M&A: UNDERSTANDING CASH VERSUS STOCK TRANSACTIONS

Fourth in a series: A quick guide to the differences

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In many of my recent blogs, I have focused on community bank mergers and acquisitions. Although I remain a firm believer in the future of community banks in the marketplace, I also realize that community banks will combine in the coming years for a number of reasons. Among these reasons:

- • They have to, because they need capital.

- • All the traditional reasons, i.e. older management and no succession plan, etc., apply.

- • Many have had all the fun they can stand over the last four years or so.

In previous blogs, I focused on issues of credit due diligence, general due diligence, documentation, and the like. I will comment in this blog about one of the more critical questions: Pricing a community bank acquisition.

In other words, how do you know how much to pay if you are a buyer?

"Will that be for stock or cash, sir?"

In a restaurant, usually the cash or credit question comes at the end of the meal, after all the important matters have been settled, and consumed. But the starting point for a pricing discussion is whether the acquiring holding company is paying with stock, cash, or some combination.

Stock or partial stock deals. The simplest rule, if the holding company is paying with the holding company's stock, is that at least half the purchase price given to the target should be in stock. (There is some flexibility on this, but that is the simple rule.) That allows the selling bank shareholders who receive the stock to receive it on a tax-deferred basis, i.e. their tax basis in their existing stock carries over into the stock they receive from your holding company.

On a stock-for-stock deal between two companies that are not publicly traded, i.e., no public market and no indication of market value for their shares, then the question comes up: How do you determine how many shares the buyer gives to the seller's shareholders?

The answer results from a "contribution" analysis. This evaluation reflects how much each of the combining companies contributes to the resulting company in the areas of equity, assets, and earnings. Each of those three characteristics is weighted appropriately and the final result determines what percentage each shareholder group should own of the resulting company. This creates the "exchange ratio." (Earnings are weighted more heavily.)

Cash deals. A cash transaction is different.

In a cash transaction, the purchasing bank holding company is going to weigh what it pays against the earnings stream of the target company; it is not going to give up more cash than the "cost" of obtaining the cash either through:

- • Incurring debt

- • Issuing new securities in an offering

- • Liquidating existing investments

The fundamental goal of any acquisition, whether for stock or cash, is to make the purchasing shareholders better off than they would have been without an acquisition. This generally means, in a cash transaction, a focus on accretion to earnings. In other words, will the earnings per share be higher post-acquisition than they were pre-acquisition, at least over some decent time horizon?

If the answer is yes, then it probably would make sense assuming that due diligence is accurate and it can be integrated appropriately.

If the answer is no, and shareholders would be worse off post-acquisition than they would without an acquisition, then why go ahead and do it?

An important reminder

Also, do not forget about the issues associated with Statement of Financial Accounting Standards 141R which requires fair-value accounting for assets and liabilities at the time of acquisition.

This will be a topic for another blog, but do not be blindsided by the accounting rules in connection with an acquisition transaction. Understand them on the front end.

About the Author

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