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THE MERGER MARKET

“Pricing doesn’t solve culture issues – if the target doesn’t feel like a fit, a great currency will not fix that mismatch of cultures.”

Rick Childs, Partner, Crowe Horwath LLP

It’s certainly not inaccurate to characterize the M&A market for community institutions in 2017 as active, provided one takes into consideration not only the deals that actually got done, but the serious discussions of possibilities that took place in offices and board rooms as well. While most institutions try to maintain a standing game plan for how to proceed with either side of a potential transaction, many of those plans likely received a serious airing over the past twelve months – whether or not they ever got to the point of real action.

So even though it wasn’t a record-setting year for deals, pricing and other factors led to an environment that was nevertheless thick with the intrigue of potential. What was fueling these considerations, and what does it mean for 2018? FMS checked in with Rick Childs of Crowe Horwath LLP and Robert Kafafian of The Kafafian Group to get their takes on where the M&A market stands and where it might be headed.

FMS: What are some of the factors driving M&A activity in the current environment?

RICK CHILDS: First and foremost, I believe that the current prices being realized by institutions of all sizes have led to a decision threshold for many boards and shareholders of banks, because they likely view the environment as the perfect storm of pricing and enthusiasm in the marketplace. Many community institutions have management and board succession issues, as well as potential shareholder liquidity events looming; for these institutions, the impact of pricing strength is a welcome potential solution to those issues.

Early in 2017, I believe there was optimism among many community institutions that regulatory relief would be enacted, and that such relief would increase the feasibility for many to continue to thrive and remain independent. As some of that optimism has eroded, it may be spurring more institutions to seek an acquisition partner.

ROBERT KAFAFIAN: Since 2008, for the most part, large banks have been out of the M&A business – particularly when it comes to buying other banks. They’ve been mostly sitting on the sidelines. In other words, since the Great Recession, a lot of the M&A discussions and transactions have been primarily among the community institutions.

Many institutions are realizing that they may not have the scale they need, they may not have the performance they want, they may not have the management succession in place to extend themselves into the future – there are a lot of factors that are causing them to review their strategic alternatives. In light of all of this, there have been a lot more discussions between community institutions regarding mergers of equals – even if many of those haven’t led to actual transactions, often for social reasons.

The one that’s particularly interesting here is the succession issue, because even though a lot of institutions probably don’t want to admit it, that may in fact be what’s pushing them into M&A discussions. The smaller the institution, the more difficult it is to have a stable of successor employees lined up to move into management positions.

FMS: Where do things stand in terms of pricing?

CHILDS: The pricing for most sizes of sellers is up significantly from the same period in 2016. The median overall price/tangible book value for all announced deals through September 30, 2017, compared to the first nine months of 2016, increased approximately 28% year over year. This has resulted in an overall median price/tangible book value of almost 165%.

KAFAFIAN: Pricing has clearly moved up, but there’s also a pretty wide gap between some of the top deals and some of the lower-end transactions. After the recession, we saw pricing get down around, and often below, book value. Now there have been a few transactions recently that have been closer to, and above two times book value, so multiples are clearly rising. But there are still some institutions that have issues, so not every bank can expect to get full price, and there’s still a wide gap.

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“There are a lot of institutions that think that the rising tide (of pricing) is raising all boats, but the reality is that it may not be raising them as equally as it has in the past.”

Robert Kafafian,
President and CEO, The Kafafian Group

FMS: What are some of the emerging factors or trends for an institution considering either side of an M&A transaction to be aware of?

CHILDS: Much of the pricing increase realized in 2017 has been the result of the increase in the performance of publicly traded bank stocks. This provides sellers with better results on the day of closing, but also provides some risks in terms of price protection from a decline in the received currency, post acquisition. As a result, sellers need to perform due diligence on buyers – including the factors that are contributing to stock performance and the sustainability of those factors. In the letter of intent and definitive agreement, sellers should consider whether price protection in the form of a collar should be considered to provide an opportunity to protect shareholders from a price decline at the buyer. Additionally, sellers should consider the volume of daily trading to gauge the ease of being able to diversify shareholders’ holdings without unduly affecting the market price.

While strong stock price for the buyer can make an expensive transaction easier to achieve, buyers shouldn’t lose sight of pricing fundamentals when doing a transaction. Pricing also doesn’t solve culture issues – if the target doesn’t feel like a fit, a great currency will not fix that mismatch of cultures.

Because of CECL’s pending implementation, I also think buyers should pay close attention to the quality of the data they would be taking on at the selling institution, as it may add hidden costs to the transaction that impede the buyer’s ability to efficiently implement CECL at the acquired institution.

KAFAFIAN: The two biggest factors that we’ve been seeing for successful community institutions in the long term are the ability to adapt to changing technology and the ability to manage human capital – how they develop their employee base in order to stay relevant, successful and independent.

In the next 15 years, the industry is likely to be flipped on its head as Millennials start to accumulate wealth, become CEOs, start companies and have growing families. The way that they’ve learned how to bank is materially different than older generations. So the industry needs to be transitioning towards that in terms of the technology and human capital, while not abandoning its current core customers in the Baby Boomer and Generation X age groups. The institutions that come through this transition successfully are likely to be the ones that will emerge from the pack, and become the next group of consolidators.

FMS: What are the prospects for M&A heading into 2018?

CHILDS: I believe that 2018 will be similar to 2017 – that is, a steady flow of transactions in most regions and for most institutions. The stock prices of buyers clearly was the story in 2017, and the tone of 2018 rides upon the realization of the drivers of stock price increases.

If the stock market retracts, as some have suggested, it is likely that bank stocks will follow and that could have a slight chilling effect on transaction pricing and deal volume. If tax reform does not materially impact overall corporate tax rates, then some of the optimism built into bank stocks will also likely evaporate. If net interest margins don’t expand as much as anticipated from the rate increases at the Federal Reserve, there again there could be a bit of a pullback on stock prices.

KAFAFIAN: Within the next two years, some of the larger banks may get back into the M&A game, and there may also be more action in the $25 billion to $50 billion asset group, as well. So the risk factor for the smaller institutions is that if they wait it out, they may wind up not finding enough candidates to attract desired price levels.

Throw this idea in with some of the other factors we’ve discussed, and add in the potential economic landscape of the next recession, and you have a very interesting time for community institutions to navigate. ▪

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