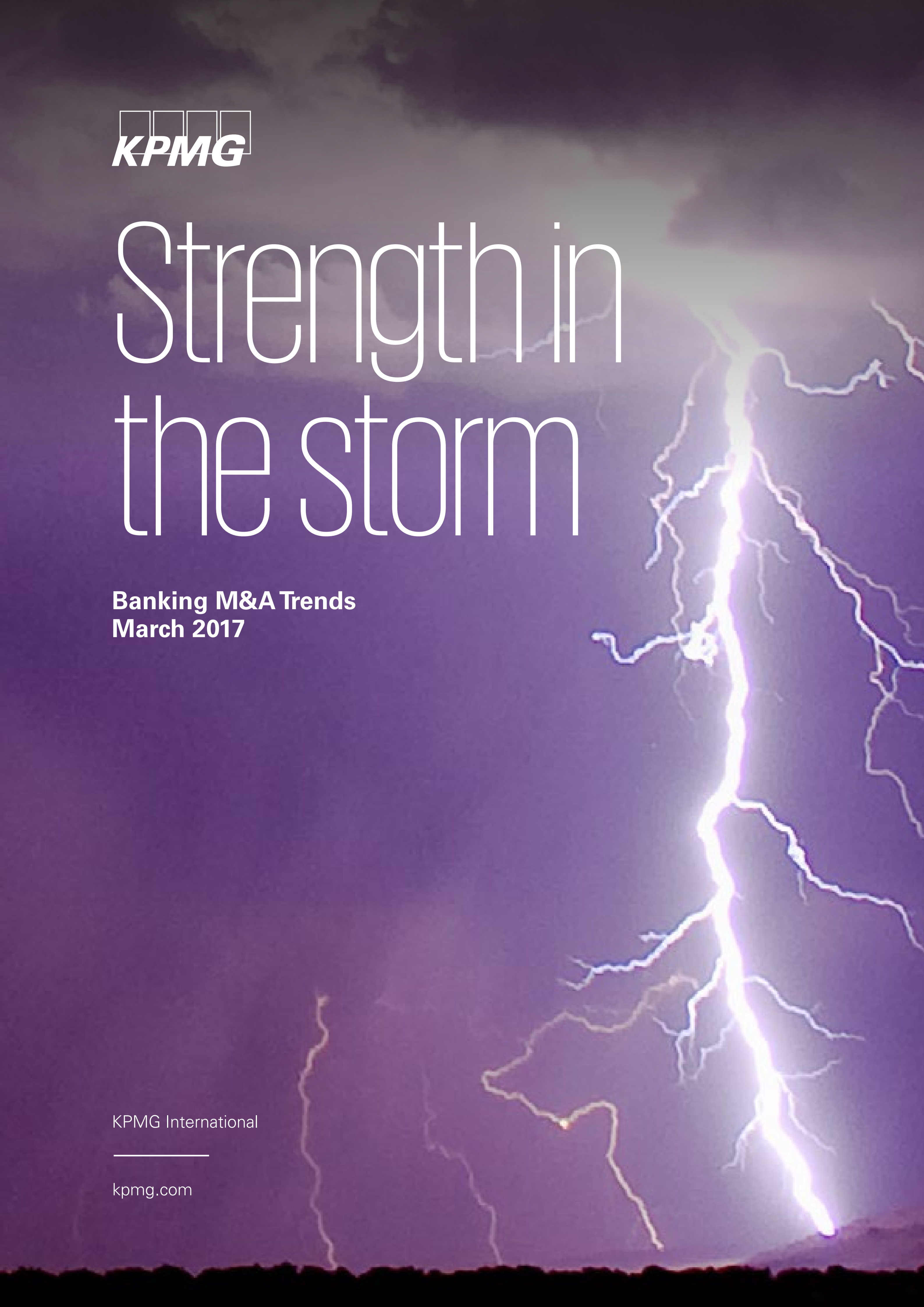

Strength in the storm

Banking M&A Trends
March 2017

KPMG International

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Introduction

The year 2016 was not a record breaker for deal activity in the global banking and capital markets space. Even though the industry's underlying fundamentals remained relatively unchanged, the operating environment became much tougher. We had predicted a higher level of deal activity in 2016; however, deal value and volume remained relatively stable compared to 2015. The continued regulatory pressures, combined with various geopolitical and economic events such as the US election, Brexit, the continued low interest rate environment and the economic slowdown in China all created uncertainty that lingered over the global markets and kept investors cautious.

Domestic deals were a predominant feature of 2016 (with a 73 percent share of total deals) with most deals announced in the US and China.

Most deal activity was concentrated among small and medium-sized banks; continued regulation and increasing capital requirements inhibited acquisitions by the large global banks. Chinese and Japanese players focused more on regional and domestic growth and remained less active in overseas acquisitions. The year nevertheless witnessed a few mega-deals — the long-awaited stock exchange merger between London Stock Exchange and Deutsche Borse, the acquisition of regional Crédit Agricole banks by Sacam Mutualisation and the merger between National Bank of Abu Dhabi and First Gulf Bank. Most high-value deals were centered around 'merger' as a mode to improve financial strength plus build expertise, global network and synergies.

As the dust from the political uncertainty settles, we expect a reasonably healthy level of M&A in 2017. With President Donald Trump's administration, interest rate hikes (actual and expected) and a talked-about relaxing of regulation, some of the pressure on local US banks is expected to subside. Additionally, overall deal activity is likely to pick up the pace thanks to: banks eyeing fee-based businesses; the European Central Bank (ECB) encouraging further consolidation amid overcapacity at European banks; continued non-core disposals by global banks; regional deals in Asia-Pacific; increased competitive pressures in the market driving continued demand for fintech innovation; and active NPL markets driven by weak balance sheets. At the same time, we expect the continued emergence of new non-financial services buyers — from real estate, industrials, technology and funds — to change the overall landscape.

Top 10 trends

01 **A wave of M&A in the wholesale market infrastructure industry; the battle for Asia 'gateway' exchange will accelerate M&A.**

02 **US regional and local banks to bulk up** — continued consolidation in 2017.

03 **Continued European banking overcapacity** — further domestic consolidation looks inevitable.

04 **Chinese banks will focus more on domestic M&A, eyeing high-growth tech firms.**

05 **Large Japanese banks will remain acquisitive overseas, while more regional consolidation is expected.**

06 **Active NPL market to fix weak balance sheets.**

07 **A wall of capital desperate to deploy** — private equity houses, pension and sovereign wealth funds, insurers and high-cash deposit holders looking for returns. New buyers entering the market in 2017.

08 **Fintech will remain front and center in 2017.**

09 **Banks will eye wealth management businesses as margins tighten.**

10 **Most-active deal corridors: from the US to ASPAC and to Western Europe.**

Battle for Asia's 'gateway' exchange.

Trend 1

A wave of M&A in the wholesale market infrastructure industry; the battle for Asia 'gateway' exchange will accelerate M&A.

Market infrastructure plays a key role in an economy to serve and foster financial stability. With the changing capital markets business models, new opportunities are being created for market infrastructure providers, enabling them to continue expanding across the value chain. The industry is divided into two broad areas — wholesale market infrastructure (exchanges, data/market services companies, trading platforms, post-trade utilities) and consumer market infrastructure (big organizations, with large market capitalization, that are customer-centric, and data services companies). The industry is gaining momentum due to several factors: the strategy of large exchanges is to engage in inorganic growth and investments; industry participants such as exchanges have shown better share-price performance over the last 10 years compared to large banks; the opportunity to acquire small players exists; and the market holds potential for large-scale transactions.

In 2017, trends that are likely to continue in the wholesale market infrastructure industry include continued convergence of listing platforms/exchanges, data companies and post-trade services. Competition to acquire data companies, meanwhile, will drive up valuations of these companies, and competition authorities will continue to review almost every transaction in wholesale market infrastructure. With Brexit further fragmenting banks' footprints, we expect exchanges, financial market utilities and intermediaries to act as the 'bridge' and 'aggregator' of flows and data.

The wave of consolidation and M&A across wholesale market infrastructure dominating North American and European markets until now will push into Asia in 2017–18. The battle to be the 'gateway' exchange for Asia will accelerate. Frontier markets, including Africa, South America and Eastern Europe, are expected to follow similar trends, including setup of new exchange and utilities companies. A range of privately held market utility companies in areas such as 'know-your-customer' (KYC) will start to consolidate. Lastly, we expect to see divestments because of consolidation and increased scrutiny from competition authorities.

US banks bulk up. European banks shed.

Trend 2

US regional and local banks to bulk up — continued consolidation in 2017.

In 2015 and 2016, about 35 percent of financial services deals in the US confirmed the regional consolidation trend. US regional and local banks are expected to see further consolidation in 2017. This trend will be driven by the confluence of higher fixed regulatory costs, low growth amid low interest rates, rapidly changing technology and financial innovation. These factors have contributed to structurally lowering bank profitability. If we look at the expense side of the income statement, it indeed reveals a challenge to absorb such costs in a small bank. Banks up for sale cited a heightened regulatory burden as a major driver.

However, interest rate hikes (actual and expected) may spurn potential deal activity. The impact of the new administration on banking regulation is uncertain but is unlikely to affect bank M&A significantly in 2017.

Trend 3

Continued European banking overcapacity — further domestic consolidation looks inevitable.

In Europe, the greatest concern is the low profitability of banks that continue to face fundamental returns on equity issues as investors can no longer expect returns seen before the crisis. High levels of NPLs persist and asset quality still remains weak at many banks, to varying degrees across countries. Being over-branched has European banks conducting the speedy closure of some branches. In addition, regulatory pressures demanding more capital remain a strong headwind hampering profitability and returns.

In 2017, we continue to expect low growth and declining EU lending, a turbulent political landscape (Italian referendum, Dutch election, Brexit, French election), a continued low-interest environment and the 'uberisation' of the banking sector. Further rationalization of branches and consolidation of entities appears inevitable. M&A deals among mid-tier EU banks are more likely than large-scale deals. Many larger banks, traditionally active in the deal space, are capital constrained, making it more difficult to fund sizeable deals even though such deals could reduce their cost base.

Convincing board members and shareholders on the merits of a deal when returns generated by many EU banks are poor is likely to be tough. We expect bank consolidation to be mainly domestic in 2017 (especially Italy and Germany). The exception to this is Portugal, where PE funds have acquired a major stake in a bank, and we may see similar activity in the year ahead.

Cross-border M&A activity is likely to remain subdued. Banks would need: top-level political support for European banks; changes in regulation to make capital/liquidity fungible across borders; support from the Single Resolution Board (SRB) and national resolution authorities; a pan-European deposit guarantee scheme to reduce governments' worries about being responsible for depositors in other countries post-merger; and evidence to convince the European Central Bank (ECB) that M&A would alleviate NPL and profitability issues. As such, it is likely that domestic M&A will dominate in 2017, with some smaller cross-border deals and PE acquisitions.

Chinese banks focus inwards; Japanese look abroad.

Trend 4

Chinese banks to focus more on domestic M&A — eyeing high-growth tech firms.

Chinese banks' growth strategy will likely remain focused on deals in the domestic market. They are also focusing on growth through product diversification and by obtaining other financial services licenses (insurance, trust, futures, securities, bancassurance, etc.) in China.

Further, we see Chinese banks eyeing high-growth tech firms. A pilot program initiated last year allowed selected commercial banks to set up equity investment arms to take direct stakes in technology firms. The program, aimed at supporting high-tech innovation in the country, will also enable Chinese lenders to compete with private equity players.

From a cross-border perspective, a conservative and conscious approach is being taken by Chinese banks amid uncertain economic and political situations in western countries. However, Chinese banks are still active in evaluating cross-border opportunities, particularly in more-stable economies.

Trend 5

Large Japanese banks will remain acquisitive overseas, while more regional consolidation is expected.

Japanese banks will remain active in acquiring overseas financial institutions or fintech-related companies against a background of slow economic growth and a shrinking population in the home market. Key areas of focus are the US and ASEAN countries. Last year, we witnessed major Japanese banks, such as Sumitomo Mitsui Banking Corporation and Mitsubishi UFJ Financial Group, undertaking acquisitions in the US to expand their presence and customer base.

In the long term, we are likely to see a major consolidation of Japanese regional banks due to a shrinking customer base amid low birth rates and a shift of economic activity and population to major cities, plus ultra-low interest rates squeezing the profitability of regional banks. We may also see banks achieving cost synergies by consolidating subsidiaries. Four key trends will push consolidation: a diminishing customer base; digital banking; privatized Japan Post Bank's increased saving limit posing competition to regional players; and negative or ultra-low interest rates.

In addition, the level of regulators' support for consolidation could also affect the trend. Regulators appear to focus now on encouraging regional banks to strengthen their solid business models in each region, rather than consolidating to achieve cost efficiency.

Portfolio sales to clean-up balance sheets. Private capital transforming competitive landscape.

Trend 6

Active NPL market to fix weak balance sheets.

Bank deleveraging will be accelerated by the active NPL market. Markets to watch are Europe (Italy, Portugal and Greece), Latin America (Brazil) and Asia (China and India). Momentum in the European NPL market continues to shift south as the UK and Ireland near the end of their deleveraging cycles, while countries in southern Europe such as Italy and Greece have only started resolving their mountain of NPLs. Greek banks have already begun disposing of their subsidiaries in Southeastern Europe, with portfolio sales likely to follow in Bulgaria, Romania and Serbia.

Portfolio sales are further expected in the emerging markets of Asia. In Indonesia, the downturn in commodities pricing has led to an increase in NPLs, particularly from corporates in the mining and manufacturing sectors, which will lead to restructurings and collateral asset sales. In India, the government's demonetization initiative will lead to an increase in the non-performing asset levels of Indian banks until enough cash is in circulation again.

The development of the NPL securitization market will serve as an additional platform for banks to resolve NPLs. Moves are afoot to revitalize the European securitization market. While most of the activity is still in the UK and Ireland, many investors will continue to look towards Italy due to the potential securitization pipeline. In Asia, particularly China, NPL securitization could be one way that Chinese banks dispose of their bad debts to domestic and international investors. Interests from international investors to invest in China's NPL market will continue to increase in the short to medium term.

Trend 7

A wall of capital desperate to deploy — private equity houses, pension and sovereign wealth funds, insurers and high-cash deposit holders looking for returns. New buyers entering the market in 2017.

Over the past few years, we have seen private capital playing an increasingly important role in the financial services space. Private capital firms have been increasingly acquisitive — acquiring bank debt and banking/insurance/asset management businesses and moving into areas where banks are reducing lending due to regulatory restrictions. The highest level of involvement was seen by private equity firms, particularly from the US and Western Europe. They were involved in approximately 15 percent of banking deals in 2016. Overall, we expect private capital firms to make investments in fintech, specialty finance and wealth-management platforms in the next couple of years.

At the same time, banks and private capital firms are forming new partnerships and joint ventures in areas such as credit card services, asset management, collection platforms or custody. As banks continue to evolve their business models, private capital will influence what a bank looks like in terms of structure, offerings and interaction with customers.

Additionally, over the past few years, we have seen a new wave of buyers emerging globally, predominantly in the ASPAC region. These non-traditional buyers are gaining importance in the FS M&A environment and were involved in about 20 percent of banking deals in 2016. The key sectors that these buyers belong to are real estate, industrials, technology, consumer markets and transportation. We expect the emergence of these new buyers to continue in 2017, particularly in China.

Fintech bridges over torrents of liquidity.

Trend 8

Fintech will remain front and center in 2017.

Last year, we saw payments and lending remain the leading fintech subsectors across the globe and they continued to earn considerable venture capital attention despite signs of market saturation in some subsectors. Other areas, including RegTech, blockchain, data and analytics and InsurTech, are on the rise. In 2017, we expect to see an increase in investment into enabling technology. Key areas of focus are security, fraud prevention, regulation management, compliance and risk management, data analytics, customer personalization and blockchain. With strong interest in emerging technologies like blockchain, we predict continued organic and inorganic investments, including further consortia activity.

In Europe, especially in the UK, while a cautionary mood remains given ongoing concerns around the potential impact of Brexit on the wider economy, private equity and venture capital firms continue seeking potential targets. Additionally, as old legacy platforms at banks continue to impact the bottom line, fintech companies can provide enhanced processing operations, freeing up capital and improving CET1 ratios. This is likely to accelerate collaboration between banks and fintech companies in 2017. Increasingly, large financial institutions are viewing fintech companies as more than an investment. Through fintech partnerships, banks are looking to create and adopt solutions to reduce risk and improve customer engagement. Similarly, fintech continues to be a powerhouse in the ASPAC region. In 2017, we expect to see more transactions in emerging payments infrastructure and fintech businesses in the region.

Overall, the attraction of financial technology companies, both to realign corporate strategy to appeal to the new normal and as a private equity play, is expected to continue in the next couple of years. Financial institutions will continue to look for ways to embrace the promise of these innovations via different avenues, including partnerships, direct investment and M&A transactions.

Given the lack of large targets, wealth managers will focus primarily on organic growth.

Trend 9

Banks will eye wealth management businesses as margins tighten.

All major global banks will continue to strengthen their wealth management units and other fee-based businesses, and will look to leverage other technology and distribution channels as net interest margins continue to be dampened by low interest rates. Banks have been buying small to medium-sized wealth managers at an increased pace and are also looking for alternative technology distribution and solution channels. In 2016, we saw banking groups such as Bank of Singapore Ltd., DBS Bank Ltd., National Australia Bank Ltd. and Societe Generale making acquisitions in this space to increase their regional wealth management presence. In Switzerland, the world's largest offshore wealth management centre, we saw consolidation among domestic private banks. International expansion, especially in emerging markets of Asia, remains high on the agenda of global Swiss private banks such as UBS, Credit Suisse and Julius Baer. To grow, these large wealth managers will have to adopt a predominantly organic growth strategy, given the lack of large targets.

Wealth management will remain especially attractive to banks trying to capture more 'wallet share' of existing customers and those looking to develop a 'unique customer experience' value proposition. Larger banks especially are looking for institutions with scale in discretionary wealth management, as the revenue is considered 'stickier' and enables them to leverage other products.

Domestic deal activity dominant; cross-border/ regional opportunities still exist.

Trend 10

Most-active deal corridors: from the US to ASPAC and to Western Europe.

Domestic deals were a predominant feature of 2016 (73 percent of total deals), followed by regional and cross-border deals at 15 and 12 percent, respectively. Domestic activity was largely seen in the US and China. From a regional perspective, buyers from Hong Kong, Japan, France and the UK were the most active. With respect to cross-border activity, US buyers, in particular private equity houses, were active in the ASPAC region. For 2017, we anticipate activity along the following corridors:

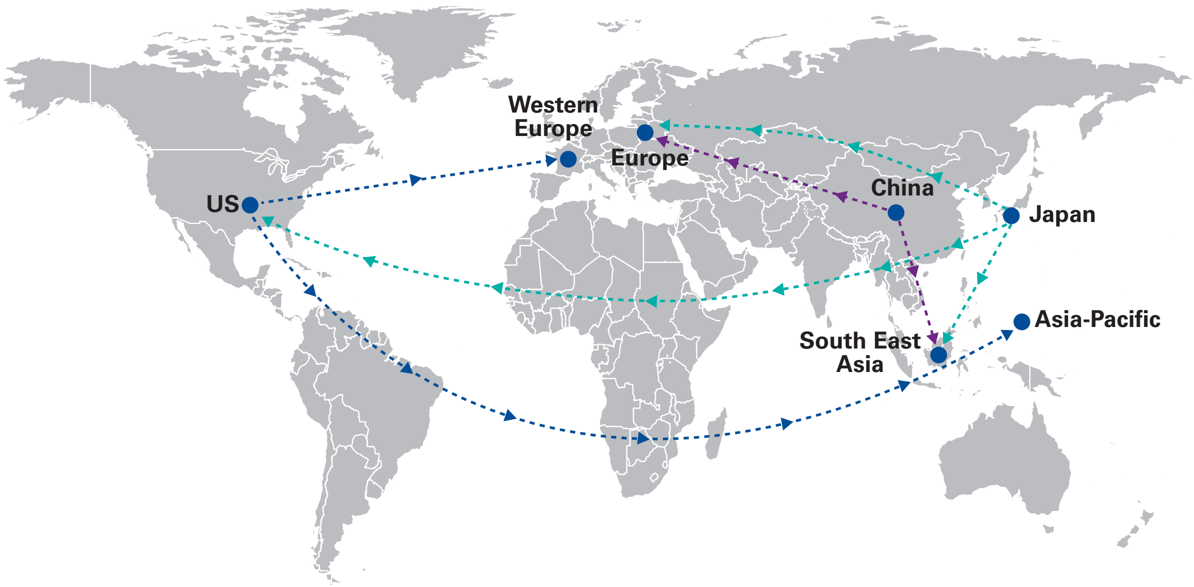
US > ASPAC and Western Europe:
We expect US-based private equity houses to remain active in ASPAC, particularly in India. Private equity firms have targeted the financing and leasing sectors. Additionally, we expect to see US-based strategic and financial buyers seeking targets in Western Europe.

Japan > US and Europe
Japanese financial institutions are expected to further penetrate the US and European markets. Most Japanese buyers are in growth mode and keen to expand globally through acquisitions.

China > Europe
Non-financial services buyers in China have already established their foothold in the domestic market. In 2017, we expect them to target Europe as well. Should one big deal take place, others are likely to quickly follow, as the interest for co-operation exists.

ASPAC > ASPAC
We expect continued regional consolidation as well as transactions in emerging payments infrastructure and fintech disruptive businesses across financial services. There will be continued interest from Chinese and Japanese investors, along with increasing capital flows from private equity and sovereign funds from Singapore and Hong Kong, targeting high-growth markets in Indonesia, Vietnam, Thailand, Taiwan and Malaysia.

M&A deal corridors to remain active in 2017

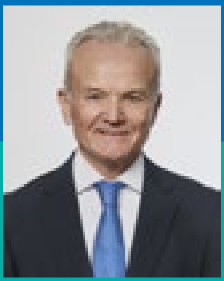


Source: KPMG International, 2017

Key considerations

Key considerations impacting the growth playbook:

1	There are opportunities for non-FS buyers to make attractive investments in the banking sector in areas such as loan portfolios, payments, leasing and financing, brokerage services and utilities.
2	Further consolidation in the US and European domestic markets seems inevitable — banks will need to reshape their strategic plans to adapt to the new world order.
3	NPLs are a top priority for ECB — weaker banks will need to prepare multi-year strategic plans, set out ways to deleverage NPLs and the expected resources required.
4	To grow, wealth managers will have to adopt a predominantly organic growth strategy given the lack of large targets.
5	We will see a continued increase in deal activity in Asia.
6	Many avenues are available to embrace fintech and innovation as a key growth driver.
7	In spite of current growth focus on domestic markets, global and regional opportunities still exist for strong global banks.
8	Regulatory and capital constraints will continue to factor highly in inorganic growth decisions.



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