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Fewer, but bigger, banks go upside-down on their currency to land deals

By Kiah Lau Haslett and Venkatesh Iyer July 25, 2018

Bucking broader pricing trends, big-bank buyers are increasingly stretching on their valuations to announce deals.

The bank M&A environment overall has improved for acquirers as the gap between buyers' valuations and offers for sellers has grown this year, but the math has still proved challenging for larger deals. The market is hoping that recent regulatory reforms could lead to more big-ticket transactions, but deals with values in excess of $1 billion have increasingly featured what some call "upside-down" pricing.

Upside-down deal pricing occurs when a buyer values a seller above where its own stock trades on a price-to-tangible-book basis, resulting in a negative pricing gap. Between

Upside-down US bank deals since 2016 with largest negative pricing gap

			At announcement				
Buyer (ticker)	Target (ticker)	Announcement date	Deal value ($M)	Pricing gap (pps)	Buyer P/TBV one day prior (%)	Deal value/ TCE (%)	As reported TBV earnback (years)
Meta Financial Group Inc. (CASH)	Crestmark Bancorp Inc.	01/09/18	321.2	-94.0	310.0	404.0	2.2
Fifth Third Bancorp (FITB)	MB Financial Inc. (MBFI)	05/21/18	4,604.8	-84.7	186.0	270.7	6.8
BOK Financial Corp. (BOKF)	CoBiz Financial Inc. (COBZ)	06/18/18	978.3	-67.7	221.0	288.7	5.8
Mechanics Bank (MCHB)	California Republic Bancorp	04/28/16	330.2	-43.6	149.7	193.3	NA
TriCo Bancshares (TCBK)	FNB Bancorp	12/11/17	324.0	-41.3	218.6	259.9	4.7
Sandy Spring Bancorp Inc. (SASR)	WashingtonFirst Bankshares Inc.	05/16/17	499.8	-38.1	223.3	261.3	3.8
Huntington Bancshares Inc. (HBAN)	FirstMerit Corp.	01/26/16	3,371.3	-36.1	127.7	163.8	5.5
Bar Harbor Bankshares (BHB)	Lake Sunapee Bank Group	05/05/16	145.6	-30.4	133.8	164.2	4.0
Valley National Bancorp (VLY)	USAmeriBancorp Inc.	07/26/17	852.1	-28.5	208.2	236.7	4.7
Heartland Financial USA Inc. (HTLF)	First Bank Lubbock Bancshares Inc.	12/12/17	185.6	-27.2	212.4	239.6	3.6
F.N.B. Corp. (FNB)	Yadkin Financial Corp.	07/21/16	1,486.8	-24.5	207.6	232.1	4.5
People's United Financial Inc. (PBCT)	Suffolk Bancorp	06/27/16	402.7	-23.4	172.6	196.0	< 5
Columbia Banking System Inc. (COLB)	Pacific Continental Corp.	01/09/17	660.9	-22.1	294.8	316.9	3.7
Allegiance Bancshares Inc. (ABTX)	Post Oak Bancshares Inc.	04/30/18	349.9	-22.0	201.4	223.3	4.8
Byline Bancorp Inc. (BY)	First Evanston Bancorp Inc.	11/27/17	169.0	-20.3	152.3	172.6	3.3
BancorpSouth Bank (BXS)	Icon Capital Corp.	04/18/18	145.8	-16.5	201.4	217.8	< 3.5
Guaranty Bancorp (GBNK)	Home State Bancorp	03/16/16	133.7	-14.3	151.5	165.8	4.4
Renasant Corp. (RNST)	Brand Group Holdings Inc.	03/28/18	476.3	-14.0	233.6	247.7	< 3
Old National Bancorp (ONB)	Klein Financial Inc.	06/21/18	433.8	-13.0	222.7	235.8	3.5
First Financial Bancorp. (FFBC)	MainSource Financial Group Inc.	07/25/17	1,005.6	-9.1	257.3	266.4	3.0
Top 100 deal median				**23.4**	**222.7**	**194.3**	

Data compiled July 13, 2018.
Analysis includes top 100 whole-company U.S. bank deals by deal value announced since Jan. 1, 2016. Excludes terminated, government-assisted, asset and branch deals, as well as merger conversions.
Upside down = announced deal value/TCE > buyer P/TBV one day before deal announcement
Pricing gap = buyer P/TBV one day before deal announcement - announced deal value/TCE
Buyer P/TBV = buyer price to tangible book value one day before deal announcement
Deal value/TCE = deal value as a percentage of tangible common equity acquired; derived from per share values when all ratio components are available, otherwise aggregate values are used
Tickers excluded for historical targets.
TBV = tangible book value; TCE = tangible common equity; NA = not available
Source: S&P Global Market Intelligence

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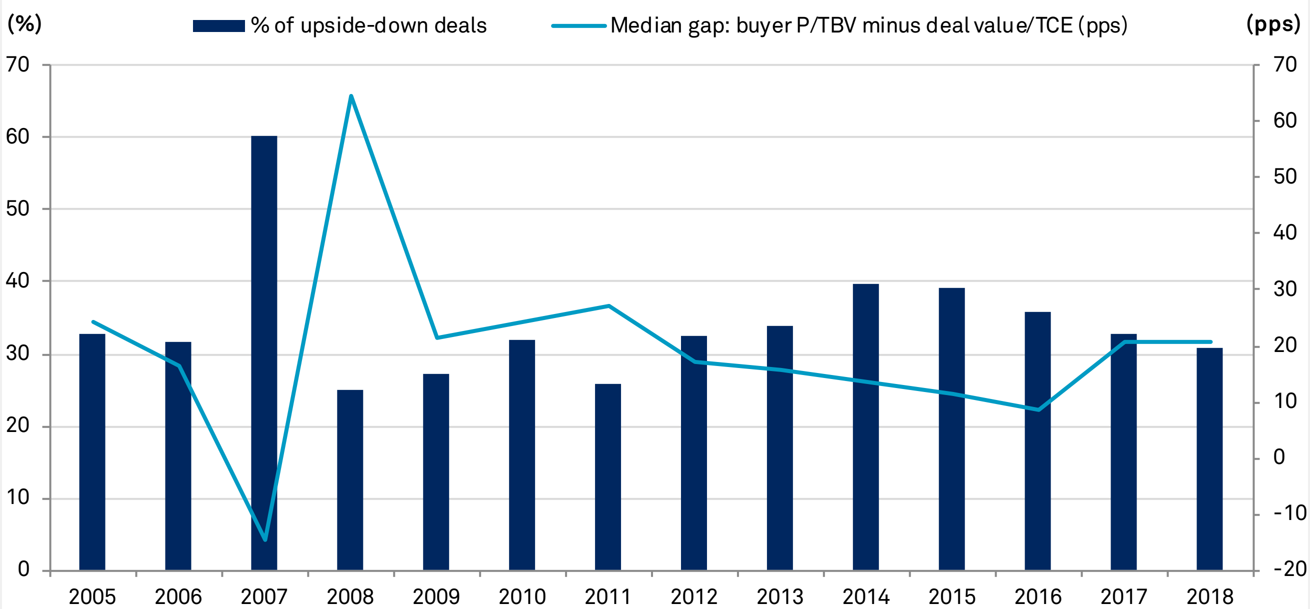
Upside-down US bank deals since 2005



Data compiled July 13, 2018.
Analysis includes whole company deals for U.S. banks and thrifts announced since Jan. 1, 2005. Excludes terminated, government-assisted, asset and branch deals, as well as merger conversions.
Only deals with both buyer P/TBV and deal value/TCE available are included.
Upside down = announced deal value/TCE > buyer P/TBV one day before deal announcement
Buyer P/TBV = buyer price to tangible book value one day before deal announcement
Deal value/TCE = deal value as a percentage of tangible common equity acquired; derived from per share values when all ratio components are available, otherwise aggregate values are used
TBV = tangible book value: TCE = tangible common equity
Source: S&P Global Market Intelligence

2010 and 2015, one-third of deals with price tags that were more than $1 billion featured an upside-down valuation. Between 2016 and 2018, that figure increased to 55%.

This trend in big-bank deals has moved counter to broader M&A activity. In general, deals with negative pricing gaps at announcement have been on the decline as bank stock valuations increased following the election of President Donald Trump. About 31% of deals announced year-to-date in 2018 have featured upside-down pricing, down from last year's 33% and well below the 36% in 2016. The median pricing gap between buyer's currency and seller's offer went from 20.9 percentage points last year to 20.7 percentage points year-to-date.

Upside-down deals could be a consequence of richer deal valuations, which can then increase tangible book value dilution and the time it takes to earn it back, said Rick Weiss, chief bank strategist at Ambassador Financial Group. But larger banks with lower valuations may find it easier to buy a seller of size and pay up to quickly gain scale.

This year has seen several examples of that, the largest being Fifth Third Bancorp's announced acquisition of MB Financial Inc. for $4.6 billion. The deal valued MB Financial at 270.7% of tangible common equity, which was 84.7 percentage points higher than Fifth Third's own ratio the day before the announcement. The acquisition carried 7.7% dilution to tangible book value and excluded restructuring charges; it carries a reported earnback period of 6.8 years.

Another reason a deal could feature upside-down pricing is that buyers with lower currency valuations are willing to take that hit because executives see it as a more-attractive avenue for capital distribution. Piper Jaffray analysts found that in six recent "notable" deals, the announced acquisitions had a shorter earnback period compared to a hypothetical share buyback, according to June 29 note.

The report showed that even as earnback periods are increasing, the amount of time it would take one of these buyers to do a similar-sized share buyback was slightly more than 10 years. That excludes any strategic rationale a bank may give for doing a deal, including accelerated earnings growth, geographic footprint or attractive funding sources.

"Perhaps it'll change once the deals have closed and we see how they go, but my interpretation is that the initial market reaction may be too punitive on these buyers," said Piper Jaffray senior research analyst Brett Rabatin.

Concern over potential pricing may be one reason why BB&T Corp.'s stock price dropped almost 5% after executives discussed the bank's ambitions to ink a deal for a bank with $30 billion in assets. Large deals have been met with investor disapprobation over long dilution periods, which often accompanies an upside-down valuation.

Curtis Carpenter, principal and head of investment banking at Sheshunoff & Co., said that upside-down deals can still work if earnings per share accretion and enhanced profitability keeps dilution within an acceptable time frame.

"The math can still work even though it's upside-down in terms of the pricing," he said. "We have become so accustomed to seeing these deals that are overwhelmingly in favor of publicly traded buyers that it makes you raise your eyebrows when you see when it goes the other way."

Indeed, some deals with the greatest negative pricing gaps since 2016 reported manageable tangible book value dilution. However, several upside-down transactions announced in 2018 also recorded high amounts of dilution and extended earnback periods, which can often motivate investors to sell-off the stock.

Weiss said one counterweight to offset the impact of upside-down pricing is the relative difference in size between buyers and sellers. Large acquirers with relatively lower values can manage the dilution that can come from an upside-down deal with a smaller company that has a higher book value.

"One CEO once told me, 'We paid a lot for their equity, but they didn't have that much equity,'" he said.

But buyers risk a sell-off if they stretch on dilution and go outside the 5% tangible book value dilution that investors generally seem to approve of, and that can make future deals more expensive, said Compass Point analyst Laurie Havener Hunsicker, who has called out upside-down deal pricing in her weekly M&A reports and popularized the term.

"If you're going to be a serial buyer and you're going to do dilutive deals, chances are that your currency will weaken off of where it could've been," Havener Hunsicker said.