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The Outlook for Bank M&A in 2012

Posted by Edward D. Herlihy, Wachtell, Lipton, Rosen & Katz, on Thursday February 16, 2012

Editor's Note: Edward Herlihy is a partner and co-chairman of the Executive Committee at Wachtell, Lipton, Rosen & Katz. This post is based on a Wachtell Lipton firm memorandum by Mr. Herlihy, Richard K. Kim, Lawrence S. Makow, Nicholas G. Demmo, David E. Shapiro, Matthew M. Guest, Patricia A. Robinson, and David M. Adlerstein.

This time last year appeared to hold the promise of increased deal activity, as a series of significant strategic deals were announced in the waning days of 2010 and fundamentals appeared to be aligned. That promise began to manifest itself in the opening months of the year, with several significant deals. As the year wore on, though, deal activity was dampened by several troubling environmental realities: an alarming sovereign debt and bank crisis in Europe, persistent U.S. monetary policy promising sustained low interest rates and a flat yield curve, a weak U.S. housing market and a tricky legal and regulatory landscape.

There were, though, some very bright spots. Leading the way were transformative deals by Comerica, Capital One and PNC. We also witnessed increasingly ambitious efforts by several stronger community banks to intelligently strengthen their franchises through successive smaller acquisitions in strategically important markets. Bank M&A in 2012 will likely remain episodic, as current ongoing business and regulatory conditions and weak equity market valuations will surely take more time to work through. Still, we should see a continued trend of stronger banks making selective, targeted acquisitions focused more on securing their long-term competitive positioning and maintaining balance sheet strength (and less on a short-term boost to quarterly earnings) as well as increasing pressure on smaller banks from several fronts to accept current valuations.

Crisis Conditions Moderated in the U.S., but Difficult Operating Climate Remains. While economic conditions facing banks have improved in some respects, a turnaround has not come as swiftly as many had hoped. Despite signs that the economy is improving, particular challenges remain for traditional banking businesses; the key has been to stabilize the institution based on current realities, build a platform to weather the storm and position the institution to best take advantage of an eventual recovery. Much of that stabilization has in recent years come through self-help. Banks underwent the painful, yet necessary, purging of bad assets, resulting in lower nonperforming rates and better and more stable balance sheet valuations. In some cases, this housecleaning was a necessary prerequisite to attracting outside capital, another area where institutions have taken aggressive steps that have promoted industry stabilization. Signs of this stabilization can been seen in the marked decrease in the number of bank failures — 92 in 2011, versus 158 in 2010 and 140 in 2009.

What became clear in 2011 was that the declining interest rate environment in the U.S. — initially a boon to banks through a lowered cost of liquidity and through fees from increased client refinancing activity— had become a persistent expectation for the future. The resulting flat yield curve has led to severe net interest margin erosion. At the same time, regulatory initiatives like the Durbin amendment and other Dodd-Frank programs negatively impacted fee income and increased operational costs. Equity valuations suffered as investors, already spooked by volatile economic conditions and legal uncertainty, began to question whether there was a new reality for the profitability of the traditional banking model. Potential bank consolidators found it more difficult to think offensively when the prospects for their existing franchise seemed diminished. For potential sellers of banks, memories of pre-crisis sales at integral multiples of book value made offers at or below book value hard to swallow. Even so, motivated and creative parties still found ways to do deals, often involving sophisticated approaches to contract terms. We expect they will continue to do so this year, as loan demand begins to stir and bankers steadily adapt their businesses to the new regulatory realities.

Deal Technology Remains Key to Successful Deals. A number of the deals announced in 2011 involved intricate pricing or risk allocation terms to bridge gaps between buyers and sellers during the often lengthy period between sign and close, but in other cases buyers opted for the competitive advantage of taking a more straightforward, traditional approach and performed the more rigorous pre-signing diligence necessary to support this strategy. Generally, a buyer that has been able to adequately gauge the risks in a deal is best served by pursuing a relatively straightforward transaction that will be well-understood and well received by interested constituencies, including regulators, investors, and target shareholders. Even where the basic pricing terms can be straightforward, however, in times of regulatory and economic uncertainty more than ever the other terms and conditions of the transaction agreement are fundamentally important and can make or break a deal. As always, buyers and sellers alike should pay careful attention to material adverse effect provisions and regulatory covenants and conditions. This will help ensure that a deal, once announced, is likely to be completed and that the parties can avoid unexpected surprises in what may be contractually required of them to get to the finish line.

Given the ever-increasing importance of capital parties should focus on potential capital actions required by the regulators or expected by the market post-signing and build into the contract appropriate terms to anticipate the need for these actions. A basic example: providing for the cooperation of the target in the buyer's capital raise. There may also be opportunities for buyers to obtain additional capital flexibility. For example, Capital One negotiated for the right in the HSBC transaction to deliver a significant portion of the consideration in the form of stock valued at signing rather than cash, if efforts at a subsequent capital raise would not generate net proceeds in excess of that signing value. In the process Capital One greatly enhanced certainty of completion and allowed market analysts at announcement to precisely bound their views of the deal's financial impact.

European Crisis Spawns Divestitures. Among the most significant developments affecting the global economy in 2011 were the severe economic difficulties faced by Europe and their impact on the financial sector. While the repercussions were felt most acutely by banks with direct European sovereign debt exposure, the potential enormous size of the exposure and widespread skepticism that European governments would find a comprehensive solution has, particularly in light of events such as MF Global, acted as an overhang for a much broader group of financial institutions.

A number of major European banks had already been engaged in divestiture programs in an effort to meet strict new capital requirements or repay state aid. With the deepening of the sovereign debt crisis and Europe's slide towards recession, these efforts were redoubled. A notable example was ING's efforts to sell non-core businesses to repay financial assistance provided earlier by the Dutch state, which resulted in Capital One agreeing to acquire ING Direct bank in the U.S. Other major European-based banks, including Anglo Irish, Deutsche Bank, HSBC and RBS either undertook or reportedly considered major divestitures in 2011. A sizable pipeline of these transactions remains. As the deadline to meet higher capital requirements approaches, continued divestiture activity by European banks is likely.

Not all European banks were sellers, and some European institutions, such as Banco Santander and BBVA, continue to look to the United States as a major part of their global strategy. Nor were all sellers European. Major 2011 transactions included RBC's agreement to sell its U.S. banking and credit card franchise to PNC.

Regulatory headwinds create challenges and opportunities. Lawmakers and bank regulators have impacted M&A in numerous ways. Initiatives like the CARD Act, the Durbin Amendment and the Volcker Rule have impacted non-interest income. Increasingly demanding capital and liquidity requirements have put additional pressure on banks. Indeed, uncertainty surrounding the amount and type of additional capital that regulators will require in the context of an acquisition has been an impediment to bank M&A. And, on January 9, 2012, the 31 largest banks were required to submit capital plans and stress test results to the Federal Reserve. It is likely that many of these banks will proceed somewhat cautiously on the M&A front until they feel comfortable about the outcome of their submissions. Regulators have further impacted bank M&A by rating banks more stringently and by requiring those with less than satisfactory ratings to, in effect, sit on the sidelines. Multiple enforcement actions on issues ranging from mortgage servicing to anti-money laundering have further put banks on the defensive. The regulatory process for deal approval has grown more complicated, with deals possibly implicating the need for systemic risk analysis and updated formal capital plans..

However, while the regulatory conditions for acquirors are difficult, they will also create opportunities by increasing pressure on some banks to divest businesses or to sell themselves. In order to take advantage, prospective sellers should focus on building regulatory support for transactions early in the process, well in advance of signing, through discussions with regulators about strategic plans and potential acquisitions. Active efforts to create positive trends in an institution's regulatory profile and engaging its regulators on strategic priorities and deal possibilities demonstrate earnest and long-term interest in improving relations and lay the groundwork for prompt regulatory consideration of a transaction. Indeed, in this environment, a key differentiating factor that sellers are actively diligencing and using to distinguish among buyers – perhaps as important as headline price – is the perceived ability of a buyer to promptly and smoothly obtain regulatory clearance.

Institutions are also well-served by having an active deal team that regularly reviews acquisition opportunities and is ready to move on short notice. Buyers with significant outstanding regulatory issues will often need a plan for addressing them as part of obtaining deal approval. Having in place a well organized team that is prepared to quickly and thoroughly address regulatory concerns, whether financial or legal, will be a key competitive advantage.

Capital Remains Key to all Strategic Initiatives. Capital remains king for both ordinary course operations and strategic initiatives. In recent years the quality of capital, in addition to the quantity, has become increasingly important. Many-post crisis transactions have demonstrated the importance of having abundant capital in the form of common equity. Deal activity has also demonstrated the risks of holding other types of capital, or of issuing capital in structured transactions.

As described in our earlier memorandum, trust preferred securities have been particularly difficult nuts to crack for sellers and acquirers in a number of transactions. In the case of BB&T's recently announced agreement to acquire BankAtlantic Bank, holders of trust preferred securities (supported by some of the TruPS trustees) have used the "fulcrum" position of their holdings to attempt to block the transaction. In other deals, including Ford Financial Fund's 2010 acquisition of Pacific Capital, the ownership structure of the Pacific Capital trust preferred securities, embedded in the murky depths of CDOs, rendered it effectively impossible to locate or negotiate with their beneficial owners, requiring the TruPS to be left in place.

Transactions like these or those that withered on the vine due to "hold up" issues embedded in target capital structures are stark reminders of the value of healthy skepticism when evaluating proposals to use complex securities to raise capital. There is no doubt that common equity can be an expensive form of capital. But among their many other advantages, simple equity securities such as common stock benefit from their relative clarity of ownership, limited and well-understood holder rights and well-developed custodial and administrative systems to facilitate trading. Reflecting the upside potential of the securities, the investor profile of common equity and debt securities is markedly different. These features make it easier to deal with common equity in the context of a transaction, including obtaining charter amendment or other shareholder approvals when there is a need.

Opportunities are great for disciplined, experienced acquirers. While reaching terms and executing a deal remains challenging, with lower prices come potentially greater long-term rewards for successful buyers. Now, more than ever, advance preparation to seize attractive deal opportunities is essential. It is no surprise that bank M&A activity in 2011 was concentrated in a very few strong institutions with longstanding commitments to active regulatory engagement and deeply experienced deal teams. Among the most notable transactions of the year were PNC's acquisition of RBC's U.S. banking and credit card franchises (which complemented its branch acquisitions from BankAtlantic and Flagstar) along with Capital One's acquisitions of ING Direct Bank in the U.S. and HSBC's U.S. credit card business. While sizable deals, these were not risky forays into new businesses, but rather measured expansions and fillins of existing businesses in which each firm was deeply experienced. Capital One and PNC each were optimally positioned to compete for and win these deals as a result of years of developing the institutional discipline and expertise to safely and soundly acquire and integrate large businesses.

Smaller institutions also pursued ambitious acquisitions in 2011. For example, SCBT Financial Corporation successfully executed two assisted deals and one significant open bank deal, and NBH Holdings completed two of the larger assisted transactions of the year, through each institution's constant executive management and board-level engagement in the acquisition process and prompt and effective integration of their prior deals. The landscape for medium-sized and smaller institutions is likely to be revamped dramatically over the next several years, and today's successful acquirors are showing the way.

The opportunities in 2012 are likely to be numerous. Larger institutions addressing capital requirements and other regulatory concerns will continue to divest non-core businesses. Dispositions by European banks at the behest of their regulators will likely continue. In the U.S., there remain a few hundred small banks that have not yet redeemed their TARP preferred stock; many of them have little apparent prospect of paying or raising common stock dividends. In many cases these banks are also privately held or thinly traded, so there is little liquidity for the common stock. The Treasury Department recently sent issuers with outstanding TARP preferred stock a letter pointedly encouraging consideration of strategic processes. While many prospective acquirors remain on the sidelines, there are some carefully surveying the landscape and readying themselves to take advantage of opportunities that will inevitably arise unexpectedly. Regardless of the source of the opportunity, those institutions who can see beyond the current challenging conditions will continue to find rewarding strategic possibilities.