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M & A Focus

Will 2006 continue to be a seller-friendly market? It sure looks that way.

by John Nelligan and Tim Stute

In the mergers & acquisitions market in 2005, 28 commercial finance transactions were announced representing $4.6 billion in total deal value, versus 40 transactions for $8.8 billion in deal value during 2004, according to SNL Financial LC. While transaction volume and value declined in 2005, several characteristics of the merger environment remained consistent with 2004, including the ability of independent finance companies to receive multiple offers from potential buyers at solid valuations.

In 2005, as in 2004, longtime commercial finance players exited niche markets due to increased competition, such as SunTrust selling its Receivables Capital Management factoring business to CIT, which continued its strategy of seeking fill-in or bolt-on acquisitions for its vast array of product offerings. In addition, banks continued to enter the asset-based lending market, either for the first time, or to bolster existing efforts through acquisitions at attractive pricing multiples to buyers. Furthermore, financial investors, including hedge funds, entered the space aggressively in 2005, seeking the substantial risk-adjusted returns the assets can generate.

But how long will this active acquisition environment, which has generally been characterized as a seller's market due to high buyer demand for assets, continue to exist? If the end of 2005 and beginning of 2006 is any indication, it appears that banks and thrifts, large commercial finance companies, and financial buyers will continue to aggressively seek acquisitions in the asset-based lending and factoring sectors.

For banks and thrifts starved for yield, asset-based lending remains attractive. In an environment characterized by a flattening yield curve, banks and thrifts continue to take steps to gain better understanding of asset-based lending, while at the same time examining ways to grow the business internally or, more notably, through acquisitions.

The smaller, independent lenders, which generally have less than $150 million in outstandings, generate asset-based loans consisting of both an interest income component and a fee income component, which positively affect a bank's net interest margin and its noninterest income.

Banks and thrifts have shown sustained interest in acquiring, creating, or maintaining asset-based loan origination capabilities. This strategy manifested itself through Sovereign Bancorp's June 2005 acquisition of Business Alliance Capital Corp. and Discovery Bancorp's

basis points to prime-plus 200 basis points. When combined with a bank's lower cost of funds, profitability increases substantially, perhaps even doubling. A purchase-price multiple calculated on adjusted earnings will end up being far less than the multiple paid on actual stated earnings. Taken one step further, with bank valuations remaining at or near all-time highs, the market value implications of asset-based lending acquisitions are substantial. These transactions result in a highly accretive transaction for the buyer and an attractive purchase price multiple for the seller.

purchase of California-based Celtic Capital Corp. in September. Other banks, large and small, such as Columbus, Georgia-based Synovus Financial Corp. and Bettendorf, Iowa-based Quad City Bank and Trust Co., have expressed their intentions to grow their asset-based lending divisions through acquisition or otherwise.

The recent healthy market for bank and thrift consolidation has driven up price-to-earnings and price-to-book multiples in the asset-based lending sector to the point where banks can exploit highly valued currencies in pursuit of acquisitions at levels that may not be attractive to other financial and strategic buyers on the basis of future earnings accretion.

P/E multiples in asset-based lending acquisitions have been as high as 20x trailing after-tax earnings in recent years, with the average multiples ranging from 10x to 15x trailing after-tax earnings. The highly valued currencies, coupled with the lower cost of funds that banks enjoy, present a multitude of opportunities for both bank buyers and asset-based lending sellers.

"The shareholders of Business Alliance Capital felt that M&A pricing had reached a peak or was nearing a peak, " said Ted Kompa, president of the Princeton, New Jersey-based firm. "Those market conditions, coupled with our interest in partnering with an entity that could help us substantially grow our outstanding loans, led to our transaction with Sovereign. So far, the marriage has worked well because of Sovereign's understanding of what we do and how we do it. They let us run our business with minimal interference, all the while providing cheaper funding, which has had a significant impact on our earnings generation."

Asset-based lenders and factors typically borrow senior debt at interest rates ranging from LIBOR-plus 200

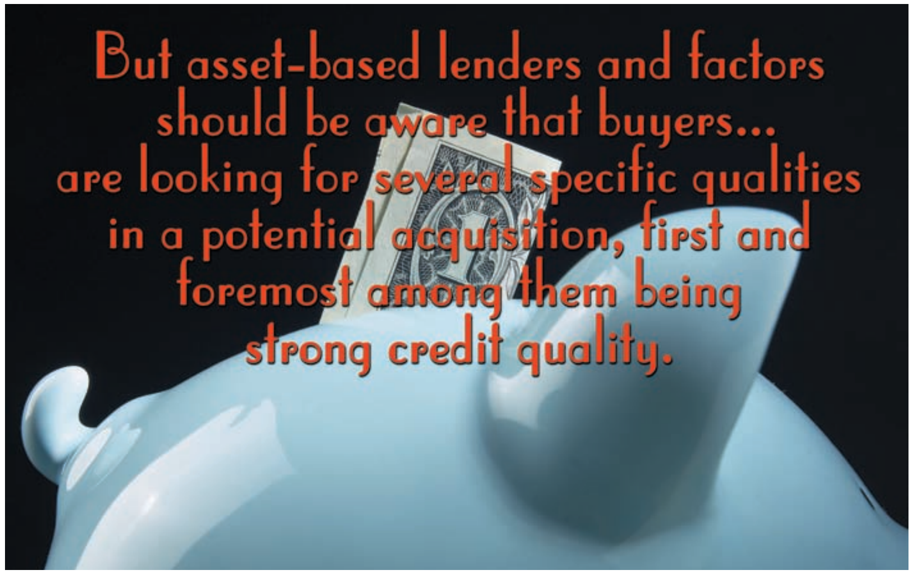
As interest in the asset-based lending and factoring business among banks and thrifts increases, large, acquisitive commercial finance companies, such as General Electric Capital Services Inc. and CIT Group Inc., remain actively involved in the merger marketplace. In addition to the SunTrust acquisition, CIT acquired Healthcare Business Credit Corp. and Semele Group's railcar leasing business in 2005. Meanwhile, GE Capital acquired Bomardier Inc.'s inventory finance business.

Other smaller independent finance company mainstays such as Presidential Financial Corp., out of Atlanta, made fill-in acquisitions to expand product offerings. Presidential acquired San Antonio-based Alamo Capital Corp., a provider of financing to the healthcare services industry.

Commercial finance companies, whether large firms like GE Capital and CIT, or middle-market firms such as Presidential, continue to complement internal growth strategies with an acquisition strategy. Competition from community banks and thrifts which are offering competitive financing to the same small businesses targeted by asset-based lenders and factors has resulted in difficulties finding sustained asset growth. Acquisitions of large portfolios or businesses that operate in a niche sector, such as government contracting or healthcare, provide a necessary outlet for continued growth.

Still, an acquirer's cost of funds has often been the determining factor for successfully winning an M&A auction due to the tremendous arbitrage potential that exists. As a result, independent finance companies often lose out to bank, thrift, or large commercial finance company buyers who can afford to pay more for a company or portfolio of loans.

"When we were looking into the possibility of selling



our business, we were very interested in talking to banks," recalled Jim Adamany, president of Phoenix-based First Community Financial Corp. who sold to Los Angeles-based First Community Bancorp in February 2004. "We knew that a bank could bring us a lower cost of funds and cross-selling opportunities that would provide additional earnings growth for our company. We also understood that banks would benefit the most from a transaction of this type and could arguably pay a higher earnings multiple for our company than other strategic or financial buyers."

The benefits of asset-based lending businesses can extend beyond valuation considerations for banks and thrifts. Cross-selling opportunities exist as bank parents can refer numerous leads that do not meet their underwriting criteria to their asset-based-lending subsidiaries. On the other side of the equation, customers who graduate to traditional bank financing no longer need to go outside of that institution.

Meanwhile, financial buyers who typically have the most trouble competing for asset-based lending and factoring transactions due to high cost of funds and low leverage, made a splash in the M&A market in 2005. Perry Capital, a $10-billion hedge fund out of New York, acquired Capital Factors, Inc. from Regions Financial

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Corp., which inherited the business from its acquisition of Union Planters Corp. Also, Greystone & Co., New York, acquired Metro Financial Services, Dallas.

Financial buyers, led by the hedge fund community, have been flush with capital and seen at the negotiating table across the commercial finance space. While these buyers historically have stayed away from specialty finance opportunities because of lack of expertise, funding constraints, or high purchase prices, a strong desire to put capital to work and a recognition of the stellar risk-adjusted yields that asset-based lending and factoring can provide when prudently executed has led to this increase in activity.

But asset-based lenders and factors should be aware that buyers — whether banks, finance companies, or hedge

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funds — are looking for several specific qualities in a potential acquisition, first and foremost among them being strong credit quality. Other factors that acquirers take into consideration are the rates of asset and earnings growth, management experience and depth, the size and scalability of the lending platform, geographic focus, experience of the sales force, and discipline in underwriting and monitoring collateral.

Asset-based lenders and factors thinking about the prospects of a potential sale should take steps to prepare for such an important event. Potential sellers should look to achieve critical mass while adding depth to the management team. Sellers should also utilize appropriate financial leverage, while also updating underwriting and reserving policies, and maintaining limited debtor concentrations.

Taking these steps when positioning for a sale will improve an asset-based lender's or factor's chances of achieving a better valuation. And with banks and thrifts seeking yield, commercial finance companies searching for asset growth, and financial buyers looking to put capital to work, 2006 will be a very active year. ▲

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