February 2014

INVICTUS

Bank Insights

Using the Right M&A Analytics to Drive ROI

By Kamal Mustafa

Many factors drive banks toward acquisitions, including increasing efficiency due to size, loan/deposit growth opportunities, or expansion of geographical footprints. However, one consideration is always dominant — improving return on investment, or ROI. Whether short, intermediate, or long-term, ROI is the most critical factor in the M&A decision.

Banks that enter into acquisitions without considering the impact of their target's regulatory capital requirements are doing a disservice to their shareholders. As *Bank Insights* discussed in **November**, accretive to earnings has unfortunately gained acceptance as one of the primary justifications for a transaction, which has distorted the perception of market pricing.

M&A done properly can be one solution to the ROI problems besetting community banks. An Invictus Consulting Group analysis incorporates the results of capital stress tests of virtually every U.S. bank with assets below $10 billion into a proprietary formula that helps identify and rank acquisition targets, and calculates the best M&A option for each bank to improve shareholder value. This is the only legitimate way to properly understand the financial implications of an acquisition.

This categorization is known as the Invictus Acquisition Gauge. It focuses on the best strategy for an individual bank and doesn't predict likely activity. The five groups are:

- **Must Sell.** These 828 banks have limited strategic options due to low capital and poor earnings power. These banks may experience very little M&A activity in the future, although they are the ones that need in the most.
- **Should Sell.** These 573 banks have somewhat more flexibility than Must Sell banks. They have better capitalization levels , but extremely low to insignificant returns on the capital required to support their assets. Many have high fixed cost structures that further weaken their capital and return levels.
- **Must Buy.** These 815 banks have sufficient capital, but less-than-robust earnings power within their existing asset portfolios.
- **Should Buy.** These 1,110 banks will do better if they make selective acquisitions.
- **Balanced banks.** These 3,395 banks are in the "balanced" category and are well positioned for the future. This amounts to about 50 percent of the community banks in the U.S.

One of the primary objectives of bank management is to increase the bank's ROI or shareholder value. The most important driver is the overall efficiency of the bank's assets, taking into consideration the capital required to support those assets. Scarce loan demand, increased competition and declining net interest margins have limited the ability of many banks to achieve increased ROI through traditional organic growth. For these banks, meaningful changes can be achieved only through acquisitions or divestitures.

While there are many important qualitative and quantitative considerations that drive transactions, any analysis that ignores the regulatory capital requirements of acquisition targets and their net impact on the acquirer's regulatory capital requirements is seriously flawed and harmful to shareholders. ▪

States Where Banks Must Sell

These 10 states have the highest percentage of banks in the Must Sell or Should Sell categories: Vermont, Connecticut, Massachusetts, New Hampshire, New Jersey, Florida, Washington, Michigan, Colorado and South Carolina.

By sheer number of banks, the top 10 states are: Illinois, Minnesota, Missouri, Florida, Massachusetts, Georgia, Texas, Wisconsin, Ohio and Pennsylvania.

Source: Invictus Consulting Group analysis

States Where Banks Must Buy

These 10 states have the highest percentage of banks in the Must Buy or Should Buy categories: Maine, Indiana, New York, West Virginia, Mississippi, Pennsylvania, Massachusetts, Delaware, New Mexico and Ohio.

By sheer number of banks, the top 10 states would be: Illinois, Texas, Minnesota, Missouri, Iowa, Kansas, Ohio, Wisconsin, Pennsylvania, New York.

Source: Invictus Consulting Group analysis

Inside this issue:

- Ways to use the Invictus Acquisition Gauge, *(page 2)*
- Risk Assets, Loan Vintages Key M&A Analytics, *(page 3)*
- Targeting Acquisitions, *(page 3)*
- OCC Enforcement Stats, *(page 4)*

330 Madison Avenue ▪ New York, NY ▪ info@invictusgrp.com ▪ 212.661.1999

INVICTUS
Bank Insights

Ways to Use the Invictus Acquisition Gauge

- Identify targets that are truly accretive to earnings.
- Early-stage assessment of potential targets or merger partners.
- Filter data by geography, asset size and other criteria to produce short list of targets.
- Look for banks with a higher Invictus Return on Required Capital Ratio, but lower post-stress leverage ratio – in other words, banks that are more capital-constrained yet operate with greater capital efficiency than your bank.
- Do the same analysis in reverse to evaluate discounts-to-book for banks with lower Invictus Ratios.

Barring the raising of new capital, the objective of bank management should be to improve the bank's horizontal position (earnings capacity), which would over time organically improve its vertical position (capital adequacy). The ultimate goal is to improve the bank's ROI.

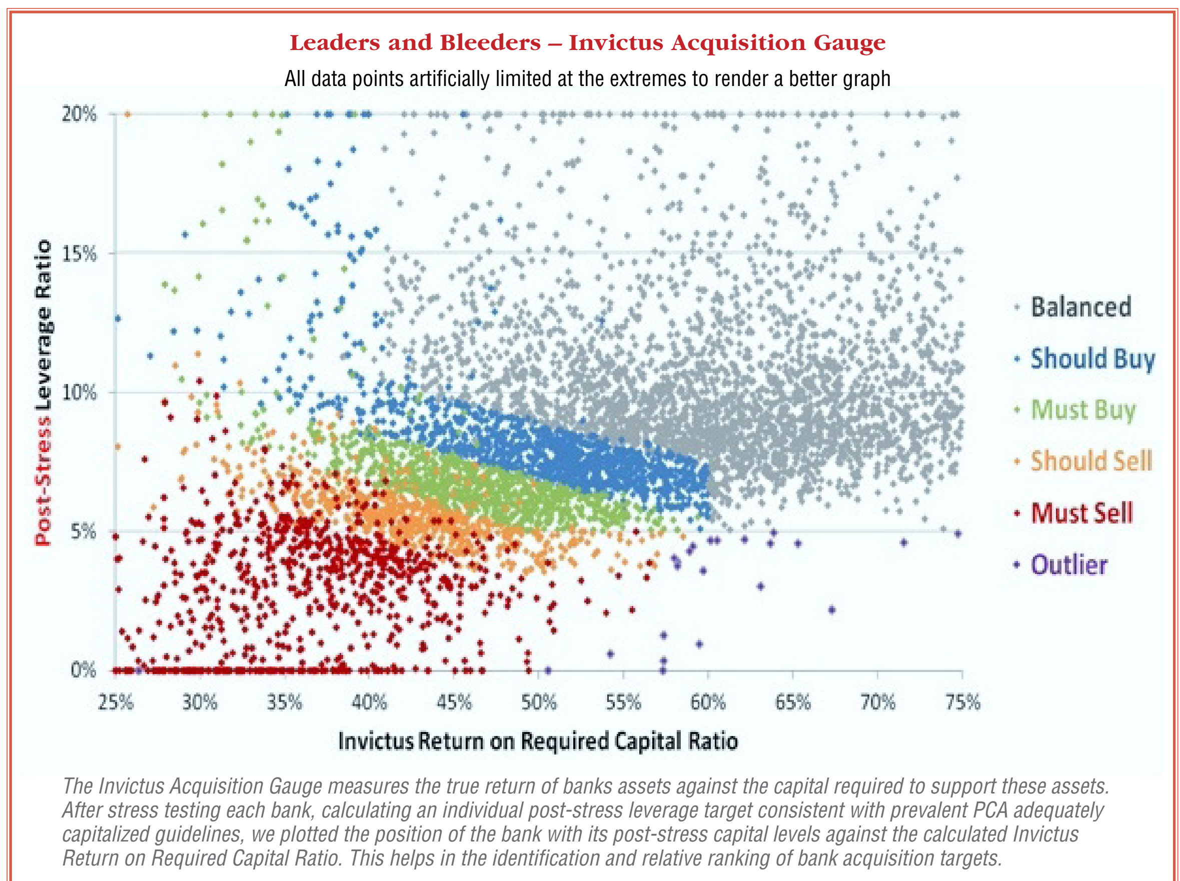
In creating the appropriate subgroups, we consider not only the static capital available for acquisitions, but also each bank's ability to generate profits that would contribute toward increasing or maintaining this excess capital. This process is the only practical way to identify and justify "truly accretive acquisitions" that do not end up diluting the acquirers' overall return on required post-acquisition regulatory capital.

This explains the left to right slope of the chart. Banks with lower earnings power, as represented by the Invictus Return on Required Capital Ratio, must hold more capital, as represented by Invictus' Severe Leverage Ratio calculation.

After initial classification, each bank is rated based upon three additional measures.

1. The Capital Burn Rate, which is the amount by which capital decreases from the bank's current position under a severe stress scenario;
2. The ratio between pre-provision net revenue (PPNR) and the bank's regulatory capital required to support its assets. This process rewards banks whose low Invictus Ratios are offset to a large extent by highly efficient operations (low efficiency ratios);
3. Banks with unusually high Invictus Return on Required Capital Ratios, but low post-stress capital. These banks are in a position to grow their way into a stronger capital position.

The first two tests can result in a one-notch upgrade or downgrade in the bank's classification. This is a comparative ranking, meaning that upgrades and downgrades depend upon the banks' relative ranking among the entire universe of community banks. The results of these additional measures are why some banks appear to be outside their natural band. ▪



The Invictus Acquisition Gauge measures the true return of banks assets against the capital required to support these assets. After stress testing each bank, calculating an individual post-stress leverage target consistent with prevalent PCA adequately capitalized guidelines, we plotted the position of the bank with its post-stress capital levels against the calculated Invictus Return on Required Capital Ratio. This helps in the identification and relative ranking of bank acquisition targets.

330 Madison Avenue ▪ New York, NY

INVICTUS
Bank Insights

info@invictusgrp.com ▪ 212.661.1999

Risk Assets and Loan Vintages Emerge as Key M&A Analytics

Bank acquisitions that ignore the regulatory capital requirements of their targets and instead focus solely on earnings and market or book value can be considerably flawed. This analytical error is amplified by the fact that many target banks with higher earnings have a greater than average dependence on higher risk, regulatory capital-intensive assets.

Regulatory capital calculations are tied to the levels of risk associated with different loan categories. Post-recession, it is important to evaluate this risk under extreme conditions best described as a "hypothetical severe recession scenario." The impact of individual risk characteristics associated with different loan categories and subcategories is magnified, which raises the importance of specific asset risk on the capital adequacy calculation.

Two banks with identical total assets could have substantially different regulatory capital requirements based on their loan mix. Even if their return on total assets were identical, their "return on required regulatory capital" would be radically different. Given this, it becomes clear that Return On Assets is no longer a valid measure in acquisition analysis.

The proper measure of value in an acquisition is now found by taking the Gross Asset Return divided by the Regulatory Capital Required to Support the Assets, (which we call the Invictus Return on Required Capital Ratio). Obviously, the impact of cost of funds and operating efficiency and the all-important franchise value must be applied once this return is calculated.

The Invictus approach reveals some disturbing insights into the use of accretive-to-earnings as justification for deals. Many recent acquisitions tagged with this label were indeed accretive-to-earnings, but primarily because of two essentially negative factors:

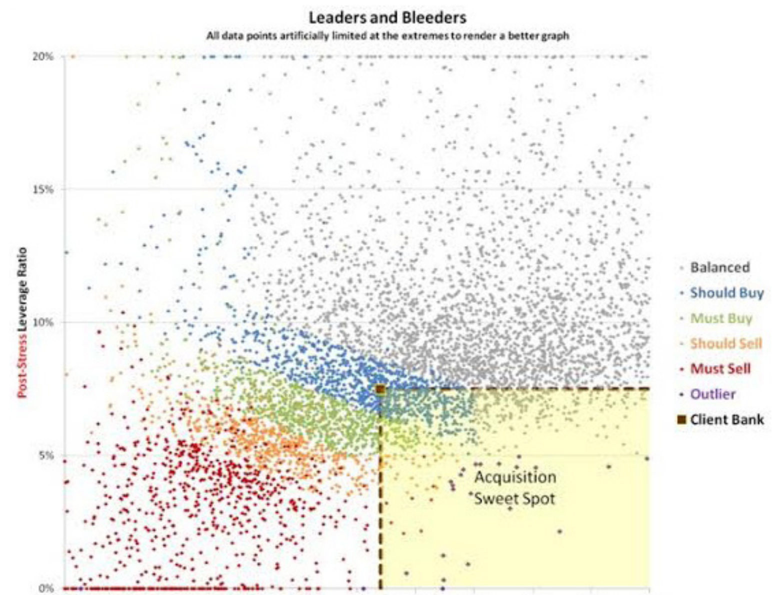
- First, they had a portfolio mix of high return and high-risk assets that required more capital relative to other loans.
- Second, they tended to have higher proportion of loans with pre-recession vintages. These loans tended to have higher margins and far greater risks associated with them.

These accretive-to-earnings transactions not only required a disproportional amount of regulatory capital, but they will also rapidly lose their inherent net profitability when their pre-recession loans roll off their books.

These factors highlight the absolute necessity for acquisitive banks to stress test their target banks. They must review in detail the target bank's regulatory capital requirements, as well as the impact on the capital requirements of the consolidated entity.

To properly estimate a Bank's Regulatory Capital Required to Support its Assets, Invictus performs a CCAR-like test and uses publicly available Call Report data as well as Invictus proprietary analytics to stress test all but the largest U.S. banks. This process provides a reasonable estimate and a fairly accurate relative calculation of each bank's regulatory capital requirement, based on its unique portfolio distribution. Because we stress test almost every U.S. bank, we can look at relative capital requirements in the country, in a region, or in a categorization of banks. ▪

Targeting Acquisitions



M&A clients can use the Invictus Acquisition Gauge to get an early-stage assessment of potential targets or merger partners. We produce a graph similar to the one above (an example for a theoretical client bank). Banks in the lower right corner of the graph inhabit the "sweet spot" for acquisitions. (Banks to the left of that corner would have to be purchased at discounts-to-book to achieve similar benefits). For instance, a Should Buy bank should prioritize any bank in the Sweet Spot box above subject to regional, size and other attribute screening.

330 Madison Avenue ▪ New York, NY
INVICTUS
Bank Insights
info@invictusgrp.com ▪ 212.661.1999

Read Between the Lines

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

OCC Reveals Enforcement Statistics

The Office of the Comptroller of the Currency's 2013 **Annual Report** always offers a few telling nuggets. In fiscal year 2013, the OCC issued 43 cease and desist orders, 31 formal agreements, 1 PCA directive, 7 memorandums of understanding and 35 individual minimum capital ratio letters. IMCR letters require banks to maintain capital levels higher than regulatory minimums. If the bank's capital slips below this requirement, then regulators can mandate a capital plan.

Comptroller Thomas J. Curry highlights capital throughout the annual report, noting that "at the end of the day, the hundreds of community bank failures that followed the financial crisis came about because they lacked capital of sufficient quantity and quality to weather the storm." He writes that the new capital rule should help banks avoid such meltdowns in the future. The report also notes that the OCC expects banks to maintain capital "well above regulatory minimum capital ratios, especially during expansionary periods" when risks increase.

Make Sure Your Bank Follows Servicemembers Act, Fed Warns

The Federal Reserve is reminding community banks that examiners will review policies to make sure that the bank is complying with the Servicemembers Civil Relief Act. The Fed's latest issue of **FedLinks** reviews the Act, which gives certain rights to the military. Banks, for instance, cannot foreclose on real property during military service or 12 months afterward without a court order.

HELOCs Again in Spotlight

Many community banks have failed to account for a borrower's ability to service their HELOC lines on an amortizing basis at origination, writes Michael Webb, Managing Examiner, Federal Reserve Bank of Richmond, in the Fed's **Community Banking Connections**. Webb warns that there could be risk in HELOC portfolios as they approach their peak reset years for 2004-2008 vintage originations. Like other bank risks, board members must be kept informed of the bank's policies and procedures on HELOC exposures.

Underwriting Standards Easing

The OCC's **Annual Survey of Credit Underwriting** shows that standards in commercial and retail loan products are easing, primarily though reduced collateral requirements and loosened covenants. Loan portfolios that eased the most included indirect consumer, credit cards, large corporate, asset-based lending, international, and leveraged loans. Portfolios that tightened since last year included HLTV home equity and conventional home equity.

Complaints to CFPB Rising

Community banks have viewed the Consumer Financial Protection Bureau with unease since it began operating in 2012. But consumers have embraced it. Director Richard Cordray told the U.S. Conference of Mayors that the CFPB has been inundated with complaints, from 600 in its first month, to more than 15,000 complaints in December. About 27,000 complaints have been about credit reporting, 31,000 concern debt collection and more than 109,000 have been about mortgages.

Banks Not Prepared for Stress Testing Requirements

A recent survey from the accounting firm of Crowe Horwath found that just 20 percent of banks with assets ranging from $1 billion to $10 billion were prepared to meet stress testing requirements. The firm wrote that "it's likely that even community banks will face mandatory stress-testing requirements in the future" and that failure to comply could "limit all capital actions," including executive bonuses and dividends. The survey found that 87 percent of banks were still relying on a "mostly manual process for risk management and governance."

While stress testing is not mandated for community banks, many regulators have begun to view it as a best practice when it is integrated into strategic planning. ▪

EDITOR'S NOTE

The M&A articles in this issue are adapted from **"Bleeders and Leaders,"** an Invictus white paper.

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.

*For editorial, email Lisa Getter at **lgetter@invictusgrp.com**.*
*For information about Invictus, email **info@invictusgrp.com**.*