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Bank - Operations and Strategy

When it comes to M&A, only fools fall in love

BLOG

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The importance of conducting proper due diligence was a theme reverberated during several panel discussions this week at [SNL's Bank M&A Symposium](#).

The recipe seems to be: take precaution and thoroughly evaluate a target by not only scrubbing the seller's loan portfolios, but also ensuring it has a compatible culture. If buyers follow that process, they have a much greater likelihood of identifying risks and pricing them properly – or as a handful of investment bankers at the event said, making that "go" or "no go" decision.

Many people at the event seemed to think that the latter choice is often the wiser decision, including Sullivan & Cromwell LLP Chairman Rodgin Cohen, who said the best deal you do is often the one you walk away from. With that in mind, many bankers cautioned potential buyers to not get wrapped up in the idea of doing a deal. Richard Fowler, executive vice president, mergers and acquisitions, at [BB&T Corp.](#), has worked on as many deals as almost any banker and said acquirers cannot fall in love with a deal. They must take a dispassionate approach, he said, and acknowledge when two cultures simply do not fit together, even if the financial part of the transaction makes sense.

Terrance Dolan, executive vice president and controller at [U.S. Bancorp](#), provided a similar assessment and said buyers should not underestimate the importance of understanding a target's market, its customers and its employees. Dolan said it is easy to get caught up in what seems like an ideal transaction, but when the due diligence process uncovers problems, the acquirer needs to recognize those problems and possibly abandon the transaction. He encouraged banks to take those realizations to heart and employ lessons learned through the due diligence process when looking at deals further down the road.

Miguel Sagarna, principal at KPMG, offered guidance on the best practices in conducting due diligence. He said at the conference that buyers need to determine the size of the credit hole on the target's balance sheet. And acquirers are taking that precaution when evaluating targets as they are now reviewing 60% to 80% or more of troubled institutions' commercial, commercial real estate and land and construction loan portfolios.

Sagarna said buyers also need to assess the quality of the target's remaining platform, its processes and its customer base, particularly its key deposit and lending relationships. He said buyers must understand the target's deposit base because many troubled institutions relied heavily on "hot money" that will likely evaporate after a deal closes.

Participants also cautioned that buyers watch out for potential regulatory bombs like insufficient compliance with anti-money laundering and bank secrecy laws. Ellen Zimiles, co-founder and CEO at Daylight Forsenic & Advisory LLC, said the real culture of a bank is often revealed when evaluating the quality of a target's compliance group and its relationship to senior management. Buyers inherit targets' regulatory risk, she said, and if they identify a potential problem, they should let their own regulator know and present how they plan to address the issue in the future.

Zimiles said buyers would be surprised just how poor some banks' compliance really is. For instance, she once encountered a bank in upstate New York that wanted to sell, but did not have an internal auditor. The seller brought in an internal auditor to prepare itself for a transaction and discovered that its chief credit officer had a gambling problem and had been taking money.

She highlighted another example where a target had 90 branches, two of which were located in the jungle of Peru. Despite their small size relative to the rest of the organization, she said the two jungle branches generated 90% of the revenues of the organization. Clearly, the buyer realized something was wrong, she said.

Daniel Bass, managing director at Carson Medlin, said buyers need to recognize such problems during the initial due diligence process and walk away before inking a transaction because an acquirer will have egg on its face if it terminates an announced deal. He said terminated deals also have a negative impact on the seller too, since it will appear tainted and will likely end up selling for a lower price. To help avoid that pitfall, he said sellers need to prepare for the M&A process and

make sure all their loan files are in place.

Participants at the conference said proper due diligence is also necessary when looking at government-assisted deals, even though the majority of those transactions come with loss-sharing agreements that minimize asset risk. Conducting thorough due diligence in an FDIC transaction is even more difficult because those deals happen in a short period of time and, accordingly, bankers at the event said buyers must be prepared to act quickly. They suggested closely monitoring troubled institutions in their footprint, evaluating those companies and being in a position to act when the FDIC calls because they often only have a few days to submit their bids.

Working at U.S. Bancorp, Nolan took part in the acquisitions of two failed thrifts – [Downey Savings](#) and [PFF Bancorp](#) – on the same day. He said the company deployed 150 people to the two franchises' 130 branches shortly after announcing the transactions. Nolan said U.S. Bancorp wanted to have people on the ground to help with the branch managers and employees and also make them and their customers feel at ease.

BB&T's Fowler described a similar approach when his company [acquired](#) Colonial Bank from the FDIC. He noted that BB&T had hundreds of people at the airport waiting to fly to Colonial's footprint in case his company won the bidding for the failed Alabama-based bank. Shortly after BB&T received word that it had won, BB&T sent its integration team to Colonial's headquarters and its branches to ensure a smooth transition.

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