How banks can drive growth, manage risk through M&A

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It's no secret that merger and acquisition activity has been heating up among financial institutions. If you only looked at the multiples, you might think it was primarily a seller's market.

But averages aren't very instructive. Larger institutions are generally selling for better multiples than smaller ones. Banks are generally doing better than thrifts. The current range in pricing multiples is much wider than historical averages. Sellers in the right market with limited asset quality issues and viable long-term franchises are attracting considerable attention, but some banks in other markets with troubled portfolios or other issues are selling below book value.

In short, every deal comes down to the right seller meeting the right buyer.

What's driving M&A?

Much of the consolidation occurring in the industry results from questions boards are asking in response to the financial crisis and the resulting regulatory changes and market realities. Financial institutions are asking themselves the following questions:

- Do we have enough capital based upon increasing regulatory expectations?
- Do we have the right management team to achieve growth?
- Can we afford the specialized expertise to meet rising regulatory standards?
- Do we have economies of scale and infrastructure to be competitive?
- Do we have the right products, services and technology to meet the evolving needs of our customer base?
- Do we have the energy and motivation necessary to move our organization to the next level?

The answers to those questions are the real drivers of transactions. Success in the M&A market isn't driven by average multiples. It's driven by strategy. That strategy should start long before a target is identified, and must continue well beyond any transaction. If you are considering a merger or acquisition as a path to growth, what should you consider?

The right strategy and the right team

Understand that M&A shouldn't be an ad hoc activity. It should be a disciplined strategy driven by clear goals and guided by an established team. Identify your M&A goals, so that you'll know which institutions to target. Are you looking to expand geographically? To reach into different market segments? To deepen penetration in existing geographies? Set your goals and then build the right team to work toward them.

M&A is hard work, and it is not the place for inexperienced team members. Mistakes here are very expensive. Build an M&A team from proven leaders within your institution, and augment your team with experienced, outside resources where necessary. Understand that the M&A process will consume much of their time and effort. You don't want to burn out your best so be sure to address how to help your M&A team members with their current daily duties. You will have to take something off of their plates.

Your M&A team will have to address a broad spectrum of issues, so build subteams to focus on a variety of areas, such as:

- People—Identify and retain key performers at the target institution, evaluate and rationalize staff and coordinate human resources (HR) policies and procedures.
- Processes—Be prepared to objectively evaluate processes across the board to develop the best integrated approach going forward. Remember that you may need to adopt leading practices from acquired organizations, especially if you are acquiring a new product or service set.
- Technology—System integration and vendor or contract management will be vital to a transaction's success and can significantly impact financials of the combined organization.

Your team should meet regularly to refine goals and criteria to ensure they remain aligned with realities in your business and in your target areas. Also, meeting regularly will keep your team focused and ready to react when the right opportunity presents itself. The institution with its team and plan in place when the right deal appears has a decided advantage.

Recognizing the right deal

The right target is an institution that helps you meet your M&A goals, that doesn't present undue risk and that best aligns with your bank in other key ways. Here's a checklist of questions to consider when evaluating a potential target:

- How strong is its management team?
- What markets is the target in, both geographically and by customer demographic? How do they either overlap or complement our own?
- What is the target's product mix? Are products or services offered that add value to ours?
- How effective are the target's information technology (IT) systems and how compatible are they with ours?
- Will overlapping transaction volumes or other areas offer economies of scale?
- Are there opportunities to consolidate or eliminate overlaps to drive value?
- Will the merger either create or help to address any regulatory concerns?

If the answers to these questions align with your M&A goals, the next step is gaining buy-in from your board to move ahead. When presenting an opportunity to the board, be prepared to answer questions on two key topics: a) How will this acquisition improve earnings? and, b) How will you anticipate and address any risks the acquisition presents?

The goal at this point is an objective analysis of all publicly-available information to clearly articulate potential strengths and weaknesses in the deal, and to evaluate it for potential deal killers before significant effort and expense are invested. Once you decide to make an offer, the costs and risks go up. Remember, you are working in concert with the board to make a candid, objective evaluation of the target, in order to decide whether an offer is warranted.

Due diligence

Once you have identified a target and agreed to a letter of interest, it's time to move on to the due diligence phase and dig deeper into the detail that separates successful deals from expensive failures. A first step is augmenting your internal M&A team with the right outside resources, including:

- Investment bankers
- Attorneys
- Accountants
- Tax advisors
- Valuation specialists
- Consultants

If you've bought a home, you've seen the home inspection report—an exhaustive checklist of all the items that affect the structure's value, positively or negatively, with some items weighted more heavily than others. Approach due diligence the same way. Here's a checklist to start from:

- Loans, loans and more loans—You can't overemphasize the importance of understanding the quality of the loan portfolio.
- Allowance for loan and lease losses—This has to be reasonable. After the deal, the target's bad debts are your bad debts.
- Deposits and liquidity—Does the target have a solid and stable core?
- Investments—Is there any impairment? Are you dealing with derivatives or subprime assets?
- Valuation—You need solid values on all loans, deposits and intangibles.

- Audit reports—What are the auditor's credentials? Are there any high-risk findings?
- Management—How effective are the target's key leaders, and how will they fit within the combined organization?
- Contracts and agreements—Can you live with them?
- Litigation and regulatory—Anything under the rug?
- Compliance and BSA—Any high-risk activities?
- Operational controls—Look at the structure, quality and efficiency on internal audit and other controls.
- Information technology—How compatible are the target's systems with yours? How secure are they? What long-term contracts exist and what are the early termination penalties?
- Financial reporting—Is it accurate, reliable and timely?
- Tax and accounting implications—Compile pro formas to confirm near-term expectations.

It's vital to maintain objectivity throughout the process. Never get emotionally invested in any deal. No matter how good a deal may have looked early on, you have to be willing to walk away at any point, should the risks, terms, pricing or fit fail to meet your goals and complement your strategy.

Compliance due diligence

Compliance has always been a key focus for due diligence for financial institutions. It is especially important in today's environment of heightened regulatory oversight. Compliance due diligence should focus on two key areas:

- Compliance within your loan portfolio
- Compliance with the Bank Secrecy Act (BSA), anti-money laundering regulations (AML) and the Office of Foreign Asset Control (OFAC)

On the lending side, thoroughly review the target's loan portfolio and compare it to your own. Answer the following questions:

- Will the acquisition mean you are moving into new lending areas—for example, from primarily commercial lending to consumer residential lending?
- What is the target's risk tolerance? Do they make subprime loans? Payday loans? Other high-risk loans? If so, are their controls and reserves adequate to support those activities—and are those activities you are willing to continue?
- If you will be taking on unfamiliar loan products, will personnel at the target bank continue with the organization after the acquisition, or will you need to hire or train existing staff?

On the BSA, AML and OFAC side, take the following steps:

- Evaluate the systems and controls in place at the target to detect potential money laundering activities and transactions with entities blocked by the OFAC.
- Evaluate the target's products and services to highlight areas with which your staff is unfamiliar, especially areas with a higher risk of BSA, AML and OFAC issues, such as correspondent banking, private banking and U.S. dollar drafts.

Also, take a close look at the target's audit and regulatory history. Has the auditor raised any open or recurring issues on either the lending or regulatory front? Are there any current or past enforcement actions?

With both compliance areas analyzed, you can make an informed decision if the risks involved in the deal are acceptable. If they are, you should develop a plan to address any compliance gaps that you will need to deal with going forward.

Tax due diligence

A variety of issues will affect the tax ramifications of an acquisition. The earlier these are considered, the less likely they will complicate your deal. Here are four key questions to consider:

- What will you be buying—stock, partnership or limited liability company (LLC) interests, assets or stock?
- Who are you buying from—an individual, corporation, S corporation, partnership or LLC?
- Where are the target's operations and how are they held?
- What is the company's tax situation, specifically with regard to net operating loss carryforwards (NOLs)? Section 382 of the Internal Revenue Code also limits the use of NOLs following a more-than-50-percent change in ownership, so be sure to check those ramifications, as well.

What you are buying significantly affects your post-deal liabilities. If you buy stock, you are acquiring all of the target's preacquisition liabilities, including all of their tax liabilities. You will want to investigate the target's tax liabilities to understand your total potential obligations. That includes not only income-based federal, state and foreign taxes, but also non-income based taxes such as property, payroll, sales and use and franchise taxes. In an asset deal, income-based tax liabilities generally remain with the seller. However, you may have successor liability for some non-income-based taxes.

The tax status of the seller also affects your tax concerns. If the seller is an individual, check for related-party issues and determine their ability to satisfy indemnification claims, which increase the importance of escrow.

If the target is structured as an S corporation, you need to ensure that the target properly maintained S corporation status so that any outstanding or unrecorded tax liabilities flow through to the owners. If not, they could become your concern. Also, state tax treatment of S corporations can differ from federal treatment.

If the seller is a corporation and a subsidiary in a consolidated group, it may be liable for the taxes of the entire group in some cases, which could require expanded due diligence.

Documenting your deal

You've completed the due diligence. The target still looks like a good strategic fit, and you've reached a general agreement on purchase price and terms. Now it's time to document your deal with a definitive agreement. It's a good idea to prepare a closing checklist while you are preparing the agreement, so that once the agreement is signed, you and the target have a mutually agreed-upon path to closing. It is also wise to involve your tax and accounting advisors early in this process to advise and help you appropriately finalize the structure of the deal. Finally, if it is a stock deal, determine if you will need a fairness opinion. Your agreement should address a comprehensive list of issues and information, such as purchase price calculations, tax issues regarding structure, representations and warranties, employee issues and more.

Integration—transforming a deal into a success

You can pick the right target, perform flawless due diligence, execute a perfect deal at an advantageous price—and your deal can still turn out to be an expensive failure. According to a *Business Week* analysis of major acquisitions since 1990, only 17 percent have contributed significant value, 33 percent have contributed marginal value and 50 percent have eroded shareholder returns. *Fortune* magazine found that 77 percent of acquisitions do not earn or exceed their cost of capital. Furthermore, in the four to eight months following an acquisition, half of the newly combined entities see a drop-off in productivity.

Retention of leadership at the acquired entity is a key integration issue, especially in banking, where there is a shortage of experienced executive talent, and where retaining leaders with ties to their communities can be vital to success in many geographies. Nearly 50 percent of senior executives at acquired companies leave in the first year, and nearly 75 percent leave within the first three.

So what are the critical factors to a successful transaction? Clearly, quickly and effectively integrating two separate entities into a single financial institution that makes the most of their collective strengths and mitigates their challenges.

Here are nine key factors for optimal integration:

- **Perform thorough due diligence.** The last thing you need during the integration process is to uncover new and significant problems that would have changed the terms of, or possibly even prevented, the deal in the first place.
- **Pick leaders who understand the strategic rationale for the acquisition.** The goal of integration is to build a combined entity that supports a specific set of strategic goals. All aspects of the integration process should be aligned toward those goals. It is especially important to educate leaders from the acquired entity about your vision and gain their buy-in. Their support for the effort will be vital, since they already have relationships and credibility with personnel at the acquired entity.
- **Assess the people, processes and technology for all common functions across the two institutions.** What's redundant? What should be consolidated? What compatibility issues must be addressed? And in what order should all this be done?
- **Decide which people, processes and technology from your institution need to be transferred to the acquired institution, in order for your goals to be met.**
- **Identify where the acquired institution's culture is incompatible with your culture or with your strategic goals.** For example, perhaps the acquired entity has an overly aggressive sales culture in its lending operations that raises the likelihood that overly risky loans may be made.
- **Develop and implement a detailed plan for:**
  - Integrating systems and data
  - Integrating organizational structures and processes
  - Capturing best practices at the acquired institution, and communicating your own best practices to your new personnel
  - Implanting your desired culture and management practices across the institution
  - Setting integrated financial and operational targets, and determining how those will be measured
- **Define and communicate your integration objectives, and then reward behavior that supports those objectives.**
- **Look for low-hanging fruit.** Identify quick-hit integration opportunities, and capitalize on them to build momentum.
- **Leverage experienced and dedicated integration resources.** These often come from outside your organization. You don't perform M&A integration for a living—you run a financial institution. There are other people who do.

Integration hot spots for financial institutions

In any industry, there are certain key functions that deserve special attention during integration. For financial institutions, the following five areas deserve special consideration:

- Technology
- Lending
- Special assets
- Operations
- Customer accounts

On the technology front, both core and ancillary systems will need attention. On the core system side, you will need to address your accounting systems (general ledger, accounts receivable and payable, purchasing, reconciliation, etc.), as well as your trust and investment systems.

Financial institutions also have a host of ancillary systems that play key roles across a variety of functions. Without a detailed integration plan, it's easy for one of them to fall through the cracks. You need to make a comprehensive list of these systems at both the acquiring and acquired entity, and prioritize integration efforts for each. Ancillary systems to consider include ATM networks, Internet banking systems, loan origination systems, wire transfer systems, automated clearinghouse (ACH) systems, marketing systems and more.

Be particularly diligent about customer-facing systems, as major disruptions to these technologies can create significant reputation risks.

Lending culture can be a touchy integration issue among financial institutions. Every organization strikes its own balance between wanting to sell loans and acceptable levels of risk. You need to clearly delineate the combined entity's position, and document all loan policies and procedures to support that philosophy. With that established, you can work through issues like lending forms, credit files and the timetable you want to set for originating, underwriting, approving and closing loans.

Special assets deserve special attention. Be sure to devote enough resources to this area—it can take a considerable amount of effort. Inventory all special assets—the watch list is a good place to start. Then, review the workout plans for each one with the officer currently assigned to the account.

Since operations are driven by policies and procedures, you will want to merge those as quickly as possible. This effort should include deposit operations and return items. You will also want to consolidate wire transfer operations quickly to avoid the risk of managing two separate wire transfer functions. The consolidation effort is a good chance to improve the overall functioning of that department, as well as internal controls and compliance procedures.

Losing customers is a real risk in any financial institution combination, so quickly and efficiently merging customer account operations is also vital. Focus on:

- Merging account numbering for loans and savings accounts
- Eliminating transit routing number
- ACH consolidation
- Transferring and merging customer information

Compliance integration

In today's regulatory environment, compliance is a key concern for every financial institution, so special attention must be applied to integration of compliance efforts.

Fair lending compliance is one key concern. You will need to:

- Integrate underwriting criteria
- Establish consistent consumer loan prices and fees
- Revise the fair lending risk assessment
- Determine the appropriate level of loan officer discretion
- Document policies and procedures for waiving fees, counteroffer criteria and treatment of medial collections

Compliance with the Community Reinvestment Act (CRA) is also important. You will have to conduct a post-merger assessment of your new area demographics, which may require new or revised community outreach efforts. You will also need to review your CRA lending, investment and service testing criteria.

A post-merger assessment of the newly combined entities' Unfair, Deceptive or Abusive Acts or Practices (UDAAP) risks should also be on your compliance integration checklist, along with other issues, such as:

- Reviewing compliance issues concerning integrating marketing and advertising activities
- Ensuring compliance with regulatory requirements around new product knowledge
- Evaluating product offerings at both entities to determine the best mix of products to offer moving forward, and planning appropriate customer communications about product or service revisions

Customer retention

Without customers, nothing matters. In a March 2012 article, the *Wall Street Journal* reported that "Customer defections are a major reason why more than half of all mergers fail to deliver the intended improvement in shareholder value."

Customer retention is a complex challenge. Consider starting with a proactive communications effort. Many customers do their banking online, so set up a Web-based welcome message with a short video communicating the one central message you most want to share with your customer base. Also consider print-on-demand welcome kits that deliver customers' new account information, compliance notices, information about the new bank and possibly even contact information for their closest branch manager.

Of course, avoiding any hiccups in service goes a long way to minimizing customer defections, so be sure to address the following issues:

- Mapping data between dissimilar systems
- Merging routing and account numbers
- Communicating all necessary compliance and other disclosures

Maximize growth, minimize risk

Clearly, a merger or acquisition is a huge effort. But in today's financial institutions marketplace, it's often the right choice for growth. Realizing that growth without taking on unacceptable risk is the key. By first determining a clearly defined strategic goal for your acquisition effort, and using that goal as the driving force for everything from identifying and evaluating targets, to due diligence to closing your deal to integration, you can maximize the chances for a successful deal, while controlling the risks inherent in any business combination.

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