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BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

Fairness Opinions

Evaluating a Buyer's Shares from the Seller's Perspective

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REASURY DEPARTME

Fairness Opinions

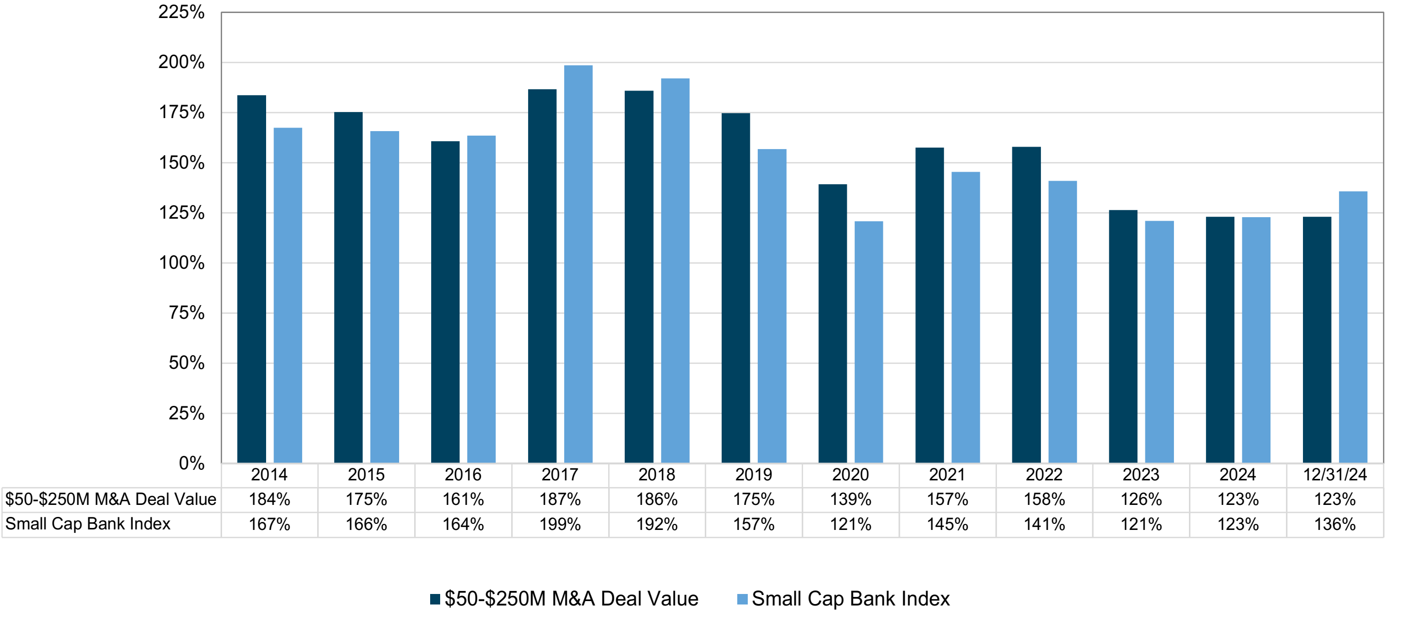
Evaluating a Buyer’s Shares from the Seller’s Perspective

Bank and thrift M&A activity rose off the bottom in 2024, but not by much while pricing remained modest by historical standards. There were 129 transactions in 2024 that equated to 2.7% of January 1 bank charters compared to the multi-decade low of 101 transactions in 2023 (2.1%). Transactions with a disclosed value increased to 54 with an aggregate value of $16.8 billion from 26 deals in 2023 ($4.2 billion), though the aggregate value this year was the sixth lowest since 1990.

The set-up as of year-end 2024 is for more M&A activity in 2025 provided fair value “rate marks” applied to seller balance sheets do not become a bigger hurdle with further increases in intermediate- and long-term rates.

- Institutional investors have supported M&A by funding nine common raises buyers undertook to strengthen post-closing capital ratios.
- Bank stocks as acquisition currencies improved as P/E multiples expanded to 11-13x consensus 2025 estimates compared to 9-11x consensus 2024 estimates last year.
- Earnings are expected to improve in 2025 after two years of contraction for many banks as NIMs stabilize or improve while credit costs increase only modestly.
- The incoming Trump Administration is expected to pursue policies that are business friendly, including the appointment of bank regulators who nix or modify a range of burdensome regulatory edicts and more quickly approve merger applications.

Public Market P/TBV vs M&A P/TBV



	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	12/31/24
$50-$250M M&A Deal Value	184%	175%	161%	187%	186%	175%	139%	157%	158%	126%	123%	123%
Small Cap Bank Index	167%	166%	164%	199%	192%	157%	121%	145%	141%	121%	123%	136%

Source: S&P Global Market Intelligence and Mercer Capital; P/TBV values for the Small Cap Bank Index for 2014-2024 represent the average values for each year, except for the spot value as of 12/31/24.

To be clear, M&A activity follows the public market as shown in Figure 1. When public market valuations improve, M&A activity and multiples have a propensity to increase as the valuation of the buyers' shares trend higher. When bank stocks are depressed for whatever reason, acquisition activity usually falls, and multiples decline.

Excluding small transactions, the issuance of common shares by bank acquirers usually is the dominant form of consideration sellers receive. While buyers have some flexibility regarding the number of shares issued and the mix of stock and cash, buyers are limited in the amount of dilution in tangible book value per share ("TBVPS") they are willing to accept and require visibility in EPS accretion over the next several years to recapture the dilution.

Because the number of shares will be relatively fixed, the value of a transaction and the multiple(s) the seller hopes to realize are a function of the buyer's valuation. High multiple stocks represent strong acquisition currencies for acquisitive companies because fewer shares are issued to achieve a targeted dollar value.

It is important for sellers to keep in mind that negotiations with acquirers where the consideration will consist of the buyer's common shares are about the exchange ratio rather than price, which is the product of the exchange ratio and buyer's share price. A fairness opinion will address the fairness of the exchange ratio and consideration received by selling shareholders, not "price" per se in a stock swap transaction.

Unlike cash deals, comparing and assessing fairness (and value) when stock swap offers are received requires a lot more deliberation by a board of directors and its advisor. One offer may entail a higher nominal price, but the acquirer's shares may trade at a premium whereas a competing offer may equate to a lower price but the shares may entail less risk. Also, exchange ratios can be evaluated based upon the pro forma ownership of the acquirer post-closing compared with the contribution of operating income, core deposits and the like.

When sellers focus on price, it is easier all else equal for acquirers to ink a deal when their shares trade at a high multiple of TBVPS and EPS. However, high multiple stocks represent an under-appreciated risk to sellers who receive the shares as consideration. Accepting the buyer's stock raises a number of questions, most of which fall into the genre of: what are the investment merits of the buyer's shares? The answer may not be obvious even when the buyer's shares are actively traded.

Our experience is that some if not most members of a board weighing an acquisition proposal do not have the background to thoroughly evaluate the buyer's shares. Even when financial advisors are involved, there still may not be a thorough vetting of the buyer's shares because there is too much focus on "price" instead of, or in addition to, "value."

A fairness opinion is more than a three or four page letter that opines as to the fairness from a financial point of the consideration to be received; it should be backed by a robust analysis of all of the relevant factors considered in rendering the opinion, including an evaluation of the shares to be issued to the selling company's shareholders. The intent is not to express an opinion about where the shares may trade in the future, but rather to evaluate the investment merits of the shares before and after a transaction is consummated.

Key questions to ask about the buyer's shares include the following:

Liquidity of the Shares

What is the capacity to sell the shares issued in the merger? SEC registration and NASADAQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently. OTC traded shares should be scrutinized, especially if the acquirer is not an SEC registrant. Generally, the higher the institutional ownership, the better the liquidity. Also, liquidity may improve with an acquisition if the number of shares outstanding and shareholders increase sufficiently.

Profitability and Revenue Trends

The analysis should consider the buyer's historical growth and projected growth in revenues, pretax pre-provision operating income and net income as well as various profitability ratios before and after consideration of credit costs. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.

Pro Forma Impact

The analysis should consider the impact of a proposed transaction on the pro forma balance sheet, income statement and capital ratios in addition to dilution or accretion in earnings per share and tangible book value per share both from the seller's and buyer's perspective.

Tangible BVPS Earn-Back

As noted, the projected earn-back period in tangible book value per share is an important consideration for the buyer. In the aftermath of the GFC, an acceptable earn back period was on the order of three to five years; today, two to three years may be the required earn-back period absent other compelling factors. Earn-back periods that are viewed as too long by market participants is one reason buyers' shares can be heavily sold when a deal is announced that otherwise may be compelling.

Dividends

In periods marked by lower interest rates, dividend paying stocks have greater attraction. Sellers should not be overly swayed by the pick-up in dividends from swapping into the buyer's shares; however, multiple studies have demonstrated that a sizable portion of an investor's return comes from dividends over long periods of time. Sellers should examine the sustainability of current dividends and the prospect for increases (or decreases). Also, if the dividend yield is notably above the peer average, the seller should ask why? Is it payout related, or are the shares depressed?

Capital and the Parent Capital Stack

Sellers should have a full understanding of the buyer's pro-forma regulatory capital ratios both at the bank-level and on a consolidated basis (for large bank holding companies). Separately, parent company capital stacks often are overlooked because of the emphasis placed on capital ratios and the combined bank-parent financial statements. Sellers should have a complete understanding of a parent company's capital structure and the amount of bank earnings that must be paid to the parent company for debt service and shareholder dividends.

Loan Portfolio Concentrations

Sellers should understand concentrations in the buyer's loan portfolio, outsized hold positions, and a review the source of historical and expected losses.

Ability to Raise Cash to Close

What is the source of funds for the buyer to fund the cash portion of consideration? If the buyer has to go to market to issue equity and/or debt, what is the contingency plan if unfavorable market conditions preclude floating an issue?

Consensus Analyst Estimates

If the buyer is publicly traded and has analyst coverage, consideration should be given to Street expectations vs. what the diligence process determines. If Street expectations are too high, then the shares may be vulnerable once investors reassess their earnings and growth expectations.

Valuation

Like profitability, valuation of the buyer's shares should be judged relative to its history and a peer group presently and relative to a peer group through time to examine how investors' views of the shares may have evolved through market and profit cycles.

Share Performance

Sellers should understand the source of the buyer's shares performance over several multi-year holding periods with returns disaggregated into three components: EPS growth, multiple expansion or contraction, and the impact of reinvested dividends. If the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.

Strategic Position

Assuming an acquisition is material for the buyer, directors of the selling board should consider the strategic position of the buyer, asking such questions about the attractiveness of the pro forma company to other acquirers?

Contingent Liabilities

Contingent liabilities are a standard item on the due diligence punch list for a buyer. Sellers should evaluate contingent liabilities too.

The list does not encompass every question that should be asked as part of the fairness analysis, but it does illustrate that a liquid market for a buyer's shares does not necessarily answer questions about value, growth potential and risk profile. When one surveys the M&A history of banks, there is no shortage of sellers who were waylaid by the performance of the buyer's shares after the deal closed. We at Mercer Capital have extensive experience in valuing and evaluating the shares (and debt) of financial and non-financial service companies garnered from over four decades of business.

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