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Sell-off in Sandy Spring Bancorp shares curious

By Jeff K. Davis

Sandy Spring Bancorp Inc. shares fell nearly 8% on May 16, following the announcement that the bank would acquire WashingtonFirst Bankshares Inc. for $489 million. The shares subsequently only fell a little over 1% the following day when the SNL U.S Small Cap Bank Index fell 3.2%, as the air may be coming out of the Trump trade that has propelled bank stocks since November 8. It is hard to know what the market's precise expectations are on any given day, especially for small-cap stocks that are traded among sector-focused hedge funds.

Years ago I published a negative First Call note on Baltimore-based Mercantile Bankshares Corporation about a particular credit exposure. I penned the note during a long coast-to-coast flight that took forever due to a headwind. When the plane landed, I submitted it because Gogo inflight internet service was not then available. Management flipped out when they saw it and issued a rebuke via an 8-K filing; it was the equivalent of being cussed-out with the SEC as the intermediary. What I did not know, but apparently a number of investors knew or suspected, was that the company was negotiating to acquire F&M Bancorp in a transaction that was announced the day after my note was published.

Maybe Sandy Spring surprised the market because its last bank deal closed five years ago and was small at $25 million. Nevertheless, Sandy Spring is a logical buyer as presumably would be Eagle Bancorp Inc. or United Bankshares Inc. Investors were put-off by the announced pricing that approximated 256% of tangible book value and 26x LTM earnings, but should they be?

Let's step back. The consideration to be paid consists solely of SASR common shares. The announced deal value was predicated upon Sandy Spring’s closing price on May 12 of $41.89 per share, which equated to 219% of its tangible book value and 19x trailing twelve month earnings. It's a stock swap. Assuming the companies are not too different in terms of franchise value, the key is the relative ownership positions vis-a-vis what is contributed in terms of earning power and the like. On the qualitative side, Sandy Spring should be a more attractive acquisition candidate, given a larger franchise in the greater Washington area.

Management has projected the deal will be ~13% accretive to 2019 earnings per share once all expense savings are realized. The initial ~5% dilution in tangible book value per share is projected to be recovered within four years. These seem like middle of the fairway metrics for the current M&A market. Big accretive deals such as Renasant Corp.'s 2013 acquisition of First M&F Corporation are from another time period when the credit quality and earning power for many sellers was on the cusp of turning up. That is not where the cycle is today.

Maybe investors implicitly did not like the ownership percentages. WashingtonFirst will own around one-third of the pro forma company, but will contribute ~28% of pre-provision net revenue based upon each institution’s trailing 12 month results. The expense savings are the bridge to EPS accretion and a reasonable earn-back period for TBVPS dilution when ownership is greater than contributed earnings. Who gets credit for the expense saves is always tricky in an acquisition or merger. Sandy Spring shareholders may be implicitly voting that the credit was a bit too high for WashingtonFirst via the 0.8713 exchange ratio. Or maybe investors question the amount of savings (39%), even though the franchises overlap. Deep expense cuts may not fit with the ethos of a bank that was founded by Quakers in 1868.

There is no way to know, but would investors have sold Sandy Spring’s shares as aggressively if the deal had been announced a year ago with the same exchange ratio? At the time the shares were trading in the high $20s compared to the low $40s when the deal was announced. I bet not, though WashingtonFirst shareholders might have revolted at a nominal price that would have been a third less than the nominal price that was announced on May 16.

Management of National Commerce Corp. has the right perspective when announcing a transaction: There is no reason to extend congratulations because it will be execution over several years that determines success. Lousy execution can make a moderate-priced deal expensive, and great execution can make a rich deal moderately priced with the perspective of hindsight. It always comes down to execution. Assuming the execution is good (or great), and no credit issues emerge, the transaction probably will be fine; and if not, Sandy Spring will represent an attractive acquisition target if the board decided to sell.

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