Can an Acquisition Turn Around the Profitability of a Bank in 5 Years?

The year 2016 saw an unprecedented wave of consolidation in Asia's Private Banking industry. An increasing number of banks have resorted to Mergers and Acquisitions (M&A) as a means to increase their scale of business and to achieve cost and revenue synergies. The valuation of M&A deals is customarily strongly impacted by the assessment of synergies. Whether the synergies are realized however, depends on the chosen transformation strategy.

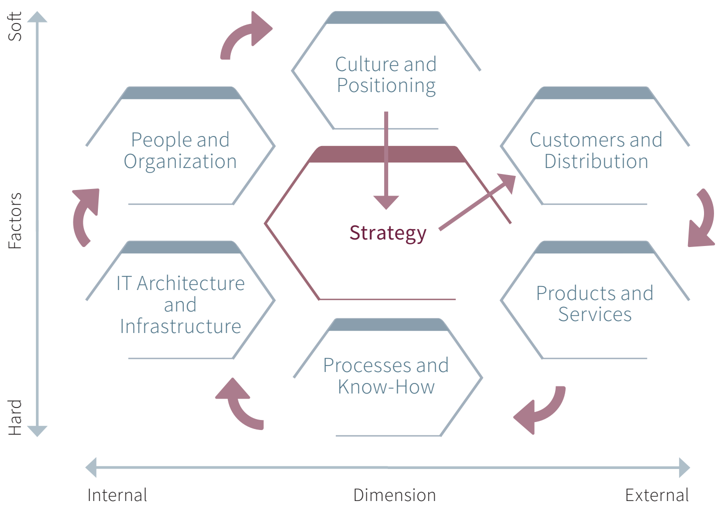
Consequently, the transformation strategy is at the center of every take-over. Private Banks may ask themselves; «What are the key elements of a transformation strategy that will result in value creation and an instant impact on our performance?». This article builds a case for defining a well-structured integration framework when choosing inorganic growth as an upscaling strategy.

Our Case Study: The M&A story of Asia Private Bank (APBank)

In an attempt to understand the impact of an M&A deal on the acquirer bank, we focus on analyzing the performance trends of three different banks in the post-merger transformation period and weighing the trends against the banks' underlying transformation strategies. The varying performances of different growth strategies is also captured through a comparative analysis drawn from previous M&A deals over a five-year-period (2010-2015) and from Synpulse industry insights.

Similar to our previous publication «How to Survive the Perfect Storm: A Perspective from an Ailing Private Bank in Asia»[1], where Asia Private Bank was chosen as a baseline example for our analysis, we will use APBank as an example for the current article. APBank — a fictitious name given to a small to medium-sized Asian private bank — faced challenges such as decreasing profit margins, high innovation costs, and inability to achieve economies of scale. In order to tackle the challenges and remain competitive, APBank had three main strategies to choose from:

- To specialize and restructure/standardize their operational model
- To pursue BPO via industrialized third parties
- To extend their footprint by acquiring additional assets and a front office (M&A)



1 Key M&A Integration Areas

[1] http://bit.ly/2ncsdnf

In this case, APBank chose to delve into the third path of in-organic growth through an M&A deal. In order to illustrate APBank's performance gains after the merger, it is compared against two similarly sized peers given here the fictitious names «Top performer» and «Bottom performer». These banks also had a similar market footprint and product- and services landscape as APBANK and closely represent the benchmarks on the opposite ends of the growth spectrum during the period of analysis.

Top Performer is a bank of similar size to pre-acquisition APBank. This bank has implemented a series of lean projects such as the implementation of a new Core Banking System (CBS) and the acquisition of a smaller player in the period of 2010-2015. This wealth manager follows a very aggressive growth strategy and exhibits the high performance that can be achieved from a well implemented M&A deal and industrialization projects. As a result it has established itself as a market leading bank in the region.

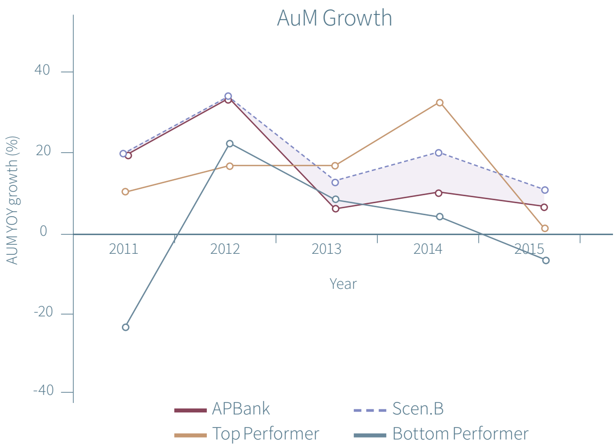
Bottom Performer is a bank who opted against pursuing any transformation or consolidation strategies in the same period of time. It represents an industry player with a very conservative growth strategy and a potential candidate to be acquired by a stronger market player.

Through this comparative assessment, we could conclude that if the key M&A integration areas, as shown in 1, are addressed through a comprehensive transformation strategy, APBank could have shown comparatively superior performance gains compared to the other two players. In the next few sections, we present our findings in light of the key insights on the synergy gains (AuM growth, CIR and profitability) for APBank versus its competitors.

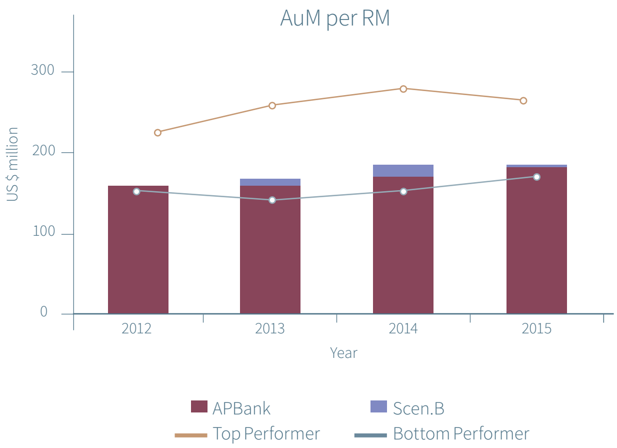
Did APBank improve its revenue generation capability?

An M&A Integration, where the focus is on the definition of the target operating model (TOM) of the future organization — the enhancement of products and services landscape as well as the alignment of the distribution channels — leads to an improved efficiency in the company's revenue generation capability. This is observed when the asset base grows steadily after transformation coupled with an increase in productivity of each Relationship Manager (RM).

For APBank, the acquisition translated into a jump of 288% in assets under management (AuM). In addition to that, the bank's AuM growth rate during the 4 years after the implementation (2011-2015) averaged 17% per year. Although slightly slower than the top performer (whose assets grew at 20% per year in the same period), this growth pace was considerably higher than bottom performer's, which averaged an approximate 2% growth per annum. The explanation for such observations lies in the front line synergies from the acquisition, the main cause being APBank's expansion to new markets. The bank would also have benefited from a bigger customer base and a stronger product offering, including high yield fixed income and structured products, estate management, and discretionary portfolio management.



Source: Authors' analysis from Annual Reports and media.



Source: Asia Private Banker, BCG

2 AuM Growth of Asia Private Bank vs. selected competitors

3 AuM per RM of Asia Private Bank vs. selected competitors

In 2, an alternative best-case scenario (Scenario B) could be constructed based on our estimates for APBank where the AuM growth rate for the bank would be higher than the actual growth path. This performance could have been achieved if the bank implemented a Post-merger Integration (PMI) strategy based on a TOM that resulted in better target and synergy achievements. Our estimates show that AuM growth rates would have doubled from 2012 onwards due to additional benefits, such as better distribution efficiencies — resulting in a higher productivity of the front line teams (higher AuM per RM) and higher performance of APBank when compared to Top Performer.

The jump in assets also had an impact on the productivity of relationship managers. For example, the AuM per RM increased during the period following APBank's consolidation, from US$130 mn in 2010 to US$175 mn in 2015. This meant a growth rate of 6.5% per year between 2010 and 2015. Our analysis shows this was made possible due to focus on integration strategies linked to better talent retention and legacy system enhancements.

Did APBank achieve cost efficiency?

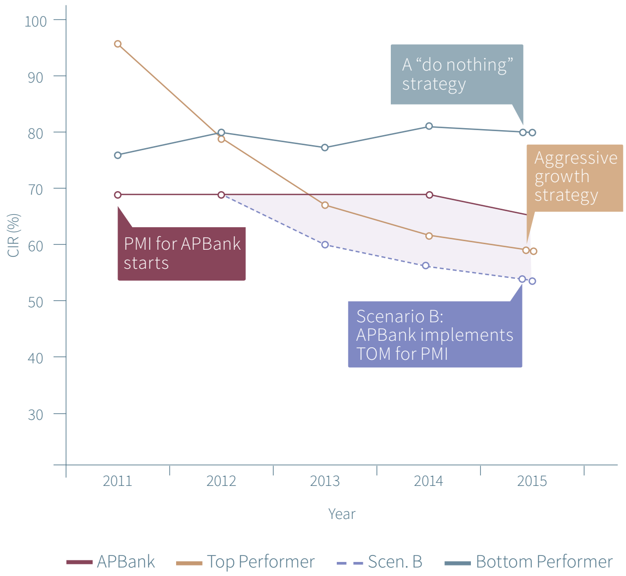
Cost efficiency is the key cost synergy that private banks hope to achieve from an acquisition. It is measured as the amount required to generate 1 dollar of income. A transformation strategy which focuses on streamlining processes, on removing IT redundancies and on standardization, is likely to create cost efficiencies for a bank.

Achieving economies of scale usually translate into a decline in the Cost-to-Income ratio (CIR) almost immediately after the transition starts and throughout the integration period.

Although APBank's acquisition strategy was focused primarily on market penetration and gaining financial strength, the bank still managed to reduce its CIR by almost 5 percentage points during the 5 years following the acquisition, roughly from 70% in 2010 to 65% in 2015. This behavior is explained by an increased scale in operations and the cost synergies linked to standardization, wide distribution channels and cross selling opportunities.

In comparison, the Top Performer bank, pursuing an aggressive growth strategy with a focus on industrialization coupled with inorganic growth, reached a CIR of 59% in 2015, which is a stunning gain of 35 percentage points over 5 years.

A «do nothing» strategy for the Bottom Performer bank, given its limited size and the conservative growth in assets managed, resulted in the bank struggling to reduce its operating expenses during the period analyzed and a CIR of 80% in 2015, an increase of four percentage points over 2011 levels. Cost inefficiencies and external cost pressures (such as system changes due to new regulatory requirements) can cause similar banks to operate under a very thin profitability band and makes them appealing candidates for a merger or an acquisition.



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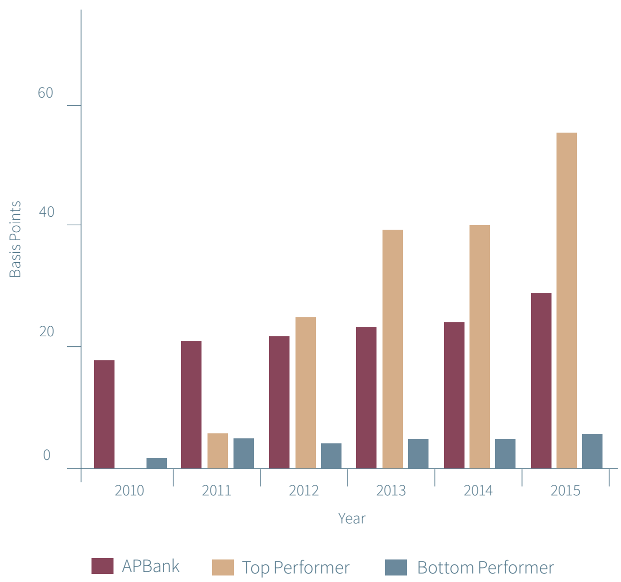


**Profit margin = Net Income / AUM*

Source: Asia Private Banker, BCG, Synpulse Global Bank Database

4 CIR - Asia Private Bank vs. selected competitors

5 Profit Margin (bps) of Asia Private Bank vs. selected competitors

Here again, a best case scenario (Scenario B) in 4 for APBank, would be the cost trajectory the bank would have had if it would have adopted a comprehensive TOM strategy. It is estimated the CIR would be substantially reduced as these strategies are effective to reduce inefficiencies and also have a high impact on productivity. With an estimated CIR close to 54%, APBank would have outperformed the Top Performer and experienced a higher profitability margin by 2015.

How did APBank's profitability grow over these years?

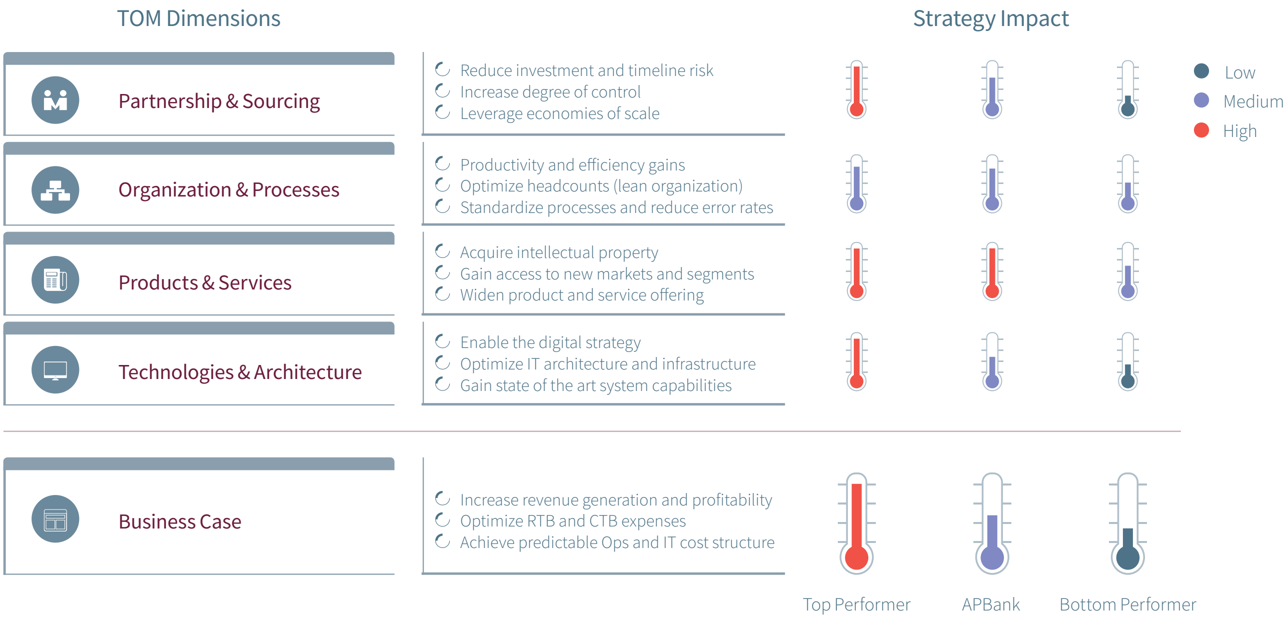
When an increase in a bank's revenue generation capabilities is coupled with increased cost efficiencies due to economies of scale, its overall profitability should also show remarkable improvement. As expected, the profit margin (5) for APBank, increased to 29.4 basis points in 2015, which is a 11 points increase from the 2010 figures. A continual growth in profitability indicates that this bank, through an effectively implemented integration strategy, managed to improve its overall financial standing from its pre-acquisition state.

Conclusion

In summary, after analysing APBank, Top Performer, and Bottom Performer's performance over the last few years, and also looking at how they approached transformation across the key TOM dimensions (6), we observe a direct correlation between the transformation strategy adopted by each bank and its impact on the performance.

Given the industry dynamics in Asia, it is critical for private banks to attain a minimum size in order to be sustainable. A focus on stronger revenue generation — with a wider range of products and services — lends private banks some competitive advantage to differentiate themselves from stagnant and declining players. Alternatively, pursuing inorganic growth is a more viable and impactful option for small to medium-sized wealth management firms/private banks to remain competitive in the years to come.

Defining the right Target Operating Model (TOM) for the Post-Merger Integration (PMI) phase is part of the recipe for achieving the intended synergies set out during the deal analysis. As highlighted in our Whitepaper «Next Generation Private Banking Riding the Consolidation Wave in Asia», a TOM is the backbone of a post-merger integration. It addresses challenges commonly present in most M&A deals such as changes in the organizational structure, IT capabilities, and increased product scope. It also helps to control risks by identifying areas where an integration plan is required — such as incompatible core systems — and requires management to set up plans for common issues faced during the reorganization like a potential talent drain and customer service impact.



6 Strategy and Target Analysis

With a focused approach addressing the strategic levers of change and dealing with the key TOM dimensional requirements of the target entity, the vision of a transformed bank can be fast achieved and pave the foundation towards the establishment of a brand new and focused entity with an enhanced value proposition.

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Revenue Synergies

- **Productivity growth:** Increased selling avenues due to access to new products and markets
- **Cross-selling:** Selling an enhanced suite of products and services to an increased client base
- **Product pricing:** Increase in market capitalization enables higher fees & commissions
- **Innovation:** New distribution channels, product innovation could lead to an enhanced product and services portfolio

Cost Synergies

- **Distribution:** Unified front-end applications, branch optimization, contact center transformation, marketing optimization
- **IT:** Systems and applications rationalization, optimized project and solution delivery
- **Corporate:** De-duplicate of corporate functions
- **Streamline Back-office:** Back office automation and offshoring, product engineering standardization

Source: Synpulse project experience.

7 Synergies from an M&A

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