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BANK VALUATION Concepts to Influence How You Lead

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HOW CAN YOU USE BANK VALUATION CONCEPTS TO INFLUENCE HOW YOU THINK AND LEAD?

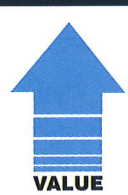
By Z. Christopher Mercer

Owners and managers of privately owned community banks tend to think about running their banks effectively, of course. And then, there is an annual or occasional valuation of the bank for the ESOP, a repurchase of shares, some other transaction, or pure curiosity. It is my observation that many bankers don't think about managing their banks with valuation concepts in mind. This short article may help bring valuation concepts and management concepts into better alignment for thinking about and leading your bank.

As complex as bank valuation can be, it can be summarized with only four terms.

$$\text{VALUE} = \frac{\text{Earnings}}{\text{R - G}}$$

Increase Earnings
Decrease Risk =
Increase Growth



This basic valuation equation summarizes a much more complex discounted cash flow analysis, but it is helpful for our discussion. The value of a bank, today, or V, is its Earnings (technically, expected earnings), capitalized by a discount rate, R, minus the long-term expected Growth rate of Earnings, or G. The algebra in the equation at the top is fairly straightforward.

We learn three things (other things being equal, of course):

- Increase Earnings and Value will increase.
- Decrease Risk and Value will increase (it is in the denominator). Increasing Risk, on the other hand, will decrease the Value of a bank.
- Increase Growth and Value will increase.

VALUE =	$\frac{\$10 \text{ per share}}{15\% - 5\%}$
MULTIPLE =	1 / (15% - 5%)
=	10.0
VALUE =	\$10 per share x 10.0
=	\$100 per share

We know these things almost intuitively, but the focus helps. To be clear how this all works, assume that Earnings are \$10 per share, R is 15%, and G is 5%. The math is fairly simple. The Multiple developed is the typical price/earnings multiple that we see in the markets for publicly traded banks.

If you want another quick valuation fact, there is a relationship between the Multiple and a bank's return on equity (ROE). If, as in our example, the ROE is 15% and the Multiple is 10.0x, then the Price/Book Multiple will be 150% (10 x 15%). All bank leaders and shareholders are interested in their Price/Book Multiples!

So far, we have explained the basics of bank valuation in just over 300 words. Now let's talk about how these concepts can influence how you think about your bank and, perhaps, how you lead it.

FOCUS ON EARNINGS

Banks generate interest income on loans and other earning assets and pay interest on interest-bearing debt. In so doing, they generate a spread. They also generate fee and service income in a variety of forms. The question is: How can we influence Earnings in our day-to-day interactions with our banks?

At The Emmerich Group®, we learn the importance of cross-selling. Other than a score you can calculate, what is cross-selling? It is developing multiple relationships with the same customers. Why is this important? Let me provide a personal example.

I have banked with Commercial Bank & Trust Company, a community bank here in Memphis, for about 30 years. I have multiple personal accounts and my wife and children (now grown) have accounts. Commercial Bank has also been Mercer Capital's banker for those same 30 years. It has provided financing for our ESOP's purchase of half of our stock, multiple build-out loans when we have moved or expanded, and our seasonal line of credit.

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I don't know if I'm a Top 100 Customer at Commercial Bank, but collectively, we probably are. I know that we get lots of attention from Mercer Capital's banker, and she has taken care of numerous things for me over the years. They have worked hard to retain me and Mercer Capital as a customer for many years. They are not cheap, but the little bit more they might charge on loans or the little bit less they may pay on deposits have been worth it for many years.

Where am I going to go? How many of your customers are happily in the position I am with Commercial Bank in Memphis?

Two other things to note quickly about Earnings. When you look at the bank, look at staffing levels around the bank and the work loads of employees. Are things reasonably balanced? Over- or under-staffing tends to decrease employee satisfaction and increase staff turnover, which can be an insidious drag on earnings if excessive. Good employees are expensive and hard to find, and when they leave, you lose important parts of your institutional memory and relationships.

In this short discussion of earnings, we have talked about customer retention, cross-selling, incremental pricing, Top 100 Customers, staffing levels and staffing work levels, and staff turnover. Know that when you focus on these things, and when your staff focuses on them, you are focusing on enhancing the Earnings and the Value of your bank.

RISK

The obvious issues regarding Risk relate to loan quality and maturity decisions and deposit maturity and pricing decisions. Let's broaden the discussion to providing excellent service levels in every corner and department of your bank. Good service keeps existing customers and attracts new ones. Reducing Risk in this fashion is also helpful for Earnings and Growth.

A high level of staff turnover can also increase the riskiness of your bank's Earnings and its Value. Excessive turnover, as mentioned, is expensive. Its greatest cost, however, is not seen directly on your bank's income statement: The real cost of turnover is in lost institutional memory and customer relationships. Turnover can increase the riskiness of your bank's Earnings and diminish Growth prospects as well.

As you walk around your bank, look through the lens that evaluates risk. Does what you see tend, at the margin, to increase overall Risk or to decrease it?

GROWTH

We all want the balance sheet to grow, fee income to grow, and balance sheet relationships to remain within good ranges. Let's look at Growth a bit more marginally. Every community bank is in one or more markets, and there is competition in nearly every market. To grow, you can, hopefully, grow with your markets. However, with Growth relatively slow in many community bank markets, that won't provide the kind of Growth (and Value) you and your shareholders desire.

To grow, you will have to take some market share from your competitors. You can do that by vigorously cross-selling to existing customers and through customer retention. In turn, you do that by providing excellent service, the kind that people talk about, to attract new customers from other financial institutions. You can do that by developing a sales culture in the bank. And you can do that by making your bank an attractive place to work for great employees while minimizing overall turnover and, hopefully, among your key employees.

WRAP-UP

The Value of your bank is a function of its future Earnings, its Risk, and its expected Growth. Bankers intuitively know this at the time of the annual appraisal (a great idea, by the way), and when they think about Value in planning meetings.

The idea presented in this article is to look at your bank through the lenses of Earnings, Risk, and Growth in your everyday movements about the bank and in your everyday interactions with your employees. The more you do this, and the more of your key leaders who do this, the easier it will be to build the Value of your bank. That is good for customers, your community, all employees, and, of course, your shareholders.

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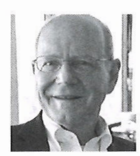
ABOUT THE AUTHOR



Z. Christopher Mercer is the Founder and CEO of Mercer Capital (MercerCapital.com). Chris is the author of eight books on valuation and a frequent speaker on valuation for banks. He has prepared, overseen, or contributed to hundreds of valuations for purposes related to tax, ESOPs, buy-sell agreements, and litigation, among others.

He can be reached at MercerC@MercerCapital.com