Banking Mergers and Acquisitions Webinar

By:

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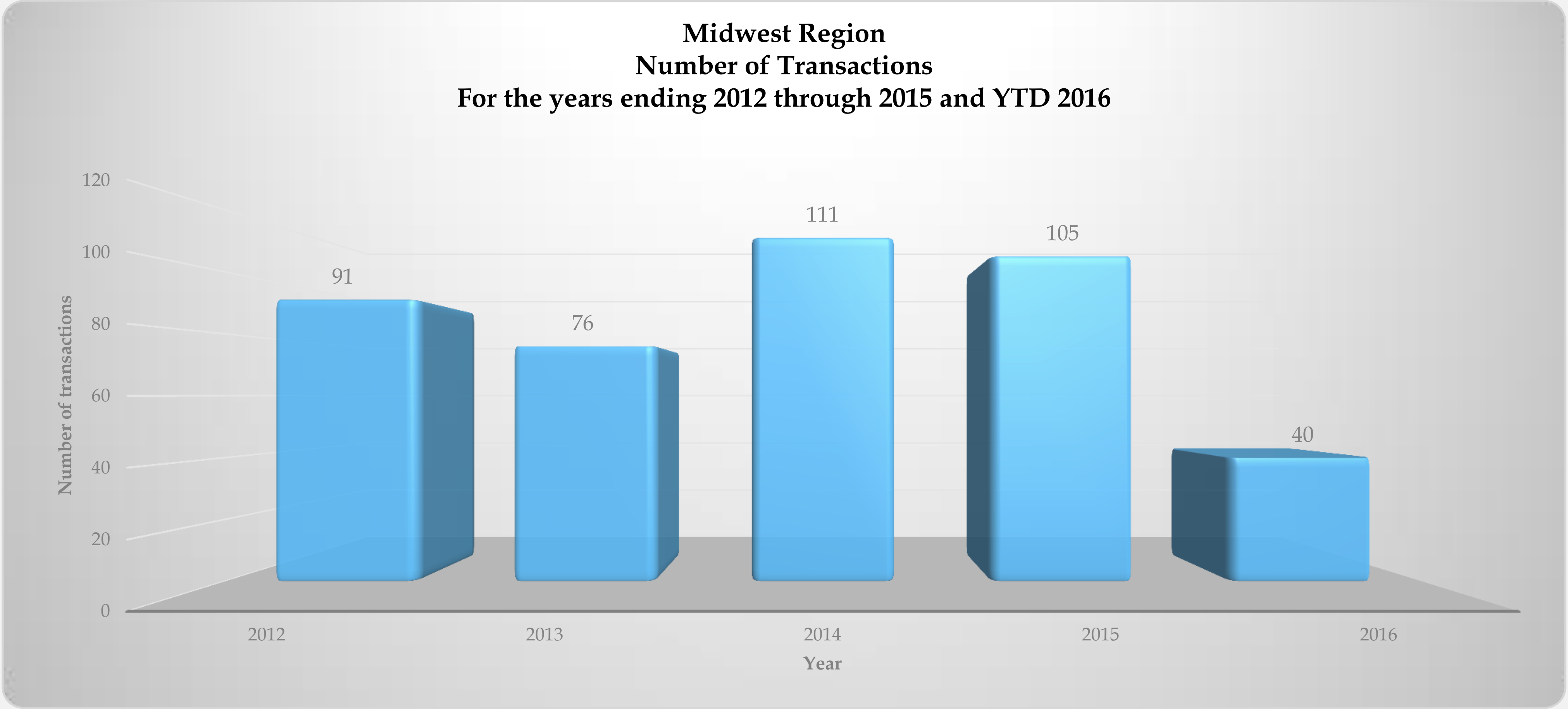
Topics Covered in Today’s Presentation:

- Today’s Market in Terms of Prices
  - Expected trends in the next 3 to 5 years
- M&A Process: To Market and to Acquire
- M&A Issues: Tax Consequences
- Best Practices: In Terms of Due Diligence
- Definitive Agreement Terms
- Structures: Stock Versus Asset Purchase

Today's Market in Terms of Prices



Includes all whole bank transactions in Illinois, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, and Wisconsin. Source: SNL Financial

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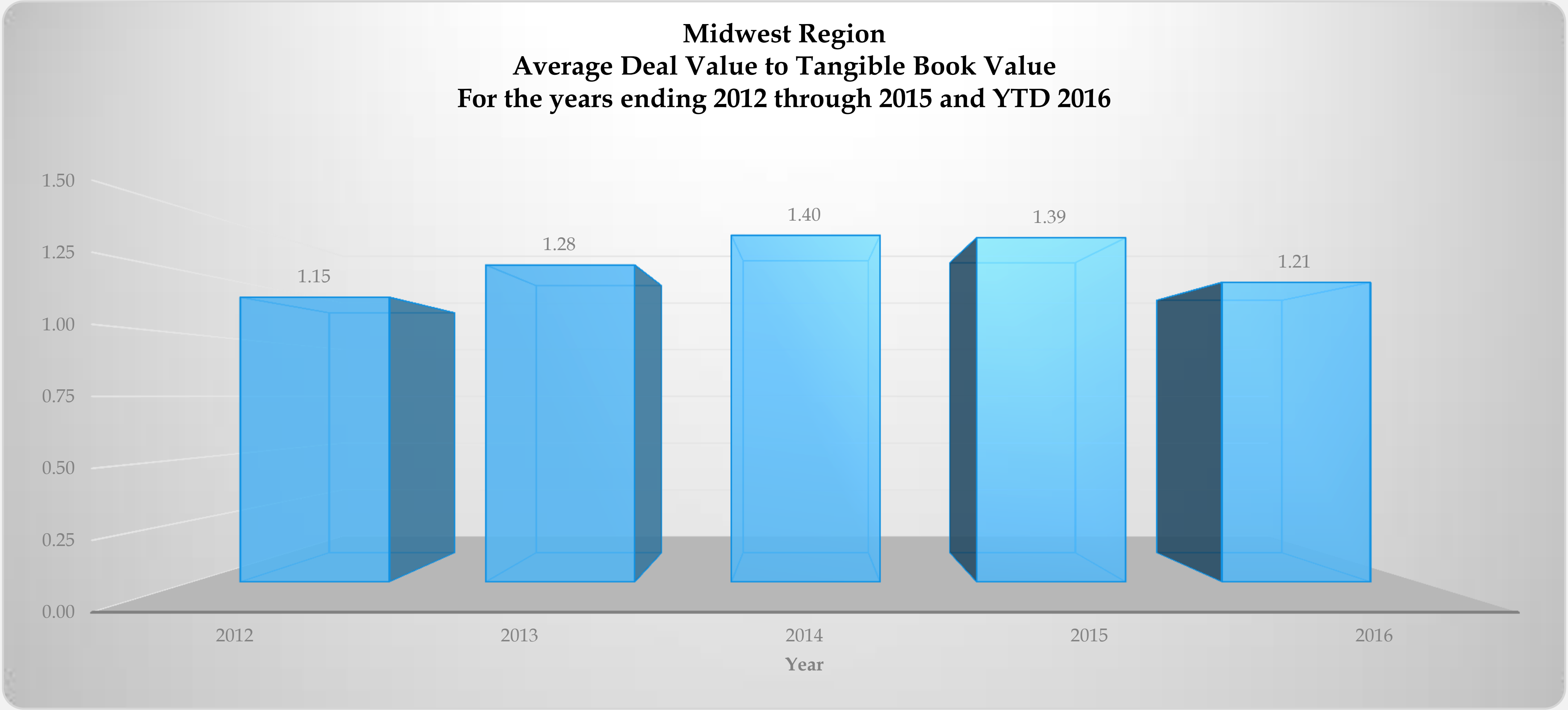
Today's Market in Terms of Prices *(Continued)*



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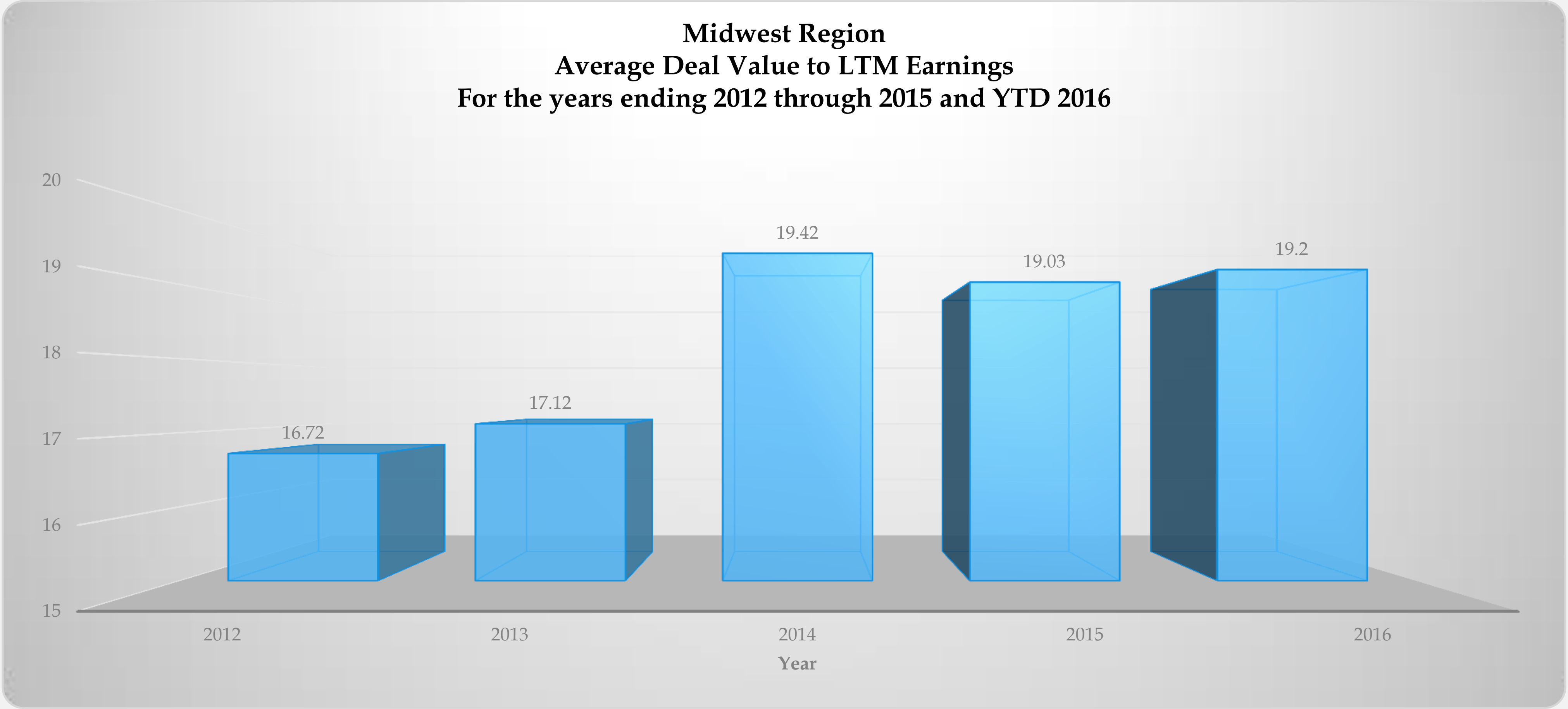
Today's Market in Terms of Prices *(Continued)*



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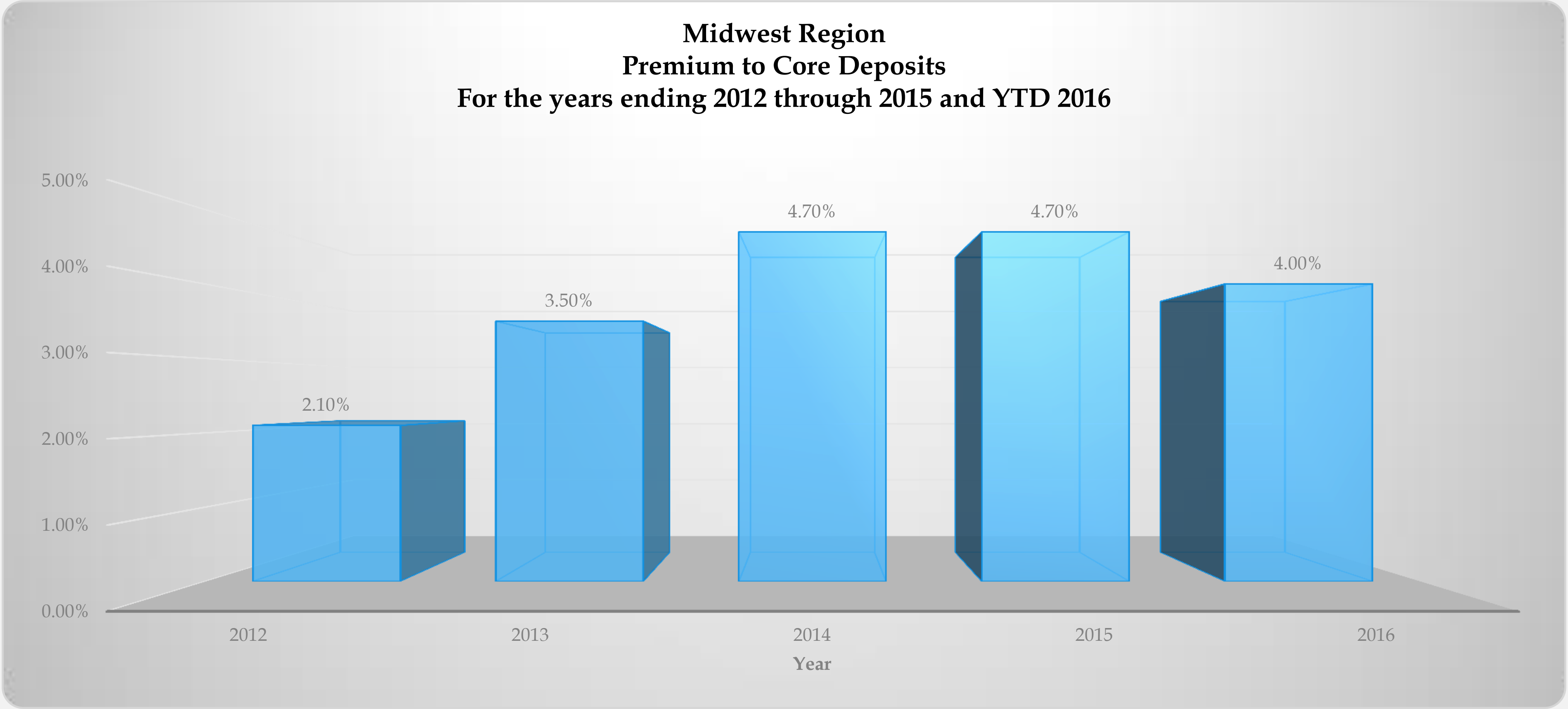
Today's Market in Terms of Prices *(Continued)*



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Expected trends in mergers and acquisitions in Iowa

- Number of transactions should increase significantly in the next 3 to 5 years as consolidation continues in the industry
  - Most of the consolidation is occurring in banks with under $100 million in total assets

- Major causes of consolidation
  - Increased regulatory burden has made it extremely difficult for smaller institutions to make a reasonable profit
  - There is minimal difference in what is required for the large multi-billion dollar banks and the community banks in terms of risk management, compliance, and regulatory oversight
    - Internal audit
    - Independent loan review
    - IT exams
    - Regulatory compliance reviews
    - Asset liability management reviews

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Expected trends in mergers and acquisitions in Iowa *(Continued)*

- Major causes of consolidation *(Continued)*
  - Increased competition has put downward pressure on net interest margins
    - Technology has made it possible for financial institutions to expand their geographical footprints
      - Remote deposit capture
      - Loan officers who work from their vehicles and cover 100+ mile trade territories
      - Credit unions have grown in size and product offerings.
      - Non-traditional lenders and deposit providers such as insurance companies, internet banks, and mutual funds continue to grow

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Expected trends in mergers and acquisitions in Iowa *(Continued)*

- Major causes of consolidation *(Continued)*
  - Increased competition has put downward pressure on net interest margins
    - Many smaller institutions are owned by families
      - Next generation doesn't want to live in smaller rural communities
      - Next generation doesn't all work at the bank making it more difficult to transition ownership and "make it fair" among the kids
    - A lot of owners just became tired after working through the problem credits during the economic crisis

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Expected trends in mergers and acquisitions in Iowa *(Continued)*

- Major causes of consolidation *(Continued)*
  - Expect a lot of mergers and sales of banks under $200 million in total assets

  - Also expect prices to continue to increase as activity picks up
    - Predict we will see two times book again within 3 years although prices will not likely go above that because of the absence of trust preferred security financing

  - Deal activity hasn't increased yet as many banks are waiting for the prices to increase and to improve their earnings so they can obtain a higher multiple

M&A Process: To Market and to Acquire

- Process to acquire a bank
  - Create a M&A strategic plan
    - Determine the ideal size in terms of total assets and geographic location of the target
      - Prepare pro forma balance sheets to verify the capital position of the bank before and after the acquisition
      - What type of bank do you want? A fixer upper or a established earner? Will you transfer someone to manage it or does the target need to have qualified management in place?
      - Obtain preapproval for financing
      - Assign the contacting of targets to individuals and hold them accountable for completion

M&A Process: To Market and to Acquire *(Continued)*

- Process to acquire a bank *(Continued)*
  - Create a M&A strategic plan
    - Consider use of third parties (helps demonstrate you are serious!).
    - Define the deal breakers up front!
  - Contact targets to gauge interest. Be prepared to discuss range for the multiple to be paid if you want to obtain their interest

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M&A Process: To Market and to Acquire *(Continued)*

- Process to acquire a bank *(Continued)*
  - Hold preliminary discussions with regulators
  - Prepare non-binding letter of intent
    - Present a calculation of the price
    - Discuss structure and tax consequences
    - Address key employees who have an influence over the shareholders
      - Understand who the shareholders are and how they feel about the key officers
    - Discuss preliminary discussions with regulators needed financing, and capital ratios
    - Put enough outs in the letter so that you are not legally bound to complete the transaction.
    - Commit to performing due diligence confidently and quickly
  - Perform due diligence

M&A Process: To Market and to Acquire *(Continued)*

- Process to acquire a bank *(Continued)*
  - Create definitive agreement (this is the buyer's responsibility)
    - Reps and warranties
    - Hold back or escrow accounts
  - Create communications for the press, customers, and employees of both sides and have both parties approve
  - Regulatory application
    - 60 to 75 days to complete
  - Closing
    - Set the final calculation date prior to the scheduled closing. Have the calculation blessed by both parties prior to scheduling the closing
    - Should be nonevent

M&A Process: To Market and to Acquire *(Continued)*

- Process to market a bank *(Continued)*
  - Engage a third party who knows the market and has experience

  - Have the third party perform due diligence before they begin to market the bank
    - Identify possible issues
    - Address the issues such as problem loans, contract matters in significant vendor contracts, legal matters, or problem employees **before** you market the bank

  - Prepare Offering Memorandum
    - Disclose the good, bad, and the ugly. Build creditability!

  - Contact possible buyers (third party should do this)
    - Be realistic on price expectations and who may want to acquire
    - Obtain confidentiality agreement including agreements regarding solicitation of key employees

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M&A Process: To Market and to Acquire *(Continued)*

- Process to market a bank *(Continued)*
  - Review letters of intent obtained
    - Focus on net after-tax proceeds and not multiples
    - Request a listing of their reps and warranties, name of the law firm they intend to use, the proposed structure of the transaction, and deals they completed in the past
    - Ask for pro-forma balance sheets showing before and after the transaction capital ratios
    - Sample of the calculation of the purchase price
    - Timing of the due diligence
  - Select parties to perform due diligence
    - 3rd party advisor should be on site to help ensure the process goes smoothly
    - Prepare all the required documents ahead of time and have organized

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M&A Process: To Market and to Acquire *(Continued)*

- Process to market a bank *(Continued)*
  - Definitive agreement
  - Consider requesting 3^{rd} party to oversee escrow accounts
  - Inform employees and key customers prior to the submission of the regulatory application
    - Be honest!
  - Have communications prepared for the press, customers, and staff prepared ahead of time and approved by both parties
  - After approvals obtained, close the transaction

M&A Issues: Tax Consequences

- Stock versus asset purchase

- Advantages of Subchapter S banks
  - Shareholders with material participation and shareholder longer than 10 years may be exempt from state taxation

Best Practices: In Terms of Due Diligence

- Areas to be covered in due diligence
  - Loans
    - At least 50% of the outstanding dollars for commercial loans and 20 to 30 consumer loans
    - Review all classified credits and all loans over a pre-specified dollar amount that are more than 75 days past due
  - Investment securities
  - Exam , third party, and internal audit reports
  - Employee benefit programs and compensation of staff
  - Deferred compensation, retainage, and poison pills

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Best Practices: In Terms of Due Diligence *(Continued)*

- Areas to be covered in due diligence *(Continued)*
  - Major vendor agreements
    - IT contracts may require payment of entire remaining years of payments at closing
  - Legal review
  - Asset liability management review. Compare pricing and maturities of loans, deposits, and securities against your balance sheet
    - Understand the differences in product features
  - Composition and pricing of deposits

Best Practices: In Terms of Due Diligence *(Continued)*

- Areas to be covered in due diligence *(Continued)*
  - Technology– Is the target's hardware compatible with yours? Talk to the vendors and understand the cost and timing of the data conversion
  - Physical facilities (branches)
  - Other real estate owned
    - Be careful of environmental issues on both REO and facilities
  - Culture – Interview key employees
    - Biggest issue is culture!
    - If the target's staff don't get on board terminate them immediately!

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Definitive Agreement Terms

Typical Components:

- Basic Terms of Transaction including purchase price and procedure for converting shares into price
- Representations & Warranties majority are seller reps
- Covenants & Agreements including clause designed to maintain status quo
- Indemnification Clause
- Termination Rights

Seller's Representations & Warranties

- Title to Assets
- Financial Condition
- Status with Regulators
- Absence of Contingent Liabilities

Schedules should list all exceptions and be detailed

Seller's Representations & Warranties *(Continued)*

- Personal liability to key shareholders for the representations and warranties will be a point of negotiation

Status Quo Provisions

Restrict

- Dividends, stock issuance or options
- Increase in employee compensation
- Anything that would materially change value of deal

Request approval for

- New loans or capital expenditure of a certain amount
- Trading in Bank's bond portfolio

Buyer’s Representation & Warranties

- Ability to pay
- Aware of no regulatory or other impediment to close and work expeditiously to close

If buyer stock included will need additional representations regarding financial soundness and SEC filings

Material Adverse Change or Termination Clauses

- Can be addressed by requiring minimum seller capital at closing
- Termination clause allowing termination if "future prospects" adversely changed

No Shop Clauses & Break-Up Fees

- No shop clauses are standard
- Break-up fees are unusual at community bank level

Spin-outs, Earn-outs & Escrow

- Certain assets such as problem loans or repossessed real estate can be held back from sale.

Earn-outs or Escrow

Seller shareholders get money in the future or money is held back based on:

- Collecting large loan
- Settling lawsuit
- Selling real estate

Dealing with Continuing Directors Liability

- Indemnification clauses should be added to definitive agreement even though acquiring bank has this obligation in stock transaction.

Structures: Stock Versus Asset Purchase

- Asset purchases are rare and usually only when troubled bank or a branch sale.

Questions?

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About the Speaker: Toby Lawrence

Toby Lawrence is the President of Lawrence Advisory Services. He has 30+ years of experience working in or serving financial institutions including having served as the Founder, President, and CEO of a community bank. Toby has also been a senior partner and owner of two national public accounting firms, RSM US (formerly McGladrey) and CliftonLarsonAllen.

He has served literally hundreds of banks and credit unions across the country providing loan review, internal audit outsourcing and enterprise risk management, regulatory compliance, profit improvement and operational review studies, asset liability model validation reviews, litigation support, and merger and acquisition services.

He has also provided consulting services to the Federal Deposit Insurance Corporation and the Federal Housing Finance Agency that oversees Fannie Mae, Freddie Mac, and the Federal Home Loan Bank system.

Toby also served as an expert witness for the United Nation's Compensation Council assessment of damages caused by Iraq's unlawful invasion of Kuwait and performed an extensive operational review of the former Resolution Trust Corporation which involved 50 consultants spread over 5 separate locations throughout the country. Toby is a frequent speaker at state and national industry bank and credit union conferences.

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About the Speaker: Lynn Hartman

Lynn Hartman is a member of Simmons Perrine Moyer Bergman where she represents primarily banks and other financial service providers. Ms. Hartman consistently represents financial institutions and other clients in transactions totaling more than $200 million annually. She works on commercial lending transactions of all sizes, including sophisticated large commercial transactions. Ms. Hartman serves as Chair of the firm's Banking and Finance Practice Group and is a member of Simmons Perrine Moyer Bergman Board of Directors.

Prior to joining Simmons Perrine Moyer Bergman, Ms. Hartman was in-house counsel for Firstar Bank (now U.S. Bank). She is a highly regarded attorney among her peers; being recognized as an AV Rated attorney with Martindale-Hubbell® and was included in The Best Lawyers in America® 2016 and Best Lawyers® 2015 Lawyers of the Year Listing for Banking and Finance Law. She is also recognized by Thompson Reuters as a 2015 Great Plains Super Lawyer.

Ms. Hartman is the firm’s primary contact with the USLAW NETWORK banking practice. Along with her many professional affiliations, Ms. Hartman regularly speaks to public and private groups, primarily on topics related to banking and finance law.

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