

## Should TBV Dilution Be Dead?

By: Rick Childs | MAY 29TH, 2017



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 rely on narrow metrics to measure a deal's value. Simple metrics are inadequate for evaluating the true value of a transaction. One widely used but 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. TBV dilution and earn-back are 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 toward more comprehensive evaluations. Broader measures, coupled with a more qualitative evaluation of a transaction's effects on bank strategy and shareholder value, can provide a holistic understanding of the relative worth of a merger or acquisition.

### Gaps and Challenges

Despite its widespread use, TBV dilution earn-back can produce an incomplete measure of the viability of a bank M&A transaction. Reliance on simple metrics produces gaps and challenges such as the following:

- 1. M&A structure:** 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 different effect on book value and earnings metrics than a deal that involves the issuance of new stock.
- 2. External factors:** Management actions such as post-deal stock repurchases can influence TBV dilution earn-back and various other earnings-based metrics. These metrics also are shaped by numerous 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 regulatory reform.
- 3. Regulatory expense:** Despite 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, many banks still are likely to find it challenging to price deals fairly, due to the constraints of regulatory capital requirements.

- 4. Indirect consequences:** The market's reliance on simple metrics can pose less immediate—but equally serious—indirect consequences. For example, negative perceptions about prior deals can 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 damaging for banks and thrifts whose growth strategies are built around continuing M&A activity.

### **Measurable Success**

Serious investors begin their evaluations with an estimate of the deal's impact on earnings and earnings per share (EPS), but they also 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.

Management should lay out meaningful steps with measurable indicators of success. When evaluating cost savings, both the recurring savings and the one-time expenses that will be incurred to achieve them must be considered. An equally stringent standard also should be applied to projected merger-related expenses, such as professional fees and operational costs.

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.

The financial impact of an M&A transaction also should be compared with its potential return. Management should outline the rationale for the deal compared to alternative uses of capital, and it should be ready to present complete and relatively detailed plans, timetables, and targets. This analysis might be time-consuming, but it produces a clearer picture of a transaction's true value.

### **A Comprehensive Approach to Deal Valuation**

A complete analysis involves studying 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. Thorough analysis also takes into account unpredictable external factors such as general economic conditions, changing interest rates, new competitive pressures, future technological advances and the changing needs of bank customers.

When management demonstrates a history of competence and a clear and credible rationale for its planned actions, it makes a more compelling case for investor confidence than simple metrics 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.



Rick Childs is a partner in Crowe Horwath LLP. He can be reached at 317.706.2654 or at [rick.childs@crowehorwath.com](mailto:rick.childs@crowehorwath.com).