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TKG Perspective

Teaching & Speaking Engagements

Washington Bankers Association
Bank Executive Conference
Seattle Motif Hotel
Seattle, WA **December 5**
Issues and Answers to Bank Distribution and Delivery Channels

American Bankers Association
National Conference for Community Bankers
Hilton Hawaiian Village Waikiki Beach Resort
Honolulu, HI **February 25-28**
Merging Mutuals

Pennsylvania Bankers Association
School of Banking
The Penn Stater Conference Center
State College, PA **June 3-7**
Strategic Decision-Making and Organizational Structure

Conferences, Conventions & Other Events

Financial Managers Society New York/New Jersey Chapter
Holiday Party and Toys for Tots
The Fiesta
Wood-Ridge, NJ **December 5**

Maryland Financial Bank
Banker's Holiday Celebration
The Maryland Club
Baltimore, MD **December 12**

Maryland Bankers Association
"First Friday" Economic Outlook Forum
Renaissance Baltimore Harborplace
Baltimore, MD **January 5**

New Jersey Bankers Association
Economic Leadership Forum
The Palace at Somerset Park
Somerset, NJ **January 19**

Bank Director
Acquire or Be Acquired Conference
Arizona Biltmore Resort
Phoenix , AZ **January 28-30**

Pennsylvania Bankers Association
2018 Economic Forecast Summit
Sheraton Harrisburg-Hershey
Harrisburg, PA **February 15**

TB or Not TB? Is that THE Question?

By: Richard B. Trauger, Jr., Managing Director

In the early stages of *Hamlet*, William Shakespeare's epic 15th century play, the protagonist says "To be or not to be, that is the question." Through this phrase, Hamlet questioned the meaning and value of his life after his father was killed by Claudius.

For bank mergers, our take on Hamlet's age-old question is "tangible book value dilution or no tangible book value dilution, that is THE question!" If an institution makes a deal the investment community questions, in the short-term the acquirer's stock seems to suffer. But the same holds true over the long-term if the institution stagnates. Sticking with our *Hamlet* analogy, here's our take in five short acts.

Act I - Perfect Transactions: The Slings and Arrows of Outrageous Fortune…
When one institution pays a premium to acquire another, generally speaking, the transaction creates identifiable intangible assets and goodwill.

There appears to be a thought process in the investment community that every bank acquisition should be immediately EPS accretive, require no capital formation event, and have a nearly instantaneous tangible book value earnback period. *In other words, the perfect transaction!*

If acquirers sought only perfect transactions, then there would be no transactions. In the grand scheme of things, industry consolidation is a means for re-allocating capital and resources. Being good at making acquisitions has made some institutions extremely valuable in the eyes of the investment community.

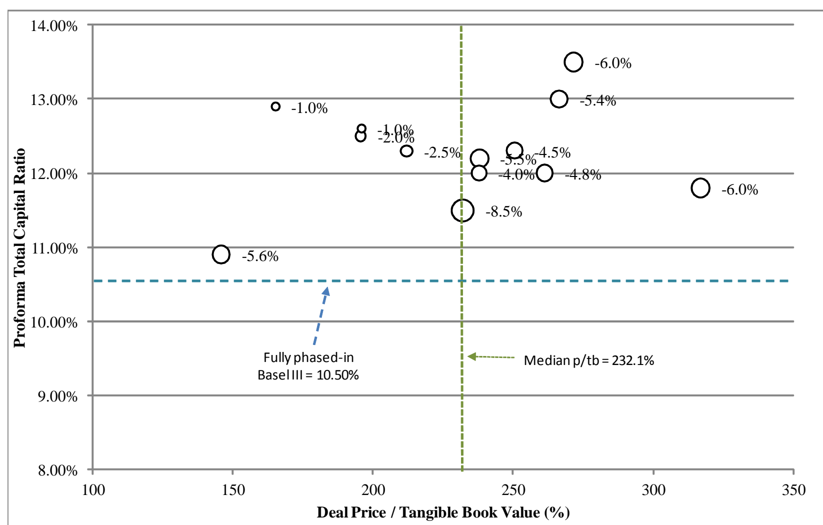
Act II - THE Measure on Business Combinations: Though this be madness, yet there is method in it…
The decision to pursue or forgo an opportunity to make an acquisition is vexing. Nearly everyone loves a deal, whether it's getting two breakfast sandwiches for $3 or buying a bank.

Over the long-term, shareholder value is created through sustained growth in free cash flows (or net income). In an industry where organic growth is increasingly difficult to come by, acquisition-driven cost savings and related revenue enhancements change the paradigm of how earnings can be sustained.

For the most part, and certainly in the eyes of an acquirer, if a transaction appears to have a materially negative impact on the acquirer's earnings per share and requires unrealistic cost savings to become EPS accretive, institutions themselves are and should be self-policing and most likely won't pursue the transaction. Taking on a deal that is not going to generate incremental earnings is a sure way to erode value.

This brings us back to the investment community's focus on tangible book value as THE measure in a business combination. The investment community measures an acquirer's pre and post-transaction tangible book values and, if dilutive, determines how many future periods (usually years) it will take before proforma tangible book value meets or exceeds (aka "crosses over") stand-alone tangible book value. Tangible book value dilution is a way of life in larger transactions and is our focus of the TB or Not TB question.

Graphic 1: TB Dilution, Capital and Transaction Pricing



Graphic 1 presents the proforma total capital ratios and price/tangible book for transactions with deal value in excess of $400 million that have been announced or completed since January 1, 2016. The bubbles represent the tangible book value dilution percentage. Of these 20 transactions, 14 resulted in tangible book value dilution to the acquirer, with a median tangible book value dilution of 5.1% and an earnback period of 3.50 years, using the cross over method. The median proforma total capital ratio was a healthy 12.30%.

Act III - Regulatory Capital: Me thought I lay worse than the mutines in the bilboes…

The banking industry has a system in place that acts as another "check" on a bank acquisition. That system is called "Basel III." Regulatory capital calculations include a deduction from Common Equity Tier 1 (CET1) capital for intangible assets. Therefore, pay too much to make an acquisition and CET1 suffers. Capital ratios are more than a number; they are layers that represent both regulatory requirements and Board and management's risk tolerances and appetites. Therefore, if regulatory capital ratios for the proforma organization meet or exceed "well-capitalized" levels under Basel III, and meet or exceed an institution's policy limits without loan concentration issues, should an acquirer care more about tangible book value per share impact or regulatory capital impact? Or let capital continue to accumulate and not enter into a business combination?

Act IV - Capital Efficiency: Whether 'tis nobler in the mind to suffer…

We appreciate, and in fact assist, clients with active capital management programs. Due care still needs to be exercised as share repurchases can also be dilutive to tangible book value. But we know of no institution that has ever managed to sustain increased shareholder value via share repurchase programs or special cash dividends. Capital management programs are a tool that is used by management to provide a source of liquidity to shareholders that have a different perception of value than the management of the institution. And financial engineering helps tweak, not sustain, increased shareholder value.

If the investment community supports an institution's share repurchase program, they're saying "we think your shares are undervalued and you should buy them back so that capital can be managed more efficiently." What Graphic 1 does not show for all U.S. publicly traded banking institutions, is that the median total capital ratio is 14.27%. If capital efficiency in part drives return on equity, is a total capital ratio of 14.27% or 12.30% more desirable? The answer certainly depends on your audience. Regulators (understandably so) prefer more capital, but regulators also recognize that there is such a thing as too much capital because this may lead to increased risk appetites. And if the investment community wants capital efficiency, does it matter how an institution achieves it?

Act V - Is TB Dilution the Question?: Our indiscretion sometimes serves us well…

The stock price of nearly all 14 acquirers represented in Graphic 1 suffered double digit declines within the first few days after announcing an acquisition, with tangible book value dilution or transaction uncertainty cited as the culprit. The longer-term, bigger picture, though, tells a different story.

Since September of 2011, there have been approximately 1,400 banks acquired in the U.S., with a total announced deal value of $256.6 billion. Institutions that have made three or more acquisitions with total deal value of the three transactions exceeding $400 million are termed "Serial Acquirers" for the purpose of our analysis. The 27 institutions that comprise the group of Serial Acquirers have participated in nearly 10% of all transactions and represent nearly 15% of total deal value. As of September 14, 2017, Serial Acquirers enjoy valuation premiums with a price/book ratio of 138.1% (vs. 128.0% for the banking industry) and price/tangible book ratio of 219.0% (vs. 138.6% for the banking industry). In the end, it appears bank stock analysts' fascination with TB dilution is all hat, no cattle. So what is the question?

For another take on valuations, please see my colleague Jeff Marsico's July 2017 blog post @
http://jeff-for-banks.blogspot.com/2017/07/are-banks-overvalued.html

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, process improvement or financial advisory services, please call us at (973) 299-0300 or visit us at www.kafafiangroup.com.