DRIEHAUS EVENT DRIVEN FUND

Financials Sector M&A is Back: Examining the Causes and Implications of a Resurgent Bank M&A Market

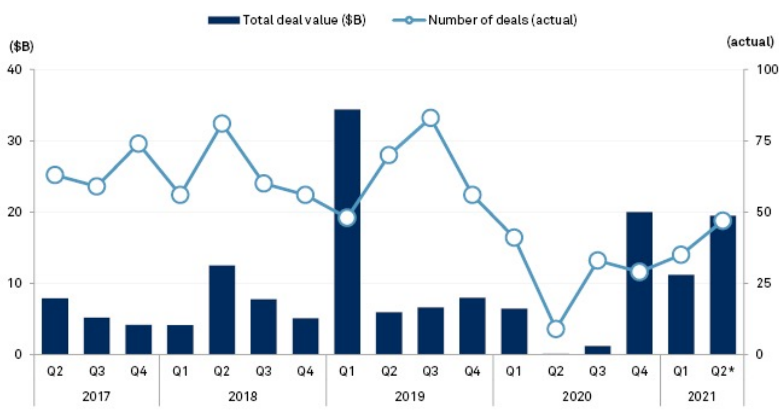
After a notably quiet 2020, merger and acquisition (M&A) activity in the financials sector has surged during the first half of 2021. We expect the accommodative deal environment will have multiple implications for the event driven landscape in the year ahead.

As we have highlighted in previous letters, the Driehaus Event Driven Fund (DEVDX) consistently identifies attractive investment opportunities in the thrift demutualization process when mutually-owned thrift banks convert into fully public companies. The fund is currently invested in four different converted thrift banks which all boast valuations that are well-below the industry average and growth profiles that are projected to meaningfully exceed the industry average. These characteristics, coupled with the recently expanded appetite for M&A in the sector, will eventually make these banks attractive targets for larger acquirers.

The financials sector – particularly small and mid-cap banks - was slow to participate in the rebound in capital markets activity that followed the 2020 market decline. However, since interest rates began moving higher in November 2020, M&A and capital markets activity in the industry has been robust. The trailing six months ending April 30, 2021 registered the most active six-month period of bank M&A activity since the Global Financial Crisis.

In this note, we explore the drivers of this now bustling M&A landscape and its implications for the event driven investing opportunity set.

Exhibit 1. Bank M&A deal value soared to $30.7b year-to-date in 2021, surpassing full year deal values for 2017, 2018 and 2020. The median price-to-tangible book ratio* for deals announced in 2021 increased to 152%, compared to 134% for 2020



US Bank Deal Statistics

	2018	2019	2020	YTD
Number of Deals (actual)	253	257	112	82
Total Deal Value ($B)	29.56	55.03	27.84	30.72
Assets Sold ($B)	166.98	409.78	275.85	234.20
Deposits Sold ($B)	133.82	316.77	221.64	187.88
Median Deal Value-to-Tangible Common Equity (%)	165.5	157.7	134.8	152.3

Source: S&P Global Market Intelligence. *Price to Tangible Book Value - is a valuation ratio expressing the price of a security compared to its hard, or tangible, book value as reported in the company's balance sheet. The tangible book value number is equal to the company's total book value less than the value of any intangible assets.

Willingness and Ability

There's an old adage in the banking industry that says a good client is one who has both the ability and willingness to meet their obligations; having one without the other is useless. The same principle applies when executing M&A in the bank industry – in order to effectuate smart M&A transactions, institutions need both the proper incentive (willingness) and an attractive currency (ability). Over the last decade, the banking industry has rarely simultaneously exhibited both the willingness and ability to conduct M&A. However, over the last year, the stars have aligned to create a robust M&A environment.

Banks Need Scale to Compete and Grow:

The change in banks' willingness to seek M&A partners is the result of increasing need for size and scale in order to improve operational efficiencies, help drive earnings growth and compete in a rapidly changing digital landscape.

Cost control has always been a critical part of any successful banking operation. Traditionally, acquisitive banks could reasonably expect to remove 20-40% of legacy operating costs from their target – mostly in the form of consolidation of physical assets and labor. Recently, however, banks have struggled to keep up with a new and capital intensive cost of doing business: the need to provide clients with cutting edge technological solutions and services (aka FinTech). Competition to provide these services has become an arms race with multinational, mega-cap* financial institutions on one side and well-capitalized, tech-savvy new entrants on the other side. Traditional small and mid-cap banks simply cannot compete with the resources of these competitors, and consequently, they are increasingly deciding to merge for scale or simply sell to a larger competitor, who can better utilize their assets.

Exhibit 2. FinTech is changing the way consumers use traditional banking services – and the way banks compete. PayPal is now larger than 24 of the Top 25 Publicly Traded Banks

Market Cap Rank	Institution Name	Market Cap ($B)	Market Cap Rank	Institution Name	Market Cap ($B)
1	JPMorganChase	$392.4	13	KeyBank	16.5
	PayPal	274.5	14	Regions	16.3
2	Bank of America	256.5	15	Citizens Bank	15.6
3	Wells Fargo	123.8	16	Huntington	13.5
4	citigroup	120.7	17	Signature Bank	8.7
5	Truist	64.7	18	East West Bancorp	8.5
6	usbancorp	64.6	19	Comerica	8.0
7	PNC	60.9	20	Commerce Bancshares, Inc.	7.8
8	Capital One	47.9	21	First Horizon National Corporation	7.7
9	First Republic Bank	25.2	22	Zions Bancorporation	7.2
10	svb	22.7	23	Western Alliance Bancorporation	6.8
11	Fifth Third Bank	20.6	24	Prosperity Bancshares, Inc.	6.2
12	M&T Bank	17.0	25	FirstCitizensBank	5.8

Source: Keefe, Bruyette & Woods, market data as of 1/29/21. Please see end of this piece for top ten holdings.
For illustrative purposes only. Not a recommendation to buy or sell any securities. *Mega Cap - is a designation for the largest companies in the investment universe as measured by market capitalization. While the exact thresholds change with market conditions, mega cap generally refers to companies with a market capitalization above $200 billion.

Elevated Share Prices Drive Activity:
Banks' ability to conduct M&A improved as stock prices across the industry rose over the last year. While it may sound counterintuitive, higher stock prices beget more M&A activity in the bank industry because acquirers tend to utilize their own stock as the primary currency for M&A.

Prior to the news of a vaccine for Covid-19, shares of large cap banks traded at 1.3x tangible book value (TBV)* on average; this low valuation made it nearly impossible to use stock to fund an acquisition without incurring an unacceptably high level of dilution to the acquirer's equity book value. The market punishes acquirers who dilute their book value, so banks had limited appetites for acquisitions. Since October 2020, share prices have increased and large cap bank stock valuations now average 2.1x TBV. This higher valuation makes it much easier to forecast equity accretion when pursuing stock-for-stock M&A, particularly when the target companies are small cap banks which trade at notable discounts to large-cap peers. Small-cap bank valuations have only increased from 1.1x to 1.5x TBV during the same period. With valuations elevated in both absolute and relative terms, share prices of banks – particularly larger banks – are being rewarded by the market for opportunistically pursuing accretive M&A.

As greater amounts of banks forecast M&A to be a potential source of competitive scale advantages, earnings growth and, ultimately stock price appreciation, we believe it is reasonable to expect a continued strong pace of deal making in the space.

Exhibit 3. Bank valuation metrics have rebounded from 2020 lows, but the spread between valuation metrics for Large Cap and Small Cap Banks has rarely been as wide as its current level. This valuation mismatch facilitates accretive M&A opportunities for larger banks pursuing smaller banks

Bank Index Historical Bank Price-to-Tangible Book**

	Large Cap	Small Cap	Differential
Pre-2016 Election (11/8/2016)	1.4x	1.6x	-0.2x
12/31/2017	2.0x	1.9x	0.1x
12/31/2018	1.6x	1.6x	0.0x
12/31/2019	1.9x	1.6x	0.3x
Pre-Vaccine News (11/6/2020)	1.3x	1.1x	0.2x
12/31/2020	1.6x	1.2x	0.4x
6/18/2021	**1.9x**	**1.5x**	**0.4x**

Source: SNL, Compass Point Research and Trading.
Indices include all publicly traded (NYSE, NYSE MKT, NASDAQ, OTC) Banks and Thrifts in SNL's coverage universe; Small Cap = $250M-$1B market cap; Mid Cap = $1B-$5B market cap; Large Cap = >$5B market cap. Indices are size-weighted. Data as of 6/18/2021. **Past performance does not guarantee future results.** Securities in the Funds do not match those in the indexes and performance of the Funds will differ. It is not possible to invest directly in an index.*Tangible Book Value - is also known as net tangible equity, measures a firm's net asset value excluding the intangible assets and goodwill. **Price to Tangible Book Value - is a valuation ratio expressing the price of a security compared to its hard, or tangible, book value as reported in the company's balance sheet. The tangible book value number is equal to the company's total book value less than the value of any intangible assets.

Implications for the Investment Landscape

High levels of M&A activity in the financials sector should continue to produce attractive investment opportunities across the event driven spectrum – prior to, during and after the M&A lifecycle. The fund's approach to investing across event driven sub-strategies allows us to pursue opportunities at each stage of the process.

- Owning Logical M&A Targets: As we noted above, we currently own four public banks that recently completed the demutualization process. These banks offer cheap upside optionality because they trade at deep discounts to industry indexes and have multiple levers to pull in order to unlock value via capital allocation and growth. Given these characteristics, these banks often become targets for larger banks looking for scale in mature markets. In fact, 74% of all the mutual thrifts that have gone public since 1990 have been acquired within five years of their IPO.

  This is a very fragmented industry with large players who are aggressively looking to acquire scale. Banks that have multiple levers from which they can unlock value and are still trading cheap enough to be potential targets for acquisition can be attractive investments.

- Traditional Merger Arbitrage: One of the more straightforward effects of the increase in M&A in the financial industry is an associated increase in merger arbitrage opportunities. Because the acquirer's stock is the primary currency used for bank M&A, structuring merger arbitrage in the space takes on a more traditional form (long/short stock) and the investment research is focused on state and local bank regulation and the potential for post-close competitive disruption. We expect merger arbitrage to be an on-going source of core opportunity for the fund.

- Opportunities for Post-Deal Earnings Upside: With record deal flow comes record levels of post-merger execution and the potential for synergies. The process of executing and realizing synergies introduces both risk and opportunity. These post-merger risks and opportunities lead to misunderstood earnings potential, which can create discounted valuations and attractive investment opportunities. If M&A is executed well, an acquirer can realize upside to initial synergy estimates and drive meaningful upside to earnings and valuation. Conversely, poor execution can lead to years of increased expenses and asset write-downs causing valuation to languish.

  The merger of two distinct enterprises – and shareholder bases – can lead to share price movements that are often irrational; given the fund's ability to analyze the merits of acquisitions and their potential for value creation, these transitional price declines can be a compelling source of opportunity.

Expect These Opportunities to Persist

This time last year, few would have predicted that the financials sector would be among the busiest areas of the M&A market in 2021. But market sentiment shifted dramatically and M&A has followed as banks see the need for scale in the post-pandemic landscape. With sellers now receiving higher multiples and buyers armed with both the currency and motivation to bid aggressively, we believe the sector will continue to experience increased deal activity into 2022. This dynamic should continue to produce attractive investment opportunities at each stage of the M&A process.

What a difference a year makes: the financial press and many market participants seemed to believe the banking industry was on the verge of collapse during the first and second quarters of 2020. Over the last eight months, sentiment has shifted, capital markets have recharged and M&A activity has skyrocketed in the financial sector.

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Foreside Financial Services, LLC, Distributor

Top 10 Holdings* (as of 5/31/21)

Company	% of Strategy
Eastern Bankshares, Inc.	3.7
Golden Entertainment, Inc.	2.9
Liberty Media Corp. Series A Liberty SiriusXM	2.7
Relay Therapeutics, Inc.	2.6
Equity Commonwealth	2.3
Invitae Corp.	2.2
Cytokinetics, Incorporated	2.1
XPO Logistics, Inc.	2.1
Jpmorgan Chase & Co. 3.6555% Perp	2.1
T-Mobile US, Inc.	2.1