AMERICAN BANKER BANKTHINK

Small-Bank M&A Hindered by Cognitive Bias of "Anchoring"

By David B. Moore
May 23, 2012

Anchoring is a cognitive bias that describes the common human tendency to rely too heavily, or "anchor," on one piece of information, which may or may not have any actual relevance, when making decisions.

The anchoring heuristic (that is, rule of thumb) was first theorized by Amos Tversky and Daniel Kahneman. (Kahneman was awarded the 2002 Nobel Memorial Prize in Economics for his work in prospect theory; Tversky could not share in the award because he died in 1996 and the prize is not given posthumously.)

As Wikipedia explains: "In one of their first studies, the two showed that when asked to guess the percentage of African nations that are members of the United Nations, people who were first asked, 'Was it more or less than 10%?' guessed lower values (25% on average) than those who had been asked if it was more or less than 65% (45% on average). The pattern has held in other experiments for a wide variety of different subjects of estimation."

The point, of course, is that initial percentage proffered in the question had absolutely nothing to do with the actual answer and yet it clearly had a meaningful impact on responses. The same issue is impeding mergers and acquisitions in the bank sector.

When asked about the price at which they would be willing to sell, many community bank boards and managers respond with some variant on the following: "Well, banks were selling at 2.5 times book value prior to the financial crisis, so we'll sell once those valuations return." The problem, of course, is that acquisition prices garnered prior to the crisis have little in common with what banks are actually worth today or what they will likely be worth in the future.

BankUnited CEO John Kanas took note of this recently at a conference. From an article in SNL: "'I'm not encouraged that we'll see a high volume of M&A activity for the balance of this year. The smaller banks that tend to be weak… are managing to hang on,' Kanas said. [Kanas] believes that most boards at those institutions still have stock valuations from the middle part of the last decade wired into their memories, which means 'decent proposals' often get ignored in the hopes that valuations will eventually return to pre-crisis levels."

Using the faulty logic that Kanas correctly identifies, the investor holding technology stocks during the summer of 2000 (after the Nasdaq Index had fallen from 5,000 to 3,500) was completely justified in holding onto those stocks until the market returned to 5,000. Clearly this was irrational, as the 5,000 valuation had no relationship to reality – it was just a number. Twelve years on and the Nasdaq remains 40% below its year 2000 peak.

Most investors and bank managements concur that from here on out increased regulatory costs will have a modest negative impact on earnings while slightly higher capital requirements will reduce small banks' ability to leverage. Consequently, that typical small bank that generated an average return on equity of almost 14% between 1990 and 2007 may only be able to generate an ROE in the 11% to 12% range a few years down the road (assuming the economy remains stable and nonperforming assets continue declining). (For context, the median ROE for publicly-traded banks with assets between $500 million and $5 billion was 3.7% in 2009, 6.1% in 2010, and 8.8% in last year's fourth quarter.)

Which brings us to the issue of future valuations. If in the future the typical small bank's cost of equity is a normalized 9% to 10% while its return on equity hovers in the 11% to 12% range, then we should expect to see average trading multiples in the range of 1.2 to 1.3 times tangible book value. While this compares favorably with current valuations (a median 0.92 times tangible book at the end of 2011), clearly this is a significant diminishment relative to historical levels.

Likewise, acquisition multiples, reflecting anticipated operating efficiencies, should be proportionally higher as well. Thus, if in the "normalized" future the *typical* publicly-traded small bank trades at 1.2 to 1.3 times tangible book value and is acquired for 1.4 to 1.6 times tangible book, it is likely that a *subset* of high-performing small banks will trade at over 1.6 times tangible book and be acquired for over double tangible book.

So, while it is likely that *some* community banks will be acquired for valuations that were common during the mid-aughts heyday, the *typical* community bank – for fundamental reasons – is not going to return to those exalted levels.

The sooner bank boards accept this "new normal," and disregard the previous valuations to which many of their memories remain (irrationally) "anchored," the faster the pace of small bank M&A will pick up steam.

David B. Moore is managing principal of Marathon Capital Holdings, Inc., a merchant banking and advisory firm specializing in the community bank sector.

© 2012 American Banker and SourceMedia, Inc. All Rights Reserved. SourceMedia is an Investcorp company. Use, duplication, or sale of this service, or data contained herein, except as described in the Subscription Agreement, is strictly prohibited.