THE "JUST RIGHT" ECONOMY

2018 HAS BEEN A BANNER YEAR FOR MERGERS AND ACQUISITIONS, THANKS TO AN ECONOMY THAT'S BEEN NOT TOO COLD AND NOT TOO HOT, BUT, IN THE WORDS OF GOLDILOCKS, JUST RIGHT.

BY PETER G. WEINSTOCK AND HEATHER ARCHER EASTEP

M&A

THE 12-MONTH PERIOD ending March 31 may have been the most attractive for bank mergers and acquisitions for both sellers and buyers in a decade. It will be interesting to see how much momentum M&A tailwinds still have for the remainder of 2018 and into 2019.

To see where we are going, it is noteworthy to see where we have been. In 2016 up through the election, bank stocks trailed the S&P 500 in the broader market. As a result, during 2016, circumstances were fitting for mergers of equals (MOE) and other transactions by non-strategic buyers. Of the 15 transactions we worked on that were announced in 2016, three were notable MOE transactions, namely Wilshire Bancorp Inc. and BBCN Bancorp Inc. forming the largest Korean American Bank—Bank of Hope; Xenith Bankshares Inc. and Hampton Roads Bankshares Inc. under the Xenith brand; and Lapeer County Bank and Trust with Capac Bancorp Inc. forming the $600-million-total-assets Lakestone Bank and Trust.

During the decade after the bankruptcy of Lehman Brothers, groups wanting to get into banking have opted for acquisitions of smaller targets to serve as platforms for expansionary plans—essentially quasi-new bank charters—rather than a path that, at least previously, was fraught with uncertainty relating to obtaining a new bank charter. The lower valuations rewarded such activity.

With the election of President Donald Trump, bank pricing immediately skyrocketed. The market analyzed the president's policy positions and noted that tax reform, regulatory reform and infrastructure spending, with an expected upward bend to interest rates, were all beneficial to banking organizations. This led to the so-called "Trump bump" as the market, and especially publicly traded banking organizations, jumped in price. The "Trump bump," however, was followed by the "Trump slump" as the market turned pessimistic on the president's ability to turn campaign rhetoric into policy achievements. As a result, bank M&A, in both the number of transactions and percentage of banks that were targets, trailed 2016 activity through the first half and into the third quarter of 2017.

EDITOR'S NOTE: *Peter G. Weinstock will facilitate a panel of investment bankers at the 2018 IBAT Convention, September 22–25 in San Antonio. The group will explore mergers and acquisitions, along with other trends, in the session "Community Bank M+A."*

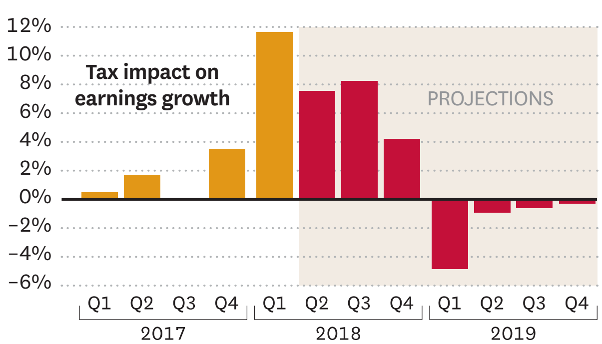
Despite the "Trump slump," bank stock pricing was notably higher than it had been in 2016. Most importantly, the market kept moving upward after the first quarter of 2017. Investors appeared to be unduly complacent during 2017 despite significant risks and pricing above historical norms. For instance, the S&P 500 never declined more than 2 percent on any day during 2017. In contrast, it did so five times in 2018 in just the first quarter alone.

In the fourth quarter of 2017, it became apparent that the president was going to be able to deliver on his signature achievement of tax reform. Stocks that were trading at all-time highs in terms of forward price-earnings ratios all of a sudden fell back to historically normal ranges. The post-election peak price-earnings ratio had reached 18.8x for the KBW Regional Bank Index to 15.4x in January after tax reform kicked in. As a result, M&A activity spurted ahead in the fourth quarter of 2017 as both buyers and sellers became believers that stock price changes were going to remain.

Buyers were able to structure deals using a greater percentage of stock than had previously been the case; 90 percent of deals were a mixture of stock and cash or all-stock deals as compared to a high of 73 percent in any other year over the past decade. Buyers were still able to recoup that tangible book value dilution in under the gold standard of four years, and in many cases the deals were immediately accretive to both tangible book value and earnings.

How the Tax Cut is Supercharging Earnings Growth

Tax cuts are giving a big boost to earnings growth for the S&P 500 stock index. Next year, the tax impact on earnings growth is expected to be negative, according to Wall Street consensus.



Percentage point difference between net income and earnings before taxes, by quarter. Q1 2018 is based on a blend of actual results and analysts' expectations. Subsequent quarters are Wall Street projections.

Source: Thomson Reuters I/B/E/S

Similarly, sellers enjoyed the assurance that the deal price at closing would be equal to or better than the deal price at announcement. These trends continued into the first quarter of 2018. Now what can we expect?

Publicly traded banks should continue to enjoy the benefit of some of the earlier tailwinds. As is the case with corporate America, earnings growth has been extraordinary so far this year. Both core earnings and the effect of tax reform have led to outsized performances. According to Thomson Reuters, nearly 80 percent of the companies in the S&P 500 have reported earnings that outstripped analyst expectations. Earnings per share grew 26 percent year over year.

The forward price-earnings multiple for the S&P index started 2018 at a premium level of 18.5x the index for expected 2018 earnings, but declined to 16.9x after first-quarter earnings announcements. The 16.9x price-earnings multiple is in line with the 30-year average for the index. The effect of tax cuts was 11.6 percent, so corporate America enjoyed a 13.2 percent growth in operating earnings. Thomson Reuters similarly projects tax reform will continue to be the gift that keeps on giving through 2018.

The Federal Reserve's efforts to bring interest rates back to historical norms is perceived as a net positive to banking. The expectation is that net interest margins will continue to widen. An increase in interest rates is expected to have an especially salutary effect on the two-thirds of banks operating at below a 90 percent loan-to-deposit ratio. Moreover, credit issues remain muted.

Accordingly, we expect M&A activity to remain elevated for the remainder of 2018. There have been some notable aspects of M&A activity other than just the numbers. The increasing franchise values have made platform bank deals—quasi-de novo transactions—pricier. As a result, we are starting to see a return of true de novo charters. Michigan, which was one of the hardest hit states during the economic downturn, is set to approve a new bank charter for one of our clients. Moreover, technology firms are seeking to enter banking. Stripe has applied for an industrial loan company charter. Two of our clients, one a bank being formed by the founders of OnDeck and Apple Pie, are in the application process.

Moreover, we believe that we have cracked the code on how to work a mortgage company into a bank without running afoul of regulatory issues, such as an abhorrence of monolines, affiliate transactions and "debt" stuffing.

We are also seeing rural banks increase in value as bankers are looking for cheap deposits. We continue to see strategic transactions where institutions join together even when the merger consideration is stock that is not publicly traded, particularly strategic transactions in targeted geographies or transactions to achieve scale.

However, the current positive trend line, like any market activity, can be expected to dissipate. First, pricing expectations of sellers are continuing to rise and may reach a level that is not economically supportable. For instance, through April 25, the announced median deal value to tangible common equity ratio was 1.837 percent—within striking distance of the 2x book value "holy grail."

Bank stock pricing also may reach an outer edge. As Patrick Ryan, president and CEO of First Bank in New Jersey, put it, banks do not have the "cool" factor that other institutions possess, with the result that investors may seek greater returns elsewhere.

Second, market volatility has, to some extent, been unprecedented in its scope. Although the equity indices finished only slightly lower for the quarter, there were certainly steep peaks and valleys.

Third, investors may also return to the bond market once the Federal Reserve adds another 75 or 100 basis points in rate hikes. At such point, the TINA principle—There Is No Alternative—that has also helped fuel the stock market may pull some of the fuel out of the market rally.

While inflation and the Federal Reserve's efforts to increase interest rates were perceived as a net positive, there is recognition that higher rates will have a negative impact on certain borrowers. The perception is that past-dues and nonperforming numbers will continue to grow modestly through 2018, but start picking up near the end of the year and into the new year.

The underlying fundamentals that are powering the consolidation in the banking industry are not likely to go away any time soon. Nonetheless, some of the tailwinds in the market rally, and thus, the ability of banks to use high stock prices to "wallet-whip" would-be targets, could be expected to diminish. As the chart on the facing page shows, the impact of tax reform on projections turns negative in 2019, which is also when expected credit challenges become more pronounced. Thus, we may look back at the current level of activity and conclude that—to quote Goldilocks—it was *just right*. ★

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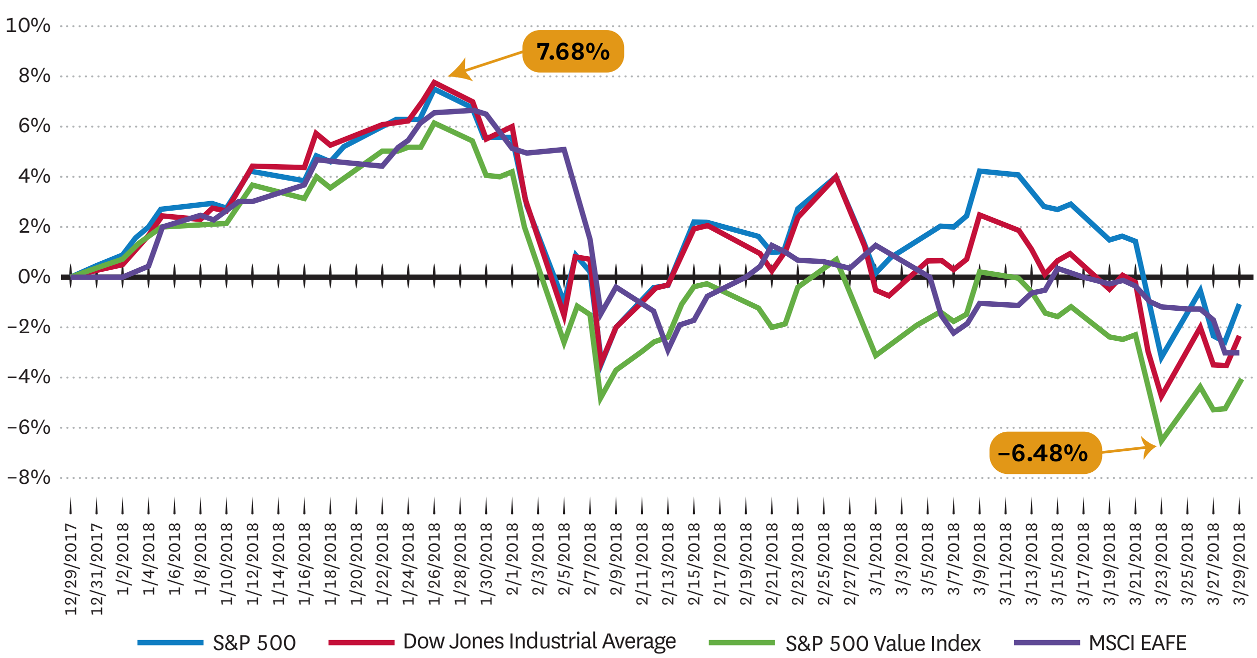
Rolling Daily Index Returns | First Quarter 2018



Source: Bloomberg