HERBERT SMITH FREEHILLS

DEAL MAKING ON THE RISE IN THE FINANCIAL SERVICES SECTOR

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Legal Briefings – By **Rebecca Maslen-Stannage** and **Mike Flockhart**

SUMMARY

- The level of deal making in the financial services sector has been particularly robust during the last financial year.
- Consolidation, with the aim of building scale, extracting synergies and maintaining margins, is a recurring theme, particularly in the insurance, wealth and funds / asset management subsectors.
- Sector specific regulatory reform (and the higher costs it invariably causes) is a constant theme and is likely to remain a catalyst for further deals in the sector, consistent with the global financial services deal space.

FINANCIAL SERVICES M&A HAS SEEN A STRONG LEVEL OF ACTIVITY

We have experienced a strong level of M&A activity in the Australian financial services industry – for example, *MergerMarket's* Australian analysis for FY2013-14[1] reveals that the number of deals is up by around 13% and deal value by a massive 800% as compared to FY2012-13.

This is consistent with the robust level of activity we are seeing in our global network across the UK, US and Asia-Pacific financial services sectors – as well as with *Mergermarket's* global analysis. In the UK for example, the number of deals in the financial services sector is up by 43% and deal value by 26% for first half 2014[2] as compared to first half 2013.

Below we explore sub-sectors within the financial services industry which have been particularly active and reflect on drivers of recent deals. Regulatory reform remains a constant in the financial services industry and the select examples mentioned below could contribute to further deal activity.

THE INSURANCE, WEALTH AND FUNDS/ASSET MANAGEMENT SUBSECTORS HAVE BEEN PARTICULARLY ACTIVE DURING THE LAST FINANCIAL YEAR

Wesfarmers has led the charge in terms of deals in the insurance sector. It sold its insurance underwriting businesses to IAG, followed by the sale of its broking and premium funding business to US-headquartered Arthur J. Gallagher & Co., after running a dual-track process. Steadfast Group - a broker network and ancillary services provider - acquired equity interests in approximately 60 businesses conditional on its IPO, and has announced numerous deals post-listing, including its proposed acquisition of Calliden Group. Austbrokers has also made a series of acquisitions. Tower sold its remaining life insurance business to Foundation Life, while Elders sold out of its underwriting joint venture with QBE. QBE has separately announced a round of non-core asset sales.

The wealth and funds management space has also been busy. Perpetual ultimately won the contest for The Trust Company, after Equity Trustees and IOOF had also separately tried to acquire Trust. ANZ sold its private trustees services business to Equity Trustees. Serial acquirer SFG Australia has itself just been acquired by IOOF, after SFG withdrew its merger proposal with WHK Group.

Fund managers, Treasury Group and Northern Lights Capital recently agreed to merge, and alternative investment manager Stafford Capital Partners acquired three funds management businesses from Macquarie. CHAMP sold Centric Wealth, and Wilson HTM and Shaw Stockbroking are in discussions in relation to Wilson’s securities business. PwC bolstered its private wealth and succession planning capability by acquiring MGI Melbourne, while Australian Unity has offered to acquire dealer-group Premium Wealth Management.

Looking at UK financial sector M&A for comparison, its wealth and asset management sub-sector has been particularly strong. In the last two years there have been a number of significant transactions, including Credit Suisse's acquisition of Morgan Stanley’s EMEA wealth management business, Schroders' takeover of rival fund manager Cazenove Capital and Bank of Montreal's takeover of F&C Asset Management. Other recent transactions include Lloyds Banks's sale of Scottish Widows Investment Partnership to Aberdeen Asset Management and Northill's acquisition of a majority stake in global equities manager Longview Partners. Standard Life has also been active, recently acquiring Ignis Asset Management, following its purchase of Newton’s private client business in 2013.

WHAT’S DRIVING THESE DEALS?

The desire for scale: Increasing profitability by broadening product offerings for clients, increasing funds under management (or advice) and securing broader distribution channels, are common M&A drivers in the wealth and funds/asset management industry.

Moreover, the opportunity to reduce costs by accessing economies of scale and synergies, for example through leveraging (or rationalising) existing IT, platform, marketing and compliance infrastructure is also a focus. This is seen as a way of improving or at least maintaining margins, in the face of higher regulatory and compliance costs.

Strategic acquisitions have been popular – IAG’s acquisition of Wesfarmers’ underwriting business, Perpetual’s acquisition of Trust, IOOF’s acquisition of SFG and Equity Trustee’s acquisition of ANZ Trustees, are all expected to strengthen the acquirers' respective market positions. Conversely, Wesfarmers, ANZ and Elders all disposed of non-core operations.

Regulatory reform and the costs associated with it continue to influence consolidation in the wealth and financial advice industry.

REGULATORY REFORM IS A CONSTANT – LIKELY TO REMAIN A CATALYST FOR FURTHER DEAL MAKING

The financial services industry is impacted by a wide range of legislative regimes and reforms – the following are select recent examples from Australia.

Future of Financial Advice (FoFA) reforms

Anecdotally, FoFA has increased the cost of advice for consumers and industry participants are having to absorb implementation and higher ongoing costs associated with FoFA imposed licensing and compliance requirements. Additionally, FoFA has curtailed organic growth options for many industry participants. Therefore, smaller players in particular are needing to engage in M&A or other strategic transactions in order to compete, in what is a largely vertically integrated industry.

As such, we expect that the deal activity which started rising in the post-June 2012 transition period will continue.

Senate Economics Committee inquiry into the performance of ASIC

The Committee noted the good work ASIC had done in a challenging environment, but is pushing for ASIC to become a more proactive regulator.

If ASIC is put under pressure to pursue increased penalties and more frequently issue infringement notices to industry participants, as well as require stricter enforceable undertakings, then managing the risk around these is likely to lead to higher costs for industry participants, as well as perhaps becoming a more common structuring consideration and negotiation point in financial services M&A deals.

Financial Systems Inquiry

At this early stage it’s difficult to predict what impact the Financial Systems Inquiry may have on M&A in the financial services sector. The Inquiry has flagged the potential to increase the regulation of financial products by imposing suitability requirements and giving ASIC powers to ban product features. Separately, the Inquiry commented that a stronger penalty regime could strengthen the impact of ASIC’s enforcement action. These measures could also make the financial advice industry a less attractive place to be for smaller players, leading to further consolidation.

The industry awaits the Inquiry’s final recommendations to the Treasurer – there is some speculation that these may include structural changes to the largely vertically integrated industry. Any such recommendation would raise a raft of issues and would no doubt be hotly debated. If that type of reform is required it would clearly be a ‘game changer’.

Regulatory reform in the UK

Again, looking offshore, we see that the financial services sector in the UK has been significantly affected by regulatory reform. In the UK there has been a wave of recently imposed or pending regulatory changes, many of which driven by legislation applicable throughout the European Economic Area. Some of these reforms – particularly the Retail Distribution Review, have put existing fee levels, and therefore margins, under pressure, catalysing deal activity as affected companies seek economies of scale and broader, more compelling product offerings. Others, including in particular the Alternative Investment Fund Managers Directive (AIFMD) (for asset managers) and the forthcoming implementation of a new Markets in Financial Instruments Directive (MiFID II) have or are expected to increase the regulatory compliance burden on many financial services companies. MiFID II in particular may require substantial system changes and will have operational and other compliance implications. This may also drive deal activity, as smaller operators' margins come under pressure from the increasing compliance burden and M&A presents synergy opportunities.

Herbert Smith Freehills, recently awarded the Asset Management M&A team of the year by Financial News, advised Wesfarmers on the sale of its underwriting business, Perpetual on its acquisition of The Trust Company, Treasury Group on its merger with Northern Lights, Cazenove Capital on its takeover by Schroders and Lloyds on the sale of its Scottish Widows Investment Partnership unit to Aberdeen.

ENDNOTES

1. MergerMarket's Australia M&A Trend Report: Financial Year 2013-14
2. MergerMarket's UK M&A Trend Report: H1 2014

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

REBECCA MASLEN-STANNAGE
CHAIR AND SENIOR PARTNER, SYDNEY
+61 2 9225 5500
Rebecca.Maslen-Stannage@hsf.com

MIKE FLOCKHART
PARTNER, LONDON

+44 20 7466 2507
Mike.Flockhart@hsf.com

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