Banking M&A: A Bad Deal For The Buyer—Still

Recent data shows shares of active acquirers tend to lag those of less-active ones

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The historical record where bank acquisitions are concerned is unambiguous: in aggregate, acquisitions have been a disappointment to shareholders of acquiring firms. That is, the empirical evidence from academic studies conducted during the 1990s and early-2000s indicates, paradoxically, that the aggregate value of merger activity from the perspective of acquiring firms is negative. Put simply, on average, the shareholders of acquired firms gain at the expense of the acquiring firms' shareholders.

Despite the weight of prior empirical evidence, I decided to conduct a study using more recent data to determine whether things had improved over the last several years with the respect to value creation on the bank acquisition front. To that end, I started with that group of publicly traded banks with assets greater than $2 billion as of June 30, 2008, and compared the degree to which the amount of goodwill had increased on their respective balance sheets since year-end 1997. Banks for which the ratio of goodwill to common equity had increased dramatically over the period and met a minimum ratio of 25% as of June 30, 2008, were put into a group called "Most Active Acquirers" (or "MAAs"). Banks for which the ratio of goodwill to common equity had increased the least, or declined, over the period were put into a group called "Least Active Acquirers" (or "LAAs").

Next, I simply calculated the total (cumulative, *not* annualized) return to shareholders for the banks in each group. The median return among the 43 banks in the MAA group was 38.6% between year-end 1997 and June 30, 2008, as compared to a median return of 46.9% among the 39 banks in the LAA group. Thus, in keeping with previous research from earlier periods, the financial returns of active acquirers lagged that of less active acquirers, on average.

The underperformance of the MAAs, however, while measurable, was not substantial. Upon closer inspection, however, the MAAs displayed significantly higher betas over the period than the LAAs. Specifically, the MAAs sported a median beta of 0.61 as compared to a median beta of 0.35 for the LAAs. (*Beta* is a measure of a stock's volatility relative to some index. In this case, the stock of the median MAA was 61% as volatile as the S&P 500 while the stock of the median LAA was 35% as volatile as the S&P 500.) Consequently, the median *risk-adjusted* return was substantially lower for the MAAs as compared to the LAAs.

So, why do so many bank acquisitions result in sub-par returns for the acquiring firm? There are three primary reasons: *1*) the acquirer tends to overpay, *2*) mistakes are made during due diligence, and *3*) the integration of the two banks is sub-optimal.

The first reason is easy to understand. Here the acquirer pays too much, thereby transferring too much of the economic value of the transaction to the seller's shareholders. Virtually no level of operational improvement can save a deal in which the acquirer has overpaid by a significant amount.

Where due diligence is concerned, mistakes will always be made – it is the nature of the process. The goal, however, is to avoid making mistakes so large that the economics of the transaction change dramatically for the worse. The biggest due diligence-related mistakes tend to occur in evaluating the loan portfolio. If the seller's loan portfolio (and the acquirer's loan portfolio, in a stock-for-stock deal) turns out to have considerably larger credit issues than identified originally during due diligence, problems will ensue. The only way to fix such problems is additional capital, which hurts the economics of the deal.

Finally, a slew of integration-related issues can unhinge a merger as well. First, if the acquiring bank doesn't handle personnel issues (known as "social issues") with care, valuable personnel at the acquired bank may walk out the door to work for another bank, taking profitable customers with them. Second, if the customers of the acquired bank feel that they are not being treated as well as they were prior to the merger they may decide to take their business elsewhere. Finally, if the integration of data processing systems goes awry, there will be technical snafus that lead to customer dissatisfaction and perhaps defection. In the final analysis, there is a lot that can go wrong in the acquisition process despite how easy it all looks from 40,000 feet.

Which, of course, raises the question: Why does consolidation continue in the face of overwhelming empirical evidence suggesting that such consolidation is all for naught in terms of value creation?

Warren Buffett, in a humorous explanation of managers' fits of acquisition-related "animal spirits" – despite the overwhelming evidence of the folly of such acquisitiveness – noted the following in Berkshire Hathaway's 1981 annual report:

Many managements apparently were overexposed in impressionable childhood years to the story in which the imprisoned handsome prince is released from a toad's body by a kiss from a beautiful princess. Consequently, they are certain their managerial kiss will do wonders for the profitability of Company T(arget). Such optimism is essential. Absent that rosy view, why else should the shareholders of Company A(cquisitor) want to own an interest in T at the 2x takeover cost rather than at the X market price they would pay if they made direct purchases on their own? In other words, investors can always buy toads at the going price for toads. If investors instead bankroll princesses who wish to pay double for the right to kiss the toad, those kisses had better pack some real dynamite. We've observed many kisses but very few miracles. Nevertheless, many managerial princesses remain serenely confident about the future potency of their kisses even after their corporate backyards are knee-deep in unresponsive toads.

It is also possible that managers are intentionally misleading shareholders. After all, where executive pay in banking is concerned, there is a strong link between a bank's asset size and the compensation of its officers and directors. Consequently, an acquisition that is at once harmful to shareholders may at the same time be financially advantageous to the acquirer's senior executives. This is one of many so-called "principal-agent" problems.

In my experience, which includes stints as an investment banker as well as both the buy- and sell-sides of equity research, most bank acquisitions are undertaken in the genuine – albeit, often misplaced – belief that the merger will benefit the acquirer's shareholders in some way. Unfortunately this belief is too often shrouded in wishful thinking. And, as the empirical evidence continues to show, the gap between reality and wishful thinking typically comes out of the pockets of the acquirer's shareholders at some point in the process.

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