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Opposites sometimes attract in bank M&A too

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL 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.

I may have missed M&A chatter among buy-siders and sell-side analysts on the subject, but I was surprised by the announcement on Thursday that Bank of the Ozarks Inc. and Intervest Bancshares Corp. entered into a definitive agreement to merge. Little Rock meets New York City, with no apparent connection to a private equity investment made by Arkansas-based Stephens Inc.

Opposites sometimes attract in M&A. There are a few recent precedents. CIT Group Inc.'s pending acquisition of OneWest Bank NA reflects two opposites with a common bond of a financial crisis rescue. CIT is a longtime commercial finance company that became a bank holding company in late 2008 and then proceeded through a bankruptcy restructuring in 2009 due to parent company liquidity issues. OneWest is a retail bank that was constructed from the 2009 acquisition of IndyMac Bank from the FDIC. What outwardly appears to be an odd combination should satisfy CIT regulators' apparent view that CIT Bank needs lots of retail core deposits to dilute its reliance on brokered and internet deposits.

PacWest Bancorp's acquisition of CapitalSource Inc. — actually it was more akin to a merger of equals, given the ownership split — married PacWest's core deposit franchise with CapitalSource's high-yield commercial finance asset origination platform when the two merged in April. I think this is going to be a really interesting deal for investors and bankers to watch given the outwardly attractive ROE math of funding high(er) yielding commercial finance assets with low cost deposits.

Maybe Bank of the Ozarks and Intervest are not as different as they seem. Both are led by driven men, and both banks have a real estate bent. However, Bank of the Ozarks surprised the Street (or at least me) by navigating the financial crisis really well in spite of 34% of the portfolio consisting of construction and land development loans at year-end 2008. That many of these loans were commercial C&D in Arkansas and Texas was helpful — plus, management was quick on its feet in purchasing deeply discounted bonds that were being dumped by levered investors in late 2008.

Intervest entered the downturn with 54% of its portfolio in non-owner occupied commercial real estate and 34% in multi-family as of year-end 2008. As an OCC-regulated bank with exposure in Florida, Intervest incurred $120 million of loan loss provision and ORE expense in 2010 to build reserves and facilitate problem asset dispositions. A common raise in mid-2010 helped the company bridge the charges and capital needs, but roughly doubled the share count. Since then, management has engineered a turnaround in asset quality, capital and profitability that has been gaining momentum.

So Bank of the Ozarks is buying a rebounding Intervest. The strategic calculus is interesting, but it is not as simple as the financial calculus. Bank of the Ozarks will pay $228.5 million for Intervest, subject to pre-closing adjustments, by issuing common shares that trade for 23.3x LTM EPS and 3.4x tangible book value as of August 1. The deal values Intervest at approximately 14.0x LTM earnings and 1.1x tangible book value. Not surprisingly, the transaction is expected to be 90 cents to $1.10 per share accretive to tangible book value, and 10 cents to 15 cents per share accretive to EPS in the first 12 months. This accretion probably accounts for the 3%-plus gain in Bank of the Ozarks shares the day after the announcement.

The strategic angle of the deal is more interesting to me. Intervest's six offices in Florida will add deposit density in a state that is no longer a four-letter word. Intervest will also add geographic diversity to the loan portfolio in an apparent category that Bank of the Ozarks does not play — income-producing stabilized properties. As of Mach 31, 57% of Intervest's loan portfolio was attributable to New York and 29% to Florida. There may be an element of macro rate hedging too that will provide for some relative reduction in the bond portfolio because Intervest tends to be a fixed-rate lender with maturities of five-to-10 years. Second-quarter originations entailed a weighted average rate of 4.72%, 6.6 year average term and loan-to-value of 59%. In addition, with a bigger capital base Intervest can make larger loans.

I do not believe the deal is about financial engineering, but the math is not bad. The near-term accretion will help offset the accretion that will fade from FDIC-era deals soon; however, that is just accounting and does not address underlying economics. More important is the impact that Intervest may have on helping Bank of the Ozarks sustain its long-term growth trajectory if cultural differences can be navigated. Sustaining growth is important for a high-multiple stock, especially through organic means over time interspersed with periodic acquisitions.

Jeff previously maintained a long position in Intervest's common shares, but sold all of the shares following the merger announcement. He has no position in the Bank of the Ozarks.

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.