BANK DIRECTOR®

2008 M&A SUPPLEMENT TO BANK DIRECTOR MAGAZINE

2008 OUTLOOK ON M&A

Will M&A Bounce Back?

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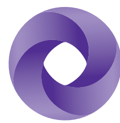

Grant Thornton

Will M&A Bounce Back in 2008?

By all accounts, 2008 will be a slow year for bank M&A. Indications that a recession was imminent earlier this year now appear to be fully realized—which will likely result in sluggish financial sector growth and a snail's pace for transactions in the near term. Notwithstanding this prediction, some deals will close, but in most cases, viable sellers will have to realign their price expectations. At the same time, prospective buyers in this market are advised to leave no stone unturned during due diligence, and in some cases, a merger of equals may be the best option. For the majority of institutions, the best advice may be to concentrate on cost cutting and preserving capital, which will create funding for new opportunities that will arise as the economy rebounds.

In this year's annual Outlook on M&A supplement, *Bank Director* magazine, in association with Grant Thornton LLP, gathered some of the nation's most respected dealmakers to discuss these and other issues pertinent to boards considering growth strategies in the year ahead. The investment bankers and attorneys we spoke with agree 2008 transactions will be slow, but they also say relative values for U.S. bank stocks remain intact. And while the media's coverage of the current subprime crisis seems to paint all financial institutions with a broad brush, in the end, well-managed banks that maintain conservative underwriting and a strong capital base will emerge in good standing. This, according to our experts, will lead to more opportunities for value creation when the economy bounces back—sooner, we hope, rather than later.

Bank Director and Grant Thornton are pleased to offer this year's Outlook on M&A supplement as an informational resource for you and your board to help make key decisions in the year ahead.

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Planning for a Healthy 2008

While talks of a recession and a major credit crunch are swirling throughout the industry, our panel of imminent investment bankers offers sage advice to help plan for a robust rebound.

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How do you anticipate the national economic situation will affect the market for banking transactions in 2008?

Steve Hovde: Our view is that the housing-related issues are deeper than the national press talks about. Currently (in late January), housing prices are down 1.7%, according to national press articles, but if you try to sell a house right now, you'll find that buyers aren't jumping on price drops of only 1.7%. The total price drop to get buyers to act is much greater, around 30% or more. So I think we have a psyche problem with regard to the housing market that is not going to correct itself quickly. This isn't a subprime problem, per se. It's a nationwide housing problem that is causing the difficulties we're having right now, and eventually, it may spread to commercial real estate.

John Duffy: I think the subprime problem has become a housing problem, but I think the genesis of the problem is faulty underwriting. These loans were done on a collateral basis. They clearly weren't done based on borrowers' ability to repay, because they were lending money on a 100% loan-to-value basis, and the only reason bankers would have made some of those loans is because they thought the collateral value was going up. However, the industry is finding out that real estate doesn't always go up.

There are at least four parties guilty of getting us in this situation. First, there were the borrowers, who, in some cases, were just borrowing because it was an option, and they didn't put any equity in the house. Second, there were some unscrupulous mortgage brokers who, given the lack of regulation, felt they could make a lot of money writing mortgages and didn't really care about the implications. Third, the rating agencies clearly blew it. Whatever assumptions they were using to rate the securitizations have proven to be wrong. And fourth, there were the investors that ultimately bought the paper. These same investors are now pointing fingers at the rating agencies because they thought they were buying an insurance policy, when, in fact, they were buying a rating. So the investors didn't do their diligence either. Greed is probably the common theme among all these parties.

Hovde: I'd add two more factors to that. I think the fundamental problem was that the Fed kept rates too low for too long, and people were chasing yields. Also, the low rates propelled housing values up, which started the vicious cycle. The other factor is that a number of the big Wall Street houses were selling these things as fast as they could propel earnings. The investors should have known better, but at the same time, they were relying too much on the securitizers.

Mike McClintock: I think we're right on the precipice of gloom and doom, but, fortunately, I don't think we're there. We haven't had negative growth yet.

Emmett Daly: I agree. We are well into a liquidity crisis and yet we have had only one asset class, subprime mortgages, go bad. You really haven't seen other asset classes on bank balance sheets deteriorate. But if consumers start thinking we are in a recession, the

psychology will change and other asset classes will start to deteriorate. It will move into credit cards, auto loans, commercial real estate. Sandler O'Neill's economist Robert Albertson thinks macro problems will extend through the end of 2008 or early '09. It's not going to be an easy time.

David Burns: We conduct an annual survey of community bank CEOs, and we found they are extremely pessimistic about 2008. If you look at similar charts from 2007, CEOs were very optimistic because the economy was still on the uptake. The pessimism holds true across the board for the large public banks, the nonpublic banks, and the private banks. But as you said, Steve, the emerging problem with many of the smaller community banks is in the area of real estate development loans. It's the larger banks that are seeing the credit issues right now. There is also subprime exposure in the community banks, but not on the scale of the larger banks. We are seeing many land development deals going delinquent. So we will have to wait and see with many of these items.

Hovde: In terms of what that means for our deal business, I think there has to be a readjustment of expectations. There are very few banks that haven't traded down significantly. I can't think of any banks that have gone up, although there have been quite a few that have moved up in the last couple of days.

Is that because of the recent lowering of rates?

Hovde: That is the perception. It could be a dead cat bounce; we'll have to wait to see.

Daly: I think deal activity will be almost nonexistent this year. You'll see some mergers of equals, you'll see some distressed sales, but activity always slows down when there is asset deterioration. It is a moving target; if you can't value something, if you can't shoot at a target because it's moving too quickly, then you can't figure out a proper price to pay a seller.

Duffy: You might see some foreign interest, but I think deal activity is going to be down a lot. Financing is tougher. You will see buyers, if they're willing to do a deal, trying to get the seller to take all stock. Sellers first have to adjust their prices and expectations. And second, you're going to have to convince them to take stock instead of cash. So there are two uphill battles.

McClintock: Is the trust-preferred market going to reopen?

Duffy: It's going to be a lot more expensive, so even when it's open, I think you're going to have some sticker shock.

Explain the dynamics of what makes mergers of equals more attractive this year and what issues there are for boards considering that strategy.

Duffy: Well, the main reason they are going to be popular is obvious: First you'll have banks that have been trying to sell themselves for a few years and have found no one is bidding! Or you may have a CEO who is leaving and the board doesn't have a management succession plan. In those cases, an MOE may be the only option available.

Hovde: You can make the argument that in this low stock price period and facing the difficult headwinds we have, if two banks come together and position the combined company correctly, they will come out stronger on the other end. So if you are looking for a liquidity event in a couple of years, then you'll get more shareholder value than if you remained independent. Interestingly, in your [Acquire or Be Acquired conference] survey, 75% of the respondents said they had explored a merger of equals.

Daly: And yet, investors discourage mergers of equals. They prefer a control sale premium, but in an environment where you can't get a control premium, investors may be more tolerant of something like

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this. Mergers do create value. If the two groups can get together successfully and bear the risks together, there is a tremendous amount of financial upside.

Hovde: Another attractive attribute now is a no-premium deal. With stocks trading where they are, the amount of goodwill created is down significantly, so you don't have to worry about having a future impairment charge, which isn't a bad thing. In fact, with the impairment charges that are starting to take place now, you wonder if the accountants will ever go back and start to amortize goodwill all over again. I don't know why we ever got off that structure in the first place.

Burns: You know, some have suggested for a long time that goodwill should be netted against equity and only evaluated for impairment, or perhaps it should be amortized while classified in equity. But those are not the rules today. With a merger of equals, one would think there would be little goodwill recorded or even day-one gains if the fair value of net assets is greater than what you've exchanged, which is where the new FASB on purchase accounting is heading.

Given the challenges you've outlined for the year ahead and the weakening credit situation, do you think the foundation of governance and more responsible oversight has prepared banks to better handle the downturn this time around, compared with previous down cycles?

Duffy: In large part, I don't think the community banks are guilty of anything. A lot of the problems we're experiencing now have to do with financial engineering that was done outside the community bank system. I mean, look at all the mortgage companies that have failed or are going to fail—they really have a much different business model.

So you don't think the current situation will lead to eventual bank failures?

Duffy: There may be some, but in part, that may be due to people who have bought into the real estate optimism over the last half of a decade who now may have significant exposure. Those who did that have put their bank in harm's way, but what the board and management were really guilty of was believing that this real estate frenzy was going to last forever. That's poor judgment, but that's different than poor governance. After all, if you really believed that real estate values were going to go up forever, then you might have thought your underwriting standards were fine.

Daly: The question of governance and oversight is interesting, and it points to another issue we will be confronted with in regional banking. The percentage of a regional bank's loan portfolio in real estate and real estate-related assets has increased dramatically over the past five to seven years. So this correction, if it spreads to commercial real estate and really turns bad, will put banks and their directors in a very difficult position. I don't think it was malfeasance that caused these concentrations; it was just an effort to pursue the last line of wider-margined business that was available to community banks. A lot of other businesses have slipped away from them. Credit cards have gone to bigger banks. Many other lines of business have gone to Wall Street in the securitization markets. The last opportunity for profit that the regional bank has had is local commercial real estate. So there are big concentrations in those portfolios, which could make things pretty challenging.

This really gets back to how the true role of the bank's board is to manage risk. How does this cycle compare with previous ones, and what lessons can directors apply from the past?

Hovde: We have more capital, so that's going to help weather a lot of this storm.

Duffy: But the business is a lot tougher than it was in the late '80s

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Chairman & CEO, Keefe Bruyette & Woods, Inc.

in terms of the points Emmett just talked about. I mean, banks in '89 still had credit card portfolios. MBNA had just gone public in that period. Capital One was hidden underneath part of Signet. Countrywide had been started, but it was not anywhere near being the number-one mortgage lender. Community banks were writing mortgages back then and it was a good asset class for them. So their situation on the asset side has changed dramatically over the last 20 years. Margins were much wider. We've had a systematic decline in margins, regardless of what the yield curve shows over the last 20 years. Bankers are dealing with 3.5% margins today versus 4.5% back then.

McClintock: So what do you do if you're a small community bank and can't sell in this market? Because you're sure not going to make as much money.

Hovde: You can sell your bank, but I think you're going to have to change your price expectations significantly or figure out how to get stock from a bank that has been beaten up but whose price will rise again more quickly with a bigger partner when the market comes back.

Daly: I don't think it is all doom and gloom. As risk is repriced in the capital markets, banks will see wider spreads on loans and customers will be more inclined to work with their loyal community bankers.

Duffy: Right. If you make it through, you'll be able to get paid more for the risks you are taking.

So obviously, managing credit and asset quality is the big issue for the coming year.

Hovde: I think there's one more and it's politically driven—whether the capital gains tax rate will change.

Are there any regulatory or accounting issues you can discuss that will help boards and management make sound growth decisions next year?

Duffy: The issue of mark-to-market accounting and reserve levels is a big one. At this point we're assuming it's not affecting community banks, but that may turn out to be a bad assumption.

Hovde: I think the SEC made a mistake in saying you have to take reserves when you take losses. Historically in banking, you put acorns away for cold winter days. By not allowing them to do that, I think you just gyrate earnings that much more, so that when reserves have to be boosted, the natural tendency is to tighten up credit standards. But when you tighten up credit standards, it's going to make the dip even tighter in a recession. So all you do is create a deeper situation when the problem hits.

McClintock: I recently worked with a board that had been told that their reserves were way too high and that if they were to take any additional reserves, they would have a tax problem. As it turns out, currently, the bank has one problem loan—just one. So there goes the bank's reserve! Now the accountants are saying the bank is underreserved, but from its perspective, for three years it wasn't allowed to take a reserve.

It's really a conundrum. How can banks manage those situations?

Hovde: And furthermore, what's surprising about that is the regulators didn't think about that short-term accounting issue and the problems it creates, as far as cycles of the economy. It just creates higher highs and lower lows. But you don't want banks tightening up and having to really overprovision in a downturning economy. If that happens, what is the banker going to do? The answer: Stop lending. But if you stop lending, what happens to the economy? It freezes up even more. It's a vicious cycle.

Burns: Mainly, the SEC and the accounting industry are concerned about the smoothing of earnings by the public companies or the private banks. But bankers believe if they do away with their cookie jar

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reserves they will have no cushion for earnings if all of a sudden, delinquencies and nonaccruals increase. And they will have no cushions in capital because they managed these reserves too closely when they had little or no nonperformers or nonaccrual loans. The catch is, when you read many of the MD&As of the banks, there's a large disconnect between the trends in nonperforming assets and their effect on the bank's earnings. That's the disconnect that SEC is concerned about, and so are we! The answer is not to build fat reserves when times are good but to build capital to a level that will weather volatile earnings.

McClintock: Interestingly, that used to be regarded as a positive thing—smoothing and managing your earnings.

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Duffy: Right. That way, you basically didn't worry about the volatility of earnings.

Hovde: Yes, but now they're not looking at it from a broader economic spectrum and the true impact is being ignored. Think about it, just like David said: Banks are at the heart of the economy. So if you shut down the banks because of the volatility that's been created, where does that leave us? It used to be that banks took higher reserves than they otherwise would have had and held down earnings to suffer through bad times. It wasn't a case of overstating earnings.

McClintock: But if banks all of the sudden go from a profit one quarter to a massive loss the next quarter to a profit the next quarter, is that a realistic reflection of their performance?

Burns: Well, I would hope that the process in place and the methodologies they've created for developing their allowance would not generate such high highs and low lows in subsequent quarters. But the issue should not be the reporting of volatility, but rather the management of volatility, which is not done through reserves, but through underwriting, lending, funding, and investing decisions.

Hovde: Yes, but here's the problem. Historically, If you look at the last five years up until around July of '07, all historical loss rates are nonexistent. If you apply any historical loss rates, that will result in saying you need no reserves. But I don't think the last five years has anything to do with what the risk factors are now.

Burns: The historical losses should be weighted, but they are less of a piece of the calculation today. Significant factors should include economic trends on a local and national level, such as increases in delinquencies and nonperforming assets.

As we close, could you each offer some insights for directors to help them plan for a healthy 2008?

Burns: What we see around the country is that banks have to do a much better job at cross selling the services they offer their customers, and they need to expand into other lines of business that are not going to add unnecessary risk. Many banks do not do a good job of cross selling to customers. They tend to do more one-off deals, where they have a loan, but they don't have deposits. Or they have the deposits, but they don't have loans. The successful mining of their customer base is the biggest challenge I see that banks need to address to have a prosperous year ahead.

Hovde: Because loan growth is iffy and banks will not want to stretch too much for credit in this environment, financial institutions should focus more on transforming their deposit base. Hopefully, the silver lining behind the sale of Countrywide will be to get the high-rate payers out of the market. Although Fed funds have been cut 175 basis points, have deposits come down anywhere near that much? No—nowhere near. So banks this year should focus on core deposits.

Daly: I'm very excited about financial technology. Sophisticated

products and services are available at the community bank level, giving community banks a chance to compete with some of the bigger banks. For instance, remote capture has almost come to the retail level now, which reduces the need for additional branching. You have banking services being delivered over cell phones, which is going to transform how the community bank can attract customers. That might not be a 2008 event, but it is something to be optimistic about in the future.

Duffy: My view is, banks have to start getting paid for the risk they're taking. Actually, I don't think loan growth numbers are going to be that bad this year. We're forecasting something like 7% growth, because a lot of the securitization market has disappeared for the time being and I'm not sure when that will come back, and to what extent. Commercial mortgage securitizations are probably less likely to have a big impact on commercial lending opportunities for community banks, or at least regional banks. But I think they've got to charge for the risk they're taking. Asset yields are being repriced across the board, so banks shouldn't be afraid to price accordingly. In this way, they're going to be competing with each other for this business as opposed to Wall Street.

I do disagree with Steve on one point regarding the deposit issue. I think banks are unlikely to be able to reverse that situation. Of the largest banks in the country today ranked by deposits, 11 of them have less than five branches. These are not traditional players. It's the INGs of the world, who've got $360 billion or so of deposits. And any of us that have kids can tell you, the next generation is going to be willing to put their deposits in almost any kind of vehicle and they may never walk into a branch in their entire life! So it's changed, and I think the biggest challenge for the community bank structure going forward is how they will fund themselves in terms of any kind of reasonable growth. Technology has changed the business for them and I think that's a long-term thing, because we're talking about a generational change.

McClintock: In terms of advice, I would simply say less is more. Banks should concentrate on doing fewer things better because in my view, at the end of the day, what kills almost all community banks is that as they get larger, they start to do more and more things. It's more fun at board meetings to talk about wealth management and asset management and insurance brokerage. But then they forget what they're really good at—taking deposits and lending money.

Deal Challenges in the Year Ahead

Transaction partners may need to do some soul searching over the next 12 to 18 months if they want to close a deal. But our experts say good governance and clarity of vision can help pave the way toward a successful outcome.

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In recent weeks the news has been quite bad for the nation's largest banks, with profits down and stocks diving precipitously. As a general overview, how are economic conditions likely to affect community bank earnings and thus the investment climate for financial institutions in 2008?

Ben Plotkin: When we look at fourth quarter (2007) earnings, it's not just the big banks that are facing challenges. Obviously, some of the smaller banks are really showing strain, particularly in credit. There are two pluses and two negatives that are coming out in terms of themes. The first plus is that some of the nonbank competitors have serious funding challenges—everyone from mortgage bankers to investment banking companies. Under normal circumstances, they take a lot of market share away from community banks. But due to their funding challenges, they are less robust competitors right now, and that's good news for community banks that are portfolio lenders. The second plus is the steepening of the yield curve due to the Fed lowering rates.

But there are also two big negatives, one of which is obviously credit deterioration across the board. We've seen it in investment securities, auto finance, credit cards, and obviously home mortgages. And the question is, how far will that go? The second big negative hinges on a swing into a very slow-growth economy, whether you call it a recession or not. That's going to affect loan demand. So as we speak in late January 2008, that struggle is going on. Personally, I think we're going to have a very challenging year.

Michael Mayes: What we don't currently know is exactly where we are in the cycle. Everybody is wondering and speculating. One of our bank analysts has referred to the upcoming cycle as a V-shaped recession—a sharp decline followed by a sharp increase out of the recession. It could be more prolonged. External economic conditions will have more of an impact than anything else on community banks over the course of this year.

One of the things I think we'll see this year is more rate cuts. Many banks believe that will have something of a negative impact on them, because it's lowering their asset yields, and deposit costs are not declining in a commensurate way. But as the year progresses, I do believe we will see some relief in deposit costs. If it turns out to be a more difficult year economically, and that does have an impact on the market, then we'll see more money coming back into the banks. People will feel more comfortable depositing money in banks, and having a more certain return. And that will help funding and margins, which will help banks in general.

In 2008, loan growth is obviously going to be relatively slow. Many banks are struggling with how to replace all the real estate loan growth they've grown accustomed to. But some of the indicators we see are positive—the rate cuts, for example, and the shape of the yield curve, as Ben mentioned. When you think about it, the yield curve was inverted or flat almost two years ago. It's not a recent or new phenomenon. And with these rate

cuts, the yield curve is starting to get a better slope. The other issue is the stimulus package that is allegedly coming out of Washington. Stimulus packages tend to come at the end of an economic cycle, not the beginning, so we're hopeful that the recovery this year will be quicker than we initially anticipated. Of course, bank stocks have been down, and the fact that bank stocks have been down so significantly over the past year is something of a leading indicator that we were or are in a recession. Hopefully, as we get through the year, those will rebound.

Jean-Luc Servat: There are three additional points I would offer. First, picking up on what Michael just said, banks are like oysters in the bay. If the water (the economy) goes bad, they're the first ones to go down, and they're probably the last ones to come back once the environment rights itself. So banks are clearly being affected by all of this. Second, I don't think there's uniformity around the country with regard to a slowdown. And though it may not be apparent in the slide we've had, once things stabilize, you're going to see very clearly that a number of regions are continuing to do very well. Texas may be one such area; New York City is another. In contrast, look at California or the Northwest. Clearly, you're going to have some have nots in this process. Today, I don't think it makes any difference—everybody is being painted with the same brush. But when it does come down, you will see the difference. And the third point I'd like to make is that I don't think this is as deep or prolonged a problem as we had in the 1990s. We don't have the same elements that we had in the '90s. We don't have the defense builddown. We don't have any of the base closures. We don't have the RTC liquidating real estate at any cost. Today, we have a different environment, and we have job creation still going on in a lot of markets. Given those differences, I think we will have a much less pronounced downturn overall than we experienced back in the 1990s. Generally speaking, I'm the eternal pessimist, but on this one, I'd say I'm more optimistic about this cycle than I've been about others.

Ron Janis: I'm also generally a pessimist, but I agree with you. One problem that concerns me is whether the housing market downturn will spread from the areas where it is currently very bad to other areas, which has certainly happened in the past. But as Ben has pointed out to me, and I think it is very true, the difference between the 1990s and now is that in the '90s there was office building expansion going on, which isn't the case today. I'm currently looking in New York and hoping to find rents going down, but they're not going down because there isn't that much space available, and there's certainly not a lot coming online. So what you see is a part of the economy, mostly housing, doing very poorly and affecting banks in the United States and much more so around the world, but I don't think basic commercial loans are going to be as affected as they were in the last decade.

So with all that in mind, how should bank boards approach the subject of strategic acquisition in 2008?

Servat: As Ben suggested, the first step is sort of an acceptance of the current environment, and it's taking some time to get to a point where boards and management teams recognize what the new levels of value are, and it may be another five or six months until we get to a point where people feel comfortable enough that we are at a new level and can begin to talk about relative values and doing deals. What may possibly happen before that, though, is that the regulators may, in some instances, promote transactions, though those might not necessarily be the types of transactions that make headlines. There's probably a whole group of de novo institutions out there that may not necessarily be running out of capital or in immediate trouble, but there is a sense that some of these might be encouraged to come together and pool their resources.

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Mayes: There will be some regulatory pressures—you could say there was regulatory encouragement involved in the Bank of America/Countrywide deal. I think we'll start to see that on a smaller scale. I also think there will be regulatory pressure on some of the sellers, and I do think we'll find that there are some banks and some bank boards that feel they're going to need the safety and comfort of a larger bank. Furthermore, expectations have come down. We need to have a little bit of a lift in share prices for the buyers. Valuations need to come up a bit for them to be prepared to use their stock.

Plotkin: I won't argue with the facts. Acquirers are skittish and risk-averse for good reason. There's a lot more execution risk in terms of inheriting someone else's credit problems when you're on this side of a slowdown, because you don't really know where the credit problems are. So two things need to happen. One, buyers have to conquer their fear of making a mistake and inheriting somebody else's credit problems To do so, they have to develop the expertise and analytics to manage credit risk. Second, buyers have to be paid more for taking that risk through more attractive valuations.

So deal valuations will drop because acquirers need to be paid more for taking on risk. Trading values will adjust, and, in some cases, regulators will apply pressure to encourage consolidation. As we know, there are too many banks in this country, though we all dance around saying so. But there is a consolidation wave that has to happen. And it doesn't necessarily have to happen in a high-growth economy. It can happen in a slow-growth economy, too. So I believe there is a wave of consolidation coming. There are going to be barriers to that wave cresting—right now it's execution risk and prices being sticky, that is, too high. But those barriers will fall over time.

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Executive Vice President, Stifel, Nicolaus & Co.

Janis: There have been a number of deals where, as Ben said, the buyer needed to be paid for taking a risk, but that risk is not as easily perceived as we might have thought. You have mark-to-market accounting, which makes some things in a bank's balance sheet marked right through the income statement. But with the loan-loss reserves not being subject to the kind of protection they were in the past (because the SEC doesn't want you to take anything other than clear losses), targets have no ability to look into the future and say, "This is how much I think I'm going to lose." And the result is, if you buy, you're going to buy more risk than you would have before.

Mayes: Ben spoke of execution risk and requiring larger returns on some of these loan problems or potential loan problems. When we counsel banks and bank boards about a prospective purchase, we advise looking at a loan portfolio in three ways. Are the loans collectable? Are they bankable? And are they investable? The notion of "collectable" means how a lender or senior lender might look at a loan: It's a good loan; we'll collect it; we'll get our money back eventually. "Bankable" is more how a regulator might look at a loan. Does it have more than a normal amount of risk, and if so, does the holder need to establish some reserves for that additional risk incurred? "Investable" is really what the buyer should be looking at. What return is acceptable for the level of risk? To get to Ben's point, you have to look at the loan, evaluate the risk, and build in the return that you want to see to protect you from the risk of acquiring something that six months, 12 months, or two years from now might be worse. What that translates into is a wider spread and a lower deal price, but it does help mitigate some of the execution risk.

But with all the uncertainty right now, do you see banks that are reluctant to take that step forward and do a transaction?

Servat: We haven't seen many deals in the last few months, and we're having trouble closing the ones that are announced. So it's hard to say.

Plotkin: I think there are acquirers out there. Potential acquirers recognize that the value in community banking is still in deposits, specifically core deposits.

Mayes: And in the franchise.

Plotkin: Yes, and everything that's happened with the liquidity crisis in the broader market since last year makes it even more true that core deposit funding at the community bank level is incredibly valuable. So there are acquirers that want to acquire that. The question is, what baggage comes with it, and at what price? So the next move is up to the sellers more than the buyers. Prices need to adjust, just like trading prices have adjusted down 40%, in many cases. Acquisition expectations haven't adjusted down to the same degree, but they're going to have to adjust. And then there's going to have to be some outside pressure from regulators and proactive shareholders. The pot will be stirred because there is still very high institutional ownership of small-cap companies. And they would rather see a liquidity event, even at a lower price, than sit there.

Mayes: There are definitely situations where boards are taking a step back and saying, "Let's wait a quarter or two and see how this settles out." Fourth-quarter nonperformers and charges are going to be significantly higher for many banks, not at the levels of the large banks, but there will be increases. People want to see when we get into the spring and summer, whether that trend is going to continue or level off. So we have a wait-and-see period here. Then I think the things Ben has been discussing will inevitably occur.

Servat: There's plenty of money on the sidelines, plenty of potential buyers interested in the banking sector, plenty of foreign buyers, plenty of existing consolidators who continue to say that that's their goal. But we are definitely in a situation where people feel the need to wait, just to see how the smoke and the dust clear and settle. And I don't think that's unusual. At the same time, we are seeing boards and managements focus more on cutting costs and hunkering down for the inevitable downturn by preserving capital. But I do think people will get back into a deal mode relatively quickly. After a quiet four or five, maybe six months, we may see a new reality setting in.

Plotkin: Well, there's another constraint we have yet to talk about, which is that buyers' capital is a lot more expensive, and trust-preferred markets are effectively closed at the moment. They may open up by the time this discussion is published, but even so, they're going to be a lot more expensive. If you look at the overall tangible equity ratios in the industry, they're certainly not impressive. There's not a big cushion, and acquirers' currency valuations are at lower PEs. Those points all argue that when deals do happen, there are going to be fewer cash deals and more stock deals. Affordability is the question, because buyers can't afford to pay the prices that were paid in the last two years, given currency valuations today.

So is this the year that will turn around sellers' expectations?

Servat: Sellers are becoming more reasonable. It's interesting to see the deals that are being renegotiated, or at least that are closing, as Ben noted, based on a relative value basis more than anything else. So I don't think we're there yet—there's still plenty of boards that are either in denial or overwhelmed by what has happened and still remember their stock prices as they were 18 months ago, even 12 months ago. But eventually, they will get there.

Mayes: Some of the buyers who have done deals recently are getting chastised for paying what investors referred to as one-year-ago, two-years-ago, three-years-ago pricing. What you're seeing is investors, institutional shareholders, and activist shareholders becoming more vocal when their bank is making purchases without taking into

JEAN-LUC SERVAT
Managing Director, RBC Capital Markets

account the realities of where market valuations are headed. That's influencing the buyers, and again, it's just a matter of people getting their head around where the relative valuations are going to be in six months.

Plotkin: Until now, potential sellers have had the option to continue to run their banks at pretty good growth rates. And that was always there. You didn't have to sell because growth rates were 5% or 10%, and you could make a decent return, knowing you could always sell your bank later on. Now, however, in a slower-growth economy, it's going to be difficult to do that, because provisions will go up a lot faster than expense reductions can kick in. Most well-managed community banks run at 50% or 55% efficiency ratios, and they're not going to be able to do a whole lot better than that. So provisions will outpace expense cuts, thus growth rates and earnings growth will come down. That's what will drive M&A activity. But they have to go through that process first.

What effect has this had on de novos that had hoped to be selling out at this point? What is their future?

Plotkin: Those de novos are no longer de novos. They're struggling adolescents.

Servat: Well, a few have been able to sell; but a very few.

Plotkin: But there are still hundreds and hundreds, and they were formed, in many cases, with pretty short-term money. This was not the typical de novo phase—many of these banks were started with hedge fund money. We're talking two–or three–year money with very high-growth expectations, and if these new banks really did grow that much that quickly in the last couple of years, then they're going to have credit problems. So there are going to be some rude awakenings. I recall in the early 1990s in New Jersey, a number of de novos failed. So I think we will have some failures.

Janis: The difference, from a regulatory perspective, is that ever since the '90s, the regulators have been very careful in insisting on experienced, knowledgeable management and knowledgeable boards. Their insistence on risk management and a variety of changes has resulted in a situation that is going to cause fewer banks to fail. They might not do as well, but failures are not going to be as likely as they were in the '90s when almost every de novo in New Jersey failed.

Plotkin: The shareholder bases are very different. In past cycles, de novos were effectively built off of retail bank investors and founder money. Retail bank investors, for the most part, weren't involved in this round. These dollars were basically raised by bank managements among founders and the hedge fund community. So this time around, I just don't think those people are going to be as patient.

Mayes: It's clearly going to be painful for the existing shareholders. So they're in a little bit of a box, and I would say the rate of formation for de novos over the next couple of years is going to slow dramatically.

Plotkin: And the other phenomenon is many of those de novo banks had trust preferreds built into their business plan to fuel growth once they hit profitability, because everyone took the trust-preferred pools for granted. Now, effectively, that source of funding is closed.

To help sum up a lot of these comments, if you were advising a board planning its acquisition strategy over the next 12 months—what would you say to those directors?

Mayes: For banks interested in expanding via acquisition, particularly in-market or near-market, now is the time to be out there in front of the CEOs and the boards of the banks you're interested in. Now is the time to solidify those relationships, and make sure the chemistry between people is good. Sometimes what happens in these particular periods is that banks become very introspective. They look at things like internal expense reductions as a way to improve their business, and in doing so, they lose touch with a lot of the banks they were planning to get together with.

Plotkin: Just to build on what Michael said, acquirers need to create a shopping list. If I were advising an acquirer today, I would say build your list based on core deposits, because as long as the Fed keeps the yield curve steep for banks to rebuild capital, core deposits are going to have tremendous value. The statistics over the last three to five years indicate acquirers paid 20% of true core deposits, and that number could come down. If you look at other difficult times in the market,

that number could drop to 10% or 12%, which would be a tremendous opportunity for acquirers in that environment. So that's what I would counsel people to do.

Servat: One element that it's important not to lose sight of is capital, and to preserve capital by not unnecessarily repurchasing their stock. If a bank out there today is repurchasing its stock in this tidal wave, it is running a great risk of squandering assets that are precious. And just turning off the repurchase program, or at least not acting on the agreed-upon repurchase program, is probably a good thing.

Another recommendation is to develop various sources of capital. There are pockets of money out there. They may not be ready to commit themselves quite yet, but whether they're in private equity, hedge funds, or people that have ambitions to get into the sector because they feel there will be some great value plays, now's the time to meet these people, develop them, and maybe even take some money if necessary. And acquiring capital today is relatively cheap. Just as courting the sellers is critical and you should not give up, courting the sources of capital is important, particularly private capital.

Plotkin: Your point on buybacks is important. Companies need to take a more strategic view of buybacks, as opposed to thinking, "Well, our stock's cheap, because it's off 20%."

And Ron, what perspective do you have for the next 12 months from the legal side of things?

Janis: I haven't seen a lot of regulatory reaction as of yet, but I think we will see plenty of reaction as the examiners come in, look at the books, and try to discover what has happened and what they're concerned about. In the recent past, risk management for the examiners has meant that they were not going to examine every loan; they were just going to examine risk management procedures. I believe there's going to be some reconsideration of that approach, and instead we're going to see examiners looking more carefully at the underlying assets and offering their views on how to manage those underlying assets, perhaps to an extent that we haven't seen in awhile.

Safeguarding the Deal: The Board's Role in Due Diligence

A cautionary word to the wise: No more "fly-by" due diligence in this environment. Buyers must carefully investigate every chink, and cash versus stock will be a key issue among sellers.

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What do you believe will be the biggest challenges for buyers and sellers this year?

Dory Wiley: One of the challenges will involve managing buyers' and sellers' changes in expectations. Buyers' expectations tend to lag historical comps over a one-, two-, and three-year period. Plus, in the past, we may have had one seller with 10 to 15 potential buyers, and now we have a lot less buyers—maybe even more sellers than buyers at this point. In addition, many of the big banks are in trouble with credit problems, or their stock is in the tank, so they're not eager to go out and acquire right now. They're trying to shore up their balance sheets and make sure they're safe. So getting a handle on expectations is probably the issue I would mention first, although there are others.

Art Loomis: I would add that valuation disconnects are present, such that there is a bifurcation in the marketplace right now for larger target banks versus smaller targets. So one of the issues the industry is going to face is the relevance of small sellers. In the next five years, you're going to find that smaller institutions generally won't be considered as relevant, and so they will not command the pricing currently being received. On the other side, the nice thing about smaller bank targets is that buyers are able to finance transactions using cash and, so that in this way, they are taking the risk of stock consideration off the table.

Steve Klein: I'd like to step back a little further to set the tone for today. Historically, merger multiples have pretty much tracked how bank stock prices have traded. In other words, the higher the trading multiple, the richer the currency, so it was easier to pay those multiples. The other interesting dynamic over the last three to five years is that community and regional bank stocks were trading at a much higher multiple than the larger institutions, and they've come back down now. So many deals were done by midsize institutions buying smaller ones, and that's the dynamic you see changing today.

Having said that, I see four big challenges. Number one is pricing and buyers' expectations. With stock prices down, it's nearly impossible for buyers to pay the same prices they paid a year ago, and sellers' expectations have not yet fully adjusted to that. Number two is asset quality. Due diligence is now a two-way street. You can't necessarily assume that a buyer that is a public company and reports good asset quality actually has good asset quality. Surprises are being announced daily. Number three concerns walk-away provisions or break-up fees. As a seller, I would submit—and I represent some buyers who may not like this—that we're going to see movement toward a cash breakup fee if a deal falls apart, not purely because the stock price may go down, but because of issues related to the seller's asset quality or regulatory compliance that puts the buyer at risk. Number four is something Art mentioned—the problem of getting cash. Raising capital is nearly impossible, and trust-preferred is expensive and only available in small chunks. Today, it's harder to throw more cash into deals to offset the risk of stock. So those are the challenges I see going ahead for this year.

Loomis: One last challenge I would throw into the mix is the extent of the board's knowledge about change-of-control compensation when it's being developed inside a transaction. Many boards are surprised by the magnitude of that number, but going forward, this challenge should lessen. At present, though, I'm not confident that boards of directors of financial institutions know how much is involved and how that dynamic affects pricing.

Do you think the SEC's new proxy disclosures are helping to alleviate those surprises?

Loomis: Well, there is some improvement from the disclosures, but the main thing is, whereas we used to see 95% of transactions where change-of-control amounts were off the charts and affected pricing, now you're starting to see much more sensitivity toward it. There's an evolution toward sharing that information with buyers up-front in the process.

Klein: We encountered that, too. We counsel our clients that generally 2% to 3% of purchase price is a tolerable zone for severance. Beyond that, it starts to impact shareholder value.

Wiley: Another example is the BOLI [bank-owned life insurance] vehicle. It's a great product, but the assumption is always that the executives are going to retire and then the liabilities will go away. But that doesn't always happen. Sometimes the bank is sold, and when it does, you have a tax issue. If the buyer wants to come in and pay that off, then the question is: Does the seller have a deferred tax asset placed on the books, and how do you recognize that? It can be a really big hickey.

Let's follow up on a topic Steve touched on—asset quality. How are asset quality concerns affecting expectations on pricing and due diligence in this market?

Wiley: Many banks are having asset-quality issues. They may not be severe, but there's an uptick across the board, which is affecting buyers' assumptions. Instead of assuming sellers have a clean portfolio, buyers are doing due diligence to prove the contrary to that expectation, So it's imperative that banks have outside loan review and that boards are involved in a lot of the things that are going on.

Also, some banks refuse to do some basic things with their credit and loan portfolios, and in this market, this attitude is backfiring on them. If their NPAs are rising and asset quality eroding, then raising capital is going to be very difficult, and they're going to have to get creative, which can be expensive. If the upticks are really large, then it's important to have a good lawyer and investment banker to help the board and management navigate through the process with the regulators and make sure they can deal with these assets without being taken over or failing. This is very, very important. So many people can't grasp the downward spiral risk. So how you handle it, how you work with the regulators, how you work with your board and your counsel is extremely important.

Loomis: Different regions of the U.S. have different economic phenomenons occurring right now so some regions are not going to have as pronounced a risk profile as others. But we counsel boards to inquire about the portfolio by loan type. In theory, whenever you have a fallout in the underlying real estate values, that can be a first line of defense, in terms of knowing how much you may be underwater or not. Similarly, we tell boards to look at the weighted average age of the loan. In other words, how seasoned is the loan? Because if it was made at 75% loan-to-value originally and it's been outstanding for two years, chances are, regardless of the economic phenomenon, there's still collateral protection on the back end. We also counsel banks to focus on loan renewals and extensions. The activity that typically transpires when a borrower gets into trouble is that they're going to start tapping credit card lines or asking

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for additional monies disguised in some way in order to provide new funds to service existing indebtedness. Those are some elements boards should ask of management.

Klein: I would simply say, no more "fly-by" due diligence. Normally you see due diligence done over a weekend for a small-size bank, but a client I talked to recently said it was taking a week to two weeks. Of course, that can create a problem with confidentiality.

In my experience, there's too much attention given to avoiding paying too much for a bank, when the biggest cost of all will be if you buy troubled assets. That cost will dwarf any small premium you may pay above market. And while I represent some buyers who may not like this, historically there's been very little done in the way of reverse due diligence, particularly on asset quality.

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Loomis: Especially where the consideration is stock.

Klein: That's right. When you use cash, it doesn't matter. But almost every deal is going to involve some stock. So to make sure stock value will hold up and the quality of that institution is solid, just looking at 10-Ks and 10-Qs and earnings releases may not be adequate. I would suggest sampling the loan portfolio, perhaps some of the larger loans, looking at their underwriting practices and actually digging a little bit. There's always been resistance on the part of larger public companies to disclose the condition of their portfolios, but I don't think a seller would be doing proper due diligence if it didn't do some measure of loan review. How that will play out will vary, case by case. So that's going to be a big change in dynamics from what I've seen over the last 10 years.

Wiley: Absolutely. But also, while pricing expectations are interesting, it still can be a very effective market right now. If you were expecting "X" price before, and now that price is off 20%, if you still have a stock that looks appealing, you need to evaluate that situation. It still could be very advantageous to do a merger at this time. Get out, get a higher relative price, and then pick your reentry point, if you want to.

Klein: Yes, but here is the challenge: As a target or selling institution, you have to look at your own prospects. And we're seeing earnings growth slowing down because of margin pressure, because of regulatory burden that's disproportionate for smaller institutions, because of potential asset quality problems, and because loan growth is slowing down. So you have to ask whether you'll be able to add value independently. You also have to consider whether or not deal multiples will hold up over the next few years. But the key is to make sure you're getting quality consideration. I would say you want at least a 50/50 stock/cash deal so most of your investors get their equity out. So in that respect, there are going to be challenges to getting deals done, not just because of price expectations, but also because of quality and consideration issues.

Loomis: You also have different balance-sheet growth rates occurring in certain economies versus the experiences in California, Texas, and Florida. The Midwest and the Northeast have had relatively benign growth rates in terms of new assets on the books. As a consequence, these banks are not outstripping their capital ratios, so in fact, they are building capital ratios to what some would consider excessive levels. Acquisitions enable them to utilize that excess capital, and so we're actually seeing transactions that are 100% cash.

Of course, Steve is right on the money about asset quality. Things have changed. That is probably the biggest sea change we're going to experience in the next 18 months, with any transaction.

So has that created a chilling effect on M&A?

Loomis: Transactions with drive-by due diligence are still occurring,

although not so much in the regions where the spectacular growth occurred and where many of the loan losses and delinquencies are starting to pop up. In those areas, we are going to see more exhaustive due diligence.

Wiley: Also, there have been numerous banks that have funded themselves very hot on the deposit side. There are banks, particularly in the Georgia area, that have abandoned core deposits altogether, and they've just gone for an efficiency asset-side play. That strategy is going to be extremely risky in the face of declining rates. But you know, the rapid decline and cost of funds is just not going to be there relative to the short end of the curve, because everyone is funded hot. So squeezing margins is going to be a big concern to banks.

Everyone is fairly pessimistic, but what we don't know is how long the recovery time will be. I sense an anticipation of a fairly quick recovery—a lot of folks are talking about six months. But there are those of us who lived through the '80s, who think it will take longer than that. We had a very light recession in 2000, mainly because credit quality was good in banks. We had some trouble in the technology sector and in large syndicated credits, but across the board, banking held up really well. But it didn't do that in 1990, so we have something much closer to 1990 than what we had in 2000. So I sense that some banks will seize the opportunity to sell in the face of an anticipated quick recovery.

Klein: I tend to agree with Dory, but I will also add that this recovery is tempered by capital. So I don't think we'll see all the failures, but I do think we'll see a reduction of earnings, or reported losses. I think the credit quality issue, because of real estate markets, is going to be deep. Many developers will likely walk away and leave the banks with undervalued collateral, which is going to have a pervasive effect on the industry. It's going to be interesting to see how we work through that. You may end up seeing some troubled banks selling, but not many people have the appetite today to take on troubled institutions.

Wiley: That's right. It's a lot of work.

Klein: Right, and we have to remember, it was different when the thrift debacle occurred. They basically were buying for pennies on the dollars, and they were dead institutions. This time around, we'll see banks that are still alive, but are in trouble. So we're going to have to get creative. There will have to be deferred payouts, and companies, because of the liquidity crunch, may end up using their own notes, cash or stocks, and various combinations. And I think it's an 18-month- to two-year cycle because out in the Northwest, where I reside, we tend to trail the rest of the country, and we haven't had the full effect of the slowdown. So I would not be surprised if we're still talking about this next year, if not the year after.

Loomis: And it's also a case of "be careful for what you wish for" because for years, bankers wanted an expanded margin or spread. What is ironic is that that scenario is now starting to play out, and it's probably going to happen. So spreads or margins probably will increase, but loan losses will likely swamp the benefit the yield curve is providing in the near term.

Wiley: Right, and while it's easy to sell a clean, well-performing bank, it is very, very difficult to sell or merge a bank that has issues, particularly asset-quality issues. It's all about structuring the assessment of risk, and the assignment of risk to the buyer or the seller.

Klein: One reason there's going to be some reluctance in doing these troubled bank deals is that it's been almost 20 years since we've had severe problems, and there aren't that many bankers who have the experience of having worked their way through that. Nor are there many banks that have been through it as an acquirer, and have the appetite or manpower to do deal with it. So it's going to be an interesting dynamic to see how that plays out.

Wiley: Well, the first thing you do is find out how deep the hole is. We've had to bring in someone who is separate from the existing team to work the loan portfolio, because you have to assess management. Because the first thing that shows up on the C&D is the board. So the board needs to get involved and assess whether management stays or not.

How have regulatory issues such as BSA factored into the M&A strategic decision this year?

Klein: Well, compliance issues can be a deterrent to doing deals, as either a buyer or a seller, because if the regulators can put a Wells Fargo in cold storage as far as an

ability to do deals, they'll can do it to anybody. So, from a seller's standpoint, if you have compliance issues, it could certainly block a deal. Or it could scare a buyer away or be a burden in trying to get the regulators to approve it. From a buyer's standpoint, if you have regulatory dings on compliance, including BSA, you could be frozen from doing deals. So while compliance itself is not a general factor, in isolated case-by-case situations, it can be an obstacle.

Loomis: But from an economic perspective, I would say compliance costs have been stimulating transactions, mostly in the small-bank arena. One of the investment themes, frankly, that we've been a great proponent of is the concept that institutions below $250 million are heading for the exits. When your spreads are declining and your growth is 3% a year, you have a hard time offsetting something you really can't control. So the economic stimulus and ramifications of the increased compliance standards are things that are pushing smaller institutions to sell. Plus, last year we did two transactions where regulators were pushing either MOU agreements or formally asking the bank to merge with somebody. So those transactions are occurring in institutions where the acquirer's systems have been deemed by the regulators to be adequate. In those cases, what you're doing is trying to transition between an inadequate system and making sure, on the diligence front, that you're not buying a real bucket of bolts, and that you can repudiate or fix the deficiencies as far as compliance—as part of the deal costs.

Everyone has touched on this a bit already, but can you sum up the dynamics that are affecting whether to take cash or stock in a deal?

Klein: Capital is gold right now, and we've been counseling our clients to treat that capital preciously. Even on stock buybacks, banks should think long and hard about doing excessive ones to improve stock performance or to improve ROE in the short term, because capital is the one buffer you have with the regulators if you start having asset-quality issues. Having a little too much capital can make the difference on your rating or whether you have a regulatory enforcement action. And even if you're a well-managed bank, there are unknown risks in your portfolio. What has surprised me the most is the rapidity of events in the last six months—how quickly problems have trickled from subprime lending to other areas. For example, we haven't seen the full impact of credit card losses yet, or auto dealer paper, or commercial real estate. That's why I am concerned that this is very broad based.

Wiley: I'll take your point a little further. Historically, bankers' mindset on capital levels has been a tug between investors who want capital utilization and regulators who want high capital for cushion. Today, bank management has to have a bent toward the regulatory side.

So it sounds like everyone agrees there are opportunities, as long as due diligence is done thoroughly.

Wiley: I would say it's a great time to buy if you know what you're doing, if you're a great banker, you know how to look at credit, and you know how to underwrite credit, then go in, do your due diligence, and buy. It's a great time because there are a lot of folks out of the market, and you don't have to pay three, four, five times book anymore.

Loomis: My opinion is that it depends on the size of the target and it depends on the relative growth the buyer is trying to accomplish through that acquisition. If it is an institution under $250 million in assets and you covet that franchise and can afford cash consideration, it's an ideal time. If it's the next tranche up, maybe a $500 million to $1 billion organization, pragmatically, you're going to have to issue some stock. At that point you have to ask, "Do I really want to dilute my existing shareholders with stock being issued, even if it is a 50/50 transaction, because my stock is trading below intrinsic value at historic lows as a multiple on tangible book value or earnings?"

Klein: I agree that there are potential opportunities for both buyers and sellers, but my advice would be twofold: Tread cautiously, but think creatively, on both sides.

Wiley: One last point regarding the buyer: If your stock is down 30% and you're a buyer of your stock—you're a believer—and it's just gone down because of sector rotation, what a great message to send to the market that you're going to go out and buy something at 2.5 book and do a stock deal because you believe in your stock. In the end, that will greatly support your stock.

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