Bank Watch

April 2015

www.mercercapital.com

Bank Watch

Increasing The Capital Cap For Small Banks: Regulation A+

Unlike the dark days that prevailed during 2008 through 2010 for many capital-starved financial and non-financial institutions alike, the current environment of ample liquidity may become more so based upon recent rule making by the Securities and Exchange Commission (SEC).

On March 25, 2015, the SEC issued its final ruling amending Regulation A, an existing exemption from registration requirements for smaller issuers of securities. The new rules, commonly referred to as "Regulation A+," were first proposed in December 2013 under Title IV of the Jumpstart Our Business Startups (JOBS) Act.[1] Regulation A+ is expected to increase access to capital markets for small companies that do not report to the SEC, including banks and bank holding companies with fewer than 1,200 equity holders, by exempting registration requirements for securities offerings of up to $50 million annually.[2]

The new regulation aims to amend certain weaknesses in Regulation A that led to its limited use as a capital raising tool. The original $5 million ceiling under Regulation A was considered by many to be too low relative to the costs for a small offering, and not worth the burden of complying with blue state laws in each state in which the offering was conducted. The expansion of the offering limit and more reasonable filing requirements under Regulation A+ will create new opportunities for mature, private companies that wish to raise capital without going public or asking permission from state regulators. The new rules create a two-tiered offering structure with differing requirements based on the size of the offering.

» Tier 1 consists of securities offerings of up to $20 million in a 12-month period, with no more than $6 million in offers by selling security-holders that are affiliates of the issuer.

» Tier 2 consists of securities offerings of up to $50 million in a 12-month period, with no more than $15 million in offers by selling security-holders that are affiliates of the issuer.

Both tiers are subject to the same basic requirements of Regulation A, including issuer eligibility and disclosure, but with additional requirements and exemptions under each tier that aim to solve some of the limitations of Regulation A. In effect, the rules for Tier 1 will be the same as the current Regulation A, but are now limited to a greater aggregate offering of $20 million over a 12-month period. The issuer can elect whether to proceed under Tier 1 or Tier 2 for offerings up to $20 million. However, there are no longer investment limitations on purchasers, and all securities issued under Regulation A+ are non-restricted and transferable. Tier 1 offerings must still comply with blue sky laws, but financial disclosures are less rigorous.

In comparison, Tier 2 offerings are limited to an aggregate offering of $50 million over a 12-month period, and are offerings are subject to periodic reporting requirements that are effectively scaled-down versions of the annual, quarterly, and ongoing reporting requirements that Exchange Act reporting companies are subject to. However, Regulation A+ exempts all Tier 2 offerings from blue sky requirements, which are instead preempted by federal securities law.

In addition to removing barriers and increasing capital limits, Regulation A+ has also broadened the base of investors. Originally, only accredited investors who made over $200,000 a year or had a net worth of $1 million could buy securities that were not subject to SEC registration under Regulation D.[3] According to the SEC, only 7% of American individual investors could invest as an accredited investor as presently defined.[4] Under Regulation A+, there is no cap to the total investment from each unqualified investor under Tier 1 and a cap of 10% of annual income or net worth under Tier II.[5] A definitive ruling on crowdfunding is still pending under Title III of the JOBS Act.

The preemption laws and expansion of the investor base under Regulation A+ has received considerable push-back from state regulators and the North American Securities Administrators Association. According to the Secretary of the Commonwealth of Massachusetts, "[preemption] is a step that puts small retail investors unacceptably at risk."[6] Under the original Regulation A, companies were required to file the offering and pay fees in each state in which they were selling. Although the additional level of scrutiny was considered a safeguard by many states, the cost and the burden of filing under the blue sky laws were often too much for the limited capital gains.[7]

The updated Regulation A+ provides a greater annual dollar limit without the "costly entanglement in the web of state blue sky regulation" for larger sums of capital.[8] Companies are still required to provide audited financial statements and ongoing periodic reporting that will provide the transparency necessary to maintain investor confidence, while investors can diversify their portfolios and provide liquidity without an IPO offering. Regulation A+ is seen as especially beneficial for community banks, as with greater amounts of capital at their disposal, smaller banks can increase lending limits and make more or larger loans. In effect, Regulation A+ acts as an intermediary step in the IPO process and a means obtain growth capital for small companies and community banks alike.[9]

The issuance of debt and especially equity raises a number of questions, including those related to valuation and fairness from a financial point of view. At Mercer Capital we have over three decades of experience in assisting managements and boards of directors in evaluating such questions. Please call if your firm is considering a raise, whether under Regulation A+ or otherwise, that will require financial advisory services.

Madeleine L Harrigan

Madeleine L. Harrigan
harriganm@mercercapital.com

1 Largason, Paula Grace. "SEC issues proposals to increase smaller companies' access to capital." SNL. Online. Accessed April 15, 2015.
2 http://www.cbaofga.com/uploads/4/1/3/7/41371065/sec_opens_capital_spigot_for_small_banks,_online_lenders_american_banker_article.pdf
3 http://www.sec.gov/answers/accred.htm
4 http://www.cbaofga.com/uploads/4/1/3/7/41371065/sec_opens_capital_spigot_for_small_banks,_online_lenders_american_banker_article.pdf
5 http://sddco.com/updates/the-sec-gives-an-a-plus-but-are-proposed-reg-a-edits-enough/
6 The Commonwealth of Massachusetts. Secretary of the Commonwealth. Online. Available: http://www.sec.gov/comments/s7-11-13/s71113-1.pdf. Accessed April 16, 2015.
7 "Regulation A+ Offerings – A New Era at the SEC." Online. Available: http://corpgov.law.harvard.edu/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec/. Accessed April 16, 2015.
8 http://corpgov.law.harvard.edu/2014/01/15/regulation-a-offerings-a-new-era-at-the-sec/
9 http://www.cbaofga.com/uploads/4/1/3/7/41371065/sec_opens_capital_spigot_for_small_banks,_online_lenders_american_banker_article.pdf

What We're Reading

This thought-provoking article from Radek Jezbera of PWC examines the following question: Can banks be more like FinTech companies?

http://mer.cr/1yRgQFT

Al Dominick draws parallels from non-bank deals in an article entitled "Why Big Banks Aren't Merging."

http://mer.cr/1Hmz8BY

SNL Financial had an interesting article entitled "Bank Investor Sees M&A as Path Away from Lending 'Slippery Slope.'" (subscription required)

http://mer.cr/1JdqmXp

Observations from the Initial Q1'15 Bank Earnings

Jeff K. Davis, CFA, Managing Director of Mercer Capital's Financial Institutions Group, is a regular editorial contributor to SNL Financial. This contribution was originally published April 22, 2015 at SNL Financial. It is reprinted here with permission.

If U.S. Bancorp CEO Richard Davis' comments on April 15 about the corrosive impact of low loan yields on bank profitability did not get the attention of the Street, it should have. Davis made an analogy to a fitness challenge that the zero rate world is increasingly stressful the longer it lasts. I thought Comerica Inc.'s results summed up what has been occurring the past few years. The company had $48 billion of loans based upon average balances in the first quarter, up about $3 billion from the year ago quarter, but net interest income only rose $3 million to $413 million.

Until this quarter, I thought the Street had not been paying much attention to what was happening to loan yields the past couple of years. Maybe because declining credit costs and a shift in earning assets to more loans and fewer bonds masked the implications of declining loan yields. And since the second half of 2014 the consensus coalesced around the view that the Fed would begin to raise short rates in June or September of 2015. Now Fed rate hikes, which may be a one-and-done move, look iffy for 2015.

Without assuming the Fed is going to change the math "next year," it is hard to ignore what the numbers are saying: earnings are at best are going to move sideways to slightly higher for most banks with high single-digit ROEs other than for the leanest of cost structures such as U.S. Bancorp and Birmingham, Ala.-based ServisFirst Bancshares Inc. ROEs will decline further whenever credit costs rise, though nothing in bank results to date indicate an upturn is anywhere near. Sustained loan growth at some point is going to require reserve building to resume, however.

At some point loan yields will bottom, but the bottom may be much lower than envisioned. First Horizon National Corp. CEO D. Bryan Jordan commented on April 17 that the market had seen an acceleration of weakening loan pricing and structure. Aircraft lessor FLY Leasing Ltd. (B1 Moody's; BB S&P) announced on April 20 that it had repriced its 2012 term loan for the third time since it was originated to LIBOR +2.75% with a LIBOR floor of 0.75% from LIBOR+3.50% and 1.00%. And a loan made by U.S. Bank NA to Pinnacle Bank earlier this year to partially finance an investment in Bankers Healthcare Group points to where the bottom may be for "A" credits like Pinnacle: the greater of zero or 30-day LIBOR plus 165 bps to 195 bps. At least U.S. Bank, and I assume most banks, is thinking about the potential for the Fed to target negative rates by writing loan agreements to set a 0% base rate floor.

In most mature industries, volume growth to offset margin pressure may not be ideal, but is manageable. Banks can do so too, but loan growth eats capital and implies risk adjusted returns may not be so good. Or in the vernacular of an operating company: capital expenditures have to increase to maintain EBITDA. My take on bank ROEs is that over extended periods of time ROE tends to be roughly 500 bps to 700 bps over the 10-year U.S. Treasury. It does not seem appealing for equity investors, but that implies current ROEs of 7-9% that banks such as Comerica Inc. and SunTrust Banks Inc. posted in the first quarter are about where they should be. But will they hold?

Investors will have to decide what entry price makes sense, which along with the decision of when to sell, is the only thing that an investor controls. For bankers there are only two logical conclusions: hack costs and/or merge. U.S. Bancorp's Davis, who runs one of the nation's best banks, commented that so far he had resisted special cost cutting and mass layoffs; however, I wonder how long even a high return bank like U.S. Bancorp can hold out if the Fed does not relent.

Jeff K. Davis, CFA
jeffdavis@mercercapital.com

What We're Reading

Thomas Michaud, CEO of KBW, talks about expectations for bank stocks and what those valuations mean for M&A in a video on *American Banker's* website entitled "Valuation: The Have and Have-Nots in M&A."

http://mer.cr/1Gk4p89

Chris Mercer, CEO of Mercer Capital, has an interesting piece where he takes a look at ways to unlock wealth in private companies and improve rates of returns for their owners in a piece entitled "Private Company Wealth Destruction or Current Wealth Realization?"

http://mer.cr/1MbZAM8

Mercer Capital's Resources for Depository Institutions

The Financial Institutions Group of Mercer Capital works with hundreds of depository institutions and other financial institutions annually providing a broad range of specialized resources for the financial services industry.

Newest Webinar

Sponsored by SNL Financial
Presenters from Mercer Capital and Sutherland Asbill & Brennan

An Introduction to Business Development Companies

In the hunt for yield, investors are increasingly setting their sights on business development companies (BDCs), which offer public equity investors access to portfolios of private equity investments. This webinar explored the features that have contributed to the growth in BDCs, underlying asset classes to which BDCs offer investors exposure, and highlighted the key performance metrics for evaluating BDCs. Our panel discussed relevant regulatory developments affecting BDCs, reviewed the portfolio valuation procedures and assumptions that influence quarterly profits, and explored the relative performance of key market benchmarks.

View webinar on SNL Financial's site at http://mer.cr/ZnauO7
Complimentary Download of Slides at http://mer.cr/1tuwzal

Webinars Available for Replay

An Overview of the Leveraged Lending Market and Bank Participation in the Market

There has been a flurry of media reports this year that regulators—especially the OCC—are intensifying scrutiny of leveraged lending. In this webinar we took a look at one of the fastest growing markets that has emerged post crisis.

View webinar on SNL Financial's site at http://mer.cr/VRc9JV

Understanding Deal Considerations

Key issues that we see when banks combine as it relates to valuing and evaluating a combination are reviewed. This is particularly critical when the consideration consists of shares issued by a buyer (or senior merger partner) whose shares are either privately held or are thinly traded.

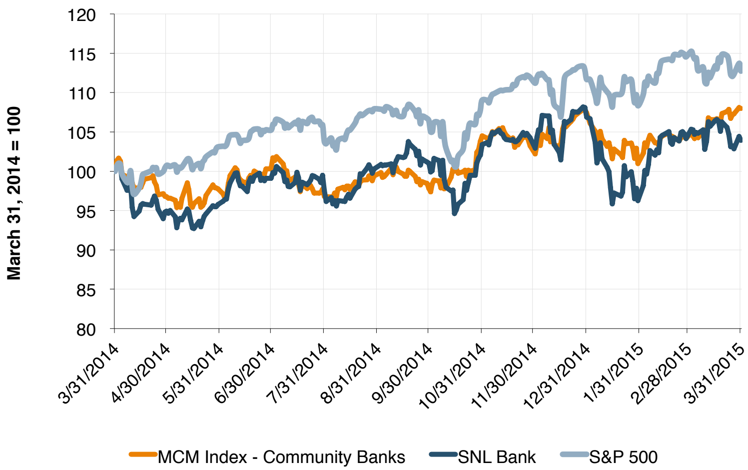
View replay at http://mer.cr/bnkweb2

Basel III Capital Rules Finally Final: What Does It Mean for Community Banks?

Finalized at last, the regulations provide direction for bank capital management decisions. This webinar, co-sponsored by Mercer Capital and Jones Day, reviews the final rules and assesses their impact on community banks.

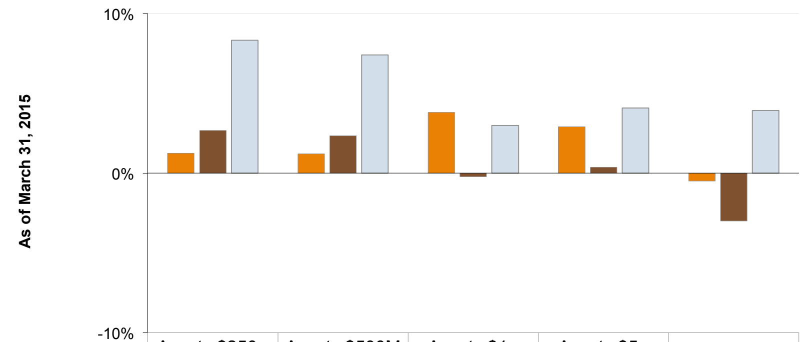
View replay at http://mer.cr/capital-rules-webinar

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



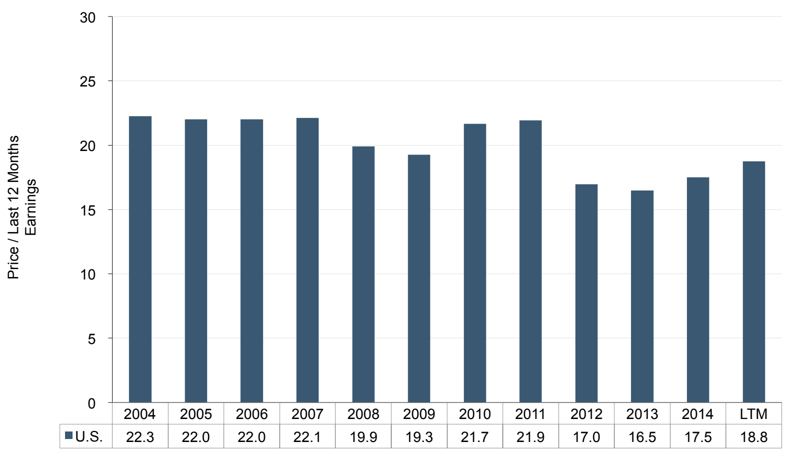
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	1.24%	1.20%	3.80%	2.91%	-0.50%
Quarter-to-Date	2.68%	2.33%	-0.22%	0.37%	-3.00%
Last 12 Months	8.33%	7.41%	2.99%	4.07%	3.93%

Median Valuation Multiples

	Median Total Return			Median Valuation Multiples as of March 31, 2015					
Indices	Month-to-Date	Quarter-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2015 (E) EPS	Price / 2016 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	4.22%	1.39%	11.21%	15.45	16.22	12.93	106.8%	113.8%	2.2%
Midwest Index	2.24%	-0.40%	7.62%	14.91	13.78	12.42	107.5%	124.8%	2.3%
Northeast Index	3.80%	-0.35%	4.93%	14.68	14.72	12.71	116.4%	122.2%	3.0%
Southeast Index	2.45%	1.54%	14.38%	12.08	14.41	13.50	106.9%	113.5%	1.6%
West Index	4.54%	0.91%	5.14%	15.85	14.45	13.08	119.4%	126.9%	2.4%
Community Bank Index	3.69%	0.55%	7.99%	14.88	14.91	12.78	111.2%	122.4%	2.4%
SNL Bank Index	**-0.23%**	**-2.77%**	**3.92%**						

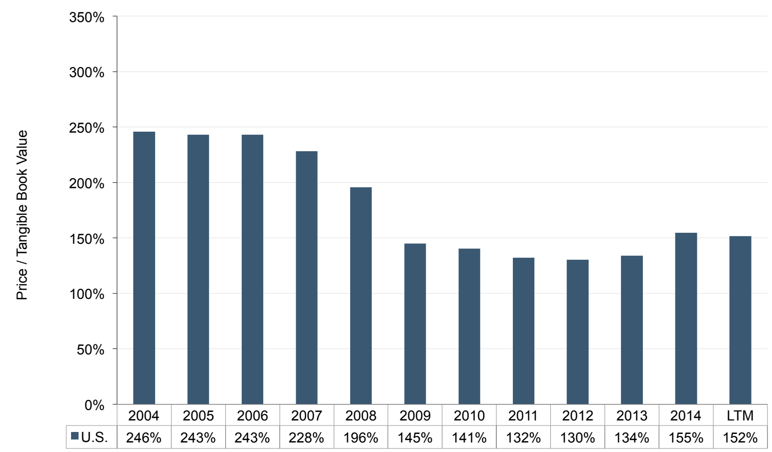
Median Price/Earnings Multiples

Target Banks' Assets <$5B and LTM ROE >5%



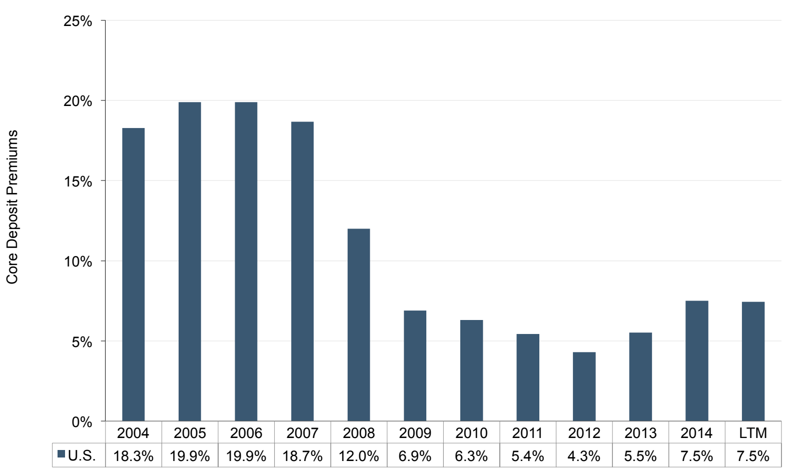
Median Price/Tangible Book Value Multiples

Target Banks' Assets <$5B and LTM ROE >5%



Median Core Deposit Multiples

Target Banks' Assets <$5B and LTM ROE >5%



Median Valuation Multiples for M&A Deals

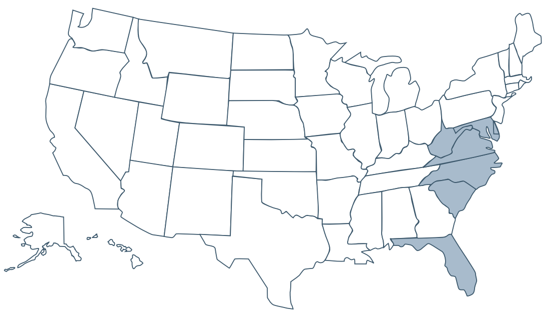
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended March 2015

Regions	Price / LTM Earnings	Price / Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value	Target's Median Assets	Target's Median LTM ROAE (%)
Atlantic Coast	19.93	1.56	6.7%	13	51.60	451,519	9.19%
Midwest	18.38	1.57	7.3%	72	35.89	107,801	9.04%
Northeast	21.90	1.71	8.9%	8	101.87	431,132	7.10%
Southeast	16.93	1.36	5.6%	29	50.58	198,314	8.23%
West	18.88	1.48	7.8%	17	65.51	359,964	9.16%
Nat'l Community Banks	**18.75**	**1.52**	**7.5%**	**139**	**50.00**	**200,005**	**8.93%**

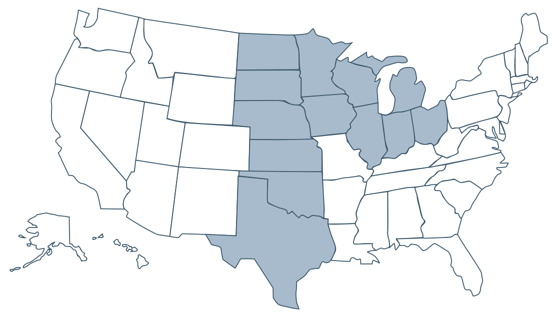
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

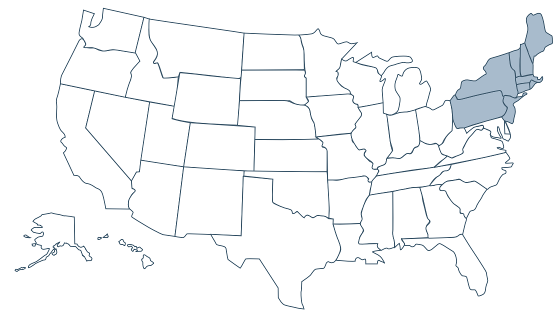
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



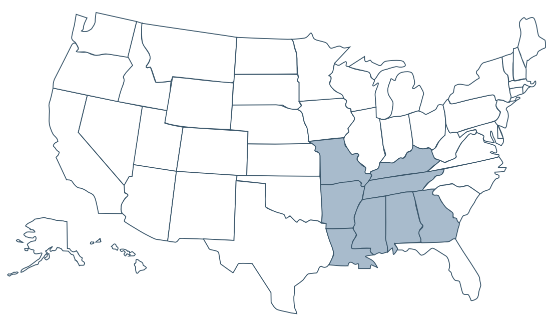
Atlantic Coast



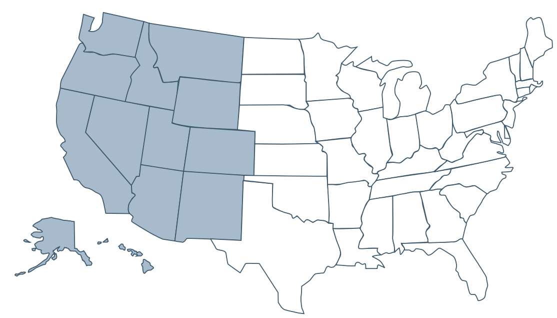
Midwest



Northeast



Southeast



West

Mercer Capital

Financial Institutions Services

About Mercer Capital

Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transactional advisory services, and other strategic decisions.

Mercer Capital pairs analytical rigor with industry knowledge to deliver unique insight into issues facing banks. These insights underpin the valuation analyses that are at the heart of Mercer Capital's services to depository institutions.

Mercer Capital is a thought-leader among valuation firms in the banking industry. In addition to scores of articles and books, *The ESOP Handbook for Banks* (2011), *Acquiring a Failed Bank* (2010), *The Bank Director's Valuation Handbook* (2009), and *Valuing Financial Institutions* (1992), Mercer Capital professionals speak at industry and educational conferences.

The Financial Institutions Group of Mercer Capital publishes *Bank Watch*, a monthly e-mail newsletter covering five U.S. regions. In addition, Jeff Davis, Managing Director, is a regular contributor to SNL Financial.

For more information about Mercer Capital, visit www.mercercapital.com.

Contact Us

Jeff K. Davis, CFA
615.345.0350
jeffdavis@mercercapital.com

Andrew K. Gibbs, CFA, CPA/ABV
901.322.9726
gibbsa@mercercapital.com

Jay D. Wilson, Jr., CFA, ASA, CBA
901.322.9725
wilsonj@mercercapital.com

Mercer Capital
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120 (P)

www.mercercapital.com