Samples Business Report

The National Australia Bank Limited Takeover of Challenger Financial Services Group Limited

The National Australia Bank Limited (NAB) acquired Challenger Financial Services Group Limited (CFS) on October 30th, 2009.

Prior to the takeover, the National Australia Bank was involved in general banking in both the private and commercial markets. A traditional bank which initially began trading under the name of National Bank Limited in 1893. NAB offered personal and commercial banking services, including savings, checking and high interest accounts, alongside lending products including credit cards and a range of loans, including both commercial and residential mortgages, secured loans, unsecured loans and commercial finance.

Challenger Financial Services Limited was operating as a specialist finance house, with a focus upon mortgages. CFS was known for its modern approaching to mortgage aggregation and its strong product line up. CFS operated a network of in excess of 5,700 individual mortgage brokers. Additionally, CFS also sold a range of insurance related products, which operated under the Challenger Life Company brand.

There are compatibilities between both companies, as they both operate within a financial market, and each specialises in products which are complimentary.

CFS was made available for acquisition through a process of restructuring. The company planned to reduce its footprint in the mortgage market, and concentrate more upon the Challenger Life Company products. By selling off the mortgage side of the business, CFS would be able to inject around $200 million in to its insurance business. (The Age, 2009)

NAB found CFS attractive for very understandable reasons. As a banking house with its own range of mortgage products, it would be able to significantly increase its reach, and extend its product range. The total value of transferable mortgages at the time of the acquisition was in excess of $4 billion. Due to the open infrastructure of CFS, based around local mortgage brokers, NAB would also be able to incorporate the CFS product line very easily into its own product structure

(National Australia Bank, 2009). Financially, NAB would be set to reduce its tier 1 capital by around 15% and acquire the existing mortgages at something in the region of a 22 point discount.

Prior to the takeover, with NAB operating as one of the largest banking institutes in Australia, its corporate capital structure was both diverse and robust. HKBA Nominees Limited was the largest single shareholder, with 16.60% of all NAB shares, with J.P. Morgan Nominees Australia Limited holding 12.13%. The remaining shares were split across 18 more shareholders, with a total of 1,153,265,577 shares.

CFS was a much smaller, simpler corporation, with a much more easily understood capital structure. At the time of the merger CFS had issued 558,725,530 shares, with a further 10,734,605 set aside as share options, which totalled 569,460,135 shares valued at $2.24 each.

The offer which NAB made to CFs was for a 100% acquisition of all of the mortgage management side of the business, as well as a 17.5% share in the mortgage origination company Homeloans Ltd. The offer was a purchase price of $385 million.

The finance market in Australia reacted very positively to the NAB takeover of CFS. As we would expect, with a merger that makes financial and strategic sense to the acquiring company, with NAB share prices rising, and quite dramatically. CFS was already in a period of restructuring, and had faced some financial difficulties previously, so the resulting slight loss in share price is hard to attribute solely to the announcement of the takeover. At first glance it would appear that based upon market action, that the takeover would not be entirely beneficial to CFS.

Upon the release of the news of the impending takeover, the NAB share price raised 3.4% (99 cents) within a matter of hours. However, the CFS share price did drop by 3.8% to $2.80 at the same time.

NAB acquired 100% of the shares capital of the mortgage management business of CFS (National Australia Bank, 2010). Additionally it acquired 17.5% of

Samples Business Report

Homeloans Ltd, a mortgage origination company operated by CFS, for which it paid an additional $25 million.

There were no changes to the board of directors at CFS as a direct result of the takeover, as CFS would still continue to operate its insurance business through Challenger Life Company. However, it should be noted that CFS did operate an employee share ownership scheme at the time of the takeover, and these shareholdings were not affected. In effect, CFS simply saw the sale of the mortgage business as a capital asset gain, and not something that affected share disbursement.

Post-acquisition, CFS continued to sell commercial mortgages, and continued to operate its annuity funds management business. (Australlian Competition & Consumer Commision, 2009). It also began to focus more upon its successful insurance products under its Challenger Life Company brand.

As a direct result of the takeover, CFS was able to post a significant net cash position of somewhere in the region of $350 (Challenger Financial Services, 2009), giving it sufficient working capital to complete its corporate restructuring and extend the reach of its insurance products.

From an employee point of view, lost jobs were few. At director level little changed, as the company was still operating in existing markets, and expanding into new ones. Staffing was not overly affected, as the mortgage products were being sold via a network of around 5,700 independent mortgage brokers, who continued to work with NAB after the acquisition. The only employees who suffered a loss of jobs were administration staff who previously dealt solely with mortgages.

The bargain position for the acquiring company was twofold. Firstly there were some striking financial benefits. The face value of the mortgages which NAB took ownership of was approximately $4 billion, and this represents a basis point discount of 22%. NAB projected that this would allow the company to reduce its tier 1 capital ratio by 15 basis points in the first year. Additionally, the takeover was set to increase the footprint of NAB in the broker distributed mortgage market significantly.

With regards to goodwill, as NAB were not originally operating a mortgage business using distributed brokers, there could be neither a positive nor negative affect on goodwill as a direct result of the takeover.

The takeover was a very good deal for NAB. Financially it made very good sense, as the price was fairly low considering the significant assets it would take ownership of. However, we cannot overlook the risk factor in purchasing debt. In theory, depending upon the financial environment, the loan assets it acquired could drop or rise in value. From a strategic viewpoint it allowed NAB to enter the distributed broker mortgage market with a ready-made infrastructure, bolting on a financial product to its already diverse range with little effort.

At the time of the takeover, NAB was the 3rd largest banking house in the country, and was valued at $65 billion. As with any affluent financial house, there was a possibility that the Australian economy could be affected as a result of the takeover, either positively or negatively. NAB added $4 billion to its asset base in a single move, which represented an overnight growth of 6.15%, which came with the attached possibility (although remote), of destabilising the share price. Had the share price suffered significantly, the entire economy could have been affected.

The acquisition of the entire mortgage management arm of CFS is certainly going to reduce competition. CFS was one of the largest independent mortgage companies in Australia. CFS operated a streamlined and efficient network of mortgage brokers, who transferred to NAB en masse. This already effective infrastructure, once exposed to the increased resources and support of a large bank, would undoubtedly see NAB slicing off a huge segment of the market traditionally serviced by a distributed mortgage broker network. This was not a simple case of one trading entity purchasing another one; it was a case of a powerful financial force spotting a bargain acquisition, which would allow it with minimum investment, to purchase a chance at capturing an entire market.

Samples Business Report

Bibliography

Australlian Competition & Consumer Commision, 2009. *Australlian Competition & Consumer Commision.* [Online]
Available at:
http://www.accc.gov.au/content/trimFile.phtml?trimFileTitle=D09+184274.pdf&trimFileFromVersionId=901830&trimFileName=D09+184274.pdf
[Accessed 12 May 2012].

Challenger Financial Services, 2009. *Challenger Financial Services announces the sale of its Mortgage Management division and preliminary expected results for the full year ended 30 June 2009.* [Online]
Available at:
http://www.challenger.com.au/group/CompanyAnnouncements/20090814_Market_Release_CGF_Pre_Release_v6FINAL.pdf
[Accessed 12 May 2012].

National Australia Bank, 2009. *NAB to acquire Challenger's mortgage management business.* [Online]
Available at: http://www.rns-pdf.londonstockexchange.com/rns/5872X_-2009-8-18.pdf
[Accessed 12 May 2012].

National Australia Bank, 2010. *Annual Financial Report 2010.* [Online]
Available at: http://www.nab.com.au/NABGroup/archives/annual-reports/Annual-Financial-Review-2010.pdf
[Accessed 12 May 2012].

The Age, 2009. *The Age - Business Day.* [Online]
Available at: http://www.theage.com.au/business/nab-buys-challenger-mortgage-arm-20090818-eo33.html
[Accessed 12 May 2012].