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Community Bank M&A Likely to Take a Twist With Covid-19, Advisors Say

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Takeaways

- The ongoing economic crisis brought on by the coronavirus pandemic will likely see a shift in factors driving future M&A activity, including exposure to distressed industries and geographies, which may heighten the need for consolidation, advisors said.
- Low valuations will dissuade sellers, and cash components of deals will need to be much higher, one advisor said.
- Covid-19 may force even larger players to consider M&A options, and there could be more deals involving targets with $2 billion to $5 billion in assets, one advisor said.

The trend of community bank M&A will likely take a twist in the wake of the coronavirus pandemic as new challenges will reveal additional vulnerable targets, FIG sector advisors said. However, deal activity may not pick up until the end of the year as banks will take time after the financial markets stabilize to assess loan book damage, they added.

Prior to the pandemic, the industry was seeing a wave of consolidation among community banks looking to grow in scale and compete with the larger super-regional players, and the surge in 2019 M&A activity was expected to continue well into 2020, four advisors said.

In 2019, there were about 270 transactions, the highest in the last three years, said Jonathan Roberts, managing director of transaction advisory services at BDO. Macro trends and the need for scale were driving the consolidation especially in some of the larger states like Florida, Illinois and Texas, said Roberts. According to the Federal Deposit Insurance Corp. (FDIC), there are more than 5,000 community banks in the United States, which represent 92% of insured institutions.

Significant merger of equal deals in 2019 include First Horizon National's combination with Iberiabank for $3.9 billion, and Texas Capital Bancshares' merger with Independent Bank Group in a $3 billion deal.

The ongoing economic crisis brought on by the pandemic will likely see a shift in factors driving future M&A activity, including exposure to distressed industries and geographies, which may heighten the need for consolidation, advisors said. The pandemic is also expected to affect deals that are yet to close, as evidenced by Flushing Financial's $111 million acquisition of Empire Capital, which was announced in October and has been delayed due to financial and stock market volatility.

M&A Dynamics to Change

Potential buyers need to focus on their own businesses now, and it will take time to build an offensive strategy, said James Cassel, chairman and co-founder of boutique bank Cassel Salpeter and Weber.

The more likely buyers for the smaller regional banks with $1 billion to $3 billion in assets are perhaps the institutions with $10 billion to $30 billion in assets, said Timothy Johnson, partner at KPMG's transaction services, adding that mergers of equals between two banks each with $3 billion in assets are also a possibility.

When M&A activity in the space regains momentum, community banks in a position to use cash for deals are the likely consolidators, as depressed stock prices will deter sellers from agreeing to typical stock deals, Cassel and Johnson said. Low valuations will dissuade sellers, and cash components of deals will need to be much higher, agreed Osnat Naporano, managing director at independent investment bank Brean Capital.

Geographies will play a big role in where community bank M&A might occur, said Naporano. Florida has historically seen a high number of community bank mergers, while Arkansas, Louisiana and Oklahoma have also been active states, said Johnson. Traditionally banks within the same geography merge to build a larger community presence, but this could be an opportunity for regional banks to expand into another geography, said Cassel.

But for the time being, pre-Covid-19 negotiations have been halted as the industry waits for the financial markets to settle, advisors said. Only then will it be possible to evaluate the extent of the damage caused by the global shutdown, particularly to small businesses, the advisors added.

Once the economy is in a less volatile state, it could take up to three months to fully assess credit losses and the credit quality of the loan books, said Roberts. If that initial stability comes sometime in the summer, it may mean no deal flow until the fourth quarter at the earliest, Roberts said, with the other advisors agreeing on the timeline.

In 2019, a larger majority of community bank M&A involved targets with less than $1 billion in assets that were struggling to compete, said Johnson. The trends of the past year spoke to long-term community bank consolidation, and at the start of this year, given margin pressures and the lack of economies of scale, there was anticipation for mergers among smaller banks going as low as $250 million in assets, said Roberts. But Covid-19 may force even larger players to consider M&A options, and there could be more deals involving targets with $2 billion to $5 billion in assets.

Covid-19 Direct Impacts

Covid-19 will amplify the yearn for digital enablement as citizens get used to accessing their online account for banking needs, and given that expansion requires capital investment, M&A among smaller banks may be the only way to achieve that, Johnson said.

The next few months will be telling, and the major difference between now and the global financial crisis is capital, Cassel said. Regulators did a good job of making sure banks had adequate capital to withstand stress in their loan portfolios, said Johnson. Even so, being liquid will be much more important, said Naporano, adding that better deposit franchises will be more attractive.

The U.S. Federal CARES Act has resulted in a surge in applications for the Paycheck Protection Program (PPP), and smaller banks may struggle to service this demand, Johnson said. Consolidation may be one avenue to maintain customer service standards, which is the main draw for community banks, he added.

A big concern is around commercial real estate, and the exposure that banks have in their unique geographies, Naporano and Cassel said. Johnson agreed, saying over the next three months, institutions over indexed to commercial real estate may need help sooner than later, and if they have a decent franchise that is distressed, it may push them closer to a transaction.

It will be unique to the institution, but banks with a fair amount of business in the hospitality and leisure space, will be exposed to higher risk. Community bank books reflect the health of the economies in their geographies. Florida and Southern California, for instance, have local communities that are dependent on tourism, while community banks in Texas could be suffering due to links to the energy industry, said Roberts.