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Upfront in brief

April 2013

M&A in banking: A new world for the brave

IDEA IN BRIEF

- In the coming months and years, financial, regulatory and political pressures will continue to reshape the international banking landscape. Mergers and acquisitions will play an important role in this realignment.
- To determine the impact of M&A activities on the banking landscape, Deloitte conducted an assessment of the top 100 largest banks by assets to determine their current financial stress and their long-term fundamentals. Our findings identified four distinct clusters, each using M&A in different ways which can be viewed as a microcosm of the wider banking industry.
- We estimate only 1 in 5 banks can be considered financially and strategically strong. These banks have been expanding by making selective acquisitions across a varied portfolio of assets ranging from wealth management to credit card businesses.
- On the other hand, we consider 40 per cent of the banks as financially and strategically weak. These banks have divested $61bn of assets in the last couple of years in a struggle to survive. However, nearly a quarter of these divestments were acquired by banks in the same cluster, suggesting they have been passing round the same 'toxic parcels'.
- While it seems inevitable that weak banks will have to continue to sell assets to raise additional capital, in such volatile conditions, sellers are likely to outnumber buyers.
- A select few banks are using the current conditions as an opportunity to transform themselves into global institutions. A brave new world awaits.

Dealmakers need to view banks through a 'lens' that looks not only at their current financial stress, but also at their long-term fundamentals, as these reflect their capacity to underpin economic recovery. Deloitte conducted such an assessment and identified four distinct banking clusters. In the future we expect banks in these clusters to use M&A to reposition themselves paving the way for a new set of winners who will dominate the global landscape.

Given the fragile confidence of investors, it is not surprising that the immediate response of banks has been focused squarely on remedial action relating to regulatory reforms. As a result, banks are urgently seeking to boost their capital ratios to meet the mandatory Tier 1 capital ratio requirements and to create a buffer against future systemic shocks.

Deleveraging will inevitably result in some shrinkage of banks' balance sheets, and that is likely to have a negative impact on earnings. If in response to short-term pressures, these banks reduce their lending capabilities that could further destabilise the fragile recovery and reverberate across the global economy.

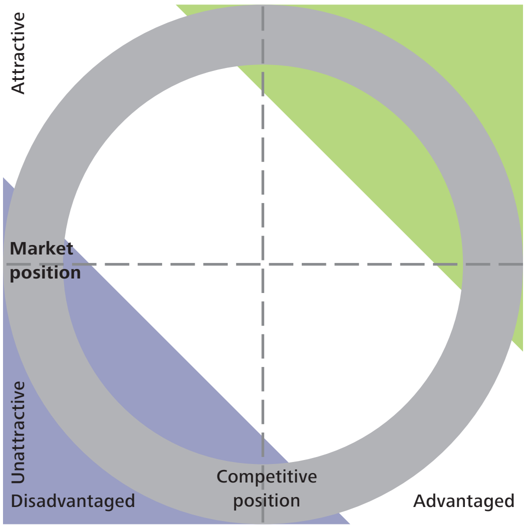
Dealmakers need to view banks through a 'lens' that looks not only at their current financial stress, but also at their long-term fundamentals.

A changing landscape

Anticipating such possibilities, stakeholders need to consider banks through a framework that evaluates not just their current financial stress, but also their long-term fundamentals. This calls for a combined assessment of banks' relative strategic positioning (which is indicative of their ability to capture and support future growth opportunities) and their relative financial stability (which is a trade-off between their need for capital, as measured by the Tier 1 capital threshold and their ability to raise capital from the markets).

Deloitte considered various parameters that serve as proxies for these measures for the world's 100 largest banks by assets and, within this two dimensional view, segmented the banking industry into four distinct clusters. The research also looked at M&A activity from January 2009 to Q1 2012 within these four clusters to determine how banks are using M&A to reshape themselves and the wider banking landscape. What emerges is a microcosm of the global banking industry.

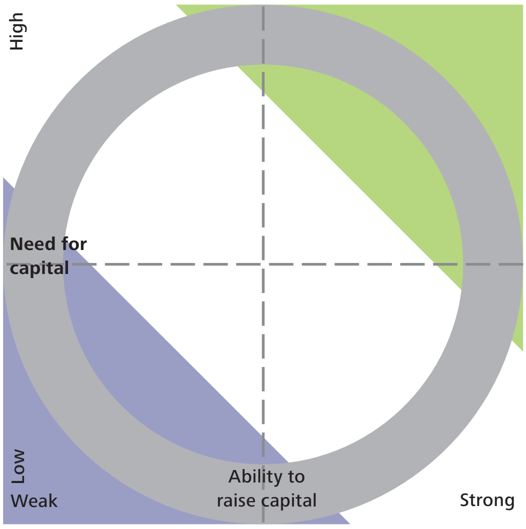
Strategic position matrix methodology



Relative strategic positioning reflects the positioning of the banks to benefit from future growth opportunities. It can be assessed by comparing attractiveness of the market with the competitive positioning of respective banks.
We considered the following parameters:

- **Price-to-Book:** This indicates the potential of the banks to capture growth and **return on common equity:** This indicates the return banks have delivered to their shareholders. Together these are considered as a proxy for competitive positioning.
- **Market attractiveness:** Here we considered their relative revenue from various geographies against the projected GDP growth for those geographies.

Financial position matrix methodology



Relative financial positioning is the trade off between the bank's need for capital versus its ability to raise capital. Here we considered the following parameters:

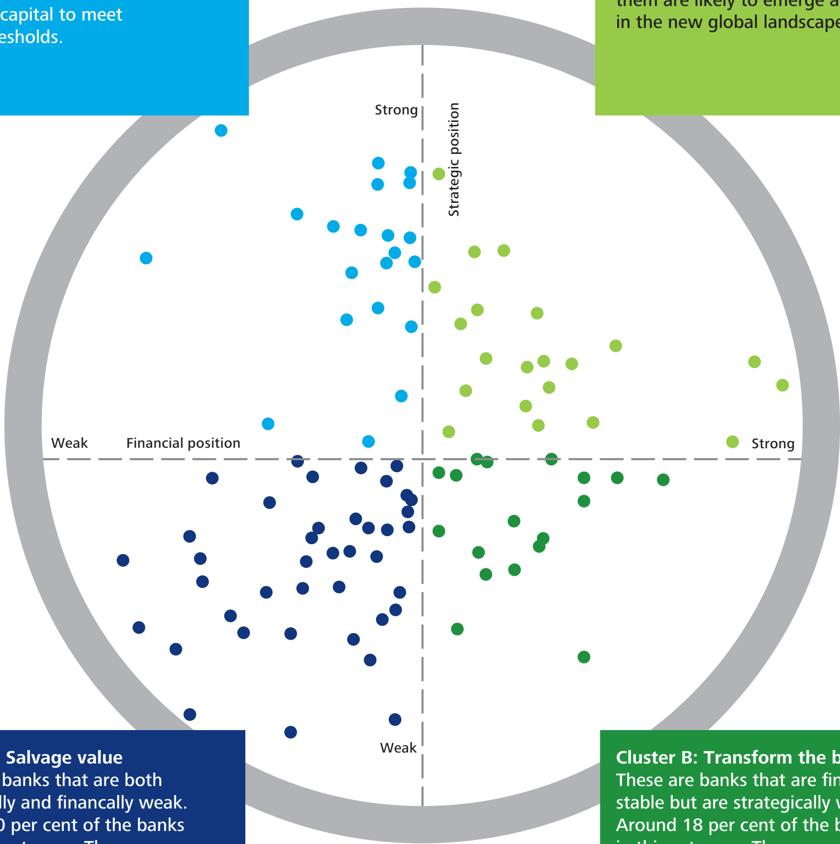
- **Tier 1 capital:** Tier 1 capital in excess of Basel III threshold of 6% as a proxy for need for capital.
- **CDS spread:** CDS spreads are a proxy of a banks' ability to raise capital from the markets.

Deloitte estimates that only 21 per cent of the world's largest banks can be considered both financially and strategically sound.

Figure 4. Top 100 global banks positioning – Four distinct banking clusters have emerged

Cluster D: Acquire capital
Banks in this cluster are strategically well placed, but in a weak financial position. Around 21 per cent of the banks fall in this category. This cluster is dominated by emerging market banks, who are well entrenched in growth markets but still need to raise adequate capital to meet global thresholds.

Cluster A: Shape the market
These are banks that are both strategically well placed and financially stable. Only 21 per cent of the banks fall into this category. We expect them to shape the market in the coming years and some of them are likely to emerge as winners in the new global landscape.



Cluster C: Salvage value
These are banks that are both strategically and financally weak. Around 40 per cent of the banks fall in this category. These are some of the weakest banks and unsurprisingly the majority of them are eurozone banks. Many of these banks are distressed and need to aggressively salvage value.

Cluster B: Transform the business
These are banks that are financially stable but are strategically weak. Around 18 per cent of the banks fall in this category. They are some of the largest banks in the world and many of them achieved this position through aggressive deleveraging or external capital assistance. These banks need to reposition themselves for growth.

In cluster A the most acquisitive were the Canadian and US banks, accounting for more than 60 per cent of all the deals.

Cluster A M&A activity

137 acquisitions
(25% of all acquisition volumes)
worth $26.7 billion

44 divestments
(8% of all divestment volumes)
worth $6.2 billion

Figure 5. M&A activities by banks in Cluster A by region (volume)

Region	Acquisitions	Divestments
Africa	4%	0%
Asia	29%	38%
Europe	9%	7%
North America	49%	48%
South America	9%	7%

Bubble size is relative to deal values
Source: ThomsonONE, Deloitte Analysis

Cluster A: Shape the market (Strategically strong, financially stable)

Deloitte estimates that 21 per cent of the world's largest banks can be considered both financially and strategically sound. These banks are well placed to shape the market in the coming years.

Some of the strongest banks are also some of the smallest. Only three of the 25 biggest banks in the world fall into this cluster. It consists mostly of banks from Scandinavia, Australia, Canada and the United States. These institutions have an average Tier 1 capital ratio of 12.5 per cent; their average price-to-book ratio is 1.65; their cost-to-income ratio is 54 per cent; their return on common equity 13.2 per cent and their net interest margin is 2.11 per cent.

In the last couple of years they have been selectively expanding into overseas markets. Between 2009 and Q1 2012, they made 137 acquisitions, worth $26.7 billion, and 44 divestments, worth over $6 billion. The most acquisitive were the Canadian and US banks, accounting for more than 60 per cent of all the deals. Their acquisitions included a varied portfolio of assets such as wealth management firms, credit card businesses and insurance companies, all of which suggest that at least some of them are aiming to become the next universal bank.

Interestingly, only 18 per cent of their acquisitions were from other top 100 banks so they should not be expected to emerge as saviours for any of the distressed banks. Nor can they be expected to make any 'big bang' acquisitions.

The priority for these banks is to gain significant marketshare and to propel themselves into a dominant position. In the coming years, we expect the banks in this sector to continue making selective and small acquisitions to augment their strong positions.

Cluster B contains some of the largest banks in the world, including ten of the top 25.

Cluster B: Transform the business (Strategically weak, financially stable)

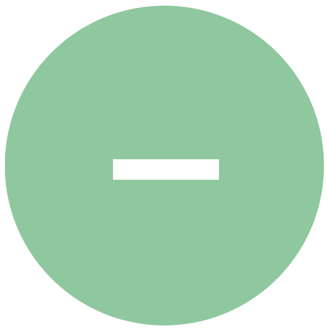
Deloitte estimates that 18 per cent of banks fall into this category. This cluster contains some of the largest banks in the world, including ten of the top 25. Severely stretched during the crisis, these banks have managed to bolster their capital ratios through a combination of aggressive deleveraging and external assistance. Currently they have an average Tier 1 capital ratio of 13 per cent; their average price-to-book ratio is 0.77; their cost-to-income ratio is 77 per cent; their return on common equity is 4.1 per cent and their net interest margin is 1.55 per cent. This suggests that while these banks are financially strong, most of them are in a relatively weak strategic position.

Between 2009 and April 2012, banks in this cluster divested assets worth $40.5 billion in an attempt to deleverage and bolster their financial position. They also made acquisitions worth $27 billion, with 43 per cent of their dealmaking in the emerging markets of Asia.

The priority for them is to use their position of financial strength to transform their business and take measures that will improve their long-term growth prospects. If they don't, they risk eroding their financial advantage in the future.

Cluster B M&A activity

126 acquisitions
(23% of all acquisition volumes)
worth $27 billion



187 divestments
(35% of all divestments volumes)
worth $40.5 billion

Figure 6. M&A activities by banks in Cluster B by region (volume)

Region	Acquisitions	Divestments
Africa	4%	3%
Asia	43%	19%
Europe	32%	39%
North America	15%	26%
South America	6%	13%

Bubble size is relative to deal values
Source: ThomsonONE, Deloitte Analysis

Nearly a quarter of cluster C's divestments were acquired by banks in the same cluster, suggesting they have just been passing round the same 'toxic parcels'.

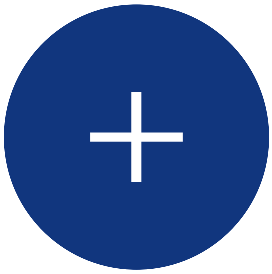
Cluster C: Salvage value (Strategically weak, financially weak)

Deloitte estimates that 40 per cent of banks fall into this third (troubled) category. Not surprisingly, the cluster is dominated by European banks – including ones from Greece, Ireland, Spain and Italy. Currently they have an average Tier 1 capital ratio of 11 per cent, often supported by external assistance, have an average price-to-book ratio of 0.61, a cost-to-income ratio of 69 per cent, a return on common equity of 1.17 per cent and a net interest margin of two per cent.

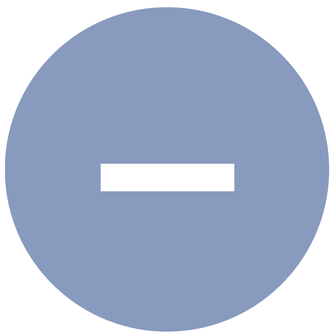
These banks have been divesting assets at a phenomenal pace, accounting for 51 per cent of all the divestitures done by the top 100 banks in the period 2009 to April 2012, and raising a total of $61 billion. Banks in the group also made nearly $38 billion worth of acquisitions. However, domestic deals accounted for 71 per cent of them, suggesting there has been large-scale consolidation. Despite this, they remain financially and strategically weak. A closer look reveals that nearly a quarter of their divestments were acquired by banks in the same cluster, suggesting they have just been passing round the same 'toxic parcels'.

Some of these organisations are genuinely distressed and urgently require recapitalisation. The priority for them is to continue to sell or run down assets and pursue consolidation where required.

Cluster C M&A activity



189 acquisitions
(34% of all acquisition volumes)
worth $37.6 billion



270 divestments
(51% of all divestment volumes)
worth $61 billion

Figure 7. M&A activities by banks in Cluster C by region (volume)

Region	Acquisitions	Divestments
Africa	2%	4%
Asia	12%	7%
Europe	71%	63%
North America	14%	18%
South America	1%	8%

Bubble size is relative to deal values
Source: ThomsonONE, Deloitte Analysis

Cluster D contains many emerging market banks, including ones from China, South Korea and Brazil … their acquisition strategies have been focused on regional consolidation.

Cluster D: Acquire capital (Strategically strong, financially weak)

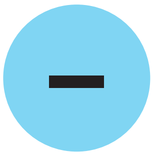
Deloitte's analysis puts 21 per cent of banks in this category. While they are facing short-term capital adequacy problems, these institutions are well entrenched in markets that are positioned for long-term growth. This cluster contains many emerging market banks, including ones from China, South Korea and Brazil. They have an average Tier 1 capital ratio of 9.9 per cent, an average price-to-book ratio of 1.41, a cost-to-income ratio of 51 per cent, a return on common equity of 19 per cent and a net interest margin of 3.63 per cent. In future, these banks can be expected to drive the regeneration of the whole sector.

Cluster D's acquisition strategies have been focused on regional consolidation; 59 per cent of their acquisitions were domestic deals and 84 per cent were in the same geographic region. The acquisitions included a mixed portfolio of insurance and commercial banking deals as the institutions look to extend their product range and capture marketshare.

The priority for this group is to build up their capital reserves. They will continue to strengthen their positions in their respective regions and selectively pick up emerging market assets from distressed banks. Many of the institutions in this cluster are still in heavily regulated and protected markets; however as these regulations are relaxed, more ambitious moves can be expected.

Cluster D M&A activity

102 acquisitions
(18% of all acquisition volumes)
worth $16 billion



29 divestments
(5% of all divestment volumes)
worth $9 billion

Figure 8. M&A activities by banks in Cluster D by region (volume)

Region	Acquisitions	Divestments
Africa	4%	0%
Asia	37%	38%
Europe	23%	17%
North America	12%	10%
South America	24%	35%

Bubble size is relative to deal values
Source: ThomsonONE, Deloitte Analysis

Banks that are financially well positioned will use the opportunity to 'cherry pick' prized assets, portfolios and businesses.

Reshaping of the banking landscape

It seems inevitable that weak banks will have to sell more assets to raise additional capital. The International Monetary Fund (IMF) estimates that 58 large European Union (EU) banks alone could shrink their combined balance sheets by as much as $4.5 trillion through the end of 2013, twelve per cent of total assets.[1]

Divestments therefore are likely to be influenced by demand, and in such volatile conditions sellers are likely to outnumber buyers. The M&A moves of these four clusters will indeed reshape the banking landscape and in the coming months and years we expect M&A to play out in the following manner:

Cherry picking assets

Banks that are financially well positioned will use the opportunity to 'cherry pick' prized assets, portfolios and businesses. Often these acquisitions are made with the intent of growing and/or strengthening them, for example, Sumitomo Mitsui has picked up The Royal Bank of Scotland Group's Aviation Capital business to take advantage of the growth in commercial air travel in Asia.[2]

Some of these banks are also using this opportunity to build their presence in emerging markets, which have accounted for 37 per cent of all acquisitions since 2009. Canadian banks are particularly aggressive; 37 per cent of their acquisitions since 2009 have been in either Latin America or Asia. In Asia many of the stronger banks are acquiring banks from neighbouring countries to enhance their position as significant regional players.

Regulatory enforced structural realignment

Structural changes required by new regulatory measures, such as Basel III and the Volcker Rule (part of the Dodd-Frank Act in the US), could also encourage divestments, particularly of capital markets businesses. We expect some of the banks that are trying to develop new business lines, particularly those in the emerging markets, will pick up some of these assets.

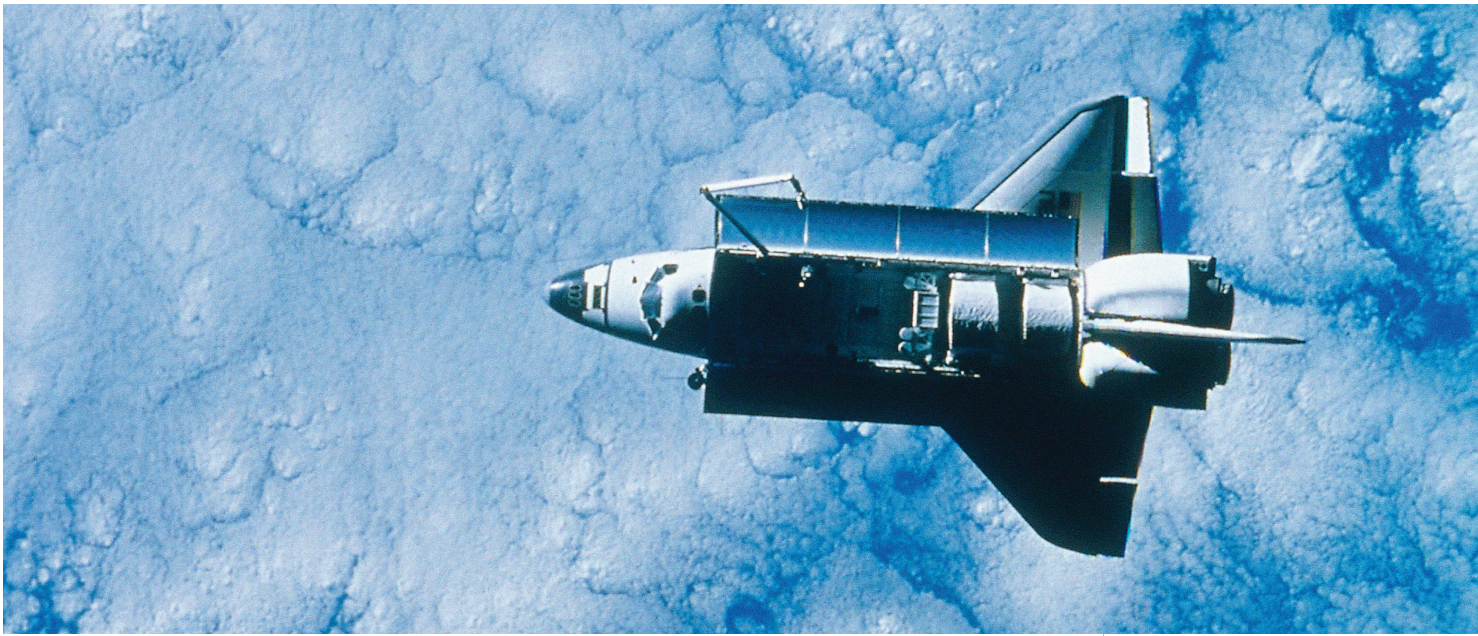
We estimate European banks accounted for 67 per cent of all divestments carried out by the top 100 banks since 2009. State-imposed consolidation in European banking is likely and will be critical for the weakest banks' survival. Small and medium-sized regional banks (those with assets of less than $10 billion) are particularly susceptible to such action. The process has already started in Spain with the Cajas (savings banks) and others can be expected to follow.

Growth in the shadow banking sector

A Financial Stability Board study of the 11 largest economies suggests that 'shadow banking' – lightly regulated entities that compete with the traditional banking sector to provide credit to the global economy – has now grown to $60 trillion, surpassing pre-crisis levels.[3]

Shadow banking comprises financial institutions that have been less subjected to regulatory changes. Such banking is also less burdened by bad loans and other legacy issues, and is often more nimble than the traditional banking system. Such institutions are well placed to buy assets and portfolios that are being divested by the traditional banks. This allows specialist asset consolidators to enter the market and pick up these portfolios at discounted prices. Haymarket Financial LLP, a new private equity-backed corporate lender, was one of the first into this market. In 2011 it purchased Bank of America Corporations' loans to Foxtons Limited, the estate agent, for less than 90 pence in the pound for the senior loans.[4] More such deals can be expected as the new entrants seek to build marketshare.[5]

… operational activities could be under-funded and may have to be sold off … new entrants could potentially acquire the back-office capabilities to create 'utility structures' to service the broader banking landscape.



Emergence of back-office utilities

The current environment is putting significant pressure on profits, particularly for weaker banking institutions. This means that other operational activities could be underfunded and may have to be sold off. Outsourcing companies and other new entrants could potentially acquire the back-office capabilities to create 'utility structures' that use economies of scale and platform-based transformation to service the broader banking landscape.

For instance, Indian information technology and business process outsourcing companies have acquired back-office capabilities from banking and insurance companies and taken over the running of those businesses.

The future landscape

One of the more poignant lessons of 2008 was that a financial crisis ultimately leads to the destruction of wealth. If banks shrink their asset base rapidly, it could mean fewer opportunities for lending and growth. Therefore, banks need to consider any such realignment measures in the context of a larger restructuring programme aimed at getting them back on the growth platform.

Meanwhile, a select few banks are using this opportunity to transform themselves into global institutions. In the coming years the banking landscape is set to be completely reshaped. A brave new world awaits.

Notes

1. Global Financial Stability Report: Restoring Confidence and Progressing on Reforms, International Monetary Fund, October 2012
2. http://www.rbs.com/news/2012/06/sale-of-rbs-aviation-capital.html
3. http://www.ft.com/cms/s/0/39c6a414-00b9-11e1-930b-00144feabdc0.html
4. http://www.ft.com/cms/s/0/c544069e-cfeb-11df-bb9e-00144feab49a.html#axzz1xTrVwIk9
5. http://articles.economictimes.indiatimes.com/2011-02-14/news/28540403_1_government-bailouts-outsource-top-banks

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About the research
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