Upward?

M&A trends in financial services

Q2'23

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Introduction

Still dropping

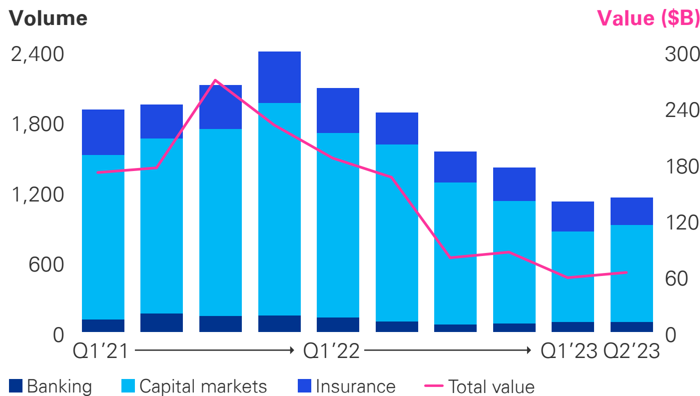
- The trend in financial services (FS) mergers and acquisitions (M&A) activity turned positive in Q2'23. Compared to Q1'23, total deal value rose 9.7 percent to $63.6 billion from $58.0 billion, and total volume went up 3.1 percent to 1,150 deals from 1,115.
- Comparisons remained negative for the year's first six months: Deal value plunged 65.4 percent to $121.6 billion from $351.2 billion in 2022, while volume shrank 42.8 percent to 2,265 deals from 3,957.
- Economic uncertainty remained the biggest obstacle for potential buyers and sellers. Inflation and interest rates continued to rise—albeit at a slower pace—and the political showdown over an extension of the debt ceiling prompted significant anxiety in May. The availability of credit tightened, furthermore, as banks responded to stressful developments in the first quarter.
- Interestingly, stock prices enjoyed solid gains, revealing a disconnect between deal makers' caution and investors' optimism.
- Activity should stay weak at least through year-end, we believe. Our case rests on a foundation of higher rates, rising unemployment, tight credit conditions, and companies' reluctance to deploy cash reserves on M&A.

Jonathan Froelich
Partner
Deal Advisory & Strategy

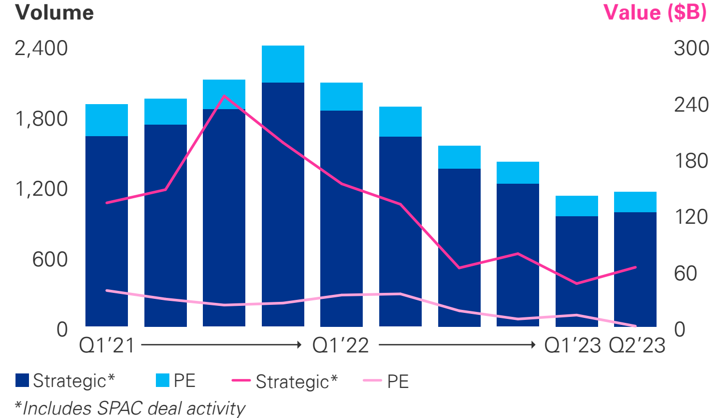
Q2'23 highlights

1,150 deals ▲ **+3%** increase QoQ | **$63.6** billion deal value ▲ **+10%** increase QoQ

FS deal activity by sector



FS deal activity by type

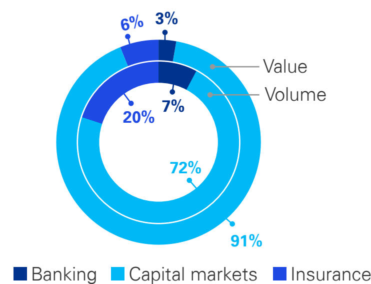


*Includes SPAC deal activity

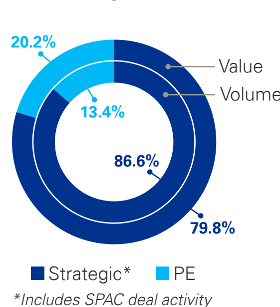
Q2'23 deal mix

Outer ring represents value. Inner ring represents volume

Sector mix

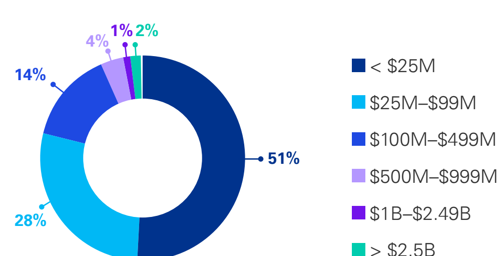


PE/Strategic mix



*Includes SPAC deal activity

Value size mix



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Top strategic deals

Acquirer	Target	Rationale	Value (billions)
Extra Space Storage	Life Storage	To create a highly diversified portfolio of quality storage assets	$12.7
Nasdaq	Adenza Group	To improve standardization, address market reform efficiently, and accelerate digitization	$10.7
Prologis	Blackstone RE fund properties	To add scale to its product portfolio, expand customer relations, and increase opportunities	$3.1

Top PE deals

Acquirer	Target	Rationale	Value (billions)
Antarctica Capital	Midwest Holding	To enhance the policyholders' value and to gain expertise in investment management	$0.1

In July, Bain Capital raised $1.15 billion for its fund dedicated in investing in the insurance sector.[1]

Deal data has been sourced from Capital IQ, Pitchbook, and KPMG analysis and excludes asset purchases/minority purchases. Q2 2023 covers all US deals announced from April 1, 2023 to June 30, 2023. Deal values are presented based on publicly available deal data and might not be exhaustive. Previously published statistics may be restated to incorporate new data and/or any changes.

[1] "Bain Capital Closes Inaugural Insurance Fund at $1.15 Billion." Baincapital.com, July 19,2023.

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At a glance

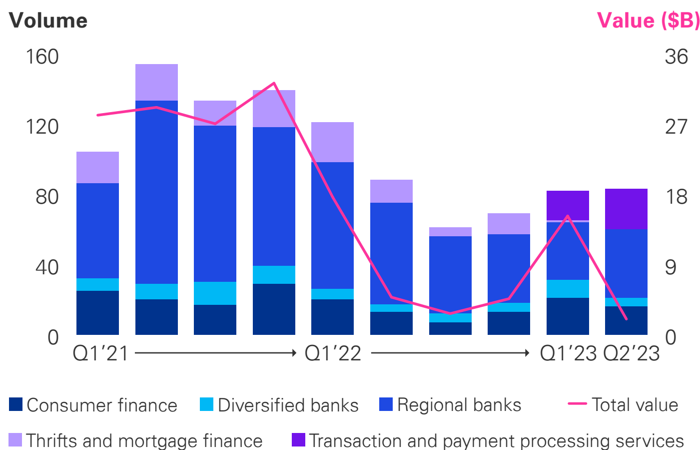
Banking

A weak half and quarter

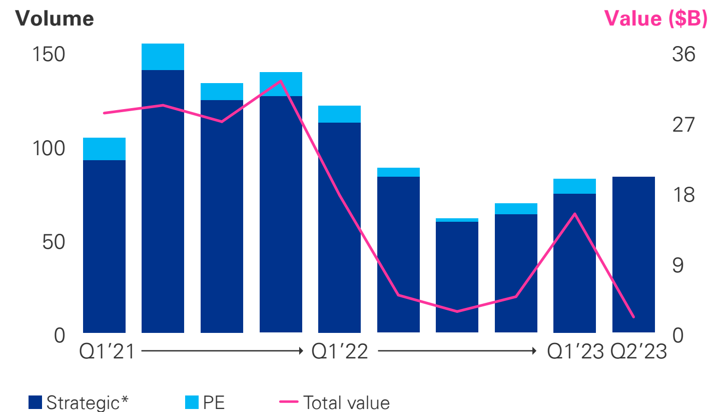
- Banking M&A activity declined in H1'23, but less so than the other FS subsectors we cover. Deal value dropped 23.2 percent, to $17.2 billion from $22.4 billion in H1'22. The number of deals fell 21.1 percent, to 165 from 209.
- Two banking transactions in Q2 stood out for their significance to the industry. The first was JPMorgan Chase's acquisition of most of the assets and deposits (a total of $295 billion) of the First Republic Bank from the FDIC. The deal resolved uncertainty about First Republic and helped to dampen concerns about the viability of midsize and regional banks.
- Days later, TD Bank and First Horizon announced the termination of their 2022 merger agreement due to uncertainty about obtaining US regulatory approval—a clear signal that the Biden administration's tough antitrust stance toward banks was succeeding.
- We expect most banks to remain on the sidelines in the second half of 2023. Between the challenging macroeconomic environment and a pronounced tightening of lending standards, banks will sit things out until they see more light at the end of the M&A tunnel.

Q2'23 highlights

Banking deal activity by subsector



Strategic and PE banking deals



Significant banking deals

Acquirer	Target	Rationale	Value (billions)
Visa	Pismo Soluções Tecnologicas	To boost its digital payments products and services	$1.0
Mr. Cooper Group	Home Point Capital	To grow its customer base and diversify its product portfolio	$0.3
Ripple Labs	Metaco	To expand its global footprint and establish its crypto services	$0.3

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Visa–Pismo Soluções Tecnologicas deal

"[M]ore differentiated core banking and issuer solutions they can offer to their clients"

— Jack Forestell, Chief Product and Strategy Office at Visa

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At a glance

Capital markets

Large deals even as activity slows

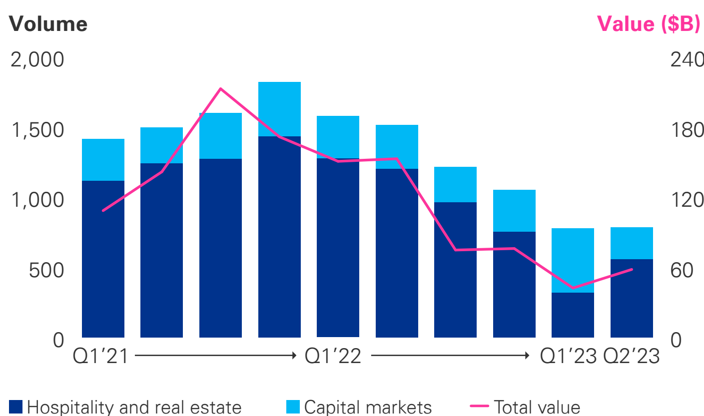
- Of the FS subsectors we cover, capital markets suffered the sharpest decline in M&A during H1'23. Deal value and volume dropped 67.0 percent (to $100.1 billion from $303.2 billion) and 47.9 percent (to 1,609 from 3,091), respectively, versus the same period in 2022.
- Capital markets accounted for four of the second quarter's five biggest FS transactions. Buyers in all of the quarter's top five capital markets deals were strategic rather than financial.
- Some large asset management deals were announced despite the overall slowdown in activity. TPG bought Angelo, Gordon for $2.7 billion, and Franklin Templeton paid approximately $925 million to acquire Putnam Investments.
- Prospects for activity in the rest of the year are muted due to the challenging macroeconomic environment. That said, we believe that the longer-term need for consolidation in asset management and investment banking continues to apply. In addition, alternative asset managers (real estate) are seeking new sources of capital as traditional lenders tighten their underwriting standards. Strategic players with available resources could take advantage of both of these trends.

Q2'23 highlights

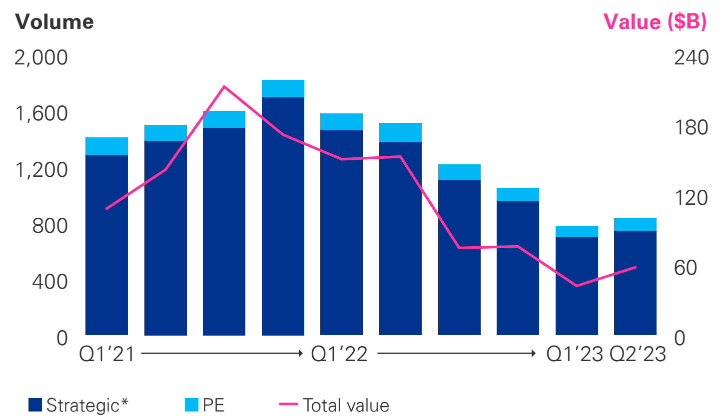
833 deals ▲ **+7%** increase QoQ

$58.0 billion deal value ▲ **+38%** increase QoQ

Capital markets deal activity by subsector



Capital markets deal activity by type



Significant capital markets deals

Acquirer	Target	Rationale	Value (billions)
Nasdaq	Adenza Group	To improve standardization, address market reform efficiently and accelerate digitization	$10.5
Prologis	Blackstone RE fund properties	To add scale to their product portfolio, expand customer relations and increase opportunities	$3.1
TPG Operating Group	Angelo, Gordon & Co.	To grow its position in the credit investment business	$2.7

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Nasdaq–Adenza Group deal

"We will have a more complete suite of essential software and technology solutions"

—*Tal Cohen, President of Market Platforms at Nasdaq*

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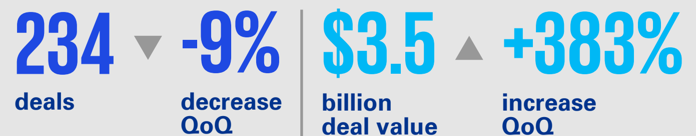
At a glance

Insurance

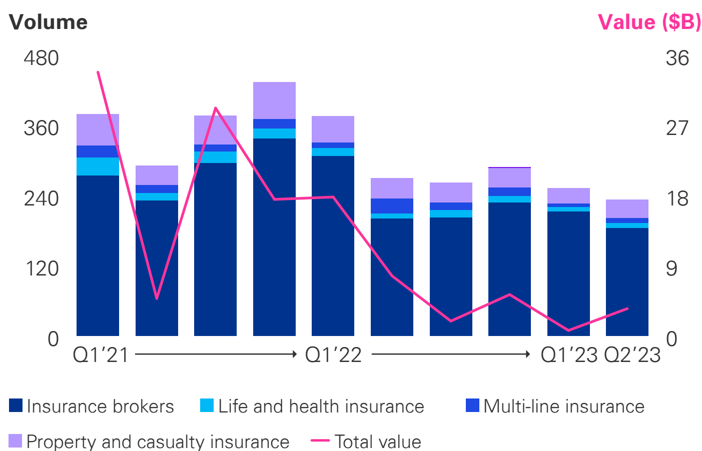
Not much going on

- Insurance M&A continued its precipitous descent in the year's first half. Compared to H1'22, deal value plunged 83.5 percent to $4.2 billion from $25.5 billion, while volume fell 25.3 percent to 491 deals from 657.
- The two largest transactions in the quarter were strategic divestments by American International Group, which continues to focus on its core operations. AIG sold some of its reinsurance holdings to RenaissanceRe for $3.0 billion and its crop risk business to American Financial Group for $240 million.
- Our outlook for insurance M&A is unchanged. Carriers with strong capital positions seek acquisitions that are good strategic fits and potentially accretive to earnings, but such opportunities are in short supply.
- We similarly see limited near-term activity involving insurtechs. Given the difficult economic environment, potential acquirers want targets with clear paths to profitability, of which there are few at the moment.

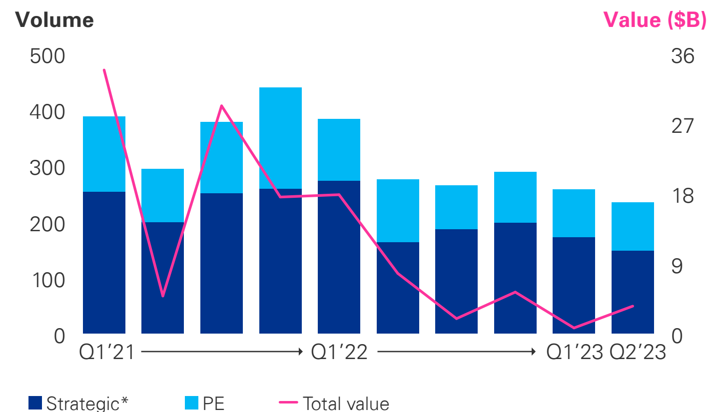
Q2'23 highlights



Insurance deal activity by subsector



Strategic and PE insurance deals



Significant insurance deals

Acquirer	Target	Rationale	Value (billions)
RenaissanceRe Holdings	Validus Reinsurance	To expand in the property and casualty and specialty traditional and alternative reinsurance market	$3.0
American Financial Group	Crop Risk Services	To expand its agricultural insurance services and gain from economies of scale	$0.2
Antarctica Capital	Midwest Holding	To enhance the policyholders' value and to gain expertise in investment management	$0.1

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RenaissanceRe Holdings–Validus Reinsurance deal

"This acquisition advances our strategy as a leading global property and casualty reinsurer, providing additional scale, and increasing our importance to customers." —*Kevin O'Donnell, President and CEO at RenaissanceRe*

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Improving performance for PE exits

During recent periods of high economic growth, private equity-owned businesses with strong organic growth were able to position themselves well for exit. That paradigm has shifted, however, due to macroeconomic factors that have negatively affected the pace of organic growth. These factors also have affected companies' cost structures, scalability, efficiency, and effectiveness.

PE portfolio companies that support the banking industry—think fintechs and payments companies—find themselves particularly challenged by this new paradigm today. In our view, they must focus on improving performance to maximize their chances for a successful exit. There are several key steps in this process.

Clear strategy and value proposition. Defining and articulating a clear business strategy and value proposition are the foundations of performance improvement. They establish the company's growth agenda, dictate the operating model's structure, and set the tone for how the company functions. If done correctly, they make it easy for potential buyers to understand where the company's value lies and how it can grow going forward.

Powerful value creation story. It's one thing to have a value proposition, but it's quite another to create the value. The latter requires fintechs and payments companies to evaluate their operating models and ask these critical questions:

- Is the operating model scalable to support future growth?
- Is pricing optimized relative to costs?
- Is pricing tiered for customer categories?
- Are residuals (i.e., revenue-sharing agreements) optimized to capture as much revenue as possible?
- Are customer service levels optimized for efficiency and effectiveness?
- Is the sales force optimized for maximum results?
- Is the sales force properly aligned to sell the product set?
- Are the product set and sales force positioned to meet the addressable market?
- Are general and administrative costs optimized for profitability?
- Is the labor force optimized to deliver value as defined by the company?
- Is information technology optimized and scaled for maximum efficiency and performance?
- Are office and facility locations optimized to service customers and minimize costs?

It's likely that the answers to most of these questions are "no" or "not quite." Regardless, they provide clear direction for what the companies and their PE sponsors need to do in anticipation of an exit.

We believe that private equity firms eyeing exits for their portfolio companies must shift their focus to maximizing operating performance from achieving growth. The firms must determine the right business strategy for the portfolio companies and then execute it to drive performance in both the near and long term. If done in a disciplined manner, this approach should result in successful exits.

The starting point is to establish, reset, or validate the strategy. From there, the firms and portfolio companies must conduct a concentrated assessment of the customers, products, and channels that will drive top-line value. Simultaneously, they should review the technology, operations, and processes that must be optimized or scaled to deliver the operating performance that can drive the highest exit multiple.

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Operational improvement

KPMG has helped numerous private equity firms prepare their portfolio companies for exit. The following cases exemplify our work on improving operational performance in this context.

Boosting EBITDA

The situation

A PE firm sought to sell a payment processing company. The firm had reached its return target and saw an opportunity to monetize its investment and refocus attention on a recently raised fund. The goal was to show potential strategic buyers that there were further opportunities to create and realize value via boosting the company's EBITDA.

The approach

KPMG conducted an analysis highlighting cost drivers, scalability, level of buyer overlap, integration costs, and the addressable cost base for each opportunity. We utilized proprietary and industry-specific tools to develop findings. These tools included evaluating market research reports and data sets, reviewing historical operational and financial results, and interviewing key management stakeholders.

Our analysis covered cost-of-sales (COS) and general and administrative functions to find opportunities for cost reduction across card and ACH/check processing, equipment purchasing, personnel, technology/infrastructure, facilities, and travel and entertainment expenses.

The outcome

We identified 11 main cost-reduction opportunities across the business's COS and personnel (full-time and non-full-time) functions. In addition, we outlined different scenarios for cost savings depending on the strategic buyer and its level of overlap with the business.

Over the course of multiple workshops, the firm and the company reviewed and agreed on the opportunities to boost EBITDA. Potential buyers received our analysis alongside the confidential information memorandum and diligence reports.

Reducing costs

The situation

A PE firm wanted to transform a portfolio company—an insurance agency franchiser whose profits had fallen and costs had risen during the onset of COVID-19. The franchisor's call center/customer servicing costs and handle time were considered suboptimal and above industry norms.

The PE firm sought to position the company as offering potential buyers opportunities to create and realize value, as well as to grow the business.

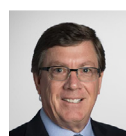
The approach

KPMG conducted operational due diligence and value creation for the call center/customer servicing function. Our analyses looked at the company's financial and organizational baseline to understand the customer servicing operating model. We also sought to address the root causes of the cost bloat and compared current costs, KPIs, and workflows against industry standards and benchmarks.

The outcome

We identified nine cost-reduction opportunities that mitigated the root causes of the operating model's inefficiency. These opportunities—which represented 20%-30% of the customer servicing cost base—focused on arbitraging labor, improving technology, enhancing self-service capabilities, improving interactive voice response routing, and increasing agent utilization through training and standardizing schedules.

We worked with the management team to further assess the opportunities and to understand the timeline and complexity of execution, as well as the preliminary cost savings to be achieved.



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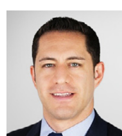

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Outlook

All eyes on the Fed

We continue to believe that macroeconomic conditions will dictate the level and pace of FS M&A in 2023. Appetite for deals among buyers and sellers remains highly dependent on the Federal Reserve's interest-rate policy.

The Fed raised its benchmark fed funds rate in quarter-point increments three times in H1 and once in July, bringing the rate to a range of 5.25-5.50 percent. While this represented a welcome deceleration from its previous increases of 0.50 or 0.75 percent, the Fed also made clear its intention to continue hiking until it was confident that inflation was under control. KPMG Economics expects one more increase in 2023, probably in November.

Good news and bad news. It's likely that inflation won't be under control—defined as close to the Fed's long-term annualized CPI target of 2.0 percent—until at least 2024. The economy isn't slowing down as the Fed has hoped: Annualized GDP growth in Q1 was 2.0 percent, significantly higher than the initial estimate of 1.3 percent and the 1.4 percent consensus forecast.

Strong GDP growth is both good and bad news for M&A. It reduces the probability that there will be a recession, meaning that corporate profits and cash flows should be high enough to support deal activity. But at the same time, it has negative implications both for inflation and the cost of capital.

Capital markets. Higher rates mean higher debt costs—a harsh reality for deal makers in all industries. Nonetheless, there are enduring market forces that should compel capital markets players to pursue M&A. For asset management and investment banking, the key force is consolidation as a way to cut expenses and increase scale. In alternative asset management (real estate), it's the confluence of participants' needs. Capital providers such as passive managers and insurance companies want real estate for its attractive revenue streams and returns, while real estate operators seek new sources of funding as traditional lenders strengthen their underwriting standards.

Banking. Banks face major headwinds that should keep them on the sidelines for the next few quarters. These include economic uncertainty, more restrictive lending standards, and falling demand for commercial and consumer loans. According to the Fed's April quarterly survey of senior loan officers, most banks expect to tighten lending standards even further through 2023.

Insurance. Large insurance carriers generally have a moderate-to-high interest in deals and capital to deploy, but they are finding few targets with a clear path to profitability. The marketplace could continue to be more active in the insurance brokerage sector, where the need for consolidation is undiminished.

Key considerations as we look ahead

FS deal makers thinking about M&A in the current environment should consider the following:

1 Divest strategically

In such a challenging period, companies should contemplate divesting noncore units. This is the time to focus on the core and strengthen business lines with greatest potential.

2 Prepare for departure

To maximize their chances for a successful exit, private equity portfolio companies must concentrate on improving performance rather than pursuing growth at any cost.

3 Do your diligence

Deal makers must more closely scrutinize their due diligence processes, integration approach, and the financial performance of their transactions.

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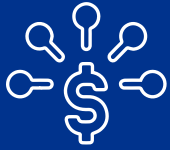

How we can help you

KPMG helps clients overcome deal obstacles by taking a fully integrated approach to delivering value by leveraging its depth in the FS industry, providing data-supported and tools-led insights, and delivering full M&A capabilities across the deal lifecycle. Our specialized FS teams bring both transactional and operational experience, delivering rapid results and value creation.

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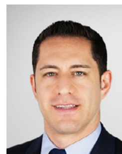

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