

## E-Memo

**TO:** INVESTORS/MEMBERS/PARTNERS AND FRIENDS  
**FROM:** Jon Bruss and James Bruss  
**DATE:** December 30, 2011  
**SUBJECT:** What Consolidation Wave? When?

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Over the last couple years, one of the most common themes in the banking industry has been the “coming wave of consolidation”. Many analysts have long believed the country is overbanked. With 7,000 banks in the U.S., the industry seems ripe for rationalization. Analysts point to a slew of factors they believe will coalesce to push the industry to consolidate: increased and costly regulatory burdens introduced by Dodd-Frank; the desire of the regulatory community for fewer depository institutions; growing fatigue of management teams and boards that have just lived through a major financial crisis and barely survived; increasing pressure for better returns on higher equity ratios; the need to pay back TARP or SBLF funding; FDIC-assisted transactions; increased capital ratios; etc., etc. With forces like these at play in the economy, there is an air of inevitability about the whole thing.

But something happened on the way to the party. Nobody consolidated. In fact, open bank M&A activity was even lower in 2011 than in an otherwise dismal 2010. In 2009, most of the industry (including us) assumed the low M&A activity resulted from being crowded out by TARP funding. That year saw 118 whole bank M&A transactions. For 2011, this number fell to 68 (assuming no deals are completed between now and the new year). You’ll need to go back to 1988 to find such anemic activity.

So, why is an industry so poised for consolidation in a major M&A funk? With continued low valuations in the banking industry, historically low interest rates, regulatory burdens, and so on, why are not more banks merging or being bought. The short answer is, we don’t know. But we can speculate. There are two dominant psychological strains in the market for banks today: pessimism and skepticism. Together they have contributed to a climate of uncertainty and resulted in severely constrained consolidation activity.

The pessimism draws on the tepid economic recovery and the myriad crises that followed the panic of 2008. According to the National Bureau of Economic Research, the recession that began in late 2007, ended in June of 2009. After the long and deep recession, many economists predicted a V-shaped recovery. That hasn’t happened; rather, unemployment continued to get worse during the “recovery” and GDP growth was disappointing. Moreover, stimulus programs—whether from Congress or the Fed—have had no noticeable effect on the economy. Congress’s spending was poorly targeted. Instead, high-profile bombs (think Solyndra) and ineffectual temporary programs (e.g., the first-time homebuyer credit, which merely exposed the housing market’s deep weakness when it ended) served to underscore the futility of spending our way out of a mess. Quantitative easing, the Fed’s own stimulus program, has not produced the jobs it was hoped to but it has stoked fears—well-founded or not—of inflation.

Apocalyptic fears about Europe and even growing concerns that China’s economy might be a soon-to-burst bubble added to the lackluster economic performance in this country. No one knew (or knows) exactly what would be the effect of a wave of sovereign defaults, but everyone agrees it would be more than just unpleasant. The entire European banking system might be at risk and major U.S. banks would suffer as well (though no one has any idea how much).

In short, the market’s pessimism is not without justification. But there is also skepticism. The experiences of the last five or six years have taught many investors and bankers to find suspect what other banks tell them. The recent announcement of fraud cases against Fannie Mae and Freddie Mac executives highlights how it all began. In SEC filings, the companies obscured the extent of their subprime mortgage holdings. The subprime mortgage market blew up and, yada yada, 170 billion in US

taxpayer dollars later the companies are still digging out of their holes. Fannie and Freddie weren't the only ones. Major Wall Street banks and investment banks sat on mountains of credit default swaps but made sure no one knew exactly how big their portfolios. On a smaller scale, community banks often hid (from themselves, even) the extent of their losses. Everyone knew community banks had grown their commercial real estate portfolios during the early part of the century. But too many of those banks continued to rely on outdated appraisals. Even today, some community banks pretend their credit is clean. But credit surprises do not encourage investors or add to management's credibility. (On the other hand, those that aggressively addressed their credit problems are now profitable and, usually, flush with capital, forming one of the promising currents in the banking industry.)

Bankers know these trends too well. They are skeptical of what selling banks tell them. Partly as a result of this skepticism, buyers and sellers cannot agree on pricing and deals fall apart before they ever get any momentum.

The only way out of this present M&A funk is a cure to both the pessimism and the skepticism. Pessimism won't go away completely (there are always bears) but the most recent domestic economic news has been positive. Unemployment trends continue to improve and point to more job growth in the new year. Even housing construction has picked up. We are not economists and won't predict whether these trends will continue unabated or whether they are even sufficient; but if they continue, they will lend themselves to counteracting pessimism.

It might sound glib to claim many buyers are waiting for one more regulatory examination before trusting a potential seller's representations, but that is just the case. Anecdotal evidence suggests bankers (both buyers and sellers) view regulatory examinations as sufficiently rigorous about credit issues to overcome the suspicion and skepticism that attend credit questions. Many banks are delaying capital offerings until they "have one more exam under the belt". Likewise, many buyer-banks are loathe to step into someone else's credit swamp until they have received the imprimatur of the regulators and/or a third-party credit review.

We are wary of merely mouthing conventional wisdom. But we are confident both the market and the regulators want to see consolidation in the banking industry. Of the 7,000 banks in this country (defined as the top-tier entity, including banks, bank holding companies, thrifts and mutual holding companies), over half are smaller than \$250MM in assets. Lacking scale, these institutions will find it increasingly difficult, if not impossible, to be profitable in the Dodd-Frank world.

When the pessimism is replaced by realism (or even optimism) and buyer skepticism is overcome by sellers' transparency and credibility, the consolidation wave will begin in earnest. Given the dismal M&A market over the last four years, expect whiplash.

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