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Recent Bank Mergers and Market Reactions

Well-Conceived Bank Mergers Should Not Be Unduly Discouraged by "Day-One" Market Reactions

There has recently been a pick-up in bank merger and acquisition activity that likely reflects both the increased importance of scale in the banking industry, particularly in the technology area, and regulatory and legislative developments that reduce certain obstacles to approval of bank merger transactions. Nonetheless, the immediate negative market reaction that has greeted the announcement of several recent mergers may discourage other banks from considering sensible consolidation transactions. Not only purchasers, but sellers, may be reluctant to engage in transactions, notwithstanding their strong business and financial merits, if concerns over the "day-one" market reaction play an outsized role in strategic considerations.

This pattern of market reaction may seem surprising because these recently announced transactions appear to have convincing business rationales. Also, these transactions do not have certain hallmark negative aspects that led to criticism of past bank mergers. The recent transactions generally offer meaningful accretion and high internal rates of return, and do not rely on aggressive synergy assumptions. The premiums are significant, but below premium levels reached prior to the 2008 Financial Crisis.

A principal reason asserted by those who criticize some recent transactions appears to be the tangible book value ("TBV") per share dilution and related "earn-back" period (an issue rarely cited pre-Financial Crisis when investors focused on earnings impact). From our perspective, this criticism seems both to underweight more important financial metrics – earnings accretion, return on equity accretion and internal rates of return – and to fail to appreciate that many banks are building capital faster than the regulators will permit capital to be returned through dividends and stock repurchases. Although the argument is made that excess capital can be more safely returned to shareholders by an increased stock repurchase program, that argument is not only limited by regulatory considerations, but can only be analyzed appropriately by comparing all the relevant financial metrics of a merger and a stock repurchase program. In particular, a stock repurchase program generally has its own TBV dilution, but without the enhanced earnings provided by a merger to shorten the payback period.

We believe that these recent market reactions should not discourage bank mergers that are well-conceived from a business and financial perspective. It will be necessary, however, to explain clearly to investors the investment thesis of the merger. This will require addressing directly a TBV issue (if it arises), including a precise and detailed calculation of its amount and earn-back period, and a TBV comparison to the alternative of a stock buy-back. The investment bankers to the transaction can be helpful in preparing this comparative analysis, particularly by using their own analysts (who have been "wall-crossed") and can bring an investor's perspective to the investor presentation. In addition, regular ongoing communications with investors and the market generally should be developed so that the announcement of a merger would not be viewed as a major change in strategy.

We also note that, notwithstanding a similar initial negative market reaction to larger bank mergers in 2016-17, the market ultimately responded positively once the "industrial" and financial logic was demonstrated by post-merger results. Examples include the combinations of First Niagara with KeyCorp and of FirstMerit with Huntington.

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