



Say Cheese And Smile

by [Steve Brown](#)

American cheese is a comfort food near and dear to many Americans. Kraft developed the process to make the original and it is still the preferred brand for most people. There are plastic wrapped Kraft singles, the much beloved Mac and Cheese in a box and there is Velveeta. Velveeta sits on grocery store shelves, not in the refrigerator case. This is curious as most cheese is refrigerated but because of the way Velveeta is manufactured, it doesn't require refrigeration. James Lewis Kraft invented the pasteurization process (in 1916 in Chicago) which heats the cheese to 175 degrees for 15 minutes and this gives it an exceptionally long shelf life.

Kraft is now getting married to Heinz with the assistance of Brazilian private equity firm 3G and Warren Buffett in a stock and cash transaction that is expected to improve growth. It is curious because Kraft just split in two in 2012 when it separated its North American grocery business from its global snacks line, so why is it joining up with Heinz? Is it a better idea to be bigger and more diverse or smaller and more specialized? There is never a simple answer to this and many banks are asking the same question.

Kraft has struggled to adapt to changing consumer demands for fresher, less processed food. Cheese that doesn't require refrigeration probably doesn't fit the bill and with a full 20% of its revenues generated by the processed cheese business, it seeks to diversify its business lines and customer base. This makes sense when you consider Kraft's sales dropped almost 7% last quarter. Heinz is a strong brand and has global reach, so the combined brand should drive more sales.

Some banks may also be considering a merger and the reasons are often not so different than those outlined in the merger of the food giants - gaining market share and economies of scale. Most community bank mergers are based on geography and branch networks rather than product sets, but the economies of scale are similar.

When considering M&A, banks should carefully analyze the past as well as the present when looking at the portfolios of prospective partners. Most banks spend the bulk of their time looking at the loan portfolio of an acquisition target and it is important, but there are other factors too. Banks should also carefully look at the deposit portfolios, because there may be future problems hiding there. Remember that the long-term rock bottom interest rate environment has desensitized deposit customers who mostly are tranquilly resting in low-cost non-maturity deposits like checking and savings accounts. These could be at risk as rates rise.

Certainly a bank with a large proportion of non-maturity deposits is a better target than a bank loaded up with high cost CDs, but almost no bank looks like that now, so digging deeper is required to predict what could happen going forward. When assessing an acquisition, the buying bank should seek out the history of the deposit mix and determine what percentage of the deposit portfolio is likely to migrate back to higher cost deposits. Did the acquisition target offer rate specials on CDs or money markets to bring in its deposits? If so, these customers are likely to revert to similar behavior

in a higher rate environment. This could either drive up deposit rates overall or these customers may leave the bank, causing a runoff in deposits.

Just like the new Kraft-Heinz culinary hookup, a newly merged bank will be different from either of the originals and hopefully will offer improvements for customers and staff alike. That said, never forget to do extensive homework, never fall in love with a potential partner and objectively understand how the partners' history might affect the combined future. Otherwise, the new bank may make as little sense as a slice of cheese with ketchup.

BANK NEWS

M&A Activity

1) Home Federal Savings Bank (\$576mm, MN) will acquire Kasson State Bank (\$60mm, MN) for an undisclosed sum. 2) The Bryn Mawr Trust Co (\$2.2B, PA) will acquire insurance and risk management agency Robert J. McAllister Agency Inc. (PA) for an undisclosed sum. 3) First Savings Bank of Hegewisch (\$563mm, IL) will acquire South End Savings, s.b. (\$34mm, IL) for an undisclosed sum.

Competition

Bank of America said it plans to close drive-up teller lanes in some of its branch locations given low usage.

Mortgages

Bloomberg reports the top 8 mortgage originators in the US as of the end of 2014 and their market share percentages are: Wells Fargo (15.0%), JP Morgan (7.2%), Quicken Loans (4.9%), Bank of America (4.5%), US Bancorp (3.1%), PHH Corp (3.0%), Citigroup (2.6%) and PennyMac Financial (2.4%). Did you notice that #1 (Quicken), #6 (PHH) and #8 (PennyMac) are not big banks? Boy how things have changed since 2008.

Rate Hikes

Fed Atlanta President Lockhart said he does not see Q1 economic softness continuing and is probably more biased for a rate hike "toward the July or September dates as opposed to June." Meanwhile, Minneapolis Fed President Kocherlakota said the Fed should be "extraordinarily patient" and "defer the initial interest-rate increase until the second half of 2016." He said the Fed should then raise the federal funds rate to about 2.00% by the end of 2017 to reach a more "normal" level seen prior to the credit crisis. Finally, billionaire Bill Gross said he expects the Fed to raise rates in Sep because "they want to get off zero." He projected the Fed would increase rates 50bp in 2015 and to 2.00% by the end of 2018.

Settlement

The Treasury said PayPal will pay \$7.7mm to settle alleged sanctions violations related to processing payments for transactions in Cuba, Sudan and Iran.

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