2014 Financial Services M&A Predictions

Riding the current wave of activity

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Foreword

Welcome to the second edition of Deloitte UK's Financial Services M&A Predictions.

Looking back, 2013 has been a busy year for M&A in the sector. Activity increased, especially in the second half of the year, and a number of significant transactions completed or are awaiting regulatory approval. However, teasing apart the details, while the insurance sector enjoyed a strong year (with a good deal of corporate and private equity interest) banking was much quieter, aside from headline-grabbing deals such as the LBG and RBS branch divestments. We consider the reasons for this and the knock-on impact on 2014 M&A activity in more detail in this document.

So how did we do with our 2013 predictions – did our crystal ball work properly? On the plus side, our insurance predictions were largely borne out, especially the forecast of continuing activity in the Lloyd's market. Less accurate were our views on the future of the banking market where shadow banking did not drive the activity levels that we predicted and uncertainty over capital and other regulatory requirements appeared to dampen enthusiasm for transactions.

We think that 2014 will sustain the increased activity experienced at the end of 2013, with the interesting added dimension of an IPO market that seems to be warming up. We believe that there will be specific hot areas but the industry as a whole is likely to see a greater number of successful transactions – something which will benefit both buyers and sellers.

I hope that the document is of interest to you.

Ian Smith
Lead Partner
Financial Services M&A, Deloitte LLP

The Payments sector has experienced both regulatory and technological change over the last year. Colin Farquhar considers the impact of the Payment Services Directive and innovation on future M&A activity.

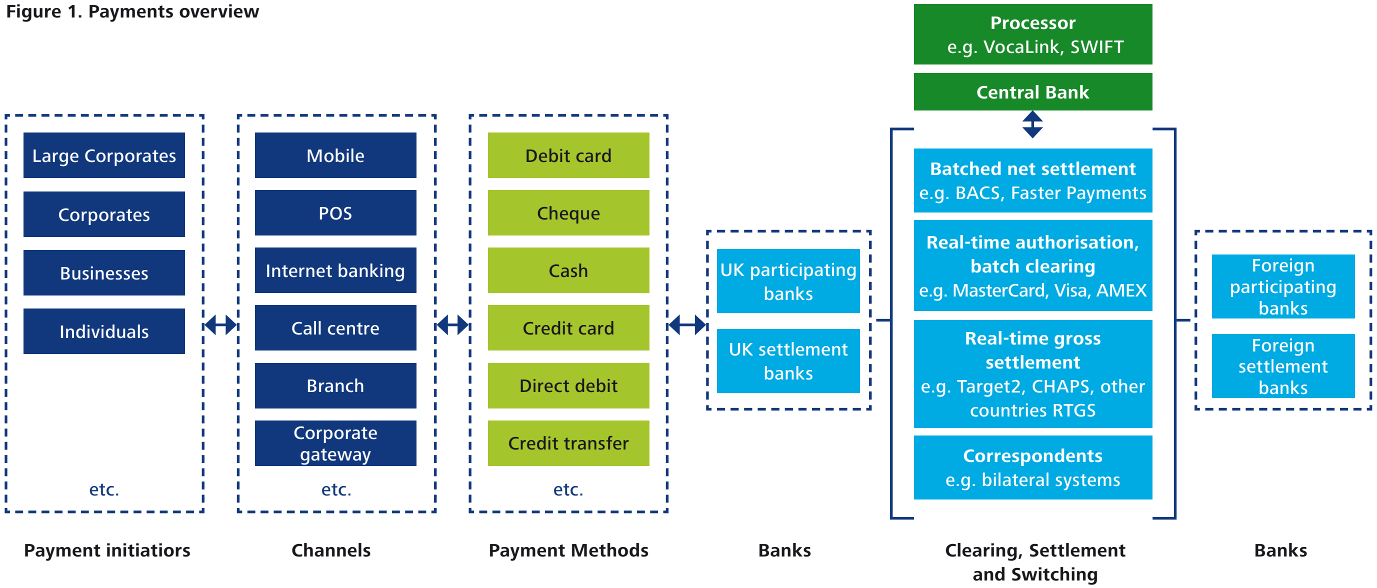
Payments

We think that there will be M&A activity in the Payments sector during 2014, driven by increased competition, technological innovation and legislative transformation in the UK and EU.

Overview

The payments sector involves, at its simplest level, the process of transferring funds through a payment method from the designated account of an initiator through a payment channel to the bank account of the receiver, be they an individual, a corporation, or another bank. This can touch almost all areas of banking and involve a wide range of stakeholders.

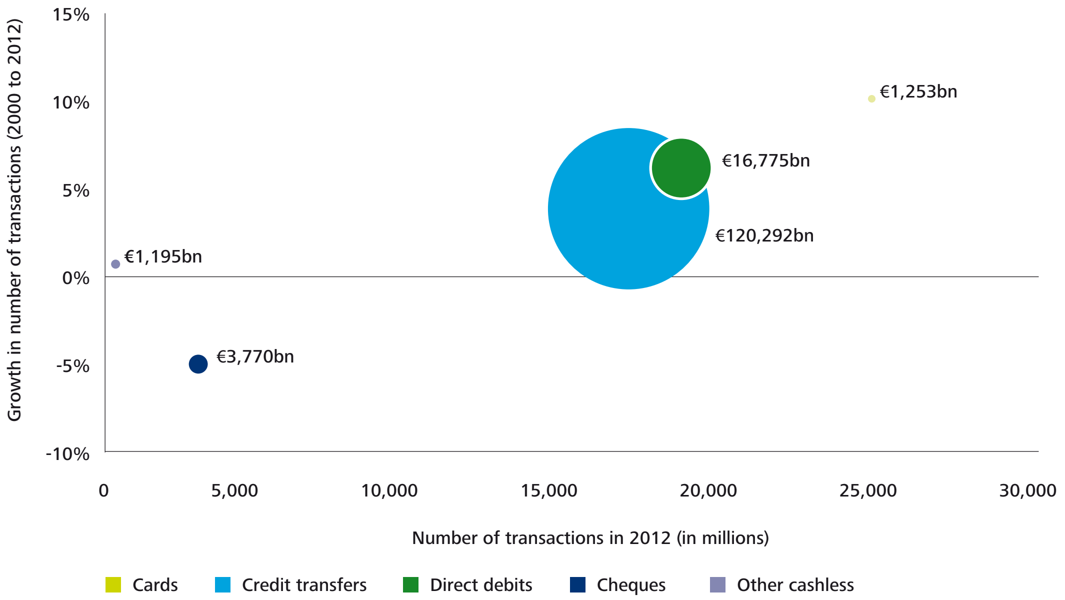
Figure 1. Payments overview



Note: Payments can be classified as either Domestic Payments (i.e. in-country), Cross-border Payments, Retail Payments (consumer-originated), or Wholesale Payments (business or government-originated)

Source: Deloitte analysis

Figure 2. European transactions and value per payment instrument



Note 1: Cards data includes e-money
Note 2: The size of the bubble represents 2012 value of transaction
Source: European Central Bank Statistical Data Warehouse

The present infrastructure for payments processing is dominated by banks, although third-party service providers such as Automated Clearing Houses and payment schemes provide infrastructure to facilitate the movement of payments between parties. As a result, the payments structure is complex and fragmented, with different participants occupying different roles in terms of placement in the value chain and country-specific arrangements.

It is further complicated by the number of specialists providing specific services, and by the recent trend for non-bank organisations to offer acquiring, merchant servicing, remittances, international payments, processing and e-wallets.

Why invest?

Most acquiring, merchant servicing and processing-related businesses share characteristics that make them appealing to investors, and there has been increased private equity interest in recent years:

- **Cash generative** – payments businesses provide robust cash flows if operated under a well thought out and executed strategy. However, the need for regular and, at times, considerable capital investment offsets this benefit. Investment is required to make the infrastructure future-proof and is also necessary to ensure compliance with the various regulatory standards notably PCI Data Security Standards (PCI DSS), Know Your Client and anti-money laundering procedures.

- **Forward visibility of earnings** – payments businesses provide consistent recurring revenues and customers with long-term contracts. Electronic payments continue to grow at a steady pace but there is increasing pressure on margins. Average Merchant Service Charges (MSCs) continue to decline in Europe, reducing the growth in the value of the market to be shared by players in the value chain. Without innovation, mature markets may have a limited ability to grow faster than GDP.

- **Low capital intensity** – the current regulatory environment for payments businesses is light touch and therefore the regulatory capital requirements are low.

- **Defensible position** – substantial barriers to entry remain despite the current regulatory flux. The requirement for participants to be linked to other entities in the processing environment and the long-term nature of processing contracts provide existing participants with a highly-defensible position.

- **Residual opportunities for growth** – transaction volumes have continued to grow despite the current economic downturn. In particular there continues to be growth in cashless payments in the Nordic region where card usage is the strongest in Europe. Despite consolidation within countries, the European market remains fragmented, creating opportunities for bolt-on acquisitions and profitable inorganic growth. The Single Euro Payments Area (SEPA) integration initiative will enable consumers to make cashless euro payments to anyone located within the eurozone using a single bank account and a single set of payment instruments. Innovation in this area is creating opportunities to 'de-commoditise' the payment and create new value for merchants.

Regulation and innovation

In 2014 and beyond, the Payments industry will be heavily influenced by regulatory change, technology and innovation. In July 2013, the European Commission adopted legislation in respect of the EU payments framework.[1] The package has been designed to create an effective Europe-wide payments market, fully contributing to a payments environment that nurtures competition, innovation and security to the benefit of all stakeholders and consumers.

Key attributes of the legislative package include:

- **Payment Services Directive (PSD2)** – the new directive, which is due in 2015, is expected to bring a range of new players inside the regulatory regime. Notable changes include 'one-leg' transactions (i.e. where the payment service provider of either the payer or the payee is outside the European Economic Area). In addition, transactions in any currency will be subject to regulations relating to transparency and the supply of information to users, encouraging competition and structural change through new players.

- **Multilateral Interchange Fees (MIFs)** – MIFs are collectively-agreed inter-bank fees usually between the acquiring payment service providers and the issuing payment service providers belonging to a certain scheme. Among a number of proposals, one has been made to cap the level of interchange fees for cross-border transactions with consumer debit and credit cards and, in a subsequent stage, to cap the level of interchange fees for domestic transactions with consumer credit cards and consumer debit cards. Proposals to MIFs are expected to result in structural change through divestment and new entrants to the market.

In October 2013 the UK Government proposed legislation to establish the Payment Systems Regulator (PSR) which will be effective from April 2015.[2]

The PSR will focus on promoting the interests of current and future end-users of payment systems, promoting competition and innovation and ensuring that the payment systems are adequately funded to achieve these and will be required to avoid actions that would have a material negative impact on financial stability. The PSR is likely to drive consolidation, divestment and structural change in the industry.

Increasing innovation is also expected in the Point of Sale (POS) environment. This innovation is due to the trend for retailers to create an integrated payments infrastructure and includes e-wallets, targeting marketing (for example, coupon distribution) and POS format innovation through which identification and authentication data is transferred between customer, merchant and into the payments systems. Innovation is driving experimentation and presenting challenges for incumbents. The process has led to in-house development. It has also increasingly driven acquisitions, as incumbents utilise M&A to obtain technological improvements.

Outlook for 2014

Historically the payments industry has seen substantial growth and increases in transaction volume and value at the same time as experiencing rapidly changing technology. This trend is expected to continue with M&A activity levels in 2014 driven by increased competition and structural transformation as a result of legislative changes in the EU and UK, and technological innovation.

Unsecured personal lending continues to grow despite the persistent default risk caused by high unemployment rates and low wage growth. Ahmed Shah discusses how this situation coupled with a return of funding to the debt purchase industry could lead to opportunities.

Debt purchase M&A activity

We think that the recent M&A activity in the debt purchase sector will continue as the supply of, and demand for, consumer debt remains strong, and regulatory and market pressures favour consolidation.

Overview

The debt purchase and collection industry in the UK operates primarily through the sale of unsecured consumer debt balances by an originating institution (bank, utility company or other) to specialist purchasers, on the assumption that purchasers are able to collect these debts more efficiently.

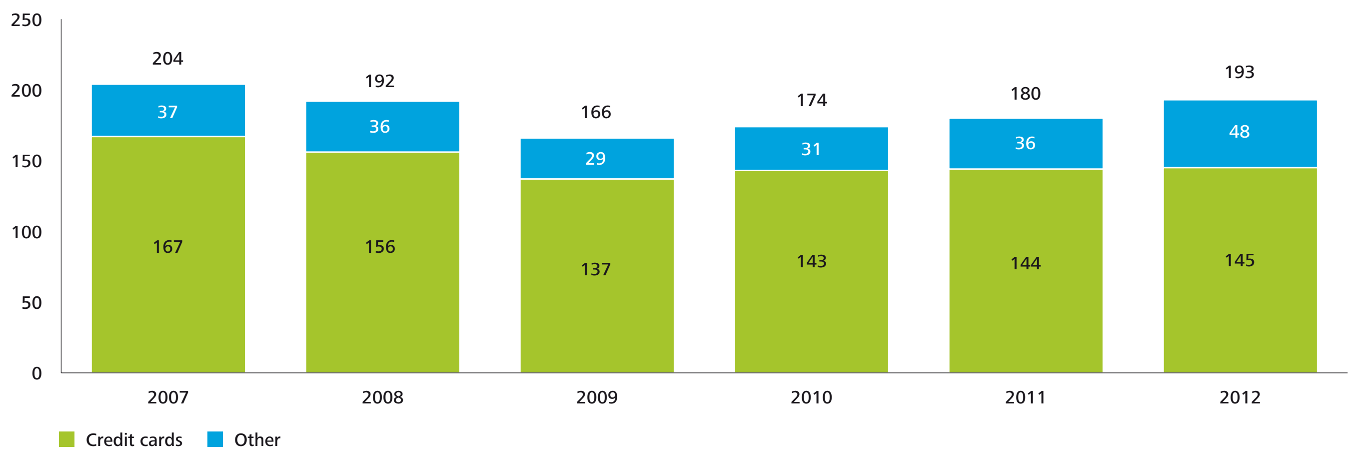
The industry is predicated on the supply of non-performing debt balances by lenders, and demand from debt purchasers driven by the availability of funding and an acceptable risk and return profile.

Unsecured lending in the UK

Unsecured lending forms an essential part of the UK's consumer-driven economy and has been a major economic driver accounting for £193 billion of consumer spending in 2012. The continued availability of credit is encouraged by the Government to support consumer spending and economic growth.

Customer defaults are an inherent component of this lending. Historically, lending by financial institutions has assumed an expected delinquency rate of between 4% and 7%, which varies cyclically. The industry employs a relatively-uniform write-off policy: debts that are more than 90 days past due are typically fully provided.

Figure 3. Unsecured lending (UK), £bn



Source: Bank of England statistical interactive database

This has resulted in a steady flow of defaulted debt, and approximately 70% of this is held by the five largest UK lenders (Barclays, Lloyds Banking Group, Royal Bank of Scotland, HSBC and Santander).

Any amount that can be achieved from a sale of debts previously fully provided is capital accretive and has operational advantages.

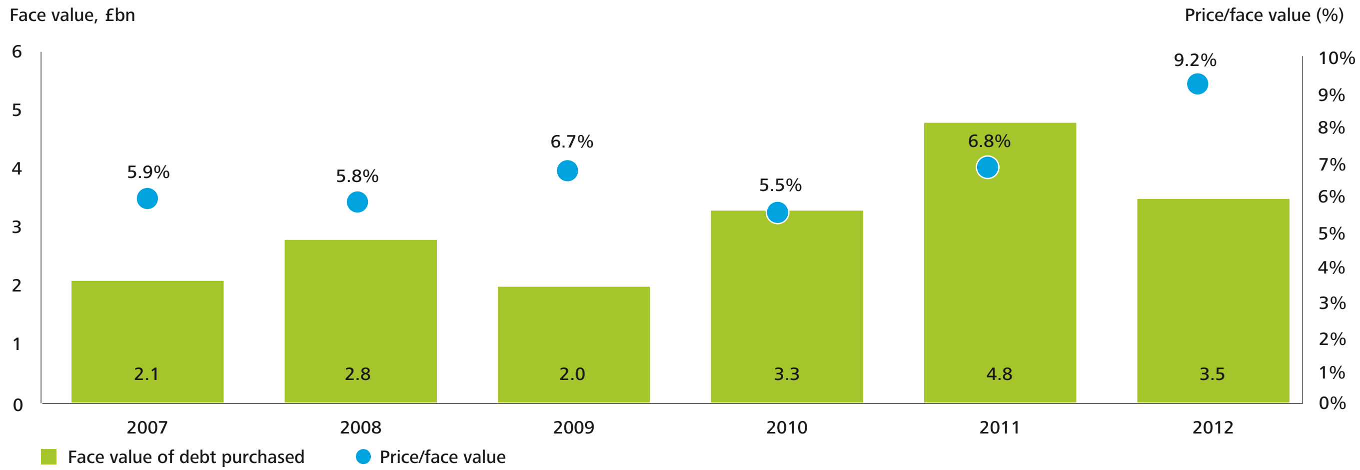
Debt purchase opportunities

The debt collection process for these defaulted balances can take several years and is becoming increasingly regulated. It can also become a complex administrative task due to the regulatory and reputational challenges of pursuing collections. As a result, the market attracts specialist purchasers who possess the proprietary data, experience and operational capabilities to efficiently price and subsequently collect these debts.

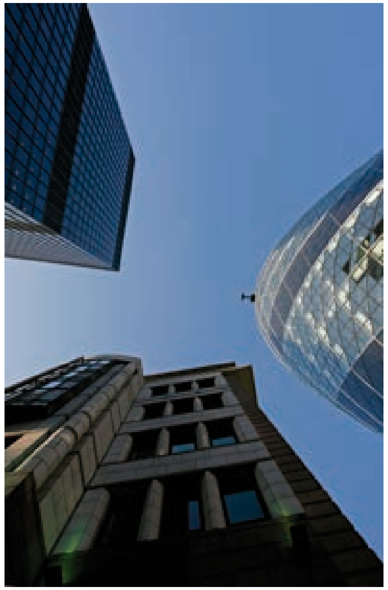
Each lender typically maintains a panel of up to 15 purchasers who participate in competitive processes for tranches of debt.

The financial crisis resulted in a number of debt purchase entities exiting the industry as asset prices declined, funding reduced and collection activity deteriorated. This in turn led to a reduction in the size of panels as lenders focused on selecting a smaller number of participants with robust compliance structures who were considered to be best able to obtain funding and viewed as trusted outsourcing partners.

Figure 4. Debt purchased by top four players (UK)



Source: Company accounts, Debt prospectuses (Arrow, Marlin, Cabot, Lowell)



Near-term debt supply

Consumers and financial institutions have largely recovered from the dislocation in lending during the credit crisis with unsecured lending and default rates returning to historical levels. The market outlook for the industry is positive with favourable near-term growth trends. These are driven by a backlog of defaulted debt, a return of unsecured lending, the decline of default rates to pre-recessionary levels, and the potential upsides from public sector debt sales. A recent example is the sale of £890 million of student loans to a consortium of investors including Arrow Global.

After the impact of the credit crisis, unsecured lending has increased in the last two years as consumer optimism has grown and financial institutions have recovered. Retail sales rose by over 4% during 2013 and car sales increased to the highest level since 2008. Against this, inflation and tax rises continue to outstrip earnings, resulting in a continuing decline in the level of disposable incomes. In the near team, this is likely to put additional pressure on household budgets and increase personal indebtedness. These conditions are likely to result in an increase in the volume of new unsecured consumer debt as lenders correct for the over-adjustments made coming out of the recession and the delinquency rate increase above the relatively low recent average of 4%.

The trend from lenders towards selling fresher (recently-defaulted) debt earlier in the default cycle also means that this debt will come to market sooner.

There is currently a backlog of defaulted debt. Unsecured lending peaked at £204 billion prior to the onset of the credit crisis and default rates subsequently increased to around 9% in 2010 as unemployment increased, real wages fell and credit dried up.

This created a backlog of defaulted debt which remained unsold until 2012 as purchasers stopped buying due to funding constraints and financial institutions cut back on asset sales as prices dropped. With prices recovering and funding returning to the industry, creditors are likely to dispose of this backlog over the next few years, increasing the level of debt available for purchasers.

The public sector has the potential to develop into a large and sustainable source of debt sales with approximately £40 billion in outstanding saleable non-performing balances related to student loans, and amounts due to HM Revenue & Customs (HMRC) and local government. Historically there has been little third-party involvement due to perceived sensitivity around collecting debts on behalf of the government. However, increased regulation and transparency in the debt purchase and collection sector is encouraging the use of outsourcing. As an example of this, HMRC doubled its spending on debt collectors to £13 million in 2012. Any further developments are anticipated to benefit the largest purchasers who have an established track record and well-defined compliance and monitoring structures.

Strong industry funding and demand

Demand has risen in the last two years primarily due to a return of funding to the industry after the credit crisis. Several major players have gained access to financing, with over £1 billion of bond issues and £400 million of new rolling credit facilities issued since the start of 2012.

Arrow's recent initial public offering shows renewed investor interest and access to capital markets which has been more common historically in the United States and continental Europe.

There is also potential to apply the American funding model whereby tranches of a debt portfolio are secured by special purpose vehicles which can result in lower funding costs. Additionally, key players have gained experience in purchasing and collecting on a wider variety of debt types, including paying debt, and have acquired portfolios in partnership with distressed debt funds in many cases.

There has been a degree of price inflation for a number of reasons. The growth in funding has enabled purchasers to increase their scale. In addition, lenders have become more sophisticated in the segregation and sale of portfolio assets, and are more aware of the value created by specialist collectors who have achieved collection efficiencies through investments in data analytics and advanced IT systems. The increase in demand and prices is expected to continue, albeit at a slower rate, reflecting stable access to funding and improved pricing discipline achieved through recent collections experience and the use of data.

Increasing market concentration

Following the financial crisis, the debt purchase industry experienced considerable change at a time when funding was limited for smaller participants. This led to M&A activity which created a small group of leading participants. This concentration is best demonstrated by debt purchase levels. In 2012, more than half of the total debt sold by financial institutions was acquired by the top five players with the majority of the balance acquired by distressed debt funds. This concentration of collections experience and data has benefitted the larger players who have developed proprietary databases of customer records and payment histories which should provide a competitive advantage in both pricing decisions and collection strategies in the future.

The majority of the top ten players are owned by buyout firms and have achieved significant growth in the last three years. Recently, owners have been looking to make profitable exits, gain access to capital or add to their range of specialisms. International interest in the UK market has been strong as illustrated by the purchase of Mackenzie Hall by Portfolio Recovery Associates, Cabot by the Encore Capital Group and JC Flowers, and the acquisition of mid-market players Robinson Way and the Lewis Group by Hoist

Current market drivers

Growing price competition, increasingly onerous regulatory requirements and lenders trending towards maintaining smaller panels of established purchasers is likely to result in further consolidation in the near term. Trade players from the US and continental Europe investing in the UK market are likely to acquire mid-sized companies and grow them in scale to compete.

Regulation is likely to become more intensive as the Financial Conduct Authority (FCA) assumes responsibility for the sector from April 2014. The FCA has already signalled its intent to focus on the industry as a high risk sector, raise standards of service and improve access to redress while replicating existing Office of Fair Trading guidelines and best practice recommendations as legally enforceable rules.

Compliance and regulatory scrutiny are also likely to become more relevant in terms of defining the competitive landscape with lenders who are keenly aware of the reputational risks associated with the management of their debts post sale.

At a time when lenders are increasingly seeking to reduce the size of their panels, this will have a negative impact on small to mid-sized players who do not have the depth of relationships or an established track record.

A change in the portfolio mix towards the sale of fresher, costlier debt has increased average acquisition size. This has created a further barrier to entry for smaller players with limited balance sheet scale.

Outlook for 2014

We expect M&A activity in the debt purchase sector to continue in 2014, as the main factors driving 2013 activity remain positive.

International expansion by UK-based companies remains an attractive proposition as European markets are less developed than the UK. They also typically have more creditor friendly legal systems and can offer higher opportunistic returns.

Lowell’s recent purchase of the Interlaken Group illustrates the opportunities to integrate vertically with established local contingent collection agents who have seen their margins erode in the last few years.

Following the successful listing of Arrow further IPOs are possible as investors become more knowledgeable and receptive towards the industry.

The level of issuance of Asset-Backed Securities globally increased during the second half of 2013 indicating rising demand for these products. Michael Artt considers the impact of this and the likely effect on future M&A in the banking market.

Issuance of Asset-Backed Securities

We think that the recent increase in investor appetite for securitised products could lead to a return of the 'originate to securitise' model, enabling banks to increase lending volumes and their profitability.

Overview

In the UK, banks continue to hold large volumes of loans on their balance sheets. These tie up capital and sources of funding. At the same time the investor community is seeking higher yielding investments as monetary policy keeps interest rates at historic lows.

The return of the securitisation market could offer a solution to both problems with banks able to clear their balance sheets of existing loans, therefore freeing them to make further loans and provide investors with higher yielding securitised products.

Background

In the years immediately prior to the credit crunch, the securitisation market played a major role as banking moved away from the traditional savings and loan model towards an 'originate to securitise' model characterised by a rapid turnover in assets held on the balance sheet. This speed allowed both mainstream banks and specialist sub-prime lenders to increase lending volumes and earnings. However, once the credit crunch took hold the securitisation markets effectively closed to banks, which in turn prevented them from generating the necessary balance sheet turnover to continue to maintain their previous lending levels.

The resulting capital injections (often from the UK government), together with monetary policy interventions such as quantitative easing (QE), saved the banks. However, such actions did not provide a way for the banks to restructure their balance sheets from the high volumes of loans other than through capital repayments or the sale of whole portfolios, often at a discount and therefore an unattractive proposition for performing portfolios.

Current investor demand

The current low interest rate environment and loose monetary policy required to allow the economy to recover from the results of the banking crisis have led to low yields across a range of assets, such as corporate bonds. Pension funds and other similar investors have had to consider alternative strategies in their search for higher yields.

As a result the securitisation market has seen increasing interest with levels of demand globally surging in recent months as investors are attracted by the higher yields offered by these products. Although the primary source of offerings is currently the refinancing of older securitisations there are indications that the market for new issuances could make a comeback.

Demand for higher yield from investors is continuing. In July 2013, the European Central Bank also widened the range of collateral accepted in exchange for liquidity to include asset-backed securities with a lower credit rating and to apply a smaller 'haircut', or discount, to the value of these securities. The head of the Basel Committee on Banking Supervision said that it may consider reducing capital requirements for securitised products.[3]

There is however a contradictory argument to consider: with QE keeping interest rates at historic lows why would banks turn to the securitisation market? Our view is that with the end of QE likely to begin in the near team, and the apparent demand from the investor community for securitised assets, banks are likely to explore the opportunities in this area, particularly if securitisation could be used as a more attractive alternative to portfolio sales.

Furthermore, absent a change of approach from the Basel Committee, the capital treatment of securitised products under Basel III makes them more capital intensive than they were in the period leading up to the credit crunch. This may result in the origination coming from non-bank financial institutions, such as specialist lenders, with bank participation being limited to arranging the securitisations.

The return of specialist lenders

In recent years the UK banking sector has seen the effective withdrawal of specialist sub-prime lenders and other non-bank financial institutions, who have been replaced in part by payday and peer-to-peer lenders, as their access to funding disappeared when the securitisation market closed.

The return of the securitisation market would provide a route back for these types of lenders who could find a niche in the market between the mainstream banks and payday/peer-to-peer lenders.

Existing market participants with the necessary skills and platforms to return to the securitisation market might be able to differentiate themselves from competitors. This would make them attractive targets for investors seeking acquisitions in the financial services sector or, alternatively, allow them to consider a public listing to generate capital for further growth.

In addition, although banks may not wish to originate securitised products themselves, they could still benefit from fee income generated from arranging such products on behalf of the non-bank financial institutions.

Outlook for 2014

Against the backdrop of a potential return of the market for securitisations, what effect do we believe this will have on M&A? Our view is that the return of the market for new securitised loans from banks would drive a number of changes to M&A activity in the banking sector.

A reopening of the securitisation markets would allow non-bank financial institutions to increase lending and, in turn, profitability which could increase M&A activity. However, for this to happen the current surge in investor appetite for securitised products will need to become a longer term trend, particularly against any changes in monetary policy.

In the absence of organic growth in many mature markets, insurers and brokers are targeting growth in emerging markets. Will Geer and Laura Scarpa examine what makes emerging markets an attractive proposition, as well identifying which markets offer potential for insurers and brokers.

Insurance deals in emerging markets

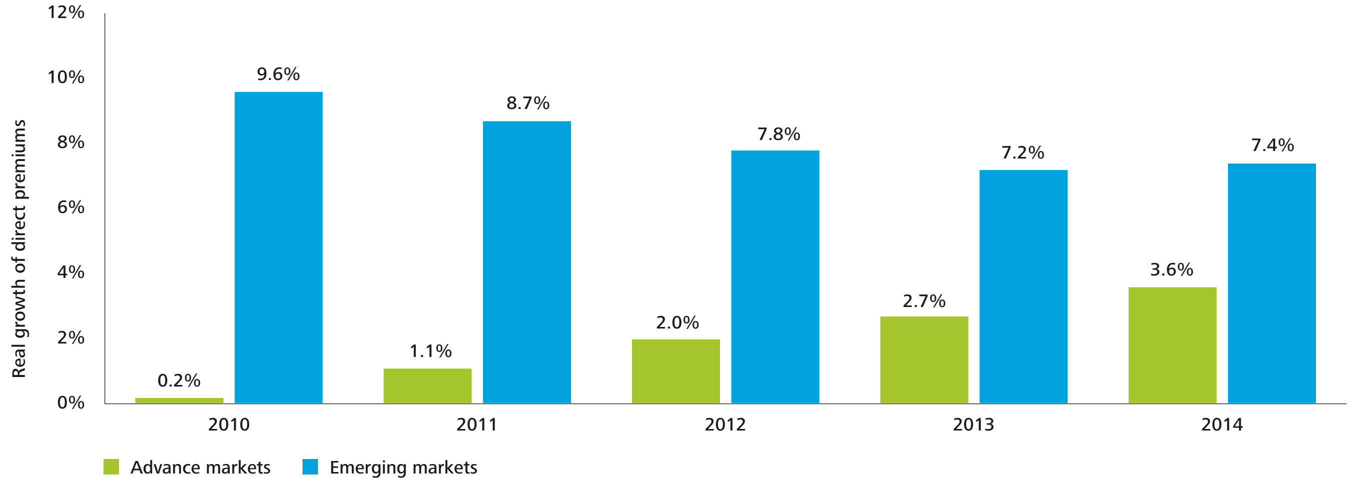
We think that insurance M&A activity in emerging markets will be strong in 2014 as UK insurers seek growth opportunities.

Overview

In light of low growth rates and a challenging economic environment in mature markets, insurance M&A activity has transferred towards emerging markets. Key deals in 2012 included AXA buying HSBC's general insurance business in Asia for $914 million and Ace's two Mexican acquisitions (Fianzas Monterrey for $293 million and ABA Seguros for $865 million). In 2013, M&A activity includes Swiss Re's investment in Brazilian Insurer Sul America for $339 million and New China Life for $493 million.

GDP growth rates between 2013 and 2018 in emerging markets, particularly in developing parts of Asia and Latin America, are forecast to continue to outperform advanced economies, although the recent International Monetary Fund update has revised growth expectations downwards.[4,5] This has direct benefits on the insurance industry with Swiss Re forecasting a 7.4% direct premium growth rate in 2014 for emerging economies compared to 3.6% in advanced economies. In some countries, Gross Written Premium growth rates materially exceed this with Indonesia forecast to grow by 11% year-on-year.

Figure 5. Direct premium growth rates: Advanced economies versus emerging markets



Source: Swiss Re Economic Research & Consulting

It is important to note that the countries currently labeled as emerging economies are at different phases of the insurance development cycle. Therefore, they are attractive to different insurers and brokers depending on whether they are direct insurers or reinsurers, or wholesale or retail brokers.

The diagram overleaf describes the path of insurance development as an economy matures over time. In the initial phases, personal lines insurance growth is key. In 2012, motor insurance accounted for 45% of the total non-life premiums written in emerging markets.[6] This typically benefits local domestic insurers and there are limited opportunities for global insurers (outside of reinsurance) unless they develop or acquire a local insurer. However, this can be challenging due to regulatory restrictions. For example, in China overseas ownership of a domestic general insurance company is restricted to 25%, although it is 100% for other insurance entities.

As the middle class grows in countries this drives insurance penetration as people are keen to insure new assets. At this phase of market development there is a high reliance on reinsurance by domestic insurers as they are unable to retain high levels of risk due to capital constraints.

In parallel to personal lines development, commercial lines insurance becomes important in the early growth phase to support the development of industry and infrastructure. This provides opportunities for global specialty lines insurers and international wholesale brokers to enter the market. This is currently the case in the Middle East where there is a strong demand for capacity for Construction and Energy risks. The aviation, engineering and liability insurance sectors should also benefit in this stage of development.

Phase 4 is where Specialty lines accounts for a more material share of the market and becomes particularly attractive in volume terms for Lloyd's of London. The distribution network has become more advanced and allows Lloyd's to access business in a region more effectively.

Figure 6. Insurance market development phases

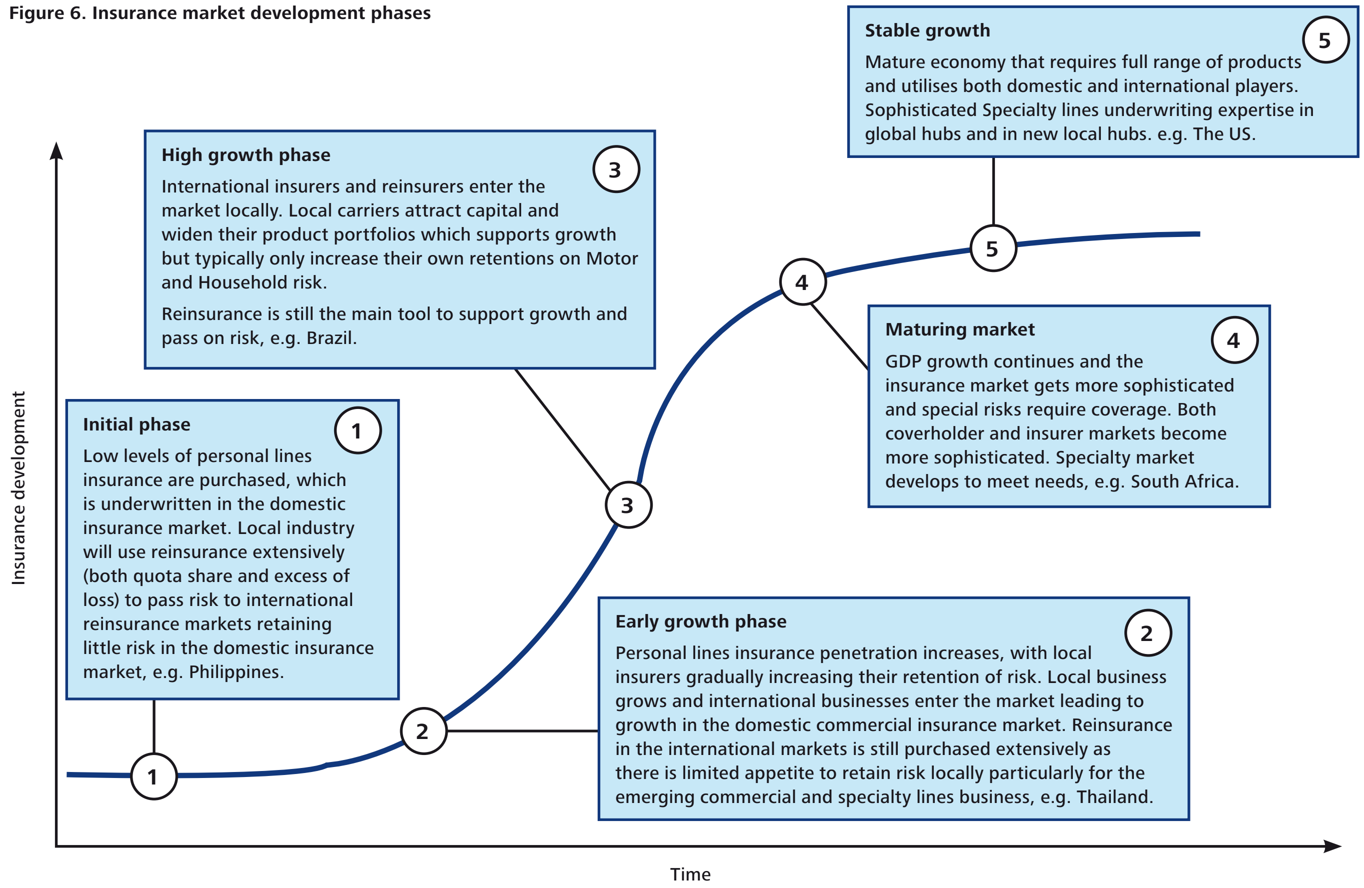
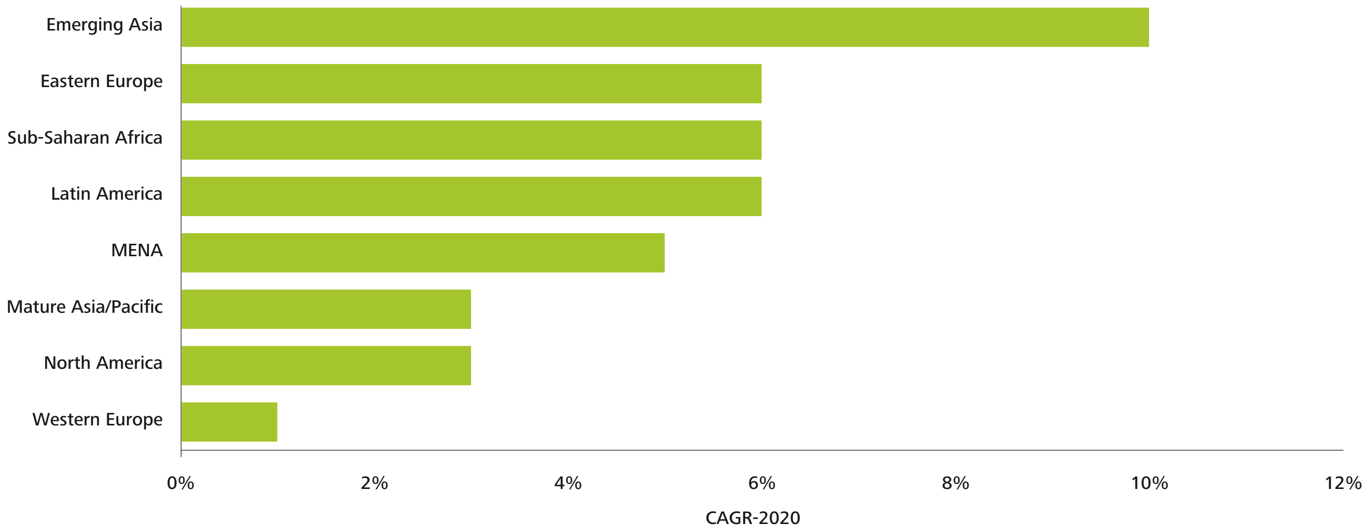


Figure 7. Estimated Property and Casualty growth rates, 2013-2020



Source: Munich Re Economic Research

Forecast Property and Casualty growth rates 2013-2020

The graph above highlights a 10.2% CAGR forecast for Emerging Asia between 2013 and 2020. The development cycle and forecast Property and Casualty insurance growth rates all point to a concentration of emerging market hotspots in Asia.

There are a number of factors brokers and insurers need to consider when choosing which countries to target in Asia, and more broadly in emerging markets:

- **Broker penetration** – broker presence in East Asian markets is relatively limited. This creates potential difficulties in developing a wholesale presence and limited opportunities for brokers to acquire incumbents. For example, non-life insurance local broker market shares are 1.0% and 5.9% in Japan and China respectively, compared with 17% in India.

- **Regulatory regime** – the sophistication of regulatory regimes is improving with many looking to the US and Europe for frameworks for solvency requirements. For example, Indonesia has increased the level of capital which has to be held through the introduction of a 250% increase in capital requirements for insurers by the end of 2014.

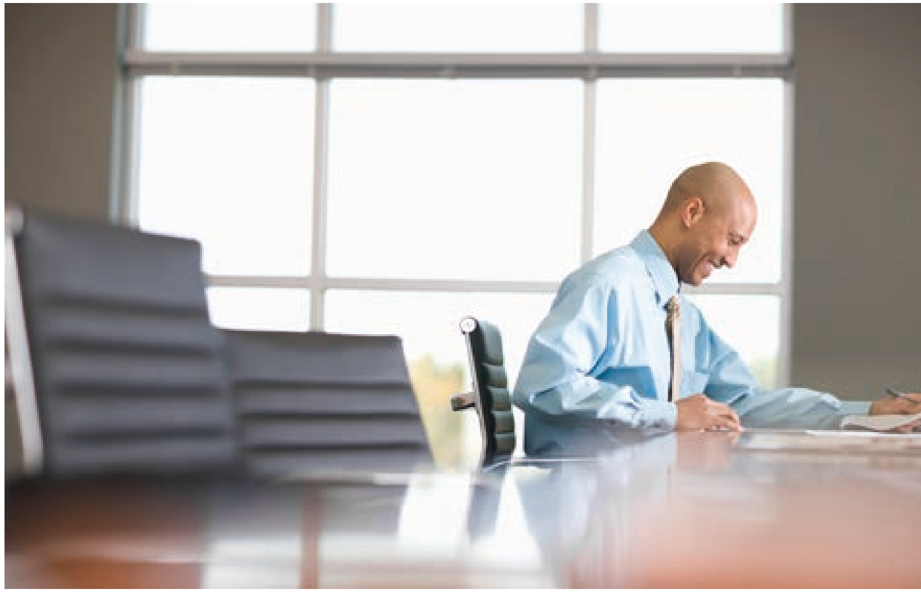
- **Ease of doing business** – according to the Ease of Doing Business index, South Korea, Malaysia and Thailand all appear in the top 20 economy rankings suggesting that they have a regulatory environment that is relatively conducive to business operations.[7]

- **Mode of entry** – foreign ownership of domestic insurers is limited to 26% in India, 49% in Thailand, 70% in Malaysia and 80% in Indonesia, which increases the use of joint venture operations and minority investments. For example, Sanlam has a 49% investment in Pacifica and Orient Insurance in Malaysia.

In Asia, we expect Insurance M&A to be focused on China, Indonesia and Thailand as the business environment in each country is supportive of growth.

Lloyd's of London has been highly visible in stating its ambitions to grow its share of business in emerging markets. Its target is for 25% of Lloyd's Gross Written Premium to originate from emerging markets by 2025, an increase from 12% in 2012. It is supporting this ambition by:

- building relationships with large emerging market insurers such as People's Insurance Company of China and GIC Re to ensure they see Lloyd's as a viable platform to access Specialty lines business



- utilising its existing overseas hubs such as Singapore and Shanghai.[8]

Key for Lloyd's is the appetite of brokers to source business from emerging markets. Aon, Marsh and Willis have traditionally had a strong global presence but are supplementing this with ad hoc acquisitions and partnerships in new markets such as Willis' partnership deal with Willis Peru and Credicorp, the largest bank in Peru. This flow of emerging market business is now being supplemented by the M&A activities of the second tier brokers. Hyperion and Cooper Gay have been leading exponents of this approach.

Lloyd's has identified Latin America as one of its key emerging market targets. The countries continue to show economic development and growing insurance penetration. Brazil, Argentina and Mexico have been attractive targets for insurers and brokers as highlighted by Ace's two Mexican acquisitions.

Our analysis suggests there is still room for further growth. The majority of premium in the Latin American market is written by international insurers and there are over a 100 insurance companies which suggests the potential for consolidation. Insurance in Latin America is predominantly sold in person through agents and brokers. This makes the market suitable for wholesale distribution.

Outlook for 2014

A number of insurers and brokers have already recognised that emerging markets provide an opportunity for accelerating their growth. Building long-term relationships in insurance and reinsurance is the key to success in new markets and helps to build support with local regulators.

Investment in emerging markets by key players is needed now to ensure that they are well positioned to take advantage of expected future growth.

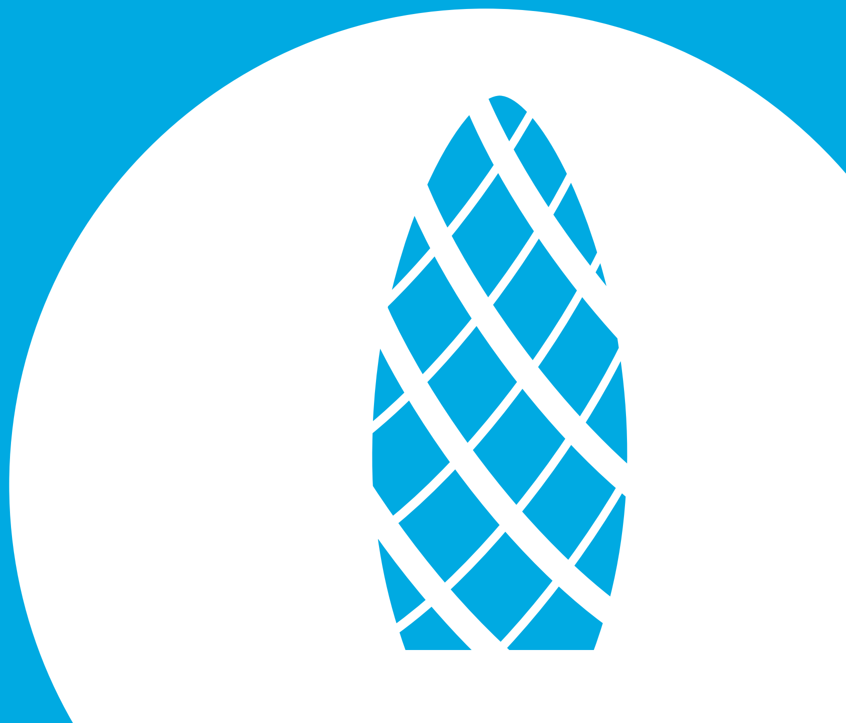
Figure 8. Largest potential market growth ($bn)

	Current	Potential	Growth	
Brazil	37.4	64	26.6	71%
Mexico	13.2	33.4	20.2	153%
Colombia	6.1	10.4	4.2	69%
Peru	1.6	5.7	4.1	256%
Chile	4.4	7.5	3.1	70%
Ecuador	1.2	2.4	1.2	100%
Dominican Republic	0.6	1.6	1.0	167%
Argentina	12.3	13.3	1.0	8%
Guatemala	0.5	1.4	0.9	180%
Uruguay	0.7	1.4	0.7	100%

Note: Potential market size based on non-life insurance penetration reaching South American market average, 1.72% of GDP

Source: Swiss Re and Deloitte analysis

London market brokers have experienced less M&A activity than in the UK regional broker market in recent years. Jamie Lamont considers whether 2014 has the potential to reverse this trend by assessing the key factors that could drive activity.



London market brokers

We think that M&A activity relating to London market brokers is likely to accelerate in 2014 as smaller participants are disadvantaged due to the costs of regulation, and an ageing ownership profile is matched by demand from private equity.

Overview

M&A activity in relation to London market brokers has been subdued over recent years compared to the regional UK broker market, which has experienced high levels of activity driven by private equity-backed consolidator business models. Acquisitions that have taken place focused on the top independent London market brokers while interest in smaller brokers has been limited.

Consolidation is overdue in the London broker market and evidence suggests that activity could increase in 2014. Market changes are making it increasingly difficult for smaller brokers to operate in the London market and this combined with an ageing ownership base is likely to lead to an increase in the number of businesses available for sale. At the same time improved economic conditions and increased private equity interest in the market will support demand for acquisitions.

Drivers of M&A

There are currently 192 registered brokers placing business into the market although approximately half of premiums are from Aon, Willis and Marsh. This concentration continues with the top 20 brokers accounting for around 80% of premiums. This means that a fifth of Lloyd's premium volume is shared between the other 172 brokers. These smaller brokers are often businesses established in the 1980s and 1990s as a result of individuals leaving the big brokers to set up their own businesses.

Since Aon executed a 'build and buy' strategy among London market brokers more than 15 years ago there has been no major M&A activity targeting smaller brokers. As a result many of these brokers have an ageing shareholder-management base with shareholders in their late 50s or 60s, a factor which is likely to increase the chances of an exit in the near future. In addition, over the last ten years there have been a number of market developments that have increased the cost and difficulty of operating as a small independent London market broker:

- **Regulatory burden** – London market brokers have faced an increasing regulatory burden over the last five years as a result of the greater scrutiny from the Financial Services Authority and more recently the Financial Conduct Authority. Conflicts of interest, threshold conditions and client money rules have become more important for brokers to understand and implement in their businesses. The cost of complying with regulatory requirements has increased, which has put pressure on smaller brokers who have more limited means or capability to adapt to regulatory change.

- **Technology costs** – Investment in technology and data analytics has increased the capability gap between the top independent London market brokers and smaller brokers. Management information has become a critical tool for insurance brokers to be able to monitor their business performance adequately, ensure regulatory compliance and make effective business decisions.

- **Consolidation of business flows** – The US market accounted for 40% of Lloyd's gross premium in 2012 and therefore heavily influences broker activity in the market. The US wholesale broker market has been through widespread consolidation and is now assessing the London market and questioning why, as a major US wholesale broker, they are dealing with smaller brokers in their interactions with Lloyd's. As a result there has been a reduction in the premium volumes available to smaller London brokers.

Interest from private equity in London market brokers also increased in 2012 and 2013. There were investments by private equity firms in leading independent London market brokers to help support existing acquisition led growth strategies. There was also the launch of Global Risk Partners in 2013, a private equity-backed London market broker consolidator. Global Risk Partners made its first acquisition in November 2013 and is set to target acquisitions of small and medium-sized brokers.

Outlook for 2014

We believe that the combination of an ageing ownership profile of smaller Lloyd's brokers, the increasing cost of operating as a broker and the demand from investors including private equity is likely to result in increased levels of M&A during 2014, and that this will be the start of a period of consolidation of smaller London market brokers.

There are also likely to be continued acquisitions by the larger independent London market brokers seeking to increase scale within the market. This activity is likely to be focused on mid-sized brokers that have strong positions and expertise in specialty areas or niches, or where there are cost synergies and the ability to build leadership positions in attractive market segments.

In recent years, capital markets investment in catastrophe insurance has increased as investors have sought higher yields. Colin Gleeson explores the impact of this in 2013 and whether the phenomenon is likely to continue in 2014.

Catastrophe insurance and capital markets

We think that capital markets involvement in insurance will continue, driven by the improving understanding of the asset class and the yields available. This in turn will drive M&A activity as businesses reassess their operations in light of this structural change.

Overview

In many ways 2013 was the year that the insurance market recognised the potential for convergence between insurance and the broader capital markets. The concept of capital markets participation has existed for more than a decade; however for most of that time it has remained at the fringes of the market, with occasional bursts of growth followed by retrenchment.

The surge in recent years has been driven by a number of factors. Most important of these is the low investment return environment across traditional capital market asset classes following the financial crisis. A low interest rate environment coupled with limited underlying economic growth has meant that investors and fund managers have struggled to generate superior returns. In that context the returns available from diversification have appeared attractive. In a sense, the recent growth in capital markets participation in insurance can be seen as a supply led phenomenon as investors take advantage of what they see as an attractive and uncorrelated asset class that has the potential for strong returns.

The second driver has been the growth of new routes to access these opportunities. These include the development of reinsurer 'sidecars' which pair the underwriting expertise of reinsurers with third-party capital, the growth of specialist investment managers such as Leadenhall Capital Partners and Nephila, and significant improvements in the modelling of North American windstorm risk (though many in the industry would dispute this point).

Guy Carpenter estimates that between 14% and 16% of the estimated $312 billion of global catastrophe premium is now from non-traditional capital. This percentage has been growing strongly over recent years and some expect this to peak at between 20% and 30% by 2015. Such a market share gives these non-traditional investors a significant role in price formation and as a result we have seen significant pricing pressure for North American catastrophe exposed treaty reinsurance. With the 2013 hurricane season appearing benign, and returns high for reinsurers as a result, it is likely we will see significant rate pressure for 1 January 2014 renewals.

While the growth has been impressive and the focus of much attention, it is worth noting its limitations. Capital markets investors are generally seeking risk exposures that are transparently modelled in detail. The North American catastrophe reinsurance market is the natural market for these investors. It is modelled at a highly granular level by independent modelling firms such as EQECAT and AIR. In the short term this largely confines the increased involvement to North America as the quality of underlying risk data and modelling in other catastrophe exposed regions of the world is significantly more limited.

Impact on traditional reinsurers

So what does this mean for the 'traditional' reinsurance community? In the short term it means increased competition and lower rates for reinsurance underwriters with a focus on the North American catastrophe market. This includes some Lloyd's and Bermudan reinsurers in particular who tend to have higher exposure to this market. Many reinsurers are also seeking to participate in the growth by developing capital markets divisions.

Some suggest that recent growth is a short-term phenomenon driven by the unusual conditions in broader financial markets. When markets normalise investors will lose interest in the insurance market and return to their traditional asset classes. This, we believe, is unlikely. One of the lessons of the financial crisis is that correlation between traditional asset classes appears to have increased when financial markets are stressed, raising questions about historical assumptions regarding portfolio diversification. The insurance industry has stood out during the financial crisis and subsequent depressed economic climate emerging largely unscathed.

This is in large part due to the limited correlation of the risks that the industry assumes with financial markets. This is highly attractive to investors and now that they have experience of the class it is likely to remain an asset class that will form part of investor portfolios.

Another argument has been that when investors experience a significant loss, they realise the true nature of the risks which they are taking and withdraw. There is certainly the potential for some moderation of interest in the case of large losses. However most structures position investors so that they will only lose in the most extreme situations.

Outlook for 2014

In the medium term convergence is likely to persist and capital markets investors are here to stay. This has implications for reinsurance pricing patterns in future. One of the more important consequences is that the speed at which post-event capital enters the market will accelerate. As a result the post-event spike in rates that has historically driven strong returns for reinsurers will likely be shorter-lived and cross-cycle returns will be lower for catastrophe focused reinsurers.

This will have an impact on the niche North American catastrophe exposed reinsurers in particular. Many of the Bermudan reinsurers were originally created to take advantage of large catastrophe events. While a number have since diversified, there remain businesses in London and Bermuda that have a significant dependence on North American catastrophe that on average should see lower returns than they have earned historically across the cycle. This may drive M&A activity as businesses reposition their portfolios to take account of the new environment they face.

The Wealth Management and Private Banking sectors are seeing changing business models, technological shifts and increased regulation leading to uncertainty and opportunity. As the economic outlook improves and a degree of regulatory clarity emerges, Baber Din highlights how improving confidence may boost M&A activity in 2014.

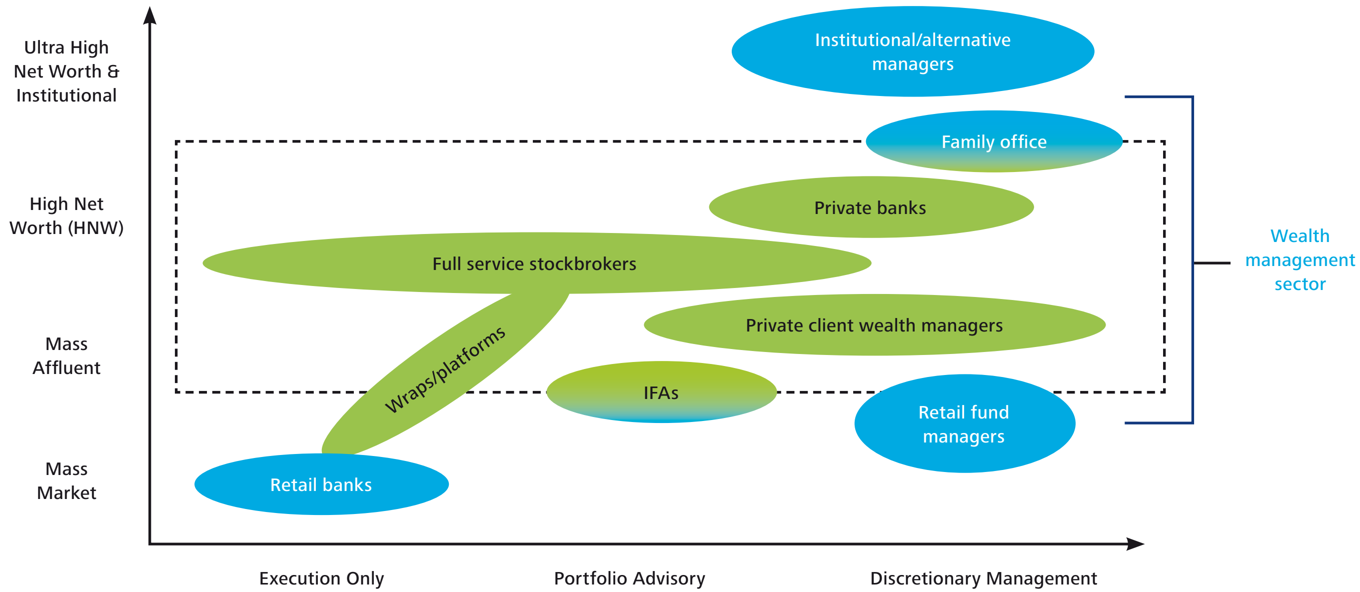
Investment management

We think that M&A activity in the Wealth Management sector will continue, driven by regulatory change, technological developments and margin pressure making scale more critical in a fragmented sector.

Overview

Wealth Management covers a broad variety of services for retail customers ranging from the execution of transactions, to regulated investment advice through to full service discretionary fund management.
The interaction with the customer is either direct or intermediated, with relationships important.

Figure 9. Wealth Management sector



Wealth Management can be provided by financial institutions whose core proposition historically may have been distribution (such as Independent Financial Advisors or IFAs), asset management and/or private banking, who provide Wealth Management in addition to their regulated banking services (deposit taking and personal lending). The customer base ranges from the mass market, with limited investible assets, through mass affluent customers, with investible assets of approximately £100,000 or more, to high-net-worth clients (HNW) whose investible assets will typically be between £1 million and and £2 million.

Overview

Wealth Management has seen significant change and challenges since the global financial crisis. This has been due not only to economic conditions but also to the implementation, in the UK at least, of significant regulatory changes, as well as technological innovation. Major developments include:

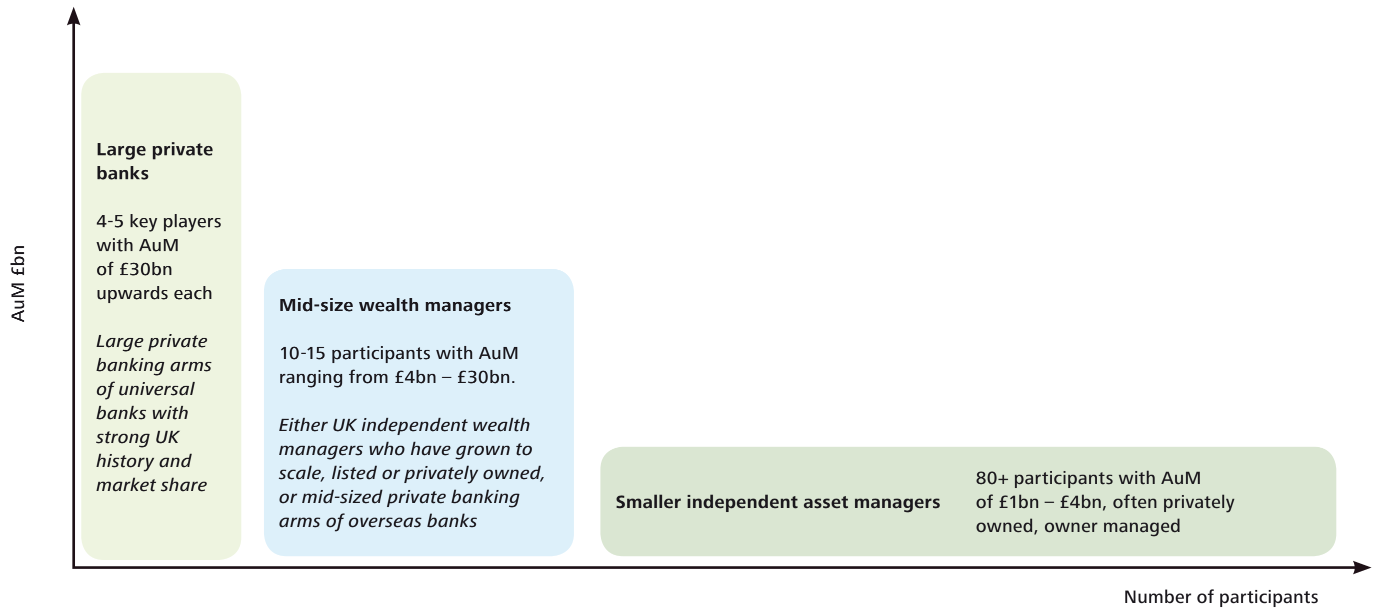
- **Improving market outlook** – economic uncertainty as well as recession inevitably dampened assets under management (AUM), and therefore fees earned. It also impacted net new investment. Increasing economic stability and rising equity markets are now resulting in rising levels of AUM and net new money flows. Additionally, customers' asset allocation decisions are returning to higher margin equity products.
- **Emerging regulatory clarity** – the implementation of the Retail Distribution Review (RDR) in the UK resulted in consolidation in the IFA segment as scale became important and segments of the market (the mass market in particular) shrank. This occurred through advisers exiting businesses as well as corporate acquisitions. There has also been a push from the Financial Conduct Authority around broader transparency of fees and their components (unbundling), while EU legislation on packaged retail investment products (PRIPs) are beginning to move Europe towards the new UK model. Now that 'RDR1' has been implemented, there is greater certainty on its impact on the market. Successful participants have been able to adapt to the new regime, either moving further away from advised services (a trend previously under way) or continuing to transition clients to fee-based services. Early clarity on margins and volumes is beginning to emerge and the picture is challenging; profitability solely from advisory services is difficult and the strategic focus is on capturing more of the value chain.

- **Evolving distribution models** – retail asset management in the UK has been dis-intermediated for over 20 years and some independent asset managers now regret breaking the link with their underlying retail clients. Typically, products were primarily distributed through IFAs, or directly by insurance companies and banks to their underlying client base. For higher-net-worth clients, distribution of products was led by private banking relationships. Wealth managers can be distributors, owning a client relationship and distributing investment and saving products to them or, increasingly, evolve into product providers who have their own discretionary fund management offering (which will typically be portfolios of existing, third-party funds, securities and, increasingly, lower cost Exchange-Traded Funds or ETFs).

- **Increasing overlap between manufacturing and distribution** – for many wealth managers, a centralised investment proposition, based on broad categories of risk appetite and self-selection (rather than bespoke investment solutions) has been the successful strategy. This is especially the case for smaller and more nimble wealth managers, who have been able to protect margin. At the higher net worth end of the client spectrum, high touch (and higher cost), relationship led service provision remains critical and margins have been challenged. Similarly, many providers and distributors have been focused on seeking to devise 'guided' or 'non-advised' mechanisms to provide efficient solutions for mass market customers, or those at the lower end of mass affluent.

- **Continuing technological improvement** – platforms (fund supermarkets or wraps) have proliferated, with many large insurers establishing less than profitable platform propositions for defensive purposes to ensure that their books of business are not eroded by the advance of technology elsewhere and migration to platforms hosted by competitors. At the same time, the direct-to-consumer channel, still a small proportion of the market, is dominated by a small number of well-established players. Wealth managers (even where they do not have a platform but use third-party platforms) need a platform strategy. There is an expectation that the current number of platforms will be consolidated into a handful of players (perhaps eight to ten compared to over 30 currently). Their business models remain uncertain – many have been run for strategic rather than profitable purposes by larger institutions. A platform proposition can be a valuable differentiator in terms of capturing revenue share and margin rather than ceding them to third-party platform providers. The role of platforms within Wealth Management is complicated by the ban on fee rebates from product providers to platforms, and the battle for how client fees are shared between manufacturers and distributors (be they platforms or wealth managers/ IFAs) is still being waged.

Figure 10. Wealth management in the UK



The UK Wealth Management sector

The UK Wealth Management sector is dominated by a small number of large participants. Currently the Top 15 wealth managers hold some 70% of the market in terms of assets under management, while the Top 4 (which are fundamentally the private banking arms of universal banks) hold around a third. However, this picture of a concentrated market tells only part of the story.

The UK has a long tail of medium-size and smaller wealth managers, many of whom have effectively used lower cost operating models to shift from the HNW segments of the market to the mass affluent or affluent sectors, while remaining profitable.

M&A trends

The sector has seen a number of key trends which have driven M&A activity in the recent past. We believe there are four key themes:

Banking divestment – certain UK and European banks have disposed of their non-core assets, including Private Banking and Wealth Management businesses, in order to boost capital and reduce peripheral activities. That has driven a number of divestments, particularly in Europe. While most of the obvious deleveraging has probably already occurred, some opportunities remain outside the UK.

On the other hand, banks, with successful Wealth Management/Private Banking activities are focused on growing this part of their business, especially those that have a Private Banking deposit arm which generates funding. Some of these bigger entities have used, or will use, M&A to help grow their businesses.

New entrants – overseas participants from the Far East or Middle East have explored acquisitions of Wealth Management or Private Banking operations in Europe. They have generally focused on targets that operate at the HNW end of the customer spectrum. The strategic rationale is to acquire capability and platforms to drive revenue synergies from their home market. The challenge in competing on valuation remains a lack of synergies where it is a genuine new entrant competing with local trade buyers.

Scale – the regulatory and technological trends described above mean scale is becoming increasingly critical, particularly given the long tail of smaller wealth managers in the UK. Some medium-size players have acquired smaller rivals but M&A volumes have been constrained by the fact that many smaller businesses are owner-managed and unless an exit or succession plan is already in place, finalising a deal has been challenging. Some participants have had some success at 'roll up' strategies while others have faced challenges either in finding targets of sufficient scale and quality, or in reaching valuations which are acceptable to vendors in times of uncertainty. As investment markets improve, we expect to see some of the issues around valuation to be resolved.

Margins – clients are increasingly aware of fees, as well as being more sceptical on the effectiveness of higher margin actively managed products following the global financial crisis, which, combined with the increased costs associated with the rising regulatory burden, is driving compression in margins for wealth managers.

Private equity – private equity has had a mixed relationship with the Asset Management sector as a whole, sometimes concerned by the cyclicality and sensitivity of revenues to markets. Wealth Management can seem more attractive as it is potentially less exposed to markets and is less reliant on key personnel (although, of course, it does have some reliance), it also has a direct relationship with customers and focuses on capital preservation, which can help stability. Set against the economic cycle and demographic trends, private equity interest in the sector is increasing due to the limited capital requirements and attractive historical returns for those businesses with effective operating models.
A sense that the current flux in the market will create an opportunity for winners is increasing this interest. We see this level of interest being maintained although the challenge will be around the availability of businesses of sufficient quality and scale to invest in.

Outlook for 2014

We believe that the key changes in the Wealth Management sector set out above, combined with renewed economic confidence and market stability, will generate increased transactional activity in 2014, particularly outside the bulge bracket Private Banking players.

This reflects the sector themes of consolidation, continued technological developments and emerging clarity on the impact of regulatory changes in the UK. At the larger end of the spectrum, we believe that any further divestment of Wealth Management or Private Banking arms by universal banks will be more limited, and primarily focused on exiting geographically peripheral or sub-scale operations.

In Retail Banking, 2013 will be remembered as a year that saw reversals of previously announced megadeals, a turnaround in the underlying profitability of high-street banks and a complex regulatory lanscape. Ben Carroll considers the likely activity in 2014 with IPOs of new banks and continuing challenges ahead.

Retail Banking and IPOs

We think that M&A activity in the UK Retail Banking sector will continue to be dominated by major divestments although conditions for new entrants are improving driven by regulatory change.

Overview

Transactional activity in the UK Retail Banking sector in 2013 was surprising for a number of reasons, the main ones being:

- The collapse of Project Verde, Lloyds Banking Group's (LBG) proposed disposal of over 600 branches to the Co-operative Bank
- The change in Project Rainbow, Royal Bank of Scotland's (RBS) transaction from a sale to an Initial Public Offering (IPO)
- The restructuring of the Co-operative Bank resulting in a debt for equity swap.

In the case of the Verde transaction, the proposed purchase by the Co-operative Bank changed to an IPO under the TSB Bank brand, while in the case of RBS branches it has evolved from a sale to Santander into an IPO of Williams & Glyn backed by a consortium of investors led by Corsair Capital. In the case of the Co-operative Bank the original plan for an IPO leaving the business 75% owned by Co-op Group changed into a non-listed bank where 70% of the ownership transfers to previous bondholders.

Retail Banking M&A activity at the end of 2013 therefore points towards a shift away from large banking transactions designed to promote strategic growth.

Instead, groups of sophisticated investors are looking for value in UK retail banks as cyclical and structural factors move in banks' favour. Banks can look forward to an upturn in margins when rates eventually rise, which forecasters expect much sooner than the Bank of England's late-2016 target, and to improving loan loss experience as the economy recovers. Reinforcing these cyclical factors is a hoped-for structural increase in competition in the sector.

The investment case

UK retail banks have started to return to profitability. Their financial performance has shown a modest increase in net interest margin despite underlying base rates remaining unchanged. A reduction in risk-weighted assets as a result of the continuing deleverage programmes and the benefit in early 2013 of the continued Bank of England funding support has resulted in an increase in Core Tier 1 equity ratios in nearly all of the high street retail banks (subject to the Co-operative Bank successfully completing its financial restructuring), reaching levels which are above the minimum requirement at 31 December 2013 of 7% which was set by the Prudential Regulatory Authority (PRA).

Overall, credit metrics are looking positive across UK retails banks. However recent credit loss experience (notably loan losses as a percentage of loans to customers) has been mixed. LBG's retail bank and the Co-operative Bank have experienced an increase in this metric despite the improvement in the UK economy. This may reflect the lag in benefitting from newer loan underwriting in operating results.

Retail banks continue to make significant unanticipated losses in conduct risk. Throughout 2013, they have increased their provisions for Payment Protection Insurance mis-selling as well as for other areas of potential customer compensation (for example the mis-selling of interest rate swaps, interest-only mortgages, and card and identity protection products). These factors and the ensuing regulatory burden continue to dent their profitability and operational efficiency. The more recent investigation into the potential rigging of the foreign exchange market suggests that further conduct risk provisions may continue to affect the profitability of the more established retail banks in 2014.

Do competition hurdles still exist?

The UK Government has been keen to promote the level of competition in UK banking. This is being achieved by proposing new rules to make it easier for new market participants and also by breaking up RBS and LBG as required under EU state-aid rules.

The radical plans announced by the Financial Services Authority in 2013 in its regulation of new banking start-ups are likely to encourage other customer-facing industries to consider developing a banking proposition.

New start-up banks will be required to hold 4.5% of core capital against risk-weighted assets compared with a minimum level of 9% currently envisaged in the UK.[9] This is still an increase over the Basel II rules. However, it is significantly lower than the targets set by Basel III or those recommended by the Independent Commission on Banking.

This start-up benefit helps level the playing field against the more established banks, that benefit from the more advanced and beneficial Basel III approaches. Start-up banks may enjoy a lower cost of capital than their rivals that would enable them to offer cheaper finance, in turn spurring growth in their lending book.

The key question is whether the prospect of cheaper lending will increase competition where it is needed most, i.e. in the high-street banking market and in lending to small and medium-sized entities, where few banks currently compete. The UK has several high-street banks and a further 100 or so building societies and mutual lenders competing for savings products, retail lending and mortgages. However very few of these offer, or have the capacity and infrastructure to support, full service current accounts.

Without a current account offering, banks potentially lose out on the competitive benefits not only of a cheaper more stable funding source, but also from the cross-selling opportunities associated with a more loyal customer base.

What are the barriers to entry for current account providers?

The barriers to entry for the sector are structural. They include the ability to access the clearing systems whether directly or indirectly through an existing clearing bank, the significant investment required to create an IT infrastructure which is able to process the trillions of transactions required annually as well as safeguarding systems, fraud protection systems, card-issuing capabilities and access to ATM channels. Recent IT failures at the high-street banks have suggested that these systems are not perfect at the larger banks and that developing a robust future-proof infrastructure would be very costly.

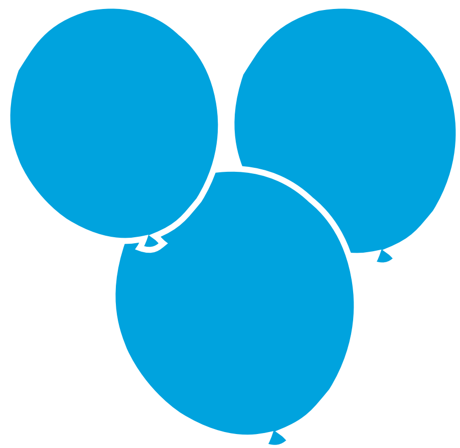
The UK Government suggested earlier this year that it would demand that the current Big 5 banks permit access to their systems. These systems have developed organically to fit their existing architecture and requirements. Even if the UK Government could force the banks to sell clones of their system, there is no guarantee that they would be fit for purpose for a start-up business. The level of interest in the spin-off banks and in the Co-operative Bank is therefore not surprising, despite further investment being required in developing their systems.

Outlook for 2014

The manner in which 2013 has ended gives us reason to believe that the momentum in Retail Banking M&A will continue into 2014.

The confidence shown by experienced investors in recent Retail Banking M&A transactions demonstrates the belief that profitability is improving in the sector, and that there is a genuine opportunity for new competitors in the UK current account market. 2014 will see the start of the IPOs of the spin-off and emerging challenging banks. Current trends indicate that the main alternative to these IPOs will continue to come from investor groups looking for opportunities to invest in the early growth of the new challengers in the sector.

The IPO market for Financial Services businesses is gathering momentum. Amanda Stafford contemplates the history of IPOs within the sector, current market drivers and whether this trend is likely to continue.



Financial Services IPOs

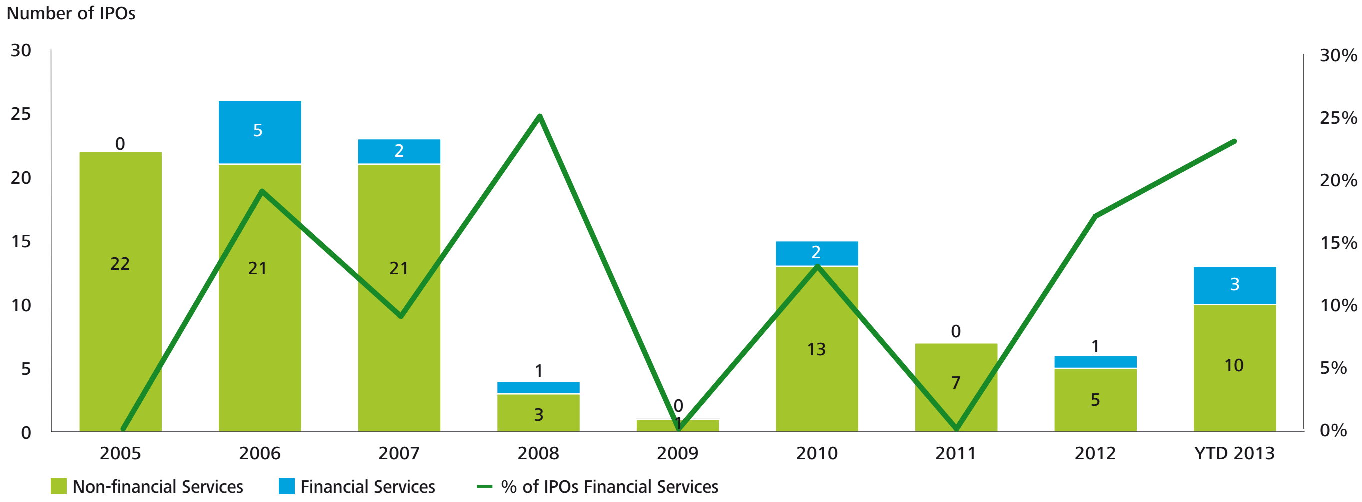
We think that the current trend of Financial Services IPOs will be sustained in the short and medium term, given market conditions, recent successes and the pipeline.

Overview

While the average number of initial public offerings (IPOs) executed on the London Main Market has decreased from the highs seen in 2006 and 2007, equity capital markets have reopened in recent months and IPO activity has included a greater proportion of Financial Services businesses than has been the case historically (except in 2008 where overall IPO activity was very low).

The peak of activity between 2005 and 2007 was driven by Energy and Resources businesses. Equity markets tightened during the financial crisis although 2010 was strong, again dominated by the Energy and Resources sector.

Figure 11. London Stock Exchange main market IPOs (2005-October 2013)



Note: IPOs have been defined here based on the London Stock Exchange definition excluding companies in sectors defined as Company bonds, Debentures & loans, Investment instruments (equity and nonequity), Investment trusts (split capital, real estate, venture capital) and Investment (companies, entities). Financial Services IPOs exclude speciality finance.

Source: London Stock Exchange information and Deloitte analysis at 31 October 2013

Financial Services IPOs

From the beginning of 2010 until September 2012 only two Financial Services businesses were listed (see Figure 12). However in the past 15 months, there have been five Financial Services businesses undertaking an IPO: Direct Line Group ('Direct Line'), Esure Group ('Esure'), Partnership Assurance Group ('Partnership Assurance'), Arrow Global Group ('Arrow') and Just Retirement. Although the recent floats have concentrated on insurance groups, the trend is not solely confined to this sector. Arrow is a debt purchase business and rumoured candidates for an IPO in 2014 and beyond include a number of banks.

Figure 12. Recent Financial Services IPOs

Date	Entity	Market capitalisation at listing (£m)
24 March 2010	CPP Group	396
21 June 2010	Jupiter Fund Management	755
16 October 2012	Direct Line Group	2,625
27 March 2013	Esure Group	1,209
12 June 2013	Partnership Assurance Group	1,540
11 October 2013	Arrow Global Group	392
15 November 2013	Just Retirement	1,125

Note: IPOS have been defined here as London Main Market Premium Listed companies. Venture capital trusts, cash shells and move-ups have been excluded.

Source: London Stock Exchange, Company Prospectus

The drivers for recent Financial Services IPOs

Improvements in the economic environment have made IPOs more achievable. This includes a return to robust growth in the UK, strong stock market performance (the FTSE 100 index of leading shares has returned to levels last seen in 2008) and lower volatility (the VIX index, widely used as a proxy for volatility, is currently at a lower level than in 2008). Confidence has been helped by the experience of 2013 flotations: eight of the nine trading companies that listed on the London Main Market in 2013 have outperformed the FTSE 100 (all as at 16 October 2013).

Within this improved backdrop for IPOs in general, the reasons for the recent Financial Services IPOs have been varied.

Direct Line was listed as a result of the European Commission ruling in 2009 which stated that the Royal Bank of Scotland (RBS) had to divest of (among other things) Direct Line as a result of the state aid that RBS received from the UK government during the financial crisis. A similar state aid-related requirement is also the driver for the proposed disposal of TSB Bank by Lloyds Banking Group by an expected IPO.

The Esure and Partnership Assurance IPOs were driven by their owners' desire to exit from their investment. The Esure IPO resulted in the partial exit of its Chairman and founder and its private equity backers. Similarly, the IPO of Partnership Assurance was driven by the partial exit of its private equity backers. These IPOs demonstrate a renewed enthusiasm for private equity to use IPOs as an exit strategy, as well as investor appetite for them.

Arrow was listed to raise capital to fund further purchases of debt portfolios. It is the first UK debt purchase business to list its equity. This industry has previously been funded by private equity and bank finance. However, since Lowell Group raised money in the capital markets by issuing a high-yield bond in March 2012, Cabot, Arrow and Marlin have all followed suit.

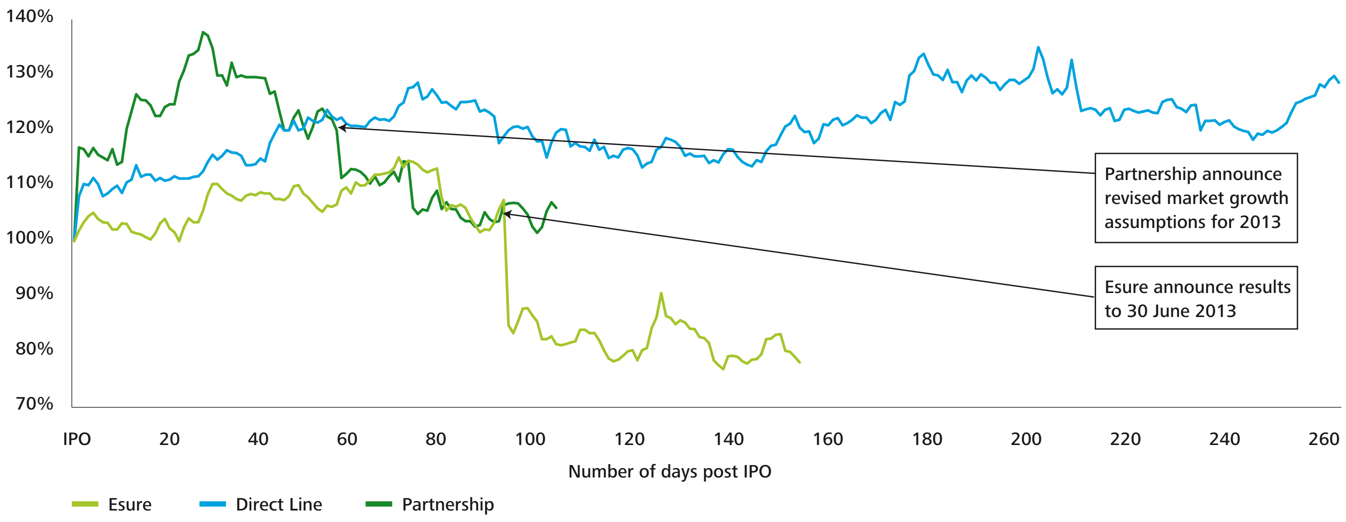
FS performance

A £1,000 investment in shares in each of this year's ten IPOs (£10,000) would have returned £13,520 on 31 October 2013. This return is £3,032 more, or seven times greater, than investing the same amount in the FTSE 100 Index at the time of each company's IPO.

However, while it is relatively early days to assess the performance of Direct Line, Esure and Partnership, Esure began to track below issue price after 91 days. Given how recently Arrow and Just Retirement have been admitted to the market, they have been excluded from the analysis in Figure 13.

The Esure share price fell 21% in August 2013 following its first results statement since listing. Although profits for the first half of the year were slightly better than the analysts' consensus, the interim dividend announced (2.5p) was 14p lower than expected. The share price has not yet recovered to its issue price.

Figure 13. Relative share price since IPO



Source: Yahoo finance, 31 October 2013

Partnership Assurance had its largest share price fall (7%) since listing in August 2013 following the announcement that market growth assumptions for 2013 would not be reached.

While there are no doubt many reasons for these share price movements, they highlight the importance of managing expectations with respect to strategy, performance and dividends to ensure the market is not surprised, particularly in the period after the IPO.

Outlook for 2014

The number of IPOs in general seems to be increasing and Financial Services businesses are participating in this trend. A number of our clients are accessing the public markets for raising capital and, as noted above, owners are again considering IPOs as an exit option. Consequently the short- and medium-term pipeline of IPO deals expected to come to market is strong. Banks are a particular feature of this pipeline: Lloyds Banking Group is planning an IPO of TSB Bank in 2014; RBS has announced its plans to seek a listing for Williams and Glyn's Bank; Virgin Money has stated its intention to float in due course and the newly restructured Co-operative Bank intends to seek a listing at some stage. Press speculation has also centred on other potential IPOs in the pipeline such as Saga, Travelex, Hyperion and Towergate.

There is concern that the large number of businesses rumoured to be considering an IPO may mean that those that get to market early will absorb the capacity for IPOs, restricting the ability for longer term IPOs. However, given the current level of demand for equities overall, this should support floats for the foreseeable future.

IPOs remain complex, time-consuming and expensive to implement. They also arguably pose higher execution risk than a trade sale, and bring higher on-going costs and scrutiny for the businesses concerned. However, given the pipeline, current market conditions and the success of recent IPOs, together with more limited alternative exit options, we think that the increasing trend for Financial Services IPOs will remain in the short and medium term (and certainly for 2014).

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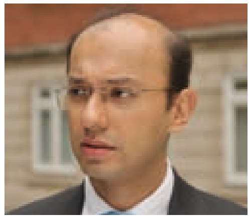

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Notes

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