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Acquisition trends

Merger activity seen modest in 2011, acquisition of troubled assets up

Merger and acquisition activity is expected to remain modest in 2011, but there could be a pickup in sales of smaller institutions in 2012 if the U.S. economy improves, according to industry strategists.

There was a modest uptick of M&A activity in April, but the volume in the first quarter was still low, compared to previous years.

"What I expect is that the numbers will remain modest in 2011, as the FDIC continues to work off its backlog of insolvent institutions," says M&A specialist Peter Weinstock, partner and co-head of the financial institutions group, Hunton & Williams, LLP, Dallas, Tex.

Economic pickup

"In 2012, I'm hoping the economy firms a little, which would result in pricing firming," Weinstock said. "I think at some point, we're going to have a lot more supply of people who want to sell than there is perhaps demand; so I think in 2012, we're poised for a significant pickup in M&A activity."

Two M&A specialists cited these trends:

- Merger activity generally slowed in the last year.
- Most transactions involve acquisitions of troubled assets.
- Acquirers are paying above current prices in some transactions.
- The FDIC recently slowed the pace of troubled bank sales.
- Some bank boards are simply "throwing in the towel."
- Branch sales are increasingly widespread.

First, in the last year to 18 months, mergers "dried up unbelievably," explains M&A specialist Sam Malizia, partner, Malizia Spidi & Fisch PC, Washington, D.C.

One reason is that sellers could not get the price they want, Malizia said. "And now there are so many financially distressed companies that the FDIC has taken over, that everybody is buying the 'sick' institutions—they're getting them from the government."

"So nearly all acquisitions have been quasi-supervisory, and the number of negotiated mergers among community institutions is way down," he added. With more than 800 mostly small banks now on the FDIC's problem list, many institutions are expected to be under tremendous profit pressures, causing some to seek buyers.

"I know that a lot of the banks have come back in the last year or so, but the thrift industry is still trading low," Malizia said. As a result, the prices being offered for mergers are also low—and so sellers are just not as interested.

Problem assets

Secondly, most transactions today are essentially the acquisition of problem assets, as well as the financial institution platform, Weinstock explained. "So buyers are very hesitant to take risks to their own regulatory standing and also to their balance sheets."

Thus, buyers are seeking out various "structural techniques" to try to isolate those troubled assets. Such techniques may entail an escrow or "holdback," a sale of the assets back to the sellers, or other structures that would protect the buyers. "Every buyer is looking at what portion of that they are willing to absorb, versus what portion they need additional protection for, for their balance sheet," he said.

The idea is to carefully analyze the assets. "In a merger, you get all the assets—so you have to look at structures or techniques, to try to minimize the exposure of those assets or spin them out," he added.

The other thing that acquiring institutions consider is the use of purchase accounting, to minimize a "going-forward hit" from those assets. "So if you charge those assets down aggressively, then it won't be a hit to earnings, going forward," he explained. "It would create more goodwill front end, but if you've got the capital to absorb that good will, then you can add some protection to your balance sheet in the form of discounts on those assets."

A third trend is that in some cases, acquirers are looking strategically at target institutions and are willing to pay more than the perceived value.

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Either the target represents something significant to the buyer, or the buyer believes there is a one-time opportunity to buy at pricing above current levels but below historic levels.

For example, in the acquisition of Sterling Bancshares in Houston by Comerica Inc. earlier this year, the pricing was higher than what most people expected. Comerica justified it because of what it would do for them, Weinstock said.

"The thinking is that if you're taking a longer term view, then you may be willing to pay more than what the market indexes indicate as current pricing, in order to get that institution," he added.

Fourth, there have been "stops and starts" in the FDIC's resolution process in the last four to six months—but the pace of resolutions is expected to pick up. "The FDIC, whether they did it consciously or not, really slowed down the number of resolutions," Weinstock said.

"Basically, they sold a lot fewer insolvent banks than the pace they had been engaged in previously," he said. As a result, the problem bank list of banks that are rated CAMELs 4 or 5 continues to grow.

Competitive pricing

"Other commentators have said that they thought the FDIC was dragging out the process in order to encourage investors who are inclined to buy problem banks to do so without FDIC assistance," he explained. "Basically, the concept would be: if you reduce the supply, the institutions that are supplied would be priced more competitively."

"If you look at the statistics for the FDIC cost of resolution so far this year, the percentage of the cost of the hit to the government as a percentage of assets sold is lower than it was last year," he added.

Offering a related perspective, Malizia pointed out that regulators have recently made things very challenging for those wanting to launch a new de Novo institution. It seems that instead, regulators are trying hard to get people to buy the undercapitalized, or sick, institutions.

"They're bigger, and it costs more to buy a sick institution than to start a de Novo," he said. "And that's where the government wants investors to put their money—not into a de Novo institution."

For example, he explained that now regulators want to see at least $50 million available in order to start a de Novo. "But you don't need $50 million to start a bank," Malizia said. "The reality is, if it were like it used to be, if you could put up $5 million or $10 million to start up a de Novo, why would you spend $50 million or $100 million to buy a sick institution?"

"But if that's all you can do—they (regulators) are not granting any de Novo charters—then people who have money are buying the undercapitalized institutions, and that's where the FDIC wants the money to come," he said. "They're not looking to start new institutions."

Getting out

A fifth trend is that some institutions are simply "throwing in the towel." Sometimes boards and management teams at smaller institutions have been under intense regulatory pressure, and they see the opportunities for revenue going down in the future, while the costs of compliance increase.

"They're throwing in the towel and saying: let's get what we can and get out," Weinstock said.

Looking to the future, such boards note that on the revenue side, recent regulatory changes would dramatically reduce debit card fees and overdraft fees, he said. "And loan demand has continued to be soft, and God knows when that will pick up—so how will we make a buck?"

"And on the expense side, even before the Dodd-Frank regulations kick in, compliance costs have been increasing exponentially," he said. For example, he cited the compliance burdens of a $125-million-asset bank that has a business line serving money-service businesses. The bank has 21 employees, but three of them—roughly 14% of the total—are devoted to compliance issues related to the Bank Secrecy Act (BSA).

Sixth, there has been a significant increase in branch sales in recent months. Not infrequently, such branch sales are a function of the difficulty for troubled institutions to raise capital, Weinstock said.

For example, an institution experiencing financial difficulty may have losses or capital ratios that are falling, and, as a result, administrative actions imposed by regulators. For example, such an administrative action may require the institution to maintain minimum capital requirements for its leverage ratio, say, at 9%, and for its total risk-based capital ratio, at 13%, he said.

"The first thing they'll do is try to raise capital to meet those levels, but in this environment, that may be difficult for it to do," he said. "So another alternative—which is not a long-term exit but will buy them time to try to get their asset problems under control—is to sell some branches, get some premium for the sale, and reduce their size, thereby increasing the capital ratio," he said.

Raising capital

The many troubled, smaller banks on the FDIC's problem list are having a difficult time raising capital, he said. "You can see how a branch transaction in order to shrink would preserve what they have—it makes some sense."

Further, he noted that more than one-third of the industry's total banks and thrifts (of all sizes) have an administrative action of some sort, either informal, such as a memorandum of understanding, or a formal written agreement.

"To the extent that they either don't want to raise capital because it's too pricey and dilutive to their shareholders, or they can't raise capital, they may have to shrink the balance sheet to meet that requirement," he said.

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