The 2019 Bank M&A Survey finds a more positive operating environment could have an adverse impact on dealmaking.

Don't Hold Your Breath for the Next M&A Wave

BY **EMILY MCCORMICK**

You would be excused for thinking today's environment has all the ingredients needed to fuel M&A activity in the banking sector, due in large part to recent actions served up by lawmakers in Washington. The tax cut, signed in December 2017, subjects businesses to the lowest corporate income tax rate in seven decades, boosting profitability for the banking industry by 20 percent. And the regulatory relief bill passed by Congress in May 2018 raises the threshold for financial institutions to be considered systemically important and more narrowly construes the definition of brokered deposits, among other benefits. Yet, while these changes improve the operating environment for banks, the results of Bank Director's 2019 Bank M&A Survey, sponsored by Crowe LLP, show that these tailwinds shouldn't be expected to trigger a flood of mergers and acquisitions anytime soon.

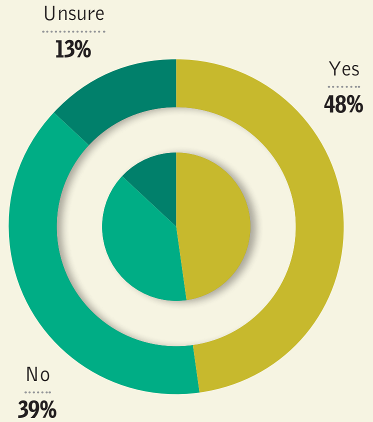
Put simply, it's a good time to be a banker. Why cash out now?

"Now that we have regulatory relief, it's plausible to remain independent, [and] now that we've got tax reform and the interest rate expansion and a [strong] economy, there are opportunities out there [for organic growth]," says Rick Childs, a partner at Crowe.

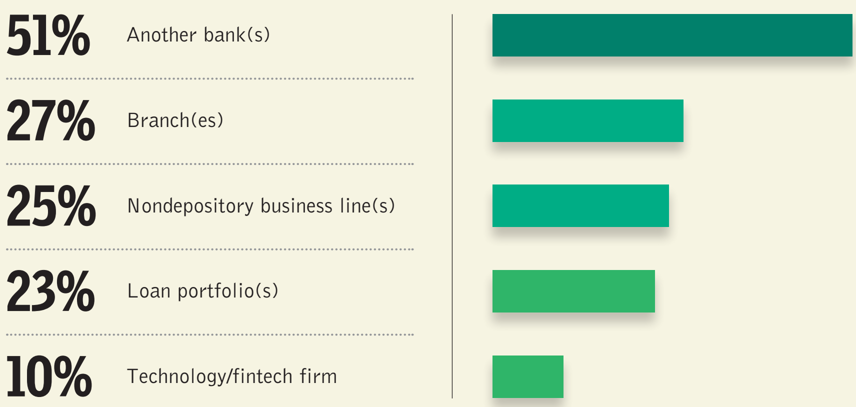
Eighty-seven percent of respondents say the Trump administration's business-friendly approach has had a positive impact on the banking industry as a whole. Eighty-eight percent say the same for Congress. These positive perceptions are presumably driven by Washington's ability to pass reforms that will benefit banks and the businesses they serve. More than three-quarters of respondents indicate their bank saw enough of a gain from tax reform to increase investments in their business or share it amongst the bank's stakeholders—employees, shareholders and customers.

This is all good news for the industry, but it also signals there will be fewer viable targets in the market. According to the survey, 39 percent of respondents indicate there are not a sufficient number of viable targets in their markets, or markets in which their bank would like to enter. Respondents from banks with less than $1 billion in assets

Are there a sufficient number of viable acquisition targets in your bank's markets, or in markets your bank would like to enter?



Is your bank likely to purchase the following by the end of 2019?



KEY FINDINGS

1. More than half of survey participants believe today's environment is more favorable for deals.

2. Thirty percent want to be active acquirers over the next five years. Fifty-seven percent are open to acquisitions but say they'll focus on organic growth.

3. Two-thirds say the passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act in early 2018 has not impacted their bank's acquisition plans.

4. Eighty-seven percent say the Trump administration has had a positive impact on the banking industry.

5. Forty-six percent believe increased tariffs will have a moderate impact on their bank's business customers.

are more likely to report a lack of targets in their area.

"I'm starting to hear that there aren't good targets available for buyers in some markets," says Childs.

What makes a bank a viable target wasn't defined in the survey, so that will differ by each respondent's bank, including its strategy and markets. This could be indicative of pricing—sellers expect more than buyers want to pay—or it could mean there are concerns about potential targets' growth prospects or culture. Maybe the market doesn't offer opportunities to enhance the bank's business. Or perhaps the banks in the target market want to remain independent.

Due to the combination of regulatory relief, tax reform and a strong economy, "there's a lot of optimism, even among banks that would normally be thinking of partnering up with someone," says Joe Bower, CEO of $3.1 billion asset CNB Financial Corp., in Clearfield, Pennsylvania. "They can keep going by themselves and don't need to partner at this point in time." CNB's most recent acquisitions were $152 million asset Lake City Bank in 2015, and $367 million asset FC Banc Corp. in 2013.

The desire to buy is certainly out there, and that will likely result in M&A activity on par with what we've seen over the past few years—somewhere between three and five percent of bank charters.

Fifty-four percent of respondents feel the current environment is more favorable to M&A activity, up five points from last year's survey. When asked about their own strategies around M&A over the next five years, 30 percent say they want to be active acquirers. Sixteen percent say their institution is very likely, and 35 percent somewhat likely, to purchase a bank in 2019, with banks above $500 million in assets more apt to indicate they'll do so.

While some things that make a target desirable are evergreen—a growing market, good loan quality, cultural alignment with the buyer—one notable change is the value placed on the target's deposit base. Seventy-one percent indicate this is a highly important factor in their decision to acquire—up 33 percentage points from when we last asked directors and executives the same question in the 2017 Bank M&A Survey. Today, just 3 percent say deposits are not important.

Competition for deposits has been heating up over the past year. In response, 74 percent say the interest rates their bank pays on deposit accounts has increased since early 2018. However, respondents weren't asked by how much they increased rates.

"As we think about deposits and pricing, rate increases are in the eye of the beholder," says Childs. Many banks are still lagging behind the Fed's rate increases. "If you're competing against [digital banks like] Ally, you really need to be aggressive to catch up to them," he says.

Interest rates were effectively at zero until December 2015, when the Federal Reserve began gradually increasing the federal funds rate—in December 2016, March, June and December of 2017, and March, June and September of 2018, when it exceeded 2 percent. (This story went to print before the Fed met in December 2018.) While the interest rates charged on loans have been quick to rise, increases on the rates paid on deposits have been gradual. Some institutions were offering upwards of 2.3 percent on money market and savings accounts at the end of October 2018, according to BankRate. Many of these higher rates were offered by digital-only banks or divisions. Most traditional banks continue to advertise lower rates.

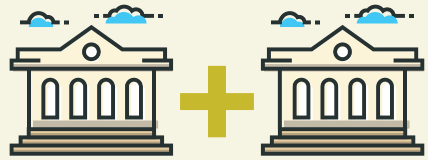
More than half of respondents say their bank is actively working to steal deposits from competitors in their markets, with some recycling old tricks. Free toasters may not be coming back, but some banks are offering gifts. Metaire Bank & Trust Co., a $290 million asset bank based in Louisiana, for example, offers a free gift for new checking accounts that it changes regularly—in the fourth quarter of 2018, it was giving out flannel blankets. But more banks, it seems, are just providing cold, hard cash in exchange for opening an account. Citigroup was offering $500 for accounts opened in the fourth quarter.

Twenty-nine percent of respondents say that gaining deposits via acquisition is one way their bank will position itself to better compete.

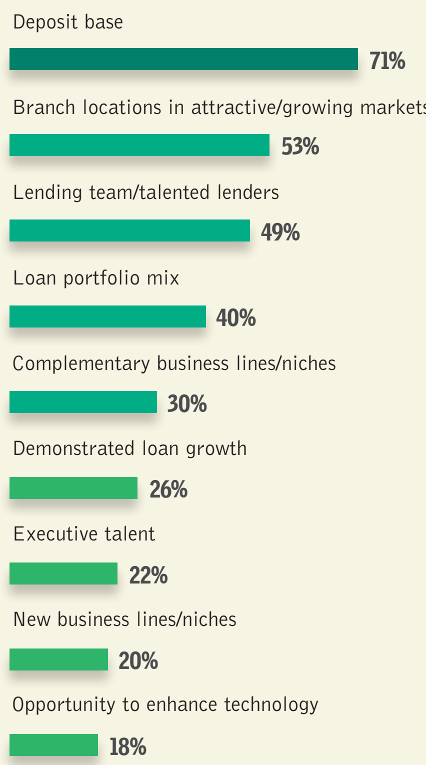
An alternative way to gain deposits without buying an entire bank's operations is to acquire a branch or branches. Twenty-seven percent say they're likely to do so in 2019. But much like whole-bank deals, there are fewer opportunities to buy branches today.

More banks seem to be closing branches rather than selling them, reports Bower, which makes it harder for smaller banks to acquire those deposits. "They relocate the customer [to another branch] and shut the branches, even if the relocation is several miles [away]," he says.

Closing rather than selling branches is easier to do today as digital channels mature and provide another way to serve customers.



Which factors are highly important in your decision to acquire another bank?



"Banks are relying upon their digital footprint to make the option of moving deposits from one branch location to another a more viable alternative than selling the branch," says Childs. "In most branch transactions, the loans are not being sold, so it really comes down to a bank's analysis of the stickiness of their deposits." Banks considering a branch sale must weigh the potential loss of deposits against the cost of operating the branch and keeping the deposits.

Another barrier to branch deals is a preference on the part of national and regional banks to sell branch packages—all the branches in a certain area, for instance—instead of individual branches. This arrangement is better for the seller but puts smaller banks on the sidelines. "The seller is looking for an easier transaction," says Keith Sebade, chief strategic officer at $616 million asset BankSouth, based in Greensboro, Georgia. "It's hard to have a viable look at anything." He has seen exceptions for branches in rural markets that might be excluded from this type of package due to their less attractive location.

Flagstar Bancorp's acquisition of 52 branches from Wells Fargo & Co. is a good example of this trend. The deal was a direct negotiation between the two banks. "Branch acquisition and deposit acquisition is on the radar, but the opportunities have been non-existent in our markets of central and northern Indiana over the last five years," says David Findlay, president and CEO of Lakeland Financial Corp., a $4.8 billion asset bank holding company based in Warsaw, Indiana. Many of the former Wells branches are located in his markets. "Banks didn't get a chance to look at [the Wells branches], and that would be the only [opportunity] that's in our footprint."

Troy, Michigan-based Flagstar, with $18.7 billion in assets, gained $2.3 billion in deposits and $130 million in loans when the deal closed in December 2018.

An increase in profits stemming from tax reform helped many banks invest that money into growing and improving their business. Thirty-seven percent invested in new growth initiatives, 36 percent in new technology and 19 percent in other capital investments.

Respondents also indicate their bank raised employee salaries (25 percent) or paid a one-time bonus (19 percent), or gave some of the windfall to shareholders through a dividend (25 percent) or stock buyback (10 percent).

Using a write-in response field, some respondents also indicated they used the tax reform windfall to bulk up their capital reserves. (Eight percent selected the "other" option on this question, with most of those writing in that they increased capital.) Accumulating capital is another way for banks to offset higher loan-to-deposit ratios in today's highly competitive environment. "[Tax reform] affects our clients and our

How is your bank positioning itself to better compete for deposits?

74% Interest rates we pay on deposit accounts have increased in the past six months

52% We are actively working to steal deposits from competitors in our markets

35% We are accepting brokered and/or other wholesale deposits

29% We plan to gain deposits via acquisition

27% We are accepting reciprocal deposits

communities in our ability to retain higher levels of capital to continue to lend as aggressively as we do," says Findlay, who adds that his bank is laser-focused on commercial and industrial (C&I) lending. "The more capital we have, the more we can lend out."

Banks with loan-to-value ratios at or near 100 percent will need to look beyond core funding sources if they want to keep making loans. Thirty-five percent say their bank is accepting brokered deposits as well as other types of wholesale deposits purchased through a broker. The Federal Deposit Insurance Corp. only allows well-capitalized banks to accept these types of funds, as they have proven over time to be less stable than core deposits obtained directly by the bank in its home markets.

Twenty-seven percent of survey respondents say their bank is accepting reciprocal deposits—large deposits spread among a network of banks. The depositor can receive deposit insurance coverage for the entire amount placed through the network. The market for reciprocal deposits opened up after the recent regulatory relief bill excluded them from treatment as brokered deposits, assuming a bank is well-capitalized and in good standing after its most recent examination. Reciprocal deposits also cannot exceed $5 billion, or 20 percent, of a bank's total liabilities.

If growth opportunities dry up for deposits, this could compel more banks to sell: 28 percent of respondents pointed to limited growth opportunities for deposits as a leading reason to sell their institution. One-quarter point to regulatory costs, 22 percent to technological change and 21 percent to a lack of CEO or executive successors.

Potential acquirers are less interested in the target's loans—40 percent say the loan portfolio mix is highly important, and 26 percent highly value demonstrated loan growth. Forty-nine percent say a lending team is highly important, and 22 percent place a high value on executive talent. More than half highly value branch locations in attractive or growing markets.

One area that respondents really aren't looking for in a deal is an opportunity to enhance their bank's technology—39 percent say it's unimportant in a target. And few—just 10 percent—say their bank is likely to purchase a technology firm over the next year.

"A number of institutions don't desire to invest in fintech from an acquisition standpoint, but they are clearly interested in partnering," says Childs. These vendor partnerships, says Childs, are driving industry optimism, too. "Technology always enables a community bank to compete with a larger institution."

Fifty-seven percent say that while they're open to acquisitions, they plan to focus on organic growth. Given an environment where fewer banks may be willing to sell, it's a strategy that makes sense. And being choosy about M&A at this stage in the credit cycle may prove to be a smart move in the long run.

"We've successfully failed at M&A," says Findlay. Lakeland has not made an acquisition since the 1980s and hasn't won opportunities they pursued in the interim, which he says is a credit to the bank's focus on creating long-term value for its shareholders.

"The best way to create long-term, lasting viable relationships with our clients is originating every deposit and every loan one by one," he says. M&A "creates critical mass of size, but it doesn't necessarily create the best client relationships or the best community relationships."

Fourteen percent believe M&A is an unlikely growth path for their financial institution. Of those, 75 percent express a preference for organic growth.

"The environment is ripe for organic growth right now," says Childs. "You have a combination of a lighter regulatory touch for smaller institutions [and] good economic opportunity" that's fueling optimism in the industry.

Some banks have no choice but to grow organically. Thirty-eight percent of respondents who say M&A is an unlikely growth path indicate there are few or no viable targets in their desired markets. That's the case for Denali BanCorp., the $290 million asset bank holding company for Denali State

68%

believe it would be easy to find a buyer for their bank at a fair price

How has your bank dedicated the profits gained due to tax reform?

76% **expect modest economic growth through 2019**

Bank, in Fairbanks, Alaska. There are only seven banks in Alaska, including Wells Fargo and KeyCorp.

The bank is challenged to grow loans, rather than deposits, due to Alaska's small population and limited economy, explains CEO Steve Lundgren. And it's difficult to attract talent to add to the management team and board. Despite the growth challenges faced by his bank, he thinks a sale is unlikely, because the price won't be better than what the bank can do on its own. With a stock split, he says his shareholders expect a 12 to 18 percent annual return on their initial investment. "They don't think they can get that if they sell to another bank," says Lundgren.

About the Survey

Bank Director's 2019 Bank M&A Survey surveyed 184 independent directors, chief executives and other senior executives of U.S. banks to gain their views on the M&A environment, including their expectations around the U.S. economy and the regulatory environment, and how both factors affect bank mergers and growth. The survey was conducted in September and early October 2018. Forty-two percent of the respondents are independent directors or chairmen, and 42 percent serve as the bank's CEO. Thirty-four percent represent banks between $1 billion and $10 billion in assets. Forty-seven percent represent a public bank, and 45 percent a privately-held institution. The 2019 Bank M&A Survey is sponsored by Crowe LLP. The complete results are available in the research section at BankDirector.com.

Questions About Our Research?

Contact Emily McCormick at emccormick@bankdirector.com if you'd like to know more about Bank Director's research initiatives.

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As seen in the 1st Quarter 2019 issue of *Bank Director*