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2023 Australian Banking M&A Outlook

The search for growth in a turbulent environment

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Introduction

With the major Australian banks and lenders safely navigating through the pandemic, their resilience is now being tested by the current uncertainty and volatility in the economy. While banks have robust capital positions and are yet to see major credit quality challenges, they are still working to grow and transform their underlying businesses.

The Australian economy is clouded by uncertainty and volatility as we start 2023. Higher inflation, rising interest rates, falling house prices, and weakening consumer confidence are testing the resilience of the post-pandemic recovery, just as a resurgent virus reminds us that it can't be ignored.

The ripple effects will be felt across the Australian banking industry where we expect to see larger, diversified, and well-capitalised banks performing better.

Rising interest rates will continue to impact near-term valuation expectations, volumes, and debt markets. The rise in discount rates means there will be a return to focus on bottom-line profitability as well as top-line growth, playing into the major banks' strategies following their wave of divestments over recent years.

Increasing interest rates are also likely to result in greater funding cost and leverage disparity within a financial sector that had grown accustomed to lower-for-longer interest rates. This should mean a greater focus on relative balance sheet strength and potential financing structures in an M&A context, which may change the buyer universe and appetite for particular assets.

Access to funding could be a further challenge in 2023, as the Federal Government's pandemic stimulus through the RBA Term Funding Facility (TFF) matures requiring banks to source alternative funding potentially reducing liquidity/demand for Australian bank/non-bank debt in debt capital markets.

Another challenge facing Australia's major banks is across the Tasman, with the Reserve Bank of New Zealand (RBNZ) commencing the roll-out of their new, higher capital requirements. This will see the four largest banks in NZ (Australia's big 4 banks) required to hold 18% capital by 2028[1]. This punitive capital position may result in banks re-evaluating their size and position in the NZ market due to the implicit reductions in return on equity, all else being equal.

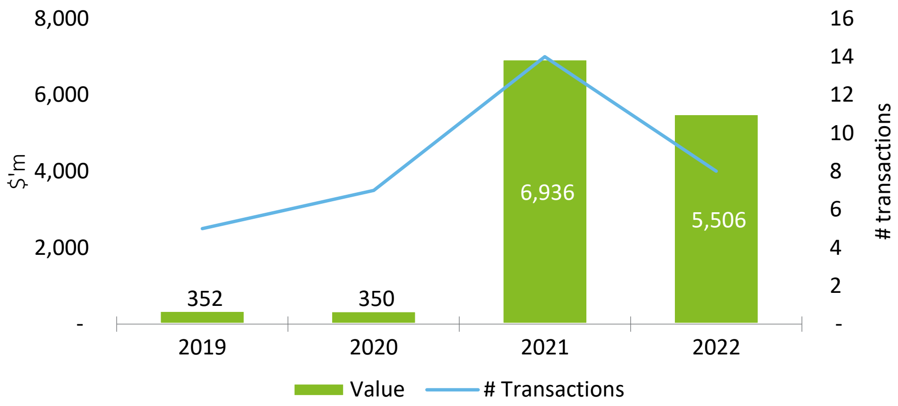
Australian banks have almost completed their exit from Asian investments after a long period of trying to exit these positions. The Commonwealth Bank of Australia (CBA) is in the process of selling its operations in Indonesia, and PT Bank

Commonwealth has reduced its stake in China's Bank of Hangzhou. ANZ Bank is also seeking opportunities to divest its stake in Bank Pan Indonesia (Bank Panin).

Banking M&A activity returned to normal historical levels in 2022. The momentum from record M&A activity in 2021 carried into 2022 but is slowing, as shown by the decrease in the number of transactions (from 14 in 2021 to 8 deals in 2022).

**Please note that the below graph has 6 deals with undisclosed value (2 in 2022, 3 in 2021, 1 in 2020)*

Banking M&A transactions in Australia



Source: Mergermarket[1]

2022 was marked by ANZ's cornerstone acquisition of Suncorp Group's banking unit for c. AUD 5bn[2]. It was the largest 2022 M&A deal in the Australian Banking sector and the largest since Westpac bought St. George and CBA bought Bankwest during the depths of the global financial crisis.

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After a multi-year period of divesting non-core businesses, the major incumbents in the banking sector are now hungry for growth. Divestments and capital raisings have given them strong balance sheets, providing the funds and appetite to invest.

Below we explore the key focus areas driving banking M&A in the Australian market as we look ahead into 2023 and beyond:

Focus area 1: Shaping the new 'core'

Australian banks are continuing to shape their new 'core' by undertaking strategic acquisitions and further divestments of non-core assets in a less uniform manner, focused on alignment with their individual strategies to deliver the growth that can underpin more stable ROEs. In Deloitte's 2022 Deal in Focus survey, 63% of Banking and Capital Markets respondents state that expediting synergy capture from recent acquisitions is the highest priority while 58% of respondents state filling gaps in their core portfolio is the second highest priority[3].

Focus area 2: Consequence of interest rate rise, a shift from variable to fixed

Rising interest rates and inflation have increased indebted households' loan payments and living expenses, with further increases in prospect. Variable-rate mortgages account for around 65 percent of outstanding housing credit. The market consensus of additional interest rate rises by the RBA, coupled with two-thirds of fixed rate loan mortgages converting to variable rate mortgages by the end of 2023, the impact for some borrowers of 300-400 bps increases in mortgage interest rates may put some consumers under significant mortgage stress. Buyers who took out fixed-rate mortgages with very low rates of interest in 2020 and 2021 will "roll off" to much higher variable interest rates in the second half of 2023 as their fixed terms end[4].

Moreover, the latest increase in interest rates will likely intensify the already surging numbers of applications for credit cards and personal loans as more people struggle in the face of higher costs of living having run down their savings accumulated during COVID-19. Higher rates should boost banks' net interest margins for card portfolios, but persistent inflation and depletion of savings could weigh on consumers' appetite for spending. Nonetheless, these same conditions may increase net new debt as credit revolvers' financial position worsens. Recent data from some major banks suggests that some consumers have spent their way through the savings accumulated during COVID-19 and there are now trends of increasing credit card balances and increasing non-discretionary spending on credit cards.

Focus area 3: Acquiring capability

While banks focus on their 'core' offerings, they are also seeking to acquire distinctive capabilities, principally technology and channels, as they shift towards integrated platforms and cloud solutions. This strategic imperative is intended to enhance banks' customer experience, cyber security, and analytical capabilities as an alternative to in-house transformation (exemplified by NAB's acquisition of 86 400, Latitude Financials' acquisition of Symple (albeit in the non-bank financial institution (NBFI) space) and CBA's acquisition of Whitecoats)[5]. We expect capability acquisition to span across core lending segments (either through product or channel diversification) and ancillary services; and deal structures are likely to extend beyond M&A, through alliances, partnerships, and white labelling, etc.

63% of Banking and Capital Markets respondents to Deloitte's *2022 Heads of M&A* survey state their M&A objective is to expedite synergy capture[3]

Focus area 4: Compression of net interest margin impacting NBFIs

The steep increases in the market's yield curve and RBA's official cash rate have significantly increased the cost of funding over a short period, challenging some NBFIs to be nimble and proactive in repricing their products. Laggards in this domain have seen their net interest margins compressed, and are now searching for alternative lower-cost debt, whether organically or externally. This is particularly a challenge for fixed rate products, such as personal and auto loans where the lender has limited ability to reprice the back book (albeit they can significantly enhance yields on their front books). In addition, the previously deep debt capital market for Australian issuers or warehouses from larger banks may see liquidity challenges in the year ahead as those major banks look to refinance their TFF exposures. NBFIs may therefore need to hold more capital, and those without large institutional shareholders may struggle to raise capital in a non-dilutive way and be forced to sell in the shorter term. NBFIs can look to whole loan portfolio sales for liquidity, or consolidate (within the NBFI segment) to optimise their portfolios and improve return on equity.

Focus area 5: Shifting focus from retail banking to business banking

Some incumbents are shifting their focus to business banking, placing greater competitive emphasis on the relationships and expertise necessary to effectively drive growth – which in this segment has historically been underpinned by high-touch engagement with the customer. Many long-established incumbents are searching for M&A opportunities to acquire (or partnership/alliance) technology and digital capability (particularly in light of current skills shortages), and to improve customer experience, which reflects an industry-wide transition towards considering new service models for the traditionally conservative business segment.

84% of Banking and Capital Markets respondents to Deloitte's *The Deal in Focus: Heads of M&A* survey 2022 state that valuation of assets is the greatest challenge to M&A success[3]

Focus area 6: Banks potentially moving back towards wealth advice

The Australian Treasury is seeking feedback on the preliminary findings from the Quality of Advice Review, potentially making it easier for banks to provide cheaper forms of advice by adjusting consumer protection and disclosure regulations which are argued to have priced some Australians out of accessing appropriate and affordable financial advice. Although the outcomes from this review are still in their early stages, it is clear that more stakeholders are acknowledging a regulatory-driven advice gap, and a policy shift may create the circumstances for banks to once again leverage distribution synergies in advice and wealth products - albeit the banks' model will likely look different this time around, being tech-led. Given the comprehensive bank exits from wealth, a quick reentry to the market may well necessitate M&A, and overseas advice businesses are also more likely to consider brownfield market entry which may increase competition for takeover targets.

Focus area 7: Reconfiguring the banking value chain with Banking as a Service (BaaS)

BaaS players are largely focusing on only one to two stages of the value chain, as opposed to traditional banks that have owned the end-to-end customer journey. We are increasingly seeing mid-tier banks and other institutions leverage BaaS capabilities of more 'pure-play' product manufacturers to enhance their own offerings or eliminate the need for the incumbent to undertake an expensive technology transformation (for example the recent agreement between AMP Bank and Nano Home Loans). Recent market activity shows that successful BaaS players can be aligned as providers of a banking licence and core products, operational services, and/or technology i.e., incumbent banks such as Westpac; as aggregators such as fintech companies (Afterpay or SocietyOne) that overlay their own capability set; as distributors such as eCommerce or platform providers including Shopify, which leverage their end-customer relationships to sell financial services; or as distributors-turned-aggregators such as fintech or mobile wallet companies that enhance legacy propositions with their own new product. M&A activity will likely be robust as all these four areas mature and grow.

Focus area 8: Environmental, Social and Governance (ESG)

On a global scale, both shareholders and stakeholders are increasingly urging banks to take the next step when it comes to ESG, and in particular climate change. The emphasis on ESG topics within the banking industry is not new, however, there have been intensified calls for more transparency and improved data availability. ESG standards and expectations will continue to play an increasing role in M&A activity for the foreseeable future, reflecting what is ultimately a new field of competition for banks to address such as acquiring capabilities far outside the bank's traditional business lines that will allow them to directly benefit from firms wanting to assist in the global transition to net zero.

What’s next?

We have curated short-term and medium-term M&A strategy responses[6] to the current market landscape:

What's next?

Divestment of non-core assets (short-term)

Companies could consider divesting underperforming loan porfolios and non-core divisions to raise capital and improve efficiency.

1 2 4

Technology-led capability acquisitions (short-term)

Investments and acquisitions of new technologies (e.g., digital payments, e-trading platforms) will be critical to position banks to compete in the future.

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5 6 7

Cross-selling opportunities (medium-term)

Banks need to establish alliances outside of their core sector with players from technology, retail, health, and others to cross-sell new services to a wider customer base, introduce new capabilities, and improve utilisation of their current assets

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Growth investments (medium-term)

Banks also need to consider acquiring high-growth, innovative businesses in areas like cybersecurity, fintech platforms, blockchain, AI, and others in adjacencies that could, in time, become the new core.

Legend: Focus area #

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Endnotes

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