

Ms. Katrín Jakobsdóttir
Prime Minister
Stjórnarráðshúsinu við Lækjartorg
101 Reykjavík

and

Mr. Bjarni Benediktsson
Minister of Finance and Economic Affairs
Arnarhvoli við Lindargötu
101 Reykjavík

Reykjavik, 14 March 2018

Subject: Sale of shares in Arion bank hf.

Introduction

I am writing to you to:

- update you formally on progress regarding the sale of shares in Arion bank hf. (“Arion”);
- explain that Kaupthing ehf. (“Kaupthing”) no longer supports a separation of Valitor holding hf. (“Valitor”) from Arion; and
- request that Kaupthing and the Icelandic state work to vary the Icelandic state’s step-in right on the sale of Arion shares in an IPO, in line with agreements previously made between Kaupthing and the Icelandic state.

Background and context

Kaupthing acquired an 87% stake in Arion at the beginning of 2010 when an agreement was reached with the Icelandic state on the financial restructuring of the resurrected local operations of Kaupthing under the name of Arion. Kaupthing’s initial capital contribution amounted to 66 b.kr but at that time the company was in winding-up proceedings and was therefore assessed by the FME as ineligible to own a qualifying holding in Arion. As a result, the ownership was only authorised in a separate subsidiary of Kaupthing, Kaupskil ehf (“Kaupskil”), which was to be governed by a board of directors with the majority consisting of members independent of Kaupthing (and indeed its creditors and Arion itself).

The winding-up proceedings of Kaupthing concluded when its composition agreement was approved by the district court in December 2015. Among the contractual stability conditions¹ agreed at the time, Kaupthing and Kaupskil undertook jointly² towards the Icelandic authorities to monetise the stake in Arion, achieve a satisfactory and acceptable fair market value for it and pay the majority of the monetisation proceeds, or around

¹ Written into the following agreements: Shareholders’ Proceeds Apportionment Agreement, Assignment Agreement, Bond, Pledge Agreement

² Kaupskil is not permitted to take on any obligations according to the FME conditions and it is therefore Kaupthing that pays the stability contribution from the monetisation proceeds of the Arion shares according to the agreements, but Kaupskil is the owner and seller of the shares

70%, to the Icelandic Treasury as a stability contribution. In summary, the profit sharing agreement means that once the proceeds exceed certain thresholds, a greater proportion is paid to the Icelandic Treasury. According to the agreements, Kaupthing manages the sales process, selects and pays all professional advisers and establishes the timing, structure, pricing and all other terms and conditions of the monetisation process and Kaupskil commits to promote the sales process as the formal owner of the shares. The stability conditions mean that all parties are aligned in obtaining the highest value reasonably achievable from the sale of the shares.

From that point in time consideration has been given to a sale of the shares in Arion in an M&A transaction or through an IPO. Morgan Stanley has provided financial advice on the project³.

Sale of shares in Arion


So far, investors have not had any interest in acquiring Arion in an M&A transaction at an acceptable price, and the focus has largely been on an IPO sale. Preparations for a public offering and listing of Arion shares were well advanced in mid to late 2017, as Kaupthing informed the Icelandic authorities in a letter dated 1 August 2017. However, when new parliamentary elections were called in September 2017, it was decided to delay any sales efforts given the political uncertainty.

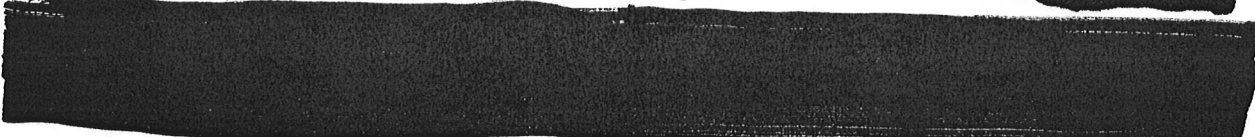
In preparation for an international initial public offering, just over 44% of the issued share capital in Arion has changed hands in the last 12 months. The sales price in all these transactions has been at a level above 0.8x the book value of shareholders' equity in Arion, based on the latest quarterly financial statements of the bank at the time when the transactions were concluded. In addition to the reduction in risk achieved for Kaupthing and the Icelandic state, these changes in ownership provided a number of additional benefits. Our interactions with local and international institutional investors informed them more about the Arion investment opportunity, confirmed the interest of institutional investors in anticipation of an IPO, reduced the shareholding of the original shareholders and limits the overhang of shares after the listing. The ownership changes should therefore contribute to better price formation in an IPO.

Value increasing measures

In the above-mentioned letter from Kaupthing to the Icelandic authorities in August 2017, certain value increasing measures were identified that could be applied (within the scope of the Kaupskil ownership conditions) to maximise the monetisation proceeds of Kaupskil's shares in Arion and thereby Kaupthing's stability contribution to the Icelandic state.

As set out in the letter, Kaupthing supported the principle of a reduction of Arion's surplus capital in connection with the sale of shares in Arion, as new investors would likely not pay par value for it in an IPO. A major milestone was achieved by Arion's reduction of 25 b.kr. of its excess capital in connection with the sale of shares in Arion to domestic and foreign investors in February this year⁴. The Icelandic Treasury's share in this distribution was over 21 b.kr.

Up until now, Kaupthing has also been supportive of the separation of Valitor from Arion. 



³ See Arion's stock exchange announcement from June 2016 and Kaupthing's announcement from September 2017

⁴ See announcement from Arion dated 26 February 2018

[REDACTED]

Accordingly, for these reasons Kaupthing's position towards the separation was that it would be beneficial from the perspective of maximising monetisation proceeds for the ultimate benefit of Kaupthing and the Icelandic state.

This all said, we are aware that the Icelandic state has expressed caution about proceeding with the separation for a number of reasons. [REDACTED]

[REDACTED]

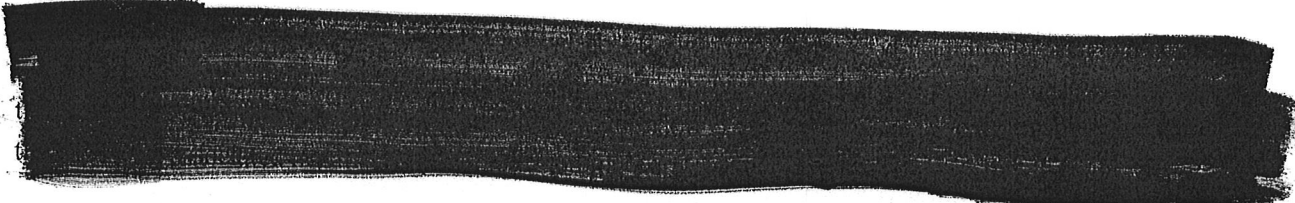
In short, whilst Kaupthing considers it has conducted itself properly and with the aim of maximising realisations, Kaupthing notes these concerns and in any event, the support of the Icelandic state is essential to ensure a successful separation in this situation. Accordingly, Kaupthing has now changed its position and it will not now support a separation of Valitor from Arion, either before or after an IPO. Kaupthing would now prefer to proceed to being able to launch an IPO of Arion at the earliest possible opportunity.

Step-in right of the Treasury

As a safety measure for any circumvention of the contractual stability conditions in connection with the sale of Kaupskil's stake in Arion, the Icelandic Treasury received a step-in right on all share transactions priced at or below 0.8x book value of the shareholders' equity in Arion based on the latest audited accounts at every time. In the event of an IPO sale, the parties undertook to vary the step-in right in accordance with the advice from an independent international investment bank to ensure a proper and orderly sales process in the IPO, as the risk of any circumvention greatly diminishes in an IPO where the market value is set by offers from a broad group of investors.

In a letter from the Icelandic State Financial Investments ("ISFI") to the Minister of Finance and Economic Affairs dated 19 February 2018, in connection with the exercise of Kaupskil's call option on the 13% stake in Arion held by the Treasury, it was among other things pointed out that the exercise price of the call options at a level close to 0.80x book equity value of Arion as of the end of December 2017 was acceptable in comparison to the estimated market value of the shares and any comparison between the estimated market value and book equity value two issues would have to bear in mind:

"First, the book value of equity is high because the Icelandic banks' performance has been partly reflected by positive one-off items. Secondly, the Financial Supervisory Authority makes more stringent capital requirements than supervisors in other countries. As a result, Icelandic banks hold shareholders' equity, which in proportion to their assets is much higher than in other countries. As a result, the profitability of the regular operations of Icelandic banks can be lower, which is partly reflected in the derived market value that is lower than the underlying book value."



Conclusion and next steps

Kaupthing, Arion and its advisers have undertaken a huge amount of preparatory work for an IPO. To ensure that an IPO is successful, and in line with the consistent advice of Kaupthing's advisers, Kaupthing wishes to commence the formal process set out in article 3.6 in the Shareholders' Proceeds Apportionment Agreement. That is, that the parties work together to vary the step-in right in accordance with the recommendation from an independent international investment bank.

In Kaupthing's view, a successful IPO is in everyone's best interests and the variation of the step-in right will not only ensure an orderly IPO process but will also demonstrate strong support of the local authorities to this final stage of the sale of the Arion. Kaupthing looks forward to engaging with representatives of the Icelandic state, as the state considers appropriate, in order to progress this matter.

Respectfully,



Paul Copley, CEO of Kaupthing

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Fjármálaeftirlitið, Katrínartún 2, 105 Reykjavík (for the attention of Jón Þór Sturluson)
Arion banki, Borgartún 19, 105 Reykjavík (for the attention of Eva Cederbalk and Höskuldur H. Ólafsson)
Kaupskil, Borgartún 26, 105 Reykjavík (for the attention of Reynir Karlsson)