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When Will M&A Activity Pick Up After a Sluggish 2022?

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James Stevens, co-leader of Troutman Pepper's Financial Services Industry Group, was interviewed in the December 27, 2022 *ABF Journal* article, "[When Will M&A Activity Pick Up After a Sluggish 2022?](#)"

The headline is it is down dramatically compared to last year. And I think the biggest contributor to that has been the injection of a lot of uncertainty in our economy. M&A, specifically bank M&A, doesn't really do well in periods of uncertainty, especially with some of the more specific factors that are impacting it today. One is the rising rate environment, and the federal government's attempts to try to temper inflation by raising the Federal Funds Rate. The impact that is having and is going to have on the future is uncertain, but I think that most people believe a recession is coming and banks just don't do M&A during a recession.

The changing rate environment also has had a dramatic impact on the pricing of investment securities. So, there have been massive losses in this component of the balance sheet of banks, which also has injected a lot of uncertainty as to when that is going to recover and what that means for purposes of a bank's ability to either be a buyer or a seller.

Lastly, the looming specter of a recession has dramatically impacted bank stocks, so buyers' valuations are not where they need to be when it comes to using that stock as currency. When you combine all those uncertainties, it is not a recipe for a lot of M&A, and that's exactly what we've seen this year.

[...]

What we saw during the pandemic was a very, very rapid halt in all things M&A and capital markets in March of 2020, when the world stopped and we started working from home. I think that all the players in the capital markets were worrying about surviving and how they were going to take care of their employees and serve their customers from home. So, M&A and capital raising absolutely stalled for a couple of months, but we really started to see M&A swing back at the end of 2020. Of course, the pandemic was continuing, but we had a nice period of M&A in the banking sector at the end of 2020 lasting until the beginning of 2022, because people began to better understand what the pandemic meant for them and that it wasn't going to be a total halt on everything. In fact, many parts of the U.S. economy started to experience the largest growth they had encountered in some time.

[...]

I think it's down, but I don't think it will be down for long. We have seen a multi-decade process of consolidation within the banking sector. I've heard investment bankers say that there has been a 5-10% consolidation of the industry per year. There are multiple macro factors here, including the need for scale to spread costs of

technology and regulatory costs, the pricing pressure from customers expecting to get financial services at no cost or low cost, the competitive environment, the technology environment and the need to undergo digital transformations. All of these require banks to get bigger.

So, we're going to continue to see this consolidation. I think that the slowdown we're seeing now is almost completely explained by the potential looming recession and concerns about what a recession means for taking on another loan book. Once we realize we're into the recession or on our way, we can see a little bit further in the future as to what the economy's going to look like, and then you'll see a rapid turnaround, particularly due to pent-up demand.

[...]

I don't know exactly when in terms of time, but can explain the necessary conditions. I think we will see M&A pick up when people start to get comfortable with the new valuations of their stock. A lot of sellers have big holes in their tangible book value because of losses in their investment securities portfolio, and they've been trying to make the argument that those losses should be added back for purposes of valuation of their stock. I think at some point, banks will realize their value is what their value is even after taking into account the loss in their investment securities portfolios.

Another condition that's got to be satisfied is knowing that we don't have a recession in the future. I don't know that we need to be out of a recession, but we just need to know that it's here and understand what it looks like. Is it going to be something like what we had in the Great Recession, which would be potentially catastrophic, or is it going to be something like other recessions we've had? When people feel like that, they can understand where we are and where we're going from a recession standpoint, that's another condition that will have to be satisfied.

Lastly, inflation has got to get under control. I'm not an economist, but I have faith in the Federal Reserve that their efforts to tighten the money supply and to increase rates will eventually tamp down inflation, but I don't really know how long that's going to last. However, when we start to see that inflationary pressure going down and price increases go back to normal levels, that also will be a condition that will indicate that we're at the beginning of another period of M&A for banks.

[...]

The Fed raising rates is actually going to produce phenomenal bank earnings to close 2022. Banks are in the business of borrowing money from depositors at low rates and loaning it out to borrowers at higher rates. Most banks have the pricing power to increase the rate that they're charging to their loan customers in real time as rates go up and to have their deposit pricing lag, both in terms of overall rate but also in the speed at which the price is changing, which creates a wider net interest margin. That increased net interest margin drops to the bottom line as increased revenue and, ultimately, increased net income at banks.

So, rising rates are not necessarily a bad thing. I think that the issue is all the other stuff that comes with that. As rates go up, that is going to put pressure on borrowers. Eventually this pressure will lead to some credit quality issues, and credit quality issues lead to losses at banks.

Also, these rate hikes are not in a vacuum. Rates are rising because we have out of control inflation, which leads to other negative impacts on the economy that can be bad for banks. So, it's a complicated question. Rising rates are actually working in banks' favor at this very moment in time. But I think the fear is that a prolonged period of a rising rate environment coupled with a recession will more than outweigh that earnings pickup from net interest margin.

[...]

A trend that we've seen over the past 10 years is a convergence of the non-bank financial services and the depository institution spaces. The most talked about version of that is fintechs and banks coming together, but there's a lot of other non-bank financial service providers outside fintechs that are having this convergence with banks. I think we're going to see that continue to escalate. It has picked up noticeably in recent years, and it's going to pick up more substantially. For banks, that's a good thing in several respects. For example, when you have an industry that's consolidating rapidly, at some point there are not going to be enough buyers for all those that might want to be sellers. In addition, potential buyers are going to get too big to worry about sellers that are relatively small.

Having non-bank financial services providers interested in buying banks is a good thing in the sense that it creates some demand for banks that otherwise might not be able to find a bank buyer. But I do think those transactions are difficult. There are some significant barriers to entry into owning a bank or being a bank and a lot of non-bank financial service providers are not going to be able to satisfy the regulators.

So, I think the convergence works two ways. The other way it works is that banks are going to be increasingly buying fintech companies and other non-bank financial service providers. We've seen that pick up already, and I think that's going to continue to increase because, relatively speaking, it's easier for a bank to buy a fintech than it is for a fintech to buy a bank.

[...]

If you're a company that desires to sell, since the market is not there right now, you can spend the time outside the throes of a transaction getting yourself ready, getting the house in order. One of the big elements of that is regulatory readiness. Do you have outstanding regulatory or legal issues that you need to get cleaned up before someone else is coming in and looking at buying your bank? Do you have credit quality issues? There's been hardly any credit quality issues in banks lately, but are there cracks that are starting to show that you need to shore up before you start showing your loan book to a buyer? Are there other products and services that you've been wanting to offer that could add franchise value, new offices you want to open, for example, or new lines of business you want to incorporate that could add franchise value?

In a period where you're not selling your bank actively, that's the time to start really leaning in and getting those projects done so you can make yourself more attractive. That's what I would say for buyers: Get yourself ready so that when the market comes back, you can hit the market quickly.

On the buy side, I think a lot of the same things. Buyers that have regulatory problems can't be buyers. Buyers that have big legal issues may be too distracted with those to be a buyer. Buyers that are going to be using their

currency need to make sure their currency is attractive, which may mean that they need to also implement new products, services and offices to improve the performance of their stock relative to sellers and put them in a good position when it comes down to purchase. I think capital is another thing that buyers always need to be thinking about. There's a big market for sellers that are looking for cash. If you need to raise capital or you need to borrow money, you can do some of those things during the down period in order to get ready for a more active M&A environment.

[...]

I think the M&A space is going to be active in the second half of 2023. We've been up against this wall in M&A since the beginning of 2022. At some point, even if we're in a bad economic environment, as long as people understand where we are and where we're going, companies will find an ability to get together and work out transactions. We likely will continue to see this convergence of banks and non-bank fintechs and other financial service providers as it continues to pick up in 2023, both with fintechs buying banks and vice versa.

I also think we will continue to see a trend from more recent years with more mergers of equals. A merger of equals is basically a no premium or a low premium transaction where two people are saying, "You know what? We're worth more together than we are separately." Those deals are often done without a big premium, so in an environment like this where stocks are up and down, if both the buyer and the seller in a merger of equals are similarly low priced relative to where they think they should be, a deal can be made because no one's taking advantage of the price situation of the other party.

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