WHITE & CASE

Financial Institutions M&A: Growing opportunities for sponsors

Appetite continues to grow, driven by the emergence of new financial technology and asset classes

At a glance

Financial sponsors are involved in approximately one third of M&A auctions for financial services targets

Private equity was involved in nearly 25 percent of announced deals in the financial services sector in 2018[1]

Significant opportunities exist for financial sponsors to invest across the whole spectrum of financial services sub-sectors

Growing appetite for fintech, payments, specialty finance, credit cards, challenger banks and stressed/distressed bank situations

Hotspot countries include UK, France, Germany, Spain and CEE

1 According to Mergermarket data 1 January 2018 through November 2018 for financial services sector M&A deals by value

High demand for investment in financial services assets

Private equity's share of financial services M&A has increased dramatically since the global financial crisis, and financial sponsors are now estimated to be involved in up to one third of all competitive auctions in the global Financial Institutions (FIG) sector. While some well-capitalised banks are beginning to consider strategic acquisitions after a long hiatus, financial sponsors will continue to serve as a crucial source of new capital into and deal flow in the sector.

The universe of sponsors actively pursuing financial services targets is also broadening. Alternative capital providers, family offices and sovereign wealth funds such as Temasek have also been drawn to the space.

But at this time of macro-economic and geopolitical uncertainty, increasing regulation and technological disruption, how do financial sponsors see the market, and where will the best opportunities for private equity participation lie?

White & Case conducted a series of in-depth interviews with senior FIG industry leaders, including c-suite executives, bankers and private equity partners, to understand where financial sponsors are focusing their resources.

"This is a very exciting time for private equity firms with FIG expertise to be in the market. Political uncertainty in the UK and Italy has put these regions firmly on the radar for bargain hunters, and in Germany and across central Europe governments are actively disposing of stakes in bailed out banks in order to comply with EU state-aid rules," a senior FIG dealmaker said.

Deals such as Warburg Pincus's acquisition of Banca Monte Paschi Belgio and Nordic Capital's bid with Sampo to take Swedish bank Nordax Group private demonstrate private equity aptitude to and appetite for complex deals in a highly regulated environment.

Financial sponsors are also picking areas of financial services that have been vacated by traditional bank incumbents and are now serviced by fast-growing new entrants using technology to create digital distribution channels and lower operating costs.

Specialty lending, encompassing peer-to-peer lending, crowdfunding, payday lenders and specialist consumer and small and medium-sized enterprise (SME) lenders, has received substantial investment. Atomico and GP Bullhound, for example, led a US$40 million round for property loans platform LendInvest.

"The SME and consumer space has become very difficult for banks, who have stepped back to focus on their lowest risk customers. This makes leasing, asset-finance, SME lending and any consumer lending at the prime/sub-prime margins very attractive for sponsors," a FIG PE partner said.

The non-performing loans (NPL) market, although more competitive and less attractively priced than a few years ago, is also set to remain a hot area.

"The NPL servicing platforms backed by private equity remain hugely active, and there is still huge NPL volume coming out of southern Europe, central Europe and Ireland," a FIG investment banker said.

"Private equity firms historically focused on unregulated financial services, but have moved into the regulated space with much success.

Just some of the NPL deals announced recently include Apollo acquiring €2.8 billion of mortgage NPLs from Bank of Cyprus, Cerberus's acquisition of €1.4 billion of NPLs from Ulster Bank, and Oak Hill Advisors and Värde Partners buying a US$1 billion batch of shipping NPLs from Deutsche Bank.

Private equity firms have also strategically invested in debt servicing companies, which they then use to service their NPL portfolios. This means sponsors benefit from the fees and rising equity value of the servicing companies, in addition to the primary NPL assets. One of Italy's largest NPL servicing companies, DoBank, is 50 percent owned by Fortress Investments. Intrum Justitia, which in 2018 agreed to a deal to acquire the debt collection business of Italian bank Intesa Sanpaolo, is also private equity-backed.

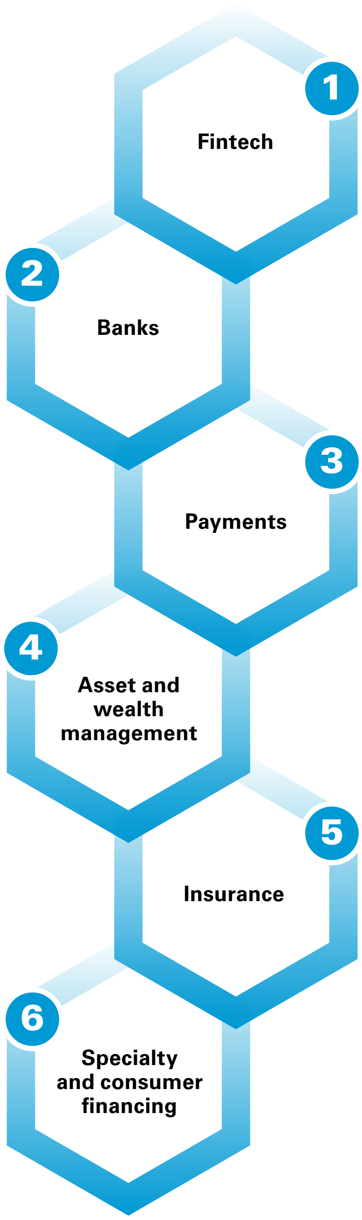
Financial sponsors are also moving back into the adjacent area of credit cards as regulatory and Brexit pressures create opportunities in specific jurisdictions.

"Anything that involves unsecured credit and debt collection will be very attractive for sponsors. They have the technology to manage these assets, which can be packaged up and are easy to sell. Losses have historically been low, funding costs are low and volumes have been climbing," a founder of a FIG private equity firm said.

Investing in financial services, however, does require a clear strategic approach from financial sponsors. Identifying sub-sectors under-serviced by traditional providers, picking the parts of the industry that are growing the fastest and avoiding head-to-head confrontations with strategics in auction processes form the foundations for financial sponsor investment in the FIG space.

Financial services sub-sectors ripe with opportunities

We highlight six sub-sectors where FIG M&A is most active, with three case studies focusing on particular hotspots for financial sponsors.



1. Fintech

Fintech remains a red-hot area of interest for financial sponsors.

"Incumbent institutions have been slow to react to technological disruption because of legacy assets and physical infrastructure. Tech-enabled disruptors have gained market share with leaner channels. Financial services is all about technology now. It is about how you harvest and analyse data, streamline processes and implement digital distribution models," a FIG investment banker said.

Digital lenders Revolut, Monzo and Afterpay, for example, have all received significant private equity backing.

Private equity firms are also well-placed to pick up fintech assets from industry incumbents.

Financial institutions often develop their fintech platforms by forming joint ventures, funding incubators or setting up their own fintech venture funds. Only a small proportion of these joint ventures or starts-ups are ultimately acquired and/or integrated into the incumbent's business, and if the decision is taken to exit, private equity firms are often ready to step in.

Munich Re, for example, was a business partner of Italian digital auto insurer Prima Assicurazioni before Blackstone and Goldman Sachs' private equity arm invested approximately €100 million in the company.

As digitalisation continues to take hold across financial services, and regulation like the second European Union Payment Services Directive (PSD2) opens up opportunities for new providers to sell to bank customers, private equity will continue to see plenty of fintech deal flow.

2. Banks

Financial sponsors will be a key stakeholder in European bank M&A over the next 12 to 24 months as governments push to exit stakes in bailed out institutions, banks continue to dispose of assets in non-core markets and buyout firms fund the next wave of digitally enabled challenger banks.

After rescuing distressed banks following the financial crisis, governments are actively seeking buyers for these assets. In 2018, Cerberus and J.C.Flowers led the consortium that acquired HSH Nordbank (HSH) from regional government owners Schleswig-Holstein and Hamburg for around €1 billion. Bailed out by regional government in 2009, shipping financier HSH had to find a private buyer before the end of February to comply with EU state-aid rules. Other state-aided banks, such as Slovenia's Abanka, are now coming to market as European Union exit deadlines loom. Slovenian Sovereign Holding (SSH) has put its entire stake in Abanka, Slovenia's third-largest bank, on the market and hopes to find a buyer before the end of 2019.

Incumbents are also selling off assets in non-core jurisdictions, delivering further opportunities for financial sponsors to buy and build.

Banks have a clearer picture of how they want to be structured and what their core services and geographies are. Non-core divisions, service lines and legacy assets will be offloaded to simplify business models and eliminate overcapacity. Financial sponsors are well-placed to pick up unwanted assets at good prices.

Greece's Piraeus Bank, for example, sold Piraeus Bank Romania to J.C. Flowers, and Alpha Bank sold its Serbian subsidiary to AIK Banka, which itself is ultimately owned by the Kostic family. These are fairly typical examples of financial sponsors and family offices acquiring banks in central and southern Europe and using them as a platform to consolidate the region's fragmented banking market. We expect a lot more similar deals in the region.

On occasion, financial sponsors will encounter some competition for these assets from strategic buyers—BNP Paribas has acquired the core banking operations of Raiffeisen Polska and private equity was outbid by Hellenic Bank for Cyprus's Cooperative Bank—but these deals offer a strong upside for sponsors who do bid successfully.

"Domestic banks in small markets offer scope to lead consolidation plays, build up SME and retail customer bases and cross-sell products," a head of FIG M&A said.

Financial sponsors have also continued to invest in new bank entrants. Private equity capital funded the first wave of UK challenger banks to emerge post-crisis, including Shawbrook and Aldermore, and are now backing the next wave of tech-focused banks coming into the market. Online bank OakNorth, for example, achieved a valuation of US$2.3 billion following a private equity fundraising in September 2018.

> **Across Europe governments are preparing to divest shareholdings in banks bailed out during the financial crisis. Strategics are still on the defensive, so these deals are very much on the radar for private equity firms.**

> **The recapitalisation of the UK's Co-op Bank by a group of US hedge funds shows that there is appetite for bank assets across the whole spectrum of financial investors, not just mainstream private equity funds.**
>
> —Patrick Sarch, Co-Head of Global Financial Institutions Industry Group, Partner, London

3. Payments

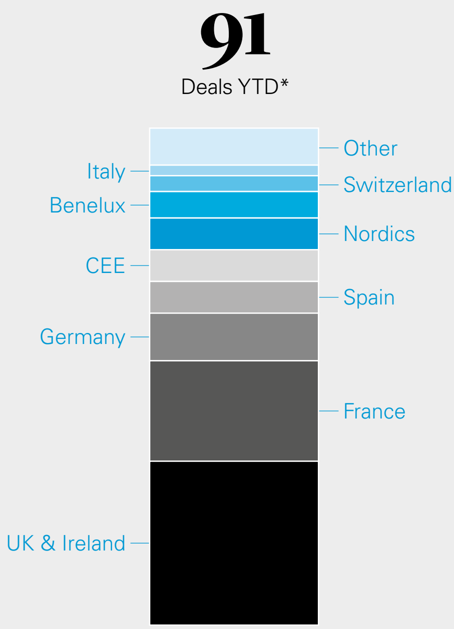
Payments services, where buyout managers have already enjoyed huge success, continue to deliver compelling investment opportunities.

Consolidation across this fragmented and fast-growing sub-sector is firmly underway, but there is a huge amount still to go for. Hellman & Friedman's Nets merged with Advent and Bain Capital's Concardis in one of the largest payments deals of 2018. Other deals include Third Point's acquisition of a stake in PayPal and the acquisitions of Microgen Financial Systems and Global Processing Services by CJJ Investments and Dunedin, respectively.

The market is at an inflection point, however, and valuations are reaching giddying heights. It will be difficult for new sponsors to break into payments at this point in the cycle, but firms which have already participated in the first wave of payments consolidation have the knowledge and experience to replicate past successes.

"Payment processing is hot, and it does feel crowded. All the generalists are active in the space, and you see some competitive auctions and high prices. If you aren't one of the firms that already has a payments track record, it is going to be difficult," a fintech CEO said.

Geographic hotspots



Source: Mergermarket

*November 2018

Payments processing is all about building scale or developing a really strong tech component that can process payments in a smarter way.

4. Asset and wealth management

Robo advisory wealth managers may not be generating substantial profits yet, but the likes of Moneybox and Nutmeg are scaling their customer bases at pace. Nutmeg has received funding from Convoy, Balderton Capital and Pentech, among others, and Moneybox secured £14 million in a series B funding round led by Eight Roads and now has plans to double headcount to 60. Robo advisors have attracted the millennial generation into the savings and wealth management market with strong brands, low fees and easy to use online customer interfaces. Although not vastly profitable at this stage, there is a long-term growth story for private equity firms to buy into.

"Wealth management has some really interesting demographic drivers. There is a generation who will not be able to rely on state pensions for retirement, so there is a huge market for new wealth management tools. If you can acquire customers with tech-enabled, user-friendly wealth management platforms, you can cross-sell other wealth management products and services," a private equity partner said.

Sponsors also see growth potential in independent wealth managers that are untethered to a single institution's product set, as demonstrated in deals like Toscafund taking a minority stake in independent wealth manager Plurimi.

5. Insurance

Private equity firms have delivered strong returns from investments in closed-life insurance funds and remain active players in the wider insurance space with recent deals like Apollo's investment of a further US$700 million in Catalina, a buyer of old property-casualty policies that it then runs off.

"There has been a lot of activity in insurance back-book consolidation over the last four to five years, and that looks set to continue. You have steady, uncorrelated, long-dated fee income and great visibility over portfolios," another private equity partner said.

There has also been activity in the fragmented insurance broker industry. Eurazeo is consolidating the property insurance brokerage space with its platform Assurcopcro, and Sovereign Capital has made three bolt-ons to its insurance broking platform company Arachas.

Reform of the Lloyd's of London insurance market, where much work is still paper-based and trading costs are high, could also see private equity investment come in to fund modernisation. BGC Partners recently acquired Lloyds reinsurance, wholesale and specialty broker Ed Broking Group, and Synova Capital has backed specialty insurance broker Stackhouse Poland.

"Lloyd's of London is going through a period of change and has had a tough few months, but it will be a very interesting area as it reforms," the same private equity partner said.

25%

PE involved in nearly 25% of all announced financial services deals in 2018 by value

Total value

US$256 billion

20%

PE involved in nearly 20% of all announced financial services deals in 2018 by volume

Source: Mergermarket

6. Specialty and consumer finance

Banks are stepping back from riskier retail and SME lending, leaving a vacuum for challenger banks, crowd funders and peer-to-peer lenders to fill.

"Bank credit and risk appetite have changed. Banks are focusing on prime customers and leaving significant gaps in the market for new providers to serve customers who are self-employed or work in the gig economy," a CEO of a specialty lender said.

The IPOs of Amigo and Funding Circle demonstrated that there are real opportunities for financial sponsors in the specialty lending space, notwithstanding subsequent turbulence in the markets.

Private equity firms were among the main funders of the first wave of challenger banks and alternative credit providers like Shawbrook, Aldermore and Northview Group. Now sponsors are backing the next generation of technology-driven specialty lending providers. Recent deals include a US$15 million funding round for consumer-lending platform Divido led by Dawn Capital and DN Capital, and an Ubon Partner-led seed funding of £3.7 million in Molo Finance, which claims to be the first digital mortgage platform in the UK with a focus on providing buy-to-let mortgages.

In the credit card market, meanwhile, sponsors are either backing credit card consolidators or transferring their NPL experience and technology to credit card loan portfolios.

> **"Specialty finance for SMEs and consumers is a huge growth opportunity, especially where you can serve the market using technology to reduce costs and analyse risk. There are good credits that the incumbents just aren't serving because they don't fit a particular profile.**

M&A hotspot #1: Credit cards

> **Sponsors have developed deep expertise in servicing non-performing loan portfolios, debt collection and credit analytics. They are now applying the same playbook to credit card businesses.**
>
> —Gavin Weir, Co-Head of FIG M&A, Partner, London

Overview

Investment case

- The combination of higher costs and regulatory overhaul in certain jurisdictions has opened up opportunities for financial sponsors to acquire credit card businesses without having to go up against strategic buyers.
- Financial sponsors built up debt collection capabilities as investors in credit cards before the financial crisis. Firms then moved into the adjacent NPL market, where they applied the same playbook.
- Investing in credit cards has re-emerged as a credible alternative to an increasingly competitive NPL market, with attractive credit card investment opportunities emerging in particular jurisdictions. Firms with NPL and credit card experience can pivot between the two, leveraging the same infrastructure and technology.
- Acquisitions of card businesses also provide opportunities for the debt arms of financial sponsors to fund those businesses, making it a win-win situation for sponsors who have dual equity and debt capability.

Context

- Regulatory changes and macro-economic uncertainty in certain jurisdictions are allowing private equity firms to bid successfully for credit card assets.
- In Israel, new legislation introduced to increase competition and reduce concentration in the banking market has obliged banks to spin off their credit card divisions.
- Credit card operating costs are also on the rise. New rules introduced by the Financial Conduct Authority (FCA) in the UK, for example, force credit card providers to extend recovery processes for customers in financial difficulty and reduce, waive or cancel fees and interest in certain circumstances. Some banks may consider selling non-core credit card divisions as costs and regulation rise.

Deal activity

- The current round of private equity investment in credit cards has already begun. Warburg Pincus has acquired Leumi Card for around US$690 million as Bank Leumi responds to regulatory obligations to offload its credit card assets. Advent International and Bain Capital are amongst those interested in Isracard, the credit card division of Bank Hapoalim, another Israeli bank.
- Avantcard, the credit card consolidator backed by Apollo, meanwhile, has acquired Tesco Bank's Irish credit card portfolio as the UK institution, which holds a British banking license, pulls back to its domestic market.
- Värde Partners has taken full control of WiZink, the digital bank serving Spain and Portugal, after buying an outstanding 49 percent stake from Banco Popular. It will now manage WiZink's more than €3 billion of credit card balances.
- Financial sponsors understand the returns metrics of credit card portfolios and have proven their ability to manage regulation.
- The expertise in analytics, credit-servicing, legals, risk management and regulation that alternative asset managers have built up from investing in credit cards, and then NPLs, is now being applied to the credit card space once again.
- It is no surprise that the first movers in the current wave of credit card deals—including Apollo and Warburg Pincus—have extensive NPL and credit card track records.
- Loan portfolio deals have delivered exceptional returns for investors, who anticipate double-digit internal rates of return (IRRs) in certain regions. But as competition for NPL portfolios increases, European NPL stocks are in decline, falling from €1.2 trillion at the end of 2014 to €944 billion by the end of Q2 2017, according to the European Central Bank. Credit cards offer an alternative with similar dynamics.

M&A hotspot #2: Payments

> **Payments processing has delivered rich rewards for sponsors. As valuations and competition for assets intensifies, firms with established payments track records will be in a stronger position.**
>
> —Roger Kiem, Co-Head of FIG M&A, Partner, Frankfurt

Overview

Investment case

- Huge growth in digital payments has seen payments processing providers proliferate. Although the market is at an inflection point and valuations are full, financial sponsors with experience in payments are well-positioned to lead consolidation in what is still a fragmented sector. Firms are focused on executing buy-and-build strategies to beef up mid-tier players and make them attractive targets for global strategics, who are aggressively chasing scale and geographical reach to streamline costs and address increasing regulation. Banks are back in the market, too, buying payment processers in order to take ownership of the customer experience and relationship.

Context

- A material shift away from cash to digital payments is firmly underway. Global non-cash payments are expected to achieve CAGR of 10.9 percent from 2017 through 2020 to reach 726 billion transactions, according to the most recent World Payments Report produced by Capgemini and BNP Paribas.
- New regulations such as PSD2 have broken the bank monopoly on payments by facilitating third-party provider access to customer accounts. New entrants, most notably fintechs, have been able to accelerate the take-up of digital payments processing offerings as a result, leading to the proliferation of the number of providers and the fragmentation of payment services.
- Some large global players such as WorldPay and PayPal have emerged, but a large rump of mid-tier independents, operating across disparate geographies and all parts of the payment value chain, remains ripe for consolidation.
- Scale has become a strategic priority, with larger players in a stronger position to compete globally, enhance the user experience, cope with margin squeeze and adapt to closer regulatory scrutiny.

Deal activity

- Buyout and venture capital firms played a crucial role in the formation and evolution of payments processing giants like WorldPay. Financial sponsors are now dipping into their payments playbooks to replicate these successes.
- Financial sponsors with payments track records are leading the second wave of payments processing consolidation. Just months after leading the acquisition of Scandinavian producer Nets, Hellman & Friedman agreed to a US$6 billion merger with Germany's Concardis, backed by Advent and Bain, to create a global player with the scale to compete against WorldPay.
- Large payment players show a strong appetite for paying good multiples for targets that expand geographic and value chain reach. Sponsors who can build up mid-market providers to the necessary size are in line for material upside.
- Opportunity abounds for mega and mid-market firms to participate. Blackstone and CVC paid £3 billion for Paysafe and have subsequently backed the bolt-on of US-based iPayment. Mid-market deals have included EQT's acquisition of Saxo Payments Banking Circle, while lower mid-market sponsors FPE Capital and MMC Ventures almost tripled their money from the sale of cross-border payments provider Small World to Equistone Partners Europe.
- The consolidation drive will support continued high levels of financial sponsor activity even though the market appears frothy. The realistic potential of an exit to a global strategic player, or bank seeking to take control of the customer experience, is a major incentive for buyout firms to participate.

M&A hotspot #3: Specialty lending

"Some consumer and SME markets have been under-served by traditional banks. Sponsors see significant growth potential in challenger banks and digitally enabled specialty lenders stepping in to fill the void.

— Ashley Ballard, Partner, FIG M&A, London

Overview

Investment case

- At the same time as bank SME loan issuance has dropped, loans issued by crowdfunding and peer-to-peer (P2P) lending platforms to small businesses have increased. Banks have shown little appetite to grow their SME loan books, preferring to focus on their steadier, higher-margin corporate lending business. There has also been little appetite among banks to provide retail mortgages and loans to customers who are self-employed or gig economy workers.
- The space vacated by the banks has been filled by challenger banks, crowdfunders and P2P lending platforms that are hungry for capital. Financial sponsors have the opportunity to invest in new entrants that are rapidly growing market share. As the market matures, financial sponsors backing the right players will benefit as leaders expand rapidly through acquisition.

Context

- Various data points indicate that traditional banks have little appetite for expanding their retail and SME lending businesses. Trade body UK Finance data shows that in Q4 2017 SME loan volume was down 11 percent on the previous year, while the British Business Bank found that only 1.7 percent of SMEs had made loan applications over the last year, the lowest level since they began tracking SME loan issuance in 2011. Bank of England figures, meanwhile, show that from 2011 to 2017 the amount of capital lent to small companies by the UK's 30 largest banks had fallen 14 percent.
- Specialty crowdfunding and P2P lenders have stepped in to fill that void. The UK Peer-to-Peer Finance Association said lending to businesses by its members had grown by close to £100 million quarter-on-quarter over the last 12 months, reaching nearly £750 million in the second quarter of 2018. One of the largest global SME direct lending funding platforms Funding Circle, which operates in the UK, US, Germany and the Netherlands, was only founded in 2010 but has already provided £4 billion of lending to 40,000 small businesses.
- In the UK demand for alternative finance is expected to increase now that the Bank of England's Term Funding Scheme has been withdrawn.
- Funding Circle has recently listed (although its IPO came in below expectations), following the float of Amigo Loans. Rival platforms LendInvest and Zopa are also believed to have considered listings. Should these IPOs proceed, the formation of a market for trading in SME loans, similar to that in the United States, is a real possibility.

Deal activity

- As the first group of specialty finance companies mature and list on the public markets, the next wave of well-funded specialty lenders is ready to grow through acquisition in what is still a fragmented market. Challenger banks, P2P lenders, niche alternative credit providers and payday lenders all offer attractive targets.
- US-based White Oak, for example, expanded its asset-based lending (ABL) offering in the UK and Europe with the acquisition of ABL lender LDF, while Finstar increased its equity investment in alternative finance lender Spot. Quilam put its support behind specialist SME lenders 1plus1 Loans and Catfoss Finance.
- Financial sponsors will continue to seek out fast-growing alternative lenders that are hoovering up market share vacated by the banks, and gaining increasing traction among SME borrowers who are eager to find alternatives to traditional sources of funding.

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