NASHVILLE NOTES

Scale for another reason

Wednesday, February 6, 2019 1:28 PM CT

By Jeff K. Davis

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I count myself among the consensus view that the merger of equals between Chemical Financial Corp. and TCF Financial Corp. makes a lot of sense for both companies. It makes so much sense that the industry should see hundreds of MOEs and quasi-MOEs among banks in the coming years because scale — or operating leverage — is important to drive returns. The explicit assumption is that MOE transactions are good for both companies' shareholders, though not always in proportion to the relative ownership.

The market seems to think MOEs make sense, too. Shares of both Chemical and TCF rose more than 5% on the day of the announcement, which contrasts with announcements during the past year by Synovus Financial Corp., WSFS Financial Corp., Fifth Third Bancorp and Ameris Bancorp in which the buyer's share prices were hammered on the news of a major acquisition. The market thought these companies overpaid, and in some instances, potentially incurred credit issues with the target's loan portfolio.

Wall Street does not tend to like MOEs because there is usually little premium for either party. The Street often sees MOEs the same way University of Alabama football coach Bear Bryant viewed a tied score: "A tie is like kissing your sister!" he famously said.

Setting aside the issue of a premium to the current market price, an MOE is like an acquisition in that the bulk of the EPS accretion comes from expense savings. In the case of the Chemical-TCF deal, projected expense savings approximate 13% of the combined companies' expense base, which does not seem like a heroic amount. The result is projected EPS accretion of 17% for Chemical and 31% for TCF once the expense saves are fully realized. Earnback of dilution to tangible book value per share is projected to be less than three years. The return on average tangible common equity is projected to be 19% in 2020 on a pro forma basis, assuming a full phase-in of the cost savings.

What's not to like with the projected numbers? Nothing, as long as they are realized, which as an aside raises the issue that the projected EPS accretion for 2020 is based upon the analysts' consensus estimates rather than management forecasts.

Whether the 2020 consensus estimates are in the ballpark or not, TCF, Chemical and the industry have to obtain greater scale to drive costs lower. In the short run, scale will drive ROE higher. Over the long run I suspect improved scale may be required to protect existing returns rather than enhance them because the Amazon effect will apply to deposit pricing, too. Informed depositors with mobile technology will force deposit pricing to become more competitive.

That's what has happened to the asset management business. Widely available information for increasingly cost-conscious investors, easy-to-use technology and a push to lower fees by behemoth Vanguard has upended the industry's pricing model. There is no reason that cannot happen to banks, too, in which the spread between rates paid for core deposits and what the funds would cost if obtained in the capital markets cannot narrow dramatically.

Wall Street Journal reporter Jason Zweig recently ran a column about how a small subset of banks — mostly online ones — were offering rates in the range of 2% to 2.5%, which is close to the rate you can get from short-term U.S. Treasuries. Both are risk-free returns. He speculated — and I think most of you reading this would agree — that inertia and until recently a very low opportunity cost of doing nothing has led to a lot of lazy money sitting in banks and brokerage accounts that still earns very little.

Zweig touched on a secular change that is afoot rather than the cyclical nature of deposit pricing that ebbs and flows

with loan demand: Depositors who are empowered with information and mobile technology are in a position to sweep excess deposits from their primary bank to institutions that pay much more competitive rates. In effect everyone can be a corporate treasurer.

The secular issue I see will intensify with time as deposits and other financial assets transition from baby boomers and their parents to tech-savvy millennials and Gen Z. Banks are going to be forced by technology to pay rates on core deposits that are closer to the capital market rate for an equivalent maturity. Scale to improve operating leverage is the only offset I see.

MOEs are a logical, often-overlooked and sometimes disdained transaction that can achieve scale for both companies' shareholders. However, like all transactions, execution is what really matters, because creating scale and accretion with spreadsheets is easy.

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