BANK DIRECTOR®
2009 SUPPLEMENT TO BANK DIRECTOR MAGAZINE

The Banker & Board Poll

SPEAKING OUT ABOUT M&A AND GROWTH–2009

in association with

At the 15th annual Acquire or Be Acquired conference in Phoenix, *Bank Director* asked nearly 500 audience members to offer their M&A predictions for 2009, including their prognostications for the industry as well as details regarding their own banks' approach to growth in today's turbulent times.

2009 M&A FORECAST

With a confirmed recession, international credit crisis, and spiraling real estate market, banks are confronting a weakened economy on all fronts. Even if the institutions themselves are healthy, bankers are concerned about the viability of their relationships with anxious depositors and cash-strapped loan customers.

Add to this mix a reactionary stock market and a young administration trying to quell political wrangling over a massive economic stimulus package, and many experts are finding their crystal balls maddeningly opaque. As a result, most banks are watching from the sidelines, though some opportunistic institutions seem to think this could be the right time for a strategic play. For the latter, due diligence will be critical to a successful outcome.

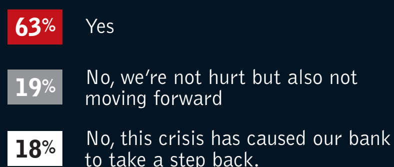
It's no surprise that responses from the bankers and directors we surveyed reflect a heightened level of caution in this era of uncertainty. Overall, the majority are continuing to display a conservative attitude toward growth, though a growing number appear intrigued by the unique options a down market can present.

INDUSTRY OUTLOOK

On the optimistic side, 43% of conference attendees expect to acquire a bank, nonbank entity, or branch in 2009; only 7% are looking to sell, with nearly an equal number (6%) interested in a combination of buying and selling. Those numbers still allow for a slight majority to continue watching and waiting (44%), even though nearly two-thirds of those polled (63%) do believe that the current environment creates a good growth opportunity (Figure 1).

FIGURE 1

Do you believe the current banking crisis creates a good growth opportunity?



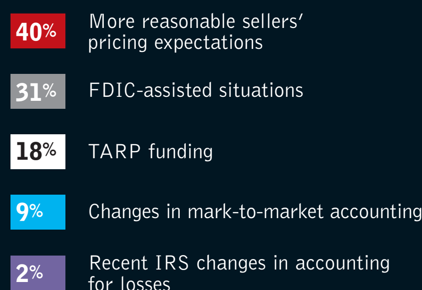
63%	Yes
19%	No, we're not hurt but also not moving forward
18%	No, this crisis has caused our bank to take a step back.

So what are the primary obstacles to growth? Forty-four percent of attendees responding as buyers say the inability to judge risk in a seller's business is the most substantial impediment to M&A activity. Another 30% are worried about capital constraints, while 15% still point to inflated seller valuation expectations. On the flip side, 50% of those responding as sellers say valuations are the main obstacle, while buyer preoccupation, judging risk in a buyer's business, and discomfort with a buyer's stock all captured between 15% and 18% of respondents.

However, when asked which factor they believe will impact potential buyers the most in 2009, 40% indicated more reasonable sellers' pricing expectations will be key, followed by FDIC-assisted deals, 31%; TARP funding, 18%; and changes in mark-to-market accounting, 9% (Figure 2). (As a side note, in another poll question, nearly 90% say something should be done about mark-to-market accounting: 41% believe it should be abolished and 48% say it should be altered.) Finally, when asked when M&A pricing multiples will return to pre-credit-crunch levels, our audience was not so optimistic. Fully three-quarters believe it will be 24 months or more. Even more sobering, no one forecasts such a return within 12 months, and 16% say such levels will never return (Figure 3).

FIGURE 2

Which factor do you believe will impact potential buyers the most in 2009?



40%	More reasonable sellers' pricing expectations
31%	FDIC-assisted situations
18%	TARP funding
9%	Changes in mark-to-market accounting
2%	Recent IRS changes in accounting for losses

FIGURE 3

When will M&A pricing multiples return to pre-credit crunch levels?

0%	Within 6 months
0%	6-12 months
8%	12-24 months
76%	24+ months
16%	Never

DEALMAKING IN A DOWN MARKET

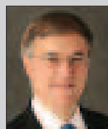
Despite the pessimism over pricing, many believe opportunity exists if you can find the right deal. Our survey attempted to determine what appeals to buyers and sellers in this strained market.

First we broached the topic of forms of consideration for buyers and sellers. We asked conference attendees to think like buyers and tell us which type of transaction they would be most interested in as acquirers: 39% chose a combination of cash and stock, followed closely by all stock (36%). The remaining 25% chose all cash.

Digging a little deeper, we asked attendees to put on their seller's hat and tell us if they would be willing to accept an all-stock transaction. Nearly 40% were willing to do so: One-third said they would do so to receive a premium, preserve upside potential, and gain the benefits of a strategic combination, and 6% said they would do so to obtain a more influential role in the combined organization. While the remaining 60% said they would be unwilling to accept all-stock consideration, 44% said they would consider a combination of stock and cash and 16% said they would consider an all-cash transaction.

Next we asked participants whether they would ever consider entering into a merger of equals. Almost 90% said yes, but 50% qualified their response by saying they would do so only if their company would retain more control than their merger partner. Eleven percent would not considering doing an MOE. Last, we asked if an investment by

In Depth Perspective...



We asked Erik van Nispen, managing director and sector head of the U.S. Financial Institutions Corporate and Investment Banking Group for BMO Capital Markets, to comment and give some perspective about this year's survey findings.

What factors would make a majority of bankers (63%) believe that the current environment creates a good growth opportunity? And do you agree or disagree?

This speaks to the relative strength of the attendees' banks. For banks that have maintained solid asset quality and capital levels, the current environment presents a good opportunity to grow through both acquisitions and organic means. Acquisition multiples are at levels not seen since the early 1990s and increased government-assisted transaction activity will provide additional and relatively low-cost expansion opportunities. Further, the repricing of risk and retrenchment of many struggling competitors presents an opportunity for healthy banks to generate strong loan growth at attractive yields. At the same time, on the funding side, the flight to quality and extreme risk aversion, combined with a low interest rate environment, have improved significantly the ability of banks to attract deposits at favorable rates, as evidenced by the 24-point drop in the percentage of respondents concerned with deposit generation relative to 2007.

What will be the largest impact of the CPP/TARP plan on consolidation for the banking industry?

An overwhelming majority of the respondents (77%) believe that CPP/TARP has contributed to a delay in inevitable bank failures, which could have been acquisition opportunities for healthy institutions with strong capital positions and asset quality. At the same time, the respondents do not seem to believe that CPP/TARP has provided potential buyers with a lot of leverage in pursuing acquisitions, as only 18% of respondents believe that TARP funding will impact potential buyers in 2009. I tend to agree with the views of the audience. Furthermore, I believe the CPP will ultimately have a smaller impact on consolidation than was originally thought. After all, as evidenced by the responses, 57% of respondents did not participate in TARP, and among those that did, most are focused on preserving capital. In addition, government and public scrutiny that has accompanied the CPP investments is higher than initially anticipated and is focused on encouraging lending activity. The stronger banks are now actively considering repaying the government to avoid further scrutiny and allow themselves greater flexibility.

Should banks use TARP money for acquisitions? Why or why not?

This may be a moot point now as participating institutions are essentially prevented from making cash acquisitions of "healthy" firms until the CPP investment is repaid. On a more theoretical level, however, my answer to this question would vary from case to case. Those who got TARP money because they needed it are likely to use it to satisfy the specific need that prompted them to take it in the first place. Accordingly, using it for acquisitions was never an option for them. On the other hand, a number of otherwise healthy banks also took CPP funds, as they saw it as a cheap form of capital. All other things being equal, these banks ought to be free to pursue shareholder value-enhancing acquisitions, especially as most of them have continued to be responsible, although appropriately prudent, in their lending activities. However, I would encourage them to carefully consider the impact of those prospective transactions on their tangible common equity ratios and asset quality, as these are currently top of mind issues for the analyst and investment community.

Forty-four percent of bankers said buyers are unable to judge risk in a seller's business. What guidance can you offer that would help bankers and boards in that regard?

There is no doubt that the inability to quantify risk is inhibiting M&A activity right now, but unfortunately there is no magic solution. Reviving ideas from prior banking crises, today there are some creative structures under discussion to bridge the gap between how buyers and sellers value risky assets. Having said that, none of the more recent transactions have adopted these structures. In this environment, thorough due diligence is as important as it has ever been and buyers will benefit from exercising additional caution in absorbing a seller's risks. With that as a given, I do believe that transactions that make sound strategic sense and are appropriately priced will be well received by shareholders.

What is your forecast for pricing multiples in 2009?

Multiples are going to remain at suppressed levels for the rest of the year for a couple of reasons. Banks currently have historically low TCE ratios and many buyers cannot incur the capital dilution that goes along with a high premium deal. Further, even acquisitive banks with strong capital positions are faced with substantial challenges in the context of their M&A transactions, emanating from the current difficult environment for financing and generally depressed public market valuations of their currencies. Buyers are also concerned about catching the proverbial falling knife when it comes to evaluating the risks in sellers' balance sheets. Further, uncertainties resulting from recently adopted changes to certain accounting rules may have a dampening impact on M&A activity. Additionally, the opportunities to pursue lower-cost, lower-risk government transactions will continue to hold down valuations for healthier franchises.

What are the relative pros and cons of cash versus stock consideration in this environment?

We spoke during the conference about the opportunity for banks to create significant value through all-stock transactions in times of trough valuations. In fact, we looked at returns from all-stock deals during the last trough period of 1999-2002, and 72% of the transactions done during that period outperformed the bank index from the time of announcement through the end of the trough period. The median annual excess return was 5% from a buyer's perspective, although the excess return exceeded 10% in a full one-third of the transactions. The excess return was even higher for sellers, as they received takeover premiums on top of the excess return in the buyer's shares. The data shows that all-stock deals, especially during trough periods, create substantial value. To be successful, though, both buyers and sellers need to approach a transaction with the mindset that they are making an investment in each other and focus on how they can create value together. With capital foremost in investors' minds, in the current environment, I believe an all-stock transaction puts many organizations in the best possible position to succeed while also preserving upside potential for the seller. Accordingly, this is also a great environment for mergers of equals. Nonetheless, for well-capitalized acquirers, who can preserve attractive post-transaction tangible common equity ratios, using cash in transactions would minimize dilution of existing shareholders' interests in light of generally low public market valuations.

a private equity firm in 2009 would be of interest. Nearly 60% of those surveyed said no (51%) or never (8%), meaning 41% indicated they would consider such an offer.

THE TARP FACTOR

For banks that need a jumpstart, the primary source of aid thus far has come via the Capital Purchase Program, which allows qualified financial institutions to receive a capital injection from the Treasury Department in return for preferred stock and warrants, and the Troubled Asset Relief Program (TARP), which provides similar assistance for troubled institutions. The hope is that banks will use these funds to shore up lending and stimulate growth.

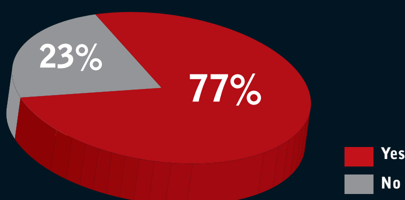
When asked how they expect recent government regulation to impact industry M&A, 52% anticipate an increase in activity, 26% expect a decrease, and 22% see either limited (20%) or no impact (2%).

TARP funds, in particular, have been the subject of controversy as to their efficacy. In an interesting commentary on the bailout, slightly more than three out of every four of those surveyed believe that as asset values continue to decline, TARP funds are only delaying inevitable bank failures (Figure 4).

Indeed, about 60% of those we surveyed told us their banks did not request TARP funds. Of those that did participate in the program, 22% are using the money to bolster capital ratios, 13% plan to make acquisitions, and 9% will increase lending. Thirteen percent of those participants indicated they would consider replacing TARP capital with new capital at current

FIGURE 4

As asset values continue to decline, do you think TARP funds are delaying inevitable bank failures?



valuation levels, while 11% said they would do so if their stock price rises at least 40%; another 11% said they would do so with a stock price increase of at least 25%. Six percent would do so if their stock price were to rise at least 15%.

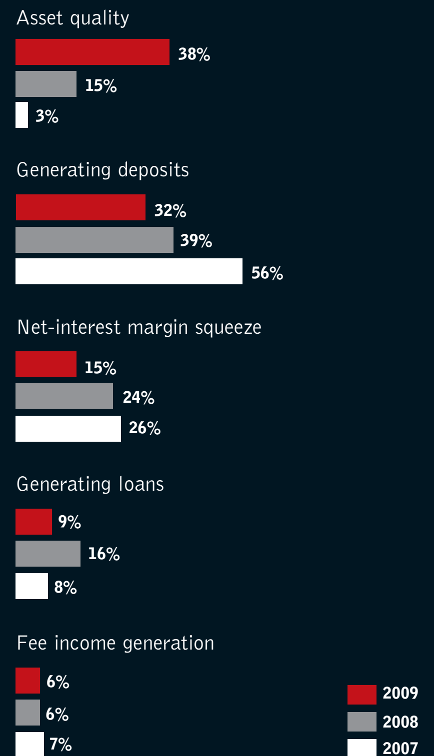
GENERATING DEPOSITS AND LOANS

For the last two years, conference attendees had said their biggest challenge for the coming year would be generating deposits. This year, nearly 40%–more than double last year's percentage–chose asset quality as their top concern, followed closely by generating deposits at 32%. Other concerns include net-interest margin squeeze, 15%; generating loans, 9%; and fee income generation, 6% (Figure 5).

Attendees' choice of asset quality as their top concern echoes its current focus industrywide and underscores the steps being taken to prevent further capital erosion during the downturn. Given the ongoing attention to asset issues, we were curious whether banks are putting more emphasis on Tier 1 capital or tangible common equity. We found that nearly three-quarters of our respondents favor Tier 1 capital as the preferred measure of capital strength.

Moving to the continuing challenge of deposit generation, we wanted to gauge the impact of the presence of megabanks on the business of community banking. To do so, we asked our attendees whether the premise that large banks are "too big to fail" is affecting community banks' ability to gather deposits. Interestingly, nearly a quarter of those responding reported that they are the ones taking market share from the big banks. Thirty-nine percent admitted that competition from megabanks is having a modest impact on deposit gathering, while 22% are finding it substantially harder to compete. Only 15% believe there has been no impact.

In the lending arena, many people expect commercial business loans and commercial real estate loans to be the next shoe to drop for the banking industry. When we asked attendees which of these two was creating the highest level of stress, 63% chose commercial real estate loans as

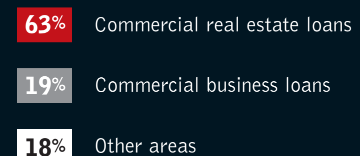


most problematic, with 19% naming commercial business loans and 18% pointing to other areas (Figure 6).

Finally, while loan pricing has improved and banks seem to be getting paid appropriately for the risks they are incurring, we wanted to find out how willing bankers will be to lend as the economy worsens. It appears most are still optimistic in this regard: nearly two-thirds (64%) are moderately willing to lend and another 31% say they are very willing to lend. Only 5% indicated they are unwilling to lend in this difficult environment.

FIGURE 6

In which areas are you seeing the most stress?



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