# M&A May Be Experiencing a Rebound: Here's Why

industry update economy Mergers and Acquisitions

**Summary:** CFIs face tough economic challenges led by rising interest rates. Finding a way forward may require strategic partners. We discuss M&A trends from 2023 and why consolidation might be a solution.

Warren Buffett has coined lots of pithy sayings about finance. One boils down his investment philosophy to two points. Rule 1: Never lose money. Rule 2: Never forget Rule 1.

The financial sector isn't necessarily losing money these days, but the direction it's heading in is certainly less than desirable. Fed rates rose and profits fell through the start of this year as a result of bank collapses, which resulted in community financial institutions (CFIs) being heavily impacted. Recent banking financial data has shown the impact of higher rates and the change in deposit flow, indicating a flight to safety and tighter lending as many CFIs tried to stave off deposit outflow and prevent margin compression.

Throughout this year, CFIs have seen a migration from non-interest-bearing accounts to interest-bearing accounts and money market accounts, which has resulted in net interest margin (NIM) compression. The Q2 and Q3 results reflected this struggle, showing that CFIs in most regions of the US experienced lower returns YoY, worsening efficiency ratios, and slower deposit growth. Despite the negative headwinds that the banking industry experienced so far this year, the number of unprofitable community banks has fallen to near a record low. Net interest margins are starting to improve, and deposits, albeit slowly, are starting to return to regional and smaller institutions. Even with all the headwinds in 2023, balance sheets look to be resilient for the next year of lending.

**An M&A Comeback**

But those positive signs don't mean an end to the struggle to preserve liquidity while generating returns, which represents a delicate balancing act in the current financial climate. For some CFIs, the challenges may be too daunting, prompting them to seek shelter through mergers. Already, there is talk of a rise in bank M&A on the horizon.

If deal-making between CFIs does turn around, it will represent a marked shift. M&A activity had been sluggish early this year, with just 32 bank deals announced through May 31, compared to 66 for the same period in 2022. Deal value was $580MM, an even steeper drop from nearly $3B a year ago. Only four deals were announced in May. However, June brought eight M&A announcements, and the increase in activity continued in August, with 18 deal announcements, the most in a month since July 2022 (which had 19). September had seven M&A announcements, bringing the Q3 2023 M&A total to 34, the highest amount of deals announced in a single quarter this year.

What's more noteworthy is the value of the deals being announced. According to S&P Global, the aggregate deal value for Q3 was $2.76B, a significant jump from the aggregate deal value of $629.9MM for both Q1 and Q2 combined. Experts across the industry are expecting M&A activity to continue to increase in 2024. There are a few reasons behind this prediction, and they're better signs than might be assumed.

**Driving Forces Behind Increased M&A**

The increasing costs for technology and regulatory compliance are driving costs up for community banks, compounding the fears of deposit loss. This is putting extreme pressure on profit margins, which could be slightly alleviated if banks combine to share those costs. Another reason why M&A deals might ramp up is that smaller CFIs are looking to be more competitive. Joining forces can actually be a normal part of a CFI's strategy to keep up with larger banks' offerings. Forbes Finance Council notes that "history shows that M&A deals made during times of economic uncertainties tend to be successful."

**M&A Regulatory Woes**

Despite the need for some institutions to consolidate, there could still be some hesitance. One of the hang-ups for dealmakers is the tough regulatory oversight. There are several questions still hanging in the air for regulators to answer that will ultimately impact expenditures in the financial industry for years to come. That being said, the Wall Street Journal reported that some regulators have privately expressed openness to M&A as "part of the solution to instability in the banking system."

While that could be an incentive for more consolidation among CFIs, it is unclear whether there are enough financial incentives to make deals worthwhile at the moment. Striking a balance that makes financial sense for both buyers and sellers has become difficult in the current climate.

Still, the urgency of finding a way out of the current interest rate crunch may be incentive enough for some stressed CFIs to come to the bargaining table. If the profit picture doesn't improve soon, many more may be seeking new partners.

CFI profits are under stress, leading to a hunt for ways of generating returns and landing new depositors. For those unable to find solutions in-house, mergers may represent the best way forward.

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## ECONOMY & RATES

Rates As Of: 11/09/2023 10:07AM (GMT-0800)

| Treasury | Yields | MTD Chg | YTD Chg |
|---|---|---|---|
| 3M | 5.54 | -0.05 | 1.12 |
| 6M | 5.46 | -0.08 | 0.70 |
| 1Y | 5.36 | -0.08 | 0.65 |
| 2Y | 4.99 | -0.10 | 0.56 |
| 5Y | 4.63 | -0.22 | 0.63 |
| 10Y | 4.64 | -0.30 | 0.76 |
| 30Y | 4.82 | -0.28 | 0.85 |

| FF Market | FF Disc | IORB |
|---|---|---|
| 5.33 | 5.50 | 5.40 |
| **SOFR** | **Prime** | **OBFR** |
| 5.32 | 8.50 | 5.32 |