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Evaluating Bank M&A Deals: Don't Be Misled by Simple Metrics

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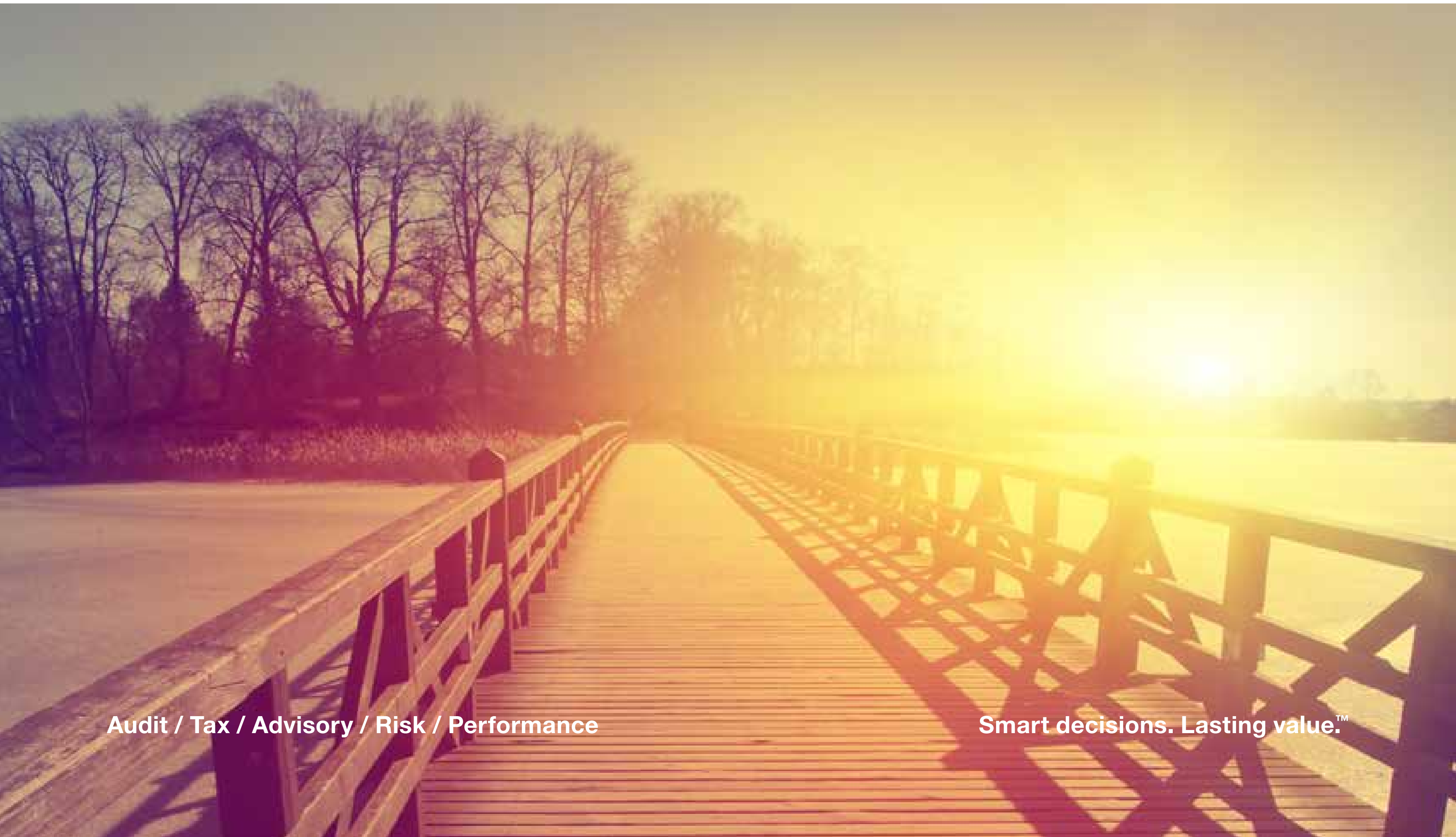

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Simplistic deal metrics are a popular method for assessing the value of a bank M&A transaction, but some of the most widely used measures present an incomplete and often misleading picture. A broader, more comprehensive, and more qualitative evaluation is needed to get a clear and accurate picture of the deal's value and viability.

As bank executives look to add value through mergers and acquisitions (M&A), a recurring source of frustration is the tendency of investors and analysts to punish active acquirers by relying on narrow and often misleading metrics to measure the value of a deal. One widely used but particularly misleading metric is the dilution of tangible book value (TBV) that occurs as a result of a transaction, coupled with the TBV earn-back period – that is, the number of years it will take to earn back the TBV dilution through the incremental earnings improvement the deal will produce.

While the urge to break down the analysis of a deal into a single number or ratio is understandable, such simple metrics inherently are inadequate for evaluating the true value of a transaction. Moreover, TBV dilution and earn-back are particularly poor indicators of a transaction's full effect on the overall value of an organization.

Rather than using a single number to evaluate the success of a transaction, shareholders, boards, and analysts should strive to make a more complete – and more accurate – evaluation that takes into account all aspects of a merger or acquisition. Of particular interest are the speed, thoroughness, and effectiveness of integration plans; the potential and actual cost savings and potential revenue synergies; the long-term effect on earnings per share (EPS); and the earnings multiple or price/earnings (P/E) ratio.

Such broader measures, coupled with a more qualitative evaluation of a transaction's effects on bank strategy and shareholder value, can provide a much more comprehensive and instructive understanding of the relative worth of a merger or acquisition.

Trends

The credit crisis of 2008 had many serious, immediate, and obvious effects, but it also generated some more subtle changes. Among these were some important shifts in the way analysts and investors evaluate the success of a bank or thrift acquisition.

Traditionally, some of the most widely recognized measures of the affordability of a deal involved the deal's effect on the bank's EPS and P/E ratio. Specifically, investors kept a close eye on any dilution to EPS resulting from the deal and on how quickly the bank could turn the dilution around. This turnaround metric generally was accepted as a benchmark that indicated when the deal would start adding value to shareholders.

Obviously, this metric fails to take into account a variety of other factors, particularly changes in share value resulting from external events or from the market's general reaction to a bank's active acquisition strategy. Nevertheless, such earnings-based measures often were used as a convenient way to evaluate a deal at a glance.

Beginning in 2008, however, as more and more of the banks and thrifts that were sold had negative earnings (or at best, no reasonable level of profits), measuring a deal's effect on EPS or the P/E ratio became a pointless exercise. Predictably, markets began looking for other shorthand metrics that could give them a quick reading on an M&A transaction's likely success.

Many analysts and investors settled on an indicator that previously had garnered little attention: TBV dilution. More specifically, analysts and investors started paying attention to the TBV dilution earn-back period, which measures how long it will take to recapture any dilution in TBV that results from the deal. Eventually, the general consensus seemed to settle on the view that an earn-back period of three to five years was desirable, although various pundits and analysts have varying opinions about the length of this period.

One of the consequences of the growing use of TBV dilution earn-back and other simple metrics to evaluate M&A transactions has been a tendency for the market to punish active acquirers. This tendency was measured by a 2016 Morgan Stanley study of 40 recent deals involving mid-cap banks (those with $2 billion to $10 billion in assets).

The study found that acquiring banks' day one stock prices dropped by an average of 1 percent, underperforming their mid-cap bank peers by 120 basis points on that day. Two weeks post-acquisition, acquiring banks still were underperforming their peers by 110 basis points, on average. These findings prompted the report's authors to note, "(I)t seems that the market has become unreasonably bearish on bank acquisitions, irrespective of the financial metrics or strategic rationale supporting the deal."[1]

Gaps

Despite its widespread use, TBV dilution earn-back sometimes can produce an inadequate or incomplete measure of the viability of a bank M&A transaction. As noted in a recent Bank Director article, [T]he link between TBV earnback and value creation is tenuous." The author goes on to point out: "Fully earning back the transaction's TBV dilution is sufficient, but not necessary, to create value since the bank will trade at a higher multiple of its diluted TBV."[2]

It also should be noted that TBV dilution earn-back – and other popular metrics – are significantly affected by the way an acquisition or merger is structured. An all-cash acquisition will have a dramatically different effect on book value and earnings metrics than a deal that involves the issuance of new stock.

Metrics such as TBV dilution earn-back and various other earnings-based metrics also can be readily influenced by management actions such as post-deal stock repurchases. These metrics also can be influenced by the infinite number of external factors that can affect stock price, such as the run-up in bank stock values in the month after the 2016 election, when the markets began to anticipate the new administration would introduce regulatory reform.

Challenges

Beyond the obvious and direct negative effects of lagging share prices, the market's reliance on overly simplistic metrics also can pose less immediate – but equally serious – indirect consequences. For example, negative perceptions about prior deals can severely limit a publicly traded bank's growth opportunities, since its ability to compete in future deals often hinges on the value of its stock.

This limitation can be particularly damaging for banks and thrifts whose growth strategies are built around continuing M&A activity. Facing increasing competition from nonbank providers of financial services, many organizations must continue to gain scale in order to compete cost-effectively.

Despite some expectations of future regulatory relief, regulatory expense will continue to contribute to banks' financial pressures in the near term, reinforcing the need for continued growth in order to spread compliance-related costs across a larger base. Moreover, regardless of the post-election surge in stock prices, many banks still are likely to find it challenging to price deals fairly due to the constraints of regulatory capital requirements.

Not only do these complicating factors put added pressure on banks, they also make it even more complicated to rely on TBV dilution or any other simple metric to evaluate an M&A transaction.

Solutions

Although it is tempting to look for simple metrics that can serve as indicators of a deal's value, serious investors and analysts rarely will rely on a single number. Instead, they will consider all aspects of the transaction and evaluate how each of the various factors contribute to the ultimate objective of any deal, which is to generate additional value for shareholders.

While a speedy integration is the ideal, a hurried or poorly executed integration actually can destroy value.

Such an evaluation usually begins with an estimate of the deal's impact on earnings and EPS. But beyond such basic metrics, investors also should consider factors such as projected cost savings, expenses related to the transaction itself, and the speed and costs associated with a successful integration of the two organizations.

It should be noted that while a speedy integration is the ideal, a hurried or poorly executed integration actually can destroy value. Management should be able to lay out meaningful steps with measurable indicators of success, such as integrating core systems and platforms within a specified timetable or developing consistent and uniform product offerings by a given date.

Projected cost savings should be evaluated critically and in detail. Rather than merely laying out broad categories, management's savings projections should identify specific opportunities and explicit cost saving targets.

When evaluating cost savings, it's also important to consider both halves of the equation – both the recurring savings and the one-time expenses that will be incurred to achieve them. An equally stringent standard also should be applied to projected merger-related expenses, such as professional fees and expenses, as well as the operational costs involved in carrying out an M&A project, such as changing forms, signage, and documentation.

Above all, the totality of these various projections should be compared to the actual results achieved in prior transactions. If they vary significantly – or if earlier deals failed to achieve promised results – management should be able to explain the variations and rationale for the current projections. Savvy investors will look for evidence that the organization learned from its previous experiences.

The Bank Director article cited earlier also points out another very fundamental question that is sometimes overlooked, particularly by banks that have significant excess capital. In such organizations, the financial impact of an M&A transaction should be compared with the potential return that could be achieved through alternative uses of capital, such as share repurchases, dividends, or other M&A transactions that could produce better returns.[3]

Management should be able to outline the rationale for the deal compared to alternatives, and it should be ready to present complete and relatively detailed plans, timetables, and targets that it intends to meet. This type of analysis obviously is more time-consuming and demanding than applying a simple mathematical formula, but it produces a much clearer picture of the true value of a transaction – both before and after the deal is done.

Conclusion

Although analysts' fascination with TBV dilution earn-back as a measure of deal value is a relatively recent phenomenon, it is not unusual or unprecedented. In fact, it is symptomatic of a long-standing and fundamental truth: All of us have a natural tendency to look for simple, clear answers that allow us to make clear and confident decisions.

Analysis of M&A performance typically begins with a careful review of earnings-based ratios and other metrics. In this context, TBV dilution earn-back can be an interesting aspect of this review, but it is far from a conclusive indicator of success.

Other metrics provide more accurate measures of the ultimate return on investment that a bank achieves on a deal. Widely recognized ratios such as EPS and the P/E multiple are popular for good reason – they help establish a solid first impression of the value of a bank's stock and what impact a merger or acquisition will have on that stock.

But even these reliable numeric indicators are more meaningful and relevant when they are considered in the context of other qualitative indicators, such as management's prior performance and the completeness and specificity of its merger plans. Moving beyond metrics alone, a more complete analysis also will involve qualitative judgments and a study of other factors, such as a deal's impact on capital ratios, management's integration plans and benchmarks, projected cost savings, and the management team's track record and credibility.

Finally, any thoughtful analysis also must take into account the unpredictable effects of external factors such as general economic conditions, changing interest rates, new competitive pressures, future technological advances, and the changing needs and preferences of bank customers. When management demonstrates a history of competence in anticipating and planning for such trends and couples that competence with a clear and credible rationale for its planned actions, it makes a much more compelling case for investor confidence than any single number or combination of numbers can offer.

This more analytic approach can help investors, analysts, and other stakeholders – and ultimately bankers – by encouraging a more disciplined and comprehensive approach to deal valuation.

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[1] Todd Castagno and Snehaja Mogre, “Bank Buyers Beware – Let’s Use the Right Metrics for Assessing Value Creation in Bank M&A,” Morgan Stanley white paper, March 9, 2016, p. 2, https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=2&cad=rja&uact=8&ved=0ahUKEwj2z-L20NXPAhUF4YMKHSgbDOYQFggwMAE&url=http%3A%2F%2Flinkback.morganstanley.com%2Fweb%2Fsendlink%2Fwebapp%2Ff%2Frrou14em-3pf5-g00d-900c-005056013401%3Fstore%3D0%26d%3DUwBSZXNlYXJjaF9NUwBkYTU2OWYyZS1jOWMzLTExZTUtYjA3Ni02ZTA3MzY4MTQ3ZDA%253D%26user%3D41m00ax1rgomb-13%26__gda__%3D1583662142_2791573312c56e8b88c96fdb58057010&usg=AFQjCNGy7rfKGKT4KeRJqyzvtKcvxXTJYQ&sig2=dtDGDymY2FQTrbW-TzzthA

[2] Jason Blumberg, “Measuring Value Creation in Bank M&A,” Bank Director online article, July 18, 2016, http://www.bankdirector.com/index.php/issues/manda/measuring-value-creation-bank-m/

[3] Ibid.

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