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Bank Insights

The M&A Analytical Primer: Notes for the Intelligent Acquirer

Part Two: The Loan Portfolio

By Kamal Mustafa and Andrew O'Keefe

A community bank's most capital-intensive and strategic decision is a merger or acquisition. It has instantaneous operating and financial implications, ultimately measured by the impact on the acquirer's return on capital. But that's not the entire story. For the results to be truly meaningful, an acquisition's impact has to be measured in the context of its alternative, namely organic growth.

Any other methodology is incomplete and misleading, since it is an analysis done without any contextual reference point. And that means it grossly misrepresents the acquisition value because the consolidating forecast establishes a zero baseline as a reference point for valuation. In reality, this baseline is usually positive or negative, depending on existing and expected market prospects. Furthermore, this process ignores the selective and individual impact of the acquisition on key driving variables that eventually justify any price in excess of the target's existing book value.

The most commonly-used transaction analyses make this mistake; these prevailing methodologies rely heavily on stand-alone and consolidating forecasts. Beyond being wrong, these analyses can lock in unpleasant surprises for senior management after the combined entity's first year of operations.

A very simple example of distorted analysis is the prevailing use/reference/promotion by investment bankers of historical book value multiples. Every CEO contemplating an acquisition or a sale has had a report from an investment bank outlining a series of "historical comparable transactions."

There are two patently absurd assumptions built into the use of these multiple-of-book charts. First, they assume that these were properly priced transactions that can be used as a standard reference. And second, they assume that these transactions are comparable even though they took place in very different operating and economic environments.

Inside this issue:

- Why CEOs are Approaching Compliance the Wrong Way *(p. 3)*
- Future of Dodd-Frank Under Trump *(p. 4)*
- OCC to Add Innovation Office *(p. 4)*

Unfortunately, once the transaction is completed and the fees paid out, CEOs are left alone to live with the results and consequences of the transaction, no matter the multiple-of-book value.

The vast majority of CEOs have the knowledge and experience to properly evaluate M&A transactions provided they have access to the proper methodology, data and analytics. But they must be willing to stop being manipulated by antiquated and illogical methodologies and thumb rules proscribed by many in the M&A community.

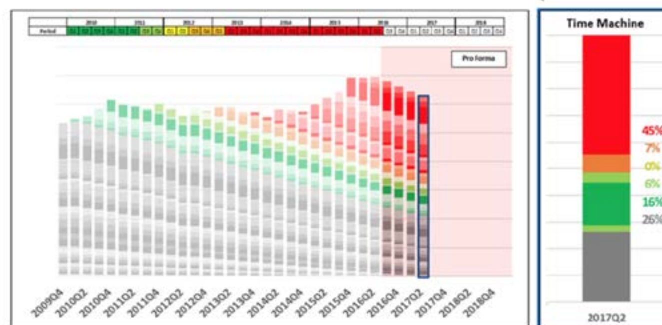
There are several different value propositions involved in an acquisition that would justify/contribute to the multiple paid over book, taking into consideration the acquirer's existing and expected environment. This box shows several components of a selling bank which could add or detract value from a potential acquisition. This article focuses on the loan portfolio.

Target Component	Potential Value to Acquirer
Loans	**Alternative to organic growth**
FreeCapital™	Engine for growth
Deposits (Loan/Deposit Ratio)	Changes in constraint
CRE Concentration	Changes in constraint / Deal structuring
Other	Ag concentration, Oil & Gas Exposure, etc.

The following oversimplified, conceptual step-by-step analysis will show bankers how to estimate the acquisition target's loan portfolio contribution to its book multiple. It relies on the underlying methodologies described in the previous *Bank Insights* **articles** that make up this M&A Analytical Primer.

Step 1: The target's loan portfolio is extrapolated (conservatively – no growth/replacement) over 12 months. This provides the gross earnings that would be generated by the acquisition loan portfolio and the size and composition of this portfolio at year-end. The size of outstanding loans after one year of amortization then establishes the targeted level of baseline organic growth.

Acquisition one year out



Step 2: The acquirer's loan portfolio is allowed to amortize (with no growth and replacement) over the one-year period.

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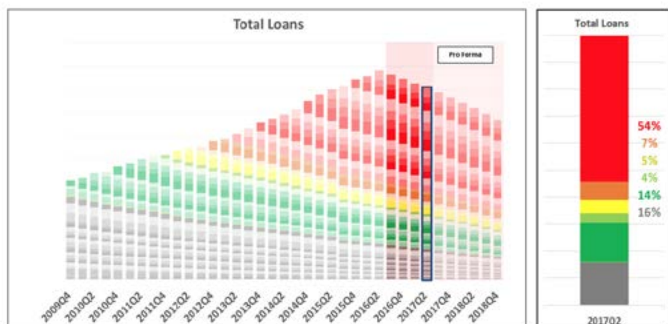
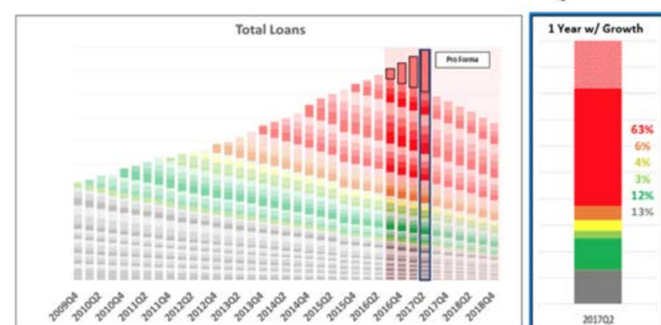
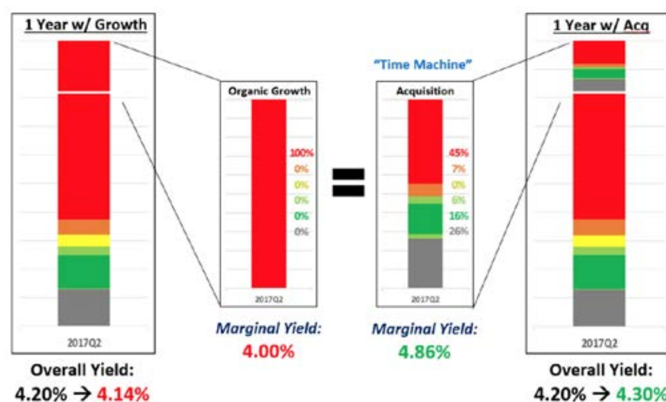


Step 3: A steady growth rate in loans is superimposed on the acquirer's loan portfolio, accumulating in an incremental volume level that equals the outstanding loan level of the acquisition after one year's worth of amortization. The acquirer will end up with the same amount of assets in the one-year-period in both the acquisition and organic growth scenarios. This process establishes an equivalent baseline of organic growth to evaluate the proposed acquisition. It also considers the time value of money, which is a real tangible consideration when evaluating an acquisition. The expected rate environment is a critical part of this step.

The acquirer must also recognize market conditions for loan originations. Examine the "Organic Growth, one year out" graphic. The sample acquirer assumes new loans will be originated at current market rates (represented by the red shading). The bar chart depicts the bank's portfolio after a year of growth, including both existing loans and new originations.

Organic Growth one year out



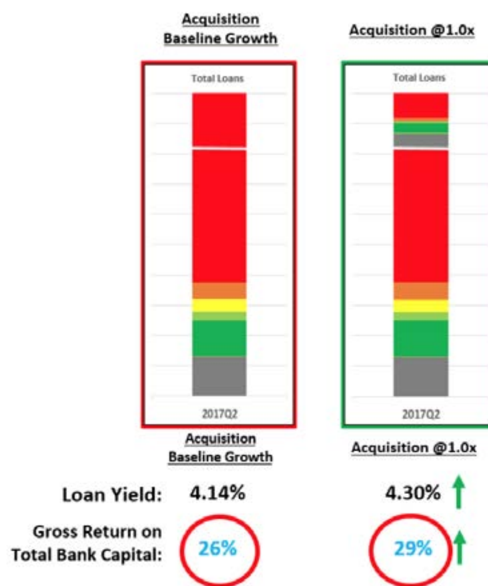


What Investment Banks Get Wrong

- ✓ Relying on a zero baseline for valuation
- ✓ Ignoring the impact of the acquisition on key variables, such as loans
- ✓ Using historical comparable transactions
- ✓ Not comparing the deal to organic growth

Note: The amount of organic growth implied in this step might not be practically realistic, however it must be matched to the acquired loans outstanding at the end of one year to establish the correct baseline. Obviously, this is conservative, but we believe this conservatism is necessary in any acquisition evaluation. However, if desired this credit can be easily appended to the analysis.

Step 4: This step calculates the gross yield generated in the organic growth scenario, taking into consideration the monthly/quarterly outstandings and yields of the loan portfolio and the expected yield of this organic growth over the pro forma period. This then allows for the calculation of return-on-capital over this period. This process is repeated with the acquisition being treated as a simple dollar-for-dollar purchase of assets with no implied purchase multiple.



Step 5: Once the implied return-on-capital for both scenarios have been calculated, it is a fairly simple matter to calculate a multiple for the acquisition that would reduce the acquisition return-on-capital to the identical level of the organic growth return-on-capital.

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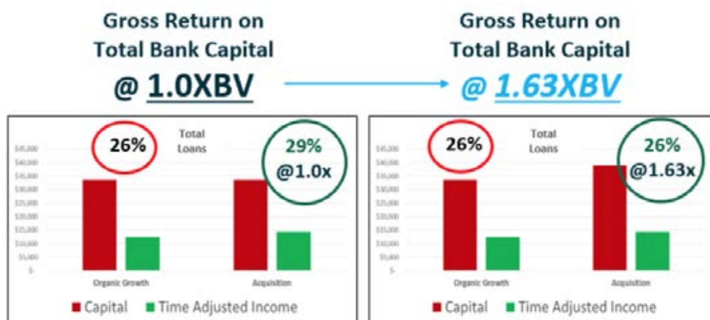
This step establishes the absolute ceiling price/multiple that can be attributed to the target's loan portfolio.



Remember, transactions will more often than not require a premium to book value. Rather than using comparative deal analysis to derive the premium paid, the acquirer should calculate the precise value of the seller's loans to itself and then determine an offering price, as we have shown.

The analysis allows the acquirer to quantify its return on capital from both organic growth and the acquisition (at book value).

The return from organic growth is the acquirer's baseline, or hurdle rate, above which the acquisition is attractive.

The acquirer calculates its price ceiling (or its "breakeven" price) by adjusting the multiple until the return on acquisition equals exactly the return on organic growth.

If the going market price for the seller is reasonably below the price ceiling, the acquirer knows it that the acquired loan portfolio would contribution positively towards the final multiple over book value.

Future *Bank Insights* articles will explore the impact of FreeCapital™, deposits and CRE concentrations on multiple of book. Previous articles are available in our **archive**. To contact the Invictus M&A team, please email **MandA@invictusgrp.com.** ▪

Why a Compliance Mindset is Hurting Community Banks

By Adam Mustafa

Community bank CEOs are wasting money on compliance. They are spending more than ever, hiring additional risk officers, internal auditors, compliance officers, vendors and consultants. They are checking every box and fulfilling every mandate.

And they are doing it all wrong.

A **new study** by the Federal Reserve Bank of St. Louis' supervision division found that spending more on compliance isn't leading to higher regulatory ratings for the smallest community banks. It isn't elevating their managing scores, or positioning the bank for success.

And that's because having a compliance mind-set is a recipe for mediocrity, no matter the size of the bank. The banks that will earn the most leeway with regulators—and maximize value for shareholders—will naturally implement and utilize the tools and processes that are a prerequisite for "compliance" as a critical function of their strategic and capital planning processes.

When that happens, compliance becomes a mere afterthought; something that is more icing on a cake that doesn't need icing to begin with. This type of approach is actually easy to execute. You don't need expensive, overrated and highly misleading black-box models and software. You don't need an entire department dedicated toward enterprise risk management.

What you do need is a cultural mindset, which starts with the CEO. This mindset starts with an objective to use these tools to play offense by seeing problems before they materialize. The CEO then positions the bank to gain a competitive edge, while their competitors (from both an operational and capital markets perspective) get blindsided.

I participated in a panel this month with regulators from the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corp. at the New York Bankers Association Financial Services Forum. The topic was how best to manage commercial real estate concentrations.

Part of the discussion revolved around the role of stress testing, which can be critical to showing examiners that a bank has enough capital to handle a risky portfolio.

Stress testing is a great tool for the job, but it's a tool, not the job. Banks that simply submit stress tests to regulators as evidence that they can manage a loan portfolio aren't going to get what they want.

Instead of viewing stress tests as an end game, bank CEOs need to think of them as tools to provide insights. Reports must be discussed at the board level and understood by the highest levels of management. And then the bank must adjust its strategy if the tests show a potential problem.

The trick to compliance is to not treat it as a compliance exercise. A bank CEO must say, I am going to use this as a strategic planning tool. A CEO cannot give a stress test to the chief risk officer and say make the problem go away. CEOs must look at the results, understand them and use them to adjust their strategic thinking.

A funny thing happened when I began talking about compliance on the New York Bankers Association panel. The regulators nodded their heads in agreement. ▪

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Read Between the Lines

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

What a Trump Administration Means for Community Banks

A Trump administration will likely mean changes to the Dodd-Frank Act, the controversial regulatory reform bill passed after the financial crisis. Republican control of the House and Senate may give new life to the 512-page proposed replacement from House Financial Service Chair Jeb Hensarling of Texas, **"The Financial Choice Act"**. Hensarling met this summer with President-elect Donald J. Trump to discuss the proposal, which was formally introduced in September.

Among other things, the bill would allow the largest, best-rated banks to opt out of Dodd-Frank and Basel III requirements if they maintain a 10 percent leverage ratio, though that would require billions in additional capital. The proposal would replace the Consumer Financial Protection Bureau with a Consumer Financial Opportunity Commission, run by a five-member panel rather than a powerful director. It would end too-big-to-fail and relieve the regulatory burden on community banks by streamlining their Call Reports. Hensarling's committee says the plan "requires financial regulatory agencies to appropriately tailor regulations to fit an institution's business model and risk profile, thereby reducing dead-weight compliance costs and allowing banks to devote more of their operating budgets to meeting customer needs." Trump's **transition website** said the new team will be working to "dismantle" Dodd-Frank and replace it "with new policies to encourage economic growth and job creation." Stay tuned.

OCC Will Establish Innovation Office

The OCC will open a central office for innovation in the first quarter of 2017, Comptroller of the Currency Thomas J. Curry said in a recent **speech**. The office will conduct outreach, provide technical assistance and work with banks and fintech companies that need regulatory advice. "Having an open dialogue with regulators in developing a pilot also helps by encouraging product and system designers to ask the right questions as they determine a product's features and the parameters of the test," he said. It will also ensure that new products meet consumer protection standards. Curry noted that the OCC is still evaluating the question of whether fintech companies could ever get bank charters.

CRE Section of Comptroller Handbook Updated

Worth Reading: The OCC has updated key sections of its "Community Bank Supervision" **booklet**, incorporating updated guidance on concentration risk management, stress testing, appraisals and more.

FDIC to Discuss Succession Planning

Expect the next meeting of the Federal Deposit Insurance Corp.'s community bank advisory committee meeting to include a discussion on succession planning. FDIC Chairman Martin J. Gruenberg asked the committee to include the topic, saying "it comes up in every meeting we have with bankers."

CRE Focus Continues

Regulators are approaching CRE concentration risk management on an interagency basis, with frequent communication about the issue. "We want to make sure we are out front of any problems," said Doreen R. Eberley, FDIC director of the division of risk management supervision, at an FDIC community bank advisory committee meeting in November. She said they expect community banks to have concentrations but they want to make sure they are managing them correctly. If a regulator asks a bank to maintain higher capital levels because of its CRE levels, then that is probably related to weaker underwriting or other deficiencies, she said.

Tips on Managing CRE

Regulators from the FDIC and OCC gave these CRE concentration risk management tips at the New York Bankers Association Financial Services Forum in October:

- A bank's CRE strategy should be included in its strategic plan
- Identify exceptions and track them
- Tie stress testing to the capital planning process
- Make sure the board has information on the assumptions used
- Identify what risk management parameters have changed
- Justify interest only loans, refinancing risk
- Make sure board minutes include discussions about changing trends
- Link stress testing to risk management
- Make sure market analyses are sufficient. ▪

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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