

■ M & A s

Bank of America's Acquisition of Countrywide

Merger of Convenience?



America's largest consumer bank expects that its acquisition of Countrywide will start generating savings to the tune of \$670 mn over the next two years. However, the merger poses significant challenges as risks are huge.

Bank of America's acquisition of Countrywide Financial rescues America's biggest mortgage lender and expands the financial services empire of the country's largest consumer bank. However, the acquisition of Countrywide underlines the severity of the financial challenges that have besieged the US mortgage industry. Countrywide led the front in fueling the subprime crisis by offering loans to high-risk borrowers. It is the central point of subprime crisis because of its massive size, has issued more than nine million loans worth \$1.5 tn, and holds a nationally regulated thrift with \$55 bn in deposits.

It is now apparent that Countrywide's development was mainly due to the sloppy lending practices. By the end of 2007, when the borrower defaults soared, the company was already

very late in recognizing the need to amend its business practices. Subsequently, the crisis compelled it to write-off \$11.5 bn credit line and report a decline of around 50% in the loans that it had funded, from \$42.8 bn to \$23.5 bn. The troubled mortgage lender has more than 1,000 field offices and 15,000 sales force, and a \$4 bn all-stock deal gives Countrywide 0.1822 share of Bank of America for each share they own. Analysts say that the move could build a bulwark against the mortgage-default crisis and save Countrywide from collapse.

What the deal means

The collapse of Countrywide, the biggest mortgage lender, would have posed a major risk to the US economy, since the lender services about one of every six loans in the country. Moreover, the bankruptcy of Countrywide would have

shifted huge financial risk to Fannie Mae and Freddie Mac, the US government-sponsored mortgage buyers.

Now, the acquisition of Countrywide marks the end of the regime of a mortgage lender, long known as an innovator, survivor of slumps and fierce competitor and ranked number one in the US mortgage lending in the early 1990s. It lost this position in the mid-1990s, but regained the position in 2004 and sustained its market share by hiring aggressive sales people and lowering its lending standards, which finally saw a rising tide of defaults.

While supporters say that the deal would help borrowers, stabilize the housing market and infuse confidence in global investors, the critics say it's not a perfect solution for the US mortgage mess, as investors are still nervous about the mounting losses in mortgage-related investments. As more than 1.8 million mortgages given to borrowers with poor credit are scheduled to reset to higher rates, the threat is still not far away. Investors are worried that Bank of America is overpaying for a franchise that is reduced to rubble to save its face after its ill-timed \$2 bn investment in Countrywide Financial Corp during the height of the summer's (August 2007) global credit crisis.

A bold move?

The deal is expected to close in the third quarter of 2008, and on the whole, Bank of America expects to see \$670 mn in cost savings, but doesn't expect to fully realize them until 2011. Henceforth, the combined company doesn't plan to originate subprime loans, a key cause of the continuing credit crunch. It's not much of a cure to Countrywide's financial problems. As the US economy is slipping into recession, rising mortgage delinquencies have begun to feed off

INTERVIEW

"Acquiring a company from the troubled mortgage industry in the US at this time has quite a few risks."

How do you view Bank of America's decision to acquire the troubled mortgage lender, Countrywide Financial?

Bank of America's opportunities to realize major growth externally by mergers and acquisitions within its existing major business divisions seems likely to be blocked by antitrust regulation. What companies in such a situation usually do is to look for expansion by diversification into more or less related or even unrelated businesses or to strengthen their positions in businesses where they are weaker. Related acquisitions are certainly to be favored over unrelated ones, because they offer at least some sort of opportunities for synergies. In the case of Bank of America, the acquisition of Countrywide Financial is a related acquisition where BoA has a weak business.

What are the synergies BoA can gain from Countrywide?

Synergies can be reached by cutting costs and increasing revenues. First of all, costs can be cut by using Countrywide's larger systems and resources for BoA's existing mortgage business. Second, further economies of scale can be expected to be realized. Third, the client base might be expanded. Countrywide Financial might have clients that have not been clients of Bank of America. Fourth, there is the potential for cross-selling products. This acquisition will be an



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opportunity to offer all clients a more complete financial product range.

What are the risks it will be taking along with the acquisition?

Acquiring a company from the troubled mortgage industry in the US at this time has quite a few risks. The portfolio of the lender could cause more troubles than thought. But it can be expected that the portfolio has been studied in detail. I think that this deal might offer the opportunity to make a bargain. Mortgage lenders might be rather undervalued. Having the rare opportunity to buy a number one player does not come along too often.

What about the financing of this acquisition?

It is interesting to see that BoA is offering stocks and not cash for Countrywide Financial. On the one hand, such offers are usually perceived as being applied when stocks are overvalued. Raising debt to finance this acquisition might have been quite difficult. On the other hand, most investors favor receiving cash instead of stocks. Stock offers are also more likely to attract other bidders and less likely to be accepted by stockholders; for example, we can see what happened to ABN Amro. In the current market situation, the emergence of another bidder for a mortgage bank, however, is unlikely.

each other in a dangerous spiral amidst falling home values and tightening credit that have begun to sap consumers' spending. Bank experts view the deal as a daring move and also consider this as a strategy to protect its earlier \$2 bn investment in Countrywide. Ken Lewis, Chief Executive, American Chairman is very optimistic about the deal and opines, "We are aware of the issues within the housing and mortgage industries. The transaction reflects those challenges. Mortgages will continue to be an important relationship product, and we now will have an opportunity to better serve our customers and enhance future profitability."

Countrywide's brisk growth during the first half of this decade, when net income tripled from \$841 mn to more than \$2.6 bn, no longer prevail: reasons being the absence of stringent credit standards and low interest rates. Moreover, as Bank of America is going to absorb roughly \$100 bn in subprime mortgage-related securities and a lot of assets of the most volatile nature, there is high risk associated with the deal. Identifying and getting rid of redundant lending procedures is also a complex and lengthy process that could take some years to complete.

London-based research firm, CreditSights estimated that on an after-tax basis, the deal is likely to cost an-

other \$8-9 bn, resulting in at least another \$4 bn in credit write-offs. If Countrywide had failed and declared bankruptcy, those claims would have been secondary. By acquiring Countrywide, Bank of America will be taking on a barrage of subprime mortgage lawsuits by federal and state agencies stemming from its lax lending practices.

Moreover, Countrywide's belligerent mortgage operations are quite opposite to Bank of America's genial retail banking environment. Integrating these two is a daunting task for America's largest consumer bank. Different cultures, converting mortgage customers into prospective clients of its own, and other financial ser-

vices may, perhaps, pose a significant challenge. Bank of America will have to reach out to distressed borrowers, whose credit profiles would have made them eligible for low-cost loans but were misguided into exorbitant mortgages. Critics argue that acquiring a giant mortgage lender like Countrywide to get exposure to credit—spending and retail bank customer deposits is an untested strategy.

Will Ken Lewis deliver again?

Given Ken Lewis' impeccable record as a successful acquirer, this move cannot be underestimated. In the past, he has extended the Bank of America's retail operation with multibillion purchases of FleetBoston Financial, secured credit card business by acquiring Maryland Bank, North America (MBNA), and seized a wealth-management business in US Trust Co. With federal laws ruling out any bank from making an acquisition that would increase its market share of US deposits to above 10%, the acquisition is regarded as a masterstroke by Bank of America to spread its business to other financial services within the federal laws.

Despite troubles, Countrywide was the leading mortgage lender of the US for the first nine months of 2007. Getting the largest independent mortgage lender of the country, which was worth \$24 bn six months ago, for \$4 bn, is practically not a big deal for the banking giant. Bank of America was a little hasty with its October 2007 purchase of \$2 bn in newly issued Countrywide shares, which were convertible into about 17% of the common stock. But now, it is paying a meager \$4 bn in stock for the remaining 83%.

Hidden synergies

Bank of America gets Countrywide's sophisticated office, customer base, the facilities and cutting-edge technologies which are all priceless assets that make Bank of America the largest diversified financial services giant, ahead of its competitors like Wells Fargo & Co and Washington Mutual Inc. Countrywide's retail distribution will augment its network of more than 6,100 banking centers across

the US. Even though Countrywide is headquartered in California, it does maximum of its business in states where Bank of America is the weakest: Michigan, Ohio, Indiana and other Midwestern states. Hence, the deal strengthens Bank of America and provides an obvious geographical gain in areas where it has not prospered.

Ken Lewis proudly declared that "The merged company will easily dominate the US real estate finance sector to an extent never before seen. It will control 25% of mortgage originations and 17% of mortgage servicing market." He also revealed that the key reason behind the rescue of the collapsing lending giant: cross-selling "credit cards, deposits and all other financial services" that the bank offers. According to analysts who are well aware of company's inside data, customers who take home loans from Bank of America usually are expected to take six other financial products like credit cards, savings accounts, etc.

Bank of America is anticipating that the acquisition will start giving savings to the tune of \$670 mn over the next two years, and Countrywide is capable of returning at least to the earnings at the pre-real estate bubble level of \$850 mn-\$1 bn. It also intends to use some of Countrywide's losses to compensate its own taxable income, which could be equal to \$500 mn over the first five years.

A lifeline to borrowers

Even though it is too early to predict what tangible benefits this deal brings to Bank of America, for scores of borrowers, who are struggling with unaffordable mortgages the acquisition has eased some of their concerns. According to Bruce Marks, CEO, Neighborhood Assistance Corporation of America, "The deal will allow Bank of America to restructure loans to what homeowners can afford." Many customers are of the opinion that Bank of America will do a better job of setting up loan modifications for struggling borrowers, as it has shielded itself from the subprime crisis by not participating in mortgage lending. They believe that since Bank of America is the biggest re-

tail bank with an impressive financial track record, it has got the capacity to tackle the volume of Countrywide loans. In fact, Bank of America reinforced that it does not want to initiate any subprime loans even after the merger is completed, but would like to restructure the borrowers' loans that are closer to prime loans and performing assets to get better returns. Moreover, the consolidation between the two lending giants may steady credit markets, give a confidence boost to the mortgage industry, and force their competitors to reach out to customers, leading to a drop in risk premiums.

The road ahead

The deal is definitely like a blessing in disguise for Countrywide's investors, who have observed the value of their stock plummet in recent times, as subprime mortgage losses started mounting. Bank of America is projecting this as a rare opportunity, not only to expand its geographical footprint, but also to achieve operational efficiencies. Moreover, it is expecting a smooth transition with regard to some important operational challenges such as integration of management systems and appraisal of risky loan portfolios. However, the immediate challenges would be to deal with persistent weakness in housing, which is expected throughout in 2008, sharp fall in mortgage market origination volumes, and higher credit losses.

Bart Narter, Senior Analyst, Celent, a Boston-based financial research and consulting firm, opines, "There's still plenty of risk involved. But I think that it's very likely down the road to be profitable, maybe not immediately, but long-term." Despite gains, there are potential losses that are associated with the deal. There are chances that Bank of America may ultimately realize a profit by turning around Countrywide. However, it all depends on how fast the policy-makers in the US steer the economy onto the growth track. ■

— N Janardhan Rao and PS Sharath Chandra

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