In all of 2017, there were $33 billion in announced deals among U.S. banking and capital markets firms. After six weeks in 2019, we had already passed that level.

What's going on?

There are many factors that underlie any given transaction. But there are also some broad themes at work in the market, and we expect them to continue for the foreseeable future. Whether you're a would-be acquirer or a potential target, this is a good time to review some trends and consider how they might apply to your own institution. In fact, two recently announced transactions – the $28 billion proposed merger between BB&T Corporation and SunTrust Banks, and the $3.6 billion combination of Chemical Financial Corporation and TCF Financial Corporation – say a lot about where the industry may be heading.

Innovation and digital capabilities

For several years now, the largest U.S. banks have grown significantly faster than their regional competitors. We believe this trend is due to two factors: a sustained push to develop strong digital capabilities at scale, and more successful, better-funded marketing efforts. Some of the strongest customer growth in retail is being driven by millennials and older, wealthier clients; PwC analysis shows that both of these groups tend to be especially responsive to digital and marketing strengths.

Between 2011 and 2014, the biggest U.S. banks accounted for nearly two-thirds of deposit growth and virtually all the net growth in debit cards, which is a good proxy for consumer checking accounts. Given their scale, these players can significantly out-invest other banks in brand marketing, data analytics and digital products and services. The converse is also true: financial institutions that don’t, or can’t, invest to achieve digital capabilities at scale are finding themselves at an ever-greater disadvantage. With both of these deals, the banks involved cited their desires to invest in innovation and digital capabilities as a strategic reason for the deals.

Favorable deal economics

Higher-priced deals typically require aggressive synergy and growth targets to create attractive returns. Our research has shown that more than 50% of banks fail to achieve their growth-adjusted cost synergy targets. However, recent deals referred to as “mergers of equals” (MOEs) have found a sweet spot, where both sides structure a deal with book value multiples and targets that might reward all stakeholders.

Recent transactions are setting a new standard for attractive bank deals. In 2018, bank transactions averaged above 1.8x a target's tangible book value (TBV), and as high as 3.2x. At around 1.7x, the BB&T-SunTrust and Chemical-TCF mergers represent great prices for strong organizations. These deals appear to have been priced reasonably, and this increases their chances of generating the desired return on investment.

Further, when banks link up, they typically announce that they will see synergies (cost savings) ranging from 10-45% of the acquired bank’s non-interest
expense. Our experience with bank integration shows that synergy targets in the 20-30% range tend to be conservatively achievable. Synergies greater than 30% usually require rationalizations of branch networks, products and operations that are far more ambitious, and therefore harder to accomplish. In the first transaction, the banks have announced a target of 29% of SunTrust’s non-interest expense. In the second, they are aiming for 18% of TCF’s non-interest expense. We believe that if other banks can create deals with relatively low TBV multiples and achievable synergy targets, we are likely to see many more similar transactions in the market.

Regional, digital tie-ups
MOEs traditionally bring together complementary strengths, such as uniting a strong commercial bank with a strong community bank franchise, distinctive product sets or adjacent territory. If both firms in a transaction can effectively distribute their combined product portfolios across their combined geographies, they may boost top-line revenue. Digital capabilities may provide an additional path to these kinds of synergies: the new variable in bank M&A.

Receptive investors
The total number of U.S. banking deals has remained relatively flat for awhile. Despite equity markets getting increasingly skittish, shareholders have reacted well to these transactions; the MOE deals have traded up on announcement. With such optimistic responses from investors, we’re likely to see more of these types of transactions in the year ahead.

No deal is a slam dunk. Integration issues associated with change management, data and technology can limit the payoff from a deal that looks good on paper. These challenges may be harder for MOEs relative to outright acquisitions, because the two firms often have comparable processes and teams. Leveraging the best of both cultures, choosing what to preserve, aligning and retraining everyone to follow a new operating model and a set of desired behaviors, thinking through location strategy, transparency around how people and communities will be affected: these all require work. But when MOE deals are integrated properly, there can be winners on both sides of the transaction – as well as shareholders, customers and employees.

We expect the trend toward M&A in the community and regional banking sector to continue. Consolidation is a strong path forward for many banks in the sector, especially those that are beginning to invest in customer-focused digital transformation. The BB&T-SunTrust and Chemical-TCF mergers suggest that fairly priced deals with reasonable synergy targets will nearly always attract interest, especially when shareholders believe that the integration is achievable.

Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.

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