SNL Blogs

SNL NASHVILLE NOTES

Wednesday, March 08, 2017 8:49 AM CT

Garbled game theory for PrivateBancorp

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence or Mercer Capital, where he is the managing director of the financial institutions group.

In late January, I listened to Richard Davis, the outgoing CEO of U.S. Bancorp, give a soliloquy on U.S. banking at a conference where a heavy proportion of attendees were bank directors. Among the topics he discussed was uncertainty — a word that is subject to overuse, especially as it relates to investing. The world has been uncertain since the dawn of time and always will be. No one can predict the future, especially Wall Street analysts and Fed economists; yet it seems like the talking heads on CNBC and Bloomberg are citing "uncertainty" more than usual.

What I heard Davis say is that directors who are evaluating an acquisition, a merger of equals or a decision to sell should wait a little longer for more clarity; or, stated more directly (with my interpretation of his remarks), boards should wait until there is more clarity as to what a bank's earnings power will be as a result of the national election last Nov. 8.

Mr. Market, who is to be respected, has expressed the unambiguous opinion that earnings are going to be much better given the 30% gain in the SNL U.S. Bank Index from Nov. 8, 2016, through March 6, 2017. That is a phenomenal change considering that current industry earnings are not depressed for cyclical reasons and because valuations before the election were not inexpensive in my view. Exactly which variables (i.e., tax rates, higher rates, less regulation and possibly faster GDP growth) will drive the increase, and by how much, is uncertain.

Unfortunately for PrivateBancorp Inc., its board of directors approved a merger agreement with Canadian Imperial Bank of Commerce before the election, on June 29, 2016. Entering into any significant corporate transaction such as a merger or acquisition entails a lot of uncertainty, but on balance sufficient upside for both parties. Otherwise, one side or both would not sign the merger agreement. Maybe there were a few investors (Jeff Gundlach?) who expected a new world order to emerge from the election that would cause bank stocks to soar in anticipation of a rewrite of the postcrisis playbook for banks. But not many individuals and even fewer boards, if any, expected such an outcome. It is called manna for a reason.

When the deal was announced June 29, 2016, the transaction was valued at about $3.8 billion, or $47.00 per share. Consideration consists of $18.80 per share in cash and 0.3657 of a CIBC share, which trades both in Toronto (in Canadian dollars) and in New York (in U.S. dollars). Private closed on June 28 at $35.93 per share; its 10-day average close was $38.58 per share. The companies struck a deal that entailed a healthy premium and valuation at 2.2x tangible book value and 19.4x trailing earnings. Private is a solid company, but the context is a competitive but not extraordinary return on tangible common equity of approximately 11% to 12% the past four years. Over a longer investment horizon, the deal looks stupendous relative to two common raises in 2009 that priced at $19.25 and $8.50 per share and one that occurred in 2012 at $15.75 per share.

Following the announcement, the market priced Private as if it expected the deal to close with the company's shares trading at a mid-single-digit discount to the implied deal value based on daily fluctuations in CIBC's share price. As would be expected, the discount narrowed during the fall as the Dec. 8 shareholder meeting to approve the deal and the anticipated first-quarter closing date approached.

Private continued to trade at a slight discount to the implied deal price during November; however, on Dec. 1 the proxy firms issued a split decision, with Glass Lewis & Co. and Egan-Jones Proxy Services recommending a "yes" vote and Institutional Shareholder Services recommending a "no" vote. Also on Dec. 1, Glazer Capital LLC, a merger arbitrage firm which then owned 1.0 million Private shares, issued a letter urging shareholders to reject the deal. Over the next few days Private began to trade at a premium to the implied deal value. On Dec. 6, Glass Lewis and Egan-Jones punted by changing their opinion to recommend a "no" vote. Private later announced that it was postponing its shareholder meeting.

Private recently rescheduled the shareholder meeting for early May, but the market still wants a better deal. Private's shares closed March 6 at $57.72 per share compared to the implied deal price of $51.41 per share based on CIBC's $89.18 per-share closing price on the NYSE and $18.80 per share of cash. Unfortunately for Private, CIBC's shares have not risen like those of U.S. banks, not to mention that 40% of the deal consideration consists of cash. CIBC's shares are up about 19% since the election in U.S. dollars through March 6 compared to the 30% gain in the SNL U.S. Bank Index. Had CIBC's shares tracked the index since Nov. 8, then if my math is correct the implied deal value would be over $54 per share as of March 6 and closer to $60 per share if CIBC's shares matched the index since June 29. Stated differently, the market/arb community wants a revised deal that is close to what Private shareholders would realize if CIBC were a U.S. bank whose shares tracked the U.S. index.

The game theory calculus has gotten interesting. A deal that seemed to be comfortably "fair" when Goldman Sachs & Co. and Sandler O'Neill & Partners LP opined as such in late June may not be today. Neither is obligated under the agreement to affirm the opinions as a condition to close, though the board could ask. Richard Davis' admonition to wait for more clarity is up against a clock. It will be several years before we know how much earnings will improve, if at all, due to the new world order that emerged Nov. 8, 2016.

Running out the clock by not rescheduling the shareholder meeting was not a viable option because the agreement obligates Private to put it to a shareholder vote (with the board's recommendation that shareholders approve the deal). Such a path presumably would trigger payment of the $150 million termination fee, or roughly $1.20 per share after tax, based on 80 million outstanding shares.

Now that the meeting has been rescheduled, it seems likely shareholders will vote against the deal with or without the board's recommendation given where Private's shares trade relative to the implied deal value. Then what? Pursue an independent path and return to acquisitions after having last completed a whole bank deal in 2006? Or, have Goldman Sachs formally contact potential acquirers that it deemed were unable or unwilling to acquire Private in early 2016 when the discussions with CIBC were intensifying? Both paths entail risk and uncertain value for shareholders.

(A side note: The F-4 indicates that Private was not formally shopped. The deal was negotiated with CIBC exclusively, which twice upped its original offer that had an implied value of $44.00 per share.)

If shareholders vote the deal down, CIBC could then up its offer if it chose to do so. The market expects this or possibly the emergence of another suitor given where Private trades. But to do so would raise the uncertainty quotient for CIBC. J.P. Morgan Securities LLC and CIBC's other financial advisers can change assumptions in Excel spreadsheets to justify a higher price based on better future earnings than originally projected as a result of lower U.S. corporate tax rates, higher interest rates and less regulation. But would doing so be "fair" to CIBC shareholders whether expressed euphemistically or formally in a written opinion? So far, the evidence of higher earning power is indirect via the market placing a higher multiple on current bank earnings in expectation of much better earnings that will not be observable until 2018 or 2019.

Or maybe the arb community has gotten it wrong. Perhaps shareholders will reject the deal, but then CIBC will walk away rather than offering more shares or cash. Arbs have been burned before by sure things that fell apart.

Ben Graham, who coined the term Mr. Market and who was all about fundamental analysis, believed the market had a tendency to swing between undue optimism and pessimism. It is likely bank earnings will be higher than would have been the case had the election gone the other way, but how much higher? And what if an errant tweet derails the agenda? The answers are uncertain.

Not all transactions are straightforward. Private's and CIBC's advisers and attorneys are working hard to earn their fees on this one.

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.