PRUDENTIA M&A FOLIO

BALTIC M&A OVERVIEW

May – Aug 2016

Deal Overview

This year merger and acquisition (M&A) activity from May till August has decreased compared to activity during first four months this year. During *holiday season* 51 deals were announced, which is 20% less compared to period from January till April (64 deals). Moreover this period's deal count has also decreased by 14% compared to the same period last year. The most inactive months in this period were July and August with 12 and 8 M&A deals, respectively.

Despite the little M&A activity this summer, the total number of deals from January till August 2016 has increased by 6% compared to the same period last year. There is a foundation to assume that 2016 will end with a relatively high M&A count due to high M&A activity that has been present in last four month of each year for past three years.

A noteworthy is the United Kingdom (UK) M&A market, which was affected by pre-referendum temper and ambiguity of the region's future. The speculative prognosis expressed by economists and industry experts, which can be anticipated if the UK leaves the EU or Brexit, significantly decreased the accumulated M&A value (more than 80% plunge in Q2'16 vs. Q2'15). A partial negative effect can be observed also in the Baltic M&A market due to Brexit ambiguities, which translated in investor discretion and slower investment pace.

Notable Transactions in the Baltics, May-Aug 2016

Target Company (Country)	Acquirer (Country)	Deal Value* (M EUR)
"Akropolis" malls** (Lithuania)	Vilniaus Prekyba UAB (Lithuania)	>400
airBaltic*** (Latvia)	Latvian State and a private investor	131.1
"Rīga Plaza" mall (Latvia)	N/A	93.4
"Domina" mall (Latvia)	EfTEN Kinnisvarafond II AS (Estonia)	74,5

**NB: Table included only deals with publicly available transaction value.*

***3 companies were acquired, which control 3 "Akropolis" malls and other real estate assets.*

****Deal was closed in this period. In the result German investor Ralf-Dieter Montag-Girmes invested 51.1 million EUR and Latvian State – 80 million EUR.*

Investors have expressed a significant interest in purchasing malls in the Baltics. 4 mall acquisitions were announced during May and August period, besides 3 of them were present in Latvia. Vilniaus Prekyba UAB, owner of the retail chain MAXIMA, acquired "Akropolis" malls and other assets for more than 400 million EUR, although it must be mentioned that this was within a group transaction and litigation between shareholders is present. Latvian malls "Rīga Plaza", "Domina" and "Atrium Azur" were sold for 93.4, 74.5 and 12.5 million EUR, respectively. For EfTEN Capital, the Baltic commercial real estate fund and the acquirer of "Domina" mall, this was already the second purchase in this period.

These transactions indicate that investors are forecasting an increasing residential demand for consumer goods, which would positively reflect in mall area occupancy. Based on the development of the sold consumer good index it can be concluded that investments in this sector are economically justified.

Prudentia is proud to announce that its organized deal was closed in May, where a private capital was raised for Latvian national airline airBaltic. In result airBaltic raised a new 131.1 million EUR capital, where Latvian State and German financial investor Ralf-Dieter Montag-Girmes contributed 80 and 51.1 million EUR, respectively. Financial resources will be utilized in purchasing a new *Bombardier CS300* fleet and in the development of new routes.

Geographical Distribution

In 29 deals during these four months (57% of total M&A count) investor and target companies represented the same Baltic country. Compared to first four months in 2016, when 49% were within country transactions, the summer period has been "less international". It can be concluded that via M&A's companies have been deliberately strengthening their position in domestic market.

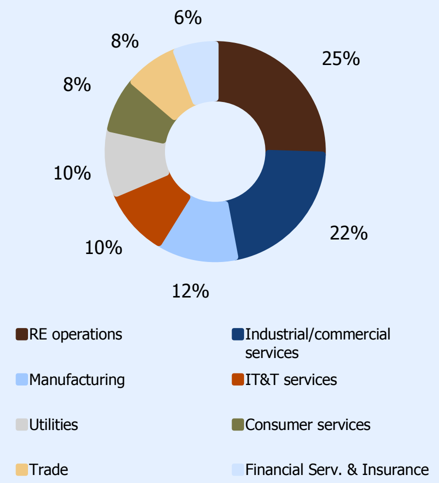
Also this analyzed period has not been different in terms of investors – Estonian investors continue to be the most active in this region with 20 announced acquisitions. Lithuanian and Latvian companies have been investors in 11 and 7 M&A deals, respectively.

Industry and transaction overview

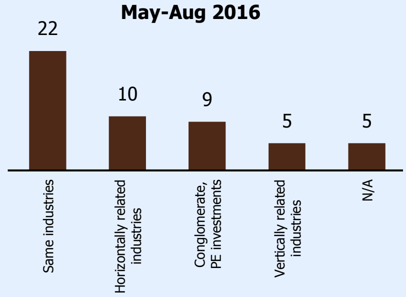
Real estate has been particularly active industry in the Baltic M&A market. Moreover this activity can be observed in both deal count and deal value. The available information indicates that in this industry aggregated deal value was 588 million EUR (82% of total publicly available Baltic M&A value). Industrial and commercial services industry has continued to emphasize its significance by counting for 22% of all announced Baltic M&A's in May to August 2016 period. In the previous Prudentia M&A Folio a management buyout (MBO) transaction in IT&T sector was mentioned. Also in this period there was one MBO deal, when employees and current shareholders of IT consulting company Nortal AS acquired 50% of this company from private capital fund Enterprise Investors and fund manager LHV Group. This kind of transactions in IT&T sector confirm that the management and employees are absolutely aware of the potential and essentiality of this industry.

An unchanged trend is present in breakdown of investors by their type – corporate strategic transactions are the most popular in the Baltic M&A market. Again, in period from May to August in 2016 70% of all investors were strategic ones.

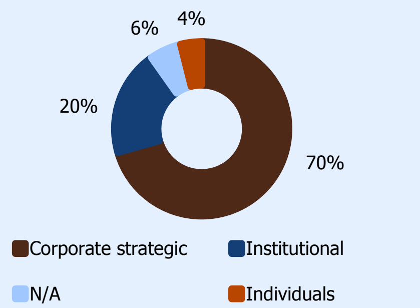
Percentage Breakdown of Deal Count by Industry, May-Aug 2016



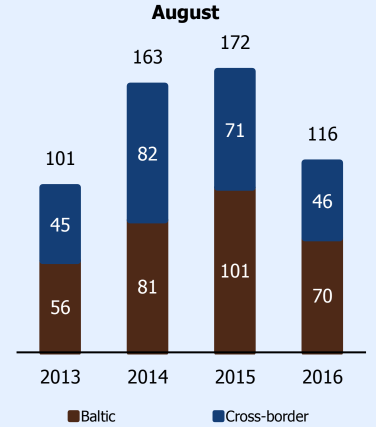
Breakdown of Deal Count by Relatedness of Acquirer and Target, May-Aug 2016



Percentage Breakdown of Investors by Their Type, May-Aug 2016



Breakdown of Deal Count by Geographic Parameters, 2013 - 2016 August



Sources: S&P Capital IQ database, Advisors' homepages, EUROSTAT, Baker & McKenzie, Baltic bank supervisors, ECB. According to publicly available information, all announced M&A, PE, selected VC and selected real estate deals in Baltics in the corresponding time period are reviewed in this report.

Nordea and DNB merger

Very recently two of the TOP10 banks in the Baltics – Nordea and DNB – announced that they will combine their strengths in Estonia, Latvia and Lithuania in order to become one of the leading bank in this region. Even though the deal will not be closed till second quarter next year, already now a positive intrigue is present in the market on what kind of result can be anticipated from this deal.

In Latvia Nordea is represented as a branch, thus its financial results are not available and its enterprise value cannot be determined. On the other hand, DNB is regularly at the upper end in the Latvian TOP101 most valuable enterprises list. DNB Latvia enterprise value has increased from approximately 160 million EUR in 2013 to 230 million EUR last year, which is an outstanding growth in such a short time span.

Global trends in the banking industry

The valuations of European banks in recent years do not look that prominent. In the European public market bank shares have declined by 25% compared to previous year – market capitalization against their equity book value (P/B) on June 30th, 2015 was 0.91, whereas on the same date this year it was only 0.68. Thus the banking sector in Europe is in a downward trend and in order to survive and develop in these circumstances a logical move would be to merge with competitors by realizing synergies and market power. It can also be observed in European M&A activity – in the first half of this year 69 transactions were announced in banking sector compared to 58 transactions in the same period last year.

Also in the conference this July in Madrid, where discussions were held about the banking industry in the future, European Central Bank (ECB) emphasized the necessity for innovation and consolidation. Over saturated sector with equally distributed small market shares puts a pressure on cost efficiency. ECB considers that eurozone needs optimally large and influential international banks, which could offer a vast service bundle as well as diversifying potential risks. Nordea and DNB merger signalizes that both banks have evaluated conjuncture of the future market, therefore via this kind of strategic step the merged bank will ensure itself a leader position.

Banking sector in the Baltics

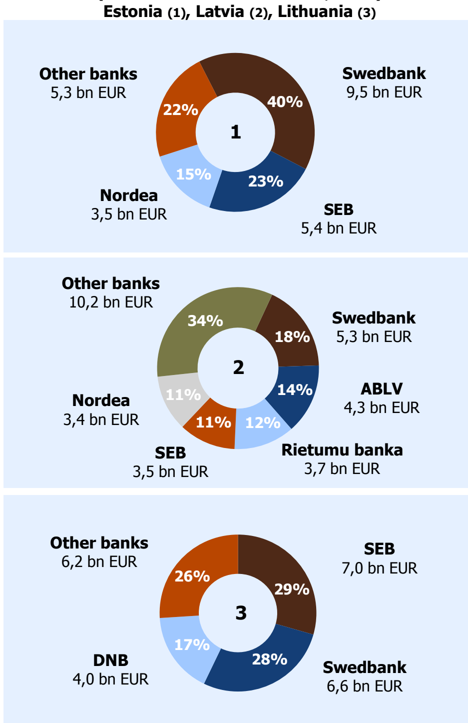
In the Baltic M&A and public stock market a successful example is recent public stock offer by Estonian LHV Group where the demand for their shares was 3.3 times higher than the supply. P/B in this deal was well above European average, which could be explained by the fact that this is in a way a specialized bank. Therefore by merging DNB and Nordea the value of a business can be increased, finding own market segment and self-positioning accordingly.

On question, whether this kind of merger in Latvia is needed, the answer is definitely yes. In Latvia and the Baltics consolidation is a must. Gathering bank and foreign branch data, as well as demographic indices, the Baltics do not stand unnoticed. In the Baltics, especially in Estonia and Latvia, the number of banks per 100 thousand citizens is at very high level. For example, the approximate average number in the EU is 0.2 banks per 100 thousand citizens, whereas in Estonia and Latvia this metric is six times higher – approximately 1.2 banks in each country. Also Lithuania with approximately 0.5 banks per 100 thousand citizens is way above the EU average. If Luxembourg and Malta (5.3 and 2.7 banks, respectively) are excluded from this list then Estonia and Latvia would be relatively the most bank-dense countries in the EU. This kind of statistics in the Baltics seem illogical, taking into account EU average indicator, annually decreasing number of Baltic citizens, as well as falling return on equity in the Eurozone. One of explanations for high number of banks in the Baltics, especially Latvia, is the developed popularity of non-residential services business. Recently the servicing models for residential and non-residential segment were developing parallel and supplemented each other. But in these circumstances, when more rigorous banking sector regulation is implemented and pressure is made towards non-residential segment, for those banks servicing non-residential businesses a review of existing models will be needed, focusing on new service development. The prognosis of industry correction and *Fintech* development will continue to aggravate the competition in the banking sector.

It is clear that the merger of DNB and Nordea aims to increase the value of combined banks, following the rational that "1+1>2". One of the clearest part of this equation is cost synergy, which can be realized in relatively short period. Most likely it is planned that the new company will decrease its fixed costs by merging branches and excluding duplicate activities. Besides merger will happen between two differently specialized leaders, thus supplementing each other. For example, Nordea has positioned itself as one of the leaders in servicing large companies, whereas DNB – small and medium companies segment. Also recently published data by the Association of Latvian Commercial Banks on banking activity in the first half of 2016 confirms these differences. From all DNB issued credits on June 30th, 2016 approximately 62% went to private individuals and 38% to companies. For Nordea these proportions are 36% and 64% (largest portfolio of issued credit to companies in Latvia), respectively. Therefore with this deal the new bank will be able to become one of the leaders in servicing both private individuals and companies with different sizes.

First, second and third charts show bank market shares in Estonia, Latvia and Lithuania, respectively, which are calculated based on each bank's asset values on June 30th, 2016. Market distribution in each Baltic State shows that Estonian and Lithuanian banking sector is very similar in terms of market distribution – there are three dominant banks based on asset values with market share above 10%, but 22%-26% are managed by smaller size banks. But in Latvia market share distribution is different – there are 5 banks with market share above 10%, moreover four of them (ABLV, Rietumu bank, SEB and Nordea) have very similar asset values.

Bank market shares*
(Asset values as of 30th June, 2016)
Estonia (1), Latvia (2), Lithuania (3)



**NB: The bank market share is calculated based on each individual bank's asset value on June 30th, 2016 relative to corresponding country's all bank asset summation. Under "Other banks" all banks are included with market share less than 10%.*

Continuing to analyze these four Latvian banks with similar market shares one interesting fact can be noticed – all of these four banks have devoted majority of their assets towards issuing credit for companies. For example, for ABLV, SEB and Nordea 64%, 65% and 64% from all issued loans, respectively go to companies. Therefore, ignoring geographical and industry component, it can be stated that in Latvia there are three (could be more if banks with market share less than 10% are analyzed) very similar banks in terms of their size with identical credit strategies. It can be concluded that the environment in Latvia is adequate for consolidation, which would allow banks to decrease previously mentioned duplicate direct and indirect costs, diversify their loan portfolios, as well as ensuring higher margins.

Coming back to Nordea and DNB merger, the question still remains on how this merged bank will position itself and where is the growth of the company anticipated, because the competition in the market is very fierce and this merger will most likely increase the competition among leading banks. It also must be noted that there are still many open questions for this merger, let's hope that the shareholders of both banks will be able to agree upon everything. But certainly the good news are that in such a competitive environment banks will continue to improve their service bundles and quality.

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