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2013 M&A TREND REPORT

As Stock Prices Rise, Expect Slow and Steady Consolidation in the Banking Industry

WHITE PAPER

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Is there a mad rush to consolidate the banking industry? The numbers would say no. Bank merger and acquisition (M&A) deal volume in the first half of this year is flat compared to the same time period last year. Aggregate deal value actually has fallen a little bit. Pricing on a tangible book value basis is flat.

That could soon change.

Investment bankers and attorneys attending Bank Director's upcoming Acquire or Be Acquired conference in Phoenix, Arizona, say they are noticing a pick-up in deal-making discussions that could lead to actual deals in the second half of the year. In fact, the biggest deal of the year was announced in July when PacWest Bancorp agreed to buy CapitalSource Inc., both Los Angeles-based banks, in a combined stock and cash transaction worth $2.4 billion. If that deal had been announced in the first half of the year, aggregate deal value would have risen by about 50 percent.

The environment seems ripe for more activity: net interest margins and high regulatory costs are putting pressure on community bank balance sheets, providing incentives to sell. Buyers have seen stock valuations soar during the last year, which means more banks can afford to pay a premium to buy a bank and potentially overcome one of the biggest hurdles to M&A during the last few years: a lack of agreement between buyers and sellers on a price. Asset quality also has improved during the past year for both buyers and sellers. Capital levels at many banks are high. Basel III rules for U.S. banks and thrifts have been finalized, offering clarity on what capital levels will be required, therefore making it easier to do deals. In another sign of an improving economic environment, failed bank deals have been on the decline, and healthy bank deals have been taking their place.

The slow and steady economic improvement may be leading investors in publicly

traded banks to turn their attention away from price to tangible book value metrics, and looking more at earnings accretion and growth potential in M&A deals. Still, regulatory concerns and compliance issues are having more of an impact on M&A than during the financial crisis, when the focus was on asset quality. Both buyers and sellers need to assess the potential for regulatory problems in any M&A deal, as well as closely assess the potential synergies and growth opportunities resulting from a combination. Banks in general are cautious, and investment bankers and attorneys are shying away from predictions of a coming wave of bank M&A. Instead, many predict slow but growing consolidation.

Volume & Pricing Trends in M&A

For a number of years, analysts and investment bankers have predicted an increase in the pace of consolidation in the banking industry. That hasn't been the case. Bank boards, as weary as they are of slow economic growth and new regulations, have not rushed to sell their banks. In many cases, they were waiting for a better price. At other times, regulatory approval was not forthcoming or buyers were in short supply. In 2011 and 2012, "the only people talking about an M&A wave were investment bankers and lawyers, not bankers," says Bill Hickey, the co-head of investment banking for New York-based Sandler O'Neill + Partners. "Buyers are cautious. They understand the [stock] market is very focused. And the market is focused on both the tangible book value earn-out period and earnings accretion. Buyers are not going to do deals outside the bounds of reasonableness."

(Banks should try to earn back the dilution to shares from issuing stock for a transaction within three to five years, investment bankers said.)

Through the second quarter of this year ending in June, 105 whole bank or thrift deals were announced with an aggregate deal value of $4.86 billion, according to SNL Financial. That was comparable to the first half of 2012, when 106 deals were announced with an aggregate value of $5.60 billion. The median price to tangible book value was 117 percent in the first quarter of 2013, and 112 percent in the second quarter, roughly in line with the same quarters last year.

There are wide disparities in geography, influenced by the asset quality and the local economies of the banks being sold. The median price to tangible book value in Southeast deals was 94.5 percent in the second quarter, but it was 138 percent in the Southwest, which has a much healthier economy than other regions thanks to the strong performance of banks in Texas, and 106.7 percent in the Northeast, according to SNL Financial.

But asset quality on bank balance sheets is improving across the country, and that should improve pricing for deals, investment bankers say. Foreclosures are falling and property values are improving. "It has improved so dramatically," says Hickey. "In every market throughout the country, valuations have stabilized so the hole isn't getting any deeper."

Failed bank deals, meanwhile, are on the wane. There have been just 16 acquisitions of banks from the Federal Deposit Insurance Corp. through the second quarter, compared to 28 at this time last year, and 46 during the first half of 2011, SNL

Financial's data show.

"Despite the slowdown in FDIC deals, we have noticed a pickup in failed bank activity recently, which could signal that the FDIC is attempting to flush out the remaining troubled institutions," says Steven Hovde, the president and chief executive officer of the Chicago-based investment bank Hovde Group. "Healthy bank M&A is definitely picking up, as well."

Fewer banks are willing to engage in loss-share agreements with the FDIC than earlier in the downturn, due to the cost of compliance and administration. Most of the larger bank failures have already taken place, leaving primarily smaller institutions to go through the process, which are less attractive to larger potential buyers who compare the financial benefit of the transaction to the cost, says Richard Quad, a senior managing director at Reading, Pennsylvania-based investment bank Griffin Financial Group.

The decline in bank failures and distressed sales in general could help improve healthy M&A activity. "The decline in deep discounted opportunities in some of the harder hit markets will make buyers begin to focus on valuing and acquiring healthy institutions," Quad says.

One perfect example is the $9.4-billion asset MB Financial Inc., which had a history of buying failed banks but has switched gears. It recently agreed to pay 1.8 times tangible book value for fellow Chicago banking company Taylor Capital Group.

Hovde says banks are having a difficult time growing earnings in a slow economic growth environment; one way to grow is through acquisitions.

FIG. 1

Quarterly M&A Whole Bank and Thrift Deals

Quarter	No. of deals	Aggregate deal value ($M)	Median price/ tang. book (%)
Q1 2010	27	277.0	128.9
Q2 2010	53	671.3	120.2
Q3 2010	49	2,078.3	114.7
Q4 2010	50	9,234.1	110.7
Q1 2011	35	2,367.8	118.8
Q2 2011	44	13,782.8	102.3
Q3 2011	33	226.3	113.3
Q4 2011	37	622.9	94.4
Q1 2012	55	3,339.7	123.2
Q2 2012	51	2,259.9	113.1
Q3 2012	73	6,727.7	113.1
Q4 2012	57	1,461.6	103.8
Q1 2013	51	1,767.5	117.4
Q2 2013	54	3,091.9	112.1

Source: SNL Financial

What Does the Future Hold?

Stephen Klein, an attorney with Graham & Dunn in Seattle, agrees. Sellers are looking at their future prospects and figuring out things will not look better in a year or two, he says.

"In the past, you could say, "I'll grow earnings 10 percent and it will look better next year,"' he says. "But what if you can't?"

He thinks small, community banks struggle to afford the kind of advanced technology that will enable them to compete head-to-head with bigger banks. If people aren't walking into branches as much, bigger banks with better technology gain an advantage. "The challenge is what is going to happen to branch banking over time?"

Some banks will be able to achieve certain efficiencies and afford more services and technology by combining forces.

Richmond, Virginia-based Union First Market Bankshares Corp. expects to achieve economies of scale in its acquisition of StellarOne Corp., a $445.1-million stock deal when it was announced in June. The combined institution, with $7.1 billion in assets, will be the largest community bank based in Virginia. (The credit card giant Capital One Financial Corp. also is based in Virginia). Union First expects to save $28 million in pre-tax expenses by joining forces with the $3.1-billion asset StellarOne, achieving double digit percentage increases in earnings per share the first year, and a recovery of tangible book value per share dilution in five years. Union First's stock has climbed from about $20 to $22 per share since the deal was announced. (Raymond James represented StellarOne and Keefe, Bruyette & Woods Inc. represented Union First.)

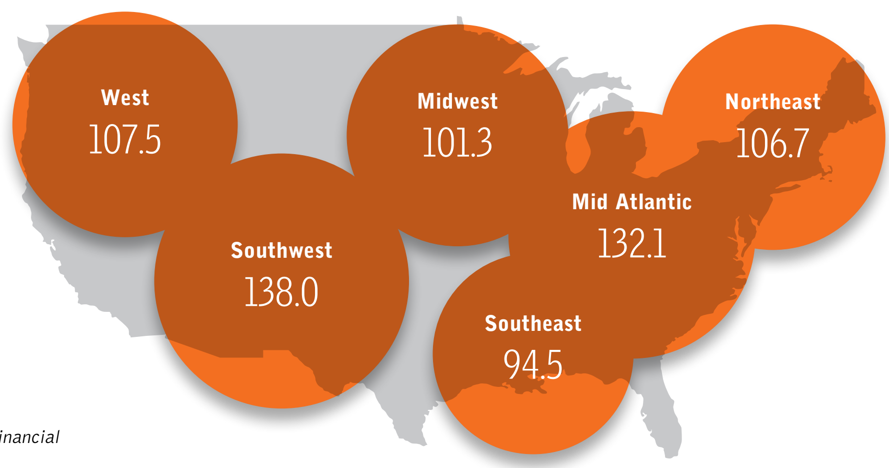
Also, this year many more banks have been better able to pay the premiums that sellers want in M&A deals than in 2012. At the time the deal was announced, Union First was paying 141 percent of tangible book value for StellarOne. Although asset quality and credit quality have been improving for some time, one of the most dramatic changes during the past two years has been the rising stock values of banks. Publicly traded banks between $2.5 billion and $10 billion in assets were trading at 162 percent of tangible book value at the end of the second quarter, compared to 120 percent at the end of 2011, according to SNL Financial.

This gives potential buyers a stronger currency to do acquisitions at modest premiums, especially if the target bank is smaller and trades at a lower multiple, says Ben Plotkin, vice chairman of Stifel Financial Corp. and executive vice president of Keefe, Bruyette & Woods. "The $500-million banks have been waiting for a buyer to pay a respectable price. They're not going to receive two times book but they want 1.25 or 1.40 times book, and that wasn't happening until buyers' stocks were at a point that they could afford to pay those kinds of premiums."

Smaller bank stocks haven't increased in value as much as larger banks, so larger banks can afford to pay the premium that sellers want, he says. Investors pay a premium for banks in the $2.5 billion to $10 billion asset range because those banks have the resources to compete against the bigger banks, they can afford the increasingly high cost of regulatory compliance, and there is enough of a public float in the stock for investors to buy and sell the stock quickly if they need to, Plotkin says.

FIG. 2

Q2 2013 Deal Price to Tangible Book Value Medians by Region



Source: SNL Financial

Another factor that could improve M&A activity is finalization of the Basel III rules, which federal regulators completed this summer.

Michael Mayes, a New York-based managing director at St. Petersburg, Florida-based investment banking firm Raymond James, said uncertainty about required capital levels was a damper on M&A. Banks need to know how a deal will impact their capital levels, and now there is more clarity as to whether the combined company will have enough. "We would be in a board room looking at a potential acquisition, and half of the board would say, 'that's plenty [of capital],' and the other half would say, 'that's not enough,' because the regulations weren't clear," he says. "There was often hesitation on the part of the board where pro forma capital might not be adequate."

Luigi De Ghenghi, a partner in New York at the law firm Davis Polk, agrees that a cloud of uncertainty has been lifted. But few predict a coming wave of M&A activity.

"It's really going to be slow and steady, and very geographically dependent," says Quad. "Every year that goes by, where margins are tight [and] competition is still tough, more and more [bankers] will say, 'it's hard for us to do this on our own.'"

John Gorman, a partner in the law office of Luse Gorman in Washington, D.C., says the difficulties facing banks today are not likely to lead to a sudden avalanche of deals. "It's not that kind of crisis," he says. "It's more of a drawn out type of pain."

Mayes, of Raymond James, points out that in some regions, such as the Northeast, a lot of consolidation already occurred during the 1990s. "I don't see a coming wave of consolidation," he says. "I do see activity picking up, and if economic conditions improve, you could see more activity in the next 12 months."

Hovde says that M&A activity is picking up in his shop.

"We have an anecdotal take that suggests the second half of the year could be a lot more active than the first," he says.

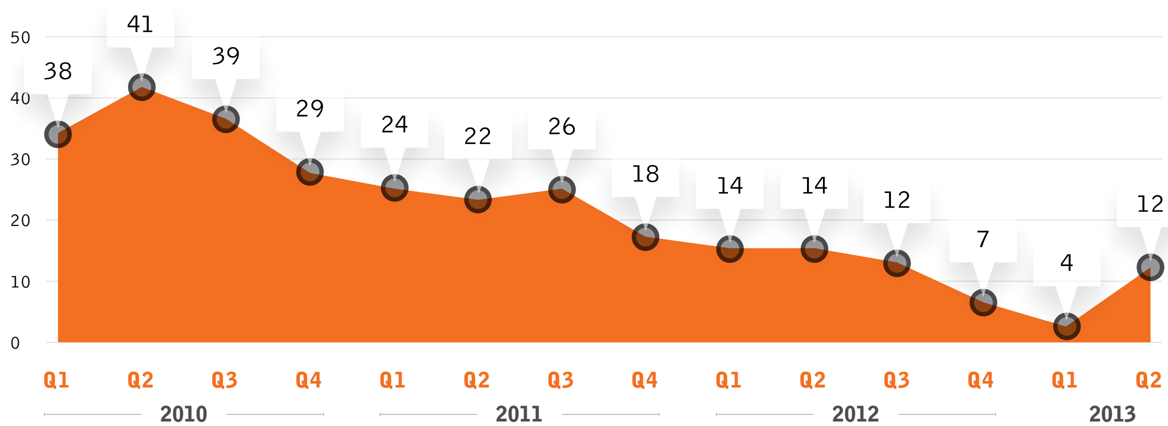
But there are hurdles.

As the bigger banks get bigger, the regulatory hurdles become harder to clear. The regulators will not allow the megabanks to grow through acquisitions, says Gorman. Compliance problems can be a hurdle for some bank deals in this environment as well. Buffalo, New York-based M&T Bank Corp. proved that when it announced in April a delay of its purchase of Hudson City Bancorp amid regulatory questions about M&T's anti-money laundering program (AML).

"We are in a bit of a mini-reign of terror when it comes to regulatory compliance matters, particularly with respect to BSA [Bank Secrecy Act] and AML on the one hand, and consumer compliance on the other," Gorman says. Some sellers are even asking for reverse break-up fees in case regulatory issues or other problems prevent the deal, says Bill Taylor, a

FIG. 3

Number of FDIC-Assisted Deals by Quarter



Source: SNL Financial

partner at Davis Polk. Normally, buyers, not sellers, request break-up fees in case the seller takes a different offer. Banks, both buyers and sellers, need to talk to their regulator about a specific deal before making any announcement, De Ghenghi says.

If You Want To Be a Buyer

Buyers also need to check with regulators way ahead of an acquisition announcement to make sure they can get approval for acquisitions and determine that they will have enough capital, says C.K. Lee, a managing director of Dallas-based investment bank Commerce Street Capital. A buyer should have a strong currency, both in terms of the stock's value, but also in terms of having the money to buy banks. Having to go to the public markets to raise capital after a deal is announced or not having the cash on hand could be risky. It's possible to get pre-approval for a bank stock loan, perhaps as a bridge loan to fund the acquisition.

Investors like to see a track record of successful M&A deals, so buyers hoping to get into acquisition mode can start with smaller deals to make sure their bank has the infrastructure to handle the integration smoothly. Also, when assessing a seller, look at the strength of the franchise and loyalty of those deposit relationships, says Lee. As soon as interest rates rise, some low-cost deposits may be lost to higher-earning investments.

If You Want to Be a Seller

It's equally important for the seller's management team to perform due diligence on the buyer as well as the other way around. If stock is a significant part of the transaction, the seller is buying into the future earnings power and growth potential of the buyer. It will become irrelevant what the price was at the time of the announcement if the buyer's stock price drops in the future, Hickey says.

To make a bank more attractive for potential buyers, improve earnings potential by deploying capital in a smart and efficient way, Lee says. If a bank does some attractive acquisitions of smaller banks, it can increase its size and value.

"A $100-million bank in a country market will not fetch as much as an $800-million bank in a metro area," he says.

However, growing for the sake of growth is not a good idea. "Your bank's value will be undermined by inflating your balance sheet and growing your loan portfolio with rates and terms that are off-market," Quad says.

What's Driving M&A Deals:

- Investors like to see growth, but loan volume has generally been lackluster for many banks. M&A is one way to grow.
- More banks can afford to pay a premium now to buy a bank.
- Asset quality and stock values have improved, and sellers could benefit from better pricing.
- Increased compliance costs are leading some banks to combine to improve efficiencies.

What's Hindering M&A Deals:

- There is a disconnect between buyers and sellers on price.
- In some markets, there is a dearth of healthy banks with a strong franchise to buy.
- There are not enough willing and able buyers.
- Compliance problems are hindering some deals.

Conclusion

While size and geography matter, investment bankers and attorneys say more investors are beginning to focus on the future earnings potential of M&A deals, a welcome sign for an industry that has been damaged by years of failed banks and lingering asset quality problems. "Asset quality is not as much of a question mark anymore," Gorman says. "What you see is what you are getting."

Good organic growth stories are selling for a premium these days. For both buyers and sellers, becoming a bank with strong growth prospects is key to improving value. "At present, if you structure your deal right and it makes strategic sense, there is investor support for transactions," Plotkin says.