The Challenges, Lessons Learned In Making Merger Process Work

Credit Union Journal | Monday, March 14, 2011
By Jim Jerving

An article in the *New York Times* last fall forecast a merger boom in the corporate world: "the ground is firmly seeded for another mergers and acquisitions boom: Interest rates are low, companies are flush with cash and the recession has made it nearly impossible for companies to grow on their own. In short, conditions haven't been better in years."

The author, though, pointed out a pothole in the merger road: "If, that is, companies can get past the government."

Credit union chief financial officers are heeding the warning and also noting the regulatory elephant sitting in the room. In the past, mergers were relatively easy, CFOs would add up the balance sheets, review the contracts and perform due diligence. With the pooling method of accounting, the transaction was straightforward and comfortably black and white.

All of that changed on Dec. 15, 2008, when mergers after that date had to comply with new regulations. Revisions to the Statement of Financial Accounting Standards 141 require that credit unions change from the pooling to the acquisitions method of accounting. The effect of the new regulations made the merger transaction more time consuming, costly and complex for CFOs, management, boards and their organizations.

The CFO's Evolving Merger Role is a white paper sponsored by CUNA's CFO Council that looks at credit union mergers and the increasing portfolio of the chief financial officer in the transaction.

Despite the media attention and the lingering effects of the Great Recession, mergers have declined. The rate of mergers was at a high of 3.6% in 2006, dropping to 2.8% in 2009 and an estimated 2.6% in 2010 as the accompanying chart shows.

Merger Activity Declines in Recent Years

Merger accounting is more complicated now with SFAS 141-R. For example, most merger costs can't be capitalized, instead all acquisition costs-with the exception of capital issuance costs-must be recognized as an expense when incurred, which are usually after the merger.

If, for instance, two credit unions have separate core systems, the core system you choose not to keep may have multiple years left in the contract. Because you can't eliminate the acquired credit union's processing system until after the merger when their members' accounts are converted to the acquirer's system, these costs are incurred and expensed post merger. Not factoring these types of issues into the total "cost" of the merger can be an expensive mistake.

The CFO and the organization need to be realistic about management forecasts, which sometimes are illusory, not that they knowingly misrepresenting the facts, but management may have illusions about the value of the loans.

In the past, there was plenty of capital to take care of these illusions and resulting loan losses, but due to the general change in the economic environment, the degree of accuracy has become more important. The ability to build capital over time is related to how members perceive their relationship to the credit union.

Is Valuation Three-Card Monte?

Much of what we do in our personal lives depends on valuations or simply estimating the value of a car, house or potential business venture. And the result of faulty valuations can have disastrous effects; the source of the problems in the boom and bust that caused the Great Recession can be traced, in large part, to overly optimistic valuations of real estate.

Valuations of an acquired credit union include an analysis of the loan, investment and share portfolios. Loans are examined by type and maturity. Loan cash flows are forecasted and discounts are applied to these forecasts.

Valuations are part science, part judgment, and sometimes part BS. Reuben Advani writes in Wall Street MBA that if there is "one thing that years of work in the field of valuation have taught me, it is that valuation is more art than science. In fact I would go so far as to say that it is more Three-Card Monte than science... I'm the first to admit that there is only one true value of a company: what the buyer and seller agree upon."

A first view due diligence can eliminate the bad apples from those that deserve a second look. The $3.6-billion Patelco CU in Pleasanton, Calif. uses the following metrics for a due diligence first view. By examining these ratios, you can determine if the acquired credit union is holding, losing or gaining ground.

• Loan performance over time.

• Charge-off rate as percentage of loans, is it increasing or decreasing and is it lower or higher than the market rate?

• Current delinquencies, which will indicate the organization's credit shape.

• Net interest margin, yield on assets, and cost of funds.

• Operating expense to average assets, operating expense to gross income

• Net worth ratio

The authors of "When to Walk Away from a Deal," published in the Harvard Business Review examined 20 companies and interviewed more than 250 merger and acquisition executives to identify the following questions to ask before a merger:

• What are we really getting? Senior execs develop a mental image of the company, according to the authors, that is derived from its public profile or reputation within the business community. An effective due-diligence process challenges this mental model and gets at the real story.

• What is the target's stand-alone value? The target's books should be examined to verify numbers and assumptions, but also to determine the business' true value as a stand-alone entity. The value of a company is the value as it is, not as it will be once combined with the acquirer.

• Are there any accounting ruses? Examples include using overly optimistic projections to inflate expected returns from investments in new technologies; disguising the head count of cost centers by decentralizing functions so you fail to see the full picture and underfunding capital expenditures during the period leading up to the merger to make the cash flow look healthier than it actually is.

Synergies & Skeletons

• What are the synergies and skeletons in the closet? Managers typically overestimate the value of cost and revenue synergies and underestimate the difficulty in achieving them, according to the authors. Eliminating duplicate functions are the easiest cost savings to achieve. Cutting shared operating costs are also somewhat straightforward. Savings from duplicate facilities can be more difficult because they typically involve staff and regulations.

Whether the merger boom will hit CUs is compelling. Intuitively it makes sense due to the declining margins and increasing expenses, but so far it hasn't happened.

A merger is like most financial decisions, especially if valuations resemble Three-Card Monte; when they do, emotions tend to play a much larger role than most of us would like to acknowledge.