



SNL Specialty Finance M&A™

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A strategy to grow spreads For yield-hungry banks and thrifts, asset-based lending remains attractive

In an environment characterized by a flattening yield curve, community banks and thrifts continue to take steps to gain better understanding of asset-based lending while at the same time examining ways to grow business through organic means and acquisitions.

For small and medium-sized businesses that don't qualify for traditional bank financing, asset-based loans can be an efficient alternative. Asset-based loans are collateralized by accounts receivable, inventory or equipment. They are typically advanced at 70% to 80% of asset value but are fully collateralized. Even with the collateral to 100% of asset value, yields typically exceed those generated by traditional cash-flow loans as part of a commercial-and-industrial loan portfolio, and the product offers an attractive alternative as an earning asset to mortgage loans and investment securities in a period of rising interest rates and slowing refinancing activity.

Community banks in particular have shown an increased interest in the asset-based loan product, oftentimes entering the sector by acquiring smaller, independent commercial finance companies with less than \$150 million in loans outstanding. An acquisition of finance businesses in this size range generally brings the acquiring bank a large enough portfolio to make a significant earnings impact while also maintaining a well-diversified overall loan portfolio.

The asset-based loans originated by small, independent finance companies can generate yields ranging from prime-plus-2% to prime-plus-12%, and they consist of both an interest income component and a fee income component that will positively affect a bank's net interest margin and its non-interest income. Those yields are particularly enticing during a time in which the spread between the two-year and 10-year Treasury notes has narrowed to only a handful of basis points, down from 150 basis points only 18 months ago, and the Federal Open Market Committee has implemented 12 consecutive increases in the Fed funds rate.

"A number of banks continue to face challenges in this interest rate environment. As a result, we are seeing interest across the board among banks pursuing higher risk-adjusted returns such as asset-based loans in order to increase their net interest margin," said John Nelligan, managing director of Milestone Advisors LLC.

Milestone, a Washington, D.C.-based investment bank, has advised on several notable deals recently in which banks and thrifts have acquired asset-based lenders. In addition, the firm's principals have completed over 220 M&A and corporate finance transactions for clients in a variety of financial sectors, including banking, insurance and specialty finance.

Banks and thrifts have shown sustained interest in acquiring, creating or maintaining asset-based loan origination and servicing platforms, Nelligan said. That is evidenced by First Community Bancorp's acquisition of Arizona-based First Community Financial Corp. in March 2004, Sovereign Bancorp Inc.'s June 2005 acquisition of New Jersey-based Business Alliance Capital Corp. (BACC) and Discovery Bancorp's \$6 million purchase of California-based Celtic Capital Corp. in September. Milestone served as adviser to the seller in both of the first two deals.

Additionally, Quad City Bank & Trust Co. announced earlier in November that it will launch an asset-based lending program on a de novo basis, tapping former First Business Capital Corp. head Jim Munhofen to lead the effort. Other banks, such as Synovus Financial Corp., have expressed their intentions to start asset-based lending divisions rather than build through acquisition.

As interest in the business among banks and thrifts increases and large, acquisitive commercial finance companies such as General Electric Capital Services Inc. and CIT Group Inc. remain actively involved, Milestone characterizes the M&A environment as a seller's market, with heightened competition among potential buyers. The typical asset-based-lending platform generates interest from multiple bank buyers.

"While we had significant interest from the bank community for BACC, Sovereign Bank proved to be the most aggressive," said Gene Weil, CEO of Milestone Advisors. "They understood the risk profile of BACC's asset-based loan portfolio better than the other bidders and saw the value in moving into an asset class which, for them, presented smaller average loan sizes, but much higher yields: The risk-return value proposition made sense for them."

A robust market for bank and thrift financial performance over the last two years has driven up price-to-earnings and price-to-book multiples around the industry to the point at which institutions can exploit highly valued currencies in pursuit of asset-based-lending acquisitions at levels that may no longer be attractive to other financial and strategic buyers on the basis of future earnings accretion, Milestone said.

"When we were looking into the possibility of selling our business, we were very interested in talking to banks," re-

called Jim Adamany, president of First Community Financial. "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."

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.

But while the earnings multiples paid for asset-based lenders appear higher compared to other finance company acquisitions such as mortgage or consumer finance company acquisitions, that can be a misleading conclusion. The lower costs of funds the acquiring banking institutions enjoy present a multitude of opportunities on which the lenders could not otherwise capitalize.

"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 that 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."

Independent asset-based lenders typically borrow senior debt at interest rates ranging from LIBOR-plus-200 basis points to prime-plus-200 basis points. When this is combined with a bank's lower cost of funds, profitability increases substantially, perhaps even double, Milestone said.

"On the surface, a bank may appear to be paying 15x after-tax earnings for an asset-based lender," said Tim Stute, vice president of Milestone. "But once you factor in the sig-

nificant cost of funds synergy that a bank typically provides, that same purchase price multiple will look more like a 7x or 8x multiple, which will make an already accretive transaction even more lucrative."

A bank may acquire an independent finance company with a borrowing cost of LIBOR-plus-200 basis points and 4:1 leverage and, upon consummation of the acquisition, fund the business with lower yielding deposits at much higher leverage. Therefore, purchase price as a multiple of adjusted earnings is substantially less than purchase price as a multiple of stated actual historical earnings, Stute explained.

This earnings arbitrage results in significant market value accretion for the acquiring bank that doesn't exist in many acquisition opportunities, Stute noted. In most bank acquisitions, the acquiring bank has to rely on cost-cutting measures such as branch closings or staffing reductions in order to make the deal accretive.

However, when a bank acquires an asset-based lender, the only requirement in order to ensure an accretive transaction is to allow the bank to provide funding to the newly acquired asset-based lender. The bank buyer wins because of the earnings and market value pick-up, and the selling shareholders of the asset-based lender win because they are getting a strong multiple for their historical earnings, Stute added.

"This is why banks who understand the business are jumping in," he said.

The benefits of acquiring asset-based-lending businesses can extend beyond valuation and earnings considerations alone. Cross-selling opportunities are plentiful 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 when that time comes.

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