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Executive Compensation Out of Sync with Shareholders on M&A

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So-called agency problems naturally arise when the compensation and ownership structure of the contracts that exist between the principals (shareholders) and agents (management) are not well thought out and the two parties' respective incentives fall out of alignment — or perhaps were never properly aligned in the first place.

To wit, there are almost 100 publicly traded banks with the following financial characteristics: Less than $2 billion of assets, greater than 6% nonperforming assets to total assets and a less than 13% total risk-based capital ratio. Most of these banks are in need of additional capital and trading at steep discounts to their reported tangible book values. And much to their shareholders' chagrin, any capital raise would likely be priced at an even steeper discount to tangible book value.

In many cases, there are acquirers for these banks who would be willing to pay a price well above the price level that would be attained for raising capital. Which, of course, begs the question: Despite the favorable economics to shareholders for these "crippled" banks being acquired by healthier, better-capitalized competitors (at a premium to the price realized in a capital raise), why are there so few transactions materializing?

The answer is disturbingly simple: Despite the damage they've inflicted on their shareholders, management teams at the crippled banks don't want to lose their jobs. That is, the present value of these executives' compensation is greater than the present value of their ownership stakes in the companies they manage. Consequently, they are more than willing to engage in stock offerings that are, on the one hand, dilutive to shareholder value and yet, on the other hand, accretive to their own personal financial position.

I was on a conference call recently with one such crippled bank, which shall remain nameless. The bank is trying to raise capital at a 50% discount to its reported tangible book value. My question (among others) to management was: "Assuming there's a company willing to acquire your bank at a premium to the price at which you're trying to raise capital, and further assuming that the combined entity will be a much stronger company than the bank you have now … why don't I want you to be acquired at a premium by a stronger competitor? I end up with a premium to your current pricing considerations and I'm a shareholder in a stronger company. What am I missing?"

The answer, in so many words, was that the board of directors "after considerable deliberation" had decided to go down the capital raise path and they felt it was too late to change course. Which is a fancy way of saying: "Don't confuse us with logic — we've already made up our minds. We need our jobs and the shareholders will just have to pound sand."

And so, despite the billions of dollars in fresh capital that has flowed into the community banking sector in a desperate search for acquisition targets, the managements of many struggling banks are choosing to further torture their shareholders via dilutive offerings instead of simply merging with stronger institutions.

What can be done about this sad state of affairs?

Nothing in the short term. In the longer term, however, shareholder groups should make a greater effort to elect board representatives who will design compensation packages for senior management that more closely align their interests with those of the shareholders. Otherwise, shareholders will continue to suffer abuse at the hands of management teams who value their compensation more than their ownership stake.

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