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Banking & Capital Markets Deals Insights Q3 2017 Update

Executive summary

Despite the initial high hopes that the strong post-election rally in bank shares would boost M&A activity, based on year-to-date September 2017 results it appears the rally may have actually been an impediment. The number of Banking and Capital Markets ("BCM") transactions based on year-to-date September 2017 activity was down 5% compared to the same period prior year and flat compared to the prior quarter in 2017. The question in many people's minds now is whether the so-called "Trump bump" ended up slowing down bank M&A instead of boosting it.

BCM transaction volume (which includes not only bank activity but also specialty finance, investment banking, broker dealer and exchange deals) is at its lowest level since 2014. There were 620 transactions announced in 2014 compared to only 291 deals so far through September 2017. 2017 started strong on the back of the rally, which pushed up bank shares by approximately 23% between the election and the end of 2016. In addition to the expected tax cuts that supported an overall increase in stock markets, the bank share rally was also supported by anticipated changes in bank regulations which could allow banks to reduce regulatory costs and undertake activities to support more robust growth.

The first quarter of 2017 started strong with 109 deals, of which five were mega deals (i.e., transactions with purchase price greater than $1 billion). While some may argue this spike in activity was driven by the increase in bank share prices, the subsequent quarters did not follow suit, as the second and third quarters of 2017 saw 90 and 92 deals, respectively, with only one mega deal announced in each of these quarters.

M&A Deal Volume

92 Deals

$5.7B

2% — Increase in M&A deal volume versus Q2 2017

35% — Decrease in M&A deal value versus Q2 2017

Equity Offerings

1 IPO

83% — Decrease in IPO volume versus Q2 2017

75% — Decrease in IPO volume versus Q3 2016

M&A and Multiples Source: S&P Capital IQ and PwC Analysis Equity Offerings Source: Dealogic and PwC Capital Markets Watch

"Banking M&A activity has been at one of its lowest levels since the aftermath of financial crisis. While the post-election rally gave banks strong currency to be able to do deals, it has also created uncertainty that has negatively impacted the deal market. The 33% increase in bank stocks since the election, without any significant changes in bank performance, make acquisitions potentially risky at these values. Also, to date, there has not been much clarity around the extent of regulatory repeal, tax reform or real improvements in the interest rate environment. Bank executives are cautious, and with good reason. Unless there is a compelling argument for a transaction that supports a bank's growth strategy, that cannot be efficiently achieved organically, "wait and see" seems to be the approach bank executives are taking."

Scott Carmelitano
US Banking and Capital Markets Deals Leader

Key trends/Highlights

- Banking & Capital Markets deal volume remained relatively flat compared to the prior quarter, with activity predominantly driven by commercial and retail banking deals. The consolidation of small regional banks continues to be a prevalent theme in the space, as these deals comprised 47% of Q3 2017 deal volume.
- Although the quarter saw a high volume of regional and community bank deals, these deals were mostly small in value (less than $250 million). Only two regional bank deals exceeded $500 million in value.
- M&A transaction multiples increased slightly versus the prior quarter, however transaction multiples were 47% above levels observed in the same quarter of the prior year, reflecting the impact of "Trump bump" that followed the 2016 US Presidential Election.

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Highlights of Q3 2017 Deal Activity

Key announced transactions

- First Financial Bancorp's announced acquisition of Mainsource Financial Group, Inc. for $1.0 billion. The combined company is expected to become the sixth-largest bank in the state of Indiana and the fourth-largest bank in the Cincinnati area, with plans on consolidating 45 to 50 overlapping branches upon completion.
- Valley National Bancorp's announced acquisition of USAmeriBancorp, Inc. for $816 million. The acquisition further enhances Valley National Bancorp's Florida franchise, marking its third acquisition of a Florida-based bank in the past four years (1st United Bank (2014) and CNLBank (2015)).
- Associated Banc-Corp's announced acquisition of Bank Mutual Corporation for $482 million. The acquisition expands Associated Banc-Corp's Wisconsin presence by 63 branches, improving to third in market share based on total deposits.
- UK-based Paysafe Group Plc's announced acquisition of Houston, Texas-based Delta Card Services, Inc. for $470 million. The acquisition expands Paysafe's processing scale and product-set for independent sales organizations and merchants in North America.

Source: SNL

Deal size

- There was a high volume of small deals during the quarter; among deals with disclosed deal value, 41% had values below $50 million (6% of deal value) and 79% had values below $250 million (33% of deal value).

Announced deal volume by subsector

- Commercial and retail banks continue to be the most active subsector in terms of deal volume, accounting for over half of all transactions in Q3 2017, as regional and community banks continue to consolidate.

Figure 1 – M&A deal volume and values by quarter

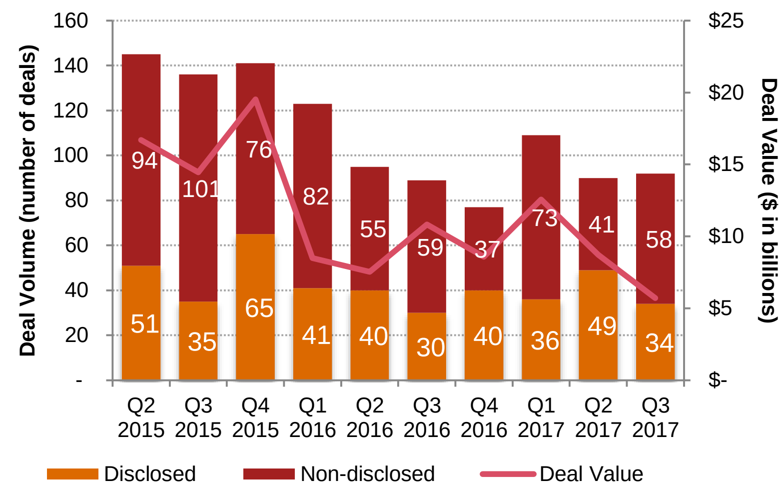


Figure 2 - Number of M&A deals by disclosed deal value

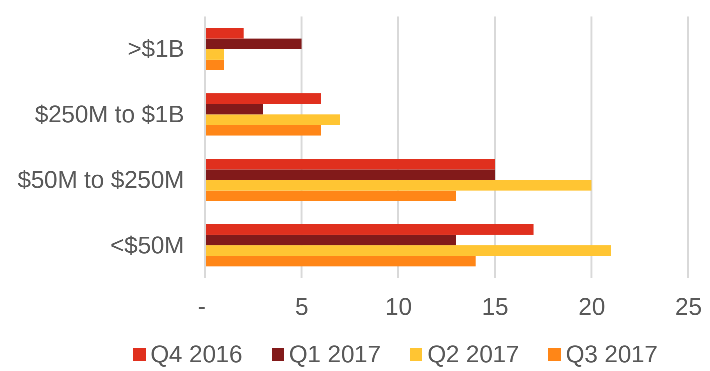
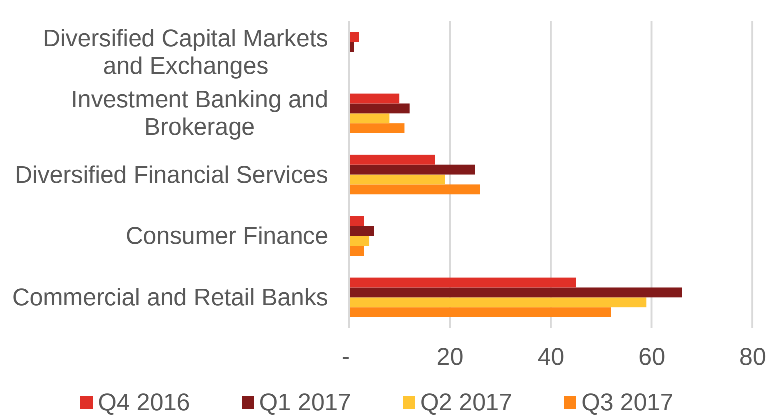


Figure 3 - Number of M&A deals by subsector



Source: S&P Capital IQ and PwC Analysis
Note: Deals included in this chart are those that have disclosed value.

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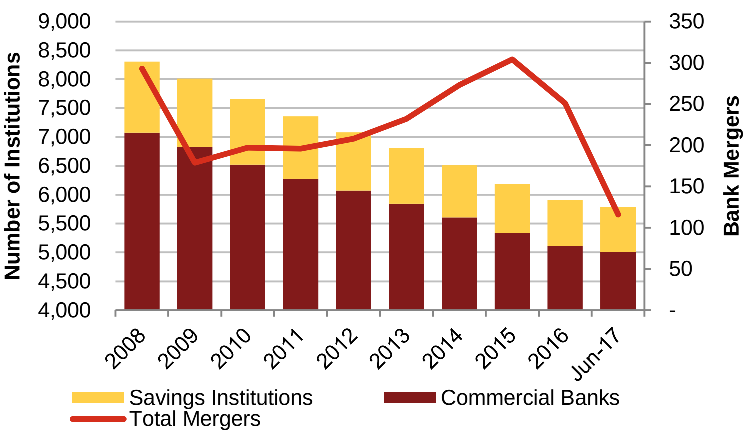
Key Trends

Key Trends

Consolidation primarily among community banks and to a lesser extent smaller regional banks continued throughout the year, driving deal volume during the period. As the benefits of consolidation outweigh the transaction risk associated with M&A among the smaller banks, current uncertainties that slowed down the mega deals (those with purchase price greater than $1 billion) did not impact community and regional banks to the same extent.

As smaller banks continue to look for strategic opportunities to further expand their presence in specific geographies and improve efficiency ratios through greater scale as well as the fact that level of regulatory scrutiny is lower at small bank level did not hurt the small bank M&A market as much.

The chart below illustrates the significant reduction in bank mergers based on FDIC data. While bank M&A during the post-financial crisis era peaked in 2015, it has since declined significantly, with year-to-date June 2017 being the lowest level seen since the financial crisis.



Source: FDIC

Unlike traditional bank M&A, FinTech companies focusing on services that used to be primarily provided by traditional banking and capital markets institutions continue to be active in the M&A space. Many FinTech companies took advantage of the fact that post-financial crisis banks focused on improving core businesses. So-called marketplace or on-line lenders now make up a significant portion of consumer and small-to-medium size enterprise lending. Banks have been supporting these businesses by purchasing portfolios of loans from and/or acquiring minority stakes in such companies. See additional discussion to the right about certain FinTech subsectors.

Unconventional Lending

As growth in lending has slowed – according to the Federal Reserve, year-over-year growth in bank loans has dipped to approximately 3% at the end of September 2017, from approximately 8% in the prior year – industry players have turned to unconventional loans as a source of growth. And, in order to gain exposure to these types of loans, many have looked to M&A. For instance, Goldman Sachs recently announced its acquisition of Genesis Capital, which lends to borrowers who seek to “flip” houses, a business that has been popularized by various home improvement cable-TV shows. This comes on the heels of Goldman’s launch of Marcus, an online-lending platform, in late 2016. We’ve also seen loan servicers and payments companies jump into the lending business through acquisitions, most notably Navient through its deal for online lender start-up Earnest, as well as PayPal through its acquisition of Swift Financial, which provides working capital loans to small businesses. Look for both banks and non-banks to continue to search for creative growth opportunities through acquisitions of non-traditional lending platforms.

Payments

US payments deal activity was highlighted by UK-based Paysafe’s acquisition of Delta Card Services Inc., the holding company for payment processor Merchants’ Choice Payment Solutions. The transaction was announced the same day in July that news broke of a $3.9bn bid by private firms Blackstone and CVC to acquire Paysafe, a deal that was later announced in August. The acquisition of Paysafe (while not captured in our data set of US-based acquirees) was one of three cross-border mega deals involving publicly-traded payments businesses announced during the quarter, along with Vantiv, Inc’s $10.4bn acquisition of UK payment processor Worldpay Group, and the acquisition of Danish payments company Nets by a consortium led by US buyout firm Hellman & Friedman. Multiples for such business ranged from 13 times to 17 times in the recent period.

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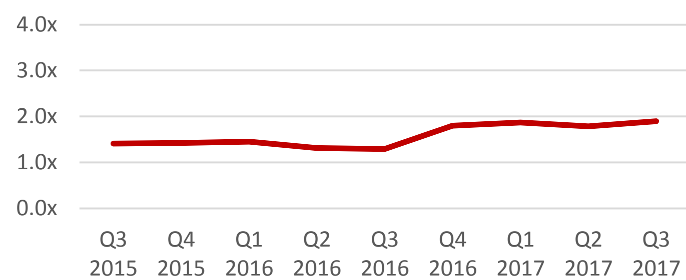
Valuation Multiples

Transaction multiple trends

Deal market activity in terms of volume is consistent in Q3 2017 relative to Q2 2017, with 92 banking M&A transactions in Q3 2017 compared to 90 in Q2 2017. Although the deal volume remained consistent, we saw an uptick in the average price/tangible book value ("P/TBV") which increased from 1.8x in Q2 2017 to 1.9x in Q3 2017. However, we continued to see transactions predominantly by smaller community banks (assets<$10 billion) that are seeking economies of scale to counteract the cost of regulatory compliance.

Transaction P/TBV Multiples



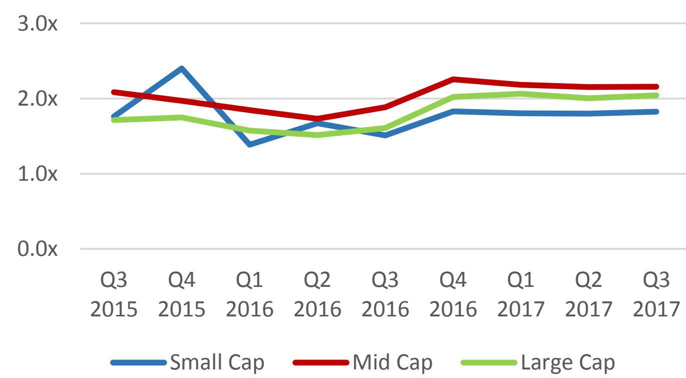
Source: S&P Capital IQ and PwC analysis.

Note: Transaction multiples are presented on a marketable basis, while trading multiples are presented on a non-marketable basis. A total of 13 transactions with available pricing information were considered in Q3 2017, excluding outliers and canceled transactions.

Trading multiple trends

From Q2 2017 to Q3 2017, trading P/TBV multiples have remained consistent at 1.8x, 2.2x and 2.0x for small-cap, mid-cap and large-cap bank stocks, respectively. We note that this trend is essentially flat from the gains seen in Q4 of 2016. This suggests that investors remain cautious as they wait to see if the Trump administration will deliver on the regulatory and tax reform that was expected.

Trading P/TBV Multiples

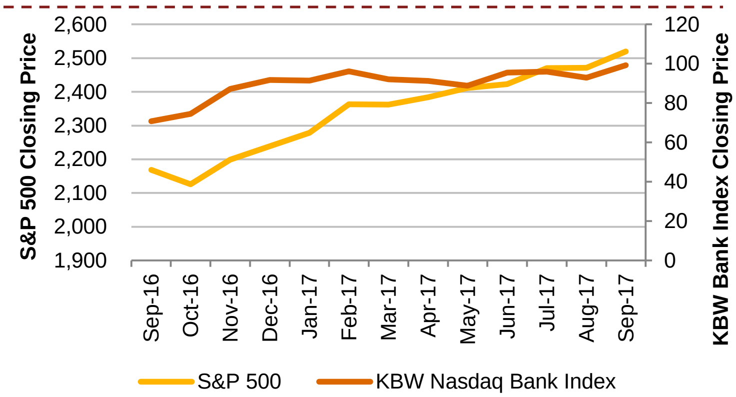


Source: S&P Capital IQ and PwC analysis.

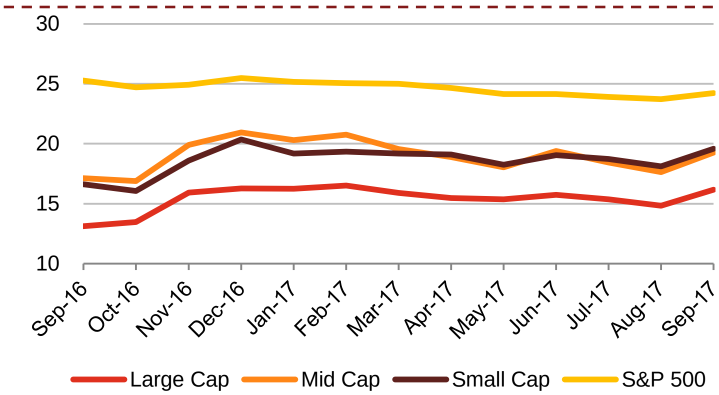
Bank valuations

As noted earlier bank shares increased by approximately 33% since the elections where this increase has not been matched by earning increases as can be seen in the rising trend in P/E ratios to the right.

Banking Stocks vs. S&P 500 Performance



Banking Stocks Price/Earnings Ratio



Source: S&P Capital IQ and PwC analysis.

Note: Small cap: less than $2 billion; mid cap: between $2 billion and $10 billion; large cap: greater than $10 billion. A total of 436 banks with available pricing information were considered.

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Outlook

Outlook for Q4 and beyond

As we move into the fourth quarter of 2017, we believe the following four issues will be the primary drivers of M&A activity in the banking sector: (1) Interest rates, (2) Tax reform, (3) Regulation and (4) Valuation.

Interest rates: Although the Federal Reserve did not raise interest rates in Q3 2017, many expect another Federal Funds Rate increase in Q4 2017 as the inflation rates appear to be in line with the Fed's target. Further, the Fed announced plans to begin offloading its balance sheet starting in October, a reversal of its quantitative easing policy during the financial crisis, a move that is expected to increase interest rates.

Tax reform:

With the recent failures of Congress to pass legislation on some of the key campaign promises of President Trump, tax reform has become a significant focus for President Trump and Congress. While the ultimate details are yet to be finalized, it is clear that any legislation will provide for a reduced U.S. corporate tax rate.

A number of banks across the United States, as well as other financial institutions, continue to report deferred tax assets (DTAs) on their financial statements. These DTAs are primarily due to loan loss reserves, tax credits, and, to some degree, net operating losses. To the extent corporate tax reform is passed with a reduced tax rate, many of these companies should anticipate some contraction of their balance sheets due to this line item. Conversely, to the extent these institutions maintain deferred tax liabilities (DTLs) (e.g., due to significant leasing operations), they should anticipate a benefit to the balance sheet.

DTAs and DTLs can also impact regulatory capital for banks under the final Basel III rules. For example, where banks possess DTAs that are more than 10 percent of their common equity tier 1 capital deduction threshold, there is a corresponding reduction to common equity tier 1. If a bank has a reduction to common equity tier 1 due to this line item, and the DTA shrinks due to a change in tax law (rates), we would anticipate seeing a smaller reduction to common equity tier 1 capital. If a bank is in a net DTL position (where DTLs are offsetting DTAs), banks should also consider the impact of any tax law changes.

While it is still too early to tell whether legislation will be passed, it would be wise to plan for these potential risks (or benefits).

Regulation: There have been indications that the floor of systemically important financial institutions ("SIFI"), or the amount of combined assets that would trigger a systemic risk review of proposed bank deals, could be raised from $50bn to $100bn. In Q3, Congress introduced a bill that would replace the $50bn threshold with a series of standards that, according to the bill's authors, more accurately measure systemic importance. Such standards include an institution's size, interconnectedness, substitutability, global cross-jurisdictional activity, and complexity. The amendment could effectively lower the hurdle bank mergers have needed to clear since the threshold was established in 2012.

Valuation: Although the macroeconomic factors discussed above may bode well for the sector, considering bank stocks appreciated by approximately 33% since the election, without a similar increase in earnings, in our view, the potential benefits from potential tax reform and regulatory relief are already incorporated in the current valuations as well as to some extent expected increase in interest rates. This implies that even if these events occur, there will be little impact on valuations in the near term.

This increase in stock prices presents both a benefit and a risk. While using stock as the acquisition currency can reduce the risk of dilution if valuations drop, it can also mean acquisition candidates are more expensive and an increase in target valuations may not be matched by the projected cash flows. Buyers have been cautious that increased valuations reflect expectations of tax and regulatory relief that as of yet, have not been realized and it remains unclear when they will be realized. This uncertainty makes doing deals at current valuations more risky. While using stock instead of cash can provide some hedge against potential dilution, it may not protect the buyer if there is a market correction.

About PwC's Deals Practice

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We would like to thank Scott Carmelitano, Sam Yildirim, Charlie Simulis, James Clarke, Chris Gaskin, John Giordano, Craig Hallock and Vu Tran for their contributions to this publication.

Smart deal makers are perceptive enough to see value others have missed, flexible enough to adjust for the unexpected, aggressive enough to win favorable terms in a competitive environment, and circumspect enough to envision the challenges they will face from the moment the contract is signed. But in a business environment where information can quickly overwhelm, the smart deal makers look to experienced advisors to help them fashion a deal that works.

PwC's Deals Practice advises companies on key M&A decisions, from identifying acquisition or divestiture candidates and performing detailed buy-side diligence, to developing strategies for capturing post-deal profits and exiting a deal through a sale, carve-out, or IPO. With more than 9,800 deals professionals in 75 countries, we can deploy seasoned teams that combine deep banking industry skills with local market knowledge virtually anywhere and everywhere your company operates or executes transactions.

Although every deal is unique, most will benefit from the broad experience we bring to delivering strategic M&A advice, due diligence, transaction structuring, M&A tax, merger integration, valuation, and post-deal services.

In short, we offer integrated solutions, tailored to your particular deal situation and designed to help you extract peak value within your risk profile. Whether your focus is deploying capital through an acquisition or joint venture, raising capital through an IPO or private placement, or harvesting an investment through the divesture process, we can help.

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About the data

We define the market as all banks large and small as well as investment banks, broker dealers, commercial and retail brokerage, as well as selected new entrants. M&A information was sourced from S&P Capital IQ (a division of McGraw-Hill Financial) and includes deals for which the target company was located in the United States of America and the industry classification of the target company falls into one of the following categories: banks, diversified financial services, consumer finance, investment banking and brokerage, or diversified capital markets. Certain adjustments have been made to the information to exclude transactions that are not specific to the banking sector. This analysis includes all individual mergers and acquisitions between July 1, 2015 and September 30, 2017, with a deal status of announced, closed, or effective.

IPO and follow-on information was sourced from Dealogic Equity Capital Markets Analytics and the PwC Capital Market Watch. For the IPO data, US IPOs include IPOs that listed their stock for the first time on either the NYSE or the NASDAQ, including companies uplisting from the OTC markets that raise capital and list on the NYSE or NASDAQ for the first time, foreign-listed and private companies that raise funds in the US and list on the NYSE or NASDAQ for the first time. IPOs do not include unit investment trusts, commodity trusts, fully classified closed-end funds, BDCs, demutualizations and best-efforts offerings. For follow-ons, the following parameters were excluded: closed-end funds, spot secondary, best efforts, pre-arranged placements, and accelerated bookbuilds/bought deals with undisclosed selling shareholders. Only those listed on NYSE, NYSE Market, NASDAQ, or Nasdaq Small-Cap are included in follow-ons. Deal values exclude over-allotments for both IPOs and follow-on offerings.