Will the Capital Markets Drought Spur an M&A Rebound?

By Bill Sammon

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Given the less-than-positive coverage of the marketplace in the mainstream media, it shouldn't come as a surprise to anyone that investing in financial institutions today is not a sport for the timid. Industrywide financial fundamentals have been in steady decline for the last several quarters. Margins are contracting, asset quality is deteriorating and capital ratios are stressed. For most banks, balance sheet maintenance is considered a victory and earnings per share growth an anomaly.

Many of the giant banks have been obligated to address their financial distress by issuing additional capital. Citibank, National City, Washington Mutual and countless others have raised billions of dollars in common equity, preferred stock, convertible preferred stock and debt. While traditional bank investors have participated in these offerings, wealthy international investors and private equity have also entered the picture.

It is encouraging that all that capital has been available to the big banks in need. However, this new capital has not been raised on the cheap. Common equity has been issued with large market discounts on already depressed valuations. Preferred equity and debt have been issued with wide spreads and onerous conversion pricing where applicable. With so much of this distressed capital being raised, there is now a perception that a bank in need of capital is a bank with current or anticipated problems.

Unfortunately, healthy community banks that need capital for growth have been the collateral damage of this perception. While community banks have not been immune to financial distress, on average they have weathered these conditions markedly better than their large-cap counterparts (see Table I). Large-cap banks have not only felt the pain of investing in subprime and other asset classes that community banks avoid, but they are also subject to the wide variety of conditions in the numerous markets in which they operate.

Most community banks, of course, operate in one market. Find a healthy market or micro-market and you will find

Table I

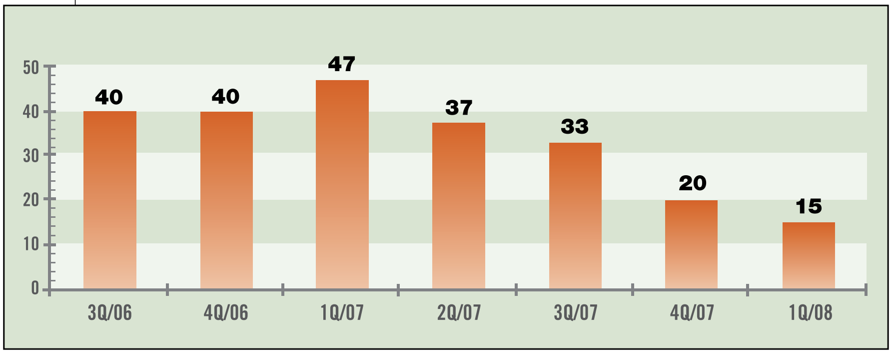
Last 12 Months Ended 3/31/08 Versus 2006 Fiscal Year

	Tangible Equity/ Tangible Assets	Core ROAA	Core ROAE	Core Earnings per Share	NPAs/ Assets
Banks with Assets > $50B	-10.8%	-36.5%	-43.7%	-34.7%	179.3%
Banks with $200M < Assets < $10B	-4.1%	-23.6%	-23.0%	-19.3%	165.5%

Source: SNL Financial LC and Howe Barnes, Hoefer & Arnett

Table II

Number of Deals: $5M < Deal Value < $15M



Source: SNL Financial LC and Howe Barnes, Hoefer & Arnett

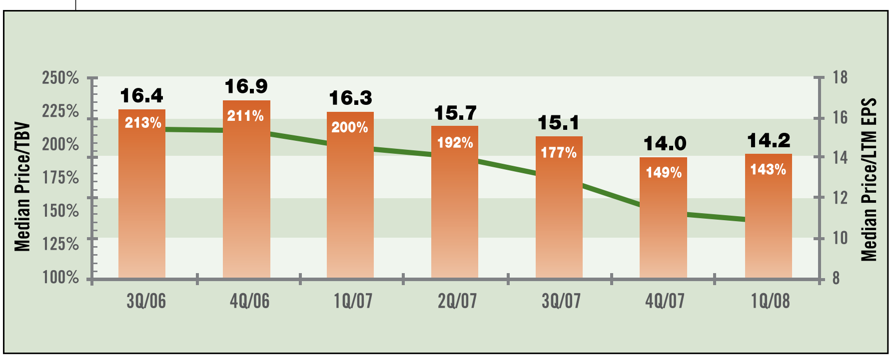
community banks experiencing healthy financial returns and attractive growth opportunities. This growth, however, may require an infusion of fresh capital … and therein lies the rub.

Capital Alternatives

Capital is available for community banks. Unfortunately, even healthy community banks have not been able to escape the steep market pricing and limited availability of capital created in the wake of this negative perception of banks.

Table III

Bank Trading Multiples: $200M < Assets < $10B



Source: SNL Financial LC and Howe Barnes, Hoefer & Arnett

Trust Preferred: For the last 10 years, issuing trust preferred securities has been the cheapest and easiest way for a bank to raise Tier I and Tier II capital. However, this form of capital has become increasingly difficult to issue. For the time being, pooled deals are non-existent, as the difficulty in finding investors to buy the tiered bonds has prevented the accumulation of collateral. Stand-alone issues, both public and private, have been completed but are largely fixed-rate deals with rates approaching 10 percent.

In addition, a community bank would likely need to issue a minimum of $20 million to achieve appropriate cost-efficiencies. Small private placements are being done but are dependent upon a strong sales effort and buyers willing to portfolio a fairly illiquid piece of paper.

The bottom line is that the Trust Preferred market continues to be active because it still represents a much cheaper alternative to raising equity.

Senior and Subordinated Notes: Tier II capital in the form of senior and subordinated notes is available from various correspondent banks. Understandably, the correspondent banks are apprehensive to issue to all but the best credits, and spreads have been relatively wide. Bank holding companies with less than $500 million in assets will be able to downstream the debt as bank-level equity, but for most community banks this form of financing will not satisfy Tier I capital needs.

Common Equity: Very few community banks have completed Follow-on common equity offerings in the past year. The combination of depressed bank valuations and healthy current market discount demands by investors (+/- 15 percent for healthy banks; 25–40 percent for distressed banks) makes these transactions extremely dilutive to current shareholders. This financial disincentive has limited these transactions to those banks where survival has trumped the inevitable dilution.

Preferred Stock: ICBA Securities Capital Markets has seen a fair number of preferred stock deals, especially those of the convertible variety. Essentially, the issuing banks view these deals as a common equity raise that eliminates any market discount and potentially issues common at a premium to current market. Of course, in return for the discount elimination the bank agrees to pay a near double-digit coupon for a certain period of time.

These deals can be structured with a variety of terms and are very much in vogue with investors right now.

Market Impact

Market characteristics today have created the perfect storm for the relative stall in bank mergers and acquisitions. Table II shows this decline over the last seven quarters for transactions with deal values between $15 million and $500 million. No longer are buyers able to dazzle sellers with high prices. These are not the days of the “three times book” deal; there are at least two reasons for this change:

For one, the precipitous decline in bank trading multiples has created a proportionate decrease in a bank’s capacity to pay attractive multiples with stock. Table III details this multiple movement for banks between $200 million and $10 billion in assets over the last seven quarters.

Secondly, the difficulty of raising capital has placed a premium on the use of cash in deals. Even if buyers have the cash, they’ll likely be hesitant to leverage their capital ratios when they do not know the source of their next dollar of capital.

Despite this perfect storm, the fundamental business reasons for bank mergers are stronger than ever. Increased regulatory scrutiny, the need to consolidate management talent and the ability to heal asset-quality issues in the context of a larger balance sheet are each prevalent deal-drivers today. In fact, if banks could afford to pay multiples that sellers saw in the market a year ago when the capital markets were active, the mergers and acquisitions market would still be relatively active.

Eventually the business reasons for mergers will take center stage and transaction activity will increase (leave it to investment bankers to be optimistic). When it does, anticipate a dramatic

Table IV

100% Stock Acquisition Scenario

	Tangible Assets	TE/TA Ratio
Sample Bank	$1,000,000	6.00%
Target Bank	$400,000	10.00%
Pro Forma	$1,400,000	6.99%
Additional Growth	$233,000	0.00%
Pro Forma with Growth	$1,633,000	6.00%
Capital Needed to Support Additional Growth	$233,000 x 6.0% = $13,9	

Source: SNL Financial LC and Howe Barnes, Hoefer & Arnett

Table V

Minimum 75% Stock Consideration Acquisitions of Banks Total Assets < $2B

20 Deals Announced 6/1/06 - 5/31/07		
	Stock Consideration Valuation	
	Announcement	At 5/2/08
Median Price / LTM EPS	20.72x	12.38x
Median Price / TBV	304.33%	173.21%
10 Deals Announced 9/1/07 - 5/2/08		
	Stock Consideration Valuation	
	Announcement	At 5/2/08
Median Price / LTM EPS	17.56x	16.53x
Median Price / TBV	228.34%	204.75%

Source: SNL Financial LC and Howe Barnes, Hoefer & Arnett

increase in all or near all-stock transactions. Essentially, in these transactions, the board of a seller is making a decision to invest in the stock of the pro forma company. Long-term prospects for the pro forma company's stock will become more important than the deal price on the day the transaction is announced.

From a buyer's perspective, the all-stock deal eliminates (in most "all" situations) the need to issue outside capital. Assuming the seller's capital ratio is greater than the buyer's, an all-stock transaction has the added benefit of being a capital raise.

Table IV details the ability of a buyer to raise capital through a merger of an overcapitalized seller. In this example, the transaction will provide Sample Bank the equivalent of an additional $14 million in capital.

Another phenomenon that can develop in a down market is an increase in the relative value paid in stock deals. Table V analyzes the acquisition of banks between $200 million and $2 billion in assets via transactions comprised of at least 75 percent stock. The top of the Table V details the 20 such deals announced in the 12-month period preceding June 2007—when we saw the implosion of the subprime and collateralized debt obligation markets. We compare the median deal multiples at announcement with the current value that selling shareholders would have now had they retained the buyers stock they received in the transaction. As you can see, the multiples have decreased dramatically as the buyers' stock prices have declined.

Using the same criteria, we analyzed the 10 qualifying deals announced since September of 2007, reflecting the period since the souring of the bank trading market. You can see that the median adjusted value of those deals is greater than double tangible book and a full 15 percent higher than the adjusted value of the deals announced in a much more favorable market. It does make intuitive sense: When a buyer can't wow a seller with a high multiple, he may be willing to reach a little deeper into his pocket to get a deal done.

Obviously, it is a tough environment for both banks and bank investors. However, the market has shown itself to be dynamic enough to provide capital where and when it is needed. Offering terms may be expensive relative to a year ago, but their issuance is still reasonable enough for banks to financially justify.

In addition, opportunities will present themselves in the merger market, and it is important for community bankers to know what their options are, in order to recognize those opportunities when they appear. Deal prices may not be large enough to make waves at the country club, but the market is ripe for smart deals that can provide long-term value to shareholders. ib

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