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Mixed outlook for European bank M&A

by **Sid Verma**

Cheap debt, decent valuations and lack of competition relative to the US mean there are plenty of opportunities for private equity executives to snatch up European financials on the cheap. However, tighter regulations, combined with a lack of political will to restructure peripheral banks through a market-driven process, have dampened appetite.

Sharp divisions over the EU banking union plan threaten a 'Lehman-type' crisis that will force the ECB to backstop zombie banks in the periphery, paving the way for a US-style restructuring, J Christopher Flowers, the godfather of bank M&A, said last month.

J Christopher Flowers, chairman of JC Flowers & Co

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Bank-focused PE executives are exasperated with EU policymakers' foot-dragging over a joint liability plan that would eventually reduce bank liabilities in peripheral Europe.

Germany's bid to engineer a contraction of asset-poor banking systems in southern Europe, which are outsized relative to national GDP, has not been met by decisive action to resolve banks at risk of insolvency, market players charge.

These financial institutions need to be restructured through a FDIC-like market-driven process, in contrast to the Japan-style reluctance of policymakers to impose mark-to-market losses on assets held on besieged banks' balance sheets, PE players said at an AFME conference last month.

The negative sentiment towards bank-investing and regulatory inertia means FIG M&A deal volumes have in recent years not met expectations.

This year, European financial institution-targeted mergers and acquisitions volume (pending or completed) totalled $46.5 billion year-to-date, versus $20.7 billion during the corresponding period last year, amid growing supply and fading eurozone break-up fears – though the supply is not as large as IMF headline predictions imply.

In an October 2012 report, the IMF estimated that European banks are likely to try to offload some $2.8 trillion of assets, or 7% of total assets, in the next two years.

At the AFME conference, PE executives painted a mixed picture of the FIG M&A climate in Europe. Cheap valuations, lack of competition relative to the US, and the growing supply meant US PE groups are targeting Europe.

Joanna Nader, chief investment officer of JRJ Group

The PE executives noted that regulators are now more hospitable to private equity capital in banks, given a lack of alternative investors.

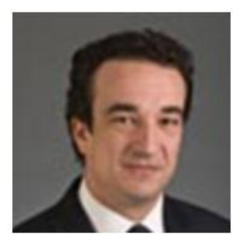
Flowers, who moved to London last year to run the eponymous $3.5 billion fund, said "distressed asset financing" for PE firms had improved "dramatically" during the past three years but banks, and PE investors, now face a prolonged period of lower returns with G7 policy rates at historic lows.

Joanna Nader, chief investment officer of JRJ Group, a European financial services-focused PE firm, warned: "Bank resolution is being impaired by excess liquidity provided by national governments and the European Central Bank," citing the oft-touted charge that zombie banks will remain until monetary policy normalizes.

Thanks to new regulation – seeking to sharply restrict wholesale banking activities, protect clients' money and reduce counterparty risks held in banks' trading books – Nader said there were many new M&A opportunities in the "mid-market" sector, including investment in consumer-lending vehicles.

Lance West, CEO of Centerbridge Partners Europe, added that the availability of cheap debt finance was offset by "global uncertainty". This means "it will take longer to resolve credit and asset issues while laws are changing, the politics of default goes on, all of which increase the cost of managing asset pools in a new regulatory environment," he said at the conference.

Olivier Sarkozy, head of global financial services group at Carlyle, added at the conference: "Investment horizons are now longer," high returns from conventional PE transactions in the bull-run are over, thanks to lower discount rates, but he added "those high returns are available elsewhere in the niche mid-market sector".



Olivier Sarkozy, of Carlyle Group

Thanks to short political cycles and the challenges of engineering a consensus in the 17-member eurozone, EU policymakers will fail to implement a mutualization plan that would act as a crisis circuit-breaker, the investors said.

Sarkozy, the half-brother of the former French president, concluded: "The reality of the European Union is that it is going to take longer that you need to achieve consensus, given the broad range of customs, systems, regulations and the like.

"It is not easy to homogenize them. As investors, we have to presume that is not going to get fixed."

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