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To Sell or Not to Sell? Here's How to Decide

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"Is it in our shareholders' interest to remain independent or sell the bank?"

That's a key question for directors of many regional banks. With regulators and shareholder activists scrutinizing their independence, it is critical that they take a strategic and well-thought-out approach.

The bank M&A market heated up last year. Well-known companies like Bank One, Charter One, Fleet, Provident of Ohio, SouthTrust, and Union Planters have ceased to exist.

But the U.S. banking market is still fragmented. There are 9,029 FDIC-insured banks and savings institutions operating. The top five control only 41% of the assets in FDIC-insured institutions, the top 20 only 64%. Compare this to Canada, where the top six control 87% of assets, or Australia, where the top five control 75%.

It is safe to assume that consolidation will continue. However, the evidence that it has created value for shareholders is unconvincing.

A 1999 update by Federal Reserve economists Simon Kwan and Robert Eisenbeis of a 1998 study by their colleagues Steven Pilloff and Anthony Santomero (now the president of the Philadelphia Fed) found that more than half of the performance variables studied declined post-merger. There was a shift from positive to negative in the mean ROE based on operating income in the eight quarters that followed the merger, and the mean efficiency ratio fell by a marginal 0.34%.

But though most bank mergers failed to create value, there are powerful exceptions. Consider U.S. Bancorp under the leadership of Jerry Grundhofer, whose Starbanc/Firstar bought the old U.S. Bancorp in 2001 and took its name. Its assets grew from \$7 billion in 1992 to \$190 billion; its efficiency ratio improved from 62% to 42%; and the compound annual return to shareholders was a stellar 24%.

In any case, today's prices make it tough to just say no. Deal premiums based on closing prices rose from 1.84% of equity in 2002 and 1.89% in 2003 to 2.17% last year, topping 2% for the first time since 1999. Saying no to such returns may leave you open to challenges from the

shareholders.

In evaluating strategic options, directors of regional banks, particularly medium-size and smaller ones, need to assess:

- Their market (conditions, changes in customer and business demographics, rivals' strength).
- Their people (leadership capability, management transition issues, overall bench strength).
- Their community (erosion of employment and service).
- Their macro environment (interest rate and business cycle).

But the key question is whether the bank's strategy and management justify independence.

In considering that question, there is no substitute for discipline and structure. Maintaining a dialogue with management on strategic options can be a delicate matter as the board balances shareholder, employee, and community interests.

Engaging management in a dialogue around strategic options can be a delicate matter as the Board works to promote shareholder interests while balancing the potential perception of conflict between the community, employees and senior management's own interests.

One regional bank Board found its answer by engaging the management team in a series of strategic workshops, aimed at a frank assessment of the company's strategic opportunities. Here's what they did:

Get the real story: In preparing for the initial workshop, management and directors completed an anonymous survey that assessed perceptions of the company's strengths and weaknesses, corporate culture, organization and management style, key challenges and opportunities. As it turned out, the survey revealed significant convergence of thought between directors and senior management, but it also exposed distinct areas of difference between the groups.

Get everyone talking the same language: The survey results, and differences in perception among Board members and management, were discussed in a joint workshop. External benchmarks, other banks' experiences, peer

group and best practice strategies were added to the mix, resulting in a constructive, fact-based dialogue examining key strategic paths. As an outcome of the workshop, management was tasked with developing a "blueprint" for implementing the key, agreed strategic drivers.

Develop a Blueprint: Management engaged the organization in an interactive process, and 400 discrete action programs were developed to enable realization of the strategic objectives. Action programs were in-depth, granular descriptions of enablers that made the strategy come to life, and were established within each line of business. For instance, within the consumer bank, action plans addressed criteria for balancing de-novo branches against whole institution acquisitions, defined banking center staff core competencies and addressed talent gaps, and developed relationship-based product packages and sales programs.

Refine the Blueprint: The Board engaged with management in a two-day strategy review where key aspects of the plan were refined. Directors and managers continued their open dialogue as they examined the various key enablers.

Implement the strategy and assess results: As the strategy is being implemented, the Board will receive regular updates and independently assess whether the results meet the objectives and whether a course of continued independence is warranted.

Following this structured approach to asking hard questions and developing a measurable set of enablers to deliver its strategy, the bank's Board and management are able to develop jointly a vision that the organization can rally around.

A shared vision of the future has helped equip them to decide if some offer is too good to refuse - but this bank is likelier to be among those making the offers.

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