Community Banks – Changing Market Dynamics Put Spotlight on Strategic Options

by Ed Usalis, United Bankers' Bank, Midwest Strategic Options Conference Keynote Speaker

Significant changes have occurred within the community banking industry over the past 20 years. Most notably, the number of FDIC-insured commercial banks and savings institutions has declined from 9,024 as of March 31, 1998 to 5,606 as of March 31, 2018. This level of consolidation has undoubtedly led many community bankers to contemplate the future of their bank. Specifically, should community banks sell now or double down on their investment?

To provide some context for this decision, the financial performance of community banks should be considered. As of the end of March 2018, America's community banks were performing well. According to the FDIC's Quarterly Banking Profile, community banks reported strong earnings, lower levels of noncurrent loan balances and higher levels of regulatory capital. Given this strong financial performance, will community bank consolidation continue?

The various challenges that community banks face need to be examined in order to understand the motivations behind future consolidation. These challenges include: increasing regulatory costs, heightened competition, and revenue challenges. Additionally, smaller closely held community banks may have concerns regarding economies of scale and raising capital.

Historically, regulatory pressures incentivized community banks to make acquisitions in order to justify the more stringent supervision and associated costs they must face. However, the Economic Regulatory Relief and Consumer Protection Act (the "Act")

Don't be a pawn in the game! Bankers from across the Midwest explored growth options, discussed strategic opportunities and investigated innovative partnerships at the 2018 Midwest Strategic Options Conference held in September.

At the 2018 Conference bankers from Illinois, Michigan, Pennsylvania, and West Virginia joined OBL members to hear leading keynotes, network with peers and discuss 2019 market developments.

Featured speakers from Haberfeld; Boenning & Scattergood, Inc.; and Dykema Gossett, PLLC; along with other strategic options experts, the event focused on hot topics like increasing the value of your bank, fintech as a strategic growth opportunity and maximizing the performance of acquired loan portfolios.

was recently signed into law on May 24, 2018. It is expected that this Act will reduce the regulatory burden on small and mid-sized banks, including changes to regulatory requirements imposed under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. While the costs of compliance might have fueled past consolidation, it is unclear if this will impact future consolidation.

Today, community banks face increased competition from investment banks and non-bank lenders which are changing customer expectations. Given the changing competitive landscape, community bankers will have to understand their customers and their financial service needs more than ever. To be successful, community banks will need to continue their focus on customer relationships and accountability and leave the transaction-based model to the larger regional and national banks. As long as community banks continue to "know their customers" and provide tailored products and services, continued consolidation should not be a foregone conclusion.

The low interest rate environment of the past nine years has been a valuable source of support for business and consumer borrowers. However, these low rates have made it difficult for community banks to increase net interest margins. With the economy continuing to expand and unemployment at historic lows, the Federal Reserve has already raised interest rates twice this year and signaled that more rate increases will likely follow. Given the ability to charge higher rates on loans, community banks will likely be able to increase their profitability. This enhanced profitability can allow community banks to build capital to re-invest in technologies that provide economies of scale and enhance the customer experience.

While the previously mentioned challenges provide justification for the consolidation among community banks, there is one other motivation that cannot be ignored – community bank valuations are at fairly high levels. Since 2013, the median price to tangible book multiples for bank acquisitions has increased from 1.28 times to 1.60 times at the end of 2017. Additionally, the median price to last 12-months earnings multiple has increased from 19.20 times in 2013 to 22.06 times at the end of 2017. The multiples and the potential sales proceeds that they represent provide considerable motivation for additional community bank consolidation.

Currently, community banks have to consider a number of strategic options. While there are a number of considerations, including strong financial performance, reduced regulation and a favorable interest rate environment, favoring a "doubling down"; the high valuation multiples may compel a "sell now" transaction. Unfortunately, evaluating these strategic options is never an easy decision.

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WHAT DID ATTENDEES HAVE TO SAY?

The Strategic Options Conference was very informative for any size bank for strategic planning purposes. I would strongly recommend board members also attend.

Everything was on point! There were good presenters at a nice venue with an excellent opportunity to maintain business contacts.

The interaction with other bankers was great as there were many networking opportunities.

The program provided a good overview of M&A and I valued the discussions of probable values and prospects for remaining independent.