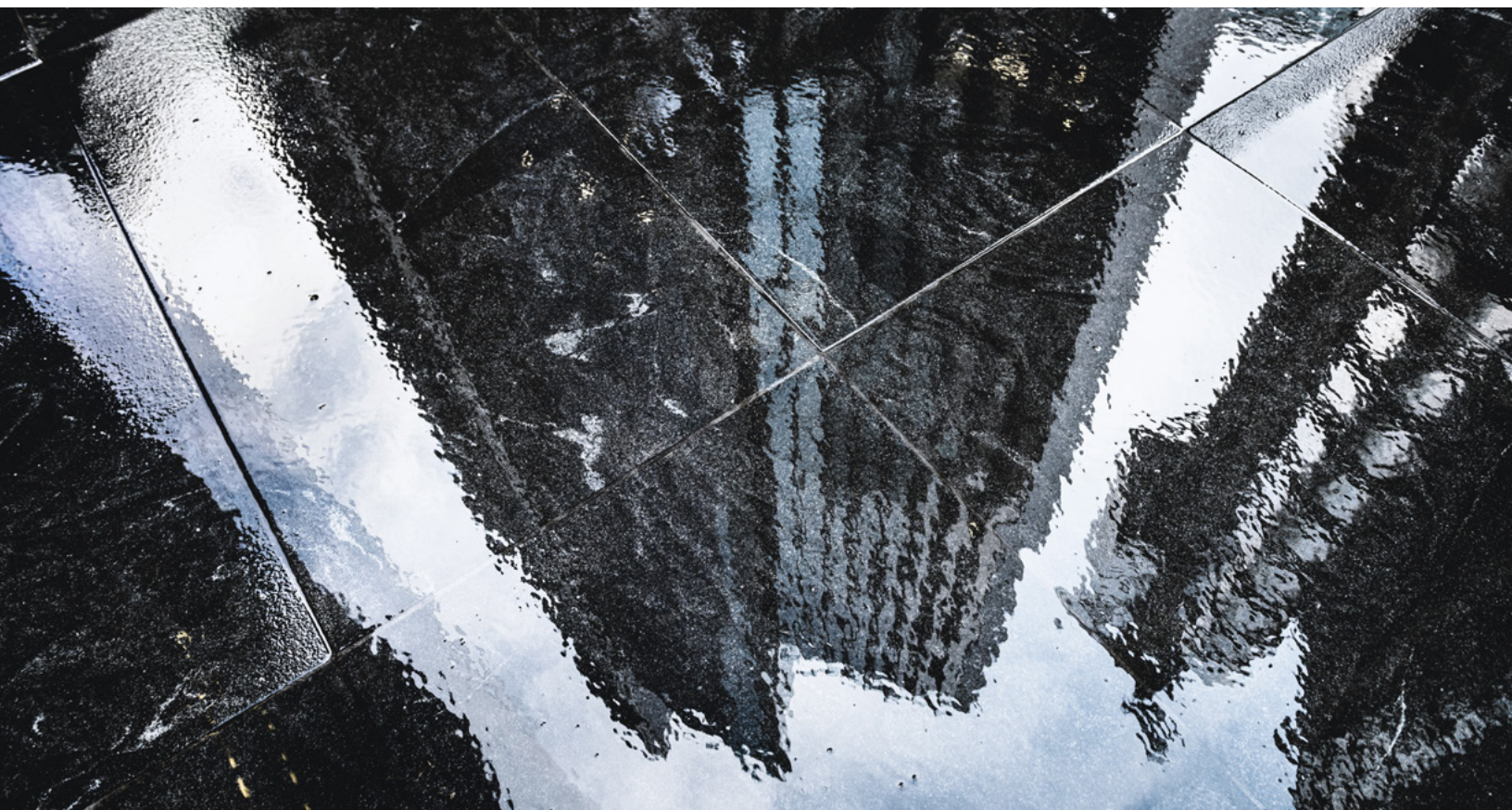


Global Banking & Securities

US midcap banking: The shakeout ahead?

Midsized US banks have held their own in recent years, but competitive pressures may bring a new wave of consolidation. Those using M&A best practices will have an edge.

by Vijay D'Silva and Zane Williams



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Early in the morning of October 16, 2020, a press release hit the wires: CIT Group and First Citizens Bancshares announced their intentions to merge and create a bank with a combined \$100 billion in assets, to rank in the top 20 in the United States.¹ The merger aimed to accelerate their joint growth and profitability through greater scale, as First Citizens' low-cost regional deposit franchise would complement CIT's national commercial-lending business. The two companies had identified significant cost synergies and could scale the regulatory infrastructure of CIT for the new institution.

Both banks had made acquisitions in the past, but the October 2020 transaction was the largest deal either had undertaken (see sidebar "About the merger partners").² The two CEOs had first met about a year earlier,³ and both companies had been

simultaneously exploring combinations with other institutions. This prospective deal became more attractive and urgent, however, as the prices of bank stocks fell during the COVID-19 pandemic and the benefits of their combined scale became more apparent. Investors welcomed the potential value creation of this combination: on the announcement day, the respective share prices of CIT and First Citizens closed 24 and 13 percent higher than their levels a week earlier.

The CIT–First Citizens merger is just one data point in a pattern of broader changes in US banking. Greater pressures from larger banks and fintechs in a low-rate environment and an uncertain credit outlook have created fertile ground for combinations of midcap banks—those with assets totaling between \$10 billion and \$100 billion—pointing to a further increase in pace and scope.

¹ "First Citizens BancShares, Inc. and CIT Group Inc. announce transformational partnership to create a top-performing commercial bank," First Citizens press release, October 16, 2020, firstcitizens.com.

² "Transformational partnership creates a top-performing commercial bank," First Citizens and CIT merger announcement presentation, October 16, 2020, ir.cit.com.

³ Joint proxy statement/prospectus, filed November 16, 2020, www.sec.gov

About the merger partners

By the time of the deal announcement, CIT Group, 112 years old, had come a long way from the 2008 financial crisis. Funding challenges forced a bankruptcy in 2009,¹ but management had strengthened and derisked the balance sheet, exiting noncore segments such as commercial aircraft and equipment financing, as well as subprime and reverse mortgages. The bank had acquired stable funding through acquisitions of OneWest Bank in 2014 and Mutual of Omaha Bank in 2019, and it had undertaken a restructuring of its operating model and cost base. Ellen Alemany, who became CEO in April 2016, accelerated many of these actions. The 2020 pandemic tested her team, which moved quickly to operate remotely and to support struggling small-business and commercial customers with forbearance programs and Paycheck Protection Program loans.

First Citizens Bancshares was founded in 1898 in North Carolina,² and from the 1950s had grown rapidly through acquisition, first within the state and then entering West Virginia in 1994. After the financial crisis, the bank acquired over 20 institutions, mostly community banks,³ and honed a seasoned approach to integration.⁴ By 2020, under CEO Frank Holding Jr., the third generation of Holding family leadership, the bank had expanded its footprint to 19 states, with a strong retail franchise and deposit cost of 0.13 percent, consistently below peers.

¹ Dan Wilchins and Elinor Comlay, "CIT Group files for prepackaged bankruptcy," Reuters, November 1, 2009, reuters.com.

² "About us," First Citizens Bank & Trust, firstcitizens.com.

³ First Citizens Bank & Trust, firstcitizens.com.

⁴ "First Citizens Bank, part 1: History and growth," TIBCO Software, tibco.com.

However, bank M&A transactions are complex and difficult to plan and execute, and they produce a wide range of results for the combined institutions and shareholders. In this article, we analyze the track record of such transactions, discuss the strategic and tactical options available to management teams, and lay out a set of best practices that have created value in past deals.

A consolidating industry under attack

Even after several waves of consolidation over the past 30 years, banking in the United States is fragmented in comparison to the financial sectors of most developed economies. FDIC-insured banks numbered about 5,000 at the end of 2020, holding assets of \$21 trillion.⁴ An equal number of credit unions held assets of \$1.85 trillion.

US banks show wide dispersion in their size, profitability, and valuation. There are five major segments (Exhibit 1). At the top are four banks with more than \$1 trillion in assets, followed by superregional and regional firms (assets of \$100 billion or more), midcap institutions (\$10 billion to \$100 billion), and community banks (less than \$10 billion). In addition, there are other financial

institutions—including investment banks, brokerage firms, and insurance companies—where deposit taking and lending make smaller contributions to enterprises' overall business.

Given their scale, the four trillionaire banks enjoy significant advantages in their capacity to fund investments in digital and analytics at a level others cannot. It also enables them to enter certain lines of business—particularly in offering services to large corporate clients—that require large balance sheets and a global presence.

Against this backdrop, US midcap banks have held their own. Since January 1, 2010, their annual share performance has averaged 13.5 percent, versus 12.2 percent for the industry as a whole. In the last three years, midcap banks grew their assets and revenues faster than other segments. However, the midcap segment seems likely to experience significant upheaval, given the increasing competitive pressure from large banks and from fintechs.

Larger banks are advantaged in two broad ways. The first is that they can afford more of the technology and skills needed to compete.

Exhibit 1

US banks vary considerably by size.

Segment	Total assets, ¹ 2020 \$ trillion	Total deposits, ² 2020 \$ trillion	Number of firms
Trillionaires	10.4	6.6	4
Regionals	3.2	2.5	12
Midcap banks	2.5	2.0	94
Community banks	3.1	2.5	4,727
US subsidiaries of non-US banks	2.3	1.2	15
Other financial institutions	5.1	2.3	26

¹Includes assets outside of FDIC-insured entities.

²Includes both foreign and domestic deposits.

Source: SNL

⁴ FDIC Statistics at a Glance, Federal Deposit Insurance Corporation, September 30, 2020, [fdic.gov](https://www.fdic.gov).

Consumers are used to the high bar that e-commerce firms have set for mobile and digital experiences, and they have started demanding the same convenience from their banks. Therefore, the field of play has shifted from branches to digital capabilities—a trend greatly accelerated by the COVID-19 pandemic. In the race to digitize, smaller banks could be left behind. JPMorgan Chase, for instance, spends approximately \$11 billion on technology annually, while technology spending for the midcap banks *in total* is estimated at about \$3 billion.⁵ Likewise, as the industry continues to advance, the need for talent in marketing, risk, compliance, and data science increases, favoring institutions with the ability to invest.

A second source of advantage for larger banks is their strong balance sheets and business mix. The larger banks entered the current crisis with stronger capital ratios than they had prior to the 2008 financial crisis. Diversification also favored larger banks, because surges in some earnings engines compensated for declines in others. In 2020, for example, capital-markets businesses fared well, and retail banking declined. Furthermore, in a world of falling interest rates, net interest income represents only about half of megabanks' revenues, versus two-thirds at regional banks and three-quarters at midcap banks. Midcap banks' reliance on interest income has therefore left them vulnerable in an environment of compressed net interest margins.

Meanwhile, chipping away at the industry's profit pools are fintechs such as Chime, Robinhood, Sofi, and Square. Fintechs' operating models are more akin to those of technology firms than to those of traditional banks: they feature lean functional organizations, delivery-based performance management, flexible and collaborative resource allocation, engineering versus managerial talent, and modern scalable technology stacks. As a result, fintechs' operating costs per customer can run about one-tenth of those at conventional branch-based banks.

Two recent trends have strengthened fintechs' position even further. One is rapidly increasing valuations, providing a currency to acquire talent and capabilities. In addition, fintechs including

Brex, LendingClub, Sofi, Square, and Varo Money have applied for bank charters, which will give them direct access to the US banking industry's payment system and enable them to acquire low-cost deposits and develop broader lending platforms.

With large banks exerting pressure from one direction and new entrants from another, it's no surprise that the number of banks in the United States is in decline. In 2000, FDIC-insured banks numbered nearly 10,000, twice the current count. And at today's pace, more than three banks a week are exiting the industry, as banking franchises move into stronger hands.

Midcap banking: The urge to merge

In 2018, the criteria under the Dodd-Frank Act, which subject US banks to enhanced prudential standards, were revised, so that only banks with assets exceeding \$250 billion would be affected (raised from a threshold of \$50 billion). Overnight, about 20 banks were relieved from significant regulation and benefited from reduced capital requirements, estimated at 50 to 75 basis points of assets. And while previously there was a reluctance among midcap banks to breach the \$50 billion asset level, this barrier was now eliminated.

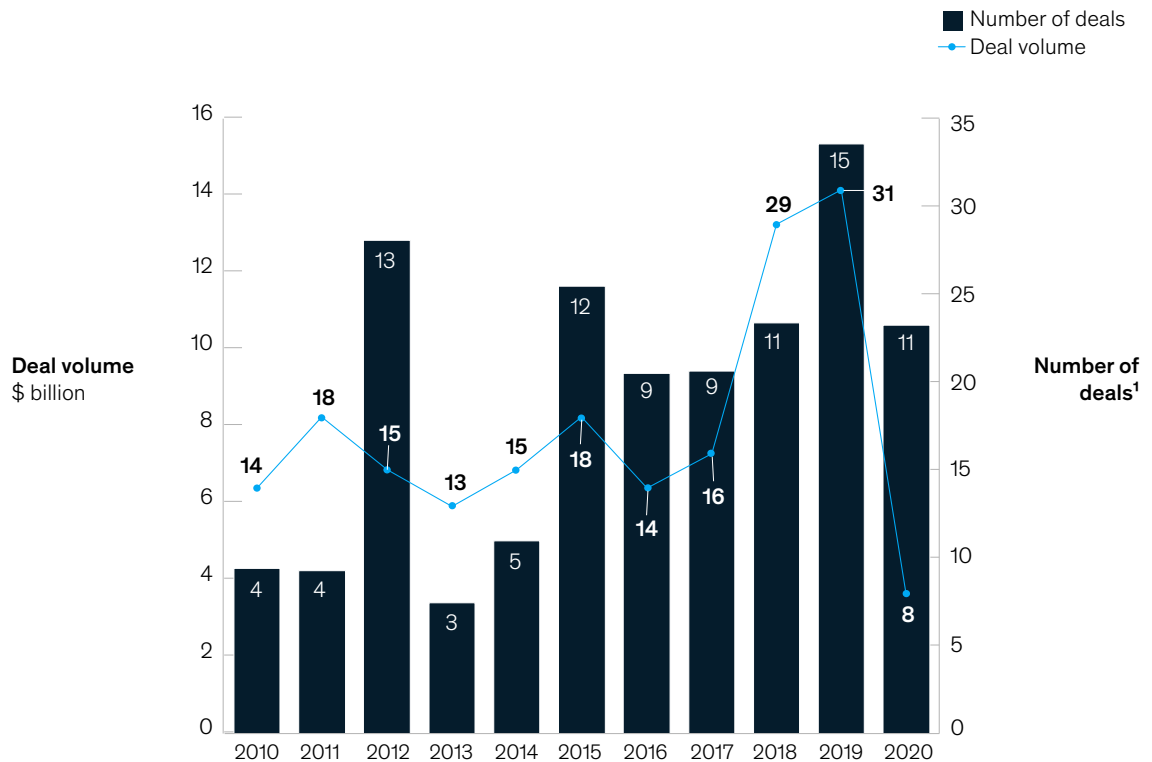
In response, deal volumes among US banks in 2019 and 2020 jumped to about \$75 billion and \$36 billion respectively, versus an average of around \$15 billion in the previous six years. Consistent with the increasing importance of digitization, deals between banks and fintechs were particularly frequent, jumping from an average of fewer than three per year in 2012–14 to 11 deals per year in 2018–20.

Against his backdrop, midcap banks are feeling the pressure from larger banks and fintechs, and some are responding by restructuring their operating models, improving their digital capabilities, and developing new revenue streams. Besides this, it seems inevitable that midcaps will participate in the increased M&A activity. Already, deal volumes among midcaps have steadily increased, rising to between \$10 billion and \$15 billion annually in the last few years (Exhibit 2). These transactions were propelled by three broad strategies: out of a sample

⁵ "This \$11 Billion Tech Investment Could Disrupt Banking," [jpmorganchase.com](https://www.jpmorganchase.com).

Exhibit 2

US midcap bank M&A activity has been steadily increasing—and 2019 hit new highs for both deal number and volume.



¹Announced deals.
Source: S&P Capital IQ

of 68 deals in the last three years, we found that 47 (or 69 percent) aimed to build scale, 15 (22 percent) pursued geographic expansion, and 6 (9 percent) targeted new capabilities (Exhibit 3). The median of announced synergies for midcap bank transactions has been 31 percent of the target's operating expenses, with top-quartile deals aiming for nearly 40 percent.

But not so good for shareholders?

While there are clear strategic reasons for M&A in US banking, the desire to merge is at odds with the history of post-acquisition returns to shareholders. Recent midcap mergers on average have not been successful, according to a metric we call the

Combined Value Creation ratio. That metric looks at the percentage change in companies' combined market cap, in contrast to traditional analyses, which look at acquirers' and targets' stocks separately (see sidebar "Mapping Combined Value Creation").

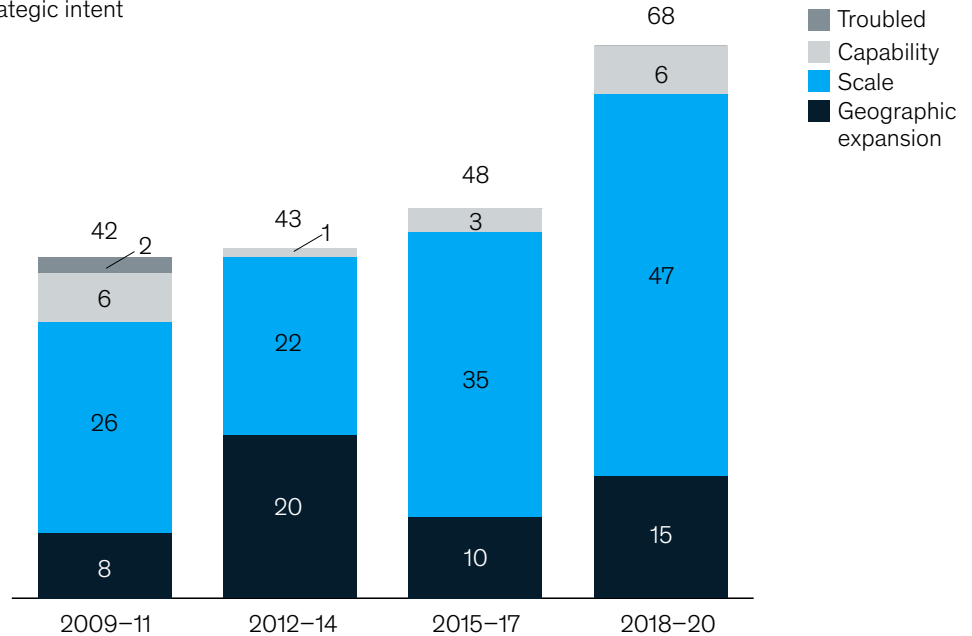
We mapped the Combined Value Creation (CVC) for transactions made between 2010 and 2021 for which we found share price data for both banks. Of the 79 combined companies, 38 deals actually saw value destroyed on the day of deal announcement (octants 5 through 8 in Exhibit 4). Of the remaining 41 deals that did create value, there were 13 in which the target's shareholders received more than 100 percent of the value created, and the acquirer's stock price dropped (octant 1). In two

Exhibit 3

Midcap bank deals have been driven primarily by scale.

Number of US transactions¹

3-year totals, by strategic intent



¹For acquiring banks having assets between \$10 billion and \$100 billion.
Source: S&P Capital IQ; McKinsey analysis

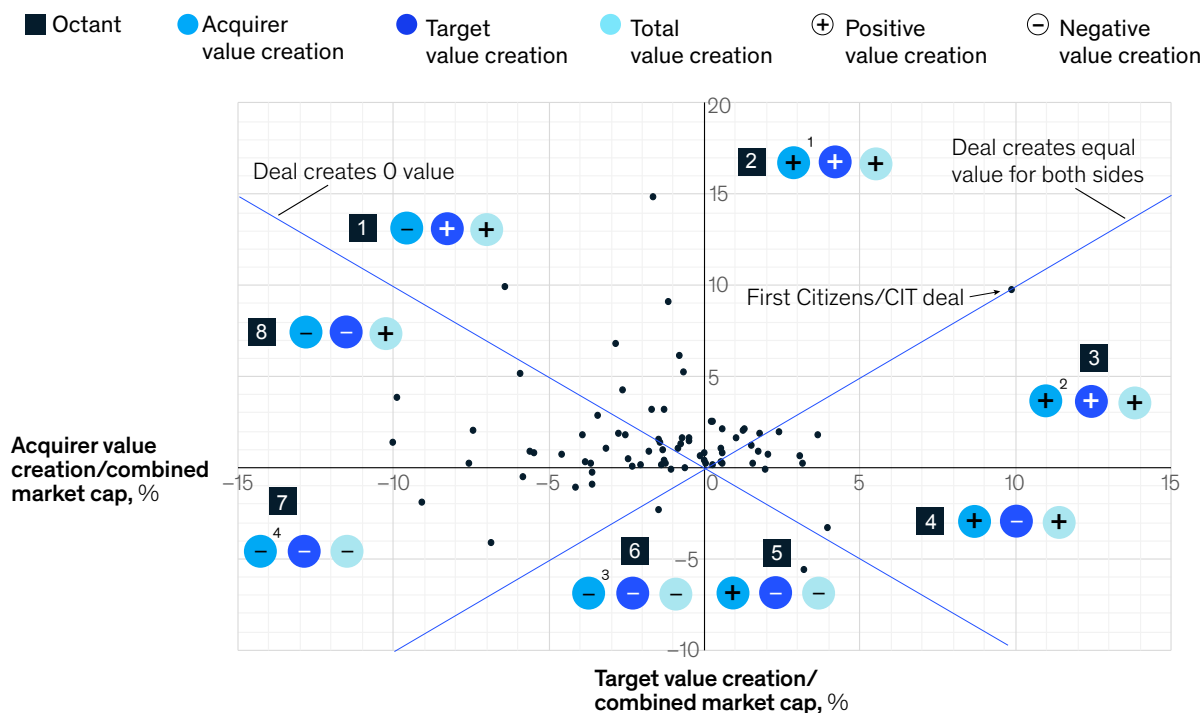
combinations, the acquirer's shareholders gained while the target's stock price dropped, likely the result of a distress sale (octant 4). In only 25 deals, or 32 percent of all transactions, did both groups of shareholders benefit (octants 2 and 3). First Citizens and CIT, for instance, saw their combined market capitalization increase by almost 20 percent, the highest among the deals we looked at, split equally between the two companies' shareholders.

Viewed from a higher level, the average midcap banking transaction between 2010 and 2021 resulted in a transfer of value from the acquiring shareholders to the target's shareholders. Across the board, the average value captured by the target was 0.6 percent of the combined value, while the acquirer lost 0.6 percent, resulting in a Combined Value Creation of zero.

While the stock-price impact on the day of a deal announcement can reflect the market's immediate interpretation of the logic of the strategy and confidence in the management teams, a full grasp of these transactions' success requires a longer view. When we consider the returns of newly merged institutions over the two years following the deal, the picture darkens considerably. On average, these institutions tend to underperform their midcap peers over the period. Among 58 transactions for which we had a full two-year history, only 17 merged institutions—less than one in three—outperformed their peers. And overall, during their two-year integration periods after announcement, merged institutions turned in share performance 7 percent below that of their peers.

Exhibit 4

Mapping Combined Value Creation shows that in deals by publicly traded midcap banks, acquirers often lose value or create little of it.



¹Acquirer value creation positive but smaller than target's value creation.
²Acquirer value creation positive and larger than target's value creation.
³Acquirer value creation negative but higher than target's value creation.
⁴Acquirer value creation negative and smaller than target's value creation.
Source: S&P Capital IQ; McKinsey analysis

Getting it right

For acquirers and targets alike, M&A deals provide no guarantee of success. However, once a trusted integration team is in place, banks considering M&A can maximize value for shareholders by getting three steps right: (1) planning a transaction that will likely create value, (2) structuring a successful deal, and (3) integrating the acquired business.

Planning a transaction for value

Given that almost half of US midcap deals destroy value in terms of market cap change after their announcement, banks should be able to describe clearly how the deal will create value. This involves addressing five areas:

1. *The value-creation strategy.* A value strategy answers three questions: First, is M&A the best path to creating value, or are other strategic options a better fit? Second, is there a clear fundamental thesis for a deal? Is it solving for capabilities, scale, and geographic expansion? And at a secondary level, is it building a stronger balance sheet or adding complementary products or technology platforms? Finally, can the bank objectively view its strengths and weaknesses, especially with regard to the key value drivers?
2. *Identifying a target.* A bank seeking deals will need a disciplined process to tap into the deal

flow through industry roundtables, structured pipelines, and outreach. Seasoned acquirers treat sourcing prospects as a well-oiled sales process, maintaining connections with dozens of board members and CEOs around the industry. Key questions to ask include these three: Does a given deal fit with the target institution's stated strategy? What motivates the target's CEO and board? Will the target's succession plan be a help or hindrance?

3. *Due diligence.* Some banks take a broader view of due diligence, including advance due diligence on potential targets. Areas of focus should include compatibility of core banking systems (for scale and geographic expansion), nonlinear exposure to credit risk (especially given economic uncertainties from COVID-19), cultural compatibility (often assessed outside in, using social media), footprint and branch overlap, digital capabilities (using outside-in benchmarking tools), customer experience (for example, using mystery shopping), and risk management capabilities.

4. *Synergies assessment.* Banks considering a deal often estimate synergies by using rule-of-thumb, ratio-based approaches—say, assuming 12 percent of the total cost base. However, models built from the bottom up can provide more reliable and accurate results and create a basis for more targeted integration. Such assessments consider function-by-function cost structure, funding cost differences by asset class, and cross-selling revenues by customer segment. For example, real estate synergies depend on lease terms and occupancy assumptions, while a technology blueprint is critical for timely execution—both for rapid capture of synergies and avoidance of value-destroying delays in technology and product rollouts.
5. *Cultural assessment.* The parties should assess the cultures of the two organizations at an early stage, so they understand characteristics such as decision-making processes, compensation philosophy, and team structures. This effort can also help them anticipate any major clashes.

Mapping Combined Value Creation

Our research sought to measure the value creation of the larger organization resulting from a merger or acquisition, so we wanted an alternative to traditional analyses, which examine the changes in stock price for acquirers and targets separately. For this, we developed the Combined Value Creation (CVC) metric, which looks at the change in market cap for each institution as a percentage of the combined market cap on the day of the announcement. To calculate this, we measured total return to shareholders from one week before the announcement to the day after.

We present the changes in market cap on a CVC map, which has two axes. The vertical axis represents the change in the target's market cap, while the horizontal axis shows the change in the acquirer's market cap, each as a percentage of the total market cap. In addition, two diagonals divide the quadrants created by the axes into eight octants. The downward-sloping diagonal (reading from left to right) indicates where the change in target market cap is exactly offset by the change in acquirer market cap, meaning the deal created zero value. The upward-sloping diagonal represents the points at which there is equal value creation (or destruction) by target and acquirer.

The octant of a deal indicates whether the deal created or destroyed value and to what degree the target's and acquirer's shareholders captured value from the deal. Deals that fall above the downward-sloping diagonal (octants 1 through 4) created value overall, while those in octants 5 through 8 eroded shareholder value. In octants above the upward-sloping diagonal (octants 1, 2, 7, and 8), the acquirer created less value or destroyed more value than the target did; the target outperformed the acquirer in octants 3 through 6.

Structuring for success

The historical record of M&A is rife with last-minute decisions overriding careful early planning. However, it is the rare CEO and board that can simply walk away from an announced deal. Accordingly, two structuring dimensions are critical and intertwined:

1. *Deal negotiation.* In stock transactions, the exchange ratio is at the heart of the deal, and small changes can greatly affect the outcome for shareholders. As noted earlier, only 32 percent of midcap deals have resulted in win-win outcomes for shareholders (octants 2 and 3 in Exhibit 4). And beyond the pricing of the deal, taxes, regulation, legal structure, and talent retention are crucial factors and warrant primary consideration. Thus, for a buyer, taking a firm line on pricing and structure of a deal is critical.
2. *People.* The cultural issues stemming from a poorly structured deal—particularly in a merger of equals, in which there is no dominant party—can be debilitating. Effective acquirers are unambiguous about who is in charge and operate well-oiled deal machines where the governance is clear. However, even in these

cases, talented managers in the acquired bank can be left without a meaningful role in the new institution. Well-structured mergers set clear leadership roles for the best managers from both institutions (and sometimes, in return, end up minimizing the control premium paid to the target's shareholders). However, it is also important to avoid the temptation to appoint co-heads as a way to avoid making tough decisions.

Integration excellence

In a well-run integration, the value creation and structuring steps lead to a swift and smooth critical-path execution. This happens in two phases:

1. *Integration planning.* Experienced acquirers conduct wall-to-wall assessments of the target as soon as feasible after a deal is announced. The aim is to fully understand the cost and potential for revenue synergies, measured with a set of granular performance markers and benchmarks tailored by business and function. For forward-leaning institutions, this is a rare chance to reset expectations. The best acquirers move early to raise synergy aspirations, often 50 to 100 percent above

Mergers of equals have their own challenges

Among midcap banks, four deals since 2019 have been described as “mergers of equals,” or deals between banks of a similar size. Even in a merger of equals, one bank becomes the nominal acquirer, and the other the nominal seller, but for purposes of corporate identity and communication, neither party is designated the buyer or seller. As a result, these transactions offer a unique strategic advantage: management teams can combine the strongest aspects of each company, rather than enacting sweeping change that adopts the business-line structure and operating models of a dominant buyer.

These transactions also offer critical financial advantages to the nominal buyer. They are priced closer to current share levels, so the premium paid to the nominal seller in this structure is often much lower than in typical deals.

However, mergers of equals bring their own integration challenges. They generally require the two banks to coordinate the development of synergy estimates and plans for integration, potentially slowing the process. Combinations of equals also can entail more extensive negotiation of shared governance and leadership roles and require greater accommodation of two different corporate cultures.

original targets. They also look not just for transaction-related synergies but for the opportunity for broader transformations in operating costs, revenues, and capital expenditures.

2. *Integration execution.* As noted, roughly 70 percent of merged midcap institutions underperform during integration. While some of this shortfall may be attributed to factors other than integration performance, we believe that winners share common integration strengths. Many banks adequately integrate the simpler functions but struggle with more complex functions that account for substantial operating expenses. Critically, banks need to rethink their integration-management offices—moving from a traditional checklist mindset to an approach that targets the major sources of value and risks of the deal. During integration, high-value critical activities (as defined by the deal strategy) should be distinguished from standard functions (such as legal, finance, and accounting), for which leveraging tried-and-tested methods should suffice. Banks also need to focus on making decisions as quickly as possible in key areas such as branding, core banking systems, and leadership, to enable staff to begin implementing changes.

US midcap banks are facing challenges from many directions. Chronic low interest rates are compressing net interest margins. Retail customers are being lured away by larger banks and by fintechs offering fresh products and a superior digital experience. Management teams have several ways to meet these challenges by

expanding product portfolios and strengthening relationships with existing customers. But their ability to deliver superior returns to shareholders through organic growth is limited, given the slow rate of underlying market growth.

An increase in mergers and acquisitions—whether to expand product capabilities or penetrate new customer segments and geographic regions—seems likely, given the potential for scale advantages that accrue to greater technology budgets and larger balance sheets, as well as effective diversification. But defining, negotiating, and integrating bank deals pose challenges of their own. Only about half of recent deals have been viewed positively by investors, and shares in the newly combined institutions have underperformed on average during their integration period.

This may already be changing, however. Some recent deals, including M&T Bank's acquisition of People's United Financial and—in an example from outside the mid-cap context—PNC's acquisition of BBVA US, resulted in significant value creation on announcement. Over the long term, acquisition-minded CEOs can greatly improve their chances of success through thoughtful planning of transactions, careful attention to valuation and talent management, and integration that recognizes the unique strengths of each bank and the combined whole.

Postscript: On February 9, 2021, CIT and First Citizens each announced that they had received stockholder approvals for the merger. Between the October announcement of the deal and the stockholder approval, share prices for US midcap banks rose by 66 percent in aggregate. Over the same period, the share prices of the First Citizens and CIT roughly doubled.

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