

Bank Director's 2023 Bank M&A Survey examines an uncertain, dynamic environment that has created a number of hurdles to dealmaking.

Waiting Game

BY LAURA ALIX

First Interstate BancSystem has long been a regular acquirer, closing eight deals since 2014, but the Billings, Montana-based company is taking a bit of a breather this year.

In 2022, First Interstate closed on and integrated its largest deal to date, for Sioux Falls, South Dakota-based Great Western Bancorp, adding \$13 billion to its balance sheet and 170 branches to its network. While \$31.3 billion First Interstate is a seasoned acquirer, CEO Kevin Riley says pursuing another acquisition straightaway is not a priority in 2023.

"We have to prove to our shareholders that we've got [Great Western] integrated, we're producing earnings, we're growing organically, and everything is operating effectively and efficiently before buying something else," Riley says. "It's a very thoughtful process here about how we acquire institutions."

It's not uncommon for acquirers to take time between deals, but that's not the only factor contributing to today's decline in deal volume. M&A appeared to be back in 2021, exhibited by an active deal market through the first quarter of 2022, but dealmaking slowed dramatically the rest of the year. And according to Bank Director's 2023 Bank M&A Survey, sponsored by Crowe LLP, the proportion of bankers who say their company is likely to purchase another bank this year has declined to 39%, compared to almost half a year ago. Economic ambiguity, a rising interest rate environment and lackluster performance by bank stocks are all giving bankers pause to

rethink whether dealmaking will be a part of their growth story through 2023, says Rick Childs, a partner at Crowe. That's not to say that interest in M&A has evaporated, but would-be acquirers could be a bit more sensitive to price or selective about strategic fit. A majority of bank directors and executives say their bank is open to M&A but will mainly focus on organic growth in the year ahead.

"We've been talking for a long time in the industry about whether or not there's going to be a recession coming and will we have, therefore, a credit crunch. It has yet to materialize — it may never materialize — but the uncertainty aspect of it is causing people to keep their powder dry," Childs says. Banks are "willing to look for the right deal," he says, but are unlikely to pursue it as their primary growth strategy.

The 2023 Bank M&A Survey, fielded in September 2022, reveals some bleak, if also somewhat contradictory, views about economic conditions. Two-thirds of responding executives and directors feel the U.S. economy is in a recession, while 70% say they feel their bank's own markets are not in a downturn. Fifty-nine percent expect the U.S. economy to be in a downturn or recession through the end of 2023.

That uncertainty could have bankers questioning whether M&A is a worthwhile pursuit in the current

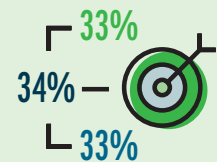
Key Findings

Thirty-nine percent of executives and directors say **they're likely to purchase another bank by the end of 2023**, a sharp drop from the previous year.

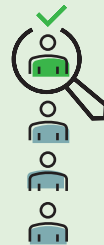


Among bankers who are open to M&A, **81% say that cultural integration is their biggest concern after a deal**, followed by retaining key staff (68%) and integrating technology (65%).

Respondents are split on whether there are a sufficient number of suitable acquisition targets to fuel their bank's growth strategy: **33% say yes, 34% say no and 33% are unsure.**



Less than half say that management **would be open to selling their bank in the next five years**. An inability to provide attractive returns (42%), CEO or senior management succession planning (38%), the regulatory compliance burden (28%) and a need to provide shareholder liquidity (28%) rank as the top situations that could drive a sale.



Most bankers see M&A in their market as an opportunity to acquire new talent: 47% actively recruit from merged organizations, while 39% are open to it but do not actively recruit employees.

environment, even if recession fears do not ultimately pan out.

"Even in the pandemic, everybody kept waiting for the other shoe to drop, and it never did. We're in the same place where we seem to be always treading water waiting for there to be problems," Childs says. "Certainly, there are enough signs that would give you pause, but at the same time, I feel like a lot of businesses are still well positioned to be able to muddle through."

To some degree, perception is reality, at least insofar as it influences the kinds of deals that bankers are or are not willing

to consider. "Anytime there's uncertainty or perceived risk, you'll see a slowdown or temporary inactivity," says Patrick Vernon, a senior manager with Crowe.

Concern over credit quality is likely to be another significant headwind to dealmaking in 2023, says Greg Steffens, CEO of Southern Missouri Bancorp in Poplar Bluff. He adds, though, that "M&A still makes a lot of sense for a lot of people."

The \$3.4 billion company is currently working to close its acquisition of \$1 billion Citizens Bancshares Co., based in Kansas City, Missouri. That deal is expected to close

in the first quarter of 2023.

"We think integration and just bringing things online and converting will take the remainder of '23," Steffens says.

Just 19% of respondents say their bank could buy a loan portfolio in 2023. That number includes the Cooperative Bank of Cape Cod, based in Hyannis, Massachusetts. The \$1.4 billion bank has sought growth by way of participation loans on larger commercial loans and lines of credit, as well as by purchasing residential mortgage portfolios from established partners, usually also based in Massachusetts, says CEO and

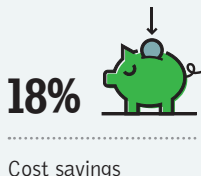
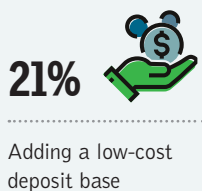
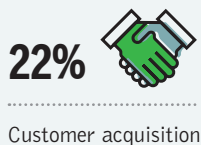
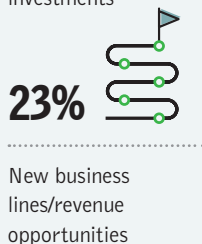
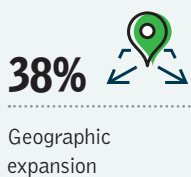
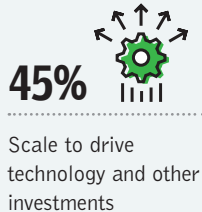
62%



are open to M&A but focused primarily on organic growth.

What are the two primary factors that make M&A an important piece of your bank's growth strategy?

Top responses.



85%



believe their bank has adequate access to capital to fuel its growth strategy.

Chair Lisa Oliver. Those moves, along with employing bankers who live and do business away from Cape Cod, have helped to reduce concentration risk that the bank might otherwise gain, by virtue of being based on a peninsula with a highly seasonal market.

But the bank has also been taking a harder look at those commercial loans it participates in, given the shifting credit cycle.

"We've been making more difficult decisions about protecting our asset quality and walking away from deals where the debt service coverage is going from a traditional 1.2% down to 1%, or commitments where loan to values are pushing upper limits," Oliver says. "All of that's a bit concerning to me."

Bank stocks' performance over the past year could also have an impact on dealmaking. The Dow Jones U.S. Banks Index lost roughly 20% of its value over a one-year period ending Dec. 5, 2022. Some bankers may therefore be less willing to take the hit to their stock price that often comes with announcing a deal, while others may feel their currency isn't strong enough to negotiate for their desired target, Childs says. A third of the survey participants do not believe their bank's stock valuation is attractive enough to buy a target that fits their criteria, although just over half believe it is.

"We have a variety of headwinds from an inflation and/or stock market perspective. Interest rates are, to me, a mixed bag," Childs adds. On one hand, rising rates mean higher loan yields and reduced pressure on margins. On the other hand, higher interest rates also increase the probability that non-performing loans will surface.

Rising interest rates have also caused bond values to decline, leading to unrealized losses in banks' securities portfolios. Those unrealized losses can drive down tangible book value or make it difficult to figure out a seller's true book value.

Consequently, the broader decline in accumulated other comprehensive income could exacerbate an extant mismatch on pricing expectations. Forty-three percent of potential buyers say their bank would pay 1.5 times tangible book value for a suitable acquisition, while 22% would pay more than

that. Meanwhile, just 28% of potential sellers would accept 1.5 times book value or less in a deal.

Executives and directors who are open to M&A cite increasing scale, geographic expansion and new business lines or revenue opportunities among their motivations.

That aligns with what Dominic Canuso, chief financial officer of WSFS Financial Corp., says of the Wilmington, Delaware company's M&A rationale. The \$20 billion bank has pursued deals to strengthen its position in the Greater Philadelphia area, enhance its fee revenue mix and add scale. Most recently, the company closed on its acquisition of The Bryn Mawr Trust Co. in Bryn Mawr, Pennsylvania, early in 2022.

Canuso believes that the uptick in M&A in 2021 had a cooling effect in 2022, with acquirers uninterested in pursuing another transaction just yet. He speculates that those banks may still be focused on integrating and benefiting from deals closed late in 2021. "That just takes a lot of the buyers out of the game," he adds.

The attributes potential buyers value in a target have shifted compared to last year's survey. The proportion of survey respondents who rank an attractive deposit base as a valuable feature rose from 36% in 2022 to 58% this year. Similarly, those who rank demonstrated or potential loan growth among the most attractive qualities in a target rose to 44%, from 22% a year earlier. Executives and directors still rate a complementary culture and locations in growing markets as desirable characteristics in a potential target, but interest in gaining a new deposit base took a slight precedence this year.

Canuso expresses surprise at the increased interest in deposits and wonders whether that might affect pricing in any deals that shake out in 2023.

"For the last few years, we've been in an environment where excess liquidity has built up customer deposit levels, to a point where it's almost difficult to know what is sustainable," Canuso says. "I actually see that as a headwind in valuations that could result in overpayment of value when doing an acquisition, because you could be paying for

deposits that might have only 60% of them remaining two years later.”

Vernon notes that in many of his recent conversations, bankers have expressed that a low-cost deposit base is a more attractive feature to have, although “not necessarily as attractive as the pricing of it turns out to be.” He sees that largely as a function of the rising interest rate environment and notes that bankers aren’t necessarily looking to juice fee income from the new deposit base so much as add to a strong and loyal customer base.

Integration is critical to a successful deal, as First Interstate’s Riley and WSFS’s Canuso understand well. Blending two cultures topped the list of concerns respondents say they would have about integration, should they make a deal this year. Majorities also expressed concern about retaining key staff and integrating technologies.

“Cultural integration is our top priority,” says Canuso. To ensure that aspect of a deal goes well, WSFS encourages senior leadership teams from both parties to spend time together integrating their teams and encourages executive leadership to do the same, often without the CEO. The bank’s M&A playbook outlines who at WSFS has what responsibilities before, during and after a deal, and having those duties laid out in advance has helped integration run smoothly.

“Then it is truly becoming one team long before you’re one team,” he says. “That has benefited our efforts, even through Covid when there was a lot more remote engagement. Having that cultural integration effort present in every conversation makes a significant difference.”

First Interstate’s Riley says that for his organization, cultural integration begins well before the deal even closes. If he likes the executive team and its philosophy toward banking, that tends to be a strong indicator that the merger will be a good fit, he adds. It also matters whether management is on board with the deal; when the board is directing the sale, then that’s likely to make for a tougher integration.

“If management isn’t in favor of selling the institution, that’s going to be a hard integration process,” he says. “If management is

in favor of the acquisition, then it’s an easier integration process because they’re working with you, not against you.”

He also makes a strong case for paying out bonuses to acquired employees, even to operational staff who could ultimately be deemed redundant and laid off after a deal is integrated. For one thing, those bonuses help key staff bridge the gap to their next job, mitigating the reputation risk that might result from a merger. It also reduces operational risk by ensuring the bank will have the right people in place to make the integration go smoothly. Retaining key staff was the second-highest integration concern of potential buyers in the survey, after cultural integration.

“If you don’t make it valuable for them to stay, you run the risk of losing all these talented people that will help you make this successful,” Riley says.

But would-be acquirers can only buy banks that are actually for sale, and less than half of all respondents say their bank’s management and board would be open to selling in the next five years. In comments, executives and directors cite myriad reasons their bank is unlikely to sell, including a preference for organic growth, a desire to remain independent or family ownership.

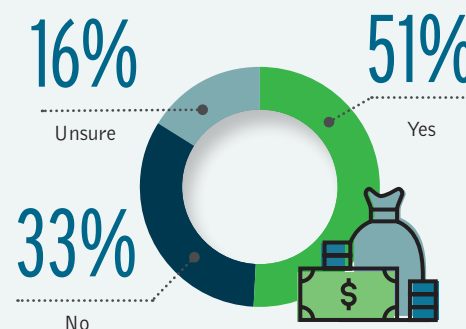
“The stockholders are not interested in selling due to lack of an opportunity to reinvest at similar return with similar return risk,” writes the CEO at a privately held Midwestern bank under \$5 billion in assets. “Many are long-term family stock holders [who] have established plans to pass on stock to other family members.”

Among those who would be open to a sale, an inability to provide competitive shareholder returns and succession planning issues were named as the top situations that could drive a sale. The proportion of respondents who cite an inability to keep pace with the digital evolution fell significantly from the 2022 survey. Crowe’s Vernon expresses surprise at this decline but theorizes that succession planning concerns, which dipped over the past two years, have overtaken digital issues as banks emerged into a post-pandemic world.

“I was less surprised that succession plan-

Do you believe that the valuation of your bank’s stock today would be attractive enough to acquire an institution that meets your acquisition criteria?

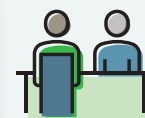
Question asked of public banks that are prospective buyers.



What would be the top five attributes of a target in today’s environment?

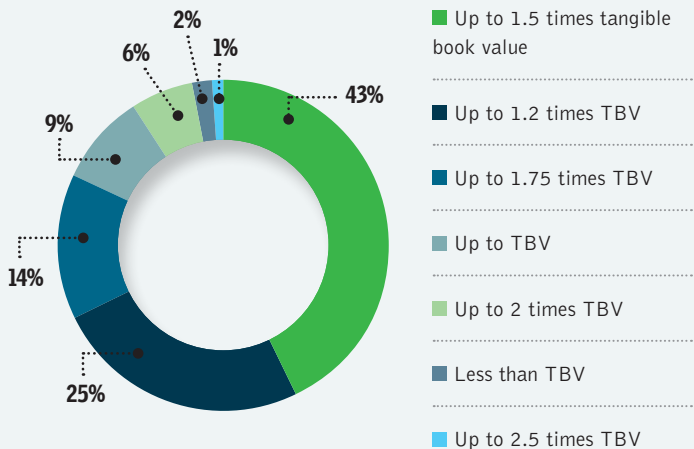


38%



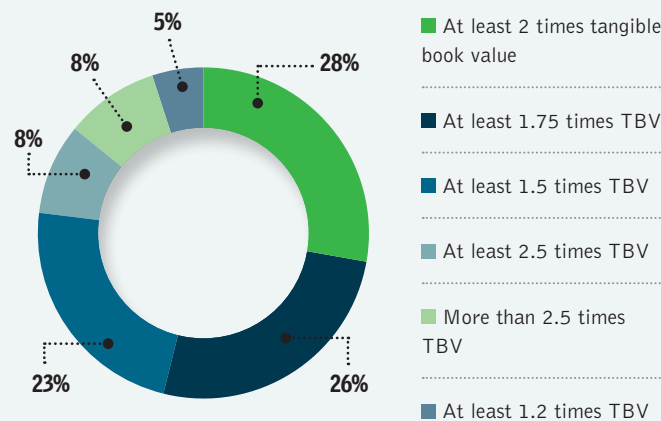
are likely to acquire a lending team this year.

At most, how much would you be willing to pay today to acquire another institution that meets your target acquisition strategy?



If your bank were to consider a sale, what would be the minimum value that you'd be willing to accept for your institution?

Numbers don't add up to 100% due to rounding.



ning kind of returned to its place as one of the concerns," Vernon says.

Childs adds, "You could just put it down to 'Another year, another year closer to retirement and we haven't actually solved the problem.'"

While there's seldom any singular reason that drives a bank to sell, succession planning tends to be a bigger factor in rural markets than in urban ones, says Steffens. Smaller institutions frequently have a tough time finding an appropriate CEO successor who truly understands rural banking, and many would rather sell to a like-minded bank than bring in a candidate who doesn't know the market.

"One of the biggest drivers of M&A is succession planning," he says. "Most of the deals that we have done have been over succession. [Executives feel that], 'I don't want to turn the reins over to somebody else,' so they stay in place until they're ready to retire. And then they sell." **[BD]**

About the Survey

Bank Director's 2023 Bank M&A Survey includes responses from 250 independent directors, CEOs, chief financial officers and senior executives of U.S. banks below \$100 billion in assets, who share their views on current growth strategies, particularly M&A. The survey was conducted in September 2022. The 2023 Bank M&A Survey is sponsored by Crowe LLP. The results are available in the research section at BankDirector.com.

Questions About Our Research?

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