

## Bank & Thrift 2004 Year-End Review

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**2004** proved to be a dynamic year on many levels for banks and thrifts, as institutions across the country implemented a variety of strategies and initiatives to increase shareholder value. In this special year-end issue of *Banking Themes*, we are pleased to provide you with a brief overview of bank and thrift activities during the past year as well as a glimpse of what we foresee in 2005.

Of particular interest in this issue is our discussion of several major trends and developments. One such development has been the strength of M&A activity among banks and thrifts throughout the past year. A second, related development has been the increase in M&A activity involving banks and specialty finance companies. For a variety of reasons, banks and thrifts are increasingly turning to non-bank alternatives to help them achieve their goals and objectives. A third noteworthy trend is the growing interest among banks and thrifts in more actively using balance sheet management as a means of succeeding under a wide range of market conditions, including a rising interest-rate environment.

The old adage that “the past is prologue” has never been more true than today. We can all anticipate and successfully address the issues and conditions we will face in 2005 and beyond if we understand the historical circumstances from which they emerged. It is with this thought in mind that we provide you with this special Bank and Thrift 2004 Year-End issue of *Banking Themes*.

### Bank & Thrift Mergers and Acquisitions—A Seller’s Market

2004 has been an outstanding year for bank and thrift M&A activity, rivaling developments in this sector in the late 1990’s. During the past year we have seen a number of “mega-deals,” a substantial number of combinations among large regional banks, and continued strong M&A activity among mid-cap and smaller banks and thrifts. The following are some key observations regarding 2004 activity.

#### **Transaction Volume**

Through December 20, 2004 there have been 243 M&A transactions announced, approximating the total number in 2003. However, total deal value of \$131 billion is 80% above the \$72 billion total in 2003. This significantly larger number reflects the impact of the JP Morgan Chase combination with Bank One, as well as combinations of large regionals such as SunTrust/National Commerce Financial, Regions Financial/Union Planters, and Wachovia/SouthTrust. While every region of the country has been active, the Midwest region has seen the greatest increase in activity in comparison to 2003, as well as the largest number of transactions. The number of large transactions with deal values over \$500 million doubled to 18 in 2004 over 2003. Conversely, smaller transactions with deal values of under \$10 million dropped to 32 in 2004, from 57 in 2003 and 84 in 2002. Between these two extremes, transactions with deal values of \$10 million to \$500 million continued at the strong pace set in 2003.

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## **Pricing Multiples Are Very Strong**

During 2004, the average bank sold at a Price/Book and Price/Tangible Book Value of 233% and 247% respectively, up more than 10% from the 211% and 221% levels of 2003. The median LTM P/E ratio for bank acquisitions announced in 2004 was 25.0x, versus 23.5x in 2003. Average thrift Price/Book and Price/Tangible Book ratios of 181% and 200% were comparable to those of 2003. The median LTM P/E ratio for thrifts in 2004 of 24.5x was up significantly from 21.7x in 2003. Pricing ratios have been strong throughout the country, although the averages among bank transactions in the Midwest region and thrift transactions in the Southeast region are slightly lower than those in other regions. Buyers are increasingly differentiating among their opportunities. Well-diversified community banking franchises with solid growth prospects and critical mass are commanding the highest multiples. Banks and thrifts that generated substantial prior period earnings from mortgage banking activities generally had weaker pricing multiples. Sarbanes-Oxley and the Patriot Act have created additional regulatory and accounting pressures. Compliance with these regulations has become both expensive and time intensive, influencing a growing number of smaller organizations to consider the sale of their companies.

## **This Is a “Seller’s Market”**

Most transactions announced in 2004 attracted a significant number of bidders. Buyers’ objectives included generating growth by entering new markets and enhancing profitability by leveraging product delivery capabilities, existing infrastructure, and capital. Sellers’ issues included limitations on growth, earnings challenges, and board and management succession. Sellers were also swayed by high merger pricing, often in exchange for shares of an acquirer with strong prospects for future growth in earnings and franchise value.

## **Innovative Transaction Structures Are Being Used**

In August, TD (Toronto Dominion) Bank Financial Group announced a transaction whereby it would acquire 51% of Banknorth at a merger premium, allowing the remaining 49% to trade in the public markets. This structure enabled Banknorth to keep its U.S. currency for acquisitions and compensation, and allowed management to retain its independence while securing a deep-pocketed partner to help it continue its expansion in the United States. Toronto Dominion benefits from this structure by obtaining a capital-efficient way to develop its U.S. retail banking business. While there are clear benefits to this structure, uncertainty regarding the ultimate disposition of the remaining 49% minority stake make it controversial. Another innovative structure is the acquisition of a company with a simultaneous divestiture of a substantial business unit. A recent example is the acquisition of **Staten Island Bancorp**<sup>1</sup> by Independence Community Bank, which included the simultaneous divestiture of Staten Island’s mortgage banking operation to multiple buyers, including Lehman Brothers. Further, Colonial BancGroup used an innovative “forward sales transaction” to lock in the price of the shares it needs to issue to fund its pending acquisition of Union Bank of Florida. Finally, 2004 saw the completion of yet another transaction involving a simultaneous mutual-to-stock conversion and acquisition. There have been 11 of these transactions announced since 1996, including six in the last two years.

## **Milestone Has Been Active as an Advisor to Banks and Thrifts**

Recent advisory assignments include the \$138 million acquisition by **FNB Corporation** (Hermitage, PA) of **NSD Bancorp** (Pittsburgh, PA), as well as the sale of **Ponce General** (San Juan, PR) **and its subsidiary, UniBank** (Miami, FL), to First Bank of Puerto Rico for an undisclosed amount.

## **Outlook for 2005**

We fully anticipate that 2005 will see a continuation of the trends in M&A that developed in 2004. The fundamental forces driving consolidation activity are likely to continue to be strong motivators for both buyers and sellers. As always, merger pricing will be affected by the valuations afforded to buyers’ shares in the public markets. Hence, any meaningful, across-

<sup>1</sup>Milestone served as financial advisor to the company

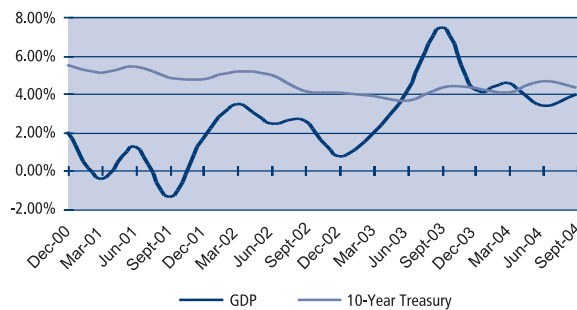
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the-board weakening of buyers' stock prices is likely to adversely affect the strong pricing multiples experienced in 2004, inevitably leading to a slowdown in merger activity. Conversely, the high valuations currently afforded banking companies in the public markets continue to have a strong positive effect on merger pricing and transaction volumes.

## Mergers and Acquisitions of Specialty Finance Businesses

In 2004, banks and thrifts continued to be active buyers and sellers of specialty finance businesses. There are a variety of reasons for the heightened activity. Some banks and thrifts sought to expand existing business lines or shift to higher margin lending during a flattening yield curve. Others sought to take advantage of strong underlying credit strength or to acquire loan volume to sustain growth in a rising-rate environment. Still others sought to divest of non-core businesses that were cyclically unfavorable. Here we explore M&A activity during 2004 and highlight within the specialty finance sector what types of companies were acquired by banks and thrifts and why divestitures may have occurred. As shown below, a strong economy, a favorable interest-rate environment, changes in regulatory and fiscal policy, and accommodating debt and capital markets were among the many external drivers of the robust M&A activity in 2004.

### GDP vs. 10-Year Treasury



Source: FRB, Bureau of Economic Analysis

Milestone defines the specialty finance area to include those companies operating within the mortgage finance, commercial finance, and consumer finance sectors. *Mortgage finance* includes single-family residential lenders, home equity lenders, and companies focused on the commercial mortgage or multi-family markets. Our *commercial finance* sector includes asset-based lenders and factoring companies, residential and commercial construction finance companies, leasing companies, and small business lenders. Finally, our *consumer finance* universe is comprised of auto lenders, credit card companies, manufactured housing finance companies, premium finance companies, pawn and payday lenders, student lenders, and installment lenders.

Bank and Thrift Transactions			
2004	Acquisitions	Sales	
Sectors	Commercial Finance	16	6
	Consumer Finance	11	10
	Mortgage Finance	21	11
<b>2004 Total</b>	<b>48</b>	<b>27</b>	
<b>2003 Total</b>	<b>42</b>	<b>20</b>	
<b>% Change</b>	<b>14.29%</b>	<b>35.00%</b>	

Source: SNL Financial LC

### Mortgage Finance

Somewhat surprisingly in this rising-rate environment, mortgage finance acquisitions by banks and thrifts represent the largest number of transactions within the specialty finance sector, as is shown in the chart on the left.

2004 saw a large increase in mortgage finance transactions, as institutions reacted to falling origination volumes in a cyclical slowdown. Most transactions involved banks as the buyers. Financial institutions, with their favorable capitalization/leverage structure and charter preemption, continued to represent the

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best corporate vehicle for mortgage operations. A good example is Lehman Brothers Bank's acquisition of the mortgage operations of **SIB Mortgage**<sup>1</sup> in April, 2004, where earnings from Lehman's mortgage operations were a major component of its overall profitability. Other institutions such as **Washington Mutual**<sup>1</sup> and Guaranty Bank realigned their mortgage strategy and divested non-core components of their mortgage operations in the face of declining revenue and margins.

## Commercial Finance

2004 also presented an increase in demand for commercial finance platforms driven by bank and thrift demand for higher margin lending and leasing in a generally sound credit environment. In February, we saw First Community Bancorp purchase **First Community Financial**<sup>1</sup>, an asset-based lender and factor, in order to broaden its product mix for its commercial customers. For bank and thrift acquirers of independent commercial finance companies, the cost of funds and leverage advantage can effectively increase the target entity's pro-forma earnings, in some cases by as much as 80%–100%.

After an anemic 2003, there were five reported leasing transactions in 2004. The increase is in large part due to a more favorable business environment characterized by greater capital spending, and the recovery of general equipment values in the secondary market.

## Consumer Finance

M&A activity in the consumer finance sector trailed the pack, as it has for several years. Within this group, credit card portfolio acquisitions showed the highest level of activity, including those by large card issuers such as Barclays, Royal Bank of Scotland, and U.S. Bancorp. We believe activity in this sector is hampered by the fact that significant card issuer consolidation has already taken place—the top 10 issuers control 90% of the market. However, the necessity of scale, a difficult regulatory environment, and continuing high consumer debt levels raise questions for many community and regional banks regarding risk adjusted returns on consumer lending businesses. Nevertheless, Milestone believes that activity in non-card consumer lending (i.e., unsecured lending, manufactured housing, auto lending/leasing) will begin to increase if expectations of continued employment gains and personal income growth prevail.

	Specialty Finance Pricing Ranges			
	Price/Next Year Earnings		Price/ Book Value	
	Low	High	Low	High
Commercial Finance	8.00x	15.00x	1.50x	2.00x
Consumer Finance	6.00x	12.00x	1.00x	1.75x
Mortgage Finance	5.00x	10.00x	NA	NA

Source: Milestone Advisors, LLC

The fundamental drivers of M&A activity in 2004 should continue into 2005, assuming we do not experience any major liquidity or credit shocks in the economy. Localized home price inflation remains a potential factor after two years of double-digit increases. However, improvements in personal income, job growth, and benign inflation should mitigate those concerns. As mentioned earlier, the strength of bank and thrift buyers' valuations will be a major contributor to continued acquisition activity. Any industry-wide reduction in multiples would have an adverse impact on merger activity.

Unfortunately, most pricing information regarding specialty finance companies acquired or sold by banks and thrifts is generally not disclosed. Milestone's transaction experience for whole company transactions is depicted in the chart on the left.

Because average stock price multiples for banks and thrifts (see chart below) far exceed typical M&A pricing valuations of specialty finance businesses (chart on left), smart acquisitions should be extremely accretive to such buyers in the short term.

	General Bank and Thrift Multiple Ranges			
	Price/Next Year Earnings		Price/ Book Value	
	Low	High	Low	High
Banks	15.00x	25.00x	2.00x	3.00x
Thrifts	12.00x	20.00x	1.75x	2.50x

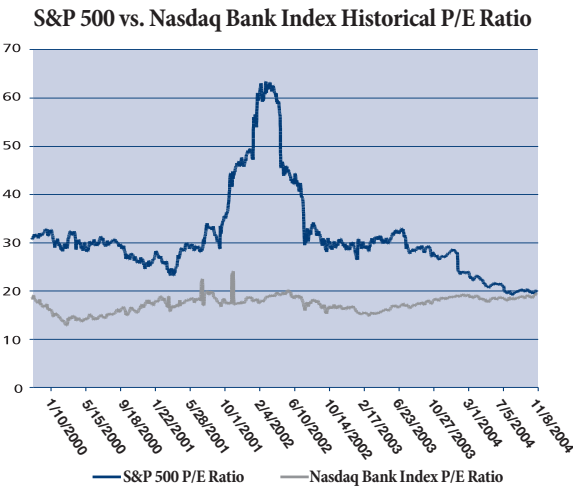
Source: Milestone Advisors, LLC

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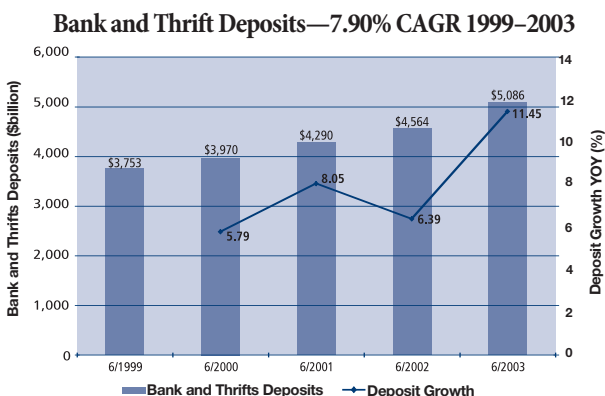
## Balance Sheet Strategies—Taking A Two-Sided Approach

Bank and thrift earnings momentum remains strong. In fact, for all insured institutions, the FDIC reported record high 3rd Quarter industry earnings of \$32.5 billion. Consistent loan demand, a benign credit environment, and the Federal Reserve taking a “measured approach” toward tightening have contributed significantly toward the positive backdrop. The sector’s equity valuations remain high after having generally outperformed the markets for the past five years.



Source: Bloomberg LP

however, is aimed at preparing the asset side of the balance sheet for higher rates. Oftentimes, institutions work toward this goal simply by purchasing adjustable-rate mortgages. In Milestone’s opinion, however, ARMs are not a cure-all. Unlike most broker/dealers, Milestone recommends that depository institutions take an active and diversified approach toward **liability** management in order to develop earnings consistency and preserve valuation. (See Milestone’s Banking Themes, September 2004, “Liability Management: Diversify Your Approach”). Consider the charts below:



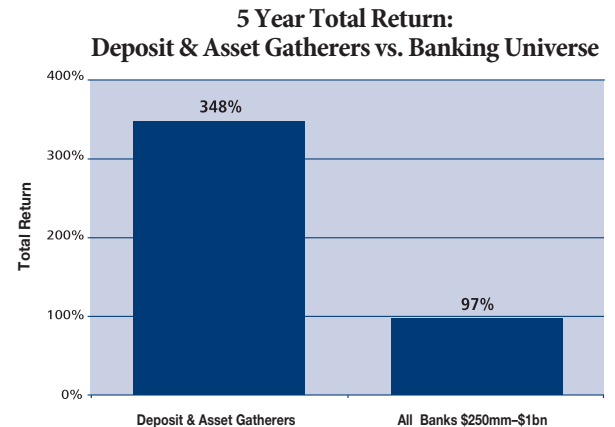
Source: SNL Financial LC

Investors recognize that core deposit growth is a major contributor toward building franchise value. By emphasizing low-cost core deposits and reducing dependence on short-term certificates of deposit, these companies have dramatically outperformed the universe of bank stocks.

While industry consolidation will likely continue, institutional investors are expressing discomfort with current valuations as they consider some of the emerging strains within the banking system. The Federal Reserve’s recent language clearly suggests a commitment toward continued draining of liquidity. As a result, the fed funds rate is expected to rise well into next year. Commercial banks focused on prime-based lending and core deposit growth should see margin expansion with each increase in the prime rate. On the other hand, liability-sensitive institutions may find it challenging to maintain current levels of profitability in the year ahead.

### Active Liability Management

Asset/liability management considerations appropriately gain attention as rates rise. A disproportionate amount of attention, however, is aimed at preparing the asset side of the balance sheet for higher rates. Oftentimes, institutions work toward this goal simply by purchasing adjustable-rate mortgages. In Milestone’s opinion, however, ARMs are not a cure-all. Unlike most broker/dealers, Milestone recommends that depository institutions take an active and diversified approach toward **liability** management in order to develop earnings consistency and preserve valuation. (See Milestone’s Banking Themes, September 2004, “Liability Management: Diversify Your Approach”). Consider the charts below:



Source: SNL Financial LC

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Milestone's approach is centered on providing well-thought-out strategies using **both** sides of the balance sheet, as well as evaluating off-balance sheet options. By understanding and making use of a broad array of liability management tools, many of our clients have taken steps to protect their margins in the event that deposit growth slows as rates continue to rise. These tools include:

- ▶ Term Federal Home Loan Bank advances
- ▶ Term repurchase agreements
- ▶ Structured repurchase agreements
- ▶ Brokered certificates of deposit
- ▶ Interest rate caps and corridors
- ▶ Interest rate swaps

## Market Dynamics

*“Rising interest rates have been advertised for so long and in so many places that anyone who hasn’t appropriately hedged his position by now obviously is desirous of losing money.” —Alan Greenspan 12/15/2004*

Earlier in 2004, the fixed income markets expected the Federal Reserve to raise rates sharply. As a result, market forces drove the 10-year treasury to a peak of 4.89% on June 14th—despite a 1.00% fed funds rate. Concerns over Net Portfolio Value (NPV), also known as the economic value of a financial institution, emerged as institutional investors and regulators alike considered the implications of sharply rising rates. The degree of wholesale leverage on banks' balance sheets became a material issue, driving down stocks of those companies that were perceived as exhibiting the greatest exposure. Fortunately, the language and actions of the Federal Reserve have been well telegraphed. As a result, going into the end of the year, fed funds have increased to 2.25%, while the 10-year treasury has declined significantly to 4.29%.

## A Balanced Approach

Capital levels continue to grow rapidly within the industry following a period of strong profitability and an ease in raising capital through both trust preferred debt and common equity issuance. Banks continue to leverage excess capital through a variety of means. In Milestone's opinion, however, purchasing long-term securities and funding them with short-term liabilities in this environment exposes companies to undue interest-rate risk.

Rather than speculating on interest rates in this manner, Milestone recommends banks undertake strategies that display a stable balance that insulates earnings as rates rise. (*See Leverage Strategies, October 2004, “Leverage and the Current Economic Environment”*). Pairing cash-flow oriented securities with some of the liability or off-balance sheet products mentioned above allows banks to capture stable returns to leverage, even if rates rise aggressively.

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## Restructuring

A number of banks, particularly those that funded investments and loans with highly optional liabilities when rates were substantially higher, continue to experience earnings challenges. During 2004, our Balance Sheet Strategies Team successfully restructured a number of our clients' balance sheets in order to accelerate their rate of earnings growth (See *Banking Themes, October 2003, "Margin Compression: High-cost Borrowings Taking Their Toll"*). We provided a number of solutions to offset or eliminate the expense of long-term, high-cost borrowings.

2005 promises to see the Federal Reserve continue to raise short-term rates. While growth in monthly payroll figures will prove prominent in their emphasis, look for the Fed to place increased importance on oil prices and the dollar's relative strength or weakness. If both break down, short-term rates could climb well above expectations. Truly asset-sensitive organizations should fair well under this scenario.

## About Milestone

Milestone Advisors, LLC ("Milestone") is the financial advisory division of Milestone Merchant Partners, LLC. Milestone is a NASD licensed broker/dealer and is headquartered in Washington, DC, with additional offices in Short Hills, NJ, Miami, FL\* and New York, NY\*.

Milestone's core focus is providing investment banking services to banks, thrifts, and specialty finance companies. The firm specializes in mergers and acquisitions, corporate finance, mutual-to-stock conversions, investment portfolio and interest rate risk management, and fixed income securities transactions. Collectively, the principals and investment bankers of Milestone have completed over \$24 billion in capital markets transactions, including approximately 150 M&A engagements. Milestone ranked as the #1 Specialty Finance M&A Advisor for 2004, based on number of transactions. (Source: *SNL Specialty Finance Mergers and Acquisitions, 12/31/2004, SNL Financial LC*)

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