NASHVILLE NOTES

A potentially great M&A year

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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; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

I have a friend who develops commercial real estate, the bulk of which is retail-focused on behalf of institutional investors. His take on the U.S. retail scene is that the market is not "over-retailed" with too many stores — rather, it is "under-demolished."

I'm taking a liberty in this post and conflating demolition with M&A in the banking industry, where mergers are the equivalent of demolishing excess capacity. (In the retail industry, bankruptcy courts and bulldozers do the job). The process has been underway for over three decades, ebbing and flowing with the economic and credit cycles.

Recent activity has been robust with bank and thrift acquisitions since 2014 exceeding 4% of the industry charters at the beginning of each year. With only a handful of new charters granted since the financial crisis the industry is shrinking fast. As of Sept. 30, there were 5,256 U.S. banks and thrifts, down from about 18,000 in 1985.

I see 2020 shaping up as a potentially great year for bank M&A even though the outlook for bank investors is less clear after the 28.2% gain in the SNL U.S. Bank Index in 2019 through Dec. 9. The backdrop is an M&A trifecta: buyer and seller earnings will likely be flattish primarily due to sluggish loan growth and lower net interest margins; asset quality is stable; and stock prices are higher, meaning buyers can offer better prices (but less value) to would-be sellers. Also, the capital markets remain wide open for banks to issue subordinated debt and preferred equity at very low rates to fund cash consideration not covered by existing excess capital.

While investors focus on deals that entail a significant premium for the seller, I think the more interesting development this year is the four mergers of equals announced with a value above $1.0 billion. The relatively good investor reaction to these transactions could portend more MOEs in 2020, even though this kind of deal by nature entails very little or no premium for the "seller."

The largest transaction closed Dec. 9 when BB&T Corp. and SunTrust merged to form Truist Financial Corp. Others announced this year include tie-ups between TCF Financial Corp./Chemical Financial Corp., First Horizon National Corp./IBERIABANK Corp. and Texas Capital Bancshares Inc./Independent Bank Group Inc.

MOEs are a viable transaction structure for many community and regional banks, but do not occur too often because of social issues or perceptions of relative value. In an ideal transaction the relative valuation or market cap of each company closely approximates the relative contributions of earnings, capital, core deposits and the like to the pro forma company. Setting the exchange ratio should be relatively easy.

In most instances shareholders of both companies will own a better piece of paper in which both parties see EPS accretion from shared expense saves, no material reduction to tangible book value, an improvement in the liquidity of the shares and greater franchise value if a true sale ever occurs.

I don't know if the Texas Capital/Independent exchange ratio was easy to set. If the boards and their advisers were focused on market valuation, it appears to be an easy call because the pro forma ownership of 55% for Texas Capital and 45% for Independent closely approximated the relative market caps of each bank. Likewise, the relative contribution of consensus net income estimates for 2020 and 2021 was in the ballpark of the agreed upon exchange ratio and resultant relative ownership.

The deal has one outward quirk, however. The pre-announce price/tangible book value valuations were not the same

and may explain why the legal acquirer is Independent rather than Texas Capital. Based on the Dec. 6 closing price, Texas Capital traded for 10.4x consensus 2020 earnings and 113% of tangible book value compared to 11.8x and 212% for Independent.

Most of the difference in the tangible book value multiples is explained by Independent's higher return on tangible common equity (16.7% for the latest 12 months vs. 12.9%) rather than its higher P/E multiple. The transaction will be consummated with Independent issuing shares to Texas Capital that trade at a much higher tangible book multiple. The result is projected 27% accretion in TBVPS. Projected EPS accretion is significant too, at 26% for Independent and 14% for Texas Capital based on 2021 consensus estimates that are overlaid with expense saves.

The market liked the deal, as it should have. Texas Capital shares rose nearly 10% on the day of the announcement while Independent's rose 4%. I suppose complete acceptance would entail Independent shares rising upwards of 15% to reflect 26% EPS accretion, but as CEO David Brooks said, no one can predict the future. My take is that on rare occasions when EPS accretion is projected to be huge the market tends to take a "show-me" attitude.

What ultimately matters will be execution by management. In one of the more perceptive questions on the deal call, an analyst asked how the more community-focused Independent will combine with Texas Capital, which makes large loans and has a leveraged loan portfolio and large mortgage finance business.

The shareholder math and combined footprint in Texas and Colorado look super. The challenge will be converting the spreadsheets and PowerPoint presentations into reality.

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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.