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KeyCorp and BB&T offer differing MOE paths for VantageSouth

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. Davis holds long positions in Aircastle Ltd. and FLY Leasing Ltd.

In many corners of Wall Street, the merger-of-equals is the equivalent of Coach Bear Bryant's description of a tie: it's like kissing your sister. Few liked ties in college football, so the rules were changed in 1996 for Division I football in which overtime was added.

Historically, institutional investors have sometimes tolerated and often loathed MOEs because they entailed no acquisition premium unless the senior MOE partner traded at a richer multiple than the "seller" and thereby allowed for an upward revaluation of the junior MOE partner. The SNL Financial M&A database designated only 167 deals as MOEs among over 9,100 transactions since 1985. The last large MOE was announced in 2006 when Bank of New York Company Inc. and Mellon Financial Corp. agreed to merge in a deal that was valued at $16.9 billion. Other notables involved in MOEs since 2000 include AmSouth Bancorp., First Union Corporation, Regions Financial Corp., Union Planters Corp. and Wachovia Corp.. Otherwise, 1998 was notable for several large MOEs (e.g., NationsBank Corporation / BankAmerica Corp.) that occurred as the market for financial stocks was peaking. The group is not a who's who among money making bank stocks.

Times do change, however. Two transactions have been designated as an MOE this year following eight in 2013. In the regulated banking environment where there are fewer active consolidators than there were pre-crisis, investors are quickly warming to MOEs and quasi-MOEs when the pro forma bank has reasonable prospects for sustained multiple expansion due to an improvement in profitability, growth, share liquidity and strategic profile. I think the operative assumption among investors in smaller banks that enter into MOEs is that the combined company will continue to acquire until the math no longer works, at which point the board would be expected to sell the company.

These factors were on display with the January 27 announcement that VantageSouth Bancshares Inc. and Yadkin Financial Corp. would combine in an MOE. VantageSouth CEO Scott Custer described that transaction as a "true MOE" that would emphasize the "E" for equal.

I am not sure there is a bright-line test that defines an MOE. Many bank deals that entail relative ownership ranges of 45%/55% to 55%/45% or even a bit wider may qualify. Others within the range do not qualify such as the 1999 acquisition of First American Corp. by AmSouth Bancorporation for $6.3 billion. AmSouth was the acquirer. It held 12 of 17 board seats for the combined company, but First American shareholders owned about 55% of the pro forma. How could this be?

AmSouth used its fully valued shares to structure the deal that valued First American at 388% of tangible book value and 28.9x trailing 12-month earnings. The announced deal value priced First American's shares at a 30% premium relative to the prior day's closing price. It proved to be a pyrrhic victory for First American shareholders. AmSouth's shares fell 14% on the news and later stumbled in the fall of 2000 when management preannounced earnings (and, in my view, admitted to earnings dilution and execution issues) at a widely attended conference. AmSouth management earned additional investor ire because change-of-control payments for its executives were triggered as a result of the deal.

VantageSouth elicited an opposite reaction compared to AmSouth's shares. Although the potential for the two to combine had been covered in SNL and elsewhere late last year, VantageSouth's shares rose 14% between January 23 and January 27, the day of the announcement. The SNL U.S. Bank Index of banks with $1 billion to $5 billion of assets fell 3% during those three trading days.

The VantageSouth-Yadkin transaction is about as even as can be with ownership split 46% for VantageSouth, 45% for Yadkin and 9% for investors who funded a $47 million private placement that will be used to retire VantageSouth's TARP preferred. Also, the board will be comprised of seven directors from both companies, and senior management will be comprised of an equal number of executives.

So, is a "true MOE" a good thing for shareholders? Investors do not care about "E" in the context of equality or egalitarianism; they care about earnings, capital, risk profile, share performance and little else. The VantageSouth/Yadkin Financial deal appears to be a low-risk transaction. Management is targeting annual pre-tax expense savings equivalent to 8% of the combined overhead, or $10 million, which implies about a two-year recovery for $23 million of merger related expenses. The transaction will create the largest community bank in North Carolina with a meaningful presence in the Raleigh and Charlotte MSAs. Unlike an MOE involving much larger banks, VantageSouth/Yadkin Financial should be more attractive to a larger bank than either as a stand-alone entity. If management fumbles the execution, I suspect First Financial Holdings Inc. would have an interest in the company.

Two MOEs from the 1990s point to very different paths, though I think for reasons investors may not appreciate. They are the KeyCorp/Society Corp. combination, which at the time of announcement in October 1993 was among the largest MOEs in U.S. bank M&A history with a value of $4.0 billion. The other notable was the August 1994 announcement that Southern National Corporation and BB&T Financial Corporation would merge – in a deal value that seems incredibly small at $933 million vis-à-vis BB&T Financial Corp.'s present market cap of $26 billion.

Investors panned the KeyCorp/Society deal that had its center of gravity in Northeast Ohio and Western New York while spanning from Maine to Alaska. There are a number of stories floating around Wall Street that KeyCorp then struggled with culture and hybrid management: one bank was more decentralized and retail focused vs. the other that was centralized and commercial focused. That may have been true, but I suspect the real issue had to do with the economy. While the industrial Midwest has seen bouts of strength – especially the last few years – the economic backdrop since the MOE occurred has been one of sluggish growth and migration of population to the Sunbelt.

The Southern National/BB&T deal apparently did not entail as many culture issues. Kelly King's predecessor as BB&T CEO, John Allison, was emphatic on many occasions when addressing the Street that the reason the MOE worked was because one management team was in charge (Allison's team) and one team was paid to leave. I think another reason the Southern National/BB&T MOE worked is the reason Society/KeyCorp struggled. Population, jobs and businesses flowed from the Snowbelt to the Sunbelt. BB&T was a big beneficiary of this trend, perhaps more so than companies such as Atlanta-based SunTrust Banks, Inc., as sleepy towns like Wilmington, North Carolina and Greenville, South Carolina began to exhibit economic dynamism.

When contemplating an MOE, the returns for these two benchmark deals are sobering. KeyCorp produced a total return of 61% for the nearly 20 years from March 1, 1994 through January 31, 2014 compared to 355% for the SNL U.S. Bank Index. BB&T produced a total return of 536% vs. 314% for the index from February 28, 1995 through January 31, 2014. That said, KeyCorp has been a better stock the past three years having produced a total return of 51% compared to 46% for BB&T and 36% for the index.

No guarantees, of course, but I suspect VantageSouth/Yadkin Financial will prove to be more similar to BB&T's than KeyCorp's MOE. The economic backdrop in North Carolina is improving, and perhaps more importantly heavy institutional and private equity ownership no doubt will lean on management to hit profitability targets.

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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.