The navigator: perspectives on financial services M&A

Issue 1

Forward-thinking financial services firms are poised to capitalize on market disruption.

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Welcome to the first issue of The navigator, where we share our insights on trends in the deal environment that impact your business.

These are tumultuous times for financial institutions (FIs). Geopolitical uncertainty is challenging business models and strategies, while inflation — and the efforts to combat it — are taking a toll on economic growth and the markets.

The pandemic threat has receded but continues to be the biggest influence on strategic decision-making, according to the EY CEO Outlook Survey October 2022. But market volatility has not helped. Valuations have slumped, making it more challenging to finance growth.

Not surprisingly, the US financial services M&A market has slowed, with total deal values down 68%[1] in the first three quarters of 2022 from a record-setting 2021. While some large FIs are focused on digesting recent acquisitions, others have scaled back activity to preserve capital and contain costs in an unsettled, post easy-capital world.

Is that the right approach? History has shown that disruptive times often provide forward-thinking FIs with opportunities to re-examine their strategies and use acquisitions, divestitures, partnerships, and strategic investments to gain a competitive advantage in a rapidly evolving marketplace.

Actions taken today could reshape the competitive landscape for years to come, repositioning those with the agility to effectively leverage inorganic growth. Against a complicated backdrop, here are some of the deal trends we expect to accelerate in the coming months:

- **Adapting to change:** we expect to see FIs using M&A more often to reposition existing businesses for a fluid operating environment. For example, mortgage lenders might respond to lower origination volumes by acquiring technologies that can make servicing more efficient or expanding into adjacent businesses where they can leverage customer data. In the latest EY CEO Outlook survey, 61% of financial services leaders said they expected a "significant" or "moderate" increase in M&A over the next six months.
- **Partnering as the "new M&A":** at its core, M&A is about bringing capabilities together to create something greater than the sum of its parts. For traditional FIs, using partnerships to help meet evolving customer expectations has become a preferred way to move quickly into new strategic areas, such as digital assets, or to access revenue-generating capabilities quickly and with less capital than building or buying. FIs are increasingly partnering with non-financial firms to embed products into customer journeys, such as offering insurance products at the point of sale.
- **Recovering PE demand:** volatile valuations and tight debt financing markets have driven PE exit volumes down 80% in 2022, leaving a backlog of delayed M&A deals and IPOs. While PE firms continue to attract funding, most have paused or slowed new investments, waiting for greater clarity around monetary policy. We expect PE firms to be more active both as buyers and sellers in the first half of 2023.
- **Capitalizing on the market swoon:** valuations of listed FinTech firms declined 70% through the first 10-plus months of 2022 and the market for IPOs and special-purpose acquisition companies (SPACs) has all-but halted.[2] The lack of FinTech exit alternatives has created opportunities for FIs to use M&A to add strategic technology capabilities or reshape business portfolios for the future.
- **Monetizing by divesting:** with capital costs rising, more FIs are looking to monetize businesses that are no longer critical to their long-term value propositions — or represent exposures that no longer fit their risk profiles — and redeploy the capital into areas of competitive strength. In the EY CEO survey, 30% of financial services CEOs listed divesting a non-core business as a strategic priority in the next six months.

While the M&A market has slowed, it remains dynamic, particularly for tapping innovation. In the spotlight this edition, we take a closer look at what to expect in three technology-driven sectors: payments, digital assets and WealthTech.

[1] EY analysis of data from Mergermarket, Refinitiv and S&P Capital IQ Pro
[2] "Mastercard will help banks offer cryptocurrency trading;" *CNBC website*, https:/www.cnbc.com/2022/10/17/mastercard-will-help-banks-offer-cryptocurrency-trading.html, October 17, 2022

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Payments: ready to roll

Adapting the business mix to a changing environment.

The wave of consolidation that hit the payments industry two years ago has largely been digested. If not for the uncertainty in the market, it would be go-time for M&A. The space is primed; the players are ready to act, and some investors are selectively adding to their holdings to support firms' growth plans and capitalize on falling valuations.

In an environment that offers smaller margins for error, appetites are especially strong for deals that offer revenue and cost synergies and can be immediately accretive. For now, most are waiting for the economy to stabilize before committing to transformational deals.

What to watch for:

- **Network effects:** Visa and Mastercard, relatively untouched by lower valuations, are expected to go on the offensive, using M&A to add to their overlay offerings. Capabilities with the greatest appeal include authentication, fraud protection and data services to fuel growth in Buy Now, Pay Later (BNPL) installment payments, crypto, account-to-account payments and other non-card rails. For example, Mastercard recently announced plans to partner with banks as a "bridge" to Paxos, a crypto trading platform.[3]
- **Banks becoming operators:** big banks are poised to accelerate their use of M&A to strengthen payments businesses in key verticals. For example, JPMorgan Chase acquired InstaMed,[4] a healthcare payments technology firm, to add scale to that vertical and capture additional payments and lending revenue. PNC Financial Services is similarly targeting the restaurant industry as a source of growth with its September acquisition of Linga, a provider of point-of-sale solutions.[5] Expect other banks to follow suit.
- **Realign business portfolios:** payments firms will use M&A to proactively reshape their business portfolios for a rapidly changing marketplace. While some will add capabilities and geographies to strengthen competitive advantages, we expect others to divest non-core units that no longer fit management's strategic vision, generate inadequate returns or are vulnerable to a possible recession.

[3] "Mastercard will help banks offer cryptocurrency trading;" *CNBC website*, https://www.cnbc.com/2022/10/17/mastercard-will-help-banks-offer-cryptocurrency-trading.html, October 17, 2022.
[4] "JP Morgan buys health-care payments firm InstaMed in the bank's biggest acquisition since the financial crisis" CNBC website, https://www.cnbc.com/2019/05/17/jp-morgan-buys-instamed-in-biggest-acquisition-since-financial-crisis.html, May 17, 2019
[5] "PNC announces acquisition of point of sale and payments solutions firm, linga," PR Newswire, September 26, 2022.

Digital assets: transforming market turmoil into opportunity

Targeted investments can position FIs for long-term growth.

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As digital assets gained greater mainstream acceptance, sky-high valuations kept many established players from investing. That could be changing. The crypto winter, reduced funding levels and the recent collapses of high-profile exchanges and stablecoin issuers are causing a shakeout in the space. Valuations have slumped by as much as 70% in Series B funding and beyond.[6] For now, funding activity has cooled.

While M&A volumes in 2022 have remained roughly on pace with 2021's record numbers, deal values have fallen. The market might be slowing, but we believe the crypto M&A market still has energy, with wallets, trading infrastructure, data providers and stablecoin issuers among the most-likely targets. Despite recent headwinds, there is little doubt that digital assets and blockchain technologies are here to stay.

What to watch for:

- **Buy instead of partner:** in recent months, several incumbent FIs have begun to explore potential acquisitions of niche digital-asset capabilities to capitalize on the valuation swoon, add talent with needed technological skills and position for the future. This could accelerate going forward, as more FIs weigh the counterparty risks of partnerships.
- **Focus on institutional capabilities:** as retail crypto exchanges consolidate, investor focus will continue to shift to FinTech firms with capabilities that support institutional infrastructure, such as custody, data & analytics, security, and use cases like tokenization.
- **Fundraising changes:** we expect overall fundraising levels to decrease, but firms with capabilities that support institutional infrastructure and security, or emerging Web3 use cases, such as decentralized finance (DeFi), nonfungible tokens (NFTs) and gaming, will continue to attract investor interest. One example: In October, Uniswap Labs, a Web3 and DeFi firm, secured $165 million in Series B funding, a record investment in the DeFi space.[7]

6 Source: EYP analysis, PYMNTS.com, Coindesk

7 "Uniswap's $165M funding round a bright spot for DeFi in Crypto Winter," *Yahoo website*, www.yahoo.com. October 13, 2022

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WealthTech: an exit wave looms

WealthTechs poised to emerge as acquirers.

The nature of WealthTech is changing. Where once the wealth management technology space was about competing head-on with established wealth managers, today it's more about developing solutions like advisor toolkits to help incumbents deliver superior customer experiences or drive efficiency.

The shift from foe to friend has played well with investors. Venture capital flows into WealthTech startups began accelerating in 2019 and peaked in 2021 with $12.8 billion of investments recorded, much of it late-stage. The pace has slowed in 2022, but the stage has been set for a flurry of M&A activity.[8] IT services firms and healthy WealthTechs, both seeking to expand their partnership offerings, could emerge as buyers, sparking competition for distressed firms with differentiating solutions.

What to watch for:

- **Exits accelerate:** VC firms live for the well-timed exit. Beginning in 2023 — and accelerating through the next two years — they'll be looking for the door. The glut will likely push pricing down, creating opportunities for IT services firms, wealth managers and PE firms to acquire better capabilities.
- **Three deal drivers:** activity in the WealthTech ecosystem will continue to be driven by three core themes: delivering hyper-personalized experiences to meet customers' changing expectations; boosting advisors' customer engagement and retention with digital productivity tools; and helping retail broker-dealers deepen client relationships and automate key functions via Software-as-a-Service (SaaS) solutions.
- **Invest to learn:** established wire houses are not anticipated to be big WealthTech acquirers, but we expect to see them accelerate investing alongside late-stage VCs to gain access to new expertise. For example, JPMorgan Chase, through its strategic investment unit, owns a minority stake in Zanbato,[9] which runs an inter-broker platform to source liquidity and speed trade execution for venture-backed shares.

The views expressed in this article are of the authors and not necessarily Ernst & Young LLP or other members of the global EY organization.

[8] Source: Pitchbook, as of December 31, 2021
[9] "J.P. Morgan Makes Strategic Investment in Zanbato," *Business Wire website*, https://www.businesswire.com/news/home/20210222005272/en/J.P.-Morgan-Makes-Strategic-Investment-in-Zanbato February 22, 2021

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