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2008 SPECIAL SUPPLEMENT

Board Focus on M&A

A Closer Look at Financial Services Trends for 2008

Market Uncertainty Sets the Stage for Financial Services M&A

Our experts discuss the trends shaping the financial services deal landscape, including how many organizations are looking to preserve capital and reduce risk by selling noncore businesses.

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Some of the largest deals in 2007 were in the financial services sector. Do you see that trend continuing in 2008?

Sam Das: First, we really need to take a look at 2007, which was a mixed year for deals. The first half of the year benefited from the deal momentum coming out of 2006. At that time, there were some significant deals getting done in the financial services sector. Wachovia acquired A.G. Edwards and Bank of America acquired LaSalle from ABN AMRO. But as 2007 progressed, we saw several high-profile deals terminated due to the state of the market and credit deterioration. MGIC and Radian decided to terminate their deal, PHH terminated its pending deal with General Electric, and it's looking doubtful that the Sallie Mae transaction will ever be completed. In general, the M&A trend in financial services should remain fairly quiet. Current valuations in the market are not conducive for sellers looking for attractive pricing for the intrinsic value of their franchises, and buyers may be unwilling to pay large premiums, given further uncertainty.

David Brown: I agree. I think we'll continue to see some deals, as with Fifth Third Bank's acquisition of Citizens, more along the lines of regional banks buying each other. But that will depend upon reaching an agreement on price. We're also going to see more deals like Banco Popular selling its U.S. consumer finance business to AIG. Some organizations will need to raise capital, and so rather than sell the entire institution, they will sell off pieces that are not core but may, for the right buyer, command a premium price, or at least free up capital. I'm not sure how that will affect deal volume, but we may see a different mix of deals.

Susan Harrington: I agree we'll probably see a different mix of deals, and that might be driven by a particular region or segment. I think there could always be a special situation where you would see another megadeal, but over the next 12 to 18 months, it's hard to say there will be many of those. Certainly any specific set of circumstances might still result in two large players coming together, even with the current conditions.

Steve Butters: As David mentioned, some of the deals we'll continue to see will be along the lines of Banco Popular's announcement and will involve companies getting out of areas that perhaps aren't in their core strengths, for both capital needs and risk reduction. We've also seen an increase in minority investments and PIPE-type transactions, which I would expect to see more of in 2008.

Brown: On the minority equity investing side, I would agree with that, although I think many banking organizations are coming to realize that a lot of the folks trolling for minority equity investments are, to a great extent, bottom fishing. So I am aware of lots of conversations surrounding minority equity investments, but the ones you see executed involve the truly desperate.

Harrington: I agree with David's comments for U.S. transactions, but I have a different take for non-U.S. situations. Outside the United States, toehold investors may not strictly be bottom fishing, but rather acquiring a public stake to facilitate negotiations with management in hopes of transforming the arrangement into a change-of-control investment.

What do you think about Bank of America's acquisition of Countrywide, and how will it affect the financial services M&A landscape in 2008? Do you anticipate more deals in the form of rescues, and will larger financial institutions see this as an opportunity to expand geographically?

Harrington: In the current environment it's really hard to say, especially with the events that took place last year. There are many more write-offs to come. So over the next 12 months or so, it's anybody's guess as to who will be left as a strong player once the dust settles. I'm not sure what the Bank of America transaction really says to the state of the overall market. There was news earlier this year of a potential government bailout for some of the bond insurers, for example. But the current environment is in too much of a state of flux to draw any sort of conclusions about trends at this point.

Brown: I want to pick up on one point Susan mentioned, and that is the impact of downgrade pressure on the bond insurers. I think to the extent we see more bond insurers downgraded, notwithstanding the capital they've raised through minority equity investments, something clearly must happen, because the bond insurers represent one of those systemic risks that will lead to calls for the Fed to intervene, even though the bond insurers only tangentially touch what the Fed ostensibly has jurisdiction over. I can see potential rescue activity in the bond insurer area, but I don't think any of us know how bad that's going to get or what those rescues might look like. In the meantime, there will be a cascade effect throughout the rest of the financial services industry because bond insurer downgrades affect the market value of everyone's holdings.

Das: I'm really not convinced there are many rescue deals on the horizon. I think the exceptions are like the Bank of America/Countrywide deal, where there is a prior vested interest in the company and the buyer is looking to protect that investment, or, as was mentioned, pure opportunistic plays and parties looking for cheap valuations and getting a toehold. An example would be what Citadel Investment Group did with E-Trade. Citadel put in $2.5 billion and got E-Trade's entire asset-backed securities portfolio. Deals such as Bank of America/Countrywide are unlikely to be the norm going forward. There is a lot of integration risk involved there, and BofA is looking to extract sizable cost savings. On the flip side, it also reinforces the push for more asset deals so larger organizations can streamline their core assets and divest properties that really don't make sense to hold onto going forward. This will, in turn, free up cash to shore up their balance sheets.

Butters: The market turmoil is certainly not over. Financial services companies will most likely be returning to their core operations, and I don't think we have seen the last of distressed deals that will present some opportunities for companies that have the capacity to add acquisitions later in the year.

With tough conditions in the credit markets and ongoing woes in the housing sector, how are the drivers behind deals changing?

Das: Larger organizations will look for opportunities for earnings growth, especially as the rest of their operations stagnate. However, they may not be willing to pay substantial amounts for it. Regional and niche players, especially the ones that are more capital constrained, will be the more likely candidates to seek out partners to help weather the downturn. But in general, capital management is going to be critical for the broad spectrum of financial services companies. Balance sheet stress will test everyone's resolve, and the lack of a stable secondary market will force many firms to take further substantial losses. I doubt we've seen the full extent of the fallout due to this downturn. Once there is more market clarity, perhaps in a couple of months to a year, we'll see things turn around.

Harrington: This credit market turmoil is going to have a chilling effect on those institutions that have been affected the most–the ones we've all read about, and the ones yet to be announced. So with these serial acquirers, I think we're going to see far fewer deals in the short term. It's likely we'll see more of the same as far as the bottom fishers coming in and putting money into very large financial services companies. But until it all shakes out, it's hard to say where we're going to end up. I think it will be more of what we've seen the last few months.

Brown: I agree. I think capital preservation, whether it be obtaining new capital or preserving existing capital, will be the main driver of most transactions.

Butters: In addition to the need to preserve capital, we are seeing companies evaluating noncore operations, not only in terms of risk management, but also in terms of cost of capital and expense control. These considerations could generate consolidation-type transactions in certain sectors.

How do things bode as far as the balance of power between buyers and sellers?

Das: It's clearly a buyer's market. Valuations are depressed across the board. Those who have the excess capital can really put it to work. Generally speaking, buyers are going to look to conserve cash and focus on those acquisitions with the best value propositions. The decline in the market has significantly limited buying power right now. Stock can be a very expensive currency given lower valuations, leaving cash as the primary source of funds. But as many of these larger organizations look to deploy their cash, they're

only going to do so opportunistically with an eye on managing downside risk.

Brown: I agree. The other trend that occurred during 2007 was a considerable amount of litigation involving classic deal protection terms. There were more decisions in 2007 on material adverse change or adverse effect than we've seen in years. There was also a lot of litigation over specific performance and bust-up fees and other sorts of deal protections that lawyers have argued about for years, but during the go-go days, few deals actually involved a dispute over those terms. Whatever sellers and buyers may have learned this past year about how to negotiate those a little more tightly or a little more loosely, depending upon your perspective, it's economic leverage that will still determine how those deal terms shake out in particular merger and acquisition agreements. For instance, if you were to take a look at the Countrywide merger agreement with Bank of America, you would not see any particular fanciness or necessarily aggressive negotiation on either side. It is the classic stock-for-stock merger agreement we have seen for decades now. I think that is reflective of the fact that the agreement needed to be negotiated quickly, as well as a reflection of Bank of America's leverage. And I think you'll see that replicated in many more deals this year.

Harrington: There are different dynamics when you're talking about the current market and the lack of liquidity and required capital. Some of the financial institutions experiencing liquidity issues and/or regulatory capital shortfalls may not be able to negotiate good deals or finance them on the buy side, and in their quest for capital, or as sellers of noncore businesses, they probably aren't in the best negotiating position. Cash is king right now, so those with cash are the ones calling the shots.

Butters: I think over the next several months we're going to see more distress situations than strategic-building efforts driving transactions. But as we move into the latter half of the year and into early 2009, before the market really begins to settle down, I also think we'll see an increase in the size and volume of deals being done.

Brown: Speaking of the latter part of the year, I'm especially interested in the impact of the implementation in 2009 of FAS 141R, which, among other things, will require expensing of deal fees and closing date valuation, rather than agreement date valuation. Basically this means that for anything that's not all cash, the value can fluctuate, which may be less attractive to buyers. I anticipate we'll see less deal activity in the fourth quarter of 2008 for deals that might close during the first quarter of 2009 than we otherwise would, assuming the market recovers. Overall, I suspect we will see a very quiet November and December in terms of new deals getting signed.

Is this a favorable market for foreign interests to scope out U.S. financial services companies?

Butters: Yes, it appears that some of the European players are becoming more active, given the continued strength of the euro and relative health of the European markets vis-à-vis the U.S. markets, and I think European investments will increase. We've all read about sovereign wealth fund investments, although it remains to be seen if or how much those are going to expand. Asian players are also looking toward the United States, and it is quite likely we could see increased activity in that direction as well.

Das: To follow up on that, many of the Japanese banks have indicated they're willing to help out Wall Street firms. Much of the interest will depend on how long favorable exchange rates persist, coupled with their minimal preexisting U.S. exposure. That should prove to be a significant advantage over a lot of domestic investors going forward.

Brown: Classically, large foreign financial institutions, and this has definitely been true under the Basel II capital framework, have an advantage in deploying capital over domestic competitors in the quest to acquire U.S. companies. So you can see them being able to justify higher valuations because they have to utilize less capital to make acquisitions. That advantage, together with foreign exchange rates, makes this a pretty attractive market for foreign investors, assuming they can get

comfortable and catch the falling knife everyone else worries about trying to catch.

Harrington: Picking up on all that has been said, I think there's a lot of talk right now, but I question how many transactions will actually get done until some of this uncertainty in the market shakes out. I think there's a lot of interest from foreign buyers, but it will most likely be a while before we see a large volume of transactions close, assuming the dollar stays weak relative to other currencies.

In closing, what does the overall forecast for the financial services deal environment look like for 2008?

Das: Deal activity will likely be slow for at least the first six months of 2008, if not the entire year. Given the continued uncertainty in the market and the overall slowdown in the economy, that trend is unlikely to change in the near term. With that said, buyers in the meantime will have much stronger negotiating ability at the deal table. They're going to need adequate time to assess price based on market volatility and adverse developments. The larger transactions, especially, will be scrutinized heavily by all constituencies, from the markets to regulators. You're going to see much longer times to completion for deals going forward, given increased diligence efforts that will be required to ensure buyers are getting what they're paying for.

Harrington: In the short term, we're likely to see a lot of divestiture activity for the large financial services companies that are going into distress mode right now. It's anybody's guess what's going to happen with the rest of the sector.

Butters: Picking up a little bit on the nature of transactions, consolidation is likely to continue, probably at a more measured pace, and I think the degree of caution, level of diligence, and regulatory oversight are likely to lengthen transaction periods more so than perhaps we've seen in the recent past.

Brown: Sam referred to extended diligence earlier and Steve just now referenced the extended regulatory review. I think we'll see both of these things, particularly where either buyers or sellers, leaving aside their investment portfolios, have historical entanglements of any great size with the mortgage industry, mostly subprime, but not exclusively subprime. So if a buyer or seller is wrapped up in state attorney general investigations or has expensive private litigation, such as the suits filed by certain cities against a number of mortgage lenders over accusations of redlining, those issues will require lots of diligence, and also will provide a basis for community groups to hang up applications for a longer period of time than we have seen previously in this decade.

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