EVALUESERVE

Global Financial Services Industry: M&A and Capital Market Landscape H1'23 Review

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Global Financial Services Market H1’23: A Turbulent First Half

The global economy has been burdened by concerns about a recession and rising interest rates while central bankers battled record inflation across many countries. There is no doubting that the first half of this year has been challenging for dealmakers and investors across the financial services industry.

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 were other possible sources of macroeconomic risks that can still 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.

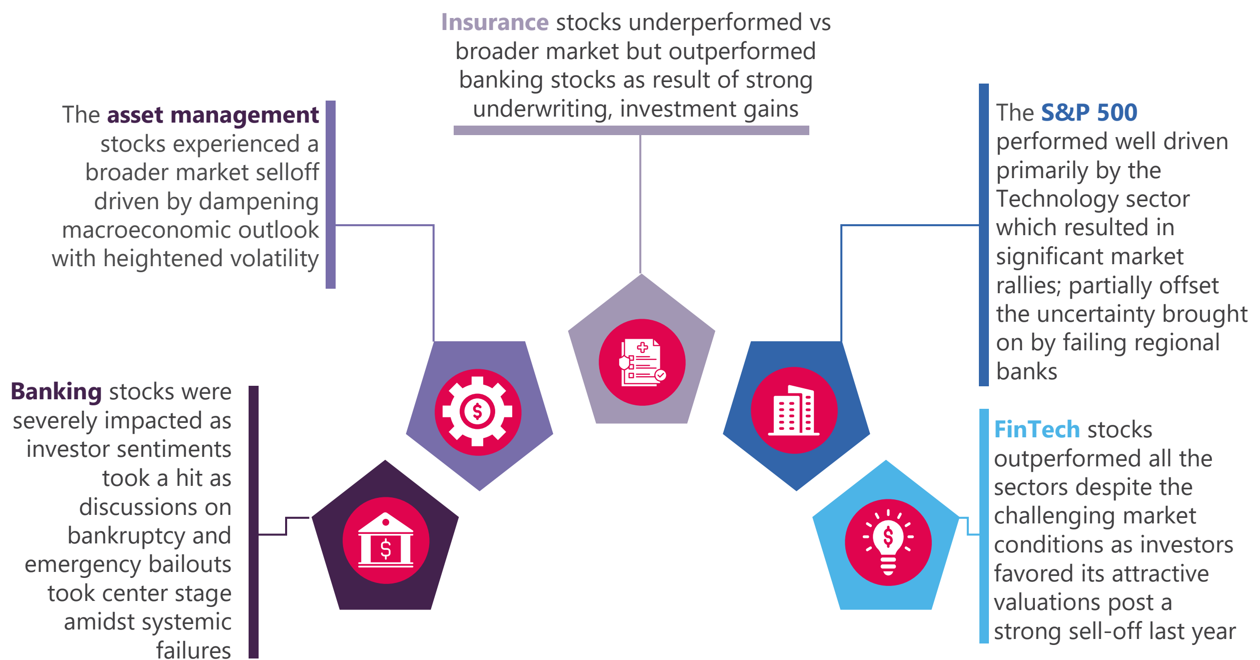
As a result, the need for transformation is acutely felt in the financial services industry. The global market uncertainty still lingers, regulators continue to exert pressure, environmental, social, and governance (ESG) issues are becoming more prevalent, and platforms, including embedded finance, and fintech’s are disrupting the status quo.

The narrative changed a bit in Q2’23 with the peaking of interest rates, a slowdown in inflation, the failure of several banks, the avoidance of the US debt limit issue, and the general sense that everyone is waiting for the next big development. The light at the end of the tunnel continues to grow brighter.

The following key developments had a strong bearing on M&A and Capital markets’ activities across the global financial services market during the H1’23:

- 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
- Financial sponsors’ cautious approach to deploy their 'eager capital'
- More stringent regulatory approval process ensured there were lesser mega deals
- The focus seems to be shifting to long-term planning and M&A as a way of addressing strategic issues in the sector like market access, economies of scale, and technology debt as inflation and interest rates come under control, leading to a return of investor confidence and stability to banking markets.

Sector Wise Performance (H1'23)



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.
- The additional regulation of increased capital requirements may have a greater impact on banks with less than US$100.0bn in assets, which could lead to smaller banks considering M&A.

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.
- 300+ deals were announced, despite persistently high inflation, rising interest rates and other headwinds.
- Announced several transactions with deal values of US$1.0bn or more including TPG's

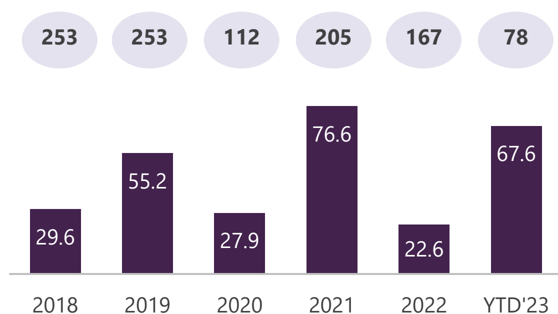


Figure: Count and Value of US Banks' M&A Deals (in US$bn)

acquisition of Angelo, Gordon & Co., a private credit and real estate investment firm.

- Looking ahead H2'23 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.
- H1'23 witnessed strong interest from Private Equity for registered investment advisers (RIAs)

Insurance

- Even though deal making has slowed down on account of higher cost of capital there are signs of positive buyer's interest which should stem the volume in the later part of the year.
- As per OPTIS Partners, there were a total of 359 insurance agency M&As in US during H1'23 that showed a 24% drop from H1'22 (474)
- There were 177 announced deals in Q2'23; relatively flat compared to the 182 announced in the prior quarter. In YoY terms the count declined 36% over Q2'22 and is 6% below the previous 5-year average
- Deals in the Insurtech sector continue to appeal to investors seeking creative companies and cutting-edge technologies for strategic purchase.
- Divestments of complex legacy portfolios (high capital charges) as part of portfolio optimisation are on the rise.

FinTech

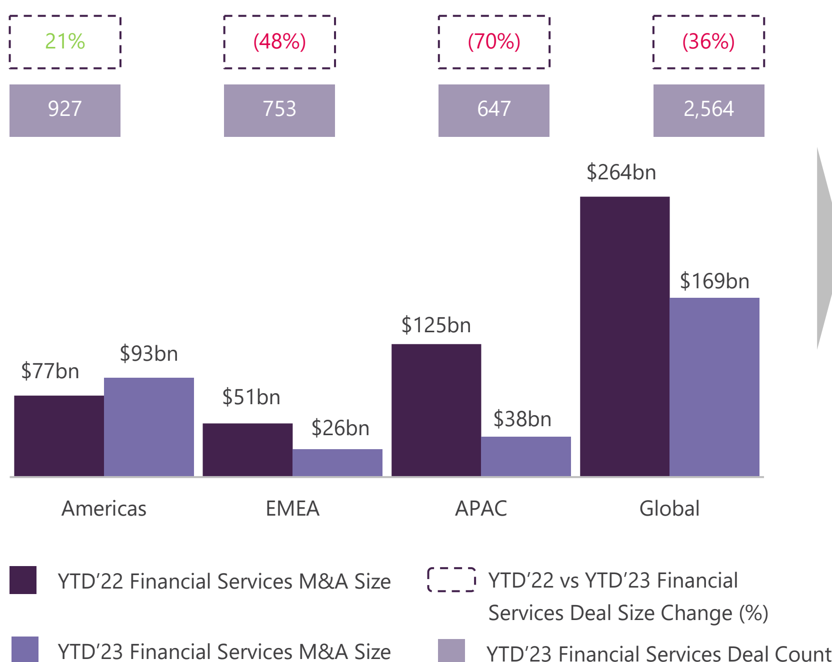
- In H1'23, venture capital financing for fintech firms fell by 49% globally YoY to US$23.0bn due to the global economic slump.
- The mid-March failure of Silicon Valley Bank have reduced the investor risk appetite, as the deal count reduced to 522 rounds in Q2'23 (compared to 656 rounds in Q1'23 and 944 rounds in Q2'22), making it the slowest quarter on record over the past 2.5 years
- 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.

Global Financial Services M&A 2023: In the Midst of a "Stress Test"

The regulatory examination of large banks' M&A activity continues to grow. Numerous banks, private equity companies, wealth and investment managers, and FinTech's have consequently suspended M&A activities until interest rates stabilize and regulatory activity slows.

While rising interest rates and tighter credit have made it difficult to complete leveraged deals, Private equity (PE) players have shifted their attention to the portfolio, conducting portfolio reviews, carrying out bolt-on acquisitions, and making investments in cloud transformation, data and analytics capabilities.

Additionally, dealmakers anticipate an increase in M&A volumes from activist campaigns in the upcoming quarters due to 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, we anticipate that there are plenty of opportunities to carry out strategic deal across the FS sector, albeit with greater discipline and caution.



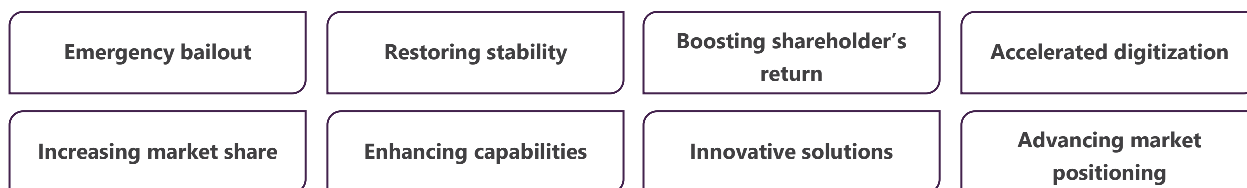
Source: Refinitiv. Figures in US$bn. Data as of July 13, 2023.

Overall big-ticket deals have become harder to complete in the current financing environment and are heightened regulatory scrutiny.

Worldpay's acquisition by GTCR, for US$18.5bn and First Republic Bank's acquisition by JP Morgan for ~US$12.1bn are some of notable big-ticket deals during the quarter.

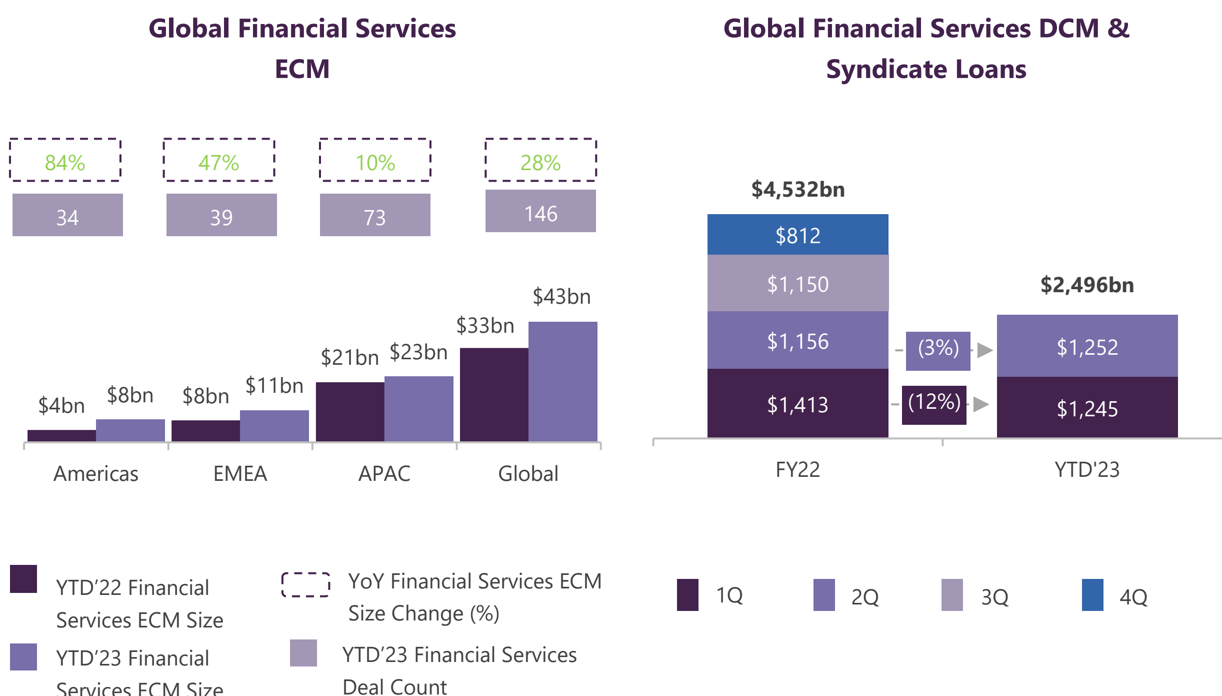
Some of the key observation during H1'23:

- Corporates with strong balance sheets and sound M&A processes still have a competitive advantage in the current market as they have the cash and the ability to extract synergies
- To finance significant deals, PE players are combining financing mechanisms such term loans, seller notes, all-equity funding, earn-outs, consortium deals (including with sovereign wealth funds, pension funds, and family offices), and minority investments
- 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: Focus on Quality as Markets Starts to Rebound

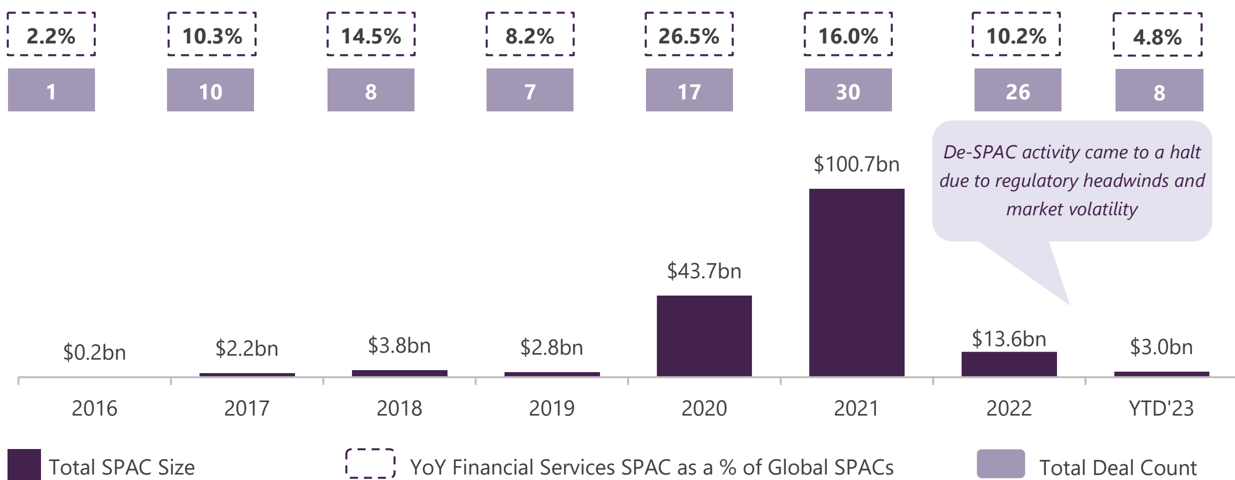
In the Debt Capital Market (DCM) credit conditions continue to tighten, however issuers have largely been able to push out near-term maturities this year. The increase in issuance in 2023 may have been influenced by a resurgence in M&A activity in March; at the same time, several large corporations have been compelled to return to the debt market to refinance debt as previous debt matured (Investment grade securities). 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. The resurgence in Equity Capital Market (ECM) activity was driven by perception of stability in interest rates, strong base effect (soft y-o-y figures) and the economy and listing companies' willingness to accept valuation resets. The IPO pipeline continues to grow and with some early indications of macroeconomic stability, a stronger pick up can be anticipated in the second part of the year.



Source: Refinitiv data as of July 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 excessive redemptions during De-SPAC, a virtually non-existent PIPE market, overcrowding and "SPAC-off" processes have 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 H2'23. 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 H1'23. Overseas targets are more in focus than ever and sponsor economics are more negotiable with the rising number of redemption mitigation mechanisms. High interest rates and expectations for future interest rate increases in July further prolonged the dry spell for SPAC IPOs, which frequently list on the stock market to raise money and buy other businesses.



Source: Eikon Refinitiv. Figures in US$bn. Data as of ending June 30, 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.

Currently, 15 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 US antitrust scrutiny as well.

H2'23 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 the second half of 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. **Capital-constrained environment:** Stronger emphasis is expected on divestitures as companies attempt to deleverage their balance sheets, free up funds for reinvestment, or, in the case of private equity, return capital to their investors.
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 H2'23, 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 H2'23 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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To know more about our investment banking offerings, visit our webpage: Investment Banking Advisory - Evalueserve.

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