WANNA BUY A BANK?

THE CURRENT M & A LANDSCAPE IS ALL IN THE NUMBERS

By Christina P. O'Neill

"Banks aren't bought – they're sold." We've heard that phrase from many sources, which means there are more sellers than buyers, with many smaller sellers looking for larger buyers. The economy, technology, demographics and regulatory costs all play a part.

Big picture: There were more than 18,000 banks in the U.S. in the 1980s. By third-quarter 2013, the FDIC reported that the count was 6,891 banks, the first time the count dropped below 7,000 since the FDIC began keeping records in 1934, and predictions are that the number may drop below 5,000 in the next five to seven years.

Meanwhile, national deposits have increased from about $2.5 trillion in the 1980s to $9.60 trillion today. With the top 10 banks controlling 60 percent of overall deposits, there are fewer banks, but there are more branches now than 20 years ago.

Bank consultants often say that a bank CEO's age can be an indicator of its likelihood to sell. Retiring senior management may want to convey an intact organization to another entity, to deliver value to long-time shareholders and also to avoid letting employees go, in the hopes that many will find positions within the acquirer.

Kevin Cummings is president and CEO of Investors Bank, a $16 billion bank with more than 130 branches. "Sometimes it's easier to sell," he says. "It gets down to social issues and then financial issues. Sometimes social issues rule the day because community banks are like a family business [in their communities]."

GROW OR SELL

Today's low rate environment hampers organic growth. Banks that can't consolidate or merge with an equal partner may decide it's time to sell, says Robert Kafafian, president and CEO of The Kafafian Group, a Parsippany-based bank consulting firm.

In the last three years, mergers and acquisitions have been coming in at prices well below seller expectations. Kafafian says sellers are usually uncomfortable selling for less than book value or less than breakup cost, and are often holding out for a stronger market. Typically, the smaller the bank, the more pricing is based on book multiples; the larger the bank, pricing moves towards earnings multiples. He adds, absent the continued discount pricing of troubled banks, multiples have improved overall.

The closer a bank is to a major metro market, the more intense the competition, particularly from larger banks, says Kafafian. Larger banks across the country are exiting rural areas, leaving smaller banks a better chance to compete in those markets, particularly since the largest banks have retreated from M&A activity given regulatory pressure.

WHAT'S CAUSING M&AS NOW

Low yields that dampen stock performance have pushed stock prices below book value in recent years, due to an inability to generate sufficient returns. And the pressure of regulatory and personnel costs on the expectation of shareholders has also crimped smaller banks. It's a commonly stated benchmark that a bank has to be at the $1 billion asset level to provide adequate returns to shareholders.

Christopher Martin is chairman, president and CEO of Provident Bank, which is acquiring privately-held Team Capital. At press time the deal had been approved by both banks' boards, and was awaiting regulatory and shareholder approval. The combined entity would have $8.3 billion in assets after closing and would have 90 branches in 13 counties in New Jersey and three counties in Pennsylvania.

Martin notes that both banks want to put their capital to work, and that their combination is expected to yield better performance for both.

Blending two organizations requires two-way communication, Martin says. The two banks discussed what the organizational pressure points might be regarding blending the staff, and to make sure both institutions shared similar risk tolerances and credit culture. Martin's former bank had been purchased by Provident in 2004. "How would you want to be treated?" he asks rhetorically.

ECONOMIES OF SCALE

Patrick Ryan, president and CEO of First Bank of New Jersey, agrees that regulatory costs are driving the tendency toward bigger banks. He says First Bank's merger with Heritage Community Bank, which got regulatory approval last December, was an example of finding a bank in an adjacent market in which First Bank didn't have a significant foothold, and also to generate economies of scale. When talks began, First Bank was in the $400 million asset range, while Heritage was in the $140 million range. The larger entity could offer larger lending limits – a winning formula. "You spend as much time on a $1 million loan as a $10 million loan, but [the latter] generates significantly more revenue," Ryan says.

Merger talks began in late 2012; the merger became effective March 7. First Bank grew well on an organic basis through 2013, ending the year with approximately $470 million in assets. The combined post-merger entity has more than $600 million in assets with eight branches.

During the 2008 financial crisis and its resulting lack of liquidity, a lot of capital left the banking industry, and it hasn't returned for the smaller banks, he says. This essentially cut off growth capital for banks not big enough to generate returns sufficient to allow investors an eventual remunerative exit.

MORE THAN A TYPICAL COMMUNITY BANK

When 1st Constitution Bank acquired Rumson-Fair Haven Bank and Trust Co., effective February 7, the combination created a $1 billion banking entity with 19 branch banking offices in Central New Jersey, primarily in Mercer, Middlesex, Monmouth and Somerset counties. 1st Constitution was approximately $800 million in assets, and by acquiring Rumson-Fair Haven, at $200 million, added five branch banking offices in Monmouth County.

Robert F. Mangano, president of 1st Constitution Bank, said the bank has built several key business lines making it more diverse than the typical community bank. So, the merger became not only a territorial overlay, but a means of bringing more business segments to the Monmouth County area served by Rumson-Fair Haven, particularly 1st Constitution's residential mortgage business, its construction lending business, and its SBA small business lending unit. 1st Constitution has been a preferred SBA lender in New York, New Jersey and Pennsylvania, a line of business in which Rumson did not have a focus.

Mangano also indicated that 1st Constitution's legal lending limit is now approximately $16 million, compared to Rumson's at $2.8 million. He said that with these additional lines of business, he was looking forward to serving the broad base of consumers and businesses in Monmouth County.

HEALTH OF THE NJ MARKET

The New Jersey market is paramount in market attractiveness, despite the recession and the subsequent lack of strong job creation, making its M&A climate healthy.

As of June 30, 2013, Bergen County had 48 banks, holding over $41 billion in deposits. Kafafian says big banks are withdrawing from M&A activity that they'd dominated, pre-recession.

"Geography is still critically important in the M&A world today," says Tom Shara, president and CEO of $3.32 billion Lakeland Bank, which acquired $368.9 million Somerset Hills Bank last year. Somerset had been performing well for many years, and the two banks' markets were contiguous with limited overlap and their culture and balance sheets were similar despite the size difference. At the time of the acquisition, Lakeland, with 46 offices, was almost eight times Somerset's size.

Stewart McClure Jr., currently chair of the New Jersey Bankers Association, is Lakeland's regional president. The wealthy Somerset and Morris counties have many small to midsized businesses that have been a solid customer base for both banks. Because Lakeland was so much larger than Somerset, positions opened up for Somerset employees, and the bank was able to keep customer-facing employees in place. After six months, deposits have actually increased in the former Somerset market area. Additionally, a title company originally part of Somerset and now half-owned by Lakeland has contributed fee income, and can contribute a larger revenue stream than it did at the smaller Somerset. Loan limits increased as well, from $5 million to $20 million.

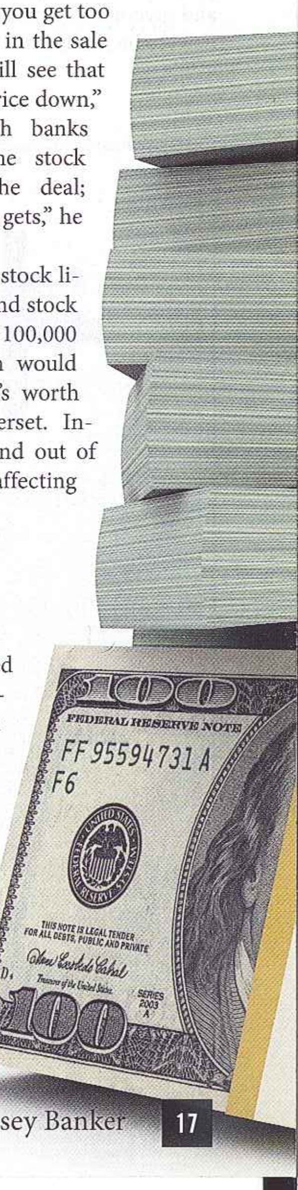
Donald Musso, president of Liberty Corner-based consulting firm FinPro Inc., says New York and New Jersey aren't likely to offer banks a growth engine for loans coming from new companies, so the trend may be to see more merger-of-equal transactions. He says he doesn't see regulators inclined to greenlight "phoenix combinations" – the pairing of two ailing banks.

He cautions that bank management should be sure that advisors are working in the bank's interest. That said, today's M&A market is modest – FinPro works with about 400 clients and only four or five of them are up for sale.

Musso points out that the difference between trading value and takeout value can be a 30 to 40 percent difference. Companies trading at 100 percent of tangible book value per share might want to hold off selling for 130 percent of tangible book value now in a takeout, rather than run the bank for three or more years to realize that same value on a trading basis. Banks with good succession plans might want to ride it out and stay independent. If not, they're likely to opt for the 130 percent return today.

CREATING SHAREHOLDER VALUE

When it goes well, a merger benefits all sides. Shara estimates that the Lakeland/Somerset Hills deal was three years in the making, including discussion with Somerset's board of directors, and with regulators. Bank management made the case to investors that the merger would supplement organic growth and that both organizations were coming off record years in 2012; that trend continued in 2013. The deal was announced at the end of January 2013 and closed at the end of May. The stock sale was priced at 1.5 times tangible book. Today, Lakeland continues to trade at a "pretty rich" multiple to book, says Shara. "If you get too much of a premium in the sale price, the market will see that and take the stock price down," McClure says. Both banks benefitted when the stock price rose after the deal; "That's as good as it gets," he adds.



Then, there's the stock liquidity issue. Lakeland stock trades 70,000 to 100,000 shares a day, which would have been a month's worth of activity at Somerset. Investors can get in and out of Lakeland without affecting the stock price.

CREATING A BIGGER PLATFORM

ConnectOne Bancorp's proposed merger with Center Bancorp (parent company of Union Center National Bank), announced on Jan. 21, would create a company with approximately $3 billion in as-

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sets, $2.3 billion in total deposits and $2.1 billion in total loans in 24 branches, if approved by shareholders and regulators. The combined company will be the fourth-largest New Jersey-headquartered commercial bank, and will focus on middle-market commercial business. The combination has been approved by both banks' boards of directors. While Center Bancorp shareholders will own about 54 percent of the company's stock and ConnectOne shareholders will own about 46 percent, it is Center, with 14 branches, two satellite locations and $1.7 billion in assets,that will combine into the ConnectOne brand. The combined entity will retain sufficient capital to continue its growth strategy, the two banks said in a statement announcing the deal, which is expected to close late in this year's second quarter or early third quarter.

ConnectOne's Frank Sorrentino, III will serve as chairman, CEO and president; Center Bancorp's Anthony Weagley, now president and CEO of that bank, will serve as COO of the combined entity.

Sorrentino says the merger will create a platform with much bigger reach, and with more lending capacity for larger clients with a significantly increased legal lending limit. ConnectOne's progressive investments in technology coupled with Center's wealth management division will create a more robust organization better positioned to serve all of the markets that the combined entity will operate in.

Sorrentino says, "The combined organization's increased footprint coupled with mobile banking technologies will create increased scale and give our clients even more access to the financial resources they need to be successful."

The two banks' territories don't overlap and their specialties are similar, and given the projected growth rate of the combined organization, Sorrentino doesn't expect major staff cuts.

Anthony Weagley says the combination of ConnectOne and Center is an opportunity to put two quality banks together. Center's history as a commercial bank taking business from the Princeton, Philadelphia and New York areas makes it complementary to ConnectOne.

In the big-bank mergers of the 1990s, the acquirers needed to shed branches because of overlaps in their markets. That's not so true today, Weagley says. Center recently opened a branch in a historic building in Princeton, where it had established a niche serving independent schools. Community leaders want their banks to have a physical presence, he notes.

Center Bancorp sought to broaden its identity beyond the regional, but based its success on the visibility of experienced staff, creating an advisory board and focusing on retaining clientele. "As an organization gets bigger, it doesn't matter what the name is," Weagley says – people want to do business with specialists they know.

Weagley's role in the merged organization is to build the management team from the staff of the two banks. He calls the Center/ConnectOne merger "a payday for the shareholder." He adds, in a very compact summation of the how-to: "You have to evaluate all opportunities in order to grow book value and propel stock value."

As for the effect on stock price, "I think the market has spoken," Sorrentino said on Feb. 7. "Our stock is up 22 percent – theirs is up 9 or 10 percent – the answer lies right there." ■

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