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2010 SPECIAL SUPPLEMENT

Board Focus on M&A

Financial Services

Opportunity, Uncertainty Characterize M&A Environment

With distressed deals dominating the financial services sector, bank boards of directors will have little time to breathe over the next 12 months. They will be faced with the task of deciding what path is more strategically sound: attempting to fix their current issues or potentially divest what they have and determine what they really want to be under the new regulatory framework.

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Most forecasts for financial services M&A signal a game-changing year, especially as conditions shape up to be favorable for banks to return to traditional M&A opportunities in 2011. Would you agree the current environment is creating an opportunistic market, and if so, what key factors are contributing to it?

Michael S. McMahon: Broadly speaking within financial services generally, we are currently observing increased momentum in M&A with a larger number of initial discussions leading to a higher execution pipeline. With improving market conditions that started in February, there was a sense that the bottom had passed, and many potential capital providers/buyers did not want to miss the opportunity for what they deemed to be an opportunistic price point. Certainly many companies in the financial services space have financial statements that are improving. Reserve building is also leveling out, or perhaps coming to an end. From a seller's perspective and for nonbank entities such as asset managers, among others, some of the driving factors in this market include expectations of higher capital gains tax rates in 2011 and beyond, thereby enabling selling shareholders to do a monetization this year at a lower capital gains rate. This is important, and has been driving some of the decisions to get to the market early in order to achieve a transaction closing in the current calendar year.

Also, with the increase in asset prices experienced in early 2010, I think there has been a narrowing of the bid/ask spread on valuations among buyers and sellers. Accordingly, the ability to execute deals at something both parties can agree to, or perhaps without FDIC assistance or seller financing, has started to improve dramatically with the increased momentum in the market. For motivated sellers of noncore assets, this has resulted in some acceleration of their divestiture plans. Among asset management platforms, heightened regulatory implications and simply the cost of doing business at current scale, in addition to tax planning, have been the primary drivers of discussions. For banks, the predominant form of YTD M&A activity has been distressed M&A, whether FDIC-assisted or non-FDIC-assisted, where the principal drivers continue to be driven by regulatory-imposed enhanced capital requirements, and/or extensive changes to historical business models/practices such as the elimination of the wholesale funding models. We have yet to observe any meaningful revival in healthy bank M&A for a variety of reasons, including, among other things, the continuing uncertainty of the financial reform activities currently under discussion.

Mark C. Kanaly: The other thing I'd add is that there are many banks out there that have broken revenue models. They're used to superimposing a lot of real estate loans on top of their charter, in many cases with wholesale funding, and it was easy to earn a scrape with that. Having to diversify the portfolio, get back on track in a different direction, and hire people to help create a portfolio in a space in which they're not as familiar and where it's harder for them to turn a nickel, especially on the commercial side, means there are a lot of banks that don't have their revenue models working at the moment. That makes it difficult, even if you can address the capital crisis they're facing and demonstrate how you're going to have long-term return for your shareholders in these banks. So I think

that's also a big part of what's creating this tremendous opportunity for consolidation.

Randolph A. Moore III: We're seeing the same things that Mike mentioned. At the beginning of the year FDIC-assisted transactions were all anyone was interested in, and it was all anyone talked about, but I'm hopeful that we'll return to more of what I would view as healthy bank M&A activity—even though by that I mean simply bank acquisitions prior to the failure of a bank. Hopefully, more people will begin thinking about non-FDIC-assisted transactions. We've seen some meaningful, new deals recently on this front, such as The South Financial Group acquisition by TD Bank Financial Group that was announced in May. This is a positive sign for this longer-term trend of consolidation. The shareholders, I'm sure, weren't very happy about that as it was a take-under transaction, essentially, but that bodes well, I think, for the type of consolidation that is much needed in the banking industry. Healthy bank M&A is in the FDIC's interest, the public's interest, and the overall financial system's best interest.

McMahon: On the FDIC-assisted deals, there's been a lot of fatigue. I have observed some financial sponsors who, for example, were 0 for 12 in terms of success in executing an FDIC-assisted deal and are now pursuing non-FDIC-assisted deals as a way to improve their execution probability.

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Moore: Absolutely, and you're seeing more competition as the premiums on those FDIC-assisted transactions increase and the loss-sharing decreases, and so all of that portends well, I think, for more non-FDIC-assisted transactions by year-end.

Kanaly: I would underscore what Mike said. I think there's a growing perception that on the first wave of these loss-sharing deals when clients talked to us about execution risk, it wasn't nearly what it is today. I mean now, even if you get to the point where you're in a bid room and you can proceed with one, the risk of actually winning the bid and winning it at a price you can tolerate has increased significantly.

Are we likely to see a return to strategic buyers among the larger financial institutions?

McMahon: Broadly speaking I would say yes, and that is certainly the case with the FDIC-assisted deals, although

away from the FDIC-assisted deals, banks continue to be on the sidelines due to the pending financial regulation. Changing capital standards, capital composition, possible asset/liability conditions—are all under review in the Basel III discussions currently under way—and there are still potential asset-quality issues of the targets. No one wants to buy someone else's problems, and in many cases, they are prioritizing the use of their excess capital toward repayment of the government assistance over their acquisition objectives. We do think the strategic players continue to have the need to build scale, enhance their geographic footprint, capture revenue and expense synergies, and, in some cases, to optimize capital structures through acquisitions (i.e., the underleveraged buying the overleveraged companies).

Kanaly: Yes, Randy and I were talking about this earlier, and, at least from our perspective, this seems like an incredible strategic opportunity for the mid-tier banks and all the regionals out there, especially, to be able to very methodically and thoughtfully choose what direction they want to go in geographically and strategically and pick up, whether it's in a loss-share transaction or just a good old-fashion open M&A deal, opportunities that would have cost them a lot just two or three years ago in the way of premiums. This is, especially for what I'll call the mid-tier banks, the chance of a lifetime to get into some markets that were very difficult to enter not too long ago.

Moore: To add to that, the FDIC-assisted transactions are very compelling from a financial perspective, but for banking institutions that are in that superregional or regional space, I don't think Wall Street is going to necessarily reward them for just doing an FDIC-assisted transaction if it doesn't also make strategic sense. Although the financials may be compelling, banks really need to look hard and determine what their long-term strategy is, and I think there's going to be plenty of opportunity to execute on whatever their strategic plan is. I think there will be plenty of opportunity, given the number of troubled financial institutions, to execute on their strategic plan. But they have to have a good story. I don't think the

market will just reward those institutions that are picking up FDIC-assisted transactions for the short-term compelling financial reasons that exist.

Kanaly: Yes, I agree, especially for the banks out there that have real core franchise value. Consider those banks that have core deposits, that are not relying excessively upon wholesale funding, and that are in good markets. When you start looking at the piece of the puzzle they can present for a strategic buyer, trying to buy them out of receivership and hoping you get them becomes a dicey proposition. But for the banks with core franchises, those make very, very attractive strategic opportunities.

McMahon: Among banks, we see a continuation of distressed M&A in the near term. Healthy bank M&A—a healthy bank buying another healthy bank—we don't see that just yet, given where valuations are, and certainly not in terms of discussions in the near term.

Moore: We agree.

Could you briefly describe what you're seeing with regard to financial institutions' capital positions this year? Do you believe private equity is going to start stepping in more aggressively into the arena?

McMahon: We are observing the most active interest on the buy side from the financial sponsor community. They're sitting on a lot of capital and are very market-timing sensitive, and this gets to the point made earlier about missing the bottom, in terms of entry point.

In some situations we have experienced sponsors who haven't printed a transaction in over two years, and they are getting paid to do transactions. We are certainly observing momentum in seeing deals get done by the financial sponsor community.

The other thing we are seeing is that the financial sponsors are not only focused on new deals in terms of new entry points in a specific industry or segment, but also on how to add product lines to their existing portfolio companies to either diversify, build, and enhance the future monetization prospects of those existing businesses. It's a great pricing point today that can provide pretty attractive return opportunities to pick up some good franchises to enhance some of their existing portfolio companies.

Moore: And further to a point Mike made earlier, you know we're all waiting on pins and needles for financial reform to be finalized. Everyone knows we are headed to higher capital standards, and frankly, the regulators have gotten out in front of the legislature on this issue by simply imposing higher capital requirements on their financial institutions through regulatory actions. So, we're headed to higher capital levels, but generally speaking, the banks between $2 billion in assets and under have really been shut out of the capital markets. However, we are seeing an uptick in interest there. We've got several transactions we're currently working on with banks between $1 billion and $2 billion that were basically shut out in the fourth quarter from raising capital, but now have an opportunity to go to market and raise capital. That is a very positive thing for bank M&A opportunities in the future because many of these institutions are going to be able to raise capital and satisfy regulatory capital requirements that may have been imposed by their primary financial regulator. After that, these institutions could be attractive sale candidates themselves.

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McMahon: A good example of the financial sponsor activity can be observed in a sell-side process that we are currently in the market with which involves a low credit risk, high-velocity asset class that fits perfectly within a bank. The initial indications of interest that we received on the property were exclusively from the financial sponsor community, some of which could be deemed strategic given their existing portfolio companies. What was most surprising was the complete absence of any interest from the domestic or international depository institutions.

Kanaly: Mike made the comment earlier about whether we have started to get to the bottom or are running along the bottom. We are consistently hearing from clients that while credit continues to deteriorate, that the rate of that deterioration has slowed considerably. But at this point, the wild card continues to be what's going to happen on the commercial part of the portfolio. On the residential side, many banks feel like they're starting to get their arms around the problem, and many of them feel like they've taken their lumps, but on the commercial side, there are still a lot of question marks. So there's at least some belief out there that half the equation is starting to get buttoned down.

McMahon: I agree, the core focus now seems to be on commercial real estate. There is some sensitivity that residential may take another small leg down as the government pulls back support for that market, but for most of the other asset classes, there is a lot of new money coming into those markets. For example, we are observing a lot of new money coming into the commercial finance segment to take up the slack where banks are not

participating in terms of providing capital to middle-market companies. There is a tremendous amount of capital coming in for startups and funds and other strategies to go after that market opportunity.

What about divestitures of asset management businesses by banks and insurance companies? Where do you see that going in the second half of 2010?

McMahon: That trend has slowed, I think, from the heightened activity we observed in 2008 and 2009 as many participants utilized such sales of noncore businesses as capital substitutes and, frankly, as perhaps the only non-credit-sensitive assets that could have been monetized in those difficult markets. Today, we see much of the selling activity driven by those larger organizations that have not been able to achieve the desired scale within their asset management businesses and don't believe that they can actually achieve that on their own.

The asset management business continues to be one that requires scale to provide adequate returns, and I think you'll find divestiture motivations driven less for capital-substitute purposes and more because sellers recognize that if they can't realize the value, someone else can. This could change, specifically in Europe, given the sovereign debt issues going on right now and the secondary impact to the European banks. You could see a reversal of this trend if conditions were to deteriorate, particularly in Europe, if the banks choose to pursue divestitures as a capital substitute. Lastly, within the U.S., the pending Volcker Rule legislation could trigger a meaningful wave of alternative asset management divestitures or spinoffs by banks, including their holdings in hedge fund, private equity, infrastructure, and real estate asset management platforms and their related limited partnership holdings in those activities.

Moore: Yes, that's exactly right. Last year, sales of those asset management businesses were undertaken to raise capital and to avoid a dilutive common stock raise in the equity markets. But going forward, there have been several of these businesses that recently have been marketed and have not found a buyer. So whether there are still willing sellers or not, those transactions have slowed. Although I will say, on the smaller end of the scale, say $2 billion to $5 billion in assets, we're seeing a lot of interest by the smaller banks looking to acquire some investment management businesses or broker/dealers in pursuit of noninterest income. I think that is an interesting and more recent dynamic that will continue.

What is attracting smaller banks to the investment management businesses?

Moore: Well, in the particular situations that we were referring to, the financial institutions think that they're going to create certain economies of scale and generate fee income. It's the ongoing and persistent pursuit of the wealthy client through broker/dealers and investment managers.

How will regulatory reform affect financial services boards that are considering an M&A strategy? What can boards do to prepare for the coming year?

Kanaly: I think for every good crisis there's always what I refer to as the "never-again" legislation. For Tyco and WorldCom and Enron it was Sarbanes-Oxley, and so, too, in this environment, we will have a form of "never-again" legislation. The one thing that's tricky is that for every piece of legislation that comes out, while there's a lot of rhetoric on the front end about what will be entailed, a lot of add-ons get brought to the scene later in the form of regulations and rules from the various regulatory bodies that are charged with administering the regulation. So it's really difficult to say what a bank should do to prepare. It does create a fair amount of uncertainty, and so I think at this point, for boards considering M&A, that is just one thing they need to factor into the mix, because obviously it could become more expensive to run a bank. You know, there may be a level of infrastructure, internal controls, or whatever it may be that they need to be aware of.

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I think the bigger question here is whether there are lines of businesses that they need to be thinking about changing direction on. When they look at a target and the target has something unusual as part of its business—whether it's an equipment leasing company, a derivatives business, a finance company, whatever it may be—the question is whether there needs to be some thought around the risk that those companies could pose to them and whether that's something they need to think about in light of the new reforms. But at this point, I think it's really early to start casting judgment about what the reform act will ultimately say.

Moore: One of the items that came out of a proposed Senate amendment is alarming. The proposal states that trust-preferred securities would be excluded from Tier 1 capital, which is going to cause another capital crisis for a lot of banks, particularly smaller institutions that have had difficulty raising capital. I think a lot of people are hopeful that the trust-preferred market would come back. That market has been completely dead since July 2007, and I think the Senate proposal in May has scared off several of our issuers to reevaluate their capital plans because they were considering trust preferred as an alternative to another common equity raise later this year to either repay TARP or to satisfy other minimum regulatory capital requirements.

Kanaly: Yes, and on that same note, there are a handful of banks that are still considering pursuing the trust preferred for TARP exchange with Treasury. So this obviously calls those transactions into question as well.

McMahon: The regulatory reform is just creating a tremendous amount of uncertainty, particularly at the banks, and has impeded much of their willingness to participate in sell-side processes and materially impacted their perceptions of value. But I would say, for the most part, they're just sitting on the sidelines and waiting to understand the potential impact to their business. What they would not want to do is buy something and just create a bigger problem in terms of potential capital and/or return implications. And while many of the larger institutions are sitting on substantial excess cash, they are still unwilling to move without further clarity about the new operating environment. In many cases, it goes back to the plans that they have shared with their regulators and making sure they stick to those plans and not deviate at all, even though they may feel comfortable, from a capital perspective, getting into a product line or diversifying the bank. Yet they are pushing those decisions off for another 12 months before aggressively pursuing them.

Is there anything else you would like to touch on that would be pertinent for boards of directors? It sounds like there's a lot of opportunity, but also a lot of uncertainty.

Kanaly: For my part, I would recommend to those banks that are still in a position where they're playing with some degree of strength to go ahead and play from that position of strength while they can, and get out in front of the curve and raise capital now and have more choices and opportunities as they move forward. The phenomenon I know that Randy and I have seen far too often is where folks wait and, as more bidders come to the scene, both for closing banks and for opening banks, the good franchises begin to be taken. So I worry that for the banks that wait too long, that the same opportunity won't be there for them. So to bankers that are reading this, I would say to think long and hard about whether you're missing an opportunity to get out in front of this and play from a position of strength early.

Moore: Be proactive, be informed, and be engaged. That is the most important thing you can do for your shareholders. One of the consistent themes to the bank failures we have seen is a failure of oversight at the board level, either because the directors received untimely or inadequate information or were inattentive to the bank's affairs. Board members should really engage in sound and thoughtful strategic planning and think about where they want their bank to be in the future. There is a tremendous opportunity resulting from this turmoil. So many banks have been in crisis management now for two years and have been reacting to circumstances, as opposed to planning with long-term strategic thinking with their shareholders' interests in mind.

McMahon: Yes, I just think that boards have a tremendous amount of new things to think about with respect to their existing businesses, given the new regulations that will likely be coming out. They will need to decide whether to hold businesses, divest those businesses, or whether or not the returns make sense given the new capital and new capital composition rules. When you combine that with strategic M&A, I can imagine that these boards are going to be very active, certainly over the next 12 months, in trying to really cure two problems: fixing or potentially divesting what they have, and then determining what they really want to be under the new regulatory framework. So I can imagine it will be a very active time in boardrooms of financial services companies certainly over the next 12 to 18 months.

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