November 2013

INVICTUS
Bank Insights

M&A Requires Patience, Proper Analytics

Kamal Mustafa

Should your bank be buying or should it be selling? Today's bank M&A environment is nearly as dangerous – yet far more insidious – than it was in 2009 and 2010, when banks faced massive capital losses and hundreds failed.

The regulatory agencies, which had traditionally focused on capital adequacy, were hard-pressed to manage the assets that fell under their control and about half the deals had some sort of government assistance. The picture is far different today:

- Many community banks survived with depleted capital levels.
- Declining loan volumes created the illusion of improving capitalization, temporarily satisfying regulatory capital adequacy concerns.
- The weaker banks continued to face regulatory capital adequacy pressure, forcing additional deleveraging of assets.
- Regulators have substantially increased compliance costs.
- Loan demand decreased dramatically while competition increased, with national and regional banks scrambling to grab a share of the declining loan market.
- Banks continued to operate in an artificially low interest-rate environment, characterized by shrinking net interest margins, offset by a low cost of funds.
- Chasing higher net interest rate margins, many banks increased their dependence on fixed-rate loans making them susceptible to the inevitable rising rate environment.

The slow-but-inevitable hemorrhaging of banks and bank earnings will give regulators the luxury of time to force banks to seek capital or sell. Assisted transactions will be limited, and possibly even non-existent.

Overall decline in loan market demand, coupled with the reduced net interest margins, has left many banks with the unique combination of excess capital and low asset yields (these are bank that need to acquire) and many others with low capital and low asset yields (these are banks that should sell).

Invictus Consulting Group estimates that about 12% of the approximately 6,900 community banks are both undercapitalized (below 3.5% post-stress leverage ratio) and have a severely reduced Invictus Ratio (return on regulatory capital required to support the asset base). The trend by regulators to require ever-increasing capital ratios will dramatically affect the number of troubled banks. Holding the Invictus Ratio constant but increasing the leverage requirement by just 1%, for instance, would result in the number of unsustainable banks jumping to 19 percent.

These undercapitalized banks will continue to suffer, or decline even more, as quantitative easing is unwound. Regulators are primarily concerned with immediate and short-term sustainability. The decline in bank failures masks the weak earnings of many undercapitalized community banks and their increased dependence on low-cost funding. The morgue may be thinly populated now, but banks will be headed there when the Fed's low-cost-of-funds life support machine is unplugged.

The present rate of bank M&A transactions is limited. Some strongly capitalized banks are making acquisitions, often paying premiums that don't consider the regulatory capital implications of the purchase. Many of the targets are loaded with pre-recession loans that carry heavy regulatory capital loads with their attractive higher net interest margins.

Acquisitive banks use "the accretive to earnings" pabulum to sway their shareholders and justify overpriced transactions. This has created an illusion of acquisition value that is detrimental to the market.

The traditional approach of "multiple-of-book" completely overlooks the impact of the heavy regulatory

More than 1 in 10 Banks Undercapitalized

About 12% of the 6,900 U.S. community banks are undercapitalized (below 3.5% post-stress leverage ratio) and have a severely reduced return on the regulatory capital required to support their present asset base (below 45% Invictus Ratio). See page 3.

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capital requirements of the targets. Bankers focused on closing transactions the old-fashioned way are successfully completing deals at inflated prices. Banks under regulatory capital constraints and pressures are reacting to these multiples, and are reluctant to accept acquirers with more practical analytical approaches.

The ongoing hemorrhaging of these weaker banks, coupled with their mistaken belief in higher book multiples, will only hurt the long and short-term interests of their shareholders. Over time, acquisition multiples will decline and the weaker banks will perform even worse. As this process accelerates, the pendulum will swing toward low multiples. A bank feeding frenzy will commence, leading to a smaller number of community banks. The banks that did early overpriced transactions will be silent regarding their overpayments, having already received the short-term benefits of the allegedly wonderful "accretive to earnings" acquisitions.

Banks that are eager for deals need to be careful. They must evaluate transactions in a rational manner, taking into consideration the regulatory capital requirements of their targets, the composition of their loans and, most importantly, those loan vintages. As Invictus has shown repeatedly, pre-recession loans have far worse stress characteristics than post-recession loans, but carry the allure of better net interest margins. The "half-life" of loan portfolios that are being acquired as part of a transaction and their reaction to rising interest rates will have a considerable impact on the value of an acquisition.

Unfortunately, most investment bankers are mired in pre-recession analytics. They often have no understanding of these, let alone a desire to incorporate them into their analytics and recommendations.

We strongly recommend the use of proper analytics and patience for all acquisitive banks. They must resist the temptation to rush into transactions in an unrealistically priced environment.

On the other hand, weaker capitalized banks with low Invictus ratios must "bite the bullet" and contemplate earlier sales before interest rates increase, draining their capital levels and shareholder value, and the pendulum swings toward a buyer's market.

In conclusion: a caveat emptor to investors when you hear "accretive to earnings" from your investment banker. ■

Editor's Note: A version of this article appeared in the American Banker.

The New M&A Due Diligence Tool: Stress Test Your Targets

When a bank purchases another bank, it is essentially purchasing its asset portfolio, which carries its own gross yield and a unique level of regulatory capital based on the portfolio and its inherent risks.

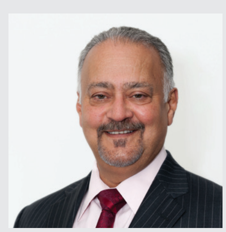
Detailed due diligence of years past, which involved analyzing call report data and standard accounting statements, will not give a potential bank buyer the information it needs to make an intelligent and cost-effective decision today.

That's because those sources cannot reveal differences in pre- and post-recession assets, which can even be within the same loan category. And they cannot reveal the impact of an acquisition on the regulatory capital of the combined new entity.

Pre-recession loans have generally relatively high net interest margins, but much higher risk profiles due to high loan-to-asset values, weak covenants and shorter remaining maturities. Post-recession loans tend to have lower net interest margins, but much better risk profiles and lower regulatory capital loads.

Capital stress testing that segregates loans by vintage is a powerful new tool in the acquisitions process. For more information, contact **info@invictusgroup.com** ■

About the Expert



Kamal Mustafa is the chairman and CEO of Invictus, which he formed in 2008 after a 40-plus-year banking career. He is the former head of global M&A for Ciitbank, was the managing director of M&A at the merchant banking group at Paine Webber and ran KSP, a billion-dollar LBO fund for John Kluge. In the late 1980s, he established BlueStone Capital, which became a leader in middle market corporate finance. In 2002, he formed Wildwood Capital, an investment bank that advised both middle market companies and some of the world's largest financial institutions. He has served as a trustee for the University of Connecticut.

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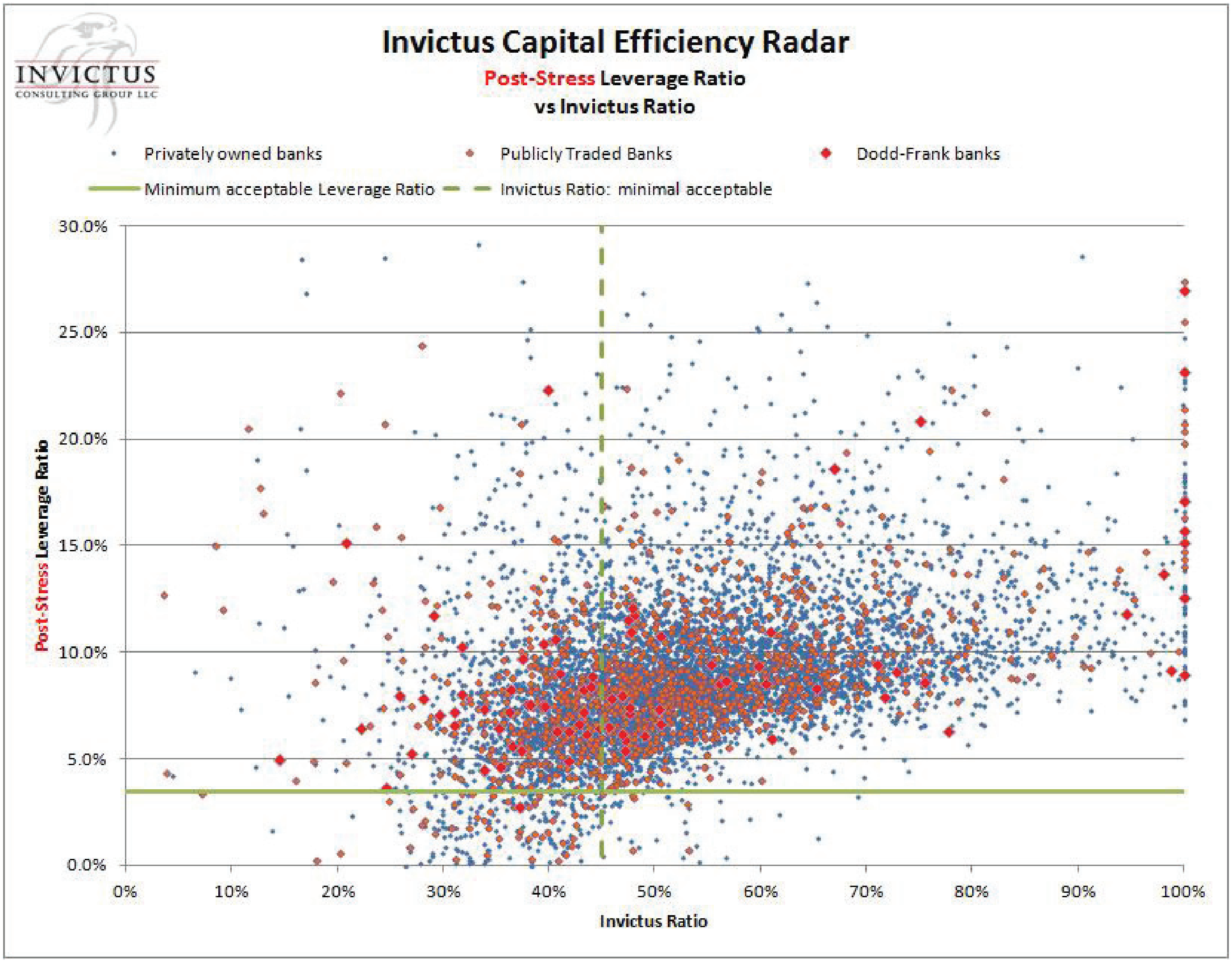

What this chart means

This graph shows the post-stress leverage ratio for the approximately 6,900 community banks compared to the Invictus Ratio. Capital requirements can be calculated only after a stress test, and will vary for each bank based on the unique combination of assets, loan vintage, and the gross return on those assets. The Invictus stress test is a regional equivalent to the CCAR scenario used with the largest banks. The banks in the lower-left quadrant have insufficient capital and inadequate returns to assure long-term viability. The Invictus Ratio has been limited to 100 percent for graphic purposes.

Defining the Invictus Ratio

The Invictus Ratio equals the ratio of gross return on assets divided by the regulatory capital required to support the assets. It takes into consideration the portfolio mix, pricing structure, historical loss experience, and risk by portfolio. In other words, it measures the return of this portfolio of assets on the required amount of regulatory capital required to support it. This is one of the most important metrics you can use in evaluating an acquisition.

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators to give perspective on regulatory challenges.

Prepare HELOC Risk Mitigation Plans

Expect scrutiny of your bank's processes to address potential risks from home equity lines of credit (HELOC) as they approach their end-of-draw periods, **speeches** and publications from regulators indicate. The Office of the Comptroller of the Currency says HELOCs are an **"emerging risk"** and banks should begin outreach and modification programs now for products that will reach their maturities in the next three years. The Federal Reserve's Community Banking Connections also highlights HELOCs, advising community banks to "understand the risks in their HELOC portfolios," and take early action to **manage them**.

FDIC Warns About Interest Rate Risk, Again

Pay attention to the FDIC's Oct. 8 financial institution **letter** warning about interest rate risk. The agency says it is "increasingly concerned" that banks are not ready for interest rate increases and strongly encourages management and boards to "analyze on- and off-balance sheet exposure." Previous guidance suggested that banks consider the impact of 300 to 400 basis point interest rate changes on earnings and capital. The FDIC also warns that hedging is a sophisticated strategy that should not be undertaken if the bank and board don't fully understand its risks.

The letter notes that nationally many banks report a significant "liability-sensitive balance sheet position" and warns that if interest rates rise markedly, banks with concentrated bond holdings in long-duration issues could "experience severe depreciation of a magnitude that could be material relative to their capital position."

Examiners consider the amount of unrealized losses in the investment portfolio – and the exposure to more losses – the letter warns, when assessing capital adequacy ratings.

Scour your D&O Policies for Exclusions

Directors and officers can be personally liable for their actions if their D&O policies don't have adequate protection. In an interesting financial institution **letter**, the FDIC advises bank officers to look carefully at their insurance policies to see if the fine print contains exclusions that may haunt them later. The letter also notes that under FDIC rules, they can't use their insurance to cover themselves for civil money penalties, which have been on the rise in recent years.

Troubled Debt Restructuring Guidance

All federal regulators issued supervisory **guidance** on troubled debt restructurings on Oct. 24, reminding banks that they won't be criticized for helping troubled borrowers with workouts, even if they result in TDRs. The guidance says it is important to evaluate whether an impaired loan is collateral dependent for regulatory reporting purposes. It also describes when a charge-off is required.

Fed and CSBS Issue Community Bank Report

The Conference of State Bank Supervisors and the Fed met with community bankers in 28 states from April to July. Their discussions are summarized in **"Community Banking in the 21st Century."** The report noted there was widespread concern about the future of the community bank model and stressed the need for community banks to be innovative. While 5.4 percent of community banks failed during the recession, the number of community bank charters has decreased by 19.2 percent since 2007. Bankers that participated in the survey overall felt that banks with less than $1 billion in assets will have trouble hiring staff to keep up with regulations. One state reported that banks were spending 10 to 15 percent of their net income on compliance costs.

The report also stressed that community bank boards have changed and members now are personally liable for what they do, so financial expertise is essential. ■

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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