IRISH LUCK + AMERICAN ANALYSIS FOR ACQUISITIONS

by Steve Brown

We used to work with a lender we routinely wished "good luck" before a sales call. His standard reply was "luck is for the Irish and rabbits." His point resonates with us today for various reasons, as we are big believers that you make your own luck. That said, one way to create value is through acquisition and that

takes both luck and skill. Sometimes when bidding on assets or liabilities, good luck is

actually bad luck because it is a mistake to win. This is called the "Winner's Curse" and it refers to the problem that while you may "win" the target item, you lose by overpaying for it. Smart acquisitions take not only good luck and homework, but an understanding of game theory.

How can you prevent overpaying? While there is no hard or fast rule, there is a structure that may help. For illustrative purposes, let's suppose you are bidding on a bank that you wish to purchase, combine with your operations and improve performance. The question arises, how much do you pay?

The answer, of course, depends on how much you think the bank is worth. Most banks correctly first try to find a historical range to help them get in the right ballpark. For our example today, we can look at how performing banks these days are trading and find that they are selling for between 0.4x and 1.2x of tangible book value. Now, if you can further narrow things down through due diligence, great. However, determining asset quality in this market is extremely difficult. Absent of any great insight, you assume that the true value of this institution is equally likely to be worth any figure within that range. Let's further assume that you believe you can improve the operations by 20%. Like a good game theorist you now have some facts to put together a model.

To understand the dynamics, let's say you believe that it is worth 0.5x book. If the bank is actually worth 0.45x book, you improve the value to 0.54 and you have made a decent profit. If however, the bank (because of loan losses), is only worth 0.4x book, you improve it to only 0.48x and you end up losing money.

Now, let's put together the wrong way to bid. As we said, the true value of the bank could be equally distributed within the range. That would make the most likely price 0.8x book (the median). Since you plan on raising the value by 20%, that would mean that most likely the bank is really worth 0.96x book (0.8 x 1.2) to you. Therefore, you could offer up to 0.96x. Did you catch the flaw in the logic? This problem is common, as the bidder did not take the current bank management into account.

Current bank management has much better information about loans and operations and thus could be an extremely valuable resource. As a result, if the seller is willing to accept any offer, most likely it is bad news, as the seller thinks the bank is worth at most the price you bid. As a result, if the seller accepts the 0.96x offer, we know that the true value of the bank is most likely between 0.4x book and 0.96x book. If true, then the actual median value of the bank is most likely in the middle around 0.68x book. You could raise the value by 20% or to 0.82x, but you have over paid and thus fall victim to the Winner's Curse.

Of course, what you really want is to pay the appropriate amount so you win the bid, but don't over pay. In the example above, the correct answer is 0.6x book. When the seller accepts the offer, the buyer knows that it is between 0.4x and 0.6x book, with an average of 0.5x. Applying a 20% performance factor, the bank is really worth 0.6x to the buyer, which is precisely the maximum amount offered. For those interested in the math, the equation we just walked through turns out to be Max Bid Price = (1+ % of expected improvement) ((minimum value + lowest expected acceptance of bid price)/2).

If you have information regarding the details of the bank, or can structure the bid price to reflect ongoing performance, this would override all the above. However, the logic we just stepped through helps bidders figure out a rough price when there is asymmetrical information, as we can use the seller's potential bid acceptance as a source of information. This method may help you gain a little more Irish luck on your own.

BANK NEWS

Program Closing

The FRB announced with its policy statement that MBS purchases (totaling nearly $1.25T) will end on 3/31/10.

Why Mobile

According to Mercatus, customers top 5 reasons for mobile remote capture are convenience (52%), speedier access to funds (45%), quicker than other options (39%), a pressing need to deposit a check (33%) and a lack of branch convenience (15%).

Lawsuit

FHLB San Francisco alleges that 9 dealers (including Credit Suisse, Deutsche Bank, JP Morgan and BofA) provided misleading information regarding $19.1B in MBS and is looking to retract its purchase.

Branch Hours

Fifth Third Bank announced that it would expand hours at almost 200 mid-west branches. While hours will vary by location, the Bank looks to add longer branch hours during the week for the most part with a select group of branches adding Sat. hours.