

Job One: Maximize Shareholder Value

By DAVID B. MOORE

Though many issues in my daily work as a bank analyst can be vexing, undoubtedly the most frustrating is having to deal with companies whose management teams have no idea what it means to run a publicly traded entity. To be blunt, most small- and mid-cap bank and thrift managements simply do not understand — or do not care — that their primary job is to maximize shareholder value.

I cannot count the times I have questioned the CEO of a poorly performing community bank about why he has not sold the company, only to be met with various forms of the following: “We are a community institution and want to retain a community focus,” or “We are concerned about our employees and worry about jobs that might be sacrificed in a sale.” When asked where the shareholders fit in, these CEOs often respond, “Shareholders can sell their stock if they’re not happy with the way we run things.”

Unfortunately, there is a less obvious, yet equally insidious, injustice being perpetrated on shareholders by many banks that have good performance records: a reluctance to maximize shareholder value by selling out to an institution that is an even better performer.

Perhaps a real-world example would be helpful, so let’s take the case of Associated Banc-Corp, a \$12.5 billion-asset

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banking company based in Green Bay, Wis. Associated has been a reasonably good performer, with earnings growth averaging 10.6% a year from 1994 to 1999 and an average return on equity of roughly 17% for the period. In addition, Associated has had good asset quality and kept operating expenses at a reasonable level. (Associated has had acquisition-related problems in recent years, but that’s another issue entirely.)

When I told Associated’s management that I believed they should sell the company, they responded, in so many words: “We shouldn’t have to sell; we’re doing a good job as it is.”

Such a response — seemingly sensible on its face — fails the shareholder-value-maximization test, however. Specifically, Associated’s management refuses to maximize shareholder value by selling out at a large market premium to a willing acquirer that is a meaningfully better performer. In Associated’s case, at least one such potential acquirer is Wells Fargo & Co.

To continue with our example, let’s assume, for argument’s sake, that Wells is willing to buy Associated for \$40 per share. This would be a 44% premium to the company’s closing price in mid-April. After such a deal, Associated’s shareholders would own stock in a company that is one of the best-managed in the country by any standard, is expected to earn an 18.5% return on equity this year and to have 15% growth in earn-

ings per share from 2000 to 2001, is expected to average earnings growth of 14% per year for the next five years (according to analysts surveyed by *Zack’s*), and has a more diversified balance sheet and revenue stream than Associated.

In other words, if Wells were to buy Associated at a reasonable premium (which \$40 per share would certainly be), Associated’s shareholders would get to “have their cake and eat it too.” That is, they would benefit from a 44% short-term increase in the value of their Associated holdings — which they could liquidate in part if they chose — and would be left holding shares of an institution that has better fundamental operating prospects than Associated.

Thus from the standpoint of *maximizing* shareholder value — as opposed to merely *maintaining* it, which appears to be management’s current strategy — investors must be persuaded that Associated’s management can outperform potential acquirers (such as Wells Fargo) by a meaningful margin (that is, a few hundred basis points in ROE and earnings growth) over the next few years in order to justify the company’s remaining independent. Unfortunately for Associated’s shareholders, the probability of this outcome is roughly zero.

Does Associated’s management rebut this logic? Of course not, because there is no rebuttal available that has any economic foundation. Management is entrenched. They don’t want to sell “their” company. End of story.

To investors’ disdain, situations like

that of Associated are played out hundreds of times a year. My advice to these bank management teams is generally the same: If you want to keep running “your” bank, then put it up for sale, and you and your buddies can raise the capital and match the best offer. That way everybody wins — value is maximized for shareholders, and management could now run the company as a private fiefdom free of pesky shareholders and analysts. Right?

Wrong. Why? Because such a scenario would require that management put its own investment capital at risk, which would undermine the “free lunch for management” principle.

Consequently, though management buyouts of publicly traded community banks and thrifts would appear to make all sorts of sense in today’s investment climate, none happen. At the end of the day, most community bank management teams are simply unwilling to accept the returns from and shoulder the risk of truly owning their institutions. These managements have far more interest in “enhancing the community,” “protecting their employees,” and preserving their own employment and status at shareholders’ expense. These executives want all the benefits of running a public company without any of the accountability.

My advice to most community banks and thrifts that have logical acquirers is either to sell out to such suitors or to let management’s capital replace shareholders’. Either way, shareholders would get what they were looking for in the first place: maximization of their stock’s value.

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