# Top 10 Issues for Banking M&A in 2013

## Seeking clarity and opportunity to re-energize the market

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# Overview

The U.S. banking industry is seeking economic and regulatory clarity in 2013 as organizations consider strategic, targeted opportunities that could re-energize the mergers and acquisitions (M&A) market.

Although the worst of the recession appears to be over, the United States' and other countries' economies may not be on firm footing just yet. In addition to overhang from the last-minute, interim U.S. "fiscal cliff" agreement, the continuing Eurozone sovereign debt crisis is likely to remain a concern. As a result of these and other uncertainties, many banks may be cautious in ramping up their M&A programs and investments.

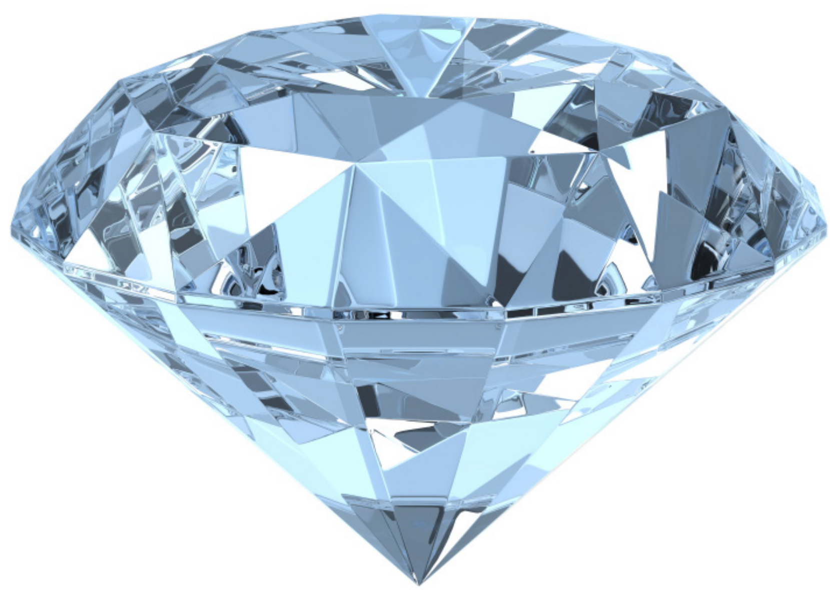
Similarly, implementation of legislation including Dodd-Frank and Basel III, as well as pending tax reform measures, could have both expected and unintended consequences on banks' operations and balance sheets, and their willingness and ability to engage in M&A. However, 2013 could (finally) be the year of clarity and, as the rules are finalized and the overall regulatory picture comes into focus, banks should be better able to analyze M&A opportunities under the new parameters. This, coupled with depleting options for organic earnings growth, may return acquisitions to many banks' strategic plan.

In addition to macro-level economic and regulatory drivers, banking industry M&A activity in 2013 could depend, in part, on institution size. Larger financial institutions aside from those already so deemed are hoping that the Financial Stability Oversight Council (FSOC) may soon finalize its Systemically Important Financial Institution (SIFI) criteria. The unresolved criteria have been perceived by some as dampening the appetite of these banks for substantial acquisitions, as they may put the combined entity on the FSOC's radar. Instead, banks may engage in small, fill-in, buy-side M&A to increase attractive demographics and/or small, non-bank, buy-side M&A to diversify their business mix and enhance margins. In addition, some large banks are likely to continue divesting assets to become smaller and avoid being a SIFI.

There may be M&A opportunities in the middle market, where the focus is likely expected to be on attaining earnings per share (EPS) growth, increasing competitive positioning, enhancing attractive demographics, and gaining scale to offset the costs of financial reform.

Finally, small institutions are likely to continue as sellers in the bank space. These institutions appear to be having significant difficulties remaining independent in the current environment, impacted by persistent EPS and organic revenue challenges, weak balance sheets, and capital and regulatory hurdles.

Assuming that the economy continues moving in a positive direction, regulatory issues are addressed effectively, and the "rules of the game" become a little clearer, banks should be in a more favorable position in the coming year to make decisions and investments in their future that they haven't made in the recent past. These important factors are among the drivers of the following issues for banking M&A in 2013.



# Top 10 issues for banking M&A in 2013

# 1 Fiscal uncertainty

Continued uncertainty amid an improving yet uneven economic recovery could be a drag on business investment, bank performance, and sector M&A activity in 2013.

Fiscal issues continue to loom large for the United States. While a bipartisan Senate agreement and subsequent House approval helped the U.S. narrowly avoid going over the fiscal cliff on January 1, 2013, the political wrangling and uncertainty around more substantive cuts to government programs, the debt ceiling, and broad tax reform — which is likely to hold significant implications for financial services companies and is fueling widespread conjecture and scenario planning — is expected to continue well into 2013.

The Eurozone sovereign debt crisis continues, with another round of meetings and policy announcements still not resolving the uncertainty around certain governments' fiscal positions and the weak position of banks in several countries. A long-term resolution of the economic instability in Portugal, Ireland, Italy, Greece, and Spain is not currently evident.[1]

### What's new for 2013

While much attention in the U.S. is focused on federal-level fiscal issues, a considerable number of counties, states, and municipalities seem to be in serious fiscal stress; will that contagion spread? Also, the community banking environment is generally wobbly, at best. Historically, these institutions have had a big role in building-up their local economies so questions about their viability are unsettling.

### Bottom line

Economic conditions in the early months of 2013 may not create a rapidly favorable environment for pro-growth businesses, although interim resolution of the U.S. fiscal cliff and easing of the Eurozone debt crisis could help to offset general anxiety somewhat. The banking industry is apt to see continued belt-tightening and to augment earnings growth; buyers are likely to be opportunistic and may focus on distressed or undervalued targets. Also, pending changes in tax legislation in the U.S. and Europe may drive banks to identify what products should be offered in different jurisdictions — and help to determine if acquisitions or divestitures may be required — to create tax-efficient revenue opportunities for customers and the banks themselves.

1 *2013 Banking Industry Outlook: Moving forward in the age of re-regulation*, Deloitte Center for Financial Services, 2013

# 2 Regulatory realities

The post-election realities of significant legislation directed at the banking industry are becoming apparent: Dodd-Frank's strengthened regulation and supervision of banks and other financial institutions is likely to remain unchanged; finalization of the Volker Rule (anticipated in first-quarter 2013) will likely require diversified financial institutions to shed alternative investment management, proprietary trading, and other non-bank businesses that may put the organization's capital at risk; the Consumer Financial Protection Board's (CFPB's) rules are putting additional regulatory burdens on banks (i.e., mortgage lending, mortgage servicing, qualified mortgages); and Basel III guidelines are set to impose higher capital and liquidity requirements, including capital buffers and surcharges for Systemically Important Financial Institutions (SIFIs) with an emphasis on Tier 1 Common. In addition, establishment of the Financial Stability Oversight Council (FSOC) heralds increased regulation of SIFIs, with recurring stress testing requirements and impacts on potential business practices and capital actions (e.g., dividends, share repurchases).

### What's new for 2013

As a consequence of Volcker Rule restrictions, banks and bank-related entities may need to promptly consider tax and divestiture planning and strategy options related to restructuring or disposing of existing proprietary trading and hedge and private equity fund operations. Although the date for banks to divest these assets — via closures, spin-offs or sales — and push them off balance sheets is more than a year away, it is likely that some large banks have already begun taking action, a signal that this process is not something that organizations are waiting to address.

Dodd-Frank implementation in 2013 may produce unintended consequences impacting smaller/mid-size banks; for example, serving the under-banked segment. If banks can't charge late fees or overdraft fees to these customers and must assume additional regulatory and related infrastructure costs to serve them, there may be little incentive for banks to retain this (in today's regulatory environment) relatively expensive customer base.

"Living wills" are another regulatory wrinkle that some banks may need to iron out. These mandatory resolution plans (covering both holding companies and insured depository institutions) should clearly demonstrate how the organization can resolve itself in a rapid, orderly manner without creating systemic risk to the U.S. economy. The largest banks have already had to submit their plans; the second wave of banks now has to do so. Living wills require a greater reliance on reporting data — financial, lines of business (LOB), material legal entities, intercompany tax agreements (tax sharing arrangements), and critical operations. Many large banks may lack ready access to the data they need to develop sound resolution plans; those institutions that are making investments in these processes and technologies may have both a regulatory and business advantage over those that don't. From an M&A perspective, living wills' requirements that banks demonstrate their ability to separate and dispose of certain businesses may prompt organizations to consider executing the sale of these assets, even if they were previously perceived as being too embedded to be able to tactically separate.

### Bottom line

The banking industry may see a short-term period of reduced, large-scale M&A and more divestiture/realignment activity until big banks digest the new U.S. and European legislation and get comfortable with their capital levels. Specifically, SIFIs may limit their incremental market share plans given the increased regulatory scrutiny of doing a deal. Still, as regulatory reform becomes finalized, it should provide banking institutions more clarity on how to formulate their operating plans going forward; this may provide acquisition opportunities for institutions below SIFI levels as various internal and external pressures cause other small-cap and middle-market banks to consider a sale as the leading way to achieve shareholder value. Also, the number of M&A opportunities may increase as stronger banks extend their ability to acquire through earnings and higher capital levels.

Investment management firms, exchanges, non-bank broker dealers, and private equity funds could benefit from Volcker-driven forced divestitures by purchasing associated bank assets to increase their market share and scale. Particularly appealing to private equity (PE) funds are investment management operations, which in addition to being cash-rich from an earnings perspective, are not as capital-intensive or as regulated as other lines of business.

# 3 Re-energizing M&A

Numerous obstacles to getting deals done have contributed to a stagnant banking M&A environment in recent months and years; among them, the cost of capital exceeding returns on equity; unrealistic bid-ask spreads; unease over tangible book value dilution that limits the multiples that buyers are willing to pay; and volatile stock prices.

From a regulatory perspective, low CAMELS (Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk) ratings of buyers, increased regulatory requirements around pro forma stress testing, and pending government investigations have precluded some regulatory approvals. Other rules have yet to be written and the CFPB remains a wild card. Also, Basel III may place onerous capital requirement on many different lending products.

### What's new for 2013

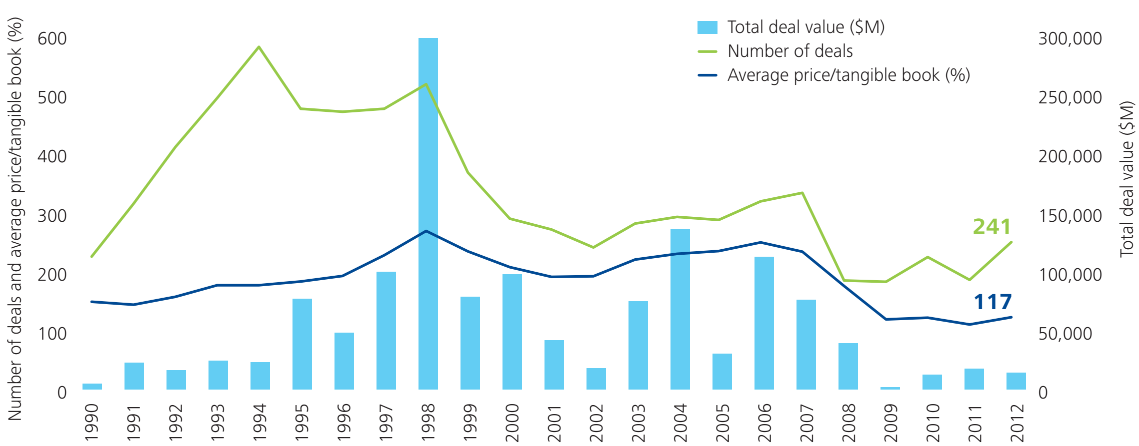
The first half of 2013 may see M&A activity (Figure 1) by larger banks slowly pick up as they digest the challenges of Dodd-Frank and other regulations, continued fiscal-related legislative wrangling, slow economic growth, and a flat yield curve. In general, conditions appear to be becoming more favorable for a re-energized M&A environment; for example, transaction multiples are starting to improve as sales of stronger banks begin to materialize. Buyers with a solid capital position are likely to focus more on strengthening their core banking businesses and less on expanding capital-intensive ancillary businesses. Larger, more complex firms may engage in divestitures and carve-outs as they seek to become more streamlined and focused, while mid-tier institutions may look to add products and/or geographies to build scale. And while larger banks may continue to be disincentivized to grow past certain asset parameters, opportunities exist for banks focused on growing within their current threshold of regulation.

### Bottom line

M&A activity that takes place in 2013 may likely revolve around strategic decisions: previous acquisitions now may be deemed non-core and divested; larger, more complex firms may become more streamlined and focused; and mid-tier institutions may look to add products and/or geographies to build scale. However, in an environment marked by continuing economic uncertainty and a flat yield curve, an acquiring institution is likely to benefit from being opportunistic and disciplined in its valuation of targets to find suitable and fairly priced assets to help avoid overpaying based upon price multiples more relevant to a high-growth environment. Similarly, an institution should determine the merits of an acquisition that may take it across the $10 billion or $50 billion regulatory threshold by analyzing the additional costs/business limitations such a decision may entail. Sellers, meanwhile, may need to revise their expectations on transaction multiples to reflect current economic and regulatory realities (which can be viewed as an impediment to the expansion of deal volume) when determining their willingness to transact a deal In addition, deal-making may require creativity to address the bid-ask spread: sellers should identify a variety of alternative structures to meet increasingly discerning buyers in the middle.

*Figure 1: Bank and thrift M&A activity expected to pick up*

U.S. whole banks and thrifts M&A activity




Source: SNL Financial. Data as of 2/3/13.

- Only includes deals where the target is based in the U.S.
- Reflects data at deal announcement event.
- Terminated deals are included.
- Excludes govt.-assisted deals.

# 4 Geographic retrenching

After a period of global expansion, banks appear to be refocusing on strengthening their domestic footprint, seemingly prompted by increased regulatory scrutiny and stringent capital and liquidity requirements. Many banks are spread thinly across the world; organizations still want geographic diversity but are expected to be selective about where they go or stay.

### What's new for 2013

Geographic retrenching may prompt some acquisitions in 2013 as banks establish or strengthen their presence in countries where their international customers are located; however, the year could also see some banks exiting selected markets, especially where changing tax laws may negatively impact future profits, the local economy may be slowing, or regulatory oversight has become too burdensome.

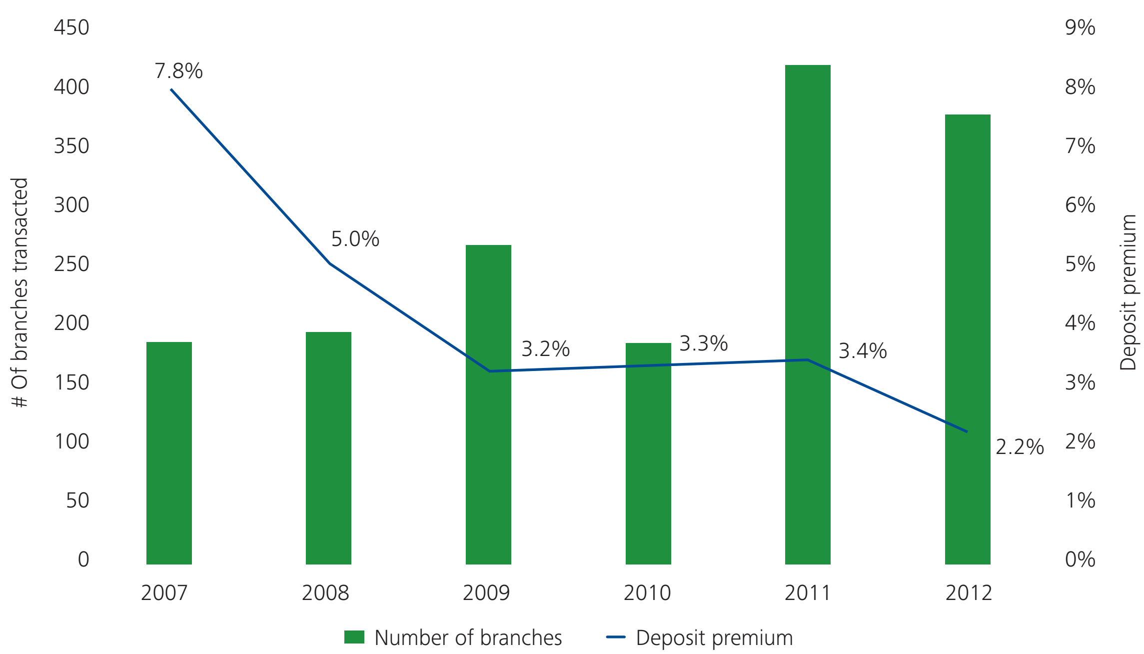
Geographic retrenching in the U.S. may be evidenced by large banks rationalizing their brand networks and smaller banks actively acquiring branches (Figure 2). Many large banks are located in metropolitan service areas (MSAs) where branch profitability is very challenging, especially as consumers increasingly move to online banking. Specific markets may see branch sales or closures.

### Bottom line

Banks may be becoming more cautious about the markets they enter or stay in. While they are following their customers globally their focus appears to be more on customer service than empire-building. Also, capital is becoming more precious, especially in light of Basel III requirements; banks may want to take a hard look at the capital requirements for each country in which they operate or plan to enter. Finally, as tax laws change, banks may also need to determine whether it makes sense to write products in certain jurisdictions.

*Figure 2: Branch transactions are on the rise*

- Large banks are rationalizing their branch networks by exiting non-core markets in an effort to reduce operating costs
- Smaller banks have been able to acquire branches sold by larger banks at low deposit premiums given the low interest rate environment




Source: SNL, Transaction Data As Of 1/16/2013

# 5 Return to core business lines

Excessive leverage, underperforming assets, and regulation-driven dislocation of asset servicing appear to be driving banks to divest non-performing or non-core assets in an effort to reduce costs and regulatory capital usage and refocus their current business to better align with strategic objectives (Figure 3). In addition, banks considering M&A transactions increasingly are instituting filtering mechanisms to screen which businesses are truly core/likely to grow, as well as to meet both regulatory and economic cost-of-capital internal hurdle rates, allowing banks to achieve overall ROE and ROA targets.

### What's new for 2013

Cost rationalization may be a major focus for banks in 2013, as they seek to improve their efficiency ratio. The bigger challenge, however, may be how and where to make money on the depository side — especially in the current low-interest-rate environment — which may require many banks to streamline their current offerings as they consider questions such as:

- How do we have to change our business model to make money in a very different environment?
- Which of our existing services are currently profitable or hold future potential?
- What do we do well that allows us to differentiate ourselves in the market?
- What core customers can we serve well and profitably?
- How many versions of the same product or service do we need?
- What superfluous assets should we jettison as we refocus on core business lines?
- What external opportunities exist to bolster our core business?
- Going forward, what products are customers going to want?
- As we examine our global footprint, which geographies are most favorable from a compliance risk and tax liability perspective?

### Bottom line

Regulatory requirements appear to be pushing banks to make changes in the businesses in which they participate; however, given current struggles around capital optimization and reaching cost-of-equity thresholds it may be difficult for banks to determine what returning to core means. Banks should consider thinking creatively, make tough decisions, and apply stringent M&A filters as they evaluate existing and potential service lines. They also should remember that there are no sacred cows when returning to core business lines; focusing on targeted accretion and operational efficiency can be essential.

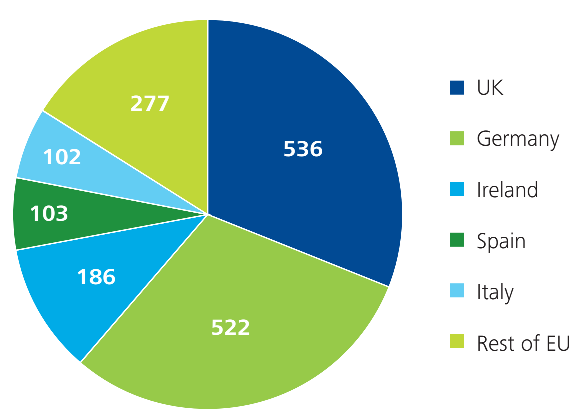
*Figure 3: Divestitures are enabling players to re-focus and re-position their businesses*

**Divestiture drivers**

- Excessive leverage remains at the heart of the financial crisis
- Eurozone debt problems prompt a new wave of divestitures
- Firms work to restructure and re-size their balance sheets
- Estimated non-performing/non-core assets ~ $1.7T in Europe alone

**Key insights**

- Core assets align with the bank's strategy, risk appetite, balance sheet size and structure, and profitability
- Non-core assets segregated into two groups:
  - underperforming, and;
  - strategically irrelevant
- Understanding linkages between core clients and non-core assets key to protecting relationships
- Linking all positions to non-core assets (e.g., hedges) is complex
- Establishing a robust data policy and structure upfront minimizes problems "down the road"




Source: IMF, Economic Intelligence Unit as of Dec 2010

# 6 Valuations

A new normal has set in for valuations across the banking industry. Lower returns on tangible equity prompted by higher capital requirements and reduced earnings power have readjusted valuation levels to well below historic levels (Figure 4).

Less complex and less volatile business models, predicable earnings with opportunities for growth, risk management as a competitive advantage, capital strength, and emphasis on tangible common equity (TCE) are providing positive support for new valuation levels against headwinds that may include:

- The tepid pace of the U.S. economic recovery
- Renewed geopolitical jitters and elevated macroeconomic uncertainty
- Basel III and associated increased capital pressures
- The costs of financial reform and litigation that continue to weigh on stocks
- Slow loan growth across many asset classes (although credit has improved with early signs of stabilization in housing market)
- Sustained low rate environment, excess liquidity, and funding costs at a near floor that are constraining net interest margins
- Wide swings in non-interest income due to market volatility and mortgage banking cyclicality
- Higher non-interest expenses

### What's new for 2013

Barring improvements in fundamentals and economic clarity, valuations are likely to remain range-bound in 2013 and earnings are expected to continue to face strong headwinds. Mortgage revenue is a near-term tail wind but outsized results have a limited life and may mask revenue and growth challenges. In addition, lower ROE may likely be the norm as banks rethink provision levels and capital targets. Potential investors may be looking closely at the level of risk that businesses are employing and the associated volatility that generates when determining required valuation multiples relative to peers.

There are considerable differences of opinion regarding what the "new normal" may be for banks' forward P/E valuation multiples. In the five years preceding the financial market's instability, from June 2002 to June 2007, large-cap banks traded at an average forward P/E multiple of 12.6x. In the last 12 months to December 2012, the average forward P/E multiple for large-cap banks declined to 9.3x.[2] Higher capital requirements being introduced by new regulations and Basel III are depressing ROEs. The lower valuation multiples for banks are likely, given the lower ROEs. However, the additional capital in banks' balance sheets may also render banks less risky and their earnings less volatile over time which, in turn, could decrease their cost of capital. A lower cost of capital could result in higher valuations for banks as the market adjusts to the sector's lower risk profile.

### Bottom line

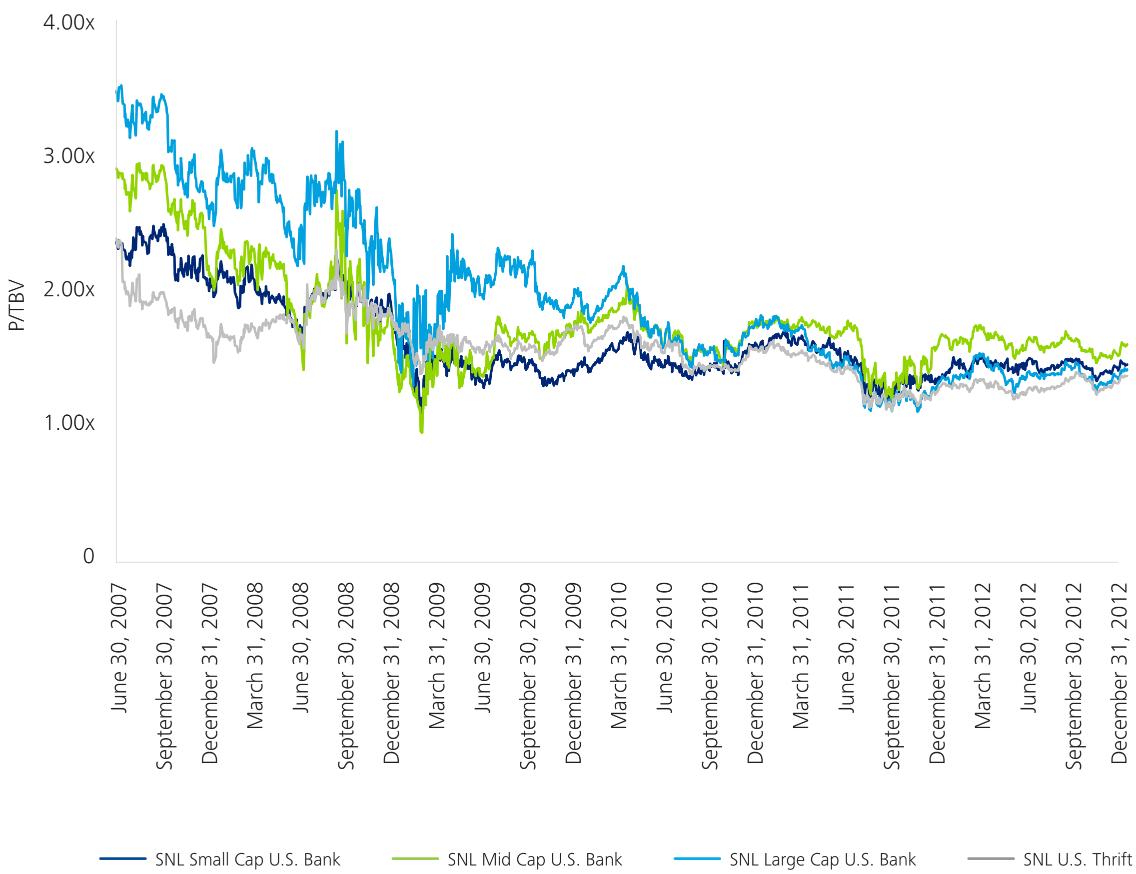
Anticipated M&A with strong corporate risk management, capital strength, emphasis on TCE, as well as general economic improvement and new or enhanced growth prospects, could be the catalysts for near-term valuation improvement. Looking ahead, the banking industry could potentially benefit from an improved, end-to-end process for strategizing and implementing M&A that addresses valuation issues upfront (e.g., topline opportunities are being underemphasized; actual deal cost in aggregate is much higher than expected; sellers have unrealistic price expectations in light of marketplace realities). Also needed is close scrutiny and analysis of revenue cross-selling abilities and cost synergies during the due diligence process to help facilitate a successful deal. As well, deals that are highly contingent on achieving significant synergy targets should require execution excellence throughout the transaction life cycle.

2 Source: FactSet. SNL Large Cap U.S. Bank Index Includes All Publicly Traded Banks In SNL's Coverage Universe With Greater Than $5B Total Market Capitalization. The Method For Calculating The Forward P/E Aggregates The Daily Price And Divides By The Estimated Earnings From Consensus For All Banks.

*Figure 4: Price to tangible book value multiples are stabilizing but remain well below historic levels*

*Relative Stock Price Performance*

| Index | P/TBV | | | | | | |
|---|---|---|---|---|---|---|---|
| | 06/30/07 | 12/31/08 | 12/31/09 | 12/31/10 | 12/31/11 | 01/15/13 | Median |
| SNL Small Cap U.S. Bank | 2.33x | 1.97x | 1.40x | 1.58x | 1.33x | 1.46x | 1.49x |
| SNL Mid Cap U.S. Bank | 2.91x | 1.83x | 1.66x | 1.74x | 1.57x | 1.61x | 1.68x |
| SNL Large Cap U.S. Bank | 3.34x | 2.33x | 1.89x | 1.73x | 1.28x | 1.42x | 1.78x |
| SNL U.S. Thrift | 2.33x | 1.87x | 1.71x | 1.56x | 1.25x | 1.38x | 1.58x |




Source: SNL Financial, Data As Of 1/16/2013

SNL Small Cap U.S. Bank Index Includes All Publicly Traded Banks In SNL's Coverage Universe With $250MM To $1B Total Market Capitalization

SNL Mid Cap U.S. Bank Index Includes All Publicly Traded Banks In SNL's Coverage Universe With $1B To $5B Total Market Capitalization

SNL Large Cap U.S. Bank Index Includes All Publicly Traded Banks In SNL's Coverage Universe With Greater Than $5B Total Market Capitalization

SNL U.S. Thrift Index Includes All Major Exchange Thrifts In SNL's Coverage Universe

# 7 Focus on asset-generators

Banks may have many challenges on the left-hand side of their balance sheets to growing assets and revenue; among them may be a continued tight commercial market, flat-to-tepid loan growth, lingering asset quality issues related to real estate, and regulatory-related higher capital requirements. It is tough on the right-hand side too, particularly for smaller banks; institutions may have loan-to-deposit ratios under 100 percent and are unable to capitalize on the low cost of deposits by investing in interest-earning assets that can generate yields to enhance net interest margins. Expectations of continued low interest rates into 2015[3] are likely focusing U.S. domestic acquisitions on asset-generators to help banks widen their margins. Yet, these opportunities are generally few and far between and they can come with a high price tag.

**What's new for 2013**

Historically, the raison d'être for many bank acquisitions appeared to be the value of their deposit base. But entering 2013, many banks have excess deposits that they can't deploy fast enough; therefore, acquirers seem to be shifting their focus to finding bank targets with strong origination platforms; especially those without unrealistic price expectations or other negative mitigating factors. Absent those targets, buyers may be looking at opportunistic purchases of non-traditional and specialty lending operations. With lack of supply, the bid-ask spread on such asset-generators has narrowed considerably, which can require potential acquirers to act promptly. Frequently, when an asset-generator works well from a regulatory perspective and the yield is good, it tends to be snapped up, as in the numerous auto finance and asset leasing deals the industry has seen during the past two years.

**Bottom line**

Banks appear to be shifting their M&A focus from deposit-gathering to the ability to generate quality origination. Their "Plan B" may be non-depository acquisitions as banks target lending operations in pursuit of increased yields. However, there is intense competition for these businesses and acquirers should be careful to avoid overpaying. And although these acquisitions are likely opportunistic, they should still support a bank's overall M&A strategic plan. Finally, the yield curve won't stay low forever and deposit franchises can become valuable acquisition once again.

3 "Most on Fed See Rates Low into 2015," *Real Time Economics, The Wall Street Journal*, December 12, 2012, http://blogs.wsj.com/economics/2012/12/12/most-on-fed-see-rates-low-into-2015/. Accessed February 22, 2013

# 8 Reputational risk

The U.S. financial system was negatively painted with a broad brush during the economic downturn. As a result, there is continued — and increasing — government and public pressure on banks (especially the largest institutions) to be more ethically and socially responsible. This scrutiny is prompting bank Boards and management teams to consider pointed questions, such as: Which among our current business lines have the potential for reputational risk? Are the proper controls in place? Should we consider modifying or exiting a particular business because it poses too much risk potential? Do non-business planning strategies expose my business to reputational risk (e.g., aggressive tax planning)? How do we comply with the tax information reporting requirements to facilitate proper compliance?

There seems to be a view taking shape around the need to manage reputational risk across business lines, especially for banks that have large investment banking platforms. In addition, banks must comply with evolving Anti-Money Laundering/Bank Secrecy Act legislation. The more banks identify potential trouble spots, the more they may realize how exposed they are — as may be the industry as a whole.

### What's new for 2013

From a reputational risk standpoint, banks appear to be under a microscope. The majority of significant investments or M&A transactions are closely scrutinized by the government and the public. In 2013, banks should carefully analyze consumer-focused businesses, such as mortgage lending and servicing, and how they price services to the under-banked, to limit scrutiny by the CFPB; the market has seen significant sales in asset servicing that are partially driven by this issue. Banks may also need to examine their business model, identify potential reputational risks, and address them as part of an enterprise-wide risk management program. In essence, banks should consider "kicking the tires" of current and prospective business lines more than they have done in the past to safeguard their brand and avoid potential malfeasance.

### Bottom line

Heightened public and government scrutiny can drive banks to consider applying a risk-averse filter when considering M&A opportunities, i.e., what existing and potential lines of business could concurrently grow revenues and avoid social/reputation risks and high volatility? Such a filter could help to avoid some problems but may also lead banks to apply a cautious lens to the social implications of certain lending or acquisition strategies, which might jeopardize the overall economic recovery. Also, in the wake of high-profile investment scandals, banks are spending more attention, time, and resources on examining their operating environment and instituting appropriate controls across the enterprise. Finally, banks may be challenged to find a way to serve the under-banked sector of the population profitably while balancing reputation concerns around exploitive pricing.

# 9 Reform-based tax changes

U.S. banking industry attention is focused near-term on 2013 capital gains and dividends tax rate increases, as well as unresolved fiscal issues. Of greater, long-term importance, however, is likely broad tax reform legislation.

Broad tax reform in the U.S. and Europe is anticipated sooner rather than later, but when might it occur and what form might it take? Banks and other financial services entities have significant amounts of tax attributes and operating deferred tax assets. What may happen to them as the industry goes through tax reform? How might banks utilize these assets? May institutions have one-time tax write-offs for their assets or might an alternative model emerge?

One question generating substantial marketplace interest: How can jurisdiction impact banks' international operations? Might the U.S. move to a territorial regime (under which banks may pay less U.S. tax on foreign earnings) or some other regime? Finally, what impacts might general tax reform have on banking industry M&A? May the industry see less cash deals and more stock deals as a result? Does increased taxation of high-net-worth individuals pose any risks to a certain class of bank clientele? Might corporations restrict cash available to invest due to short-term provision expirations or wholesale tax reform?

The options and implications are many; once legislation is in place in the U.S. and Europe, the marketplace should expect to see banks adopt the most efficient tax structure they can find.

### What's new for 2013

Since the 2013 capital gains and dividends tax rate increases have been enacted by Congress, banks may deal with them as corporate entities and as stewards of their customers' assets. In anticipation of broader tax reform, banks are modeling various strategic scenarios; clarification may spur more defined actions. Banks are also validating and substantiating their own tax profile in order to move effectively once reform occurs. A trend appears to be emerging of banks readying themselves for sale by — among other actions — reversing their allowances for deferred tax assets from a capital/earnings perspective. Such actions may make them a more attractive target from an M&A perspective. In addition, tax increases could result in more stock deals versus cash deals. Also, banks impacted by Basel III capital requirements should determine how much of their deferred tax assets may affect the amount of capital they might be able to recognize for regulatory purposes. Expect considerable tax planning and analysis in 2013 around deferred tax assets, as they may be an even more essential driver of unlocking acquisition value.

### Bottom line

In 2013, continuing legislative machinations around tax reform are expected to cloud value in the short term; therefore, modeling potential scenarios and devoting time to sufficient tax planning and deal structuring may be principal to effectively navigate a deal in the coming year.

# 10 Long-term planning

Over the next five to seven years, banks are likely to clean up lingering vintage assets and exposures on their balance sheets, get back to basics, and institute M&A target filters, activities that increase the importance and relevance of multi-year planning. While the performance side may be driving some near-term M&A activity, the industry is seeing Boards and C-suites take a more broad approach to change (Figure 5) and strategically vet opportunities with longer-term payback. Underpinning each organization's planning should be a thoughtful analysis of two important questions: Where do we want to go? How do we use M&A to get there?

### What's new for 2013

As the U.S. continues to emerge from recession and important regulatory rules become finalized, banks can and should consider shifting from short-term crisis aversion to longer-term planning in their M&A strategy.

In response to the new regulations, as well as potential lingering market uncertainty and ongoing challenges to top-line growth, many large institutions are likely to continue rationalizing their geographic footprint and product lines amid a major clean-up of balance sheets and return to core services. Mid-tier banks are likely to strategically "double down," either in a particular geographic market or line of business across geographies. The small-bank market may see continued consolidation in light of the difficult headwinds. Some of these market maneuverings should provide important lessons for banks' long-term planning efforts.

### Bottom line

Improving market conditions are creating an environment that could be more conducive to long-term planning around M&A. Proper longer-term strategic planning can help to overcome some of the shorter-term deal hurdles highlighted earlier, such as the current flat yield curve.

To begin, banks should acknowledge, understand, and address existing regulations and market realities, with an eye as to how they might evolve and bring new challenges and opportunities. In addition, lessons learned from the past five to 10 years of deal-making show that success is often predicated on marrying corporate and M&A strategies. For example, marketplace uncertainty creates an increased need for tax planning and scenario modeling to truly understand M&A's role in a bank's overall strategic plan.

*Figure 5: Looking forward, leaders are taking a more comprehensive approach to change*

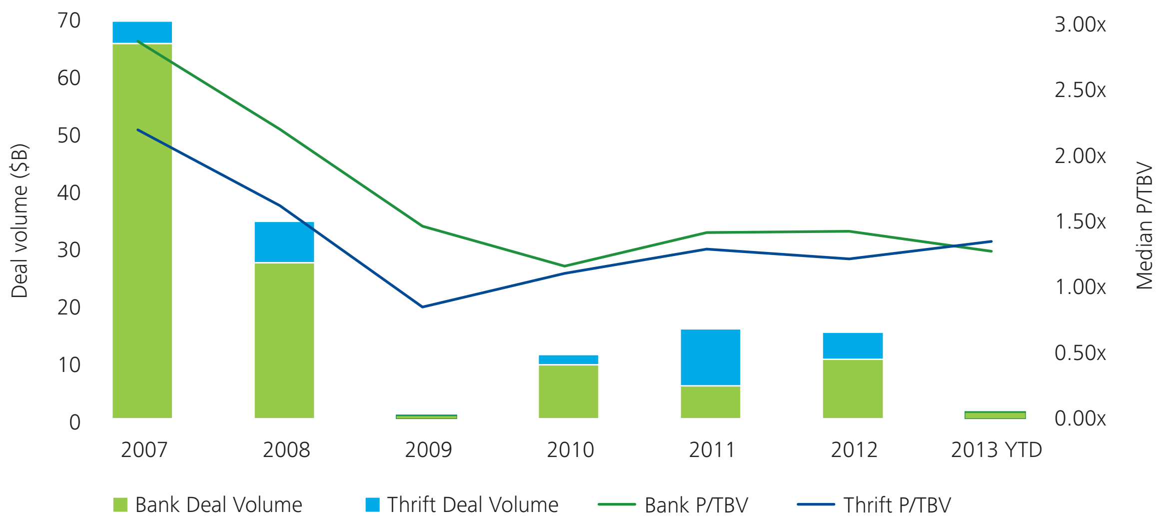
<table>
<tr><th></th><th colspan="3">"Soup to nuts" restructuring</th></tr>
<tr><th></th><th>Optimize</th><th>Re-balance & re-size</th><th>Re-architect & scale</th></tr>
<tr><th></th><th>< 1 Year</th><th>1–3 Years</th><th>> 3+ Years</th></tr>
<tr><td>Revenue</td><td>Portfolio re-assessment</td><td>Re-focus client strategies</td><td>Targeted expansion</td></tr>
<tr><td>Expenses</td><td>Cost reduction</td><td colspan="2">Upgrade and transform operating model</td></tr>
<tr><td>Capital requirements</td><td></td><td colspan="2">Reallocate capital</td></tr>
<tr><td>Balance sheet</td><td></td><td>Increase capital cushion and/or liquidity</td><td>Replenish/distribute capital/liquidity</td></tr>
<tr><td>Business activities</td><td colspan="2">Divestitures</td><td>M&A/partnership models</td></tr>
<tr><td>Regulatory</td><td colspan="2">Robust data analytics and oversight</td><td>Risk management</td></tr>
</table>

Source: Deloitte Development LLC, 2013.

# Moving forward

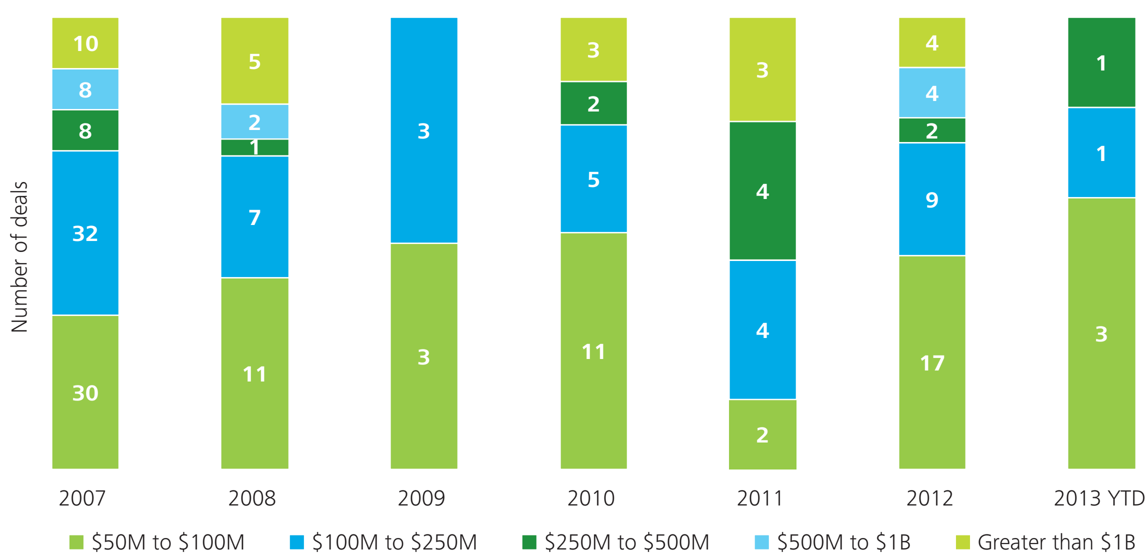
Assuming that the U.S. and Eurozone countries see sustained economic improvement and increased regulatory clarity, recent trends in transaction volume and size (Figures 6 and 7) indicate that the banking industry M&A market could become re-energized in 2013.

*Figure 6: U.S. bank & thrift announced M&A deals*




Source: SNL Financial. Transactions Are Announced Whole Deals As Of 1/16/2013.
Excludes: Terminated Deals, Deals <$50MM, Gov't Assisted Deals, Branch And Asset Deals

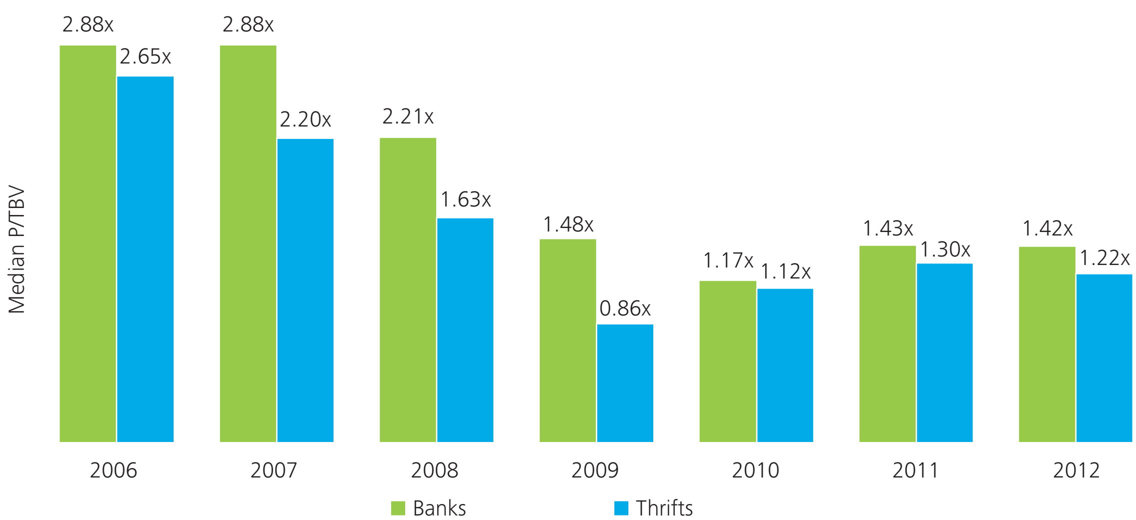
*Figure 7: Number of bank & thrift transactions by deal size*




Source: SNL Financial. Transactions Are Announced Whole Deals As Of 1/16/2013.
Excludes: Terminated Deals, Deals <$50MM, Gov't Assisted Deals, Branch And Asset Deals

Buyers may be looking to improve competitive positioning within existing markets and increase attractive demographics. They also may be seeking to create economies of scale to absorb the costs of a heightened regulatory burden. In addition, while transaction multiples have yet to fully normalize, sales of stronger banks are beginning to take place (Figure 8).

***Figure 8: Transaction multiples are beginning to improve as sales of stronger banks are starting to materialize***
*Price/tangible book*




Source: SNL Financial,Transactions Are Announced Whole Deals As Of 1/16/2013,
Excludes: Terminated Deals, Deals <$50MM, Gov't Assisted Deals, Branch And Asset Deals

Banks looking to take advantage of M&A opportunities may be discerning, strategic buyers: If it costs less to purchase a target which complements or augments current operations than to grow needed functionality or a geographic presence from scratch, the potential buyer may be likely to move forward. Purchasers, however, may be unlikely to let today's low prices be the sole driver of their acquisition choices and dictate their long-term strategy; rather, they may likely pay a fair and justifiable price for an entity that supports their business model. New, innovative structures could be needed to get deals done amidst credit and market uncertainty and to bridge the gap between buyer and seller expectations of value.

Stronger banks with growing earnings and those that are first to have marginalized their problem assets should have a competitive advantage and be able to facilitate acquisitions with higher capital levels. Also, the bid-ask spread appears to be compressing to some degree as the "open bank" market re-emerges, with challenged banks realizing that a sale — even at lower-than-desired multiple levels — may be the preferred alternative versus continued failure to generate earnings in excess of the cost of capital for investors. Additionally, a significant number of small and regional banks may likely be acquired; given that the U.S. market is still very fragmented, there is limited ability for smaller banks to lend due to commercial real estate loans' lack of appeal and existing concentration levels, smaller banks' limited ability to play in other lending products (e.g., credit cards, mortgages), ongoing economic struggles at the community business level, and the heightened regulatory burdens/costs of financial reform.

Within industry tiers, big banks are expected to strategically position themselves around the world and divest non-core operations. Foreign interest In the U.S. banking sector is likely to remain selective, as many firms sit tight or scale back In order to meet capital/ liquidity needs at home. In addition, a resurgence of non-depository lending acquisitions is expected to continue as banks look for higher-yielding assets.

Regionals may opportunistically pick-off synergistic franchises as they become available; in addition, some regionals may take advantage of branch sales to beef-up operations; as these are primarily depositor organizations, it may take time for the investments to pay off. Community banks may not see a resurgence in earnings until there is a positive change in the yield curve, likely making scale (and continued M&A) even more vital to their survival.

Over time, consolidation may rationalize the playing field and drive increased investor demand. The banks well-positioned for results in 2013 and beyond are likely to be those that have a relevant franchise with attractive demographics and customer base; a diversified business mix, product set offerings, and strong core deposit base; an attractive earnings profile which is able to be augmented by both organic growth and opportunistic M&A; sufficient size and economies of scale to absorb heightened regulatory/compliance costs; strong capital and liquidity positions with additional readily accessible sources; risk management as a strong competitive advantage; a prudent and opportunistic approach to lending; and a seasoned management team with credibility across varying constituents: regulators, rating agencies, and investors.

In contrast, those banks likely to be acquired typically can be competitively disadvantaged by a lack of scale, markets, products, business lines, technology, or cost structure; demonstrate an inability to generate and consistently grow earnings; have weak asset quality with limited turnaround options and/or significant capital needs without access to public or private markets; experience heightened liquidity pressures or regulatory scrutiny; and have boards and management that are burnt out from navigating the downturn and are still struggling to meet capital hurdles and compliance costs in today's uncertain banking marketplace.

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