Building a better working world

The navigator: perspectives on financial services M&A

Issue 2

Financial institutions are poised to recalibrate their strategies with M&A

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Recent banking turmoil has created both short- and medium-term opportunities for financial services M&A to reposition institutional strategies for growth. PE firms are sitting on $1.32 trillion in excess cash reserves and are poised to capitalize on historically low FinTech valuations once the market stabilizes.[1] Generative artificial intelligence (AI) is quickly moving from the headlines to the business world, challenging financial institutions (FIs) to explore new use cases and partnerships.

Considering the circumstances over the first half of the year, it's no surprise that there have been fewer large deals in the financial services M&A market or that private equity (PE) funding for FinTech firms has slowed significantly. While the collapse of three regional banks in the spring led to distressed deals by larger, better-capitalized institutions, most FIs have been content to hold their capital close while waiting for greater clarity from the market.

That's poised to change. In recent conversations, our clients have been talking about how to leverage the current disruption to remake their franchises and fuel growth. As conditions stabilize, we expect forward-thinking FIs will strengthen their value propositions by using financial services M&A to seize on historically low valuations.

How institutions react to times of short-term stress often defines long-term success. We believe FIs that fail to make significant market-making moves in the next 18 months will see their relevance decline. Those that act opportunistically to add assets and strengthen their value propositions can gain a competitive advantage and fuel long-term growth. Here are some deal trends we expect to see in the coming months:

- Short-term stress in the banking system will create tactical opportunities for institutions to acquire distressed assets that align with their strategies and can provide additional scale. Many FinTech firms have seen valuations plummet, making them potential targets for FIs and PE firms.
- In the medium term, as the cost of capital and rates stabilize, deals will be driven more by structural changes, including enhanced regulatory requirements and deposit flight to large institutions. Banking, property and casualty (P&C) insurance carriers and wealth and asset management (WAM) firms will be among those focusing on moves that can increase market share and sustain growth.
- PE firms, sitting on $1.3 trillion of dry powder, have scaled back FinTech funding, leaning into only the most opportunistic scenarios while waiting for valuations, already near historic lows, to bottom out. We see signs of valuations leveling out and expect PE funding levels to rebound modestly in 2024 after rates stabilize.
- Generative AI has exploded into the popular consciousness, and for many FIs, has quickly become a strategic imperative. We work with several insurers, for example, that are investing in talent and technology without knowing where it will lead. Long-term, generative AI could transform everything from how WAM firms analyze customer data to how PE firms and other buyers perform due diligence on financial services M&A targets. As the conversation evolves, we expect FIs will build their own generative AI capabilities for proprietary business use cases while partnering with solutions providers for more generic technology needs

In this issue, we take a closer look at what to expect in two sectors with different stories to tell: banking and InsurTech.

[1] Pitchbook

Banking: Predator or Prey

Reposition institutional strategies for growth

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In an unsettled operating environment, banks will need to proactively recalibrate their long-term strategic visions. The spring bank failures have renewed Washington's interest in tougher regulation, while the macroeconomic, geopolitical and interest rate environments present challenges to growth. At the same time, competition is increasing. Embracing digital business models, bolstering product offerings and scaling efficiencies while keeping pace with customers' changing demands will drive strategy. For example, most regional bank executives in a recent EY-Parthenon survey said they expect to dedicate a greater share of their budgets to collaborative ecosystems. We expect these forces will spur increased acquisition, partnership and divestiture activity in the months ahead. Banks that cannot create and invest in a compelling vision of the future could do best by making themselves attractive to buyers.
What to watch for:

- **Regional banks in the spotlight:** Following the collapse of three regional banks this spring, US regulators are likely to lower to $100 billion in assets the size threshold at which banks are subject to higher capital requirements, more-stringent stress testing and other types of scrutiny.[2] That could lead to multiple whole bank deals, as institutions in that size range seek to spread the added compliance costs over a larger asset base or divest businesses to stay below the threshold. "Mergers of equals" among regional banks could surge but might be challenging to execute in an environment where valuations remain decoupled from the fundamentals. Regulators, eager to stabilize the system, could be more pragmatic about approving larger deals.
- **Diversifying revenue streams:** We expect more banks to shield themselves from credit and rate volatility — and meet rising customer expectations — by using financial services M&A to add asset-light, fee-generating businesses, such as wealth management platforms, mobile payments and digital asset products, to their portfolios. For example, Fifth Third Bancorp in May acquired Rize Money, an embedded payments platform, to strengthen its treasury management business. Depressed valuations will continue to make such bolt-on deals attractive, but banks need to carefully weigh integration costs, culture and regulatory risks to realize their full potential.
- **Divestments: addition by subtraction:** We expect many banks to reshuffle their business mixes in response to changes in the operating environment and risk tolerances, leading to more divestitures of non-core businesses and assets. That could include entire business lines, such as mortgage origination or specific loan books. For example, as commercial real estate (CRE) loans show signs of stress, banks with big CRE exposures could opt to sell those portfolios. Some PE firms are raising funds to capitalize on lower valuations.

[2] Reuters, U.S. bank regulators considering tougher rules for banks over $100 bln in size, June 2023

InsurTech: Go time approaches

A focus on acquisitions and partnerships

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Historically attractive valuations will create opportunities for traditional insurance carriers to fill strategic gaps via InsurTech acquisitions or partnerships and for venture capitalists (VCs) and private equity (PE) firms to deploy dry powder at favorable pricing. An EY-Parthenon analysis of 103 $10 million-plus funding deals in 2022 and the first quarter of 2023 found high interest in cyber, commercial auto, worksite benefits, embedded distribution, data analytics and AI/ML tools to streamline underwriting and claims processes.

What to watch for:

- **Bolstering cyber capabilities:** As demand for cyber insurance continues to soar, we expect more carriers to partner with InsurTechs that can help them score and manage cyber risks more efficiently and those with proactive risk-monitoring and -mitigation capabilities to minimize the potential for catastrophic losses. Funds that want to minimize risks can invest in niche distribution players and firms that enable the cyber insurance value chain.
- **Filling white space:** Carriers looking to penetrate new markets and meet changing customer expectations will leverage InsurTech solutions to plug capability gaps in strategically critical areas such as commercial auto telematics, cyber insurance, worksite benefits and holistic wellness. InsurTechs with open application programming interfaces (API), embedded finance and other innovative distribution solutions — and those that can help incumbents streamline claims processing — will also garner interest.
- **Funding poised to rebound:** Valuations are tracking upward, while VCs and PE firms that have been waiting for prices to bottom out are accelerating their screenings of potential investees — both promising signs. For younger InsurTech firms with solutions that address current head winds, such as rising catastrophic property losses or rising personal and commercial auto claims, the time to lock in new funding is now. For those looking for later-stage funding, liquidity challenges could exacerbate the pain of lower valuations. We expect some to pursue "down round" funding at lower valuations than in previous rounds. For others, it might be time to sell.
- **Marching toward convergence:** InsurTechs will accelerate their ecosystem strategies, putting those with embedded insurance capabilities center stage. We expect full-stack InsurTech consolidators to continue using financial services M&A to move into adjacent markets and strengthen their one-stop shopping value propositions, while firms in the auto space will accelerate efforts to quarterback the use of connected vehicle data across auto original equipment manufacturers (OEMs), carriers, telematics players and fleet managers. To keep pace, incumbent carriers with fledgling ecosystem strategies will partner more often with InsurTech innovators to gain needed capabilities.

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