MERCER CAPITAL

Bank Watch

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Dissenting Shareholders and Bank Appraisals

Speak Now or Forever Hold Your Peace

Contrary to the silence that often occurs after the phrase – "Speak now or forever hold your peace" – is uttered in marriage ceremonies, the voice of dissent is being heard more frequently from shareholders dissenting to corporate unions.

Appraisal, or dissenters' rights, actions occur when shareholders dissent to a transaction and petition the court to determine the "fair value" of their shares. Dissenting actions are on the rise and have begun to receive considerable attention from attorneys, investors, and other deal makers.

For perspective, 40 appraisal action cases were brought in 2014 and 38 have been filed thus far in 2015 with claims totaling $2.1 billion, compared to just $129 million three years ago.[1] The press also has noted the rising use of appraisal arbitrage whereby hedge funds and activists purchase shares after a deal is announced and then dissent to trigger an appraisal action. Whether this is positive or negative for capital markets is subject to debate, although one could argue additional price discovery is not all bad.

As long as M&A activity remains robust, we would not expect the volume of appraisal actions to decline much given two recent high-profile awards to dissenters. In mid-2015, dissenters in connection with Albertson's acquisition of Safeway, Inc. received a 26% premium to the acquisition price, resulting in payments totaling more than $127 million.[2] In August 2015, the Delaware Chancery Court granted a 20% premium to dissenters in Dell's going-private transaction, resulting in an estimated $148 million award for dissenters (before statutory interest is applied).[3] The Dell and Albertson decisions are consistent with some studies concluding that Delaware courts tend to award a fair value greater than the merger price.[4] Further, the interest rate credited to the dissenter (discount rate plus 5.0%) between closing and the court's decision may be an incremental inducement to dissent given the current rate environment.

While high profile awards may be an inducement for more dissenting actions, it should be noted that dissenters do not always receive a higher price. For example, a Delaware ruling in June 2015 awarded dissenters in Cypress Semiconductor's 2012 acquisition of Ramtron International Corporation lower consideration (the merger price less synergies), while another Delaware ruling in October 2015 determined that the merger price in BMC Software, Inc.'s going private transaction in September 2013 represented fair value.[5]

Bank acquirers (and sellers) should consider the possibility of dissenters. The banking industry is not immune to appraisal actions as a **recent article** (posted on SNL.com – subscription required) noted a rise in activist involvement in a sector that can be characterized as a mature, consolidating industry with 3-4% of banks acquired annually.

A key question: what is fair value? Fair value in a dissenting shareholder action is not the same concept as fair value used in certain accounting contexts nor the fair market value standard used in many regulated transactions. Statutory fair value is defined in the corporate statutes of each state, while case law provides the courts' interpretation of the statutes. Delaware case law is the most extensive. In the case of a national bank, a shareholder dissenting to a transaction receives the "value" of his or her shares, as defined in the National Bank Act with additional guidance provided in the *Comptroller's Licensing Manual*.

Fair value usually is defined as the value of the dissenter's shares immediately before the action giving rise to the right to dissent without considering the impact of the transaction. Courts in some states view fair value as a control value, but without attributes that a strategic acquirer might consider relevant (e.g., merger synergies). Not surprisingly, disparate valuations can result from the application of premiums related to control and/or discounts related to minority status or illiquidity/marketability. Disagreements also can stem from the approaches used to value the shares. For example, consider the following quote from the *Weinberger v. UOP* case that the valuation "must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court." [6]

Against this backdrop, we discuss some of the basics of valuing a bank while acknowledging that each bank, transaction, and appraisal action is unique. Valuing a bank is, by its nature, forward looking with history serving as a guide. The process tends to revolve around three primary elements: earnings/cash flow, risk, and growth. Significant trade-offs can exist among these three elements. For example, a bank's earnings, dividend-paying capacity, and growth can be enhanced in the short- to intermediate-term by taking more risk, while the impact of the decision (usually credit losses) may not be evident for several years. A well-reasoned, defensible valuation will need to consider the potential trade-offs and the implications of higher earnings and growth today versus potential issues in the future.

Two common approaches to valuing a bank include the following:

1. **Income Approach.** The discounted cash flow ("DCF") method is an income approach whereby the bank's value is determined by summing the present value of cash flows generated from excess capital generated over the forecast period and the terminal value at end of forecast period. Key variables in a DCF method include distributable cash flow (i.e., existing and internally generated capital that is in excess of a reasonable threshold level), the terminal value multiple to apply to earnings and/or tangible book value in the terminal period, and the discount rate. If it is not obvious, it is worth noting that one attribute about banks that differs from non-financial companies is that the balance sheet drives the income statement rather than the opposite. Also, capital regulations are an additional governor on growth and/or distribution aspirations.

What We're Reading

Are Community Banks an Endangered Species?
BankDirector: Jack Milligan
http://mer.cr/1T1pl6X

Big Data and Predictive Analytics: A Big Deal, Indeed
ABA Banking Journal: Charles Keenan
http://mer.cr/1YiCyLz

2016 Bank M&A Survey: The Rising Importance of Scale
BankDirector: Emily McCormick
http://mer.cr/1PPQNVI

2. **Market Approach.** Using the market approach, the bank's value is determined based upon comparisons to transactions in public banks, whole bank acquisitions of both privates and publics, and/or transactions in the bank's own stock. The guideline public company or guideline transactions method involves utilizing pricing multiples derived from publicly traded banks or acquired banks bearing similarities to the subject bank such as business model, asset size, credit quality, geographic region, and profitability. Common bank valuation multiples include price/earnings, price/tangible book value, and core deposit premiums relative to tangible book value (control). Applying the guideline group multiples, inclusive of adjustments for fundamental differences between the subject bank and the guideline groups if necessary, can provide meaningful indications of value.

As in the BMC Software decision referenced previously, courts have found that the acquisition (or transaction) price to be fair value. We have **written** extensively on the topic of fairness from a financial point of view and the importance of process in M&A transactions. These same points often become key elements in appraisal actions and determining whether or not the merger price is a reasonable indication of the bank's fair value. While process is tricky to assess in any transaction, a process that is limited and favors insiders or particular bidders in the transaction may be viewed as flawed and provide less convincing evidence that the merger price is consistent with fair value.

While the Delaware courts appear to prefer the DCF method in appraisal actions, banks are unique because significant amounts of historical financial information and market data exist. For example, approximately 5,500 banks file financial statements quarterly in regulatory filings referred to as Call Reports. Benchmark profitability and industry trends are easy to discern. Additionally, there are approximately 340 NYSE and NASDAQ listed publicly traded banks, while 250 to 300 banks typically are acquired in a given year with reported pricing information available for many of these deals. Historical financial data and a sizable population of public companies and transactions usually allow an appraiser to produce meaningful indications of value from the market approach. These indications of value may serve as at least a sanity check for conclusions and key assumptions in the DCF method such as projected cash flows, discount rates, and terminal value estimates.

For this reason, it is important that the valuation of the bank in an appraisal action be prepared by an appraiser who is well versed in both valuation techniques and the banking industry. The appraiser should understand key valuation concepts as well as have a sound understanding of key factors/trends driving the banking industry, identify the impact of industry and regulatory trends on the subject bank, and deliver a reasoned and supported analysis in light of these trends.

Mercer Capital is a national business valuation and financial advisory firm. Financial institutions are the cornerstone of Mercer Capital's practice. Founded in 1982, in the midst of and in response to a previous crisis affecting the financial services industry, Mercer Capital has witnessed the industry's cycles. Today, as in 1982, Mercer Capital's largest industry concentration is financial institutions, and we have experts on staff that are well versed in both valuation techniques as well as the banking industry.

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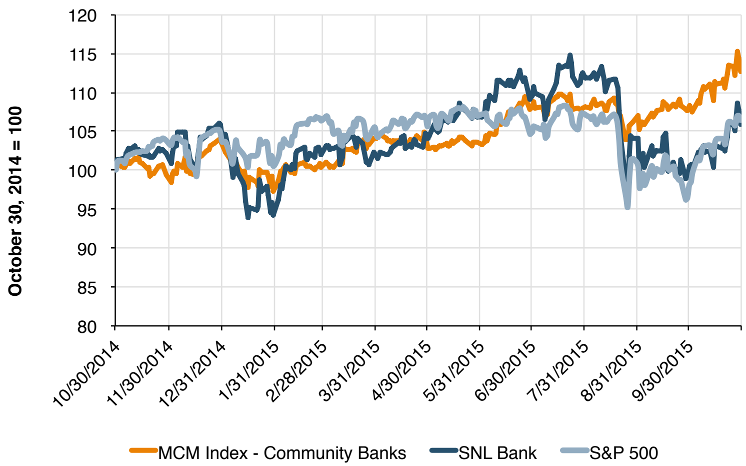
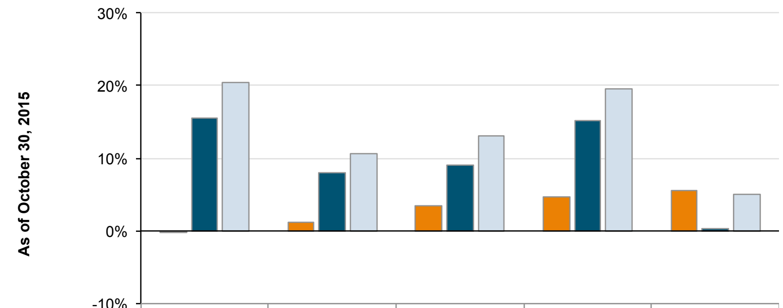
[1] http://www.wsj.com/articles/dole-executives-ordered-to-pay-148-million-in-buyout-lawsuit-1440686542.
[2] http://www.appraisalrightslitigation.com/2015/06/04/settling-safeway-shareholders-achieve-substantial-premium-within-six-months-of-closing/.
[3] http://www.appraisalrightslitigation.com/2015/08/27/dole-appraisal-case-yields-20-premium/.
[4] Jeremy Anderson & Jose P. Sierra, "Unlocking Intrinsic Value Through Appraisal Rights," Law360, Sept. 10, 2013, available at www.law360.com.
[5] http://www.appraisalrightslitigation.com/2015/10/23/delaware-chancery-looks-to-merger-price-in-bmc-software-ruling/. and http://www.appraisalrightslitigation.com/2015/07/06/with-unreliable-management-projections-and-no-market-based-models-delaware-chancery-pegs-fair-value-to-merger-price/.
[6] *Weinberger v. UOP*, Inc. (Del. 1983).

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



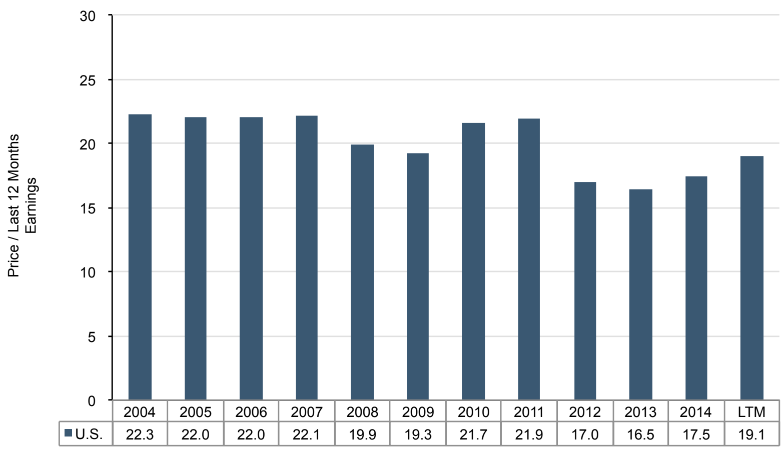
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-0.07%	1.12%	3.45%	4.74%	5.48%
Year-to-Date	15.49%	8.08%	8.98%	15.18%	0.30%
Last 12 Months	20.49%	10.61%	13.09%	19.60%	5.11%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of October 30, 2015					
Indices	Month-to-Date	Quarter-to-Date	Year-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	5.07%	5.07%	11.75%	17.04%	16.47	15.83	14.51	107.5%	117.5%	2.2%
Midwest Index	3.27%	3.27%	8.08%	11.43%	14.45	14.18	12.64	113.8%	130.3%	2.3%
Northeast Index	4.18%	4.18%	6.01%	8.36%	14.46	14.85	13.44	114.5%	129.1%	3.0%
Southeast Index	2.88%	2.88%	8.92%	16.70%	12.42	14.71	13.84	102.4%	106.7%	1.6%
West Index	3.72%	3.72%	12.53%	13.34%	17.01	17.61	14.09	115.2%	125.2%	2.6%
Community Bank Index	3.99%	3.99%	8.90%	12.70%	14.89	15.03	13.77	112.4%	123.6%	2.3%
SNL Bank Index	**5.36%**	**5.36%**	**1.14%**	**5.91%**						

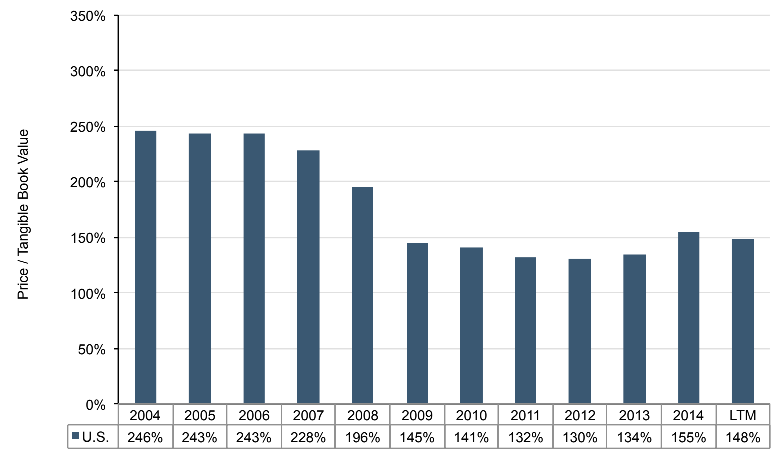
Median Price/Earnings Multiples

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



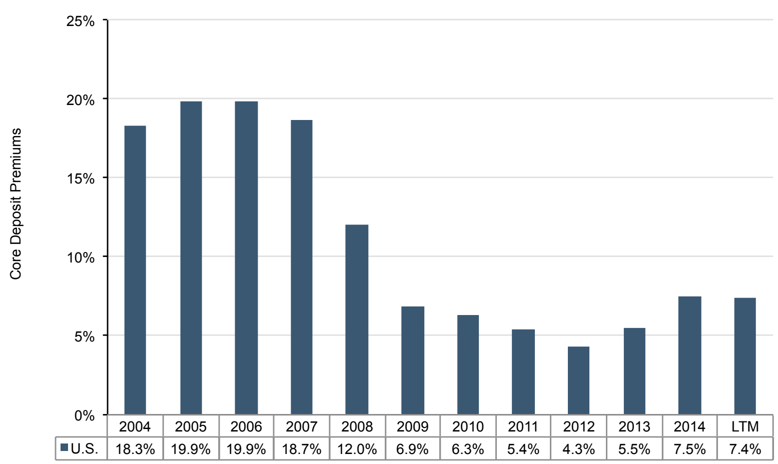
Median Price/Tangible Book Value Multiples

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

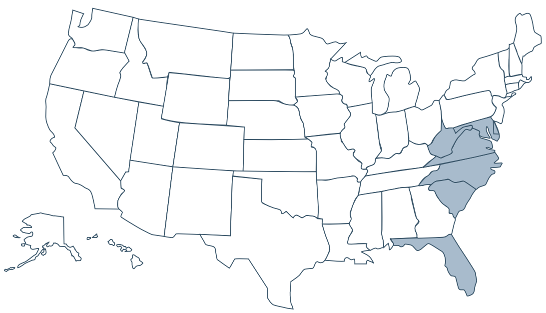
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended October 2015

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	18.16	1.60	7.8%	17	82.59	501,856	7.22%
Midwest	18.23	1.57	7.9%	68	41.02	119,262	8.95%
Northeast	22.58	1.39	7.3%	9	53.28	395,284	6.69%
Southeast	19.65	1.39	6.2%	24	32.20	174,920	7.78%
West	18.84	1.48	7.0%	15	42.85	201,457	9.31%
National Community Banks	**19.08**	**1.48**	**7.4%**	**133**	**43.42**	**196,960**	**8.29%**

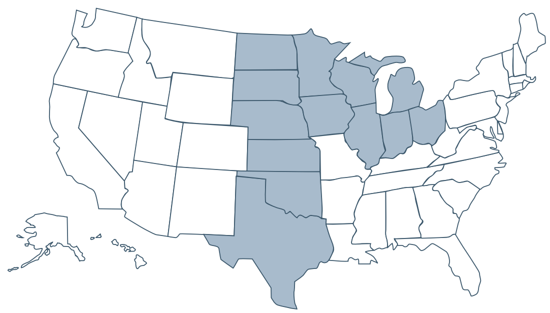
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

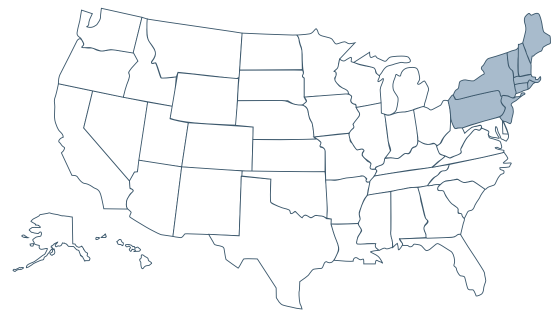
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



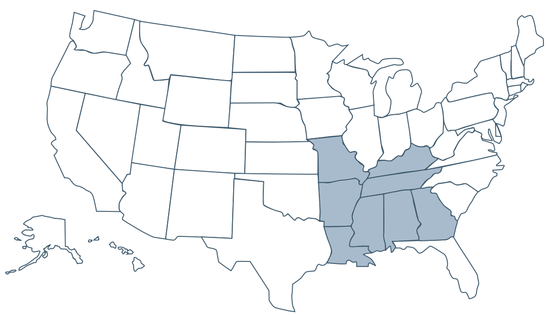
Atlantic Coast



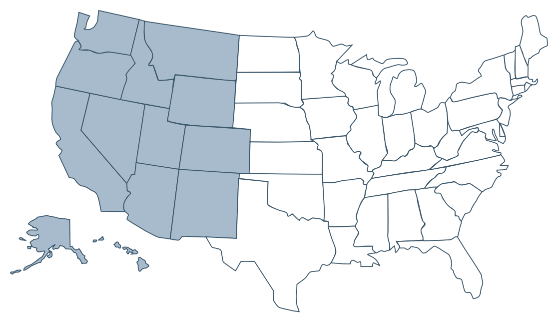
Midwest



Northeast



Southeast



West

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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.

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- Financial reporting for banks
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- Litigation support
- Loan portfolio valuation
- Tax compliance
- Transaction advisory
- Strategic planning

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

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