LEND ACADEMY

PODCAST TRANSCRIPTION SESSION NO. 218 - CHRIS HARGROVE

Welcome to the Lend Academy Podcast, Episode No. 218, this is your host, Peter Renton, Founder of Lend Academy and Co-Founder of the LendIt Fintech Conference.

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Today's episode is sponsored by LendIt Fintech USA, the world's largest fintech event dedicated to lending and digital banking. It's happening on May 13th and 14th, 2020, at the Javits Center in New York. Lending and banking are converging and LendIt Fintech immerses you in the most important trends of the day. Meet the people who matter, learn from the experts and get business done. LendIt Fintech, lending and banking connected. Go to lendit.com/usa to register.

Peter Renton: So, we're doing something a little bit different on the show today. We are talking about bank M&A, in particular, a potential fintech company acquiring a bank so I brought in an expert here. I'm delighted to welcome, Chris Hargrove, he is the CEO and Chairman of ProBank Austin. Now, ProBank Austin are a very broadly diversified consulting firm focusing on the financial industry. They provide financial institution consulting and education, they also do advisory services and Chris specifically focuses on their M&A practice and he has worked in bank M&A for several decades.

So, I wanted to get him on the show to talk about..we go through an entire example of what it would look like if a fintech company goes and acquires a bank. We go through all the different steps from the regulators to the lawyers, to valuation and due diligence and many other things. It was a fascinating interview, I hope you enjoy the show.

Welcome to the podcast, Chris!

Chris Hargrove: Thank you, glad to be here.

Peter: Okay, so I like to get these things started by giving the listeners a little bit of a background, so maybe you can give us some of the highlights of your career to date.

Chris: Awesome. I am the Chairman and Chief Executive Officer of ProBank Austin, been there...had those titles for a couple of decades, but my day job is primarily working with financial institutions in the merger and acquisition area, been involved in that since 1982.

I've represented approximately 400 financial institutions as their financial advisor and also working a lot with board of directors on strategic planning, whether they want to sell, or do they want to buy, do they need to raise capital, and things like that. But, that's in a nutshell kind of what I've been doing for the last three and a half decades.

Peter: Okay, so then maybe you could tell us a little bit about the ProBank Austin business. I know you've got a number of different things you do there and I know you guys have been coming to LendIt for a long time, but I wanted to get just...maybe you could give us a broad picture of all the different parts of the ProBank Austin business.

Chris: If you want a broad brush, it would be easier to say what we don't do. (Peter laughs) We do a lot of different things. I guess from the fintech perspective, our biggest offerings to that industry would be in the compliance area. We work for many hundreds of financial institutions and fintech companies going in and making sure that they are in compliance with the tens of thousands of pages of bank and financial institution regulation.

In addition to that, we're probably the largest, not probably, we are the largest compliance training organization in the country. We do anywhere from 700 to 800 seminars or in-house training programs to anywhere from 18,000 to 20,000 bankers every year. We have two new products, bankED, which is our online training which is becoming very popular right now and also Bank Advisor where banks and financial institutions can call in and get a quick and efficient answer to their many, many compliance questions.

Now, outside that, we do many other things; asset liability consulting, profitability, we have a loan pricing software, loan review, internal audit, HR, IT, but again, what we're talking about today, mergers & acquisitions, which if you look over the last ten/twelve years and you look at the total number of deals, bank deals in the country, we would be ranked in the top five.

Peter: Okay, so let's dig into that a little bit then. So, we are now ten years almost removed from the financial crisis where the federal government stepped in to support many of the large banks, but I'm curious, if you could sort of go back to that time period and then maybe just sort of take us through the last ten years. What's the state of M&A in the banking industry today?

Chris: As you might imagine, during the financial crisis, M&A activity dried up to almost nothing. With all the large publicly traded banks who were having problems themselves, we saw activity decrease by almost 75 to 80%. Plus, you know, you had 500 to 550 institutions fail during that period of time, so the healthy institutions were, of course, looking at those bargains as opposed to looking at some of the other deals that came along. And it's been a slow and gradual process since then to where we are today because the fuel that runs the merger and acquisition industry are the bank stock prices.

So, you could imagine, the bank stocks were trading at terribly low levels during the crisis and really, it's taken almost ten years for the bank stocks to come back to the level that they traded for pre-crisis. If you look at the SNL index, we're just now back to that level that we were ten years ago and since then, now, especially in the last few months, because the bank stocks have improved, we're seeing a significant amount of activity and a significant amount of talking going on right now. I think we're going to see...as long as the banks' stocks hold up, I think we'll see quite a bit of activity, probably 300/350 deals a year over the next three or four years.

Peter: So then maybe you could tell us a little bit about the kinds of deals that you work on personally, you know, like are we talking small banks, medium-sized banks and what sort of geographies are you looking at? Is it nationwide, tell us a little bit about the ProBank Austin's sort of M&A practice.

Chris: Yeah, we specialize in community banks and when I say community banks that's probably banks that are $5 billion in assets and less and when you get north of there, you know, you're dealing with a lot of the publicly traded larger institutions and that's kind of...and we have represented banks that were larger, but our sweet spot is that $500 billion and down.

As far as geographic, we do nationwide, we are involved in transactions, but our sweet spot there is primarily in the Midwest and the Southeast. I guess if you're picking up on my accent, you're guessing the area of the country that I specialize in.

Peter: (laughs) Right, right, got it. Okay so, I know you've been paying close attention to sort of the changes in the chartering process. We've got the OCC Fintech Charter is in a holding pattern, we've got the ILC Charters that are taking forever, no digital bank yet has received a full bank charter, I know Varo is getting close, I believe...so it seems like for the fintech companies, there actually have been a few, OnDeck and LendingClub have both indicated they're interested in getting a bank charter, but I what I wanted to talk to you today about was really an alternative to that.

So maybe for a fintech company listening to this podcast and they're thinking about going down the chartering process, why don't you tell us about a different alternative to doing that and that is obviously acquiring a bank, possibly even a failed institution. So tell us a little bit about that.

Chris: Yeah, as you might imagine, being in this business, I'm very pro acquiring a bank than I am trying to start from scratch.

Peter: Right.

Chris: Because if that were true, you wouldn't have all of this acquisition activity. It's much more efficient to acquire an existing charter with the operations and the back room, the computer systems and all that you would need, instead of starting from scratch. I encourage them to look at that alternative as opposed to starting brand new.

One, you mentioned the fact of looking at a failed institution, I don't know if I were doing a strategic plan for a fintech company, I probably wouldn't put that very high on the list because what we said earlier, the banking industry is in pretty good shape right now. Of course, that could change day to day, but as we stand here today, the banking industry has been in fine shape and we don't have that many troubled institutions.

I think the number of troubled institutions right now only amounts to like 30 or 40 banks as opposed to where we were right before or in the beginning of the financial crisis, there were over 800.

So, I don't think there are going to be a lot of banks that are going to fail over the next 18 months or so. So, there probably won't be any opportunities of any significance there. The other thing, if you're going to look at a failed bank, you have to be pre-approved by the FDIC so you got to go in and meet with them and convince them that you have the financial resources and expertise to bid on a failed bank and there's going to be a lot of competition for that.

But, I do encourage them to look at a community bank that's already active, that's clean, that's in really good shape and that way you have a base of operation that's functioning and doing well and you don't have to do everything from scratch.

Peter: Right, so tell us what would that process look like? You know, how do you sort of approach these and how do you discover which community banks would be open to, you know, to an acquisition.

Chris: Yeah, I think what I'll do is I would kind of put my mindset on, if I were doing a strategic plan for a fintech, what would I be asking them and what kind of road would I lead them down.

The first thing I would want to do is to sit down with them and go, one, of course, how much money do you have, you know, how much capital can you raise because in banking, capital is everything. That's one reason we had the financial crisis because the banks did not have enough capital. So I'd sit down with them and determine how much capital they have in place, how much they thought they could raise in order to get an idea of what size bank that they could afford to acquire. So we would sit down and determine what size bank could they afford.

Two, I would want to know, are you interested in a certain geographic area, you know, are you interested in the Midwest, the Southeast, the Great Plains states, you know, or does it really matter? But, it's funny that even though these are nationwide companies willing and able to do business just about anywhere in the country, when you sit down with these folks, they really want something, they have an idea of what part of the world they may want their bank to be located.

So then, at that point, and it's really interesting, when you find just these very few parameters, what size, what part of the country, one that's in good shape, you know, financially, does not have any problems...when you focus in on that, you'll be shocked to learn that there usually aren't that many. So, one, we identify, are there institutions out there that would meet their criteria, both from a size, profitability, location.

Then at that point....we all have to remember and I say this almost every day to people, that just because you want to acquire an institution doesn't mean there's one out there for sale, or that would meet your criteria. So, one, we want to see how many banks are out there that would meet your criteria. Now, at that point in time, if it's somewhere that, you know, our firm is strong, or we know some other firm that may be better connected in that market, what I tell people is to do one of two things.

One, is we look and say we've identified 15 or 20 banks that would meet that criteria. You know, it's more cost-effective, and sometimes better instead of the hired guns, like myself, contacting those bankers, contact them yourself and tell them what you're planning to do and tell them what you're thinking about just so, you know, they know that if they want to sell down the road that there's someone out there that might want to take a look at them, especially for the smaller banks because a lot of times the demand for those banks is pretty limited.

The other thing is to let all the professionals in that area know. If there's an investment banker that's strong in downstate Illinois, make sure that that person knows that you're looking for a bank in that part of the world. And, again, we all have these, if somebody contacted me, I can give them a list of the bankers there, also the law firms that are active in M&A in that part of the world, the accounting firms, the main thing is to let all these professionals out there know what you're looking for. Hopefully, with a little diligence and effort, you can find an institution that when they're ready to sell, or you spark an interest would be willing to sit down and talk to you.

Peter: So then, how small can we go here, I mean, are there many banks to choose that have like $100 million in assets, or less? I mean, how small can...because a fintech company is probably not going to be able to buy a large bank, or even a larger community bank. How small can they go?

Chris: Well, that's...the interest that we're seeing from the fintech world is actually in the smallest of the small.

Peter: Right.

Chris: And when you go into the western part of the Midwest, or into the Great Plains, there are a significant number of extremely small banks in that part of the world and I'm talking, as you said, less than $100 million and that's where we're seeing a lot of the looking and conversations taking place are in that part of the world, what do you call them, the "flyover states."

Peter: Right, right, And then what about sort of…I mean, what are the multiples there? Say a bank is doing $10 million in revenue and a million dollars in profit...I don't know what the typical revenues of these small banks are, what kind of multiples would you expect to pay to acquire one of these?

Chris: Oh, the nice thing is the multiples in those parts of the world for the smaller institutions are significantly less in what we're seeing, you know, in the more metropolitan areas. I mean, you could...the going number for a small bank in the western Midwest, the Great Plains is probably like 1.2, 1.25 times equity, you know, 12 to 14 times after tax earnings, or tax adjusted earnings.

Peter: Right.

Chris: So, that's why I would be a big proponent of buying these institutions because for just a small premium over their equity account, especially on a small one, you get a shop that's operating and working perfectly and hopefully, perfectly, and it will put you, you know, years ahead on your timeline on making things happen.

Peter: Right, right. Okay, so let's assume that a fintech company has talked to a bank, they're interested, what happens then? I mean, what do you do, obviously there's a regulatory perspective here, I'm sure communication needs to happen with the regulators, but tell us a little bit about how that process progresses.

Chris: Alright, there's two hurdles they have to get by to be successful. Well, after you've made the contact and they're interested in talking to you...and even if you, kind of generally, understand the price terms, the first hurdle you have to get over is dealing with somebody like me. When a bank hires me to sell them, what's my job. My job is to get them the best price and to deliver that price and I have to tell you there, when I deal with individuals, or a fintech company, or a mortgage company, finance company, anything outside the norm of what we're used to dealing with, you know, my first concern is, one, where are you going to get the money.

And then at that point, you know, the company on the other side of me that I'm dealing with, you know, I want to know that they've done their homework ahead of time because a lot of these institutions that want to buy a small community bank, and we're probably going to get into probably too much of the weeds here, but they're going to have to form, probably form a holding company which is regulated by the Federal Reserve because most of these institutions, or people, or individuals are going to want to borrow a portion of that purchase price.

So, let's talk about the $100 million bank that has $10 million in equity and assume we're going to pay them 1.5 times book or $15 million. You know, what I'm going to want to see from them is...you know, I would expect to see at least half that amount, $7.5 million, being hard equity, equity that they deliver, not borrowed money. The other half I would be comfortable with if that were borrowed.

So the first thing is, if you're going to do a deal, you have to convince me that you have at least $7.5 million of cash and the ability to borrow the other $7.5 million. That's to make sure they got the money, right, first part of my job. The second thing that I want to know is will they get regulatory approval. Alright, so, what I would be asking them then, because I work in this all the time and you're going to hear this a lot the rest of this conversation, I want to see their business plan.

You know, what are they going to do with this bank? They're buying it to change it so they would have to convince me that the things they're going to want to do with this bank and the changes they're going to want to make and the business that they're going to want to bring in is going to pass regulatory muster or pass through the regulators because the regulators are going to be very skeptical. If you go back, even before the last financial crisis…remember the savings and loan crisis which was a couple of decades ago, a lot of that crisis happened because developers and people outside the industry bought these little sleepy savings and loans and did things with them; started to invest in developments, and getting hot deposits, and growing too fast and things like that and the regulators haven't forgotten that.

So anytime someone outside the norm comes in and wants to buy a bank, you have to have a business plan that convinces them and shows them that what you're going to do is not going to jeopardize the fund, meaning the FDIC, deposit insurance fund. So, they would have to convince me first that their business plan is going to be sellable to the regulators. So, that's kind of what would get you through the first hurdle.

Peter: Okay, so then what do you think the regulators want to see because obviously, these fintech companies that would be buying these banks, as you say, to change them, these are online companies buying obviously banks are physically located in a, presumably, in a relatively small town and maybe have only one or two branches so, they're going to want to change it dramatically. Is there something that they can do to kind of position themselves to increase their likelihood of approval from the regulators?

Chris: Sure, and that's to get the regulators comfortable with it, like you wouldn't want to show them a business plan that you're going to saturate the market looking for deposits, or CDs, or anything that are 50/75 basis points above everyone else and then all of a sudden you blink your eye and that little sleepy $100 million bank is all of a sudden a half a billion dollar bank because of this flood of deposits.

So, you know, you would have to show them that one, you're not going to outdistance your capital because we have to remember, the key in banking, everything is capital. So, if I have a $100 million bank and it has $10 million in equity...let's say that's what the regulators want to see is the capital ratio or equity to asset ratio of around 10%, we have to remember that for every $10 that we increase the size of this institution, we have to have a $1 of equity backing it up.

So if we're going to show a dramatic growth in deposits and assets then we have to show them that we have the capital that's going to be coming in to support that growth and again, that's one of the things that got us in the financial crisis. You've probably heard people say, the leveraging of the industry.

Peter: Right.

Chris: So, they don't want us to leverage too much. You know, they're going to want to be comfortable with the type of lending that you do and I think the regulators are becoming more tuned in to that kind of lending, but you've got to show them that you have the loan policies and procedures and systems, you know, where you can do this kind of business and run it through the bank and fund that with insured deposits by the FDIC.

That's the key that the bank won't fail, that you won't put on the books assets that will eventually be trouble so you've got to look at all the aspects of the bank. You've got to convince them from an operations perspective that...can I take this $100 million bank and over two or three years turn it into a billion dollar bank? Do I have the expertise and management and systems in place to do that? So, this business plan, this business plan is the key to anything and everything for a fintech company to come in and buy a commercial bank.

Peter: Right, right. Okay, so maybe you could give us a sense of timelines here. Once you feel like you've got a good business plan, you're talking with a bank, you want to pull the trigger, I mean, I'm talking about...obviously, regulators have to be involved, the other party has to get comfortable and lawyers, and everything, but what is the typical timeline from start to finish of a transaction like this?

Chris: Well, one, the start to finish of when you decide you want to acquire a bank to even getting it under contract can be month or never. (Peter laughs) I mean, it can be. I have banks, I have entities out there that decided two years ago and I guess that's what I want to stress is how difficult it is to find one.

Peter: Right.

Chris: I have clients that decided two years ago they wanted to acquire another bank and they're still looking. I met with some guys in New York not long ago, they quit their jobs and their whole business plan personally is finding a bank to acquire and they still haven't, you know. So, I wouldn't quit my day job until I had something lined up, but anyway, so if you find a bank and you have a good business plan and you have the money, you guys shake hands on a deal.

Then it's usually…the next step would be, you know, finalizing the merger contract, the definitive agreement that spell...that's when the lawyers get involved, when they spell out, you know, the financial terms and conditions of the deal. I mean, these are big monster contracts, you know, 70/80 pages long, that covers every different crazy scenario that you can think of. So, that process...and, oh, more important than that, if you're looking at acquiring an institution, you have to do your own due diligence.

You don't want to buy something that has problems, so you've got to get your accountants or consultants, your loan review people, your outside folks to come in and help you look at that institution to make sure that there's nothing in there that's going to bite you after you close. So, once you shake hands on a deal, you'll want to do your due diligence, which usually takes a couple of weeks to make sure that you look and see what you're buying. During that period, or shortly after that, the attorneys would get involved working on the definitive agreement which usually, again, takes a couple of weeks to formalize that.

Once you do that, you're going to have the announcement then would come regulatory process. You have to file your regulatory application, it may take a little bit longer to prepare that for a fintech or other companies because, again...say I'm a $2 billion bank with $200 million in equity and I want to buy a little $100 million bank, the regulators are going to look at that deal almost...and I hate to say to word rubber stamp, but, you know, this is a proven bank that has been around for 75 years, the regulators know them, they've examined them, they're very comfortable allowing them to buy this other institution.

Now, anyone other than that is going to get a lot of scrutiny so we come back to that business plan. That business plan has to be bullet proof when we give that to the regulatory agencies. In addition, we've got to have projections and proformas that show that if we're borrowing money, we have the ability to pay that back, we've got to do projections that show that when we implement this business plan that we won't outgrow our capital.

If we're saying that we're going to be $300 million in three years, then we've got to show them that the capital levels will be sufficient to support that level, we've got to give them proformas showing what we anticipate the income stream to be from that. So, it's a very detailed, complicated application but, you know, basically what we're doing, we're selling the regulators on our concept of what we want to do. The regulatory process takes anywhere from three to four months.

Peter: Right.

Chris: So, they're going to have that application and they're going to look, they're going to do background checks on all the principals. They're going to make sure that we're not violating any type of anti-trust laws, they're going to look at the capital levels, they're going to come in and want to interview you guys, those folks to make sure they know what they're doing. They will want to know how much we're relying on the existing management of the bank we're buying, but it's a long drawn out process and it takes quite a while.

Peter: Okay, so then what about...once the transaction has closed, the fintech now has a bank, they have a banking license that they can use, but what happens then because keep in mind, most of these fintechs that are looking at this, they already have a relationship with a partner bank, they've had examinations from the FDIC and others so they do have some connection with the regulators, but post transaction, what do you think the fintech should be looking out for?

Chris: Well, I'll tell you what they should be concerned about from a regulatory perspective. It's going to be the other side of the balance sheet, the deposit side because, you know, because that's where the abuses have been in the past and the regulators are really going to pay a lot of attention to, you know, what type of deposits are they bringing in, how hot are they, are they just hot deposits, meaning you get them off the internet, which is where most of their deposits are going to come from.

But that they're not considered deposits that are going to leave very quickly. They're really going to focus in on that and that's the piece of the puzzle that they haven't dealt with before because, I believe, they just upstream those loans to the bigger institutions and it's just like a conduit. Now they're going to be holding on to those loans and they're going to be funding them with their own deposits.

Peter: Sure, and then do you provide guidance? Obviously, your company has all kinds of compliance capabilities, do you provide guidance post transactions?

Chris: This company was built for that. Just like I told you when we started, it's easier to say what we don't do.

Peter: Right.

Chris: I mean, anything that any type of bank or company would need in dealing with a bank. We handle the compliance piece, the internal audit piece, the loan review piece, we do those business plans that we've talked about, any type of operational issue that could ever come up. We've got the experienced folks to come in there and help them. Building that relationship is how built this company since 1978.

Peter: Right, right, So we're running out of time, but last question then. I'd be interested to get your perspective on the potential for this particular…what we've been talking about here for a fintech to come along and buy a bank. We saw it happen in Europe, I think it was in Germany with Raisin buying a bank in Germany, what do you think is going to happen here? In three years time, if we reconnect, are we going to see half a dozen or a dozen of these type of transactions. What's your prediction?

Chris: Well, as the father of six millennials (Peter laughs) what I'm learning is I think this is the wave of the future, and I think that a fintech acquiring a community bank and getting the other side of the balance sheet that they don't have is the key and the answer and I'm very bullish on this.

I think over the next four, or five years, you're going to see a dozen, or more of these announced, if not more, and again, because one, this is the future, this is where we're headed, and also there are…you know, there's 5,000 plus community banks out there in the United States and there's going to be supply.

Peter: Right.

Chris: There are going to be community banks out there to acquire and I think it's probably the most efficient way for a fintech to go that route.

Peter: Okay, it will be interesting to see. I'll have to leave it there, Chris, but I really appreciate you coming on the show today.

Chris: Thank you, I had a great time.

Peter: Okay, see you.

Chris: Bye, bye.

Peter: Well obviously, I'm no expert here. It does make perfect, logical sense to me that any fintech company that is looking at getting a bank license with the lack of clarity in the Fintech Charter and, you know, the very slow process involved in getting approved for a new license, I think it makes perfect sense that this should be an avenue that fintech companies should explore. It will be very interesting to see who goes first and how many we actually see over the next couple of years, but I'll be very surprised if that number is zero.

Anyway on that note, I will sign off. I very much appreciate you listening and I'll catch you next time. Bye.

Today's episode was sponsored by LendIt Fintech USA, the world's largest fintech event dedicated to lending and digital banking. It's happening on May 13th and 14th, 2020, at the Javits Center in New York. Lending and banking are converging and LendIt Fintech immerses you in the most important trends of the day. Meet the people who matter, learn from the experts and get business done. LendIt Fintech, lending and banking connected. Go to lendit.com/usa to register.

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