Rethinking Bank M&A — Identifying, Pricing and Capturing Value in Today's Environment

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The value of M&A is changing. Traditional acquisition synergies are giving way to new sources of value, and banks will need to adapt.

U.S. merger and acquisition transactions involving larger community and regional banks are back on the table. Above the continuing consolidation of some 10,000 smaller community banks and credit unions, and beneath the regulator-limited national banks, mid-sized banks are looking at M&A — not simply opportunistically, but now out of urgency.

The urgency arises from dual pressures: (1) to restore long-suffering profitability to support investing in digital transformation; and (2) to counter the dominant lead U.S. national banks have opened up in acquiring new core customers across all lines of business. For brick-and-mortar-centric intermediaries that wish to survive, M&A is a necessary strategic consideration. However, in searching for the right deals, successful acquirers appreciate that the underlying value of target institutions has decidedly changed.

Credit quality is, and always will be, an integral part of deal economics, but the nature of the value created from the liability side has evolved. Traditionally, acquisition justification was largely about realizing scale and, more importantly, expanding non-toxic assets, branches and customers, with only limited focus on the quality, fit and longevity of deposits. In today's environment, we see three major areas where underlying industry economics have altered relative M&A value:

- Core transacting customers with "sticky" and growing deposits are now more valuable than ever.
- Branch consolidation must be more aggressive than ever before because of the diminishing asset value of the network in a digital age.
- Finally, banks are in need of niche lending and fee businesses with high ROE potential to improve fee and spread performance over traditional intermediation.

Acquirers must find ways to identify and correctly price these sources of value, and then single-mindedly seek and execute deals that bring the right customers and deposits. This will help them compete in-footprint with the nationals and add fee generating options.

We see three new tasks needed in the acquisition process to account for the changes in value:

1. **Enhanced screening of the deposit franchise for target identification,** and in particular using better analytics and benchmarks to find banks with higher quality deposits and customers, as well as greater consolidation potential.
2. **More focused due diligence of the deposit base before providing an offer** to better understand the intrinsic customer and deal value, and price accordingly
3. **Use of "clean room" teams after a deal announcement** to allow for accelerated and optimal merger integration decisions reflecting the new liability-driven sources of value.

The costs and time of these additional efforts are clearly outweighed by the risks of an M&A "error".

ACQUISITION TRENDS

With the end of interstate banking restrictions in the 1980s, M&A became an integral component of transformation for the U.S. banking industry. Since then, bank M&A has largely been responsible for bringing the number of U.S. banks down from over 15,000 to under 6,000 (with credit unions seeing a similar reduction). Banks have consolidated at a pace of roughly 3-5% per year, slowing down following the financial crisis, but since recovering to historical averages (see Figure 1a). We expect this rate of consolidation to continue over the next several years.

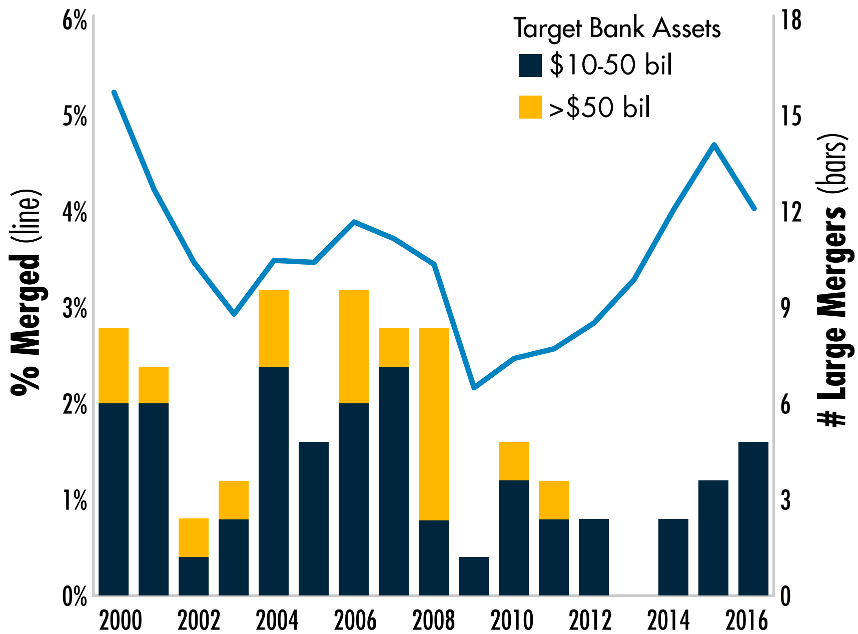
In terms of deal size, the real estate crisis saw a crescendo of large bank mergers, which thereafter went into hibernation. Since 2014, larger bank transactions have returned. We expect to see a return to regular M&A activity for larger community and regional banks in the next decade, leading to an increase in the number of banks with $200 billion and more in assets (subject to regulatory asset threshold changes).

Looking at deal pricing (see Figure 1b), tangible book value multiples have declined post crisis: median P/TBV exceeded 2.0 in 2003-07, plummeted to 1.1-1.2 in 2008-13, and then inched up to 1.3-1.4 by 2015-16. Part of the low multiple reflects stunted industry profitability prospects and bottom basement bank stock prices — both of which have improved markedly of late. Despite these positives, we do not expect bank profitability to return to pre-crisis levels; hence, while we have seen a significant increase in deal multiples in Q1 2017, we do not expect a return to prior multiples, except when it comes to unique deals.

Premiums over market price for publicly traded companies have returned to roughly normal values post-crisis. The median 1-month deal value premium over market price spiked to around 60% in the slow recovery period of 2009-12, reflecting low trading multiples of that period. Since then, premiums have dropped into the low 30s. We expect premiums to fall slightly further into the high 20s, as both acquirers and

FIGURE 1A: Bank M&A (2000-2016)

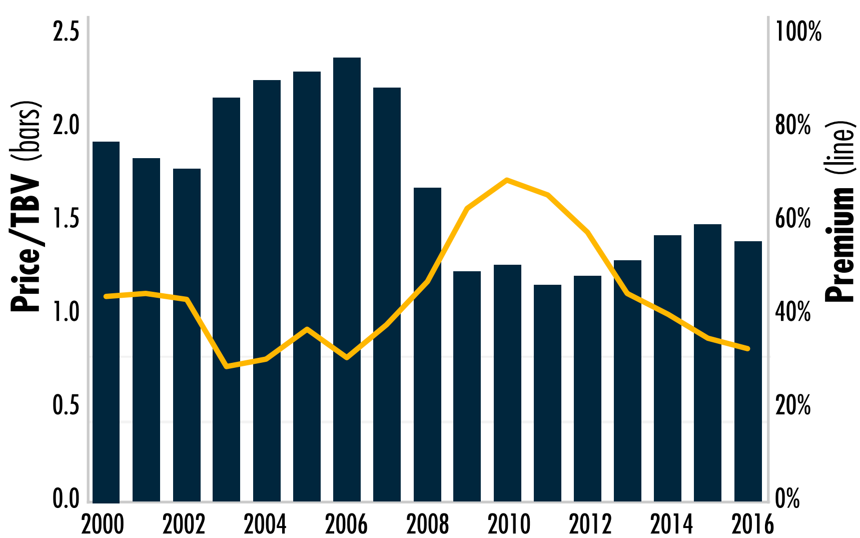
Mergers continue to reduce industry bank count by 3-4% a year, while larger bank deals are picking up after a post-crisis hiatus.



Merger size measured by target bank assets
Source: FDIC, SNL, Novantas analysis

FIGURE 1B: Annual Median Deal Price Metrics (2000 — 2016)

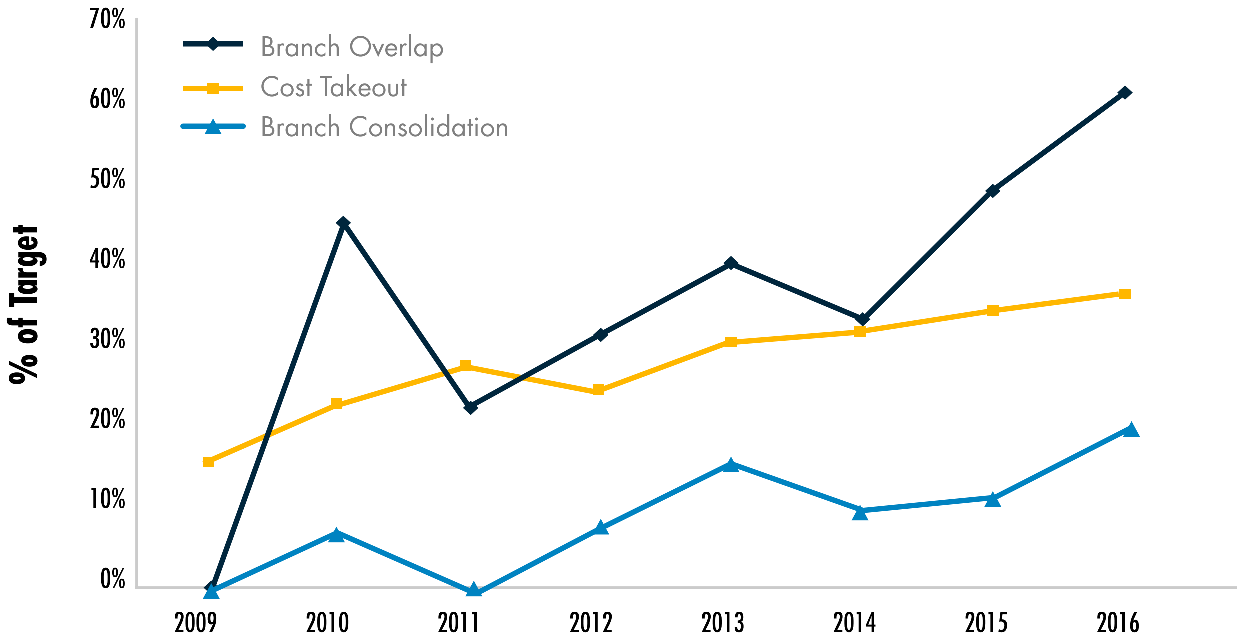
Deal pricing to tangible book value remains in the low ones though rising, while premiums are back to the low 30s.



Deal Value to Tangible Book Value, Deal Value to Market Value for publicly traded targets; annual medians.
Source: SNL, Novantas analysis

FIGURE 2: Median Cost and Branch Reductions, Ten Largest Deals by Year (2009 — 2016)

Acquirers now more aggressive in cost reduction and branch consolidation.



Branch Overlap: target branches within 5 miles of acquirer branch

Source: SNL, Novantas BranchScape, research and analysis

sellers better appreciate reduced target prospects absent a sale.

CHANGING VALUE OF BANK M&A

Historically, M&A has reflected the centricity of the branch — to bank intermediation, as well as to the goal of building franchises. Deal announcements, while typically first mentioning the safety of assets, prominently touted branches and to a lesser degree deposits. Deal rationales typically split into: out-of-footprint franchise expansion to build a regional or national franchise versus in-footprint franchise expansion to increase share and build scale. The term "footprint" is itself a reference to branch networks.

But in the years since the Great Recession, the combination of technology, customer preference, and regulation has fundamentally altered industry dynamics — and along with it, the value of bank M&A. With technology enabling mobile and online banking for both shopping and purchasing, customers are increasingly shunning the branch and shifting to digital channels. Additionally, liquidity regulation favors more stable deposits — transaction accounts as opposed to savings accounts or large, non-operating balances parked awaiting better uses or rates.

More ominously for regional and local banks, these industry trends have downgraded the importance of local branches — giving the national banks higher customer acquisition rates and creating opportunities for direct online banks. Separately, industry profitability remains subpar, and large swaths of banks are failing to meet their costs of capital. Even with economic expansion and rising rates, profitability is unlikely to return to pre-crisis levels.

Thus, all but the most successful regional and community banks are caught in a vise: how to simultaneously compete with the nationals, improve profitability, and invest in digital distribution realignment. Many regionals are again looking to M&A for some of the solution.

The pitfall is that the sources of value from bank M&A have fundamentally been altered. We see three major changes to M&A value — some of which are quite difficult to discern:

Core transacting customers and their stable deposits are now far more valuable. We believe the differentiator of profitability for banks going forward is increasingly access to a growing base of "sticky," transaction deposits. Payments-related, relationship-driven, and other stable deposit balances incur lower interest expense and are less likely to be "shopped" and switched to another bank. In contrast, hot money and balances acquired through promotion will require higher rates or leave the bank.

Accordingly, acquiring deposits with limited regard to their source puts M&A deal economics at risk — especially as rates rise, online shopping increases, and deposit competition intensifies. With stable customers and low-cost deposits, M&A becomes a contributor to long-term profitability, and a supplement to organic growth. But with fleeting customers and rate-sensitive deposits, rising interest rates will push deals underwater.

It may be toxic loans that blow up a deal, but subpar deposits relentlessly bleed deal value over time, especially as rates rise.

In-footprint branch consolidation affords greater value. In-market deals are now doubly valuable. Cost savings have risen markedly (see Figure 2) — the median stated cost takeout for the ten largest deals (as a percentage of the target bank's expense base) has risen from under 20% in 2009 to over 36% in 2016. We expect 35-40% and even higher to be the norm for cost takedown going forward.

This is only possible with deals involving substantial branch overlap and consequent branch closures. It should not be surprising to see branch closures in excess of 50% of the target bank's base, nor should it be to see acquirers use M&A to restructure their legacy network and reinvest in digital transformation. Out-of-footprint deals will likely need special circumstances — e.g., Canadian or other foreign entrants, or mergers of equals with little to no premiums, or extremely low valuations driven by other factors.

There may also be revenue value from the right in-footprint deals as they can help offset the advantage of national banks in new customer acquisition. Novantas's Shopper Survey results show that regionals have better acquisition rates in markets where they have top-tier presence and deposit share. Hence deals that give regionals primary share position in their local markets should be more attractive and thereby help stabilize regional deposit and customer growth.

Niche lending and fee businesses can help. Even with scale and share from M&A, acquirers compete in a U.S. banking industry with substantial overcapacity. That means relationship cross-sell and ancillary fee revenue are essential, and targets with unique businesses are more valuable. Examples include strong in-footprint commercial, mortgage, and indirect auto lending, or specialized businesses in brokerage, insurance, and health savings accounts. These businesses are especially attractive if they can scale and grow.

CAPABILITIES FOR WINNING IN TODAY'S M&A ENVIRONMENT

Understanding the altered value from M&A, and using that to identify and win the right deals, is critical for successfully leveraging merger transactions. We see three critical steps to ensuring acquiring institutions are identifying the right targets, paying appropriate prices, and capturing these sources of increasing value (Figure 3):

Enhanced screening of the deposit franchise for target identification. Clearly there is abundant publicly available information about potential target candidates that acquirers comb through today — call report data provides important details about target financial performance, as well as asset mix and quality. But to identify true underlying value in today's environment (e.g., whether a target's deposits are more stable or more fleeting) an acquirer needs either proprietary or benchmark data. Some of the available data and analysis includes:

- Historical detailed deposit pricing information to estimate how much deposit balance growth has been driven by price, and therefore likely "hot money"
- Shopper survey results that detail brand perception and consideration, new customer acquisition purchase rates, and reasons for leaving the institution
- Competitive assessments to determine how a target is performing in each of their micro-markets relative to key competitors
- Distribution analysis to assess the level of overlap between acquirer and target, as well as attractiveness of location of non-consolidate branch candidates

More focused due diligence of the deposit base before providing an offer. Once further down the path with a potential target, acquirers should go beyond credit portfolio due diligence and assess the stickiness of bank deposit bases. This is not an easy task as many deposits are masquerading as core deposits in our prolonged low rate environment. Digging deeper into the behavior of deposit customers provides a better understanding of how a customer base will react to basic post-merger changes (and, perhaps more importantly, rising rates), and will directly affect deal valuation.

- *Branch consolidation.* Customer attrition depends on each customer's use of and attachment to the local branch. Understanding customer-level behavior improves the forecasting of attrition under likely branch consolidation scenarios.
- *Re-pricing.* Some banks have attracted notably more price sensitive customers, and some markets are inherently more price sensitive than others (largely due to varying levels of competition). Understanding the impact of potential pricing changes is a crucial step before estimating true revenue synergy opportunities.
- *Rising interest rates.* The industry has never before experienced such low interest rates for such an extended period of time. Rising rates will reveal which

FIGURE 3: Capabilities for Winning in Today's M&A Environment

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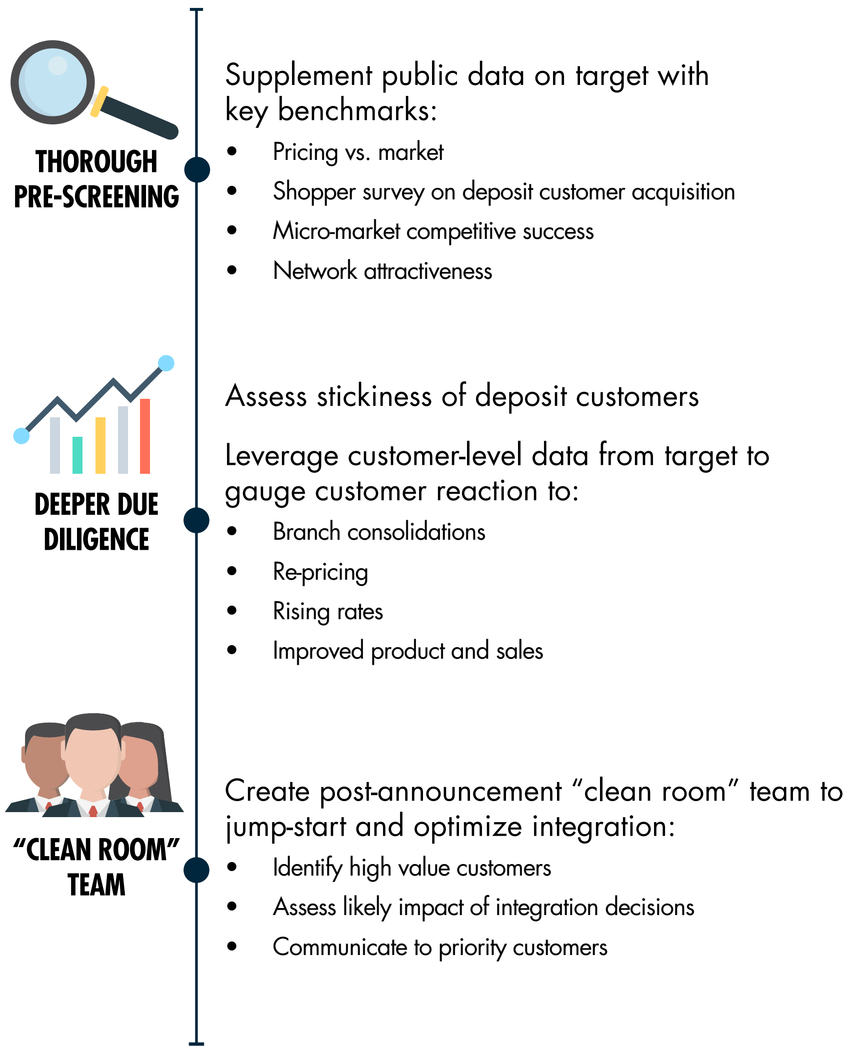


Source: Novantas

banks are hosting "parked" DDA/MMDA balances waiting to shift, and which will have much higher deposit betas. Too many banks reflexively consider these balances "core". Modeling these will directly affect deal valuations.

- *Improved product and sales capabilities.* Understanding the degree to which the target bank is underpenetrated in its markets and among its existing customers provides a better view of the potential upside opportunity. We have seen cases of fourfold sales productivity increases, depending on underlying opportunity.

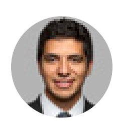
Combining proprietary data with deposit tapes and basic supplementary information that most targets are willing to provide (e.g., acquisition reports, branch transaction summary reports), thorough diligence can help acquirers more accurately forecast pro-forma deposit balances, rates, and fees to appropriately price transactions and begin developing integration strategies.

Use of "clean room" teams after a deal announcement. As soon as an acquisition has been announced, acquirers need to jump-start integration. This can be done prior to deal close with a dedicated and isolated clean room team that can collect and analyze sensitive customer information that can be shared in summary (but not in detail) to help make optimal integration-related decisions. The focus of clean room efforts should be on customer-level analysis and actions, including:

- Identifying high-value customers in terms of current and potential revenue — with a focus on those stable deposits with larger relationship potential.
- Assessing the likely impact for these customers from key integration decisions, such as product conversion, product pricing, and distribution network changes, and determining how to better accommodate them.
- Communicating impending changes (positive and negative) to high-value customers so they are not surprised, and so the acquirer can manage/maintain the relationships through the transition.

Establishing a clean room team quickly is important for both timely communication and ensuring higher quality information for key decisions. This is increasingly becoming the case as the value of M&A lies more in a target's customer base and less in its branch network.

By investing in these steps, acquirers will be well-positioned to identify valuable deals and execute effectively. For many banks, this will be critical for the transformation required to succeed in today's banking environment.



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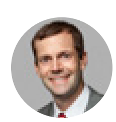

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