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THE FINANCIAL SERVICES SECTOR READIES FOR ERA OF DEREGULATION

Deregulation in the financial services sector is a priority for the newly minted Republican-controlled government. Many of the rules and regulations enacted after the 2008 financial crisis are expected to be rolled back as President Trump and many Republicans contend that the regulations are hampering companies from growing. Specifically, opponents of The Dodd-Frank Wall Street Reform and Consumer Protection Act argue that the regulation makes it difficult for businesses in every sector to get the loans they need to grow and that, in turn, these regulations stifle the financial services sector in general.

"The administration claims to be focused on enhancing U.S. competitiveness, and some of the regulations and reporting requirements that exist arguably put certain U.S. industries at a relative disadvantage to their foreign competitors and in general," says Ian Bone, senior manager of strategy & innovation at CT, a provider of business compliance and deal support services. "Given that we cannot change foreign policies, if U.S. financial regulations were pulled back to the European standard, it could allow banks to be more competitive in certain areas that have languished in recent years."

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While it's early in the new presidential term, it's almost certain that actions taken by the government will soften regulations on banks and all major financial institutions. And changes have already begun. In February, the President signed an executive order giving the Treasury secretary authority to restructure major provisions in Dodd-Frank and to make sure existing laws align with the new administration's goals. The changes are expected to make it easier for banks to lend more and for businesses and consumers to transact. As a result of the expected changes, many experts believe the sector will see more M&A activity as strategic acquirers look for growth and private equity firms look to buy quality assets.

"A reduction in regulatory burdens is good for all financial services companies and you can see that there is a positive feeling. Financials on the stock market are performing very well in general," says Nick Krenteras, a managing director on the Financial Services team with Pine Brook Partners. "There is potential for a lot of activity."

The positive sentiment Krenteras describes actually started right after President Trump was elected. At the end of 2016, respondents to *Mergers & Acquisitions'* Mid-Market Pulse (MMP), felt deal making in the financial services sector would accelerate significantly over the next 12 months as a result of deregulation of the financial services industry under a Republican president and Congress. The MMP is a forward-looking sentiment indicator, published in partnership with CT. It is based on a monthly survey of approximately 250 middle-market M&A professionals.

The financial indices since the election also show a feeling of optimism. Broad indices are up 17 percent while regional bank performance is up 25 percent, according to the S&P Regional Bank Index. All financial subsectors have had positive performances on the indices since the election through mid February 2017.

MORTGAGE LENDERS WILL BE OF INTEREST

Mortgage origination is one sub sector where growth is expected. In the wake of the financial crisis, mortgage business lines at banks were either decimated, sold or simply closed. Non-bank mortgage companies emerged in their place. In fact, non-bank lenders such as Freedom Mortgage, Quicken Loans Inc. and Loan Depot, accounted for more than 46 percent of mortgages originated in 2015, compared to just 13 percent in 2011, according to *Inside Mortgage Finance*.

Despite the growth of the non-bank lender market, the financials have been challenging for these companies. As a result of compliance requirements it has been very hard for these companies to become profitable. However, they have been able to remain in the market due to the refinancing boom across America. With interest rates rising, the refinancing boom has come to an end, leaving many non-bank lenders in trouble. What's more, there are just too many in the market. There are approximately 6,000 mortgage lenders today. In fact the largest mortgage lender, Wells Fargo, has just 12 percent of the market. There's no doubt that these dynamics will drive M&A activity.

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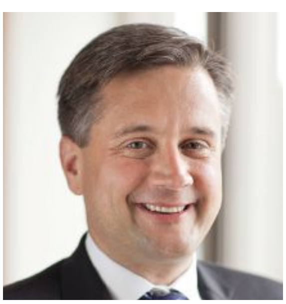
– Nick Krenteras,
Pine Brook Partners



“There is increased interest in the [REIT] space and I believe they will do fine in a rising rate environment.”

– J.P. Young,
William Blair & Co.

“There will be consolidation in the space,” says J.P. Young, a managing director with William Blair & Co. “You will see growth and there will be a high degree of acquisitions in the space.”

These specialty lending companies will be of interest to private equity firms and to strategic acquirers including banks, which by and large got out of the mortgage business after the financial crisis. “Once the banks are unshackled they will look to acquire some companies that have been in private equity firms’ portfolios, if the capital requirements are a good fit. Banks also want to maintain alignment of interests with stakeholders to avoid adverse long-term consequences,” says Krenteras.

Bone agrees that banks will likely emerge as buyers of mortgage loan companies. “You will see banks getting into markets they got out of like mortgage origination. It’s feasible to believe we will see banks acquiring lines of business they avoided or divested to get away from the regulatory costs and oversight,” says Bone.

Even if the banks don’t acquire these assets, there will be an appetite for these assets from other non-bank lenders. Larger non-bank lenders such as Quicken Loans Inc. or Freedom Mortgage are in a good position to grow their market share, while smaller originators will likely be takeover targets. Some non-bank lenders like Freedom are already aggressively buying up smaller shops. The company, which originated $36.8 billion in mortgages in 2015, has made five acquisitions in the past two years, including Continental Home Loans, Aurora Financial Group and JPMorgan Chase and Co.’s rural-housing business. At the beginning of 2017, HomeBridge Financial Services Inc. agreed to purchase Prospect Mortgage LLC while Home Point Financial Corp. agreed to buy Stonegate Mortgage Corp. for $211 million.

What’s more, although the refinancing boom may be over, the future looks bright for mortgage loan companies. As Republican leadership look to strengthen the economy, Americans everywhere may see income growth and look to borrow to buy homes or take equity out of an existing home. “The general outlook for the economy is strong and there is a pervading sense of optimism in the market,” says Bob Belke, a partner with Lovell Minnick, a private equity firm that specializes in financial services investments. “This could lead to increasing home sales, and greater origination of new mortgages.”

REITS ON THE RADAR

Real estate investment trusts may also see more M&A activity going forward. Having a President who made his living as a real estate developer will likely be an advantage for this area. President Trump needs to be savvy about what rules and regulations are hampering growth as he looks to loosen regulation. Additionally, an overall healthy economy will push the need for more real estate and encourage M&A activity in the sector.

In 2016, M&A activity in the REIT sector lagged. As of November, there were $9.2 billion worth of REIT mergers in the U.S. and Canada, according to SNL Real Estate, making it one of the lowest volume years since 2012. Malls, apartments and office REITs have had a particularly difficult time. However, if the administration’s general economic stimulus works there could be an uptick in demand for property, thus making REITs more sought after.

“There is increased interest in the space and I believe they will do fine in a rising rate environment,” says Young.

Additionally, with government policies that favor domestic oil, gas and coal production energy REITs may be of interest.

"Deregulation has big implications for the energy industry, and real estate is a key piece to the pro-energy stance of the new government. Energy companies will want access to new land and the ability to expand their exploration, as well as means to transmit their newfound capacity," says Bone.

FINTECH READIES FOR CONSOLIDATION

FinTech, broadly defined as technology used to support or enable banking and financial services, has faced headwinds because of increased regulation, which hampered growth, according to critics. Regulations today are widely considered out of date and overbearing. As regulations become more friendly, more financial services companies are expected to adopt FinTech that can be helpful to consumers and to financial services companies' bottom line. "The adoption of technology has been slowed because capital has been diverted to compliance with regulatory requirements. But there are technologies that can be really beneficial," says Krenteras. "In the insurance sector technology has become very valuable. For example, a connected home monitoring system could alert the authorities immediately if a fire alarm goes off preventing damage, which saves the consumer money and heartache, and it saves the insurance company money as well. It's these types of technologies that need to be more widely adopted."

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While consolidation is expected in the industry, FinTech isn't an easy sector to invest in. In February, Lovell Minnick made a growth capital investment in Currency Capital, an online equipment financing exchange that powers the buy now button seen on sites such as eBay, Big Tex Trailers and IronPlanet. Belke says these investments take an extra level of expertise. "To invest in FinTech you have to be a specialist because of the complexity around the sector. Understanding the technologies and the regulations is not easy. However, if the economy grows growth in this sector will only accelerate," says Belke.

The financial services industry as a whole should experience growth during the next four years and dealmakers should be able to take advantage of it. The advantage to less regulation is that it gives all financial services companies the ability to be more innovative and competitive, which can lead to positive results. "The financial services environment will become more competitive and that will ultimately benefit the consumer. The other thing you will see is more innovative products, which will also be beneficial to the consumer," says Krenteras.

Going forward, there's no question there will be regulatory change. Removing harmful regulation will be beneficial, but it's still crucial to work with your compliance providers to maximize your impact on the business while minimizing costs. "Across the board, Financial Institutions and Funds I work with are not looking at gutting the smart compliance practices that they have undertaken, but are looking forward to clearer, simpler regulations driven more by common sense which require less unnecessary overh ead," says Bone. These changes will free up opportunities for deals and the financial services sector is ripe to take advantage of this new paradigm.

ABOUT PINE BROOK

Pine Brook is an investment firm that manages more than $6.0 billion of limited partner commitments that makes "business building" and other equity investments, primarily in energy and financial services businesses. Pine Brook's team of investment professionals collectively has over 300 years of experience financing the growth of businesses with equity, working alongside talented entrepreneurs and experienced management teams to build businesses of scale. Learn more at www.pinebrookpartners.com.