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COVER STORY

MATCHMAKER, MATCHMAKER

As institutions search for the perfect partner, many factors play into their long-term compatibility. What should leaders be looking for as they explore the M&A landscape?

It's the heart of wedding season – warm summer nights spent pledging everlasting love, eating cake, and dancing to old standbys from Frank Sinatra and the Village People. But long before the celebration comes months of planning the event, making the arrangements and perfecting the details.

The story is largely the same – albeit more analytic than romantic – on the corporate wedding scene. With prices rising, competitive pressures percolating and technological concerns intensifying, many institutions are surveying the M&A scene to decide whether they want to spend the next few years flying solo or if it's time to find a partner.

Much like a good marriage, a good merger is a symbiotic relationship where both parties bring different and complementary strengths to the table, and ultimately are more successful together than either would be on their own. But much like a struggling marriage, it takes an unforeseen issue in just one of the two parties to bring the whole relationship down. Therefore, institutions need to make a concerted effort to be sure they're entering the market with a deep understanding of their own strengths and weaknesses, a clear idea of how to identify the strengths and weaknesses of a buyer or seller and a distinct understanding of their deal-breakers.

BIGGER FISH IN THE SEA?

Merger and acquisition activity has been relatively strong over the past few years, as institutions have consolidated in the wake of flattening yield curves and digital pressures. However, 2018 has created a uniquely merger-friendly environment with the recent tax reform bill and regulatory rollbacks. While the tax bill may free up more capital to fund possible deals, it is the deregulation that could introduce some bigger players to the M&A pool.

"The most important change was this bill that changed what constitutes a systemically important financial institution," says Steve Jacobs, president of BCC Advisers, speaking of changes to Dodd-Frank that were signed into law in May. "It raised the threshold at which banks are considered 'too big to fail' from $50 billion to $250 billion. This will certainly encourage banks to make more acquisitions and be more active in the M&A marketplace."

While institutions celebrate this much-anticipated relief from post-crisis rules, some are already seeing salutatory effects from the tax reform bill passed late last year.

"Cutting taxes from 35% to 21% is really going to help the M&A market," says Dan Bass, managing director of Performance Trust Capital Partners. "Because banks are fully taxed, those savings are going to fall right to the bottom line. The first quarter earnings were very strong, and I expect we'll see more of the same. That will really help."

However, these regulatory shifts have the potential to either encourage or squash the M&A interest of smaller institutions. While saving money on compliance costs and tax cuts may allow some smaller institutions to keep competing, the advantage it could hand to larger banks might cancel that out.

"With the tax law change and deregulation, small banks will see that either they need to get a really good price, or they're going to stay independent," says Scott Martorana, executive managing director of FinPro. "Small bank M&A has been really active, and I could see deregulation cutting either way."

ONLINE DATING

As digital transformation has become necessary to success, technological investments and cybersecurity concerns have both become major factors in M&A considerations. The resources required to

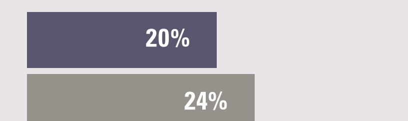
THE STATE OF M&A

If the responses in a recent FMS survey are any indication, the M&A market is heating up in 2018. When asked about the importance of M&A as a factor for their institution's growth, 12% more of the 400 bank and credit union executives surveyed deemed it either very or somewhat important than in 2017. There was a corresponding drop in the number of respondents who weren't pursuing M&A.

NOT PURSUING OR FIELDING ANY M&A OPPORTUNITIES AT THE TIME

PROSPECTIVE BUYER

PROSPECTIVE SELLER



CONSIDERING A MOVE WITHIN THE NEXT 3-5 YEARS

2017 2018

Source: Community Mindset: Bank and Credit Union Leadership Viewpoints 2018 – FMS Research

keep up with technological innovation may force smaller institutions without a strong tech profile to decide whether they can confront the digital future on their own or if they should look for a solid buyer.

"Again, this can cut both ways," Martorana says. "A small bank can use technology to their advantage by seeing it as a way of expanding their geographic boundaries. If they're a four-branch bank, ten years ago they would have been mostly limited to customers within a fifteen-minute drive of one of those four locations. That's not the case with the benefit of a strong digital presence."

Of course, while small institutions willing to make the investment can significantly widen their footprint with online banking and other technological solutions, those without the resources or the know-how to implement a suite of digital banking options may find that it's time to sell. Martorana suggests they pick one of those options and really commit.

> "Either look at selling now and strike while the iron is hot and the merger market is strong, or have a five- to seven-year plan for staying in business and reinvesting in the company."
>
> *Scott Martorana,*
> *Executive Managing Director – FinPro*

"It doesn't really make sense for them to hire new people and spend a lot of money to implement technology if they're not going to be in business for the next several years," he explains. "Either look at selling now and strike while the iron is hot and the merger market is strong, or have a five- to seven-year plan for staying in business and reinvesting in the company."

As institutions migrate to onlineplatforms, cybersecurity has become a key component of M&A negotiations as well, carrying immense significance in the due diligence process. Buyers now do well to thoroughly evaluate the cybersecurity protocol and processes of any potential acquisitions.

"Cybersecurity has become a much bigger factor – not just for banks but for all organizations," says Tom Cavanagh, vice president of BCC Advisers. "It's a huge risk and potentially a huge cost should there be a breach. So if you acquire a bank with faulty protocols, any past breaches become yours, and you may not know about past breaches unless your audit process is robust."

There are enough high-profile breaches in recent memory to impress upon buyers and targets alike the importance of a clean bill of health when it comes to cybersecurity. There doesn't seem to be any statute of limitations on data breaches, with companies being called onto the carpet long after their customers' data was accessed.

"Certainly we've all seen that criminals are becoming more creative, and everyone's information seems to be more readily available," says Cavanagh. "Some sellers are even doing their own internal audits ahead of seeking a buyer to try to ease some of those concerns and give good buyers confidence."

The concern comes from risk and reputation concerns, certainly, but regulators are also bearing down on it. Martorana notes that cybersecurity is one of the top regulatory concerns at the moment, and rightfully so: "It's top of everyone's mind."

> "The overall price-to-tangible-book value has been rising steadily. In 2016 it was in the range of 1.3 to 1.4 times book value, and in 2017 it increased to 1.6 or higher. Now that this legislation has passed, there isn't any question that it will continue to rise."
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> *Tom Cavanagh,*
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SPEAK NOW OR FOREVER HOLD YOUR PEACE

Perhaps the biggest potential deal-breaker between two institutions on their way down the aisle is the status of vendor contracts.

"The number one cost in an M&A transaction is contract terminations," Martorana says. "Whether the core processor or the loan system or any other vendor contract, sellers need to really manage those costs and keep them down."

Because of the immense cost of termination fees – often 80% of the remaining value of the contract – any institution considering a merger should begin taking steps to mitigate those costs as soon as possible.

"We have a lot of clients who negotiate contracts that have limited termination costs," Martorana says. "Even if somebody may not think they're a seller, in the next few years that might change, and your termination costs can be prohibitive."

Bass suggests taking a look at all of your contracts to see when they're up for renewal as soon as you begin entertaining ideas about selling. If your contracts are all up for renewal in the coming year, it's a perfect time to sell. Another trick of the trade is to work with vendors and your counsel to see if you can modify the contracts in any way, as even a few changes can often go a long way in making your institution more attractive to buyers.

"In early strategic planning efforts, sellers should go through and reevaluate all of their vendor agreements to ensure they are current and they're negotiated in the best fashion possible," Jacobs says. "If possible, you should get assignability clauses in vendor contracts, so it's easier to handle the transition from seller to buyer. This generates goodwill leverage and the possibility of a premium for your institution."

THE DOWRY

Of course, price is a huge factor in any M&A deal – often the biggest factor – and the elements that go into determining what an institution is worth are diverse and can vary from bank to bank and market to market.

"There are several different considerations with every institution," Cavanagh notes. "Quality of assets, return on assets, efficiency, your market, how dynamic the institution is, your growth prospects, what kind of costs savings can be implemented, your products, your employees – these are all keys to maximizing value if you're a seller."

It's a good time to sell, with prices rising steadily and no new regulations to trip up the approval process.

"The overall price-to-tangible-book value has been rising steadily," Cavanagh says. "In 2016 it was in the range of 1.3 to 1.4 times book value, and in 2017 it increased to 1.6 and higher. Now that this legislation has passed, there isn't any question that it will continue to rise."

One of the problems of such a strong market is that sellers' expectations can be unrealistic. Some targets can have a hard time finding a buyer if they set their price too high, and some buyers can be caught off guard by their sellers' demands.

"As a buyer you need to know who you can buy and at what price, and if you're a seller you need to know your buyers' capacity to pay," Martorana says. "You may think you're worth so much money, but if there are no likely buyers in your market who can afford that, you'll never get that price. Certainly there's also a difference between the ability to pay and the willingness to pay."

Sellers can do a lot to attract solid prospects with cybersecurity audits, contract termination precautions and some of the other due diligence discussed. Additionally, a solid deposit base is the kind of sought-after attribute that will make any institution a good candidate to fetch top dollar.

"I think one of the biggest shifts in 2018 is the focus on

DIY M&A?

The majority of institutions looking to venture down the road of a potential merger or acquisition will seek out an advisory firm to help guide them through the process. And for most institutions, the expertise and guidance of experienced advisors is well worth whatever they pay. However, for some, taking on an M&A transaction as a DIY project might just be a possibility.

Howard Hagen has worked out of Iowa and the upper Midwest for years, and he knows the area well. With a host of smaller community banks – often family-owned and far below the national average asset size – Hagen believes this market is ideally suited to doing M&A on one's own.

"These bankers are well connected with each other, and most of the institutions are not publicly traded," he says of these small, private companies. "If you're not public, you rely on your accounting firm and your law firm – those two working together can handle the vast majority of your needs. There's enough of that kind of activity that both the counsel and the accounting firms are well-versed in the ins and outs of M&A."

While Hagen specializes in the rural Midwestern market – the heart of community banking – he surmises that for many small markets where community banks are well-connected to their peers, the same principles will hold true.

"Some deals can be set by social contact," he says. "They know the bank, they have a high regard for them, they have a price in mind and if they can agree on a price, they'll sign and turn it over to the professionals."

However, Joshua Juergensen, a principal at CliftonLarsonAllen, cautions that while there are some scenarios where institutions can work through the intricacies of an M&A deal on their own, they could be missing out on other potential partners or getting slammed by taxes.

"With an aging bank ownership base, there are a lot of options out there," Juergensen says. "They may have options they haven't considered. And on the sell side, they need to work with the right advisors because there are significant tax ramifications that take place anytime you sell an institution."

In general, both Juergensen and Hagen agree that some smaller institutions in small markets that have solid relationships with the right people and who won't run into any complex accounting scenarios are probably in good shape to try M&A on their own – keeping the commission they'd otherwise pay to advisors and instead shelling out an hourly rate to their CPA and lawyer.

"Some community banks are more like small family businesses than corporations," says Hagen. "That makes a big difference in the way they approach M&A."

> “I’ve had deals where the board tells me culture doesn’t really matter and they just want the highest price, but when I get them the highest price and they see it’s not a good cultural fit, we end up selling for a little less to an organization that’s a better match.”

Dan Bass, Managing Director – Performance Trust Capital Partners

deposits and funding,” Martorana says. “For the past ten years, from the crisis to mid-to late-2017, those weren’t really a focus for many institutions because they were abundant, whereas now deposit competition is becoming fierce. Therefore, institutions with strong, stable, lower-cost deposit bases have become more valuable in this market than they were two or three years ago.”

COMPATIBILITY IS KEY

No matter how important the right price is and how big of a deal-breaker broken contracts can be, it may be the most subjective element of any deal that ends up being the most important to its success: cultural fit. Experts agree that any time two institutions merge, a strong cultural match is one of the most critical elements to a satisfactory final product. Yet the importance of a good fit can be something that leadership doesn’t recognize until they see a bad fit.

“I’ve had deals where the board tells me culture doesn’t really matter and they just want the highest price,” Bass says. “But when I get them the highest price and they see that it’s not a good cultural fit, we end up selling for a little less to an organization that’s a better match.”

Even when the parties realize how important culture is, it can be hard to find a good match. After all, there’s no eHarmony for banks and credit unions.

“I wish this were easier to pin down, but it’s one of those soft things,” Cavanagh notes. “You can’t just read a document and do a couple interviews and determine it’s a fit.”

While doing a couple of interviews certainly won’t cut it, extensive questioning with as many employees as possible about operations, staffing, hours, flexibility, management style, information flow, community involvement and more can help both parties get closer to a match.

“The reality is that it’s hard to quantify, but it can be the biggest asset or the biggest detriment to the surviving institution,” Martorana says. “There isn’t one right answer, but you need to understand and communicate what the combined entity is and then everyone needs to embrace it.” Having a cultural mismatch that results in not successfully combining the two institutions into a cohesive entity can take its toll on both employees and customers, with many jumping ship. Changes in schedules, titles or cultural norms can alienate employees – and if employees bail, customers may follow suit.

“One of the biggest risks in a cultural clash is the chance that you’ll lose top producers, but there are a number of options that can help keep key people around,” Jacobs says. “Stay bonuses and other incentive programs can keep top performers around at least through the transition period. If they don’t stay during that crucial period, the customers are negatively impacted.”

While acquirers should certainly do all they can to keep key employees, they should also take a strong stance against anyone consciously undermining the new combined institution.

“After the deal, you have communicate that there’s only going to be one culture going forward,” Martorana says. “It’s not going to be us-versus-them – it’s going to be we-and-our. Make sure you’re meeting with the people on the other side of the deal as soon as possible to make sure the culture is communicated, established and ingrained across the entire new entity. And if someone isn’t embracing the culture and acting in the best interest of the combined entity, they need to go. That may sound ruthless, but they can become a cancer to the culture of the new entity.”

THE GUEST LIST & SEATING CHART

Much like a bride and groom plan out their invitation list and put all their single friends at one table at the reception, smart institutions will plan out who stays and where they’ll sit early in the process of a deal.

“The more recent trend I see is that the next generation of bankers is not as deep of a pool as it was ten or twenty or thirty years ago,” Martorana says. “A lot of people see M&A as an opportunity to get the best talent from both organizations and

A UNION OF UNIONS

Credit union M&A has held steady over the past few years, and the valuation experts at Wilary Winn LLC expect to see that trend continue.

“Most credit union mergers have been smaller credit unions consolidating,” says Doug Winn, president of Minnesota-based Wilary Winn. “One of the reasons is probably the same as what you’re seeing in the community bank sector – folks are having a hard time earning enough with the flattening of the yield curve and the compression of net interest margin.”

Over the past several years, most of the deals have involved acquirers subsuming much smaller credit unions, and Winn doesn’t expect to see that change any time soon. And while many of the trends are the same for both banks and credit unions, some tend to be more exacerbated in the credit union space while others are entirely different. The very nature of credit unions creates its own strengths and weaknesses, since they’re more likely to have a homogenous membership base than banks.

“Sometimes credit unions look into mergers because of their membership profiles,” Winn explains. “You have credit unions that start as a particular employer segment and their members are older and aren’t taking out loans and are investment-heavy. Conversely, you could have a credit union where the membership is young and doesn’t have much savings and they need loans. So some M&A transactions are meant to balance out these types of things.”

Another consideration unique to credit unions is the fact that some mergers are motivated by institutions looking to broaden their charters. Sometimes growth is made difficult by a restrictive charter, and acquiring a different kind of credit union can open those doors.

“When you merge, you get the rights to their charter, and you get the right to serve their members and their segment,” Winn says. “Some institutions want to acquire a federal credit union so they can have more rights and services, or sometimes an institution will want to acquire a state charter so they can serve a larger geographic region.”

At other times, credit unions are pushed into mergers at the urging of their regulators, who are noting either year-over-year losses, holes in succession plans, poor management or receding fields of membership.

“If they’re incurring losses and depleting their capital level and their operations are being hindered, regulators might tell them to look for a buyer,” says Katelin Hartman, a manager at Wilary Winn. “Or sometimes their membership is largely runoff, like when a large employer the credit union serves closes their location in the area.”

Just as they face different reasons for merging in the first place, credit unions often face different challenges after merging as well. For instance, the cooperative model for a credit union makes it less likely that the merged entity will cut employees, which is why making sure people get moved into positions where they’ll be most effective becomes so important.

“In credit union deals, you can’t have two CFOs but they’ll offer you a different job,” Winn notes. “They’re generally softer on the employee side than the average bank transaction.”

Cultural consensus is just as important to credit unions as it is to banks, and merging institutions should give thought to representation for the seller instead of just imposing a new culture on them.

“When the institutions are more equal, the credit union being acquired is more likely to have board representation, but when they’re very small sometimes they don’t,” Hartman says.“For credit unions that are proportionally much smaller than the acquirer, we believe it’s important to set up an advisory committee to make sure that the smaller organization doesn’t lose its voice.”

By finding a partner with complementary strengths and finding ways to bring the culture of the smaller institution into its larger acquirer, credit unions can create a happy union that gives everyone cause to celebrate.

bring them together. For example, maybe you don't have a strong CFO, but this target does, or you don't have a strong lending group, but this other bank does. When you combine, you can take the best of both entities and move people to the positions for which they're best suited."

In a market where organizations are having a hard time filling executive and tech positions, employees may be forced to take on roles outside of their bailiwicks. An acquisition is the perfect time to ensure that the best person for each role is in the right place by right-setting bad matches between skills and position.

> The reality of it is that because the labor market is so tight, it's difficult to find highly skilled folks in lending, investments and other key operational departments. You either have to find a key employee at a competitor, or maybe you look into acquiring someone who has a stronger presence in a given market or a given service that can help you build a more profitable institution.
>
> *Steve Jacobs, President – BCC Advisers*

"The reality of it is that because the labor market is so tight, it's difficult to find highly skilled folks in lending, investments and other key operational departments," says Jacobs. "You either have to go find a key employee at a competitor, or maybe you look into acquiring someone who has a stronger presence in a given market or given service that can help you build a more profitable institution."

It can also be an opportunity to revisit your succession plan. Martorana recalls a deal where the CEO of the target became the president of the organization, with the plan being that in two years when the current CEO retires, he will take his seat at the head of the company.

"You can use M&A as a way to overcome your weaknesses and value detractors," Martorana says. "Finding qualified people is one of the most important issues in banking today, because banking is a people-based business."

COMPETITIVE LANDSCAPE

Competition – whether from fellow institutions or fintech startups – has become an enormous challenge for institutions. Regulatory relief and technological advancement may allow struggling small institutions to make it on their own for a few more years, but it won't be easy. If their competitors enjoy the same benefits, it may end up being a zero-sum game.

"It's a competitive environment and it's only getting more competitive," Martorana says. "Sellers are getting higher multiples than they've gotten in many years. The little guys are looking at that and wondering if they can compete if some of these regional banks become super-regionals."

On the other hand, Jacobs predicts that if regionals become super-regionals, they will likely move upstream in terms of loan and transaction size to compete with the big banks. This will allow opportunities for smaller banks to pick up the customers who fall below that increased size limit.

"This deregulation may provide an even greater opportunity for community banks to thrive as they provide better service to their customers," he explains. "At the same time, it is critical that they are large enough to be able to provide the technology expected by today's customer."

Similarly, Bass sees the landscape not as a zero-sum game, but as a move up the food chain for all who can survive.

"These regulatory changes should help the M&A market because it will bring more large buyers to the equation," he says. "Larger buyers looking at midsize banks between $5-$20 billion can increase the prices of those potential sellers. Those potential sellers, in turn, can use that richer currency to buy smaller banks."

HAPPILY EVER AFTER

Entering the M&A market knowing what you're looking for and what you have to offer give you a head start in finding your perfect partner. Doing your homework will help you to not only put together a deal that goes off without a hitch, but to create a partnership that is successful for years after the honeymoon glow wears off…as long as you both shall live. ▪

M&A AS A SUCCESSION PLAN

Faced with retirements and attrition at the top of their org charts, small banks often view M&A as a default succession plan. In fact, Dan Bass says it's the number one reason behind most of the acquisitions he's worked on.

"There have been nineteen M&A deals in Texas in the last year, and I've handled five of them," Bass says. "And every one of them had to do with succession planning issues. It's sad in a way."

Bass says his deals have fallen into two categories – banks chartered after 2000 that were always planning on selling, and smaller family-owned banks in rural areas where the next generation was either unwilling or unable to take over. For the newer banks, they never planned for succession because they thought they'd sell before it was an issue. For the family-owned banks where no one wants to step up and run the bank, it can be difficult to find a viable outside candidate.

"Even in institutions that aren't family-owned, they're looking for a candidate who's willing and able to take the reins, or they're going to sell because they don't think they can promote someone or recruit someone to fill the CEO's shoes," says Scott Martorana.

In other words, viewing M&A as a succession plan when other avenues dry up is a trend that is unlikely to slow down anytime soon.

"You're going to continue to see this for a number of reasons," says Steve Jacobs. "For the most part, these institutions are not profitable enough to pay to have a strong bench, or they're in a position where it's become very difficult to deal with compliance requirements."

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