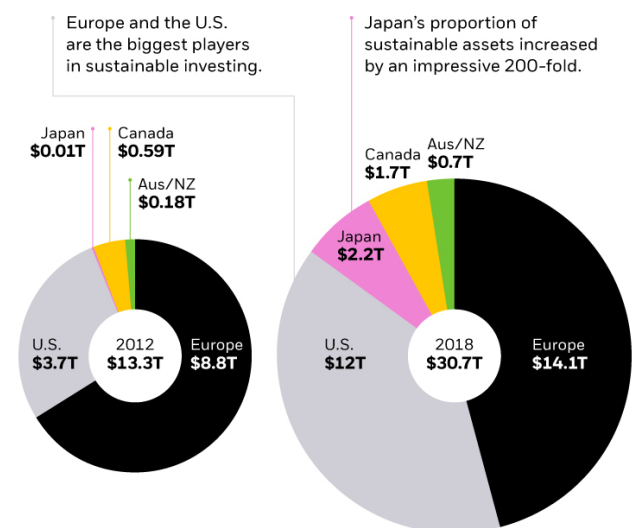


Source: Bloomberg

Figure 4: Global sustainable investments

Global growth in sustainable investments (USD\$ Trillion)

Europe is well ahead of the sustainable investing curve, and specific legislation is fundamentally shaping the industry.



Source: Global Sustainable Investment, March 2019

European real estate sector outlook for 2021: repurposing – smarter and greener

We remain optimistic on the outlook for Europe’s real estate sector in 2021, as it continues to benefit from the availability of capital at low interest rates with the region attempting to revive economies and boost business confidence. We believe it is necessary to repurpose buildings to adapt to the changing needs of employees and businesses, and expect smarter and eco-friendly buildings to be built in line with initiatives such as the European Green Deal to achieve carbon-neutrality by 2050.

Writing attribution: Kithma Gamalath

2.2. TRANSPORT AND LOGISTICS: A BREATHING SPACE FOR MARINE BUT A BLACK HOLE FOR AIR AND RAIL

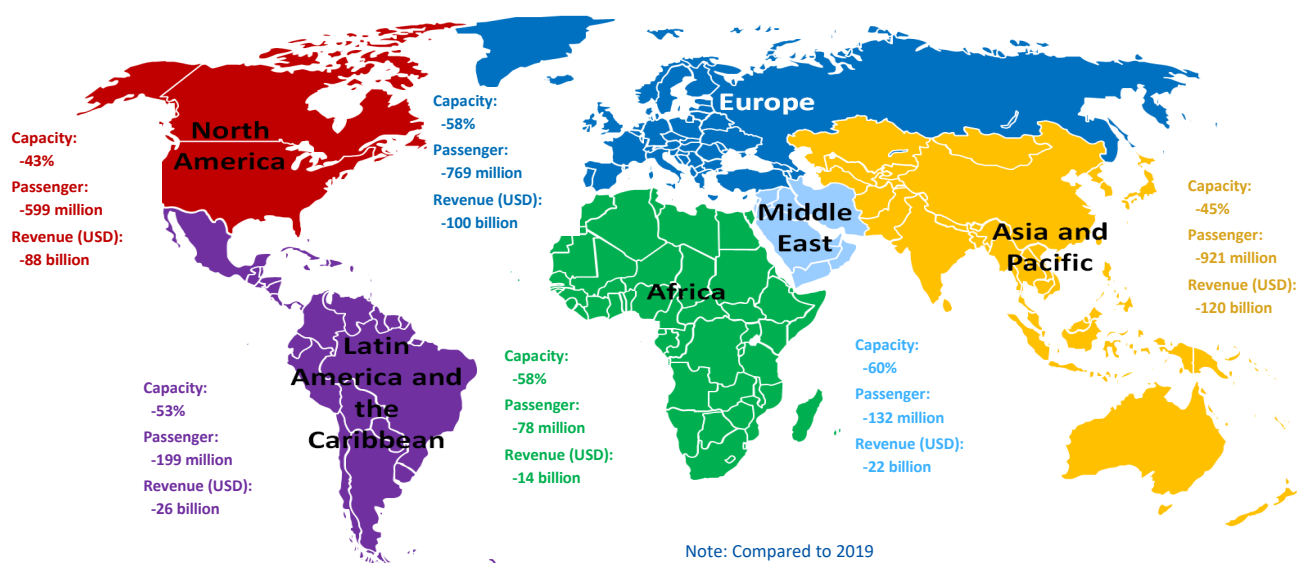


Europe's transport and logistics (T&L) sector came to a standstill amid the pandemic as multi-modal passenger and freight transport was suspended.

Hit by pandemic-induced demand shifts: The bulk of **container shipping** to Europe originates from East Asia², and this subsector fared better than the broader shipping sector, as consumption-driven demand, which was weakened significantly in 1H20, recovered in 2H20 as lockdown restrictions were eased. **Tanker shipping** took advantage of a lack of onshore storage due to the oil supply glut amid weak consumption by chartering tanker vessels for storage. Average earnings of very large crude carriers (VLCCs) reached USD240,000 a day in 2020; although they have dropped to USD7,000 in 2021. In addition, on a time charter-equivalent

(TCE) basis for **dry bulk shipping**³, Capesize vessels' average earnings were USD13,073 per day in 2020, versus USD18,025 in 2019. Earnings for Panamax vessels averaged USD9,923 in 2020 per day versus USD12,429 per day in 2019. This drop in freight rates is attributed to China's lockdowns in January 2020 that resulted in a visible slowdown in the world's second-largest economy and primary driver of bulk shipping demand. **Airline passenger numbers** fell by a large 60% globally in 2020, with international airlines incurring a total gross operating revenue loss of USD250bn and domestic travel a loss of USD120bn. The number of European passengers dropped 769m y/y, with USD100bn in revenue wiped out. Air cargo volumes recovered in 2020, although short of prior-year levels. Europe's air cargo volumes are expected to have exceeded pre-pandemic levels in February 2021.

Figure 5: Estimated impact on passenger traffic and revenue by region, 2020



Source: ICAO: Effects of Novel Coronavirus (COVID-19) on Civil Aviation: Economic Impact Analysis

² Marine travel is commercially based in Europe due to established trade routes such as the Europe-Asia Pacific route and the Europe-Atlantic route

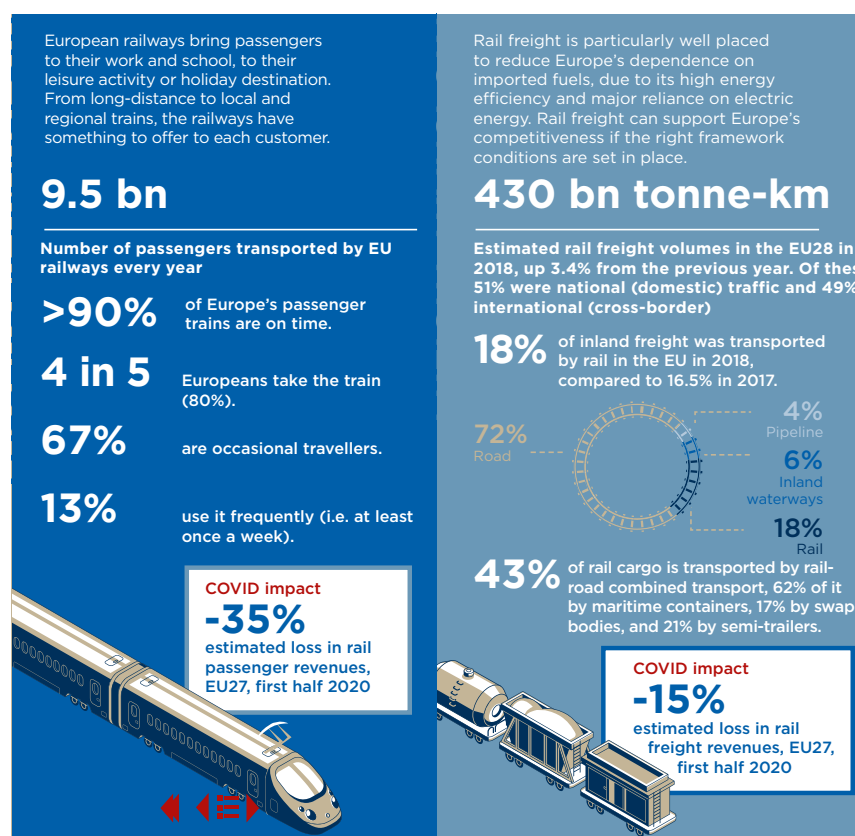
³ On Baltic exchange rates

Aggregate revenue for the EU's **rail subsector** fell by c.EUR26bn in 2020⁴, with passenger-related operations accounting for EUR24bn of that loss. Rail freight, which generates most of its revenue via intermodal services, was affected by steep declines in China's industrial output as lockdowns affected the macro environment. This resulted in six- to eight-week delays in intercontinental shipping routes, worsened by Europe's plunge into a recession, which also limited meeting internal demand.

Supply-chain challenges highlight need for resilience: Container shipping lines are vertically integrating along the supply chain to provide contract logistics services and freight management solutions, either through acquisition or by organically providing extensive onshore support. The goal is to activate end-consumer interaction and provide reliable, end-to-end logistics services at higher volumes. There is a shift away from cost-centric, just-in-time supply channels to more resilient models, with risk coverage coming from procurement diversification by moving away from single-source reliance to multi-geo networks. The shipping subsector was already weakened in 2019 due to a shift from globalisation to nationalism, triggered by the US-China trade war and Brexit. These diplomatic policy shifts would affect the supply chains of many industries, changing the direction of the shipping subsector. It would be easier to monitor the effects once the normal cyclic patterns return.

Green initiatives driving growth: Stricter environmental regulations and aggressive carbon-emissions targets have resulted in shipping

Figure 6: Summary of Europe's freight and passenger rail subsector



Source: CER: Activity report

companies incurring significant capital expenditure, for example, to order new-buildings, retrofit existing vessels with scrubbers and implement improved ballast water management mechanisms. The rail freight subsector was primed for growth, with its electric rolling stock and intermodal mileage, giving it a competitive advantage over trucks, its closest competitor. Rail freight is the greener option, as fully electric trucks have yet to be manufactured.

European transport and logistics sector outlook for 2021: marine and rail on the path to recovery
The recovery in the global marine transport subsector indicates commercial gain for Europe as the macroeconomic environment

in terms of international trade normalises. Despite the usual seasonal variations in the tanker shipping subsector, we expect sharp increases in the freight rates of both the container and bulk shipping segments. However, in line with the bleak outlook for the air transport subsector, we believe passenger transport will reach pre-pandemic levels only after 2023, considering travel bans and overall weak traveller sentiment. We expect the inbound land transport subsector to take the middle path in terms of a recovery in commuter volumes, as we believe travel within the region will reach pre-pandemic levels by 2022.

Writing attribution: Chamathka Fonseka and Dinula Perera

⁴ The Community of European Railway and Infrastructure Companies (CER) insights

2.3. TELECOMMUNICATIONS AND TECHNOLOGIES: RISING TO THE OCCASION AND BECOMING THE NEW NECESSITY

The pandemic has had only a moderate impact on European telcos, as they have been in the strategic position of keeping economies running (communication and anonymised data exchange used to track and screen infected individuals, and coverage for emergency response), and are generally relatively stable and resilient amid an economic downturn, as they are considered to be performing an indispensable service for society.

Unforeseen spikes in network traffic amid shifts in customer trends:

The market witnessed (1) a rise in network traffic volumes due to the growing use of video conferencing and other online collaboration tools, (2) fluctuations in peak hours and (3) a shift in hotspot locations, resulting in increased demand for residential fixed broadband networks and causing unexpected strain. Telcos handled the surge in traffic by providing robust networks via expanding the capacity of their base stations, enforcing call gapping, codec reconfiguration, traffic prioritisation and managing

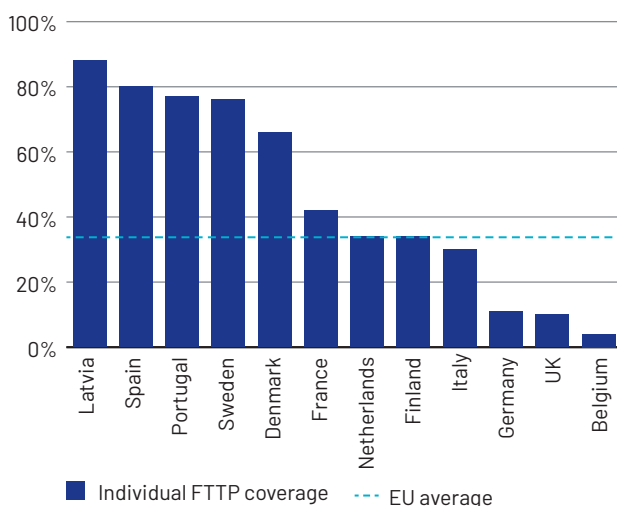
spectrum resources by applying for licences for unallocated spectrum bands and requesting access to backhaul spectrum. Telcos have increased marketing spending and bolstered their remote operations via data-driven intelligent automation applications to enhance customer engagement.

Amid the uncertainty, telcos continue to ramp up fibre rollout:

With key European fibre-to-the-home (FTTH) coverage still lagging (Figure 7; Germany: 15%; UK: 10%), the rollout has been affected significantly, with several projects deferred to 2021. Despite rapid rollout not being feasible, governments are accelerating their rollout plans (using up idling skilled labour) to facilitate remote working and other online facilities through increased network speed and reliability. Some operators are forming JVs (e.g., Telefonica and Allianz) to concentrate on underserved markets, while others form temporary partnerships with edge application providers (e.g., Proximus with EQT and Eurofiber).

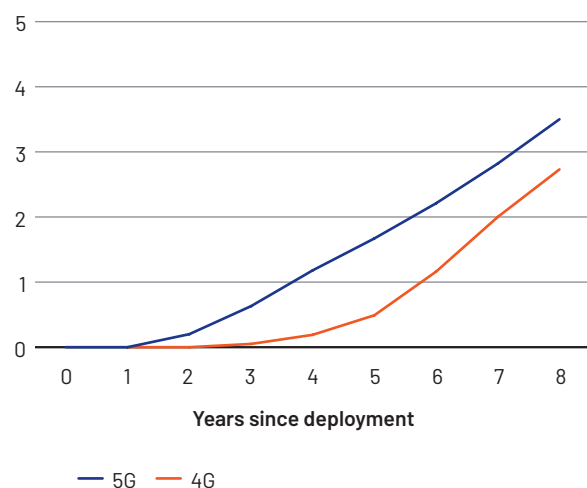


Figure 7: Overall FTTP coverage in selected European countries



Source: 2020 EC DESI Report, ING

Figure 8: Subscription uptake in the first years of deployment (in bn)



Source: November 2020 Ericsson Mobility Report

Intensified focus on mobile tower and network monetisation, fostering network consolidation:

Despite the need for further densification, and with tower infrastructure firms trading at higher valuations (e.g., Cellnex currently trades at an EV/EBITDA of 23.0x), operators are now collaborating with peers – via co-financing deals – to commercialise their towers, with 5G the dominant driver (e.g., Orange intends to share the upcoming fibre deployments with partners via fibre companies in France and Poland).

Launch of 5G in densely populated urban areas:

With several EU members delaying 5G auctions and rollouts in 2020 (a critical juncture in 5G), European telcos face the risk of trailing behind the US and China (reflecting the legacy 4G lag). Given the growing value of the internet-of-things (IoT; for remote monitoring and command) in a pandemic-hit world, telcos are now focused on the commercial launch of 5G. A fragmented market would result in delayed mass adoption of 5G (Figure 8; expects 46GB per month by 2026). Europe requires EUR150bn for a “full-5G scenario”, with an additional EUR150bn for fixed-infrastructure upgrades, according to BCG.

High expectations for mergers and acquisitions (M&A), despite acquirers being prudent with money:

With operators suffering tight cash flow due to customer-focused regulations and increased competition from global internet players offering alternatives via over-the-top (OTT) content,

companies are now interested more than ever in M&A, particularly with the annulment of the European Commission’s decision to block Hutchison’s proposed acquisition of Telefonica UK. This is reinforced by the fibre and 5G rollouts (e.g., Liberty Global’s acquisition of Sunrise), although post-Brexit cross-border M&A is predicted to fall due to governments owning stakes in the incumbent operators. To maximise the value of M&A, operators need to focus on network/IT integration (50% of synergy plans) through network coverage improvements and marketing and distribution (30%) through creating a multi-channel experience ensuring less customer dissatisfaction and a temporary increase in sales and customer care capacity to handle customer queries.

Telehealth and cybersecurity

gaining traction: The authorities have been passing laws to extend telehealth coverage in addition to waiving regulation as emergency measures have increased patients’ access to virtual care. We expect telco partners to provide end-to-end solutions in addition to network connectivity and integration and application enablement, with 5G playing a major role in facilitating remote patient monitoring. Several individuals and businesses have been exposed to cybersecurity and phishing attacks by cybercriminals posing as health organisations. The introduction of 5G led to the reported increase in attacks due to the increased number of vulnerable access points. The

General Data Protection Regulation (GDPR) rollout has a wide impact, with telcos collaborating with ecosystem partners on joint threat intelligence sharing (e.g., AT&T, Telefonica and Singtel) and spreading awareness among retail customers. Telcos need to reorganise their internal operations to break down silos and create a standard edge computing platform with other operators, creating a new-age digital business model.

European telecommunications and technologies sector outlook for 2021: greener pastures with digitalisation

Overall, with the proven resilience, we expect the latest consumption trends to outlast the pandemic, creating commercial opportunities amid the continued negative impact on roaming and B2B revenue of the more vulnerable firms with lower churn in the sector (i.e., challengers). Against the enhanced M&A and consolidation backdrop, we expect telcos to (1) continue lobbying regulators for both spectrum access and favourable regulation, ensuring enhanced service quality; (2) support the value chain, eliminating possible weak links in the operation; and (3) focus on 5G opening up other technological solutions, diversifying their business lines. Telcos with strong continuity and contingency plans outperformed most of their peers during the pandemic and are, therefore, likely to revisit their continuity plans to resolve future crises more quickly and effectively.

Writing attribution: Wayomi Hemantha and Kavinda Jayasinghe

2.4. CLEAN ENERGY: THE NEED OF THE HOUR



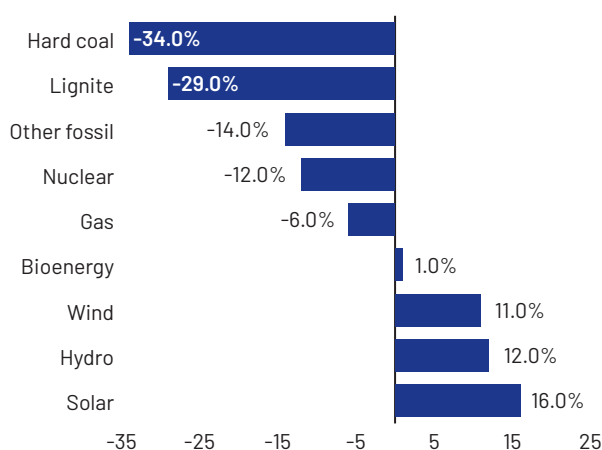
The pandemic disrupted Europe's energy markets and did not spare the renewable energy sector. Nevertheless, the sector remained resilient, unlike the fossil fuel sector. The crisis has highlighted the need to accelerate the shift towards cleaner energy, as fossil fuel resources have proved volatile and are expected to be depleted in the not-so-distant future.

Pandemic reinforces the need for renewable sources of electricity generation:

Europe's electricity consumption fell temporarily amid the lockdowns. Operations at wind and solar farms were curtailed due to restrictions on movement. Clean energy investments also declined (capacity additions

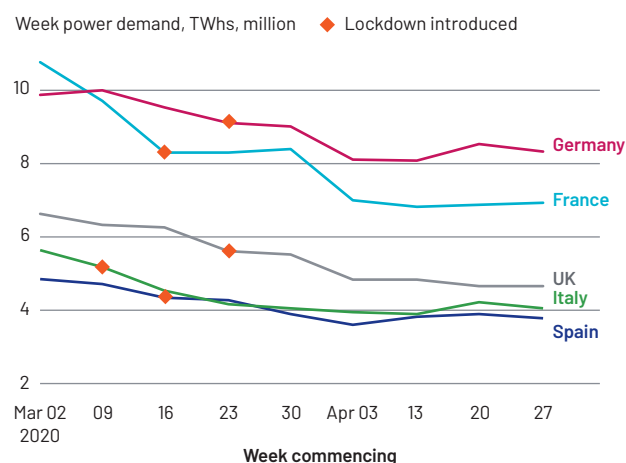
for 1H20 decreased by 15% y/y) owing to delays in construction, disruptions across the supply chain and the credit crunch. However, electricity grids relied heavily on renewable energy during the period as electricity generated from fossil fuels plummeted. As the share of renewable energy in the energy mix rises, grids and distributors are likely to upgrade their networks and technologies to manage the increased congestion (industry bodies forecast investment of EUR375-425bn in European distribution grids until 2030). For example, grid company Enexis Groep experienced a 60% y/y increase in renewable energy transmission in 2020, highlighting the need to upgrade the grid.

Figure 9: Power generation in EU-27, 1H20 vs 1H19



Source: Bloomberg

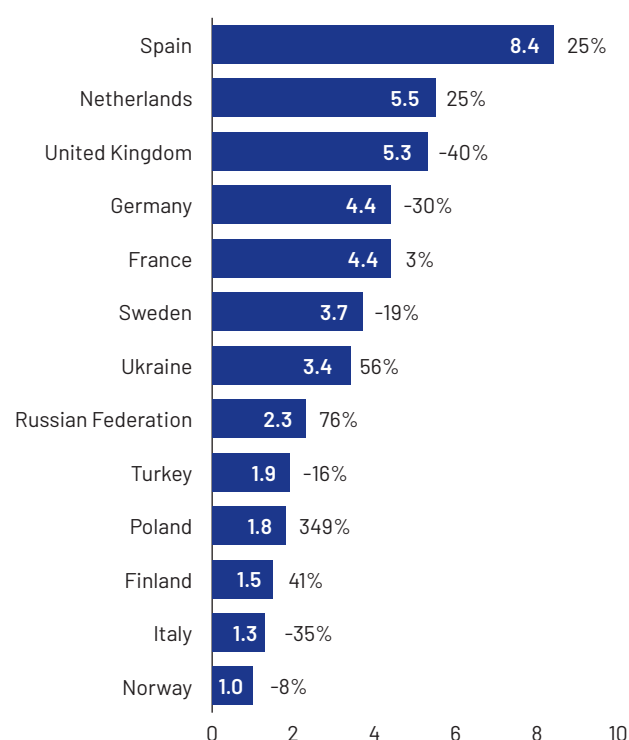
Figure 10: Weekly power demand across Europe



Source: FT. com

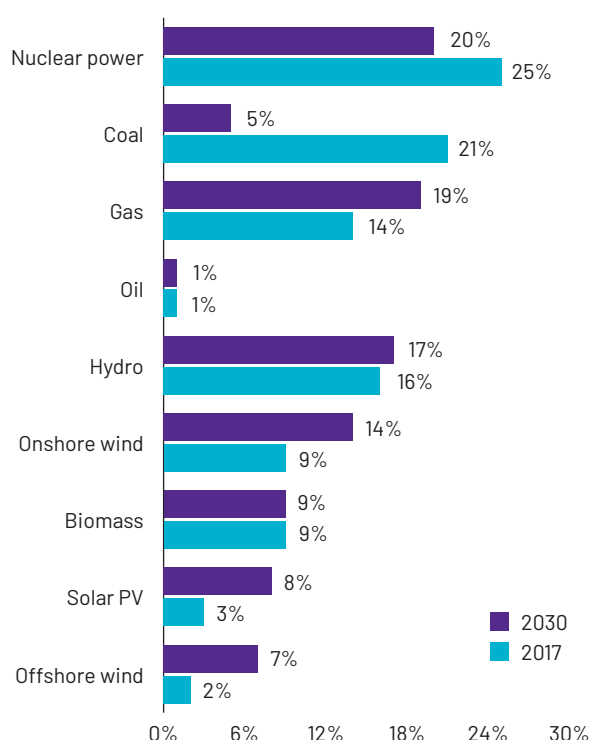
More geographies are commissioning clean-energy projects: In line with the EU's target to achieve a 32% share of energy from renewables by 2030, the region has invested in large projects that are trailblazers in the sector – a 17MW floating solar power plant in Rhone Valley (operating since 2019), a 4.8GW offshore wind farm in the North Sea (to be completed in 2026) and a 105.6MW wind farm planned for construction by Energiekontor in the Scottish Highlands (completion in c.12 months). Clean energy production was previously limited to a few regions such as France and Spain, but as evident from the abovementioned projects, there is promising growth across Europe. The European Commission has also indicated that by 2050, 300GW of offshore wind and 40GW of wave and tidal energy would be needed to meet the climate change targets and that new projects would be initiated by each of the EU-27 members. The North Sea, Black Sea, Baltic Sea, Atlantic Ocean and Mediterranean Sea are some of the resources likely to be used for these projects.

Figure 11: Renewable energy capacity investments in Europe, 2019 vs 2018



Countries with investments rounding up to \$1 billion or more in 2019
Source: UNEP, Frankfurt School-UNEP Centre, BloombergNEF;
https://www.fs-unep-centre.org/wp-content/uploads/2020/06/GTR_2020.pdf

Figure 12: Share of power generation from new renewables in Europe



Source: Statista 2021

Development of supporting industries, easing of regulations and diversification of oil majors:

The inherent low marginal costs, use of information technology (such as AI, machine learning and big data) and improvements in technology are expected to drive long-term growth of the sector. Apart from electricity producers and distributors, policymakers are also keen to improve supporting industries such as equipment manufacturers and battery makers that are vital for the growth of the sector. Furthermore, regulators are making favourable amendments related to pricing and distribution of renewable energy [e.g., regulations governing capacity auctions have been streamlined in Spain, while authorities in Ireland are considering the potential for participation of hybrid facilities (wind and solar) in auctions]. European

oil majors such as Royal Dutch Shell and Total, which intend to shift away from the fossil fuel business, are investing in renewable energy assets (e.g., Royal Dutch Shell has acquired stakes in CrossWind and Blauwwind wind farms) and expect to invest in low-emission production such as hydrogen and low-carbon biofuels as well.

European clean energy sector outlook for 2021: the promising era of renewables

We believe the clean energy sector is well positioned to benefit from European policymakers' initiatives such as committing 30% of the EU's EUR1.8tn economic stimulus package (announced in 2020) towards achieving climate-related goals, which include investing in renewable energy. We expect demand for power to increase again in 2021 (especially

from the manufacturing sector); this, along with the growing need to replace fossil fuels, would increase the number of viable opportunities for the clean energy sector in 2021. This would enable capital expenditure plans and capacity additions to be expanded across the region at an efficient scale. We also believe the emergence of hybrid projects is another factor that could expedite growth in 2021. We expect the cost-competitiveness of renewable sources (especially wind and solar), along with expected reductions in the levelised cost of electricity (LCOE) and the regulatory need to achieve carbon neutrality by 2050, to result in continued growth prospects for the clean energy sector and related industries.

Writing attribution: Ashok Navaneethan and Dulith Perera

2.5. FINANCIAL INSTITUTIONS: ON DAMAGE-CONTROL MODE AND THE LONG ROAD TO SANITY

The pandemic seems to have had a deeper effect on Europe's financial sector than on that of the US. Europe has been in a prolonged recovery since the last financial crisis. Lower economic activity, depressed interest rates and sluggish demand in the region have resulted in this imbalance over the past decade. Despite the headwinds from the pandemic, decisive and timely support measures adopted by the European Commission, the European Central Bank (ECB) and governments on both the fiscal (loan guarantees, payment holidays, short-time work schemes and tax deferrals) and monetary (static policy rates, PEPP, APP, TLTROs and PELTRO) fronts have enabled the financial system to remain resilient and adaptable.



Figure 13: Top 10 European banks – a synopsis (2020 FYE – y/y change)



Reporting is based on the FY 2020 performance of Europe's Top 10 largest banks by asset size. Top 10 banks in descending order include HSBC (UK), BNP Paribas (France), Credit Agricole (France), Bano Santander (Spain), Societe Generale (France), Barclays (UK), Groupe BPCE (France), Deutsche Bank (Germany), Lloyds Banking Group (UK) and Intesa Sanpaolo (Italy).

*Excluding the reclassified financials of Intesa Sanpaolo (Italy) for FY2020.

**Risk = ECL and other credit impairment charges as % of average gross loans and advances to customers and banks.

***Excluding HSBC Holdings PLC.

Source: Company annual reports and investor presentations 2020.

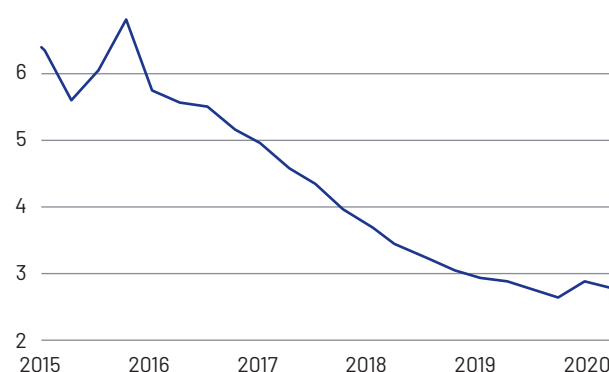
Deteriorating credit quality dragging down banks' profits:

The pandemic's effect on the European banking sector can be assessed by analysing the performance of the 10 largest banks on an aggregate level. Bank revenue [both net interest income (NII) and non-interest income] declined by 5%, resulting in a larger trickle-down effect on profitability, which fell a sharp 57%. Borrower defaults pushed up banks' ECL and impairment losses by 102% in 2020, and the downtrend in the banking-sector non-performing loan (NPL) ratio since 2016 reversed in 2Q 2020, moving to 2.8%, +20bps from 4Q 2019 levels⁵. Thus, the average cost of risk attributed to the top 10 banks increased by a considerable 40bps to 0.77% in 2020 (from 0.37% in 2019), with a 102% increase in expected credit loss provisioning.

NPL ratio in the EU

EU total gross non-performing loans and advances in

% of total gross loans and advances, end-of-quarter values



Source: European Central Bank.

⁵ EC.

Respite for banks' risk-adjusted assets from government holdings and targeted divestments: Despite the muted growth in loans of the 10 largest banks in 2020 (versus 2.4% in 2019), a reduction in the density of RWAs drove a 90bps improvement in the CET1 ratio to 15.1% in 2020 from 14.2% in 2019. Notably, the expansion of assets with low risk weights such as central bank reserves, sovereign bond investments and strategic divestments drove the reduction in RWAs in major European banks such as HSBC and Lloyds. This includes aggressive long-term cost base reduction strategies followed by both HSBC (USD4.5bn savings by 2022)⁶ and Lloyds (maintaining a >20% opex reduction since 2010)⁷ in order to be industry leaders in cost-efficiency and maintain healthy ROE.

Public guarantees and bank-specific relief driving lending growth, with heightened risk scrutiny: For the 10 largest European banks, pandemic-induced loan grants under their relief schemes (excluding HSBC group's) increased by more than USD212bn in 2020. Within the Eurozone, state guarantees announced amounted to over 17% of GDP⁸. Overall,

fiscal support, led by the ECB and member states, has contributed to the confidence in loan markets by aiding refinancing of legacy debt, reducing regulatory capital bases and helping banks offer fresh credit. Moreover, there are early signs that the economic fallout from the pandemic has somewhat tapered; HSBC reported a gradual reduction of its relief loan package outstanding to USD41bn (a 47% drop since 1H 2020) as of end-2020, which augurs well for confidence in economic activity and market recovery in general. Yet, this lending growth and subsequent public financial easing expand the risk exposure of FIs. The pandemic prompted c.12% of companies to negotiate covenant waivers on existing bank debt in 2020⁹, enforcing higher scrutiny of credit portfolios by banks. Large banks including HSBC revamped internal stress testing, data collection and analysis in order to adhere to intermittent regulatory guidance on payment moratoria, relief measures and classification of forborne/renegeotiated loans.

Capital efficiency highlighted, growth markets to outperform on ROI with reins on sustainable

finance: Banks in Europe are taking a conscious approach to redirecting capital by exiting unprofitable ventures/markets, aiming to reduce their excess regulatory capital bases and redeploy it towards efficient ROI. On this front, HSBC aims to achieve a cumulative RWA reduction of >USD100bn by 2022 by allocating USD6bn in investments and capital to growing its Asia business (predominantly China and India) while exiting less-viable US retail operations. Moreover, sustainable investing driven by sound ESG principles remains a high priority for European banks with the EU's EUR1tn green budget provision for supporting climate, biodiversity and sustainability projects by 2030⁶. Europe's focus in this area is reflected by BNP Paribas's position as the global leader in ESG-linked loans and the sustainable bonds market in 2020. Similarly, HSBC aims to facilitate USD100bn in credit under sustainable finance by 2025 (it has facilitated a cumulative USD93bn since 2017) and intends to achieve "net zero emissions" in its operations and supply chain by 2030.

Figure 14: Top 10 European insurers – a synopsis (2020 FYE – y/y change)

Net Premiums (aggregate)	Claims (aggregate)	Profits (aggregate)	Loans (aggregate)	Combined ratio (average)	Solvency II (average)
↓ 9%	↓ 11%	↓ 16%	↑ 2%	96%	200%

Reporting is based on the FY 2020 performance of Europe's Top 10 largest insurers by AUM. Europe's Top 10 insurers in descending order include Allianz (Germany), AXA (France), Legal & General Group (UK), Generali (Italy), AVIVA (UK), CNP (France), Aegon (the Netherlands), Prudential PLC (UK), Zurich (Switzerland) and Munich Re (Germany).

*Average combined ratio excludes unpublished annual details w.r.t Legal & General Group (UK) and Prudential PLC (UK).

**Average Solvency II ratio exclude unpublished data w.r.t Prudential PLC (UK).

Source: Company annual reports and investor presentations 2020.

⁶ HSBC: Presentation to investors and analysts, 4Q20 results, 23 February 2021.

⁷ Lloyds Banking Group: Presentation to analysts and investors, 2020 results, 24 February 2021.

⁸ ECB Economic Bulletin 2/2021.

⁹ Global Capital.



**Deprived premiums partly
compromised by seesawed claims
with insurer focus on higher returns:**

The insurance investment sector, worth EUR10tn, is considered to be the single largest pool of institutional capital based in Europe. Of this large pool of assets in the insurance sector, loans currently account for just 7.3%. In 2020, the 10 largest insurers on aggregate saw both net premiums and claims decline by 9% and 11%, respectively. Interestingly, the pandemic has forced both a surge in and a subdued effect on insurance claims. Lower economic activity has led to significant reductions in property and casualty (P&C) insurance claims, primarily in aviation, driven by fewer accidents and injuries due to reduced road travel and fewer work-related incidents. Moreover, social distancing has led to a reduction in claims during the normal flu seasons. However, this could easily be offset by a rise in claims in entertainment, owing to disruption of movie or film production and cancellation of live events.

Investments in public infrastructure projects, real estate and private

credit are sensible avenues for ROI-conscious insurers reeling from current low market yields, as they provide a way to diversify risk in loan portfolios that typically comprise conventional mortgage and policy-linked loans. Allianz group's investments in wind and solar power parks in Poland, its 101st such renewable project investment, and MetLife's (US) successful bid to secure a bilateral senior secured loan of GBP117.5m for the English Football League (EFL) to cover the EFL's payroll obligations are recent examples of the sector actively diversifying into commercial lending.

**European financial institutions
sector outlook for 2021: pandemic
woes to ease but dovishness
to prevail**

We believe earmarked developments such as the phasing-out of loan moratoria and state-sponsored loan guarantee schemes across European countries will necessitate notable adjustments to banks' lending dynamics in 2021, especially in countries such as Italy, Spain and Portugal. While only a small fraction

of loans granted moratoria are likely to be active in 2021, loans on state guarantees are expected to continue for the most part of 2021 and possibly beyond. Moreover, we believe the overall bank NPL level will move slightly beyond 3% in 2021. However, the capital headroom provided for European banks through the relaxed Pillar 2 Requirement (P2R), including dividend restrictions, is likely to help them absorb loss provisions without compromising their lending ability. We expect the regulatory leeway afforded through measures such as NPL securitisation for banks, coupled with broader liquidity stimulus (i.e., PEPP, APP and TLTRO) guaranteed by the ECB throughout 2021, to reduce stress on banks' asset quality and risk to incremental credit creation. We also expect the insurance sector, partly pressured by the regulatory guidance on capital (Solvency II directive) and persistently lower yields on investment pools, to increase its foothold in the commercial lending subsector, based on meritocracy, in 2021.

*Writing attribution: Shamika
Ramanayake*

2.6. FOOD AND AGRICULTURE: OPPORTUNITIES TO ADVANCE SUPPLY CHAIN IN THE LIMELIGHT

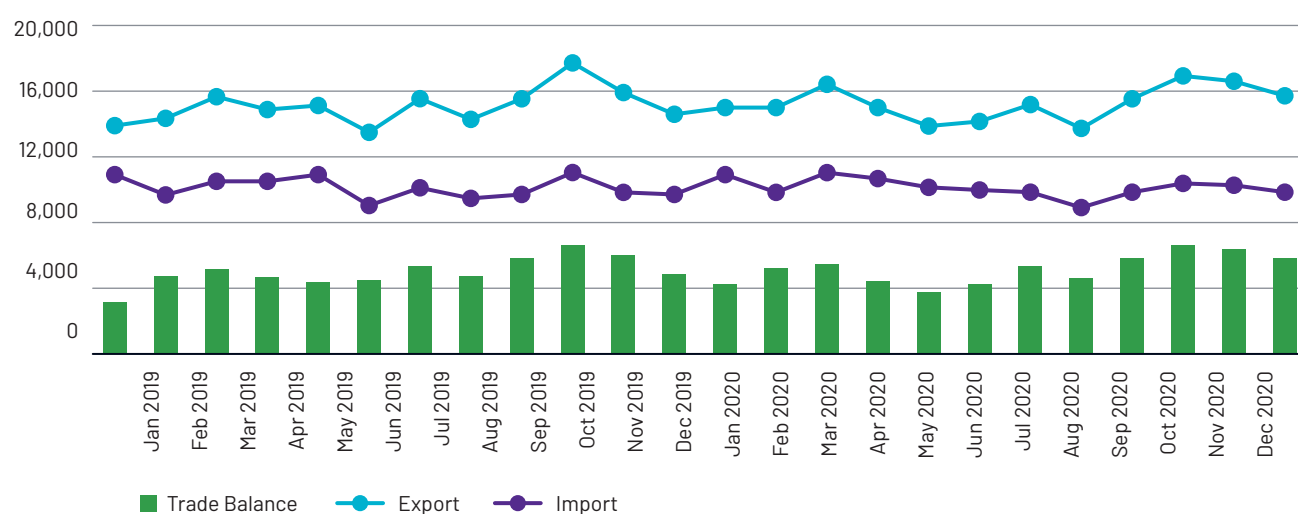
Global lockdowns and restrictions on factor mobility affected the food and agriculture sector's supply chain, and overnight shutdowns in the food service sector (such as of restaurants, cafés and hotels) erased everyday demand in the downstream food value chain. This hampered momentum in "want-based" demand, but "need-based" demand saw a shift in consumer consumption concentration towards supermarkets. Shortages in seasonal migrant workers, coupled with limited availability of and access to inputs, strained food

and agriculture trade at the start of the lockdowns. However, the supply chain recovered towards the peak of the pandemic as short-term product shortages were rectified by the creation of "green lanes" that ensured the smooth movement of products, especially within the EU.

The region is ranked the world's largest exporter of agri-food products, but it imports approximately half of its food consumption volume, maintaining a trade surplus, which was unaffected during the pandemic, as shown below.



Figure 15: Europe's trade of agri-food products



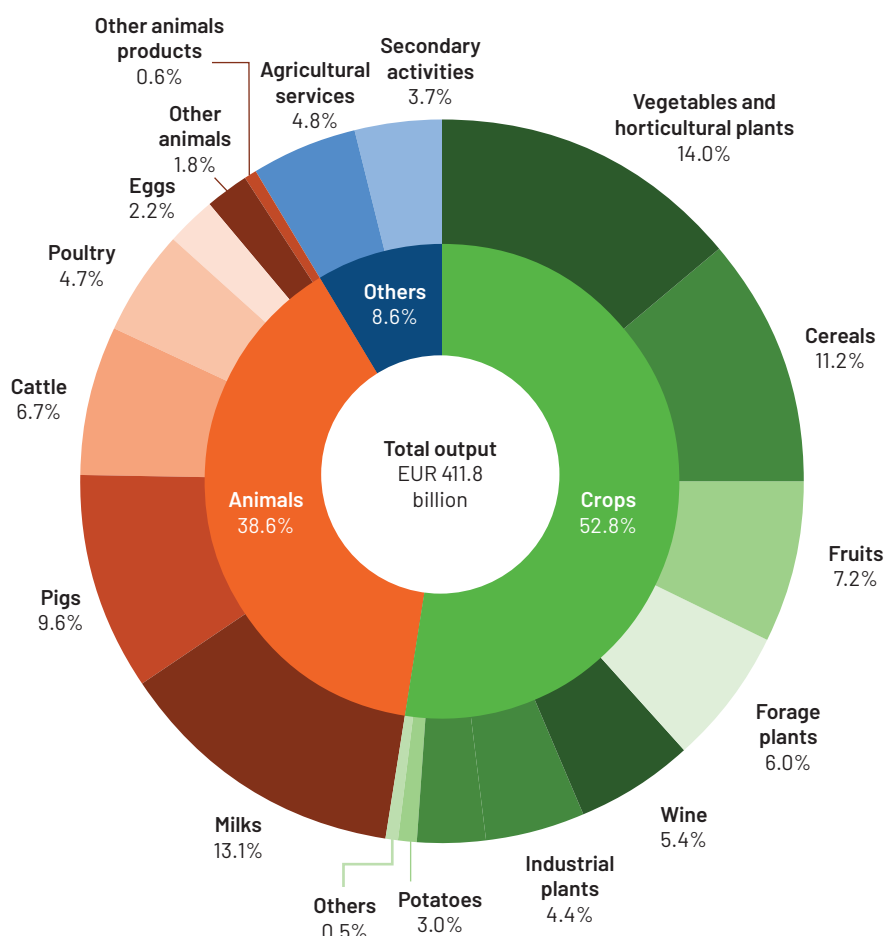
Source: Context; European Commission – 2020 a year of stability for EU agri-food trade.

China's peak-to-plateau journey amid the pandemic saves Europe's export earnings: Overall, the sector remained stable in 2020, with marginal export growth (+1.4% y/y) driven mainly by strong sales to China through exports of pig meat, wheat and infant food that grew by EUR3.2bn from 2019 levels. China, the largest agri-food importer, recovered steadily from economic inactivity in early

2020, helping Europe manage its export earnings, despite the sharp reduction in domestic consumption due to harsh lockdowns. Exports of cereals and dairy products (the EU's two largest agricultural outputs; Figure 16) contributed, particularly with notable growth to destinations in the Middle East and North Africa. This was partially offset by the decline in exports to the US by EUR0.4bn and Singapore

by EUR0.3bn, attributable to the fall in exports of spirits and wines (products directly linked with outdoor dining, large events and festivities). The sector was also impacted by ongoing challenges such as the decline in availability of agricultural land, climate change, adverse weather conditions and animal diseases such as African swine fever that took a toll on the European pig meat market.

Figure 16: Output of the EU's agriculture sector, 2020 (% share of total output)



Note: Values at basic prices; Source: Eurostat – Performance of the agriculture sector.

Pandemic exposes weaknesses in Europe's food supply chains:

The pandemic exposed many weak links in supply chains, highlighting the need for technology-driven innovation, despite Europe pioneering the tech-driven agronomy work done to date. Amid increasing pressure on producers and farmers, governments and relevant authorities have taken the necessary measures to improve the efficiency of food supply chains, such as by testing new labour-free, machine-driven harvesting mechanisms and investing in upstream research activity to minimise human intervention in

organic food manufacturing. In addition to strengthening future-oriented food supply chains, the European Commission has acted to prioritise food security while supporting farmers and suppliers. Several measures have been introduced to safeguard farmers, such as increasing advances on the common agricultural policy that provides income support and increasing government aid to farmers (up to a maximum of EUR100,000) and food-processing companies (up to a maximum of EUR800,000). Efficient food supply chains have been created through implementing "green lanes", resulting in a single

market that minimises border-crossing restrictions and classifies seasonal workers in the sector as "critical workers".

Already significant technology advancements to be made pivotal in the food and agriculture sector:

Other agricultural trends have also evolved over the years in response to growing sector demand and systemic pressure to increase efficiencies. The agricultural machinery industry is expected to grow in line with growth in demand, towards enhancing agricultural data-sharing, supporting investment

in research and infrastructure, upgrading digital skills or deploying machines to respond to an evolving agricultural sector. Precision agriculture and smart food processing – key concepts that have gained prominence – are also expected to increase efficiency gains. Precision agriculture involves modern farming practices that optimise resource consumption and agricultural output through digital techniques to monitor and optimise farming practices. Smart food processing uses advanced manufacturing technologies, IoT, robotics, sensors and other technological solutions in food processing.

Global demand and increasing regulatory guidelines on sustainable farming have resulted in the EU's food and agriculture

sector progressively adopting the sustainability agenda amid the crisis. The "Farm to Fork Strategy" published by the European Commission in early 2020, aiming to make food systems and processes fair, healthy and environmentally friendly, sets out targets to reduce the use of chemical pesticides and fertilisers and sale of antimicrobials, while increasing the amount of agricultural land used for organic farming. It also seeks to improve animal welfare, protect plant health and encourage adoption of green business models.

European food and agriculture sector outlook for 2021: consumption-driven positive trajectory to continue, led by technological innovation

Immune to global economic disruption, Europe's food and

agriculture sector is set to continue its growth momentum in 2021 with a special focus on safety, efficiency, sustainability and digitalisation as the driving forces. We expect the sector to grow in parallel with GDP growth. Safety and sustainability are now process norms, with the sector mandating products that are ethically sourced, have nutritional value and are safely distributed while conforming to the European Commission's Green Deal and Farm to Fork Strategy. Short supply chains and technological innovation are expected to help the sector achieve efficiency goals while increased demand for e-commerce, coupled with digitalisation, precision agriculture and smart food processing, create a need for technological investment.

Writing attribution: Shamila Deen and Chamathka Fonseka



How Acuity Knowledge Partners can help

With over 18 years of experience in delivering research and analytics services, we have built a robust and sustainable ecosystem of people, process and technology. We have strong credentials within the corporate and commercial banking space, supporting banks across the lending value chain, helping them centralise, standardise and digitalise lending processes.

Support we offer:

- » KYC and client due diligence
- » Origination – target screening and cross-selling, peer comp studies, pre-qualification credit assessment
- » Underwriting – cash flow modelling, capital structure analysis, drafting term sheets
- » Credit monitoring – covenant monitoring and validation, financial spreading, risk ratings, credit reviews

- » Lending operations – loan servicing, collateral valuation, lien termination, document management

With digitalisation initiatives specially designed to automate parts of the credit analysis function, coupled with the flexibility to choose from different engagement models, we enable financial institutions to scale their lending operations while remaining client- and risk-focused. As business/operational uncertainty increases, our lending service offerings can help banks simplify lending, improve speed to market and make better credit decisions.

The recent crisis amplifies the need for robust credit risk governance, including timely monitoring of loan portfolios

and early identification of deteriorating credit risks. We partner with UK and European lenders, helping them maintain the ability to take risks prudently while driving ROI in their lending processes. Combining our credit expertise with lending best practices and domain-driven technology, we have partnered to

- » build effective monitoring frameworks including early warning signals, portfolio-level analytics and dashboards
- » ensure timely monitoring of loan portfolios, especially of at-risk businesses through re-risk ratings, financial modelling, covenant headroom and credit memos
- » automate repetitive tasks to drive efficiencies

Automation and workflow management platforms



Proprietary engagement management solution



Financial and covenant data extraction module



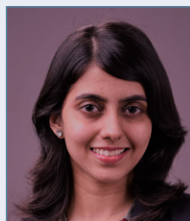
Proprietary covenant validation and analytics platform

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Acuity Knowledge Partners (Acuity), formerly part of Moody's Corporation, is a leading provider of bespoke research, analytics, staffing and technology solutions to the financial services sector. Headquartered in London, Acuity Knowledge Partners has nearly two decades of experience in servicing over 350 clients by deploying its 3,000+ specialist workforce of analysts and delivery experts across its global delivery network.

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- » Asset Management services support: across marketing, investment research, portfolio management/optimisation, risk and compliance
- » Corporate and Consulting services: market and strategic research; survey work; treasury and counterparty risk support; and CEO office support, including M&A, FP&A and investor relations support
- » Compliance support: AML analytics, KYC, counterparty credit risk modelling and servicing across banks, asset managers and corporates
- » Data Science: web scraping, data structuring, analytics and visualisation These services are supported by our proprietary suite of Business Excellence and Automation Tools (BEAT) that offer domain-specific contextual technology.

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