

Merger Math: Earning Your Right to Remain Independent

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The right to remain independent is often spoken of, rarely defined, and harder to quantify. Until now.

In most states, a bank board (or bank holding company board) must consider multiple constituencies when fulfilling its fiduciary responsibilities: shareholders (if stock owned), depositors (in some cases if a mutual), customers, employees, and communities. There is a surefire formula to say, “stay” or “go.” And when a bank underperforms, boards often define their right to remain independent by putting heavy weight on the “other” constituencies — the non-shareholders. Because your customers would be happy with a boost in rates paid on deposits, or a reduction in yields on loans.

That would reduce revenue, therefore reducing how you can compensate employees or the level of benefits you can offer them. It could also serve to reduce your bank’s commitment to the community. And what about your shareholders? There must necessarily be balance in how you meet your obligations to each constituency.

So what does it mean to “earn your right to remain independent?” In descriptive terms, it means that shareholders, customers, employees and communities would be better served by your bank as an independent institution rather than turning the keys over to a buyer and letting them serve your constituencies.

On the surface, earning the right to remain independent appears as a tall order in a consolidating industry staring at the prospect of recession. A larger bank can more easily deliver top tier profitability due to economies of scale. A larger bank can provide more upward mobility opportunities to employees. A larger bank has more resources to contribute to their communities. And a larger bank can bring more sophisticated technology to customers. All of which should in turn enhance total return to shareholders.

So the conventional wisdom goes.

There are myriads of exceptions to the rules. First Defiance Financial Corporation of Defiance, Ohio, has a better year-to-date ROA and ROE than First Busey Corporation of Champaign, Ill. First Defiance is \$3.3

billion in total assets, First Busey is \$9.7 billion, three times the size. And what is the definition of service to community? Would First Busey serve Defiance, Ohio, and surrounding communities better than First Defiance? And First Defiance’s operating expense run rate is \$96 million per year. Do we think that they are not big enough to invest in technologies that improve their customer experience?

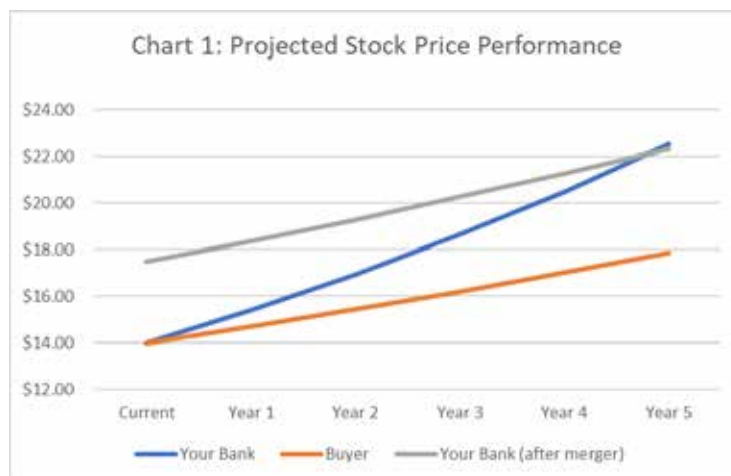


Table 1:

	Earnings Per Share (EPS)					
	Current	Year 1	Year 2	Year 3	Year 4	Year 5
Your Bank	\$1.00	\$1.10	\$1.21	\$1.33	\$1.46	\$1.61
P/E	14.0	14.0	14.0	14.0	14.0	14.0
Your Estimated Stock Price	\$14.00	\$15.40	\$16.94	\$18.63	\$20.50	\$22.55
Shareholder Total Return Expectation	10.0%					
Dividend Yield	2.0%					
Needed Capital Appreciation (discount rate)	8.0%					
Present Value of Plan	\$15.35					
Does Plan Add Value?	Yes					
Assumed Merger P/E	17.5					
EPS Plan Variance	5.0%					
Year 5 new EPS after variance	\$1.53					
PV of Year 5 EPS after variance	\$1.01					
Merger P/E less Trading P/E	3.5					
PV of Option to Sell	\$3.53					
PV of Plan + PV of Option to Sell	\$18.87					

If First Defiance can serve employees, customers, and their communities equally or better than a would-be buyer, then the “right to remain independent” is necessarily weighted towards shareholders. And we have some math for you.

Math

We suggest two calculations to determine if your institution earns the right to remain

independent. The first is to compare the estimated stock price appreciation to executing your strategy versus selling, receiving a premium, and then riding the buyer's stock price appreciation.

For ease of description, let's assume that your current stock price and that of the buyer's is \$14 per share, the exchange ratio is one to one and that pre- and post-transaction, your shareholders would receive the same dividend yield. Your bank's strategy calls for 10 percent annual earnings per share growth, while the buyer's historical performance was 5 percent and you see no reason why past is not prologue. So projecting your stock price appreciation versus theirs in this example is purposefully simple. Take EPS times p/e ratio.

But wait. Most bank acquisitions go off at a premium to the seller's stock price. In this example, the merger premium is 25 percent of your current stock price. In this situation, realizing the full economic value of your plan is projected to occur in year five, the same year you eclipse the value of selling, receiving the premium, and riding the buyer's stock price.

If your board has confidence in your ability to execute the plan, then you have earned your right to remain independent. Makes you think twice about putting forth a sand-bagged strategic plan that does not contain aspirational financial projections.

Math 2

The second calculation is the present value of your strategy. Present valuing the plan must necessarily include a discount rate. And if we pulled out our college textbooks we're sure there would be a great CapM or Ibbotson Build Up Method description right here to calculate the discount rate. But, in more simplistic terms and using the denominator in a single stage dividend discount model, the discount rate is the annual total return expected by your shareholders minus your dividend yield. So, if your shareholders expect 10 percent per annum total return, and you target a 2 percent dividend yield, then the discount rate would be 8 percent. Simple, right?

Table 1 demonstrates the concept. In the most simplistic terms. Your earnings per share growth rate needs to exceed the discount rate in order to have a present value per share that exceeds your current stock price.

As you saw in Chart 1, projecting EPS and then multiplying by the p/e multiple is only

part of the "independence" math. Because a buyer usually pays a premium due to synergies. And executing your plan does not mean you give up the right to sell your bank at some point in the future. There should be value in that option, in our opinion.


If the management team fails to execute strategy within a board-defined tolerance level, they can still call the investment banker, put up the "for sale" sign, and likely get a premium.

So let's assume your board's tolerance to miss plan projections is 5 percent. Instead of year five EPS of \$1.61, management only achieves \$1.53. The board calls the investment banker, who estimates the bank can get a 25 percent price premium, or 17.5x EPS. Therefore, the present value of the "option to sell" is \$3.53.

If the "option to sell" value plus the present value of your strategic plan is greater than what you can reasonably achieve in a sale or it is within a board tolerance level, and the board has confidence in management's ability

to achieve the plan, then you have earned your right to remain independent.

This level of discipline has benefits, including the board exercising reasonable judgement in assessing whether your bank should sell or execute the plan, and that management puts together a plan that strives for excellence instead of "last year plus 5 percent."

The "right to remain independent" is math. Does the math work for you? 

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