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M&A: Beat today's market blues (July 08)

The M&A market frankly stinks right now, thanks to several concurrent trends. There are some things would-be sellers can do now to be ready for the next round.

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Today's M&A market just plain stinks. In the meantime, you can take steps to prepare for M&A's rebound

Mary Lynn Lenz and her board faced a bittersweet choice.

Lenz had arrived at 48-year-old Slade's Ferry Trust Co. five years earlier, from a large-bank background, and she had enjoyed the challenge of building up the Somerset, Mass., lender. Slade's Ferry, publicly traded, had grown to \$605 million assets with decent profitability. But she and the directors, strong believers in strategic planning, had come to a tough three-pronged fork in the road.

Steady-as-you-go wouldn't work. Projections indicated that the sheer number of competitors would make the costs of growing by even 5% "astronomical," says Lenz. Yet pulling back and maximizing profits on the book of business the bank already had wasn't too appealing, either.

"It wasn't really a good marketing strategy," says Lenz. "Once you pull back, it's very difficult later on to push back in."

That left the M&A route, with two prongs of its own: buying and selling.

Only a handful of Massachusetts institutions would have made suitable targets, and none looked likely enough to bank on. For the sake of shareholder value, board and banker agreed, it was time to test the waters for sale, and the bank reached out to four prospective purchasers.

In the end, Independent Bank Corp., parent of Rockland Trust Co., submitted the winning bid. The deal was announced October 2007 and went live March 2008.

"The timing was perfect," says Lenz, "because it was done before the market got tough." Lenz notes that the NASDAQ peer group for Slade's Ferry Bancorp had declined approximately 20% in the course of the deal. Had the bank remained independent, says Lenz, the company by now would have been trading below its book value.

Stuck in no man's land

Many boards entertaining similar discussions as those at the Slade's Ferry board can't currently do such a deal—they missed the boat. (We'll talk about how to get ready for the next round later.)

The desire is there, for certain. "The \$400 million-to-\$1 billion category is 'no man's land,'" says Don Musso, FinPro, Inc., Liberty Corner, N.J. Below \$400 million, he says, a bank can play the local relationship card quite happily, and above \$1 billion, it can enjoy some economies of scale. In between, the company is neither one nor the other, and suffers the ailments of the extremes, according to Musso.

However, thus far M&A volume for 2008 remains significantly off the pace for 2007. In the first quarter, only 42 bank and thrift deals were announced, versus 86 in the first quarter of 2007.

"Timing is everything," says John M. Eggemeyer III, a noted bank investor and "rollup" artist. Eggemeyer's Rancho Santa Fe, Calif., merchant banking firm, Castle Creek Capital, made a name for acquiring groups of banks into merged operations that could be later sold at a handsome profit. (See "Patient Capitalist," ABA BJ, July 2006.) However, Eggemeyer has kept to the sidelines for about a year and a half.

"We saw the economy softening," he says, adding that even then, the way things have turned out defied his crystal ball. The speed and depth of deterioration have made both buyers and sellers hold back.

"Sellers haven't adjusted their thinking to the reality of the economic situation that we're in right now," says Eggemeyer. As a result, there is a "disconnect," he says, between what institutions are worth to buyers, and what their current managers, directors, and owners think they ought to be worth.

In addition, Eggemeyer points out, many potential buyers hesitate to buy right now, given the potential for paying to own someone else's problems. Many bank managers are busy trying to deal with their own portfolios.

"We are in the slowest merger market since 1990," says Walter G. Moeling, IV, co-chair of the financial institutions group at Powell Goldstein LLP, Atlanta, Ga. "The few deals that are being done are very specific. By and large, historically active acquirers have gone to ground."

Unwilling sellers, unwilling buyers

With bank stocks taking a beating in the markets, the value of the "currency" that acquirers often use to do deals is devalued—which makes mergers about as appealing to publicly held buyers, thus far, as European vacations look this year to dollar-decimated American tourists.

Attorney Moeling says that 90% of the merger picture at any given point hinges on the value of bank stocks in general.

"You can have the best bank in the world, but if bank stocks are down or you are in a difficult market overall, your value will go down," Moeling explains.

A related factor, says Curtis Carpenter, managing director at Sheshunoff & Co. Investment Banking, Austin, is the demise of trust preferred stock offerings, which

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had been the method of choice for many steady acquirors. Hurt by the collateralized debt obligation debacle, trust preferred is showing some signs of waking up again, but the return of a pulse is not going to do much, experts concur, for the M&A market for some time.

Contrarians and the future

One expert tells of an investment banking firm so anxious to look like it was still in the game that it offered to do a recent deal gratis, just to generate a tombstone ad. While the field has been thin, it hasn't been vacant, however, and some players say they have deals in the hopper.

Jeffrey Gerrish, attorney and consultant at Gerrish McCreary Smith LLC, Memphis, Tenn., says a great deal is beginning to develop among banks in the \$500 million-assets category. His firm, by itself, has eight different deals in various stages, and he thinks more will be coming. Pricing has been an issue, but he adds that "sellers are getting a little more reasonable."

And there is a school of thought, expressed by David Baris, with the Washington, D.C., office of Kennedy & Baris LLP, that suggests some sellers will take the stock of solid acquirors whose shares are suffering merely because of the market's current distaste for bank. Such sellers, he explains, will be anticipating a bounceback in the acquiror shares' price.

Election-year spoiler?

Another argument being made for a buildup in merger action is the strong possibility that the Democrats will control the White House and Congress after the election. The Democrats have made it clear that the Bush tax cuts—in this context, favorable treatment of capital gains—won't be renewed if they hold all the keys. At present, the favorable gains treatment expires at the end of 2010, notes Curtis Carpenter of Sheshunoff. If rates simply reverted back to what they had been, he says, sellers would be looking at a rate of 25% instead of 15%.

"This is motivating a number of sellers to consider offers sooner, rather than later," says Carpenter. And he says a key demographic evolution also applies.

"The majority of community banks are now being run by Baby Boomers, who are near retirement age, and often there is no management succession plan in place," says Carpenter. Put these two factors together and the urgency to do some kind of deal looms large, if you buy the tax argument. Under this scenario, given regulatory steps and other built-in time constraints, Carpenter says the latest a deal could start and be reasonably assured of the superior tax treatment would be mid-2009. That leaves a year for buyers and sellers to do their mating dances.

Some players do buy the argument—Gerrish says some deals that are teetering between "yes" and "no" could tip to the affirmative because of tax treatment. Others scoff.

"You've been talking to investment bankers," says attorney Walt Moeling. "That's their story. We have plenty of sellers right now, but few buyers. And the buyers don't care what the capital gains tax rate is."

For one part of the industry, the capital gains issue is a moot point on nearly any level. These are the Subchapter S banks, which now account for nearly one in three institutions. FinPro's Don Musso points out that these institutions actually face their own tax "incentive"—more of a reverse incentive—to not do deals. In the first ten years after conversion to Sub S form, an organization that sells must give back part of the tax break that it was enjoying as a Sub S.

"It's a very healthy penalty," says Musso.

Outlook: a gradual return of volume

In forecasting the future of community bank M&A, the impact of anticipated slashes in CAMELS ratings and associated regulatory orders can't be ignored.

Some institutions will simply see the writing on the wall, and before the regulators begin to push them towards a merger, will decide to seek a buyer on something like their own terms. Attorney David Baris suggests that some institutions, for instance, that need to raise more capital will be put on the block, instead. Jeff Gerrish sees some of the de novos of the Southeast, in the five-to-eight-year-old range, as willing targets. Some will be in difficulty, having not achieved the core deposit bases that they had hoped for.

Gerrish also sees some troubled states as a source for strategists seeking living banks that can be recapitalized as a base for further acquisitions, rather than using the time-consuming de novo approach.

"Michigan is a poster child for such opportunities," says Gerrish.

In other cases, there will be mergers done at the behest of regulators, where institutions are told to find a buyer.

One way or another, "they will be motivated deals," says FinPro's Musso.

And then some deals will be situations where buyers wait until a bank with troubles fails. This will enable them to pick up what they want, and to leave the rest to FDIC. Pointing to the takeover of ANB Financial, N.A., closed by the Comptroller's Office in May, Carpenter says "we'll see dozens more such deals in the year ahead."

While some of the de novos that will be up for sale will be healthy ones, David Baris says that opportunities for healthy, long-established banks to sell should also come back. They may prove more attractive than some of the newer banks because they did not have to buy their way into the local credit markets, as did some de novos.

On balance, Carpenter predicts that the return to a more "normal" M&A pace—meaning 60 or more community bank transactions per quarter—will begin in the first quarter of 2009. **BJ**

PREPARING FOR OPPORTUNITIES

The experts we spoke with for the accompanying article agree there are steps that banks interested in selling can take now, during the market lull, to make themselves more attractive when opportunities arise.

Below is a condensed, five-point "to-do" list compiled from our interviews. The full treatment of the five points can be found on our website, www.abaj.com, in an article entitled, "5 steps to be ready to sell," that appears under the heading "Exclusives."

Review the following list with these two caveats from attorney David Baris, Kennedy & Baris LLP, in mind:

First, "there's only so much you can do. You are what you are."

And second, own up to things up front, before due diligence begins.

"Buyers don't like surprises," says Baris. "If they find a problem later, that undermines the credibility of the target institution."

1. Eliminate the negatives.

This is the top recommendation from most advisors, and typically what they really mean is, clean up the loan portfolio, both in content and records.

2. Become realistic regarding what buyers really care about.

Be ready to face some hard truths. Among them: buyers don't care much about your bank's name and history; may have little interest in your branches; will almost certainly have no interest in nontraditional activities (like insurance) that aren't producing strong earnings. Their primary interest? Core deposits and core loans.

3. Reconsider management contracts.

Contracts with the CEO and other top managers can be a ticklish balancing act between seller and buyer. Buyers may balk at huge change-in-control payments, but at the same time will want to keep "rainmakers," while letting nonessential managers go. Banks considering putting themselves on the market need to address these issues before negotiations with a buyer begin, if possible, or as contracts come up for renewal.

4. Avoid entangling vendor and facilities contracts.

A related point: If your bank appears to be moving toward selling, don't create a batch of long-term contracts that a purchasing bank will either have to live with or buy out.

5. Consider hiring a financial advisor.

An obvious suggestion from a group of M&A advisors, but that doesn't mean it is bad advice. Outside expertise can help you get a better price.

—Steve Cocheo

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