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As Consolidation Looms, Once-Reluctant Banks Begin M&A Conversations

By Lisa Getter and Kamal Mustafa

Even community banks that haven't contemplated a merger or acquisition in the past are now having frank M&A discussions in the boardroom. In an economic environment with artificially low interest rates and low yields, an M&A deal may be a better strategic option than organic growth for many overcapitalized banks.

Regulators are even giving banks an incentive to acquire. Under the Federal Deposit Insurance Corp.'s proposed small bank assessment **rule**, banks that grow significantly in a year may face a higher assessment rate, unless that growth is 'through merger or by acquiring failed banks."

So once a bank board decides it wants to embark on the M&A path, what should it do? How does a bank evaluate a deal and know when the price is right? How does it pick a target? And how does it evaluate the impact of an acquisition going forward?

Many banks still rely on legacy M&A analytics to answer these questions. But three things in recent years have rendered those analytics essentially obsolete: We are in a never-before-seen economic environment. U.S. monetary policy, with its near-zero interest rates, is also unique in this country. And banks are operating under a new set of regulatory restrictions since the 2008 recession. M&A analytics that do not take these three things into consideration will not accurately quantify a merger or acquisition.

New forward-looking risk analytics, which incorporate stress testing, regulatory capital and loan level vintage analysis, give banks a competitive edge in this new environment. Here, for instance, are six ways that appropriate strategic analytics can quantify the value of an M&A deal:

1. The same target has a substantially different value for each individual bidder based on the bidding bank's unique balance sheet and P&L, with a substantial focus on the risk reward structure of their individual loan portfolios. Multiples-of-book have zero value in this analysis and should never be used to establish a target price. They can be used to help in a "proceed/not proceed to bid" decision, assuming the balance of bidders are relying on these misleading analytics.

2. Since valuation is a function of each bank's condition, the value of a potential acquisition for two different buyers should not be the same. An acquisition is literally a compressed period of organic growth that must be measured. Banks must establish a baseline of what a target is worth to them before proceeding.

3. Targets must be evaluated, not in a vacuum, but in the context of market alternatives (primarily organic growth and secondarily, alternative transactions) to establish their true value to the bidder.

4. Subjective factors, which typically are difficult to quantify, should have the proper price/cost allocation applied to them to help management make an appropriate decision. These include the geographical footprint of the target, its deposit base composition, its regulatory capital and even its management resources.

5. Due diligence should not be limited to loan review, loan classification and ALLL.

6. The "to bid or not to bid" decision must be made early, before time and costs begin to mount. Nine out of 10 bidders end up on the losing side of a transaction. That's an awful lot of time and resources deployed for naught. (Except for the advisers, lawyers, investment bankers and accountants, who get paid regardless). Proper analytics can let a bank know whether to stay in the game. If a deal is borderline, and there are better opportunities in your region, don't jump into the bidding arena.

Editor's Note: *Invictus has developed a unique M&A analytical system built from proprietary forward-looking risk analytics linked to economic conditions. The system evaluates a potential target based on the capital structure, timing needs, product line, geography and yields of the acquirer. It allows banks to understand at what ceiling price a deal is worth, and what strategic options exist for the bank if it decides not to buy. The system also quantifies the hidden risks a target might present. It allows a bank CEO to explain this to a board: To win this deal, we must pay X, and the value to us is Y. Once a bank understands that equation, it can bid competitively, but will never overpay.*

*To find out more about these M&A analytics, attend the Bank Insights' complimentary **webinar** on November 6.* *(See story, p. 3).* ■

Inside this issue:

- How New Analytics Determine M&A Valuation *(p. 2)*
- Lessons from Serial Acquirers *(p. 3)*
- *Bank Insights* Sponsors Free M&A Webinar *(p. 3)*
- Regulatory Focus on Strategic Planning Continues (p. 4)

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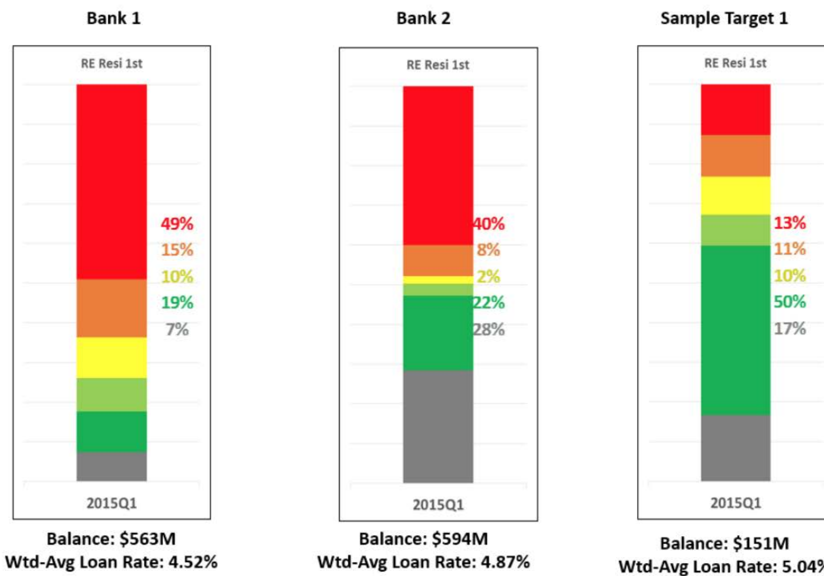
How New Analytics Determine M&A Valuation Based on the Acquiring Bank's Financials

By Andrew O'Keefe , Senior Strategist

Bank 1 and Bank 2 are roughly the same size. Each wants to bid on Sample Target 1. The value of the potential acquisition differs for each bidder, depending on its unique loan portfolio makeup. Invictus' proprietary analytics can determine the maximum price each bank should be willing to bid. This illustration is just one example of the determinants for acquisition pricing.

As the graphics show, Banks 1 and 2 have similar balances of residential mortgage loans. Each portfolio generates different yields due to the vintage of those loans. Bank 1 has grown faster than Bank 2 in recent quarters and has a higher percentage of lower yielding (and higher risk) loans, which are represented in red. Its overall weighted-average rate on loans (4.52%) is lower than Bank 2's rate (4.87%). Sample Target 1 would be accretive to both banks with a weighted-average rate of 5.04%.



So which bank can afford to pay more?

If we assume a multiple of 1.3xBV, the acquisition would provide about the same gross contribution to each bank's capital over a 1-year period* (75% for Bank 1 and 74% for Bank 2). But the acquisition must be valued in relation to alternative uses of capital. If each bank were to grow organically in the current environment, each would generate different returns due to the yield of assets in their portfolios. Assuming a market rate of 4.23% on new originations over the next year, Bank 1 would generate a return of 63%, while Bank 2 would generate a 73% return for the same amount of growth. Bank 1 can afford to pay a higher price for (and accept a lower return from) the same target.

**Measured as the PV of Gross Interest Income of the target and the bank (assuming no new originations) divided by Day 1 capital.*

Five Lessons that Banks with M&A Aspirations Can Learn From Serial Acquirers

By Adam Mustafa

After the financial crisis, a new crop of serial acquirers emerged in the community banking space.

These banks have developed and refined M&A as a core capability. Other community banks with aspirations for acquisitions can leverage some best practices commonly deployed by these serial acquirers. Community banks can also use new analytical tools to achieve these same objectives. Many banks are unaware of these new powerful analytics and don't use them. (See story, p. 1)

Here are five lessons in particular:

1. **These banks create deals, instead of waiting for them.** In other words, serial acquirers do not wait for banks to put themselves up for sale. Instead, they proactively approach banks and begin a courtship process. Even if the vast majority of banks say "no thanks," they move on quickly and leave their calling card behind. This approach yields a number of benefits. First, by being proactive, serial acquirers often preempt an auction, and in fact, many of them consider an

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auction process to be a showstopper. When serial acquirers send an offer letter, it typically comes with a "no-shop" clause as a non-negotiable condition. Second, this approach gives them scalability and increased efficiency. Each proactive attempt is a seed being planted. They plant seeds fast and the more seeds they plant, the more opportunities they can harvest down the road.

2. **They don't make low-ball offers.** Serial acquirers recognize that to successfully circumvent an auction process, they must be willing to make an attractive offer relative to the bank's condition. In fact, the offer is usually politely presented as non-negotiable, putting the onus on the target to "take it or leave it." Target banks can reject the offer, but they run the risk of not finding a better offer in an auction. The key to making attractive offers without overpaying is analytics. Serial acquirers recognize that a given bank has a specific value to them, and can also quantify how the value of a given bank would change if economic conditions change. This approach gives these banks a competitive edge in the market, and also makes them independent of investment bankers.
3. **They make decisions quickly.** Serial acquirers can value target banks very quickly, and can do so with only publicly-available data. They don't need to do exhaustive due diligence as part of the analytical exercise used to price the initial offer. Instead, due diligence is treated as an exercise that confirms there are no surprises. When receiving a reverse inquiry from another bank, they make "go or no go" decisions very quickly.
4. **They bring other forms of value to the table besides price.** Talk to any serial acquirer, and the one thing they promise to a target before they even send an offer letter is speed and certainty. When they make an offer, it should be viewed as "good as gold," barring a shocking discovery in due diligence. In many cases, they have received their regulator's blessing in advance.
5. **They view M&A as a priority in their strategic planning.** In other words, serial acquirers don't just dip one toe into the water. They jump in with both feet. While they are not always in constant acquisition mode, they treat M&A as a line of business when they are. They budget for it, they create timelines for it, and they measure how they are doing. Most banks with less deal experience take more of an "opportunistic" (i.e. reactive) approach to M&A. In other words, if "the right deal is presented to me at the right price, I might be interested." This approach is rarely effective and more often than not, leads to a low success rate when bidding in auctions or looking at banks that have already been shopped around.

Aspiring acquirers can apply these lessons without requiring any deal experience or having to be in a constant acquisition mode. In fact, Invictus is currently working with several banks to provide them with similar capabilities. Many serial acquirers are on a temporary break, focused on digesting their recent acquisitions. This has created a vacuum for would-be acquirers who are willing to take a similar, albeit aggressive approach to M&A. The Invictus approach uses new analytical tools that can help would-be acquirers gain significant knowledge about a target without ever having to contact it. ▪

About the Expert

Adam Mustafa *is a co-founder of Invictus and has been providing stress testing, capital adequacy advisory and M&A services to banks, regulators, bank investors, and bank D&O insurers since the beginning of the financial crisis.. 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.*

Bank Insights Sponsors Free M&A Webinar

The community banking market is consolidating. M&A opportunities may be attractive for even some banks that have never considered a deal in the past. Yet traditional bank analytics – which are widely used in the industry -- cannot help banks determine their appropriate strategic options.

Bank Insights **is sponsoring an hour-long webinar, "To Bid or Not to Bid: M&A Secrets and Essential Analytics for the Community Banking Market," on Nov. 6 at 11:30 a.m. EST. The webinar features Invictus Chairman Kamal Mustafa, the former head of global M&A at Citibank, who will discuss how new analytical techniques can accurately pinpoint at what multiple an acquisition would be equal or better than organic growth. He will show how new analytics can also facilitate interactions with regulators, optimize regulatory capital adequacy requirements and maximize M&A war chests. These new tools can highlight which loan categories are giving a bank – or its target – the best returns, and show bankers the ceiling price they should pay for an acquisition.**

To register, please click here.

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Read Between the Lines

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

OCC's Focus on Strategic and Capital Planning and M&A to Continue

The Office of the Comptroller of the Currency's examiners will have a "specific focus" on "determining the adequacy of strategic, capital, and succession planning" in 2016, according to the Committee on Bank Supervision's Fiscal Year **2016 Operating Plan**. This has been a priority for all bank examiners since the recession. OCC examiners will also scrutinize business models and strategy changes, as well as M&A processes and procedures. Other priorities for the coming year include credit underwriting, particularly HELOC end-of-draw periods, cybersecurity, interest rate risk, bank secrecy and AML compliance.

Reciprocal Deposits Lead to Ire in FDIC Small Bank Assessment Rule

Community bankers are objecting to the section of the Federal Deposit Insurance Corp's small bank assessment **proposed rule** that would treat reciprocal deposits like brokered deposits, saying that would in essence be a "significant new tax." The FDIC received 505 comments from community banks and trade groups on the rulemaking proposal, and most objected to the new treatment of reciprocal deposits. The letters noted that the FDIC did not give a reason or data to justify the change, which would lead to higher assessments for banks with reciprocal deposits.

OCC to Explore Ways to Promote Urban Rehab

Comptroller Thomas J. Curry wants to examine how the OCC

can support loan-to-value exception loans, even as it insists on strict underwriting standards to avoid mistakes that led up to the financial crisis, he said in **speech** to the City Club of Cleveland. Curry noted that home ownership levels were at their lowest since the 1960s, and he hoped that the OCC could devise parameters for banks to make exceptions "in a safe and sound manner." He said that banks might consider adopting policies and procedures that would identify how much money would be committed to a specific neighborhood and for how long, spell out specific underwriting, evaluation and compliance standards and institute a monitoring program with direct approval by bank's board.

Top Four Banks Hold 91 percent of Derivatives: OCC

The largest four banks hold 91 percent of the total notional amount of derivatives, and the largest 25 banks hold nearly 100 percent, according to the OCC's **quarterly report** on trading and derivatives. Derivative contracts are concentrated in interest rate products (78 percent), which gives larger banks an edge over community banks in hedging interest rate risk.

Regulators Propose Call Report Changes

The Federal Reserve, the OCC and the FDIC have **proposed revisions** to portions of the Call Reports to reduce the reporting burden for banks. Other changes are expected in the future. The proposed changes delete some items and change the reporting thresholds for others.

CFPB Wants to Survey Thousands about ATMs

The Consumer Financial Protection Bureau wants to conduct a web survey of 8,000 people as part of its study of ATM/debit card disclosure forms. The **survey** would explore consumer decision-making and experiences with overdraft fees.

Worth Reading: FDIC Overview on Rules About Bank Investments

The latest issue of **Supervisory Insights** offers an overview of the new regulatory landscape for bank investments in securitizations. The article notes that all financial institutions must understand the key features and risks of their investment securities and do everything they can to make sure they receive scheduled payments of principal and interest. It also gives advice on the investment decision process. Banks must be able to demonstrate to examiners that they understand all details of an instrument and all risk factors that could negatively affect its performance, including interest rate risk. ▪

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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