## SNL Blogs

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# Shared upside vs. shared downside

By Jeff K. Davis

*Jeff Davis, CFA, is a veteran bank analyst and SNL Financial contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.*

There is no shortage of commentary about KeyCorp's $4.1 billion agreement to acquire First Niagara Financial Group Inc. and New York Community Bancorp Inc.'s $2.0 billion agreement to acquire Astoria Financial Corp. I am adding my two cents, though maybe with a somewhat different perspective from what I have read so far.

Bank M&A is almost always about creating operating leverage from expense savings and secondarily expansion into better growing markets. Occasionally transactions are transformative like Mellon Bank Corp.'s 1994 acquisition of Dreyfus Corp. The deals for First Niagara and Astoria are expense stories. As such, I think the deals make sense strategically.

Astoria is an in-market deal for New York Community. Management is targeting 50% expense savings. First Niagara represents a combination of an in-market deal and expansion into Pennsylvania, Massachusetts and Connecticut. KeyCorp is publicly targeting 40% expense saves. I suspect both management teams hope to do better. After all, much of the cost base is in the branch network, and branch banking is going to be radically scaled back in the coming years given the digitization of money and migration of transactions to the Internet. ZIRP only increases the urgency to do so because it devalues core deposits and the expensive branch networks that were necessary in the 20th century to gather the deposits.

There are a few other benefits too. Both companies will benefit from diversification of their loan portfolios. Core deposit funding will increase. Revenue synergies are always questionable. In the case of KeyCorp, there is the potential to overlay what I believe has been a decadelong successful corporate-investment banking effort. Will that be enough to offset the loss of top-notch lenders who will be bid away by competitors with a checkbook? I don't know.

And neither transaction will be dilutive to growth because none of the buyers and sellers has exhibited much growth. KeyCorp's pre-tax, pre-provision net revenues were $1.36 billion for the LTM period ended Sept. 30, compared to $1.22 billion in 2011, according to SNL Financial data. New York Community's LTM metric was $749.3 million compared to $806.7 million in 2011. The targets' trends are worse, but they are selling for a reason. First Niagara saw a reduction in its pre-tax LTM PPNR to $418.9 million from $451.9 million in 2011, while Astoria's pre-tax PPNR fell to $109.3 million from $143.2 million.

Perhaps the PPNR histories point to why there is some skepticism that I have heard among investors about 2017 EPS accretion. In fairness to the companies, pro forma EPS after expense savings is based upon the analysts' consensus forecasts for buyer and seller. I think all of the management teams could be modeling lower stand-alone earnings than the analysts for 2017.

If I am right that the deals make strategic sense, the market's bloodless verdict was not so optimistic. KeyCorp's shares fell more than 7% on the day of the announcement to close at $12.42 per share. The drop was even sharper if the decline is measured from the close on Oct. 28 because media reports on the 29th indicated KeyCorp would be the suitor. New York Community fell 12% on the announcement. The one deal that comes to mind that was comparable was Comerica Inc.'s Jan. 18, 2011, announcement that it would acquire Houston-based Sterling Bancshares Inc. Comerica was pushed in the bidding process; its shares fell more than 8% on the day of the announcement. These deals are atypical. Post-crisis, the propensity of many buyers' shares has been to rise (or not fall) on announcement.

The market was clear: both companies overpaid. I think the better technical description would be to say the exchange ratios for both First Niagara (0.68 of a KeyCorp share plus $2.30 of cash per share) and Astoria (1 NYCB share, plus 50 cents cash per share) were too generous.

This was particularly true with KeyCorp, which at the time of the announcement was trading for about 13x LTM EPS compared to an announced deal value that equated to about 19x earnings for First Niagara and included 12% dilution to tangible book value per share. The effective multiple to KeyCorp shareholders is lower including the 40% expense savings, but the question is, who is being paid vs. who is taking the execution risk? KeyCorp's slide deck included an NPV calculation for net expense synergies, which at about $3.1 billion equated to 67% of the transaction value.

In the case of Astoria, the math was not as daunting. New York Community was trading around 17x LTM EPS immediately prior to the announcement. The announced deal value equated to about 23x LTM earnings for Astoria. The effective multiple is much lower with the 50% targeted expense savings, plus TBVPS accretion of 6% is expected.

What was unexpected was a $650 million common raise to offset a $614 million after-tax charge to restructure fixed-rate borrowings. A 32% cut in the quarterly dividend to 17 cents per share had a pile-on effect, although investors should not have been surprised by the cut. The company raised the quarterly dividend to 25 cents per share in 2004, failed to earn it on an annualized basis from 2006 to 2008, and has only modestly covered it since then. Sustainability of the dividend has been part of the New York Community investor lexicon for years.

It is easier said than done, but one of the nuances of M&A involving share exchanges entails buy-in from the seller to create "shared upside" rather than "shared downside" as First Niagara and Astoria have experienced. This requires a seller that is willing to back off just a bit in terms of the exchange ratio to help create a favorable market reaction. It is a tough argument for an investment banker to make to a seller's board even though it may be sound. For the buyer and investor, it is a variation of the most important factor in terms of determining the return from an investment: the price paid. It is the one variable all can control. For acquirers of businesses, the second variable is execution.

So, did KeyCorp and New York Community management cut bad deals? Probably not. New York Community used the announcement to take care of other business that the market had ignored. KeyCorp was pushed, I think, by Huntington Bancshares Inc. — something I suspect CEO Steve Steinour took great pleasure in doing. Nevertheless, I think both should work out in time, although that does not help investors who held shares of the buyers prior to announcement.

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Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial.

He can be reached at jeffdavis@mercercapital.com or 615.345.0350.

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