

Examining the Case for MOEs

By Bill Sammon
and Tom Lynch

factoid:

In 2006 mergers of equals grew **67%** over the preceding five years combined.



Bigger is not always better. There are many smaller community banks that prove this claim in their markets every day. These banks know the impact a well run, independent, local bank can have on the businesses and individuals of their community. Despite this truth, community bank management and boards have recently been exploring, both theoretically and practically, the strategic business affiliation known as the merger of equals, or MOE.

The MOE structure has been around for some time and includes some very large transactions, including the \$34 billion merger of Wells Fargo and Norwest in 1998 and the \$29 billion merger of ChoiceOne Financial Services and Valley Ridge Financial. There have been five MOEs in 2006 versus three in aggregate from 2000 through 2005. That represents a 67 percent increase in volume for this structure from the total previous five years.

Why have we seen an increase recently? Many of those community banks struggling with the current operating environment have begun to see a MOE as a way to build scale while continuing to serve their community.

MOEs on the Rise

A look at Table 1 brings into focus one reason many community banks are looking to create larger organizations. MOEs can provide economies of scale, market or product extension, diversification and synergies. In-market MOEs

can ultimately create a larger, more market-dominant institution that will operate more efficiently and provide its shareholders a better return.

As already stated, many community banks face a difficult operating environment today. Some community banks have deficiencies in their capital or management or even on their balance sheet. A good merger of equals helps the institutions mitigate each other's deficiencies to a material degree and allows the *pro forma* company to leverage each company's strengths. For example, a high asset growth, lower capital institution that relies heavily on wholesale funding should seek a slower growing merger partner that has good core deposits and is well capitalized.

Another reason for the increase in the community bank MOE is the effect that consolidation has had on community banks. Unit banking, prohibitive interstate branching laws and so forth had maintained a certain scarcity value for smaller institutions. Today, however, the M&A market is driven primarily by scale, and the number of potential acquirers for smaller institutions has been reduced significantly.

Banks must find new paths to increase their profitability and thus create higher returns to its shareholders. MOEs provide banks with an opportunity to expand either their product line or geographic footprint, allowing the *pro forma* entity to initiate changes that might come from an outright

sale without the material disruption of a sale both internally and externally.

Other Attributes

One driving issue for MOEs has been management succession. A MOE allows a revamp of upper management and may provide non-management employees of both institutions upward mobility. This allows the *pro forma* company to reward employees on both sides with greater responsibility, reducing the potential for significant employee disruption.

Another significant benefit, particularly for community banks, is the ability of the *pro forma* company to minimize the disruption to the community. Community bank MOEs typically have not

Table 1

As of Sept. 30, 2006	Median ROAA	Median ROAE
Banks with assets < \$250 million	0.62%	5.08%
Between \$250 million - \$500 million	1.00%	10.97%
Between \$500 million - \$1 billion	1.06%	11.66%
Between \$1 billion - \$5 billion	1.14%	12.19%

All publicly traded institutions. Source: SNL Financial LLC

Rather, the MOE is a strategic affiliation that allows the bank to expand significantly and still retain a material level of control and ownership. Further, the metrics used to look at a MOE are different than those of an outright sale. Board representation, manage-

negotiated. The majority of recent MOEs (83 percent) have had equal board representation. Management has been mixed with the majority shareholder institution, or technical acquirer, having the CEO position 30 percent of the time, the chair-

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been driven by geographic extension. And the parties involved have maintained an intimate knowledge of the market. Thus, unlike an outright sale, a properly structured MOE provides energized employees, knowledgeable market management and product extension that gives the *pro forma* company a solid base to increase its returns while continuing its community commitment.

But is this truly a merger of equals?

To answer this question, we must look at how MOEs are valued. A MOE is not the sale of either company. The management and board are not required to seek the highest "bid" or market the bank to potential acquirers.

ment positions and ownership are the three most important issues.

What drives these metrics are the underlying characteristics of the institutions. The *pro forma* contribution of deposits, loans, capital and earnings provide a reasonable basis for the *pro forma* ownership. Ownership is primarily driven by earnings contribution, but can be adjusted to some extent for other contributions. Typically, excess capital does not carry a significant premium, but it may adjust ownership slightly.

MOE ownership can be anywhere from low 40 percent to middle 50 percent depending on the overall contribution analysis.

Board representation and management responsibility is typically

manuship 50 percent and the CFO position 50 percent. That means that the minority shareholder base had equal board membership in the majority of the transactions and the CEO position 70 percent of the time.

The higher growth company has earnings and growth, which are two very highly valued characteristics by most bank investors. The business model will break down at some point, however, if the funding becomes too expensive or the capital constrains the growth. The lower growth institution has good core deposits and excess capital. Core deposits are highly valued in a rising-interest rate environment, and the capital position, while viewed as strength,

can easily be identified by investors or potential acquirers as less than optimal.

In most cases, the lower growth company's returns to its shareholders often lag behind those of the higher growth company. The *pro forma* company will be a reasonably capitalized company that will reduce its funding cost. A larger, more efficient and diversified company, with a better managed capital position and asset liability mix will command a better premium in the market than either could have separately.

Bank boards need to understand these transactions take time. Many deals take years before the two organizations are comfortable enough to begin serious negotiations. It is important that the two teams share a vision for the combined company and that each person's new responsibilities are clearly defined.

The MOE is a unique transaction that, when executed properly, has tremendous potential to increase long-term returns for both parties' shareholders. For a truly successful MOE, each party and its board of directors must take the consideration to put the best members on the *pro forma* board; form the best management team; leave no policy or procedure unexamined and take the best from each institution, combining those strengths going forward. **ib**

Bill Sammon is director of capital markets for ICBA Securities, ICBA's NASD-registered broker-dealer in Memphis. E-mail him at bsammon@icbasecurities.com. Tom Lynch is managing director at Howe Barnes Hoefler & Arnett. E-mail him at tlynch@howebarnes.com.