Divestments are core to financial services’ strength, resilience and growth

2020 Global Corporate Divestment Study
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After a decade in which many financial services firms have re-engineered and, in some instances, completely transformed business and operating models, the pandemic will have provided a stern test of their financial and operational strength and resilience. Most immediately, financial services firms have prioritized ensuring the safety and security of their workforce together with meeting the needs of customers, building operational resilience and protecting solvency.

However, many banks, insurers, wealth and asset managers will also need to take decisive action now to strengthen balance sheets, ensure liquidity and reposition their business to endure the crisis and seize growth opportunities as they emerge.

To achieve this, firms will take different approaches for different reasons. But a core pillar across industries should involve portfolio optimization and increased divestment activity as strategic imperatives for firms as they seek to withstand the impact of a global recession and better position their business for a new operating paradigm once growth and stability returns to the global economy.

This was evident on reopening the EY Global Corporate Divestment Study in April. For while firms’ immediate priorities are raising capital to bolster balance sheets, 70% said that a reshaping of their portfolio for a post-crisis world was one of the key actions they would need to take in response to the potential impact of the pandemic on their business.

What’s more, intentions to divest were high going into the crisis; they have since risen significantly. Indeed, some 85% of financial services firms said they expect to initiate their next divestment within the next two years, up from 72% that said the same pre-crisis. Strikingly, most (58%) of these firms said they planned to divest assets in the next 12 months.

In many situations, firms will invest in their core business and, crucially, in enhancing the technology infrastructure supporting it; close to half (48%) of firms in April said they were more likely to divest to fund new technology investments, up from 30% that said the same pre-crisis.

In addition, financial firms are looking to grow their war chests for strategic, step-change acquisitions or acquisitions that support their transformation agenda, which itself has been accelerated by the enduring impacts of the pandemic.

Across financial services, such strong intent to divest is notable, not only highlighting how divestitures are a strategic imperative for firms as they build financial resilience and optionality now, but also as they think about what’s next and beyond.
Divestments are a core pillar of banks’ resilience and growth strategies

Going into this crisis the banking sector was in a strong and stable state. Global and regional economic growth was supporting solid revenue and profit generation and most banks had record levels of capital set aside to help them withstand the severe financial impact of a seismic economic event.

The banking sector remains solid overall, but there is no doubt banks and nonbank lenders’ robustness and resilience will be sternly tested by the extent of the recession the COVID-19 pandemic has provoked.

Paramount for the banking sector most immediately has been the safety and security of their staff and ensuring operations across businesses continue at optimal levels. Just as crucial, however, has been the fortification of balance sheets, ensuring liquidity, allocating stimulus funding, management of funds and the need to build a strategy around what’s next and beyond the near-term challenges. More specifically, banks may need to take action to reposition their business, accelerate digital transformation and seize growth opportunities as they emerge.

The extent of this repositioning will differ from one bank to the next. Yet a common imperative among them all is enhancing their financial strength together with operational resilience, agility and efficiency, some of which will be achieved through portfolio rebalancing and the divestment of assets better owned by others together with more capital raises to maintain key ratios in due course.

Banks have been increasingly assiduous in their overall business portfolio reviews – 90% in our survey say they review their portfolio more frequently and in greater depth than in previous years – for several reasons. In the main, they say it is to respond more quickly to changing client and customer demand and, importantly, to better navigate market disruption; an objective now under intense examination.

The upshot should be another round of robust divestment activity, potentially including large, transformational carve-out deals. The last financial crisis resulted in both mandatory and voluntary divestments that were relatively easy and obvious to pick. This crisis combined with ongoing digital and cost challenges will mean banks need to think much harder than previously about what assets are core and noncore. This is due to leaders having to make profound strategic decisions around what sort of bank they want to be in the future and how easy will that transformation will be to execute.

How is COVID-19 impacting divestment activity?

Pre-crisis the appetite among banks for divestments was already high – 61% said they planned to initiate their next major divestment within two years. On reopening the survey in April, this intent jumped to 87%, with 60% saying they plan to divest in the next 12 months – up from 46% pre-crisis.

What’s more, they also plan to use the funds raised from divestments to invest in their core business (70%), part of which will include upgrading their digital technology capabilities; 43% say they are now more likely to divest to fund a new technology investment in the next 12 months. Many banks are still grappling with old technology and are desperate to provide customers with better experiences and operate more efficiently and effectively. These platform-type changes often come with large upfront costs that need funding.

On the flipside, 51% of banks say they are now also more likely to dispose of business units delivering – or expected to deliver – sub-optimal returns on capital, and, in extreme situations, distressed assets. Indeed, some (41%) expect to see an increase in distressed asset sales over the next 12 months.

This will, in turn, present investment opportunities to buyers leading to unsolicited approaches – 49% of banks expect to see an increase in this activity compared with 34% pre-crisis – from within the industry and outside. Some 43% expect to see an increase in the number of buyers outside the seller’s sector.
How can banks better prepare their divestments?

With execution and active marketing of large assets still mostly on hold, the focus has turned to reviewing portfolios and, according to 49% of banks, continuing their divestment preparation.

Dedicating adequate time and resources to this process is important. Unfortunately, it is often overlooked; close to two-thirds (64%) admit they significantly underestimate the internal resources and time needed to prepare an asset for sale – the highest percentage across the financial services sector.

What’s more, 66% agree that they should have invested more time and resources into creating pre-sale value on their most recent divestment.

In a market where the price gap between sellers and buyers is already wide, and could potentially widen further, the importance for sellers of preparing their divestments in the right way to achieve the highest possible price should not be underestimated. Indeed, sellers will most likely need to face the reality that they are unlikely to achieve pre-COVID pricing in the near term. Recognition and acceptance of the new pricing dynamics could, therefore, be critical for divestment activity to increase.

For some banks, preparation will include pursuing value creation or restructuring initiatives to make the business for sale more attractive to potential buyers. The creation of staple financing and increased use of insurance, for instance, are enabling deals to be done and, importantly, reducing any price erosion from the uncertainty.

Value creation strategies vary but the top two areas where banks are now placing greater focus before putting the business up for sale are: ensuring the quality of the management team in the business (49%); and optimizing the asset’s legal structure (41%), which could mean separating it partially or fully.

Of various restructuring approaches being considered in the middle or back office, most (54%) say they may carve out capabilities (employees, assets, infrastructure) and transfer them to a managed service provider; and collaborate with industry or market peers to form a shared capability or utility.

For those banks ready to sell, the following advice could be valuable:

- **Be rigorous in preparing for a divestment**: 72% say a lack of understanding around workstream interdependencies delayed or derailed their closing – more than other financial services sectors.

- **Deploy adequate and appropriate resources**: 64% say they significantly underestimated the internal resources and time to prepare the divestments for sale, while 79% say that in their last divestment they lacked access to the right tools for data flow decision-making around project management milestones.

- **Keep an open mind**: 54% say a lack of flexibility in changing the deal perimeter either scared off buyers or delayed the closing – more than other financial services sectors.

- **Get advice early**: the regulatory, competitive and technological landscape is changing rapidly and it is important to understand the implications in terms of asset performance and valuations.

**Private equity is actively looking at banking sector deals**

Some of the most successful PE-led deals have come from executing on very complex and messy carve-outs from banks. As stated, the simple disposals from many banks were done in the last crisis and this round of divestments may require a lot more unpicking of businesses to create strong disposal cases.

We would expect to see PE looking very actively at embedded businesses in banks such as the wealth and asset management, asset servicing, insurance and payments businesses. Another rich area of future deals in the sector will be the software, technology and regtech sectors where the banks are the major user groups and in some cases still the owners of these assets.

**Activists will return to agitate for change**

Activist campaign activity has been impacted by the crisis but they will return to focus attention on the banking sector and in specific situations where underperformance and poor management during the pandemic exist.

That most banks (57%) say they are less likely to divest due to activist pressure in the next 12 months is perhaps indicative of activist campaign activity slowing as they themselves navigate the impact of financial and economic impact of the pandemic.

However, activists will be back and perhaps more ambitious than before. Activists’ investment rationale can differ from one target firm to the next. Yet agitating for a divestment of a noncore or underperforming business, or even a breakup, have been core objectives.

So how should firms respond?

- **Formulate and articulate a clear strategy with detailed timelines, objectives and rationales for the existing or proposed business structure in terms of competitive dynamics and capital and regulatory requirements.**

- **Ideally, set out a road map and timeline for business improvements even if they do not necessarily address the issues highlighted by activists; strategies that aim to simplify banking activities and which explicitly focus on the needs of the customer base are best received by the market.**

- **Even if there are no opportunities for disposals, look for outsourcing or other cost-cutting opportunities.**
Importantly, accelerating digital transformation is likely to be a big focus of insurers' investment in the core business, especially now as systems and platforms are being tested as never before. This is perhaps why 50% of insurers say they are now more likely to divest to fund new technology investments, a striking increase from 25% pre-crisis.

What's more, 44% — up from 28% — said they are now more likely to divest due to the geopolitical uncertainty and macroeconomic volatility. Such potentially strong supply, in turn, will present ample opportunities for buyers, from within the industry and outside. Some 50% now expect to see an increase in the number of buyers outside the seller’s sector, an increase from 34% in our pre-crisis survey.

Pre-crises factors driving divestments maintain their importance and relevance:

- **Scale**: Insurers are seeking to offload products or segments where they do not have leading market share; 60% of insurers say their last divestment was triggered because of this.

- **Capital efficiency**: Some insurance products, most notably annuities, absorb significantly more capital than others. Annuities are also complicated to manage and have greater uncertainty attached to them. They are a prime target for sale in both Europe and North America, where there are a growing number of specialty annuity businesses out there that have been structured to buy and manage these books of business.

- **Streamline the operating model**: Insurance leaders increasingly recognize the need to address how large and complex some of their organizations have become; some 68% said their last divestment was triggered by a need to streamline the operating model.
What must insurers do next?

While the pandemic and economic downturn has thrown-off the original timing for divestments, insurers should be using the time now to prepare the business for sale, and in most situations increase the level of focus and attention on this area.

Certainly, 63% of insurers said one of the main impacts from the crisis on their divestment strategy was increasing their level of divestment preparation, which will be even more crucial for sellers in getting as close as they can to achieving their price expectations.

Indeed, about half of insurers, in our pre-crisis survey, said that the price gap between sellers and buyers was more than 20%. It’s alarming that 88% now expect the price gap to increase further as a result of the crisis.

If achieving expectations was not so challenging in the past, more than half (56%) said they met or exceeded their target price in their most recent divestment – it will be for the foreseeable future amid such turbulent markets. Therefore, the internal resources and time needed now, amid turbulent markets, to prepare an asset for sale should not be underestimated (44% said they did so in their last disposal).

What’s more, there is a need to focus attention now on value-enhancing strategies: 47% said they should have invested more time and resources into creating pre-sale value on their recent divestment.

Key here, ahead of putting a business up for sale, will be focusing on ensuring the quality of the management team (according to 50% of insurers). Interestingly, some 68% said they would also consider an earn-out as a mechanism to achieve desired deal value.

Key divestment challenges to prepare for and address

When selling assets, insurers need to address some important sector-specific challenges. Chief among these are client and regulatory sensitivities around data.

As many insurance products are long-term in nature, divestments are essentially a sale of a group of specific policyholders: the selling firm must ensure that these policyholders are well protected in the future – both for their sake and for the reputation of the seller.

From a regulatory perspective, any insurance entity sold must continue to be regulated as an insurer. Consequently, in some markets, regulators have pushed back on private equity-type structures unless they give the same protections to policyholders as the incumbent provider. Being acutely aware of the regulatory implications of a transaction is important: more than half (56%) said a lack of understanding around regulatory requirements deferred closing.

Another important consideration is the need to be realistic about benefits from potential synergies. When evaluating bids, insurers must scrutinize assumptions about potential efficiencies (resulting from merged back-office functions, for instance) as they may have implications for stakeholders. Many insurers would be cautious about a potential bidder assuming a massive IT synergy because of the potential impact on staff, customers, other stakeholders and the opinion of regulators.

In short, price – while important – is often not the main driver of bid selection in a divestment. The long-term outlook and protection of policyholders within the divested asset – because of its ongoing reputational and regulatory implications for the seller – can be far more significant.
Wealth and asset managers engage divestment strategies in response to crisis

Wealth and asset management (WAM) firms are no different from other companies across industries in applying an immediate focus during this crisis on the well-being of their staff, addressing client needs and overall business resiliency and operational continuity.

To be sure, the financial market turbulence has already caused a significant reduction in assets under management and administration, attendant valuation and liquidity challenges, all of which are greatly impacting financial results across the industry. Strikingly, more than 55% of WAM executives expect a severe impact to their business’ profitability and margin, according to our latest Global Capital Confidence Barometer.

The extent of the financial impact will, of course, vary from one wealth or asset management firm to the next. But make no mistake, all firms will be impacted. As a result, divestments are likely to take on greater strategic importance as firms seek to build greater operational resilience and agility during this crisis and beyond.

Certainly, intentions to divest were already high when we surveyed them pre-crisis – 77% said they expected to initiate a divestment in the next two years. Since then, that intent has likely stayed high, or has perhaps moved even higher, as firms move to rebalance their business portfolios, fortify balance sheets and raise capital to invest in core businesses.

This is the case for other financial services firms, especially banks and insurers, which indicated when resurveyed in April, that their intent to divest in the next couple of years has risen higher, with most now expecting to execute a divestment within the next 12 months.

What’s driving divestments in WAM?

First, the pandemic and resulting economic fallout has brought the more-than-decade-long bull market in equities to an end. That will affect investment firms by impacting assets under management, revenues and share prices. Consequently, an increase in divestment activity is to be expected as firms seek to rebalance their portfolios, increase agility and efficiency, and strengthen balance sheets.

Second, firms are seeking scale – in terms of distribution, reach, product offering and assets – to sustain themselves over the next three to five years. Scale is important because it facilitates investment in technology and talent and the transformation of the customer experience. Indeed, half of the firms we surveyed earlier this year said they were intending to divest a substantial part of their portfolios to redeploy capital toward their technology transformation and digital strategy.

Similarly, firms need to meet the demand for a suitable product capability set (to compete in increasingly important product areas such as sustainability, for instance). Among those who said they were planning to divest a significant part of their portfolios, some 54% said their firm needed to exit certain businesses to invest or acquire assets in other existing businesses or new areas.

Scale is also essential to prosper in an environment where margins continue to be compressed and high cost asset management products that do not offer differentiated returns are increasingly being shunned (especially by retail investors) in favor of passive strategies.

Thirdly, in order to gain share of industry wallet, firms are increasingly reviewing their portfolios with a focus on having the right mix of products. In a fiercely competitive industry, it is essential to have the right mix to attract large pools of institutional money and benefit from the growth in retail investment.
Applying the right focus to portfolio reviews

Wealth and asset managers have significantly improved their portfolio review process – both its thoroughness and regularity – in recent years. Almost nine in 10 firms (89%) said they now review their portfolio more frequently than in previous years. The main reasons given are so that they can be opportunistic given market conditions (31%) and quickly respond to client or customer demand (20%).

Key considerations in portfolio reviews amid this new environment:

- **A review of individual portfolio strategies to identify opportunities to combine products or, in a multi-boutique model, divest particular boutiques.** This is essentially a product alignment decision focused on improving efficiency and outcomes.

- **A review of captive activities within banks and insurance companies.** Such divestments can be complex: discipline is required to realistically assess relative hurdle rates, cost of capital and balance sheet utilization, for instance.

- **A review of the geographical footprint.** Firms need to focus on whether they can be a material player in a given market. Despite ongoing rationalization, there continues to be many sub-scale businesses because firms believe they are necessary in order for them to be considered global. While firms must have international product to offer local clients, sub-scale businesses should be exited so that capital can be devoted to activities that offer a better return.

Preparing the next wave of divestments

Wealth and asset managers will need to adjust their strategy, timing and level of preparation in order to achieve what they aim to in any forthcoming divestment.

The market has changed dramatically from 12 months ago, when it was essentially a seller’s market, enabling firms to largely achieve the pricing they sought from buyers for a range of assets. Indeed, 59% of firms said the price they achieved in their most recent divestment met or exceeded their expectations.

Now, however, the tables have turned; buyers are in the ascendancy. This means sellers will likely be pressured in most situations to lower their price expectations in order to get the deal done. In fact, pre-crisis, the price gap between sellers and buyers was already greater than 20%, according to 51% of firms surveyed at the beginning of the year. The crisis has undoubtedly widened that gap even further.

To help combat this and help sellers achieve a price closer to their expectations, preparation is crucial, and the internal resources and time needed now to prepare an asset for sale should not be underestimated (51% of firms said they did so in their last disposal).

What’s more, there is a need to focus attention now on value enhancing strategies: 57% said they should have invested more time and resources into creating pre-sale value on their recent divestment. This is likely to include areas similar to those being focused on and applied by other financial services firms.

For instance, before putting the business up for sale, most wealth and asset management firms (46%) said they would apply greater focus to ensuring the quality of the management team in the business being divested. Also important is optimizing the asset’s legal structure (56%) and forming new alliances, agreements, acquisitions, partnerships or joint ventures (30%).

Interestingly, some 85% said they would also consider an earn-out as a mechanism to achieve desired deal value, significantly higher appetite for this approach compared with their banking and insurance peers.
About this study

The EY Global Corporate Divestment Study is an annual survey of C-level executives from large companies around the world, conducted by Thought Leadership Consulting, a Euromoney Institutional Investor company.

Results are based on an online survey of 1,010 global corporate executives and 25 global activist investors pre-COVID (conducted between November 2019 and January 2020), and an online survey of 300 corporate executives and 25 global activist investors following the onset of the crisis (conducted between April and May 2020), including companies from 11 industries, with 75% of respondents holding the title of CEO, CFO or other C-level executive.

Financial services highlights are based on interviews with 196 financial services executives pre-COVID-19 and 59 financial services respondents in the resurvey.

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