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No one goes broke taking a profit if they can sell

By Jeff K. Davis

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This year is shaping up to be a great year to sell assets; it is unclear if it is a great year to be a buyer. The opposite occurred in 2008 and 2009 when it was a great time to buy and not such a good time to be a (forced) seller. The path of the economy over the next several years will have much to say about whether 2013 is a good year to be a buyer. *Investors' Business Daily* in a Sept. 13 article noted that year-to-date there had been 131 IPOs compared to 125 and 127 for all of 2011 and 2012. Plus, there are another 118 pending IPOs in "regular" registration and upwards of 75 in "confidential" registration like Twitter's, according to Renaissance Capital. The rebound in IPOs, which is a good sign for the U.S. economy, is being driven by investor demand for social media, technology, energy and income plays such as MLPs. It is not being driven by cheap valuations.

[Umpqua Holdings Corp.](#)'s CEO Ray Davis noted last week when discussing the proposed acquisition of [Sterling Financial Corp.](#) that the price-to-tangible book value multiple was closer to 1.61x rather than 1.67x because Umpqua's stock price rose about 5% to around \$17 per share in the days leading up to the announcement. The shares spent most of 2012 and the first five months of 2013 in an approximate range of \$11 to \$13 per share before taper talk pushed bank valuations higher as the yield curve steepened in a mistaken notion that declining industry NIMs would turn higher absent higher short rates. Umpqua put the stock to work as have other bankers that have seen their shares rise sharply this year.

Sterling shareholders will receive 1.671 Umpqua shares and \$2.18 per share of cash for each Sterling share. Had Umpqua's shares been trading in the \$11- to \$13-per-share range, Sterling's board might not have been agreeable to a deal that would have valued the company at \$21 to \$24 per share rather than \$30.52 per share as of the announcement date. Of course, the economics other than "price" would not be any different if the exchange ratio and cash component were the same. Sterling would still own 49% of the pro forma company and the per-share accretion/dilution analysis would be the same.

The deal metrics do not have a stretch feel to me given Sterling's improving performance and a footprint that is highly complementary to Umpqua's. The \$2.0 billion deal equates to 19.1x Sterling's trailing earnings, 17.2x core earnings and less than 13x once expense savings are realized. The earn-back period for tangible book value dilution is estimated by Umpqua to be 2.5 years, which is better than the three to four years for most deals when the metric is disclosed. It is significantly better than [Columbia Banking System Inc.](#)'s \$509 million deal for West Coast Bancorp that entailed approximately seven years. Columbia management probably would note that projected EPS accretion is more than 30% compared to 12% for Umpqua.

After initially seeing its shares punished in the weeks that followed its Sept. 25, 2012, announcement for West Coast, Columbia's shares more than recovered. Over the past year through Sept. 16, both Columbia's and Umpqua's shares produced a total return of 25% compared to 23% for the SNL Small Cap Bank Index. Investors usually get over deal metrics if pricing is not egregious and a transaction makes strategic sense. Umpqua's shares are little changed from the pre-deal run-up.

The Sterling transaction and deals such as [Old National Bancorp's](#) announcement that it will acquire [Tower Financial Corp.](#) are good news for investors in small- and mid-cap banks. I think M&A is needed to support stocks that trade for 14x to 15x earnings when revenue growth is in the low single digits, mortgage and bond gains have evaporated and credit leverage has run its course. For example, Sterling's last-12-months earnings through June 30 entailed a negative loan loss provision of \$1.1 million. I assume Sterling's normalized earnings would reflect 35 to 50 basis points of annual provision expense, or \$25 million to \$35 million based upon \$7.0 billion of loans.

Sterling's key shareholders, [Warburg Pincus LLC](#) and [Thomas H. Lee Partners LP](#), are aware of the industry's earnings trajectory in spite of the sell-side pushing hockey-stick earnings increases in the "out" year for the past several years. Warburg exited its highly profitable investment in [Webster Financial Corp.](#) in May via a secondary offering. The question for Warburg and Thomas H. Lee: what is the exit strategy?

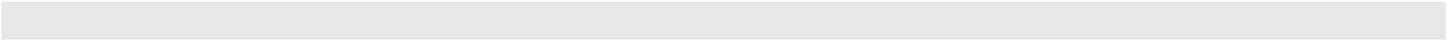
Each owns 12.9 million shares, excluding options for 1.4 million shares. The respective ownership for each is about 21%, excluding options. The two private equity firms invested \$139 million each (\$278 million) in Sterling during the second quarter of 2010 to recapitalize the company. Based upon the announced deal value of nearly \$2 billion, their combined interest was valued at nearly \$800 million a little more than three years after the initial investment was made. Plus, Sterling has paid \$1.35 per share of common dividends since 2012, or about \$17 million each to Warburg and Thomas H. Lee. Even if Umpqua's share price were \$13.00 per share, the internal rate of return would still be pretty good if the announced deal value was \$23.90 per share. And the potential upside for Umpqua would look better given a more modest valuation than the current valuation of 17x consensus 2013 EPS and 178% of tangible book value.

Private equity is the best investing model today, and perhaps it always has been. Ideally, capital is committed near the trough of an industry's earnings and valuation cycle. Add some leverage, patience, board representation and a sense for exiting when the target's recovery and/or growth has run its course and the combination can produce big returns. Further, private equity and the firms it backs can ignore short- and intermediate-term moves in the market. Still, private equity firms have to sell their position to monetize their investments. And unlike other industries, bank investments are not candidates for dividend

recaps.

So the question remains: Who will Warburg and Thomas H. Lee sell their positions to? Their ultimate positioning may be for Umpqua to be acquired by [KeyCorp](#), [U.S. Bancorp](#), [BNP Paribas SA's Bank of the West](#) or another large institution; however, regulatory policy presently discourages if not precludes large banks from getting larger via M&A. That may change in time. For now, the modus operandi may be to exit via secondary offerings if necessary.

But I wonder about the execution risk of a large transaction and the potential impact on shares over the next few years, something that is beyond the control of board members. The [merger of Hancock Holding Co. and Whitney Holding Corp.](#) is a case in point. Street expectations for Hancock's earnings after the initial expense synergies were realized were way too high. Hancock management may have known that but assumed rising short rates that pushed the NIM higher would bridge the gap. Hancock's shares traded above \$35 per share when the Whitney deal was announced in December 2010. Today, the shares trade in the low \$30s and have traded below \$28 per share several times since the Whitney announcement was made. For Warburg and Thomas H. Lee, a comparable analogy may mean all of the investment gain to be expected from Sterling has been realized, leaving risk of erosion if Umpqua's earnings disappoint or the sector's valuation declines.



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