Growth Equity and Buyout Deals for Commercial Banks

Can You Have a Buyout Without the Leverage?

Question That Came in a Long Time Ago…

"I've noticed you have many examples of leveraged buyouts and LBO models for traditional companies.

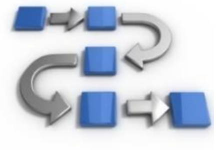
But how would you set up a leveraged buyout model for a **commercial bank**? I have an upcoming case study at a financial services-focused PE firm. Help!"

What We'll Cover Here:

- **Part 1:** Key Differences in Bank Buyouts and PE Investing

- **Part 2:** Overview of Bank Buyout Model for MidFirst Bank

MIDFIRST BANK



The **Key Differences** in Bank "LBOs"

- **Truth:** There's very little traditional PE/LBO activity in commercial banking – *far* more in insurance, specialty finance, fin-tech, brokerage, etc.

- **Why:** Combination of regulations and deal math

- **Regulations:** The PE firm may be classified as a "bank holding company" if it acquires a certain percentage of the bank's voting shares (25% in the U.S., but even 5% could be problematic!)

- **PROBLEM:** Then, the PE firm has to comply with Regulatory Capital and other requirements – and they do **NOT** want that!

The **Key Differences** in Bank "LBOs"

- **Deal Math:** Most banks are already highly leveraged and cannot take on much additional Debt to fund a deal

- **Remember:** Debt is more like a raw material than a financial liability for a bank; won't necessarily "de-lever"

- **Also:** Possible CET 1 shortfall if we write down a bank's Equity and don't replace it with new Equity

- **So:** Most PE firms *pretty much* have to use 100% Equity, or close to it, if they want to do traditional buyouts

How to **Get Around** the Rules and Restrictions

- **Option #1:** Structure the deal as a minority-stake investment for, say, 5%, 10%, or 20% of the bank's common shares

- **Option #2:** Invest in something *other* than the bank's Common Equity – Preferred Stock, Convertibles, Mezzanine, etc.

- **Option #3:** Do the deal with multiple PE firms such that it *is* a buyout for 100% of the bank, but *no firm* controls more than, say, 20% of the bank's voting shares

- **End Result:** "Bank buyouts" are more like **growth equity deals** or **debt investments** than traditional leveraged buyouts

Bank Buyouts vs. Traditional LBOs

- **KEY QUESTION:** What *drives* the returns in a model?

- **Traditional LBO Model:**

Value Creation Analysis:	Units:	Projected FY16	FY17	FY18	FY19	FY20
Value Creation in EUR:						
EBITDA Growth:	*EUR m*	35.0	367.4	684.5	958.8	1,207.0
Multiple Expansion:	*EUR m*	-	211.2	454.1	722.2	1,012.6
Debt Paydown and Cash Generation:	*EUR m*	23.1	117.5	272.4	438.0	634.9
Total Equity Return:	*EUR m*	**58.1**	**696.0**	**1,411.0**	**2,119.0**	**2,854.5**
Value Creation in %:						
EBITDA Growth:	*%*	60.3%	52.8%	48.5%	45.2%	42.3%
Multiple Expansion:	*%*	0.0%	30.3%	32.2%	34.1%	35.5%
Debt Paydown and Cash Generation:	*%*	39.7%	16.9%	19.3%	20.7%	22.2%
Total Equity Return:	*%*	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

This Returns source goes away in "bank buyouts."

- **Bank "Buyout" Model:**

Returns Attribution Analysis:		Amount:	%:
TBV Growth:	*$ M*	$ 1,910.4	46.7%
P / TBV Multiple Expansion:	*$ M*	1,008.5	24.6%
Dividends:	*$ M*	1,175.8	28.7%
Total Return to Equity Investors:	*$ M*	**$ 4,094.7**	**100.0%**

Same idea as with traditional companies and LBOs, but different metrics and multiples.

Dividends aren't really "new" - they could still be a source of returns in traditional LBOs. But they're more common and important in bank buyouts/investments.

Bank Buyouts vs. Traditional LBOs

- **Goal:** Grow the bank's TBV and expand its P / TBV multiple

- **P / TBV =** $$\frac{\text{(ROTCE – NI to Common Growth)}}{\text{(Cost of Equity – NI to Common Growth)}}$$

- **Method #1:** Boost the bank's ROTCE via cost cuts, higher Asset growth, higher-yielding Assets, or lower-cost funding sources

- **Method #2:** Boost the bank's Net Income to Common Growth

- **Method #3:** Reduce the bank's Cost of Equity (Ke) by changing its business model, loan/deposit mix, or timing the market cycle

Overview – MidFirst Bank Buyout Model

- **Step 1:** Make transaction and operating assumptions


- **Step 2:** Set up Sources & Uses and PPA schedules – Similar to M&A deal, but just the Target's Balance Sheet here

- **Step 3:** Adjust the Balance Sheet – Cash, Loan Marks, Allowance Write-Down, Goodwill/Intangibles, Deferred Taxes, and Equity

- **Step 4:** Project the Balance Sheet and Fed Funds

- **Step 5:** Project the IS and CFS (if applicable)


Overview – MidFirst Bank Buyout Model

- **Step 6:** Project the Regulatory Capital and Dividends for the company

- **Step 7:** Calculate the MoM Multiple and IRR and build Sensitivities and a Summary

- **Evaluate:** Doesn't seem like a great deal because we need 20% Exit P / TBV multiple expansion (to 3x) get a 20% IRR, but the bank's ROA and ROTCE *fall* over this 5-year period

- **But:** To evaluate it more fully, we'd have to look at different scenarios and sensitivities (and get more detailed statements)

Recap and Summary

- **Part 1:** Key Differences in Bank Buyouts and PE Investing

- **Part 2:** Overview of Bank Buyout Model for MidFirst Bank