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Bank Insights

M&A Economics: Navigating the Trade-off between EPS Accretion and TBV Dilution

By Adam Mustafa

Although bank M&A deals are essentially flat versus last year, if there were a metric that measured the amount of M&A chatter in the market, it would likely be at an all-time high. Our clients are looking at more deals at a more rapid pace than ever before, and that trend will only increase as the business cycle changes.

But then why aren't more deals getting done? The short answer is because too large a spread still exists between the "bid" and the "ask."

On the "ask" front, many investment bankers are creating unreasonable expectations in the board room with respect to the pricing and valuation a selling bank could fetch in the market. As far as the "bid" side goes, buyers are perhaps overly focused on dilution to tangible book value and the corresponding payback period. Buyers are essentially struggling with weighing the boost to earnings from a deal against the dilution to tangible book value and how long it takes to recoup the dilution. Community banks tend to shy away from a deal if the payback period is longer than four years.

However, the better way to think about M&A is from a risk / reward perspective. The analyses that buyers should focus on should be guided by the following questions:

- How much capital are we deploying based on the risk profile of the target and the structure of the transaction?
- What is the return on capital we are getting as measured by increased earnings?
- How does that ROI compare to other viable alternatives such as organic growth?
- What is the time value of money relative to organic growth, which is a much slower and frankly more uncertain process?

Banks armed with the necessary array of analytical tools should be able to quantify the answers to these questions very quickly when assessing a given deal. Absent a change in economic conditions and the low interest rate environment, M&A becomes a very attractive way to deploy capital, perhaps by default. This is because the risk / reward characteristics of making new loans in this environment continues to rapidly erode. Banks that analyze a given deal in a vacuum and are unable to quantify the return on capital of pursuing organic growth or other strategic actions (including returning capital to shareholders) will fall into the trap of overly focusing on TBV dilution and its corresponding payback period.

In summary, buyers tend to focus too much on TBV dilution and the pay-back period for the dilution. Instead, the emphasis should be on return on capital. However, in order to measure capital and the return on capital properly, forward-looking analytical tools are required.

Management teams will need to be able to educate their boards and shareholders on this critical distinction. Those who are able to do so will find themselves with a massive competitive edge in the M&A market. ▪

Nine Ways a Stock Market Correction May Affect Community Banks

By Adam Mustafa and Leonard J. DeRoma

We are clearly in the face of a stock market 'correction' as investors struggle with problems in China, the threat of normalizing interest rates from the Federal Reserve, a strong dollar that is depressing oil and commodity prices, and other global economic issues. At one point in late August, the Dow Jones Industrial Average dropped a stunning 1,500 points.

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So what does this mean for community banks? To answer this question, a correction must first be put into perspective. Think of it as a symptom of a possible economic downturn driven by all of the aforementioned headwinds. We don't know what that may look like, but

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here are nine ways a stock market correction, increased volatility, and a change in the business cycle may have an impact:

1. **The risk and reward characteristics of lending will change dramatically.**
   Although it's counterintuitive, banks with the right set of analytics will be able to take advantage of a great opportunity to make very attractive loans and increase their market share. Bankers always forget the old saying that "the best loans are made in the worst of times." Easy to say, hard to execute – unless you have the right analytics. We are working with all of our clients to quantify the risk and reward of their loans in a near real-time basis to help them determine when to get more aggressive or more conservative with making new loans.

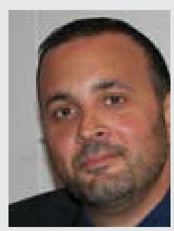
2. **Acquisitive banks will see a shift in the power of their stock as currency.**
   This may affect banks very differently. Those banks that were previously trading at a premium may lose purchasing power, and those banks that were trading at or around book value will no longer be at such a disadvantage.

3. **Look for sellers to begin rushing for the door.**
   There are a number of banks that have flirted with the idea of selling, but have decided against it in hopes of a larger price. In the wake of a stock market decline, many of these institutions' shareholders may be kicking themselves for not taking earlier offers. This will be especially true for banks in low growth markets or slim NIM products, since the "go it alone" approach that relies on organic growth is already difficult and inefficient in the current environment. This strategy will only become tougher in any kind of economic slowdown. We suspect many of these banks will revisit previous bidders to see if these deals are still available.

4. **Commercial real estate deals may come to a grinding halt.**
   The Fed's zero interest rate policy may not have created inflation in the price of consumer goods, but it certainly has created inflation in the price of assets. A stock market correction may be the market's way of saying "enough." If that's the case, CRE investors will no longer be willing to accept low cap rates on deals. In turn, this could further slow lending activity, which has already become overly dependent on existing borrowers

About the Experts

Leonard J. DeRoma *is a founding partner and CFO at Invictus. He began his career at Citibank in the 1970s working with Kamal Mustafa in corporate finance. Using new techniques, together they developed sophisticated financial planning and modelling tools to help provide financial advisory services to Citibank's corporate finance clients. At Lehman Brothers, he managed global financing activity; for Barclays Capital, U.S. fixed-income investment banking, trading, capital commitment, derivatives, sales, underwriting, foreign exchange and research. As the President of Barclays U.S. securities business, he was in charge of product development, was an advisor to the U.S. ALCO committee and chaired the U.S. Risk Management Committee. He managed the same businesses for McDonald Investments and KeyCorp. He has a Bachelor of Science in Electrical Engineering from the Massachusetts Institute of Technology and a Masters of Business Administration from the Harvard Business School. He has served on several industry boards and associations, including the Public Securities Association and the Bond Market Association.*



Adam Mustafa *is a co-founder of Invictus and has been providing stress testing and capital adequacy advisory services to banks, regulators, bank investors, and bank D&O insurers since the beginning of the financial crisis. Mr. Mustafa has overseen the design and implementation of fully-customized capital stress testing, capital management, and strategic planning systems for community banks ranging from under $100M in assets to Dodd-Frank banks that have in excess of $10B in assets. Within the community banking space, he has advised acquisitive and high growth banks, banks under enforcement action and significant regulatory pressures, and de novo banks. He has also been a featured speaker on stress testing for community banks at a number of conferences, including those hosted by regulators. Prior to joining Invictus, he had senior-level experience as a banker, financial services consultant and corporate CFO. He has an MBA from Georgetown University and a BA from Syracuse University.*

simply shopping around for a lower refinancing rate. It may even slow refis since lower appraisals could squeeze borrowing capacity.

5. **Going public may not be an option.**
Some banks have considered going public as a way to attract capital more easily and give long-term shareholders an exit. Volatile equity markets that have repriced downward may make this less likely.

6. **Subordinated debt funding may get more expensive.**
A number of banks have raised subordinated debt privately. Expect the return demanded by bank investors to increase in volatile markets, especially if the perceived risk to loan portfolios is increasing.

7. **Paying off grandfathered TruPS may become more problematic.**
Any decline in bank earnings due to economic slowdowns or increases in defaults may affect the dividend-paying ability of banks, reducing their capability to service or retire existing TruPS.

8. **Investment portfolios may get a "reprieve."**
Although the Fed has jawboned about raising rates, they will find it difficult to do so on their current schedule. Having painted themselves into a corner over the past seven years, the Fed will be loath to take the blame on an economic slowdown due to higher rates. Any increase in rates will potentially strengthen the dollar, making exports more expensive, and negatively affecting GDP. Banks' fixed-rate investment and liquidity portfolios may not suffer from the predicted AOCI losses caused by a rising rate environment. On the other hand, the spread differentials (yields over corresponding U.S. Treasury maturities) may rise to accommodate the increased return needed to support perceived corporate bond or agency/mortgage-backed paper.

9. **Depositors may not rush out the door.**
The flood of liquidity into banks from deposits has created an environment where banks have been able to achieve cheap funding. The theory of the higher FDIC insurance limit attracting depositors as a safe haven from volatile investments will continue.

In summary, the stock market has just thrown a surprise speedbump that could symbolize the end of the post-crisis era, which featured a weak recovery, historically low rates, and asset inflation. A new environment will create a playing field that will have different winners and losers. Some banks will have the tools needed to cope with the expected rapid changes in the risk/reward profile and be able to profit from it. Other banks will continue on the same road, but with many new potholes. ▪

Strategic Planning Means Managing Tradeoff between Risk and Return: FDIC

The Federal Deposit Insurance Corp.'s latest issue of Supervisory Insights explores how banks should handle strategic planning "in an evolving earnings environment."

Written by the FDIC's policy staff at the division of risk management supervision, the article notes that "the return of loan growth and an uncertain future interest-rate environment pose important strategic questions" for bank directors and managers.

"Strategic planning involves setting the direction of the bank and the broad parameters by which it will operate," the Supervisory Insight article notes. "Doing this is a basic responsibility of boards of directors, with the assistance of executive officers. Indeed, setting the strategic objectives and future direction of the bank is a key theme running through FDIC guidance regarding corporate governance and is the initial step in a sound governance framework."

The writers suggest that banks need "a disciplined approach" to identifying opportunities and quantifying risks. It advises banks that they must manage "the tradeoff between risk and return," making sure that "capital, earnings and staff expertise" have a reasonable correlation" to a bank's risk profile. It would be wrong for bankers to manage to earnings targets without taking into account risk, the article warns.

All the prudential regulators have been focusing on effective strategic planning lately; the Office of the Comptroller of the Currency has listed it as a supervisory priority. (See the **June issue** of Bank Insights for more information). ▪

Note: *Invictus has developed proprietary forward-looking risk analytics (FLRA™) that focus on portfolio risk/reward. These new analytics, which are integrated with stress testing and capital planning, are an essential part of Invictus' strategic planning advisory services.*

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Read Between the Lines

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

Fed Concerned about Community Bank Interest Rate Risk: Yellen

Community banks typically have risks from their lending activity, but the Federal Reserve is also concerned about interest rate risk, Fed Chair Janet Yellen says in the **latest issue** of Community Banking Connections. "Our examiners have been reviewing whether banks are able to manage risk arising from future changes in rates," she says. She adds that "the vast majority" of community banks are paying "adequate attention" to interest rate risk management. Yellen also said the Fed is "mindful" of complaints from community bankers that large bank requirements often trickle down to smaller banks as industry best practices. She says that the Fed is "enhancing communications with and training for examination staff" to make sure they know that the expectations for smaller banks are not the same as for the largest ones.

Fed Reveals Three Common IRR Mistakes

A new FedLinks **advisory** on interest rate risk for community banks reveals three common interest rate risk management deficiencies:

1. Board-prescribed risk limits do not match the risk measurement tools used to quantify risk exposures.
2. Banks are failing to customize or assess vendor default or industry standard assumptions in IRR models.
3. Banks are not using independent or third-party reviews to ensure the integrity of their IRR management programs.

Bankers Agree on Rule Changes

Regulators have been **meeting** with community banks across the country as part of their initiative to get rid of outdated and unnecessary regulations under the Economic Growth and Regulatory Paperwork Reduction Act. Common themes have emerged, according to James Watkins, FDIC senior deputy director of risk management supervision: Banks generally want streamlined Call Reports, less frequent exams, higher thresholds for appraisals and Bank Secrecy Act requirements, more communication in the exam process and a promise that supervisory expectations for the largest banks are not applied to community banks.

OCC Launches Initiative to Evaluate New Financial Products

Comptroller Thomas J. Curry **told** the Federal Home Loan Bank of Chicago on August 7 that the Office of the Comptroller of the Currency is developing a "framework to evaluate new and innovative financial products and services." He said a team of policy experts, examiners, lawyers and others is involved in the initiative, which should help the OCC "identify and understand new trends and new technology" and make sure that regulators will be in a position to approve and monitor risks associated with them. "That means understanding the technology and the issues that arise from it, as well as the very different perspectives that characterize the traditional banking industry and those that underlie the new fintech companies that are offering banking services," Curry said.

Living Wills Must be Transparent to Avoid Too-Big-to-Fail: Fed Paper

A Richmond Fed **economic brief** concludes that livings wills for systemically important financial institutions can reduce the probability of bailouts if the wills are transparent. Ideally, SIFIS will be resolvable through bankruptcy with little economic disruption, but "short-term financing needs, organizational complexity, and cross-border issues" pose significant challenges. "Reconciling the need for transparency with the institutions' need for confidentiality will require careful crafting of a regulatory solution," the economists conclude. ▪

About Invictus

*Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. For past issues of Bank Insights, please go to the **Invictus website**.*

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