

## A DIFFERENT WORLD:

# How Credit Woes Impact Commercial Finance M&A

BY TIM STUTE

**In a time when earnings are decreasing from quarter to quarter** and many big players are selling off assets to address the shortfalls, there is still hope in commercial finance — especially with M&A opportunities. Here Tim Stute discusses how the commercial finance world has been impacted by the current credit crisis.



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**A** year ago this time, our firm had just completed the sale of BFI Business Finance, of San Jose, CA, to First Community Bancorp (now PacWest Bancorp), an experienced buyer of asset-based lenders and factors. As had been the case in nearly all of our commercial finance mergers and acquisitions transactions in recent years, we were able to achieve an attractive valuation for our client, when measured as both a multiple of earnings and a multiple of book value.

Today, the landscape for merger and acquisition activity among asset-based lenders, factoring companies and leasing companies, as well as finance companies on the whole, has changed dramatically. While select sellers have and will continue to find the rich valuations of years past — some reaching 10–15 times trailing after tax earnings — those valuations are harder to come by in today's market. And that is not likely to change in the near term. Merger and acquisition activity will remain steady, but the composition of transaction types witnessed will begin to appear quite different from those seen in the last three years, when eager entrepreneurs sold their businesses for piles of upfront cash and lucrative employment arrangements.

As discussed in depth below, the credit crisis has simultaneously impaired bank and thrift interest and the ability to consummate acquisitions while also creating funding issues for many independent finance companies. But M&A transactions will continue to occur, and many buyers will be well positioned to find good deals.

### **Will There be Bank Buyers?**

In the commercial finance sector, a major driver of acquisition activity is interest from banks and thrifts. Over the last four years, banks and thrifts of all sizes have entered the asset-based lending and/or factoring markets, and in some instances, they have liked the risk-adjusted returns from the asset class so much, they have completed add-on acquisitions on top of other completed deals. Smaller community banks such as Gulf Coast Bank, First Community Bancorp, and Capital Corp. of the West have

increased their commercial finance presence, while large banks and thrifts, such as Wells Fargo and Sovereign Bank, have made strategic acquisitions to bolster commercial finance product offerings.

But while many bank acquirers, such as those above, completed those transactions while their stocks were trading at or near all-time high valuation levels, those valuations have declined dramatically in the wake of the credit crisis. In June 2007, the average price to tangible book value of all banks and thrifts in the U.S. was 320.7%. As of the end of June 2008, that ratio was down to 223.5% (Source: SNL Datasource).

Bank valuations have a major impact on a bank buyer's ability to pay a high valuation for an acquisition target. The wider the spread between a buyer's valuation metrics and the valuation paid for an acquisition, the greater the impact to the buyer's market capitalization upon realizing the target's earnings generation. Given lower bank valuations and unchanged seller valuation expectations, a negative arbitrage exists for some banks that are exploring acquisitions of commercial finance companies.

On top of the valuation challenges, many banks and thrifts are going through significant credit quality issues due to challenges in the construction and development, residential real estate, commercial real estate, and consumer lending sectors. U.S. banks and thrifts had an average nonperforming asset-to-total-assets ratio of 1.71% as of March 31, 2008 compared to 0.83% as of March 31, 2007 (Source: FDIC).

While equipment lending and leasing is generally a relatively easy concept to introduce to bank executives, asset-based lending and factoring (especially the latter) can be far more challenging subjects for bank CEOs to digest — and that's in a healthy market. It is much harder to get a bank CEO to take the plunge into asset-based lending or factoring today, if for no other reason than the product sounds like a "subprime" asset, and that just won't fly with shareholders today.

Of course, for those banks that do still maintain an understanding of, and interest in, asset-based lending and factoring acquisitions, the losses incurred from other problem assets may have eroded capital to the point where booking goodwill from a purchase price premium will harm regulatory capital ratios, rendering an acquisition impossible unless it can be consummated at a lower price.

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While many banks have felt most of the pain that they're going to feel from the residential real estate crisis, many have not yet seen the complete fallout from their commercial real estate lending and small business commercial lending activity from the last few years. As a result, more credit problems may lie ahead. Therein lies the opportunity for commercial finance company buyers.

### Opportunities Exist for Finance Company Buyers

With banks likely playing a lesser role in the acquisition of commercial finance companies, competition for acquisitions should lessen, creating opportunity for other finance companies to find acquisitions. But while the issues facing banks could create greater acquisition opportunities for existing commercial finance companies, in addition to generating greater loan flow as turnarounds increase, there is another role that banks will play that could benefit finance companies: the role of seller.

Banks and thrifts, including Wachovia, Washington Mutual, Citigroup and others, which are facing major losses from loan write-offs or write-downs, have been forced to tap the capital markets to raise capital that can be used to plug the hole created in the capital base from substantial credit issues. Raising equity or other permanent capital is of course a common way to strengthen a balance sheet, but not all banks will find a deal that meets their needs and interest from a structure and dilution standpoint.

The alternative to the capital raise is the sale of businesses or assets — sometimes perfectly healthy businesses or assets — which, upon completion, frees up both valuable capital and deposits that can be used elsewhere in the “core” operations of the bank. Numerous banks are in the market right now seeking the sale of asset-based lending, factoring and leasing subsidiaries, divisions or portfolios that either don't fit the future strategy of the bank, or have become disposable in an effort to reduce assets, thereby increasing regulatory capital levels as a percentage of a bank's total asset base.

In many of these scenarios, speed can become more important than purchase price, especially in deals involving banks that are facing increasing regulatory pressure. Therefore, finance companies with access to financing have a golden opportunity to capture major market share at attractive pricing with acquisitions that serve as a complement to organic growth, that for many commercial finance companies is starting to blossom at the mid point of 2008. As we continue through the remainder of 2008 and into 2009, it is possible that many of these transactions will be priced at either a very slight premium over the par value of the assets being acquired, or even a discount to par, for perfectly healthy assets, as some banks become desperate to release capital.

The key, of course, is the ability to finance these deals, and do it quickly. The number of senior debt providers to specialty finance companies has declined over the last 12 months, with some senior lenders looking for any opportunity — an administrative default or a minor financial covenant bust — to pull a line. But those finance companies with enough dry powder or with the ability to upsize an existing line will be well positioned to take advantage of this market.

### Sellers Still Have Ability to Obtain Solid Valuations

Sellers looking to maximize value via a traditional sell side process should not be completely discouraged. Rather, there are still buyers out there that are willing to pay attractive valuations for commercial finance companies. There just happen to be fewer buyers today than a year or two ago.

In order to generate attractive valuations that resemble the high priced deals seen in recent years, a selling business must have a unique valuation proposition. This could be in the form of a niche product offering, a top-flight management team, a best-in-class track record of credit quality, or some other differentiating characteristic that sets a business apart from all competitors.

Two recent transactions exemplify the ability for selling shareholders to find attractive transactions. The June 2008 announcement by Wells Fargo that it was acquiring the operations of Transcap Associates, Inc. signaled to the market that Wells Fargo not only continues to have the ability to consummate acquisitions in this market environment, but also that commercial finance is a key product area that it is looking to continue to grow. Transcap is one of only

a handful of commercial finance businesses that specialize in purchase order finance products, which is a product that Wells Fargo did not previously have an expertise in.

Wells saw the benefit of acquiring a business that would give it the in-house expertise to structure and close complex international purchase order finance transactions. This niche expertise was a unique value proposition that not many other companies could present to Wells, and as a result, a deal was struck that satisfied the selling shareholders while adding a key product to the already expansive Wells Fargo offering.

Similarly, the acquisition by Crestmark Bank of Commercial Capital Lending, LLC was a deal that was completed in the middle of the overall market downturn. But Crestmark proposed a valuation that was attractive enough to Commercial

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Capital's selling shareholders that they decided to sell. Why? Crestmark was willing to pay a meaningful premium for the deal (at a multiple that was reminiscent of deals announced in prior years) in order to add a management team with a demonstrated track record of earning high yields with minimal charge-offs.

Of course, it didn't hurt that the deal came complete with a high yielding portfolio with no problem assets. But it's unlikely that Crestmark and Commercial Capital would have been able to agree to terms if not for Crestmark's willingness to pay an appropriate price for the deal. Crestmark saw the unique value proposition of adding top-notch management talent to its organization.

While the market for mergers and acquisitions has changed from a year ago, it is important for sellers to recognize that there are buyers out there that are willing to pay attractive valuations. But, we are a ways off from returning to the market of 2004 through 2007 when banks were willing to pay multiples that approached their own record high price to earnings ratios. Today's sellers will have to be willing to sell to competitors that can only meet price expectations by realizing back office synergies, which in many cases will mean the reduction of a seller's back office operation.

Another option for sellers to explore is the financial buyer universe, including the private equity or hedge fund route. While a private equity firm or hedge fund is most likely to keep a target's operation and employee base completely or substantially intact, these buyers are most likely to be looking for a bargain in this market. On top of that, most financial buyers will not offer much in the way of revenue or expense synergies, and therefore their ability to pay a high valuation is hampered. But, attractive transaction structures may exist whereby a seller could liquidate only some portion of his or her ownership today, with an option to put the remaining interest at some point in the future at some defined valuation. For sellers that need some liquidity, but do not want to sell 100% of their stake in a down M&A market, this might be a possible alternative.

In this market where senior debt financing is increasingly difficult to come by for commercial finance companies, the successful M&A players will be those buyers that exploit the opportunities generated by banks exiting lines of business and finance companies that need to sell off assets to appease their senior lenders. The opportunities will be out there, as will the equity capital — having the access to debt liquidity to finance an acquisition will be the major stumbling block for interested buyers. Those that have financing, however, could see some great opportunities throughout the remainder of 2008 and 2009. [abf](#)

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