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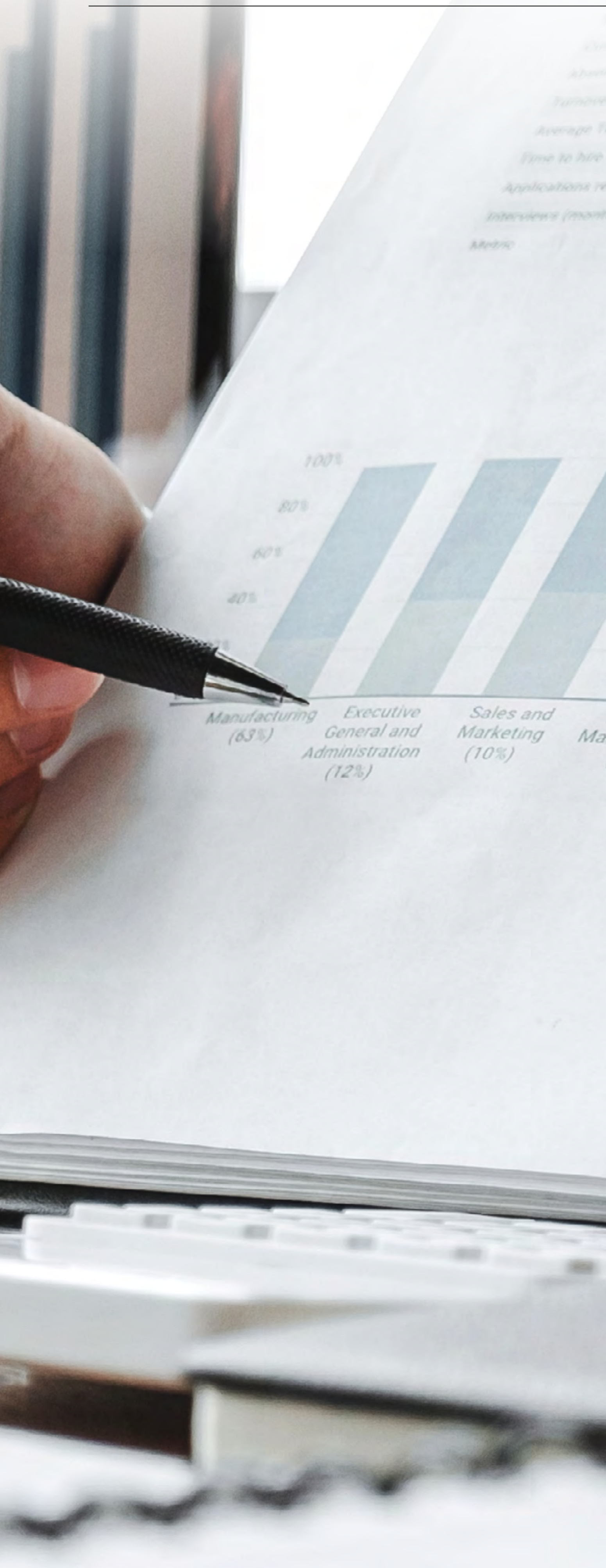
INSIGHTS FROM THE BDO FINANCIAL INSTITUTIONS & SPECIALTY FINANCE PRACTICE

BANK M&A INCREASES WITH A KEEN FOCUS ON THOROUGH DUE DILIGENCE

By Mark Houston, National Financial Institutions & Specialty Finance Practice Leader



Since March 2021, the financial institutions and specialty finance industry has experienced a sharp uptick in mergers and acquisitions. This industry had been placed under strict government regulations during the pandemic surrounding corporate transactions, deposits and lending activity. The industry also has benefited from steps taken by the U.S. government and the Federal Reserve to minimize the pandemic's economic impact. Those actions, combined with lower spending and increased consumer saving, have left bank balance sheets saturated with excess liquidity. According to Federal Reserve data, banks saw a $2 trillion surge in deposits just during H1 2020, and deposits skyrocketed by nearly 24% in the 12-month period ending in March 2021, per S&P Global Market Intelligence. Then deposits jumped by an additional $411 billion between late March and May 2021.

Being laden with cash, however, can be a double-edged sword, especially as both interest rates and loan demand remain low. As a result, bank M&A activity has increased as competitors scramble to find strategic ways to deploy their excess funds. To dig deeper, BDO recently convened a panel of four bank CFOs to discuss how recent events have reshaped the industry, affected their balance sheets, altered their current M&A outlook and increased the importance of proper due diligence.

The following highlights key takeaways from that discussion.

GROWING ASSETS, SHRINKING RATES

A confluence of government stimulus—including Paycheck Protection Program (PPP) and Main Street Lending Program (MSLP) funds—and the Fed's actions to inject liquidity into the market caused deposits to balloon. Reduced spending, increased savings rates and plummeting loan demand staunched the outflow channels banks normally rely on to avoid a buildup of excess funds. As a result, U.S. bank deposits have significantly outpaced the amount of loans, meaning that the bank loan-to-deposit (LDR) ratio hit an all-time low.

"If we look before the pandemic, City National Bank had a very high loan growth rate, and our biggest challenge was always on the funding side," said Jose Marina, the bank's Executive Vice President and CFO. "As a result of the pandemic, that has really flipped around. We've been able to increase our deposits by around 50% since the pandemic began and our loan-to-deposit-ratio has dipped from the mid-90s to the mid-70s."

This problem was only compounded by consumers and businesses taking advantage of stimulus money and low interest rates to pay off or refinance debt. According to an **October 2020 report** by the Federal Reserve Bank of New York, U.S. households spent only 29% of the funds they received through the March 2020 CARES Act. Recipients of the stimulus saved 36% and used the other 35% to pay off debt.

With interest rates at historic lows, and both the economy and loan demand still recovering, banks struggled to find strategic opportunities to deploy excess liquidity.

DEAL OPPORTUNITIES, WITH A FOCUS ON TECH

Fortunately, financial institutions found a solution for the deposits glut with M&A. According to **S&P Global Market Intelligence**, U.S. bank deal activity has already eclipsed last year's total volume, with 132 deals announced through the end of August compared with 103 during all of 2020. Total deal value has jumped to $39 billion, more than a 40% increase from total value in 2020.

In addition to precipitating a wave of liquidity, the pandemic also accelerated the pace of digital transformation for community banks, regional banks, credit unions and specialty finance companies. These institutions are seeking to enhance internal capabilities and develop new offerings to address rising customer technology expectations. According to BDO's ***2021 Financial Services Digital Transformation Survey***, 61% of middle market financial institutions are adding new digital projects, and 48% are accelerating some or all of their existing digital plans.

"We were fortunate to have started our digital transformation strategy two years before the pandemic, so at least we had a road map and game plan," explained Thomas Splaine, Executive Vice President and CFO at Lakeland Bank. "Then it just greatly accelerated once the pandemic started. From that standpoint, the pandemic has…[pushed] us down a digital channel that everyone knew we wanted to go down, but at a pace that is so much faster than we thought it would be."

Many banks have continued with digital transformation apace. In seeking to accelerate the digital strategy amid tough competition, it can be more expedient in certain cases to acquire a target with the desired tech capabilities rather than building those in-house, which is a key evaluation for any potential deal. For banks looking to partner with or acquire a fintech company, it's critical to assess expected value, ensure alignment and make specific plans for how those capabilities will be integrated.

For fintechs considering a partnership or an exit, contact **BDO's Fintech Practice** for help understanding your options to chart the best path forward.

"The pandemic has taught us that the customer base is very willing to use technology to effect what they need," said Romolo Santarosa, Senior Executive Vice President and CFO of Hanmi Bank. "So, in terms of M&A, it has become a top-of-the-line question. Where is the prospect in this evolution to the new technologies? Does it afford us some new market advantage? If the target has an advantage relative to the new technologies, that's a plus."

Digital capabilities also have a role in helping to assess the deal rationale and conduct due diligence, such as by using data analytics and other tools to identify and forecast expected synergies or identify potential issues for integration. "We look at it in terms of how digital transformation can make the due diligence process smoother, more efficient and more accurate when it comes to accurately projecting the financial outcomes that we can expect," said Kitty Payne, CFO at Commercial Bank of California.

FIVE FOCUS AREAS FOR DUE DILIGENCE

Given the ample liquidity at banks' disposal and the acceleration of timelines for digital transformation and deal-making, it's especially critical to conduct robust due diligence, particularly when acquiring fintech startups to bolster tech capabilities.

"Pre-transaction due diligence that is conducted in the months and weeks leading up to an acquisition announcement is often crammed into tight timelines and several key functional issues are not identified until after an integration plan is put in place. This is particularly the case in highly competitive auctions," said Mark Houston, BDO's National Financial Institutions & Specialty Finance Leader.

When conducting diligence in preparation for a merger or acquisition, banks need to consider these five areas:

1 / Operational Due Diligence (ODD) and Operational Value Creation (OVC)

ODD involves the identification and realization of pricing, margin, CapEx and working capital synergies. OVC seeks efficiencies and cash flow improvement opportunities that can be implemented and realized after closing. Both are necessary to account for when evaluating a potential merger or acquisition.

2 / Information Technology Due Diligence

Understanding the ins and outs of IT infrastructure and processes is imperative to a holistic view of deal opportunities and risks. One focus area for bank M&A is acquiring technology that helps manage commercial and personal fraud risk, so it's important to examine any potential deficiencies or cyber risks with the target to address negative synergies.

3 / Financial Due Diligence

Financial due diligence (aka accounting due diligence) revolves around the accurate assessment of a target's financial health. The prospect company's current and past financial performance is analyzed to identify risks and gain a clear understanding of likely future performance.

4 / Regulatory Compliance

Regulatory due diligence, including adherence to anti-money laundering (AML) regulations, is critically important to mitigate potential risk. AML diligence, in particular, can often be overlooked in the M&A process. "Bank Secrecy Act and AML are a big focus in having a good understanding of the overall risk culture of the target," said Marina.

Splaine also highlighted the benefits of being proactive in communication with regulators, not just when you're preparing a deal, saying: "We meet with our regulators every year and explain to them what we are and what we do and how we do it…We keep them in the loop. Then, when we pick up the phone and tell them that we have a deal coming and we're ready to move forward, they're a lot more comfortable because they won't have to refresh themselves with our story and what we're about."

5 / Risk Due Diligence

COVID-19 has dramatically altered the risk landscape for every business, regardless of industry, size or operation. For bank-related transactions in particular, starting to do thorough diligence early in the process for a complete view into all potential risk exposures can be the difference in realizing expected value or missing the mark.

LOOKING AHEAD

Throughout their conversation, the panelists agreed that the most important component of a successful merger or acquisition is clear communication.

"You're looking to build something, you're not looking to tear something down," said Splaine. "So, the easiest way to do that is to get everyone on the same page up front, early, and set standards and move forward."

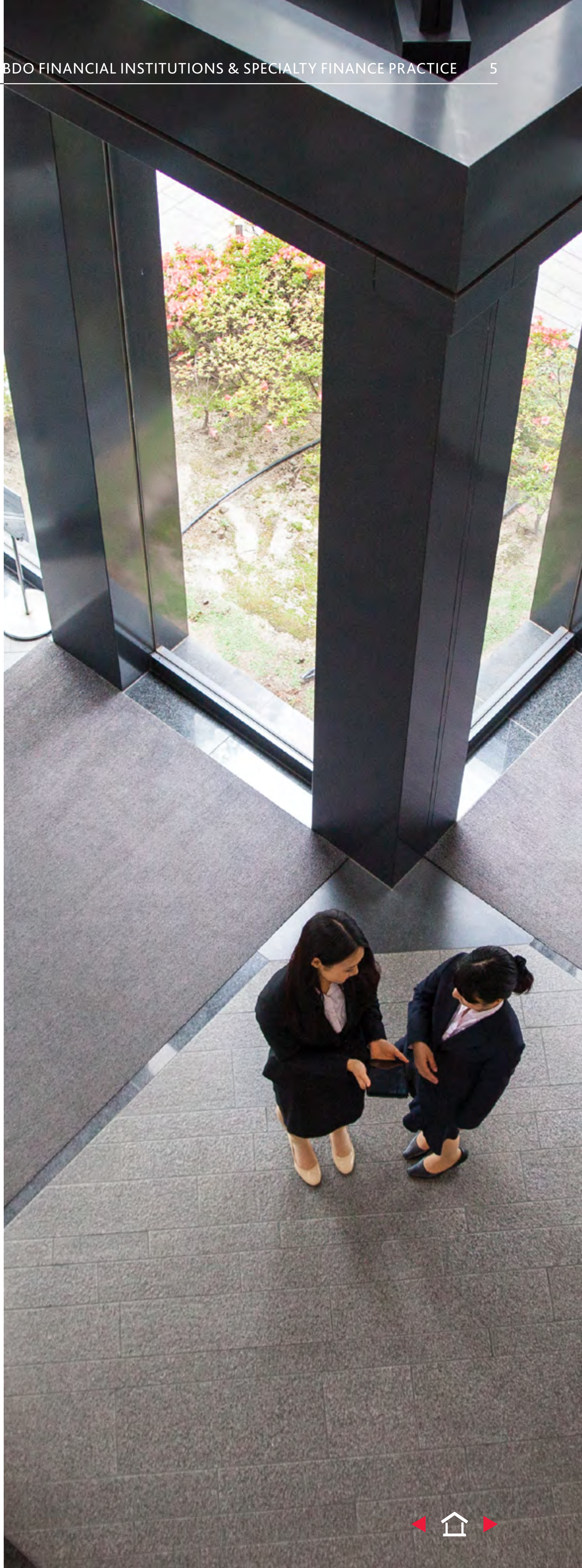
Because deal-making is only one part of an overall business strategy for growth, one pressing question on the mind of bank executives is: How much longer will the excess liquidity issue last?

"On the durability of this deposit surge, that's a question that we analyze each month, and there seems to be a staying power to it," said Santarosa. "But we've not yet seen enough of the economy reopen to cause some draining of these excess funds through activities, like commerce."

By mid-2022, we expect to see the LDR increase as financial institutions spend stimulus funds and consumers resume more typical purchasing behaviors. In the meantime, many banks will consider using excess liquidity for strategic deals while market conditions are favorable.

Although now is a good time to bolster capabilities and improve competitive standing through M&A, it's vital to conduct robust due diligence and pave a path to successful integration and value capture. Every M&A transaction is unique and presents challenges, but working with experienced diligence advisors can significantly help to avoid costly missteps and minimize the impact of unforeseen issues.

For more information on the M&A due diligence process for banks, please contact BDO's Mark Houston, National Financial Institutions & Specialty Finance Leader, at mhouston@bdo-ba.com.



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