



M&A in the Banking Sector

Company Background:

One important way Gator Capital is different from other investment managers that specialize in the Financials sector is that our portfolio has a much smaller position in mid-sized regional banks. The difference in our view is that we are negative on the prospect for widespread banking M&A.

Despite more than 7,000 banks still existing in the U.S., M&A activity among banks has been subdued. Through Q1 2013, there were only 44 bank M&A deals valued at a total of \$1.8 billion. If this run-rate continues, full year 2013 M&A activity will only total 176 deals valued at \$7.2 billion. This would mean a decline in the number of deals by 25% and a decline in total transaction value of 57%. I believe this current low rate of M&A activity will persist for a number of reasons.

Investment Thesis:

1. Executives of target banks aren't selling: There is an old saying in Bank M&A that "banks aren't bought, they are sold." Hostile bank deals just don't take place. For M&A to occur, bank executives have to be willing sellers. I do not think many bankers are willing sellers in the current environment.

a. Bankers don't want to sell at current low valuations – The valuations of banks, although off their recent lows, are still at the bottom end of the range for the past 20 years. I think bankers are willing to hold off a few years to see if industry valuations rise before they sell.

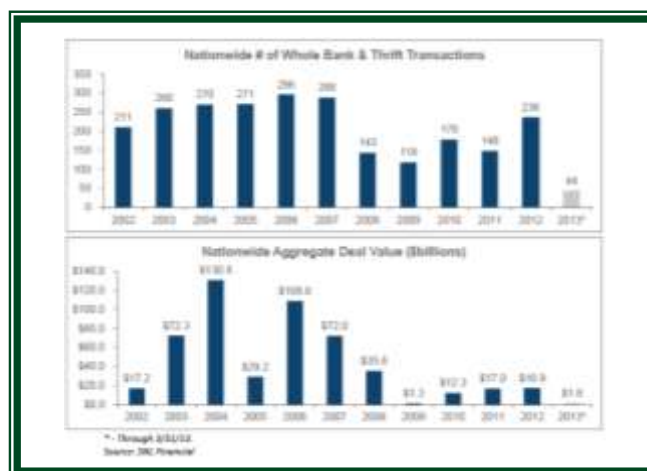
b. Often a banker's most valuable asset is his paycheck – Many bank stocks are nowhere near the levels of 2005 to 2007, so bank executives have seen their personal balance sheets decimated. Their paychecks may be their most valuable assets. If they were to sell and not secure a position with the acquiring bank, they may be out of work. It is better to control their own destiny by not selling their bank.

c. Can't start a new bank after selling – A bank executive who sells his bank is probably not able to start a de novo

bank. Bank regulators have granted just a handful of new banking licenses since 2011, so it is unlikely a bank executive can sell their current bank and get a license to start a new bank.

2. Executives of acquiring banks aren't buying:

Although "banks aren't bought, they are sold," we still need multiple willing buyers to get valuations higher. At higher valuations, there will be more willing sellers.



a. Big banks have hit deposit caps – Bank of America, JP Morgan Chase and Wells Fargo all have at least 10% of the national market share of deposits, so by law, these historically voracious acquirers can't buy any more banks.

b. Trickle-down effect makes MidCap banks less enthusiastic about buying – Midcap banks are less likely to make acquisitions because they understand their end game is not selling to one of the larger banks. Instead, they are going to have to stand-alone on their ability to grow and generate high returns on capital. Therefore, they appear to be more judicious in making acquisitions.

c. Would-be acquirers seem to be price anchoring – The average Price-to-Tangible Book paid for banks since 2009 is only 113%. From 2004 to 2007, the average Price-to-Tangible Book paid for banks was 232%. It appears the only deals

getting done in the current environment are the low priced deals. Bank executives haven't shown a willingness to pay-up for healthy bank deals so far in this cycle.

3. Banks are bought for deposits, but most banks are awash in deposits

– Since the Financial Crisis, banks have been awash in deposits. I believe this is due to the low level of rates which makes yields on bank deposits competitive with market money fund yields. Investors might as well keep their cash in banks for the extra security for the same level of yields. With all of the liquidity provided by these bank deposits, bank executives haven't had the need to buy other banks to get access to additional deposits. Instead, their problem is not having enough assets in which to invest their existing deposits.

4. Small banks tend not to have unique Asset-Generation capabilities:

To combat their problem of not having enough assets, larger banks would be willing to acquire smaller banks if they had unique abilities to generate assets (i.e., loans). Unfortunately, most small banks can only generate small commercial real estate loans. However, most large banks have spent the past five years reducing the amount of small commercial real estate lending they are doing.

5. Technological change has driven bank utilization lower and made branches less valuable:

We are all going to bank branches less and less. We are using ATMs and banking online. Even commercial customers are using remote deposit capture, so they aren't making their daily bank runs to deposit checks. With branches not used as much, executives at large banks don't feel the need to fill out their geographic footprint in every city in which they operate. In fact, they are closing branches.

6. Cheaper to take market share organically than to buy it:

Banks in position to take market share are finding it

cheaper to take share organically by hiring bankers in new markets. Plus, rather than buying a bank to get access to its customer base, they are finding it easy enough to pick-off choice customers by offering better deals.

7. Extra regulatory scrutiny: Banks that make acquisitions are receiving extra regulatory scrutiny before regulators approve their acquisitions. I believe many executives at potential acquiring banks are staying away from M&A because they don't want the hassle of going through the regulatory approval process.

8. Signal from specialty investment banking firm: As confirmation of my view, the investment banker to the banking industry, Keefe Bruyette & Woods, sold itself in November 2012 for a low premium. When an M&A banker sells itself for a low premium, it clearly signals to us that they do not see an uptick in M&A in the near-to-medium term future.

Conclusion:

The Fund's portfolio has a variety of both long and short positions in different banks. Our long positions are mainly in two areas: 1) in the TARP warrants on the cheapest large banks and 2) in microcap banks with recovering credit quality. Our short positions in banks are in 1) mid-sized regional banks with high valuations facing headwinds of loan growth and spread compression and 2) thrifts that are at risk to a flat yield curve and low rates. We do not own banks in hopes of a stronger M&A environment. We think owning many banks with lackluster loan growth and mediocre returns on capital with the hope of a stronger M&A environment will produce disappointing returns. This belief is different from those of our peers.



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