Reimagine the Traditional Banking Business Model – Fee-Generating Business Acquisitions

By Jeffrey M. Cardone

The COVID-19 pandemic has given the U.S. economy an extraordinary shock that has caused great uncertainty to the operational and financial performance of banks. The impact of COVID-19 on bank performance will depend on certain events, including the level and the duration of fiscal stimulus, the on-going control of the yield curve by the Federal Reserve and the length and severity of the pandemic. These events, including how public policy responds to the economic conditions during the pandemic, will determine its effect on customers, employees and vendors, all of which are unknown and not currently measurable. The potential adverse effects of COVID-19, along with the Federal Reserve's attempt to control the yield curve, has put significant pressure on banks to find ways to diversify their business models to counter compressed net interest margins, low asset yields and declining loan demand and credit quality.

Although net interest income will always be a core component of profitability for banks, the COVID-19 pandemic has reinforced the significance of having other sources of income. As such, the acquisition of a fee-generating business, such as a wealth management business, investment advisor, mortgage banking company or an insurance agency, can be a worthwhile use of capital by a bank to diversify its traditional banking business that could have a two-fold positive effect. First, fee-generating businesses can provide stabilized earnings to offset compressed margins and low asset yields caused by extrinsic forces, such as the interest rate environment or COVID-19. Additionally, after the effects of COVID-19 have abated, an acquired business can increase the bank's current and future earnings power by providing a source of revenue not reliant on net interest margin and greater opportunity to capture more market share through new and existing customer relationships, which could lead to a higher valuation.

The consideration of an acquisition warrants an understanding of its fundamental aspects, which involve issues and considerations not faced when acquiring another bank.

Purchase Price. Understanding how fee-generating businesses are valued is an important first step in determining an appropriate purchase price. Because potential earnings or cash flows of fee-generating businesses are greater than the value of their individual assets, fee-generating businesses are commonly valued utilizing an income-based approach. Under this approach, the valuation of the seller is determined based upon the expected sustainable earnings or cash flows being acquired. This is typically calculated as a multiple of the seller's historical EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Adjustments to the seller's EBITDA may be appropriate in consideration of any nonrecurring items, such as the impact of COVID-19, and potential cost saves that may increase or decrease the seller's sustainable earnings.

Other factors beyond the valuation of the seller may influence the purchase price, such as the pricing of other comparable deals, the available working capital of the seller, earnings accretion and the ability to enhance the one-stop-shop experience for customers and cross-sell financial products. It is also important to assess the amount of goodwill that will be recognized as a result of the transaction due to the intangible nature of a fee-generating business. A knowledgeable investment advisory firm can assist in assessing the value of a fee-generating business and other relevant metrics of the transaction.

Earn-outs. For fee-generating business transactions, a percentage of the purchase price is commonly paid to the seller immediately at the transaction closing. The remaining percentage is structured as a contingent payment (or a series of contingent payments), known as an "earnout," payable to the seller after the transaction closing only upon, in most cases, the achievement of well-defined post-closing financial goals. An earn-out serves a dual purpose - it reduces the risk to a buyer of overpaying for a business that underperforms and offers the seller the opportunity to receive a higher transaction value for realized performance, which may solve any pricing disparities. It also incentivizes the seller to help with the continued success of the business as it is integrated into the buyer.

Unlike bank merger agreements, which generally reflect well-established market and drafting principles, there are no set rules for constructing earn-out provisions, as they are often tailored to the particular facts of the deal. However, to successfully develop and implement an earn-out, the basic financial parameters should be well-defined, including how the post-closing profitability of the seller will be determined, the length of the performance period for measuring profitability and whether the earnout amount is capped.

Other more-nuanced components should also be addressed, such as whether certain post-closing revenues or expenses would be adjusted or exempted from the earn-out calculation, defining the continuing line of business or revenue stream that would be subject of the earn-out (particularly if the seller will not operate as a stand-alone subsidiary or division of the bank), procedures for calculating and verifying the earn-out calculation, dispute resolution mechanisms and offset rights of indemnity payments against the earn-out. It is critical that these components are well-drafted and precisely reflected in the purchase agreement to minimize the risk of a dispute between the parties.

Due Diligence. Although well-constructed earn-out provisions may mitigate the risk of the seller's future underperformance, significant time and effort during due diligence must be devoted to verifying the key financial metrics and expected sustainable earnings of the seller, particularly if the seller has not had annual audits and reviews. It is also necessary to consider the impact selling shareholders and certain executives have on the seller's profitability and continuity of key customers, which may influence the valuation of the seller. If significant, an employment, consulting or non-competition agreement with such individual(s) will be essential to ensure their continued service and mitigate the risk of financial harm and lost expertise after the transaction. The successful negotiation and execution of these contractual arrangements should be considered contemporaneously with the negotiation of the purchase agreement.

Structure. The transaction will likely be structured as a purchase of assets and assumption of liabilities, commonly referred to as a "P&A transaction," rather than a merger or stock purchase transaction. In a P&A transaction, the bank would purchase or assume certain assets and liabilities of the seller enumerated in the purchase agreement in exchange for cash or other consideration. This provides the bank with the flexibility to purchase only the desired assets of the seller and, except for the assumed liabilities, be protected from any ongoing liability associated with the seller. Also, P&A transactions may have built-in tax benefits not available for mergers. For example, the bank would receive a "stepped-up" tax basis of the assets received over their current tax values and can deduct and amortize the goodwill created in the transaction. However, unlike a merger, the bank would not be a successor in interest to the seller by operation of law. As such, the bank must ensure that the transfer of assets of the seller is completed in accordance with applicable law and all required third-party consents regarding assigned contracts are properly received.

Regulatory Considerations. The business activities of the seller should be evaluated in consideration of whether they are permissible activities or investments that could be conducted or held directly by the bank, the holding company or, alternatively, they should be operated or held through an operating or financial subsidiary. If the bank utilizes an operating or financial subsidiary to hold or operate the acquired business, a notice filing or application with the bank's federal and/or state regulator may be required. If substantially all assets of the seller are acquired directly by the bank, prior approval of the FDIC will be needed.

It is important to consider whether the acquired business should be held or operated by the holding company, or as a subsidiary of the holding company, due to the holding company's broader authority and powers and other advantages, such as liability protection for the banking subsidiary and other logistical and operational benefits. While many of these broader activities and investments are generally available to bank and savings and loan holding companies, there are certain business activities, such as insurance underwriting, that are only available to a holding company designated as a "financial holding company." This designation requires the satisfaction of the Federal Reserve's qualifying criteria and election procedures.

Next Steps. Acquisitions of fee-generating businesses could be an effective strategy to reimagine the traditional banking business model and enhance value in a more measured way than whole bank acquisitions. Similar to bank mergers, a successful acquisition will require attention to the fundamentals of deal execution – thoughtful pricing and earn-out provisions, vigorous due diligence, a well-crafted purchase agreement, a firm grasp of the regulatory and deal contingencies and a detailed plan of integration, both operationally and culturally.

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