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NASHVILLE NOTES

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Dashed lines to BB&T and Wells Fargo

By Jeff K. Davis

The week of June 10 did not bring a torrent of deals, but it brought three deals that point to the small regional space as the most interesting sector for investors over the next few years whereby M&A will drive earnings growth (and near-term TBVPS dilution). In the process, some of the small regionals will grow into full regionals with better liquidity and a bigger institutional shareholder base. The deals also speak to the consolidation that has to occur as returns gradually erode from the Fed's endless zero interest rate policies (ZIRP).

The largest deal last week was Union First Market Bankshares Corp. $445 million all-stock deal for StellarOne Corp.. I may be stretching a bit, but it is reminiscent of the August 1994 announcement that Southern National Corp. and BB&T Corp. would combine in an MOE. That deal established BB&T as another consolidator in the Carolinas and Virginia and ultimately the Southeast, thereby providing competition to Wachovia Corp., NationsBank Corp., First Union Corp. and SunTrust Banks Inc. BB&T's subsequent execution was better, in my view, than its larger peers.

I know the First Market-StellarOne deal is not styled as an MOE, but it has attributes that make it look like a quasi-MOE. The most pertinent is the ownership split: 53% Union First, 47% StellarOne. The approximate 20% market premium for StellarOne reflects Union First's better valuation at about 140% of TBVPS versus StellarOne's 120% multiple. Relative currency strength matters in M&A.

Also, ex-BB&T CEO John Allison gave partial credit to the success of the Southern National-BB&T deal to one executive group being in charge (his Southern National team), while the other team was paid to exit. At the time there was a hue and cry over the compensation, but it was money well spent. Union First's management team will run the combined company. StellarOne CEO Ed Barham will retire, though Chairman Raymond Smoot will become chairman of the combined company. Aside from cost saves, the deal enhances Union First's strategic value as the largest bank domiciled in Virginia, though neither bank has significant operations in the D.C. or Norfolk areas. A combination with United Bankshares Inc. in a few years might be an interesting deal that links UBSI's Northern Virginia and West Virginia franchise with Union First.

While not a large transaction, Heartland Financial USA Inc.'s June 12 announcement that it will acquire Morrill Bancshares Inc. for $62 million of stock and cash is significant for Heartland as its largest acquisition to date in terms both of assets ($752 million) and value ($62 million). Historically, Heartland has used small acquisitions to augment its presence in existing markets, some of which were established via de novo offices. Like the 2004 acquisition of Montana-based Rocky Mountain Bancorp., Morrill represents entry into a new market (Kansas City and northeast Kansas) via acquisition. Unlike Rocky Mountain, which did not always produce returns that management was targeting, Morrill looks like a solid acquisition of a long-established bank (1871 charter) with buy-in via the Morrill CEO joining the Heartland board.

The bigger picture aspect of the Morrill deal is the baton-pass it appears to be for Heartland that Wells Fargo & Co. and other large banks cannot engineer. Heartland made a well-timed push into mortgage banking in late 2010 when an established mortgage banking group, National Residential Mortgage, joined Heartland. Mortgage banking contributed just $2 million or 4% of 2011 pretax income of $38 million; it contributed $21 million, or 31% of 2012 pretax income of $67 million. Management never expected the refinancing business — or the margins — to explode as occurred in 2012. Now the excess mortgage earnings via enhanced capital and an 89% two-year increase in the share price through June 14 are being used to acquire bank earnings to expand the franchise, leverage the cost structure and offset inevitably lower mortgage income. Morrill represents the third whole-bank deal announced in the past year and the fourth including a small branch deal in May 2012.

In the late 1990s then-First Horizon National Corp. CEO Ralph Horn remarked to me that he never intended for the mortgage banking acquisitions to morph into an 800-lb. gorilla, rivaling a very high performing commercial bank (and fixed income broker-dealer) in terms of earnings contribution to the parent company. The gorilla would grow much larger, while no depository acquisitions were made to dilute it. Wells Fargo and other large banks cannot make a meaningful acquisition to reposition — assuming management wanted to do so.

The third deal of note is F.N.B. Corp.'s $79 million acquisition of Baltimore-based BCSB Bancorp Inc. The deal represents expansion into a large MSA for F.N.B., which brings commercial lending and growth opportunities if execution goes well. BB&T levered its 1999 acquisition of suburban Baltimore Mason-Dixon Bancshares into the northern terminus of its East Coast franchise.

None of these deals guarantee shareholders of the buyers will experience better returns than had the deals not occurred, but growth is a key shareholder driver. And with absent acquisitions, growth is tough to produce for the time being.

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