



Continuing to climb

Global Banking M&A trends 2018

March 2018

KPMG International

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Introduction

M&A momentum flowing into 2018

The global banking M&A market demonstrated continued resilience in 2017, with deal volume remaining relatively stable compared to 2016. Deal activity strengthened in the Americas and Asia Pacific (ASPAC), while domestic deals predominated, with a 73 percent share of total deals, the majority in the US and China. Despite uncertainty from regulatory pressures and geopolitical and economic events in 2017, we expect the industry to increase its focus on growth in 2018.

In the wake of the US presidential election, renewed economic optimism and improved bank valuations have fueled deal activity by US banks. We believe that near-term market conditions in the US banking sector will continue to drive bank M&A in 2018, as banks concentrate on interest rate management, fee income expansion, cost take-out efforts, lingering compliance costs and, finally, growth. Community and regional banks are expected to make up the lion's share of deals.

Europe, on the other hand, saw a slight dip in deal volume in 2017 with domestic consolidation high on most banks' agendas. Nevertheless, regional consolidation should pick up pace in the medium term as a group of strong and well-capitalized European banks accelerate their efforts to grow, diversify revenue streams and optimize their portfolios. Activity in the UK was mainly in leasing, commercial finance and securities brokerage, with the larger banks remaining subdued. With regards to PSD2 (Second Payment Services Directive), the EU's open banking initiative, it is too early to gauge how the industry will shape up post implementation. Although PSD2 is not expected to have an immediate impact on deal activity, over the long term it should be a catalyst for further fintech investments.

As ASPAC economies continue to forge ahead, banking deal activity is likely to gain momentum. 2018 should see regional and country consolidation, as banks invest in strategically important deals to strengthen their regional presence. Investors from East Asia, in particular China and Japan, are showing an increased interest in the South East Asian markets, as regulators in the region warm to

foreign investment in the hope it can help consolidate and strengthen their financial systems. Overseas acquisitions by Japanese financial institutions should continue, while relaxed restrictions on ownership for foreign financial firms in China is set to spark a significant increase in inbound investment in 2018 and beyond. Furthermore, relatively low penetration rate of both banking and insurance products across ASEAN economies is paving the way for more bancassurance deals.

In other parts of the world such as Latin America (LATAM), Central and Eastern Europe, and Middle East and Africa, we expect deal activity to remain muted in 2018, with LATAM activity effectively on hold pending the results of a number of local elections.

On the buy side, certain private equity (PE) investors continue to eagerly pursue financial services assets in consumer and specialty finance, micro-finance, financial technology, banking and business support services. In 2017, 75 percent of such deals were in ASPAC and Europe, and 21 percent in the US. An anticipated surge in PE players from ASPAC (China and South Korea) along with sovereign wealth funds from Singapore and Canada, signal a continued rise in new market players in PE.

Banking is also likely to be heavily impacted by the evolving financial services ecosystem, with non-traditional new entrants, cross-sector horizontal consolidation, flourishing fintech startups, alternative lenders and much more. Global banks need to continuously leverage their competitive advantages and rethink their growth strategies, to compete in this emerging landscape and to accelerate their transformation into more strategically focused, technologically driven and agile institutions.

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Trend 1: US banks

- **Regional banks to expand and diversify**
- **Community bank consolidation to continue and accelerate**
- **Specialty finance meets technology**



The outlook for US banking M&A in 2018 appears largely optimistic. The 2017 year-on-year deal volume uptick of 15 percent is set to continue, thanks to rising bank valuations, recently enacted tax reforms and an anticipated relaxation of certain banking regulations.

After many years of preoccupation with regulation and restructuring, 2018 should see some large US banks selectively get back into deal making. Banks are expected to focus on expansion into low-capital, intensive fee-based businesses such as wealth and asset management. We also expect these banks to continue to invest in and partner with fintechs, to access additional growth channels and leverage technology to improve internal operations.

Regional banks are likely to be active, building up further scale through acquisitions of larger depositories, specialty lenders and fee-based businesses. With a prolonged low interest rate crimping profits, a number of regional lenders have mimicked bigger competitors and bolstered their advisory capabilities in order to offer capital markets services in the middle-market space. Wealth management is also on their agendas, mainly through acquisitions or sales force expansion.

Further consolidation in the community bank sector is expected, to address the dual challenge of mounting regulatory compliance costs and technological investment, and to tackle high fragmentation, narrowed profit margins and weak efficiency ratios. Lastly, rising interest rates should increase the value of core deposits and may fuel depository deals.

M&A in specialty finance sector has also picked up pace. In addition to traditional, scale-driven M&A activity, a number of recent deals involved lending and technology, to create long-term viable business models. Recent examples include the acquisition of data science personal lending company Earnest by Navient, a loan servicer focusing on collecting payments

on student debt; and PayPal's purchase of Swift financial to expand into alternative lending. As interest from banks grows, we expect them to be active either by building their own platforms or partnering with existing alternative lenders.



Trend 2: Europe

- **European banks expect medium-term regional consolidation, but domestic deal activity prevails**
- **State-aided banks continue to repair balance sheets and shed assets**
- **Divestitures a continuing deal driver in 2018**



European banks have made considerable progress in the past few years, building up capital, strengthening compliance and enhancing supervision. But two key challenges still expected in 2018 are poor profitability and structural weaknesses like over-banking, cost inefficiency and large levels of NPLs (Non-Performing Loans), particularly in Portugal, Ireland, Italy and parts of Central and Eastern Europe. With an economic upturn reflected by rising interest rates and falling loan-loss provisions, banks are better positioned to restore profitability. A number of structural challenges remain, so expect to see further domestic consolidation in 2018, especially among mid-tier banks in Italy, Russia and Spain (in 2017, Spain witnessed a flurry of activity in pursuit of consolidation). The Eurozone banking union should also set the scene for further financial integration via regional/cross-border banking.

Deal flow from large banks should strengthen in 2018, with Europe seeing an emerging group of well-capitalized banks with cross-border capabilities. On one hand, such banks arise from markets being in restructuring mode or in the last stages of the restructuring process, e.g., Italy and Spain. On the other hand, such players can originate from economies that were less affected by the crisis or further through its recovery, e.g. Nordics, France, Netherlands and Switzerland. One recent example of domestic consolidation

is Banco Santander's takeover of Spanish rival Banco Popular. Moreover, governments are eager to offload stakes in banks bailed out during and after the financial crisis. This push to offload state-owned bank stakes, coupled with European Central Bank (ECB) pressure on weaker market participants — especially in Italy, Greece (mainly cooperative banks), Spain and Portugal — should continue to fuel M&A activity. NPL portfolio sales remain another option for banks seeking to strengthen their balance sheets.

Over the next 12 months, expect to see consolidation in the UK challenger banking market, driven by a need for scale and advances in technology.

Divestures should continue to be a major driver of deal activity in 2018. We have already seen European banks strategically rationalizing their business portfolios by selling minority stakes in foreign institutions, exiting non-core businesses and geographies. In 2017, amongst many others, Barclays disposed of its French retail and wealth management businesses, while UBS sold its Dutch wealth management business. With upcoming regulations such as Basel IV's new approach to risk-weighted assets (RWAs), banks divestures are likely to accelerate.



Trend 3: ASPAC

- **Regional and country consolidation expected in 2018**
- **Bancassurance continues to drive deals**



In addition to extreme global and Asian competition and low interest rates, the evolving regulatory environment, along with digital disruption, should continue to impact financial services across ASPAC, with further regional and country consolidation expected in 2018. In 2017, a number of deals helped players consolidate regional presence or expand into adjacent markets through: acquisition (OCBC's purchase of National Australia Bank's private wealth business in Singapore/Hong Kong S.A.R. and DBS's acquisition of ANZ's businesses in Singapore, China, Taiwan and Indonesia); merger (Thailand's futures brokerage firms Classic Gold Futures and Ausiris Futures); and consolidation (Vietnam and Indonesia's financial regulators indicated plans to consolidate and strengthen their respective banking systems).

In ASPAC, South East Asia should remain attractive to foreign and regional investors (in particular Chinese and Japanese) as the region's financial services regulators are keen on consolidation, and on creating opportunities for foreign investment. Indonesia, Vietnam and Thailand are set to be the most targeted markets in ASEAN for cautious inbound investment, due to continued economic growth prospects and an emerging middle class.

Bancassurance M&A should continue in 2018. The low penetration rate of both banking and insurance products across ASEAN economies means great opportunities for banks and insurers developing their bancassurance models. New digital-enabled entrants are emerging from consumer-focused businesses such as Grab from Singapore and Lazada, a German e-commerce firm, with some financial services businesses preferring to reach remote customers through joint ventures and partnerships. For example, Standard Chartered Bank and Allianz have formed a 15-year bancassurance partnership to distribute Allianz's general insurance products to Standard Chartered's retail banking clients in five key Asian markets. Singapore's DBS Bank has expanded its bancassurance partnerships with two new partners in India. With both existing insurance companies and new players making deals and showing interest in bank-sponsored insurance companies, expect to see a change in stakeholders in this space.



Trend 4: China

- **Shifting emphasis from outbound to inbound — relaxing restrictions on ownership for foreign financial firms**
- **Non-financial services Chinese buyers remain active**



In 2017 China took a big step towards further opening its financial system, with the proposed easing of ownership limits arousing great interest amongst investors eager to increase their participation in this major economy.

We expect China inbound deals to increase from 2018 onwards. The 20 percent cap on overall foreign investment in Chinese banks may have been removed, but a general cap of 20 percent remains for all individual banking investors, domestic or foreign. Foreign firms can now hold a majority stake in joint ventures with mainland Chinese securities companies and life insurers. Traditionally, joint ventures have offered a route to a foothold in China, with partners chosen for their contacts with key stakeholders and their ability to help with licensing applications.

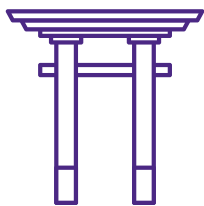
Although Chinese financial institutions' regional outbound deals should pick up in 2018, global outbound deals are expected to remain relatively flat. Meanwhile the Chinese big four banks continue to cautiously look for opportunities for inorganic growth in South East Asia. Banking regulators in South East Asia are seeking market consolidation and aim to attract well-established banks to acquire/bail-out non-performing banks.

Additionally, we expect non-sector players to continue pursuing deals in the financial services space in 2018. Last year saw an increase in non-FS buyers mainly from ASPAC, specifically China followed by Japan and South Korea. These Chinese non-FS buyers are typically conglomerates from the industrial, technology and energy sectors investing in leasing, micro and SME (small medium enterprise) financing, and brokerage. A few Chinese non-FS family offices or POEs (privately owned enterprises) are acquiring European banks to get a European Union (EU) license. Chinese buyers' dominance in this space comes from a desire to diversify into FS and improve profitability and return on investment. Some non-FS investors see a possibility to cross-sell banking products and services to their clients, and overall, we expect non-FS Chinese buyers to remain active in 2018.



Trend 5: Japan

- **Regional banks' consolidation continues**
- **Outbound M&A by Japanese financial institutions to pick up in 2018**



Consolidation among Japan's regional banks has started to gain momentum. Japanese banks' recent performance reflects the challenges of shrinking customer bases amid low birth rates, a shift of economic activity and population to major cities, and ultra-low interest rates squeezing the profitability of regional banks. Thus, consolidation between regional banks seems inevitable and is expected to continue in 2018.

Outbound M&A activity by Japanese banks was relatively quiet in 2017. The uncertainty in the global deal

environment — mainly due to the US election and Brexit — kept activity relatively muted in 2017. However, in 2018, we expect a strengthened appetite amongst Japanese financial institutions following a pickup in M&A activity in the final quarter of 2017. Japanese companies continue to have significant funds available for outbound M&A activities, and are expected to remain active in M&A, especially in the US and ASEAN.



Trend 6: Portfolio sales

- **Regulation and IFRS9 contribute to maturing but active NPL markets**



Looking back on 2017, the predicted shift south of European NPL activity was evidenced by record transaction volumes in Italy, increased activity by Greek banks focusing on local assets, and continued Iberian trades. The evolution of Europe's NPL securitization market was led by Italy, largely supported by the government's GACS (Guarantee on Securitization of Bank Non-Performing Loans) program, following more established markets like UK and Ireland.

In 2018, banks globally should experience increasing regulatory and accounting pressure to deleverage non-core loans and NPLs, met by a favorable appetite from investors looking to deploy a large supply of capital seeking yield in a low-yield environment.

In continental Europe and Ireland, banks continue to hold high levels of NPLs, with over 1 trillion Euros (€) in the Eurozone alone. Consequently, the ECB supervisory board has readopted credit risk — with a focus on NPLs — as one of four key priorities in 2018, and is expected to issue supervisory expectations on NPLs. Given a further provisioning backstop proposal from the ECB, and the impact of IFRS9's expected loss methodology, high NPL

banks have a growing incentive to deleverage. This increase in liquidity is supported by new market standards from the European Banking Authority's (EBA's) NPL templates and a proposed ECB NPL transaction platform. Activity should carry on growing substantially in Greece and Portugal, with substantial activity in established markets of Italy, Ireland and Spain. NPL securitization is set to continue to develop, from post-acquisition securitizations by experienced investors (a hallmark of 2017) to issuance by banks as per recent Italian and Portuguese cases.

Globally, in Brazil we expect some bank deleveraging through asset sales, following provision adjustments in 2017 and capital-raising waves by domestic investors. In India, the 32 billion US dollar (US\$) recapitalization plan for Indian state banks, alongside Basel III adoption, should also narrow bid-ask spreads for non-performing assets and trigger an increase in NPL disposals. In addition, a new insolvency law has strengthened the desire for NPL resolutions in India and attracted significant investment from global stressed asset funds.



Trend 7: Fintech

— **Global banks' 'buy approach' is gaining momentum — expect more purchases than investments**



Large banks have committed to invest in fintech and acquire startups to meet their strategic goals. We are likely to see more purchasing than partnering over the next year, given the strategic focus of financial institutions and the competitive environment. For example, JPMorgan Chase agreed to buy payments start-up WePay, an online payments provider for technology platforms; BNP Paribas bought French digital bank Compte-Nickel; while ING acquired a 75 percent stake in Payvision, an independent international card acquirer and payments platform.

In the Americas, particularly in the US, personal finance is a key focus for global banks. Goldman Sachs continues to show interest in digital lending with addition of new alternative lending companies to its portfolio — Better Mortgage and Neyber. Meanwhile, Citi and JPMorgan Chase invested in personal finance startups Clarity Money and Dave respectively, to access mobile platforms to help customers manage their money.

Blockchain remained a key focus of investment in Europe during 2017, with a number of large banks collaborating on blockchain-enabled smart solutions to improve cross-border trade payments — particularly for small business customers. We also expect banks to pilot partnerships and acquire fintech businesses, a trend likely to accelerate thanks to opportunities from open banking/PSD2 (Second Payment Services Directive). French banks, encouraged by their government, are expected to massively invest in fintech and seek potential targets to help transform digitally.

ASPAC should continue to see fintech deals in 2018. M&A activity in fintech and payments should carry on growing across the region, with opportunities from more sophisticated payments infrastructure, and from fintech businesses that support new distribution models to penetrate vast, untapped markets in countries like Indonesia. Singapore and China are both set to play an increasingly important role as innovators.



Trend 8: Private equity

— **No signs of slowing in 2018**



Private equity (PE) funds — the majority of whom are based in the US and Western Europe — have played an increasingly important role in financial services for many years. In 2017, they were involved in approximately 20 percent of banking deals and were very active globally. Additionally, we saw a rising number of players from ASPAC, mainly China and South Korea. Most deals were in consumer and specialty finance, micro-finance, financial technology, banking and business support services.

With regional offices primarily in Singapore, Hong Kong S.A.R. or India, ASPAC PE funds have relatively full war chests to be deployed across banking, insurance and payments given the continued strong regional economic growth and emerging middle class in this region.

Investor confidence in India is growing as new reforms and bank recapitalization plans attract capital flows. Both foreign and domestic PE players have been investing in the country's insurance and banking, housing finance, micro-finance and non-banking financial companies (NBFCs). This trend is set to continue in 2018, as government reforms continue to give investors' confidence in India's growth trajectory.

PE interest in China should rise following a recent announcement enabling foreign investors to own a majority (and eventually a 100 percent) stake in many types of Chinese financial institutions over the next 5 years. The Vietnamese banking sector is growing rapidly, requiring new capital largely funded by PE in pre-IPO (initial public offering) rounds — a trend set to continue into 2018. The Indonesian market is also attracting significant PE interest, excited about the scale of the untapped financial services market, in particular non-bank financial institutions (NBFIs) and insurance.

Europe enjoys substantial PE interest, especially in France and UK. In 2017, deal activity revolved mainly around rental and leasing (equipment and vehicle), banking and consumer finance. With the open banking/PSD2, there should be growing deal interest in personal financial management (PFM) and alternative overdrafts in the long term. Payments and business-to-business (B2B) finance are also in the spotlight. Recent B2B finance focus has been on consumer finance and payments, although there is now a shift towards SME and business customers (who actually pay for a service). We expect the new evolving transportation ecosystem to impact auto financing, while interchange

fee regulation (IFR) may force card issuers to rethink their business models; all of which creates more opportunities for PE players in the longer term.

The US PE deal market has remained buoyant, with 2017 investments in insurance services, specialty finance and financial technology, particularly in the payments space — a trend that should continue in 2018. Action in the payments space has shifted to corporate buyers. Having acquired several PE-backed businesses in the last year, these players are poised for more of the same in 2018, in what has become a hot sellers' market. The US market should be impacted by the recent tax reform bill, which is likely to have a multifaceted impact on PE investments, through a combination of reduced corporate tax rates, leverage limitations and significant changes to foreign earnings taxation.



Trend 9: Basel IV

— **Expect considerable impact on bank business models**



Futurologists may struggle to predict what the world will look like in a decade's time; but bankers now have much greater certainty about how capital requirements will be calculated.

That's because, in December 2017, the Basel Committee agreed on a standard (BCBS 424), which will take effect in 2022 and have a further 5-year phase-in to 2027, code-named "Basel IV" by the industry.

Basel IV is likely to have a considerable impact upon bank business models.

Starting with capital impacts: Basel IV restricts banks from using internal models to achieve lower risk-weights across a variety of asset classes (including equities, high loan-to-value (LTV) real-estate and exposures to large corporates and banks). When the new rules come in, this restriction is expected to have the single biggest adverse impact on banks' capital buffers.

Even where internal models can be used, Basel IV introduces a floor for the ratio of capital requirements versus the standard method. This 'output floor' — which was the subject of extensive negotiation between the US and EU — was finally set at 72.5 percent. The ratio has the potential to hurt European banks more than their peers in other regions,

due to the greater prevalence of internal models in Europe; consequently, many EU banks had pushed for a lower floor.

Basel IV rules are complex and detailed, but it's already possible to identify which banks and portfolios could be hit hardest — which produces some surprises. Banks in countries with lower credit ratings and higher NPLs are expected to see a lower capital hit from Basel IV (some initial estimates are around 70 basis points of lost Common Equity Tier 1 (CET 1). Banks in Northern Europe, on the other hand, have a higher estimated impact (possibly 250-300 CET1 basis points), as do specialist custody banks.

The long transition period gives banks the opportunity to evaluate which businesses are likely to become more expensive to run in 5-10 years' time, once the rules are phased-in.

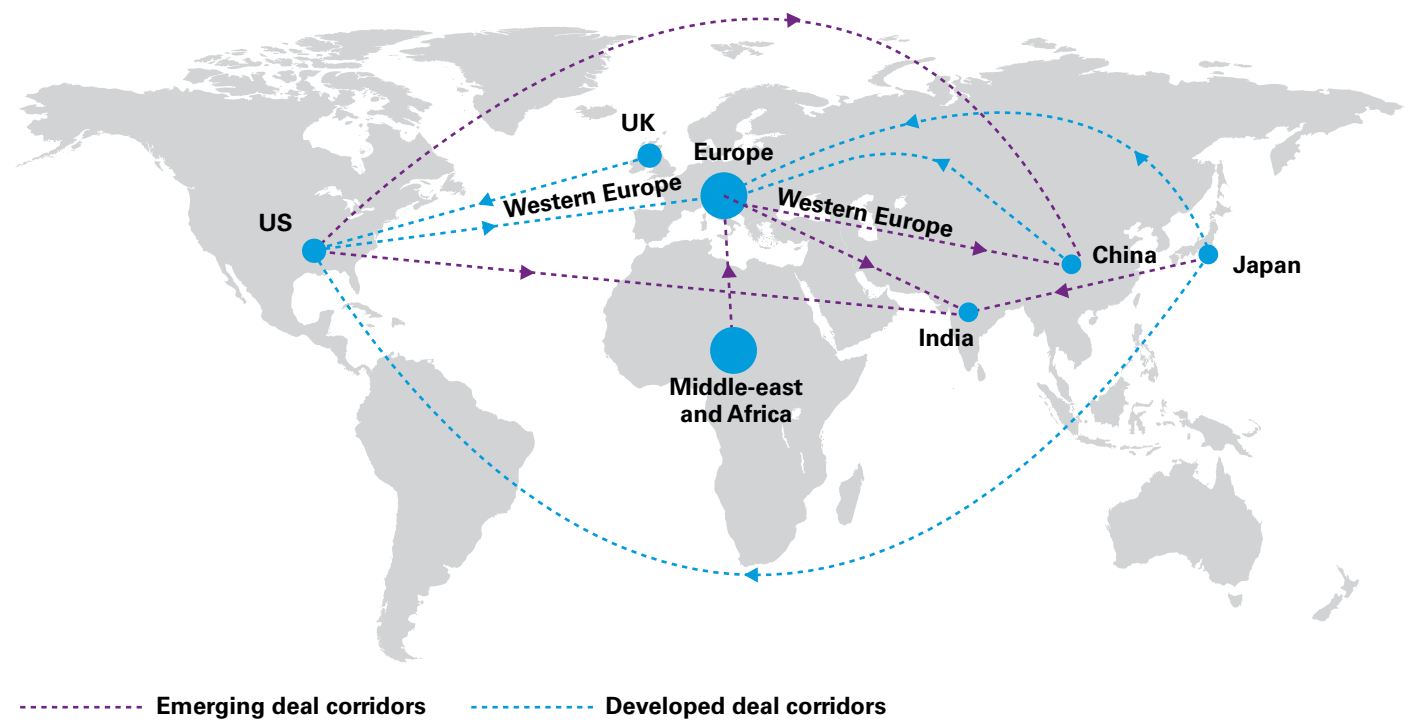
They should be able to know today that books of business involving, to name but a few, high LTV loans, exposures to equity, large corporates, or banks with weaker credit ratings, could become much more expensive for capital. From an M&A perspective, Basel IV is likely to create many more opportunities for arbitrage, altering the most capital-efficient 'home' for different types of exposure.



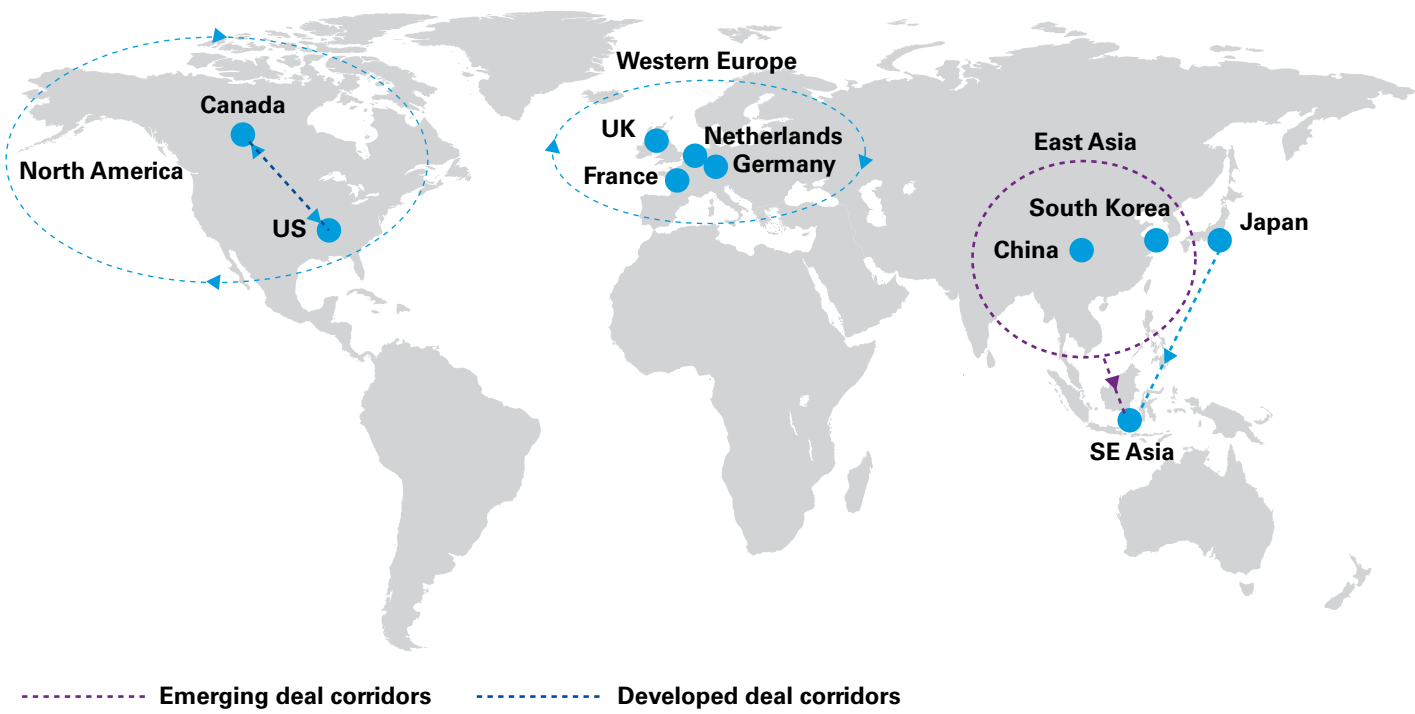
Trend 10: Deal corridors

- **New emerging corridors to watch — from the US to India and to China; Europe and Japan to India; Western Europe to China; East Asia to South East Asia**

Intercontinental



Regional



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and superior analytic tools to help you navigate a complex, fragmented process. KPMG professionals can help with business strategy, acquisition strategy, plans for divestments or for raising funds.

Further Reading

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Financial services experience a surge in cross-sector M&A

The rise in deals involving non-traditional buyers reflects sector convergence and a push for diversification and efficiency. KPMG looks at motivations, trends and challenges in our latest report.



Opening up China's financial sector

The proposed easing of ownership limits in China's financial sector has aroused great interest among investors eager to gain a greater share of the world's second largest economy. KPMG looks at the impacts across a number of sectors.



Zooming in on India's Financial Services M&A opportunities

A recent relaxation in India's regulatory regime suggests change may be in the air. Non-banking and fintech are among the market segments benefiting from an easing of regulatory constraints.



Private Equity reimagines the diligence process

Competitive pressures are encouraging leading PE funds to reassess their M&A processes. KPMG professionals provide an overview of recent changes in PE's relentless pursuit of value and consider the reasons behind these trends.

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Designed by Evalueserve.

Publication name: Continuing to climb

Publication number: 135308-G

Publication date: April 2018