Santander's Acquisition of Popular: Regaining the Upper Hand in Spain

On 7th June 2017, Banco Santander (rated AA-, Stable) announced it had acquired Banco Popular (not rated) for a nominal EUR 1 from Spain's national resolution fund FROB. Popular had been placed that same day into resolution and all its equity and capital securities had been written down.

In this report, we review the key elements of the transaction, detailing our reasoning that led to the affirmation of the AA- rating on 8th June, with Stable Outlook.

We believe Santander probably caught the last opportunity of the cycle to materially increase its market share in Spain inorganically and reaffirm its domestic leadership.

Santander's strategy has been fairly consistent in having a focussed and efficient retail and commercial banking franchise. In its core markets, it typically commands a top-three competitive position with double-digit market shares. In recent years, however, Santander's ranking in Spain had slipped, as its main domestic competitors had strengthened their franchises through the acquisition of struggling banks. During the crisis, Santander has not participated in domestic M&A, choosing instead to consolidate its market position in other markets, such as the UK and Poland.

The acquisition of Popular's franchise strengthens Santander market position in its home market, making it the largest bank with a market share of 20% in loans and 25% in the SME segment. The deal also boosts Santander's market share in Portugal to 17%. Crucially, Santander is increasing its exposure to Spain at a point in time when macro risks have materially receded and asset quality has been recovering.

The price for doing so is that the group had to purchase, together with the sixth-largest nationwide network and an especially well-regarded SME franchise, a heavy legacy of non-performing assets, and take the risk that they may turn out to be even worse than planned. To manage such risk, Santander made sure that Popular's assets were conservatively marked down ahead of the transfer, with its shareholders and junior bondholders shouldering the losses in the instant resolution of the bank.

In order to neutralise the impact from the consolidation of Popular's assets on its capital ratios, Santander announced that it would raise EUR 7bn in fresh equity. We believe this was necessary as Santander's capital already stood at the low end of peers'. Santander's fully loaded CET1 ratio as of Q1 2017 was 10.7% and the bank targets a fully loaded CET1 ratio of over 11% in 2018. Such target was confirmed after the acquisition.

Scope also sees some uncertainty relating to potential claims from former Popular shareholders and owners of capital securities, which may choose to sue in an attempt to recover some of the lost money.

Scope affirmed Santander's issuer rating of AA-, with Stable Outlook, one day after the acquisition was announced. For Scope, the sound strategic rationale for the deal, together with the announced capital increase of EUR 7bn, offset the potential risks for the transaction, namely the increase in non-performing assets and potential for legal risk.

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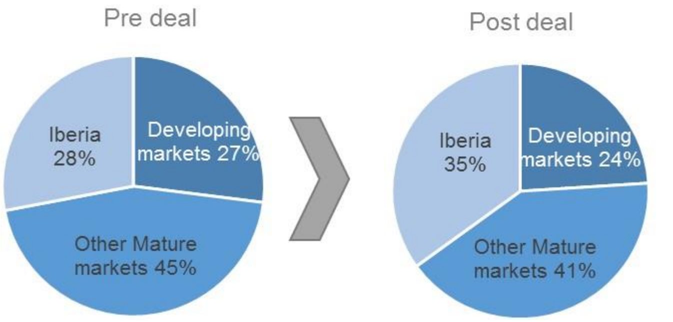
Weight of Spain and Portugal in the group to increase, but diversification profile little changed

While not immaterial, we believe the acquisition does not significantly alter the risk diversification profile of Santander.

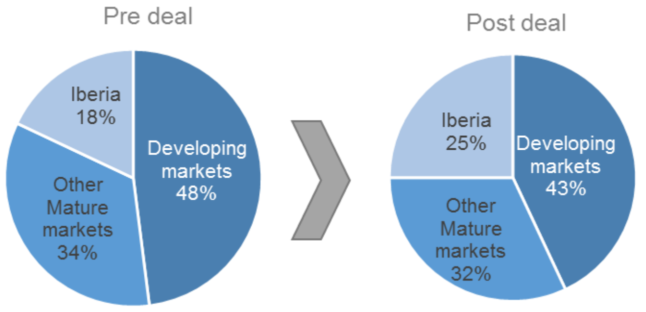
In term of total assets, Popular's EUR 147bn would be c. 10% of the combined total asset base of the group and close to 30% of Spanish assets, including RE. Profits from Spain and Portugal would increase from 18% to 25% of the group. Scope sees this as a positive development given the currently favourable cyclical conditions in Spain as opposed to some other markets where Santander operates, which face more economic and political uncertainty (e.g. Brazil).

Figure 1: Santander's group assets distribution



Source: Banco Santander, Scope Ratings

Figure 2: Santander's group profit distribution



Source: Banco Santander, Scope Ratings

Asset quality risks from the transactions are well managed

One potential downside risk to the transaction stems from the EUR 37bn portfolio of gross non-performing assets (NPAs), including both non-performing loans (NPLs) and foreclosed assets which were acquired with Popular, which essentially double Santander's NPAs.

This was mainly the legacy of aggressive lending to the real estate sector during the Spanish real estate bubble, including in the late stages of the cycle.

However, we note that post transaction the coverage on said NPA will be very high, with RE NPL coverage at 75% and RE foreclosed assets coverage of 65%.

Banco Santander's material additional provisions take coverage of the real estate NPLs and foreclosed assets of Popular to a very conservative level (65% and 75%, respectively). These levels are materially higher than at other Spanish banks, setting a benchmark that could potentially cast doubts over coverage levels in the Spanish system.

Santander plans to quickly reduce NPAs to non-material levels, and we believe the high levels of markdowns should facilitate asset and loan sales in the secondary market.

Figure 3: Banco Popular NPA coverage before and after Santander's clean-up

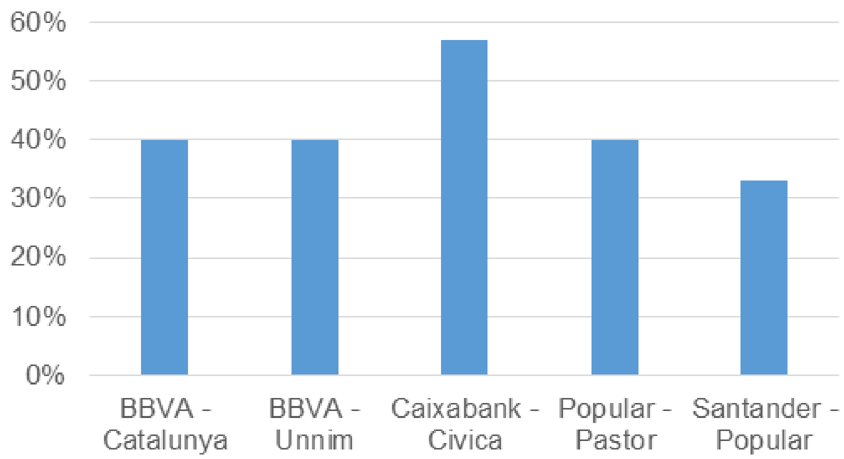
	Banco Popular Pre-deal (Q1'17)		Banco Popular Post-adjustments			Peers
EUR bn	Gross value	% Coverage	Provision	% Coverage	Net value	% Coverage
Total RE Assets	17.7	39%	4.7	65%	6.2	52%
Non-performing RE loans	12.1	55%	2.5	75%	3	51%
RE assets + RE NPLs	29.8	45%	7.2	69%	9.2	52%
NPLs ex Real Estate	7	46%	0.7	56%	3.1	51%
NPA	36.8	45%	7.9	67%	12.3	52%
Performing RE loans	3.8	0%	0	0%	3.8	

Source: Banco Santander, Scope Ratings

Cost synergy and restructuring assumptions seem realistic.

Santander expects the deal to generate cost synergies of up to EUR 500m per year (10% of combined cost base in Spain and Portugal), be EPS-positive and create value for Santander shareholders from 2019 onwards. In our view, the synergy assumptions are realistic, in the context of recent in-market deals in Spain. Santander is not including in its estimate any revenue synergy assumption, while targeted cost synergies amount to 33% of Popular's cost base, or 10% of the combined Iberian cost base.

Figure 4: Synergy targets in main in market M&A deals in Spain since 2010



Source: Banks, Scope Ratings

The cost savings would largely come from IT and headquarters integration, with about a third coming from distribution network optimisation, which we believe would limit the cost of revenue attrition and negative publicity.

Associated restructuring costs amount to 2.6x multiple of expected synergies, while for similar transaction they typically average 2x the cost synergy target.

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