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Transaction Advisory Services

Financial services M&A: why the pulse is weak

While many financial services companies could benefit from transactions, a sustained credit drought has inhibited deal volume

Global transaction markets, significantly depressed for the past 18 months, are showing signs of awakening. Significant deals are being struck across a range of industries, including life sciences, health care, technology and food and beverage. But in financial services, the prognosis for M&A remains guarded. The exception is asset management, where several key deals have taken place and many more are likely.

Key points

- In banking and insurance, wide bid-to-offer spreads and scant credit continue to dampen transaction activity.
- Deal volumes or transaction valuations are unlikely to return to prerecession levels any time soon.
- High-profile deals in asset management augur more to come.

The spirit is willing

Ironically, the financial services industry could benefit from incremental or even transformative transactions. Financial services have been at the epicenter of the global financial downturn. Many firms are under pressure to shed non-core assets and to return to core competencies, as well as to raise cash and strengthen the balance sheet. Acquisitions could help other organizations build needed scale, gain distribution or lower the unit cost of back office operations.

Even seemingly complementary needs, however, do not translate into actual transactions. The key barrier is the persistent, pervasive dearth of credit. A sustained credit drought, of course, has been a fact of life for all industries since the financial crisis began. In all M&A today, cash and/or equity must be the dominant instruments of exchange. But in industries outside financial services, a small but growing number of transactions are being fueled by a trickle of new lending.

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Beyond the financing challenges, any potential deal must show the promise of strategic opportunity, strong cash flow and above-average returns. While many possible transactions in financial services may offer good results, many, if not most, firms in the sector were battered by the global downturn. Would-be buyers have precious little liquidity or equity to support transactions. While credit spreads have tightened, boosting investment portfolio valuations, questions remain as to the quality of some portfolios. The motivation may be strong, but these conditions preclude much action.

Another inhibitor for all of financial services is the persistent gulf between bid and offer spreads. Buyers in financial services, with their eyes on volatility and risk, present offers that reflect current market conditions. Would-be sellers, on the other hand, remain attached to prior years' valuations. Great as the need to divest might be, sellers can't bring themselves to accept what they view as steeply discounted offers. No matter how strong the drive to consolidate, divest or migrate to a new business model, many in financial services are unable to bring deals to a close.

Asset management: big deals lead the way

Diversified, broad-spectrum asset management is the exception to all this. Certainly, steep, downturn-driven declines in assets under management have harmed profitability and cash flows. However, major asset managers run their businesses with lean balance sheets. As asset prices recover, these firms are reviving faster than other financial services firms. Large and midsized asset managers have cash and are able to move, even in a market devoid of leverage.

Strong balance sheets continue to be critical prerequisites for buyers.

In a significant development, a number of major commercial banks and investment banks have successfully divested significant asset management businesses. These businesses had been profitable for the sellers – and were, in some cases, the crown jewels. But to shore up sagging balance sheets, it made sense to monetize these valuable non-core businesses. Because of their underlying cash flows, these assets have been less volatile than other bank assets and were undervalued relative to the banks' market capitalizations.

Buyers, for their part, have been asset managers seeking scale, new markets, distribution or talent – and these needs are expected to drive further acquisitions and consolidation. Strong balance sheets continue to be critical prerequisites for buyers. However, in several recent deals, sellers provided financing or retained a minority interest to stay exposed to the attractive revenue stream asset management firms provide.

Asset management promises to be the fastest sector within financial services to recover. The early stages of a rebound are evident, with the enterprise value/EBITDA multiples observed among nine public asset management firms increasing by 170% from January to October 2009. Consolidation is expected to continue – likely leading to follow-on deals in adjacent industries such as fund administration and custody.

Insurance: lots of opportunities, but no qualified buyers

The past year has seen very little movement of insurance assets. Insurance assets for sale abound; businesses of every stripe on virtually every continent are potentially available. Of course, the bad news is that few buyers have the economic wherewithal to close a deal.

Even though most in the industry believe the worst is now passed, the fact is that insurance investment portfolios have sustained a severe shock and buyers are extremely cautious about current valuations. Product guarantees that companies never expected to be "in the money" resulted in many companies recognizing substantial liabilities. It is still too soon to tell when buyers will be able to look beyond these issues. Meanwhile, pricing gaps persist, with those seeking to divest assets still gaited in pre-crash pricing, while buyers want risk-adjusted discounts. With few if any transactions taking place, these gaps are not challenged, and it remains uncertain when conditions might again enable buyers and sellers to achieve accord.

Banking and capital markets: inward focus stalls deal-making

Market watchers anticipate an upturn in deal volume in the banking and capital markets areas by mid- to late 2010. Major retail and investment banks, still dealing with their own balance sheets and capital issues, are not looking to acquire others. Moreover, with deal volume down across a broad spectrum of financial services, the marketplace is considered "overbanked." Despite relatively low asset prices, banks are neither hunting bargains nor pursuing consolidation.

Yet offshore corporate buyers are window-shopping US-based and European banking assets. There are even signs that sovereign wealth funds may return to the fray.

Certain large private equity funds are also perusing the offerings. For them, the difficulty is that buying a bank typically means being classified as a bank holding company, and such an entity is subject to higher levels of regulation. Private equity funds are searching for an effective deal structure that would avoid a change in status, and few have consummated deals. Alternatively, a number of investment banks are constructing investment funds comprised not of equity in the banks but rather in their distressed loans or comparable assets. Such a structure obviates the key regulatory hurdles of bank ownership.

A slow recovery

As credit returns, deal flow across a range of industries will revive gradually – though deal volumes or transaction valuations are unlikely to return to prerecession levels any time soon. A return of a measure of debt financing may confer first-mover advantage to bold acquirers. And as conditions slowly improve, watch for increasingly motivated buyers and sellers across a range of sectors to find ways to execute transactions that make sense.

As for banking and insurance, among those industries hardest hit by the current global recession, any rebound in M&A volumes here will trail other sectors by at least six to nine months. In contrast, larger, diversified asset managers were injured less severely and are recovering more rapidly. Moreover, major deals already executed are creating pressure for others to respond. As such, M&A markets here are already recovering and volume can be expected to grow significantly.

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