

# Breakout III: How Banks Should Make the Decision to Buy or Sell

#A0BA23

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# How Banks Should Make the Decision to Buy or Sell

Acquire or Be Acquired Conference

Phoenix, Arizona

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# Joshua McNulty



## PRACTICES

Banking and Finance  
Consumer Financial Compliance and Litigation  
Financial Institutions Corporate and Regulatory

## CONTACT

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## EDUCATION

JD, Loyola University Chicago School of Law, 2010  
BA, University of Arizona, 2007

## BAR ADMISSIONS

Texas

Josh's practice primarily focuses on regulatory compliance, mergers and acquisitions, and securities law matters for financial institutions.

Josh's practice focuses on corporate governance, mergers and acquisitions, securities, and regulatory representation for state and national banks, holding companies, and other financial institutions. Josh counsels state and national banks, holding companies and other financial institutions on state and federal regulatory compliance issues, including all aspects of regulatory matters involving the Federal Deposit Insurance Corporation, the Federal Reserve, the Office of the Comptroller of the Currency, the Texas Department of Banking and the Consumer Financial Protection Bureau. He also advises clients on corporate governance, stockholder matters, shareholder agreements, fiduciary obligations and a broad range of public and private capital market transactions, including initial public offerings and private placements.

## Relevant Experience

- Represented Pioneer Bancshares, Inc. in its sale to FirstSun Capital Bancorp
- Represented Friendswood Capital Corporation in its sale to Home Bancorp, Inc. for an aggregate deal value of \$66.5 million
- Represented Texas Citizens Bancorp, Inc. in its sale to Business First Bancshares, Inc.
- Represented a community bank in purchase of a factoring company
- Represented a national bank in the creation of an Opportunity Zone Fund
- Represented Allegiance Bancshares, Inc. in its acquisition of Post Oak Bancshares, Inc.
- Represented Woodforest National Bank in the sale of its asset-based and equipment finance lending businesses, including \$495 million loan portfolio, to Sterling National Bank
- Represented issuers and investment bankers in numerous financial institution capital transactions (public and private)
- Represented Allegiance Bancshares, Inc. in its merger of equals with CBTX, Inc. (forming Stellar Bancorp, Inc.)"

# Beth Whitaker



## PRACTICES

Banking and Finance

Financial Institutions Corporate and  
Regulatory

Mergers and Acquisitions

Corporate

Capital Markets and Securities

Environmental, Social and Governance  
(ESG)

## CONTACT

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## EDUCATION

JD, Charleston School of Law, cum laude,

Chief Justice, Moot Court Board, 2008

BA, International Studies and Spanish, Elon

University, magna cum laude, 2004

## BAR ADMISSIONS

Texas

Beth’s practice focuses on corporate transactions and securities and regulatory representation of commercial banks, holding companies, credit unions and other financial institutions, including mergers and acquisitions, joint ventures, and corporate finance transactions. Beth advises clients on structuring and raising capital through public and private debt and equity offerings, including eight IPOs. She also advises publicly traded clients on securities law compliance and reporting obligations. Beth further advises clients on corporate governance and shareholder matters, including share repurchases and tender offers, as well as succession planning.

## Relevant Experience

- Represented BankFirst Capital Corporation in its acquisition of Mechanics Banc Holding Company and Tate Financial Corporation (both in 2022)
- Represented Spirit of Texas Bancshares, Inc. in its sale to Simmons First National Corporation (2021)
- Served as underwriters’ counsel in initial public offering of FinWise Bancorp (2021)
- Served as underwriters’ counsel in initial public offering of CrossFirst Bankshares, Inc. (2019)
- Represented Spirit of Texas Bancshares, Inc. in its acquisition of three separate Texas banks (2018 – 2019)
- Represented Tectonic Financial, Inc. in initial public offering (2019)
- Represented Trinity Capital Corporation in its sale to Enterprise Financial Services Corp (2019)

## Events

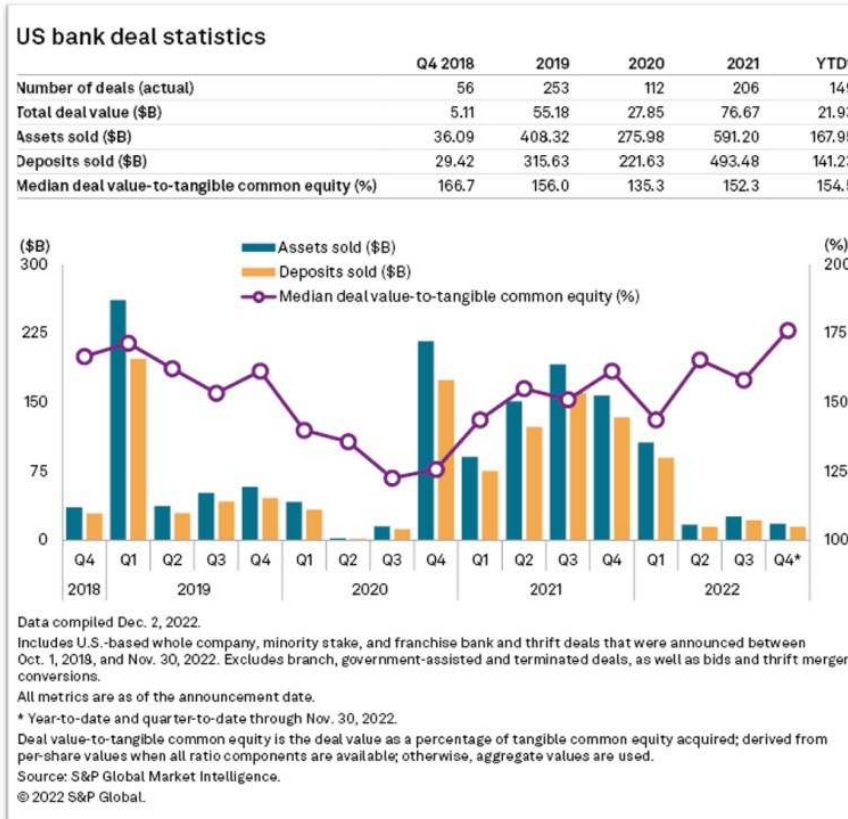
- “How Banks Should Make the Decision to Buy or Sell,” BankDirector – Bank Board Training Forum, Nashville, TN, September 2022
- “How to Grow and Keep on Growing,” BankDirector – Acquire or be Acquired, Phoenix, AZ, January 2022
- “What Banks Need To Do and/or Change to Continue Growing,” Bank Director –Acquire or Be Acquired, Phoenix, Arizona, January 2020
- “Planning for Asset Growth: What To Do At Each Ledge of Asset Size,” Bank Director –Acquire or Be Acquired, Phoenix, Arizona, January 2019
- “How Things Change: Considerations for Different Asset Thresholds,” Bank Director –Acquire or Be Acquired, Phoenix, Arizona, January 2018
- “Capital Planning and M&A Update,” South Carolina Bankers Association – CFO Conference, Columbia, South Carolina, September 2017
- “Capital Planning for Community Banks: All Regulatory Roads Lead to Your Capital Plan,” Oregon Bankers Association – Finance & Accounting Conference, Portland, Oregon, March 2017
- “Capital and Management,” South Carolina Bankers Association - Safety & Soundness Conference, Columbia, South Carolina, February 2017

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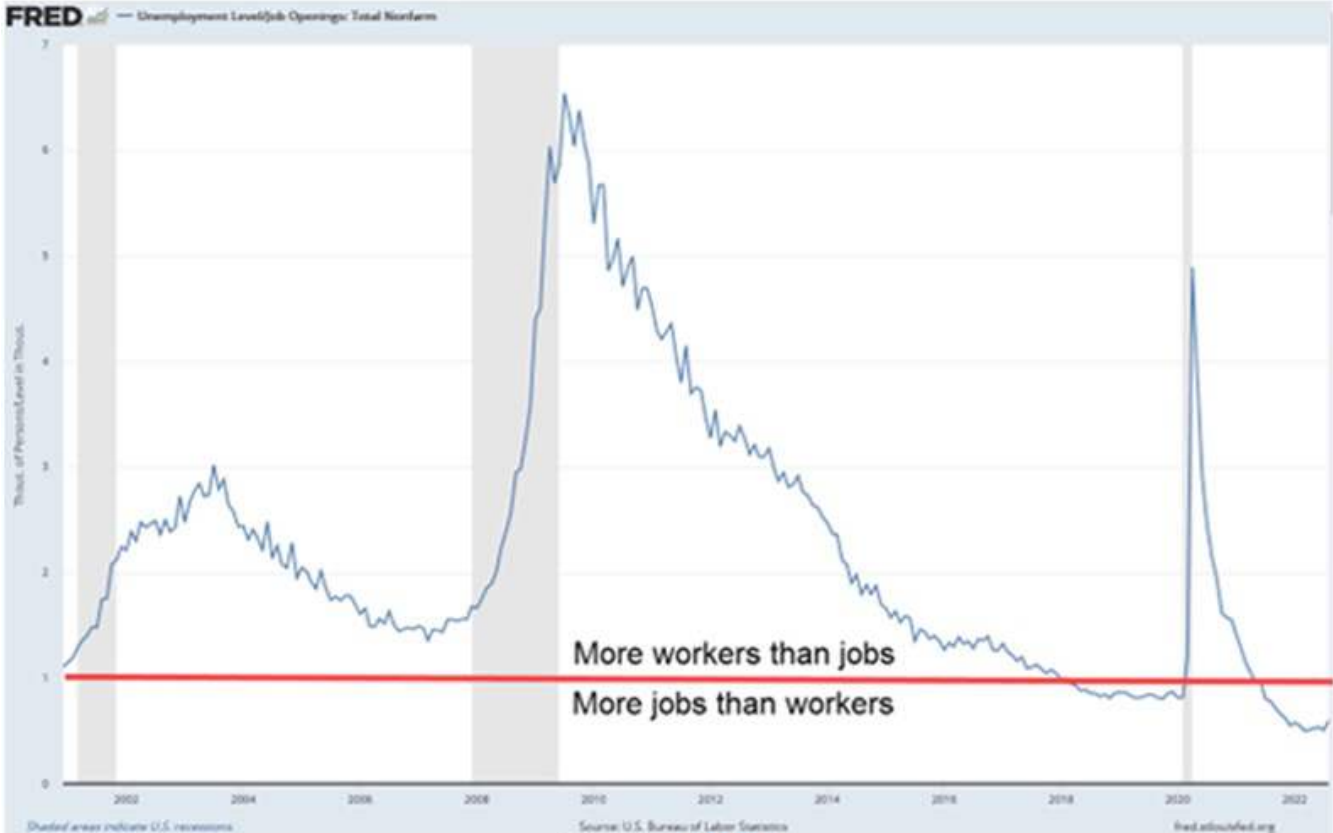
# **Where Are We Now?**

## **The Economy, Interest Rates and M&A**

# Deal Stats – Through November 30, 2022



# Labor Force

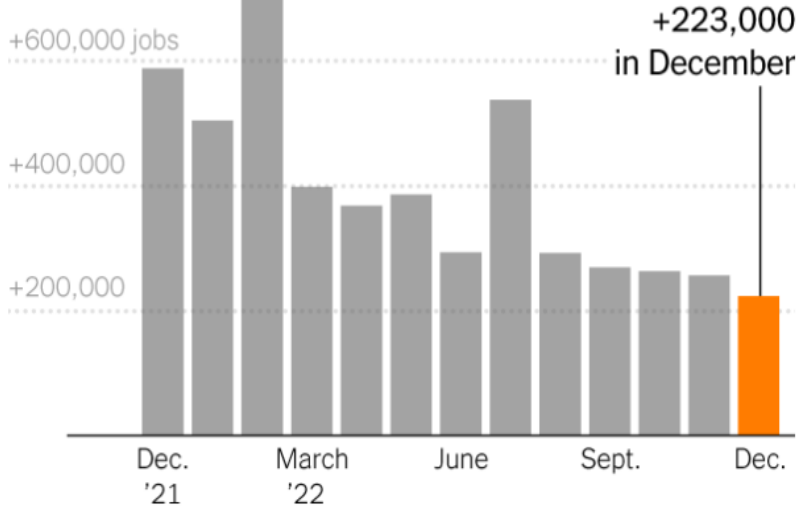


Source: *FRED*

# Labor Force

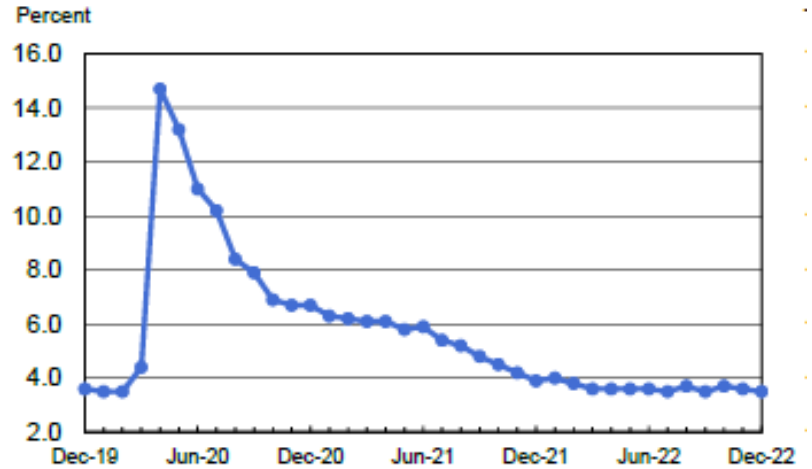
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### Monthly change in jobs



Source: NYTimes

### Chart 1. Unemployment rate, seasonally adjusted, December 2019 – December 2022



Source: US Bureau of Labor Statistics



# 2022 Monthly Inflation Rates

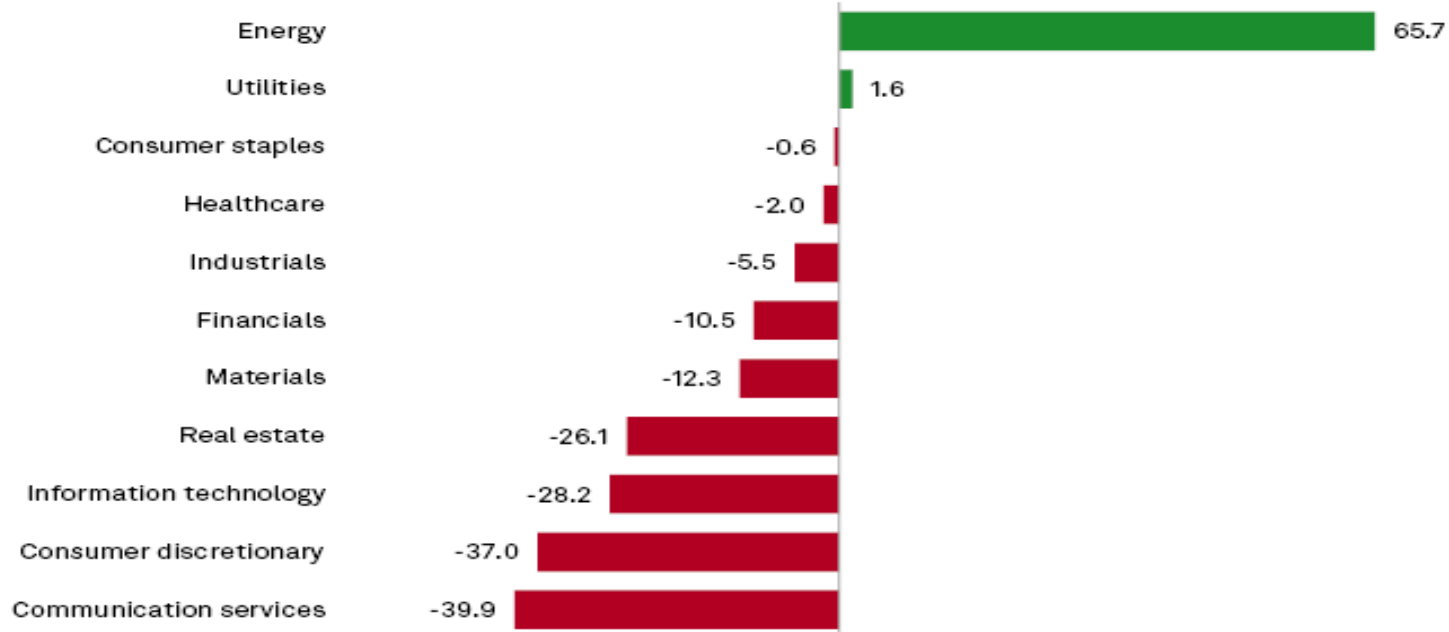
Month	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sept	Oct	Nov
Rate	7.5%	7.9%	8.5%	8.3%	8.6%	9.1%	8.5%	8.3%	8.2%	7.7%	7.1%

U.S. Bureau of Labor Statistics

- The core rate excludes volatile energy and food prices. It rose from 5.9% to 6.6% in September as rents jumped, along with other goods and services.
- But overall, inflation is easing, although modestly.

# Nearly every S&P 500 sector has lost considerable ground in 2022 (%)

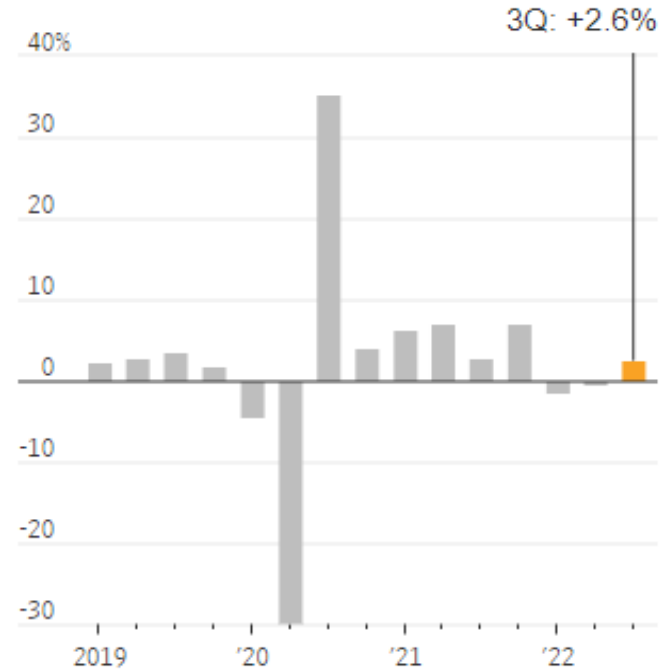
S&P 500 sector indexes 2022 total return (%)



Data compiled Jan. 3, 2023.  
Represents the total return from Dec. 31, 2021, to Dec. 30, 2022.  
Source: S&P Global Market Intelligence.  
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# Beginning of The Recession?

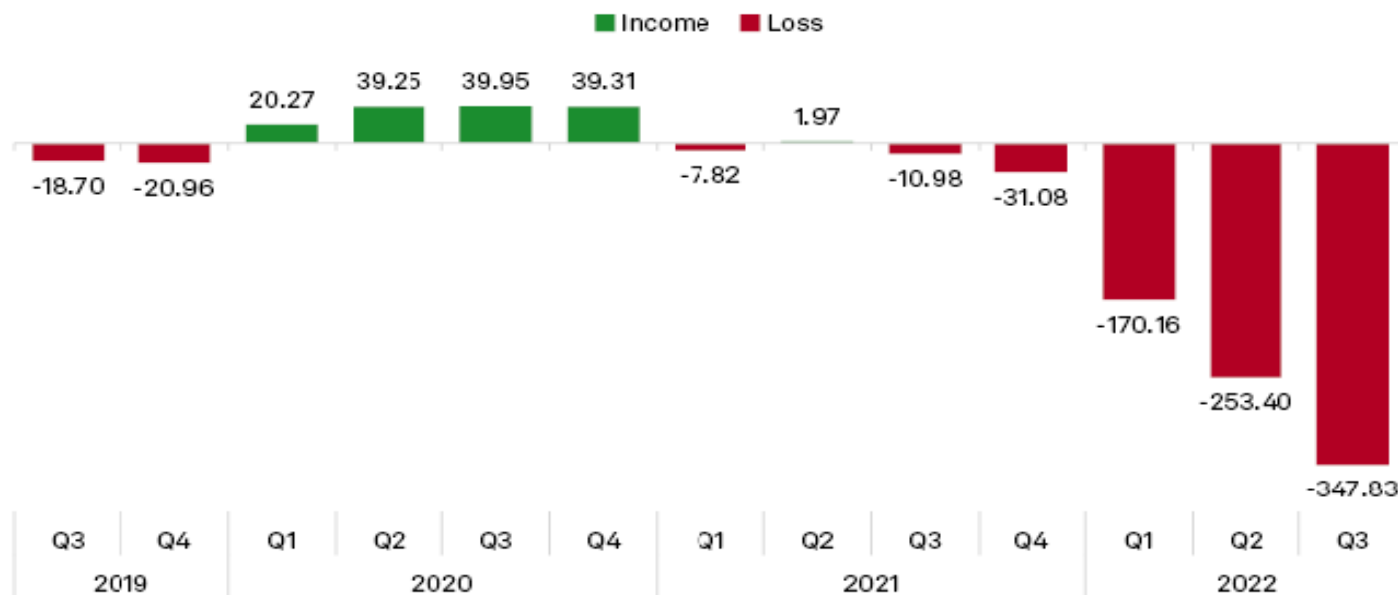
Bank Investors are worried that credit quality could soon falter in part because the GDP was negative for two consecutive quarters.



Seasonally adjusted at annual rates\*  
Source: Commerce Department

# AOCI Impact on M&A

Total accumulated other comprehensive income at US banks (\$B)



Data compiled Nov. 29, 2022.

Analysis includes U.S. commercial banks, savings banks, and savings and loan associations; excludes nondepository trusts and companies with a foreign banking organization charter.

Data based on regulatory filings.

Source: S&P Global Market Intelligence.

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# Impact of AOCL on M&A

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- All securities reported at fair value at acquisition.
- AOCL of seller is removed upon acquisition.
- Unrealized losses (gains) for all securities – transfer to the buyer as a discount (premium)
- Discount (premium) accreted into income using the effective interest method

# Impact of AOCL on M&A

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## Positive Considerations:

- Discount will increase future income
- Effective interest rate results in yields consistent with current market rates at acquisition

## Negative Considerations:

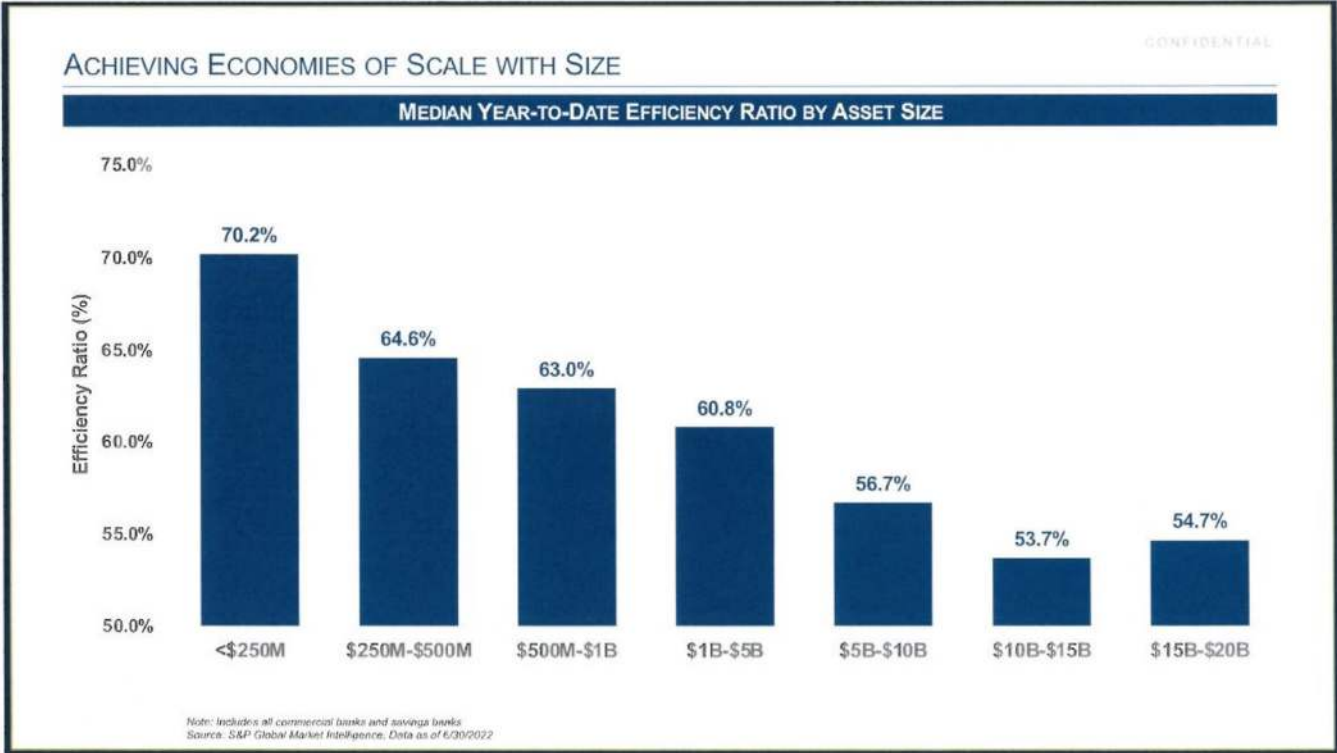
- Increases goodwill (if purchase price is not adjusted)
- Temporary hit to tangible capital
  - Temporary hit is removed through discount accretion over life of portfolio
- Current double count on loans (mark down + allowance)

# So Why M&A for Buyers?

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- Asset quality has stayed pristine
- NIMs bottomed out
- Scale and Efficiency – overall costs keep increasing, especially labor and energy
- Loan demand is up (other than mortgages), but nonbank lending competition remains
- Absent M&A, many public banks will not be able to grow earnings 5%+
- Geographic expansion/diversity

# Achieving Economies of Scale With Size





# So Why M&A for Sellers?

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- PPP, mortgage volume and ALLL reversals made 2021 an earnings aberration
- Loan demand is up, other than mortgages
- Cost-cutting has reached its limits and is reversing; sellers have 10%+ higher efficiency ratios than buyers
- Tax “windfall” is reversing
- Regulatory pressure
- Coming decline in quality buyers?
- Management succession
- Excess liquidity has dissipated

# Expectations for 2023

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- Stock repurchase programs become more aggressive
- AOCI marks will dissuade some would be sellers
- Pace of M&A to pick up; pent-up demand
- M&A pricing starting to recover with third quarter stock market recovery
- Buyers continue to increase expected cost savings (35% in 2019-2021)
- Increase in MOEs/strategic combinations, especially of < \$500mm banks
- Investor groups buy small banks in lieu of forming de novos
- CIC/composition programs continue to reflect consolidation with more reflecting best practices
- Shareholder activism

# Shareholder Email

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Having given much thought to our conference call and having discussed it at length with my other fellow shareholders, unfortunately I must tell you that I/we can simply not concur with your confidence that you can, after all these many years, turn the bank around to be awarded a stock valuation that would anywhere near approach the value received in a merger with another larger community bank in the near term. We have simply been given nothing on which to make any other rational decision. Thus, in the spirit of open communication, I have to tell you that I/we are going to have to take a more aggressive stance as major shareholders and it is our hope that we can do so in working together with you for the good of all shareholders.

# Shareholder Letters

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This letter is a follow-up to our original letter in which we advocated exploring the Company's strategic options in light of the relatively opportune market conditions for a sale of the Company.

Thank you for your \_\_\_\_\_ letter in response. In the letter you state that "carrying out the Bank's standalone strategic plan, which includes seeking growth organically and potentially through acquisitions, will result in continued strong returns on equity and will maximize shareholder value over the long-term."

Our issue is not with management's respectable, current profitability, but with the value of the shares over the medium-to-long term. Buying smaller banks with our deflated currency is not in the best interest of shareholders and growing to \$1 billion in assets – an often-stated goal – is also not an astute strategy. We feel the Board has not fully explored what the franchise is worth by discussing strategic options with potential buyers.

If these buyers were to express that the Company is not worth more than its current trading value on the open market, then a Board decision to stay the course would seem logical. However, if buyers were to offer a higher valuation to \_\_\_\_\_ shareholders, then we feel it is the Board's fiduciary duty to represent this value to outside shareholders, or to pay outside shareholders a commensurate price and run the Company privately.

We continue to believe that the Company's worth to an acquirer is \_\_\_\_\_ to \_\_\_\_\_ tangible book value per share – up to \_\_\_\_\_ per share, or \_\_\_\_\_ higher than where the shares trade now. The two most acquisitive banks in the \_\_\_\_\_ space, \_\_\_\_\_ and \_\_\_\_\_, continue to trade at premiums to the rest of the sector.

Our goal is not to nominate an outside slate of directors, as we are hopeful the current Board will act in shareholders' best interests. However, we retain the right to explore all alternatives. Since our original letter, we have been contacted by a number of like-minded outside shareholders, who believe that the Board should unlock shareholder value through genuine engagement with potential buyers of the Company.

[cont.]

# What To Do?

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- Aggressive stock buybacks
- Retain structural defenses (or consider adding to them)
- Consider amending the bylaws to:
  - Eliminate removal of directors by shareholders without cause
  - Eliminate shareholder action by consent
  - Extend advance notice to make proposals and structure
  - Extend advance notice to nominate directors
  - Require director nominee disclosure
  - Institute director qualifications (third-party compensation)
  - Adopt exclusive forum for shareholder class action
  - Provide structure around proxy access, shareholder meetings, etc.

# What To Do?

(cont'd)

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Consider amending articles/certificates:

- Shareholder percentage to call meeting
- Staggered board
- Super majority voting
- Fair price provision
- Drag/tag agreements and ROFO agreements
- ESOP

# Timing

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- When should banks consider selling?  
vs.
- When do banks consider selling?
- Do not start the process just to see what the bank may be worth
- Risks to employees / customers / shareholders of the consideration of a sale
- Role of the strategic plan

# Unsolicited Offers

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Directors have no absolute legal duty to:

- Explore a proposal to buy the bank,
- Meet with, discuss or negotiate a bid, or
- Submit a bid to shareholders, even if the bid is a premium to market.



# Strategic Plan

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Decision to “just say no” is a fiduciary decision. It must be:

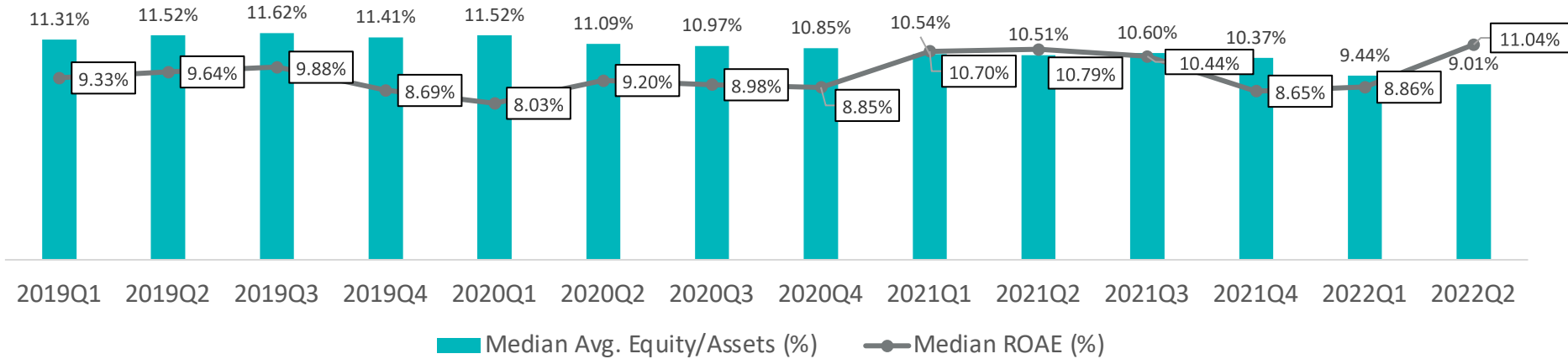
- Well informed
- Based on strategic plan
- Supported by projections

Key to strategic plan:

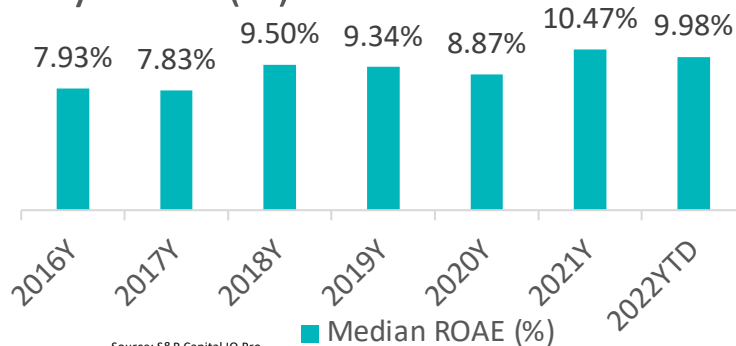
- Plan should consider short- and long-term interests
- Analyze the data (historical and prospective)
- True road map for asset and earnings growth based on reasonable assumptions
- Risk appetite
- Subchapter S
- Assistance from investment banker?

# Community Bank Return on Average Equity

## Quarterly ROAE (%)



## Yearly ROAE (%)



- Median values are derived from a nationwide population of regulated depositories with total assets under \$10.0B in the respective time period shown
- As of Q2'22, there are 4,979 regulated depositories with assets under \$10.0B

Source: S&P Capital IQ Pro  
Top Tier Consolidated Bank Holding Companies, Savings & Loan Companies, Commercial Banks, Savings Banks, and Savings & Loan Associations with total Assets < \$10B in the respective time period shown.

# Strategic Plan

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*What to do?*

- Nothing – we already chin the bar on 8.0% ROAE
- Nothing – when we clean up our problems, we will chin the bar
- Nothing – we are Subchapter S and we are clipping our coupons
- Take action to invest in the future because we are not generating a 8.0% ROAE

# Preparing to be a Seller

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- Consider time horizon
  - 1, 2 and 3 year steps, e.g., stock buybacks; ESOPs
- Employee agreements, severance, etc.
  - What is in place gets paid
- Run 280(g) calculations/valuations
- Facilitate exercise of stock options and warrants
- Address Articles and Bylaws
  - Indemnification
  - Exculpation
- If Subchapter S, confirm no inadvertent ownership issues

# Preparing to be a Seller

(cont'd)

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- “Fatten the hen”
- “Clean the cupboard”:
  - Clean up credit files and identify and work problem loans
  - Sell OREO
  - Manage portfolio to avoid risk
- Avoid capital investments and branching
- Address overstaffing
- Address compliance issues
- Address director confidentiality
- Care in selecting investment bankers

# Seller Steps in an M&A Transaction

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- Establish a special committee?
- Hire an investment banker?
- Negotiate one-on-one with limited group of prospective bidders or auction?
- Nondisclosure agreement/maybe marketing materials/limited data room
- Merger consideration composition and valuation
- Expression of interest or letter of intent
- Due diligence – more robust – fill the data room

# Investment Banker

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## Benefits for the seller:

- Sets pricing expectation at outset
- Enhances compliance with diligence
- Fiduciary duty: valuation before marketing
- Increases pricing
- Expertise in selling process
- Negotiates all economic terms – not just price
- Preserves confidentiality
- Provides fairness opinion

# How to Pick an Investment Banker

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- Negotiate investment banker agreements
- Insist on valuation before marketing effort
- Structure pricing to align investment banker compensation with seller's interests



# Evaluating the Dance Partners

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For potential sellers:

- Existing management/KSOP/community
- MOE – understand role of investment banker
- One-on-one negotiations
- Limited “auction”
- Full auction
- Pre-qualify buyers to confirm:
  - Sufficient pro forma capital to “write the check”
  - Asset quality and liquidity ratios are consistent with approval
  - No outstanding compliance issues
  - No competitive effects

# Preparing to be a Buyer

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What purchasers should do to prepare for acquisition?

- BaaS
- Branching (de novo or P&A)
- Organic growth / digital
- Deposit strategies
- “Lift outs”
- Mortgage, leasing, factoring, consumer and SBA

# For Potential Buyers – What To Do?

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- Strategic plan/M&A roadmap – rural rollup, fill in and adjacent markets, stock buyer, etc.
- Apprise team and regulators
- Board buy-in
- Capital plan
- Is your house “clean”?
  - Asset quality
  - Pro forma capital and concentration ratios
  - Compliance/BSA/ Fair Lending
- Consider the bank’s “compensation stack”
- Conducive culture

# For Potential Buyers – What To Do?

(cont'd)

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- Does the bank's name travel?
- Team in place, especially diligence and integration
- Free up talent for evaluations
- Stock authorized?
- Look for strategic fit
- Identify candidates
- Network
- Consider a financial advisor to assist in evaluations
- Understand value of buyer stock
- NDAs may lay dormant like shingles

# Recent Buyer Issues

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- Fluctuating bond portfolios / AOCI
- Fixed rate loan portfolios and deposit penalties for early withdrawals
- Deposit decay
- NSF fees and other fee differences between the parties
- Subchapter S – tax benefits/inadvertent termination
- “Adjusted shareholders’ equity”
- Blanket bond
- Bonus/retention pool/agreements
- Cost savings vs. needed investments – McKinsey
- Vendor contracts – understanding beyond termination fees
- Regulatory delays

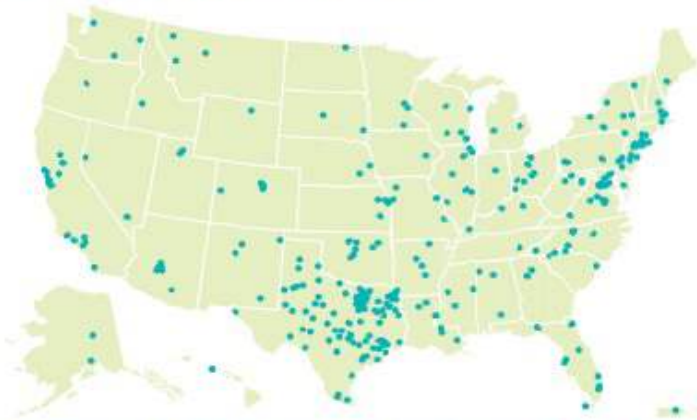
# Integration

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- Well-thought-out internal and external PR and outreach
- Written integration plan
- Functioning integration committees
- Change management plan for target/culture
- Systems conversion should not “wag the dog”

# Our National Reach

Represented banks in all 50 states and Puerto Rico.



Hunton Andrews Kurth is consistently ranked at the top of national league tables based on number of deals for banks.

### S&P Global

**#1**  
MERGERS & ACQUISITIONS IN  
SOUTHWEST AND MIDWEST  
2021  
CAPITAL MARKETS  
OFFERINGS IN TEXAS  
2017-2021

**#3**  
MERGERS & ACQUISITIONS  
NATIONWIDE  
2012-2021

**#4**  
CAPITAL MARKETS  
TRANSACTIONS NATIONWIDE  
AS UNDERWRITERS' COUNSEL  
2021

**#5**  
MERGERS & ACQUISITIONS  
NATIONWIDE  
2021

**#6**  
CAPITAL MARKETS  
TRANSACTIONS NATIONWIDE  
AS ISSUERS' COUNSEL  
2021

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