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Bank Watch

ARTICLE

Acquire or Be Acquired (AOBA) 2022: Review & Recap

In This Issue

Acquire or Be Acquired (AOBA) 2022: Review & Recap

After going virtual in 2021, the Omicron waved peaked just in time for the Acquire or Be Acquired (AOBA) conference to resume its normal physical presence in Phoenix, Arizona during late January. The virtual sessions in 2021 lacked their normal impact, given the inability, through face-to-face communications, to delve deeper into emerging strategies and industry trends with peers and subject matter experts. The most common sentiment expressed this year was simply the gratitude that we could gather once again, connecting with existing industry contacts and establishing new relationships.

AOBA's emphasis has evolved. When we first attended the conference, the sessions emphasized acquisitions of failed banks to such a degree that presenters struggled to avoid overlapping content. Then, the conference shifted to emerging from the *Great Financial Crisis* and the transition to unassisted M&A transactions. We still remember the years that distressed debt buyers roamed the halls looking for unsuspecting bankers with loans to sell.

More recently, the traditional financial services industry structure—with separate, and somewhat inviolable, silos for banking, insurance, wealth management—has been fractured by new challengers from the FinTech sector. Armed with venture capital funding, a willingness to tolerate near-term losses, and a mindset not shackled by traditional operating strategies, the FinTech challengers have sought product lines prone to automation and homogeneity, like consumer checking accounts and small business lending. However, while seeking to disrupt the banking industry, FinTech companies also need the banking industry for compliance expertise, funding, access to payment rails, and the ability to conduct business across state lines.

AOBA 2022 sought to unify several discordant themes. The first theme is fracturing and convergence. While FinTech companies seek to challenge the traditional banking industry, they rely on the industry and, indeed, have entered into M&A transactions to acquire banks. The second theme is threat and opportunity. Banks face challenges from FinTech companies for certain customer segments, but FinTech products and partnerships offer access to new products, new markets, and more efficient operations. For fans of price/tangible book value multiples, though, AOBA 2022 still offered plenty of perspective on recent bank M&A trends. We'll cover four themes from AOBA 2022.

1. FinTech Competitors/Partners & the Nature of Competition

FinTech's presence continued to increase at AOBA, both in terms of conference sponsors and mentions throughout the conference. The most popular breakout session we attended was entitled "Crypto/Digital Assets – A Threat or Opportunity for Your Bank," although it is difficult to ascertain whether the attendance reflects mere curiosity or a leading indicator that more banks will enter the Crypto space.

One common thread of FinTech-related presentations is that bankers should take a more expansive view of their competitors. Three FinTech-related companies would rank among the twenty largest U.S. banks, as measured by market capitalization, including Paypal Holdings (#4), Square (#9), and Chime (#12, based on the value implied by its last funding round). One speaker encouraged banks to adopt an "ecosystem" strategy instead of an "industry" strategy, noting that families often have 30 to 40 relationships with financial services providers, defined broadly.[1] Thus, banks' strategies should not be defined by traditional boundaries but rather embrace the entire financial "ecosystem" in which a range of competitors seek to displace banks from their traditional roles. In this view banks compete for customers from the "inside out," while FinTech companies challenge from the "outside in."

[1] *See Ronald Adner, Winning the Right Game, How to Disrupt, Defend, and Deliver in a Changing World, The MIT Press, 2021.*

It remains difficult to quantify the direct impact on community banks from the current crop of non-bank competitors. Nevertheless, banks' strategic plans should evolve to reflect the growing population of well-financed non-traditional competitors, for which the pandemic has in some cases accelerated customer adoption.

The last FinTech theme related to "partnerships." This term has evolved towards a somewhat expansive definition this millennium, with seemingly any relationship (even as a customer/vendor) deemed a "partnership." Certainly, many banks are evaluating FinTech products, with an eye on both expanding revenues and increasing efficiencies. Others are becoming more intertwined with FinTech companies, either as investors or as the banking platform used by the FinTech company itself. There is some evidence that banks more closely allied with FinTech companies are being warmly received by the market, given their potential revenue upside.

When evaluating "partnerships," we suggest deploying a risk/reward framework like banks use in evaluating other traditional banking products. The lower risk/lower reward end of the spectrum would entail limiting the "partnership" to a particular FinTech product or service, such as for opening consumer checking accounts or automating a lending process. The higher risk/higher reward part of spectrum would include equity investments or facilitating the FinTech's business strategy using the bank's balance sheet, compliance expertise, and access to payment rails. Like with any bank product, different banks will fall in different places along this spectrum, given their histories, management and board expertise, shareholder risk tolerance, regulatory relationships, and the like.

2. Traditional Bank M&A: Tailwinds & Headwinds

Mercer Capital provided its outlook for bank M&A in the **December 2021 *Bank Watch*** . Naturally, the investment bankers at AOBA are bullish on bank M&A in 2022. This optimism derives from several sources, including the pressure on revenue from a low interest rate environment and the technological investments needed to keep up with the Joneses.

Several headwinds to activity exist though:

- Some transactions initiated prior to the COVID-19 pandemic in March 2020 were placed on hold throughout 2020, but negotiations resumed in 2021. These transactions likely enhanced the reported level of deal activity in 2021, but this deal backlog now has likely cleared.
- With the banking industry consolidating, fewer potential buyers exist. Smaller banks or banks in more rural areas may face a dwindling number of potential acquirers. Meanwhile, the remaining acquirers may seek to focus on larger transactions in strategic markets. This could lead to a supply/demand imbalance, although non-traditional buyers—read credit unions—could fill the void.
- After the drama over the FDIC's leadership, many observers are expecting a more rigorous regulatory review of merger applications, such as around competition issues or fair lending compliance. In the near term, navigating the regulatory thicket would appear most fraught for larger buyers.

WHAT WE'RE READING

U.S. banks **closed** nearly 3,000 branches in 2021, up 38% from 2020, reflecting a heightened focus on expense management and increased customer adoption of digital channels.

Rising oil prices present a possible headwind to economic growth, which could **complicate** the Federal Reserve's rate hike decisions.

Mortgage rates have **risen** in recent weeks in anticipation of Federal Reserve actions; however, increased buying of Treasury securities in response to global tensions could put downward pressure on rates.

Another trend to watch is M&A activity involving non-traditional buyers. Mercer Capital's Jay Wilson presented a **session on credit union acquisitions** of banks, focusing on the perspective credit unions take when evaluating potential acquisition targets. In a reversal of roles, FinTech companies now have entered the scene as acquirers. In February 2022, SoFi completed its acquisition of Golden Pacific Bancorp, and several other precedent transactions exist.

3. Subordinated Debt: Act Now?

The subordinated debt market has been quite active, with bank holding companies issuing debt typically with a ten-year term, a fixed rate for the first five years and a variable rate tied to SOFR for the second five years, and a call option in favor of the issuer after five years. Pricing tightened throughout 2021. Through early 2022, pricing of newly-issued subordinated debt has remained stable in the 3.50% range, despite rising Treasury rates. This implies that the spread between the fixed rate on the subordinated debt and five-year swap rates has tightened, falling to levels even below those observed in 2021.

Subordinated debt counts as Tier 2 capital at the bank holding company level but can be injected into the bank subsidiary as Tier 1 capital. If bankers expect rising loan volume as the economy continues to recover from the pandemic, then it may behoove institutions to issue subordinated debt now and lock in a low cost source of capital.

4. The Regulatory Wild Card

Some attendees expect greater regulatory enforcement and rule making activity in certain areas, with the most likely suspect being fair lending. However, leadership at some regulatory agencies remains in flux, such as at the OCC where President Biden's nominee was withdrawn in the face of Senate opposition. This would not be a constraint, though, at the CFPB, which has a Senate confirmed director who appears ready to take a more active stance on fair lending matters. Interestingly, many larger banks have moved to limit overdraft and insufficient funds charges, even absent any actual (as opposed to hinted at) regulatory changes. Tightening practices around overdrafts appears to be another risk to community banks, which may lack the revenue diversification that permits larger banks to absorb a loss of consumer banking fee revenue.

Conclusion

We sense that AOBA is moving into a new era, as it did when the *Great Financial Crisis* passed. Attendees and sponsors are, to an ever greater extent, coming from outside the traditional banking industry. This mirrors the banking industry itself, with its widening set of non-traditional competitors targeting different customer niches. Future conferences will reveal the extent to which traditional and non-traditional competitors converge. Regardless of what happens with the intersection of banks and FinTech companies, we can only hope that we've attended our last virtual conference.

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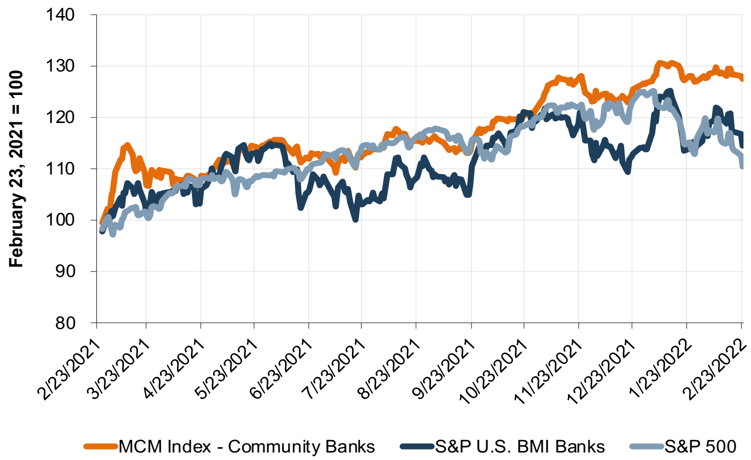
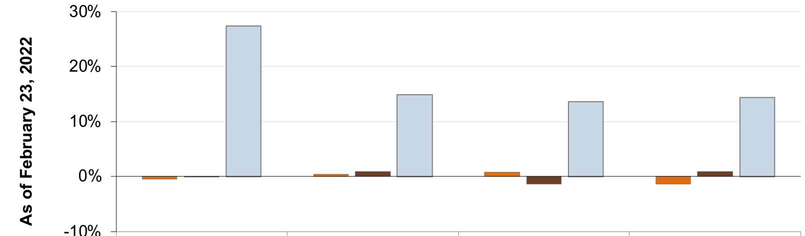
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



	Dow Jones U.S. MicroCap Banks	S&P U.S. SmallCap Banks	S&P U.S. MidCap Banks	S&P U.S. LargeCap Banks
Month-to-Date	-0.50%	0.42%	0.76%	-1.33%
Year-to-Date	-0.13%	0.94%	-1.36%	0.86%
Last 12 Months	27.35%	14.88%	13.62%	14.36%

Micro Cap: < $250 Million
Small Cap: $250 Million - $1 Billion
Mid Cap: $1 - $5 Billion
Large Cap: > $5 Billion

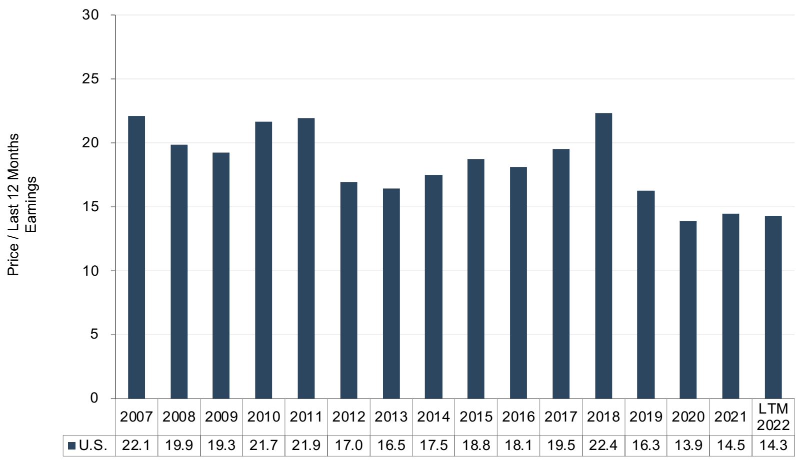
Source: S&P Capital IQ Pro.

	Total Return			Regional Index Data as of February 23, 2022					
	Month-to-Date	Year-to-Date	Last 12 Months	Price/LTM EPS	Price / 2022 (E) EPS	Price / 2023 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	-0.4%	-0.8%	29.4%	10.9x	12.1x	11.2x	117%	123%	2.4%
Midwest Index	0.5%	0.9%	20.2%	10.2x	11.3x	10.5x	108%	123%	2.4%
Northeast Index	-0.5%	1.1%	27.2%	9.6x	9.9x	9.3x	106%	121%	3.0%
Southeast Index	-0.4%	-1.2%	30.4%	10.7x	11.0x	10.1x	117%	120%	2.3%
West Index	-0.6%	2.3%	34.9%	10.7x	11.8x	9.5x	119%	121%	2.4%
Community Bank Index	-0.3%	0.5%	27.5%	10.0x	11.3x	9.9x	115%	123%	2.5%
S&P U.S. BMI Banks	-0.7%	0.7%	14.5%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

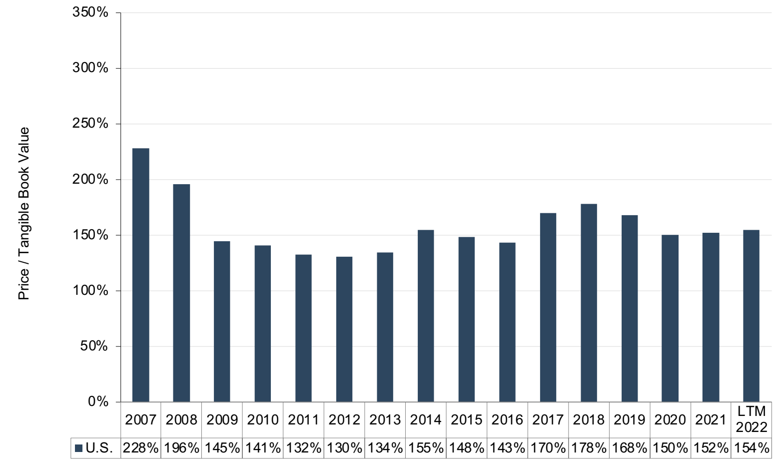
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

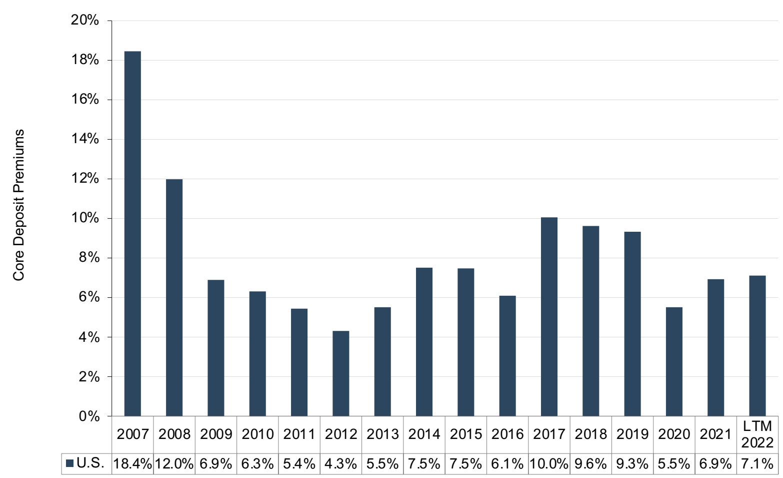
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Core Deposit Premiums

Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

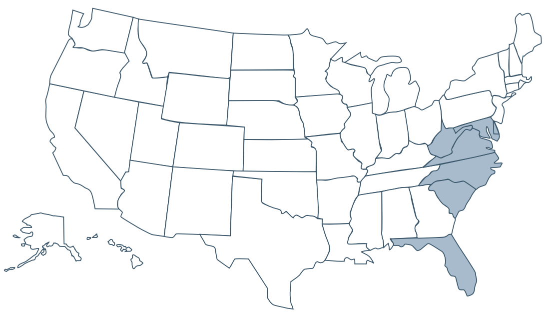
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended February 24, 2022

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value ($M)	Target's Median Assets ($000)	Target's Median LTM ROAE
Atlantic Coast	15.7x	182%	9.8%	14	211.5	594,679	10.0%
Midwest	17.9x	154%	7.5%	54	116.6	215,832	9.5%
Northeast	14.3x	144%	4.5%	6	220.2	1,093,803	10.3%
Southeast	13.0x	153%	6.7%	31	84.0	424,031	10.5%
West	12.6x	153%	6.7%	24	85.3	519,572	12.3%
National Community Banks	14.3x	154%	7.1%	129	121.0	390,599	10.5%

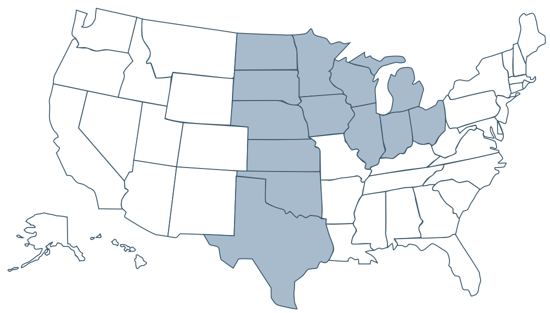
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

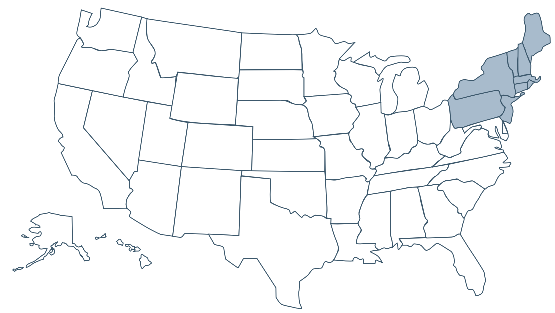
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



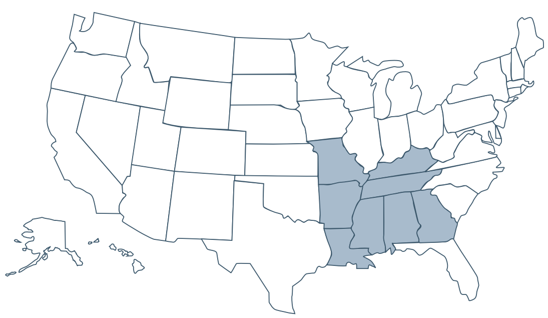
Atlantic Coast



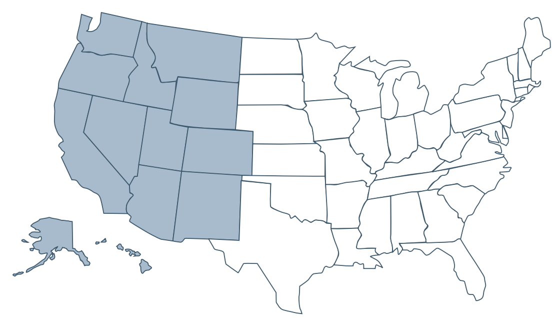
Midwest



Northeast



Southeast



West

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Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transaction advisory services, and other strategic decisions.

Mercer Capital pairs analytical rigor with industry knowledge to deliver unique insight into issues facing banks. These insights underpin the valuation analyses that are at the heart of Mercer Capital's services to depository institutions.

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- Financial reporting for banks
- Goodwill impairment
- Litigation support
- Stress Testing
- Loan portfolio valuation
- Tax compliance
- Transaction advisory
- Strategic planning

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