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ANALYST ROUNDTABLE

Community Bank M&A Picking Up As Seller Expectations Come Down

BY ROBERT BARBA

An increase in community bank acquisitions is expected in 2011, and a multitude of factors could inform the ultimate decision to sell.

During an *American Banker* roundtable held in early November, panelists said leaders of community banks face assorted regulatory pressures, capital constraints, unrelenting credit issues and a lack of income opportunities. All that said, perhaps the underlying catalyst for many bankers may simply be burnout.

"What I'm really seeing with many smaller banks is that they are fatigued, and the directors are fatigued," said Robert Kafafian, president of The Kafafian Group, Inc. "When they get fatigued, it's when they often say, 'OK, we'll almost get out at any price.' "

Kafafian was joined at the roundtable by Theodore Kovaleff, an analyst at Horwitz & Associates, and Christopher McGratty, an analyst at Keefe, Bruyette & Woods Inc. Consolidation was clearly on the minds of all panelists, each having a different view on what would spur activity.

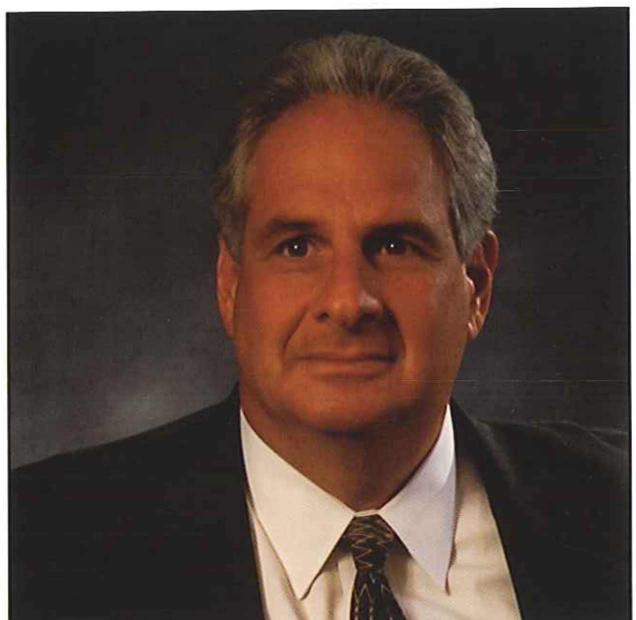
"A lot of people want to talk about M&A," McGratty said. "I think we've got to keep in mind that some of these banks are selling for a reason, and they're selling because they have problems."

The panelists said distressed banks looking for an alternative to failure will make up the bulk of potential sales. Fortunately, there's a growing market of buyers interested in such banks, since deals with the **Federal Deposit Insurance Corp.** have become smaller and the enormous bargain-purchase gains booked by buyers during the first wave of failures in 2009 have largely dried up as loss-sharing agreements have become less lucrative.

"The gains that banks are recognizing up front are modest at best," McGratty said. "The economics aren't as good and there is less incentive to bail out the government."

Aside from the strugglers are the small banks that fear for their survival under the Dodd-Frank Act.

"I think that you're going to have a lot of small institutions be purchased or acquired simply because the cost of being a small institution has gone up and will continue to go up," Kovaleff said. "In a number of cases, it's just not going to be economically feasible in the long run to be a small institution."



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To be sure, market consolidation has long been predicted and deals began to trickle in during the second half of this year, when several were announced. Those are the harbingers, analysts said.

"I think you can look at some of the recent acquisitions as a prologue to more," Kovaleff said.

The panelists said what has changed is that sellers are more willing to accept a lower price than they may have in the past just to get out while they can.

Kovaleff said **Berkshire Hills Bancorp** Inc.'s deal for **Rome**

Bancorp Inc. in upstate New York illustrates how sellers are settling for less. The deal, announced in October, is valued at $10.81 a share.

"The head of Rome had looked for least $12 as a selling point the last time I had talked with him," Kovaleff said. "That's a major change in expectations, and I'm sure that we're going to see that throughout the country."

Certain healthy banks will be unwilling to take such a discount, Kafafian said.

"There are some financial institutions that are healthier that are considering sales at this time, but what they're finding is a lack of buyers," he said.

"Oftentimes the prices that are being offered are unacceptable to them," Kafafian added.

Still, the analysts said that the advantage is clearly on the side of buyers, who have plenty of options. Beyond bargains, experts said potential buyers are squarely looking for candidates with strong deposit bases.

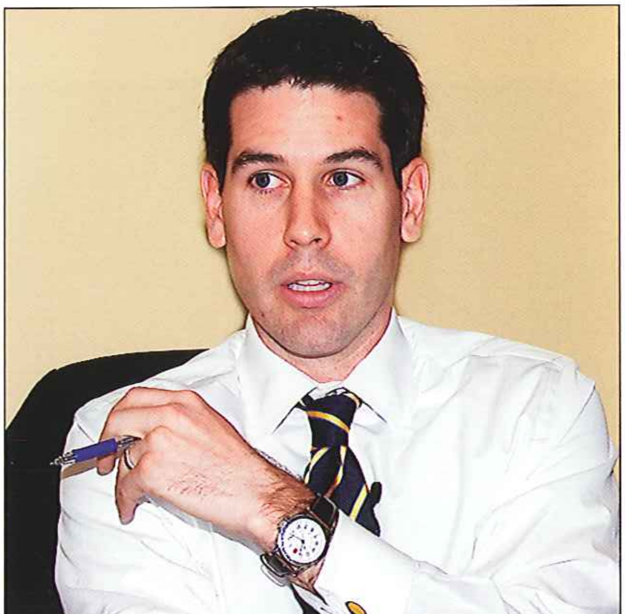
effect. McGratty said banks that were accustomed to 20% return on equity before the financial crisis can expect a future of low-teen returns at best in the future.

"They are going to make a lot less. I mean, ROEs are going to be lower because capital requirements are going higher," McGratty said. "It's more of a sobering outlook."

That is bit skewed, McGratty said, because banks are coming off of a cycle of record-breaking profits. "What people will remember is that we came from probably peak profitability and peak leverage and it's not going back there."

Beyond the expected costs of new regulation, analysts said they worried about how prepared banks are for interest rate increases. With low rates, community banks have seen massive increases in noninterest accounts and low-cost certificates of deposits.

"While there are customers that are accepting 50-basis-point CDs today or don't pay attention to the interest rate on their checking, when rates do ultimately start to rise, then they will



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Christopher McGratty
Keefe, Bruyette & Woods

Photos: Michael Chu/American Banker

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Theodore Kovaleff
Horwitz & Associates

"Core deposits are the biggest driver of franchise value," Kafafian said.

Businesses that will bring in substantial fee income are also on buyers' wish lists, panelists said.

"Banks are clearly attracted to fee-income platforms that are non-capital-intensive, but are high-return businesses," McGratty said. He added that those lines, which include trust and wealth management, are rare at community banks.

The pursuit of such lines highlights the role that revenue growth, or the lack of it, will play in consolidation. Though credit costs are waning, analysts added that finding ways to be profitable is going to remain a challenge.

High returns are a thing of the past as new regulations take

start to get more rate-sensitive again," Kafafian said.

With loan demand remaining low, banks have put excess liquidity into securities. Although securities provide less yield, they allow banks to stay fluid and adjust for changes to interest rates.

"Banks are very cognizant of staying very short in terms of duration," McGratty said. "They're willing to give up margin today to ensure they do not jeopardize their balance-sheet strength in the future."

Kovaleff said investing in securities also is useful for would-be buyers.

"Should an opportunity come along — for instance, in M&A — they can cash in their chips and not have to necessarily take out loans because they're stuck," he said.