

# *Sharing deal insight* European Financial Services M&A news and views

*This report aims to provide perspectives on the recent trends and future developments in the European financial Services M&A market and insights into emerging investment opportunities.*

August 2011



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**50%**

*of financial services CEOs are very confident about their prospects for revenue growth over the next 12 months*

**75%**

*of financial services CEOs are planning changes to their organisational structure including M&A over the next 12 months*

# Welcome

## to the third edition of Sharing Deal Insight for 2011.

*Sharing Deal Insight provides perspectives on the latest trends and future developments in the financial services M&A market.*



**Nick Page**

PwC (UK)  
nick.r.page@uk.pwc.com



**Fredrik Johansson**

PwC (UK)  
fredrik.johansson@uk.pwc.com

Earlier in the year, more than 200 investors, financial services executives and industry advisors from around the world came together at our global M&A conference to explore the developments shaping the deal environment. In addition to our normal focus on Europe, Africa and the Middle East, we thought it would be interesting to draw on the discussions at the global conference to examine some of the investment opportunities coming up in other parts of the world.

What emerges from the latest transaction data and the perspectives of the participants at the conference is the gathering impetus for M&A. There is no single spur for increased activity. Instead, a series of drivers are coalescing and creating a deal momentum that has not been seen since the earlier part of the last decade.

Financial services organisations are facing the push of the need to restructure to deal with slower domestic market growth and regulatory pressures on the one side. They are also experiencing the pull of greater confidence and more ambitious return targets on the other. As stability and optimism returns, much of the uncertainty, funding constraints and differences in sellers' and buyers' pricing expectations that had made deals harder to realise are receding.

We are still some way from the deal surge of 2006 and 2007, but financial services organisations are taking determined steps to rationalise, re-focus and invest as they look to lay the foundations for future profitability and growth.

We hope that you find this special edition of Sharing Deal Insight interesting. Please do not hesitate to contact either of us or any of the article authors if you have any comments or questions or would like to discuss the issues in more detail.

# Clicking together the drivers of M&A

Financial services M&A continues to gather pace as a series of interconnecting drivers including restructuring, regulation and the search for growth come together to increase the strategic impetus for acquisition and the availability of targets in the market.

Earlier in the year, more than 200 investors, financial services executives and industry advisors from around the world came together at our global M&A conference to explore the coalescing forces shaping a more buoyant deal environment. Drawing on the discussions at the conference, we look at how more connections are generating more activity and how investors and sellers can capitalise on the opportunities this creates. Although this publication normally focuses on Europe, Africa and the Middle East, this edition also includes overviews of some of the non-EMEA markets on the investment radar.

## Financial Services M&A: More connections, more activity



**Nick Page**

PwC (UK)  
nick.r.page@uk.pwc.com



**Fredrik Johansson**

PwC (UK)  
fredrik.johansson@uk.pwc.com

Source: PwC

## As asset quality and capital stability continue to improve, financial services CEOs are regaining confidence and moving back on to a growth footing.

### M&A shifts up a gear

As Figure 1 highlights, the value of financial services deals increased by more than 40% in 2010 and the momentum has continued to increase in 2011.

As asset quality and capital stability continue to improve, financial services CEOs are regaining confidence and moving back on to a growth footing. Our latest CEO survey found that optimism about revenue growth worldwide is now almost back to pre-financial crisis levels (see Figure 2). However, the strong prospects for growth in the emerging markets of South America, Africa, Asia and the Middle East (SAAAME) contrast with the still fragile recovery in many developed markets.

The renewed focus on growth is changing the predominant nature of deals being carried out, with government activity and forced divestments giving way to more strategically expansive and ambitious transactions. Well-capitalised financial services firms are in an especially strong position to broaden their geographic footprint and product capabilities through strategic acquisitions, taking advantage of the generally stabilising, albeit sometimes volatile, prices. Private equity firms are also taking a close interest in financial services opportunities, as the impetus to put capital to work is bolstered by improving bank appetite for leveraged deals.

### Restructuring accelerates

Rising demand is being met with increasing supply as the gathering pace of restructuring brings a large and varied selection of takeover targets onto the market.

A combination of higher funding costs and subdued economic growth in Western Europe and North America is making it much harder to sustain the return on equity (RoE) realised prior to the financial crisis. Many groups are responding by putting peripheral and capital-dilutive businesses that fail to meet their RoE thresholds, up for sale. This will allow them to concentrate capital and organisational resources

Figure 1: Global FS M&A activity by geography 2009 to 2010 (€bn)

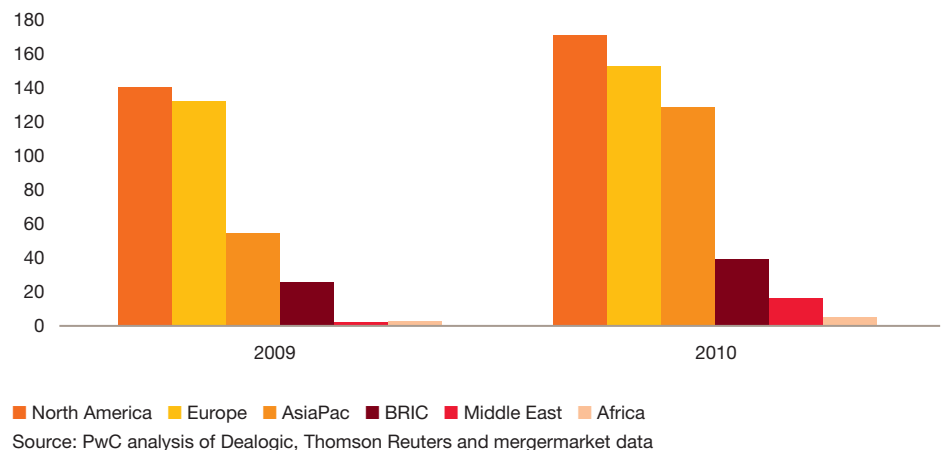
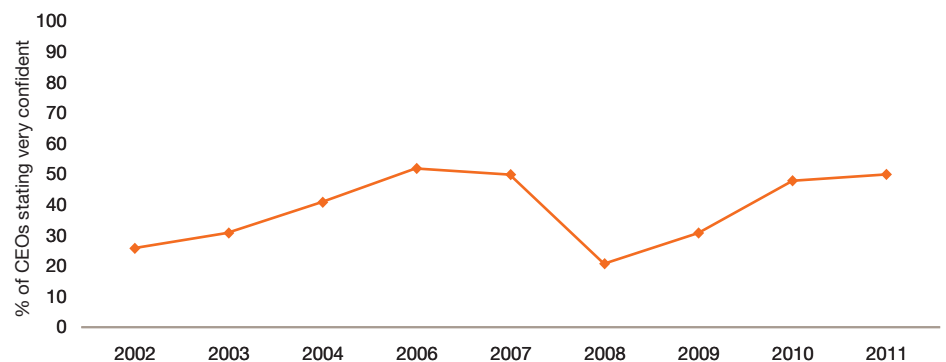


Figure 2: How confident are you about your company's prospects for revenue growth over the next 12 months?



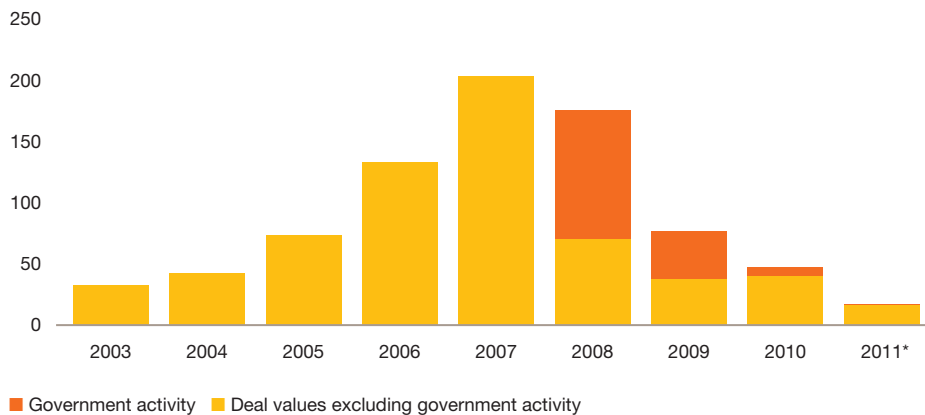
on their strategically core and better performing operations. Recent examples include HSBC's decision to withdraw from retail operations in Russia<sup>1</sup> and sell part of this business to Citigroup.<sup>2</sup> For acquirers, the slow growth in Western markets may make M&A a faster and more effective way to expand their business and strengthen their core strategic areas.

1 HSBC media release 24.04.11 and Wall Street Journal, 25.04.11

2 Reuters, 14.06.11

*For banks, organic development of a high-quality loan book is likely to be challenging in the near term, spurring institutions to seek growth opportunities via acquisition.*

**Figure 3: European FS M&A by value (€bn), 2003 to Date**



■ Government activity ■ Deal values excluding government activity  
 \*H1 deal values  
 Source: PwC analysis of Dealogic, Thomson Reuters and mergermarket data

### **Building critical mass through consolidation**

For banks, organic development of a high-quality loan book is likely to be challenging in the near term, spurring institutions to seek growth opportunities via acquisition. We are also likely to see further consolidation among small- and medium-size asset managers as they look to broaden their product offering and generate synergy savings and economies of scale in the face of mounting pressure on fees. Within insurance, excess capacity and the continuing soft market among non-life insurers are set to spur further consolidation. For life insurers, the capital impact of Solvency II on annuities and other guaranteed products is going to come up against the strong demand for such policies. While some companies may scale back or withdraw such products, others are going to be actively targeting these markets and looking to acquisitions to bolster their presence and sustain margins.

### **Europe: Bolstering returns**

In Europe, M&A values are still some way short of their pre-crisis peak, though government activity is receding and private sector deals now predominate (see Figure 3).

The relatively slow growth in GDP looks set to continue and a combination of deleveraging, tighter regulation and higher capital charges are likely to constrain market expansion. Acquisition is therefore often going to be critical in allowing firms to build scale and strengthen their core franchise.

### **Adapting to changing regulation**

The challenge of sustaining RoE is going to mount as tough new capital and liquidity requirements come into force under Basel III and Solvency II, along with a number of national initiatives such as the Independent Commission on Banking review in the UK. The result is likely to be an even greater push to concentrate resources on the best performing areas of the business and divest the rest to companies where these operations can deliver better returns.

Over the next few years, a number of banking groups including ING and Lloyd's will need to sell sizeable parts of their business to comply with EU competition and state aid rulings. The US Dodd-Frank Act may spur some groups to divest certain aspects of their proprietary trading operations, though there is likely to be a significant transitional period and the full ramifications of the new legislation are still unclear.



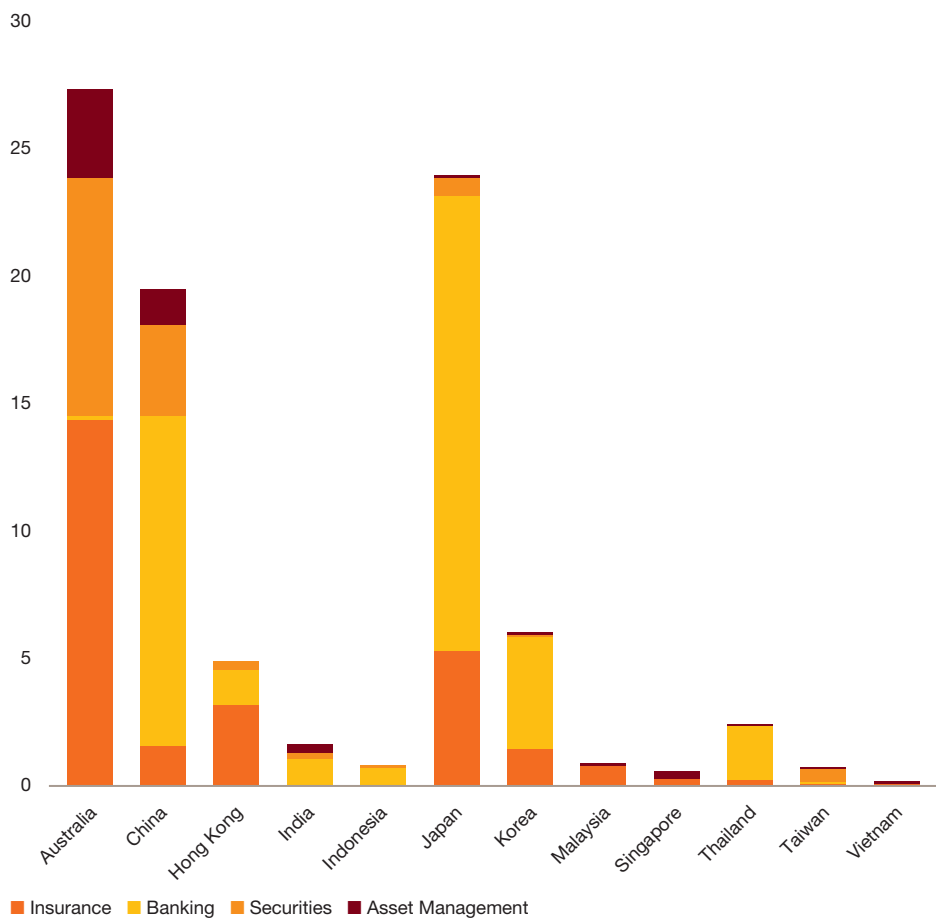
### Asia: International investors return

As Figure 4 highlights, Asian deal values were reasonably strong across all financial services sectors, with local and regional groups moving in to take advantage of the retreat by many international groups in the immediate aftermath of the financial crisis. However, Western investors are returning as they look to offset lower returns growth prospects at home.

Restrictions on foreign ownership in many countries are likely to remain, though alternative entry points such as asset management and non-bank financial institutions in India offer opportunities for full control and niche market development.

Overseas investment by Asian institutions, notably those in China, is set to be an increasingly significant element of the global M&A market. A particular focus is expected to be Africa and the Middle East, as investment in financial services follows evolving global trade flows.

Figure 4: FS deals value by industry sector in 2010 (US\$bn)



Source: Thomson Reuters

# Capturing deal value

*In the coming pages, we provide a series of snapshots looking at the countries at the centre of M&A activity and some of the issues that are likely to be critical in maximising the value of M&A. In addition to our usual focus on European markets, our round-up of global opportunities looks at some of the rapidly expanding emerging markets that many companies are targeting as part of their search for growth.*



# Spain

## Seeking scale and capital strength

**Patrick Atkinson**

PwC (Spain)

Email : patrick.atkinson@es.pwc.com

### *Increased capital demands and restructuring open up opportunities for acquisition.*

In Spain, house prices have fallen by 15% since their pre-crisis peak, with the sharpest declines seen in the coastal regions that had been at the forefront of the property boom.<sup>3</sup> The downturn in construction has seen unemployment rise to above 20%. Yet public debt (projected to be 71% of GDP in 2012) is likely to remain much lower than Germany (81%) and the UK (88%).<sup>4</sup>

As Figure 5 highlights, the banking sector has already booked the worst of the losses, though more is to come. The mutual savings institutions ('cajas'), which were hardest hit by the crisis, are consolidating as they seek to strengthen their capital base and develop more competitive scale. The number of cajas

has dropped from 45 to 16 over the past two years, as the unprecedented restructuring of the savings bank sector continues. The latest phase of this restructuring has seen the majority of the newly formed groups converting into banks.

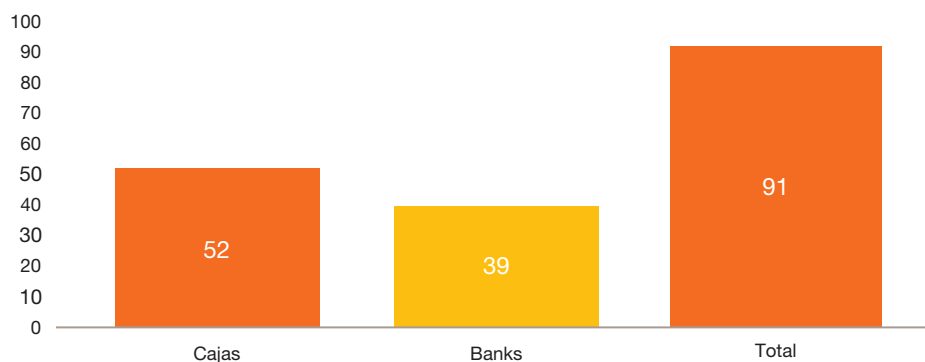
Following the introduction of new capital thresholds (8% plus a further 2% if external investors represent less than 20% of capital or more than 20% of funding comes from the wholesale market), a number of cajas will need to increase their capital ratios. Cajas are pursuing a range of options that are likely to be of interest to potential investors. This includes seeking investment through IPOs, with Banca Cívica and Bankia (formed in 2010 following the consolidation of seven regional cajas) launching listings in late June at prices below half of book value. Others such as La Caixa have secured further investment by transferring their financial business into a bank. The La Caixa group operates its financial services business through the newly formed

CaixaBank, whose shares are traded on the stock exchange (following the conversion of La Caixa's majority-owned quoted subsidiary Criteria in May).<sup>5</sup> Some medium-sized cajas are looking for investment in equity from private equity and private investors, in some cases in conjunction with funding from the FROB (Fund for Orderly Bank Restructuring), which is the Bank of Spain's investment vehicle for supporting institutions requiring additional capital.

### *Editorial eye*

Near-term revenues are likely to be curtailed by the weakness in the economy and net interest margins are coming under pressure from the competition for deposits and the increase in wholesale funding costs. However, there is known to be strong interest from private equity and strategic investors. The restructuring (and consequent synergies from branch rationalisation and central services integration) ahead of increased capital requirements opens up attractively priced opportunities to enter the Spanish banking sector.

**Figure 5: The road to recovery - Impairment losses taken (€bn)**



Source: Bank of Spain

<sup>3</sup> Ministerio de Fomento, January 2011

<sup>4</sup> European Commission 'Statistical Annex of the European Economy, Spring 2011'

<sup>5</sup> La Caixa media release, 01.07.11

# China

## Carving out openings



### Matthew Phillips

PwC (China)

Email: matthew.phillips@cn.pwc.com

*Building platforms across sectors is likely to be crucial to developing and strengthening business.*

China has one of the fastest growing banking sectors of any major market (see Figure 6).

Organic growth continues to be challenging, with foreign banks still accounting for less than 2% of the sector by assets. A number of European groups including HSBC, BBVA and Deutsche Bank hold large minority investment positions in leading Chinese institutions – individual companies are restricted to a maximum 20% holding. Although most of the big four and joint stock banks already

have foreign partners, there are still openings among the city and rural commercial banks. Many of these banks are currently planning IPOs. Most have a sizeable, but still under-exploited customer base in their local markets (circa 30%) and would be keen to attract international product, governance and operational expertise to help them develop market share.

China was the number one IPO market in 2010 and is likely to remain among the most active capital markets in the coming years. A number of leading international groups including Credit Agricole<sup>6</sup> and Morgan Stanley<sup>7</sup> have signed or are negotiating deals with local securities firms. Many Chinese institutions are looking for access to their partner's international business as the price of a stake in their home market.

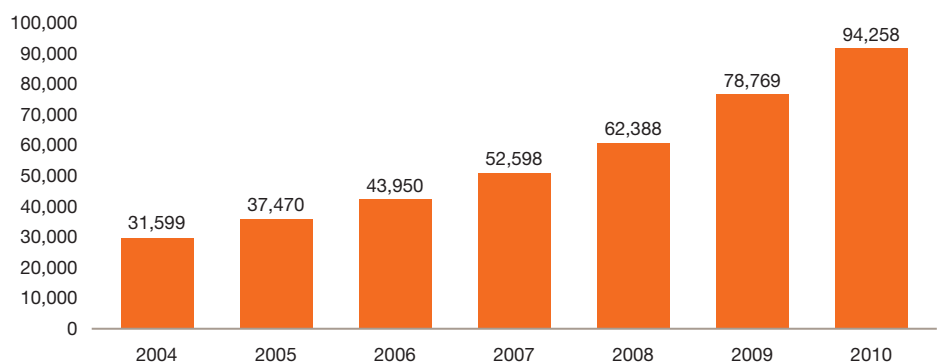
Foreign penetration within the insurance market is limited, though local firms may look for investment in the wake of tougher capital adequacy rules. Although joint ventures have been the most common route to entry, a number of companies are now considering switching to an investment in a domestic company (up to 25% permitted) to allow them to grow more rapidly.

Foreign financial institutions can use a trust company as an investment holding company to enter the banking, securities and asset management markets. They can also invest in Chinese trust companies to obtain related financial licences and integrate these with their operational platform.

### Editorial eye

The most successful international players have built up platforms across banking, securities and asset management. As permitted holdings in local institutions are fairly limited, this multi-pronged strategy is likely to be crucial in developing and strengthening a viable commercial presence in the country.

Figure 6: Asset growth in Chinese banking sector (Rmb bn)



Source: China Banking Regulatory Commission

6 Credit Agricole media release, 03.05.11

7 Morgan Stanley media release, 07.01.11

# India

## Tapping into market potential

**Samir Sheth**

PwC (India)

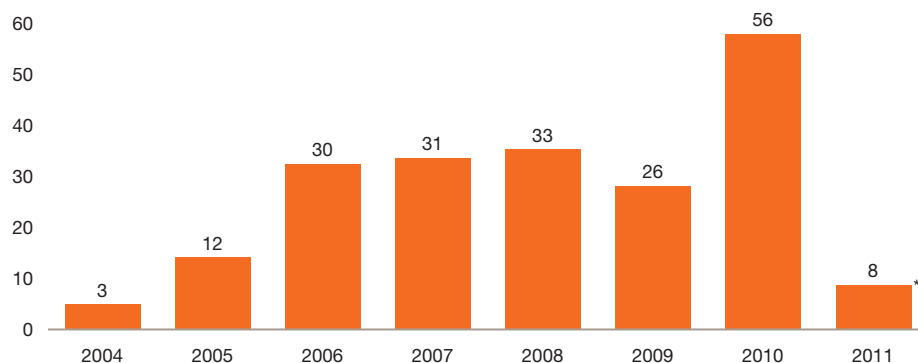
Email: samir.sheth@in.pwc.com

*Acquiring a non-bank financial institution would allow foreign investors to take full control of the company and move into fast growing market segments.*

India's economy is expected to expand by 8% in 2011 and sustain more than 5% growth in the coming decade.<sup>8</sup> The huge potential for financial services groups is further bolstered by one of the highest savings rates in the world (circa 30%),<sup>9</sup> and the third largest investor base (22 million) after the US and Japan.<sup>10</sup> The potential was reflected in a sharp rise in deal volumes in 2010 (see Figure 7).

Although India's banking sector is growing rapidly, difficulties in securing licences, tight restrictions on foreign ownership (5% limit for each firm and 74% overall) and voting rights not commensurate with an economic holding have deterred inbound investment in the sector. A more favourable route is investment in non-bank financial institutions, which allow 100% foreign ownership and offer access to fast-growing segments such as mortgages, vehicle finance, credit cards and stock broking.

**Figure 7: Number of FS deals in India**



Note: \*Number of deals as of 31.05.11

Source: Venture Intelligence

Foreign groups can also acquire full control of an asset management company. The mutual fund sector has seen explosive growth, with assets under management more than tripling over the past five years to top €100 billion in 2010.<sup>11</sup> Although the sector is highly competitive, the low level of retail investment opens up opportunities for further growth. The increasing number of high net worth individuals offers considerable potential in wealth management.

Take-up of insurance is still extremely low (at €64, average annual premiums per capita are less than half of China<sup>12</sup>), highlighting the room for further growth. Foreign stakes in Indian insurers are limited to 26%, though M&A and IPO rules are under review.

### Editorial eye

Although restrictions on foreign ownership in insurance are under review, moves to relax the ceilings on holdings in banks appear to have been put on hold.

Investing in asset management firms and non-bank financial institutions would allow international groups to own up to 100% of the company and gain access to fast growth segments. Many local firms would welcome foreign capital and the competitive advantages that could come from it.

<sup>8</sup> Indian Economic Survey 2010-11

<sup>9</sup> Indian Economic Survey 2010-11

<sup>10</sup> Moneycontrol.com, 18.05.11

<sup>11</sup> Association of Mutual Funds of India, 18.05.11

<sup>12</sup> Swiss Re Sigma 'World Insurance in 2010'

# Russia

## Taking a fresh look at the banking sector

**Andrew Cann**

PwC (Russia)

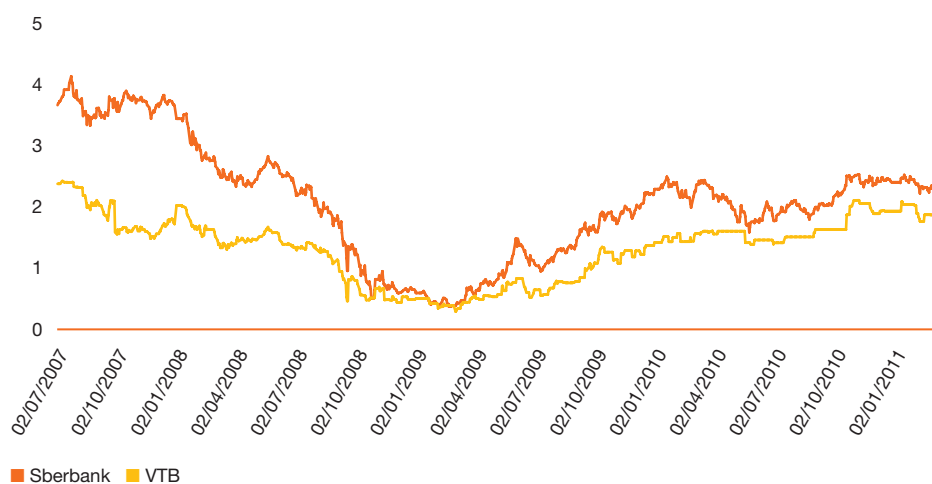
Email: a.cann@ru.pwc.com

*With profits returning and multiples still below their pre-crisis levels, could this be the time to take a fresh look at investing in Russia's banks?*

Russia's banking sector is now bouncing back strongly following the credit losses and instability of 2009. The country's banks recorded a net profit of around €15 billion in 2010 and the central bank anticipates that overall lending will increase by 20–25% in 2011.<sup>13</sup> Although the deal market declined significantly during 2009, we are now seeing renewed market confidence in the sector, which was reflected in VTB Bank's successful placing of some €2 billion worth of shares in February 2011.<sup>14</sup>

Before the onset of the financial crisis, there had been significant international investment in the banking sector as groups looked to take advantage of the growth potential in this still under-penetrated market. These conditions still prevail. The combined assets of Russia's banks are only around 70% of GDP,<sup>15</sup> compared to 105% of GDP in Brazil.<sup>16</sup> International institutions continue to have a prominent role in the Russian banking sector. Not only are the International Finance Corporation and European Bank for Reconstruction and Development active investors, two of Russia's top 10 banks are owned by international groups (UniCredit and Raiffeisenbank).

**Figure 8: Price/book value of VTB and Sberbank**



Source: Bloomberg and PwC analysis

Although some international groups have been reviewing their investments in the wake of the crisis, others have continued to perform relatively well and are now seeing a return to growth. Groups looking to establish and strengthen their presence in the Russian market might see this as an opportune time to invest. Current transaction values are much lower than 2007 and 2008 (Figure 8 sets out the

price/book values of the country's two largest banks on either side of the global financial crisis). While multiples have been recovering, they are unlikely to return to the very high levels seen before the global financial crisis, in the near term.

### Editorial eye

Many of Russia's mid-tier banks may be especially keen to attract a foreign buyer as they seek to gain access to the funds and expertise they need to sustain growth and compete with the larger institutions. While balance sheets are strengthening, careful due diligence is critical as in some cases the prevailing provisioning rules may make it difficult to ascertain the true level of bad debts.

<sup>13</sup> Reuters, 07.02.11

<sup>14</sup> Reuters, 14.02.11

<sup>15</sup> Central Bank of Russia and CIA World Factbook

<sup>16</sup> Central Bank of Brazil and CIA World Factbook

# Indonesia

## Accelerating growth

### Cliff Rees

PwC (Indonesia)  
Email: cliff.rees@id.pwc.com

### Michael Goenawan

PwC (Indonesia)  
Email: michael.goenawan@id.pwc.com

*Indonesia's financial services sector is growing rapidly and allows a relatively high level of foreign ownership by regional standards (99%).*

Indonesia is South East Asia's largest economy and is growing at around 6% a year.<sup>17</sup> It is a member of the G20.

The country's banks are confident about their prospects. A recent survey found that 96% expect to achieve double-digit revenue growth in lending and deposits in 2011.<sup>18</sup> The key focus of growth is set to be the continued expansion of SME lending (see Figure 9).

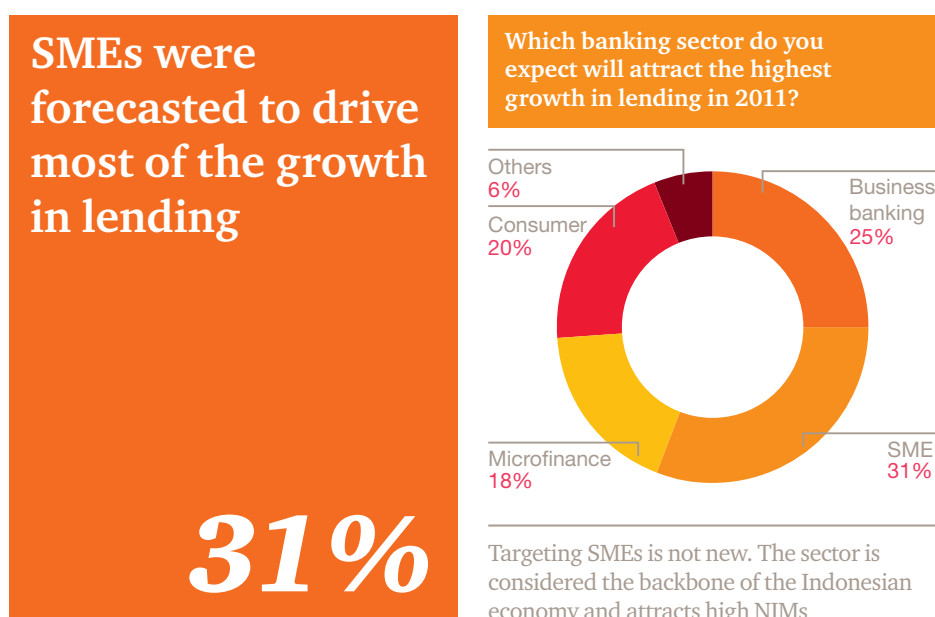
The ceiling on foreign stakes in banks is 99%. For asset management and securities firms, the ceiling is 99% if the foreign company is a financial institution and operates as a securities company, and 85% if it does not. A number of the big

national banks already have foreign partners, though the drive to raise minimum capital requirements may spur more of the city and rural commercial banks to seek investment.

Islamic banking opens up considerable and still largely untapped opportunities in the world's most populous Muslim country. Although the market for Sharia-compliant products and services has been growing at more than 25% a year, it currently makes up only around 2% of overall banking sector turnover.<sup>19</sup> The market offers opportunities for new entrants able to offer greater differentiation and specialisation.

Fierce price competition in the highly fragmented non-life insurance sector has impeded returns. Life insurance has fared better on the back of the improving economy, though new capital requirements have already led to some consolidation in the sector and reduced the number of investment targets.

**Figure 9: Focus of growth in Indonesian banking sector**



Source: PwC's Indonesia Banking Survey 2011

17 CIA World Factbook 2010 (GDP on PPP basis)

18 PwC Banking Survey 2011

19 Bank of Indonesia Financial Statistics, May 2011

### Editorial eye

The need to increase solvency margins is encouraging a number of Indonesian institutions to seek foreign investment, with some of the city and large rural commercial banks offering attractive opportunities. Although small in size, there will also be interest in some niche sectors like futures, trust, leasing and credit guarantee companies.

# Brazil

## Surging ahead



**Antonio Toro**  
PwC (Brazil)  
Email:antonio.toro@br.pwc.com

*Opportunities are increasing in this rapidly growing but largely under-penetrated market.*

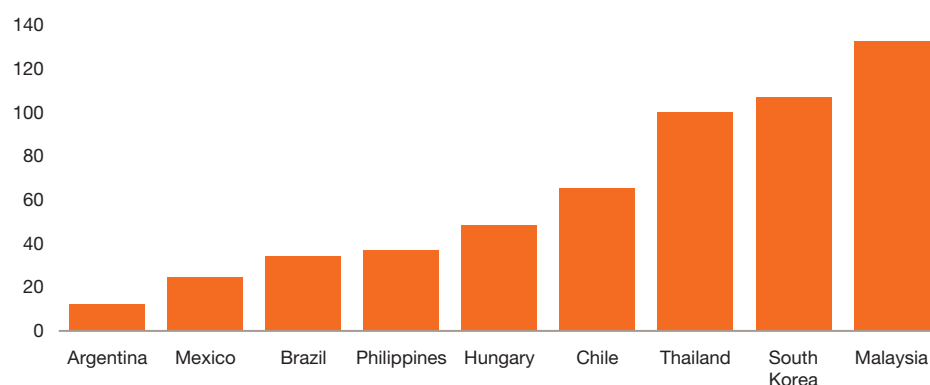
Brazil is the seventh largest economy in the world, which is growing at more than 4% a year and welcomes foreign capital.

The market for financial services is set to expand faster than GDP. Banks' assets have grown by more than 30% since the beginning of 2010 to reach US\$2,800 billion.<sup>20</sup> The room for further growth is highlighted by the fact that despite rapid growth in recent years, bank lending as a percentage of GDP is running at less than 50%. While relatively high by South American standards, credit penetration is less than half of major Asian economies such as South Korea and Malaysia (see Figure 10).

The banking sector is relatively concentrated, with the top four groups holding more than 60% of the market by assets.<sup>21</sup> International groups are already well-represented, with Santander one of the 'big four' and HSBC and Citibank also in the top 10. With new banking licences relatively difficult to obtain, acquiring an existing bank may be a more effective way to build a foothold in Brazil. While most of the leading banks are trading at price-to-book multiple of three or more, smaller banks trade at a less expensive average of 1-1.5.<sup>22</sup>

Among the potential buyers are Asian institutions, as trade links between Brazil and the Far East continue to expand. Telling deals include the recently signed memorandum of understanding between the Shanghai Stock Exchange and Brazil's BM&F Bovespa exchange, which could eventually pave the way for the cross-listing of stocks.<sup>23</sup>

**Figure 10: Comparison of credit penetration (% of GDP)**



Source: Banco Central do Brasil

### Editorial eye

Brazil's banks are highly profitable and well-capitalised (17% average capital ratio).<sup>24</sup> As the economy continues to develop, there are likely to be opportunities in a number of under-penetrated areas such as mortgages, SME lending, investment banking, asset and wealth management, and broker-dealer services.

<sup>20</sup> Banco Central do Brasil statistics, 30.06.11

<sup>21</sup> Banco Central do Brasil statistics, 30.06.11

<sup>22</sup> Wall Street Journal, 31.07.10

<sup>23</sup> BBC News Online, 18.02.11

<sup>24</sup> Banco Central do Brasil statistics, 30.06.11

# South Africa

## Gateway to African opportunities

**Anton Esterhuizen**  
 PwC (South Africa)  
 Email:anton.esterhuizen@za.pwc.com

*South Africa is not only a highly significant financial services market in its own right, but also a portal for investment in Africa as a whole.*

South African banks account for 46% of the banking assets of the top 100 African banks.<sup>25</sup> South Africa also accounts for 71% of total insurance premiums in Africa and has the fourth highest insurance density (13% of GDP) in the world.<sup>26</sup>

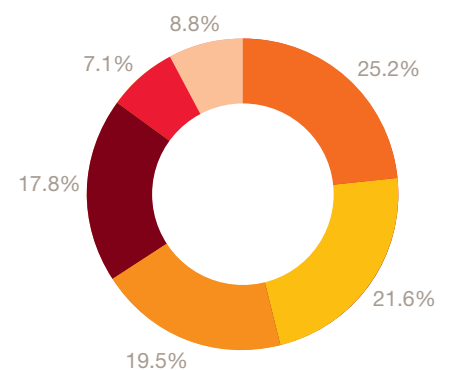
As investment and trade flows between Africa and Asia continue to grow, South African financial institutions also have the advantage of a strong and growing pan-African presence. The PwC 2011 survey of strategic and emerging issues in South African banking indicates a continued strong interest in Africa by South African banks. Similarly, international banks follow their clients and opportunities into South Africa and Africa.

The South African banking market is relatively concentrated (see Figure 11) and is dominated by four large banks. The regulatory authorities have in the past approved partnerships between local banks and strongly capitalised

international partners. Barclays holds a majority stake in ABSA, South Africa's second largest bank. Notable investments in recent years have included ICBC's acquisition of a 20% stake in Standard Bank in 2008, South Africa's largest bank, which has paved the way for a number of joint ventures in areas such as project finance.<sup>27</sup> This was followed in 2009 by the signing of a strategic partnership between China Construction Bank and FirstRand, South Africa's third largest bank, which includes providing advisory and structured services for Chinese clients looking to invest in Africa.<sup>28</sup> Key openings on the horizon include the possible sale of Nedbank, South Africa's fourth largest bank.<sup>29</sup>

A recent survey of South African insurers found that almost half of the respondents would be keen to seek a foreign strategic investor to help them expand regionally and strengthen IT and risk management capabilities.<sup>30</sup>

**Top banks by assets - May 2011\***



■ Standard Bank    ■ ABSA    ■ Nedbank  
■ FirstRand Bank    ■ Investec Bank    ■ Other  
 \* Total bank assets were €311bn  
 Source: Bank returns to South African Reserve Bank



### Editorial eye

South Africa has the largest and most well-developed banking and insurance sectors in Africa, with its major groups reaching out across the continent. While organic development in Africa can be slow and uncertain, investment in a South African institution would provide access to business across a continent that is growing at 6% a year.<sup>31</sup>

25 The Africa Report: Top 200 banks in Africa 2010  
 26 Swiss Re Sigma 'World Insurance in 2010'  
 27 Standard Bank media release, 26.01.10  
 28 FirstRand media release, 30.07.09  
 29 Daily Telegraph, 16.08.10  
 30 PwC: Strategic and emerging issues in South African insurance 2010  
 31 Africa Development Bank, 19.11.10

# Investors target non-core assets

**Richard Thompson**

PwC (UK)

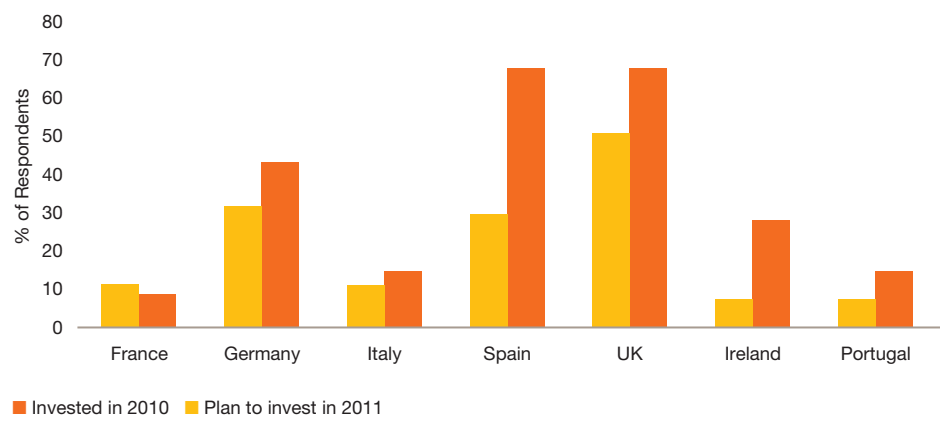
Email: richard.c.thompson@uk.pwc.com

*Non-core loans present a huge and still largely untapped opportunity for investment.*

We estimate that European banks are holding more than €1.3 trillion of loan assets that have been identified as non-core to their businesses.<sup>32</sup> This includes both performing and non-performing loans (NPLs). Although the performing books include a range of high-quality loans, the strategic focus of many banks has changed as a result of the financial crisis and these assets may now sit outside their target geographies and market segments. Relinquishing these loans would raise valuable finance, hasten deleveraging and allow banks to concentrate their capital and resources on their core franchise. There are, in turn, a range of willing buyers including financial investors and banks, looking to strengthen their presence in particular target areas.

However, only a relatively small proportion of these loans have so far come up for sale. The main reasons for this have been the gap in buyers' and

**Figure 12: Countries targeted for investment**



Source: PwC European Investor Survey 2011

sellers' price expectations. Underlying factors have included a lack of immediate pressure to sell and a reluctance to book any potential losses.

This is all about to change. Many banks will need to raise funds and/or review the risks they hold as they face a combination of higher capital charges and the withdrawal of special liquidity measures. The result is likely to be a greater readiness to restructure or divest non-core loans. In turn, a recent investor survey carried out by PwC indicates that interest among buyers is increasing, with Ireland

joining Spain, Germany and the UK on the list of most attractive markets (see Figure 12). Our investor survey also reveals that purchasers' average discount expectation is decreasing across a number of key loan segments, which will help to close the pricing gap between buyers and sellers.

Given the huge sums involved, the process of divesting these non-core assets could take many years. Many of the corporate loan books are also highly complex and can be difficult to untangle to the satisfaction of a potential buyer.

## Editorial eye

New capital and liquidity requirements are likely to spur a rethink over whether to hold or sell non-core loan portfolios. Banks will not only be weighing up the price they could receive for the portfolio, but also the potential capital benefits of divesting it. As banks consider the best options for these assets, it will be important to develop clear evaluation criteria for defining what is core and what is non-core and whether to hold, run-off or sell.

# Exchange sector transformed by consolidation

**Christopher Sur**  
PwC (Germany)  
Email: christopher.sur@de.pwc.com

*Recent months have seen a flurry of merger announcements in the global exchange sector. If they go ahead, they could accelerate the consolidation in an already increasingly concentrated sector in Europe and North America (see Figure 13).*

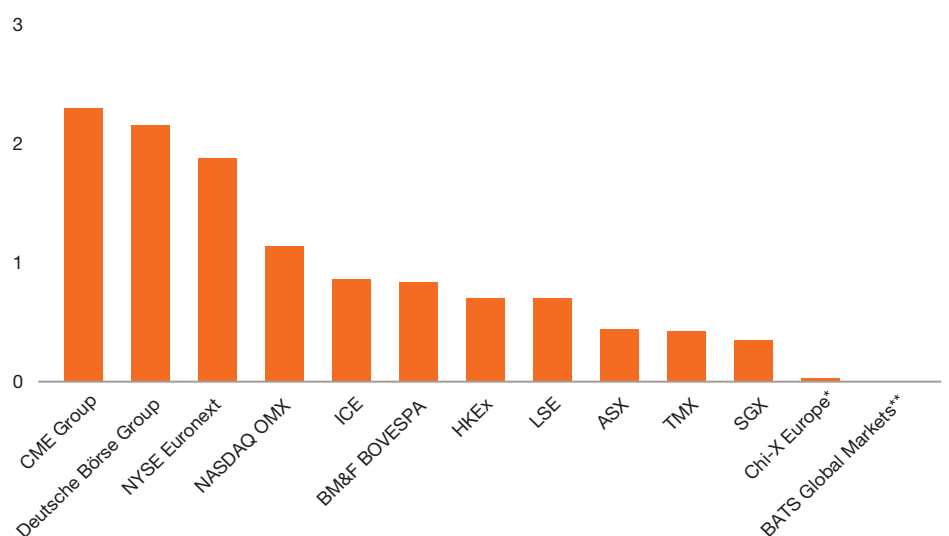
Leading stock exchange groups are looking to consolidation to help them trade across all continents and time zones. As IT costs rise and major groups face growing competition from new entrants, consolidation also allows them to shore up market share and develop economies of scale. In turn, the tie-ups can also help them to expand across the value chain. This includes developing their presence in derivatives and providing a full pre- to post-trading service where regulation allows. While it is trading that tends to attract the most attention, post-trading settlement and custody services are often the most complex and valuable areas of the business.



## Editorial eye

As the latest round of stock exchange consolidation across Europe and North America comes to a head, the only remaining questions are how many exchanges the market can support and what happens to the handful of national exchanges that have retained their independence. As the axis of growth and market activity shifts South and East, the emerging markets are set to be the focus of the next wave of transformational deal-making within the exchange sector.

**Figure 13: Global exchange - net revenues 2010 (€bn)**



Notes: \*2009 total turnover (unaudited public figures); \*\*total revenue (unaudited public figures)

Source: World Federation of Exchanges

# Making integration work

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## Holger Hintze

PwC (UK)

Email: holger.hintze@uk.pwc.com

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*Deal value can quickly dissipate unless there is a clear strategy for bringing the merged businesses together.*

Key to the success of an acquisition is an early focus on integration planning. Whilst acquirers are generally excellent at identifying value opportunities and potential risks associated with their target, integration planning tends to start too late in the process. It is treated as a post-signing task, rather than as something which is integral to the go/no go decision. Understanding the integration challenges needs to be a key senior management focus early in the deal, especially given the trend in asset as opposed to share sales from complex carve-out situations. This should not be treated as something which can be left to middle management to simply execute.

The due diligence phase is the right time to start the integration process. Understanding the business operating model implications of the purchase and translating the deal objectives into specifics is a key driver of value and integration success/failure. It is paramount that the buyer develops clarity at this point on the integration issues regarding the necessary changes to the target's and its own organisational structure, processes and systems in order to achieve the deal rationale. It needs to formulate its findings in a clear integration strategy and a high level integration plan. Setting such a route map will allow management to clearly articulate the implications of the

transaction and differentiating between a scale play or asset/capability acquisition. By establishing the route map early in the deal cycle, management will be able to quickly take control of the target once deal closing is achieved and have the required foundation to develop a detailed and actionable integration plan with a clear linkage to the key sources of value in the transaction. Moreover, it will also provide a better understanding of the complexity of delivering the cost saving potential and revenue growth opportunities that can, and should, be reflected in its investment appraisal.

Although due diligence requires different skills from integration management, there needs to be equal priority and management focus on the integration challenges from the outset. Deals rarely fail to deliver value because of poor investment appraisal decisions. Failing to bottom out the integration challenges is a key source of frustration for management and a regular cause of poor execution.

Setting clear expectations for management and benchmarking progress against these is critical to success. Acquiring and integrating companies is a different skill that has to be learnt. Therefore, it is vital that clear objectives that align with the deal value drivers are set for middle management in order to mitigate this learning process.

Finally, one of the most underappreciated challenges to integration success is culture. Initially, emotions within the acquired entity may range from enthusiasm to apathy, to outright hostility. However, the former may soon be challenged and the latter amplified as cultural and other issues come to the fore. In addressing these issues, experience has taught us that it is important to recognise that there can be only one corporate culture on integration. Management need to be clear early on what the combined culture will be and resolute in driving it into the newly merged organisation. Deferring the pain and avoiding the issue will slow both integration and delivery of value.

Making integration work is clearly a demanding task. An early focus on the integration process and creating an integration plan that is aligned to the deal value drivers is critical. Setting clear objectives for management and embedding a single culture are vital to the success of post-merger integration and delivering value from the deal.

## Editorial eye

Early focus on deal value drivers and how they can be realised through early integration planning, as well as clear expectations, decisive management and strong promotion of a single culture are vital to delivering value from the a transaction.

# Accessing growth

## The focus shifts South and East

**John Hawksworth**

PwC (UK)

Email: john.c.hawksworth@uk.pwc.com

*The financial crisis has shifted the focus of financial services growth to South America, Africa, Asia and the Middle East (SAAAME) and accelerated the projected date at which the market size of the leading emerging economies (E7) will begin to outstrip the G7.*

Earlier this year, we published our updated Banking in 2050 study,<sup>33</sup> which compared the relative growth trajectories of the G7 and an E7 of leading emerging economies comprising China, India, Russia, Brazil, Turkey, Mexico and Indonesia. The study also examined the growth potential in a selection of other emerging economies including Argentina, Vietnam, South Africa and Saudi Arabia.

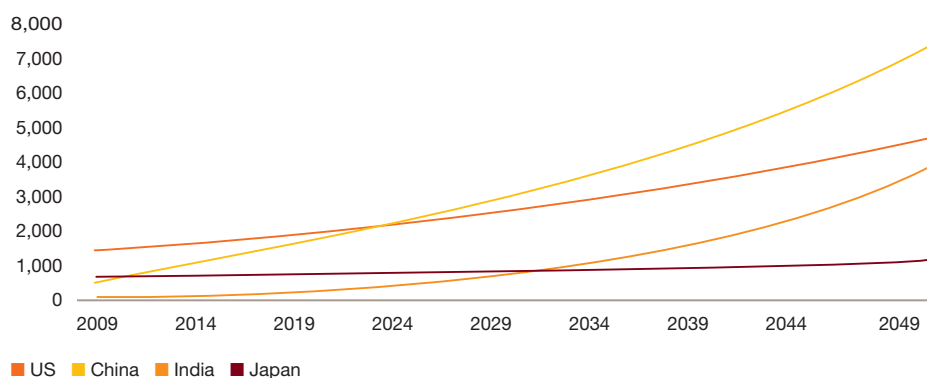
The study found that by 2050, the E7 could have domestic banking assets and profits that exceed those in the G7 by around 50%. China's banking sector could overtake the US by around 2023 (see Figure 14). India has particularly strong long-term growth potential and could become the third largest domestic banking sector after China and the US by 2050. In turn, Brazil could rise to fifth place in the global banking rankings by 2050.

The shifting focus and trajectory of growth presents clear opportunities for European financial services groups. As emerging economies expand and affluences increases, European groups can seek to build up their footprint in these markets and make up for subdued growth at home.

33 PwC Banking in 2050, 2011 study

34 Datastream, 29.09.10

**Figure 14: Domestic credit (\$ bn) at 2009 prices**



Source: IMF, PwC analysis taken from Banking in 2050, 2011 update

Yet, the returns will be hard won. While restrictions on investment, acquisition and market development had been easing in the lead-up to the financial crisis, the pace of liberalisation is likely to slow as a result of concerns over the crisis and its impact. As our snapshots on India and China highlight, companies will need to develop smart ways to work around these restrictions and forge a large enough presence to be commercially viable.

Many of the leading emerging market institutions may already have foreign partners. The challenge will be how to develop links with niche and regional institutions, many of whom may be operating in markets and geographical areas that are as yet relatively underdeveloped and underserved.

Investment and development in many emerging economies are dependent on the ability to forge relationships with national and regional governments. As recent events in North Africa and the Middle East highlight, many of the emerging economies are also susceptible to political instability. What are often relatively young populations are becoming increasingly frustrated by unemployment, corruption and lack of

political representation. This underlines the importance of balancing economic projections with a realistic examination of the political risks.

Ultimately, European groups face the challenge of sustaining relevance. As an increasing amount of global trade bypasses the West, they need to find ways to tap into emerging-to-emerging market commerce and provide services that differentiate them from local competitors. As increasingly powerful E7 banks look to expand overseas, European groups could eventually find themselves on the defensive in their home markets – the world's two largest banks are Chinese.<sup>34</sup>

### Editorial eye

As European banks look to develop their business internationally, it will be important to follow the changing global trading patterns, much of which are beyond the Western orbit and therefore largely untapped by developed market banks.

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- post-merger integration: synergy assessments, planning and project management;
- human resource and pension scheme advice.

For more information about these services or if you have any other enquiries, please contact:

**Nick Page**  
nick.r.page@uk.pwc.com

**Fredrik Johansson**  
fredrik.johansson@uk.pwc.com



### ***About this report***

In addition to the named authors of the articles, the main authors of, and editorial team for, this report were Nick Page, a partner and Fredrik Johansson, a director in PwC (UK) Transaction Services – Financial Services team in London. Other contributions were made by Andrew Mills of Insight Financial Research and Maya Bhatti, Valerie Martin and Caroline Nurse of PwC (UK).

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