

Q&A: Howe Barnes Managing Directors of Investment Banking Thomas Lynch and Daniel Weber

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The past several months have taken their toll on banks and thrifts, as several industry players, both large and small, were faced with numerous challenges, including credit quality concerns, increased pressure on earnings and share prices, trying capital markets and a considerable slowdown in deal activity.

Thomas Lynch and Daniel Weber, managing directors of investment banking at Howe Barnes Hoefler & Arnett Inc., have more than three decades of combined experience in the bank and thrift space, leading and participating in a variety of transactions, including acquisitions, mergers of equals, thrift conversions, capital offerings and branch divestitures.

SNL recently spoke with Lynch and Weber to get their thoughts on M&A, capital raises and credit quality in the current turbulent banking environment, as well as what lies around the corner for the industry.

What follows is an edited transcript of the conversation.

SNL: We've seen a difficult environment in the banking sector in 2007 and 2008. What is the biggest issue your clients are talking about right now?

Thomas Lynch: I think there are a couple of things that people are very concerned about. It really depends, to some degree, on where you are. Talking specifically about the Midwest, in Michigan the No. 1 priority is credit quality, followed closely by earnings and capital. In the state of Michigan, my understanding was that 17 banks did not make money in 2007. So I would say credit quality and earnings in Michigan. Elsewhere, in places like Chicago, it's still probably earnings and capital, because everyone's earnings are coming down; public companies and private companies are experiencing the same thing on the earnings side.

What's really limiting a lot of people's opportunities right now is that the credit markets are just unavailable. For example, even if someone had their No. 1 draft pick become available right now, in a lot of ways it's going to be difficult to get that transaction done, simply because the capital markets aren't conducive to doing a transaction and raising money. And you have companies, for the most part, over the last three to five years that have been fiscally very leveraged using trust preferred and other liquidity opportunities to fund their transactions before. There are a bunch of things; there is no one thing per se.

Daniel Weber: I would have to agree with Tom. The No. 1 issue is credit quality, and not necessarily the credit quality that exists today on their balance sheet, but the credit quality that will exist tomorrow. Everybody has listened to so much bad news and bad press and that the sky is falling, that some banks, even though they know all their borrowers, they're comfortable with their balance sheet and they're in a low-growth but thriving market from a consistency perspective, some of [these banks] are waiting for the other shoe to fall just because it's supposed to fall.

Speaking of credit quality, do you think that credit issues are remaining contained within the consumer segment, or are problems spreading into C&I loans as well?

Weber: I think that is a big concern that eventually problems will spread to the commercial side. Tom, I think you'll agree, most of our clients in the middle market are concerned with commercial real estate, because there's going to be a commercial real estate piece on every commercial loan that they do.

Lynch: I agree with Dan. Even a working capital loan that a community bank would do, for the most part, is backed by the real estate anyway, so commercial real estate is where everyone is looking right now. And if you want to break it down between the big public banks and the smaller private community banks, with the smaller private community banks, if commercial real estate starts to go, [community banks] are primarily commercial real estate project lenders. That's really going to be a difficult situation, because the concentration could be an issue for regulators, and the lack of ability to locate capital at a time when they desperately need it could be an issue. So if commercial real estate starts to go, from the market perspective, then those are the guys who are going to be in some trouble.

Weber: I think the perception — and this is generalizing — is that in the Midwest you have had real estate markets, especially on the consumer side, that have been fairly consistent. It's been 3% to 5% annual inflation of home prices, as opposed to pockets on the East or West Coast where [inflation] was 10% or 15%, and because of that, there is a fairly stable market [in the Midwest]. Add to that the fact that on the consumer side, middle-market banks have very little one- to four-family loans on their portfolio, but those that do are, for the most part, conforming. They are going to be sub-80% LTV, they're going to be adjustable-rate, and they're only going to keep the best stuff. They've sold all the other stuff. Obviously the other piece that you have on the consumer side is home equity, and in general, the borrower in the Midwest is more conservative in how they borrow. I think the bank is more conservative in how they lend, by their nature, as opposed to what you might have on the coasts.

Lynch: The Midwest does not have the highs and the lows of the rest of the country. The 3% to 5% growth rate has been pretty standard, and so people don't speculate tremendously on their homes here.

You both seem fairly confident about the Midwest. How do you see M&A activity progressing in the region this year?

Lynch: I think the biggest driver of that is that, obviously, bank multiples are suppressed. The capacity for buyers to pay what look like historically attractive multiples to sellers is just not there, and it's not going to be there because of the suppressed multiples.

Weber: And that's everywhere, not just the Midwest.

Lynch: Right. And most of what we're seeing involves a seller that's under some kind of distress, and that's exactly what you'd expect. I think you'll see more situations that's not where the seller sold because they had to. If you're looking at a low premium-to-book, historically, that's not very attractive. But in these times, it might be a struggling bank that needs someone to rescue it, so to speak.

I think there are a couple of things to look at here. As a percentage of deals that get done nationally over the last 20 years, the Midwest has about 30%, and that hasn't changed at all. Given that, I think, we'll continue to be at that level in terms of percentages on a national basis. I think there will obviously be some distress situations. I also think we have a very intense regulatory environment right now ... and the operating environment that we are currently in is going to force some people to cross a precipice and say, "You know what, I just don't want to do this for the next three to five years, and if I need to take a 25% to 50% discount to what I thought I was worth two years ago, that's worth it to me at this point." And so we'll see some people who aren't necessarily distressed — they may be distressed emotionally, but not distressed financially — step into the situation and do a deal with someone they've known for a long time. I think this is an opportunity for the buyers, who've had guys on their radar for a long, long time, to be in there talking to them. I don't think you'll see any very large premiums, but my personal belief is that you'll see deals start to get done in the second half of the year.

Weber: To take a look at it another way, as Tom mentioned before, the availability of capital is somewhat limited here. In order to do transactions, you're not going to see a large cash component, because the cash is obviously hard to come by. Which would lead you to say, if the banks need capital and want to do deals, you're probably going to see more stock used in deals. Now, if somebody were to take a lower multiple today, their reasoning could be, and should be, "What I'm getting if I do a stock transaction is I'm getting a lower multiple, but I'm receiving a better value in the stock [of the company] that's acquiring me." You should be able to participate in the upside with the institution that's buying you. So that creates a potential environment for the lower-premium, merger-of-equal type transactions. I think that those often make a lot of sense. There are sometimes cultural or management issues that prevent those from getting done, but I think we may see some more of those in the second half.

Lynch: Having said that, you always make an investment decision if you take stock [for a deal]. I think now more than ever, as you see more separation between some of the banks, that the investment decision is going to be a far more critical decision if you have one or two parties who are interested in you. You're really going to have to take a hard look at which currency you should take. A good example of that, here in Chicago, we had MAF Bancorp sell to National City Corp. Well, Nat City has clearly had some issues come up and the value of that stock has come down materially. Now, obviously no one could have foreseen that, but by making that investment, the value of that deal is ultimately far lower than what it was at the time it was announced.

The question of seller valuation has been raised by some of the bigger players, notably Wells Fargo & Co., who have said that sellers haven't yet adjusted their pricing to levels that buyers want to see, although sellers are starting to ask for less.

Weber: That's very accurate. I think that's a central issue in why we're

not seeing things get done. Most of the things that are getting done are because the seller really had to do something.

Lynch: Whether it was internally, from a social perspective, something with their board, or with the regulators, or with the company not seeing the value of the company growing at a level where they can justify even the lower price. So, I do think that's accurate, and I do think that will change. It's why I think you'll see more deals get in the second half of the year, because once that dam gets broken a little bit, some of these deals [will] get done with people who have to do a deal.

Weber: Well, you could pick any deal you want to — say in the beginning of 2007 — and the deal value was 220% of tangible book and was 80% stock. If you look at how that price has adjusted down today, it's probably going to be something like 140% of tangible book. Eventually, people are going to figure out, "Man, if I can get plus 140%, I'm actually going to get a better deal than this guy got a year ago." I think that will obviously take time. As markets settle and banks trade at these multiples for awhile, that realization will soak in. Because, from a regulatory perspective and everything else, it will still make sense for the industry to consolidate.

Lynch: I think that what sellers need to focus on, quite frankly, to help break that logjam, is exchange ratios and percentage ownership in the pro forma company, depending on what type of company's buying you. Obviously, if Wells Fargo is buying you, your pro forma ownership is going to be irrelevant as a small community bank, but if you've got a \$2 billion bank buying an \$800 million bank or a half-a-billion-dollar bank, it's really about the exchange ratio you're getting with the stock and what type of discount you're really making your investment at, in terms of premium. It's really going to matter what that stock is going to do going forward, and how much of that company you own going forward.

So, time will be the main catalyst for sellers adjusting their expectations, leading to an increase in M&A for the second half of the year.

Weber: I think we're at the slowest quarter, in terms of deal flow, in the last 12 years, something like that. So I think anything will be better than that. As people get used to seeing their stock prices at these multiples, the realization will soak in that the 3x book transaction is not there. And that's the biggest part of our job, to help these banks understand what true value is. You go into a lot of board rooms, and people have the perception that "I'm worth 2x some number" — 2x book, or 20x earnings, or whatever number it is. In deals where you're receiving stock, there is a lot more to look at than just the overall price.

Lynch: I do think you'll see continued regulatory pressure. If you stratify it by deal size, you're going to see smaller private banks do some transactions out of necessity, because they're being told to either raise capital or sell the bank, and so most of those guys at the board of directors table don't want to reach into their pockets and put more money into the bank right now, and so some of that will start the transactions moving. The bigger public companies, quite frankly, are all in the same boat. Everybody's stock price is down, everybody's earnings are down. So, the analysis gets to be one of, "Am I just trading my problems for his problems and his stock?" And I think that will take some time to work through, but I think you'll see the small, private guys get some deals done first.

And are the smaller banks having a hard time raising capital right now?

Weber: I think you have a lot of institutions out there right now that would love to raise capital if the markets were there, but aren't willing to slog through it to raise capital. Banks are not looking for a lot of growth right now. I think you have some banks pulling back on the reins and saying, "I'm just going to grow a little slower this year and wait for the markets to come to my favor." Outside of the bulge brackets and the deals we've seen with capital raised from Saudi Arabia or private equity funds, most of the bank money we've seen being raised is all de novo institutions. Really, we look at our equity desk and think of the last time that we had a deal where we did a follow-on common offering for a publicly traded bank ... they're just not there because the market is so soft right now. Add to that the pressure that's been created with the virtual elimination of the trust preferred pools. There is trepidation about growth because of the lack of capital. And that, in time, will fix itself.

Lynch: Well, there are a couple of things. First, I think the leverage in terms of negotiating an investment with any company right now is clearly with the investor, not the bank. There's never been a less opportune time within the last five years to raise capital. Nobody wants to be out there doing it unless they absolutely have to. I think capital could be raised for companies, but it's going to be very painful in terms of valuation. And what you have to remember is that a lot of these guys, 14 or 18 months ago — say it's a couple-billion-dollar public company — were trading at \$28 per share, \$32 per share, and now it's trading at \$18. And in the boardroom, there are not going to be a lot of people looking around saying, "Now would be a great time for us to raise capital and grow the bank." I think they're looking more internally. In a lot of ways, both M&A and capital raising and generally running the bank, people are looking more at risk rather than reward right now. And doing a transaction to try and raise capital to fund growth at a time when people are probably a little afraid to grow the balance sheet just doesn't make sense.

When do you see that atmosphere changing?

Lynch: There is so much doom and gloom out there that it's hard to say when the psyche will change. We're starting to see some valuations, particularly on very well-run companies, where people need to start taking that into account.

Weber: You have a well-run, middle-market bank that has no subprime risk, that has a diversified loan portfolio that's not 50% construction, they're not doing track lending, that has a long-term commitment to its shareholders, experienced management teams, and they're trading at book value, and you're asking, "Is this going to be a good investment?" If you don't see a lot of prospects for them losing money in the future, how can you argue with a book value investment that has a 4% dividend yield in this kind of interest rate environment? I think that's one thing you'll see — and we're already starting to see a little bit — is money coming into the Midwest, in the middle market. When you have banks that know their balance sheet, while they might not be the best growth stock, it's a fairly conservative investment.

Lynch: And Dan makes a good point on the dividend. If you've got a bank stock, and you know their management, and they've been long-term shareholder value guys, and they're trading at 12x earnings and book value, and their dividend is 6% or 7%, or even 5%, you're looking at, in some ways, a bond with an equity kicker. I think there are people looking at those investments now.

Weber: A lot of the Midwest, middle-market banks are feeling the pain that might not necessarily be in their markets because they're a bank and they've been brought down with everybody else. And they're saying, "Look, I know what I'm doing, I know my customers on both sides of the balance sheet, I'm comfortable with the diversity of the economy that I'm operating in, and I'm being dragged down because [Bear Stearns Cos. Inc.] faces bankruptcy and that somehow is extremely related to my core business." And I think that there's a lot of opportunity there. Not to sound like I'm pitching stocks, but I think you'll see a lot of attraction to this market over time as investors realize, "Wait, this might be a conservative play, but in this market I'll take that conservative play." *i*