

Financial Services

# European Financial Services M&A Insight

October 2009

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# Welcome

## to the seventh edition of this review

While the report's name and format may have changed, its goals remain the same.

### We still seek to:

- deliver in-depth analysis on financial services M&A activity throughout Europe
- provide a consistent and continuous means to compare and contrast that activity
- recognise current and future trends
- identify investment opportunities.

That said, identifying trends during the first half of 2009 is a challenging task. The levels of European financial services M&A activity were too low to allow for meaningful analysis. (See 'Data analysis: steady as she goes'.)

As we move towards and into 2010, we expect to see an increase in deal activity. We believe more institutions will shed their non-core businesses and we continue to predict a shake-out of financial services ownership in CEE and the CIS. The European insurance market, meanwhile, remains ripe for consolidation and, indeed, on 25 July 2009, the merger of Friends Provident and Resolution was announced in the UK. (See 'Looking ahead: the scene is set for a pick-up in deal activity'.)

It has, to say the very least, been a difficult year for the UK's building society sector. As they seek to move forward, societies are going to have to take some tough decisions. (See 'Tumultuous times: what next for the building society sector?')

In recent years, Nordic banks have experienced sharp falls in the value of their investments in the Baltic States and Eastern Europe. If their losses should increase, they may seek to sell some of their non-core assets in those regions. (See 'Northern exposure: opportunities for a macro-economic play in the Baltics and Eastern Europe'.)

The European asset management sector has been hit hard by the global economic crisis. Recognising that businesses may become available at attractive prices, private equity groups are taking an increasing interest in the industry. (See 'European asset management: coming in from the cold?') In what has been a quiet period, the sector has witnessed one of its biggest deals, BlackRock's acquisition of BGI. With BNY Mellon announcing its acquisition of Insight Investment Management for £235m on 12 August 2009, further consolidation seems inevitable. (See 'Asset management and alternatives: primed for acceleration'.)

European financial services look set to undergo major restructuring, with any increase in M&A activity in the sector being determined by the pace of restructuring in the major financial institutions. This will bring into sharp focus the divestment experience of these organisations, particularly where heavily integrated businesses are identified for sale. What are the most important practical issues? (See 'A new financial services landscape: the operational impact of divestments'.)

European equity markets stabilised over the summer and have rallied since then. This should provide some welcome respite for stockbrokers and fund management firms, and, if equity markets remain bullish, provide a platform for an increase in IPO activity.

The restructuring of the financial sector has attracted the attention of the private equity community, with more firms than ever expressing an interest in the sector. Notwithstanding the requirements around regulatory capital, this focus will inevitably lead to some activity. However, the credit markets remain cautious, with new lending remaining at comparatively low levels, a situation that could hinder private equity-led activity in the financial services sector in the short term.

We hope you enjoy this report. Please do not hesitate to contact either of us or any of the article authors if you have any questions.



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# Data analysis

## Steady as she goes



As predicted in *Back to the 'domestic' future*<sup>1</sup>, the first half of 2009 saw extremely low levels of European financial services M&A activity by the standards of recent history. Just €32bn-worth of deals was announced during the period, compared with €178bn for the whole of 2008<sup>a</sup>. If government activity were excluded, the figures would be just €19bn for the first half of 2009 compared with €70bn for all of 2008<sup>a</sup>.

Indeed, financial services deals with disclosed values were so few during the first half of the year that a detailed discussion of M&A trends is unlikely to be very meaningful. Accelerated deals involving distressed targets – a common occurrence during autumn 2008 – were absent, but a strong bias to domestic transactions remained a key feature across Europe.

Government activity continued to dominate the large end of the deal spectrum. The UK government conducted secondary recapitalisations of Royal Bank of Scotland and Lloyds Banking Group, the latter now including the former HBOS, for €5.9bn and €4.5bn respectively<sup>a</sup>. Nor was public sector activity limited to the UK. The regional government of Flanders injected €2bn into KBC, building on the €3.5bn provided by the Belgian federal government in October 2008<sup>a</sup>.

In a further deal not shown in our dataset, Commerzbank (now including the acquired Dresdner) was also reported to have received a government injection of €1.8bn in exchange for 25% of its equity<sup>2</sup>. Other, smaller rescue transactions not reflected in our data owing to a lack of disclosed value included the part-nationalisation of the Dunfermline Building Society in the UK<sup>3</sup> (see *'Tumultuous times: what next for the building society sector?'*).

As the first half of 2009 progressed, government-led deal activity cooled. Instead, the picture was dominated by June's announcement of the sale of Barclays Global Investors (BGI) to BlackRock, the US fund management group for €9.7bn<sup>4</sup>. This stands out as the largest single deal of 2009 so far<sup>a</sup>, as well as being a significant transaction in its own right (see *'European asset management: coming in from the cold?'*).

Apart from the BGI transaction, only two private sector deals worth more than €1bn were announced during the first half of 2009. One was the sale of 50% of Leaseplan by Volkswagen to a German-owned investment company for €1.3bn<sup>a</sup>. The other involved a restructuring of the Generali group of companies, not a true acquisition in the strategic sense<sup>a</sup>.

With the notable exception of BGI, there have been relatively few banking divestments so far during 2009. However, as discussed in *'Looking Ahead'*, we feel this could change. Furthermore, private equity bidders have been relatively active in the small to medium-sized deal space. Some of the most notable deals in this area have been the acquisition of two asset managers by a Clessidra fund from Banca Monte Paschi for €400m<sup>a</sup> (see *'European asset management: coming in from the cold?'*), and AnaCap's acquisition of Ruffler Bank for €89m<sup>a</sup>, the first private equity acquisition of a UK licensed bank.

<sup>a</sup> PricewaterhouseCoopers analysis of mergermarket data.

<sup>1</sup> 'Back to the "domestic" future', PricewaterhouseCoopers – 19.03.09.

<sup>2</sup> 'Berlin assurance on Commerzbank', *Financial Times* – 09.01.09.

<sup>3</sup> 'Building society failure raises questions', *Financial Times* – 31.03.09.

<sup>4</sup> BlackRock buys Barclays BGI', *Financial Times* – 12.06.09.

# Tumultuous times

## What next for the UK building society sector?

The ongoing financial turmoil and recession have inevitably led to capital, funding and profitability pressures in the building society sector and these pressures have contributed to a number of high-profile mergers and failures in the past 12 months.



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More than a decade after the sector was in danger of being consigned to history following pressure from carpetbaggers, a series of takeovers and demutualisations, recent events have once again raised questions about the direction of the sector in the years to come. It is likely that, in the short-to-medium term, there will be further merger/deal activity as societies look to secure their long-term futures, resulting in a continued polarisation of the sector into a handful of 'supermutuals' and small local societies focused on their immediate geography.

### Deteriorating asset quality and capital pressure

The building society sector has traditionally maintained a relatively conservative lending approach, as evidenced by the fact that, as at 31 December 2008, just 1.07% of building society mortgage balances were in arrears<sup>5</sup> (compared to 2.44% across all mortgage lenders<sup>6</sup>). While there have been specific examples of societies writing higher risk lending or been exposed to instances of fraud (e.g., higher LTV lending or self certification lending/Chelsea Building Society's £41m buy-to-let fraud loss announced in August 2009<sup>7</sup>), and others with exposure to bad investments (e.g., the failed Icelandic banks) the sector is generally less exposed to material credit losses arising from the recession than mortgage banks that have engaged in riskier forms of lending.

Notwithstanding the above, societies have experienced a deterioration in asset quality as evidenced by the fact that the percentage of mortgage balances in arrears almost doubled from 0.52%

at 31 December 2007 to 1.07% at 31 December 2008<sup>5</sup>. The relative size of many of the smaller societies (as at August 2009, 55% of all assets in the sector were owned by the largest society – Nationwide<sup>8</sup>) and the relatively benign credit environment in the years leading up to recession mean that it is possible that many smaller societies will not have the infrastructure in place to respond swiftly to any significant or sustained rise in arrears/repossessions.

Nearly all of the lending by societies is linked to the UK housing market, where values have contracted by 14.4% since record highs in 2007<sup>9</sup>. The Basel II rules, which came into effect from 1 January 2009, require modelling of how a lender's assets will perform in stressed scenarios and may require an increased level of capital to be set aside depending on the outcome of that analysis. The decline in house values and potential for future losses has led to a significant increase in capital requirements in the societies. Any further increase in arrears will increase capital requirements and the regulator may continue to monitor the capital position of societies to assess their ability to cope with any continued distress in the UK housing market.

To strengthen their balance sheets in response to the above, societies (in common with other lenders) have significantly reduced new loan originations. The impact has been immediate and pronounced, as illustrated by the fact that net mortgage lending declined by £2.9bn in the year to 30 June 2009<sup>8</sup>. This was the first time that the sector had recorded negative net lending since 1993 and contrasts with a figure of £17.6bn in the year to 30 June 2007<sup>8</sup>.

<sup>5</sup> Financial Services Authority's website: [www.fsa.gov.uk](http://www.fsa.gov.uk).

<sup>6</sup> Council of Mortgage Lenders website: [www.cml.org.uk](http://www.cml.org.uk).

<sup>7</sup> Chelsea Building Society Interim group accounts for the six months ended 30 June 2009 – 20.08.09.

<sup>8</sup> Building Society Association's website: [www.bsa.org.uk](http://www.bsa.org.uk).

<sup>9</sup> Nationwide House Price Index – 27.08.09, [www.nationwide.co.uk](http://www.nationwide.co.uk).

Figure 1: Recent events in the building society sector

Date	Event	Media release/press report
September 2008	Derbyshire and Cheshire Building Societies merge with Nationwide	'The Derbyshire and The Cheshire have independently concluded that a merger with Nationwide is in the best interests of their savers and borrowers given the financial issues faced by both societies.' <sup>10</sup>
November 2008	Scarborough Building Society merges with Skipton	'Scarborough has considered the possible impacts of continuing house price falls and the impending recession in the UK, and has concluded that the effect would be an unacceptable reduction in its capital resources and that, to fully protect the interests of its members, it should approach Skipton Building Society as its preferred merger partner.' <sup>11</sup>
February 2009	Britannia and Co-Op Financial Services announce merger (note: both businesses reported that they were in a strong position at the time of the merger)	'Both Britannia and CFS have been pursuing successful strategies independently, but the current lack of trust in shareholder-owned banks gives us a real opportunity to be even more successful by coming together.' <sup>12</sup>
March 2009	Nationwide acquires the savings accounts and 'prime' lending book of Dunfermline  The remainder of the business is placed into a building society special administration process	'Nationwide is in a unique position by virtue of its size and financial strength, to provide support to Dunfermline, and we regard it as both responsible and commercially beneficial to undertake this transaction.' <sup>13</sup>
April 2009	Moody's downgrades credit ratings of nine societies	'Moody's downgraded the credit rating of nine societies (Nationwide, Chelsea, West Bromwich, Principality, Newcastle, Skipton, Yorkshire, Norwich & Peterborough and Coventry) amid concerns that they will be affected by losses from the deterioration in the UK housing market.' <sup>14</sup>
May 2009	West Bromwich strengthens core tier 1 capital via an exchange of its subordinated debt, totalling £182.5 million, for a new instrument, profit-participating deferred shares ('PPDS'), which will qualify as core tier 1 capital	'The ability to absorb losses is particularly relevant given the stress-test exercises that the regulator has been undertaking on a number of the largest building societies. The Society, despite having a relatively high level of total capital, was less well placed to withstand the stress-test exercises, as around half of its total capital was held in the form of non-core tier 1 instruments.  'Accordingly, and in consultation with the FSA, the Society has reached agreement with holders of its subordinated debt to effect the exchange of all of the £182.5m of the Society's tier 2 subordinated debt, being the full outstanding principal amount, for a new form of capital for building societies, PPDS, which will count as core tier 1 capital.' <sup>15</sup>

10 Media release, 'Mergers of Nationwide with The Derbyshire and The Cheshire building societies' – 08.09.08, [www.nationwide.co.uk](http://www.nationwide.co.uk).

11 Media release, 'Joint statement: merger of Skipton Building Society and Scarborough Building Society' – 03.11.08, [www.skipton.co.uk](http://www.skipton.co.uk).

12 Media release, 'Britannia preliminary results announcement for the 12 months ended 31 December 2008' – 26.02.09, [www.britanniabuildingsociety.co.uk](http://www.britanniabuildingsociety.co.uk).

13 Media release, 'Acquisition of Dunfermline by Nationwide Building Society' – 30.03.09, [www.nationwide.co.uk](http://www.nationwide.co.uk).

14 'Moody's downgrades building societies', *Financial Times* – 15.04.09, [www.ft.com](http://www.ft.com).

15 Media release, 'Strengthening of Core Tier 1 Capital' – 12.06.09, [www.westbrom.co.uk](http://www.westbrom.co.uk).

## Tumultuous times continued...



### Funding

On the funding side of the balance sheet, building societies have traditionally relied upon retail deposits to provide the majority of their funding. The retail deposit market is becoming increasingly competitive, given the relative lack of alternative funding options for both banks and building societies, and this is also likely to impact on margin. Prior to the credit crunch, the proportion of wholesale funding increased largely because retail deposits did not keep up with the increase in demand for mortgage lending (the stock of wholesale funds as a percentage of total funding increased from 21.2% in 2002 to 31.5% in 2008<sup>16</sup>). Wholesale funding is likely to continue to be a more expensive means of funding and this is likely to be compounded by the recent credit ratings downgrades of some of the largest societies (see Figure 1).

### Profitability pressure

The issues described above have contributed to significant profitability issues in the societies. First, the margin pressure arising from increased funding costs was compounded on the asset side in 2008, as the UK base rate fell to 0.5%<sup>17</sup> and tracker mortgage products, which were linked to base rate, became very expensive from the societies perspective. Secondly, the fall in new mortgage origination also led to a reduction in fee income sources (origination fees, etc.). There are few alternative sources of income for the sector to fall back on as most societies (other than Nationwide) are not significantly involved in other forms of lending/banking activity. Finally, the increase in arrears and collection costs is placing an additional profitability burden on the societies that has been compounded by increased regulatory costs (for example, the Financial Services Compensation Scheme).

Given these factors, cost control is clearly going to be critical in the sector's ability to maintain its competitiveness and, in some cases, increase the chance of survival.

<sup>16</sup> Building Society Association's website: [www.bsa.org.uk](http://www.bsa.org.uk).

<sup>17</sup> Media release, 'Bank of England Reduces Bank Rate by 0.5 Percentage Points to 0.5% and Announces £75 Billion Asset Purchase Programme' – 05.03.09, [www.bankofengland.co.uk](http://www.bankofengland.co.uk).



### Strategic options – what next?

Across the sector, margin and capital pressures are increasingly fuelling a drive towards consolidation. Those that are not in effect ‘forced’ to consolidate must also be considering consolidation as a viable option – for example, the Britannia/Co-Op merger (see Figure 1). Mergers can enable societies to enhance their product range and cut costs (e.g., through back-office consolidation and closure of branches where there are overlaps). Larger, better capitalised organisations may also be better placed to attract cheaper wholesale funding when the market revives. This will, in turn, enable societies to offer cheaper mortgages and better rates on savings products in the medium term. Those societies that position themselves well with a clear, cost-effective delivery plan and product range are likely to be the ones that attract and retain an increasingly demanding customer base.

Those societies that do not merge, may in the short term consider alternative sources of capital. The innovative debt-for-‘PPDS’ swap entered into by West Bromwich Building Society (see Figure 1) may be replicated in societies that currently have subordinated debt in place. Some may be reluctant to go down this route, however, as it may be viewed as a partial demutualisation (since future profits are distributed, in part, to the PPDS holders and not members).

The prospect of a demutualisation through a purchase of a society by a non-mutual may not be a palatable option for many societies but, if a suitable merger partner cannot be found, then this may provide a last resort alternative.

There have not to date been any significant examples of sales of sub-performing/non-performing loan books as a means of funding, owing to an ‘expectation gap’ between valuations of buyers and sellers. This is an active market in other countries, however, and there are a large number of investment funds ready to enter the UK’s distressed loans market<sup>18</sup>. Consequently, we think that this may be an emerging theme for 2010-11.

We believe that the UK building society sector will be one of the ‘hot’ areas for M&A activity over the coming 12 months and that further deal activity in the sector is almost inevitable. While the market for smaller local societies focused on their immediate geography is likely to remain, such societies will become increasingly rare. The continued polarisation of the sector is likely to continue and a small number of ‘supermutuals’ that can offer a wider range of products across the UK will become increasingly dominant. These organisations may be well placed to benefit from the commercial virtues of their mutuality in the years to come.

### Editorial eye

The turmoil in the UK building society sector makes it a space worth monitoring for a variety of potential acquirers. A building society in difficulty or with a large under- or non-performing loan portfolio may represent an attractive consolidation play, an opportunity for acquirers of distressed debt or a good first foothold in the UK market for overseas institutions looking to gain an entry point into the UK market.

# Northern exposure

## Opportunities for a macro-economic play in the Baltics and Eastern Europe

In the mid-1990s, Nordic banks faced mature home markets with only limited growth opportunities. As a result, the main strategic opportunity identified by a number of banks involved geographical expansion outside their domestic markets.



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The regions they identified as high-growth areas were the Baltic States and Eastern Europe and, by the end of the 1990s, a number of Nordic banks had made their first acquisitions there (see Figure 1). In the first decade of this century, some banks gradually increased their commitment to those regions, through further acquisitions and organic growth.

Until the development of the property bubble in the Baltic States and the subsequent economic crisis across Eastern Europe and the Baltics, the investments did not disappoint and the Nordic banks enjoyed strong growth rates and high rates of return on their investments. Increasing competition, however, gradually saw margins forced down to lower levels and, more recently, the Nordic banks' performance has been impacted by the current economic crisis, which has had a more severe impact on the Baltic States and some of the Eastern European countries than elsewhere. As a result, the Nordic banks have experienced a deterioration in the quality of their assets, driven to a material extent by their exposures to Baltic and Eastern European real estate and property.

While the Nordic banks have, since the start of the economic crisis, made substantial collective provisions for their potential credit losses, those losses have not yet materialised to any significant

degree. There has been a great deal of publicity about the economic crises in a number of Baltic and Eastern European countries, notably Latvia, Lithuania and Hungary (indeed, there has already been much talk in the Baltic States about currency devaluation), and the full extent of the region's loan portfolio default rates are still not known. Furthermore, the global economic downturn is expected to have a material impact on the Scandinavian economies until 2011 or 2012<sup>19</sup>. This means that the Nordic banks' domestic markets may increase the pressure on the banks' balance sheets.

Should the Nordic banks begin to suffer greater realised losses, they may well look to ease the burden on their balance sheets by selling off bad debts at a discount, selling branches or disposing of other, non-core assets. Although many of the Nordic banks with exposure to the Baltic and Eastern European region see these foreign markets as 'home' markets, reducing the rate of growth – or even decreasing the banks' credit exposure – might, strategically, be an easier and more attractive option in these markets, rather than their domestic markets. Thus, the banks that have spent the last decade building a presence in the Baltic countries and Eastern Europe could now offer the best opportunities for other players to expand into those regions.



19 'PwC Economics', September 2009.

Figure 1: Selected acquisitions by Nordic banks in the Baltic States and Eastern Europe<sup>20</sup>

Effective date	Target name	Target nation	Acquirer name	% acquired	% total holding	Approximate deal value (EUR m)
December 2007	Factional Bank	Ukraine	SEB	97.3%	97.3%	84
July 2007	TAS-Kommerzbank****	Ukraine	Swedbank	100.0%	100.0%	538
April 2007	BISE Bank	Poland	DnB NORD	76.3%	76.3%	107
March 2007	Orgresbank JSB	Russia	Nordea	75.0%	75.0%	246
April 2005	Hansabank	Estonia	Swedbank	39.9%	100.0%	Market transactions at different prices
June 2004	Kredyt Bank	Lithuania	Nordea	100.0%	100.0%	Undisclosed
October 2002	LG Petro	Poland	Nordea	100.0%	100.0%	115
November 2000	Polsko-Kanadyjski Bank	Poland	Danske Bank	83.0%	83.0%	Undisclosed
November 2000	Vilniaus Bank	Lithuania	SEB	68.0%	100.0%	Market transactions at different prices
November 2000	Latvijas Unibanka	Latvia	SEB	49.6%	100.0%	Market transactions at different prices
October 2000	Eesti Ühispank	Estonia	SEB	62.9%	100.0%	Market transactions at different prices
January 2000	Societe Generale	Lithuania & Latvia	Nordea	100.0%	100.0%	Undisclosed
December 1998	Vilniaus Bank	Lithuania	SEB	32.0%	32.0%	55***
November 1998	Eesti Ühispank	Estonia	SEB	32.0%	32.0%	63***
November 1998	Latvijas Unibanka	Latvia	SEB	23.1%**	23.1%**	20***
September 1998	Hansabank*	Estonia	Swedbank	50.0%	50.0%	Undisclosed

\* 3 separate transactions

\*\* before converting convertible debt instruments

\*\*\* US\$m

\*\*\*\*excluding profit-related payments

## Northern exposure continued...

### Three issues for potential acquirers to consider

The Nordic banks that have moved into the Baltic States and Eastern Europe have invested significantly in building solid reputations in their chosen countries. Consequently, organisations interested in acquiring bad debt, branches or other non-core assets from the Nordic banks need to recognise that the banks will not allow their reputations to be tainted by negative publicity. Potential acquirers will, therefore, have to demonstrate that they will employ discretion and sensitivity in generating value from any assets that they acquire.

Potential acquirers of Baltic and Eastern European distressed debt should also be aware that the legal infrastructure in those regions has not yet been fully tested in all cases; the natural area of concern is around the pledges that banks have taken as security for their lending. While this issue varies between different countries, questions may remain over the security of some collateral types within the Nordic banks' Baltic and Eastern European bad debt portfolios.

A further factor is the lack of sophistication (by comparison with Western Europe) of the receivables management markets in the Baltic States and Eastern Europe. While those markets are certainly growing and maturing, there is relatively little outsourcing of these functions, with most of the work still done by lenders' own collection staff. Swedbank, for example, recently announced that it is developing and strengthening its existing in-house capabilities in this area by hiring 200



specialists in the Baltic region and 40 specialists in the Ukraine<sup>21</sup>. The level of sophistication varies significantly from country to country and product to product, with the most developed market probably being Poland, which has seen the greatest level of foreign investment in its banks.

### Primed for action

Given the macro-economic pressures in the Baltic countries and Eastern Europe, we believe that, in the short-to-medium term, there will be increasing pressure on the balance sheets of the Nordic banks that have exposure to those regions. This view is backed by the recent capital raising announcement of Swedbank whose c. €1.52bn rights issue<sup>22</sup>, although not entirely directly linked to loan impairments in Baltic and Eastern European countries, highlights the pressure on its balance sheet. As the recession continues to impact the Nordic region, it is likely that the Nordic banks will also find increasing pressure in their domestic markets.

We think that there will be a number of attractive M&A opportunities for those that can afford to act. First, the Nordic banks with exposure to the regions may need to dispose of Baltic and Eastern European banks and branches to ease the pressure on their balance sheets and avoid further large capital raising exercises.

Secondly, we believe that there could be interesting investment opportunities for banks and specialist finance players to acquire loan portfolios or larger individual assets.

### Editorial eye

This might be a good opportunity for strongly capitalised European banks and specialist finance players. By adopting a long-term view, they may be able to buy assets near the bottom of the economic cycle and then ride the wave of economic recovery in the Baltic countries and Eastern Europe.

21 'Interim report January – June' – 17.07.09, [www.swedbank.com](http://www.swedbank.com).

22 Media release, 'In order to further strengthen its core franchise Swedbank announces fully underwritten SEK 15 billion rights offering' – 17.08.09, [www.swedbank.com](http://www.swedbank.com)

# European asset management

## Coming in from the cold?

In common with other financial services sectors, the European asset management sector experienced few large M&A transactions during the first half of 2009.



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Over this period, there were 27 announced transactions (down from 30 deals in the same period in 2008<sup>a</sup>). While this year's deals were mainly smaller, bolt-on acquisitions, there were also a smaller number of large deals. One of these was in fact one of the largest asset management transactions in history, the sale of Barclays Global Investors (BGI) to BlackRock for €9.7bn<sup>a</sup>. Excluding the BGI transaction, deal value is down by 6.6%<sup>a</sup> compared with 2008.

The asset management industry has been significantly impacted by the global economic crisis: net outflow of capital and falling asset values have led to unprecedented pressure on revenues and profits. Even though capital markets began to stabilise over the last few months, many businesses are still in 'survival' mode and are examining ways of further reducing costs in the short term



to maintain profitability or limit losses. In France, Crédit Agricole and Société Générale are combining their fund activities, creating the fourth-largest asset management player in Europe, with €591bn under management and a plan to save €120m annually in three years' time<sup>23</sup>.

The effect of lower revenues and pressure on profitability levels is leading some financial services groups to consider the disposal of non-core businesses or, indeed, their entire asset management business. Scale can be important, because it spreads costs across a wider base. Larger investment managers continue to view this as a good time to acquire smaller counterparts and are closely monitoring developments in the market.

Private equity groups have in the past been attracted to the relative quality of cash flows provided by asset management fees. For example, Hellman & Friedman owns Gartmore; TA Associates, based in Boston, backed the management buy-out of Jupiter from Commerzbank; and Clessidra and Financial Risk Management acquired 67% of the Italian asset management businesses Antonveneta ABN AMRO and Monte Paschi Siena Asset Management from Banca Monte dei Paschi di Siena for €400m<sup>a</sup>. In addition, a number of private equity groups were linked to bids for iShares and Insight, although these businesses were ultimately acquired by BlackRock (as a part of the BGI transaction) and Bank of New York Mellon respectively<sup>24</sup>. While this might raise questions about the competitiveness of financial buyers in competitive processes, we believe we will see an increased interest in asset management businesses from private equity groups over the near term.

<sup>a</sup> PricewaterhouseCoopers analysis of mergermarket data.

<sup>23</sup> Ignites Europe, 'SocGen AM losses widen to €152m' – 18.02.09, [www.igniteseurope.com](http://www.igniteseurope.com).

<sup>24</sup> Press release, 'Leading UK Liability Driven Investment & Fixed Income manager joins BNY Mellon Asset Management' – 12.08.09, [www.bnymellon.com](http://www.bnymellon.com).

# European asset management continued...

## Trends drive out attractive M&A opportunities

A number of emerging trends in the last quarter of 2009 are likely to act as a catalyst for deal activity in the asset management industry over the next 9-12 months.

Theme	Effect
<b>Renewed faith in the profitability of asset management firms:</b>	
Over the last six months, capital markets have begun to stabilise and AUM have seen an upturn.	Potential buyers are more optimistic about the industry's prospects than they were in the first quarter of 2009.
Investors are increasing allocations to equity investments as they seek to rebalance their portfolios after a period of declining values in their equity allocations.	Potential sellers who were unwilling to commit to sales at distressed prices may now be considering their exit options as the market returns to 'normality'.
The latest figures from Lipper FMI show that European net fund sales for January to June this year finally moved into positive territory and hit €55.6bn <sup>25</sup> , with the latter months tipping the balance.	The narrowing of the 'disconnect' between buyers and sellers that prevented deal activity until the first quarter of 2009 is likely to boost consolidation activity in the near term
The increase in AUM is further supported by the results from European banks, which show a number of banks' asset management arms increasing AUM levels by as much as 12% during the last quarter <sup>26</sup> .	
<b>Large financial services groups' need for capital:</b>	
We have seen some high-profile deals involving large financial groups divesting their asset management businesses in order to focus on core activities and increase their capital. Besides Barclays, Banca Monte Paschi, Credit Suisse and Lloyds Banking Group are notable banking groups that have chosen to sell parts of their asset management business this year <sup>27</sup> . In addition, there have been rumours surrounding a number of institutions about similar divestments, including the possible sale of RBS Asset Management <sup>28</sup> .	The sale of captive investment management businesses represents a potentially attractive capital-raising option for large financial services groups.
	Banks and insurance companies remain large players, especially in the UK. These potential vendors' capital constraints are likely to remain a powerful incentive for deal-making in the short-to-medium term. We believe this will continue to contribute to deal flow in the industry.
<b>Changes to the hedge fund industry landscape:</b>	
Many hedge fund players continue to grapple with capital outflows and operational challenges.	With, in many cases, decreasing asset bases and pressure on fees, the hedge fund industry is poised for consolidation.
Man Group has reportedly indicated that it is in the market for smaller hedge funds <sup>29</sup> ; while Cheyne Capital and GLG have separately announced deals in recent months <sup>29</sup> .	Traditional asset managers may also take the chance to diversify through acquisition, with a view to distributing hedge fund products through mainstream channels using a UCITS III wrapper.
<b>Private equity firms as buyers:</b>	
Private equity firms perceive asset management as a growth industry (high returns on capital, cyclical long-term growth trends and recurring revenues).	Private equity firms will seek to buy asset managers, especially divestitures, where the parent is willing to contribute to funding. One example of this was Barclays, which announced that it would provide CVC with debt financing of £2.1bn for the proposed £3bn acquisition of iShares <sup>30</sup> .

25 Ignites Europe, 'Managers' fund flow predictions come true' – 12.08.09, [www.igniteseurope.com](http://www.igniteseurope.com).

26 Ignites Europe, 'Interim results to add fuel to M&A activity' – 10.08.09, [www.igniteseurope.com](http://www.igniteseurope.com).

27 PricewaterhouseCoopers analysis of mergermarket data.

28 'RBS Set To Sell Funds Unit', *The Wall Street Journal* – 17.08.09.

29 'Reluctant hedge fund managers eye M&A deals', Reuters – 11.06.09, [www.reuters.com](http://www.reuters.com).

30 Media release, 'Barclays announces sale of iShares for US\$4.4bn (£3.0 billion)' – 09.04.09, [www.group.barclays.com](http://www.group.barclays.com).

### The short-term future is promising

Although there has been significant volatility in the asset management industry over the last 9-12 months, we believe that the industry as a whole has stabilised. This means that there will be attractive opportunities for both trade and financial buyers to return to inorganic growth strategies in the short-to-medium term. Because some large financial services institutions will need to strengthen their balance sheets, large asset managers may continue to be available for acquisition. Underperforming small and medium-sized asset managers will attract the attention of financial buyers and trade buyers looking to make bolt-on acquisitions.

### Editorial eye

We expect M&A activity in the investment management industry to increase gradually over the next 6-9 months. If the market develops as anticipated, over the next 12-18 months transaction volumes may come close to matching those experienced before the global economic crisis.



# A new financial services landscape

## The operational impact of divestments

Recent events suggest that, over the next two years, the financial services market will see major restructuring. In order to make the most of scarce capital and reduce complexity, financial organisations will focus on sustaining and expanding core capabilities while divesting assets that are sub-scale or not critical to their customer propositions and risk appetite.



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### What are the practical consequences of such divestment?

Operating models in banking have generally become more complex and interdependent. Therefore, assessing the operational impacts of divestment early in the transaction cycle is fundamental to a successful deal. The last decade has seen considerable organisational focus on integrating financial services business models, either post-acquisition or from seeking scale economies from operations and outsourcing. Much middle- and back-office processing has been centralised and/or automated, and, in the mass market businesses, internet banking services have been used to reduce routine branch and call centre traffic. Banks have refined their customer relationship and service delivery models and have applied shared services concepts and outsourced customer operations to reduce costs and standardise service, especially in functional areas, such as finance processing and human resources. As a result, there have been some significant improvements in core cost income ratios. However, some of these efficiency savings have proven to be somewhat illusory. Income grew faster than costs over the last 15 years and, now that income has fallen and margins are under pressure, cost and efficiency are once again high on the corporate agenda. Many banking operations still offer significant scope for efficiency improvements.

Alongside this, managing change within banks has been driven to a significant extent by the delivery of larger and more complex IT programmes and the need to satisfy the requirements of the ever-increasing regulatory and legislative agenda. For many businesses within the

larger FS groups, their access to discretionary investment has been severely curtailed. While these businesses may be of significant size in their respective markets (for example, leasing/vehicle management, merchant acquiring or insurance), they are often small in the context of their parent and do not always get the investment they might expect as a standalone business. In trading businesses, the need for speed and flexibility of deployment, as well as a lack of investment, has resulted in a patchwork approach to software systems and business process deployment that raises a range of different issues around data quality or process control.

Consequently, many businesses that could be candidates for divestment have operating models that are tightly integrated with the parent business operations or have suffered from under-investment in their core business, process and IT infrastructure, or worse, both. This can mean that, when divestment decisions are made, there is a need to assess carefully business and IT operating models to understand not just the impact on the parent and the stranded costs, but also the true cost of separating out the business. For in-market trades, buyers may wish to use their own platforms and processes, but for out-of-market or new entrant/financial buyers, this may not be an option. It is an area that can have a significant impact on deal value. Management needs to ensure that they are able to identify and answer the key questions that bidders will raise on the scope, scale and robustness of the operational infrastructure at the commencement of the bidding process, not later, when it is more likely to become a critical value issue.

### The solution: overcoming the operating model's complexity for higher proceeds

The more complex business operating models are, the more sophisticated separation planning has to be. As a result, assessing the operational impact and subsequent issues around separation should take place far earlier in the deal cycle than has been the practice to date.



- For understandable reasons, deal activity has predominantly focused on the financial aspects of the transaction. The operational team charged with preparing the business for life post-sale generally gets brought into the picture at a much later stage in the transaction. As a result, work on thinking through the separation planning, developing the required transitional service agreements (TSA) and assessing the business impact on the parent at a detailed, operational level is, all too often, rushed and incomplete, leading to issues and costs later on.
- Given the M&A activity over the last decade, most financial services businesses are adept at planning acquisitions and have experience in preparing integration plans. However, few have deep experience of delivering a successful carve-out exercise on any

scale or managing the transaction risk associated with it. The focus and motivation behind an acquisition can be quite different to a divestment for the operational management teams involved. Rather than gaining capability, scale or reach, they may feel they are losing these. They may be losing key teams of people; there will also be the real temptation to focus on core business as usual, rather than spend time and effort on preparing a business for sale that will no longer be theirs to worry about.

- Many separation plans we see concentrate mainly on the practical issues of separation rather than explore how the transition can drive out additional value. Challenging the proposed standalone operating model before the sale, and seeking out operational efficiencies by looking at the standalone business with a fresh pair of eyes, can optimise the core business before the sale, rather than give the buyer the benefit of any improvements. In our experience, these upside opportunities can be considerable, even in the most efficient groups. This work needs to commence as part of the strategic review looking at the sale, and not once the IM has been issued, as is too often the case.
- Given the complexity of unpicking business processes and systems, implementation planning also requires greater focus, sooner. In particular, issues in functional areas, such as finance, risk and HR, where shared services/outsourcing arrangements are very common, can require protracted analysis. Separation needs careful, detailed planning and all of the discipline that would normally be applied to integration – not the rushed, incomplete and under resourced activity that we see all too often. By the time the operational team is brought into the frame, dates have usually been fixed with the buyer

and there is neither the time nor the resources for the quantity of work that is really required. The resultant loss of value to the seller can be significant.

- Assessing the organisational appetite and capacity for providing transition services support post-deal for the acquirer requires an early agreement and detailed planning. It also demands a detailed understanding of the true financial and opportunity costs of providing them for the scope and duration required. This means balancing, on the one hand, the acquirer's desire to reduce execution risk by taking advantage of TSAs for as long as possible and, on the other hand, the vendor's desire to exit as soon as it is feasible to do so. Knowing how much pressure can be applied to the buyer to drive the integration timetable requires careful thought and understanding.
- Finally, the people aspect is also a key issue that often gets overlooked or left too late in the deal process. While lip service is often paid to internal communication and change management in project plans, addressing the people and cultural issues early in the separation planning, and understanding and addressing the impact of ambiguity and risk, is very important. This is not just an issue for the staff in the business being sold. The impact on the parent teams and the organisational model is also highly relevant.

The people who are critical in managing a successful divestment or critical assets to the acquirer, are often those most impacted at a personal level by the sale and the ambiguities that exist at the time of a deal. It is important to ensure that concerns are addressed, key people retained and momentum maintained on delivery. By doing so, it is possible to avoid risking a loss of focus as a result of the range of personal uncertainties that arise during the deal.

## A new financial services landscape continued...

### Three key messages

In conclusion, there are three key messages to consider when seeking to improve deal value from carve-out situations:

1. start early to think through and plan the separation and implementation of the standalone operating model
2. challenge the assumptions around the standalone operating model to identify sources of value and so improve the sale proceeds and not leave value on the table for the acquirer
3. pay particular emphasis to the people and cultural impacts of divestment, as they can often be overlooked and the challenges and impacts underestimated.

None of this should be a surprise: these are all practical issues rather than nuclear fission. However, in the rush to cement a deal, drive a sales process or focus on the remaining business-as-usual assets, these issues are all too often not addressed until too late in the deal cycle and too late to do them justice. In the words of Confucius, 'Success depends upon previous

preparation, and without such preparation there is sure to be failure'. Or, in this context, perhaps that should be 'a failure to drive out the best value possible'.

Given the need to exploit asset values to their maximum in these difficult times, early preparation and focused thinking can pay big dividends.



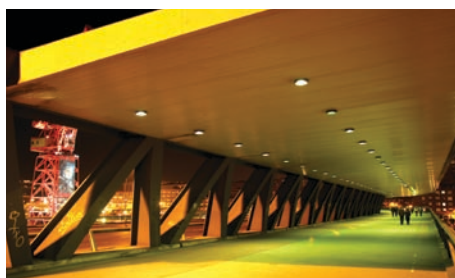
### Editorial eye

Those vendors that – in the rush to do a deal – fail to address the operational aspects of separation at an early stage may end up paying a high price. They risk leaving considerable value on the table for the purchaser and may overlook a range of downside risks that could come back to haunt them.

# Asset management and alternatives

## Primed for acceleration

*Back to the 'domestic' future*<sup>31</sup> predicted further consolidation among European asset managers in response to widespread asset withdrawals, a steep fall in profitability and a reputational crisis accentuated by the Madoff affair.



The first half of 2009 duly saw several announced deals involving European asset management targets, the largest of which was the sale of Barclays Global Investors (BGI) to BlackRock for €9.7bn<sup>32</sup>. This transaction would stand out in any period, let alone such a quiet time for M&A activity. It represents the largest asset management transaction in the six-year history of this publication, easily surpassing the 2007 acquisition of GLG Partners for €2.5bn<sup>33</sup>.

The deal is not only large, but also has several interesting features. From the seller's standpoint, it involved the apparently reluctant sale of a world-class asset manager; Barclays was seen by many observers as having sold BGI in order to avoid part nationalisation<sup>34</sup>. However, Barclays will retain exposure to the asset management business via a 20% stake in the enlarged BlackRock<sup>35</sup>. Barclays' international banking peers will also be interested to see how easily the various elements of BGI can be carved out from its parent group.

The BlackRock BGI deal creates the world's largest asset manager<sup>35</sup> and completes the firm's shift from fixed-income specialism to full diversification. BlackRock's competitors will be watching to see what economies of scale and cross-selling opportunities can be extracted from such a complex mix of products and markets.

Several other asset management deals were announced during the first half of 2009. One of the more notable was Banca Monte Paschi's €400m divestment of ABN Amro Asset Management Italy and Monte Paschi Asset Management to an investment fund controlled by Italian private equity firm Clessidra and UK hedge fund manager Financial Risk Management<sup>32</sup>. Other, smaller deals included the sale by Kaupthing of its Swedish asset management businesses to Finnish Alandsbanken for €38m<sup>32</sup>, and the acquisition of distressed asset manager New Star by UK rival Henderson<sup>32</sup>. This transaction valued New Star's shares at just 2p compared to a high of 140p during the first half of 2008<sup>36</sup>.

The hedge fund sector continues to undergo restructuring, although much of this activity falls outside our dataset. Many hedge funds are wound up, not sold, and acquirers often prefer to take on individuals or teams rather than legal entities. Nonetheless, we expect to see more deal activity in the hedge fund space in the coming months. The possible advent of new EU-based alternative products regulation will only strengthen arguments for greater scale at individual firm level. Traditional asset managers may also take the chance to diversify through acquisition, with a view to distributing hedge fund products through mainstream channels using a UCITS II wrapper.

In conclusion, we continue to believe that industry consolidation will drive asset management M&A during the months and years ahead. The asset management market remains highly fragmented in many European countries, and, at a time when the sector's profitability is under intense pressure, scale-building is likely to remain a powerful incentive for deal-making.

31 'Back to the "domestic" future', PricewaterhouseCoopers, 19.03.09.

32 PricewaterhouseCoopers analysis of mergermarket data.

33 'From uncertainty to opportunity', PricewaterhouseCoopers, 17.03.09.

34 'Barclays shares surge on BGI sale hopes', *Financial Times* – 14.05.09.

35 'A deal to alter the landscape forever' *Financial Times* – 14.06.09.

36 'Good fit takes Henderson into retail market', *Financial Times* – 30.01.09.

# Looking ahead

## The scene is set for a pick-up in deal activity



The slowdown in cross-border and growth-oriented M&A seen since the end of 2007 looks likely to continue during the second half of 2009. Nonetheless, we feel that a restructuring-led wave of deal activity will gather momentum across the European financial services landscape as we move into 2010.

Disposals of non-core businesses by large banking groups are one such example. In March, we predicted that 2009 would see further targeted disposals across Europe, but the pace has been slow. However, Royal Bank of Scotland's recently announced sale of Asian retail and commercial operations to ANZ<sup>37</sup> is a reminder that many banks are hoping to streamline their balance sheets. RBS, which has designated its retail and commercial units in continental Europe as 'non-core'<sup>38</sup>, is only one of many European banks looking to strengthen capital and focus on its core markets.

Another prediction in the last issue of this publication was for a shake-out of financial services ownership in CEE and the CIS. Once again, progress has been slow, but we continue to expect a pick-up in activity. Plenty of parent groups in Western Europe and the US would welcome the chance to sell CEE or CIS assets, and there are still local and foreign players that would like to expand in – or enter – these markets.

For now, gaps between bid and offer prices are acting as a barrier to transactions, possibly reflecting uncertainty over the region's eventual bad debt experience. Government support for parent groups in their home markets may also have reduced the urgency of divestment decisions. Even so, we think price expectations may begin to converge as the economic out-turn for CEE and the CIS becomes clearer.

Buyouts could become an increasing feature of European deal activity, especially if European equity markets continue their relatively positive stability; indeed, some private equity houses are alleged to be considering IPOs as exits for selected non-financial services investment holdings. It is clear that some houses are becoming more interested in financial

services underwriting risk (insurance and lending), and we believe that firms with unused funds and a financial services focus could soon be willing to write 'equity cheques'. In September 2009, the board of Just Retirement in the UK announced that it was recommending that its shareholders accept an offer from Permira that valued the business at £230m. (An offer had been made in June 2009 that was subject to a number of factors, including the completion of due diligence<sup>39</sup>.) Notwithstanding this directional trend towards investing in financial services, the twin challenges of regulatory capital requirements and introducing leverage (in a market where there is simply less leveraged finance available) are unchanged, which could lead to some moderation in targeted rates of return.

At a time when many large insurance companies are focused on protecting their regulatory capital, any M&A transactions will be considered very carefully. In the long term, however, we see potential for consolidation in European insurance as some diversified players are coming under pressure to rationalise their businesses. In the short term, however, we believe that the expected small number of insurers looking to engage in M&A activity may try to take advantage of non-capital intensive divestments of large financial services groups.

Lastly, we feel that several other sub-sectors of European FS could generate M&A activity during the rest of 2009. In addition to asset management and UK building societies (see 'European asset management: coming in from the cold?' and 'Tumultuous times: what next for the UK building society sector?' respectively), we have identified insurance intermediation and securities brokerage as two areas ripe for further consolidation.

37 'ANZ snaps up Asian assets of RBS', *Financial Times*, – 05.08.09.

38 'Rebuilding Standalone Strength', Royal Bank of Scotland – 26.02.09, [www.investors.rbs.com](http://www.investors.rbs.com).

39 Regulatory story, 'Recommended acquisition of Just Retirement (Holdings) plc by Avalon Aquisitions Limited, a company owned by funds advised by Permira Advisers LLP' – 25.09.09, [www.londonstockexchange.com](http://www.londonstockexchange.com).

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# Can you see the changes that are happening in European Financial Services deal activity?



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