Sellers: Be Vigilant About Stock in a Deal

By: *Rick Childs* | NOVEMBER 10TH, 2017

Through the first nine months of 2017, the pace of bank merger and acquisitions has been up slightly from prior years in terms of the number of deals, and the strong performance of bank stocks since the U.S. Presidential election—the KBW Nasdaq Bank Index is up almost 40 percent—has led to an increase in deal prices for bank sellers in 2017. Price to tangible book value for all deals through Sept. 30, 2017, is up approximately 24 percent compared to the same nine-month period in 2016. Although sellers are happy about rising deal prices and bank stocks trading at high levels, they should consider how to protect the value of a deal in an all- or mostly-stock transaction negotiated in the period after the announcement and beyond the deal closing. Here are three considerations for boards and management teams.

1. Use a stock collar.

A stock collar allows the selling institution to walk away from the transaction without penalty, given a change in the buyer's stock price. A double trigger often is required, meaning an agreed-upon decline in the buyer's stock price along with a percentage deviation from a set market index. A 15 to 20 percent trigger often is used. The seller may require that a cap be used if a collar is requested. A cap would act in a similar manner as a collar and provide the buyer with the chance to walk away or renegotiate the number of shares should the buyer's stock increase 15 or 20 percent from the announcement date. While collars and caps often are symmetrical, they do not need to be, and a higher cap percentage can be negotiated. The need for a collar tends to be driven by the buyer's recent stock trends and financial performance.

2. Consider trading volumes and liquidity in your deliberations.

In an all-stock or a combination stock and cash deal, the seller makes a significant investment for their shareholders in the stock of the buyer. For many shareholders, this represents a significant opportunity for liquidity and wealth diversification. But these goals can be thwarted if the buyer's stock is not liquid or doesn't trade in enough daily volume to absorb the shares without detrimental impact. The table below indicates some of the volume and pricing differences between exchanges. The total number of shares to be issued in a transaction should be considered in comparison to the number of shares that trade on a weekly basis.

Exchange	Avg Weekly Volume/Shares Outstanding (%)	Number of Banks	Median Price/LTM Core EPS (x)	Median Price/Tangible Book (%)	Median Dividend Yield (%)
Grey Mkt	0.00	8	13.60	92.38	2.07
OTC Pink	0.07	433	15.02	109.55	1.79
OTCQB	0.14	36	15.34	130.59	2.00
OTCQX	0.20	76	16.06	126.04	2.00
NASDAQ	1.18	344	19.35	184.02	1.69
NYSE MKT	0.98	6	18.88	197.00	2.10
NYSE	3.10	51	16.40	197.75	1.99

Source: S&P Global Market Intelligence as of Sept. 30, 2017
LTM: Last 12 months

3. Request reverse due diligence.
The larger a seller is in comparison to the buyer and the more stock a seller is asked to take, the more there is a need for reverse due diligence. Boards and management should require the opportunity to dig into the books and records of the buyer, when appropriate, to make sure the stock investment will provide the returns and values promised by the buyer. However, the request for reverse due diligence may be denied if the transaction is fairly small in scale for the buyer or only token amounts of stock are offered.

Reverse due diligence tends to be abbreviated compared to typical due diligence, and it's more focused on the items that can materially affect stock price. Reverse due diligence tends to focus on items such as earnings and credit performance, regulatory issues that the risk committee is monitoring, pending litigation or other potential unrecorded liabilities, review of board and committee minutes, and dialogue around future performance and initiatives. Also, sellers should review a buyer's stock characteristics, including reading equity analyst reports, transcripts of earnings calls, conference presentations and other public sources of information that could help to develop a holistic view of how the market might react to the transaction once it's announced.

While no one can predict what will happen with stock prices over the next 12 months, it does seem that many believe the current run-up in bank stock prices is the result of the general election, the Federal Reserve's increase in interest rates and expected additional rate increases. Stocks are trading at high levels, but bank sellers still need to be cautious about which stock they take in a deal.

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