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FirstMerit — cautious, pessimistic and opportunistic

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SNL and Bloomberg have reported that U.S. Bancorp is the lead contender for the Chicago operations of RBS Citizens Financial Group Inc. that operate under the Charter One Bank moniker. According to the FDIC, the unit had $6 billion of deposits and 105 offices as of June 30, while Bloomberg reports that the unit has $2.4 billion of loans. The presumption is that the entire Chicago operation is being marketed, though that has not been confirmed. RBS Citizens acquired the offices via the 2004 acquisition of Cleveland-based Charter One Financial Inc., which had about $41 billion of assets at the time. The Chicago offices are an outpost in RBS Citizens' $94 billion deposit franchise that is concentrated in the Northeast, plus Ohio and Michigan.

RBS Citizens' actions may point to a strategic quandary many midcap banks face where the board (or parent company) would like to sell. Given the regulatory modus operandi for the industry to consolidate from the lower end rather than among large banks, I believe RBS Citizens is too large for its parent, Royal Bank of Scotland Group Plc, to sell. The parent company, which is majority owned by the U.K. government due to its crisis-era support, is planning to raise capital by selling a minority interest in RBS Citizens in 2014 via an IPO. Presumably the IPO proceeds and those from any follow-on offerings will be used to reduce the U.K. government's interest.

As an aside, the announcement that United Bankshares Inc. and Virginia Commerce Bancorp Inc. agreed to extend the termination date for their merger while they await approval from the Federal Reserve Board seems to be another data point suggesting that federal regulators are slowing the M&A process among smaller institutions, while precluding it among large organizations for the time being.

A $6 billion deposit acquisition by U.S. Bancorp's OCC-regulated subsidiary U.S. Bank NA may not be big enough to meet the regulatory slow-walk threshold that seems to exist when a bank holding company is acquired. Also, U.S. Bancorp is large enough that the capital impact would be negligible. But CEO Richard Davis has largely sidestepped bank acquisitions excluding a few small FDIC-assisted deals, while using acquisitions to augment the payment processing business. Charter One Chicago might mark a modest strategy shift because the unit would double U.S. Bancorp's market share in the Midwest's most important city.

Although the acquisition of Charter One Chicago would require a capital raise, I would not rule out FirstMerit Corp. as a determined possible buyer. FirstMerit has the No. 16 deposit market share position in Chicago as of June 30 with $2.7 billion of deposits, compared to No. 12 for U.S. Bancorp with $6.0 billion of deposits. A deal for Charter One Chicago would push FirstMerit to No. 11 behind PrivateBancorp Inc.

Not all investors will agree with me, but I think FirstMerit's management team is one of the most underrated in the U.S., though it still has a big task in front of it in terms of integrating and hitting numbers on the heels of the $943 million acquisition of Citizens Republic Bancorp Inc. I say this because FirstMerit avoided virtually every credit issue and bond investment that blew up its small and large competitors from 2007 to 2009.

In early March 2009 I asked Chief Credit Officer William Richgels what he thought. He told me that while he was pessimistic and cautious about the general state of affairs, he thought the company would be fine. He also remarked that it was important not to be "overanalyzing things" in order to maintain consistent execution and to seize a once-in-a-generation opportunity to take market share. At the time FirstMerit was growing its commercial loan portfolio and deposit base from the implosion of National City Corp. in 2008. Also, it was clear to me (and investors) at the time that CEO Paul Greig was interested in Chicago, which could be a growth market for a well-capitalized mid-sized bank with a focused franchise at a time when most of the local banks had been hammered by credit issues. Greig knew Chicago well. Before he joined FirstMerit in 2006, he was CEO of Charter One Bank - Illinois, and before that was president and CEO of Bank One Wisconsin.

FirstMerit subsequently acquired $396 million of deposits via an FDIC-assisted deal for George Washington Savings Bank in February 2010. The larger prize in Chicago was Midwest Bank and Trust Co., which saw its capital depleted primarily as a result of heavy investments in GSE preferred stock. FirstMerit was the winning bidder for Midwest Bank on May 14, 2010, adding $3.0 billion of assets and $2.2 billion of deposits. According to the FDIC, FirstMerit's winning bid entailed a 2.7% premium for the assets and a 0.4% premium for the deposits. The cover bid entailed a 1.4% asset discount and 0.01% deposit premium.

The market was surprised that FirstMerit booked goodwill from the transaction rather than a bargain purchase gain, which investors had come to expect with almost every FDIC-assisted transaction prior to then. Maybe investors should not have been completely surprised, because most of Midwest Bank's capital issues related more to the GSE preferred write-down than to the level of problem assets. Regardless, my perspective was that some investors were irked by the pricing for Midwest Bank and the need to raise $334 million of capital to finance the deal through selling 17.6 million common shares for $19.00 per share. Since then, management has profitably grown the Chicago franchise.

I am not sure how the Midwest Bank experience fits into management's thinking about Charter One Chicago today. On paper the unit looks to be a good fit for FirstMerit. It would provide a sizable market share gain, while offering expense synergies from combining branches, and management knows the market well. If U.S. Bancorp really wants the unit, it is hard to see how FirstMerit or any other bank could bid competitively to win. If that is not the case and FirstMerit is the winning bidder, it seems to me it would have to raise $400 million to $500 million of equity capital, because its 8.0% leverage ratio does not represent much cushion if total assets increase to around $30 billion from $24 billion absent balance sheet engineering. Also, I assume a relatively healthy deposit premium in the context of the zero-rate operating environment, while the loans may also entail a premium.

That said, this may not be a bad time to be an issuer of common stock for a strategic in-market acquisition. FirstMerit's shares have risen 64% for the one-year period ended Nov. 29, compared to 39% for the KBW Bank Index. The run has produced a valuation of 2.2x tangible book value per share, 19.1x trailing EPS and 14.7x consensus fiscal 2014 earnings per share.

I think there is a technical aspect that management and its advisers may consider, too. FirstMerit's Russell 2000 weighting is one of the largest among the 1,994 qualifying U.S. equities that constituted the index as of May 31, the date when the annual rebalancing occurs. This year's Russell 2000 entailed a qualifying market cap range from $129 million to $3.3 billion ($594 million median). FirstMerit's market cap as of May 31 was about $3.1 billion. As a result, portfolio managers whose benchmark is the Russell 2000 may be inclined to purchase newly issued shares to maintain a relative weighting.

The one other transaction I wonder about involves FirstMerit merging with PrivateBancorp or Associated Banc-Corp, among a few other Midwest regionals, and relocating the headquarters to Chicago at some point in the future. However, the Federal Reserve would have to be agreeable.

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