

The Consolidation Conundrum

Emerging merger and acquisition trends from the first half of 2006

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While merger and acquisitions have been steady for the last couple of years, a number of announced deals in the first half of 2006 could jumpstart even more M&A activity for the remainder of the year, signaling an opportunity for potential acquirers who have been sitting on the sidelines the past few years due to strong pricing multiples. (There were 119 mergers announced in the first half of 2006 where the seller's assets were less than \$2.5 billion (Chart 1) compared to 112 and 107 in the first half of 2004 and 2005, respectively.)

A number of factors may be impacting current market consolidation.

Fluctuating Rates

Since June 2004, the Federal Reserve (at the time of this writing) has raised interest rates by 425 basis points. The impact on banks and thrifts has been mixed. For thrifts and banks that are primarily fixed-rate lenders, rising short-term interest rates have in some cases resulted in significant margin compression. Banks that are primarily variable-rate lenders have experienced the opposite impact. Loans have re-priced more quickly than the increase in funding costs, resulting in margin expansion.

If the Federal Reserve is indeed nearing the end of this interest rate cycle, it will be interesting to see how margins respond. It is likely that funding costs, especially deposit rates, will continue to increase even

after the Fed has ceased tightening. The market for deposits has become increasingly competitive and retail deposit growth in the aggregate has not been sufficient to fund asset growth. In response, many banks have relied on wholesale sources (brokered deposits, Federal Home Loan Bank advances, Internet deposits) to fund loan growth. This challenge in finding core funding has led to a significant increase in the core deposit premium buyers are willing to pay for targets (Chart 2).

It is also likely that as variable rate loans re-price at higher rates, the volume of loan payoffs will increase. With the prime rate above 8 percent, asset growth could slow and competition for loans could heat up, causing banks to offer loans at a discount to prime. In the near term we may see margin compression coming from both higher funding costs and lower asset yields.

On the positive side, for institutions that have already been hammered by rising rates and margin compression, a pause on the part of the Fed will be a welcome relief. Liability sensitive banks and thrifts may see some margin improvement as asset yields slowly begin to catch up with the rise in funding costs.

Asset Quality

The banking industry has enjoyed excellent asset quality in recent years. Nonperforming assets have been very low and charge-offs have been modest. Rising interest rates, higher energy prices and a cooling

Chart 1 Deal Statistics for Bank & Thrift (by quarter)

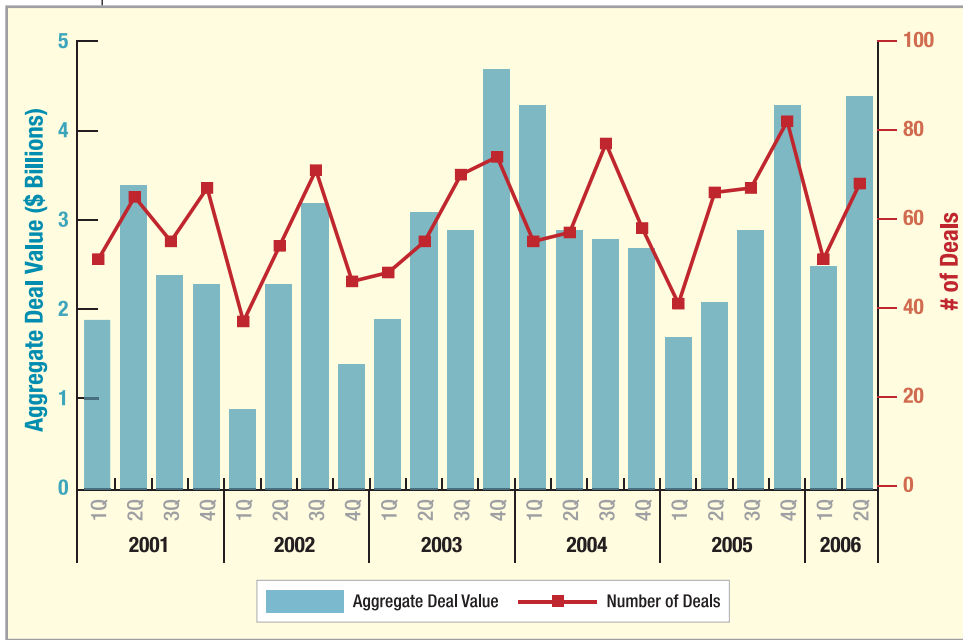
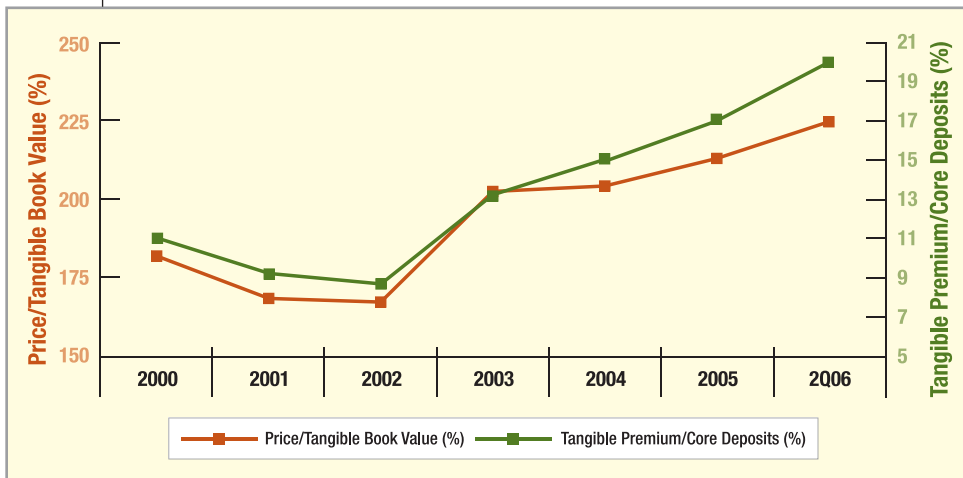


Chart 2 Deal Statistics for Bank & Thrift (by year)



real estate market have the potential to reverse that trend, with consumers and small businesses just now beginning to suffer from rate shock as variable rate loans adjust to higher rates. This is particularly troublesome for individuals who stretched to purchase a home that they could not afford were it not for some of the new mortgage products to hit the

market (e.g., option ARMs, interest only, extended amortizations).

Higher fuel prices and higher real estate taxes are a triple threat, putting additional pressure on already strained household budgets. It would not be a surprise to see another rise in personal bankruptcies in the next year due to this combination of events. Unfortunately for banks and con-

sumers the real estate market is softening and rising real estate values will not bail anyone out.

For small businesses, higher interest rates and higher energy costs have squeezed operating margins and cash flows. Many small businesses do not have the means to increase revenue sufficiently to offset these higher costs. Banks may be required to add to loan loss reserves as debt service coverage ratios fall and credit quality deteriorates.

De Novo Activity

There has been a surge in new bank formation in recent years, particularly in the Sunbelt. Merger activity and very favorable capital markets for banks have made it attractive for groups interested in starting a bank. Many of these groups have been able to raise a surprising sum in startup capital.

Where \$10 million was a common capital benchmark for forming banks in the past, today's *de novos* routinely raise double that. A number of banks have been formed with anywhere from \$40 million to \$100 million in startup capital.

The challenge for any *de novo* bank is to get up to critical mass in a short period of time. The sooner the bank has enough

earning assets on the books to cover costs, the smaller the earnings deficit before the bank begins to make money. This adds to competitive pressures in a market as newly formed banks aggressively market for loans and deposits.

On the flip side, many *de novo* banks formed in the late 90s are re-evaluating their strategic plans. For many, continued growth will

increased regulation—will continue to make it more difficult for community banks to grow and be profitable and have the potential to spur new merger and acquisition activity. While bigger is not always better, there are definitely economies of scale in banking. Given the sizeable investment most banks have in the back office, it is common to see cost

ominous and make it easier to understand why so many conversations are taking place, there are opportunities that arise in difficult markets. Banks that take a long term view to growing value and have a shareholder base that shares that vision can avoid some of the pressures that come with a tougher market. For the banks that survive, this disrupt-

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need to be funded with additional capital and significant costs to upgrade systems and talent. Depending on the outcome of some of this soul searching, these banks may choose to find a partner rather than go it alone.

Compliance concerns also play a role. Banking has always been a highly regulated industry, but new regulations (the Sarbanes Oxley Act and Bank Secrecy Act to name a few) are requiring dedicated employees and/or outside consultants at significant expense to ensure compliance. It is not uncommon to see a publicly traded bank (under \$250 million in assets) pay \$150,000 to \$200,000 per year just to comply with section 404 of Sarbanes Oxley, for example. Many community banks are finding it difficult to satisfy the regulators on compliance due to the size of their staff and limited resources. Unless these community banks get some relief from these burdens many may be forced to explore their strategic options.

A Combustible Combination

The macro trends just discussed—higher interest rates, asset quality, *de novo* activity and

savings in the range of 15 percent to 35 percent of the target's operating expenses without closing any offices.

This need for scale has been one factor in community bank consolidation. Since 2001 the largest segment of buyers in the market has been banks under \$2 billion in total assets. There may even be an increase in the number of mergers of equals in the future due to the scarcity of larger buyers in some markets.

A larger, more profitable community bank may be better suited to compete in its market. With these resources it can adequately address compliance and credit administration, invest in new offices or technology, or find a customer niche not exploited by the smaller or larger institutions. The larger community bank may also have more options for managing its margin through better use of the balance sheet and more sophisticated asset/liability management techniques. These banks may also have access to more unique capital structures that have the potential to drive higher returns to shareholders.

While these trends sound fairly

tion to the local community can lead to greater opportunity for business and talent.

All banks need to decide how their long term strategic plans fit into the current market environment. While maintaining the status quo for some makes sense, most banks are continuously debating whether it is time to buy or sell. If a bank is going to be a buyer, it needs to have the right people, systems, funding and capital base to effectively manage and integrate a transaction. The secret to a successful bank merger is to retain the best practices of both companies and not alienate the customer. Community banks that are disciplined and can make deals work will have a tremendous advantage if the trends discussed here continue to be prevalent in our market. **ib**

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