THE BANKING CRISIS: IMPACT ON INSURANCE AND CAPITAL MARKETS M&A

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Preface

Today's macroeconomic landscape presents challenges that the insurance and capital markets sectors haven't seen for more than a decade. As the global economy wraps up its recovery from the COVID-19 pandemic and the harmful consequences from high levels of stimulus injected into the economy over the last few years, businesses and consumers battle elevated levels of inflation and are faced with interest rates at a 22-year high. In the ever-evolving financial backdrop, executives and business owners in the capital markets and insurance spaces are facing pressing difficulties in navigating M&A opportunities, especially being amidst a banking crisis resembling the Great Financial Crisis in 2008 and the Savings & Loans Crisis in the 1980s and 1990s.

While rocky, 2023 presents a comparable scenario to the aforementioned time periods: the fall of Silicon Valley Bank, First Republic Bank, and Signature Bank, coupled with Credit Suisse's collapse, sent shockwaves through the global financial system. These failures evoked similar feelings of uncertainty that the world hadn't felt since the Great Financial Crisis in 2008, intensifying concern among investors worldwide.

Nevertheless, as Evolve has previously mentioned, founder-owned businesses are in high demand. From Q4 2020 to Q1 2023, founder-owned businesses' share of M&A value increased from 31.3% to 43.5%. Moreover, founder-owned businesses' share of M&A targets rose to 61.5% from 53.8% over the same time frame, marking a 15-year high.[1] Moreover, as private companies have been garnering more interest, it appears concerns about slowdowns seem overblown.[2] Both private and founder-owned companies, driven by motivated sellers, remain core to Evolve's advisory services and prove that the M&A market is still filled with opportunity despite current financial conditions.

Financial System Crises

[1] PitchBook Q2 2023 Analyst Note – Founder-Owned Businesses are Attractive M&A Targets
[2] Financial Times – Singapore's GIC warns of the end of an era for private equity

Taking into consideration the popularity of founder-owned businesses as M&A targets in the status quo, banking instability throughout 2022 and the first half of 2023 has had comparatively more severe consequences on larger corporations. Both the 2008 Financial Crisis and the Savings & Loans Crisis marked periods of significant M&A slowdowns and widespread bank failures. 2008 saw the failure of two American investment banking powerhouses, Bear Stearns and Lehman Brothers, which later came to be recognized as the climax of the crisis. Additionally, although immediate consequences were not as large as the Great Financial Crisis, the Savings & Loans Crisis resulted in the failure of over a third of all S&L companies in the U.S. over the span of about a decade, with a high of 190 failures in just one year.[3] Both bank failures had profound effects on worldwide M&A deal value, causing a 26% fall from 1990-1991 and an even more substantial 38% decline from 2007-2008. For comparison, global M&A deal value dropped 36% from 2021-2022, driven by large corporations' much smaller share of M&A value.[4]

M&A: Insurance & Capital Markets

Insurance

Accompanying the high levels of investor uncertainty came a large slowdown in M&A activity since record-high levels of activity in 2021, and these headwinds have primarily been driven by the rising cost of debt. As borrowing has gradually become more expensive over the last 16 months, companies have become increasingly cautious with M&A transactions as funding for deals becomes scarcer. Global M&A deal value fell by 36% YoY in 2022, specifically in the second half of the year as interest rates continued rising. Wrapping up the first half of 2023, global deal values further declined 12% from the already diminished levels in the second half of 2022.[5]

Despite these trends, the insurance space was more resilient to overall headwinds given its relative inelasticity in demand, with global insurance M&A deal value only dropping 13% in 2022.[6] Furthermore, during the six-month period from mid-November 2022 to mid-May 2023, deal value more than tripled from the previous six-month period, jumping from $2 billion to an astounding $7 billion, indicating a significant surge in M&A activity and highlighting the strength of the insurance industry despite decreases in overall M&A value. [7] Similar resilience was demonstrated in the Great Financial Crisis, where overall deal value in the insurance space around the world remained relatively flat from 2007-2009 despite global overall M&A deal value falling at approximately 24% per year in the same three-year period.[8]

Given that American banks were the center of the Great Financial Crisis, insurance companies within the United States were more adversely affected by the economic slowdown,

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[3] FDIC – The Savings and Loans Crisis and its Relationship to Banking
[4] Statista – Value of M&A transactions worldwide from 1985 to April 2023
[5] PwC – Global M&A Industry Trends – 2023 Mid-Year Update
[6] Statista – Value of M&A insurance deals worldwide from 1985 to 2022
[7] PwC – Insurance: US Deals 2023 midyear outlook
[8] Statista – Value of M&A insurance deals worldwide from 1985 to 2022

as almost all insurance subsectors experienced at least 10% drops in deal value.[9] However, certain core insurance subsectors, such as insurance underwriters, insurance adjusters, and property and casualty (P&C) insurance, displayed relative strength. Underwriters and adjusters are integral to the foundation of the insurance industry, and certain P&C lines, such as car insurance, are mandated by law in almost every state. These areas, known for their recession-proof nature, have proven to be resilient during financial crises, as exemplified by Evolve's recent advisory on Longshore Capital's acquisition of Southwest Adjusters in October 2022.

Capital Markets

Looking towards the capital markets sector, rising interest rates have resulted in increased demand for credit and fixed income investing opportunities. On the investment side, Treasury Securities Issuance reached $9.9 trillion as of June 2023, up 9.9% YoY from June 2022. Additionally, the total amount of Treasury Securities Outstanding hit $24.9 trillion as of June 2023, up 6.8% over the same period.[10] Overall, looking at the broader market, fixed income ETF assets have doubled in size from 2018 to Q1 2023 ($400 billion to $800 billion) and assets are projected to increase to $2.5 trillion by 2030.[11]

This same trend surrounding the attractiveness of credit and fixed income investing has been evident in the M&A space as well. Many asset managers are looking to expand their credit investing arms, with Blackstone's President, Jon Gray, calling 2023 a "golden moment" for private credit. Private credit fares well during rising interest rates environments – private credit investments frequently offer floating rate loans that avoid value erosion of long-term fixed income investments. Additionally, during times of high market volatility, private credit may be a safer option for investors that are looking to avoid sporadic market behavior.

Hoping to capitalize on these opportunities, many asset management firms are looking towards consolidation. TPG's recent acquisition of Angelo Gordon, a debt manager, in May 2023 highlights the efforts to expand to credit and diversify beyond traditional private equity. No longer the bread-and-butter of many asset management firms as PE returns turned negative for the first time since 2008, many of these firms are shifting their focus to fundraising for other strategies, namely their respective credit groups. For example, Blackstone's credit and insurance group raised $16.6 billion during the quarter, compared with $4.6 billion for its private-equity funds, and Apollo Global Management raised a total of $31 billion in the quarter but only about $1.4 billion for its PE strategies.[12]

Transaction Impact

In terms of private equity, many PE companies have been looking towards smaller, add-on investments.[13] Rising interest rates have led to PE managers financing their add-ons with

[9] Deloitte – Insurance Outlook
[10] SIFMA – US Treasury Statistics
[11] Barclays – Trading Up: Initiating on Exchanges
[12] Wall Street Journal – Listed Private-Equity Firms Stress Credit Role
[13] PitchBook – PE turns to equity to fund add-ons amid tough debt market

equity to avoid increasing the cost of existing debt and overburdening their respective companies with interest payments. These trends are in favor of private and founder-owned companies, as current private equity demand in the status quo is targeted towards companies that don't require high levels of debt to buy out.

The broader capital markets space has been pursuing M&A targets that can make their firms more efficient. As interest rates rise, many companies are looking for ways to save money. Companies that provide outsourced solutions have become increasingly popular, as firms look to save money by investing in processes that can take out the human equation. This trend is exemplified by private equity firm Capital Square Partners' recent July 2023 announcement that it will acquire Startek, a US-based provider of technology-enabled business process outsourcing solutions. Startek specializes in improving the customer experience (CX) and provides Robotic Process Automation to eliminate administrative burdens and allow capital markets companies to focus on their core competencies. Beyond that, Startek's Omnichannel Contact Center, Automated Quality Management, and Conversational AI allow customers of capital markets companies to access on-demand customer service whenever and wherever they want. Startek's ability to provide its services through automated processes highlights that capital markets firms are shifting their M&A paradigm towards companies that increase their efficiency.

Moving Forward

With inflation hopefully falling as the Federal Reserve continues raising its interest rates, the insurance space is slated to exit the hard market that the industry has been in since 2018. Hard markets are characterized by higher insurance premiums and stricter underwriting criteria caused by low interest rates and high inflation, while soft markets are the inverse. Even though premiums for commercial lines have been growing for the past three years at approximately 7 percent per year, rate hardening has driven most of this growth.[14] As rates soften and the industry likely enters a soft market, premium growth will be diminished, as insurance companies no longer need to rely on charging their customers more to compensate for high inflation and a low return on their investments. In turn, many insurance companies may look towards M&A to take advantage of lower valuations and to strengthen their competitive position in the market by offering a broader range of products and services.

Moreover, capital markets companies continue to recover from the "COVID crash" as markets normalize from the high levels of volatility and expensive valuations that has been present since the onset of the pandemic. As interest rates rise, investors are rotating their portfolios into more fixed income to take advantage of the macroeconomic environment. However, many companies are also faced with increased financial pressure from high rates, getting squeezed by high borrowing costs and leading them to pursue cost-saving mechanisms. As such, many companies are looking towards acquisitions of AI-driven

[14] McKinsey – Global Insurance Report 2023: Commercial P&C

companies and hoping to automate to reduce overall expenses, evidenced by the previously mentioned example of Capital Square Partners acquiring Startek.

Companies in both industries should focus on adapting: while rising interest rates have presented their drawbacks, there is also a myriad of opportunities for the insurance and capital markets sectors to explore. Insurance companies can shift their focus from premium growth to innovating new solutions to meet customer demands, and capital markets companies can grow their portfolios within fixed income as rates have become attractive for the first time in over a decade. Like both the Savings & Loans Crisis and the Great Financial Crisis, countless companies will persevere through adversity.