

The Journal

Brave new world: New frontiers in banking M&A

Banking M&A is evolving rapidly along new, more complicated and less predictable patterns. Deals are also becoming more risky for the institutions and individuals involved. Are you positioned for success in the brave new world of banking M&A?

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Introduction – How did we get here?

The total number and value of global banking M&A transactions has declined steadily over the past few years. If 2007 represented the end of the bull market for banking M&A, then 2008 and 2009 were defined by a wave of nationalisations and rescue transactions. Since then banking deals have cooled, although M&A has remained a vital tool for adaptation, retrenchment and reform.

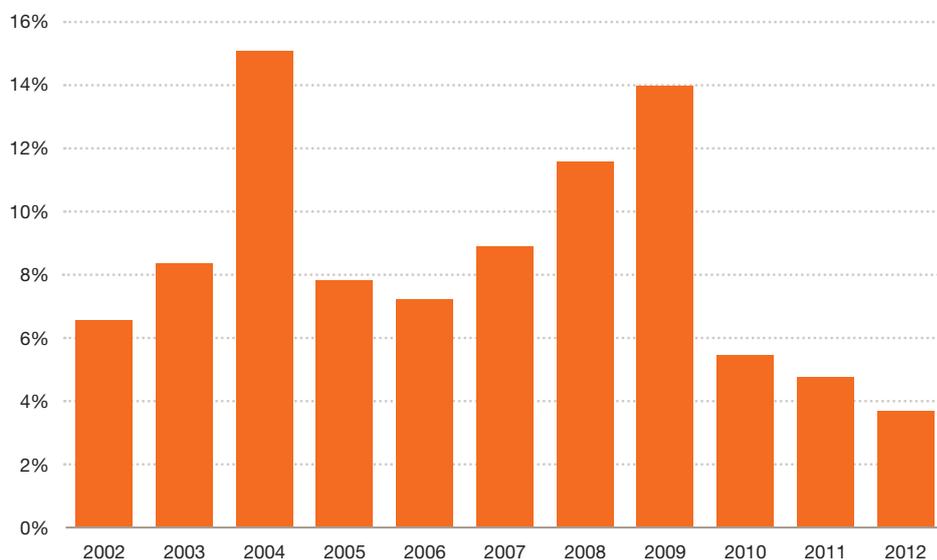
Moving forward to the present, global banking transactions continue to decline faster than all-sector M&A, and will record another weak year in 2012 (see Figure 1). During the first ten months of 2012, the total value of completed global banking deals fell by 37% on a like-for-like basis, compared with a decline of 20% for all-sector global M&A.¹

Banking deals have consistently accounted for the majority of financial services M&A over the past decade. The decline in banking M&A over the past three years – or excluding government-led deals, over the past five years – is not just a cyclical downturn. It represents

a radically changed economic and regulatory environment, and the end of previous assumptions about the banking industry's models, profitability and investment returns.

In this paper we set out our view that the size and nature of global banking M&A has changed permanently. To support this argument we review the changing drivers of banking deals; how banking M&A is already evolving; and what changes we expect to see in the future. We end with some questions that we believe all banks – including those not currently engaged in M&A activity – should be asking themselves.

Figure 1: Global banking M&A as a % of global all-sector M&A (total value, completed deals, 2012 data to end October)



¹ Thomson One

4.7%

The combined effect of these changes is that over the next 40 years, GDP in the E7 emerging economies is expected to grow at a cumulative average of 4.7%³

The new environment – What will drive banking M&A?

The environment for banking M&A over the next five to ten years will be affected by a number of trends reshaping the global banking landscape. In considering the most important factors we draw on PwC's Project Blue², which provides a framework for financial services firms to assess the future evolution of their industry.

Project Blue identifies a range of factors driving change in financial services. These include fiscal pressures, regulatory reform, technological change, customer behaviour, talent shortages and economic shifts. Looking more specifically at the future of banking M&A, we expect four factors to be particularly influential. These are: economic growth, banking integration, regulatory reform and strategic shifts.

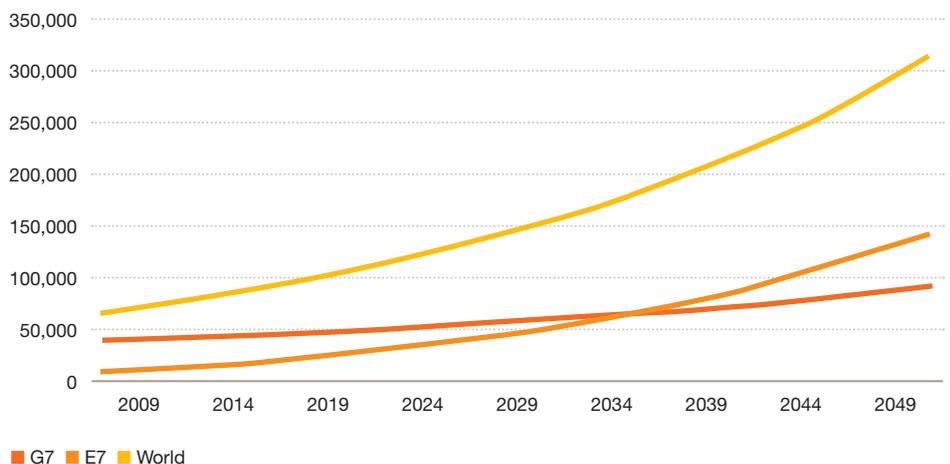
- **Economic growth:** The shift of economic power away from the mature economies of North America and Europe is well documented, but the process has much further to go. Changing demographic patterns and increasing capital investment by emerging market governments are two of the factors at work. Project Blue also highlights the importance of increasing trade flows between South America, Africa, Asia and the Middle East (SAAAME).

The combined effect of these changes is that over the next 40 years, GDP in the E7 emerging economies is expected to grow at a cumulative average of 4.7%, more than double the equivalent rate of 2.1% for the G7 economies.³

- **Banking integration:** As developing economies expand, they will experience rapid growth in middle-income consumers. PwC's recently updated study, 'Banking in 2050', predicts a steady increase in many emerging markets' ratios of domestic credit to GDP. By 2050, total banking assets in the E7 economies are expected to exceed those of the G7 nations (see Figure 2). More importantly for potential acquirers, banking profit pools in the E7 markets are also predicted to exceed those of the G7 by 2050.

Figure 2: E7 v. G7 total domestic credit

Domestic credit (\$bn 2009 prices)



Source: Banking in 2050, PricewaterhouseCoopers, May 2011

² www.pwc.com/projectblue

³ 'The World in 2050', PricewaterhouseCoopers, January 2011. E7 = China, India, Brazil, Russia, Indonesia, Mexico, Turkey

- **Regulatory reform:** Regulation is affecting banking M&A in an increasing number of ways. In the short term, the sheer unpredictability of regulatory change is adding to the uncertainty hanging over the banking industry. This is having a disruptive effect on banks' ability to plan and execute M&A.

In the medium term, several aspects of regulatory change will affect banking M&A. First, regulators and state bodies around the world are playing a more direct role in banking M&A. They are more willing to challenge proposed transactions and to broker domestic deals to support weakened institutions.

Second, national and international regulations are forcing banks to restructure. The most obvious example is Basel III, which will encourage banks to strengthen their capital and could stimulate consolidation in some markets.

Third, an increasing focus on 'subsidiarisation' is forcing more banks to fund expansion plans locally, instead of relying on foreign parents. This is being reinforced by tight cross-border interbank markets.

Lastly, banking leaders in some markets are coming under moral pressure from central bankers, regulators and politicians to limit their plans for foreign expansion.

- **Strategic shifts:** Rationales for banking M&A are changing and becoming more diverse. During the boom years the main motives were to build scale, achieve faster growth, or develop new businesses. These are still key strategic goals for some banks, but other themes such as strengthening balance sheets, simplifying business models and offsetting falling profitability have become equally important for other institutions.

It is not just the goals of M&A that are becoming more varied. A far greater range of institutions are initiating transactions than in the years leading up to the financial crisis. In particular, emerging markets' banks are becoming more active acquirers, both in their home markets and further afield. And as the participants in banking M&A become less homogenous, so do the techniques being used. Emerging market banks are developing their own approaches including partnerships and distribution agreements.

This picture of greater strategic complexity looks like an increasingly permanent feature of global banking M&A. In the next section we consider how M&A strategies are already changing in different banking markets, and how they may continue to develop.

In addition to these long-term drivers, another factor will affect banking M&A in the short to medium term.

- **The European crisis:** The sovereign debt crisis in Europe will continue to affect banking M&A for as long as it continues. The political and economic uncertainty emanating from the eurozone is making it harder to predict future impairments, agree on valuations, arrange funding and gain shareholder approval. The crisis is also having a significant impact on deal confidence, by encouraging banking leaders to delay or avoid M&A decisions carrying strategic risk for their institutions – or personal risk to their own reputations.

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Market dynamics – How is banking M&A evolving?

Asia-Pacific

Supported by rapid economic expansion, increasing middle-class demand for banking products and a growing high-net-worth segment, Asia-Pacific is likely to remain the most active region for banking M&A. Domestic deals will continue to drive M&A, as banks respond to increasing competition and the need for greater operational and capital efficiency. In-market transactions will also be stimulated by the desire to acquire customers. Other banks will use M&A to develop a broader range of services for institutional and high-net-worth clients.

Intra-regional deals are already a feature of Asia-Pacific banking, and this is only likely to grow. Large banks from markets such as Japan, Korea, Singapore, Malaysia and Australia are increasing their exposure to fast-growing South-East Asia, particularly Indonesia and Vietnam. The rapid growth of retail banking is an increasingly strong motive for regional expansion, as banks seek to acquire new customers and develop scalable platforms for growth. However, national regulators are increasingly inclined to place limits on foreign ownership, and minority stakes will become more capital intensive under Basel III. Many are encouraging local banks to merge, to develop a smaller number of nationally and regionally competitive banks.

The attractive fundamentals of Asia-Pacific banking mean that banks from more mature regions such as Europe and North America will continue to use M&A to build scale in the region. In some cases, they will take advantage of competitors' exits.

Some Asia-Pacific banks, particularly from North Asia, are becoming more focused on making acquisitions outside the region. The largest Chinese banks are already following corporate clients around the world, using M&A as well as greenfield startups to enter new markets. Large Chinese and Japanese banks may also take an interest in Western Europe, where low banking valuations could allow them to acquire valuable expertise or gain access to new clients.

North America

The US looks poised to experience a fresh wave of consolidation among small and mid-sized banks. The American banking market remains comparatively fragmented, and the effects of regulatory changes will spur many institutions to seek merger partners. The Durbin Amendment and

Dodd-Frank Act in particular will add to the costs of compliance and encourage small banks to strengthen their capital and seek greater scale. Cleaner balance sheets are also helping to stabilise valuations and stimulate transactions.

The largest US banks are likely to follow differing approaches to M&A over the next few years. Some still have significant restructuring ahead of them, and will generate transactions by disposing of foreign units or non-core businesses. Others are in stronger financial shape and well placed to expand overseas. Asia-Pacific and Latin America will be the most attractive regions for outbound M&A.



Canada's large commercial banks, on the other hand, have emerged strongly from the financial crisis and are actively acquiring businesses and portfolios at home and in the US. These bolt-on transactions may not be large by global standards, but they have the potential to make a significant impact on bidders' businesses. Like their US counterparts, Canadian banks looking further afield for growth are more interested in Latin America or Asia-Pacific than the troubled European market.

Conversely, several large Chinese banks have recently set up Canadian operations, following large corporate clients moving into Canada's resource sector. Others could follow, using inbound M&A to establish a presence more quickly than through a greenfield approach, but Canada's concentrated banking market offers few material acquisition targets.

Latin America

Brazil remains Latin America's most important banking market, and will continue to generate M&A deals. National regulators are encouraging small banks to consolidate, improving capital ratios and boosting industry efficiency. Meanwhile, the larger, well-capitalised Brazilian banks are keen to follow their multinational clients by expanding across the region. So far, they have limited themselves to comparatively small acquisitions, but this is likely to change as Brazil's economy grows. The same desire to follow trade flows is encouraging large Brazilian banks to open offices in Asia-Pacific and the Middle East.

Inbound Brazilian banking transactions will continue, but acquirers are likely to maintain their focus on niche activities like private banking, asset management and prime brokerage. Regulatory pressure in their home markets means that foreign banks could miss out on valuable opportunities to acquire medium-sized Brazilian commercial banks. Asian banks are interested in Brazil, but prefer to enter the market via greenfield startups rather than M&A.

Banking M&A in the rest of Latin America is evolving steadily rather than dramatically, but the pace of development is likely to accelerate over the next few years. Domestic consolidation will remain a common theme, and markets such as Mexico and Columbia are attracting a growing share of inbound M&A. Even so, political risk remains a concern for international buyers eyeing the potential growth of some regional markets.

Western Europe

Restructuring will remain the most important driver of banking M&A in Western Europe over the next few years, as banks seek to focus on core businesses and exit peripheral activities. Despite a backlog of potential disposals, market volatility and uncertainty over banks' potential credit losses mean that buyers and sellers will continue struggling to agree on target valuations.

Finding buyers for non-core businesses will also remain challenging. Many European banks are effectively barred from acquisitions by capital restrictions and investor scepticism. Nor are many banks from outside Western Europe attracted to invest in the region. Even so, there may be interest from some emerging market players – particularly Chinese banks – in distressed European targets that offer the chance to build a niche presence or acquire useful skills and expertise.

Some Western European banking markets – most obviously Italy, but also Germany, Spain and Greece – are still relatively fragmented and offer significant potential for domestic consolidation. As in the US market, the main motives for domestic mergers are to boost scale and to strengthen capital and liquidity positions.



1,000

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Russia and emerging Europe

Russia has generated increasing banking M&A over the past few years, and this growth is likely to continue. Russia has nearly 1,000 banks but consolidation, although long anticipated, has yet to take off. Even so, some innovative and fast-growing retail banks require capital to support their growth. The continuing withdrawal of some Western European banks is also likely to stimulate deals. Meanwhile the largest Russian banks will continue to use M&A to develop greater scale, especially in corporate and investment banking. Some may follow Sberbank, which has made acquisitions in Turkey and Eastern Europe by expanding in fast-growing markets outside Russia.

Poland continues to defy the economic gloom of many of its neighbours, generating steady credit growth. The market offers a number of investment opportunities and will remain one of the more active areas of banking M&A in Central Europe. Several banks currently owned by foreign players are in need of fresh capital, and some private owners of local banks could be interested in co-investors or a possible exit.

Turkey offers huge potential for economic growth and higher banking penetration. In recent years Turkish banks have attracted bids from the US, Western Europe, Russia and the Middle East, and they will continue to be popular targets for inbound M&A. Opportunities to make large acquisitions in Turkey are comparatively rare, so competition for any local subsidiaries coming up for sale is likely to be fierce.

Loan transactions

Although distinct from corporate M&A, the growing market for loan transactions will play an increasingly important role in banks' strategic decision-making over the next few years. Banks in Western Europe, and to a lesser extent the US, are likely to remain the major source of loan sales. European banks' non-core loans at the end of 2011 were estimated at more than €2.5tn, equivalent to 6% of total banking assets. Non-performing loans were valued at more than €1tn, and the current slowdown in many eurozone economies suggests this figure may grow.⁴ The past two years have seen European banks dispose of loans with total face values in the tens of billions of euros.

We expect the pace of loan sales to accelerate over the next few years, as banks seek to deleverage and maximise their returns on assets. Transactions will not only come from markets like the US, the UK, Ireland and Spain where loan sales are already running at significant levels, but also from markets such as Germany and Italy where non-core loans are substantial but deal activity has so far been comparatively low. Loan portfolio transactions will be stimulated by growing investor appetite, and by the increasing willingness of banks facing refinancing hurdles to ring-fence assets for disposal. A fresh wave of provisioning by European banks could also help to stimulate transactions by reducing bid-ask spreads.

Of course, sales are not the only means of deleveraging open to banks. Many non-core loans will refinance in the normal way or be subjected to accelerated workout, and asset swaps or structured arrangements will also play a role. Even so we expect loan transactions, already more significant than in previous credit downturns, to become an increasingly important tool of banking strategy.

Middle East

High oil prices and the associated flow of money through the economy has helped banks in some parts of the Middle East to maintain high levels of liquidity. By contrast Dubai, in particular, has been working through the overhang of its real estate boom. These contrasting pictures and a focus on domestic and regional investment have influenced recent banking M&A in the region. Middle Eastern banks' appetite for outbound M&A has been selective and led by Qatari institutions; there is continued interest in nearby growth markets such as Turkey, as well as European private banking assets and the growing role of Islamic Banking in Central Asia and the Far East.

Despite the long-term growth potential of the Middle East, several international banks based in Europe and North America will continue to reduce their activities in the region, in part due to the challenges faced back in their home markets. However, innate caution amongst local banks about the risks of over-expansion or, in the case of some local banks, an inability to pick-up these divestments or teams until they have tidied up their own balance sheets are a dampening factor. In Saudi Arabia, domestic banks are sizeable and well capitalised; this, combined with a conservative regulator means opportunity for market penetration or expansion by non-domestic banks remains restricted. Further, the imminent Saudi government mortgage financing fund will be an important milestone for the Saudi Arabian banking market. However, the market changes afford an opportunity for other international groups and selected more liquid institutions to take advantage, and secure expertise and a broader client base. Additionally there are early signs of interest from Chinese banks, as Chinese construction and engineering companies win contracts in the region.

⁴ Based on internal PwC analysis

Africa

Africa has the potential to generate increasing volumes of banking M&A over the next few years. Favourable demographics and a central role in SAAAME trade are encouraging local and international players to increase their exposure to African banking. Further attractions include low levels of banking penetration, African banks' strong levels of deposit funding and the scope for buyers to improve targets' operational efficiency. In short, the case for investment in African banking is growing.

South African banks are among those looking to other African markets for future growth, and the country remains the leading gateway into Africa for foreign entrants. Most major domestic banks already have international strategic or equity partners, but there is still potential for inbound M&A. South Africa's major banks' earnings growth and returns on equity compare favourably with those of global peers.⁵

Nigeria is another market that offers growing potential for M&A activity. The banking sector has gone through several rounds of restructuring, most recently in response to regulatory reforms and government intervention aimed at raising capital levels and strengthening balance sheets. There is further scope for domestic consolidation and for international players to acquire non-core businesses, divested by local banks. Other African markets such as Kenya have similar potential for banking consolidation and rationalisation, in addition to their attractive growth prospects.



⁵ 'Creating growth despite uncertain times: South Africa – major banks analysis', PricewaterhouseCoopers, 19.09.12



Sovereign investors

Sovereign wealth funds and other state-backed investors have been important participants in banking M&A since the middle of the last decade. The financial crisis has only increased their influence, but it has also made them more wary of investing in mature banking markets. Sovereign investors continue to play a role, but their investment approaches vary widely. Most hope to realise gains, but while some focus on long-term engagement, others are open to opportunistic investments. When it comes to banks, sovereign investors usually have secondary motives, too. These can include promoting stability, exercising international influence, or pursuing social objectives.

These mixed motives mean sovereign investors' objectives are often opaque, making their role in banking M&A unpredictable. Sovereign funds' potential firepower also means that rumours can easily disrupt potential deals. Until sovereign investors develop clearer, more consistent approaches to investing in banks, this unpredictability is likely to remain a feature of their involvement in banking M&A.

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Private equity

Private equity funds willing to invest in risk-carrying banking businesses remain in the minority, but we believe this will change over time as regulators become more comfortable with private equity ownership. For simple reasons of scale, this is unlikely ever to involve large banks, but private equity funds could play an increasingly important role, supplying capital to innovative banking entrants.

In contrast, the majority of private equity funds will continue to be attracted to commission-based businesses with limited regulatory capital needs such as asset management or payment processing. Interest in banks' non-core disposals is only likely to grow, but given that many banks are also focusing on these activities, competition for targets may become an increasing problem.

Private equity involvement in banking M&A is increasingly global, with some firms acquiring emerging markets' businesses from North American or European banks undergoing retrenchment. Some regulators, especially in Asia-Pacific, will remain suspicious of private equity investors' motives. To win them over, more private equity firms are recruiting banking executives to their leadership teams.

All change

Banking M&A has changed significantly in recent years, is evolving rapidly, and will continue to develop in new directions. There are cyclical factors at work, but this should not disguise the fact that permanent changes are taking place.

We should not expect banking M&A to return to its previous level, nor to its previous patterns.

In the short term, regulatory pressure on banks in the developed markets means that valuable transaction opportunities are likely to be missed. The eurozone crisis will also continue to contribute to barriers to banking M&A, most notably uncertain valuations and weak deal confidence.

In the longer term, patterns of banking M&A will become more complicated – and less predictable. As banks' motives for M&A change, deal strategies are already becoming less homogenous. Instead of recovering along a few tried and tested strategic paths, banking deals will follow more routes, in more directions, in more markets. Instead of returning to old patterns, banking M&A will develop on a new and more complex template.

Banking M&A will also become more difficult. This is about more than current problems over prices and valuations. State bodies are being drawn evermore closely into M&A decisions, and transactions will be more risky for the banks involved, for investors and for individual executives. Where strategically weak deals might once have been bailed out by a rising tide of credit, deal synergies will need to be more compelling. As in other industries, it will become more important, not just to pick the right market, but also the right target.

The corollary of this is that the ability to successfully initiate, complete and integrate banking transactions will become a rarer and more valuable strategic strength than ever before. For the banks, it is all to play for.

Luck favours the prepared: Questions to consider

- As portfolio rebalancing continues, will banks focus on core and home markets, or on expanding into higher return segments? Will any be able to achieve both goals?
- Will we reach a point where the intangible benefits of simplification force banks to sell non-core assets, almost irrespective of price?
- Will the increasing openness of some banking regulators to private equity investment lead to a new era – for banks and for private equity?
- As the dominance of global banking shifts from the US and Europe towards other regions, will we see corresponding growth in M&A involving emerging markets' banks?
- What will be the underlying inspiration for the next phase of inorganic growth in global banking – demographics, trade, technology, disintermediation or reintermediation, or shadow banking?
- Will pressure from regulators and investors prevent banks from capitalising on valuable M&A opportunities, and if so, for how long?
- Are banks – collectively and individually – building enough regulatory goodwill to be able to take an opportunistic approach to M&A?
- Will buyers continue to set tough financial hurdles for banking M&A, or will strategic considerations regain their dominance in decision-making? Can banks satisfy both criteria?
- As patterns of banking M&A become more complex and less predictable, will strategy and deal professionals need to improve their scenario modelling capabilities?



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