How Vendor Contracts Influence M&A Discussions

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AUG 5, 2014 12:27pm ET

Bankers should closely examine how potential vendor contracts could end before they sign on the dotted line.

Executives, under regulatory pressure, are paying more attention to managing relationships with third-party vendors. Such oversight should include more aggressive pricing negotiation and efforts to make sure that contracts align with a bank's strategic plan, industry observers said. As mergers pick up, poorly structured contracts could affect the bottom line for buyers and sellers.

"We're seeing these deals have a material impact on bank deals," said Aaron Silva, president and chief executive at consulting firm Paladin. "Shareholders for a selling bank could take a hit. On the buy side, banks that are in aggressive acquisition mode are impacted by millions of dollars because they didn't get these contracts right."

In the first half of 2014, banks announced 136 whole-bank deals, up 18% from a year earlier, putting it on pace to have the best M&A year since before the financial crisis. More than 60% of executives expect to be involved in M&A, according to a recent survey from Business Performance Innovation Network.

As a result, it is increasingly important for bankers to align vendor contracts with their future plans, something most executives fail to do, said Trent Fleming of Trent Fleming Consulting.

"It is easy to say the vendors are the villains and they're taking advantage of the banks," Fleming said. "But they're just offering a contract that is favorable to them and they realize the banks aren't reading them very closely."

Management teams and boards are often reluctant to admit they are likely sellers, Fleming said. Just 4% of executives in the BPI survey said they would be sellers, while 36% identified themselves as buyers. If managers are honest that an eventual sale is likely then they can structure contracts with appropriate lengths and lower deconversion costs, Fleming said.

Though vendors frequently assert that certain parts of a contract are non-negotiable, it often isn't the case, said Brian Hagan, a senior director at Cornerstone Advisors. Many factors, such as a bank's size and potential revenue from the contract, play into a vendor's willingness to compromise, he said.

Typically, banks are required to pay termination fees that are equal to a percentage of what they pay monthly multiplied by the remaining term of the contract, to end the deal early, Hagan said. Still, banks should push to have that percentage decrease significantly over the years of the contract, Fleming said.

"If you terminate early in the agreement, the fee will be substantially higher than if you exited later on," Hagan said. "That can definitely have an impact on an acquisition price."

Poorly structured termination fees have scuttled deals in the past, Silva said. The BPI survey includes an example where a $320 million-asset institution signed a letter of intent to sell to a $1.5 billion-asset buyer. But the would-be seller's core technology contracts had recently

auto-renewed and included a $1.5 million early termination penalty. The deal fell apart. The study did not identify the institutions.

"In M&A situations, there's usually a lot of money left on the table," said Christopher Herman, a senior sourcing and contracts professional at Swingtide. "The acquiring bank wants to integrate the seller as seamlessly into their contracts as possible and not be burdened with commitments and obligations the seller made."

The cost to terminate the vendor contracts for a seller is something that active acquirer CenterState Banks in Davenport, Fla., considers, though it doesn't necessarily drive a deal, said Chris Nichols, the bank's chief strategy officer. The $3 billion-asset CenterState has acquired nearly a dozen banks in recent years.

CenterState is looking more closely at its termination clauses, as a function of risk management, because the bank may always need to leave a contract due to changes in technology or regulation, Nichols said.

"The whole industry is becoming more sophisticated in terms of risk management and vendor management is at the top of that list," Nichols said. "It's important to be able to compare different contracts and structure. Naturally that includes termination fees."

Most contracts are written "in a way that punishes an institution if it wants to be a rapid growth institution," meaning banks looking to be acquirers should push for better terms, Silva said. For instance, contracts don't automatically give banks a better rate as transaction volume grows so executives must ask for tiered pricing, he said.

Executives could ask about having certain costs, like processing fees on deposit accounts, capped so the bank is free to grow, Fleming said.

There could be costs beyond early termination fees if an institution buys another bank that uses the same vendor, Silva said. For example, an acquirer could get stuck paying higher transaction fees that were included in a seller's contract, Silva said. In negotiating contracts, executives should ask to have deconversion and early termination fees waived if they buy a bank that uses the same vendor, Fleming said.

"Managing contracts is a little bit difficult," Nichols said. "It's hard to compare the risks and details of the contracts with one another. Do we just renew or do we solicit bids? There is really no efficient way to do it."