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UNCONVENTIONAL M&A

By Kamal Mustafa
Invictus Group Chairman

WHY IT MAKES SENSE TO DO A DEAL AMID DEPRESSED BANK STOCK PRICES

Community bank stock prices are down, and M&A transactions have dwindled, a reality that is troubling on many different levels.

The drop in bank stock prices and the corresponding decline in valuation of private banks has created an insular, fairly disturbing and increasingly shortsighted climate for both sellers and buyers. Buyers feel that their currency is too undervalued to use for acquisitions, while sellers believe that their values are too depressed to consider selling. As a result, even though the need for M&A has never been greater and the timing has never been better, community bank M&A transactions are few and far between.

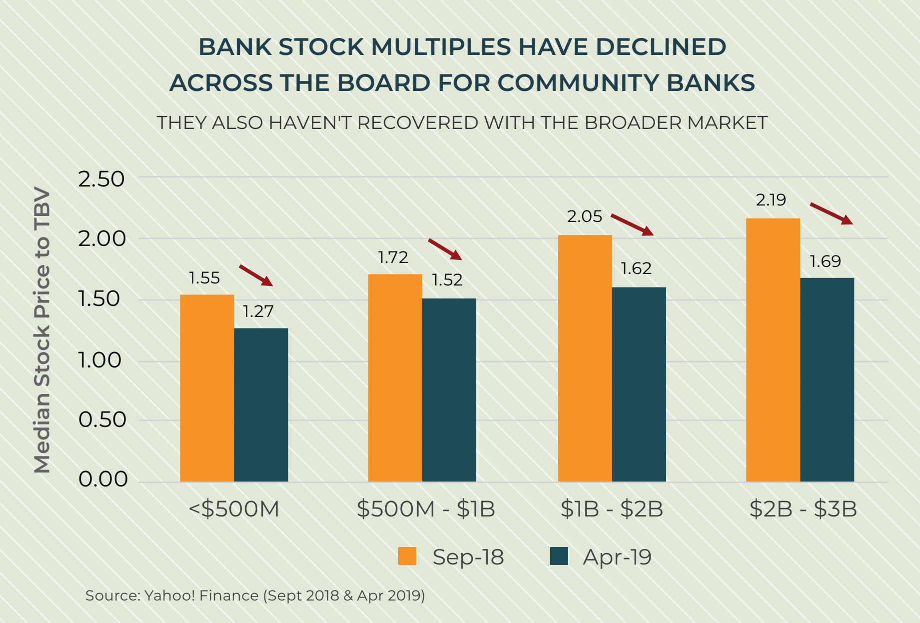
The only good thing about this bizarre situation: It creates an extraordinary opportunity for the farsighted to separate themselves from the pack and exploit the existing opportunistic vacuum in M&A activity.

Let's look at the big picture in the community banking market, rather than the intensely introspective and limited approach prevalent in the marketplace.

TWO ACQUIRING CAMPS

Bank stocks are down because the markets correctly perceive difficult times ahead for the banking industry. At present, acquiring

M&A (cont. on p. 2)



DEPOSIT DILEMMA

By Leonard J. DeRoma
Head of Liability Analytics

A PLAYBOOK FOR USING M&A AS A PROACTIVE TOOL TO SOLVE FUNDING ISSUES

Virtually any financial institution with a high loan-to-deposit ratio or with funding challenges in today's difficult and highly competitive environment for gathering and retaining deposits should at least explore M&A as a potential solution. The right acquisition can, overnight, provide the same amount of liquidity your bank can generate on its own over the next five years. However, pursuing acquisitions as a solution to the deposit dilemma must be done with diligent planning and a carefully developed process.

Simply expecting your investment banker to bring you deals is not how the process works best. As the CEO of an acquisitive bank, most M&A opportunities will be introduced to you in one of two manners:

1. You get a call from the investment banker *representing the seller* (not your advisor, but the other bank's advisor) inviting you to participate in a bidding process, and then you turn around and engage your

Deposit Dilemma (cont. on p. 5)

M&A (cont. from p. 1)

banks fall in two different camps.

Group 1. Hunker down and ride out the storm, while bemoaning their depressed stock price levels.

> "Think of how a few creative steps in structuring can get both of you the best of all worlds, while the rest of the market sleeps with its head buried in the sand."

Group 2. Capitalize on the fact 'that the number of buyers are down and the number of unsolicited targets available is greater, allowing them to use M&A to attack and overcome the "difficult times ahead."

Group 2 has an exceptional level of weapons and advantages in this environment. Please consider the following:

- If you are a student of history, look at the large number of times a US industry segment has suffered stock declines due to poor short-to-intermediate term prospects. You will find that a few select players in each of these industries broke with the norm and used their "depressed stocks" to make timely strategic acquisitions. A further examination will also show that these players end up dominating the industry during the next cycle.
- If you are a reluctant seller, call all the recent sellers that sold their banks for the high-valued stocks of acquirers and ask them how they are doing.
- If you are a potential acquirer, think about the larger unsolicited number of targets available for your "discounted" currency.
- If you are a potential acquirer, don't shy away from transactions of privately held banks whose selling prices have not declined as much as your stock price. Keep in mind that these banks are valued on a different basis and are not necessarily tied to the vagaries of the marketplace. Re-analyze them in the context of the upcoming markets. You will be surprised at the results.
- If you are an acquirer with a depressed stock price, aggressively sell the concept of "buy low, sell high" to the seller. It can be very powerful incentive.
- If you are a buyer or a seller, think of how a few creative steps in structuring can get both of you the best of all worlds, while the rest of the market sleeps with its head buried in the sand.

DEAL STRUCTURE MATTERS

Simple acquisition structuring templates can easily embrace the two possible extreme scenarios and most variations within these boundaries. These structures, which have been used successfully across many industries, will benefit both buyer and seller. While this article isn't focused on structuring issues/opportunities, the following simple example should be enough of an outline of a baseline framework to understand the value of a creatively structured M&A transaction:

- Instead of a pure stock or a stock and cash combination, build a transaction with a combination of stock and subordinated convertible debt.
- Construct the conversion features of the subordinated convertible debt to the reverse of the intermediate-term pro forma performance of the acquirer's stock.

In such a transaction, if stocks do not recover, both parties have done a valuable transaction in the new "reality". If stocks do recover, the acquirer has successfully consummated an attractive transaction that would most probably further enhance the stock recovery, while the seller gains their proportionate pricing value.

While the actual structuring will be more complex than the aforementioned, correctly done, there are substantial benefits for the seller and buyer with meaningful capital adequacy benefits for the buyer.

If senior management of both buyers and sellers can open their minds and turn on their creative juices, they have tremendous opportunities in this present lackluster M&A market. Their biggest problem will be convincing the occasional insular and recalcitrant director, obsessed with present-day stock prices, to see the longer-term picture.

M&A (cont. on p. 3)

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Kamal Musafa, the founder of the Invictus Group, is a major thought leader in banking and finance. Over the past 40 years, he has served as head of corporate finance/credit at Connecticut Bank and Trust; head of Global Mergers & Acquisitions at Citibank; Managing Director of M&A and Merchant Banking at PaineWebber; Managing Director of KSP, a $1 billion leveraged-buyout fund for John Kluge; founder and chairman of Bluestone Capital Partners and Wildwood Capital. He founded Invictus in 2008. Mr. Mustafa has an MBA from the University of Connecticut, where he has been a trustee, and serves on a number of corporate boards. More than 30 state banking associations have invited him to speak about the state and direction of the community banking market in the last few years.

M&A (cont. from p. 2)

Here's why an understanding of the past — and a glimpse of the future — should allay those director M&A misgivings.

CHANGES IN COMMUNITY BANKING MARKET

A lot has changed since the 2008 recession. Arguably, the biggest and most significant trend has been taken for granted. Quantitative Easing (QE) injected over $3.5 trillion into the US market, driving down interest rates and flattening the yield curve for an extended time.

QE was also the catalyst behind an unforeseen and generally ignored change in the community banking market: the shifting of the balance sheet.

In the 10 years after the recession, community bank deposits more than doubled, with a steady decline in their cost. These increasing levels of low-cost deposits funded a consistent increase in asset growth for many years. (See Charts 1 and 2).

This loan growth occurred naturally in areas of robust retail and corporate activity to the benefit of banks located there. In turn, this phenomenon created a marked geographic segregation of banks with high loan-to-deposit ratios and banks with low loan-to-deposit ratios.

Unfortunately, the QE injection of funds/liquidity into the marketplace has abruptly stopped. Deposits that were largely discounted and ignored by the large banks are now in demand, resulting in increased competition and market driven rate increases.

CHART 1

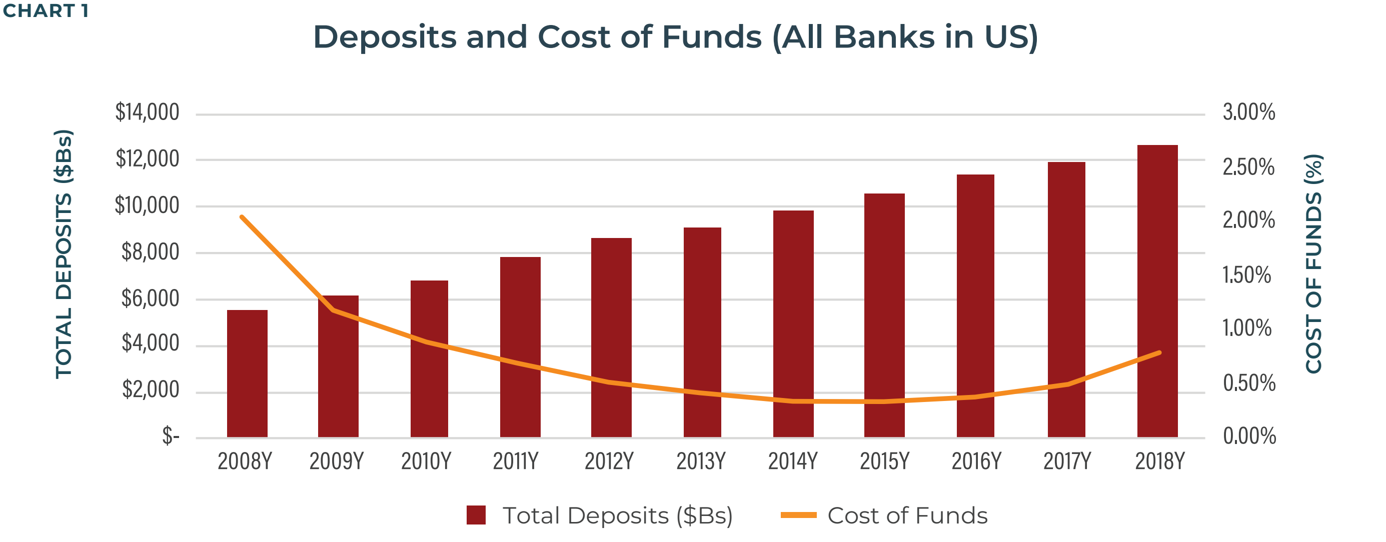
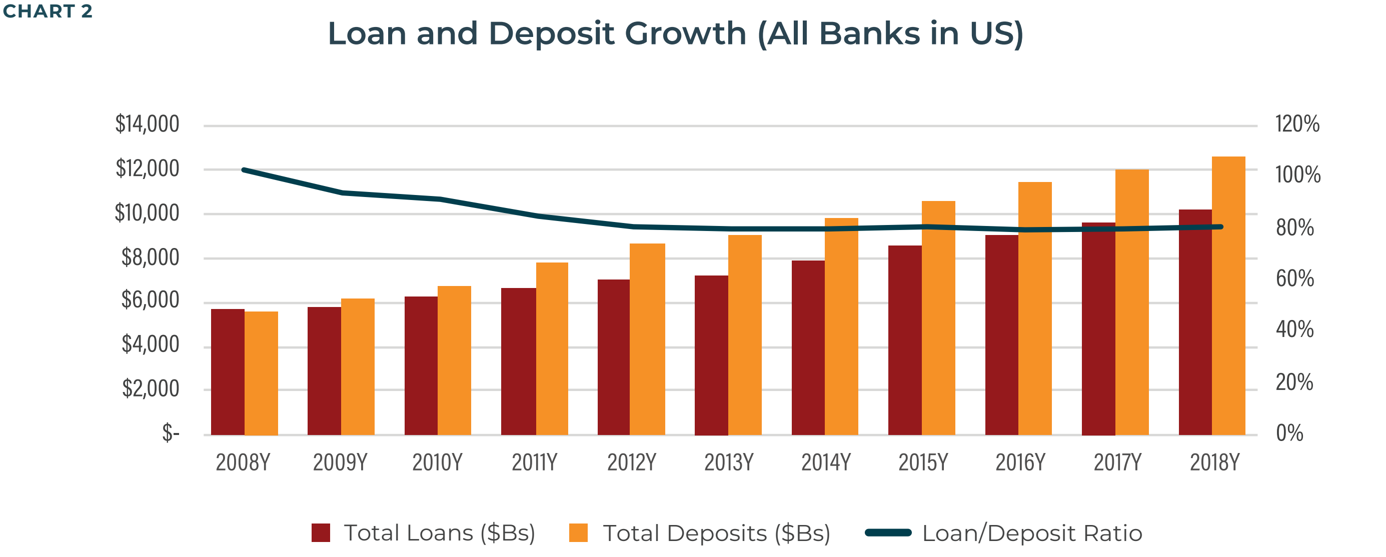


CHART 2



While most bankers recognize the lack of growth in deposits and market-driven rising costs, some of the long-term implications are not as visible:

- The 10-year growth in assets funded by low-cost "footprint" deposits is coming to a grinding halt. Banks must now learn to manage profitability and investor expectations in a low- growth environment. Given prevailing community bank operating structures, this is not an easy task.
- The prior decline in rates (loans and deposits) helped most community banks in interesting and generally unappreciated ways. Longer reset periods and maturities delayed the impact of declining rates on bank loan portfolios, while declining rates, flat yield curves and increasing volume of footprint deposits disproportionately reduced funding costs.

These unique benefits don't just disappear. They go from benefits to penalties in a rising or flat rate environment. Banks with high loan-to-deposits and cost of funds will be particularly vulnerable, while banks with lower loan-to-deposit ratios will have a remarkable opportunity to further distance themselves from the pack.

Deposit gathering techniques focused on training and software, while necessary, will not move the needle since nearly all community banks will be doing the same thing. The result will be increased operating costs. The large banks will continue to build on their technology and product range advantages, as they refocus on deposit building in the post-QE environment. For community banks, M&A will increasingly become the only way to make a meaningful difference.

The last 10 years created a new class system of banks: banks in high-growth areas that have profitability exploited these markets and ended up with high loan-to-deposit ratios, and banks in relatively low loan growth areas that have relatively poor operational profits, but low loan-to-deposit ratios and cost of funds. These two classes create a unique M&A opportunity for the enterprising banks that have the foresight and creativity to capitalize on the present environment.

Wake up and smell the deposits.

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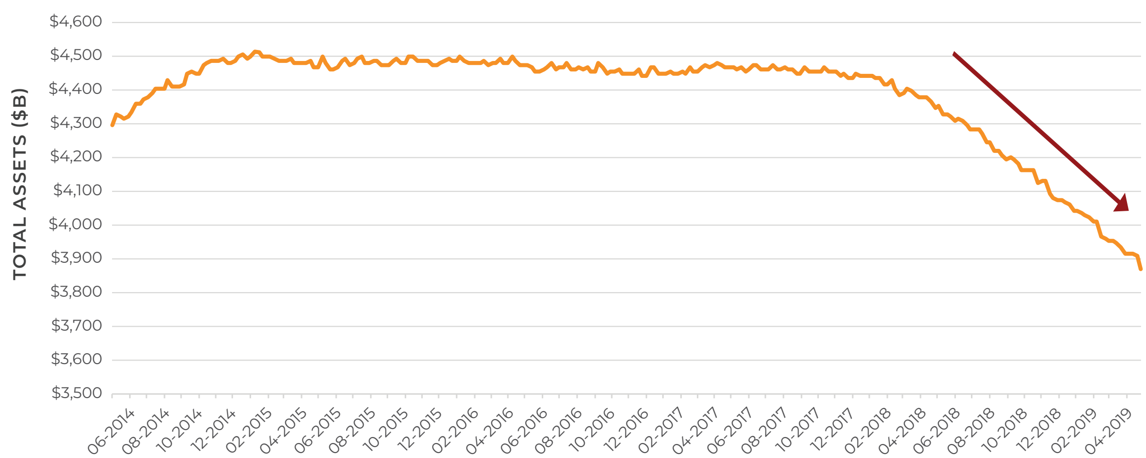
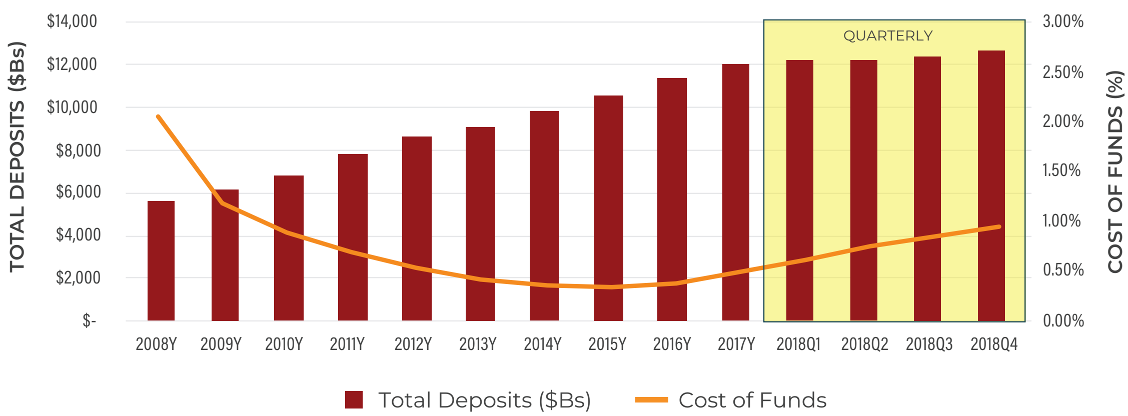
CHART 3

End of Quantitative Easing:

The Fed's Balance Sheet is Down $626B Since its Peak



Deposits and Cost of Funds (All Banks in US)



These two charts show as the Federal Reserve increased its holdings, deposits in the banking system more than doubled. The end of QE has led to the deposit dilemma

DEPOSIT DILEMMA (cont. from p. 1)

own investment banker upon acceptance of that invitation.

2. You create a transaction yourself by leveraging the relationships with other bank CEOs you have developed (also referred to as the 'negotiated transaction'). Investment bankers and lawyers are brought in 'after the handshake' to formalize and process the deal.

It is important to note that the investment banker for the buyer is generally engaged after the opportunity has been identified. In fact, investment bankers tend to prefer it that way because they have a transactional business model. Their preference is to represent sellers because that is the equivalent of having a 'bird in hand', while representing a buyer without a committed seller means they are taking a risk of expending their time and resources without a guaranteed pay day.

In most situations, would-be acquirers participate in a bidding process (option number one above). Unfortunately, this approach severely limits the probability of a successful transaction with the right bank. First, you will only be reacting to banks that 'are for sale', irrespective of how they alleviate your bank's issues. Unfortunately, most of the banks currently 'on the market' are banks in your footprint that have the same challenges with funding. Second, the chance of success is very low, since you are likely one out of 10 or so banks invited to participate in the process. Third, because it is "shopped" and in an auction situation the price will be high. Fourth and perhaps the most overlooked aspect of this approach is the 'fatigue factor.' Each time this type of an opportunity surfaces, it essentially diverts the time of key members of management to assess and analyze the opportunity, with most of their time wasted on unsuccessful bids.

THE MISSING PIECE OF THE PUZZLE: A PROACTIVE PROCESS

Unless you get lucky, the "opportunistic" M&A approach won't end up with a successful acquisition of the right bank. Instead, a bank in need of deposits needs a well-defined strategy and process that leads to the highest quality transactions. The right playbook for developing an acquisition strategy looks something like this:

1. First determine your strategic objectives and then evaluate whether M&A and/or organic growth can help the bank achieve its goals. If you are a bank with a 100% loan-to-deposit (LTD) ratio and plan on growing your loans by 10 percent next year, and you set up a strategic objective to reduce your LTD ratio to 90% by relying less on CDs, what is the best way to achieve that? M&A should not be a 'hip shot' reaction to news from an investment banker that a target is for sale. A good strategic plan treats M&A as a tool that can supplement or complement organic growth. This will lead you to create criteria for ideal targets: for example, all banks within 150 miles, with excess liquidity of at least $100 million, and with transaction accounts representing at least 30 percent of the deposit base.
2. Develop a target list based on that criteria, and then analyze each bank. The list itself shouldn't be limited to only targets that are or will likely be for sale. Banks not yet for sale are opportunities to get ahead of the market– especially if they have the characteristics of banks likely to sell in the future. The analysis of each target should include deep-dives into both the loan and deposit portfolios, considering the ability of the target's loans and deposits to absorb changes in interest rates, as well as credit risk issues, including CECL and stress testing analytics. All analyses should be performed in conjunction with how each target's loans and deposits fit with and alter those of the buyer. If you're a bank with a 100% LTD ratio, a target that also has a high LTD ratio will be a poor fit, irrespective of how impressive their loan growth has been.
3. Translate the robust analysis of each target into a valuation specific to your bank. Target valuations should include both a financial component and a strategic component. Each target should be valued on what they are worth to you, regardless

How M&A Has Changed

Legacy M&A	New World of M&A
M&A AS A STRATEGIC DECISION	M&A AS A TOOL TO CORRECT BALANCE SHEET ISSUES
OPPORTUNISTIC DEALS FUELED BY INVESTMENT BANK AUCTIONS	CAREFUL ANALYTICAL PROCESS TO FIND DEALS THAT FIT EACH BANK'S UNIQUE SITUATION
MANAGEMENT CONTROLS DUE DILIGENCE, WITH SOME OUTSIDE HELP	MANAGEMENT MUST TAKE A GREATER ROLE TO IDENTIFY CHARACTERISTICS OF THE RIGHT TRANSACTION

DEPOSIT DILEMMA (cont. on p. 6)

DEPOSIT DILEMMA (cont. from p. 5)

of market prices. You gain an edge when a target's worth to you exceeds its market price. You don't need to waste much time on those targets that are worth less to you than they are to the rest of the market.

4. Design an outreach strategy for each target. This needs to be done properly and carefully, with an analysis and reconnaissance of each target to determine the angle that most likely makes it a willing seller. Each target will have a unique narrative. Simply approaching a banker and saying, "If you ever thought about selling, I'd be interested," is not enough. Can you offer them more than the market without overpaying? What are their important intangibles? The approach to a target with weak earnings and a controlling shareholder will be dramatically different than one to a target with strong earnings but with a succession planning problem or an aging shareholder base.

5. Execute the outreach and manage the development of each relationship. Once the outreach occurs, some targets will be ruled out, some may require the 'long game' and if lucky, one or two will be immediately interested. Each touch point with any target following the first outreach but prior to sending a Letter of Intent should be handled with care and have a specific objective.

6. In certain situations, you may be invited to participate in an auction. Since you have already performed the preceding steps, you can make an immediate and well-informed decision on whether to participate. This approach eliminates the frequent 'fire drill' process that encumbers 10 days of management team's time with little chance of success. If you decide to pursue the target in an auction, it not only increases the efficiency of the process, it also improves the chance of success because the go-ahead call likely means the target is worth more to you than the market, giving you an advantage. If you have previously reached out to this target (see step 5 above), you may also find yourself with a competitive advantage. (Invictus has been part of several recent bidding transactions in which our clients won, even though their bid wasn't the highest, because of the relationship they had already developed with the target.) Depending on the situation the "soft factors" such as culture and fit can be as, if not more, important than the financial aspects.

NEW ANALYTICS AND NEW ROLE FOR MANAGEMENT

Remember that the post-recession era, marked by the Federal Reserve's unprecedented policy of quantitative easing, forever changed community banking. (See "Why it Makes Sense to Do a Deal Amid Depressed Bank Stock Prices, page 1.). Reversing these changes through traditional operating procedures is slow and ineffective, while M&A can be a powerful corrective tool for the deposit dilemma. However, using M&A to create the funding needed to grow and preserve loans, reduce liquidity risk, and maximize shareholder value requires a drastic shift in M&A analytics, the role of management and their investment bankers.

But you have a better chance of rapidly and significantly growing your deposit base using this new M&A approach than you do by trying to grow deposits organically with gimmicks such as points on checking accounts, toasters, or any other 'hacks' that are out there.

Investment bankers will continue to play an important and essential role. They provide necessary services associated with completing a transaction for the buyer, including acting as the 'deal manager' to gather up the target's shares and provide a fairness opinion. But the structure and resources of most investment banks is geared toward transaction-specific actions. They were not organized or designed to focus on identifying and quantifying the unique financial and operating challenges faced by individual community banks.

The most valuable aspect of any successful transaction is the creation of the right opportunity that fits the holistic strategy of the bank. Without that, there is nothing to do but hope that the right bank comes up for sale. And hoping is not a strategy.

> **"The most valuable aspect of any successful transaction is the creation of the right opportunity that fits the holistic strategy of the bank."**

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Leonard J. DeRoma began his career at Citibank in corporate finance, then spent the next 20 years in senior positions in fixed-income trading at Lehman Brothers, Barclays Capital and KeyBank. As the President of Barclays U.S. securities business, he was senior advisor to the U.S. ALCO committee and chaired the U.S. Credit and Risk Management Committee. He has a BS from the Massachusetts Institute of Technology and an MBA from the Harvard Business School.

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Fed Proposal to Ease Community Bank Capital Raising

The Federal Reserve issued a proposal in April that eases some rules for investors, while providing more clarity on the factors and thresholds it uses to determine if a company has a controlling interest in a bank. Those include total equity and voting stock investments, as well as the scope of business relationships between the company and the bank. The proposed rulemaking would permit an investor to have a greater number of director representatives at the target company without triggering a presumption of control, a change from past practice.

"Providing all stakeholders with clearer rules of the road for control determinations will responsibly reduce regulatory burden," Fed Chairman Jerome Powell said in a statement. "As a result, it will be easier for banks, particularly community banks, to raise capital to support lending and investment."

Banks, Trade Groups Push to Lower Community Bank Leverage Ratio

Expect some changes to the proposed community bank leverage ratio before it becomes final. Now that the comment period is over, regulators are looking at the 1,171 letters, including from the American Bankers Association, the Independent Community Bankers of America, Idaho Sen. Mike Crapo (who sponsored the bill that established the ratio) and more than 1,100 "form letters" from community bankers, all asking for an 8 percent ratio, instead of the 9 percent or more that was first proposed.

Regulators say that the goal of the proposal was to simplify the capital framework for community banks while not reducing their regulatory capital. At the March 28 Advisory Committee for Community Banking, Ryan Billingsley, of the FDIC's Division of Risk Management Supervision, acknowledged that even an 8 percent ratio is "more than what many banks are required to hold today." (This is why Invictus is recommending that its clients calculate their own capital ratios using stress testing, rather than automatically opting into the framework).

Bankers also object to the proposed PCA proxy framework, saying it would be unfair to banks that opt into the CBLR and subsequently fall below the set ratio. The Conference of State Bank Regulators criticized the proposal for including mortgage servicing assets (MSA) and deferred tax assets in the qualifying criteria; banks with MSA concentrations that exceed 25 percent of tangible equity cannot opt into the framework.

History Lessons: Regulators Offer Podcasts, Interviews

The FDIC has released a seven-part podcast series, *Crisis and Response: An FDIC History, 2008–2013*, which describes the FDIC's behind-the-scenes decision-making as hundreds of banks failed. The Federal Reserve, meanwhile, has posted dozens of interviews from former Fed Chairs, governors and staffers as part of a look at "life and culture" at the board over the past 50 years, tied to the Fed's centennial in 2013.

White House Moves to Review Guidance

Regulatory guidance, statements of policy and other interpretive rules must go through the Congressional Review Act, according to an April memo from the Office of Management and Budget. The memo notes that the CRA "specifically exempts rules concerning monetary policy" developed by the Fed, but everything else is subject to oversight. Until now, guidance had not been subject to CRA review.

Banking regulators in the fall issued a statement clarifying that guidance did not carry the same weight as rules or law, even though examiners have typically written up banks for not following guidance. "We have taken a number of steps to ensure our examiners understand this, including written instructions, all-hands examiner calls, and in-person training," FDIC Chair Jelena McWilliams said in a March speech at the Banking Institute at the University of North Carolina School of Law. "We also are reviewing our outstanding guidance documents, the role such guidance documents play in the examination process, and our approach to issuing supervisory guidance going forward."

Few Banks Have Selected CECL Methodology

While many community banks are looking at the data and analysis they'll need for CECL, only about 5 percent have selected and tested the methodology they'll be using, according to a survey of 521 bankers conducted by regulators for the Community Banking in the 21st Century conference last year. Federal regulators said on a recent webinar that no one method is appropriate for every loan portfolio.

The bankers in the survey expressed concern that CECL "will complicate collection of data on loan quality." Banks that are concerned about data may want to consider joining a data-sharing initiative, according to BankGenome Project Director Guy LeBlanc. A recent Invictus survey of community banks found that more than 75 percent of bankers regarded their lack of data as a strategic risk.