The dating game in European banking

A guide to preparing for successful deals
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The ongoing malaise in the European financial-services sector is making it incumbent on banks to boost profitability if they are to regain the trust of the capital markets and present an attractive opportunity to investors. Banking leaders are struggling to find sustainable solutions that would enable their institutions to produce returns close to or greater than their cost of equity. Indeed, banks may be reaching a limit on the degree to which senior bankers can close their firm’s profitability gap on a stand-alone basis.

That, in part, is why we believe the industry is about to experience an increase in the sector’s M&A activity, which currently stands near 20-year lows. Banks will be looking to further rationalize their portfolios by divesting poorly performing businesses. They will seek to gain efficiency by merging with other institutions, and to boost growth by making strategic acquisitions. Their mergers and acquisitions strategies might include gaining new lines of business and new digital capabilities, grabbing market share in home markets, and, for some players, expanding into new, more profitable geographies, notably in developing economies.

Such deals are likely to fail, however, unless banks fully understand the entire range of economic factors and technical details involved in every potential deal. Key success factors include a deal’s commercial viability, the financial impact of executing the deal, and whether the deal will actually deliver the expected value over time. In particular, issues such as the combined entity’s customer base, “fair value” accounting for the banks’ combined assets, tax effects, harmonization of illiquid Level 3 assets and risk-weighted asset models, and impending litigation liabilities may seem like mere technicalities, but they can make or break the viability of any deal.
European institutions looking to fix their income statements and balance sheets through M&A have a relatively brief window in which to act, as the number of attractive targets is limited. So it is essential that they move fast, but do so wisely, paying careful attention to all the factors that ensure a deal’s success.
To put it bluntly, European banks aren’t doing very well these days. Business conditions are weak, limiting their ability to boost earnings. Emerging digital players are threatening traditional revenue streams. Ever more demanding customers are forcing banks to invest in costly digital technologies. New regulations have led to higher capital requirements and operating costs, as well as poor returns on equity. And the proposed Basel IV regulations, if put in place, will only exacerbate the situation going forward.

As a result, profitability at most banks in Europe is weak — so much so that few banks are earning back their cost of equity. We estimate, based on gross profitability, that in 2016 alone banks listed in the Stoxx 600* would have had to earn an additional €129 billion (US$152 billion) to close the gap between their profits and their cost of equity. As a result, investors continue to shun the sector in their asset allocations, as they have since the 2008–09 financial crisis. As of the end of 2016, the median bank among the 46 banks included in the Stoxx 600 was trading at a 12 percent discount to its equity book value. Taken together, the gap between the banks’ current shareholder value and their book value amounts to €162 billion (see Exhibit 1, next page).

The only truly reliable way to restore investor confidence is by improving profitability, but that will be no easy task. Europe’s banks are notoriously inefficient, but even if they could reduce their costs by 15 percent, the corresponding profitability improvement would increase their average price-to-book (P/B) multiple only to 0.97 from the level of 0.88 recorded on December 31, 2016, leaving a gap of €37 billion between the P/B ratio and the banks’ equity book value — not even daring to speculate about future shareholder value creation (multiples exceeding 1.00).

It’s unlikely that many of the region’s banks can close their profitability gaps on a stand-alone basis, so banks need to reconsider their options for earning their cost of equity and improving shareholder value. One promising way to do so involves a revival of mergers and acquisitions activity throughout the sector. M&A in its various forms offers a real
opportunity for European banks to increase operational efficiency, improve capital ratios by divesting unprofitable businesses and capital exposures, and grow strategically by gaining market share, increasing competitiveness by acquiring new capabilities and new businesses, and expanding geographically.

Indeed, we expect to see a significant increase in M&A activity in the European banking sector. But getting it right requires both an in-depth understanding of the key issues that can affect the economics of any deal, and the ability to turn these insights into a consistent and workable practice for evaluating a deal’s real potential. This becomes even more critical in a deal environment in which the number of good targets is limited, and flirting with the wrong targets is simply a waste of time and money. What are the critical value levers and deal parameters, and how should they be put into practice?
The dating game

As of mid-2017, total deal count and value in the European banking sector hover around their 20-year lows, for several reasons (see Exhibit 2, next page). Banks’ weak profitability and investors’ poor appetite for exposures to financial institutions are making it difficult for banks to raise the capital required to carry out large-scale transactions. Bankers have limited confidence for venturing into large deals due to a lack of information on key issues such as pending litigation risks. And senior management has been largely focused on other pressing topics, such as rising capital requirements, the implementation of major regulations like MiFID II and EMIR, and, for some of them, ongoing litigation.

Yet, although few significant deals have closed, pre-merger discussions and newly announced deals are already on the rise, driven by several strategic levers: the need for greater portfolio rationalization, the desire to increase operational efficiency, and the pursuit of strategic growth.

• **Portfolio rationalization.** Many European banks are already moving actively to strategically rationalize their business (and credit) portfolios by selling off minority stakes in foreign institutions and exiting poorly performing businesses and geographies. Moreover, while the total assets of European banks have remained stable over the past decade, capital requirements have risen significantly under Basel III, the upcoming Basel IV, and the Financial Stability Board’s requirements for total loss-absorbing capacity, making such divestitures even more likely. Indeed, many transactions will probably take the form of “rescues” of the good parts of de facto failed banks. This is particularly true in southern Europe, where the acquisition of Spain’s Banco Popular by Santander is a case in point.

• **Efficiency.** There is evidence that institutions in markets where banking is highly fragmented, such as Germany, Austria, and Italy, tend to operate less efficiently than their peers in less fragmented markets such as Scandinavia. Yet despite ongoing efforts, the internal cost-cutting measures at banks in Europe’s core markets have not been effective enough to boost the bottom line and improve efficiency ratios. This is largely because certain business activities —
Exhibit 2
M&A activity in the European banking sector

Volumes of M&A in Western Europe

- €68 billion average

* Through first half, annualized.

Note: Includes Nordic banks, excludes transactions with deal values less than €100 million.

Source: Strategy& analysis
capital markets activities, for example — have high fixed costs that banks struggle to reduce through economies of scale.

These banks need to maintain fully fledged post-trade operations, which cannot be scaled down further, while their relatively low trading volumes make automation, other IT system enhancements, nearshoring, and outsourcing uneconomical. For these institutions, business combinations may be the only way to further optimize their operating expenses.

For example, many midsized banks have already reverted to a portfolio of standard products in their sales and trading businesses. Yet they need to maintain a certain infrastructure — including IT systems, processes, and staff — to be able to offer their product spectrum. Their fixed costs for infrastructure are high, and they don't produce enough revenues to present a strong business case. Business combinations may be the best way — if not the only way — for such players to further optimize their operating expenses.

As a result, some banks will be looking to merge in hopes of synergistically reducing costs, particularly in head office, IT, operations, and sales and distribution activities — especially with banks of similarly large size, optimizing the synergistic benefits and the economies of scale. If such efforts are to succeed, however, they must be combined with further cost cutting as well as efforts to improve efficiency.

- Growth. Banks looking to improve their top line will likely turn to M&A, for several reasons. First, many banks are lagging in the implementation of digital technologies, and so will be looking to make strategic acquisitions of online players and financial technology firms to strengthen their digital capabilities and expand their digital product and service portfolios. Doing so will allow them to be more agile in responding to a changing market environment and in devising and executing new business models.

Second, the desire among the largest banks to gain share and expand the client base in core markets — thus reducing competition and improving margins — will likely lead to further consolidation and greater operational efficiencies.

Finally, some banks are also likely to consider exiting unprofitable markets and expanding into new, more profitable ones, particularly those in developing economies. Over the past several years, U.S. banks have been just about the only players expanding geographically, but an increasing number of banks based in Europe are reviewing their geographic growth options. Such moves are risky, however, and will
require high levels of capital and careful due diligence as to the target market's long-term profitability potential, economic risks, and political and regulatory environment.

Clearly, there is good reason to expect a revival of genuine, value-creating M&A activity among European banks. For many banks, however, the environment for doing deals simply isn’t favorable. Given their current economic conditions, it is difficult for them to raise capital to finance large deals. Instead, institutions looking to make deals will be forced to divest businesses to free up the necessary capital. Yet banks are already selling off some units to lower pressure on their capital ratios, so sellers late to the game will likely find deal values considerably less attractive.

First movers will have a further advantage in finding suitable partners, since the number of strategically attractive targets, and those large enough to make a substantial difference to the acquirer’s profitability, is limited. Only a few European players are currently in a position to pursue bold inorganic growth options such as geographic expansion; most will likely focus on small and medium-sized acquisitions to strengthen their core business and acquire adjacent capabilities.
Evaluating deal economics

Even the most strategically attractive M&A transaction can cease to be economically sound if it is not analyzed and carried out properly. As enticing as a deal’s potential synergies may be, they are all too easy to overestimate, and it is easy to underestimate the “dis-synergies” — the so-called winner’s curse. Banks must fully substantiate their top-down synergy and cost expectations from the bottom up, using such methods as internal and external benchmarking, especially in the absence of detailed data about the target bank.

Asset quality, contingent risks, acquisition accounting rules, and other valuation effects of a deal can wipe out the economic benefit, no matter how compelling the strategic logic may be. That’s why it is absolutely critical that banks fully understand all the drivers and success factors for value creation of any deal they are contemplating — and to do so early on, as an integral part of the deal-screening process.

To succeed at this complex game, banks must carefully consider three critical aspects of any M&A transaction — the deal’s commercial viability, the financial impact of executing the deal, and whether the deal will actually deliver the expected value over time — before they enter into it (see Exhibit 3, next page). Indeed, most banks do take the first and third points into consideration when analyzing prospective deals. It is the financial impact, a technically complex issue, that many banks tend to explore too late — despite its importance in ensuring any deal’s success.

Commercial viability

Virtually every M&A transaction is designed to produce value through synergies, whether the goal is to be achieved by reducing costs, boosting top-line growth, adding capabilities needed to compete, or some combination of the three. Cost synergies to be realized are, of course, key and must be analyzed thoroughly during screening of any potential deal. The issues involved are many: assessing the cost savings in combining middle- and back-office activities as well as central functions, and rationalizing the front office and branch network.
Exhibit 3
Three critical aspects of every deal

<table>
<thead>
<tr>
<th>Business intelligence for deals strategy</th>
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<tbody>
<tr>
<td><strong>Commercial viability</strong></td>
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<tr>
<td>What is the net value creation potential of the deal?</td>
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<tr>
<td><strong>Transaction execution</strong></td>
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<tr>
<td>Would execution-related costs threaten the deal’s economics?</td>
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<tr>
<td><strong>Deal value delivery</strong></td>
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<td>Can the assumed net value creation actually be delivered in time?</td>
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Source: Strategy& analysis

European banks typically expect cost synergies of 30 to 40 percent of the target’s cost base, a goal that is considerably more bullish than U.S. banks' usual expectations. Overly optimistic cost synergy estimates, however, can be problematic.

The combined company’s geographic footprint, product mix, and customer base must also be analyzed carefully to determine the level of revenue synergies the deal will actually produce. How complementary are the two institutions’ business lines, and how will combining them affect both expenses and revenues, as well as go-to-market and branding strategy? How will the resulting customer base develop? Is there a risk that the consolidation of the two banks’ branch networks will lead to a loss of customers? In a merger of market leaders in a single country, for instance, risk management considerations may force large clients to scale down their credit exposure to the combined entity.

Finally, each bank’s capital and risk profiles must be analyzed during deal screening to ensure that the combined institutions’ capital plans are sufficiently robust and that they anticipate emerging regulations.

**Transaction execution**

Perhaps no area of M&A is more complex than the details of deal execution, including the financial impacts of such issues as risk, tax, legal structure, and regulatory supervision — impacts that are unrelated
to the cost of integration or any potential business dis-synergies of the deal. They are too often viewed as mere technicalities in the deal-screening process, but failure to pay close attention to these issues can have severe negative effects on the economics of the transaction and may even cause it to fail (see “How does acquisition accounting affect deal economics?” below).

Fair value acquisition accounting is a source of significant risk for the banks’ combined pro forma equity position and, hence, directly affects capital ratios. Such effects can be radical, especially given how many deals involving top European banks would require substantial fair value adjustments (see Exhibit 4, next page). Depending on the target, the impact can create a difficult position for bank executives looking to promote a potential deal’s positive effect on shareholder value — even if there is no change in the deal’s underlying economic risk.

Tax implications can also significantly alter the attractiveness of any deal and must be calculated on a case-by-case basis. For instance, virtually every major European bank holds some amount of deferred-tax assets (DTAs), whose advantaged status might be threatened by M&A-related tax laws (see Exhibit 5, page 16), and investors are unlikely to applaud management for giving away material tax benefits through an M&A transaction. At least, losses in DTAs would probably not hamper regulatory capital ratios, in contrast to fair value adjustments.

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**How does acquisition accounting affect deal economics?**

Every deal comes with critical issues concerning how the deal will be accounted for, the tax implications, and the risk involved. Under the International Financial Reporting Standards (IFRS) rules for acquisition accounting, for example, an acquirer’s balance sheet must absorb the target institution’s balance sheet at fair value. Consequently, hidden losses — attributable to assets whose book value exceeds their fair value, for instance, and vice versa for liabilities — may become visible.

The realization of hidden losses may be exacerbated by additional valuation effects, such as those stemming from the use of the acquirer’s credit spreads to value the target’s liabilities, or from the need to determine and recognize a fair value for intangible assets. Although IFRS 9 may reduce the risk associated with banks’ portfolios of financial instruments, the valuation risk remains for other components of the balance sheet.

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Further tax aspects include additional burdens such as real estate transfer taxes that could become payable as a result of ownership transfer in an M&A transaction. Frequently, such problems can be mitigated to some degree through innovative legal deal structures — but they must be carefully planned during the very early stages of a deal.

Every M&A transaction, moreover, requires the harmonization of the internal valuation and risk models of the two banks, a process that will invariably affect the combined institution’s capital ratio. Highly illiquid Level 3 assets are a case in point. Currently, more than a third of the banks in the Stoxx 600 carry significant amounts of Level 3 assets — as much as 60 percent of their common equity in some cases (see Exhibit 6, page 17). Harmonization of Level 3 valuation models may result in a lower value for some assets, and the “loss” in value will, again, affect
the banks’ combined equity position. Besides the harmonization of Level 3 valuation models, internal risk-weighted asset calculations will also need to be harmonized, posing an additional and potentially even greater threat to capital ratios — though this would not affect the capital base per se.

A further technicality involves the risk of impending litigation. After the settlement of some major litigation cases in the second half of 2016 and early 2017, our sample of 10 leading European banks set aside about €35 billion for contingent litigation and regulatory charges at the end of the first quarter of 2017. This represents just 75 percent of the total charges that analysts expect these banks to face over the next two to three years. The high degree of uncertainty this represents for some top banks, and the “swing factor” — the potentially huge variation in the outcome of any particular litigation — must also be taken into account when analyzing the economics of a prospective deal.
Finally, like any other large M&A transactions, deals among large European financial institutions will be subject to regulatory antitrust investigation. Though the concept of “too big to fail” has been a key area of regulatory concern since the 2008 collapse of Lehman Brothers, it is not yet fully clear how European regulators will address this issue in large banking deals. At present, they seem likely to support rather than hinder transactions. However, banks looking to consolidate must prepare carefully for inevitable discussion with supervising bodies, especially in light of Pillar 2 capital requirements for the combined entity.

**Deal value delivery**

All too often, ensuring that a deal ultimately results in the desired cost savings, revenue enhancements, and strategic synergies is left until after the deal is completed — and even then, measuring the results can
become an afterthought. That’s a dangerous approach. Even the best-laid ideas for creating shareholder value can fail if plans for capturing the expected benefits are not fully fleshed out and substantiated, including the proposed governance structure, executive roles, and cultural fit. A fully detailed plan for capturing the anticipated benefits, and mitigating the costs, must be in place before the deal is struck.

Poor post-merger integration has been the downfall of many bank mergers, and usually results from inadequate planning and underestimation of the complexity of the task, especially with regard to IT integration and the ongoing provision of good customer service. Banks should develop an equally detailed plan for carrying out the merger, especially for IT and client services.

Finally, the merger of any two institutions will reveal significant operational and cultural differences. The combined entities are likely to have new compositions of governance bodies and new organizational designs. There may be disputes about leadership and operational control — and, eventually, the loss of some key employees. The exodus of relationship managers, for example, can have a lasting impact on a bank’s client portfolio and revenue base. Though such factors can, of course, hamper productivity and increase operational risk, some degree of disruption is inevitable, and even desirable, as it can instigate just the kinds of cost synergies and strategic reassessment the deal was intended to trigger.

To mitigate these risks, a governance structure for the merged firms must be agreed on early in the deal process to strengthen key employee and investor confidence. As part of the effort to merge the banks’ often contrasting cultures, clear strategies and change management plans for integrating and motivating all employees must be in place, as well as the training programs needed to educate them on how the combined institution will operate.
Conclusion

Given the many structural challenges banks in Europe are facing, we see clear evidence that the level of M&A activity in the sector will likely increase substantially — and soon. Many European banks, both potential acquirers and their targets, are already preparing — completing strategic turnaround efforts, managing high levels of nonperforming loans, and resolving pending litigation and compliance issues.

Any decision to enter into a deal, however, must be tempered by a full understanding of the financial impact it would have on the bank’s capitalization and valuation, including all aspects of transaction execution and value delivery. That understanding must also be seen in the light of an honest and detailed appraisal of the bank’s current status and future prospects as a stand-alone institution.

Increased profitability, the right capabilities, and a stronger competitive position are musts for every large European bank, and if done right, a merger or acquisition offers the promise of all three. But the number of suitable partners for each bank is going to be limited, so the most advantageous deals will go to those banks that are ready to take action sooner rather than later.

* Except when explicitly stated otherwise, our analysis was carried out on the 46 banks in the Stoxx 600 index before the creation of Banco BPM, with data from the banks’ annual reports or Bloomberg.
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