

NASHVILLE NOTES

A potentially epic M&A year in the making

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According to the *Financial Times*, HSBC Holdings PLC may sell its North American retail banking operations with around \$100 billion of assets that are mostly situated in the mid-Atlantic and supplemented with offices in California, Florida and Washington. Capital One Financial Corp. and Toronto-Dominion Bank appear to be well situated as possible buyers given overlapping operations in HSBC's core mid-Atlantic footprint that could support significant cost saves through branch consolidation.

Pending acquisitions for CIT Group Inc., BBVA USA Bancshares Inc. and possibly portions of HSBC North America point to a potentially epic M&A wave to come. This year has been subdued since March, with only 104 deals announced year-to-date through Nov. 27 compared to over 245 deals annually during 2012-2019.

But, before M&A can accelerate there are a few roadblocks to overcome.

The first quarter of 2021 potentially is going to be a tough quarter. COVID-19 cases probably are going to trend much higher after the holiday season whereas vaccines will not be widely distributed enough to matter until the second quarter. Millions of renters and homeowners face eviction once forbearance grace periods end soon. And broad swaths of retail, hotels and restaurants are in a deep hole.

Because of these and other factors a double dip recession is not out of the question. Even if there is no double dip, economic growth may be sluggish as hot sectors like housing may cool while travel and leisure accelerate.

Of course, the big if is credit. Buyers must have confidence in their portfolio before they can have confidence in sellers' portfolios. That point may be reached in the next few quarters if peaking reserve builds (for now) indicate many banks have growing confidence about the likely loss content in their portfolios.

Consolidation in the industry has been ongoing for over 30 years. There is more urgency now, however. The industry suffers from massive over-capacity of physical branches — and therefore employees — that has intensified with the accelerated adoption of digital banking this year. It is just one signpost among many on the intersection of technology and banking, and the partnership between Google LLC and Citigroup Inc. to offer digital deposits as part of the Google Pay app will launch next year.

The capacity issue is made worse by revenue pressure as a result of a return to short-term policy rates by the Fed that are indistinguishable from zero. A slow growth world in which rates are pinned to the floor implies lenders will compete heavily on rate to originate loans because the bond market offers little yield.

There is another factor that could delay an M&A wave: egos.

Banks are sold, not bought. Selling in 2021 may be tough for a lot of boards that should do so because the price probably will be less than what might have been obtainable pre-pandemic even though value obtained may be greater.

Most banks make less money even with normalized provision expense due to lower NIMs, and robust mortgage earnings will ebb one day, too. Likewise, the shares of most publicly traded buyers trade at lower multiples than pre-COVID-19.

In short, it is a recipe for lower M&A valuations that some boards will have a hard time accepting.

If so, maybe one permutation of the next wave of bank M&A will be more consideration in the form of the buyers' common shares for several reasons.

Cash deals "cash-out" shareholders who then reinvest after-tax proceeds. Stock deals allow the shareholders of the selling bank to remain invested in a sector that still trades cheap to longer-term valuations even though banks experienced a fantastic rally in November. Also, there is the capital gains tax issue when shares are sold. If the Biden administration follows its platform, it will push for a much higher capital gains tax rate in the new Congress.

Not everyone will agree with me on this point, but I think stock deals have merit from a capital perspective since there is less pressure on pro forma capital ratios relative to cash deals. While the industry is heavily capitalized compared to the pre-GFC era, the improving economy could still prove to be fragile absent more government "stimulus."

I think the M&A question is when, not if. Publicly traded small cap banks as reflected in the SNL Small Cap Bank Index compared to the SNL Microcap Bank Index trade at a decent premium based upon the indexes' P/TBV and P/E multiples, which is a proxy I and others track for M&A potential. Acquisition premiums on the order of 15%-20% are icing on the cake for investors, but the gem waiting to be discovered is the next First Citizens-CIT deal in which the buyer's shares are significantly revalued higher because of the favorable metrics.

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