Expert Opinion (/expert-opinion/)

Remembering Your ABCs

What type of recovery will we experience? V, U, W or K? It isn't quite clear yet.

By **Dennis Holthaus** | November 09, 2020 at 05:03 PM

Source: Shutterstock

Penning a column on the current state of credit union acquisitions of banks on the cusp of an election, during a pandemic, with three days to go before the end of the third quarter, in one of the most extraordinary of years is one of the more challenging tasks I've taken on recently.

Trending Stories

1 **CDFI Certification Process Gives Credit Unions Unfair Free Pass: ABA (/2020/11/06/cdfi-certification-process-gives-credit-unions-unfair-free-pass-aba/)**

2 **Court Ruling Opens Door for CU Class Action Lawsuit in Sonic Data Breach (/2020/11/06/court-ruling-opens-door-for-cu-class-action-lawsuit-in-sonic-data-breach/)**

3 **How the Coronavirus Has Affected American Consumers' Savings (/2020/11/06/how-the-coronavirus-has-affected-american-consumers-savings-413-172807/)**

4 **Possible Biden Administration Poses Challenges for Credit Unions, Donovan Says (/2020/11/05/possible-biden-administration-poses-challenges-for-credit-unions-donovan-says/)**

5

On the mergers side, activity remains muted. But that doesn't mean there aren't buyers out there looking for opportunities and sellers actively looking for buyers. The key is being able to recognize what potential transactions are truly opportunities and which aren't. That's where the right advisor can be of tremendous service. Certainly, one thing contributing to the opportunity potential is the fact that bank valuations today have declined from where they were pre-pandemic. Let's walk in the buyer's shoes for a moment.

Longtime Manager Voluntarily Dismisses Whistleblower Lawsuit Against Navy Federal (/2020/11/05/longtime-manager-voluntarily-dismisses-whistleblower-lawsuit-against-navy-federal/)

Buyers have to be more cautious right now because of the importance of assessing the credit risk of a seller's loan portfolio in the pandemic scenario. Good loan due diligence is important in any acquisition, but in today's environment it's crucial – especially if the seller is an active lender on retail, hospitality, multifamily and non-owner occupied commercial properties. Proper loan due diligence will quantify the portfolio risk posed by the seller.

Third-quarter Call Reports are just now coming out, but I expect that they will not reflect any significant changes in past due loan levels or net charge-offs for the quarter. More telling will be fourth-quarter 2020 and first-quarter 2021 numbers. By then we should know much more about the quality of the sellers' credit policies and loan underwriting.

And then there's the recovery. What type of recovery will we experience? V, U, W or K? If it's a V, asset quality should stay pretty strong. But if it is a U, W or a K – well, those are much more complicated scenarios. Let me simplify:

- **V:** A high percentage of industries and businesses have reached bottom and are on the way back up.
- **U:** A high percentage of industries and businesses have reached bottom but linger for some time before going back up.
- **W:** A high percentage of industries and businesses have hit bottom and are on the way back up but another downturn occurs before the real recovery begins.
- **K:** In this nightmare scenario, industries and businesses are split into two categories. Instead of everybody experiencing the same economic activity, some businesses will be the top arm of the K where activity is accelerating – and other businesses will be the bottom leg, where economic conditions continue to deteriorate. And we don't know who, what, when or where.

Elephant in the Room

What type of recovery are we going to experience? It really isn't clear quite yet. Positive COVID-19 test results have more recently started going back up, in some cases to record levels, and the markets are on watch. If this current spike leads to a second shutdown or even a hybrid shutdown, the economy will slow down – impacting employment, business conditions and, potentially, asset quality.

A lot of buyers are concerned, not only about a seller's asset quality, but introspectively, about their own portfolio dynamics. However, credit unions have always had a good understanding of their members and, therefore, the quality of their loan portfolios.

We Don't Have a Crystal Ball, but ...

It takes a great deal of time to put an acquisition transaction together. For the contrarian thinker, this is an excellent time to pursue a potential transaction because seller valuations have come down. For those institutions, current valuations will encourage making an acquisition investment because pricing is at a level low enough to offset potential credit issues one might acquire and still allows them to meet ROI targets.

Operating Performance

This year there have been new, unplanned costs for institutions to deal with as a result of the pandemic and its shutdowns. As an example, sanitation and additional safety protocols have increased organizations' non-interest expense and are negatively impacting returns on assets. The question is, how much longer will these elevated expense levels impact operating performance?

In addition to higher non-interest expense, net margins have also been under pressure as the yield curve is negatively impacting loan rates, on both new and existing loans, more quickly than deposit rates are declining.

The scale provided by an acquisition, and the financial benefits obtained therefrom, can certainly contribute to the restoration of an institution's ROAA to pre-pandemic levels and help meet desired performance targets.

Another Arrow in the Quiver

Since we can't yet define that all-important letter for our economic recovery, or predict the duration of the economic cycle we are experiencing, capital management is taking on a new level of importance for the credit union industry. One of the tools available to many credit unions for managing capital is the issuance of subordinated debt to support both organic growth as well as the increased size resulting from the acquisition of a bank.

There's never been a better environment for issuing subordinated debt. The yield curve is at a point where debt pricing has never been better. (That's not to say it may not go lower.) Certainly at some point interest rates will rise. Potential investors in credit union debt are liquid, and they are looking for investment options. For many, credit union debt is something that fits within their investment policies. Regulatory attitudes supporting the use of sub-debt to manage capital have never been more positive. Even if an institution may not need the capital today, the issuance of sub-debt is still something to consider because of current pricing and investor interest.

Start to finish, it's easily a six- to nine-month time horizon to go through preparations, regulatory application and review, and the placement of debt with investors. The long lead time suggests developing an action plan to take advantage of the current favorable issuance environment.

History in the Making

Credit unions began with a simple idea – that people could achieve a better standard of living for themselves and others by pooling their savings and making loans to themselves and their coworkers. Credit unions have provided financial services to their members in the United States since the 1930s, and have adapted and thrived during myriad economic downturns and recoveries. Our industry will get through this, and will continue to provide quality products and services that help members achieve their financial goals and aspirations.

Dennis Holthaus

Dennis Holthaus Managing Director Skyway Capital Markets Tampa, Fla.

Dig Deeper

Growth Strategies (/Growth-Strategies/)

Recommended Stories

Beyond the Boomer CEOs: Prepare Your CU (https://www.cutimes.com/2020/11/09/beyond-the-boomer-ceos-prepare-your-cu/)

(https://www.cutimes.com/2020/11/09/beyond-the-boomer-ceos-prepare-your-cu/)

KIRK KORDELESKI AND TIM STRANDQUIST | NOVEMBER 09, 2020

If your CU is not prepared with a CEO succession plan, the transition will not go smoothly and it could take years for the CU to recover.

[Wealth Management for Credit Unions: What it Is & What it Could Be (https://www.cutimes.com/2020/11/09/wealth-management-for-credit-unions-what-it-is-what-it-could-be/)]

(https://www.cutimes.com/2020/11/09/wealth-management-for-credit-unions-what-it-is-what-it-could-be/)

MARK ALLEN | NOVEMBER 09, 2020

Robo-advisors can help CUs compete with the third parties that have been taking members and assets away from them.

[Using Data in Your Merger & Acquisition Decisions (https://www.cutimes.com/2020/11/09/using-data-in-your-merger-acquisition-decisions/)]

(https://www.cutimes.com/2020/11/09/using-data-in-your-merger-acquisition-decisions/)

RAY K. RAGAN AND TIMOTHY "BUCK" STRASSER | NOVEMBER 09, 2020

CU leaders may look to data, aligned with strategy, to guide the decision-making and final outcomes of a merger.

(/)

FOLLOW US ON (https://www.facebook.com/pages/Credit-Union-Times/95378106084) (https://twitter.com/CU_Times) (https://www.linkedin.com/company/3821859/)

About Credit Union Times (/static/about-us/) / Contact Us (/static/contact-us/) / Site Map (/sitemap/) / Advertise With Us (/static/advertise-with-us/) / Terms of Service (https://www.alm.com/terms-of-use-summit/) / Privacy Policy (https://www.alm.com/privacy-summit/)