
THE TREASURY DEPART
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The new administration seems intent on a rollback of crisis-era rules that could boost bank M&A

BY DANIELLE FUGAZY

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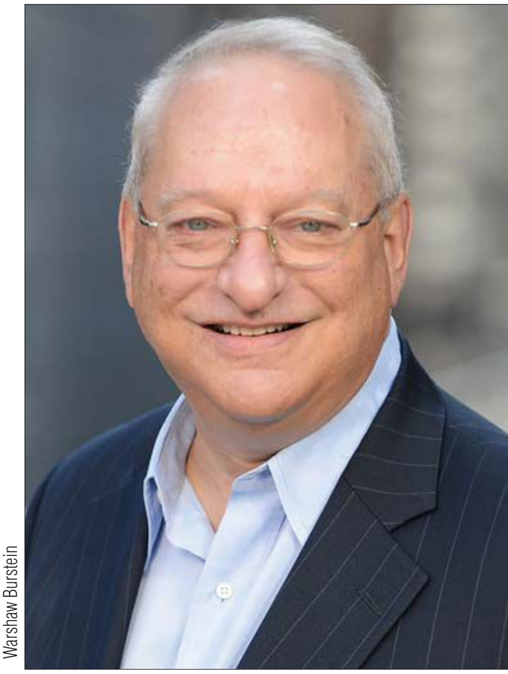
Banks divested all kinds of assets over the last several years to comply with regulations put in place after the financial crisis. Now that the regulations may be dismantled through executive orders and other moves, traditional banks may have a renewed appetite for business lines they left years ago, including loans to middle-market companies.

The specialty finance industry, broadly defined as financing outside the traditional banking system, is one sector that may see an uptick in M&A activity. Since the financial crisis in 2008, banks divested or closed leveraged-loan businesses to comply with the Dodd-Frank Wall Street Reform and Consumer Protection Act. On Feb. 3, President Donald Trump signed an executive action, designed to significantly scale back the system put in place in 2010. As the pendulum swings back, banks may set their sights on specialty finance businesses.

"After the credit crisis, banks sold, shut or de-emphasized many lines of business, but there was still demand for the products, so there was a strong emergence of specialty finance companies formed to take advantage of the void," says Brad Cooper, a managing partner with Capital Z Partners, a New York-based private equity firm specializing in investing in financial services companies in the middle market. "But with a more business-friendly administration, banks may want to get back into those businesses and some will do so by making acquisitions."

There are plenty of specialty finance companies today. As banks divested or closed their leverage finance business lines, firms like Abacus Finance and Avante Mezzanine Partners started up and established firms like Bain Capital moved into the credit business. In 2016, the Boston-based Bain launched its first business development company to make direct loans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Murray Schwartz

Bankers Count the Ways Trump will Boost Financial Services

Bankers are celebrating the prospect of lower corporate taxes and fewer regulations under President Donald Trump and a Republican-controlled Congress. "It's a new day, and we're excited about it," said Kelly King, CEO of BB&T Corp. (NYSE: BBT), in an earnings call on Jan. 19, the day before Trump's swearing in. "It's a really good proposition for the banking industry."

Other bank CEOs are similarly optimistic, contending that Trump's proposed policy changes – which also include investing heavily in infrastructure and repealing and replacing the Affordable Care Act (ACA) – will be a boon to banks' bottom lines.

"It's remarkable the difference an election can make in the economic outlook," said James Smith, CEO of Webster Financial Corp. (NYSE: WBS), on the company's fourth-quarter earnings call Jan. 26. "Nearly all of the forecasted policy changes in a Trump administration, supported by a Republican Congress, appear to be positive for our business and our company."

Much, of course, depends on how quickly Trump and his fellow party members can move on implementing their proposed changes – and how much pushback they get from Democrats in Congress. Bank CEOs should be cautious about setting expectations too high too soon, said Terry McEvoy, an analyst at Stephens Inc..

"There's very little upside for management teams to be overly bullish in light of the high amount of uncertainty around changes coming out of Washington," McEvoy said. "For any bank to be overly optimistic, given the uncertainty, may be doing injustice to shareholders."

Yet most bankers are more bullish about the sector than they have been in years.

On BB&T's Jan. 19 earnings call, King said that after the election he directed his 26 regional presidents at the Winston-Salem, North Carolina-based-company to canvass their best business customers and gauge their interest in investing in expansion. All of them expect the economy to pick up steam in 2017, he said. "Everybody was optimistic," King said. "Individual companies are already requesting loans to buy trucks, to expand their plant, expand inventory."

Smith, the longtime CEO at Waterbury, Connecticut based Webster, said he is keeping close tabs on the potential reform of the ACA, known as Obamacare. Many experts believe that reform would result in higher out-of-pocket costs for insured Americans, and that could mean more people enrolling in health savings accounts. Webster's HSA Bank subsidiary manages more than 2 million health savings accounts.

Nationwide, the number of people with HSAs is increasing at a rate of about 20 percent a year, "and that could increase significantly, given the recent election results and the increasingly likely reform of the Affordable Care Act," Smith said. "While no action has been taken, it's possible that eligibility for HSAs could expand by multiples of previous expectation, and contribution limits could potentially double. Hundreds of millions of Americans may ultimately qualify for HSA plans to middle-market companies. In 2015, GE Capital sold Antares Capital to Canada Pension Plan Investment Board for $12 billion. Additionally, specialty finance companies have grown through M&A. For example, in 2016, Business Financial Services acquired Entrust Merchant Solutions while First Financial Bank, National Association acquired Oak Street Funding LLC from Angelo, Gordon & Co.'s private equity group. And perhaps most notably, Ares Capital bought American Capital for $3.4 billion.

"The growing demand for capital from middle-market borrowers has created the need for flexible capital providers like us to fill the financing gap as banks continue to retrench from the market," said Mike Arougheti, Ares Management's president, in 2016 after the American Capital acquisition was announced.

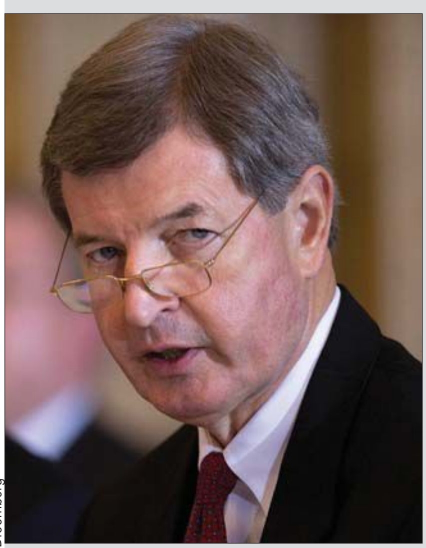
Specialty finance companies have accounted for only 5 percent to 7 percent of bank acquisitions over the last six years, according to William Blair's market update at the end of 2016. However that could be changing.

If banks do indeed want to dip their toes back into the specialty finance market, they will likely do so by acquiring companies rather than trying to start businesses from scratch. "Many banks aren't typically good at starting new businesses," says Capital Z's Cooper.

"The better approach for some is to make acquisitions. Many in the private equity world believe their specialty finance portfolio companies will be targets of the banks. The key is they have to be built properly. Banks aren't going to buy poorly run businesses."

If banks do get back in the specialty loan business, it could be good for middle-market investors and companies. "It could be a benefit to the middle market companies that struggle to secure loans now. There will be more money available for lending and that will push deal multiples higher," says Murray Schwartz, a partner with New York-based law firm Warshaw Burstien LLP. "That said, fewer quality deals may get done. More lending is generally good, unless it's abused and creates an equity bubble."

Because of the slow growth environment, banks have faced limited opportunities for organic growth, so they have instead been aggressively acquiring other regional and community banks over the past six years. Rising interest rates, which will be good for banks' bottom line, may



Bloomberg

Kelly King

versus the 18 million who had them as of midyear 2016," he said.

Also high on bankers' wish lists, of course, is regulatory relief, though big-bank CEOs said that they expect most reform efforts to be directed toward smaller institutions.

Many bankers say they hope to see a change in the tone of bank supervision under the Trump administration. "It's not just the regulations, it's the degree of intensity with which the regulators apply those regulations," King said.

The Consumer Financial Protection Bureau CFPB), under the leadership of Richard Cordray, has focused too heavily on setting policy through enforcement actions, said Richard Davis, CEO of U.S. Bancor (NYSE: USB). "I've pleaded with Richard Cordray to consider making the CFPB an endorsement agency, not an enforcement agency," Davis said during a Jan. 18 earnings call. The White House may influence the mission of the bureau by replacing Cordray, suggested White House National Economic Council Director Gary Cohn in an interview with The Wall Street Journal in early February.

Joseph DePaolo, the CEO of Signature Bank (NASDAQ: SBNY), said he hopes the administration and Congress will place a high priority on raising the threshold for determining if a bank is systemically important to well above the current $50 billion-asset mark. Signature has $39 billion of assets and at its current rate of growth, it will cross the threshold sometime in 2019.

The $50 billion threshold is "anti-competitive and protectionist of the big banks," because it gives smaller banks a disincentive to cross the threshold, DePaolo said in an interview with American Banker. Policymakers "should want more banks to grow past $50 billion, because these banks are the only ones that can compete with the megabanks."

DePaolo said that a bill that would raise the cutoff to $125 billion would win bipartisan support in the House and the Senate if it were its own piece of legislation. It will fail, though, if its passage hinges on changes to other aspects of Dodd-Frank.

Lawmakers "just need to move the number to allow for more competition in the marketplace and then they can deal with the rest."

—By Alan Kline, with additional reporting by Andy Peters and Kristin Broughton

spur them to engage in more M&A activity. Banks are excited about their prospects under Republican control. "It's a new day and we're very excited about it," said Kelly King, BB&T's chief executive, in an earnings call with analysts on Jan. 19, the day before Trump's inauguration.

The idea of banks moving back into the specialty finance business is music to the ears of private equity sellers, but it gives private equity buyers reason for pause. If regulations do loosen and banks pursue specialty finance businesses, PE firms may not want to continue to own or buy specialty finance businesses. Specialty finance companies typically can't compete on price with banks, which traditionally have a lower cost of capital when lending. "In many areas it will be difficult for independent specialty finance businesses to compete against banks who can use deposits to fund the business," says Cooper.

> "I am not sure the banks' risk appetite is going to grow all that much, even if regulation is rolled back."

While specialty finance companies may draw the interest of the banks, they won't create a free-for-all. Regulations are not expected to disappear overnight or roll back so dramatically that banks will become reckless. BB&T's King said on earnings call that his firm isn't ready to engage quite yet. "We're not ready to get back into M&A yet," King said. "Our buying constraints are our own."

Additionally, banks will likely still look to acquire the least-risky finance companies available. "Most likely, regulations won't be lightened by a lot, so there will still be some of the same road blocks," says Cooper.

"The specialty finance industry is pretty well developed," says J.P. Young, a director at William Blair & Co., who covers the financial services sector. "I am not sure the banks' risk appetite is going to grow all that much, even if regulation is rolled back."

With or without bank interest in specialty finance businesses, most experts believe the financial services industry will see positive change with the Republican controlled government. This sentiment actually started in 2016 after the presidential election. At the end

William Blair

J.P. Young

of 2016, respondents to Mergers & Acquisitions Mid-Market Pulse (MMP), believed dealmaking in the financial services sector would accelerate significantly over the next 12 months because of deregulation of the financial services industry under a Republican president and Congress. The MMP is a forward-looking sentiment indicator, published in partnership with CT, a provider of business compliance and deal support services. It is based on a monthly survey of approximately 250 middle-market M&A professionals.

M&A professionals believe that many financial services companies will grow, creating more M&A transactions in the sector this year and in the next few years. Industry professionals are keeping a close eye on what the banks will do in an era of less regulation. "There is a common perception that there will be less regulation for the next four years and people think this could cause M&A volumes to increase in the financial


GTCR

Mike Hollander

services industry," says Mike Hollander, a principal with GTCR, a Chicago-based private equity firm that specializes in financial services, healthcare and technology, media and telecom.

Young says William Blair is already seeing activity pick up in the financial services sector. "Our pitch activity has increased significantly in the last two to three months, and consumer finance stocks have gone up three- and four-fold since Donald Trump was elected. People are hopeful about the future when it comes to financial services businesses," he says.

M&A in the financial services sector should be more active because buyers are less scared of regulation when the Republicans are in control. Case in point: William Blair had a client that received an eight-figure fine for a system glitch that the company self-reported to government agencies. When that company was ready for sale, the potential buyers, strategics and private equity firms, were scared away by the risk, Young says.

"In my experience, in the last three to five years the buyer market for financial services assets has shrunk because buyers are afraid of the risk," Young says. "Potential buyers will hire regulatory experts who lay out all the potential risks and buyers get scared away. Since the election there is a perception that regulations will be pulled back and there will be reform. The pendulum had swung so far left, we are hopeful it will come back to center and fewer buyers will be scared off, and we will see more deal activity in the sector."

Experts also believe that the financial services sector may perform better just because the U.S. economic environment will be more pro business. "A friendly economic environment toward U.S. companies is giving people a more favorable view of the future and dealmakers are thinking about that as they look at any type of business that makes loans," Cooper says. "Also, a credit cycle downturn is less likely to occur, or occur further down the road, under the new administration, which makes these assets more attractive now."

Consumer finance businesses, anything from auto financing to consumer loans, are also expected to be targets of banks for acquisitions. Payday lender share prices have been increasing substantially. This is expected to continue, making short-term unsecured lending an area that banks and others may want to get into. The Consumer Financial Protection Bureau was created to protect consumers from bad credit practices, mainly caused by subprime mortgage companies. Most of the credit companies the CFPB was enacted to protect consumers against no longer exist. "I expect banks will start to buy consumer and commercial finance companies again," says Young. "You may see an uptick in banks buying mortgage companies, but only mortgage companies with prime credit. They will not buy nonconforming-loan companies. They won't take on that risk no matter what happens in the regulatory environment."

> "Private equity firms that specialize in financial services say M&A is likely to increase."