



Grant Thornton Advisory, d.o.o., Ljubljana

Analysis of performance of Slovenian banking industry

Ljubljana, April 2019



Table of contents

EXECUTIVE SUMMARY	4
<u>1</u> OVERVIEW OF SLOVENIAN BANKING INDUSTRY	7
<u>2</u> PERFORMANCE OF BANKING INDUSTRY IN 2005-2018	11
2.1 OVERALL PERFORMANCE OF BANKS BY OWNERSHIP TYPE	11
2.2 KEY PERFORMANCE INDICATORS.....	19
<u>3</u> IMPACT OF MERGERS AND ACQUISITIONS ON PERFORMANCE OF ACQUIRED BANKS.....	24
3.1 FOREIGN ACQUISITIONS IN SLOVENIAN BANKING SECTOR AFTER 2013.....	24
3.2 IMPACT OF FOREIGN TAKEOVERS ON BANK PERFORMANCE.....	25

Table of Figures

FIGURE 1: TOTAL ASSETS AND OPERATING INCOME, ALL BANKS, 2000 - 2018 (MN EUR).....	7
FIGURE 2: LANDSCAPE OF SLOVENIAN BANKING SECTOR, TOTAL ASSETS BY BANKS, 2005-2017 (MN EUR).....	7
FIGURE 3: LANDSCAPE OF SLOVENIAN BANKING SECTOR, MARKET SHARE, 2005-2017 (%).....	8
FIGURE 4: EVOLUTION OF MARKET SHARES OF THREE LARGEST SOBs, 2005-2017 (%).....	9
FIGURE 5: EVOLUTION OF MARKET SHARES OF THREE LARGEST FOBs, 2005-2017 (%).....	9
FIGURE 6: EVOLUTION OF MARKET SHARES BY TYPE OF OWNERSHIP, 2005-2019 (%).....	10
FIGURE 7: BANKS' BALANCE SHEETS (TOTAL ASSETS), BY OWNERSHIP, 2005-2017 (MN EUR).....	11
FIGURE 8: EXPANSION OF BANKS' BALANCE SHEETS, BY TIME PERIOD AND OWNERSHIP, 2005-2017 (2005, 2009, 2015 = 100).....	12
FIGURE 9: EXPANSION OF BANKS' BALANCE SHEETS, BY TIME PERIOD AND OWNERSHIP, 2005-2017 (CHANGE IN % RELATIVE TO BASE YEAR).....	12
FIGURE 10: LOANS TO NON-BANKING SECTOR AS A SHARE OF BALANCE SHEET AND DEPOSITS, BY OWNERSHIP, 2005-2017 (%).....	13
FIGURE 11: NET FUNDING OF LOANS TO NON-BANKING SECTOR BY DEPOSITS OR EXTERNAL SOURCES, BY OWNERSHIP, 2005-2017 (%).....	14
FIGURE 12: ANNUAL NEW LOANS TO NON-BANKING SECTOR AND ANNUAL IMPAIRMENTS VOLUMES (MN EUR), BY OWNERSHIP, 2005-2017.....	15
FIGURE 13: CUMULATIVE LOANS TO NON-BANKING SECTOR AND IMPAIRMENTS, BY OWNERSHIP, 2005-2017 (MN EUR).....	16
FIGURE 14: ANNUAL IMPAIRMENTS VOLUMES (MN EUR) AND IMPAIRMENTS AS A SHARE IN TOTAL LOANS TO NON-BANKING SECTOR (%), BY OWNERSHIP, 2005-2017.....	17
FIGURE 15: CUMULATIVE IMPAIRMENTS AND OPERATING PROFITS, FOREIGN- VS. STATE-OWNED BANKS, 2008-2017 (MN EUR).....	17
FIGURE 16: RATIO OF CUMULATIVE OPERATING PROFITS TO IMPAIRMENTS, BY OWNERSHIP, 2008-2017 (%).....	18
FIGURE 17: EUROZONE NON-PERFORMING LOANS RATIO BY COUNTRY, (%), Q3 2018.....	18
FIGURE 18: COVERAGE OF NPEs BY IMPAIRMENTS (%), Q2 2018.....	19
FIGURE 19: CAPITAL TO BALANCE SHEET RATIO (%), BY OWNERSHIP, 2005-2017.....	20
FIGURE 20: EUROZONE CAPITAL RATIOS BY COUNTRIES (%), Q3 2018.....	20
FIGURE 21: OPERATING PROFITS BEFORE AND AFTER IMPAIRMENTS (MN EUR), ALL BANKS, 2005-2017.....	21
FIGURE 22: OPERATING PROFITS BEFORE AND AFTER IMPAIRMENTS (MN EUR), BY OWNERSHIP, 2005-2017.....	21
FIGURE 23: NET INTEREST MARGIN, SLOVENIA VS. EUROZONE (%), BY OWNERSHIP, 2005-2017.....	22
FIGURE 24: COST TO INCOME RATIO, SLOVENIA VS. EUROZONE (%), BY OWNERSHIP, 2005-2017.....	22
FIGURE 25: RETURN ON ASSETS, SLOVENIA VS. EUROZONE (%), BY OWNERSHIP, 2005-2017.....	23
FIGURE 26: RETURN ON EQUITY, SLOVENIA VS. EUROZONE (%), BY OWNERSHIP, 2005-2017.....	23
FIGURE 27: COMPARATIVE PERFORMANCE OF NKBM AND GORENJSKA BANKA BEFORE AND AFTER ACQUISITION, LOANS TO NON-BANKS AND CAPITAL TO ASSETS (%), 2014-2017.....	26
FIGURE 28: COMPARATIVE PERFORMANCE OF NKBM AND GORENJSKA BANKA BEFORE AND AFTER ACQUISITION, OPERATING PROFITS AND IMPAIRMENTS AS SHARE OF LOANS TO NON-BANKS (%), 2014-2017.....	26
FIGURE 29: COMPARATIVE PERFORMANCE OF NKBM AND GORENJSKA BANKA BEFORE AND AFTER ACQUISITION, NET INTEREST MARGIN AND COST TO INCOME RATIO (%), 2014-2017.....	27
FIGURE 30: COMPARATIVE PERFORMANCE OF NKBM AND GORENJSKA BANKA BEFORE AND AFTER ACQUISITION, RATE OF RETURN ON ASSETS AND RATE OF RETURN ON EQUITY (%), 2014-2017.....	27

Table of Tables

TABLE 1: PRIVATIZED / ACQUIRED BANKS BY FOREIGN OWNERS AFTER 2013.....	25
--	----

EXECUTIVE SUMMARY

In terms of structure and individual performance, banking sector in Slovenia went through a turbulent period since 2005. While all banks experienced fast expansion between 2005 and 2009, most of the banks experiencing the fastest expansion also faced biggest contractions in total assets after 2009. Affected the most in this process were the biggest state-owned banks (SOBs), such as NLB, NKBM, Abanka, Banka Celje, and some private domestic banks (Probanka, Factor banka) that engaged in aggressive or even predatory lending activities to maintain or expand their market shares. Most of them failed in this endeavor by taking on too much risk and had to be bailed-out by the state in 2013-2014 or have been liquidated.

As a consequence, between 2009 and 2014 combined market share of SOBs declined from 66% to 60% and was further reduced to some 45% after NKBM was privatized and due to prolonged weak lending activities of SOBs. While combined market share of private domestic banks remained nearly constant at around 7%, market share of FOBs increased from below 27% in 2009 to almost 49% in 2017. After acquisition of Gorenjska banka and privatization of NLB in 2018, combined market share of SOBs is reduced to 16% only. Taking into account privatization of Abanka in 2019, combined market share of SOBs will further decrease to less than 7%.

By analyzing performance of Slovenian banking sector since 2005, this expertise finds a superior performance of foreign-owned banks (FOBs) over domestically (state- or privately) owned banks in terms of performance and stability. Major advantages of FOBs can be summarized as follows. *First*, FOBs are shown to have been more prudent in terms of lending standards and the ability to handle the loans turning non-performing both before and during the financial crisis. FOBs were able to handle the accumulated NPLs by the means of accumulated profits and there was, in contrast to SOBs, no need for large scale recapitalization or, worse, for bail-outs by the state.

Second, loans-to-deposit ratio is traditionally higher in FOBs as compared to domestically-owned banks, indicating FOBs' higher dependence on intra-group sources of liquidity. The latter has been shown as particularly important in adverse times. After September 2008, when all other banks were contracting their credit activities due to inability to refinance their positions in the inter-banking markets, FOBs were able to maintain the pre-crisis levels of lending also in the period of severe credit crunch. When combined with more prudent lending standards, this access to intra-group sources of liquidity increases the robustness of the entire banking sector and can have a stabilizing impact on the economy.

And *third*, FOBs are shown to operate at substantially lower costs (in terms of cost to income), while achieving marginally higher net interest margins as compared to domestically (state- or privately) owned banks. Revealed returns to assets or capital (RoA and RoE), though, are comparatively lower in FOBs, which may reflect a higher cost of capital for FOBs.

This expertise also focused on the impact of foreign acquisitions on performance of acquired banks. The sample of banks being privatized or changing ownership from private domestic to foreign after 2013 is extremely small, including NKBM, Gorenjska banka, NLB and Abanka. However, only for the former couple of banks there is at least two years of data after the acquisition that allows for a

comparative analysis of performance before and after acquisition and comparatively to non-privatized banks.

Major conclusions to be drawn from the comparative analysis are as follows. Both NKBM and Gorenjska banka (GB) substantially boosted lending in the 2-year post-acquisition period (by more than 30%). In contrast, the banks in a control group (NLB and Abanka) were able to increase lending only by 3% in the same period. Hence, privatization to foreign owners resulted in the upswing of credit activities. Though both newly privatized banks to foreign owners were able to boost credit activities substantially, they were able to reduce the need for loan loss provisions after the acquisition.

In terms of capital adequacy, all banks enjoy high capital ratios. Both privatized banks slightly reduced capital ratios in the 2-year post-acquisition period, while both SOBs in the control group improved the capital ratios significantly. This is, however, a statistical artefact as both privatized banks increased lending by more than 30% in that period, leading to a decrease in capital ratios. On the other side, credit activity of NLB was further reduced between 2015 and 2017 by 1.4%, leading to higher capital ratios.

In both privatized banks, operating profits after the acquisition increased at a similar or higher pace (both in absolute terms and relative to total loans) as compared to the pre-acquisition period. Both SOBs in the control group, however, were able to improve operating profits in the post-acquisition period at a higher pace than privatized banks. The latter, however, is a result of substantially lower requirements for creating impairments in the period 2016-2017 and / or of release of past impairments in 2017. On average, privatized banks reduced impairments at the same extent as the control group of non-privatized banks.

Net interest margins slightly decreased in the post-acquisition period in both banks privatized to foreign owners, but mostly in NKBM where net interest incomes dropped by 15% between 2015 and 2017. On the other side, both SOBs marginally increased their net interest margins in this period, to become comparable to the levels of a newly privatized NKBM, but substantially lower than in GB.

Cost to income ratios in both newly privatized banks increased in the post-acquisition period. This surge in the cost ratios is substantial in NKBM, where the ratio increased due to reduced net interest incomes by 15% and an increase in operating costs by a fifth. In GB, operating costs also increased by a fifth, whereby net interest incomes increased by a tenth, leading to only slightly bigger ratio of cost to income. For SOBs, the situation is different as Abanka is mirroring the dynamics of GB in the post-acquisition period (i.e. slight increase in cost to income ratio), while NLB was able to compensate falling net interest incomes by increased incomes from other fees.

Both privatized banks almost doubled their returns to capital and to assets in the post-acquisition period as compared to the pre-acquisition period. The improvements in profitability were substantially bigger in SOBs, though the large majority of the surge in average profitability comes down to NLB, which in the period 2015 to 2017 managed to increase operating profits by almost 250% while decreasing total assets by a tenth.

To summarize, to improve profitability, newly privatized NKBM and GB have to address the challenges of falling net interest incomes and of increased operating cost in the future. Both SOBs in the control group, NLB and Abanka, have proven more efficient in reducing operating cost, while NLB also managed to compensate falling net interest incomes by increasing incomes from other fees.

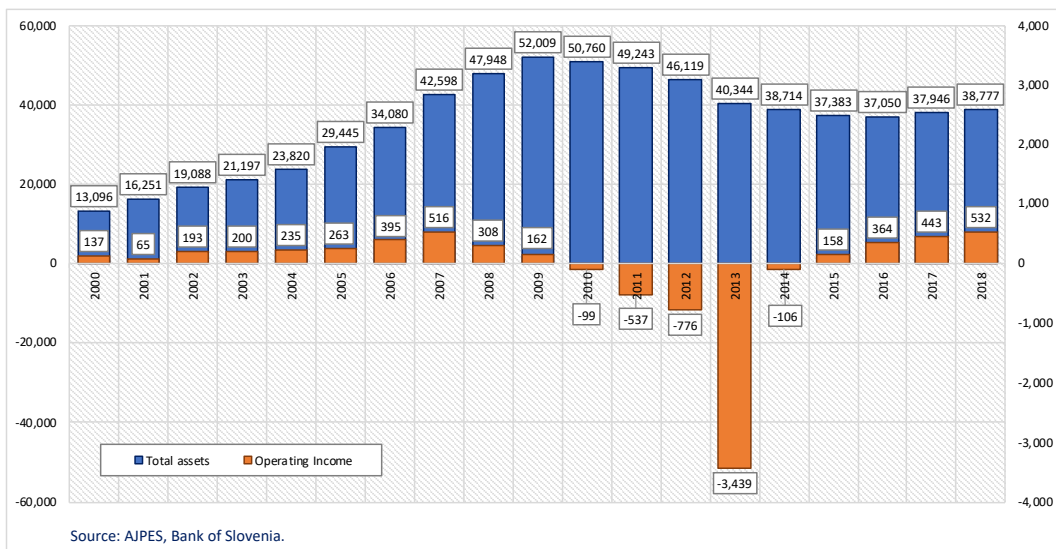
This 2-year post-acquisition episode, however, is too short to make firm conclusions. The full impact of changes in performance of newly acquired NKBM and Gorenjska banka to foreign majority owners is to be seen in the medium term of 3 to 5 years after the acquisition.

1 OVERVIEW OF SLOVENIAN BANKING INDUSTRY

Between 2000 and 2009, Slovenian banking sector quadrupled in size. Amid fast economic growth, in only 4 years (2004 - 2008) total assets doubled from 24 to 48 bn EUR. Since the peak in 2009, banking sector was shrinking for 7 consecutive years until 2016 and is only slowly picking up in terms of total assets since then despite high economic growth. Banks remain cautious in lending activities, while some of them that received state aid in 2013-2014 are constrained by the European Commission's (EC) decisions requiring to divest and decrease market shares.

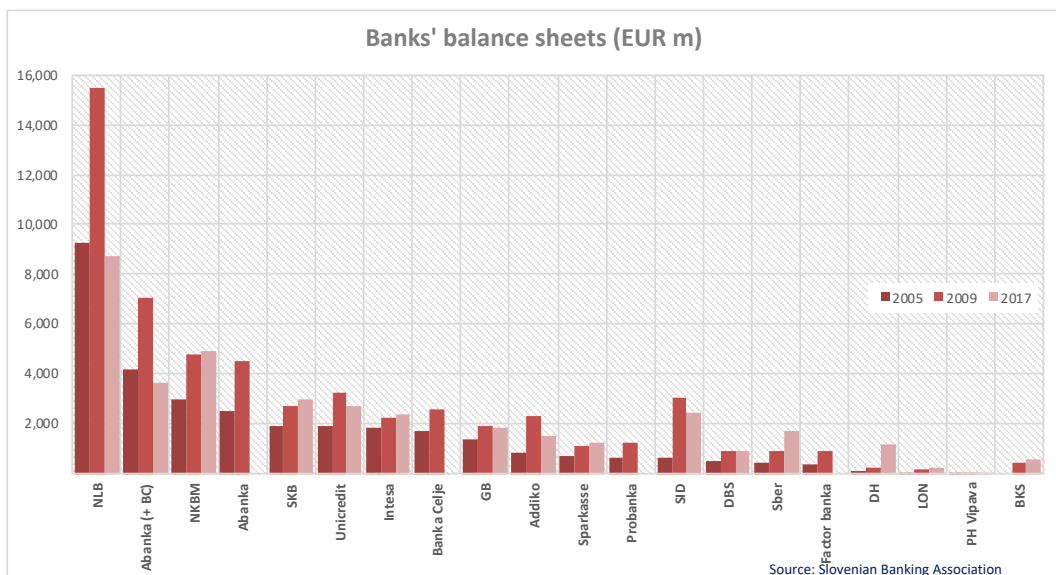
After the major bank rehabilitation in 2013-2014, operating incomes are improving and reached the pre-crisis record levels by 2018 despite the substantially lower total lending.

Figure 1: Total assets and operating income, all banks, 2000 - 2018 (mn EUR)



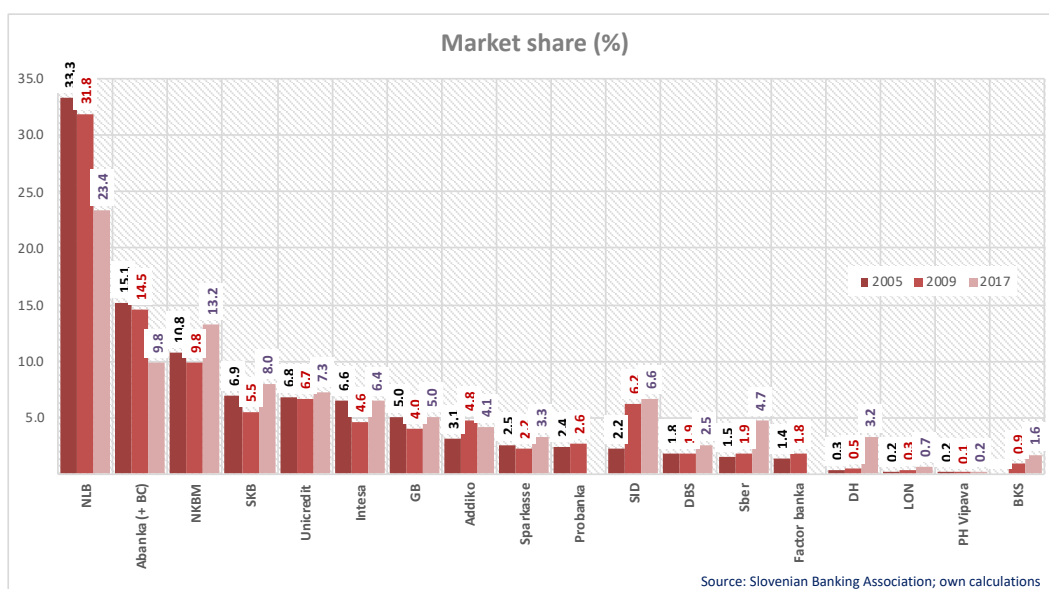
In terms of structure and individual performance, banking sector in Slovenia went through a turbulent period since 2005. While all banks experienced fast expansion between 2005 and 2009, most of the banks experiencing the fastest expansion also faced biggest contractions in total assets after 2009.

Figure 2: Landscape of Slovenian banking sector, total assets by banks, 2005-2017 (mn EUR)



Notably, the biggest state-owned banks (hereafter: SOBs), such as NLB, NKBM, Abanka, Banka Celje, some private domestic banks (Probanka, Factor banka) and some foreign-owned banks (hereafter: FOBs), such as Unicredit and Addiko (former Hypo Alpe-Adria), were particularly keen on maintaining or expanding their market share through aggressive or even predatory lending activities. Most of them failed in this endeavor by taking on too much risk and had to suffer big contractions in their balance sheets and in market shares after the start of the financial crisis in 2009. SOBs that were affected the most by the consequences of aggressive lending before 2009, were bailed-out by the state in 2013-2014 and were merged (Abanka and Banka Celje) or privatized (NLB, NKBM), while most affected domestic private banks were liquidated (Probanka, Factor banka). In any case, most of them have seen their market shares decreased after 2009. FOBs, with notable exception of the Addiko bank) seem to weather the financial crisis much better and were able to maintain or expand their market shares after 2009 (see Figure 3).

Figure 3: Landscape of Slovenian banking sector, market share, 2005-2017 (%)



The striking difference among three largest SOBs and three largest FOBs is further depicted in Figures 4 and 5. All three largest SOBs have lost their market shares after 2009. NLB as the traditionally the major and systemic bank, saw its market share decreased between 2007 and 2017 by more than 10 pp (from 33.9% to 23.4%). Similarly, combined market share of the second largest bank Abanka and Banka Celje (merged in 2015) decreased by one third (by 5 pp) between 2010 and 2107. Third largest bank, NKBM, lost more than 1 pp of market share already during the upturn between 2006 and 2008 and was able to maintain it till its privatization in 2015. After privatization, NKBM's market share surged by 3 pp. Combined, market shares of three largest SOBs between 2007 and 2014 declined by about 13 pp, while market shares of three largest FOBs increased by almost 5 pp in the same period. This is mostly due to delayed start of rehabilitation of SOBs until 2013, but later due to restricted lending imposed by the European Commission for banks receiving state aid.

Figure 4: Evolution of market shares of three largest SOBs, 2005-2017 (%)

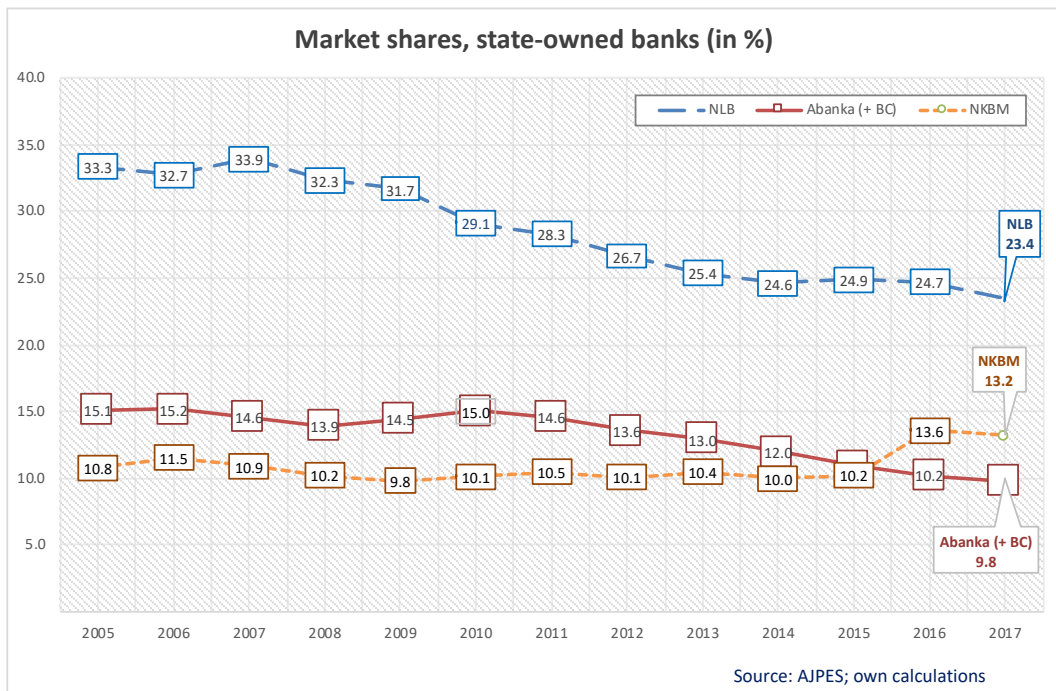
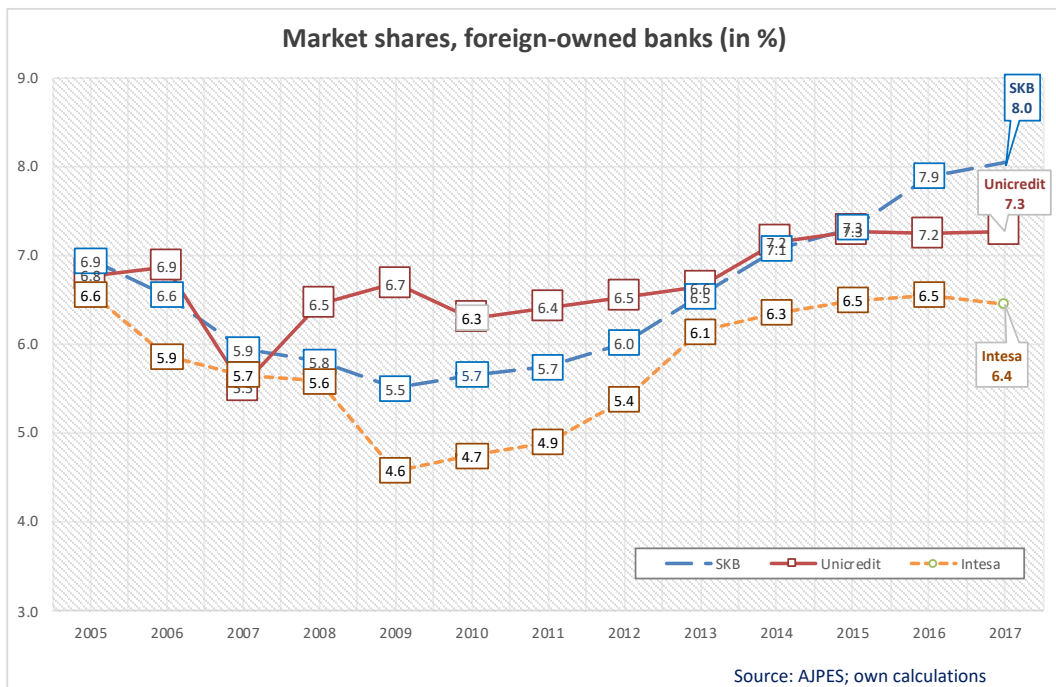


Figure 5: Evolution of market shares of three largest foreign-owned banks (FOBs), 2005-2017 (%)

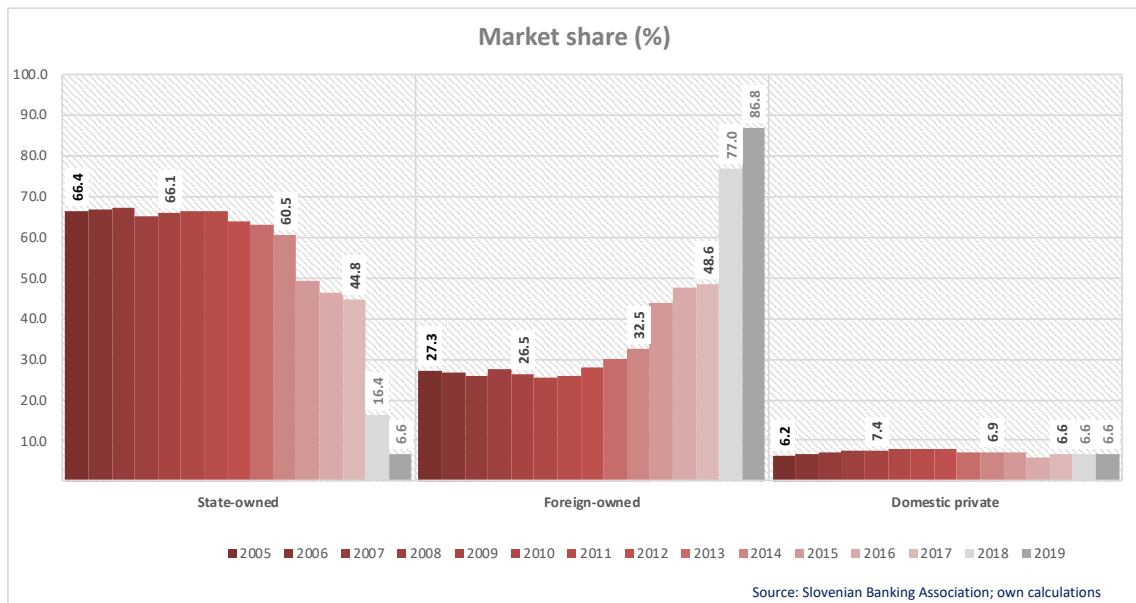


Among FOBs, Unicredit bank seems to be the least affected by the crisis and was able to further increase its market share between 2009 and 2017 by 0.6 pp. SKB seems to use the opportunity of restricted lending by rehabilitated SOBs most efficiently and was able to expand its market share by 2.5 pp in the same period. Similarly, after the initial decline in 2009, Intesa was able to maintain its balance sheet flat throughout the period after 2009 when most of the banks were in the process of consolidation, which enabled it to boost its market share by 1.8 pp until 2017.

These changes in lending activities and ownership are reflected in the evolution of market shares of three segments of banks according to majority ownership (Figure 6). Between 2009 and 2014, market share of SOBs declined from 66% to 60% and was further reduced to some 45% after NKBM was privatized to Apollo fund and due to prolonged weak lending activity of SOBs. While combined market share of private domestic banks remained nearly constant at around 7%, market share of FOBs increased from below 27% in 2009 to almost 49% in 2017.

After privatization of Gorenjska banka and NLB in 2018, combined market share of SOBs is reduced to 16% only. Taking into account privatization of Abanka in 2019, combined market share of SOBs will further decrease to less than 7%. Essentially, SID banka will remain as the only majority state-owned bank.

Figure 6: Evolution of market shares by type of ownership, 2005-2019 (%)



Notes: After privatization in 2015, NKBM is considered as foreign-owned. For 2018-2019 impact of privatization of NLB, Gorenjska banka and Abanka on market shares are simulated, whereby constant market shares for individual banks are assumed.

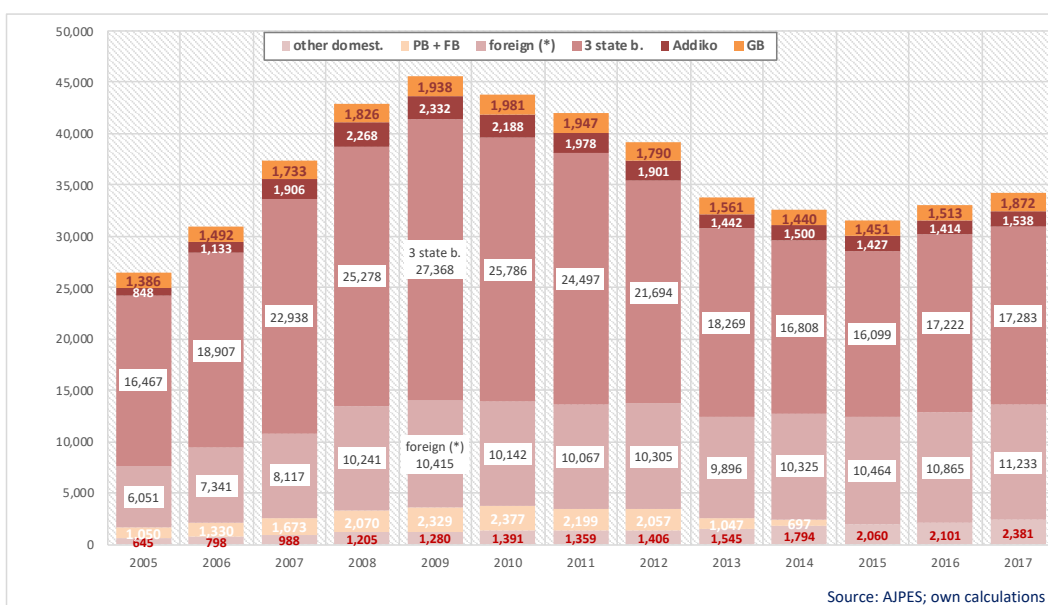
2 PERFORMANCE OF BANKING INDUSTRY IN 2005-2018

This part reviews performance of banks according to ownership type. Functional grouping is used to reflect bank's majority ownership type and special status to reflect different performance. For the comparison sake, the ownership status is treated as unchanged throughout the period 2005-2017 (later on this convention will be relaxed). Three main groups are analyzed: state-owned, foreign-owned and other domestic private-owned banks. Group of 3 SOBs consists of NLB, NKBM and Abanka (+ Banka Celje). Group of FOBs consists of all FOBs but Addiko (former Hypo Alpe-Adria) to reflect differences in their performance. Similarly, a group of other domestic private-owned banks consists of all non-SOBs (with exception of SID banka), but Gorenjska banka, Probanka and Factor banka. These three banks have been separated out due to their different performance as compared to other domestic private banks.

2.1 OVERALL PERFORMANCE OF BANKS BY OWNERSHIP TYPE

Though in 2005-2008 three major SOBs, holding two-thirds of market share, increased lending by a half, other banks were more aggressive in lending. In particular, banks owned by private domestic owners (including Probanka and Factor banka) almost doubled their lending. FOBs pursued similarly aggressive lending strategies by increasing total loans by almost 70%. Addiko bank and Gorenjska banka were two notable exceptions, whereby the former almost tripled its balance sheet until 2008, while Gorenjska banka was the most modest bank by expanding its lending by less than a third (see Figures 7 and 8).

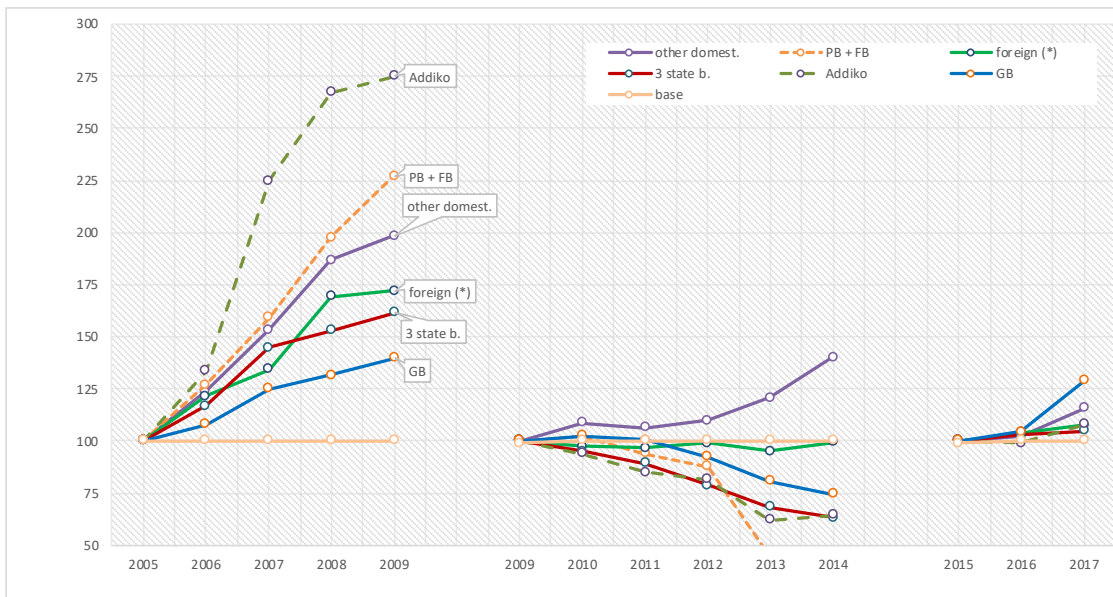
Figure 7: Banks' balance sheets (total assets), by ownership, 2005-2017 (mn EUR)



Notes: * Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

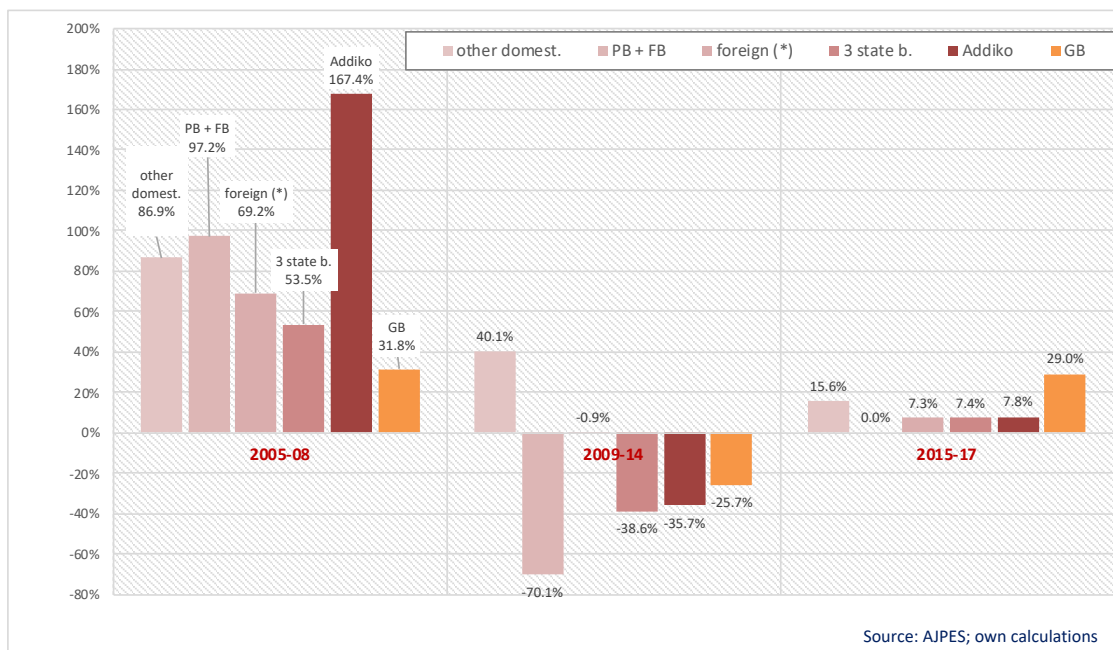
After the outburst of the financial crisis in 2009, all banks engaged in sharp contracting their balance sheets by 25% to 70% up to 2014, leading by two privately-owned banks (FB and PB) and followed by the three SOBs, as well as Addiko and Gorenjska banka. Again, two notable exceptions were FOBs by overly maintaining their pre-crisis level of lending, and a group of small domestic banks. The latter group includes also a state-owned SID banka, which was used by the government during the crisis years (2009-2014) as a vehicle to maintain lending to SMEs.

Figure 8: Expansion of banks' balance sheets, by time period and ownership, 2005-2017 (2005, 2009, 2015 = 100)



Notes: * Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

Figure 9: Expansion of banks' balance sheets, by time period and ownership, 2005-2017 (change in % relative to base year)



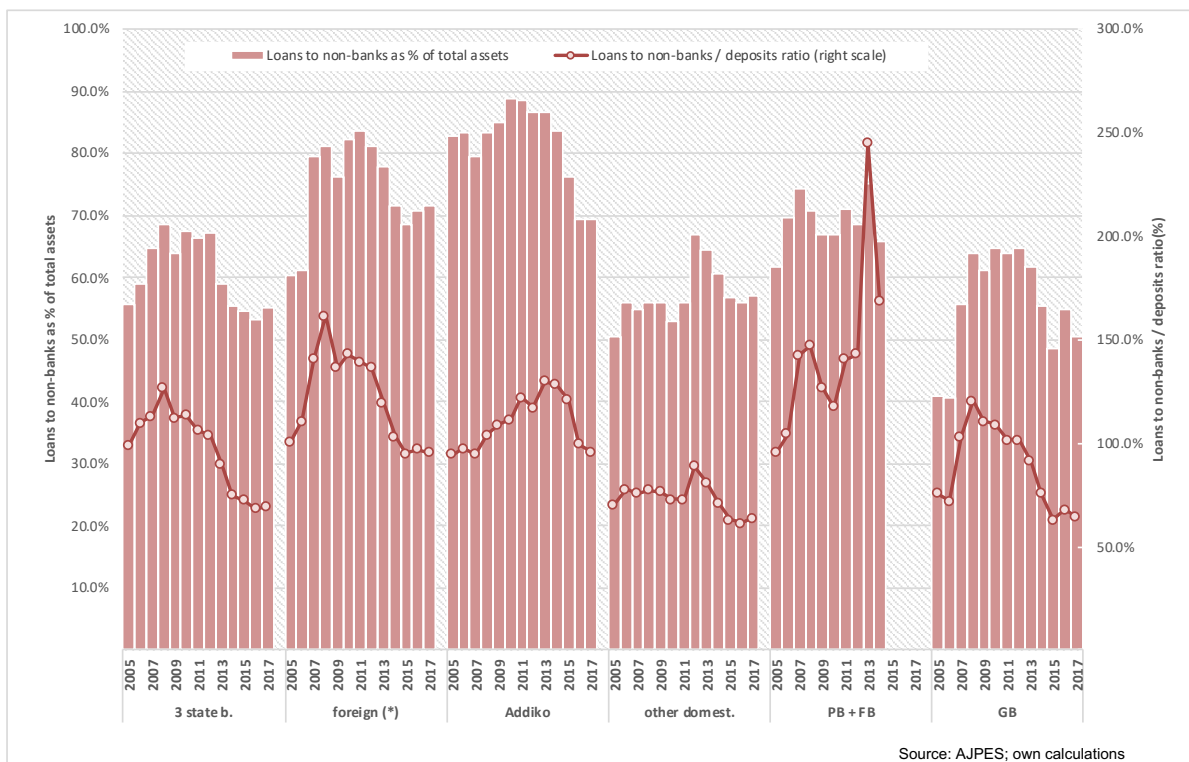
Source: AJPEs; own calculations

Notes: * Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

After 2014, most banks resumed their lending, but at extremely low growth rates. Though starting from a very low base (from pre-2007 levels), banks increased lending on average much below 10% over the period 2015-2017. Only small domestic bank, including Gorenjska banka, were more active in this period by increasing lending at double to quadruple the rates of all other banks.

In run-up to the crisis, FOBs, including Addiko, engaged at a higher rate in providing loans to households and corporate sector (non-banks) as compared to state-owned or privately-owned banks by some 15-20 percentage points in terms of total loans. State-owned and privately-owned banks allocated about 35 to 45% of assets to inter-banking lending, these shares increased by 10 percentage points after the start of the crisis, indicating extensive deleveraging processes in the corporate sector and reduced demand for loans among households up to 2016. In addition, state-owned and privately-owned banks, with exception of Probanka and Factor banka, not only reduced lending after 2009 relatively more than foreign banks, but also reduced lending relative to deposits (Figure 10).

Figure 10: Loans to non-banking sector as a share of balance sheet and deposits, by ownership, 2005-2017 (%)



Notes: Loans to non-banking sector as a share of balance sheet on left scale; Loans to non-banking sector / deposits ratio on right scale.

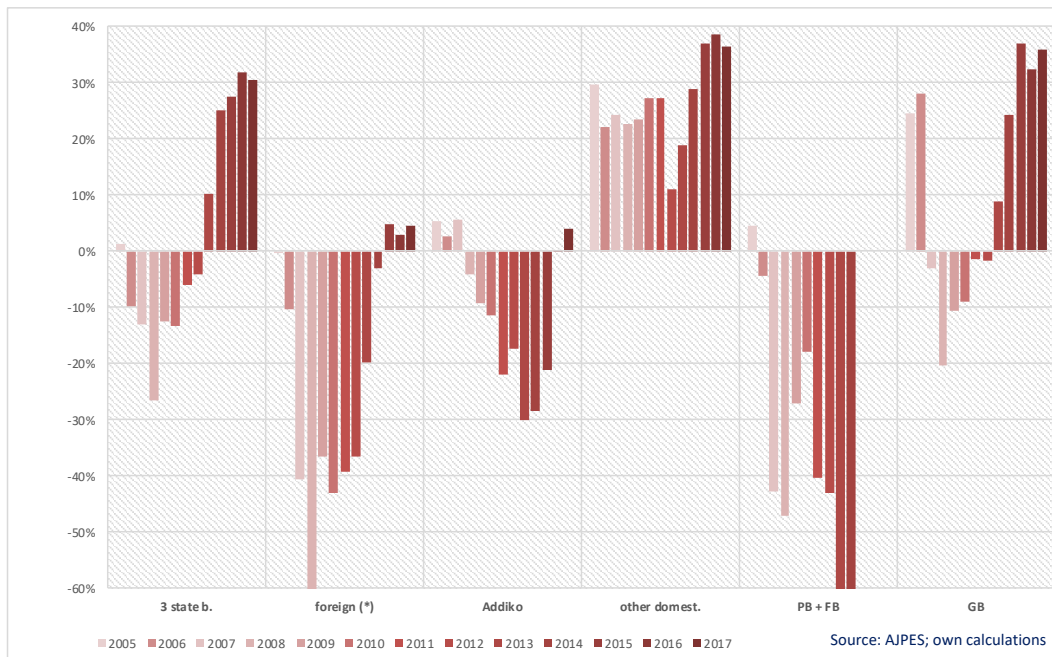
* Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

This reflects two processes at work. First, after 2009 domestically (state or private) owned banks were in a process of extensively cleaning their balance sheets, reducing lending and piling up deposits to secure liquidity. Second, with exception of Probanka and Factor banka, loans-to-deposit ratio is traditionally lower in domestically-owned banks than in FOBs and these structural differences were further strengthened after 2009 (Figure 10).

Coverage of loans to non-banking sector by deposits was and remains traditionally negative in FOBs, which reflects the fact that FOBs rely predominantly on their foreign sources (intra-group lending) rather than on domestic deposits. For SOBs, bigger dependence on external (foreign) sourcing of liquidity than on domestic deposits was characteristic only for a period before 2012. SOBs funded their credit expansion before 2009 partly also on relying on interbank lending market, while net refinancing via interbank lending continued until 2012. After 2012, SOBs net funded their credit activity by domestic deposits (Figure 11).

For privately owned banks the picture is more nuanced. Factor banka and Probanka relied throughout the period, until their liquidation in 2014, mostly on funding by interbank lending, while Gorenjska banka did so on net only in the period 2007-2012. Other smaller privately-owned banks performed more conservatively throughout the period by funding their credit activity mostly by received deposits.

Figure 11: Net funding of loans to non-banking sector by deposits or external sources, by ownership, 2005-2017 (%)



Notes: Positive figures indicate net funding of loans by domestic deposits while negative figures indicate net funding by relying on inter-bank lending.

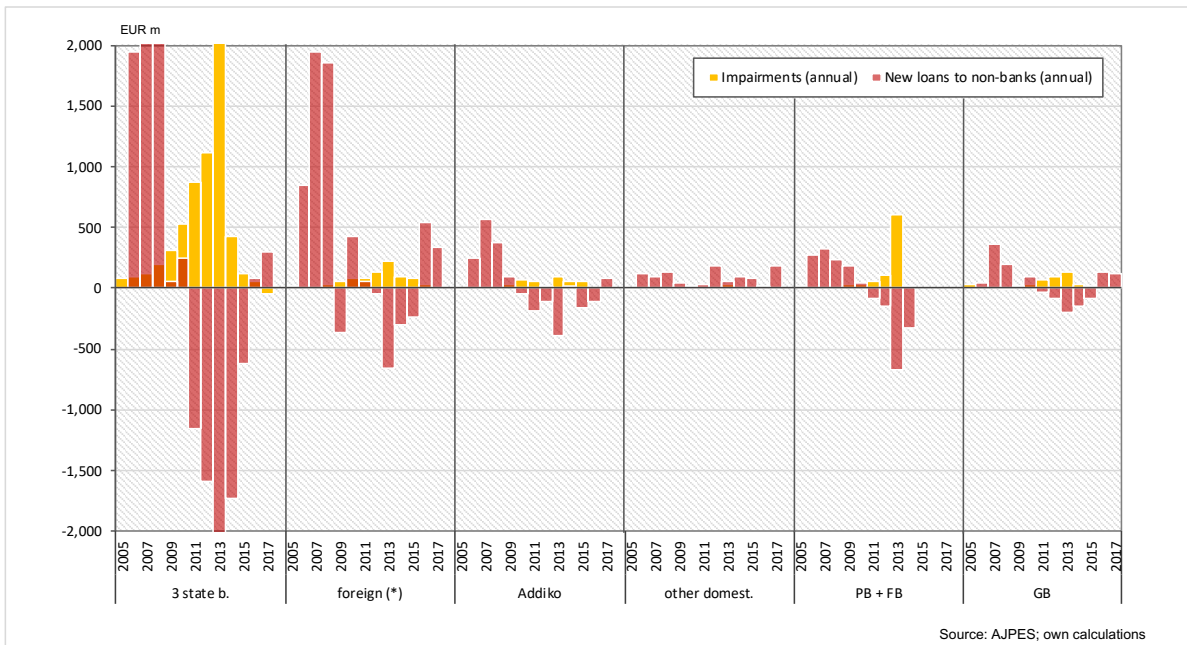
* Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

The above findings emphasize the importance of access to intra-group sources of liquidity for FOBs, giving them a comparative advantage in adverse times over domestically-owned banks. Moreover, this also had a stabilizing effect on the economy. After September 2008 (marked by the collapse of

Lehman Brothers), when all other banks (except a group of small privately-owned domestic banks) were contracting their credit activities, FOBs were able to maintain their lending also in the period of severe credit crunch (2009-2014). This is mainly due to the fact that they were not reliant on turbulent inter-bank market and not constrained by their individual ratings, but could rely on access to intra-group sources of liquidity.

Though FOBs were increasing lending in 2005-2009 at a high pace and were engaged in a higher degree of loans to non-banks as compared to SOBs (see Figures 9 – 10), they were apparently better suited to avoid engaging in provision of loans of poor quality (Figures 12-13). Overall, between 2005 and 2008 SOBs advanced about 8,400 mn EUR of loans to non-banks, of which a large portion turned out to be non-performing and banks had to create impairments and loss provisions. While most of the new loans were generated before 2008, most of impairments by the SOBs were created successively after 2008 (Figure 12). In the period 2005-2013, SOBs created impairments in the amount of about 6,400 mn EUR in total, which are mainly related to the loans to non-banks advanced before 2008 (8,400 mn EUR in total for the period 2005-2008). After the bank rehabilitation in 2013, SOBs created additional impairments for the remaining loans (those not being transferred to DUTB¹) in total amount of about 550 mn EUR (Figure 13). In total, SOBs' cumulative impairments in the period 2005-2017 account for 83% of their cumulative loans to non-banks advanced in the same period. This reflects in large part very loose credit standards of SOBs before 2019.

Figure 12: Annual new loans to non-banking sector and annual impairments volumes (mn EUR), by ownership, 2005-2017



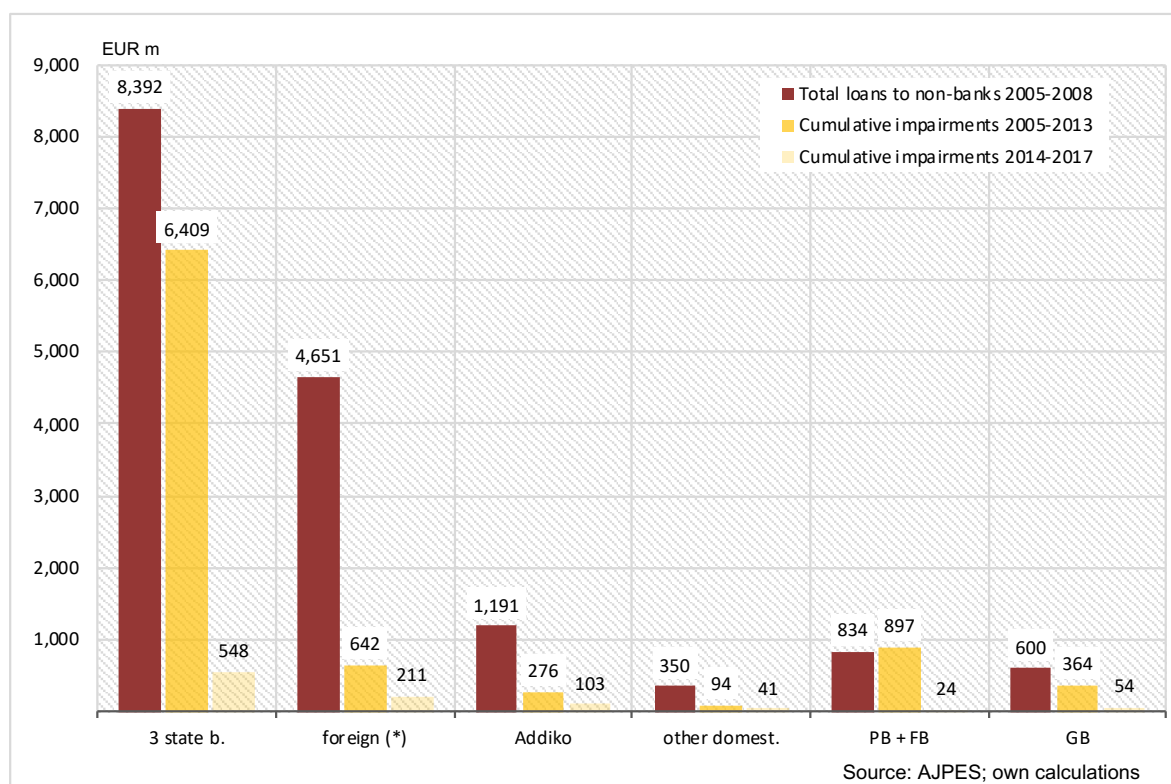
Notes: * Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

1 DUTB (Družba za upravljanje terjatev bank) is a Bank Assets Management Company set up by the Government of Republic of Slovenia in 2012 to deal with Non-performing loans of state-owned banks.

In contrast, FOBs seemed to apply higher lending standards when advancing loans to non-banks, resulting in a lower need to create loss provisions for those loans. For a total of about 4,600 mn EUR of new loans advanced to non-banks in the period 2005-2008, FOBs successively created impairments in the amount of 642 mn EUR between 2005 and 2013, plus additional impairments in the amount of 211 mn EUR between 2014 and 2017. In total, FOBs' total impairments in the period 2005-2017 account for 18% of total loans to non-banks advanced in the same period. Addiko bank's lending standards (for loans advanced in Slovenia) were lower as compared to other FOBs, but still superior when compared to SOBs, with the ratio of impairments / total loans to non-banks in the period 2005-2017 amounting to 32%.

Gorenjska banka followed a similar suit to the SOBs, with cumulative impairments created in the amount of almost 70% of loans advanced before 2008, while other, smaller domestically owned banks were more prudent, with the ratio of impairments / total loans to non-banks in the period 2005-2017 amounting to 39%. Probanka and Factor banka were a special case as they had to be liquidated in 2015 due to the amount of NPLs and the inability of their private owners to provide fresh capital.

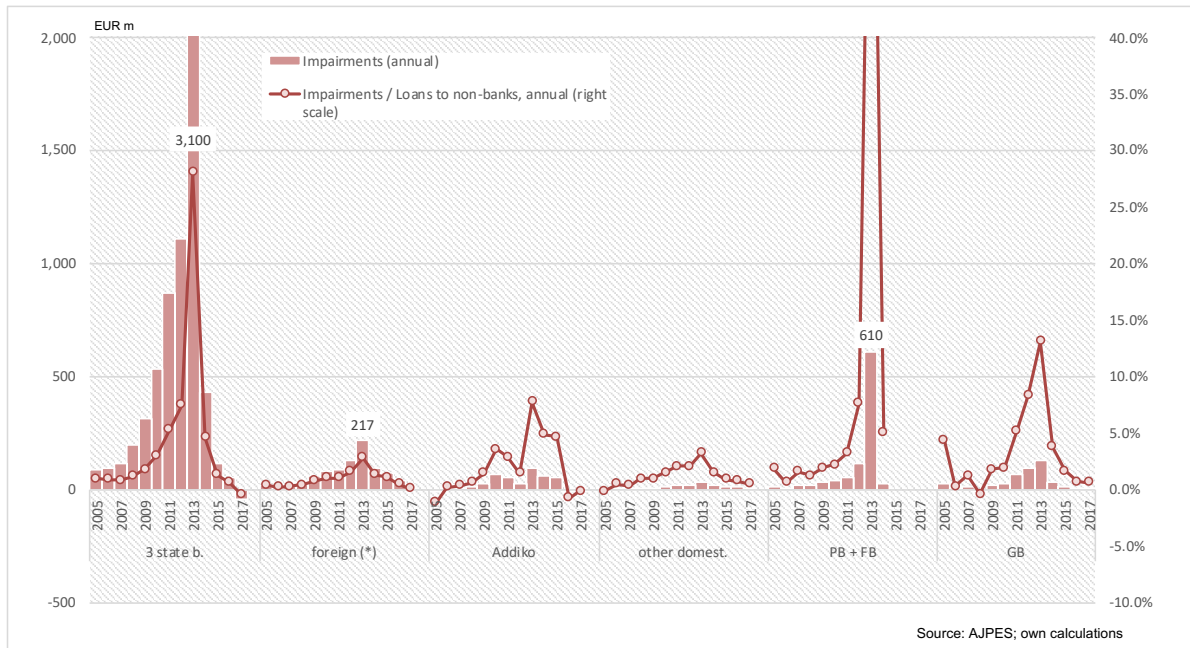
Figure 13: Cumulative loans to non-banking sector and impairments, by ownership, 2005-2017 (mn EUR)



Notes: * Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

In Figure 14, annual impairments volumes and ratios to total non-banks loans display a similar picture as above, showing SOBs (along with liquidated Probanka and Factor banka) as being impacted the most by their past inadequate lending practices. Here, again, FOBs and small domestic privately-owned banks stand out for their higher credit standards applied in the past.

Figure 14: Annual impairments volumes (mn EUR) and impairments as a share in total loans to non-banking sector (%), by ownership, 2005-2017

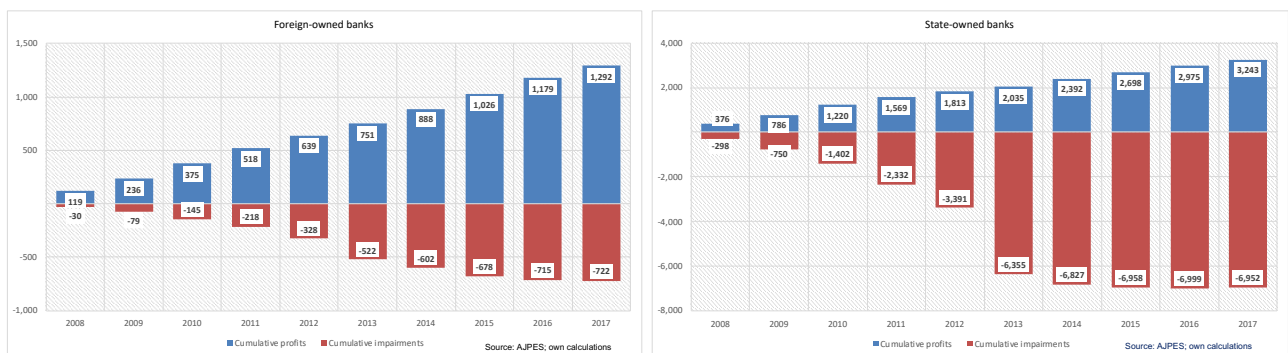


Notes: Annual impairments volumes on left scale; annual impairments as a share of total loans to non-banking sector on right scale.

* Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

A striking difference between FOBs and domestically-owned banks, either SOBs or privately-owned, is first in the adequacy of credit standards applied and then in their ability to timely handle the bad loans. Regarding the first, the above figures clearly indicate that FOBs were more prudent in their lending practices which helped preventing the bad loans to arise in the extent that was witnessed in the domestically-owned banks. There is, however, another piece of evidence in this regard showing that FOBs never ran into severe capital inadequacy problems as they were able, in any period of time during the last 15 years, to cover accumulated bad loans by accumulated operating profits. In contrast, except for the period before 2009, SOBs struggled to cover impairments with operating profits. This indicates both inadequate lending standards and mismanagement of loans before they turned out to become non-performing (Figure 15).

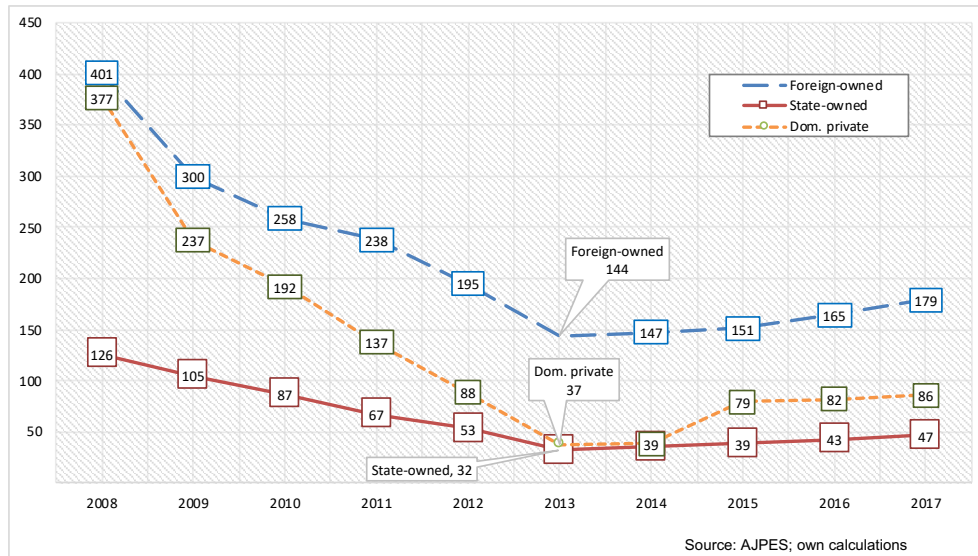
Figure 15: Cumulative impairments and operating profits, foreign- vs. state-owned banks, 2008-2017 (mn EUR)



Notes: Foreign banks group excludes Addiko bank and NKBM.

Overall, ratio of cumulative operating profits to impairments in FOBs never fell below 140%, while domestically-owned banks were less prudent in this respect. There is, however, a difference among the group of domestically-owned banks. With the exception of the period 2013-2014, privately-owned banks in general performed better in managing the balance between operating profits and impairments, both before and after the bank rehabilitation.

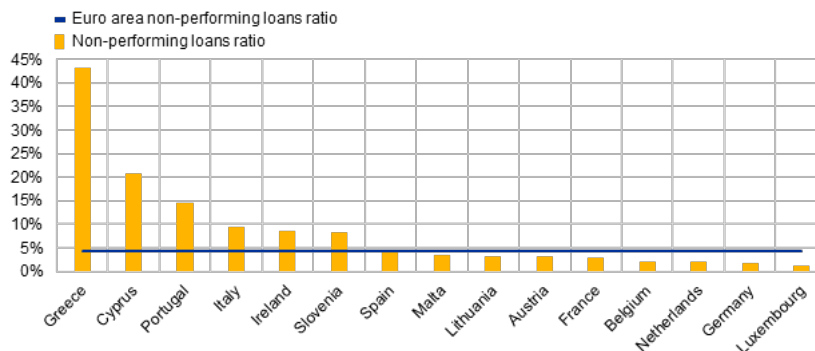
Figure 16: Ratio of cumulative operating profits to impairments, by ownership, 2008-2017 (%)



Notes: State-owned banks group includes, NLB, NKBM and Abanka (with Banka Celje). Foreign banks group excludes Addiko bank and NKBM. Domestic private banks group excludes Probanka and Factor banka.

Though in the recent period Slovenian banks are improving their balance sheet on a fast track, the shares of NPLs (exceeding 8% in Q3 2018) are still quite high as compared to other eurozone countries. There is only five eurozone countries with higher NPLs shares, all of them maturing from the sizeable banking crises.

Figure 17: Eurozone non-performing loans ratio by country, (%), Q3 2018

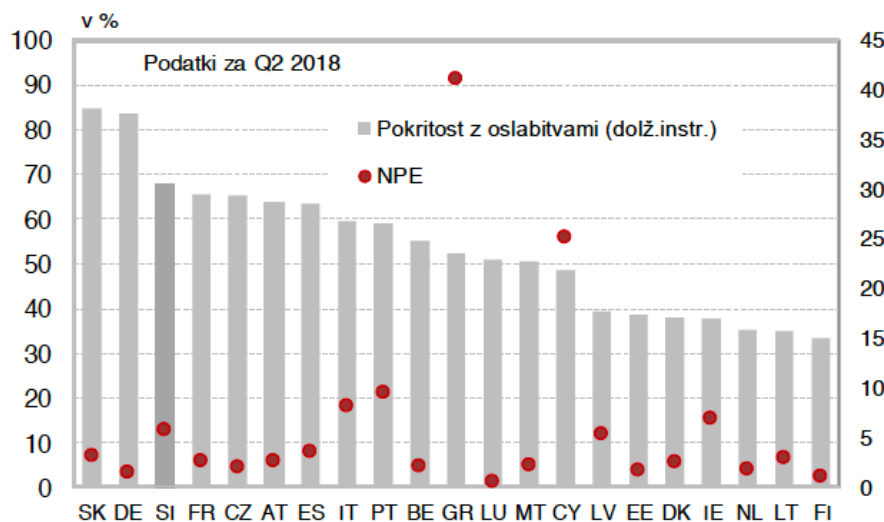


Source: ECB, [Banking Supervision](#), January 2019

On the good note, coverage of NPEs by impairments in Slovenian banking sector (a ratio of close to 70%) is quite high as compared to other eurozone countries (Figure 16). By accounting both for

impairments and reserves, the aggregate loss provisions by the Slovenian banks increases to 86% of NPEs.²

Figure 18: Coverage of NPEs by impairments (%), Q2 2018



Source: Financial Stability Report, Bank of Slovenia, December 2018

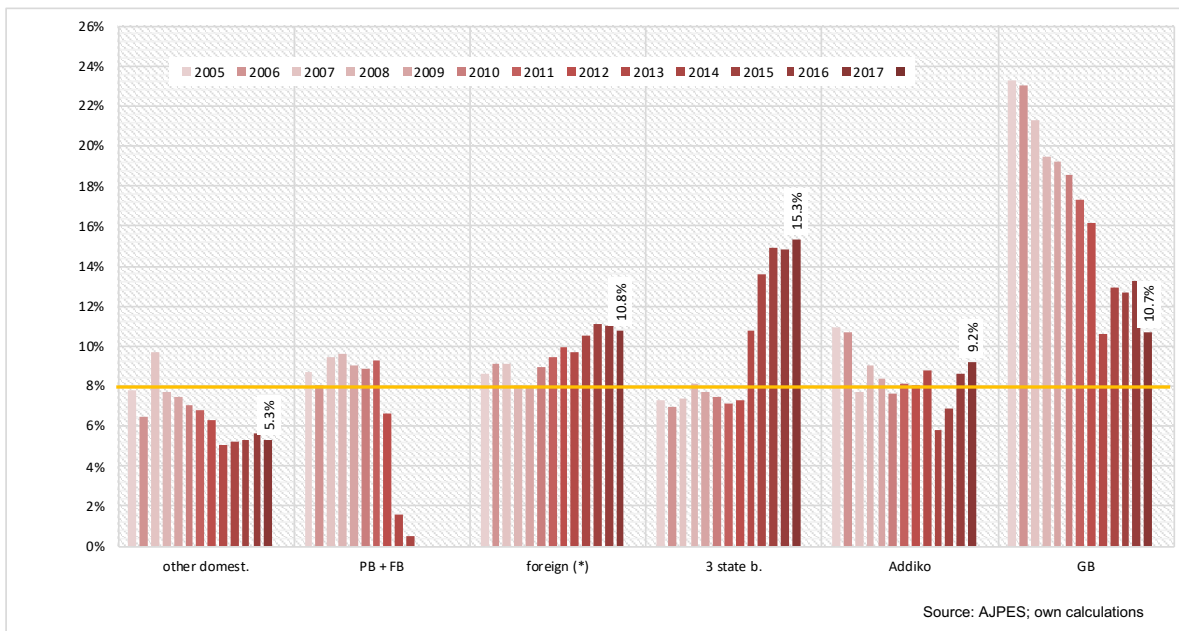
2.2 KEY PERFORMANCE INDICATORS

Though in this Section we will show key performance indicators for banks and banking groups for the total period 2005-2017, we will mostly focus on performance after 2013. In 2013, majority of Slovenian banks, in particular SOBs and privately-owned banks, undergone rehabilitation of their balance sheets under the supervision of the regulator (Bank of Slovenia). Along with improved economic outlook (resume of economic growth), this led to substantial improvements in banking performance and P&L accounts.

The first positive improvement is to be seen in the bank's capital adequacy. After the bank rehabilitation in 2013-2014, capital ratios of most the banks in the Slovenian market improved substantially. Simple capital to (risk-unweighted) total assets in most of the banks exceeds 8%. While FOBs traditionally applied higher capital to assets ratios that never fell below the 8% benchmark, SOBs passed this benchmark only after the substantial 2013 recapitalization.

² Financial Stability Report, Bank of Slovenia, December 2018.

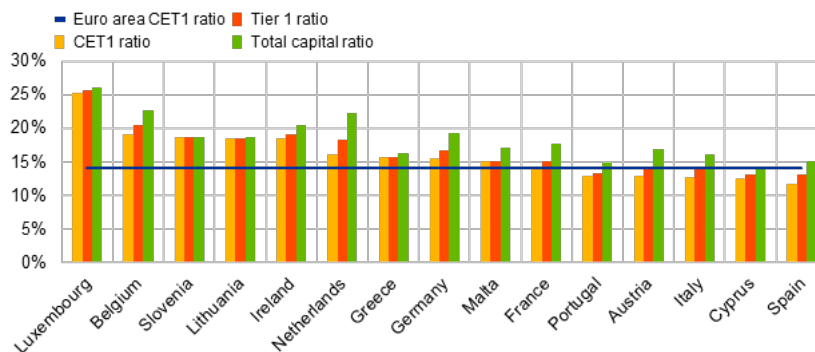
Figure 19: Capital to balance sheet ratio (%), by ownership, 2005-2017



Notes: * Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

When taking into account the risk-weighted assets, Slovenia is among the three Eurozone countries with the highest capitalized banking sectors, with the three core capital ratios exceeding 18% in Q3 2018.

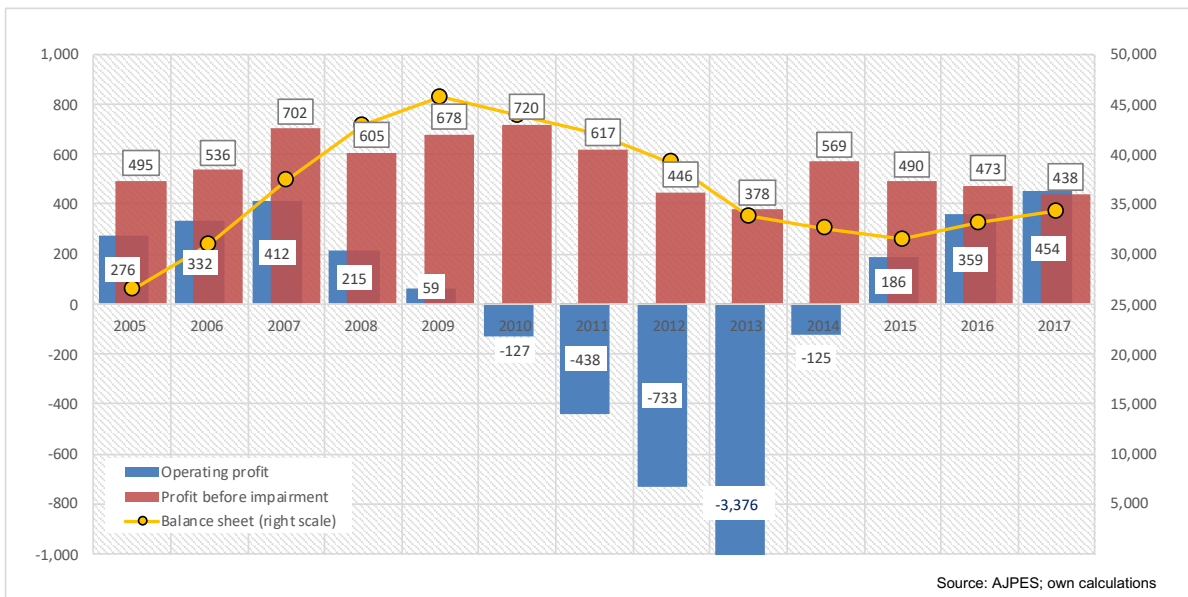
Figure 20: Eurozone capital ratios by countries (%), Q3 2018



Source: ECB, [Banking Supervision](#), January 2019

In terms of P&L account, Slovenian banks were making solid profits also during the financial crisis between 2009-2013, but only once impairments are not accounted for. In that period operating profits before impairments decreased from about 500 to 400 mn EUR. With impairments accounted for, operating profits of the entire banking sector were negative for five years (2010-2014), with the bulk of losses (3.4 out of 4.7 bn EUR) made in 2013.

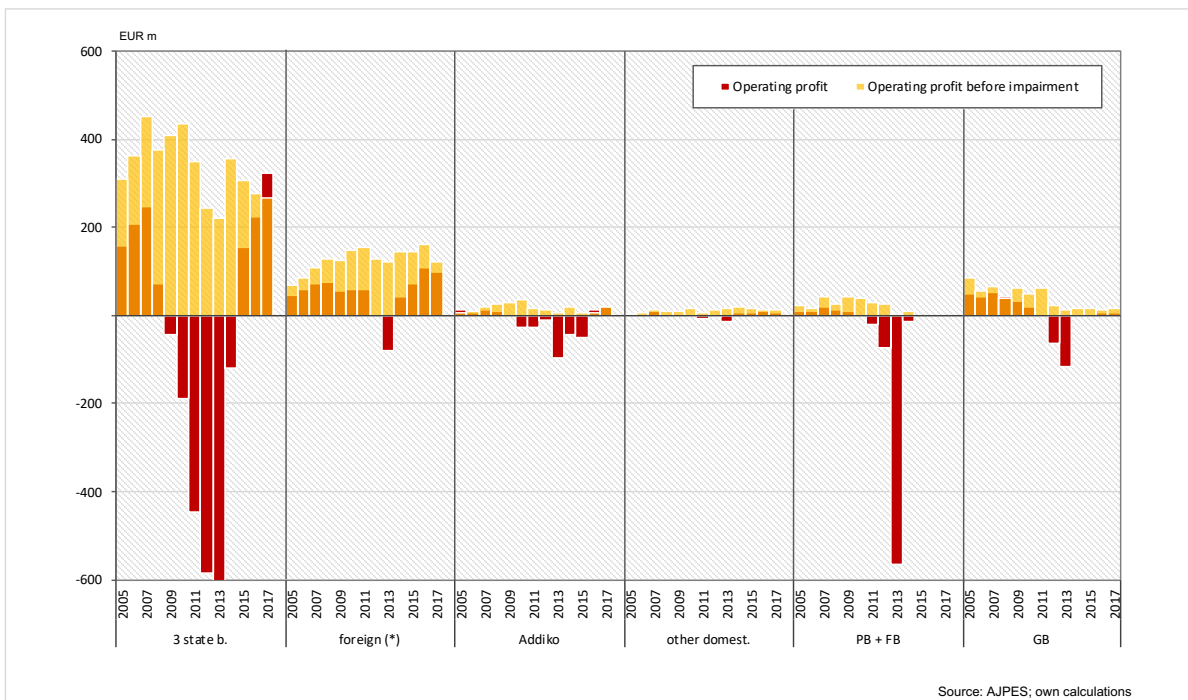
Figure 21: Operating profits before and after impairments (mn EUR), all banks, 2005-2017



A closer look reveals that SOBs are responsible for 80% of the banking sector losses during the 2010-2014 period, 14% of losses was made by Factor banka and Probanka, 4% by Addiko bank and 3% by Gorenjska banka. In contrast, FOBs recorded negative operating profits only in 2013, but making profits in all other years.

Banking sector as a whole has returned to positive figures in 2015 and is making solid profits, exceeding the pre-crisis profit levels.

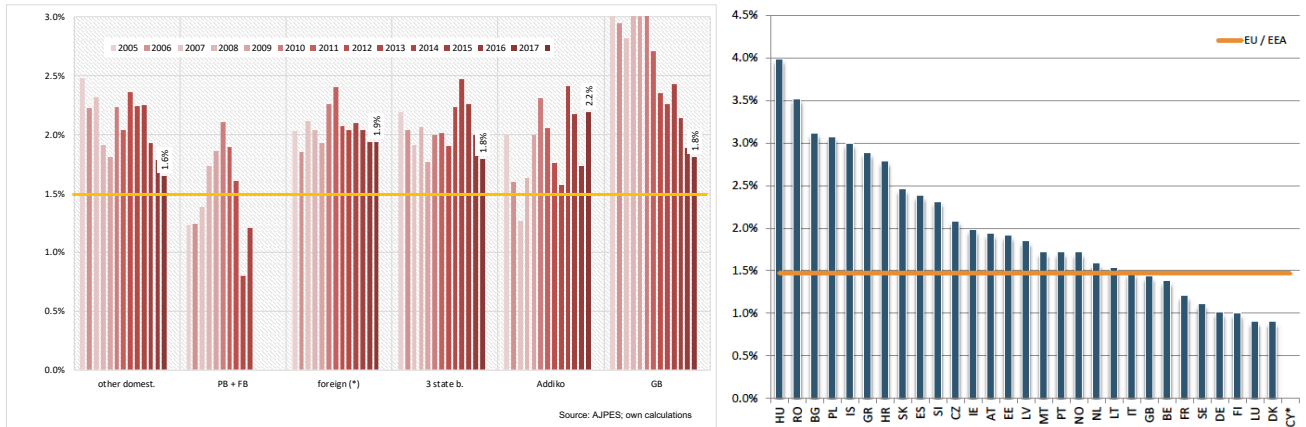
Figure 22: Operating profits before and after impairments (mn EUR), by ownership, 2005-2017



Notes: * Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

Slovenian banks are earning quite solid net interest margins as compared to the Eurozone average of 1.47% in Q4 2018. Both FOBs, SOBs and privately-owned banks are surpassing this benchmark, with FOBs marginally better than SOBs.

Figure 23: Net interest margin, Slovenia vs. Eurozone (%), by ownership, 2005-2017

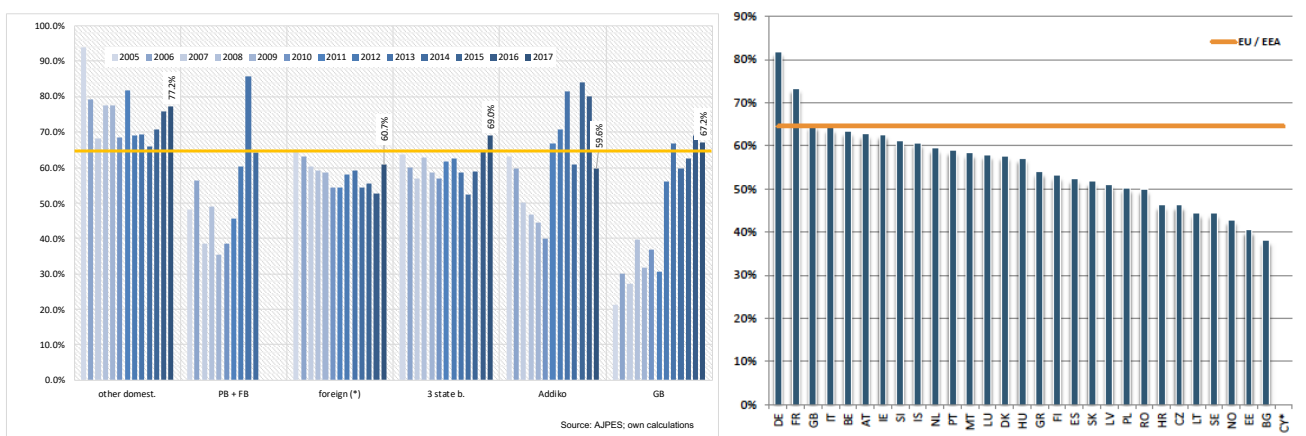


Notes: Net interest margin relative to total assets. Yellow line depicts average Eurozone banking sector net interest margin of 1.47% in Q4 2018 (Source: [EBA Dashboard - Q4 2018](#)).

* Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

In terms of cost to income ratio (CIR), with the average of 61%, Slovenian banks are in the upper third of Eurozone countries (though below the Eurozone average of 64.6%) indicating room for cost optimization. FOBs demonstrate more efficient cost management with a ratio of 60.7%, while SOBs and small private domestic banks (with CIR ratios of 69.0% and 77.2%, respectively) have a long way to follow suits of FOBs. With privatization of SOBs and subsequent cost optimization, individual banks' operating profits will improve substantially as well.

Figure 24: Cost to income ratio, Slovenia vs. Eurozone (%), by ownership, 2005-2017

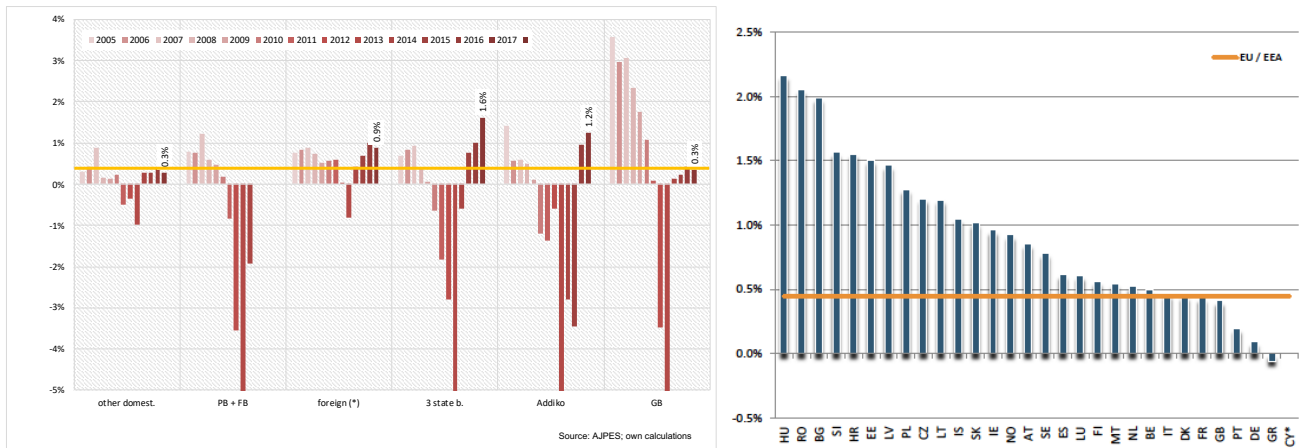


Notes: Cost-to-income ratio, calculated as the operating expenses over the operating income generated. Yellow line depicts average Eurozone banking sector Cost-to-income ratio of 64.6% in Q4 2018 (Source: [EBA Dashboard - Q4 2018](#)).

* Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

With 1.6% return to assets (RoA), Slovenian banking sector performs well in comparison to banking sectors in other Eurozone countries (average of 0.44%). These figures are mainly driven by the SOBs, while smaller privately-owned banks and Gorenjska banka are performing below the Eurozone benchmark. FOBs are performing better, with a double rate of the Eurozone average profitability, but lagging behind the SOBs.

Figure 25: Return on assets, Slovenia vs. Eurozone (%), by ownership, 2005-2017

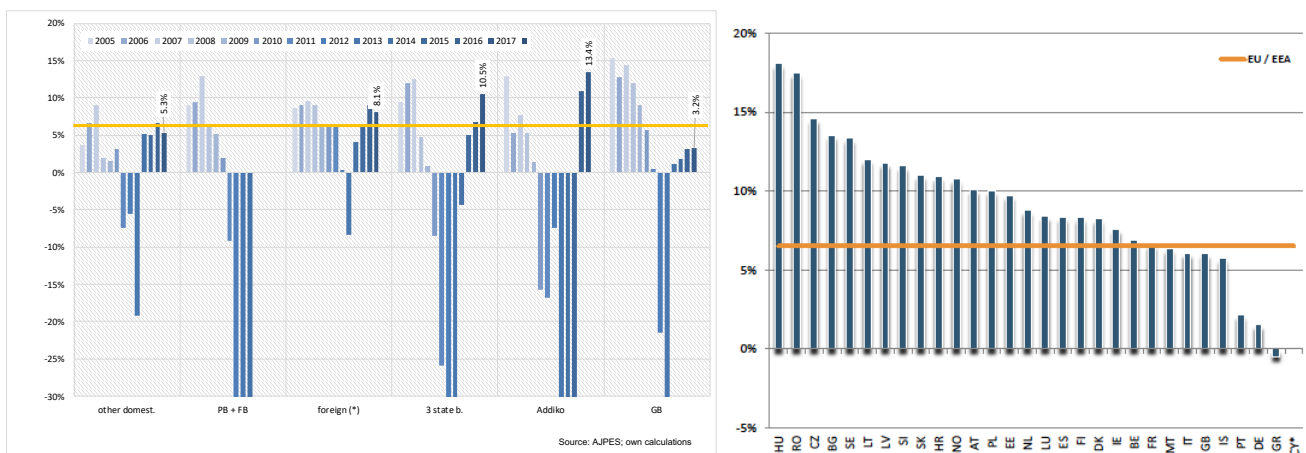


Notes: Yellow line depicts average return on assets of 0.44 % in Q4 2018 (Source: [EBA Dashboard - Q4 2018](#)).

* Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

With a 12% return to equity (RoE), Slovenian banks are on average twice as profitable as the average Eurozone banks (6.5%). Only Gorenjska banka and a group of smaller privately-owned domestic banks operate below this benchmark, while SOBs again show higher profitability than FOBs by a margin of 20 percentage points. In terms of RoE the profitability difference between SOBs and FOBs is smaller than in terms of RoA, as SOBs are characterized by higher capital ratios after the 2013 bank rehabilitation.

Figure 26: Return on equity, Slovenia vs. Eurozone (%), by ownership, 2005-2017



Notes: Yellow line depicts average return on equity of 6.5 % in Q4 2018 (Source: [EBA Dashboard - Q4 2018](#)).

* Foreign banks group excludes Addiko bank; Other domestic banks group captures all majority owned domestic banks, but Gorenjska banka, Factor banka (FB) and Probanka (PB); NKBM is considered as state-owned throughout the period.

3 IMPACT OF MERGERS AND ACQUISITIONS ON PERFORMANCE OF ACQUIRED BANKS

The analysis so far has shown several key findings regarding the bank performance and ownership structure. First, FOBs are shown to have been more prudent in terms of lending standards and the ability to handle the loans turning non-performing. FOBs were able to handle the accumulated NPLs by the means of accumulated profits and there was, in contrast to FOBs, no need for large scale recapitalization or, worse, bail-outs.

Second, loans-to-deposit ratio is traditionally higher in FOBs than in domestically-owned banks, indicating FOBs' higher dependence on intra-group sources of liquidity. This intra-group access to liquidity is particularly important in adverse times. After September 2008 when all other banks were contracting their credit activities due to inability to refinance their positions in the inter-banking markets, FOBs were able to maintain the pre-crisis levels of lending also in the period of severe credit crunch. When combined with more prudent lending standards, this access to intra-group sources of liquidity increases the robustness of the entire banking sector and can have a stabilizing impact on the economy.

And third, FOBs are shown to operate at substantially lower costs (in terms of cost to income), while achieving marginally higher net interest margins as compared to domestically (state- or privately) owned banks. Revealed returns to asset or capital (RoA and RoE), though, are comparatively lower in FOBs, which may reflect a higher cost of capital for FOBs.

This indicates superiority of FOBs over domestically (state- or privately) owned banks in terms of performance and stability. In this section, we will examine what effects in terms of key performance indicators brings foreign ownership after the acquisition for initially domestically-owned banks. We will focus on the period after 2013.

3.1 FOREIGN ACQUISITIONS IN SLOVENIAN BANKING SECTOR AFTER 2013

Process of privatization and foreign acquisitions in the Slovenian banking sector has seriously restarted only after 2013 due to the EC requirement to privatize banks that received state aid during the bank rehabilitation process in 2013-2014. In 2014, SOBs' market shares still exceeded 60%. In 2015, Abanka and Banka Celje merged to create second largest bank. NKBM was fully privatized in 2015. AIK banka acquired a 13.6% share in Gorenjska banka early 2016, expanded this share to 21% by the end of 2017, while acquiring the 90% majority share by the end of 2018. NLB was privatized through IPO in the fall of 2018, whereby 35% of shares is still controlled by the state. For other banks there was no ownership changes from domestic to foreign after 2013. Abanka is in a process of privatization and is expected to be privatized by mid 2019.

This gives us a very small sample of banks that changed ownership from domestic to foreign after 2013. This sample decreases further with a requirement to observe changes in performance for at least 2 years after the acquisition. Basically, there are only two cases for which we can perform a comparative analysis of performance before and after takeover and comparatively to non-privatized banks:

- NKBM (privatized in 2015), available date after foreign acquisition: 2016-2017,
- Gorenjska banka (minority share acquired in 2016), available date after foreign acquisition: 2016-2017.

Table 1: Privatized / acquired banks by foreign owners after 2013

Bank	Year of foreign acquisition	Available full data for post-acquisition
NKBM	2015	2016, 2017
Gorenjska banka	Early 2016	2016, 2017
NLB	Late 2018	-
Abanka	Mid 2019	-

This limits the scope for the analysis of the effects of foreign acquisitions on bank performance as many of the benefits of foreign ownership are only expected in the medium-to-long run.

3.2 IMPACT OF FOREIGN TAKEOVERS ON BANK PERFORMANCE

The main limitation of an analysis of the impact of a takeover on performance of the targeted banks is data availability. Given that changes to the target bank's functions, management and performance take time, one would ideally need to have at least 3 - 5 years of accounting data under new management of the firm to be able to draw conclusions on the changes in its performance. While foreign ownership is generally shown to result in superior bank performance in Slovenia, the impact of changes in performance of newly acquired NKBM and Gorenjska banka to foreign majority owners is still to be seen in the medium term.

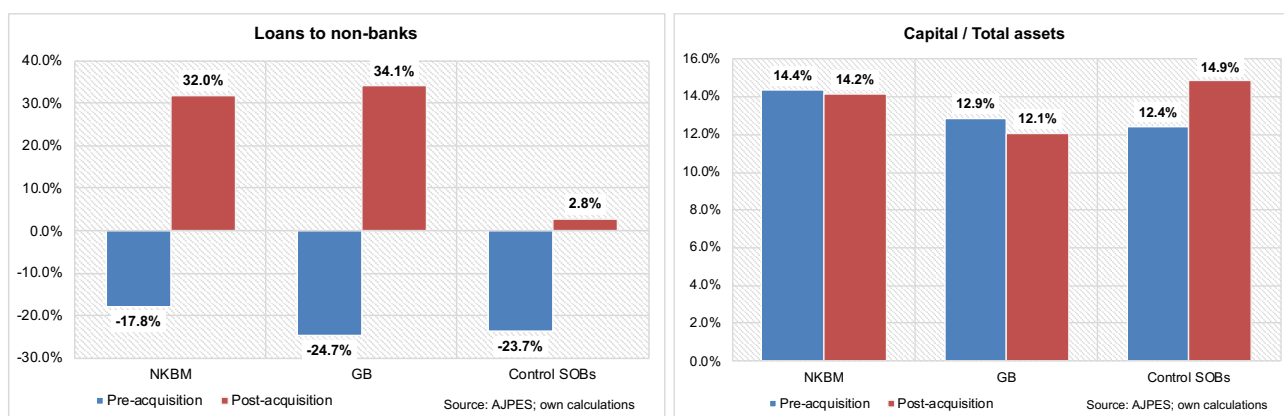
In what follows, we will be comparing the pre-acquisition dynamics of some key performance indicators with their post-acquisition dynamics as well as with performance of a control group of banks in the same post-acquisition period. In principle, we will compare:

- performance of NKBM and Gorenjska banka in 2014-2015 (pre-acquisition) to 2016-2017 (post-acquisition) period,
- performance of NKBM and Gorenjska banka in 2016-2017 (post-acquisition) to the control group of still state-owned banks (NLB, Abanka) in the same period.

First indicator to be compared is lending activity of newly privatized banks to foreign owners. While both NKBM and Gorenjska banka (GB) reduced credit activities in the two years prior to acquisition (between 18 and 25%), they substantially boosted lending in the 2-year post-acquisition period (by more than 30%). In contrast, the banks in a control group (NLB and Abanka) were able to increase lending only by 3% in the same post-acquisition period. Hence, privatization to foreign owners resulted in the upswing of credit activities.

In terms of capital adequacy, all banks enjoy high capital ratios (measured as a ratio of capital to all non-weighted assets). Both privatized banks slightly reduced capital ratios in the 2-year post-acquisition period, while both SOBs in the control group improved the capital ratios significantly. This is, however, a statistical artefact as both privatized banks increased lending by more than 30% in that period, leading to a decrease in capital ratios (due to higher denominator). On the other side, credit activity of NLB was further reduced between 2017 and 2015 by 1.4%, leading to higher capital ratios.

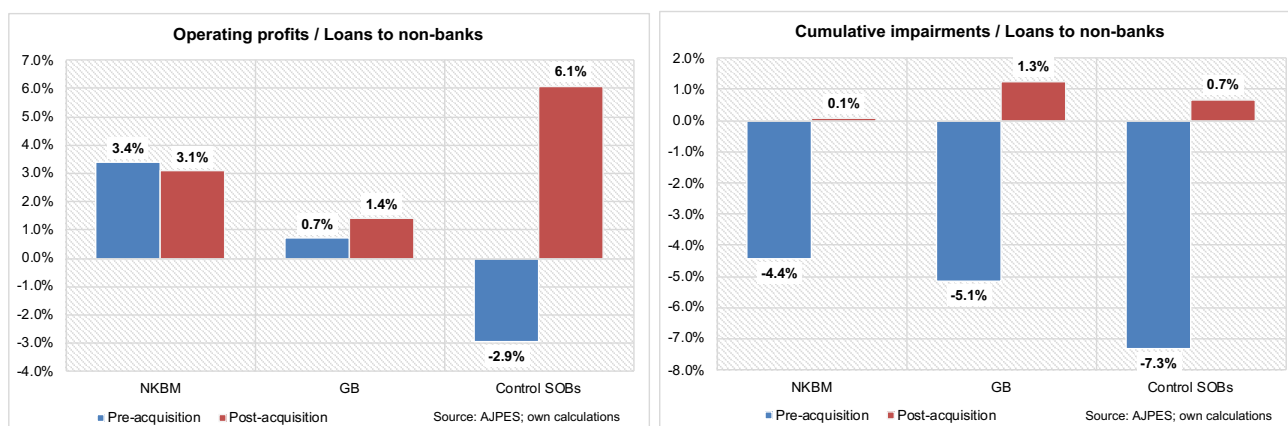
Figure 27: Comparative performance of NKBM and Gorenjska banka before and after acquisition, Loans to non-banks and capital to assets (%), 2014-2017



Notes: Loans to non-banks calculated as 2-years change before and after acquisition. Capital to assets calculated as average capital ratio in the 2-year period before and 2-year period after acquisition Control SOBs group consists of NLB and Abanka.

In both privatized banks, operating profits after the acquisition increased at a similar or higher pace (both in absolute terms and relative to total loans) as compared to the pre-acquisition period. Both SOBs in the control group, however, were able to improve operating profits in the post-acquisition period at a higher pace than privatized banks. The latter, however, is a result of substantially lower requirements for creating impairments in the period 2016-2017 and / or of release of past impairments in 2017. On average, privatized banks reduced impairments at the same extent as the control group of non-privatized banks.

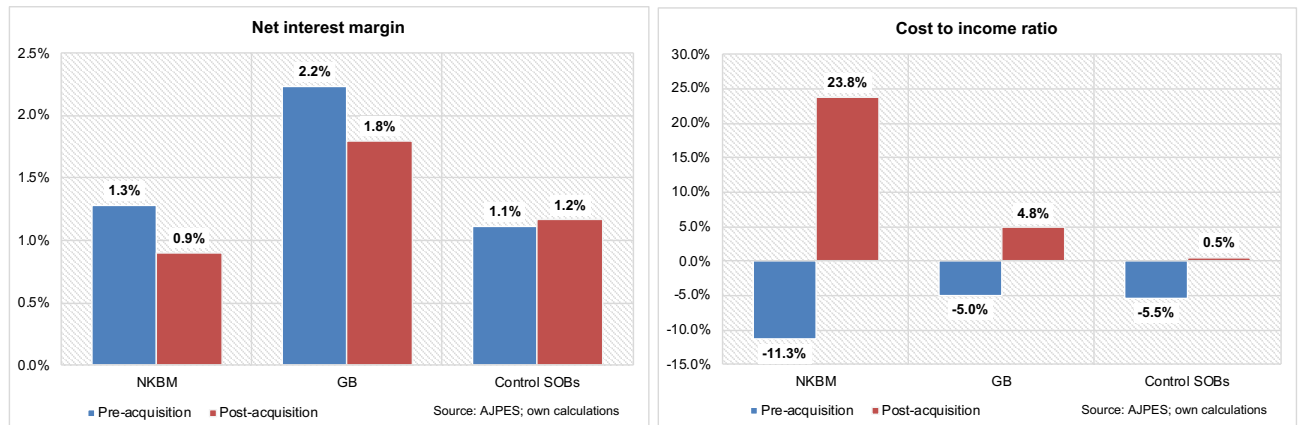
Figure 28: Comparative performance of NKBM and Gorenjska banka before and after acquisition, Operating profits and Impairments as share of loans to non-banks (%), 2014-2017



Notes: Cumulative operating profits and impairments as share of loans to non-banks in the 2-year period before and after acquisition. Control SOBs group consists of NLB and Abanka.

Net interest margins slightly decreased in the post-acquisition period in both banks privatized to foreign owners, but mostly in NKBM where net interest incomes dropped by 15% between 2015 and 2017. On the other side, both SOBs marginally increased net interest margins in this period, though the levels are similar to newly privatized NKBM, but substantially lower than in GB.

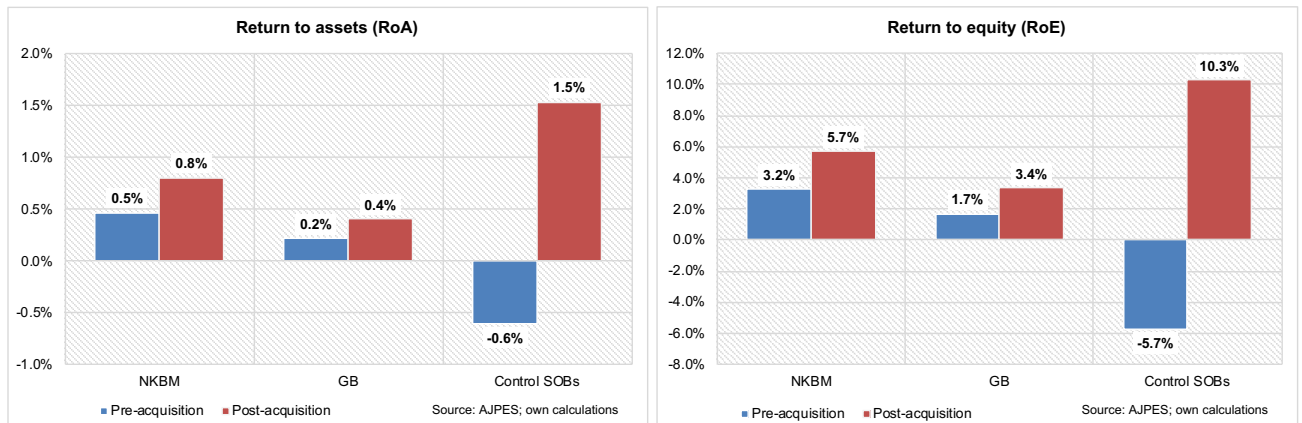
Figure 29: Comparative performance of NKBM and Gorenjska banka before and after acquisition, Net interest margin and Cost to income ratio (%), 2014-2017



Notes: Net interest margin is calculated as average over the 2-years periods before and after acquisition. Cost to income ratio is calculated as a difference between current and past ratio. Control SOBs group consists of NLB and Abanka.

Cost to income ratios in both newly privatized banks increased in the post-acquisition period. This surge in the cost ratio is substantial in NKBM, where the ratio increased due to reduced net interest incomes by 15% and an increase in operating costs by a fifth. In GB, operating costs also increased by a fifth, whereby net interest incomes increased by a tenth, leading to slightly bigger ratio of cost to income. For SOBs, the situation is different as Abanka is mirroring the dynamics of GB in the post-acquisition period (i.e. slight increase in cost to income ratio), while NLB was able to compensate falling net interest incomes by increased incomes from other fees.

Figure 30: Comparative performance of NKBM and Gorenjska banka before and after acquisition, Rate of return on assets and rate of return on equity (%), 2014-2017



Notes: RoA and RoE are calculated as average over the 2-years periods before and after acquisition. Control SOBs group consists of NLB and Abanka.

Both privatized banks almost doubled their returns to capital and to assets in the post-acquisition period as compared to the pre-acquisition period. The improvements in profitability were substantially bigger in SOBs, though the large majority of the surge in average profitability comes down to NLB, which in the period 2015 to 2017 managed to increase operating profits by almost 250% while decreasing total assets by a tenth.

To summarize, in comparison to still state-owned banks, both newly privatized banks to foreign owners were able to boost credit activities and reduce the need for loan loss provisions after the acquisition. However, to improve profitability they have to address the challenges of falling net interest incomes and increased operating cost in the future. Both SOBs in the control group, NLB and Abanka, have proven more efficient in reducing operating cost, while NLB also managed to compensate falling net interest incomes by increasing incomes from other fees.

This 2-year post-acquisition episode, however, is too short to make firm conclusions. The full impact of changes in performance of newly acquired NKBM and Gorenjska banka to foreign majority owners is to be seen in the medium term of 3 to 5 years after the acquisition.