

FRAGILE: HANDLE WITH CARE

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Deals Are Fragile

As we slowly attempt to recover from the throes of the economic debacle in the West, it has become increasingly apparent that deals – whether they be mergers or financings – are fragile creatures. For every deal done, there are many that never get completed. Frustration among both buyers and sellers, investors and targets is running very high these days. We all hear about the successes, but rarely about the misses.

Why Are Deals So Fragile?

Actually, this is a complicated phenomenon. First, lingering asset quality concerns are still the primary reason buyers or investors walk away. They simply can't get the numbers to pencil out and provide the returns on investment they are seeking. Also, relatively low bank stock prices make it challenging for more traditional acquirors (read that not private equity) to use their currency to do acquisitions. Then add the social and regulatory factors to the mix and the results are not so surprising.

Diminishing FDIC Deals

There are fewer attractive (size and location) FDIC-assisted deals remaining. It appears this number has peaked and down the road we will eventually return to whole bank transactions as the norm, with the occasional FDIC-assisted deal. Those "stuck in the middle," i.e. not yet ready for receivership, but significantly wounded banks, are finding a mixed bag out there. Private equity has shown an interest at the right price in selective deals; again size and location being important. Traditional buyers have been less inclined to participate in the arena – perhaps reflecting the reporting demands placed on public companies for NPAs and the like. One interesting play is two damaged banks combining and creating enough critical mass to attract investors. However, most of these deals fall apart in the talking stages. They often resemble "strategic alliances" or so-called "mergers of equals," with all the attendant social issues.

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The Regulatory Hurdles

While the regulators have selectively allowed private equity into the game, it still remains a costly and time consuming process. Further, mergers will continue to be carefully scrutinized by the regulators for fear of approving a deal which could later implode. And, let's face it, private equity is generally a different breed of cat, learning to adapt to a heavily regulated world foreign to them. Only time will tell how all these private equity deals will play out. Lastly, it's clear that high capital levels – i.e. 10% Tier 1 capital – will be expected by the regulators for dealmakers for the next 2-3 years.

Supply and Demand

I suppose in a nutshell, everything comes down to supply and demand. There is money out there waiting to be invested in either recapitalizing or buying banks and buyers are anxious to employ that capital and grow their franchises. As we have all seen and heard, there are a number of boards and management teams simply fatigued by the events of the past three years and discouraged by the prospects for small community banks going forward. This suggests a pick-up of whole bank M&A. While discussions continue, relatively little activity has occurred, especially in the West. So, when considering a deal, whether a merger/sale or recapitalization, it would be worthwhile to recognize how fragile deals are due to asset quality, expected premiums/returns or regulatory requirements, not to mention the all important human element. Indeed, these deals must be handled with special care if they are to be successfully completed.

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