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Bank Insights

Anatomy of a Bank Deal: Why New Bank Analytics are Essential in M&A

By Andrew O'Keefe

The 2008 recession, the changes in regulatory capital adequacy methodology, and the current artificially low interest rate environment have all rendered traditional bank analytics obsolete. Nowhere is this more apparent than in mergers and acquisitions.

Changes to regulations and the financial markets have necessitated new approaches to M&A methodologies. Traditionally, merger analysis was based upon historical call reports, financial statements and loan review data. In the new environment, it is imperative to evaluate a bank's unique mix of assets, their earnings contribution and their capital requirements before forming an opinion of value. Two banks with seemingly identical balance sheets may have very different earnings prospects and capital requirements: loans will have different decay curves and vintages. Credit terms will differ, and pricing may vary dramatically.

This *Bank Insights* article looks at two M&A deals from the past year in terms of capital requirements and earnings. The deals appear similar based on traditional analysis, but quite different when using Invictus' proprietary forward-looking, risk analytics. In both transactions, a $1B+ serial acquirer purchased a small bank to enter a new market. Each target was sold in an auction process with several bidders and received a price well over comparable market multiples. (We are not naming the banks, though these are real transactions.)

TABLE 1	Target A	Target B
Total Assets	$150M	$200M
Leverage Ratio	10%	12%
ROA	0.8%	0.5%
ROE	7.2%	3.6%
NPLs/Loans	0.9%	0.9%
P/TBV	145%	144%

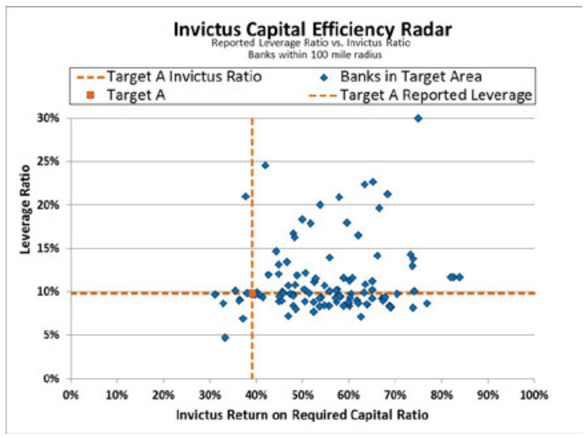
Table 1 summarizes the bank targets:

From an earnings standpoint, Target A looks like a stronger bank. However, traditional metrics such as Return on Assets (ROA) and Return on Earnings (ROE) can be deceiving when evaluating potential acquisitions because they include the impact of operating efficiencies. Once a target is acquired and integrated into the new entity, its operating efficiencies completely change.

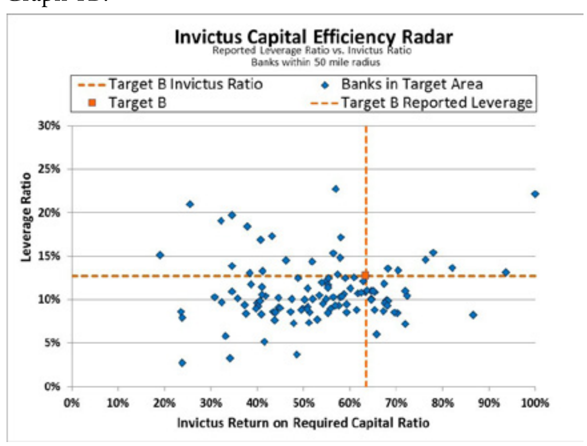
The buyer needs to understand the pure earning power of the target's loans, which will remain unchanged on the buyer's balance sheet for years to come. Loan earnings must be evaluated in terms of the capital required to support them, which can only be determined via a capital stress test.

Graphs 1A and 1B use the Invictus Ratio – which is calculated as gross interest income divided by the capital required to support the bank's assets (as determined in a capital stress test) – to drive home the difference between the banks. The graph plots each target in terms of its Invictus Ratio (x-axis) and reported Leverage Ratio (y-axis), compared with their regional peers.

Graph 1A:



Graph 1B:



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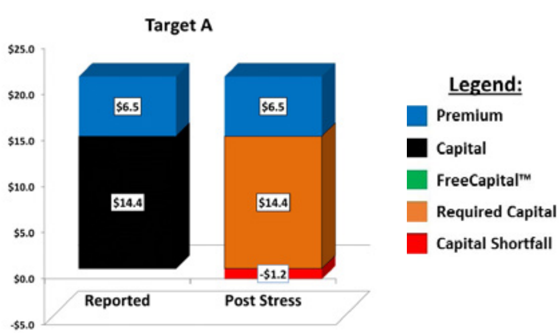
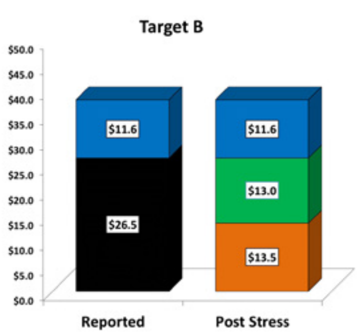
Target A reports a healthy 0.8% ROA but, as you can see in Graph 1A, it ranks well below its peers in terms of pure asset efficiency, with an Invictus Ratio of only 39%. Under a two-year severely adverse case scenario stress test, the bank's earnings fail to offset capital losses, resulting in a Tier 1 Leverage Ratio of less than the 4% minimum used by the Federal Reserve in its stress tests of the largest U.S. banks. Therefore, the bank actually requires more than 10% Tier 1 capital to adequately support its assets. Target B, on the other hand, maintains a capital level well above the 4% minimum under stress, and requires only 6.5% Tier 1 capital to support its assets. Although it reports a lower ROA than Target A, its assets provide a higher yield on required capital with an Invictus Ratio of 63% (Graph 1B).

You must analyze the bank's reported earnings in relation to the capital required to support its earning assets to determine the true yield of a potential target. In the case of Target A, the buyer would actually have to allocate some of its existing excess capital to the target post-acquisition, rather than deploying it into higher yielding assets or returning it to shareholders in a dividend. The acquirer of Target B would gain excess capital from the transaction. The excess capital that a bank has for discretionary purposes is known as FreeCapital™. It has an effect on pricing that is ignored in most M&A transactions.

Graph 2 compares reported and post-stress capital analysis of both targets, where we use Tier 1 Capital as a proxy for book value.

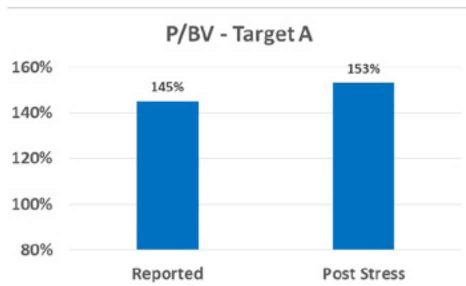




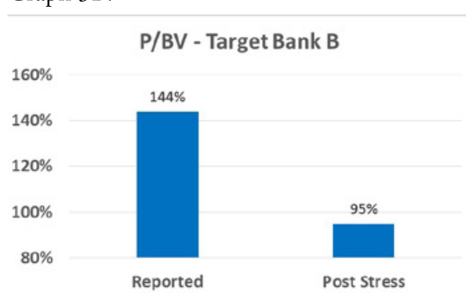
As Graph 2 shows, post-stress capital adequacy is essential to understanding potential targets and avoiding buyer's remorse.

Target B has $13M of FreeCapital™ because of its lower capital requirement, which entirely offsets the $11.6 million premium paid and increases the capital flexibility of the buyer post-acquisition. If we deduct from the purchase price the $13M of FreeCapital™ the buyer will gain from the transaction, the P/BV multiple declines from 144% to 95% (Graph 3B). If we include in the purchase price the additional $1.2M of capital that the buyer will have to allocate to Target A post-acquisition, the P/BV multiple increases from 145% to 153% (Graph 3A). Stress testing to derive FreeCapital™ levels in acquisition targets is an analytical exercise that quantifies real tangible benefits/losses to acquirers. We are presenting these benefits/losses as an adjustment to acquisition multiples to best illustrate and quantify their impact.

Graph 3A:



Graph 3B:



The buyer that evaluates targets on a post-stress basis has a powerful advantage when negotiating a purchase price because it knows the target's FreeCapital™ and the target does not.

The long-predicted consolidation in the community bank market has begun and activity will increase over the next two to three years. The minimum scale for a bank to operate and be successful bank has increased dramatically. For smaller community banks, the M&A decision is a matter of when, not if.

This analysis is based solely on public data. Every M&A deal has its own unique costs and benefits that may not be reflected in this article. We just looked at one aspect that is important and should be considered, but the actual transaction might have had other unique characteristics that made it a compelling deal.

About the Expert

Andrew O'Keefe, the senior strategist for mergers and acquisitions at Invictus, has a diverse background that includes finance, marketing and operations. Prior to joining Invictus, he was an Investment Banking Associate covering community banks and real estate investment trusts for Capital Guardian and Merion Capital Group in Virginia, where he advised clients about capital raises, public offerings and M&A transactions. His work included financial analysis and modeling, investor presentations and identification of potential merger partners. Mr. O'Keefe received an MBA from the Mason School of Business at the College of William & Mary and a BA from the University of Virginia. He holds series 7 and 63 securities licenses and is a member of the Beta Gamma Sigma honor society.

Stress testing is the only forward-looking way to evaluate the performance of loans in different economic environments and determine their impact on capital adequacy. Measuring the consolidated assets of the buyer and seller, under stress, helps regulators to get comfortable with the capital adequacy of a transaction in the post-financial-crisis world.

As the anatomy of two banks shows, without this stress testing analysis, a buyer flies blind into potential transactions, and risks overpaying significantly. ▪

Strategic Risk Emerges as Key Issue for Community Banks

Under pressure to increase earnings, some community banks are increasing their risks, and that has regulators concerned. The issue, which was discussed in November during the Chicago Federal Reserve's 10th annual Community Bankers Symposium, is highlighted in the **latest issue** of the *Chicago Fed Letter*.

"Strategic risk continues to be a potential focal point," the article noted.

Panelists from the Fed, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp. said they are seeing banks increase their commercial real estate and commercial and industrial concentrations, while weakening credit standards. Many of the community banks that failed after the 2008 recession had high lending concentrations, so examiners said they will pay extra attention now to banks with concentrations, according to the *Fed Letter*. Regulators expect banks with high CRE concentrations to use stress testing and sensitivity analysis, as well as other risk management practices, according to supervisory **guidance**. The panelists said supervisors will want to make sure that board-approved limits on concentrations are in place and monitored.

The Chicago Fed reiterated its concern about CRE originations in the first quarter of 2015 issue of ***Risk Perspectives***. "As financial institutions continue to seek new CRE originations, there remains a critical need for sound underwriting and stress testing practices to address the downside risk embedded within individual transactions and broader loan portfolios. Sound underwriting should include an analysis of the adequacy of borrower equity contributions as well as the ability and willingness of the guarantor to support credits in time of need. Controls around growth plans should be thoroughly vetted, including thresholds and parameters that would signal an increase in downside risk," the Fed warned.

Supervisors at the November community banking conference said they were seeing signs of lax underwriting that included an increase in the number of commercial loan policy exceptions and lenient terms for consumer auto loans.

One panelist also said some banks are focusing more on yield than controlling long-term interest rate exposure by increasing the duration of their securities portfolios. Interest rate risk is another examiner concern. Regulators want to make sure that banks have "acceptable risk tolerances in place and that the balance sheet is well positioned for increasing or volatile rate environments," the *Fed Letter* said.

Some community banks are trying to generate fee income by entering into new lines of business, such as third-party overdraft protection and prepaid cards. Regulators want banks to conduct proper due diligence before entering into agreements and then make sure they have effective oversight going forward.

Community banks must engage in strategic planning to monitor their strategic risks, especially as they add new lines of business and increase loans to bolster interest rate income, the panelists at the Fed conference said. A good strategic plan can help banks to make sure they are growing consistent with their strengths, while identifying the risks in their plans, the Fed Letter said. (For more information on strategic planning, see the **October issue** of *Bank Insights*.) ▪

New Analytics to Guide Strategic Planning

Invictus has spent the last year developing proprietary, patent-pending analytics that reflect the dramatic changes in the community banking system, economic environment and regulatory requirements. These forward-looking risk analytics focus on portfolio risk/reward. They show a dramatically different pro forma picture of community bank performance than the traditional pre-recession methodologies that are commonly used by community banks, researchers and M&A investment bankers. In many cases, the Invictus analytics reverse conclusions reached by traditional methodologies. Invictus will be publishing future reports that highlight these discrepancies and show how the new analytics identify not-yet-observed strategic risks in loan portfolios.

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Read Between the Lines

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

No New Bank Charters in 2014, M&A Picks Up

The latest **Quarterly Banking Profile** notes that there were no new banks chartered in 2014, for the second time in the last three years. During the year, 274 banks were absorbed by mergers and 18 others failed, leaving 6,509 FDIC-insured banks at year-end. There were 291 banks on the FDIC's problem list with assets of $87 billion.

The FDIC's chief economist, Richard Brown, told a **Fed conference** in November that there could be an increase in de novos when interest rates move up, leading to an improvement in earnings. He said there was a high correlation between new banking charters and economic variables, including the federal funds rate.

OCC Again Calls for Community Bank Stress Testing

Stress testing can help bank boards know if they have "adequate capital relative to all of its risks," Deputy Comptroller Darrin Benhart said in a **speech** last month. Although stress testing is not mandated for community banks, "all banking organizations, regardless of size, should be able to analyze the potential effects of adverse events on their financial condition as part of sound risk management practices," Benhart said. He called on community banks to use stress testing to understand risks associated with concentrations and as part of strategic planning. "The most valuable and often most difficult risk management decision is knowing when to say "no" because you have exceeded your risk limits," he said.

Community Banks Should Not Read Welcome News in Stress Test Results

Community banks should not be reassured by the **news** that the largest banks passed the Fed's stress tests, warns Invictus Consulting Group Chairman Kamal Mustafa. Here's why:

1. The Fed uses macro-economic statistics when stressing the largest banks. Those statistics don't necessarily apply to community and regional banks, which are much more susceptible to changes in their geographical footprints. Just think of the impact that oil and gas prices are having on community banks in Texas and Oklahoma, or commodity prices on agricultural banks. The largest banks have a more diverse portfolio and limited exposure to commodities, and they can use hedging to mitigate their risks. The cost of hedging is prohibitive to community banks, leaving them far more exposed. "Community bank CEOs should wake up if they are tied to regional or microeconomic factors and not be misled by the stress testing results of the largest banks," Mustafa says.

2. The fact that the banks have passed the tests is a signal that the regulators are winning the battle to manage and approve strategic plans. When stress testing first hit the scene after the recession, the largest banks fought back. "Slowly but steadily the fight has gone out of the major banks," Mustafa says. "The battle is being won by the regulators and federal institutions. Control has been established, but the pendulum has swung too far."

FFIEC Reveals Cybersecurity Tool in the Works

The FFIEC, representing all the prudential regulators, plans to issue a cybersecurity self-assessment tool for banks this year to help identify, mitigate and respond to cyber threats. Its **priorities** also include enhancing incident analysis, crisis management, training and policy development. The Information Technology Examination Handbook will also be updated. Community bank can find cybersecurity resources on the FFIEC **website**.

Supreme Court Ruling Could Affect Bank Guidance: Law Firm

The Supreme Court ruled earlier this month that federal administrative agencies don't have to seek public comments when they amend interpretive rules. And that could mean that banks won't have a say in some future guidance, suggests the White and Case **law firm**. The lawyers contend that the ruling could impact FAQs or regulatory guidance in the future, especially if regulators are revising or reversing interpretive rules. ▪

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. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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