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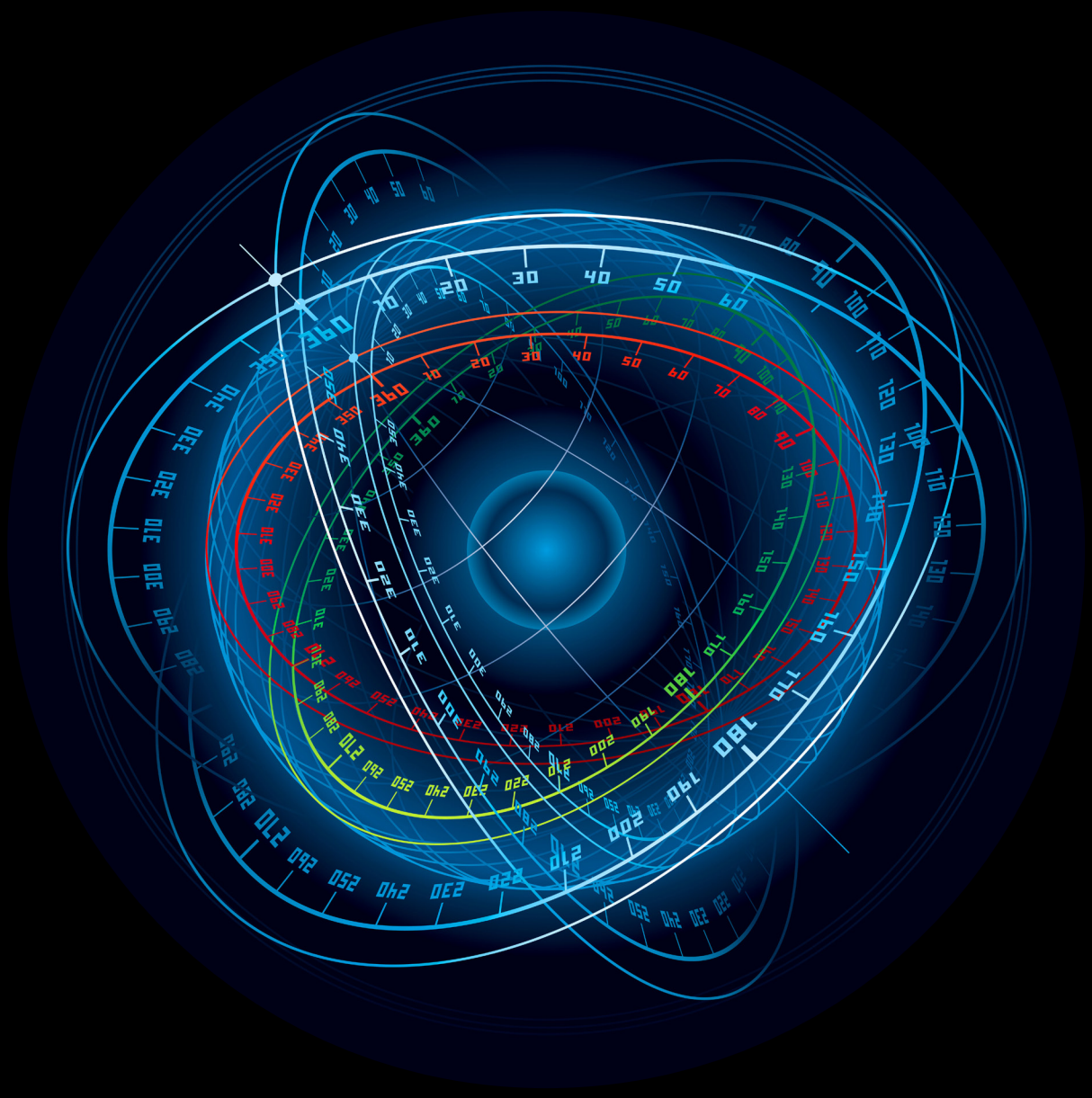

Transforming M&A capabilities for the unbundled ecosystem

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The Case for Change

Rapid advances in technology and digital infrastructure are fundamentally reshaping the competitive landscape in financial services. As we enter an era of the Industrial Internet, where machines intelligently connect to software, to other machines and to humans, old models for past business success do not bode well for future success. We have already seen the beginning of industry unbundling and the bifurcation of players as either drivers of volume or of specialization, but not both. As unbundling continues, companies could be more agile, intelligent, and increasingly interconnected in a wider financial services ecosystem. Firms may be able to offer more while owning less, and relationships between coexisting competitors will likely generate a larger share of economic value as a result.
To adapt to this new environment, large financial services providers should assess how they are organized and how they interact with incumbents and new entrants alike. Crucially, this has implications for how companies approach M&A. The traditional approach that focuses on acquiring companies to integrate their capabilities and customers will need to be augmented with a new approach that focuses on orchestrating ecosystems for value. This requires a rethink of M&A strategy and development of new capabilities to harness market disruption.

Forces of Unbundling

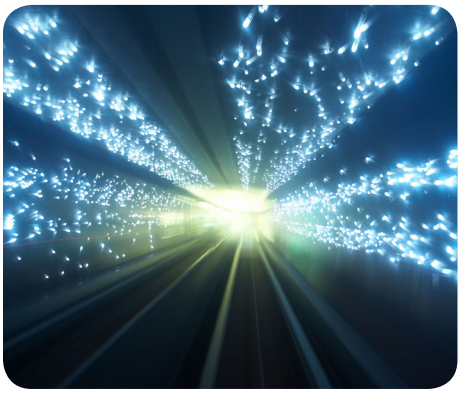
Similar to how earlier waves of the internet made communication and commerce faster and less costly, the Industrial Internet promises to make the exchange of value between financial firms both faster and more frictionless. Advances like blockchain and smart contracts are making it easier for firms to transfer money and other assets, to process and settle transactions and trades, and to share and verify records and data. The cost of doing business with other firms is decreasing, and it can become efficient to partner with other players than to keep many functions and processes in-house. Said differently, external transaction costs are becoming less than internal transaction costs—reversing the fundamental premise of why firms came into existence and why they cannot maintain infinite growth.

As transaction costs decrease, maintaining separate business units and functions to support an increasingly wide range of products and services can create diseconomies of scale. Firms should consider both the process and consequences of unbundling: choosing core areas and using the Industrial Internet to tap into services from leading players in other areas. The unbundling process is likely to simultaneously increase the concentration and fragmentation of entire industries.
Concentration can deepen in utility-like, volume-based infrastructure businesses, where scale and scope remain important given fixed costs and regulatory burdens. Fragmentation can accelerate the development of businesses that are entirely focused on the customer, driven by data and analytics to truly understand customer need.

In an evolving competitive landscape, a larger share of value could be created by partnerships among coexisting competitors within the larger financial services ecosystem. Emerging players may rely on larger partners for infrastructure and platforms to support their businesses. In turn, incumbent players will likely rely on their nimbler, smaller entities for their ability to more quickly develop and deploy personalized or niche services. Given the continued unbundling of industry and the resultant reduction in overall ownership of the value chain, firms may be able to offer more services and create more vale through participating in a larger ecosystem.The emerging challenge for large firms is to develop an M&A strategy and capabilities that allow them to tap into this ecosystem to extract value efficiently and effectively.

Future Proofing M&A

M&A is becoming more complex in this new environment. With increased partnerships and connectivity between larger, legacy competitors and smaller, specialized entrants, M&A is no longer just about acquiring a target, but orchestrating a number of transactions and partnerships all driving toward one outcome with embedded optionality. To realize value, firms should be prepared to build an ecosystem to nurture new partners and acquisitions. In the first order, firms need to grapple with a new set of M&A choices. In addition to the "traditional" M&A decisions of what to acquire and what to spin out, firms should consider what to orchestrate through partnerships or minority ownership stake investments. Looking across these strategic options, firms will need to consider at what stages of development to make a move and be prepared to pay much higher multiples for much less mature companies to get in front of the right opportunities. Given the increase in partnerships and investments, firms will also need to think about M&A on a longer time horizon as relationships with partners will need to be managed on an ongoing, business-as-usual basis.



Building Bridges to Execute

Executing in this M&A environment likely will require a new set of capabilities. Traditional capabilities—such as post-merger integration to fold acquisitions into the parent—may no longer be enough. Firms will need to develop a more sophisticated set of capabilities to orchestrate and participate in ecosystems. Financial institutions should develop the capabilities to identify new trends and players on a constant—rather than opportunistic—basis and be able to make decisions around acquisitions, investments, and partnerships quickly. These M&A capabilities should be integrated with internal-facing functions to give firms the ability to weigh decisions between organic investments or external moves. To support this enhanced and more sophisticated set of M&A capabilities, the diversity of the firm's DNA needs to be expanded. Beyond the traditional domain of corporate development, talent and perspectives from a wider range of backgrounds should be incorporated, including financial engineers, social scientists, and design thinkers to more fully understand the potential of partnerships. Beyond deal execution, firms should consider developing ongoing capabilities to optimize these new partnerships, including agile methods to implement projects and extract value.

Key Takeaways

- The Industrial Internet is driving unbundling in financial services and leading many companies to be increasingly interconnected in a wider financial services ecosystem.
- M&A strategy is more complex in this environment. Many firms are no longer acquiring targets for a single purpose but orchestrating for value.
- Traditional M&A capabilities are becoming table stakes. To realize value firms should consider developing a more sophisticated set of capabilities and a more diverse team.

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