View Bank Deals as Investments

By DAVID B. MOORE

COMMENT

As bank stocks have declined in value since mid-1998, it has come as no surprise to the banking sector's analysts and investment bankers that acquisition activity has slowed dramatically. The primary reason cited for the slowdown is "sticker shock" on the part of potential sellers. Bank managers who are considering being acquired look at the absolute valuations that were assigned to their franchise in late-1997 and early-1998 and say, in effect, "Hey, I want *that* price for my bank, not the piddling 14 times earnings that is being offered today."

Acquirers, most of whom have been using their stock as currency in the acquisition process, are unwilling to pay previously high multiples because of the sad state of their own stocks, which render the economics of high-priced acquisitions less palatable. Such deals are more likely to be dilutive to the acquirer's per-share earnings. As a result, as bank stocks have fallen, acquirers must pay less to make acquisitions work, while sellers still believe that they are worth the multiples that sellers were receiving two years ago.

In my view, the primary reason that sellers suffer from sticker shock is that they don't understand the underlying economics of selling to another company for stock. More specifically, most bank managers don't understand that selling one company to another for stock is an *investment decision*, pure and simple. The absolute dollar amount or pricing multiple is not the most relevant issue, since the resulting entity will be a combination of the acquirer and seller — no more and no less. In stock-for-stock acquisitions, after all, there's no "free lunch." If the market believes that the acquirer is overpaying, investors will punish the acquirer's stock to the extent that the deal value for the seller will ultimately represent the market's best estimate of its economic fair value.

A cursory look at most of the big acquisitions completed in 1997 and 1998 illustrates my point. In most cases, Megabank A announced an overpriced acquisition of Bank B, and investors reacted accordingly by penalizing Bank A's stock, thereby driving down the takeout value of Bank B.

If you accept my thesis you should also realize how irrational it is for a bank's management to put off selling simply because the absolute deal value or pricing multiple will be lower today than it would have been two years ago. This makes absolutely no sense from an economic standpoint.

Perhaps an example would be helpful. Let's say that Banks A(cquirer) and S(eller) have been courting each other for some time. Bank A, which is a well-run bank several times the size of Bank S, once sported a P/E multiple of 16 times earnings and was willing to pay 17 times earnings (and a 25% market premium) for Bank S in Bank A's stock. S's management, not being the most clever of sorts, thought they would hold out for more. Eventually, bank stocks began to decline.

Bank A is still interested in acquiring S, but A's stock now trades at 12 times earnings, though S's stock is down to nine times earnings. In the current pricing environment, A is only willing to pay 12 times earnings for S. Predictably, S doesn't want to sell "at the bottom," or "at such a steep discount to previous acquisition multiples."

Bank S should be evaluating any potential merger with Bank A from an *investment* standpoint. Because once the transaction has been consummated, Bank S's shareholders will end up with Bank A's stock, which will represent the value of the combined entity. If Bank S's managers are optimistic regarding Bank A's fundamental outlook, then they should be saying to themselves, "While the absolute value of my bank is lower in this deal than it would have been two years ago, our shareholders' investment in Bank A is being made at a considerably lower valuation." In other words, Bank S's shareholders will be receiving a much cheaper stock, with commensurate additional upside, in the current deal than they would have received had S sold to A two years ago. In addition, Bank A's stock is likely to be more liquid than S's. Consequently, when bank stocks recover, A's will likely recover well before S's.

Clearly, Bank A could *attempt* to pay S a higher price but, as I explained above, the market would quickly nip that notion in the bud by driving A's stock price down. In the end, Bank S's shareholders would receive little incremental benefit from such a pricing strategy.

There is one other reason for banks to resist selling at lower absolute valuations: Most senior bank executives have options packages, and the absolute dollar amount received for each share of the seller's stock in an acquisition has a very direct impact on the value of these options. So, while the per-share deal value is negotiable, the strike price on these executives' options is fixed; thus, the higher the per-share deal value, the more the options are worth. Consequently, I have no doubt that some managers are resisting selling their banks *not* because they don't understand the economic logic for shareholders, but rather because they are putting their own financial interests above those of the company's shareholders.

In the final analysis, falling stock prices in the bank sector should have minimal impact on deal activity. A stock-for-stock transaction should be treated as an investment decision. With most acquirers' stocks as depressed as they are currently, most community banks would do well to consider investing in these companies at current levels via a sale.

Mr. Moore is a vice president and equity research analyst at Podesta & Co., a broker-dealer based in Chicago.