


# THE KAFAFIAN GROUP INC.

*...helping banks perform better™*


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# TKG Perspective

## What Does Reviewing Strategic Alternatives Mean to You?

**By Jeffrey P. Marsico, Executive Vice President**

I recently read the following headline: "Next step for ABC Bancorp could be 'strategic alternatives'." It could have read, "ABC Bancorp is out of options and should sell." *[The name of the bank was changed to protect their identity.]* After reading the article, that message came through loud and clear.

Since then, I asked a group of industry CFOs and controllers what they thought evaluate strategic alternatives meant and their answer was "Sell!" I have written or spoken about why banks should do strategic alternative analysis as part of their annual strategic planning process.

Why should a bank routinely evaluate strategic alternatives? I offer the following reasons:

- It's the Board's fiduciary responsibility to stakeholders;
- It places a value on the execution of the strategic plan;
- It gives you the knowledge to respond to unsolicited offers;
- It sets strategic plan benchmarks by identifying a "strategic gap", if any;
- It helps plan for capital needs;
- It holds senior management accountable;
- It creates a targeted radar for would-be partners (either buyers, sellers, or MOE's);
- It establishes or supports an execution and accountability culture.

In our experience, undertaking a strategic alternatives review typically comes when the Board and senior management are of a mind to sell, and the review tends to focus on who the likely buyers are and what they could pay. This is a very narrow application of an important strategic endeavor.

We envision a scenario when a Board undertakes the exercise annually, typically in conjunction with strategic planning. Why? Because strategic plans project out, in financial terms, what success would look like. Applying the present value to the future earnings stream gives the Board and management an estimate of the value created by the plan. Comparing that value with what a financial institution can achieve in a sale is the basis for strategic decision making.

For example, let's say that Bank A trades at $11 per share. Note this analysis applies to non-public and mutual financial institutions as well, just not on a per share basis. But for this example, let's assume Bank A has public shareholders.

The present value of successfully executing Bank A's strategy is estimated to be $13. This sounds good since they are projecting to increase franchise value. But, in the course of performing a strategic alternative review, the bank determines it could reasonably expect to sell for $15 per share to another financial institution with similar prospects (more on this concept in a moment).

The difference between the present value of the strategic plan and what the bank can reasonably expect in a sale is what is known as the "strategy gap". This gap must be bridged during the strategic planning period. See the table below for the hypothetical strategic gap calculation.

| | | |
|---|---|---|
| Present Value of Strategy | $13 | Gap 13% |
| Reasonable Sale Expectation | $15 | |
| Minimum Board Expectations | +/-5% | |
| Additional Value Per Share Needed | $1.25 - $2.00 | |

## Watch for Us

### Teaching/Speaking Engagements

**Washington Bankers Association**
***Executive Leadership Development Program***
Washington Athletic Club
Seattle, WA **March 7**
*Bank Profitability*

**American Bankers Association**
***School of Bank Marketing and Management***
Southern Methodist University
Dallas, TX **May 15-22**
*Product and Customer Profitability*
*Profitability and Strategic Issues*

**Maryland Bankers Association**
***116th Annual Convention***
The Sanctuary at Kiawah Island
Kiawah Island, SC **June 4**
*Directors Duties and Responsibilities*

**Pennsylvania Bankers Association**
***PBA School of Banking***
Penn State University
State College, PA **June 4-8**
*Strategic Decision Making &*
*Organizational Structure*

### 2012 Conferences & Conventions

**New Jersey Bankers Association**
***Directors and Managing Officers Conference***
Renaissance Woodbridge Hotel
Iselin, NJ **March 30**

**AMIFs**
***Annual Convention***
Ritz-Carlton Hotel
Phoenix, AZ **April 25-27**

**Pennsylvania Bankers Association**
***Annual Convention***
Fairmont Scottsdale Princess
Scottsdale, AZ **May 16-19**

**New Jersey Bankers Association**
***108th Annual Convention***
Charleston Place Hotel
Charleston, SC **May 30-June 3**

**Maryland Bankers Association**
***116th Annual Convention***
The Sanctuary at Kiawah Island
Kiawah Island, SC **June 3-6**

**Florida Bankers Association**
***Annual Convention***
The Boca Raton Resort & Club
Boca Raton, FL **June 10-13**

**North Carolina Bankers Association**
***116th Annual Convention***
The Hilton Head Marriott Resort & Spa
Hilton Head, NC **June 16-20**

**Financial Managers Society**
***Finance and Accounting Forum***
Red Rocks Casino Resort & Spa
Las Vegas, NV **June 24-26**

Such an analysis leads to the strategic discussion of how to bridge the gap and generate an additional $1.25-$2.00 per share in franchise value. Ignoring such a gap does not make it go away. As a former Navy captain once said, "bad news does not improve with age."

Performing the strategic alternatives review gives Bank A options to bridge the strategy gap, such as:

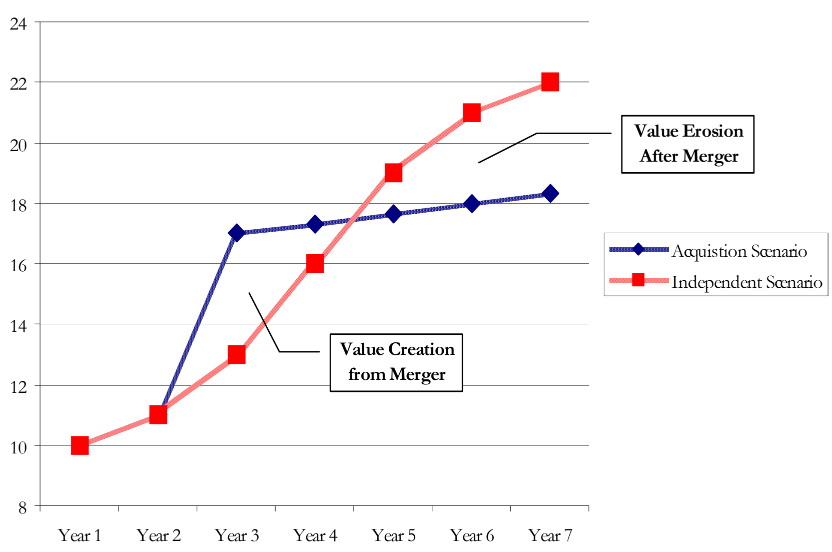
- Make or accelerate strategic investments to improve earnings growth;
- Cut costs;
- Undertake various margin expansion initiatives;
- Develop profitable fee income initiatives;
- Undertake strategic acquisitions to achieve cost savings and accelerate earnings growth; or
- Sell.

When you don't perform a routine strategic alternatives review, quite often you are left with only the last one or two options. You may not have the time or resources to execute on the others. There may be situations where ignorance is bliss, but this is clearly not one of them.

This brings me back to the concept of the prospects of potential buyers. When the analysis shows that Bank A can reasonably attain $15 per share in a sale, the next question to ask is fifteen dollars of what? If it is cash, then the value is known. If it is the buyer's stock, as frequently is the case, then Bank A's Board must assess the prospects of the buyer.

When I first described this concept to a client, I drew the chart below on the back of a sheet of paper. I wish I had a napkin, because it would make for a better story. But no, as I remember, I drew it on a piece of paper and have since created a representative chart of the original.

Rarely do we see bank M&A transactions where the announced per share price is less than the seller's trading price prior to announcement, although there are exceptions. Your bank can likely achieve a higher takeout price than your trading price because of the unnecessary duplication of effort a combination creates… the proverbial cost savings.




But after you receive your "pop" in a sale, what's left? In the example shown, you can see value creation in the difference between the independent and acquisition scenarios up to year 4. But look what happens after year 4. The independent scenario begins generating greater value than the acquisition scenario.

None of this knowledge is possible without doing regular strategic planning that includes projections on what success would look like, and assessing the prospects of would-be buyers. <u>When we perform such analyses for clients, we are gratified that the discussion that ensues is strategic, productive, and disciplined.</u>

In conclusion, waiting to perform a strategic alternatives review until you have few alternatives left further supports the notion that such reviews are the precursor to a sale. However, performing such reviews regularly, either with internal staff or by using a trusted advisor, gives Boards and management the needed information on how best to formulate strategy to earn your Bank's right to remain independent. Wouldn't you prefer the keys to your shop be in your hands?

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