THE KAFAFIAN GROUP INC.
...helping banks perform better™

Performance Measurement

Strategic Management

Profit & Process Improvement

Board & Management Advisory Services

Financial Advisory

First Quarter 2015 Volume 7 Issue 1

TKG Perspective

Teaching & Speaking Engagements

New Jersey Bankers Association
Annual Marketing Conference
Crowne Plaza Monroe
Monroe Township, NJ **April 9**
Ensuring Your Marketing Plan is Incorporated Into the Bank's Strategic Plan

Northern NJ Community Bankers
Monthly Meeting
The Stoney Hill Inn
Hackensack, NJ **May 13**
Financial Industry Overview

Pennsylvania Bankers Association
Annual Convention
Baltimore Marriott Waterfront
Baltimore, MD **May 17**
Directors Workshop

Maryland Bankers Association
Annual Convention
The Greenbrier
White Sulphur Springs, WV **May 31**
Power Hour-Basel/Liquidity Coverage Ratio/Capital Plan

More Teaching and Speaking Engagements

Conferences, Conventions & Other Events

AMifs
Annual Convention
Astor New Orleans Hotel
New Orleans, LA **April 22-24**

Pennsylvania Bankers Association
Annual Convention
Baltimore Marriott Waterfront
Baltimore, MD **May 17-20**

New Jersey Bankers Association
111th Annual Conference
Omni Nashville Hotel
Nashville, TN **May 27-31**

Maryland Bankers Association
Annual Convention
The Greenbrier
White Sulpher, WV **May 31-June 3**

North Carolina Bankers Association
119th Annual Convention
The Westin Resort and Spa
Hilton Head, SC **May 31-June 3**

More Conferences, Conventions & Other Events

What Can Banks Learn from Mutual Mergers?

By: Jeffrey P. Marsico, Executive Vice President

Since 2010, investment bankers have been predicting that the pace of merger activity in the banking industry would significantly increase and accelerate. While these predictions may have been wishful thinking, we currently see signs that many banks are, at a minimum, talking and considering their strategic alternatives.

As a result, many of these predictions are coming to life. Boards of directors and management teams of many banks are beginning to worry about being left behind. Acquisition multiples and take-out pricing are starting to improve. Buyers are starting to rationalize paying higher premiums to get deals done and in some cases are paying prices upwards of 250% of a partner's stated book value. This may be an extreme characterization, but the environment feels like we are moving in a direction of more deals.

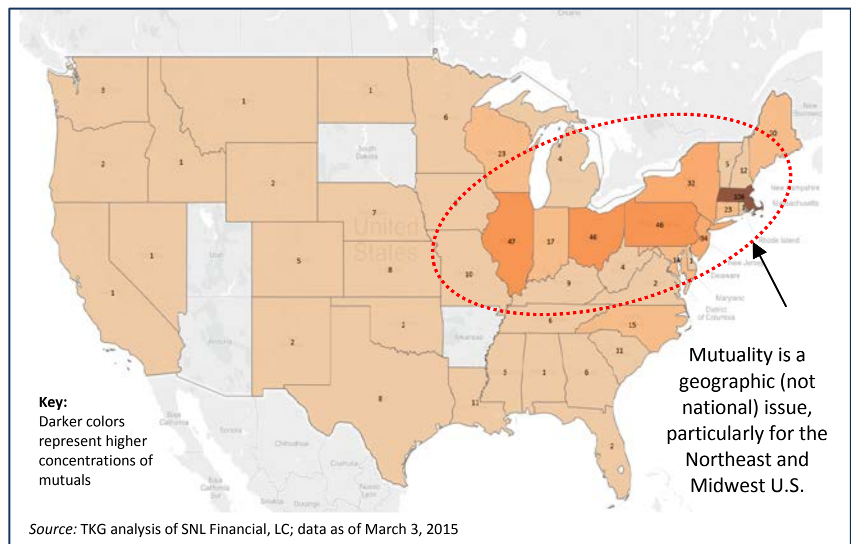
Seemingly out of nowhere have come transactions involving mutual institutions. In a mutual to mutual deal, no financial consideration is exchanged. So if price is not an issue, you might think that merger "fever" should not impact them, right?

Wrong. Mutuals are grappling with the same non-price related issues being faced by shareholder owned financial institutions.

Listening to senior managements and boards of directors of mutuals talk about the rationale for mergers that go beyond financial consideration is telling. Absent price, why merge? We have some ideas, which include succession planning, scale to create a larger platform for growth and absorb costs, realistic expectations for change, as well as many other non-price issues.

Mutual institutions make up a relatively small band of the financial institution spectrum. There are approximately 557 total mutual institutions, less than half of the total from 15 years ago. To give some perspective, if the assets of all mutual institutions were accumulated, the resulting bank would be relatively similar in size to PNC Financial Services Group, Inc. In addition, mutual institutions tend be concentrated in the Northeast and Midwest United States.

What can we collectively learn from the merger of mutuals? Over the past six months, The Kafafian Group, Inc. has been involved in three mutual to mutual mergers. This experience tells us that we can all learn a lot from these transactions. Here are three important points and valuable lessons learned, none of which have to do with a takeout price.



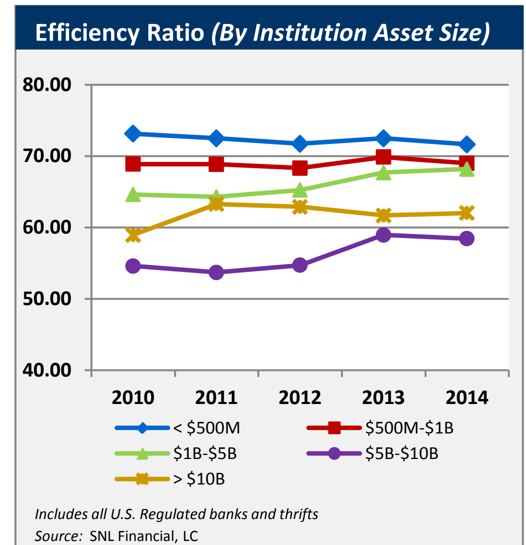
Source: TKG analysis of SNL Financial, LC; data as of March 3, 2015

Succession Planning: Many mutuals are relatively small, with limited management bench strength and aging directors. A merger of mutuals can add bench strength and create a deeper talent pool for the future. Without internal candidates, these institutions may have difficulty attracting the type of person they want to lead them into the future. Even if they can identify ideal candidates, the ability to attract and convince them to leave their current financial institution, which may be larger and have greater resources, is often difficult without equity incentives. A nearby mutual might have the right leader to successfully move a combined institution forward.

Lesson applied to community banks: The banking industry as a whole is facing a need for a new generation of bankers. To perpetuate your bank's strategic vision, continuously build employee development programs that churn out future leaders. Maintain strong relationships with industry professionals: other bankers, industry consultants, and recruiters. But don't rule out merging with another community bank that has talented or complementary management as an alternative to an outright sale to a larger competitor. Don't be afraid to address directly the "people" issues.

Scale: The U.S. regulatory scheme is tremendously burdensome on management teams of small financial institutions. Mutual mergers have developed some creative strategies to better absorb regulatory and compliance costs, while creating an institution with greater assets and capital. In the case of New Hampshire Mutual Bancorp, MHC, a non-stock holding company was formed as the parent for two mutuals. Each mutual has the same customer-facing appearance as before the transaction. But the holding company took on the non-customer facing responsibilities that heretofore only larger institutions could have established. As a result, better functional efficiency reduces costs and potentially improves internal and external service.

Lesson applied to community banks: Staying small so you are uncomplicated and easy to run may be a recipe to eventually walk your way into a brick wall. And the evidence on scale to achieve efficiencies is clear (see "Efficiency Ratio" chart).



Technology is arguably a financial institution's most scalable delivery channel investment. Many mutuals are coming to the conclusion that the investments are far greater than they can afford. For community banks, becoming larger with a like-minded partner allows the relative size of the investment to fall dramatically.

Realistic Expectations: Mutual institutions have a different sense of timing involving a merger than community banks. The reason: mutual institutions do not have to deliver returns to shareholders. In that sense, mutual institutions can build a pro forma institution with a longer-term view. It does not mean mutuals have no accountability. Merging mutuals must still remain relevant to their communities and customers, and answer to their boards and regulators. In addition, they have the opportunity to be more realistic with their expectations, while having the time to be transformative and sustain change.

Lesson applied to community banks: Most community bank merger deals involve a price premium. This means the buyer offers a greater per-share value than the seller's current market value. So the quick answer is a bird in hand is worth two in the bush. However, the acquiring banks make decisions to earn back the premium.

A well-structured transaction with a like-minded community bank partner, typically taking the form of a merger of equals and involving little to no premium, reduces the pressure to generate returns. That is a mindset that is common in the merger of mutuals.

Mutuals may not seem to be as concerned about delivering long term returns to their constituents, but they are concerned with building a sustainable, competitive institution for their customers, communities, and employees. And in that respect, the interests of community banks and these institutions are mutual.

TKG, as part of our consulting and advisory engagements, frequently evaluates our industry, its trends, successes, and challenges. We are pleased to share our thoughts with you, our valued clients and friends, in the form of this periodic newsletter. If you would like to discuss anything further, or learn more about our performance measurement, strategic planning, regulatory assistance, profit/process improvement or financial advisory services, please call us at (973) 299-0300 or visit us at www.kafafiangroup.com.

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