EVALUESERVE

Global Financial Services Industry: M&A and Capital Market Landscape Q1'23 Review

Contents

Global Financial Services Market Q1 2023: Survival of the fittest 3
Key Sectoral Performance: Tale of 4 Key Sub-Sectors 4
Global Financial Services M&A Q1'23: A Surprise 'Stress' Test 5
Funding: Flight to Quality Amidst Uncertainty 7
SPACs: Imminent Liquidations as the Merger Clock Expires 8
ESG: Key to long-term and sustainable value generation 8
2023 Outlook: Spotlight on Adaptability and Rebuild 9
Authors 10
Evalueserve Disclaimer 11

Global Financial Services Market Q1 2023: Survival of the fittest

After more than a decade of rather stable conditions in the global economy and stock markets, change and uncertainty have made a dramatic opening, and it seems they may take center stage for some time. If 2022 is any indication, industry experts have grown more concerned about what the remaining months of 2023 may bring to the financial services sector.

In 2022, several variables, such as geopolitical tensions, supply chain disruptions, a sharp increase in inflation, and layoffs, put the international economy under stress. Many of these disturbances are concentrated near or at the center of the financial services sector. Financial institutions need to fix fundamental flaws and find a method to stabilize ground, even as the world keeps changing, whether coping with shocks to the core or rippling effects.

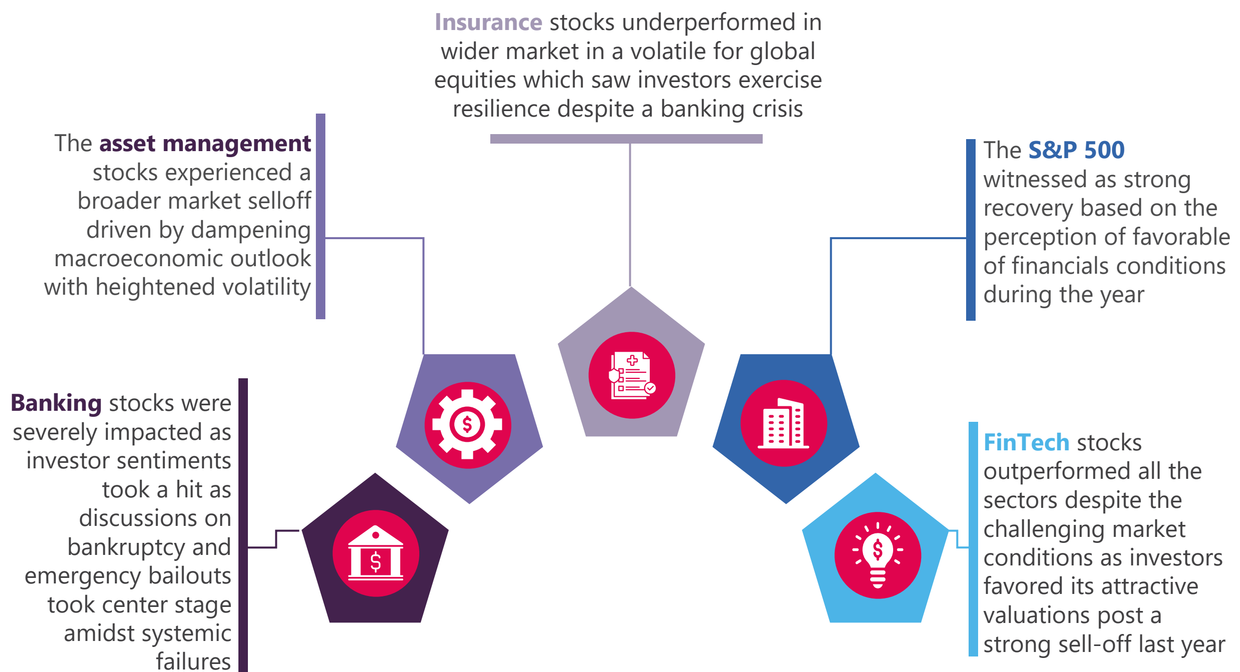
Banking stability was put to the test in March 2023. Regional US banks Silicon Valley Bank (SVB) and Signature Bank of New York failed because of a sudden exodus of depositors. A week later, following a lack of market confidence, Swiss authorities announced a state supported merger of Credit Suisse with UBS. Since the global financial crisis, this was the first instance of a globally significant bank failing.

Apart from risks related to financial stress, there are other possible sources of macroeconomic risks that can have macro-financial implications, like, an escalation of geopolitical tensions or a sharp rebound in economic activity in China could spark a sharp rise in energy prices, pushing headline inflation higher again.

The following key developments had a strong bearing on M&A and Capital markets' activities across the global financial services market during the first quarter of 2023:

- While both businesses and customers have so far managed to withstand rising interest rates and the pressure on cash flow, concerns grew louder during the quarter which might materialize swiftly if lending criteria become much stricter going forward
- Liquidity stress transmitted through parts of the international banking system and financial markets
- Spotlight on divestitures of non-core assets as businesses attempted to strengthen their balance sheets and make their business models more resilient
- Higher interest rates by global central banks over the past two years due to high inflation across countries
- Financial sponsors' cautious approach to deploy their 'eager capital'
- More stringent regulatory approval process ensured there were lesser mega deals

Sector Wise Performance (Q1'23)



Source: The sectoral analysis reflects the general performance of the respective S&P indices

Shockwaves from the banking crisis and tightening of financial conditions tested the Financial System's resilience with pockets of growth arising from the revival of investors' interest in FinTech

Key Sectoral Performance: Tale of 4 Key Sub-Sectors

Banking

- Three US banks recently failed, leading to uncertainties in various areas of the global banking system, and this caused major volatility in some financial markets.
- Increased bank stress would lead to tighter financial conditions, which would increase borrowing costs and decrease the amount of credit available to consumers and companies.
- Larger banks are typically avoiding deals to acquire other banks in favour of focusing on acquisitions to improve their fee product offerings, which will be subject to less regulatory review.

Asset Management

- The asset management sector is experiencing a turning point whereby wealth managers are attempting to restructure their business models to create a business that is safe, scalable, and cost-effective.
- Traditional active managers are expected to collaborate to scale up to fund new capabilities (such as ESG) and boost distribution.
- A total of 66 asset management deals took place in Q1'23 compared to 105 deals in Q1'22 (Refinitiv). The outlook for deal-making remains strong going ahead in 2023, driven by consolidation, focus on gaining credit,

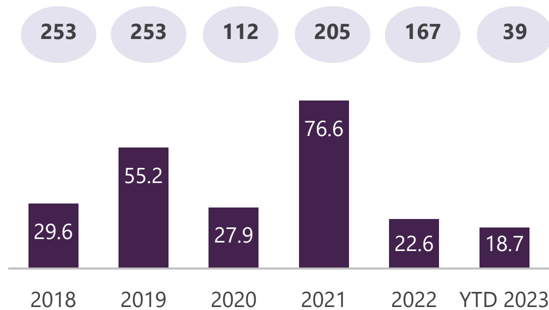


Figure: Count and Value of US Banks' M&A Deals (in US$bn)

- exposure to other asset classes and robo-advisory.
- Looking ahead 2023 is expected to witness a continuation of M&A activity due to pressure on returns, market conditions having an influence on margins and profitability, and scale and consolidation being considered as essential solutions.

Insurance

- Q1' 23 appears to be the least active for M&A activity since 2019 after the slowdown in M&A activity in 2022
- As per OPTIS Partners, there were a total of 158 insurance agency M&As during Q1'23 that showed a 17% drop from Q1 2022 (190) and was 7% lower than the five-year average.
- Property and Casualty (P&C) sellers accounted for 87 transactions (55% of the total). Benefits agencies sales totalled 13 (8%), 34 sales of P&C/benefits agencies (22%). All other sellers accounted for 24 sales (15%)
- Although the current deal climate has weakened in comparison to prior years due to economic developments, M&A in the insurance distribution sector is nevertheless anticipated to increase in the upcoming quarters.
- Deals in the Insurtech sector continue to appeal to investors seeking creative companies and cutting-edge technologies for strategic purchase.

FinTech

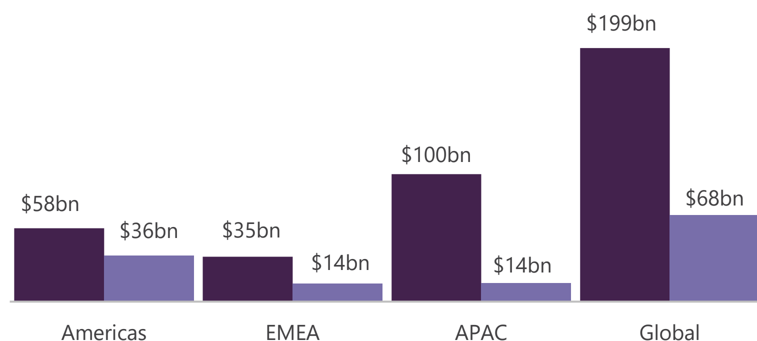
- Due to changes in consumer behaviour and technological advancements, the fintech industry is constantly evolving. In 2023, it's expected that significant developments in blockchain, digital banking, mobile payments, cybersecurity, and API integration will start to emerge.
- After investment activity steadily decreased in 2022, Q1'23 saw a 55% surge i.e. $15bn in worldwide fintech funding QoQ (CB Insights). However, Stripe's $6.5bn Series I round accounted for over 40% of the quarter's total funding amount.
- Unicorn creation dropped strongly from a peak of over 40 unicorns quarterly in 2021 to just 3 in Q1'23.

Global Financial Services M&A 2023: A Surprise 'Stress' Test

Most market observers and dealmakers entered 2023 with cautious optimism over the state of the mergers and acquisitions landscape after a difficult end to 2022 caused by macroeconomic headwinds and uncertainties.

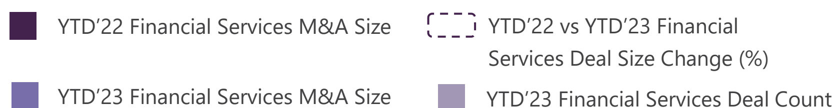
Global M&A activity fell to its lowest level in more than a decade in the first quarter as companies' appetite for deal-making was affected by rising interest rates, high inflation, banking crisis and worries about a recession.

Dealmakers anticipate an increase in M&A volumes from activist campaigns in the upcoming quarters because of the depressed market valuations, which also provided a chance for notable activist investors to start new proxy battles. While the M&A market is anticipated to remain difficult in 2023, dealmakers are anticipated to have plenty of opportunities to carry out their strategic goals in the FS sector, albeit with greater discipline and caution.



All the regions experienced a significant fall in M&A volumes due to a dearth of "big ticket" transactions.

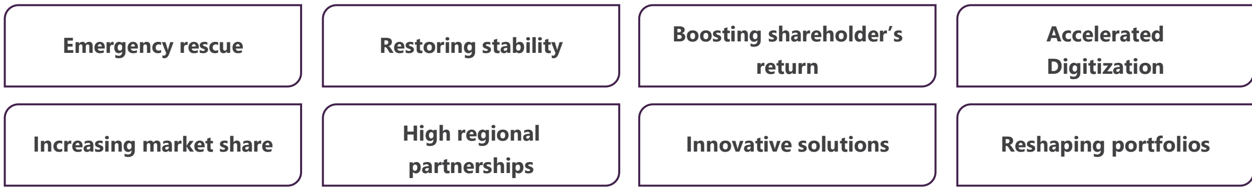
CD&R affiliates' acquisition of Focus Financial Partners for US$7bn and Silicon Valley Bank acquisition by First Citizens for ~US$5bn are some of notable big-ticket deals during the quarter.



Source: Refinitiv. Figures in US$bn. Data as of April 13, 2023.

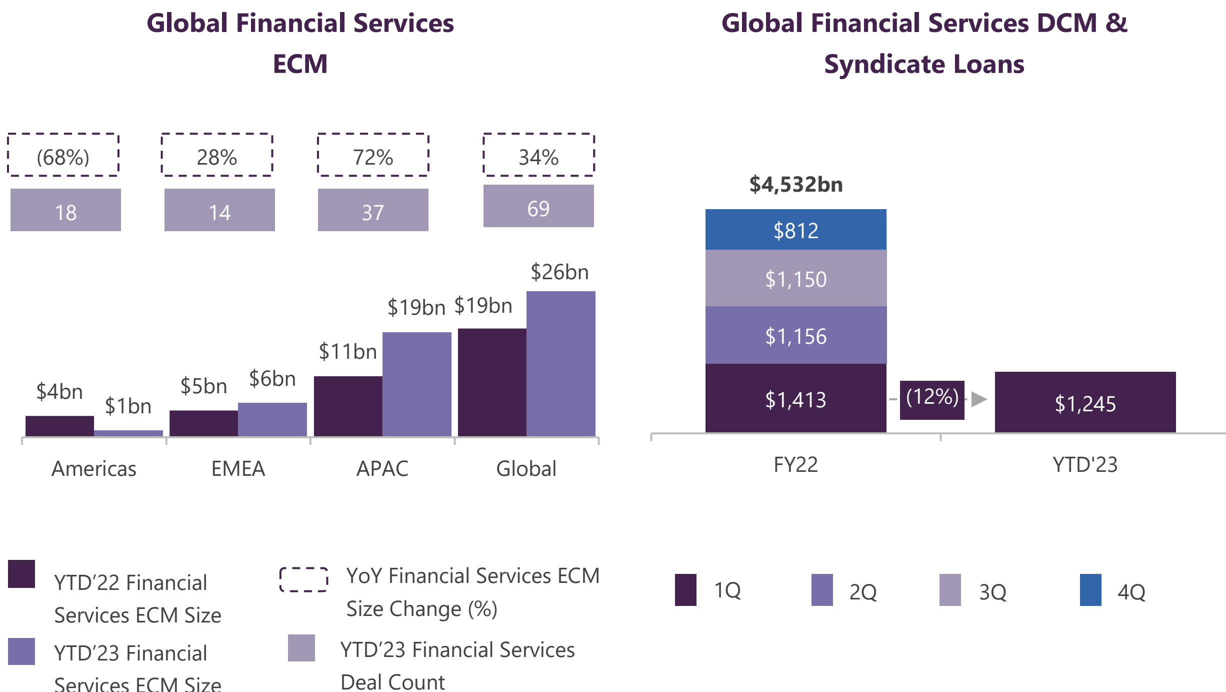
Some of the key observation during Q1'23:

- Private equity firms were forced to write larger equity cheques for their projects since there was no debt financing available.
- IPO numbers are holding up, but mega transactions are missing in the first quarter, as both investors and companies await better market conditions
- In addition to interest rate uncertainty, acquirers had to deal with numerous other external concerns. For both strategic acquirers and targets, preconceptions about the fundamental business trajectories were questioned by inflation, geopolitical tensions, and the oncoming recessionary climate.



Financial Services Funding: Flight to Quality Amidst Uncertainty

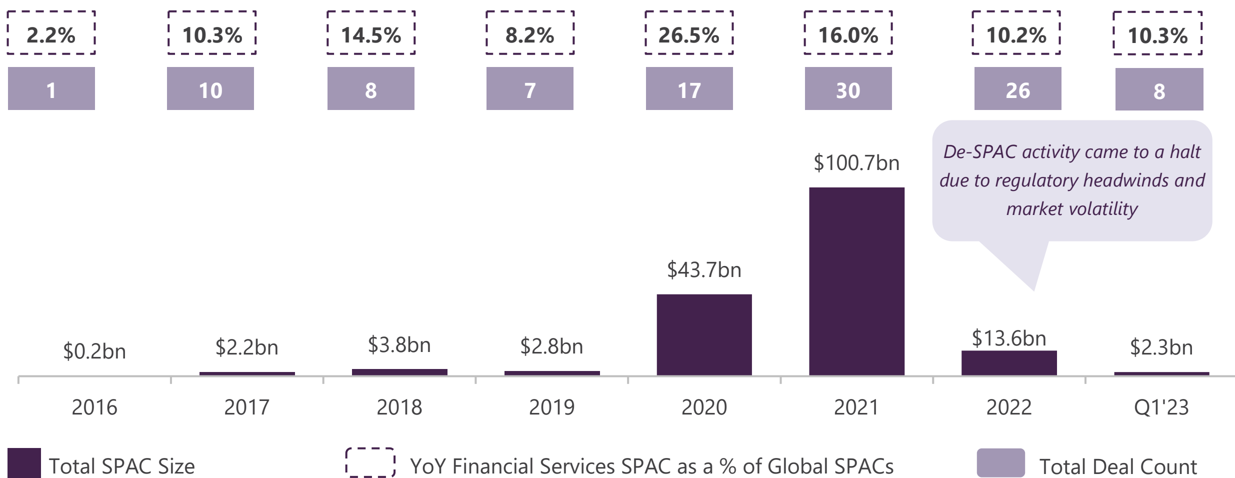
The financial equity and debt capital markets (ECM and DCM) witnessed relatively strong demand this year. The downward trend of the previous quarters seems to have reversed based on what we have witnessed so far. Recently, Nasdaq and NYSE modifications were approved by Securities Exchange Commission to allow direct listings to raise primary capital and encourage more companies to pursue the IPO route more easily. High inflation, market volatility and rising interest rates are also having a negative impact on the global equity market, and as we look ahead, all these factors might still create challenges for companies to raise equity. Looking at the DCM, the demand was still mostly driven by investment-grade securities, as evidenced by the decline in worldwide high-yield instrument issuances during the quarter (indicating a 'flight to quality'). Demand in the syndicated loans market remained muted due to concerns over profitability, rising costs of debt and a reversion to more conservative underwriting standards. Private equity firms are nevertheless active in the market today despite the stagnation of syndicated M&A and leveraged buyout activity. Despite price resets in the public and private markets, these companies are anticipated to remain opportunistic.



Source: Refinitiv data as of April 13, 2023. Figures in US$bn; ECM=Equity Capital Market, DCM=Debt Capital Market

SPACs: Imminent Liquidations as the Merger Clock Expires

The success or should we say the existence of the SPACS going froward will be heavily dependent upon their ability to adapt to the changing financial legislation and competitive environment. The heightened regulatory scrutiny along with concerns around mixed post-deal performance, excessive redemptions during De-SPAC, a virtually non-existent PIPE market, overcrowding and "SPAC-off" processes has diminished the traditional appeal to investors. Though funding has dried up in the last one-year, innovative deal structures and better due diligence can still revive investors' faith and stability. In terms of deal volumes, we can at the most expect pre-peak levels to be the new normal in 2023. For the first time in over 3 years there will be scarcity in the SPAC market which in turn can provide opportunities as witnessed in MedTech and Biotech sub-sectors during Q1'23.



Source: Eikon Refinitiv. Figures in US$bn. Data as of Q1'23 ending March 31, 2023.

ESG: Key to Long-term and Sustainable Value Generation

The COVID-19 pandemic has demonstrated that adhering to ESG factors is key to crisis-resilient long-term value creation. Companies with dynamic business cultures were relatively more resilient during the shutdowns, given their ability to absorb the shock. Globally, investors have started to recognize the potential benefits of announcing an acquisition that is ESG accretive.

Global financial regulators have identified scenario analysis as a potentially useful means of evaluating and managing financial institutions' exposure to climate-related financial risks. Regulators in the US have begun to investigate how to use scenario analysis to better evaluate the long-term, climate-related financial risks that financial institutions face, as well as how these risks may emerge and vary from past events.

As the ESG investment market continues to grow rapidly, Banks are strategically deploying fintech ecosystems to drive sustainability in their products and operations which is referred to as 'Sustainable Digital Finance'. Several banks have joined the UN-convened Net-Zero Banking Alliance. Under this, they

have committed to align their lending and investment portfolios with net-zero emissions by 2050.

As of 2022, more than ten US states had enacted or proposed "anti-ESG" legislation aimed at limiting financial institutions' and other companies' consideration of ESG factors. In addition to anti-ESG legislation, some states in the United States have opposed net zero alliances such as the Net-Zero Banking Alliance (NZBA) and the Net Zero Asset Managers Initiative (NZAM). Further, financial institutions that are members of net-zero alliances could perhaps consider potential U.S. antitrust scrutiny as well.

From a funding standpoint, the cost of capital for companies with better ESG scores is lower than for companies with weaker scores. For instance, there is higher investor demand and better pricing for issuers for many green, social, or sustainable bonds in comparison to traditional non-ESG issuances.

2023 Outlook: Spotlight on Adaptability and Rebuild

Despite the recent slowdown, the long-term fundamental M&A themes remain intact. We foresee the following trends to define the overall deal-making in 2023:

1. **Consolidation:** The development of platforms and integrated finance solutions, along with shifting customer demands and escalating competition, are all examples of how traditional business models are being disrupted. Size of business is essential for creating a feasible business model and opens more opportunities for consolidation, particularly in the more fragmented markets where players must realign themselves to take advantage of economies of scale and scope.
2. **Regulatory Environment:** There is urgent need for further evaluation of unrealized losses on bank balance sheets with concerns about economic headwinds and higher costs of capital. Additionally, the global regulatory and tax conditions have been favorable though authorities have started enhancing scrutiny for megadeals. This increased due diligence will likely slow down the execution process, e.g., work-from-home compliance, cybersecurity, privacy, data protection and accounting regulations.
3. **Technological Changes:** Despite the slowdown in the economy, digitalization remains a top strategic priority for banks and other financial institutions as they work to meet rising consumer expectations and operational complexity while attempting to strengthen their market positions. In 2023, it's anticipated that M&A and strategic alliances will be focused on transactions which will leverage data, address growing cybersecurity concerns, drive operational efficiencies, and speed up transaction processes.
4. **Private Equity Support:** While fundraising activity has slowed, dry powder remains near all-time highs, providing opportunity for companies with minimum viable products and established business plans. It is projected that competition for key technologies, ESG objectives, supply chain resilience, and recession-proof industry deals will drive deal making through 2023 as businesses navigate the current market volatility and become ready for long-term development.
5. **Evolving sectoral dynamics:** Themes such as the rise of domestic champions, challenger bank M&A, focus on deleveraging balance sheets and reconfiguration of operating models should continue to play out.

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