Mergers & Acquisitions: Will Fintech result in more deals?

“We live in a society exquisitely dependent on science and technology, in which hardly anyone knows anything about science and technology.”—Carl Sagan.

Short-term challenges and opportunities require immediate attention, but many community bankers consider the ability to efficiently deliver personalized products and services the key to long-term success. Lucrative strategies and expertise that community-based institutions emphasize include specialized lending niches (i.e., commercial real estate, commercial business, residential mortgage, consumer, etc.), noninterest income product lines (i.e., trust, wealth management, mortgage banking, etc.) and core deposit generation. No matter what the specialty or how efficiently customers are served, all community banks need to reckon with ongoing and significant investments in financial technology. Or said differently, community banks will ultimately resemble financial technology companies with a banking charter.

- Many community banks do not have a formal, long-term plan with interim targets to accommodate customers’ desire for digital, versus branch banking.
- Technology has arguably made it harder for smaller banks to compete with larger organizations. The nation’s largest banks spend around 18% of their noninterest expense, or about 10% of revenue, on technology. Information technology includes infrastructure, cybersecurity, and innovation.
- Community banks typically rely more on vendors and outside consultants than larger institutions that have in-house developed systems.
- Anecdotal evidence suggests that some recent merger and acquisition transactions considered the need to use technology more effectively.
- Independent-minded institutions should strongly consider issuing debt to help finance in-house technology investments or an acquisition of a fintech firm.
- The capital markets regarding debt issuances are almost ideal: interest rates are very low, credit spreads have not widened, and demand for bank-issued debt products is nearly insatiable.

Banks’ response to demographic shifts and changes in customer preferences will likely require a substantial change in culture along with significant technological investments over many years. This is a challenge given the initial outlays required to upgrade information technology (IT) systems and personnel while continuing to generate acceptable shareholder returns. Due to the commitment and relatively large amount of IT expenditures, a bank’s board of directors should be intricately involved in the strategic planning process.

Included among the many reasons why banks decide that selling is preferable versus remaining independent is the escalating costs of financial technology. (Nearly 2,400 banks were sold since 2008.) Other reasons that lead to mergers (banks are sold; and not bought) include earnings challenges, regulatory and accounting burdens, succession issues, and
attractive merger premiums. As we go to press, there have been 152 deal announcements in 2019, compared with 171 announcements, at this time, last year. There were 259 and 256 announced mergers in 2018 and 2017, respectively.

**Mergers afford the combined institution with more scale to make changes to improve digital delivery systems as part of the integration process.** This investment can be crafted as part of a branch rationalization program. Along with restructuring charges incurred from closing physical branches, investments in digital delivery and marketing, analytics, and robotic process automation, the expected savings can be redeployed into IT. Depending upon the bank’s shareholder base, Investor Relations Departments may be challenged to justify that the longer-term benefits outweigh the initial outlays.

Recent transactions that noted the importance of technology include:

- Kelly King, Chairman and CEO of BB&T Corporation (NYSE: BBT), cited technology as one of the underlying reasons for the merger with SunTrust Banks (NYSE: STI). Mr. Kelly described the combination as giving the organization the ability to invest $100 million in technology, with the intention to enhance customer relationships.

- Rodger Levenson, President and CEO of WSFS Financial Corporation (NASDAQ: WSFS), noted the importance of technology on its August 8, 2018 call regarding the acquisition of Philadelphia-based, Beneficial Bancorp, Inc. Mr. Levenson stated that approximately 50% of the annual cost savings from branch closures associated with the merger would be reinvested in technology.

**Independent-minded and forward-thinking community banks should find that a good tactic to finance financial technology investments is through bank debt (senior and subordinated). Pricing is very attractive in the current environment.** Please see the attached June 2019 Report - *Asset Liability Management – An Ideal Time to Issue Debt*. The new issuance market is near-perfect due to a supply/demand imbalance, low Treasury yields, and relatively tight credit spreads. Absent capital raises, it could be difficult to allocate funds from existing cash flows for IT-related investments.

Due to its position within the capital hierarchy, debt may be preferable to equity given that common shareholders will not be diluted and there are no voting rights attached to these debt instruments. Due in part to its tax-deductibility, the cost of capital on debt is often lower than that of equity capital for community banks. The ability to issue debt facilitates the use of cash to fund acquisitions (including fintech firms), which is significant as common equity raises can be more difficult for smaller institutions.

The aggregate amount that U.S. banks will spend on technology in 2019 is believed to be approximately $67 billion. Of that amount, it is estimated that JPMorgan Chase (NYSE: JPM), Wells Fargo & Company (NYSE: WFC), and Citigroup Inc. (NYSE: C) will spend around $11 billion, $9 billion, and $8 billion, respectively. Due to the lack of scale to absorb the necessary fixed costs, regional and smaller banks spend relatively more of their revenue on technology compared with large institutions.
About 60% of the total technology expense for larger banks typically goes to core existing infrastructure (network, data, support, security). Innovation accounts for roughly 40% of the total IT budget, which includes new product development and functional upgrades. New product development includes payments, loan processing, and account openings. Functional upgrades include products such as ID verification, electronic signatures, and CRM systems.

Community banks may face a lack of resources to completely address IT issues. For instance, technology spending decisions are often made by IT departments with the “need to do what can be done” based on limited budgets. Unless the bank has sufficient scale, it is difficult to develop or purchase the IT system that best suits the bank and its customers. As a practical matter, smaller banks rely more on vendors compared with bigger banks that have in-house developed IT systems. Most community banks use FIS, Fiserv, or Jack Henry & Associates. We think it is fair to conclude that community banks typically are not the innovators in financial technology.

The time has arrived – or will arrive shortly – when Millennials (those born between 1981 and 1996) drive economic activity. Millennials represent the largest generation in the U.S. workforce and use technology as a major way to communicate and interact with people and businesses. The Millennial generation is comfortable with technology; and Generation Z (those born after 1996) is even more connected to the world through mobile devices, WiFi, and high-bandwidth cellular service.

Banks, therefore, must be proactive to the economic changes that will occur as baby boomers wind down their earning and spending activity and younger generations dominate economic activity. In general, community banks appear challenged to garner Millennials and Generation Z as depositors - national banks have used their resources to attract and retain younger customers through more effective marketing and branding campaigns. Banks should expect Millennials and Generation Z to require personalized and seamless/on-demand access to the underlying services and products. If banks can’t or won’t meet these conditions, larger banks and fintech companies are eager to meet the next generation’s preferences.

Please feel free to contact a member of the PNC FIG Advisory team to discuss financial technology in more detail and how it may apply to your specific institution.
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