Baker McKenzie.

2018

GLOBAL TRANSACTIONS FORECAST

Financial Institutions

A BAKER MCKENZIE SECTOR REPORT

Financial deals to accelerate in 2018 amid continued consolidation

Ultra low interest rates, tech enabled disruption and regulatory pressure, all of which have squeezed profitability and increased costs, have created an environment which will drive M&A activity across the financial sector throughout 2018 and beyond.

Our Global Transactions Forecast, developed in association with Oxford Economics, anticipates that global M&A values in the financial sector will rise to US$616 billion in 2018, up 25% from $462 billion in 2017. Similarly global IPO values will grow nearly 40% to US$84 billion, led by fintech unicorns raising capital for disruption, many of which will be Asian based.

Before the global financial crisis, many banks made a material chunk of their profits from the net interest rate margin (the spread between customer deposits and customer loans) but have not been able to do so since 2009 because of the extremely low interest rates that US and EU central banks put in place in response to the crisis.

"This has damaged the basic business model of many banks — a problem compounded by other escalating challenges arising from new technology, tech enabled disruption and intrusive regulation," says David Brimacombe, a financial industry specialist at Baker McKenzie based in London. "Consequently the banking sector will witness substantial consolidation at the national and regional levels."

A similar story is playing out among life insurance companies that are struggling in a low-yield environment with increasing digital competition and game-changing regulatory requirements. Asset managers are also facing a period of falling profitability amid the rise of passive investment and new digital competition that is luring away clients.

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> CHAIR, FINANCIAL INSTITUTIONS GROUP

One recurring theme across banks, insurers and asset managers is the challenge of upgrading legacy systems designed for the age before artificial intelligence and machine learning, and before the tech titans based in Silicon Valley and increasingly China were targeting profitable financial services products using state-of-the-art digital technology.

Part of the solution to this challenge will come from fintechs, which bring their expertise in digital customer experience and new tech solutions that enable the incumbents to tackle old problems such as payment methods and swift product recognition matched to client needs. Most established financial institutions are fully aware of the enormity of the task of developing these upgrades internally, preferring to acquire or partner with fintechs as a means of survival.

“Legacy IT systems constrain the ability of incumbent banks to innovate as these system are incompatible with the demands of artificial intelligence and big data,” says Jeremy Pitts, global chair of Baker McKenzie’s Financial Institutions Group. “New entrants have a serious advantage, so alliances between incumbent banks and fintech start-ups are often the best solution.”

As the costs of technology and regulatory compliance increase exponentially, consolidation among financial institutions has emerged as another important survival strategy, such as last year’s US$4.7 billion merger between the UK’s Standard Life and Aberdeen Asset Management that created Europe’s second-largest fund manager.

Meanwhile a slew of new financial regulations that took effect this year in Europe and Asia have driven up the cost of compliance through capital requirements and myriad rules. Those regulations include the EU’s revised Markets in Financial Instruments Directive (MiFID II), Packaged Retail and Insurance-based Investment Products Regulation (PRIIPS), and Payment Services Directive (PSD2) as well as the UK’s Open Banking Initiative which will propel smaller institutions to merge.

GLOBAL FINANCE M&A (US$ BILLION)						
2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
495	675	540	462	616	569	450

GLOBAL FINANCE IPOS (US$ BILLION)						
2014	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
89.7	70.8	47.2	51.1	83.9	82.4	59.3

Source: Oxford Economics

Financial M&A in 2018: Key drivers

In 2018 we forecast M&A in North America's financial sector to rise to US$259 billion, accounting for more than 40% of all sector transactions globally. Following North America is Europe with US$195.7 billion, Asia Pacific with US$122.7 billion, Latin America with US$29.2 billion and Africa and the Middle East with US$9 billion.

In 2018 we forecast transactions in **North America**'s financial sector to rise 15% to US$259 billion before dropping to US$214 billion in 2019 and US$167.8 billion in 2020.

The US global banks are almost at an inflection point, having achieved a better balance between volatile trading revenues that call for high capital allocations and the steadier capital light businesses of wealth management. They have return on equity averaging close to or above 10%. A similar summary, however, cannot be provided for the small and mid-market banks, which will remain under pressure to consolidate as the number of branches drop and investment costs escalate with digitalization.

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>
> **CRAIG ROEDER**
>
> M&A PARTNER

"Significant reductions in the US federal corporate income tax rates will benefit many banks and insurance companies, as will the trend toward reduced federal financial services regulation under the new administration," says Craig Roeder, an M&A partner at Baker McKenzie based in Chicago.

US-based funds will become increasingly active globally; successful funds are sitting on record amounts of dry powder that will fuel larger and more pervasive M&A activity globally.

We forecast the largest rise in financial sector transactions in **Europe**, where M&A value is expected to nearly double to US$195.7 billion in 2018, up from US$100.8 billion in 2017.

New regulation, competition and technology, as well as de-risking, low equity valuations, elusive sustainable profitability and requirements for European banks to tackle its US$1 trillion non-performing loan portfolio will all generate higher levels of transactional activity. The sector is poised for consolidation, and European Central Bank President Mario Draghi, conscious of too much overcapacity in the Eurozone, has been predicting this shift for over 12 months.

"It's not a viable situation, particularly for the smaller banks, because they will need scale to achieve an acceptable return, a goal inhibited by escalating costs and investment required for the digital, highly regulated age," Industry Specialist David Brimacombe says.

In 2018 we forecast M&A in **Asia Pacific**'s financial sector to rise 60% above 2017 levels driven by Chinese outward investment. Of the five largest banks in the world by assets, four are Chinese and one is Japanese, according to the S&P, reflecting the growing clout of Asia Pacific's financial sector. The largest bank in the world by assets is Industrial and Commercial Bank of China (ICBC), which made its first foreign acquisition in 2007 when it purchased a 90% stake in PT Bank Halim Indonesia.

"As the largest economy in Southeast Asia, Indonesia has been targeted by many foreign banks, as demonstrated by recent activities by HSBC, China Construction Bank and The Bank of Tokyo-Mitsubishi UFJ," says Erwandi Hendarta, a banking and finance partner at Hadiputranto Hadinoto & Partners (HHP Law Firm), a member firm of Baker McKenzie in Jakarta. "We expect these types of transactions to continue for several years."

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> BANKING AND FINANCE PARTNER, HADIPUTRANTO HADINOTO & PARTNERS (HHP LAW FIRM)

The large Japanese banks have a deliberately international focus and are likely to pursue further strategic investments. Other players in Asian financial services are much newer but will have a global impact in 2018 and beyond led by two distinct camps.

The first is Alibaba, Ant Financial and Alipay, which have embarked on global financial inclusion strategies. Ant Financial provides some of the technology power behind PayTM in India, GCash in the Philippines, Kakao Pay in South Korea, and Ascent Money in Thailand. Alibaba recently bid for the US company MoneyGram International although the deal was vetoed by the US Treasury's Committee on Foreign Investment based on strategic concerns. The second is Tencent and WeChat Pay, which have almost 1 billion customers in China and frequently hit annual growth of 50%. WeChat Pay is expanding internationally by focusing on Chinese tourists abroad and making deals with global payment services such as Ayden, CITCON and Airwallex.

In 2018 we forecast that M&A activity in **Latin America**'s financial sector will dip slightly to US$29.2 billion before rising to US$35 billion in 2019 as the region's economy continues to rebound. Latin American banks are among the most profitable globally and have attracted large inward investment from Europe, although upcoming presidential elections in Brazil, Colombia and Mexico have highlighted macro-economic risk that is not a conducive deal environment.

"Financial services companies want to engage in large-scale deals but are holding back to see if the environment clears before they expend the effort, time and money only to find that regulations prevent them from closing deals at a later date," says Liliana Espinosa, chair of Baker McKenzie's Latin America M&A Group.

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> CHAIR, LATIN AMERICA M&A GROUP

We forecast financial sector M&A in **Africa and the Middle East** to drop to US$9 billion in 2018, down sharply from US$29.5 in 2017 as the result of one megadeal that inflated last year's deal total: the US$14 billion merger of the National Bank of Abu Dhabi and First Gulf Bank. In 2019, we forecast deal activity in the region's financial sector to rise slightly to US$10.3 billion before dropping to US$6.6 billion in 2020.

FINANCE M&A BY REGION (US$ BILLION)

	2017	2018	2019	2020
North America	225	259.3	214.1	167.8
Europe	100.8	195.7	182.2	153.2
Asia Pacific	75.5	122.7	126.9	95.5
Latin America	31.5	29.2	35.1	26.5
Africa & Middle East	29.5	9.0	10.3	6.6

Source: Oxford Economics

Financial IPOs in 2018: Key drivers

The total value of IPOs in the financial sector rose to US$51.1 billion in 2017, up from US$47.2 the year before. In 2018 we forecast IPOs to rise even further to US$84 billion, driven by a number of factors, including the reprivatization of several large banks that were nationalized during the global financial crisis and the recapitalization of many financial institutions.

Fintech start-ups established a few years ago will also fuel the increase in listing values as they scale up and look to IPOs to raise additional funding or to provide exits for their private equity and venture capital investors.

"Depending on the driver behind the transaction, the funds are typically used to repay the governments that stepped in to salvage the financial institutions a decade ago, improve balance sheets, or provide an exit for the VC/PE investors and founders in the fintech industry," says Koen Vanhaerents, chair of Baker McKenzie's Global Capital Markets Practice.

In Asia Pacific, numerous fintech companies are also tapping the IPO markets, as well as insurance companies in countries like India, where the sector is growing rapidly and valuations have been soaring.

Beyond 2018

Following a peak in deal activity in 2018, we forecast that M&A and IPO transactions in the financial sector will drop in 2019 in line with a larger, worldwide trend of cooling deal activity in developed markets. An exception could be private equity-driven deals as they apply their vast dry powder cash stockpiles and consolidation in Europe if the EU's banking union plans are implemented.

As interest rates rise, global trade and investment growth slows, and equity prices correct, we forecast M&A values in the financial sector to drop to US$569 billion in 2019 and US$450 billion in 2020. We forecast IPOs in the sector to decline to US$82.4 billion in 2019 before decreasing to US$59.3 billion in 2020.

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