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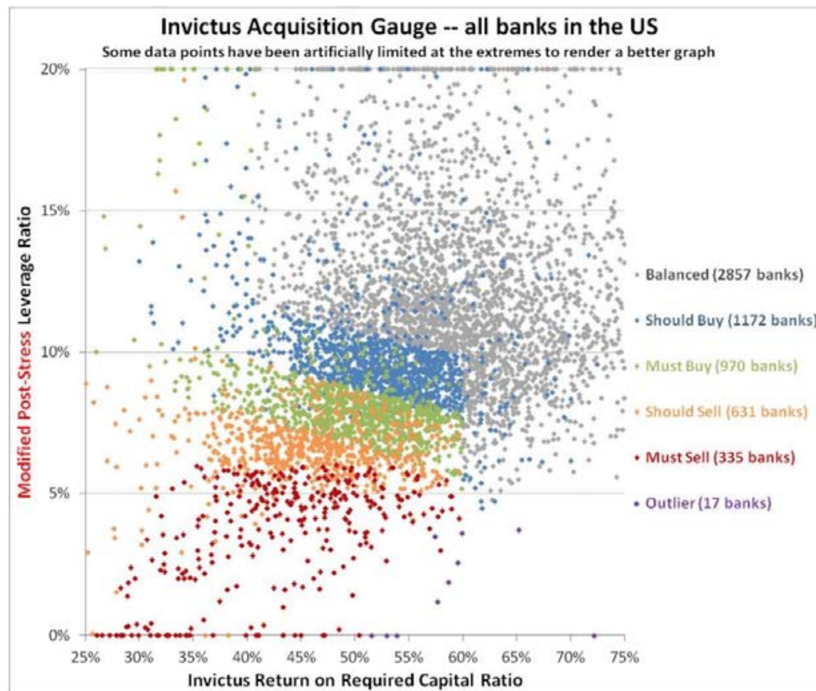
Bank Insights—A Special Report

Earners and Burners: An M&A Analysis of the 2016 Community Bank Market

By Adam Mustafa and Malcolm Clark, Senior Partners

The community banking market has traditionally been conservative, especially toward mergers and acquisitions. But there are unique pressures that are silently putting pressure on bank investors. This change has been masked by legacy accounting and asset liability management systems, and ignored by market analysts and investment bankers. The prolonged period of low interest rates has slowly poisoned balance sheets, which will eventually lead to more consolidation—even for reluctant banks.



Proper analytics are necessary to understand the new M&A landscape, what it will mean for individual banks, and how banks can gain a competitive edge through acquisitions. As this inevitable consolidation looms, banks are beginning to jockey for position as either potential buyers or sellers. One essential new metric is the Invictus Return on Required Capital Ratio, which calculates the gross asset return divided by the regulatory capital required to support the assets for each bank. Think of it is a measurement of earnings quality – the higher the ratio, the more return a bank is generating on its assets relative to the risk. This ratio is crucial because two banks with identical total assets could have substantially different regulatory requirements based on their loan mix.

Each quarter, Invictus Consulting Group uses its cutting-edge analytics, which include a public data stress test on every bank in the country, to determine its best M&A strategic option. This is called the Invictus Acquisition Gauge, and it classifies each bank with less than $50 billion in assets as a buyer or seller in varying categories: Must Buy, Should Buy, Must Sell, Should Sell and Balanced.

Now that we are eight years past the financial crisis, we can see the impact of the unprecedented monetary policy that has forced banks to accumulate assets under artificially low interest rates for years.

Five key takeaways

1. **Across the U.S., 966 banks either Must or Should Sell.** These banks are undercapitalized and have weak earnings, both in terms of quality and quantity. They are caught in a 'chicken and egg' game where they need to grow to increase their earnings, but simply cannot grow due to lack of capital. The writing is on the wall for most of these banks. Barring a miracle, many of them will begin to succumb to shareholder fatigue as their dividend drought continues with no end in sight. The good news for these banks is that their loan portfolios may be attractive—they tend to consist of older vintage loans, which have better rates, and have been right-sized from a risk perspective through their historical provisioning and charge-offs.

2. **There are 2,142 Should Buy and Must Buy banks that need to be wary of burning their capital.** These banks have plenty of capital, but a weak Invictus Return on Required Capital Ratio. This weak ratio is an

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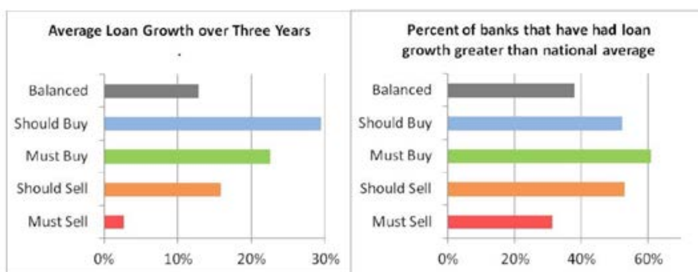
indication that the banks either are chasing low rate loans with increasing risk, or are too conservative and are heavily concentrated in low-risk but excessively low-yielding assets that do not move the needle in terms of driving shareholder value. Almost 60 percent of this group, or 1,265 banks, have been growing loans over the last three years at a faster rate than the rest of the community bank and Dodd-Frank-sized market, as these charts show:



The trap for any of these banks is that they are BURNING capital that could be used for acquisitions by making higher risk/lower reward loans. These loans are tantalizing: they increase the QUANTITY of earnings in the near-term. Making a multifamily loan at 3.5 percent will be better for next quarter's earnings then owning a 10-Year Treasury note at 1.8 percent. However, these loans are requiring more and more capital to support them as the U.S. monetary policy fuels inflation in asset values. Capital requirements for new loans are exacerbated by slipping underwriting standards as banks compete to win new business.

As a result, these newer loans to riskier borrowers generate a very low return on capital. As banks accumulate them, they are limiting their strategic options. These loans eat into the bank's capital war chest, which could otherwise be more usefully deployed into acquisitions.

Due the declining interest rate environment since the Great Recession, Invictus calculates that banks need to increase their loan books by 5 percent annually just to keep interest income steady. Alternatively, taking into account expected loan run-off, banks need to underwrite about 40 percent of their current loan book value over

> "Banks are limiting their strategic options"

the next two years to keep the same interest income level that they have now.

That growth rate may sound unchallenging given the general growth in lending over the past three years – but for many banks it is a significant chunk of their trend growth rate. Bank directors may think they are growing their bank, but in reality capital will be allocated to these loans to just keep the bank "running in place."

3. Alternatively, there are 2,857 banks that are **Balanced** by our measures. **These banks have true earnings of the highest quality** (as measured by their return on required capital). These Balanced banks are the "Earners" – while the Should Buy and the Must Buy banks are trending toward "Burners". The irony about many of the Balanced banks is that they have resisted the temptation to maximize the quantity of their earnings by using their excess capital to originate higher risk/lower yielding loans. Their instincts allowed them to keep excess capital idle, earning no return in the short-term, but positioning them perfectly for the long-term. They are feeling the pinch now, often frustrating management, directors, and shareholders due to the lack of growth and reckless competitors who are poaching their customers with low rate loans. The more aggressive banks in this group will have their instincts rewarded because they will have larger war chests for pursuing acquisitions.

4. **If the 970 Must Buy banks do not take action, they are in danger of becoming reluctant sellers.** While they have plenty of capital, their Invictus Return on Required Capital Ratio (quality of earnings) is so anemic that organic growth is not a practical option. Some of these banks are publicly traded, and will eventually become swarmed by aggressive activist investors, who will pressure the bank to drain their biggest strength – their capital -- through dividends and stock repurchases before leaving the bank with no choice but to ultimately sell. In other words, if it weren't for their excess capital levels, these banks would be MUST or SHOULD SELLS, which would double that number. The longer they choose not to deploy this excess capital, the sooner their shareholders will ultimately become fatigued. Acquire or be acquired – there is no other relevant choice for this group.

5. **There are more than five buyers for every seller so if you snooze, you lose.** Thanks to the regulators, the industry as a whole is overcapitalized and we now have a situation where there are many more banks with the means to become acquirers. As a result, would-be acquirers will need to find ways to differentiate themselves and gain a competitive advantage in the M&A market. Otherwise, they will be left behind and find that

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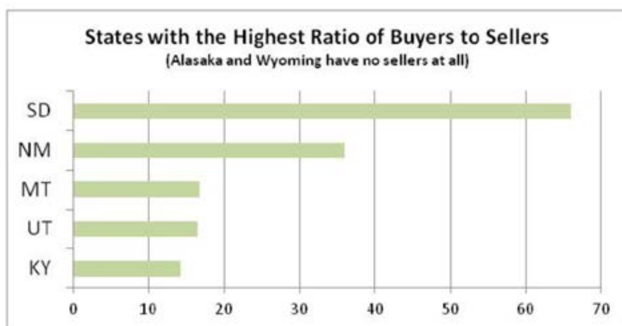
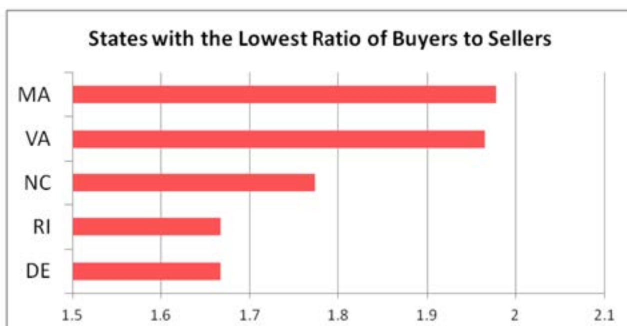
their local competitors have either become stronger or have been acquired by a larger institution that is ready to take their customers by offering more services and better rates. Again, choosing to 'go it alone' is an option that must be chosen carefully because your competitors *may otherwise choose for you.*

Regional Differences

The results of the Invictus Acquisition Gauge shed light on where M&A activity might – or won't – easily occur throughout the U.S. The states with the highest ratio of buyers to sellers are nearly all in the West (with the exception of Kentucky), while the states with the lowest ratio of buyers to sellers are all in the East. Whether intense buyer competition drives more merger activity is yet to be determined. It is also worth noting that, although the West appears to have fewer sellers relative to buyers, it also contains the vast majority of agricultural and energy banks. Both sectors are beginning to experience stress. Although the banks appear to be in a strong position to withstand stress from a capital adequacy perspective, more bankers are beginning to talk about selling as a means to maximize shareholder value, rather than experience the hardships of another downturn. There are also looming succession planning troubles as well within agricultural banks, which will provide a further catalyst to future M&A activity.

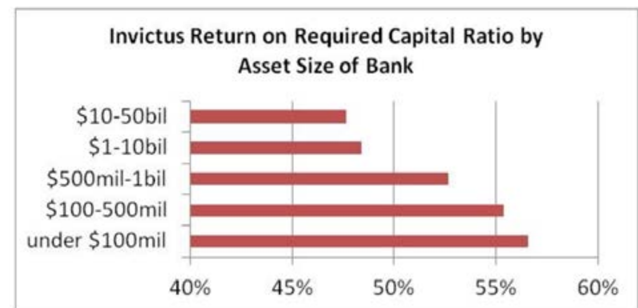




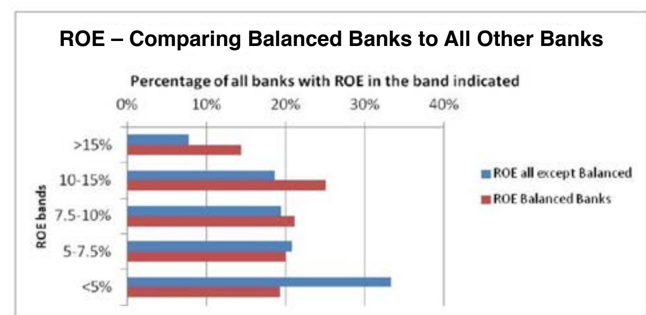
Invictus has created a version of the Acquisition Gauge every year since 2013. The methodology has changed as economic and regulatory conditions have changed, which makes direct year-to-year comparisons invalid. The one thing that has remained constant is the value of analyzing loan vintage, composition and distribution under stressed scenarios to calculate regulatory capital levels.

Bank Efficiency and Returns

The following charts examine the average Invictus Return on Required Capital Ratio by asset size. As we said earlier, this ratio is a key new metric that must be used in M&A analytics to achieve meaningful analyses.



Invictus' analysis suggests small banks are getting better risk-adjusted returns than larger. This may be because they are less likely to be publicly traded, are in rural markets where competition is less intense, or have tighter, more involved management. Larger banks may be more aggressively pricing their loans, possibly due to more competition, and have other income streams. Whatever the reason, this result flies in the face of what many bank analysts say – namely that community banks "need size to thrive". Our analysis suggests smaller banks are more efficient capital allocators than larger. But that also means *they make great acquisition targets.*



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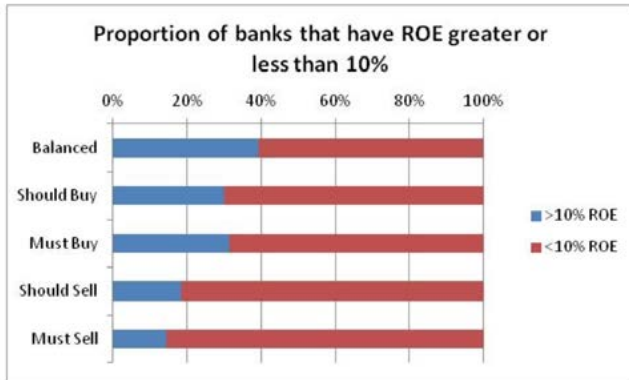
This graph shows how the balanced banks have a better ROE than all other banks.



Conclusion

Community bank executives have often believed the way to increase their loan book is to hire loan officers. In the current environment of squeezed margins, stretched valuations, increased regulatory pressure and intense competition, that's potentially a very dangerous path to take – and one that the stronger banks in the country have not taken. It's much more sensible is to look at clearly targeted acquisitions, selecting a bank that has loans of the appropriate vintage, not just loan type and geography.

It's also essential to use the proper analytics when contemplating an M&A transaction. Invictus uses this analysis to identify potential targets for its bank clients and conduct early-stage due-diligence on a short-list of the most attractive-looking candidates. Initially this analysis can be done using public data and Invictus' renowned stress-testing process. This process gives clients great insights into the state of their own bank and potential acquisitions, meaning in some cases they understand the acquisition bank better than that bank's own directors. This is a powerful position to be in for any acquisitive bank. For more information, please contact the author at **amustafa@invictusgrp.com**. ▪

About the Experts

***Adam Mustafa**, an Invictus co-founder, has been helping banks with M&A, strategic planning, and regulatory hurdles since the financial crisis. He has an MBA from Georgetown University and a BA from Syracuse University.*

***Malcolm Clark**, an Invictus managing partner, has a 25-year background in financial markets and technology. He has an economics degree from the Massachusetts Institute of Technology.*

Webinar: How to Manage CRE Concentrations

Don't miss *Bank Insights'* free webinar on how to manage CRE concentrations. Regulators **announced** in December that they would be paying extra attention to banks that planned to grow CRE loan portfolios, or whose concentrations were near or had exceeded concentrations limits. They warned that some banks might have to raise additional capital if they couldn't prove they were managing their concentrations well.

Bank Insights is sponsoring a **complimentary webinar**, "Powerful and Practical Techniques to Manage CRE Concentrations amid Regulatory Scrutiny," to help banks with this issue. The hour-long webinar begins at 1 p.m. EST on June 16, and features Invictus senior partner Adam Mustafa, who has been advising banks across the country on the best way to manage their CRE loan portfolios. Some of his clients have received regulatory approval to increase their CRE concentrations way beyond the thresholds. Mr. Mustafa will share techniques that will not only satisfy regulators, but will also be helpful in strategic planning.

Regulators have advised banks to use stress testing to determine if their CRE portfolios can withstand an economic downturn. At April's FDIC community bank conference, Maryann Hunter, deputy director of the Federal Reserve Board's Division of Banking Supervision and Regulation, said even small banks should start using scenario analyses if they have concentrations.

The CRE warning is broad: Banks that will come under regulatory scrutiny do not need to have exceeded concentration limits. Banks must merely be contemplating an increase in CRE loans, have already increased CRE lending or "operate in markets or loan segments with increasing growth or risk fundamentals," regulators said.

Banks are taking the warning seriously. One New York community bank, for instance, said in a recent earnings call that it was concerned about CRE underwriting standards in the industry, noting that it had seen "highly irrational term sheets" from competitors. The bank announced it was curtailing applications for multifamily loans and pulling back from CRE lending markets.The bank also said it expected the OCC to demand higher capital requirements, which could cause it to sell investment securities and multifamily loans.

Register here and feel free to invite any of your peers who many want to attend. ▪

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

OCC to Focus on Strategic Planning, Credit Risk and Stress Planning

Don't be surprised if examiners ask tough questions about your strategic plans, how you are managing concentrations, interest rate risk management and stress testing. The Office of the Comptroller of the Currency released its 2016 Mid-Cycle Operating **Plan Status Report** this month, and it reveals the OCC's supervisory priorities for the remainder of the year. Besides compliance and cybersecurity issues, examiners will be evaluating credit risk management, particularly concentrations, underwriting practices, loan growth strategies, allowance for loan and lease losses methodology and stress testing. They "will assess the spillover effect of continued low oil prices and evaluate the banks' practices for stress testing affected loans." The OCC also says it wants to make sure that executives and boards understand "the benefits and risks of their overall business strategies and strategic changes" before introducing new products, changing business models or taking part in M&A activities.

CSBS Highlights 'Right-Sized Regulation' in Report

Promoting "right-sized regulation and supervision of banks consistent with their size, complexity, overall risk profile, and risk to the financial system" is one of the main strategic objectives for the Conference of State Banks Supervisors, according to its recently released 2015 **annual report**. The report says CSBS will equip state supervisors with the right tools "to challenge the inappropriate or disproportionate application of federal regulation." The 68-page report highlights CSBS achievements in 2015, including certifying 1,004 bank examiners from 43 agencies.

Hoenig: Banks Need More Equity Capital

FDIC Vice Chair Thomas M. Hoenig, long a proponent of higher capital ratios for banks, told a Paris audience **this month** that there is "compelling evidence" that "more equity capital—not less—is the better choice to attain sound banks and sustained economic growth." Hoenig's speech, titled "A Capital Conflict," criticized the banking industry for lobbying for exemptions from capital requirements in the leverage ratio calculations. "If accepted, the effect of such proposals would be to again lower acceptable capital standards for this most important industry," he said. In April, Hoenig outlined a **plan** for community banks to obtain regulatory relief – as long as they maintained a 10 percent tangible equity-to-assets ratio.

Incentive Pay Rules Would Affect Community Banks

Certain community banks with $1 billion or more in assets will need to pay attention to restrictions on incentive-based compensation that encourage risk-taking. Federal regulators have released a long-delayed **proposal** that was required under the Dodd-Frank law. The proposal notes that of the 65 banks that failed during the crisis with total assets of $1 billion or more, 18 had issues related to incentive compensation. Under the proposal, regulators would consider "the activities, complexity of operations, risk profile, and compensation practices" at banks with assets greater than $1 billion to determine whether they should have to comply with the heightened standards. It notes that some of these banks "might be involved in particular high-risk business lines, such as lending to distressed borrowers or investing or trading in illiquid assets, and make significant use of incentive-based compensation to reward risk-takers."

CFPB Unveils its Regulatory Agenda

Get ready for new rules on checking account overdrafts and tweaks to mortgage disclosure regulations. That's the message from the Consumer Financial Protection Bureau, which has published its rulemaking **agenda**. The CFPB says it has been concerned about overdraft fees on checking accounts since 2013.

Fed Issues FAQ on TruPS

The Federal Reserve has clarified its guidance on the treatment of trust preferred securities under the Volcker Rule. The Fed added a **question** about whether banks were required to deduct from Tier 1 Capital an investment in a CDO backed by TruPs as part of the Volcker rule. The simple answer, which is quite long: No. ▪

About Invictus

*Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. For past issues of Bank Insights, please go to the **Invictus website**.*

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