Hovde

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The Art of the Deal

A timeless Chinese adage exhorts prudence while bartering. "You choose the price," the adage goes, "and I'll choose the method. And I'll do better than you every time." While a simple concept, the corresponding wisdom is nonetheless undeniable. Whether purchasing a car, structuring a loan, or trading baseball cards, the details framing the deal are critical. Consider, by way of example, the fortuitous individual who finds him or herself holding a winning lottery ticket. The value of the jackpot is clear; however, faced with a decision between a lump sum payment and a long-term annuity, the *structure* of the deal becomes all too critical.

Needless to say, with regard to mergers and acquisitions in the banking universe, such concerns have very real and very significant implications. When considering the ramifications of a potential transaction, whether it be from the perspective of a buyer or a seller, it is imperative to fully comprehend not only the price but also the contemplated structure, key terms, and related contingencies. Thus, in homage to the aforementioned adage, while assessing a potential transaction, we exhort our clients to focus on two major disciplines: the ***science*** of the price...and the ***art*** of the deal.

Hovde Financial has announced over 250 community bank transactions since inception, including 21 transactions announced last year. Over time and with the benefit of our industry-leading transaction volume, we have collected an array of war stories, unique experiences, and valuable insights regarding the importance of the artistic aspects of mergers and acquisitions. We share some of those insights in the examples and observations that follow.

The Blank Canvas: Assessing Deal-Related Challenges

Any successful deal begins as a blank canvas of terms and key issues to be negotiated. If successful, the deal ends up a comprehensive covenant of mutually agreed upon terms, conditions, and requirements. At its most fundamental level, a deal is a system, an engineered solution to an array of *challenges* and *priorities* introduced by the respective parties involved. A seller, for example, may consider it an utmost *priority* to obtain a price equivalent to at least 2.5 times book value. In practice, however, paying such a price may prove *challenging* for the buyer. That said, a successful deal must commonly address many challenges, several of which are summarized below.

Price and Pricing Multiples – Simply put, the price is generally the most critical component of the deal. For both buyers and sellers, price is the magic number that predominantly determines the overall feasibility of a transaction.

To be sure, a seller bears several burdens during the transaction process, but the most important is, without exception, achieving a price that maximizes shareholder value. However, sellers can encounter a variety of other price-related challenges during a negotiation process. In particular, a seller's board of directors may only be willing to consummate a transaction at a minimum total price or price per share, and/or with a specific type of buyer and/or type of currency (e.g., predominantly stock versus cash). Furthermore, a seller's board may have perceived conceptions of value that are not entirely borne out by financial analysis based on core

earnings or franchise value. Indeed, sellers commonly establish a sentimental value expectation (e.g., realizing a higher earnings multiple than the bank in the neighboring county, which was just acquired) or an otherwise arbitrary valuation (e.g., a fixed multiple of 2.5x book value). As a result of such expectations, sellers can develop unrealistically high price expectations or, conversely, may actually undervalue their franchise.

Buyers, on the other hand, typically look to offer a fair price, but typically one that best protects value for its shareholders. Moreover, buyers usually assess value more effectively and analytically by using traditional valuation techniques. That said, although some buyers may be able to meet a seller's price expectations, they may otherwise be inhibited from meeting those expectations due to concerns related to potential negative market reaction. Specifically, buyers may be wary to announce a deal at a price significantly above a seller's publicly traded market price because of the potential negative market scrutiny, which could have an adverse effect on its own stock price.

In deference to the systematic approach to deal-making, an understanding of the motivations and thought processes of both buyer and seller is essential, especially as there are many factors that ultimately influence the negotiated price. Two external forces that, in particular, ultimately have a considerable impact on price are the equity markets and interest rates. Equity market valuations are critical because, if an acquirer's stock price declines, so too does that company's ability to pay a higher price, at least in terms of an all-stock or stock-cash mixture transaction. Conversely, transactions with a material cash component will be impacted by interest rates. This is precisely a function of the fact that any cash used in a transaction can no longer be put to use earning interest; this "opportunity cost" to the acquirer materially impacts the financial component of any transaction.

Thus, as acquirers' stock prices decline and/or interest rates rise, the cost of acquisitions increases and acquirers' ability to pay declines. Indeed, a company that is considering a sale in the foreseeable future should evaluate the outlook for both interest rates and bank equity values. If a seller's board believes interest rates will decline and/or bank equity valuations will advance, a potential sale is best timed at some future point. Conversely, if a seller's board anticipates higher interest rates going forward and/or a decline in bank equity valuations, a potential sale is best timed on a more accelerated basis so as to avoid deterioration in a buyer's ability to pay.

Special Dividends — Hovde has been successful at bridging the gap between a seller's price requirements and a buyer's ability to pay through payment of a special dividend. For example, Hovde recently announced a transaction in which the buyer was originally unable to pay an additional premium beyond that which it offered in its second and final bid. However, this final bid was still below the seller's price requirements. As a bridge between the two values, Hovde negotiated a structure whereby the selling institution would be able to pay a special one-time dividend of all earnings between announcement and closing. This special dividend allowed the seller's shareholders to receive additional consideration while not increasing the actual amount that the buyer was paying in cash and stock upfront. The dividend provides more consideration for the seller's shareholders, at the current favorable 15% tax rate (identical to capital gains), while not increasing the transaction price-to-earnings multiple announced to the marketplace. Notably, a special dividend is generally only feasible when a selling institution is adequately- or over-capitalized.

Contingent Payments — Similarly, a buyer may not be willing to offer additional consideration because of concerns over certain credits or broader earnings sustainability. In such cases, contingent payments can provide a solution. A contingent payment is generally a payment contingent upon some future action or activity, or absence thereof. In the case of a buyer that is concerned with a seller's credit quality, a contingent payment can be structured that allows for full payment upon satisfactory resolution of problem credits. If they are not satisfactorily resolved, the payment (usually in an escrow account) is recaptured by the buyer. Defining the amount, proportionality, and requirements for the contingent payments is especially important in advance of striking a deal.

Price-to-Book Multiples and the "Glass Ceiling" — Over time, Hovde has worked with institutions that have maintained a highly leveraged capital position. Partially as a result of high leverage, these institutions have received record-setting price-to-book multiples, including First National Bankshares, which received 625% of tangible book value, and Destin Bancshares, which received 571% of tangible book value. However, maintaining a relatively low

capital ratio can potentially inhibit a value that might otherwise be warranted on a price-to-earnings basis.

Recognizing and addressing this potential "glass ceiling" before going to market can be critical to recognizing a higher value in a sale. In particular, several steps can be taken in advance of going to market. First, the seller can exercise any and all outstanding but unexercised stock options. In so doing, equity capital will obviously be increased. Second, a seller could consider some sort of additional equity infusion such as a private placement or secondary offering. Importantly, the timing of any equity raising activity in relation to going to market can be critical and should be reviewed with counsel. Finally, highlighting the projected book value at closing — *as opposed to at the time of announcement* — can mitigate potential "glass ceiling" concerns. Purchase accounting adjustments can also mitigate goodwill, such as built-in gains from real estate owned.

Timing —Timing is perhaps the most crucial element to be considered in order to fully maximize value. The broader merger and acquisition environment is decidedly cyclical, with peaks and troughs. 2004 was a relative peak, with the average price-to-tangible book value and price-to-earnings multiple of 230% and 25x, respectively. In fact, Hovde Financial announced 21 transactions in 2004, nine of which were greater than 300% of tangible book value, including four greater than 400% of tangible book value, three greater than 500% of tangible book value, and one greater than 600% of tangible book value. The ability to time these transactions in relation to broader macroeconomic trends was essential to realizing such record prices.

Beyond external market factors, the timing of a seller's growth, earnings, and strategic execution is also critical. While the market might be witnessing record prices, a seller may not be best-positioned internally to realize value maximization. In other words, earnings may not be maximized, balance sheet growth may not have hit full stride, asset quality may require improvement, etc. With regard to earnings, for example, during the first quarter, buyers generally tend to look at the prior year's earnings as a proxy for earnings potential. During the third and certainly during the fourth quarter, buyers look to the current year's and next year's earnings as a proxy for earnings power.

Ultimately, value maximization requires paying keen attention to two critical timing issues: one, trends in the broader M&A cycle, and two, internal growth and performance trends.

Consideration — Shareholders of a selling institution will most likely have a preference for a particular type of consideration, whether cash, stock, or a mixture of the two. This preference can be borne of tax concerns, desired dividends, liquidity issues, or the long-term outlook of the acquiring institution's stock. An acquirer, however, may be limited in its consideration of options. Capital ratios may restrict cash usage or EPS concerns may cap the total number of shares that can be issued. Importantly, a comparison and analysis of various means of consideration is critical. A buyer with a premium-priced stock may have the superior offer financially, yet their stock may trade artificially high. As a result, in all actuality, the "high" nominal offer could represent a lower true value on a longer-term basis.

Consideration Structure — The true consideration value of a stock or a cash-stock transaction hinges directly upon the trading price of the acquirer's stock both in the time period 1) between signing a definitive agreement and closing, as well as 2) post-closing. In the period between signing and closing, the interests of the seller may be opposed to the interests of the acquirer. Commonly, the seller wishes to know the dollar value of consideration to be paid while minimizing any downside risk; the way to achieve this is to fix the total consideration value, which requires the number of shares issued by the acquirer to the seller to float. Under this structure, it is in the seller's interest to have the buyer's stock fall in price so that more shares are issued to the seller at closing. Conversely, driven by concerns of dilution and overall EPS issues, an acquirer will generally prefer to know the total maximum number of shares to be issued to the seller's shareholders; the way to achieve this is to fix the total number of shares to be issued, which requires the total dollar value of the consideration (as contrasted to the number of shares) to float. After closing, both parties obviously want the stock price to consistently rise in value.

There are certainly deal structures that effectively address both concerns, and Hovde is skilled at customizing structures that address these concerns. Specifically, the consideration is structured such that either the total value or number of shares issued floats between some predetermined and mutually agreed range of the buyer's stock price. Outside of that range, the consideration value becomes fixed. This structure is

accomplished largely with the use of so-called "collars." The focal points of these collars require careful analysis, as do any corresponding adjustments within and outside of these collars. Nonetheless, effective use of collars in deal design can be exceedingly advantageous to structuring a beneficial deal while mitigating risk.

One of the determining factors that we consider in selecting the preferred structure on behalf of a seller is the value of the potential acquirer's stock; as such, it is crucial to perform the requisite evaluation of the acquirer's stock and its valuation. If the acquirer's stock is undervalued, then we would recommend a structure that fixes the number of shares – so that the deal value floats and the seller can garner any appreciation. If the acquirer's stock is believed to be overvalued, we would use a structure that fixes the total deal value – requiring the number of shares to float – so that the seller would be protected from any decrease in value. In either case, we will typically utilize collars, as discussed above, to ensure the transaction's success.

Stock Options — A majority of institutions have utilized stock options as a means of incentivizing employees and rewarding founding shareholders and board members. The treatment of these options can play an important role in deal design, especially in situations where the number of options represents a material amount in relation to the number of shares outstanding. Essentially, there are three methods of handling existing options: 1) they can either be cashed out at their in-the-money value net of exercise costs, 2) the "in-the-money" value can be converted into an equivalent value of common shares issued to the option holder, or 3) they can be "rolled" into options of the acquirer at the equivalent in-the-money value. Each of these methods respectively has unique tax considerations.

An acquirer may not utilize options, or at least not to the extent or level of the seller. As a result of this, or simply a desire to minimize the total number of shares to be issued ultimately, cashing out the options may prove the preferred method for the acquirer. This method requires the calculation of the price per share *on a fully diluted basis* in order to arrive at the in-the-money value net of exercise prices. Cashing out options will have a material tax impact for the option holders. "Rolling" options is commonly the preferred method for a seller in that it provides an avenue for deferring taxes and allows the option holders to continue to participate in the upside gain, albeit in the appreciation in the value of the *pro forma* company. The preferred treatment of a seller's options may be a result of economic concerns, but may also be influenced by simpler liquidity issues. For example, a seller's option holders may lack the upfront cash to exercise options if the merger agreement calls for it. However, in such cases, financing can usually be arranged.

Management and Board Seats — While not a financial concern, the role of the seller's management and board of directors in the *pro forma* company nonetheless has intrinsic value. Based on the seller's contribution to the combined company, for example, board representation may be in order. Generally speaking, the seller's contribution is calculated based on an analysis of the assets, equity, deposits, loans, earnings, and (if relevant) market capitalization that the seller contributes in comparison to the amount contributed by the acquirer.

The treatment of the seller's management is also a critical concern. The terms of management's existing contracts may require certain payments, yet these payments are not always guaranteed under existing contracts in place prior to a transaction. A change-in-control payment, for example, may only be payable if management is subsequently terminated after the deal. Hovde has historically been very successful in realizing these payments for our clients regardless of the contract contingencies. Moreover, in cases where management lacks existing contracts, Hovde has successfully negotiated comparable consideration to compensate for management's continued involvement in the deal. Notably, certain payments and compensation structures may trigger additional taxes pursuant to IRS Section 280G; however, there are structures and methods to avoid these additional taxes.

Negotiations: One-on-One vs. the More-the-Merrier — The approach to a transaction and the number of parties with which a seller initiates discussions generally has a material bearing on value. Without fail – and not surprisingly – buyers prefer one-on-one negotiations. Such negotiations can – but typically do not – maximize value. When unilateral negotiations do maximize value, it is because the buyer is extremely motivated and wants to preempt the seller from talking with any other prospective buyers.

However, it is generally in the seller's best interest to involve at least a few parties in the process. Such a process "keeps buyers honest" in a competitive bidding situation. A Hovde client recently received almost 360% of tangible book value at least partially as a result of receiving offers from multiple parties in a competitive bidding situation.

While the particular circumstances of each client are decidedly unique, we generally recommend a hybrid of one-on-one negotiations and a bidding war, an approach we refer to as "targeted negotiations." Instead of a broad-based bidding war involving 20+ potential acquirers, our preferred approach is to initiate discreet discussions with only a limited number of potential acquirers, typically four to eight parties. We identify these targeted parties, based on an advance screening process along three primary criteria, with the benefit of our proprietary market intelligence: 1) buyers that have the financial capacity for acquisitions; 2) buyers that can receive the necessary regulatory approvals to close an acquisition (especially as certain buyers, even the very largest banks, can still be kept out of the acquisition game as a result of such issues as CRA, BSA, etc.) and, most importantly, 3) buyers that have not only the ability but also the willingness and desire to pay the requisite premium. To be sure, there are many parties that qualify with respect to #1 and #2 above, but are decidedly unwilling to put forth a fair and reasonable price. As a result, initiating discussions with such parties wastes time and energy, and increases the likelihood of a breach in confidentiality. Therefore, the determination of the most appropriate target group of potential acquirers is critical to ensure a smooth and successful transaction.

This method has proven extraordinarily successful for a number of reasons. In particular, these discreet negotiations capture the benefit of talking with multiple parties, while not "broadcasting" to the market that an institution is for sale (the usual result when talking to 20+ parties). For this reason, Hovde has captured industry-leading market intelligence regarding all potential acquirers including consideration preference, priority markets, management treatment, etc. Moreover, we are able to leverage this intelligence to keep negotiations discreet and to only initiate dialogue with the most appropriate parties.

Other Concerns — Not all deal issues are financial in nature. As merging companies, especially financial institutions, commonly have strong community ties, a deal may require continued community involvement. Hovde recently negotiated a transaction in which the seller's contributions to a particular charity were required to be continued by the acquirer.

Needless to say, the above-referenced factors are only a sampling of the many diverse issues that can and do arise before, during, and after the announcement of a potential transaction.

Selecting the Palette: Engaging the Right Advisers

A successful artist relies heavily upon his or her materials while composing a piece of art. Careful selection of materials is emphasized, including such items as the media (canvas, marble, wood, mineral clay) and the tools employed (horsehair brushes, iron chisel, potter's wheel). Even the great masters of the ages still relied upon the masterful tools of their times. So, too, should boards of directors.

In advance of, during, and after inking a deal, complex legal, accounting, and financial questions and challenges can and do arise. Due to their complexity and their ability to hamstring an otherwise smooth transaction, a board's ability to identify and correctly address these issues is particularly essential. In order to do so, it is recommended that a board engage expert financial, legal, and accounting advisers. There is little doubt that having in place the right team that is experienced in mergers and acquisitions of financial institutions dramatically improves the quality of advice and consideration by management and the board of directors.

Financial Adviser

A well-qualified, experienced financial adviser plays a critical role in facilitating a transaction, and the most experienced, value-adding financial advisers will typically be incorporated into the process by the board well before any transaction is contemplated. In fact, in order to fully leverage the advice, analysis, and negotiating capabilities of an adviser, boards commonly retain an adviser to play a role in advance of, during, and after the announcement of a deal.

Before the Deal: In advance of a transaction, boards will commonly invite their adviser to present an educational overview, typically inclusive of the following:

- A review of the state and national community bank and thrift M&A environment and its impact on the company;

- A description of key steps in the transaction process and the timing of any potential transaction;
- A discussion of key deal and post-deal issues that may impact individual shareholders;
- A valuation or a valuation range; and,
- Potential acquirers (for companies considering a sale) and potential targets (for companies looking for acquisitions).

During the Deal: Financial advisers can prove indispensable during the actual transaction process. For a company considering a sale, an adviser should be able to leverage its experience on prior transactions and its internal contacts to identify a succinct but targeted list of potential acquirers. Once identified and contacted, the adviser can prepare an in-depth document (*"Confidential Information Memorandum"*) to be presented to the parties identified. This memorandum summarizes and provides highlights of the company's history, philosophy, management, markets, and financial statements.

After distributing the memorandum to potential acquirers, the adviser receives, analyzes and compares the offers submitted. While several offers may be received with comparable face values, the adviser should prepare an analysis that compares other key terms which can materially alter the total offers. By way of example, two offers may be received at exactly the same value. However, if one is a cash offer and the other is a stock or cash-stock offer, depending upon the tax implications, the offers can deviate substantially on an after-tax basis. Moreover, the cash offer "is what it is," while the stock offer may provide a liquid currency with a dividend stream and a potential "double dip" opportunity, not to mention organic price appreciation — *or depreciation* — depending upon the acquirer's performance. Finally, any of the seller's stock options are essentially cashed out in a cash deal while the stock deal provides for several scenarios (e.g., cashing out in cash, cashing out in stock, "rolling" the options into options on the buyer's stock, or cashing out existing options and issuing new options with a neutral face value).

The above questions are those limited to simply the composition of an offer. There are a myriad of other issues related to the main points of negotiation including overall price, structure of a transaction, treatment of options, employment agreements and contract payouts, and transaction contingencies and requirements.

An expert adviser should be able to analyze and compare the terms of any offer(s) and to concisely distill and present that analysis as well as promptly provide recommendations to the board. Given confidentiality issues, as well as other concerns, this process should move along as expeditiously as possible. An adviser's expertise and analysis should allow for this.

Once a particularly attractive offer is identified and selected as the most advantageous and a transaction is contemplated, the financial adviser can – and in most cases should – provide a fairness opinion attesting to the fairness of the transaction for the institution's shareholders from a financial perspective. This opinion is based on the adviser's detailed financial analysis from various standpoints, including projected shareholder returns, contribution analysis, valuation analyses, and an analysis of comparable transactions. Among other advantages, receiving such an opinion assists the board in satisfying its fiduciary obligations.

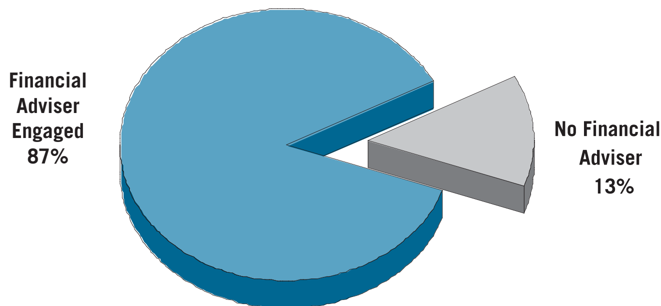
After the Announcement: Assuming a mutually attractive deal is negotiated and a merger agreement is subsequently executed and publicly announced, there are a number of steps to be taken in advance of closing the transaction. An adviser's role during this stage includes supporting the completion of these steps. Primary among these is the completion of SEC Form S-4, which must be filed in a deal involving a publicly traded acquirer issuing stock. An SEC Form S-4 includes a proxy statement and also serves as a registration statement for shares to be issued to the seller's shareholders.

In addition, in advance of a shareholder vote, the adviser can provide any follow-up or detailed financial analysis with respect to board or shareholder inquiries. Finally, if there are any material changes in the deal or the acquirer's or seller's financial condition between announcement and closing, the adviser may provide an updated, or "bring-down," fairness opinion just prior to the closing of the transaction. This bring-down opinion updates the prior analysis in order to determine that the transaction is still fair from a financial perspective for the seller's shareholders.

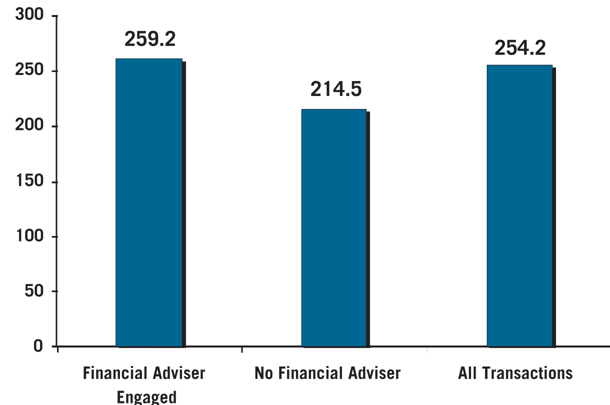
If for some reason the executed transaction should fall apart or if a higher bidder emerges after the announcement, the financial adviser, in concert with the institution's legal advisers, provides critical procedural and financial input regarding how best to proceed. As a result, it is important to remain agile and well-advised until and through closing.

The Value of an Adviser: 2004 Transactions

Percent of Selling Institutions That Retained a Financial Adviser
(Seller Assets > $100mm)



Comparison of Price-to-Tangible Book Value Multiples (%) Received by Selling Institutions
(Seller Assets > $100mm)



Source: SNL Datasource

From start to finish, the value an adviser brings to the process is unmistakable. Presumably recognizing this factor, the majority of selling institutions (87%) retained an adviser in 2004. The value of an adviser is highlighted by a comparison of price-to-tangible book values achieved in adviser-involved transactions and those involving no adviser. On average, ***all*** seller institutions received a price equating to 254% of tangible book value. However, those institutions that engaged an adviser received an average price of 259% of tangible book value compared to the average 215% of tangible book value received by sellers that did not engage an adviser.

Legal Counsel; Accountants

Simply put, the importance of qualified legal counsel and accountants is without question. Throughout the entire process, complex legal and accounting issues arise and experts in each of the relevant fields must be on hand to address these. For example, an institution that has previously elected Sub-chapter S corporation status must be aware of relevant legal issues and accounting requirements that will have a meaningful impact on the tax burden of the deal. Frankly, across the board, expert accountants and legal counsel are a virtual requirement.

Conclusion

Ultimately, the aforementioned Chinese adage provides shrewd counsel. While price is very significant, the method and structure of any transaction is commonly just as important, if not more so. Having advised on more than 250 community bank transactions, we fully advocate the importance of creativity when it comes to negotiations, structure, and deal terms, especially in order to fully address the needs of our clients. This creativity is in homage to the major disciplines: the ***science*** of the price…and the ***art*** of the deal.

Hovde

Founded in 1987, the Hovde Organization is headquartered in Washington, DC with additional offices in Chicago, Los Angeles, and Palm Beach. Hovde has a unique focus on the financial services industry, particularly in the areas of Investment Banking, Asset Management, Merchant Banking, and Securities.

Hovde
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is Hovde's merchant banking division that, in addition to providing strategic and financial advice, provides capital to privately held or closely held financial institutions in order to help finance their growth. This entity also manages a private equity fund, Financial Services Partners Fund I LLC, which invests in both privately and publicly held companies, in most cases assuming control positions through equity investments.

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