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MERGERS OF EQUALS

By Lisa Getter and Adam Mustafa
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RARE DEALS COULD HELP COMMUNITY BANKS SOLVE PROBLEMS

Last December, Virginia Partners Bank, which has $410.1 million in assets, announced a strategic merger of equals (MOE) with Delmar Bancorp, a $737.9 million holding company that owns The Bank of Delmarva. When the deal closes, each community bank will operate as independent subsidiaries of Delmar, keeping their names, management teams and boards.

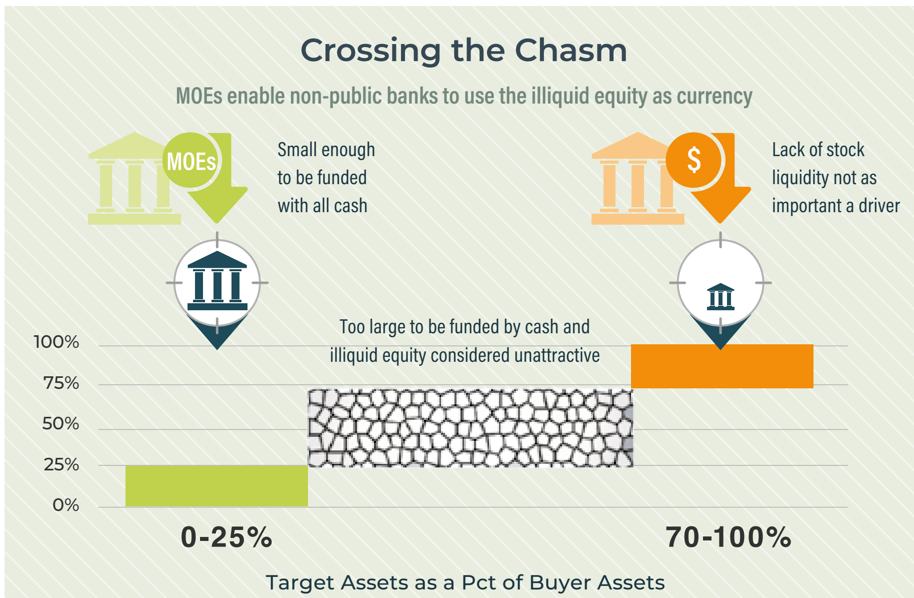
Manatt Phelps & Phillips bank attorneys took notice when the deal was announced, writing that the MOE "may portend a revival of this oft-difficult-to-accomplish transaction as banks try to get bigger to compete without selling in their entirety."

Then, in 10 days in the beginning of 2019, two larger merger of equals announcements took the banking market by surprise: Chemical Financial Corporation and TCF Financial Corporation revealed a $3.6 billion deal, and BB&T Corporation and SunTrust Banks proposed a $28 billion transaction.

The back-to-back mergers of equals could be "harbingers" for similar bank deals, Morgan Stanley analysts declared. Mercer Capital managing director Jeff Davis predicted that "the industry could see hundreds of MOEs and quasi-MOEs among banks in the coming years because scale – or operating leverage – is important to drive returns."

The reasons propelling larger banks to

MOEs (cont. on p. 2)



M&A RED FLAG

By Kamal Mustafa
Invictus Group Chairman
(and former investment banker)

BEWARE OF DEPENDENCE ON AUCTIONS

M&A transactions initiated through an auction process have become *de rigueur* in the community banking marketplace. In the right situation, they have several advantages that include speed, limited due diligence and (generally considered most important) the opportunity to create a feeding frenzy that leads to a higher-than-expected price.

If you are a profitable bank that dominates an attractive footprint and your balance sheet and P&L reflect this position, then an auction is an excellent idea.

On the other hand, negotiated transactions have the potential to create far greater shareholder value, while also protecting employees and customers within a bank's footprint. Unfortunately, community banks rarely pursue these types of deals through sheer habit, expediency and/or the absence of appropriate data and analytics.

For most community banks, whether a buyer or seller, the footprint by its very nature creates balance sheet strengths and weaknesses that are reflected in

Red Flag (cont. on p. 4)

MOEs (cont. from p. 1)

consider MOEs are different than for community banks. But many smaller institutions would be wise to include the MOE option in their strategic playbook if they are considering a merger or acquisition, especially if they can't afford to buy a larger bank. Community banks that can produce loans but need deposits, and vice versa, may also make good MOE partners.

MOE ADVANTAGES FOR NON-PUBLICLY TRADED BANKS

The community banking industry is littered with privately held community banks under $1 billion in assets that fall into one of the following two buckets:

1. They are strong loan producers in attractive higher growth markets, but they are 'loaned up' with high loan-to-deposit ratios and are having significant difficulties gathering deposits in this environment to fuel continued growth.
2. They have plenty of excess liquidity and carry low loan-to-deposit ratios but are in lower-growth markets and struggle to generate organic loan growth.

In a myriad of ways, banks in each of these buckets are perfect marriage partners. Each bank's strength addresses the other's weakness.

Private banks can also look to acquisitions. Because their stock is often illiquid, they most likely will have to pay cash. As a result, their war-chests are limited, constraining the size of acquisition targets. On the other hand, an MOE presents a very different dynamic than an acquisition. The spirit of the transaction is not to represent an exit for either institution, but to combine forces to double their size and address their weaknesses with far more materiality than an acquisition would present. MOEs will be done as 100 percent stock transactions without the liquidity of either institution's stock being a driving factor. Sure, there is a trade-off, especially since an MOE will be predominantly driven by social issues, but a $400 million bank with a 110% LTD ratio is far better off merging with another $400 million bank with a 65% LTD ratio than buying a $100 million bank with a 50% LTD ratio.

Another way to think about it is that there is a chasm in terms of asset size between what a private bank can acquire and with whom it can merge. For example, the same $400 million bank may have $8 million in excess capital and an additional $20 million of debt capacity at its parent company, but a $28 million war chest limits targets to banks with $200 million in assets at the most, and that's a stretch. More likely, it will be looking at targets with assets between $100 million and $150 million. While helpful, these acquisitions pale in comparison to merging with another $400 million bank. The combined bank complements the first bank's strengths, alleviates its weaknesses and creates an institution nearing $1 billion, armed with double the lending limits and the best-of-breed merger of talent across the two institutions. MOEs allow private banks to eliminate the constraints that acquisitions present in terms of size and materiality.

MOE POSITIONS BANKS FOR MORE M&A

Just look to Michigan to see how an MOE can propel community banks forward. In March, two similar-sized Michigan community banks on opposite ends of the state announced an MOE. ChoiceOne Financial Services of Sparta, a $670 million asset-sized institution, plans to merge with County Bank Corp., of Lapeer, a $617 million asset-sized bank in a tax-free "reorganization." Together, they will become the 12th largest bank in Michigan.

The company expects to be listed on NASDAQ after the deal closes. And the MOE also "opens the door" for the new bigger bank to make additional acquisitions in lower Michigan, investor materials state.

As a cautionary note, the announcement that an MOE is in the works does not mean it will be successful. Earlier this year, Knoxville-based Smart

Three Banks into One

There's a new $1.3 billion bank holding company in Georgia – and it's the result of a merger of equals. Heritage Southeast Bancorporation came about as the result of a merger of three institutions, not two: CCF Holding Company, the parent of Heritage Bank ($577 million), of Jonesboro, Heritage Bancorporation Inc., the parent of The Heritage Bank ($584 million) of Hinesville, and Providence Bank ($92 million) of Alpharetta.

The banks will operate under their own brand names, but as a division of Heritage Southeast Bank, serving customers in Georgia and Florida. The goal of the merger was to combine "three highly compatible institutions with aligned corporate cultures and a common vision" to "better serve the needs of clients, address the challenges of the banking industry and create value for shareholders." The merger application predicted that the transaction would earn long-term earnings-per-share accretion to CCF shareholders by 2020, with a tangible book value earn-back period of 4.5 years, while generating approximately $4.3 million in annual run-rate cost synergies by 2021.

MOEs (cont. from p. 2)

Financial, the parent company of SmartBank, announced an MOE with Entegra Financial Corp, owner of North Carolina-based Entegra Bank. But in May, Entegra paid a $6.4 million penalty to call off the deal. Entegra's board decided to take a cash offer instead from $35-billion First Citizens Bank and Trust Co. of Raleigh, choosing liquidity upfront rather than the long-term benefits the MOE might have given it.

UNCONVENTIONAL M&A

By Kamal Mustafa
Invictus Group Chairman

WHAT MAKES MOEs UNIQUE—AND HOW TO AVOID THEIR PITFALLS

MOEs are not like typical acquisitions and cannot be approached in the same manner. They:

- Comprise a very small fraction of transactions.
- Have a high failure rate due to social/valuation/process issues.
- When consummated, practically always rank as the most successful transactions within the industry.

Social issues with senior management are typically the biggest reason why most MOEs fail. The CEO approach, industry reputation and interactions are crucial factors that can make and break a deal.

In any deal, directors and shareholders are extremely important. The directors and shareholders of both banks need to be made comfortable regarding the economics of the deal, the impact of dilution and the post-transaction value appreciation of shareholder equity. Obviously, the respective board reports will differ in detail and focus.

TRANSACTION APPROACH AND DUE DILIGENCE:

From inception to completion, an MOE cannot be approached like a typical acquisition. Each step has the potential to subvert a successful MOE, negating the substantial benefits of such a transaction.

The CEO. The initial CEO level contacts in a typical acquisition tend to focus on critical points of concern regarding the value proposition, transaction structuring and interpersonal issues. But in an MOE, the entire focus is to start with mutual acceptance of both institutions, focusing on the transaction's significant operating and financial benefits. Properly managed MOEs and their financial and operating benefits can take on a life of their own, creating opportunities for each bank to make the right adjustments at appropriate times without jeopardizing the transaction.

If the initial independent evaluation of an MOE transaction is positive, the CEO of each bank becomes the primary salesperson of the transaction value to all parties in both institutions. Establishment of the potential value goes a long way in putting potential conflicts in context. Such conflicts could otherwise derail the

MOE TIPS FROM CEOs: CULTURE, EXCITEMENT AND DETAILS MATTER TO GET THE DEAL DONE

MOEs require a different mindset and attitude, particularly on the part of CEOs. See "What Makes MOEs Unique—and How to Avoid Their Pitfalls" in this issue. Here are some tips garnered from the public statements of CEOs involved in recent transactions.

Make sure the banks have similar cultures. "The culture of a partner was of the utmost importance when we considered this transaction," said Bruce Cady, CEO and Chairman of County Bank.

Build excitement and stress equality. BB&T Chairman and CEO Kelly King told analysts that the secret to a successful MOE is "that the two leaders genuinely, honestly mean equal…. You have to really be truly committed to equal because when you are truly committed to equal, then everybody gets excited and passionate about it and you really do pick the best of both organizations. And I'll tell you, having been through one, it's just pretty incredible. Every organization has great parts, but every organization has weak parts. And when you get a chance to marry two great organizations and pick the best from both organizations, you get great-great."

Get the hard details out of the way. SunTrust Chairman and CEO William Henry Rogers said the two CEOs "checked the boxes" on the essentials. "We had board, we had management, and we had transition all identified and locked down. But I think most importantly, and I can say this for the conversations we had, is everything went to the middle of the table first. I mean nothing started at the edge of the table in the conversations. Everything went in the middle of the table, headquarters, name, all those things that people get caught up in."

Know your peers. Rogers and King knew each other through years of discussions at industry conferences. So when the SunTrust/BB&T merger was first floated as an idea during SunTrust's annual strategic planning meetings in 2018, according to a joint proxy statement/prospectus, it was easy for the two men to connect.

UNCONVENTIONAL M&A (cont. from p. 3)

transaction if addressed too early.

Initial Senior Management Interactions: Normally senior management, including financial and operating executives, are focused on a due diligence process geared to identifying and qualifying potential problems. In the MOE initial stages, they must follow the CEO's lead and start collaborative discussions with their counterparts. These discussions should positively communicate the potential of the post-merger strategic plan. Once the MOE is in process, these collaborative discussions create the necessary goodwill that would support the MOE.

> **Smaller banks would be wise to include the MOE option in their strategic playbook."**

Here again, once the MOE is in full swing and senior management of both sides are collaborating, due diligence decisions will be viewed in the context of the total benefits of the transaction. In most successful MOEs, the due diligence process works in both directions. The leadership and message of each CEO is essential for this to work properly and successfully.

There are many benefits to an MOE. Some of these benefits are obvious, while others that are equally important are not recognized at the early stages of analysis:

- No acquisition premiums are involved.
- Unlike acquisitions, capital remains available for strategic actions post-transaction that would greatly increase shareholder value and facilitate integration. **This value should never be underestimated.**

Secondary benefits include:

- Minimum disruption of operations and collaborative efforts to maximize synergy.
- Greater focus of management resources and capital on a combined strategic plan rather than a traditional acquisition where integration becomes the default strategic plan.

Quite apart from the pricing benefits of the MOE, it is the CEOs' vision of how the two companies would move forward, further increasing shareholder value, that must be communicated to both institutions early on during the process.

Bank management must understand the CEOs' strategy and recognize that it is initially their responsibility to share the excitement in that vision with their counterparts. This cooperative process will also allow for a better and friendly evaluation of critical personnel and their potential role in the future of the MOE. Their objective must be to establish a collaborative environment where the job security and compensation benefits of the bank's strategic plan are effectively communicated to the counterparties. This bottom-up goodwill goes a long way toward a winning MOE.

RED FLAG (cont. from p. 1)

operating performance. This is where negotiated transactions provide the best option for shareholders, management and a bank's client base. Smart investment bankers understand this.

NEGOTIATED TRANSACTIONS: A BETTER REALITY

It is the responsibility of management (in order of priority) to:

- Maximize value to shareholders.
- Protect management and employees.
- Preserve best interests of community stakeholders.

This is difficult to achieve under an auction scenario because:

- Acquirer/seller due diligence is limited due to time pressures, management distraction and availability, and competitive pressures.

(cont. on p. 5)

Negotiated Transactions: A Better Reality

Responsibility of Management

MAXIMIZE VALUE TO SHAREHOLDERS	PROTECT MANAGEMENT AND EMPLOYEES	PROTECT SERVICES WITHIN THEIR FOOTPRINT

Advantages to Buyers

- Allows you to pursue targets that are the best fit instead of being limited to banks for sale
- Evaluation of cultural fit and due diligence happens naturally versus the 'shotgun marriages' that result from bidding processes controlled by investment bankers
- Significantly reduces the risk of overpaying
- Creates a first mover advantage over other acquirers

RED FLAG (cont. from p. 4)

- Management's control of the selling process practically disappears the moment the auction starts and the transaction takes on a public life of its own.
- Considerable amount of proprietary/competitive information is released to bidders.
- A failed transaction in an auction can be devastating to the bank's reputation, staff morale and customer loyalty.
- There are relatively fewer "greater fool's" in the community banking market that will overpay.
- Auctions are inevitably driven by a bias toward historical and year-to-date operating performance rather than a true detailed understanding of the banks' balance sheet characteristics that will have considerable impact on future performance under expected market conditions. Auctions tend to favor form over substance.

There are numerous benefits to negotiated transactions because:

- Management retains control throughout the discussion and closing process, enabling them to ensure protection for shareholders, staff and client base.
- Management can identify and discreetly communicate with potential acquirers, showing how the bank's unique balance sheet strengths can enhance an acquirer's balance sheet and/or mitigate an acquirer's balance sheet weaknesses (loan-to-deposit ratios, loan concentration issues, loan diversity, etc.). This is clearly the best way to maximize shareholder value and leverage the selling bank's strengths.
- Often, the selling bank's weaknesses can be offset by the acquiring bank's strengths, creating a real quantifiable synergy that bodes well for the future. A classic example would be a bank with a low loan-to-deposit ratio and cost of funds acquiring a bank with strong yielding loan portfolios that are offset by a high cost of funds. The excess low-cost liquidity of the acquiring bank would flow into the target bank, resulting in a substantial synergistic increase in pro forma operating profits. In a negotiated transaction, the seller can highlight and benefit from sharing this true synergy.

> **"Negotiated transactions have the potential to create far greater shareholder value, while also protecting employees and customers within a bank's footprint."**

- Management can evaluate the acquirer's culture and its potential impact on their own organization.
- Negotiations can be discreet and confidential without disrupting existing operations and morale.
- With the right non-disclosure agreements in place, the selling bank can prioritize and investigate several potential buyers without the potential negative effects associated with a sale of the bank and the broad dissemination of proprietary information.
- Management roles and board of director positions in the acquiring bank can be properly negotiated as part of the transaction. These board roles could be important to existing shareholders/directors of the selling bank, especially where stock is part of the transaction.
- Transactions can be structured taking into consideration shareholder taxpayer issues, further increasing shareholder value.

In summary, the benefits of negotiated transactions far outweigh any potential benefits from an auction for most community banks. It is unfortunate that many community banks, after spending decades building up their balance sheets and capital base, end their existence in the uncontrolled chaos of an auction.

Some bankers mistakenly think they are fulfilling their fiduciary obligation by conducting an auction. They assume that if they only talk to one buyer in a negotiated deal they may not be getting the best price. This, of course, is a myth.

While the concept of a selling bank using the *right analytics* to investigate and thoroughly analyze potential acquirers seems new to the marketplace, it is one of the most valuable actions management can take to maximize shareholder value. Negotiated transactions allow banks to take a proactive approach to M&A, gaining a competitive edge and solving their deposit issues.

ABOUT THE AUTHOR

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Kamal Mustafa has an investment banking career spanning more than 40 years. He was head of Corporate Finance at Connecticut Bank and Trust, a $3-billion community bank. He was the head of Global Mergers and Acquisitions at Citibank in the 1980s. He was managing director of Merchant Banking and M&A for PaineWebber, leading hostile takeovers and defenses. He ran a $1-billion leveraged buyout fund. Now he's the founder and chairman of the Invictus Group, working with a team bringing global analytical techniques to the community banking M&A market.

READ BETWEEN THE LINES

BANK INSIGHTS REGULARLY REVIEWS NEWS FROM OR ABOUT REGULATORS TO GIVE PERSPECTIVE ON REGULATORY CHALLENGES.

Keeping up with CECL, Despite Delay

Although the Financial Accounting Standards Board is giving small banks more time to comply with CECL, there may be advantages to implementing the standard sooner. Adopting early may help banks support their loan loss reserves without seeing a material increase by using more data and analytics instead of overly relying on qualitative factors. The board voted to delay CECL implementation for most community banks (private companies and small public business entities) until 2023. All other SEC filers remain on schedule, with implementation expected by January 1, 2020. All banks would be wise to keep abreast of FASB's efforts to clarify Frequently Asked Questions, which it recently updated. The answers include guidance on topics such as do banks need to reevaluate their reasonable and supportable forecast period each time they report (yes); whether a forecast requires a computer-based model (no, Q-factors are allowed); if banks can determine expected credit losses using only historical information (no).

Fed Enhances Exams with Risk-Assessment Data

The Federal Reserve is using "a suite of data-driven, forward-looking surveillance metrics" to classify bank risk. It then assesses whether management can properly manage and monitor those risks as part of safety and soundness exams. The new process is called Bank Exams Tailored to Risk. It "combines surveillance metrics with examiner judgment," with the goal of reducing supervisory resources and minimizing regulatory burden. High-risk activities will be targeted for increased exam attention, while low-risk activities will be streamlined. The metrics cover credit, capital, earnings, liquidity, market and securities risk, and the Fed said it is working on developing more analytics for other risks, including operational. "Banks should not bring a knife to a gun fight," advises Invictus CEO Adam Mustafa. "The tools that banks use to manage risk, build their capital plan, and develop their strategic plan must also use analytics that follow the same principles – forward-looking and pre-emptive!"

Stress Testing Lessons: They're Here to Stay

Although Congress eliminated stress testing for banks below $100 billion in assets, don't expect the tests to disappear for the largest banks. "We're still going to have them," Fed Vice Chairman for Supervision Randal K. Quarles told a Boston Fed Research conference in July. "Over the course of the last 18 months, I have heard overwhelmingly—from academics, from think tanks of every stripe, from banks of every size, from regulatory colleagues both domestic and foreign—that stress tests should continue to be a key element of the Federal Reserve's supervision of systemically important banks and a key aspect of the Fed's efforts to promote financial stability," Quarles said, noting that the tests are "the most risk sensitive and consequential assessment" of bank capital requirements. He said the Fed is considering options to provide additional transparency regarding models, scenarios and scenario design in the future. It is also considering integrating stress testing with traditional regulatory capital rules, holding the largest banks to a "single, integrated capital regime."

Bank Risks: Deposits, Interest Rates, Concentrations

The OCC's Spring 2019 Semi-Annual Risk Perspective notes that banks are facing challenges from uncertainly over interest rates, increased competitions for deposits, new technologies and changing customer expectations. The three top risks that led to Matters Requiring Attention for mid-size and community banks as of March were operational (36 percent), credit (27 percent), and compliance (23 percent). The report noted that community banks in the central, western and southern areas of the U.S. face heightened credit risk because of agricultural exposures, and CRE concentrations remain "highly concentrated" in some banks. "Approximately 6.8 percent of OCC-supervised banks report total CRE exposure greater than 300 percent of capital, or construction and development loans greater than 100 percent of capital, or both," the report notes, adding that the level is down from previous years.

Community Bank Regulatory Burdens Easing

It's official: The Volcker Rule does not apply to community banks.

Regulators also finalized the rule that streamlines Call Reports for most banks with total assets of less than $5 billion. The new rule reduces by about one-third the number of data points banks need to report for the first and third quarters.

The FDIC also approved the final community bank leverage ratio. Invictus recommends that most banks conduct stress tests to quantify their own requirements before opting into the new standard.

FDIC Chair Jelena McWilliams said in a June speech that the FDIC last year rescinded nearly 60 percent of its supervisory Financial Institution Letters after determining they were outdated or redundant.