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Modeling Cost Savings in M&A Transactions

By Britt Nosher and Scott Martorana, FinPro Capital Advisors

Of all of the components that contribute to transaction adjustments in an M&A deal, cost savings may be the most subjective.

Cost savings are initially educated estimates of synergies resulting in reductions to net operating expenses, whereas the realization of actual cost savings is contingent on the quality of due diligence, and the buyer's ability to execute after the deal closes. It is imperative to have a strong grasp on projected operating expenses when working with financial advisors to develop precise cost savings estimates.

Unlike other transaction items, cost savings are recognized over time after the transaction has closed. This not only demonstrates the importance of post-merger integration plans, but also the need for banks to understand the drivers of cost savings and the phase-in of synergies.

Employee compensation, professional fees, and data processing costs are the most likely to have redundancies when two institutions merge. Therefore, these areas generally represent the largest portion of cost savings.

Conversely, occupancy and equipment expenses typically represent a small portion of the cost savings unless branch or back office facility closures are planned. As a result, an in-market transaction may have higher cost savings with the inclusion of closed branches – versus an out of market transaction where there is less opportunity for branch consolidation.

In transactions where the target is a troubled institution, there may be significant cost savings realized as the FDIC insurance premium is lower for the combined entity and the expense for the disposition of problem assets may be higher.

A higher level of cost savings reduces noninterest expense levels for the combined entity, thereby increasing net income and EPS accretion. Strengthened EPS accretion translates to a reduction in the time it takes to workback the resultant dilution of a buyer's pre-deal tangible book value.

Often, however, it is possible that absent a reasonable level of cost savings synergies, a deal simply does not work.

As shown in the following sensitivity table, holding all other assumptions constant except for percentage of cost savings, the workback period can change significantly by adjusting cost savings. As shown below, buyers must also be cognizant of the cost savings assumptions being utilized by investment bankers as part of the pro forma modeling as a higher level of cost savings can

($000s)	Cost Saves Modeling Scenarios		
	Low	**Base**	**High**
Buyer Stand Alone Earnings	$ 35,000	$ 35,000	$ 35,000
Seller Stand Alone Earnings	1,500	1,500	1,500
After Tax Cost Saves	1,350	1,890	2,430
Pro Forma Combined	$ 37,850	$ 38,390	$ 38,930
Cost Saves %	*25%*	*35%*	*45%*
Earnings Accretion	**8.1%**	**9.7%**	**11.2%**
TBV Dilution	$ (10,000)	$ (10,000)	$ (10,000)
TBV Earn Back	**3.5 years**	**2.9 years**	**2.5 years**
Acquired Entity ROAA	0.95%	1.13%	1.31%

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make a deal look much more attractive but may not be realistic.

In the stages of a transaction prior to due diligence, when an acquirer does not have detailed information on the target's noninterest expenses, it can be difficult to fully assess cost savings. For this reason, FinPro Capital Advisors, Inc. ("FCA") stresses the importance of an institution's ability to assess whether or not modeling assumptions are realistic. It is important that a bank have a financial advisor that it can trust and always be aware that a pro forma is only as good as the assumptions driving it.

Two key questions to ask:

- *Are the cost savings that have been modeled realistic and attainable?*
- *Has your advisor incorporated realistic cost savings and performed comprehensive noninterest expense analyses?*

Cost savings of 40% or 50% of a target's operating expenses will produce a very attractive transaction on paper, but in many cases the cost savings estimate may be inflated and management should question if the elevated level of cost savings are attainable.

Although cost savings will be specific to each individual deal, below are key highlights and general benchmarks for cost savings from a recent FCA presentation.

It becomes increasingly important to assess each of the noninterest expense components if the overall savings are below 20% or above 40%. If the figures fall outside of these parameters, it is critical to be able to determine the rationale for why the cost savings may be higher or lower than normal.

As a transaction gets closer to announcement, cost savings assumptions should become more detailed. For example, a preliminary assumption for salary and benefit cost savings may be 25% based on a high level FTE analysis. However, as the bank enters the due diligence phase of a transaction, salary and benefits cost savings should be based on a more detailed staffing analysis. At each stage, assumptions should be further refined.

Levels of Cost Savings

As always, this will be deal dependent, but some general guidelines

Deal Profile	Cost Savings Range
Acquiring smaller banks	Savings between 30% and 50%
In-market deal	Savings between 30% and 40%
Strategic combinations (merger with two, clean similar sized companies)	Savings between 15% to 25% (often quoted as a percentage of combined company operating expenses as 10% to 15%)

Major Cost Savings Components and Percentages

Category	Cost Savings Range
Compensation (Salary & Benefits)	15% to 25% of run rate
Professional Fees (Consulting, Audit, Legal)	70% to 80% of run rate
Data Processing	30% to 40% of run rate
FDIC Insurance	Varies, but if the seller is troubled savings are *substantial*

Tricks to Quickly Evaluate Cost Savings for Reasonableness

Start with a compensation build up analysis

Analyze pro forma per FTE (full-time employee) ratios: assets per FTE, deposits per FTE, net income per FTE. Are the ratios reasonable?

Compare the buyer stand-alone efficiency ratio against the pro forma combined efficiency ratio. In most cases, there should not be a *material* difference

Management must critically review and sign off on assumptions, which must be realistic. Care must be taken never to manipulate assumptions to drive a desired outcome.

Throughout the transaction, buyers and targets must have a strong grasp on key modeling concepts and have financial advisors on their team not only to provide models but to guide the process and facilitate conversation.

Without question, banks can assume a more proactive role in transaction analysis by fully understanding the fundamentals of cost savings. Such institutions will be able to easily identify errors or unrealistic assumptions, and better able to control the outcome of their transaction to recognize the value creation modeled in an M&A deal.

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About the Authors

Britt Nosher, Senior Financial Analyst at FCA, and Scott Martorana, Executive Managing Director at FCA. For more information about merger & acquisitions, cost savings, pro forma modeling, and valuation, contact Britt or Scott at (908)-604-9336, bnosher@finprocapitaladvisors.com, or smartorana@finprocapitaladvisors.com.

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Financial Managers Society
1 North LaSalle Street, Suite 3100
Chicago, IL 60602
info@fmsinc.org

Contact: dyingst@fmsinc.org | 312-578-1300
www.fmsperspectives.com

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