KPMG

Hungry for more?

Acquisition appetite and strategy in the private banking and wealth management industry

Global update 2009

ADVISORY

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Growth is high on the agenda. Despite a general lack of available targets and many players adopting a 'wait and see' approach, has a wave of consolidation finally arrived in the private banking sector?

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Foreword

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The turbulence in global financial services over the past year or so has been widely reported in the international media and needs no repetition here. What is interesting is the extent to which the private banking and wealth management sector has been relatively sheltered from the travails of the broader banking industry.

Certainly the macro-economic environment and the crisis in confidence in the banking sector have left their mark – many private bankers are struggling in the face of lower asset values and commissions, generally lower yields, and their clients' growing preference for "safer" holdings such as cash, bonds and real estate. Although some of these trends pre-dated the credit crisis and have only been exacerbated by it, the current economic climate has helped to make matters even more challenging.

An inescapable fact is that many private banks face genuine profitability concerns and should take a long hard look at their operational structures and costs in this new period of austerity. In addition, public confidence in banks is relatively low and even private banks need to regain trust.

Despite the gloom, however, the mood among private bankers remains greatly optimistic. Their view of growth prospects in the sector, while lower than in the comparative "Hungry for more?" studies of 2006 and 2007, is extremely positive and there is an expectation that consolidation will accelerate over the next two years. Almost three quarters of our survey respondents felt that acquisitions are still worthwhile (in terms of return on investment) in the current climate.

Many private banks, though, appear to be adopting a wait-and-see approach until some normality returns to the global economy and/or they have got their own houses in order. In addition, there seems to be a general lack of attractive acquisition targets available, especially in Asia-Pacific – a seemingly perennial challenge in this sector but made worse by the fact that many would-be sellers are not prepared to accept current (relatively low) valuations.

A catalyst for change may be the countries that have recently agreed to adopt OECD taxation reporting standards. This move may encourage many banks to reconsider their onshore /offshore business models, especially for the newly government-owned banks in Europe where offshoring may be contrary to their owners' political agendas. Combined with generally rising pressure on beleaguered banks to raise funds by shedding non-core activities, there is a distinct impression that significant consolidation may finally arrive in the private banking world.

Highlights

- Majority confident about growth prospects (though less so than in previous years)
- Expectation of international consolidation
- Small banks more focused on organic growth; seem unconcerned about consolidation
- Lack of available acquisition targets, especially in Asia-Pacific
- Domestic deals prevail at 54 percent of deals undertaken by survey respondents in the past two years
- China and India overwhelmingly cited the countries with greatest growth potential
- Onshore/offshore banking mix may provide a catalyst for M&A

1 About the research

The survey results mentioned in this publication refer to interviews with 100 senior executives in the private banking and wealth management industry, from 17 countries around the world.

The interviews were conducted by GfK NOP in the period February to April 2009. The confidentiality of individual responses to the survey was guaranteed as a condition of participation.

Where reference is made to the size of the respondents' private banking operations, the classification is based on the number of full-time employees as follows:

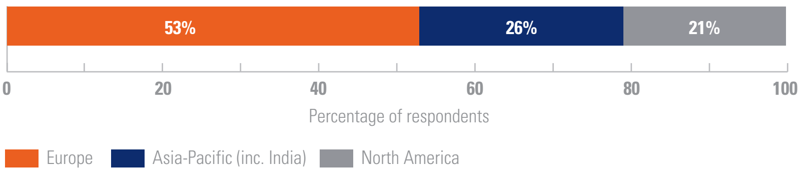
- Small: fewer than 200
- Medium: 200 – 499
- Large: 500 or more

Comparisons are made throughout this publication to the previous KPMG Hungry for more? publications of 2004, 2005, 2006 and 2007.

KPMG International would like to thank all respondents for their participation.

The terms "private banking" and "wealth management" are used interchangeably for the purposes of this publication.

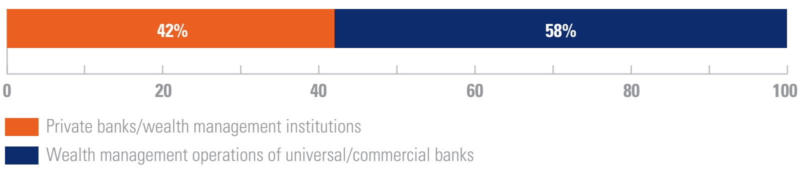
Location of respondents



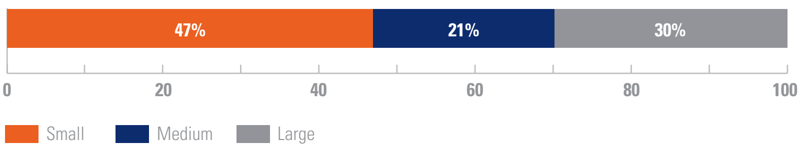
Source: GfK NOP

Businesses represented by respondents

Type of institution



Size of private banking operations*



* Of those that responded. Nine percent refrained to respond.

Source: GfK NOP

2 Observations

Private banks have to a great extent been shielded from the crisis afflicting the wider banking industry, although some effects have overflowed and are rippling through the sector, resulting in great concern and very real challenges.

The "Madoff scandal" has tainted an industry that must already have felt it was under siege from the OECD and other external pressures and has almost certainly led to an erosion of trust in the wealth management business. Private banks, however, do not generally face the same need as their universal banking cousins to restructure and overhaul themselves.

No quick fix to profitability crisis

One of the biggest challenges facing private banks is to repair their damaged profitability. This will be no easy task. Falling Assets under Management (AuM), driven by declining asset values, fewer structured products, lower yields and a growing preference among their clients for more predictable cash and fixed income portfolios are placing huge pressure on profit margins. There may also be a trend towards less profitable onshore banking in light of OECD efforts discussed later in this publication, and resulting changes in tax planning approaches for some wealthy individuals.

Some of these trends may prove irreversible even when the global economy begins once more to grow, meaning that margin improvement may need to focus on the cost rather than the revenue side.

The subject of cost control and operational structures is likely to be heading up the boardroom agenda with great speed. The largest cost item for a private bank is its staff, with highly valued client relationship managers at the forefront of the business. Redundancies, particularly among lower-performing managers, may be unavoidable.

Many banks may find it very difficult to significantly improve their margins in the short-term, and many smaller and mid-sized private banks hardest hit by the profit squeeze may well fall prey to better funded acquirers in the meantime.

Challenges may help create an M&A boom

Despite the many challenges, there remains plenty of pent-up energy in the sector. Many private banks retain considerable financial clout but are adopting a wait-and-see policy until the economic situation stabilises and they have addressed some of their own issues. There are also a number of players in geographies such as China and India who have strong capital positions and ready access to credit. In addition, some private equity houses are sitting on substantial sums of money waiting to be invested. To date private equity seems to have overlooked the private banking sector, perhaps due to traditionally high valuations, though this may change as the struggling sector throws up some attractive acquisition opportunities.

Much M&A activity may be driven by a need to divest. Universal banks may begin shedding their wealth management operations in order to raise funds and/or to focus on their core activities. This might especially be the case for those European banks that are now (partly or wholly) government-owned and subject to further pressures.

It should be noted that respondents to our survey felt that acquisitions remain worthwhile even in the current economic climate. This supports our conclusion that many are simply waiting for the right time to move.

What's putting off buyers?

Acquisition appetite does not always translate directly into acquisition activity. For every buyer there must be a seller, and it is far from clear that shareholders in listed banks, for instance, will be prepared to sell while equity prices are so relatively low. Over a period of some years there also appears to be a consistent lack of available acquisition targets – particularly in Asia-Pacific where the classic private banking concept is relatively new – which has helped maintain higher valuations but means that many would-be acquirers leave the stage empty-handed.

From a potential buyer's perspective there are a number of factors that may

Small banks appear unconcerned about consolidation; they are happy to focus on organic growth without the need for an acquisitive strategy.

hold them back, at least in the short-term. Aside from the direct impacts of the economic climate, there may be demand elsewhere in the business for any available funds and resources. There is also the question of the seller's price expectation, which according to our survey respondents remains generally too high.

Past acquisition experience may have also made some buyers more cautious. Widely reported problems include the post-deal alignment of business models and harmonisation of business processes, both of which can cause considerable headaches and can actually destroy value if not treated appropriately.

Interestingly, given that the retention of key staff seems to have much lower priority on the list of concerns this year, a more immediate threat to the success of a deal can still be the clients of an acquired bank jumping ship in the aftermath of a deal, for a variety of reasons. "Hungry for more?" has consistently shown that the percentage of an acquired business's client base that is lost within 12 months of the transaction date can be significant. In 2009 the estimate is six percent (higher in Asia-Pacific at nine percent).

To a lesser degree, many buyers may be tempted to wait a while rather than risk buying a business with possible exposure to Madoff-related losses.

Government stakes may trigger divestment of offshore operations

Pressure is growing on certain countries from the OECD and other parties. Many countries including Switzerland, Liechtenstein, Austria, Luxembourg, the Channel Islands, Singapore and Hong Kong, have signed up to adopt the OECD tax reporting standards.[1]

Government-owned banks in many countries may find it extremely difficult to resist pressures from their largest shareholder to curb or even put a complete end to their offshore banking activities, which are generally at odds with government policy. This new ownership may therefore trigger divestments in offshore activities.

As the world's primary offshore banking centre, estimated to account for around one third of the world's US$11,000 billion offshore funds[2], the impact on private banking in Switzerland may be transformational.

In parallel to this, however, is a growing trend for Chinese banks to acquire or establish subsidiaries in Asian centres such as Singapore to serve the expanding market of wealthy Chinese individuals with holdings outside China. Indeed, Singapore has actively courted funds and dozens of international private banks have set up shop there since 2004.[3]

These competing trends suggest the jury is still out on the future of offshore banking, as we currently define it.

[1] "Swiss give ground on banking secrecy laws", Financial Times, 14 March 2009
[2] "A vault prised open", Financial Times, 24 March 2009
[3] "Secrets of success", Financial Times, 26 March 2009

3

Intentions

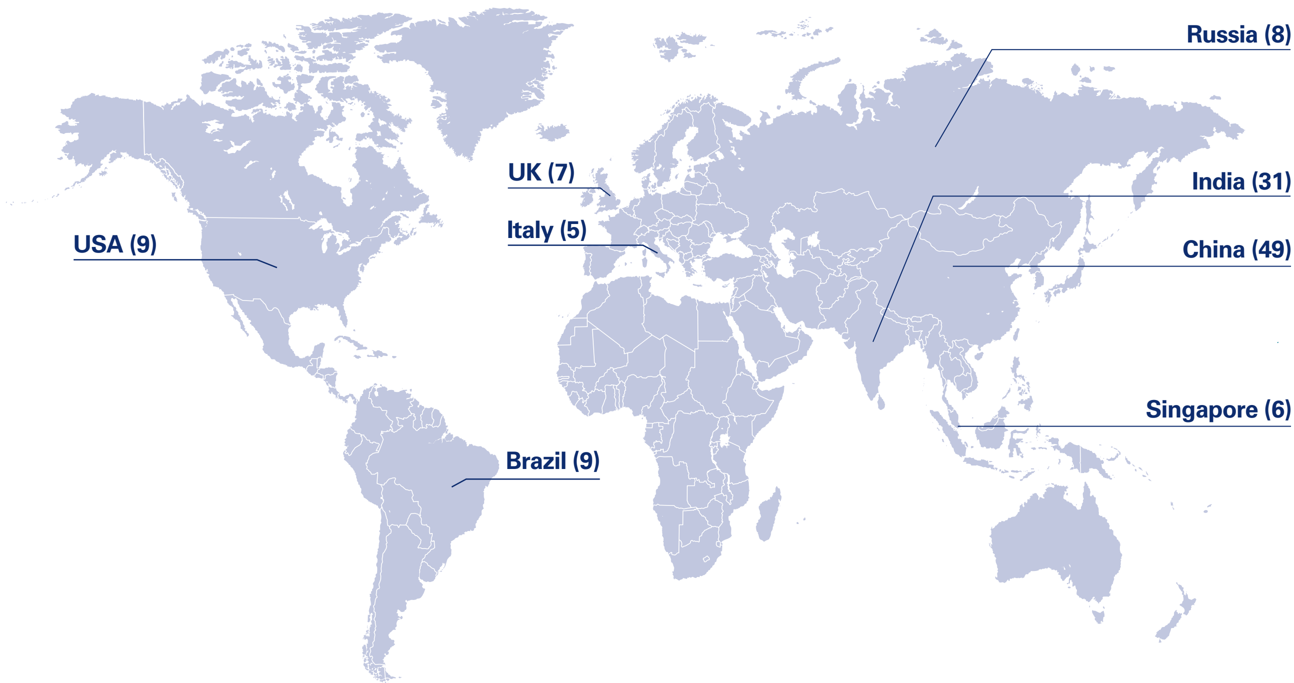
Growth and consolidation are still on the agenda.

Private banking remains a highly fragmented global sector with a large number of small players yet dominated by a handful of large powerhouses. Consolidation potential therefore remains high, particularly in a climate of falling yields where many organisations may struggle to reduce costs and remain profitable.

One might reasonably expect the prevailing mood across the financial services industry to be one of pessimism. Whilst confidence in the growth prospects of the private banking sector is down from the 92 percent and 93 percent of survey respondents in 2007 and 2006 respectively who believed prospects to be "good" or "very good", it nevertheless remains healthy at more than half of respondents. Rather than a bleak outlook, the majority of the remaining respondents described the next two years as "indifferent" – not bad given the economic and political challenges facing the industry.

As economic conditions stabilise, it may be expected that a number of strategic or opportunistic acquisitions will be undertaken by larger or well-funded firms keen to take advantage of lower prices and enter new markets or expand their presence in existing ones. Conversely, some M&A activity will be driven by a need to divest – whether to raise funds

Countries with the greatest growth potential for private banking*



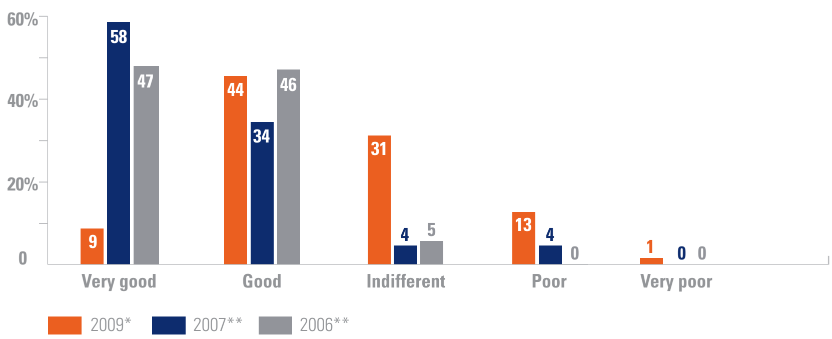
* Number of mentions by survey respondents

Source: GfK NOP

or, particularly in the case of some European government-owned banks, to shed their wealth management arms in order to focus on core domestic activities and to withdraw from offshore banking operations.

Either way, it is likely that consolidation will indeed gather pace following the current period of retrenching. This is a view supported by the survey respondents, who remain overwhelmingly and (almost) as confident as in recent years that consolidation will increase. Small banks, however, seem more focused on organic growth.

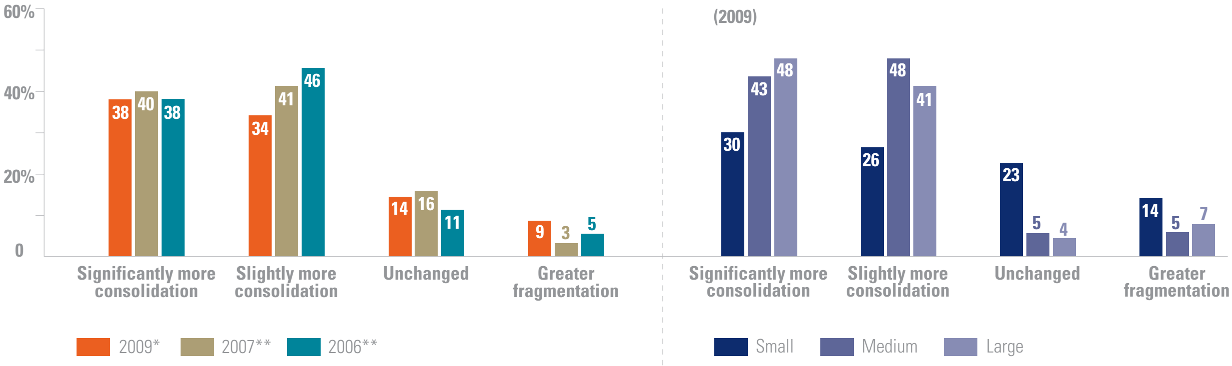
Growth prospects for the sector



*Over next two years **Over next three years

Source: GfK NOP (2009), EIU (2006, 2007)

Expectations for international consolidation



*Over next two years **Over next three years

Source: GfK NOP (2009), EIU (2006, 2007)

It is telling that almost three quarters of the senior executives interviewed feel that acquisitions remain worthwhile in the current environment

Why wait?

The level of M&A activity seems to be limited by four primary factors from a potential purchaser's perspective:

- Economic uncertainty driving a wait-and-see policy
- Pressure on margins and resources diverting attention away from expansion plans
- A lack of available acquisition targets
- A long-standing feeling that organic growth is more important

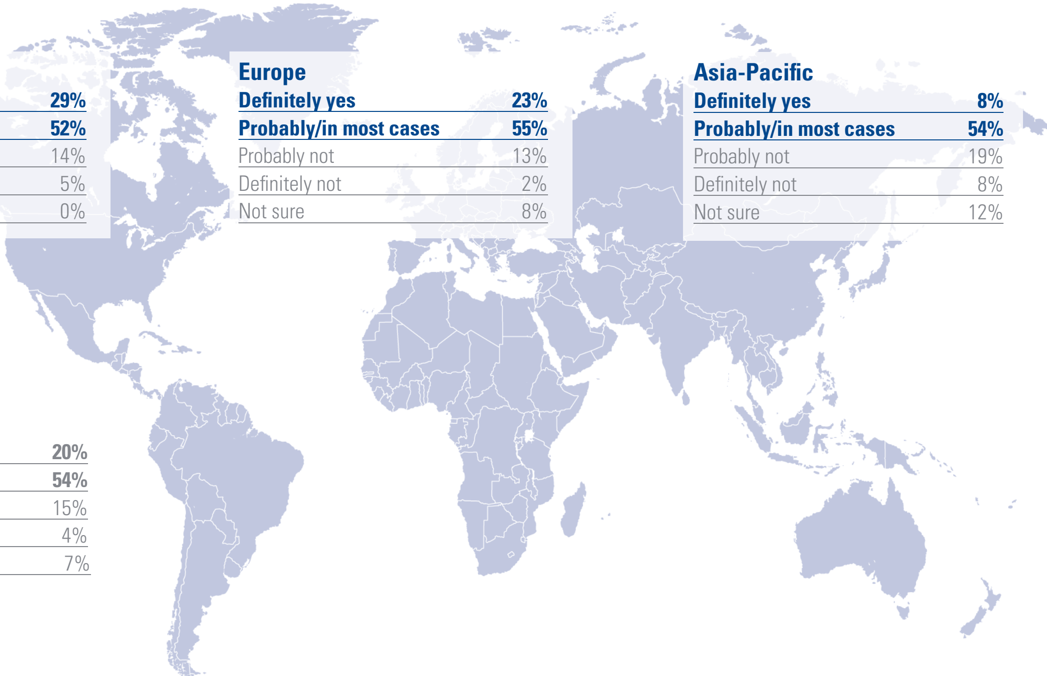
Sixty one percent of survey respondents said the economic crisis has either "slightly" or "significantly" affected their acquisition plans. Perhaps surprising, however, is the one quarter who said their acquisition plans have not at all been impacted. Of these, there was little difference between small and large banks.

It is telling that almost three quarters of the senior executives interviewed feel that acquisitions remain worthwhile in the current environment. Of these, European and North American respondents were much more positive than their counterparts in Asia-Pacific.

While the current economic crisis is clearly limiting the level of M&A activity, pressure on resources or a lack of available targets at acceptable prices, rather than a lack of willingness, appears to be holding back the number of deals in all three regions. These shine through as the primary barriers to M&A according to the survey respondents, with more than one-third citing both a lack of financial resources and excessive price expectations on the part of the seller as restricting further M&A.

When comparing responses by size of private banking operations, there is a clear distinction: smaller private banks are more restricted by internal issues such as a lack of financial resources whilst the limitations on large private banks derive primarily from external factors such as a lack of attractive acquisition targets and sellers price expectations.

Are acquisitions worthwhile in the current environment?



North America

Definitely yes	**29%**
Probably/in most cases	**52%**
Probably not	14%
Definitely not	5%
Not sure	0%

Europe

Definitely yes	**23%**
Probably/in most cases	**55%**
Probably not	13%
Definitely not	2%
Not sure	8%

Asia-Pacific

Definitely yes	**8%**
Probably/in most cases	**54%**
Probably not	19%
Definitely not	8%
Not sure	12%

Total

Definitely yes	**20%**
Probably/in most cases	**54%**
Probably not	15%
Definitely not	4%
Not sure	7%

Small

Definitely yes	**19%**
Probably/in most cases	**51%**
Probably not	14%
Definitely not	7%
Not sure	9%

Medium

Definitely yes	**20%**
Probably/in most cases	**62%**
Probably not	14%
Definitely not	0%
Not sure	5%

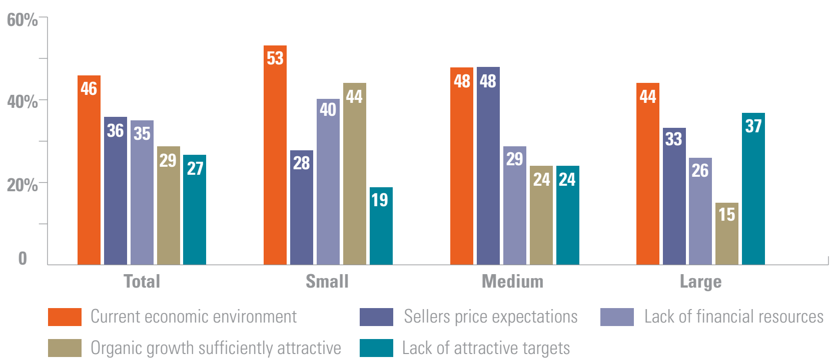
Large

Definitely yes	**15%**
Probably/in most cases	**59%**
Probably not	19%
Definitely not	4%
Not sure	4%

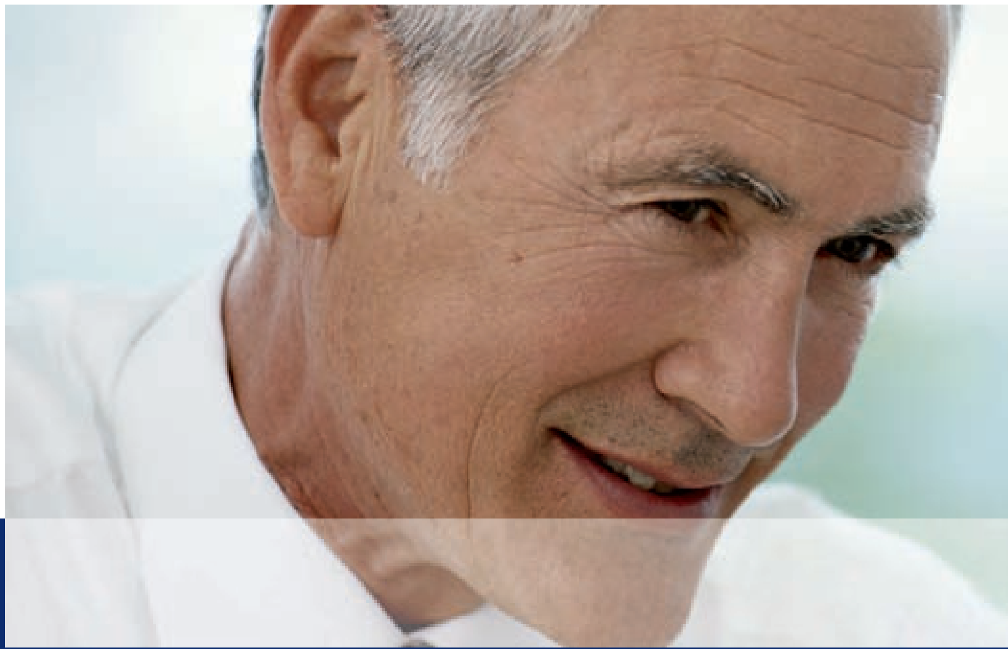
Source: GfK NOP

The change over the 2006 and 2007 editions of "Hungry for more?" is striking. In both those years, regulatory barriers and government intervention featured far more prominently as hurdles to M&A activity. They barely appeared in the 2009 results, showing quite how the landscape has altered since the onset of the credit crisis.

Biggest barriers to investment in M&A



Source: GfK NOP

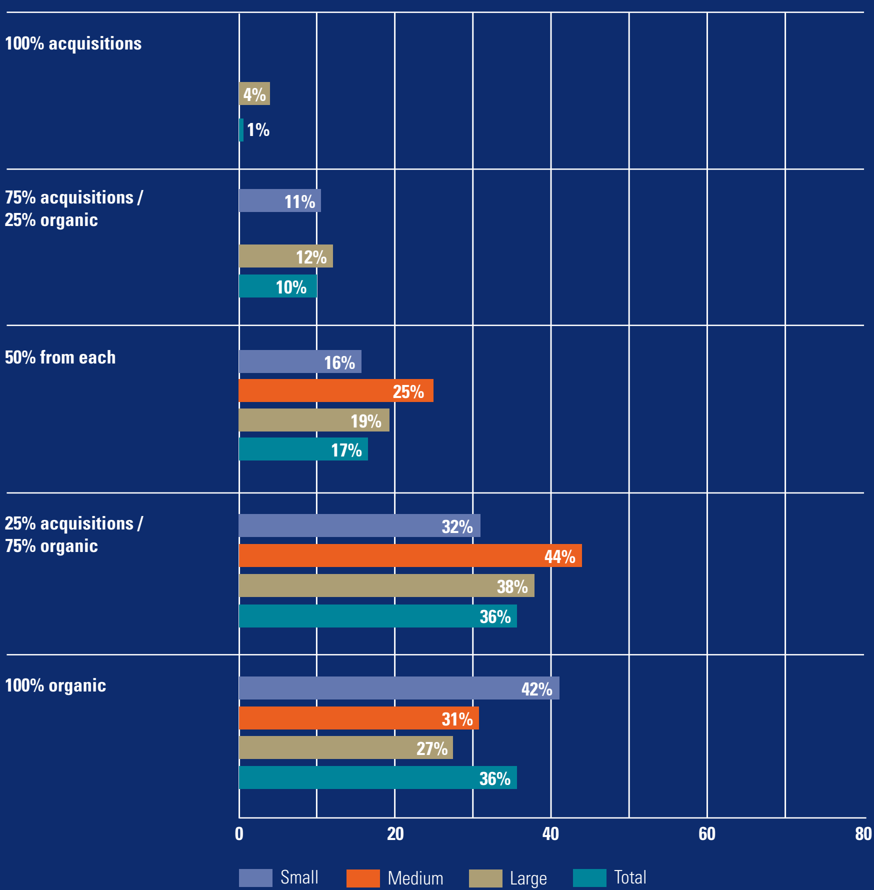


In many private banks and the wealth management arms of universal banks, resources are scarce

Organic growth is king

Irrespective of the size of the bank, the focus is firmly on organic growth over growth through acquisitions.

Proportion of growth over next two years expected organically or from acquisitions

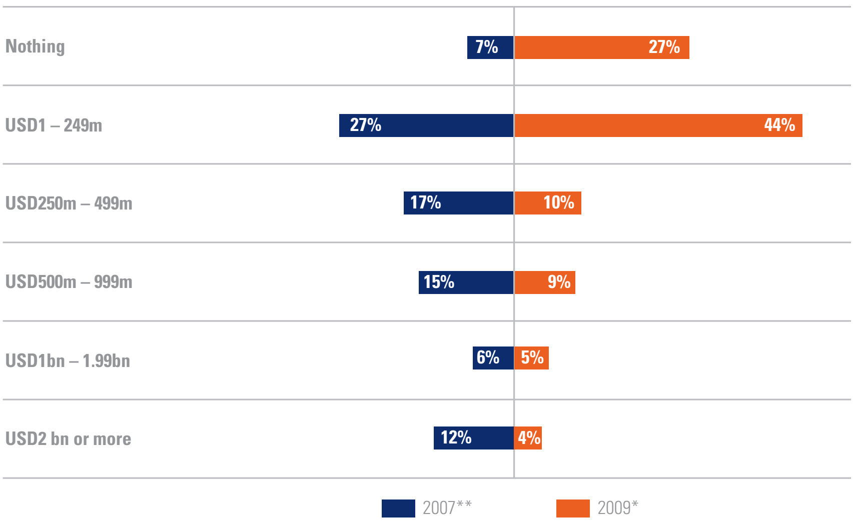


Source: GfK NOP (2009), EIU (2007)

Apart from the issue of few available targets, funds are either not available or are being closely guarded while economic uncertainty prevails, with relatively few organisations seemingly willing to take the plunge with a major acquisition. Certainly in many private banks, and in the case of those arms of universal banks, resources are scarce and margins are coming under intense pressure as discussed earlier in this publication. Cost control is therefore high on the agenda of many boards of directors and it will be some time before adequate steps can be taken to get profits back on track.

Survey respondents confirmed this lack of willingness or ability to spend, though almost one in ten respondents remain sufficiently bullish to expect to spend upwards of USD 1 billion on acquisitions over the next two years.

Respondents' expected investment in acquisitions



*Over next two years **Over next three years

Source: GfK NOP (2009), EIU (2007)

Pockets don't seem as deep as in previous years

4

Experiences

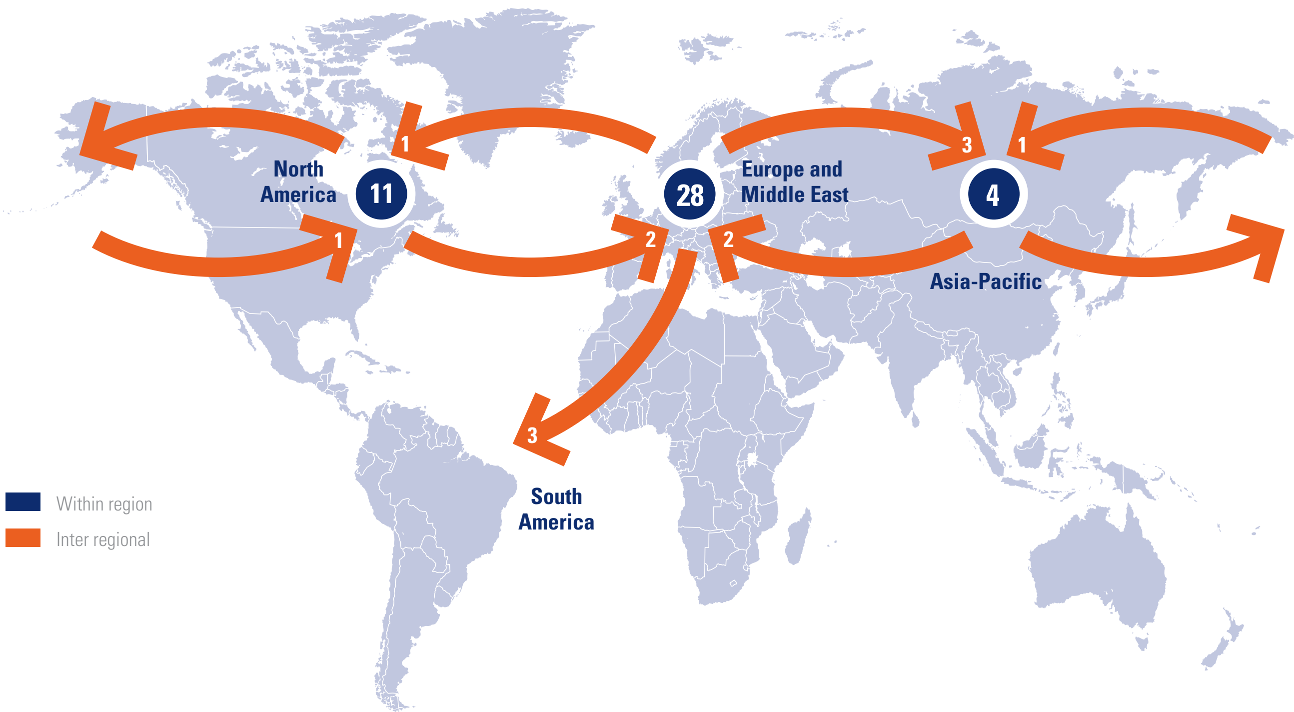
A typical deal is within the acquirer's own region, representing up to 10 percent of the acquirer's existing Assets under Management.

Where in the world?

A marked feature of previous editions of this publication has been the extent to which respondents have considered Asia-Pacific to be the region with the greatest growth potential. There has, however, always been a significant discrepancy between those who recognise its potential and those who have been able to actually undertake acquisitions there from another region. This comes back in part to a general lack of appropriate acquisition targets.

Of the 56 deals undertaken by survey respondents over the last two years, 77 percent were within the same region, of which 70 percent were domestic deals.

Regions where respondents made acquisitions in the past two years (number of acquisitions)*



* of these who specified a location
Source: GfK NOP

Realised ambitions?

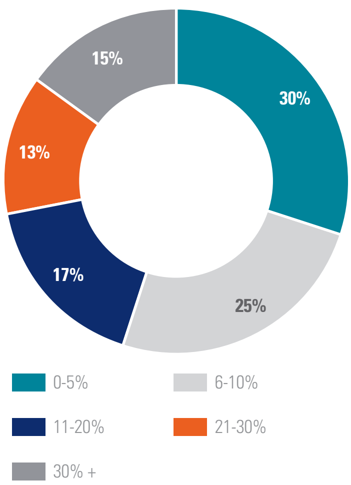
Comparing the number of respondents in 2007 who said they planned to invest in M&A over the next three years and the number of 2009 respondents who had actually acquired in the past two years shows a high degree of consistency.

Forty eight percent of respondents in 2007 said they were actively seeking acquisition targets over the next three years. This intention appears to be borne out by the fact that 42 percent of respondents in 2009 had undertaken acquisitions in the past two years (62 percent of which had acquired more than one business in this period).

Interestingly, 65 percent of respondents in Asia-Pacific did not acquire a business in the last two years despite exactly the same proportion in 2007 stating that they were actively seeking acquisition targets. This reinforces the message that there appears to be insufficient attractive acquisition targets in that region.

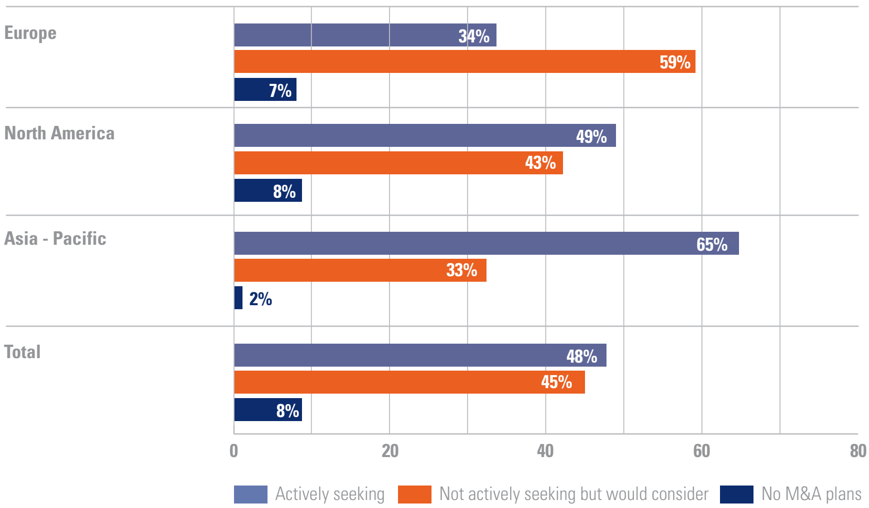
For more than half of those respondents who had undertaken acquisitions in the past two years, the acquired entities represented up to 10 percent or less of their existing AuM.

Percentage of existing AuM represented by acquisitions over the past two years*



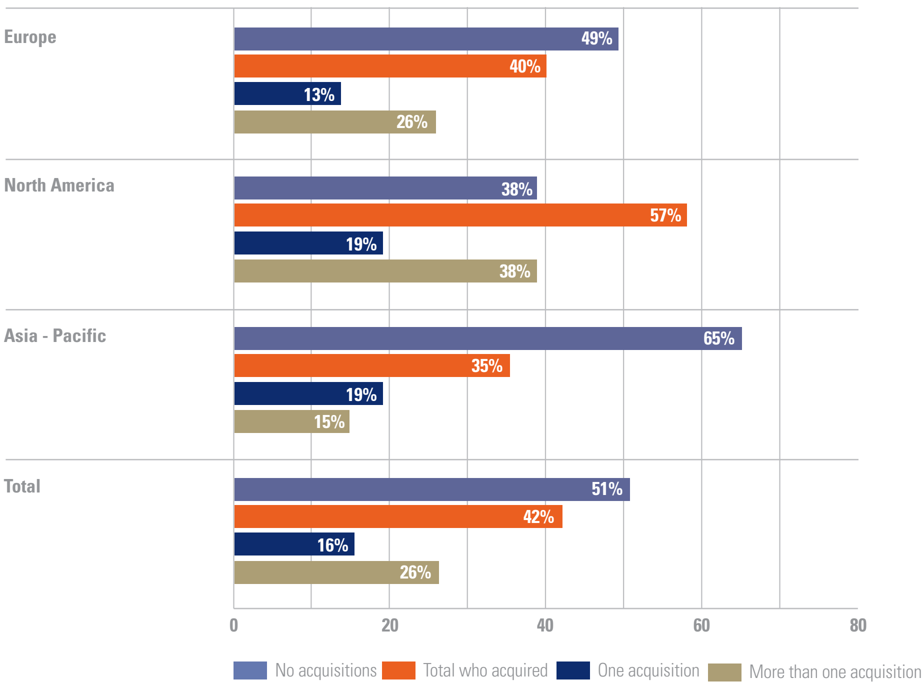
* Of those that disclosed a value or range
Source: GfK NOP

2007 – respondents M&A strategies over next three years



Source: GfK NOP (2009), EIU (2007)

2009 – respondents M&A activities over past two years



Source: GfK NOP (2009), EIU (2007)

Clients come first (and they can leave first too)

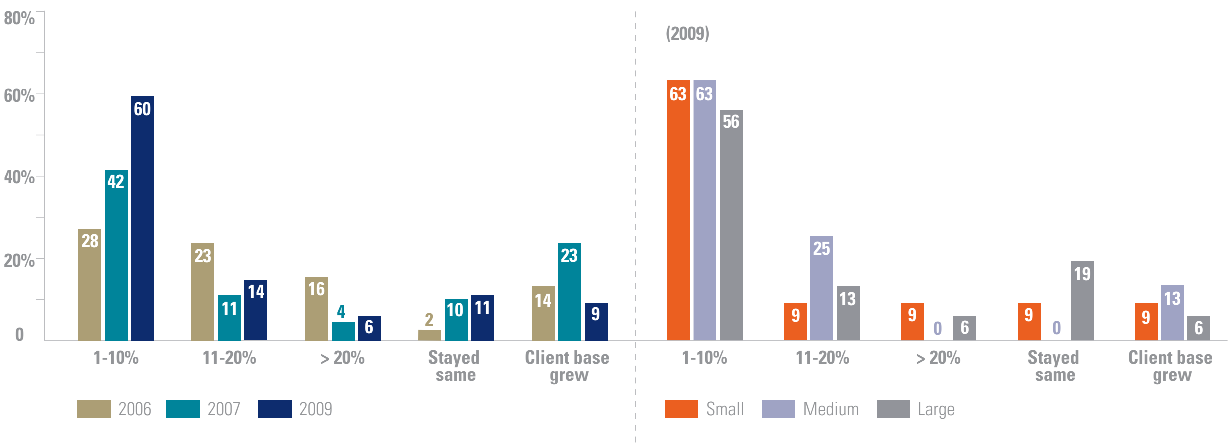
Some of the greatest post-acquisition problems faced by respondents over the past two years were aligning business models (49 percent) and harmonising internal processes (41 percent). These are issues that can severely test even the most serial dealmakers and can spell the difference between a successful and an unsuccessful acquisition.

A measure of success can be the proportion of the acquired entity's client base that has been retained 12 months after the transaction date.

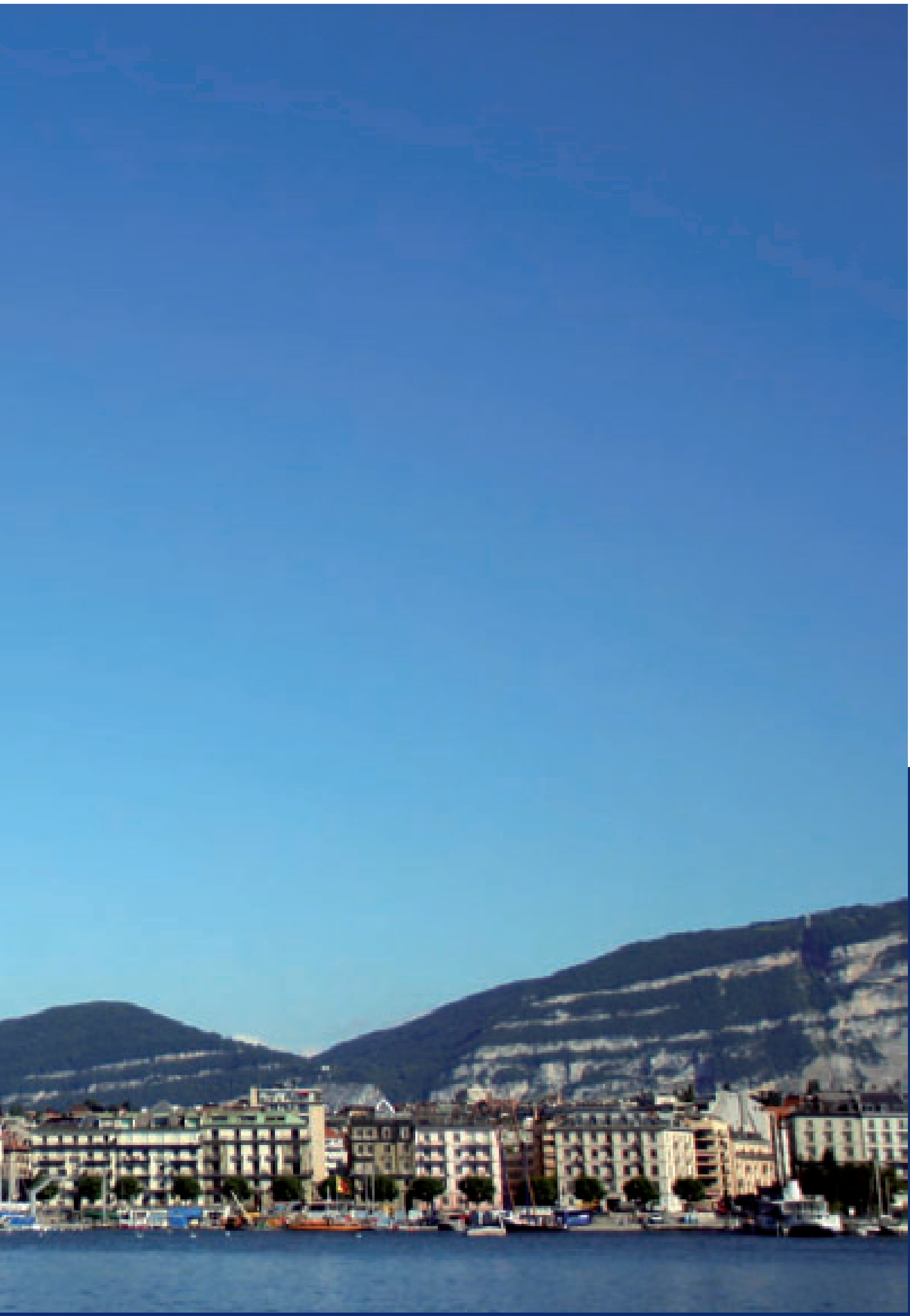
Survey results show an average of 6 percent of AuM had been lost within one year, with Asian acquirers performing worst (9 percent).

There is no significant difference between size of bank when considering effectiveness in retaining clients, as per the chart below.

Proportion of client base of acquired entity lost within 12 months



Source: GfK NOP



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