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Austrian banking M&A deals – ESG is on the rise

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This Q&A explores the direction in which Austria's financial market is heading, and more precisely:

- where the Austrian mergers and acquisitions (M&A) market is expected to go this year;
- the rise of environmental, social and corporate governance (ESG) in dealmaking; and
- how financial institutions can help better facilitate transactions.

How many banking M&A deals are expected over the next 12 months?

2022 is expected to be a very active banking year for M&A. The Austrian Financial Markets Supervisory Authority (FMA) considers Austria to be overbanked in some areas and encourages a further consolidation of the market.

This will likely lead some of the Austrian banking sectors (Raiffeisen, Volksbanken and Sparkassen) to continued merger activity. In these sectors, smaller banks with a regional focus will need to merge in order to reach sustainable balance sheet sizes.

There have also been several privately owned smaller banks, whose shareholders are currently considering a sale as a result of increasing regulatory pressure and constrained business opportunities.

Equally, there have been several requests from international investors to conduct market soundings. These requests were mainly from:

- investors from outside the European Union;
- fintech companies desiring to grow and upgrade to the next level; and
- other investors from other industries that consider a banking platform a benefit for their business model.

Austria is therefore becoming an attractive market for banking M&A. In particular, the following points are worthy of note:

- The private banking sector in Austria is currently underdeveloped, with several market players having reduced their market activities or even withdrawn from the market, hence allowing for ample opportunities for a new strongly service-oriented private wealth bank that will also provide conventional products, such as mortgages, Lombard loans and deposits. Recent withdrawals include the exit of Credit Suisse and UBS, and the acquisition of Semper Constantia Privatbank by LLB.
- Austria as a Eurozone member offers a convenient geographic location. It has a safe financial and banking system with a strong reputation and provides for human talent as well as access to a client base in the centre of Europe. Additionally, living expenses are favourable, compared to other western European prime locations, such as Frankfurt or Paris.
- Austria has a reputation as a tier 1 banking location – in particular, in relation to its anti-money laundering (AML) regime.
- The Austrian government aims to strengthen the FMA as a regulator and is rolling out initiatives to attract new investors and businesses.
- Compared to other western European prime locations, Austria – in addition to its operational attractiveness – offers a good corporate governance and beneficial tax regime, including a benign corporate income tax level.

On the retail side, there has been an exit of ING and Sberbank's from the Balkans, while the Bawag group acquired Hello Bank from BNP Paribas. There are also rumours of further international banking groups considering an exit from the Austrian market.

How is ESG expected to change in deals over the next three years?

The awareness of ESG among clients, companies and investors has increased in recent years. ESG will also be a key issue for banks in the coming years, as banks will ensure the provision of funds for corresponding development projects and promising industries and companies will be promoted and sustainable financial products further developed. ESG evaluations – be it for diversifying investment portfolios or improving corporate image – will likely become more and more important. On the one hand, the perception of the market and the inclusion of ESG criteria in ratings performed by external rating agencies lead banks to focus on their ESG compliance. On the other hand, banks are obliged either by legal provisions or by authorities' expectations to screen their assets, disclose the green asset ratio (GAR) and to include ESG aspects in their credit granting processes. This means that evaluations are also of particular importance for banks, as they assess the borrower's creditworthiness for the purpose of granting loans, and this assessment is (among other things) incorporated into the terms and conditions of the loan.

Against the background of the increased interest and relevance of sustainability criteria, ESG due diligence (DD) is increasingly requested in M&A transactions, especially when banks, insurance companies, funds and other financial market players are considered as purchasers. Due to the banks' disclosure requirements, especially the GAR, the relevance of ESG-compliant assets substantially increases. Traditional financial or tax DDs are supplemented by "soft" factors, such as environmental, social or organisational aspects. Such soft factors can have a decisive influence on the accuracy of the valuation of the target.

Possible advantages of an ESG DD arise from:

- uncovering reputational risks;
- identifying (future) liability risks;
- determining and, if necessary, quantifying value-enhancement potentials; and
- the resulting costs that could arise after the acquisition of the target.

Investors may consider ESG factors in their investment decisions in addition to more common financial variables. An ESG DD reveals additional arguments for purchase price negotiations and forms an additional basis for a company valuation. ESG factors are substantially relevant for the evaluation of the bank's business model resilience, being part of the assessment of the supervisors and rating agencies. A good ESG compliance can lead to a lower capital need and lower refinancing costs for liquidity purposes.

The scope of an ESG DD has to be based on an investor's preferences, values and ethics. It often determines which companies, sectors or activities are eligible or ineligible to be included in a specific portfolio. Most screening methods try to avoid or exclude the largest greenhouse gas emitters in a portfolio (negative screening).

ESG aspects in the banking M&A sector in particular require the coordination of various work streams that go beyond mere legal aspects but need to cover also regulatory and financial aspects, as well as IT, reporting and processing aspects. These transactions require advisors to have a deep understanding of the banking supervisory mechanics, business planning and banking processes. A combined legal, regulatory and financial advisory team approach is key to success and, if implemented from an early stage, will significantly enhance the chances of getting the deal through.

What will be the most important factor to help banks better execute M&A in 2022?

Two aspects are key to a lean and swift banking M&A transactions.

Early involvement of lawyers and advisors
Banking M&A deals tend to be of relatively high complexity. The regulatory assessment of a potential transaction and the expectations of the national competent authorities, as well as the ECB, are key to the success of a transaction. It usually centres around sustainable business models, ensuring continued operations (core banking systems and operational risks), as well as the fit and properness of the new owners.

Sell-side and buy-side transactions need to be structured accordingly to address the expectations of the regulator from the beginning.

Buyers are advised to assess fit and properness, which may require substantial preparations, such as:

- identification of the appropriate acquisition entity;
- their source of funds;
- their business model; and
- the financing of the transaction or future reporting and consolidation (financial and regulatory).

Buyers should engage their advisors during the market exploration phase when deciding in which market or country they wish to become active.

On the sell-side, the structuring entails:

- an appropriate disentanglement from group functions;
- ensuring that the target is ready from day one after closing the transaction; and
- corresponding transitional services.

The selection of the appropriate buyer will largely depend on the success of a buyer to obtain ownership-control approvals from regulators.

Definition of a lead advisor
Banking M&A requires the coordination of various work streams that go beyond mere legal, regulatory and financial aspects and also include technological support, human resources, public relations and public stakeholder management.

The lead advisor should be mandated as early as possible in the transaction. When entrusted with such a mandate, the lead advisor's task is to take the burden off the client's shoulders as much as possible. The lead advisor acts as sole point of contact with the client and sub-engages additional advisors where needed. Ideally, the lead advisor is independent and not restricted by network rules. They should also source the best experts from various IT and financial advisory firms, such as the Big Four, and negotiate pricing in the client's favour.

Comment

A very active banking M&A market can be expected in Austria in the coming years. Banking M&A remains a challenging transactional market, with complex regulatory processes that require advisors to have a deep understanding of banking supervisory mechanics, business planning and banking processes. A combined legal, regulatory and financial advisory team approach is the best option, and, if implemented from an early stage, this approach will significantly enhance the chances of a successful deal.

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