

Preparing to Acquire or Be Acquired

By Eliot Stark, Jacob Eisen and Tad Gage

Acknowledging the realities of today's community banking environment does not imply weakness.

The past decade featured two trends: bank start-ups and acquisitions of community banks by megabanks. How times have changed! Many start-up banks are now struggling with higher costs and capital constraints. What started as an “I can’t lose starting a bank” scenario has evolved into a “how can we survive?” mentality. This offers both challenge and opportunity for bank finance and accounting experts, and that’s what we’ll explore in this article.

Community bank acquisitions by superregional and megabanks resulted in the loss of many aspects of service and hands-on management that differentiate community banks from larger institutions. Large banks are under pressure to digest past acquisitions and also to shrink their businesses. As a result, small businesses and retail customers with higher service requirements are finding doors at large banks are now closed to them. This is the opportunity.

Some large banks are actively buying out credit and lending customers considered too small to service (these can be loans and credit lines running into the hundreds of thousands of dollars). This creates opportunity for community banks to capture solid, profitable business. The average asset size of community banks may increase, but the community bank model still is important. As large regional and national megabanks look for opportunities to garner loans and deposits by purchasing failed banks, there remains one key consideration: How well will business and retail customers be served?

The key to a community bank’s future is the availability of additional capital, including private equity sources that have not traditionally invested in the banking sector or that have taken a long hiatus from bank investing. With remarkably reasonable valuations and significant growth opportunities, the banking sector has captured the attention of capital firms with that valuable commodity: cash.

Bank finance and accounting executives must understand what this new breed of investors needs to see before committing cash and to prepare their companies for scrutiny. Institutions must make finances, capital position, asset quality, underwriting practices and market opportunity crystal clear to investors who may or may not be familiar with evaluating a bank’s present—and most important, future—value. Transparency and competency will be the hallmark of the next generation of high-performance community banks.

This transparency is necessary, whether a bank intends to seek growth capital or to achieve the highest valuation possible as an acquisition target. A merger of equals in complementary or relatively adjacent markets is another attractive option.

The smallest banks may not have access to the resources needed to grow or to become consolidators in their markets. This uncomfortable reality must be acknowledged and anticipated. Bank executives must analyze their company’s realistic growth opportunities in light of certain consolidation. Banks that do not have the potential to grow can do themselves and their stakeholders a service by acknowledging that they are potential acquisition targets and making themselves easy to understand and analyze.

Assessing the realities of today’s community banking environment and being prepared for them does not imply weakness. When two or more healthy, well-capitalized banks merge, they can frequently

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obtain an infusion of capital that would otherwise be unavailable to the individual parties. Banks with a certain mass have a better chance of attracting capital. A \$50 million capital raise is an easier case to make to investors than a \$15 million financing.

Information Needs of Investors

Whichever scenario seems more likely (to acquire or be acquired), potential investors will want to understand certain key areas. Today's investors need you to make it easy to analyze your company's financial statements and market opportunity.

Without a cogent plan and transparent financials, a bank that hopes to grow or be a consolidator will be dismissed by investors—too much work. Without these same metrics in hand, a potential acquisition target will be undervalued because it is too difficult to understand and correctly value. Here are some key metrics:

- Fair valuation
- Asset quality
- Book value
- Nonperforming assets and loan-loss reserves
- Underwriting practices
- Real estate loan participations
- Net-interest margin
- Capital adequacy
- Management and board

Fair valuation. Current valuations have affected many banks' capital adequacy positions. Fair-value reassessments have had an extreme impact not only on banks' assets but also on their capital adequacy. For banks that have made acquisitions during the past few years, goodwill impairments have dealt a serious blow to earnings. Yet these noncash impairments may have little to do with the actual value of the acquisitions and their contribution to growth and revenues. The same holds true with high-quality securities and other investments a bank might hold.

Going forward, bank finance and accounting executives should develop their own analysis of their fair value of assets. Do the recommended write-downs reflect your true opinion of the value of your bank's investments and assets? You can make the case for the future value of investments your bank plans to hold. Even assets that have been written down and removed

from the balance sheet could recover some value. A cogent case for the value of your bank's assets can affect an investor's or acquirer's assessment of your bank's real value. Don't expect potential acquirers or investors to do the work. Do it yourself and be prepared to justify your conclusions. It could have a positive impact on the ultimate analysis of your bank's financial health.

Asset quality. Even the sharpest bank investors admit that valuing asset quality has been almost impossible. Many loans that looked solid when they were made are now underwater. Even loans made at 50 percent LTV (loan to value) or less, whether current or nonperforming, can represent potential losses. In this situation, banks have the opportunity to explain their markets, their customers and the long-term value of their investments—even if below traditional market valuations or illiquid. Potential investors or acquirers will listen to a cogent argument. Even investments in securities, including currently illiquid but quality securities, can be explained and detailed. Collateralized debt obligations (CDOs), derivatives or investment in subprime instruments? Certainly these are tough sells, but knowledge of their potential value and the cents-on-the-dollar buyers' market will help value these assets. Millions of dollars are being dedicated to funds that are purchasing questionable assets, and banks should investigate removing such assets from their balance sheets. In many cases, it's better to shed these than to attempt to explain or justify them to a potential acquirer or financier.

Book value. A few years ago, book value seemed like a relatively straightforward number. With current concerns about asset quality, book value requires a great deal more justification and explanation. Yet it remains a critical element of valuation and of determining mutually acceptable premiums in merger and acquisition (M&A) negotiations. Capital raising may dilute book value, and this needs to be taken into account. Earnings and cash flow—not book value—will be the key values for determining the worth of your bank in the future.

Nonperforming assets and loan-loss reserves. This subset of overall asset quality must be crystal clear. General economic uncertainty is no longer an acceptable excuse for failing to document current and potential nonperforming assets (NPAs). For more than a year, bank investors have maintained that the first announcement of a troubled loan portfolio is almost always the tip of the iceberg. In most cases,

they have proved correct. Therefore, traditional and nontraditional bank investors are cautious about portfolio values. Granularity regarding a loan portfolio is an overused but appropriate mantra for all banks. Portfolio mix and exposure to sectors such as commercial real estate and real estate development and construction need to be justifiable on a case-by-case basis. Even commercial and industrial loans require a detailed explanation of mix and quality, placed in context with overall market health and opportunity. Residential lending requires explanation of current market conditions and market opportunity.

Underwriting practices. Banks able to demonstrate responsible underwriting, clear loan review policies and a strategic plan for developing a diversified portfolio mix have an edge in making the case for a capital infusion. Transaction-driven real estate deals cannot support a proper growth strategy for the future. For community banks, developing an alternative to construction and development and real estate loans is an imperative.

Real estate loan participations. Any lending activity that occurred outside your bank's traditional loan decision and underwriting practices must be thoroughly explained. Good decisions can be justified by demonstrating a cogent rationale behind the participations. If some loan participations defaulted, requiring write-downs or write-offs, a clear case needs to be made to explain the rationale for participating and to demonstrate how policies have been changed to avoid future exposure. Investors and acquirers view participations with skepticism, and for good reason. Many community banks stepped outside their markets and turned over their underwriting oversight to others. If your bank is living with loan participations, this is a significant obstacle. If they need to be written down, do so. If they have value, justify them and explain the rationale behind the investment and the underwriting principles behind the participation.

Net-interest margin. While interest rates are anyone's guess, community banks with good service and strong product selections can attract loans and deposits without having to compete for a few basis points. Your business model needs to justify why your bank can command higher rates, whether based on a service package, free checking, remote deposit capture, lock-box or cash management, etc. The critical component is capturing a larger percentage of a customer's business and explaining this revenue-generating capability to in-

vestors or acquirers. Solid spread banking is returning. Consumer penalty fees and loan transaction fees will in all likelihood form a smaller part of future income.

Capital adequacy. If, after the past year, your bank still has sufficient capital to meet the increasingly strict adequacy requirements, you are in an outstanding position. But you probably need more capital if you want to continue growing and lending. You can leverage this information to prepare for a potential capital raise, growth or merger activity by explaining current and future capital obligations. You should include calculations of current and anticipated Federal Deposit Insurance Corporation (FDIC) premium liabilities, compliance and regulatory costs and ability to meet higher capital obligations with current resources.

Management and board. Your future is going to hinge on the capability and depth of your management team. A detailed assessment of the capabilities of your lending, risk management, finance and operations team is paramount. Institutional capital will only flow to institutions with high-caliber management teams. Make the assessment and make the changes now. These steps will increase your value whether you wish to become a consolidator or a seller. As to the composition of your board, independence and business acumen are critical. Make sure that your board truly understands your business strategy, tactics, risks and how to measure and control these components.

What Investors Need to Understand

Most investors interested in banks indicate they want their capital used primarily for growth—not for pure recapitalizations. A combination of growth and operating capital may be acceptable. Here again, bank finance executives can do their organizations a real service by detailing how the bank would allocate fresh capital: what percentages would go to improving capital adequacy, replacing Troubled Asset Relief Program (TARP) funds (if applicable), operational improvements or upgrades, personnel and marketing and expansion.

Beyond the numbers, a bank needs to add color to this analysis. For example, explain specific lending, deposit and service offerings that have succeeded and merit additional resources. Justify full-service branch or loan production office expansion by detailing

served markets. Justify opportunities to take market share from other banks with specific and detailed analysis of customer trends and requirements. What needs are not being sufficiently met by competitors?

Banks facing anticipated capital shortfalls have fewer options. However, options do exist. If the franchise is competitive, sound and healthy, the same type of in-depth analysis may facilitate an effort to raise capital from existing stakeholders. There may be opportunities to reach out to local resources, including customers, to obtain additional capital. A shareholders' rights offering is perhaps the least dilutive option, giving current holders the chance to build their positions in your bank on a relative basis. More dilutive efforts can be justified to current stakeholders by demonstrating the long-term value-generating potential.

The M&A Environment

If a realistic financial assessment points to a merger or acquisition to continue effective operation, a high level of internal due diligence can facilitate valuation efforts by merger candidates. These efforts can maximize an acquisition candidate's value, and that is a winning proposition for cur-

rent stakeholders. Banks that believe they might present an attractive merger or acquisition opportunity can take the lead in identifying potential buyers. Private equity and institutional investors will consider roll-up opportunities involving two or more banks.

Whether a bank is a potential acquirer or target, it must be able to demonstrate that the value of a merger exceeds the sum of the parts. An acquisition certainly does not have to be part of a bank's growth plan, but acquisitions can provide cost-effective access to locations, deposits, loans, personnel and skilled management.

For any bank considering a capital raise or M&A, management is a critical element. While it is impossible to quantify the value of a management team, the skill and experience of management figure heavily into investors' decisions to back a particular bank. Management, senior officers and directors should be part of the value equation.

Community bank executives must anticipate and prepare for the future. Banks with superior internal due diligence and the ability to enunciate intangibles such as management and market opportunity have a distinct advantage in attracting growth capital or preparing for M&A opportunities.

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