Deloitte.

Banking and securities M&A outlook

Time to get in gear

Introduction

After several years of false starts, will banking and securities merger and acquisition (M&A) activity get in gear in 2018?

Entering 2017, there seemed to be positive momentum for increased deal-making in banking, specialty finance, investment management and securities, and financial technology (fintech). Macro-level catalysts included an improving economy, sustained stock market rally, steadily rising interest rates, pro-business election results, and the expected easing of financial services industry (FSI) regulations. Add organization-level triggers of continuing margin pressure, ample cash reserves, and the need for digital capabilities, and the combination of factors warranted an optimistic outlook. Yet, similar to 2016, the M&A engine essentially remained in neutral: Deal sizes increased in 2017, but there were fewer transactions overall.

Entering 2018, we continue to be optimistic about banking and securities M&A. Virtually all of the above drivers remain in place and are being bolstered by increasing regulatory clarity and US tax reform legislation—both of which will benefit bottom lines and add to capital war chests. We do, however, anticipate that organizations will need time to digest the implications of new legislation and may delay deal-making to the second half of the year.

Banking

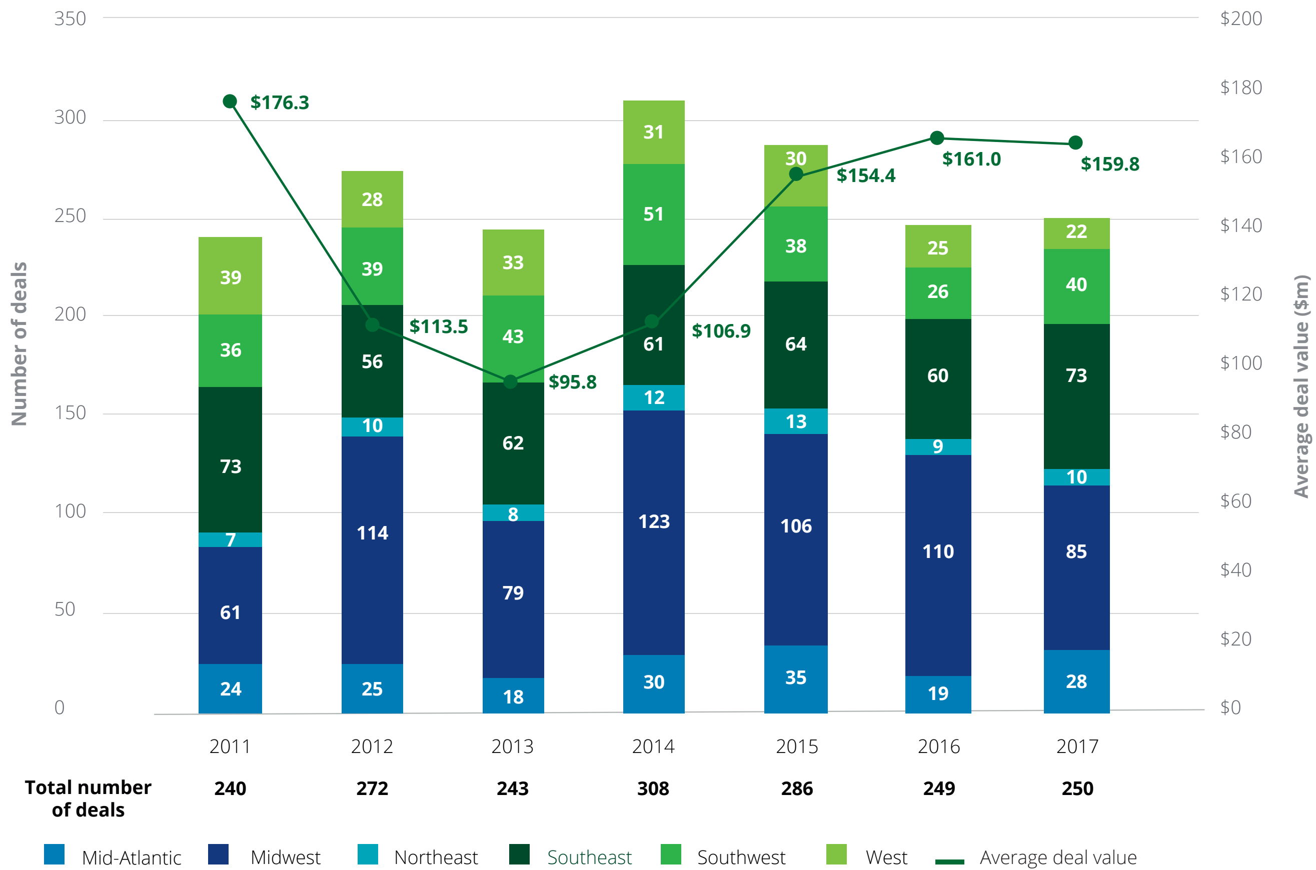
With 250 announced deals as of December 19, banking M&A volume in 2017 was almost a carbon copy of the prior year's 249 transactions (figure 1).[1] 2017's total was a bit disappointing, as the year began with numerous natural drivers for consolidation—an improving economy, sustained stock market rally, ample capital levels, and expectations for a loosening of banking regulations under the new Trump administration. However, delayed regulatory leadership changes, prolonged uncertainty around tax and health care reform, and a late-2016 run-up in stock prices (especially for small banks) let the air out of M&A's tires somewhat in 2017.

We also expected stronger consolidation in 2017 at the higher end of the regional/super-regional banks, but that didn't happen. While 2016 saw three deals in which the acquired bank had over $20 billion in total assets, 2017 saw zero deals of that size. Astoria Financial Corporation—which was acquired for $2.2 billion by Sterling Bancorp—was 2017's biggest deal.[2]

2017 banking M&A average deal value, at $159.8 million, held steady with 2016's average of $161 million[3] (figure 1).

From a regional perspective, the Midwest and Southeast led deal volume in 2017, posting 85 and 73 deals, respectively.[4] Both regions' composition of smaller, targetable banks—along with the shift in banking assets as a result of population movements—are likely the reasons for their higher deal volume. In addition to higher deal volume, the Southeast also had three of 2017's top five transactions in terms of deal value (figure 1).[5]

Figure 1. Banking deals (by region) and average deal value



Banking: 2017 top five deals by deal value					
Buyer	**Target**	**Agreement date**	**Deal value ($m)**	**Target general industry type**	**Target region**
Sterling National Bank	Astoria Finacial Corporation	3/7/2017	$2,194.10	Bank	Mid-Atlantic
First Horizon National Corporation	Capital Bank Financial Corp.	5/4/2017	$2,175.06	Bank	Southeast
Pinnacle Bank	BNC Bancorp	1/22/2017	$1,840.53	Bank	Southeast
First Financial Bank	MainSource Financial Group Inc.	7/25/2017	$1,005.57	Bank	Midwest
IBERIABANK	Sabadell United Bank N.A.	2/28/2017	$1,004.96	Bank	Southeast

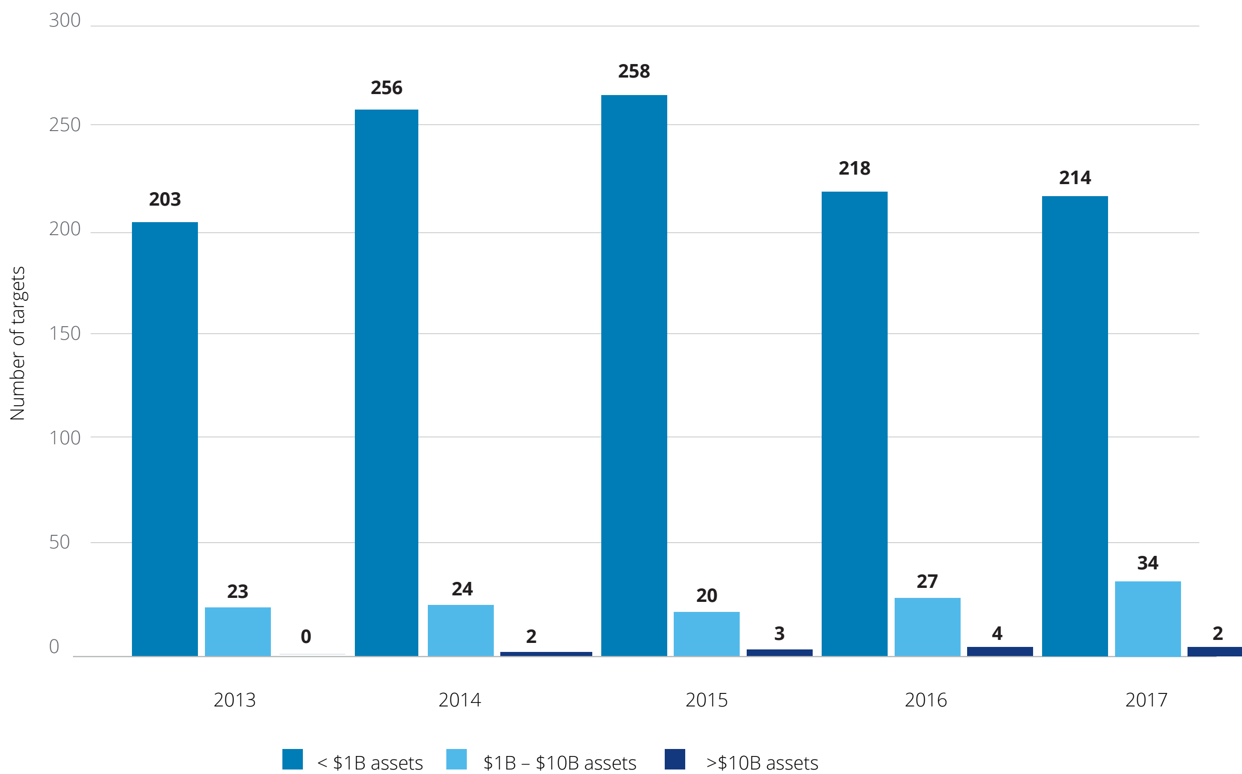
Source: SNL Financial and S&P Global Market Intelligence

Note: Average deal size is based on disclosed deal values; 60%, 49%, 39%, 43%, 41%, 36%, and 39% of reported deals did not disclose deal values for FY11, FY12, FY13, FY14, FY15, FY16, and FY17, respectively.

Continuing a multiyear trend, the majority of banking M&A deals in 2017 occurred at the small bank level, with most acquisition targets holding less than $1 billion in assets (figure 2). Pressured by prolonged, relatively low interest rates and burdensome regulatory compliance and technology upgrades that are driving high operating costs, many small banks are choosing to consolidate or be purchased rather than go it alone.

Figure 2. Bank transactions by asset size

Targets by asset size



Source: SNL Financial and S&P Global Market Intelligence

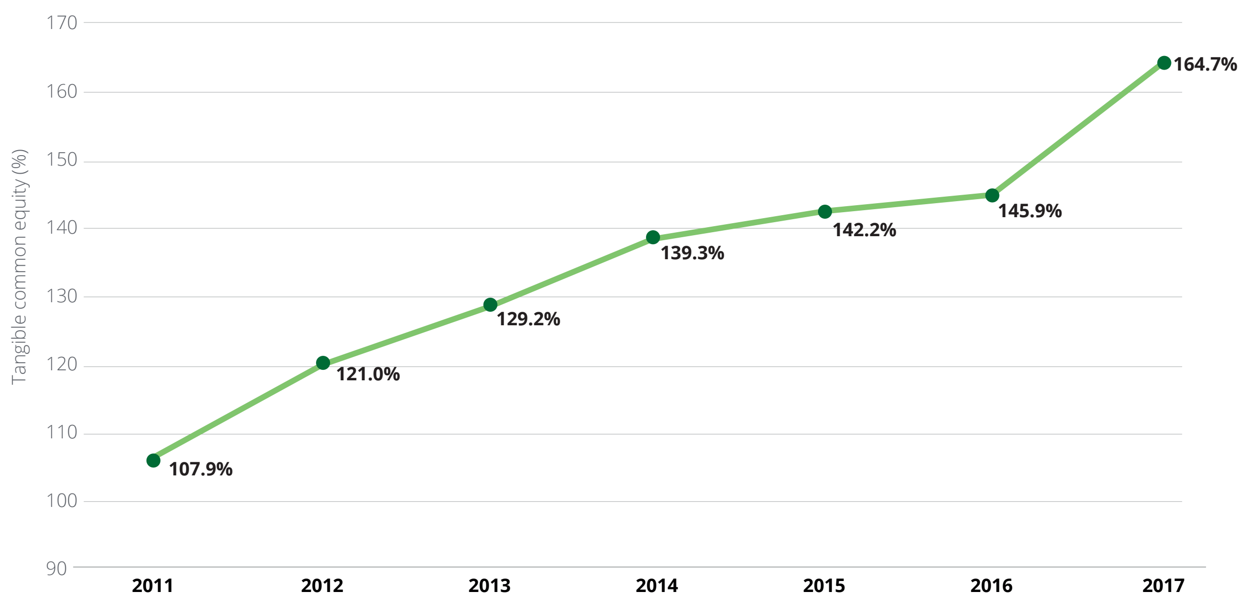
What we expect to see in 2018

Second-half momentum. With banks likely to ride the wave of tax gains (outside of the impact on deferred tax asset values), increasing interest rates, higher valuations, and the potential easing of regulations during the first half of 2018, they may see less need to push the inorganic lever of M&A to grow earnings. Still, with significant momentum in the system, the second half of the year could see some strategic and financial deal-making on par with or in excess of 2016. We expect larger banks to acquire fintech capabilities and continue evaluating whether businesses are core to their strategy and divesting those that no longer fit; smaller banks to consolidate; and private equity (PE) firms to continue to monetize remaining crisis-era investments.

Better efficiency ratios. As banks get over the hump of implementing post-recession regulatory changes, we are also anticipating improvement in efficiency ratios. With institutions heading in the right direction from a profitability perspective, it may create a healthier environment for getting deals done, with buyers benefiting from potentially higher stock prices and sellers demonstrating a positive earnings trend that helps bridge bid–ask spreads.

Valuation trends. A potential hiccup to M&A in 2018 is bank valuations, which potential acquirers may already view as full, and are reflected in rising average deal value as a percentage of tangible common equity over time (figure 3). A market correction that lowers stock prices—as recently occurred before this paper went to publication—might entice buyers to jump in. Alternatively, if values remain stable at these levels, or continue their modest rise, buyers may accept this as the "new reality" and start pulling the deal trigger in advance of potential pricing increases approaching pre-crisis levels. Conversely, sellers in stock deals may have concerns that the buyer stock currency is at inflated levels; we may see elevated deal multiples in some situations to combat that impact to selling shareholders.

Figure 3: M&A banking deals: Average deal value/tangible common equity (%)

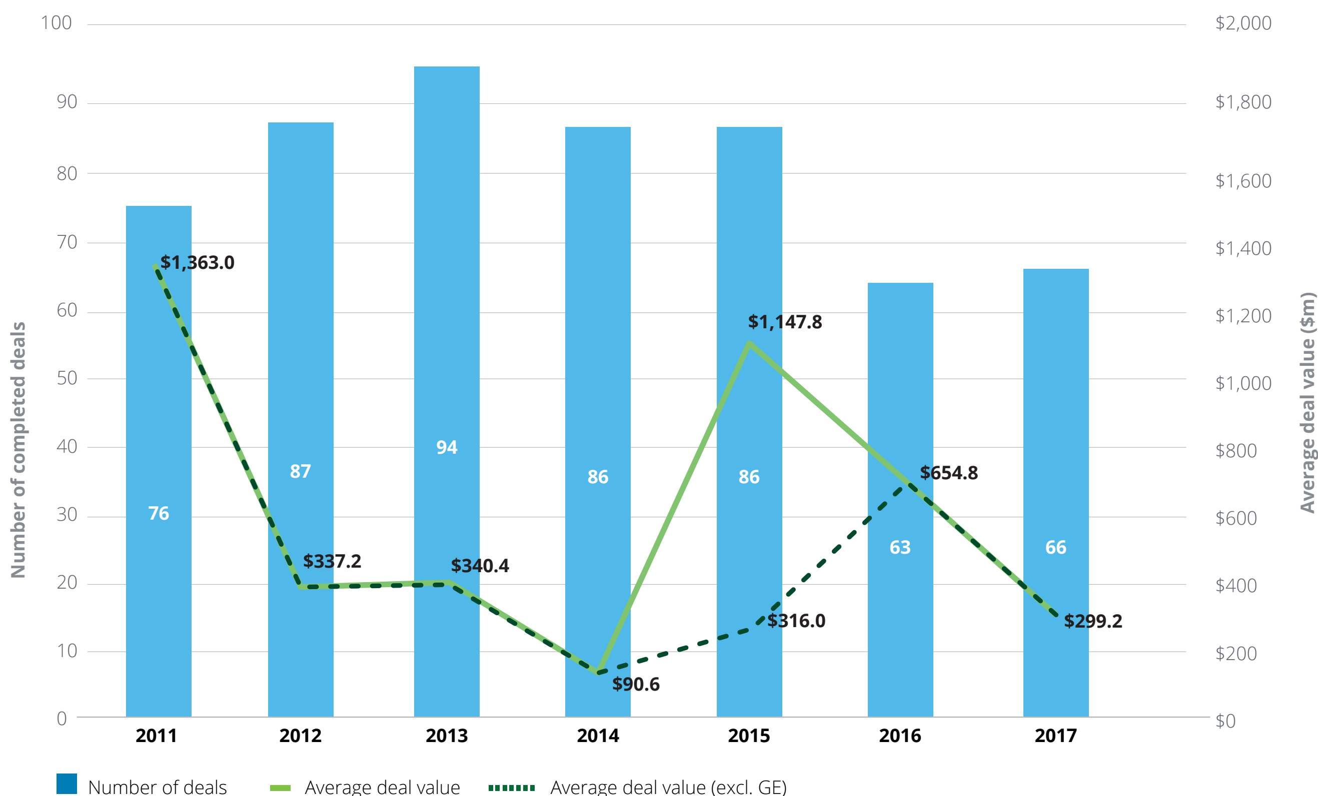


Source: SNL Financial and S&P Global Market Intelligence

Specialty finance

The mammoth 2015 GE Capital asset sell-off took much of the desirable specialty finance inventory off the table and slowed M&A activity in 2016. Jump ahead one year and specialty finance M&A deal volume remained close to par—66 deals in 2017 versus 63 in 2016. But average deal value (excluding GE tail-end transactions) dropped by more than half; from $655 million down to $299 million (figure 4).[6]

Figure 4: Specialty finance deals and average deal value



Specialty finance: 2017 top 5 deals by deal value				
Buyer	**Target**	**Agreement date**	**Deal value ($m)**	**Target general industry type**
United Rentals Inc.	Neff Corporation	8/16/2017	$1,300.00	Commercial focused
Williams Scotsman Holdings Corp.	Williams Scotsman International Inc.	8/21/2017	$1,100.00	Commercial focused
United Rentals Inc.	NES Rentals Holdings II Inc.	1/25/2017	$965.00	Commercial focused
LBC Capital Inc.	NCF Holdings LLC	5/18/2017	$923.23	Commercial focused
FE Holdco LLC	NewStar Financial Inc.	10/17/2017	$517.04	Commercial focused

Source: SNL Financial and S&P Global Market Intelligence
Note: Average deal size is based on disclosed deal values; 57%, 47%, 49%, 57%, 60%, 68%, and 65% of reported deals did not disclose deal values for FY11, FY12, FY13, FY14, FY15, FY16, and FY17, respectively.

What we expect to see in 2018

Given the scarcity of attractive properties, 2018 specialty finance deal volume should be similar to that of 2017 and focused on driving scale.

Competition-focused deals. We expect organizations to continue consolidating and making financial plays to take out the competition—especially in light of lending banks' product expansion efforts to cut into specialty finance's market share. Some deals may be cross-border; international and PE investors prefer the US specialty finance space to banking as a way to invest in the US lending sector because it has less restrictive ownership regulations.

Interest rate pressures. Specialty finance companies, especially those that secured their funding from banks, tend to be more earnings sensitive to interest rate increases than other financial services institutions. Banks typically push rate increases down to the specialty finance side, but these companies can't push increases down to customers because there is so much market competition. Continuing rate hikes may spur middle-market deals such as PE roll-ups of mortgage originators, as specialty finance firms will need scale to compete on the origination side and capital to invest in mortgage servicing rights (MSRs).

The impact of US tax reform. What will be the impact of tax reform on the mortgage industry, given limitations on property tax and mortgage interest deductions—especially in the refinance area? While the commercial impact to mortgage lenders remains to be seen, limitations on individual taxpayers' ability to deduct property taxes, along with a lower cap on the mortgage balances for which interest deductions can be claimed (as well as eliminating deductibility of interest on home equity loans), would generally suggest that the tax benefits of individual homeownership have been muted, particularly in states with higher property tax rates or for borrowers whose mortgage would exceed the reduced cap of $750,000.

Retail credit card portfolio opportunities. Sluggish growth for store-based retail has had substantial ramifications for retailers of all sizes. Among the 35 largest publicly traded US retailers, 37 percent reported declines in global sales during the first half of 2017 compared to the same period in 2016.[7] Analysts estimate that 8,600 stores will have closed nationwide by the end of the year, a figure that would exceed the number of store closings during the financial crisis.[8]

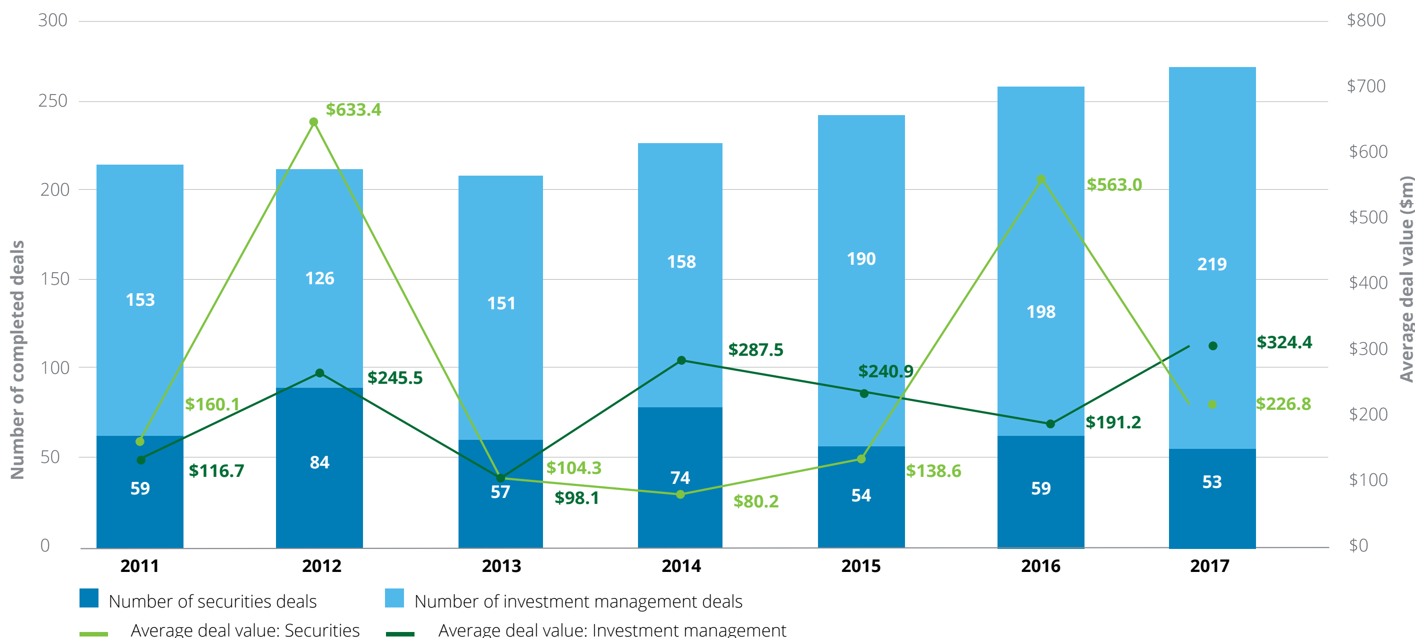
Many retailers have elected to offset declining sales from traditional channels by aggressively expanding their store card businesses. Among top US retailers, 82 percent offer shoppers store-branded credit cards.[9] Hundreds of retailers have credit card programs with banks, and many of those retailers are not expected to survive over the next five years. Shrinking retailer numbers may open the door for both banks and specialty finance (as well as PE and insurance) companies to acquire and white label their credit card portfolios, run them off, and leverage scale and well-oiled processes to operate them at a much lower cost.

Investment management and securities

Investment management (IM) M&A delivered good news in 2017: The number of deals increased to 219 from 186 in 2016. The average deal value likewise increased from $191 million to $324.4 million. The year's biggest IM deals were SoftBank Group Corp.'s purchase of PE firm Fortress Investment Group for nearly $3.3 billion,[10] followed by a consortium of PE investors' acquisition of Focus Financial Partners for $2 billion (figure 5).[11] We anticipated the increase in deal volume based on three key factors: collapsing margins experienced by IM players in general; internal cost pressures arising from long-overdue front- and middle-office technology upgrades; and external regulatory demands.[12] Many view consolidation as a means to build much-needed scale, especially with more businesses being sold to nonbank owners given the more challenging and restrictive regulatory environment for investment managers owned by banks.

Securities M&A didn't fare as well: The number of transactions dropped from 59 to 53 and average deal value decreased from $563 million to $227 million (figure 5). Some securities deals were prompted by firms exiting the independent broker channel space in preparation for the previously stated April 2017 compliance date for the Department of Labor's (DOL) fiduciary rule.

Figure 5: Investment management and securities deals and average deal value



Asset management and securities: 2017 top five deals by deal value				
Buyer	**Target**	**Agreement date**	**Deal value ($m)**	**Target general industry type**
SoftBank Group Corp.	Fortress Investment Group LLC	2/14/2017	$3,265.50	Asset management
Investor Group	Focus Financial Partners LLC	4/18/2017	$2,000.00	*Wealth management
Virtu Financial Inc.	KCG Holdings Inc.	4/20/2017	$1,419.70	Securities
Invesco Ltd.	Guggenheim's ETF Business	9/28/2017	$1,200.00	*Asset management
GenStar Capital Management LLC	Institutional Shareholder Services Inc.	9/7/2017	$720.00	Asset management service provider

*Estimates
Source: SNL Financial www.pionline.com, S&P global market intelligence
Source: SNL Financial and S&P Global Market Intelligence
Note: Average deal size is based on disclosed deal values; 68%, 70%, 71%, 73%, 78%, 80%, and 86% of reported deals did not disclose deal values for FY11, FY12, FY13, FY 14, FY 15, FY16, and FY17, respectively.

What we expect to see in 2018

Continuing profitability pressures. Pricing pressure and regulations constraining capital, liquidity, and leverage are making it difficult for IM and securities firms to meet historical norms of capital return.[13] And while cost-cutting initiatives have helped keep front-office expenses in line with revenues, back-office and administrative expenses (largely in the operations, technology, compliance, and risk functions needed to manage post-trade processing) have essentially stayed flat amid falling revenues.[14]

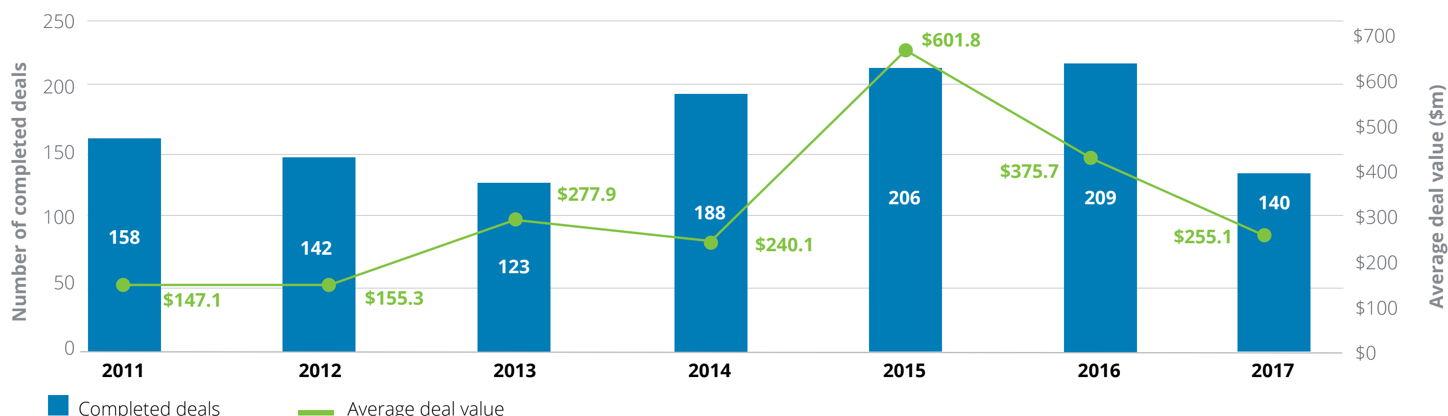
Partnering strategies. As margins continue to get squeezed, we expect IM and securities companies to include M&A in their toolbox of 2018 cost transformation levers. One likely approach is IM-to-IM partnering and/or consolidation to build requisite scale and provide distribution channels with more offerings and enhanced consumer engagement functions.

Gap-filling moves. Bolt-on acquisitions to bolster firms' technology infrastructure and drive back-office cost efficiencies also should be popular, as should deals that allow firms to fill gaps in their product offerings to clients.

Fintech

Deal volume and deal value are not always reflective of the strategic importance of certain M&A transactions. Such was the case for 2017 fintech M&A. The number of deals dropped from 209 in 2016 to 140 in 2017, and average deal value decreased from $376 million to $255 million (figure 6).[15] Still, fintech properties retain their cachet for financial services firms seeking to improve their digital customer experience, streamline back-office operations, and take cost out of the system. Among sought-after technologies are back-office cognitives and robotics (e.g., machine learning to automate repetitive, administrative tasks), digital lending, financial media and data solutions, and payment processing.

Figure 6: Fintech deals and average deal value



Fintech: 2017 top five deals by deal value				
Buyer	**Target**	**Agreement date**	**Deal value ($m)**	**Target general industry type**
Gartner Inc.	CEB Inc.	1/5/2017	$2,591.50	Financial media and data solutions
Vista Equity Partners Management LLC	ABCO's education business	8/29/2017	$1,550.00	Insurance technology
Red Ventures LLC	Bankrate Inc.	7/3/2017	$1,400.00	Financial media and data solutions
Total System Services Inc.	Cayan LLC	12/18/2017	$1,050.00	Payment processors
First Data Corporation	BluePay Holdings Inc.	10/20/2017	$760.00	Payment processors

Source: SNL Financial and S&P Global Market Intelligence
Note: Average deal size is based on disclosed deal values; 61%, 55%, 54%, 63%, 61%, and 74% of reported deals did not disclose deal values for FY11, FY12, FY13, FY14, FY15, and FY16, respectively.

What we expect to see in 2018

Although much of the low-hanging fruit, especially in the digital lending arena, has been gobbled up by banks, demand for fintech capabilities should continue in 2018.

Fintech market evolution. Pure-play deals are likely to remain on the smaller size, and alliances and joint ventures (JVs) may outpace acquisitions as some organizations shy away from buying a technology that may be outdated in two years, or where there may be an uncertain cultural fit.

Consolidation. We also expect continued consolidation in the payments and digital lending space. Some digital lenders are having challenges stabilizing funding on a long-term basis and may be looking to sell. Payments continues to evolve into a global business and we anticipate recent cross-border trends to continue in the coming year.

Deal variety. As the fintech industry continues to mature and winners and losers emerge, there are likely to be bigger, more impactful deals in 2018 and beyond. Hot spots may include sales of commercial payments fintech providers and other technology startups to financial services firms. Also, some financial institutions may acquire and use fintech capabilities internally and then sell those services to others.

Blockchain on the horizon. While blockchain remains top-of-mind in financial services given the potential for disintermediation, to date we have seen limited M&A opportunity in the space; however, the situation bears watching.

Trends and drivers of 2018 M&A activity

2018 may be the year that banking and securities M&A truly gets in gear. Favorable policy developments are easing regulatory constraints; interest rates are steadily rising; the tax reform bill should benefit bottom lines; loan growth is projected to increase; and abundant capital is available to invest. Still, positive developments are sometimes accompanied by challenges. The following trends and drivers are worth watching for their potential catalyzing or inhibiting effect on industry M&A activity during the coming year.

The flywheel: Regulatory and legislative reform

A considerable amount of potential M&A energy remained inert in 2017 as financial services institutions waited for regulatory clarity during the Trump administration's first year in office. The passage of comprehensive tax reform in December, coupled with proposed, business-friendly legislation and regulatory policy changes may act as a flywheel to concurrently control and increase the M&A machine's momentum in 2018.

There are four primary avenues through which changes may occur in FSI regulatory policy under the Trump administration: legislation, regulation, guidance, and personnel. While a broad regulatory pullback is unlikely, some laws are being reviewed and may be amended, such as the Volcker Rule,[16] guidance around governance expectations of bank boards, and the size threshold for systemically important financial institutions (SIFIs). We have seen, particularly post-crisis, bank boards of directors elevate their perception of fiduciary duty in terms of expected merger due diligence levels in a given transaction.

Others policies are being delayed. For example, the compliance date for the DOL's fiduciary standard and its related exemptions has been pushed back to July 2019. However, for at least the largest institutions, higher capital and liquidity requirements, stress testing, and recovery and resolution planning will likely remain intact. Compliance expectations, especially around fair treatment of customers and executive accountability, are expected to stay elevated. Regulators are also expected to maintain vigilant enforcement programs and demand more data from banks to test the operational integrity of complex institutions—especially when under stress.[17]

On June 12, 2017, the Treasury Department released the first of four reports pursuant to President Trump's executive order setting forth the administration's "Core Principles for Regulating the US Financial System." Although the report provides a roadmap for enacting the administration's policy priorities, it remains unclear which of the recommendations will be implemented, or how quickly. However, the recommendations may inform the regulatory and supervisory agendas of the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), and may also have significant implications for the Financial Stability Oversight Council's work going forward.[18]

Notably, several of the recommendations for Congress were included in a bipartisan legislative proposal to amend aspects of the financial regulatory framework introduced in mid-November 2017 by Senate Banking Committee Chairman Mike Crapo (R-ID). Among key provisions that have potential implications for financial services M&A:

Enhanced prudential standards

- The bill proposes to raise, from $50 billion to $250 billion, the statutory asset threshold for the imposition of enhanced prudential standards (EPS). Banks with total assets between $50 billion and $100 billion would be exempt immediately. Banks with total assets between $100 billion and $250 billion would be exempt 18 months after the date of enactment. The FRB would retain the authority to subject banks with total assets between $100 billion and $250 billion to EPS after the effective date, and could also exempt these banks from EPS prior to the effective date.

Dodd-Frank Act Stress Test (DFAST)

- The bill would raise, from $10 billion to $250 billion, the statutory asset threshold for DFAST. For banks with total assets between $100 billion and $250 billion, the FRB would be required to conduct periodic supervisory stress tests to evaluate whether these companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions.

Mortgage lending

- The bill would make several changes to various laws and regulations related to mortgage lending. For example, the bill would provide that certain mortgage loans originated and retained in portfolios by banks with less than $10 billion in total assets be deemed qualified mortgages under the Truth in Lending Act.

Community bank capital requirements

- The bill would direct the FRB, FDIC, and OCC to establish a community bank leverage ratio of tangible equity to average consolidated assets between eight and 10 percent. Banks with less than $10 billion in total assets that maintain this ratio will be deemed to be in compliance with capital and leverage requirements.

Volcker Rule

- Banks with less than $10 billion in total assets and total trading assets and trading liabilities that are not more than five percent of total assets will be exempt from the Volcker Rule.

Of the potential regulatory changes, raising the statutory $50 billion asset thresholds for SIFI designation and DFAST may have the most impact on M&A, especially within the ranks of $10 billion to $50 billion and $50 billion to $250 billion institutions. If Congress raises the thresholds, it could bring some regulatory relief around deal-making, opening the door to merger activity by small and midsized banks. The proposal bears careful monitoring, as the timing for any Senate approval is unclear. It also remains unclear how the House would respond in light of its own bill, the Financial CHOICE Act of 2017.

Simplifying the Volcker Rule—and there is momentum for this to happen—may impact how banks invest in alternative investment management vehicles. Many banks already have wound down their investments in these vehicles. If the rule changes, banks may be more willing to invest in/acquire these assets.

Although full compliance is delayed until July 2019, the date for the DOL's fiduciary standard and its related exemptions has already jump-started strategic reconfigurations and divestitures. The paths that firms choose could influence portfolio shifts, M&A activity, operating models, and compliance intensity. It could also change the nature of risks that constitute the costs of doing business. As noted above, a current key challenge in deal-making is modeling pro forma stress testing impacts of a deal in diligence, so softening in this area would reduce a key deal-making impediment.

Most financial services institutions are forging ahead with their risk and compliance initiatives to ensure they meet applicable laws, regulations, and supervisory expectations—even though regulatory uncertainty could make some of these investments superfluous should they be reversed. Fortunately, many of the changes organizations are making to achieve compliance are useful improvements that are worth doing from a risk, business, and M&A perspective.[19]

US tax reform: A boon for banking M&A?

To an industry with one of the highest effective tax rates, the December 2017 passage of US tax reform legislation should provide welcome relief to financial services—especially banks. From a cash–tax perspective, the reduction in corporate tax rates from 35 to 21 percent is a positive change that should boost bank earnings per share, organic revenue growth, and capital investments. Moreover, US-based multinational banks with previously tax-deferred foreign earnings are also subject to a one-time transition tax that is expected to have an immediate cost but will free up overseas cash. On the flip side, banks carrying forward net operating losses (NOLs)—which would become devalued due to the tax rate cut—may be trading a paper loss for a cash gain. In addition, deduction limitations on property taxes and mortgage interest rates may put a freeze on the high end of the mortgage market. Banks also could see some negative impact from the elimination of FDIC fee deductions.[20]

Will tax reform be a boon for banking M&A? The outlook is encouraging, with some caveats. Banks and other financial services organizations will have more available capital, but they also have numerous ways to use it: buy back stock, pay down debt, increase dividends, or engage in cash-based M&A. And beginning in January 2018, sellers' NOLs became a lot less attractive as an M&A trigger because, going forward, they will be applied at the new, lower tax rate.

On a positive note, while foreign banking organizations still face significant regulatory headwinds (e.g., the interim holding company structure including risk frameworks, fundamental review of the trading book in their home jurisdictions, etc.), tax reform may make US banks more attractive to foreign-owned institutions looking to offset slow in-country growth and enter US-specific markets (e.g., New York City, Los Angeles) where, historically, the tax scheme made those investments less desirable from a post-tax earnings perspective. Foreign-owned banks may become a critical M&A lever in the next three to four years if the United States continues to be a positive growth market. Meanwhile, smaller US regional banks that cater to a certain ethnic population may welcome a foreign buyer because of the potential for a better price than consolidating with another US bank, given more natural cross-border customer and brand synergies.

Other 2018 M&A influencers

While regulatory and tax relief is likely to garner the lion's share of attention among 2018 M&A trends and drivers, financial services firms also should consider several other potential market influencers:

Rising interest rates and higher valuations. The aphorism "a rising tide lifts all boats" may apply to US interest rates' impact on the overall economy—as long as the tide doesn't rise too high or too fast. Interest rates have been so low for so long that there was little surprise when the Fed, at its December 13 meeting, raised rates for the third time in 2017 and projected three more raises in 2018[21] as a hedge against inflation. Interest rates' influence on 2018 banking and securities M&A could be mixed; rising rates may spawn competition in both lending and deposits, prompting an organization to rely more on organic growth and less on inorganic levers like acquisitions or alliances. Conversely, if an organization has loan origination or liquidity challenges, an acquisition could provide more stable access to deposits.

Financial industry valuations are also marching upward, benefiting from 2017 stock market gains and expectations (some being realized in 2018) that the new administration would ease banking regulations. Average deal value-to-tangible common equity in 2014–2016 was between 139 and 145 percent; in 2017 it was over 164 percent (figure 3 on page 5).

Higher valuations may both grease and clog the gears of 2018 M&A. Some banks—especially regionals and super-regionals—that have benefitted from the "Trump bump" and have enhanced stock currency may engage in strategic deal-making to beef up their asset base, market presence, or fintech capabilities. However, they should remember that many sellers' valuations have gone up—while their acquisition currency may be higher, so is the cost of what they want to buy. Conversely, sellers may be hesitant in stock deals to accept perceived inflated currency and may, as a result, seek high deal multiples to protect their shareholders to some degree from any post-deal downside value risk.

M&A fallout from geopolitical unrest. Government instability, political acrimony, and trade wars can affect the flow of money across global banks, the payments industry, and trade routes. Current conditions might impact 2018 M&A, especially purchases of US assets by European and Asian buyers or US PE investors abroad.

Leadership unpredictability in North Korea may make people nervous if they are buying in and around Asia; however, we don't view geopolitical conditions as greatly impacting banking and securities M&A in the short term. In fact, the United States' more business-friendly regulatory environment may make it more attractive for overseas participants, or would-be participants, to get into the US banking industry in 2018. However, this situation will bear monitoring should confidence in the government, and especially the president, devolve.

The United States was at the forefront of making some necessary, post-recession regulatory adjustments and cleaning up some balance sheet, process, and front-end market challenges. Because of these activities, and because the US market is growing (albeit relatively slowly), the United States remains quite attractive to foreign investors. A lot of countries have toe-holds already, so using them to expand is the most obvious avenue for the banks that have the available capital. Beyond pure-play banking deals, there are other ways of getting in; the investment management space has been active globally, with firms trying to develop scale and cross-border distribution.

The changing face of fintech. Banking and securities' view of fintech M&A is changing. Initially, deals were very focused on purchasing or partnering to build out capabilities in loan origination, front-end customer acquisition, payment processing, and mobile wallet. Today we are seeing significantly more activity on the back end as banks seek to take costs out of the system using, for example, cognitives and robotics to automate administrative tasks.

With more emphasis on fintech's value on both sides of the income statement, deal types are also changing. Two years ago, fintech vendors' initial impulse was to disintermediate banks and take over certain customer-facing functions; now fintechs are playing in the sandbox more than expected. There are increasing numbers of strategic alliances and JVs, with fintechs using banks as a warehousing line or to buy their products. The ecosystem is evolving more toward teaming, which seems to be working well in the market—at least for now.

We expect that fintech will continue to be a strategic investment area for financial services organizations of all types and sizes:

- Large and regional banks may look for technology assets to help improve their efficiency ratio.
- Smaller banks having difficulty growing their digital presence may acquire or partner with fintechs to fill critical gaps.
- PE firms may invest in market data providers and FSI service companies such as fund administrators.
- Investment management businesses—many of which have a weak technology infrastructure and lack digital capabilities due to years of underinvesting—may be forced to do deals to keep pace with market and customer expectations.
- Fintechs that provide outsourced solutions that financial players can't do in house may become buyout targets for larger technology firms.

Regardless of their size, banks continue to struggle with diminishing brand value and reputation among certain customer segments—particularly younger demographics. As a result, traditional banks' value proposition is under attack. Embracing the rapid adoption of cutting-edge fintech, therefore, is not just a short-term means to boost revenues or eliminate cost inefficiencies; it's a way for banks to repair and enhance their brand and value perception. Failure to do so opens the door to nontraditional technology players that may lack institutional banking operating knowledge but have credibility and brand loyalty with high-value customers.

Steps to put M&A in gear

What should banks consider doing now?

At this time last year we anticipated that post-election government changes, the shifting regulatory environment, rising interest rates (yet still near historic lows), and persistent challenges to topline growth would prompt banking and securities organizations to reevaluate the efficacy of their business-building strategies and get back to the business of M&A. Despite all of these deal catalysts, the banking and securities M&A market remained stuck in neutral. We have touched on several of the drivers of delayed deal growth throughout this piece: stock currency volatility, slower-than-expected regulatory changes, and lack of legislative reform resolution. Still, these same deal-driving factors remain in place; in particular, we've seen the affirmation of a continuation in rising interest rates and greater resolution of legislative and regulatory uncertainty in the closing months of 2017. Add to this mix more long-term stability to deal and stock valuations after the post-election rise, and there is ample fuel to accelerate M&A in 2018, both in terms of deal number and size. Among key steps to put M&A in gear:

Recognize and embrace evolving M&A processes. Before starting your M&A engine, it is important to remember—especially for those who have sat out deal-making in recent years—that the M&A process has evolved since the financial crisis. It now requires greater attention to detail in the depth and breadth of pre-signing due diligence and the front-end investment on synergy validation. Today we are seeing savvy players leverage digital, analytic, and machine learning/cognitive tools to expedite post-deal integration and maximize value realization.

Empower your corporate development team. We have also seen the role of corporate development evolve in recent years. The days when its primary role was focused on screening lists of banks and identifying attractive footprints and KPIs are largely over. While this is still part of corporate development's day job, the aperture of its role has increased significantly. Teams are focused on understanding the digital landscape and emerging technologies—such as automation and blockchain—and determining creative ways to engage and structure deals with counterparties that are significantly different than more straightforward mergers of years past. In many ways corporate development is turning into more of a venture capital-type function versus a traditional in-house investment banking function. Understanding how to quickly get access to that knowledge and formulating a strategy that aligns to the organization's growth objectives is a real competitive advantage.

Prepare and communicate. Finally, potential sellers and buyers should make certain their playbook and deal processes are current to maximize the efficient expenditure of time and resources. And because both boards and regulators have a larger seat at the table at deal onset, it is prudent to communicate regularly with both constituencies throughout the deal process. Preparation is the key to keeping all your M&A gears working smoothly.

Endnotes

1. M&A market data from SNL Financial.
2. "Sterling Bancorp and Astoria Financial Corporation Shareholders Approve Proposed Merger," Sterling Bancorp news release, June 13, 2017, https://globenewswire.com/news-release/2017/06/13/1018454/0/en/Sterling-Bancorp-and-Astoria-Financial-Corporation-Shareholders-Approve-Proposed-Merger.html, accessed December 23, 2017.
3. M&A market data from SNL Financial.
4. Ibid.
5. Ibid.
6. Ibid.
7. In the Face of Disruption: Evolving the retail payment partnership, Deloitte, 2017. Note: Top US retailers based on STORES Magazine's July 2016 list of top 100 retailers, excluding supermarkets, restaurants, convenience stores, drug stores/pharmacies, auto parts stores, and cable and internet providers; https://nrf.com/resources/annual-retailer-lists/top-100-retailers/stores-top-retailers-2016.
8. In the Face of Disruption: Evolving the retail payment partnership, Deloitte, 2017, citing "Major Wall Street Firm Expects 25% of U.S. Malls to Close by 2022," Credit Suisse via Fortune, http://fortune.com/2017/05/31/malls-retail-stores-closing/.
9. In the Face of Disruption: Evolving the retail payment partnership, Deloitte, 2017. Deloitte analysis.
10. "Why Is SoftBank Buying Fortress? Son Gets a Brain Trust for Deals," Bloomberg Technology, February 15, 2017, https://www.bloomberg.com/news/articles/2017-02-15/why-is-softbank-buying-fortress-son-gets-brain-trust-for-deals.
11. M&A data from SNL.
12. Capital Markets Industrialization 2.0: Finding a path to sustainable ROE performance, Deloitte, 2017.
13. Ibid.
14. Ibid.
15. M&A market data from SNL Financial.
16. Office of the Comptroller of the Currency, "OCC Solicits Public Comments on Revising the Volcker Rule," press release, August 2, 2017.
17. 2018 Banking Outlook: Accelerating the transformation, Deloitte Center for Financial Services, 2017.
18. Navigating the year ahead: 2018 banking regulatory outlook, Deloitte Center for Regulatory Strategy, 2017, https://www2.deloitte.com/us/en/pages/regulatory/articles/banking-regulatory-outlook.html?nc=1.
19. Navigating the year ahead: 2018 banking regulatory outlook, Deloitte Center for Regulatory Strategy, 2017, https://www2.deloitte.com/us/en/pages/regulatory/articles/banking-regulatory-outlook.html?nc=1.
20. "Banks emerge as 'clear winners' in proposed tax reform bill," S&P Global Market Intelligence, December 18, 2017.
21. "Fed raises rates, projects 3 more hikes in 2018," SNL Services, December 14, 2017, https://platform.mi.spglobal.com/SNL.Services.Export.Service/v2/Export/Retrieve?filena.

Contacts

Jason Langan
Partner, M&A Transaction Services
Deloitte & Touche LLP
+1 212 436 2646
jalangan@deloitte.com

Paul Legere
Principal, M&A Consultative Services
Deloitte Consulting LLP
+1 312 486 2289
plegere@deloitte.com

Contributors

Matthew Hutton
Partner
Deloitte & Touche LLP

Masaki Noda
Managing Director
Deloitte & Touche LLP

Christopher Spoth
Managing Director
Americas Lead, Center for Regulatory Strategy
Deloitte & Touche LLP

Max Bercum
Principal
Deloitte Consulting LLP

About Deloitte
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. In the United States, Deloitte refers to one or more of the US member firms of DTTL, their related entities that operate using the "Deloitte" name in the United States, and their respective affiliates. Certain services may not be available to attest clients under the rules and regulations of public accounting. Please see www.deloitte.com/about to learn more about our global network of member firms

This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

Copyright © 2018 Deloitte Development LLC. All rights reserved.