INSIGHTS FROM THE BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

VALUING FINANCIAL INSTITUTIONS IN A NEW ERA OF BANKING

Financial institutions have been impacted by shifts in consumer behavior — which accelerated during the COVID-19 pandemic — and the industry is responding accordingly. U.S. banks totaled over **$77 billion in deal value** in 2021, with technology M&A being a key driver of deals. That momentum has continued into 2022 as multiple large deals were announced during Q1, such as Canada's TD Bank acquiring First Horizon Bank in the U.S. Southeast for $13.4 billion.

M&A and partnerships can offer a crucial growth path for banks, as an increasing number of them see opportunities to meet heightened consumer expectations by expanding digital capabilities and offerings, including through alignment with fintechs.

Although federal stimulus and central bank policy had created favorable conditions for businesses, the landscape is changing. Subsidy checks gave a temporary boost to individuals, and other policies provided a runway for businesses, but pandemic-era economic relief has dried up as COVID-19 cases wane and vaccination rates rise. The Federal Reserve also raised interest rates in March 2022, marking the first increase since December 2018, and the Fed expects **six additional increases this year**. Those rate increases and related downstream effects, as well as changing approaches to valuation, are other elements financial institutions should consider when planning next steps.

A variety of factors are converging to usher in a new era of banking that brings new challenges and opportunities for financial institutions. Organizations that respond effectively and adopt prudent growth strategies can better position themselves to capture those emerging opportunities. Financial institutions can help enhance their resilience and strengthen valuation by focusing on the following key growth areas: digitalization; environmental, social and governance (ESG) initiatives; and a presence in key secondary markets.

HEADWINDS THAT IMPACT VALUATIONS

Favorable federal policies during the past two years helped banks overcome headwinds better than expected, and BDO's **Forecast Engine Industry Impact Study** showed the industry's recovery curve had changed from L-shaped to V-shaped as of May 2021, indicating a more rapid recovery. However, recent inflationary pressures, the ongoing labor shortage and supply chain disruptions pose new challenges for financial institutions. Additionally, geopolitical tensions, and related economic sanctions, have affected markets and valuations more broadly. While these factors may impact short- and medium-term considerations, financial institutions should focus on initiatives that support strategic growth over the long term.

DIGITALIZATION

The pandemic accelerated digitalization across many industries, as businesses adjusted products and services to accommodate customers and capture emerging opportunities. More restaurants partnered with app-enabled delivery services, retailers emphasized an omnichannel approach and more doctors scheduled telehealth appointments, among other trends. Heightened consumer expectations for convenience and accessibility will continue post-pandemic. Banks should take steps to meet these elevated expectations and remain competitive.

Customers' ability to easily access account information, conduct peer-to-peer (P2P) transactions and execute other banking functions seamlessly online and across different channels is a priority. Access to information, like analytics on annual spending habits, provides value for consumers.

Digitalization offers financial institutions benefits as well. Customer data can inform decision making by helping banks better understand the customer to identify opportunities for cross-selling and upselling, as well as forecast demand and tailor new services, functions or products.

Fintech innovations and pressure from competitors outside the industry make it even more crucial for banks to accelerate digitalization to ensure they don't fall behind. Partnering with a fintech can be expedient for banks assessing whether to build or buy digital capabilities. One key element to consider is data protection, especially in a highly regulated industry like financial services. The pandemic saw an uptick in cyber threats and data breaches, making security and data privacy a key consideration for financial institutions implementing new digital capabilities or offerings.

ESG

ESG is more important than ever. Prioritizing ESG initiatives with a cohesive strategy has become a way for financial institutions to mitigate risk, and it is increasingly regarded as a path to long-term value creation. Banks like Capital One, Bank of America and Wells Fargo recently announced plans to reduce or eliminate fees for overdraft protection and insufficient funds, which can disproportionately impact people of color and low-income customers. Increasing access to banking and serving broader stakeholder interests addresses multiple social goals.

Banks also have an important role in working toward net-zero emissions. In the last year, major U.S. financial institutions have publicly promised to tie their lending portfolios to net-zero emissions goals and distance themselves from unsustainable clients. Large institutional investors like BlackRock and State Street have put an increasing focus on ESG strategy — and especially on net-zero commitments — as a priority for their clients, so ESG initiatives can have a direct impact on investor confidence.

Many public ESG goals are long-term efforts, measuring impact by 2035 or 2050, but they should include incremental benchmarks. As ESG moves from an option to an imperative, banks are encouraged to set KPIs and otherwise operate with communities and all stakeholders in mind. It's essential to take specific steps toward ESG goals and be able to report on those steps on a continuing basis.

To learn more, visit BDO's ESG Center of Excellence, and read our insight, The Sustainability Edge: Business Benefits of Embracing ESG.

PRESENCE IN SECONDARY MARKETS

The pandemic inspired a proliferation of remote work options, which led many people to move from major cities to states like Texas and Florida for more space, a lower cost of living and tax advantages. Banks in these popular locations enjoyed an influx of new customers. Banks that moved or opened satellite locations in a secondary market expanded their balance sheets and attracted or retained employees looking to take advantage of secondary markets' benefits. Amid a labor shortage, those banks also enjoyed access to a wider pool of job candidates. Partnering with a bank with an established presence in a secondary market is a way for banks to gain new customers and pave the way for future growth.

PRIORITIZING VALUE IN A COMPLICATED LANDSCAPE

Assessing quality of earnings has become more complex, and embracing data analytics can help to better understand value creation. Financial institutions that use robust data analytics can gain clearer insight into how financial, tax, accounting, operational, IT, HR and other information affects valuation. That can inform decisions about how to prioritize growth initiatives as well.

As digital investments, ESG and entry into increasingly popular secondary markets become closely associated with long-term value creation, financial institutions can strengthen their valuation by using these core strategies for sustainable growth.

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