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Creating Strategic Value Through Financial Technology

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www.mercercapital.com

About the Presenter

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Jay Wilson, Vice President, is a senior member of Mercer Capital's Depository Institutions practice. Jay also leads Mercer Capital's Financial Technology industry team and publishes research related to the FinTech industry. He is also the author of the new book, *Creating Strategic Value through Financial Technology* (Wiley Finance Series).

Jay's practice involves in the valuation of depository institutions and FinTech companies for purposes including ESOPs, mergers and acquisitions, profit sharing plans, estate and gift tax planning, compliance matters, and corporate planning.

Outline of Today's Presentation

Community Banks Are Facing Challenging Market Conditions

Why Do Large Banks Outperform? Is There Any Hope?

How FinTech Can Help Create Strategic Value

How Banks Can Develop a FinTech Framework

Build, Buy, or Partner (and Possibly Invest)

Conclusion / Questions

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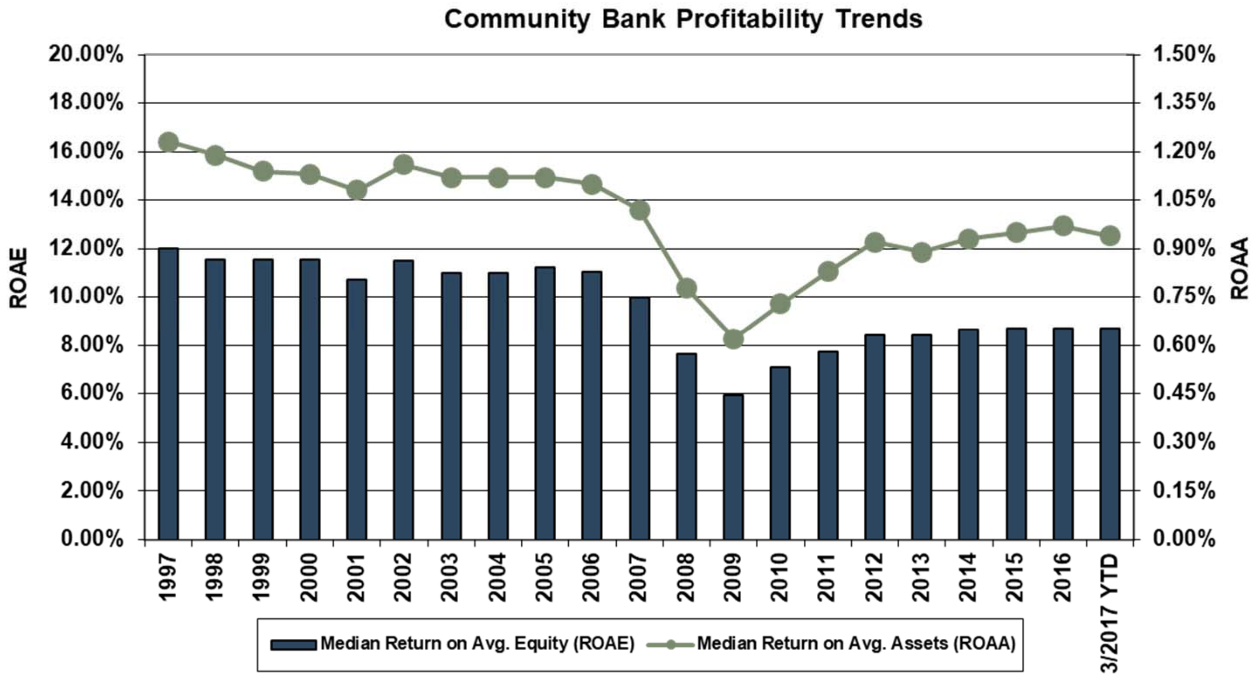
SECTION 1

Community Banks Are Facing Challenging Market Conditions

Community Banks Are Not Earning Their Cost of Capital…



Source: Mercer Capital Research and S&P Global Market Intelligence

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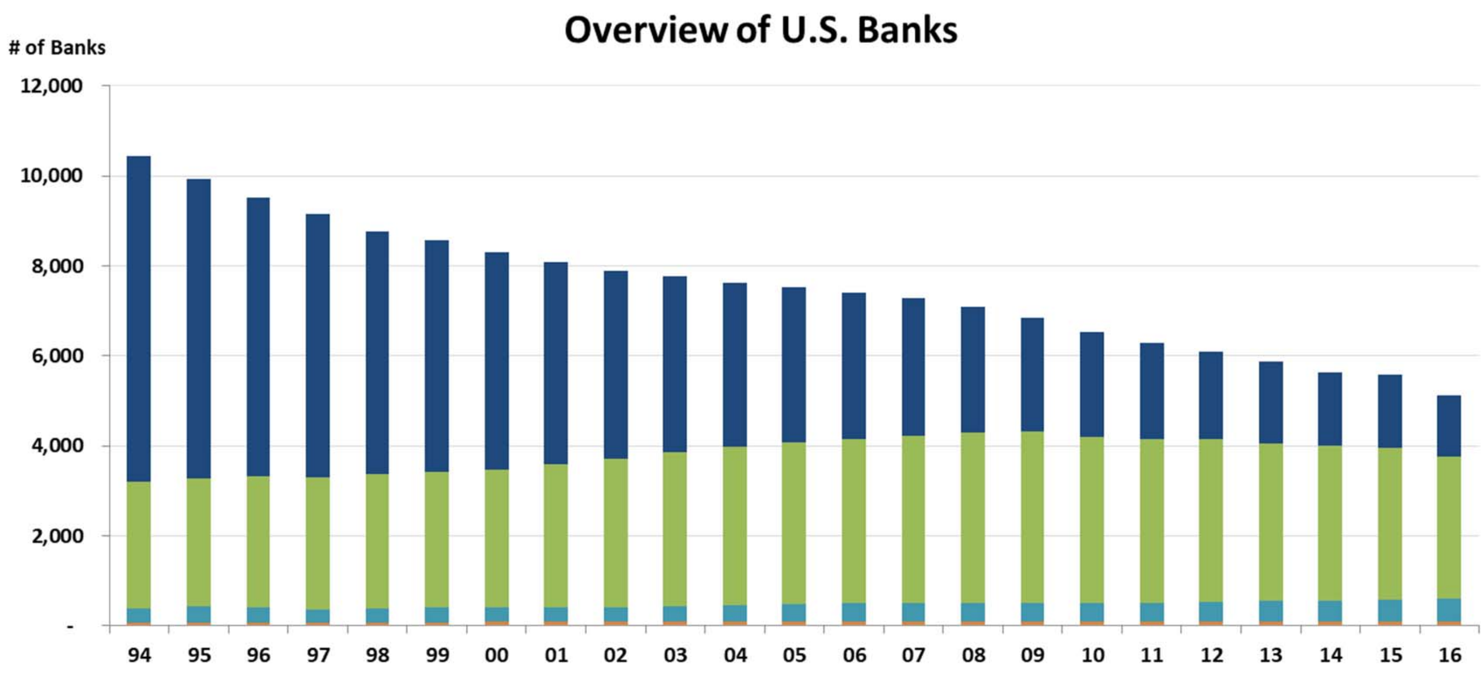
Declining in Number…



Source: QBPR, www.fdic.gov

Facing Elevated Regulatory Burdens…

Call Reports Are Significantly Longer

- < 10 Pages up until the mid-1980s
- Today > 80 pages

Sharp increase in both the number of new banking acts and the length of those acts in each decade since the 1960s

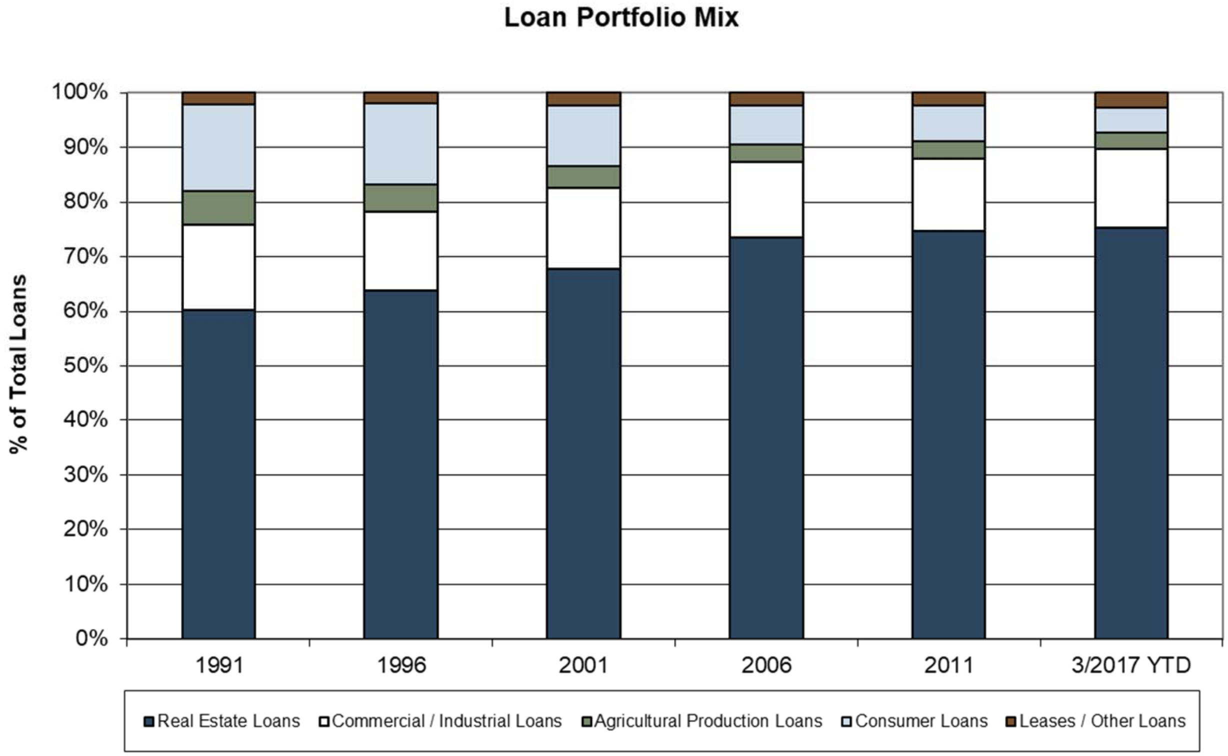
- From 2001–2010, there were 10 new banking acts that became law and totaled approximately 2,000 pages of new legislation

Hiring additional staff to handle this growing regulatory and compliance burden can have a significant impact on bank profitability

- Feldman, Schmidt, and Heinecke (2013) at the Federal Reserve Bank of Minneapolis found a reduction in profitability of 45 basis points for increasing staff by two people for smallest banks (less then $50 million in assets)

Source: First Two Bullet Points http://mail1.dallasfed.org/assets/documents/banking/firm/fi/2015/fi1504.pd
Last Bullet Point "Quantifying the Costs of Additional Regulation on Community Banks," by Ron J. Feldman, Jason Schmidt, and Ken Heinecke, *Economic Policy Paper 13-3, Federal Reserve Bank of Minneapolis*, May 30, 2013.

Developing Greater Concentration Risk…



Source: Mercer Capital Research and S&P Global Market Intelligence

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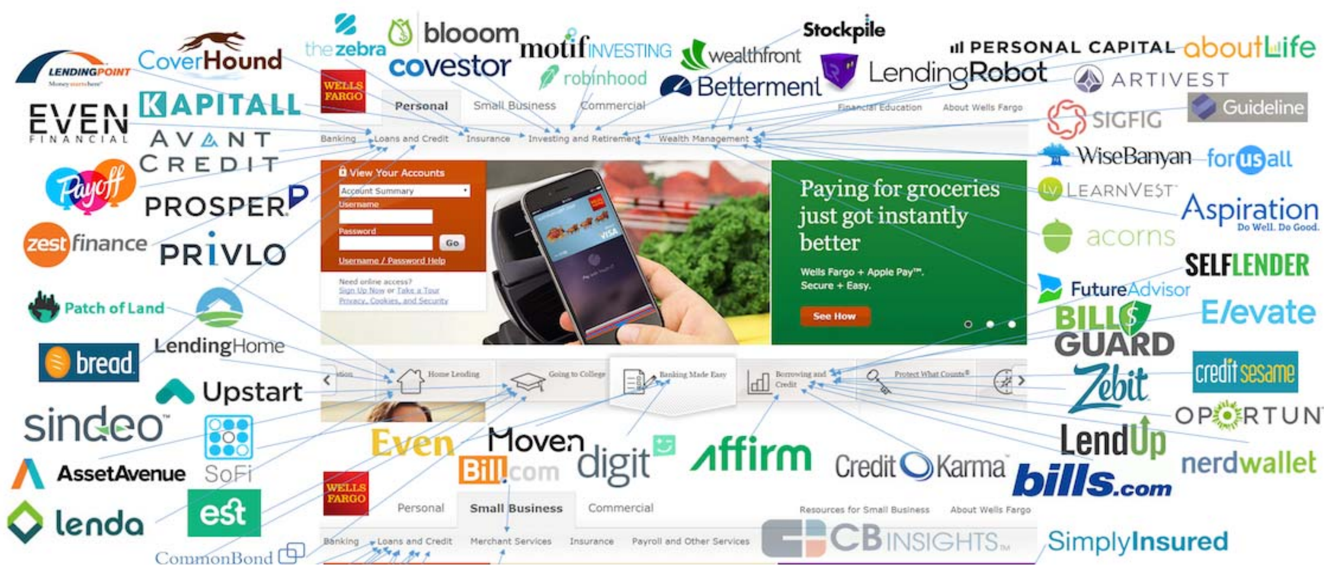
Facing More Competition from Non-Banks…

Unbundling of a Bank



Source: CB Insights
https://www.cbinsights.com/blog/disrupting-banking-fintech-startups/

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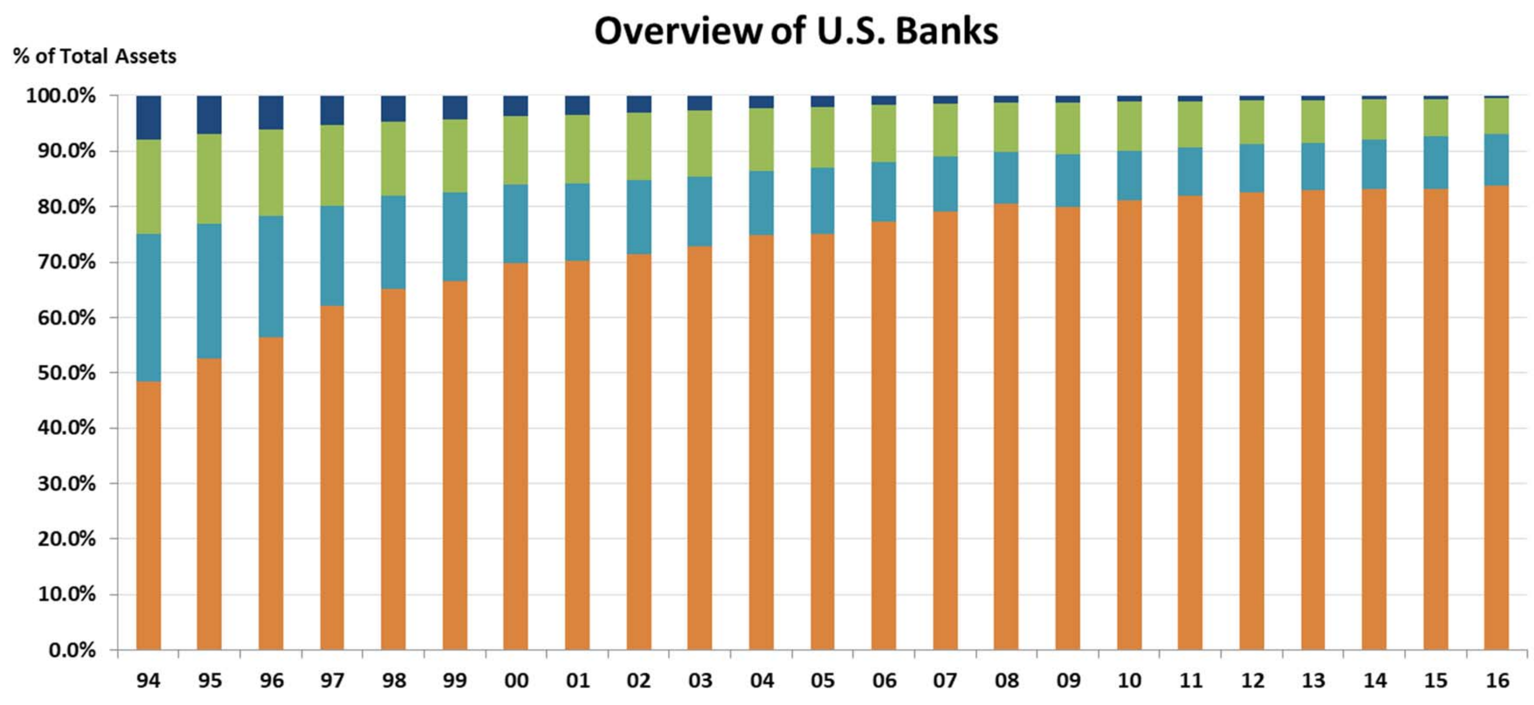
Losing Market Share to Larger Banks, and…



Source: QBPR, www.fdic.gov

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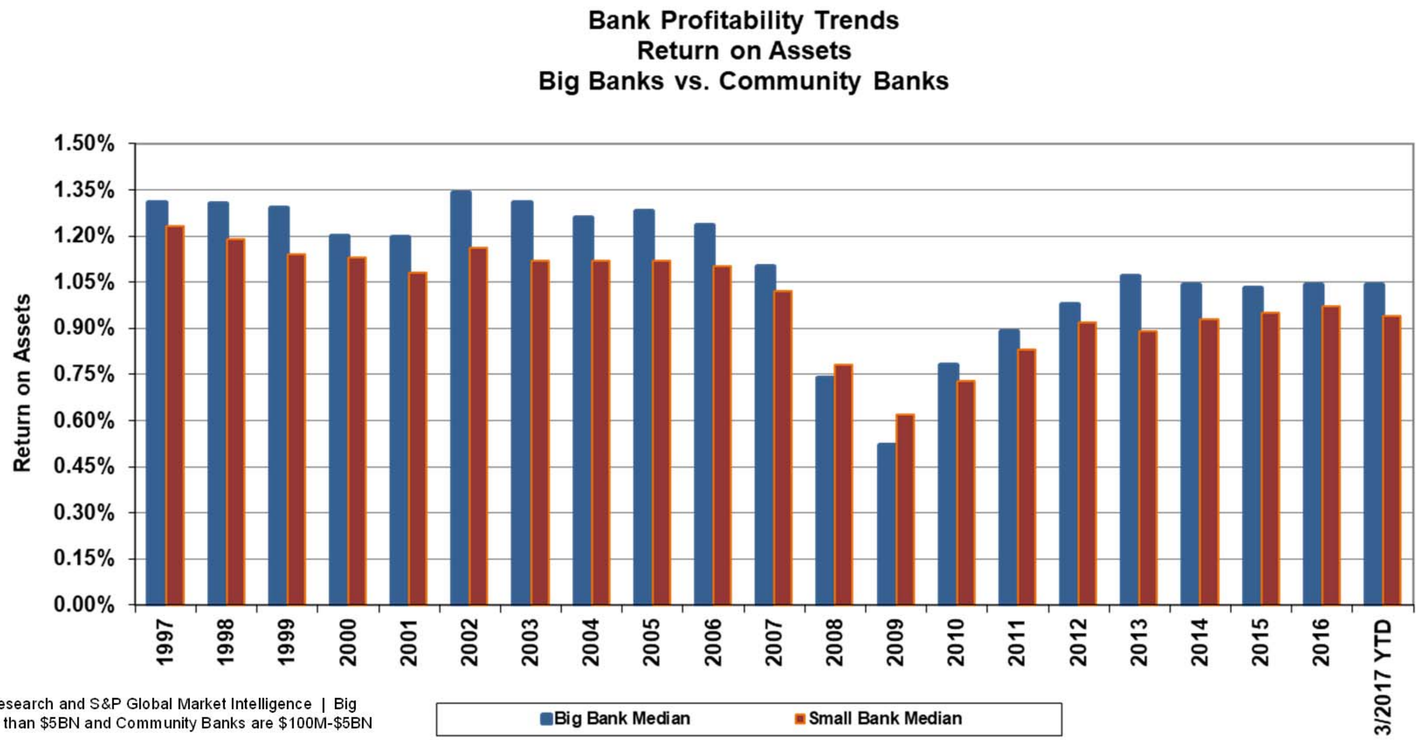
Less Profitable Than Larger Banks

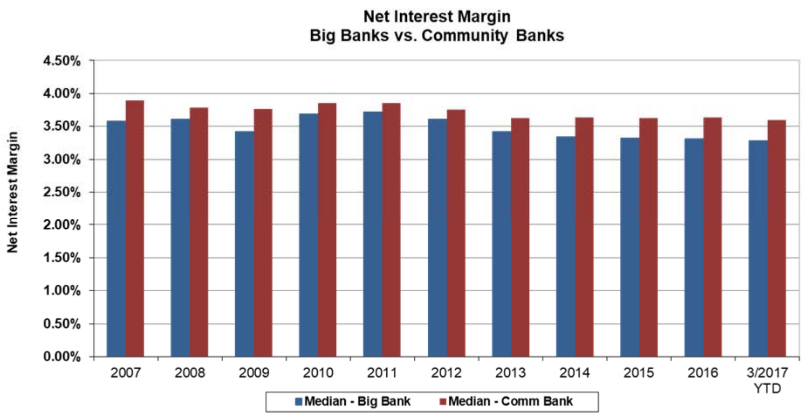


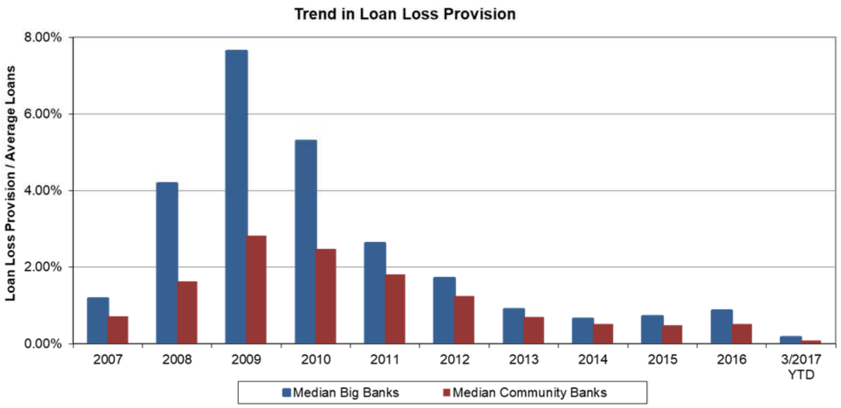
Source: Mercer Capital Research and S&P Global Market Intelligence | Big Banks are Assets Greater than $5BN and Community Banks are $100M-$5BN

Section 2

Why Do Large Banks Outperform?
Is There Any Hope?

Why Do Large Banks Outperform?





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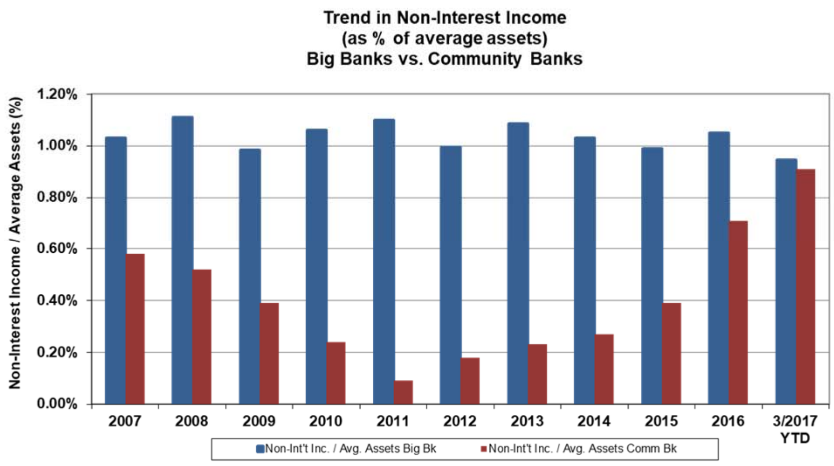
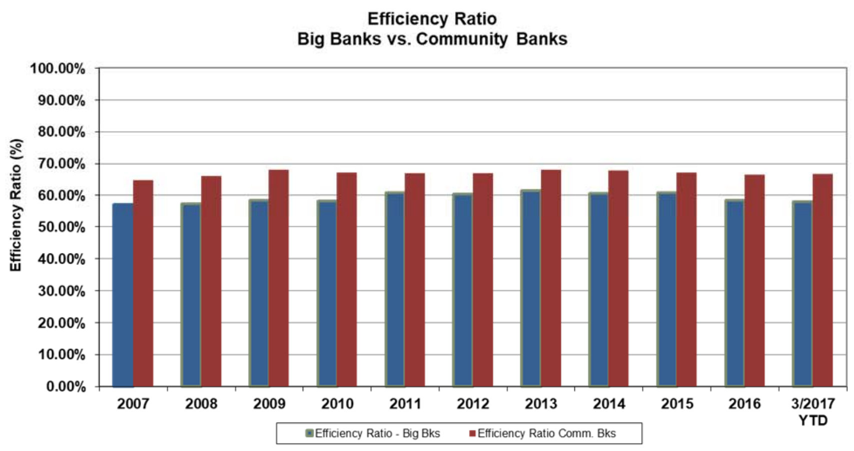
Why Do Large Banks Outperform?






Is There Any Hope?

What About FinTech?

Many FinTech companies are focused on areas where community banks have historically underperformed: efficiency and non-interest revenues…

Source: "The Future of Financial Services and Technology Explained," BI Intelligence, April 7, 2016
http://www.businessinsider.com/fintech-ecosystem-financial-technology-explained-2016-3

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Section 3

How FinTech Can Help Create Strategic Value for Your Bank

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How FinTech Can Help Create Strategic Value

Enhance Customer Satisfaction and Reduce Cost (i.e., improve efficiency)…

Costs to Service Deposits	$4.00
Costs to Service Digital Deposits	$0.15
Difference	*$3.85*
# of Deposit Accounts	*20,000*
Transactions Shifted to Mobile/Month	*2*
Pre-Tax Cost Savings Per Month	**$154,000**
Pre-Tax Cost Savings to the Bank	**$1,848,000**

Source: Creating Strategic Value Through Financial Technology

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How FinTech Can Help Create Strategic Value

Improve Profitability…

	Trad'l Comm. Bank	FinTech Comm. Bank
Net Interest Income	36,000	36,000
Non-Int't Income	10,000	12,500
Non-Int't Operating Expenses	(31,050)	(30,313)
Pre-Tax, Pre-Provision Inc.	14,950	18,188
Provision Expenses	(2,160)	(2,160)
Pre-Tax Inc.	12,790	16,028
Taxes	(4,477)	(5,610)
Net Income	**$8,314**	**$10,418**
ROAA	***0.83%***	***1.04%***
ROTE	***9.24%***	***11.58%***
Avg. Equity	90,000	90,000
Avg. Loans	720,000	720,000
Avg. Earning Assets	900,000	900,000
Avg. Assets	1,000,000	1,000,000
Net Int't Margin	4.00%	4.00%
Non-Int't Inc./Avg. Assets	1.00%	1.25%
Efficiency Ratio	67.50%	62.50%
Provision Exp. / Avg. Loans	0.30%	0.30%

$s are in $000s

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How FinTech Can Help Create Strategic Value

Valuation Multiple Expansion…

Banks with higher levels of non-interest income and efficiency are more profitable and receive higher valuation multiples (holding asset size constant)

Public Company Group Description	Price / LTM Core EPS	Price / Tangible Book Value	Core ROATCE
National Banks: Assets $500 Mil - $1 Bil	16.2x	1.34x	8.84%
High Non-Int't Income	15.0x	1.51x	10.70%
Low Efficiency Ratio	16.1x	1.42x	9.16%

Source: S&P Global Market Intelligence
Market Pricing Information as of March 31, 2017
* *Non-Interest Income / Assets > 1% in LTM Period*
** *Efficiency Ratio < 65% in LTM Period*

How FinTech Can Help Create Strategic Value

	Implied Financial Performance			Price-to-Earnings Multiple			
	Net Income	ROAA	ROTE	10.0	12.5	15.0	17.5
	7,000	0.70%	7.78%	70,000	87,500	105,000	122,500
Traditional Bank	**8,000**	**0.80%**	**8.89%**	80,000	**100,000**	**120,000**	140,000
	9,000	0.90%	10.00%	90,000	112,500	135,000	157,500
FinTech Bank	10,000	1.00%	11.11%	100,000	**125,000**	**150,000**	175,000
	11,000	1.10%	12.22%	110,000	137,500	165,000	192,500

$s are in $000s

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Section 4

How Banks Can Develop a FinTech Framework

FinTech Framework

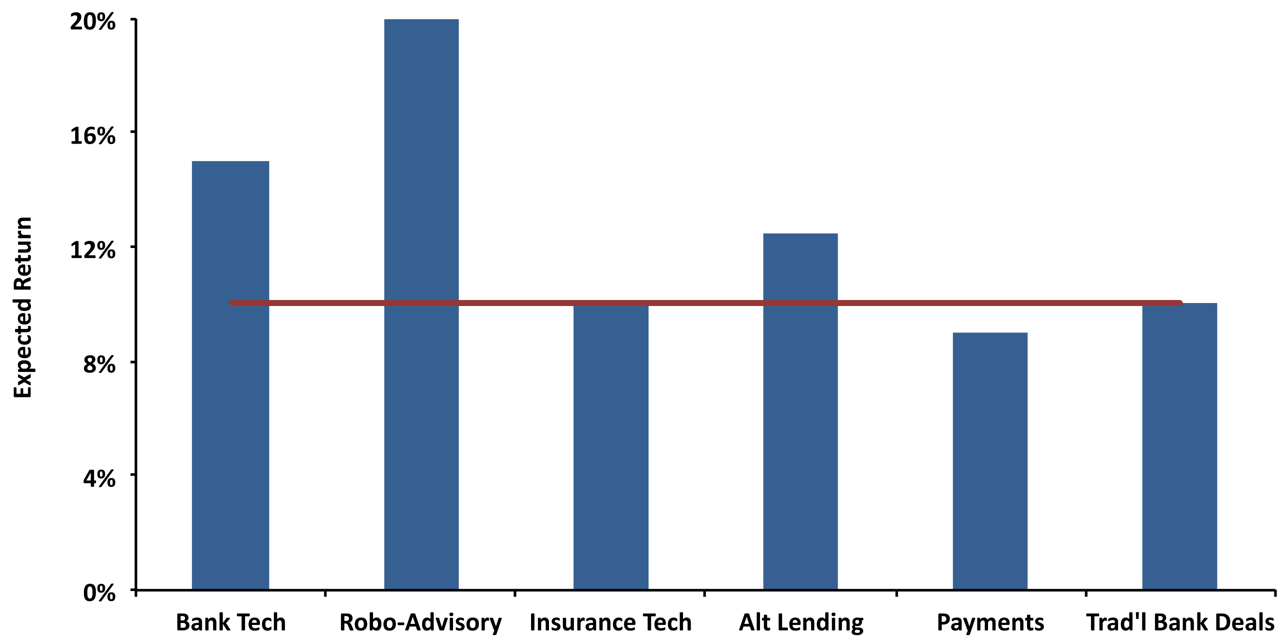
1. Identify attractive FinTech niches
2. Identify attractive FinTech companies in those niches
3. Develop a business case with estimated Internal Rates of Return (IRRs)
    - Examine build, partner (and possibly invest) strategic decision
4. Compare IRRs from FinTech strategies to traditional strategies

Step 1. Identify Attractive FinTech Niches

Key objectives from Bank’s strategic plan:

- Grow and diversify revenue base in less capital intensive businesses, particularly non-interest income
- Customer surveys indicate an interest in providing more financial and wealth management solutions
- Would like to create an additional touch point with customers
- However, historically haven’t been able to attract traditional asset managers/RIAs to the bank due to cultural differences
- ***Bank would like to explore robo-advisory offerings further***

Step 1. Identify Attractive FinTech Niches



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Step 2. Identify Attractive FinTech Companies

Robo-advisors are separated into three tiers

1. Tier I consists of early robo-advisory firms who have positioned themselves at the top of the industry.
2. Tier II consists of more recent robo-advisory startups that are experiencing rapid growth and are ripe for partnership.
3. Tier III consists of robo-advisory services of traditional players who have decided to build and run their own technology in-house

Comparison of Key Metrics of Selected Robo-Advisory Services

	AUM (B)	Fee Structure	Account Minimum
Tier I			
Betterment	$4	0.35% annual fee on <$10k, 0.25% on $10k to $100k, 0.15% on $100k+	$0
WealthFront	$3	0.25% on all accounts	$500
Personal Capital	$2	0.89% annually on <$1MM, 0.79% on $3MM, 0.69% on $5MM, 0.59% on <$10MM, 0.49% on >$10MM	$25,000
Tier II			
FutureAdvisor	$1	0.5% Annual Fee of assets managed	$0
SigFig	$0	No fee on first $10k, 0.25% annual fee on accounts over $10k	$2,000
Tier III			
Vanguard Personal Advisor	$31	0.30% annually	$50,000
Schwab Intellingent Portfolio	$5	No fees for account management and service	$5,000

Source: Mercer Capital Research, Company Websites, as of June 2016

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Step 3. Develop a Business Case

Once the FinTech niche and target companies are identified, there are a number of strategic options to consider

Each has varying degrees of commitment

Key question is often: Should we build, buy, or partner (and possibly make an investment)?

One way to answer that question is to look at potential returns from each strategy and compare

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Step 3. Develop a Business Case

IRR Comparisons of Different Approaches

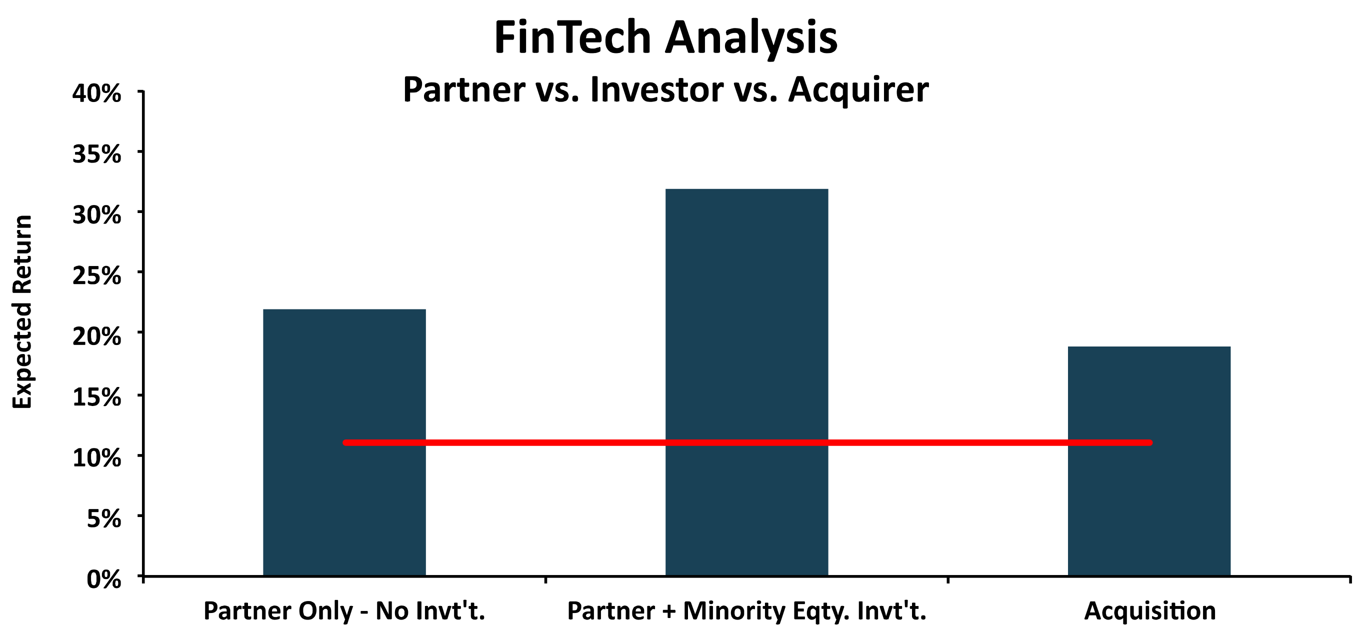
FinTech Partnership (Licensing)	Initial	Year 1	Year 2	Year 3	Year 4	Year 5
Cost Outlay	(100,000)	(275,000)	(275,000)	(275,000)	(275,000)	(275,000)
Revenue Enhancement		300,000	306,000	312,120	318,362	324,730
Total Cash Flows	(100,000)	25,000	31,000	37,120	43,362	49,730
Internal Rate of Return	**22%**					

FinTech Partnership + Minority Investment	Initial	Year 1	Year 2	Year 3	Year 4	Year 5
Cost Outlay	(100,000)	(250,000)	(250,000)	(250,000)	(250,000)	(250,000)
Equity Investment	(1,000,000)					
IPO / Sale Proceeds						4,000,000
Revenue Enhancement		300,000	300,000	300,000	300,000	300,000
Total Cash Flows	(1,100,000)	50,000	50,000	50,000	50,000	4,050,000
Internal Rate of Return	**32%**					

FinTech (Full Acquisition)						
Internal Rate of Return (Full Acquisition)	**Closing**	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Deal Consideration	(25,000,000)					
Closing Costs	(2,000,000)					
Opportunity Cost of Cash		(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)	(1,000,000)
Cash Flows Generated from Target		0	1,000,000	2,000,000	3,000,000	4,000,000
Terminal Value						60,000,000
Total Cash Flows	(27,000,000)	(1,000,000)	0	1,000,000	2,000,000	63,000,000
Internal Rate of Return	**19%**					

Step 3. Develop a Business Case

IRR Comparisons of Different Approaches



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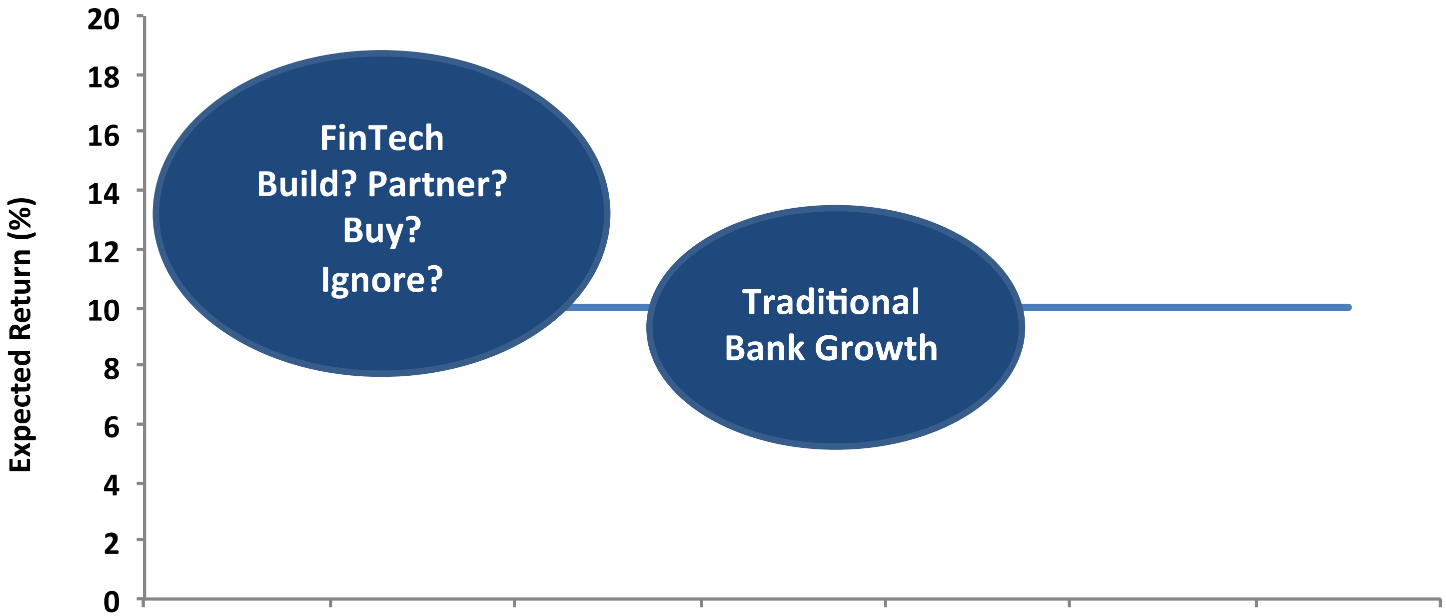
Step 4. Compare IRRs from FinTech vs. Traditional Strategies



The Challenges for Banks

Vast array of start-ups to consider

FinTech acquisitions/investments can be difficult to consider and structure

- Valuations of FinTech companies can be challenging and significantly different from traditional bank valuations (more on next slide)
- FinTech acquisitions can result in goodwill creation

Is the bank comfortable with the risk profile of the FinTech company?

What will the regulatory reaction be?

Is the partnership or investment/acquisition consistent with the bank's long-term plan?

Valuing an Early Stage FinTech Company

Valuation Considerations

Early stage FinTech company valuations should consider many factors, including:

- Market Characteristics and Potential Impact
- Management Team
- Intellectual Property and Intangible Assets
- Stages of Development and Milestones Completed
- Regulatory Considerations
- Potential Exits and Timeline To Potential Exits
- Funding Terms of Prior Investors
- Benchmarking to the extent possible to other FinTech companies

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Section 5

Build, Buy, or Partner (and Possibly Invest)

Visa and Mastercard Example

Both started with banks

- BankAmericard originated in CA from Bank of America; Mastercharge originated from five other CA Banks

Both had significant bank (both large and smaller community bank) investors/ shareholders/ customers

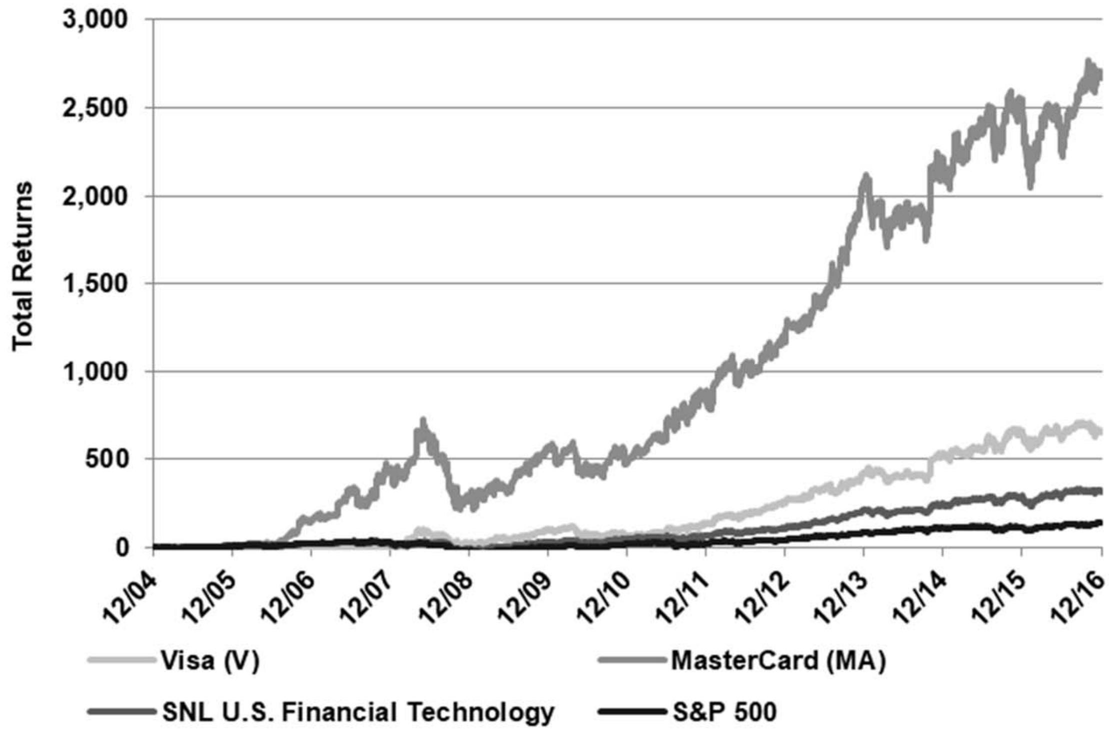
- Operated as cooperative type organizations despite being competitors

Both essentially faded into the background

Eventually ran into regulatory troubles/lawsuits that led to IPO

Importance of partnerships

Visa and Mastercard Example



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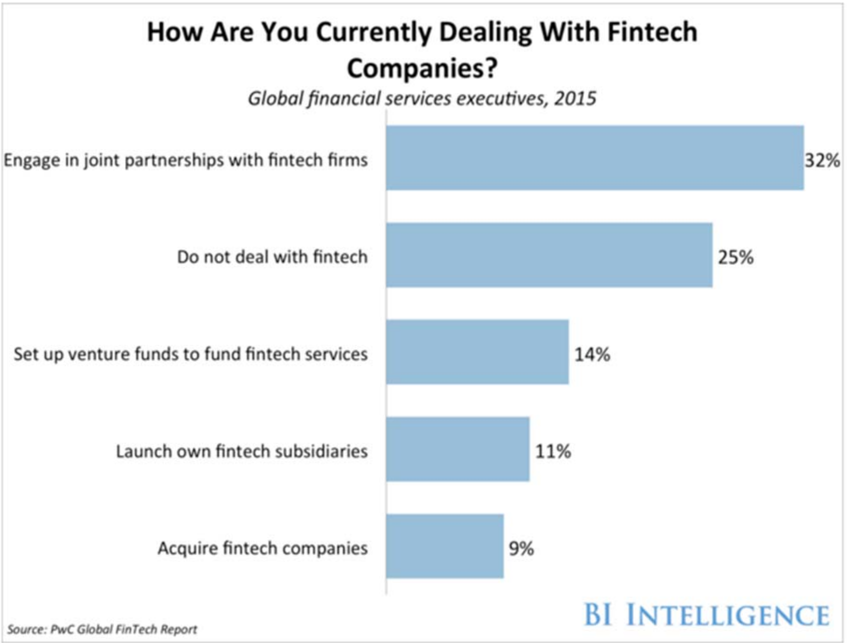
How Are Banks Approaching FinTech?



Source: "The Future of Financial Services and Technology Explained," by BI Intelligence, April 7, 2016,
http://www.businessinsider.com/fintech-ecosystem-financial-technology-explained-2016-3

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Build Strategy

Some traditional financial services companies have elected to build their own robo-advisory offering

Examples of those who elected to build or are in the process of building their own robo-advisory platform include:

- Schwab, Vanguard, Morgan Stanley, TD Ameritrade and Fidelity

Partner Strategy

Community Bank Robo-Advisory Partnerships

Partnership between ***Cambridge Savings Bank***, a $3.5 billion bank located near Boston, and ***SigFig***, a robo-advisor founded in 2007

- Built a service called “ConnectInvest“, which is available to Cambridge’s customers digitally (mobile and website), and “allows customers to easily open, fund, and manage an automated investment account tailored to their goals.”

Personal Capital, a robo-advisor started in 2009, announced a partnership with AlliancePartners to offer its digital wealth management platform to approximately 200 community banks

Other Robo-Advisory partnership examples involving larger financial services companies include:

- UBS/SigFig, Wells Fargo, Future Advisor / RBC, BBVA Compass, LPL, Motif / JP Morgan

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Buy Strategy

ALLY acquired **TradeKing**, a discount online brokerage firm (~$5 equity trades) for $275 million in cash

- Deal announced in April 2017 and completed in June 2017

TradeKing also had a robo-advisory platform that appeared to be a key piece of the puzzle

Strategic rationale reflect creative thinking on the part of Ally executives and/or its investment bankers

- FinTech acquisition that is focused on revenue synergies as TradeKing enhances wealth management offering to their existing bank customers
- Versus traditional bank acquisition strategy that often focuses on expense savings

Other Robo-Advisory Acquisitions by Traditional Financial Services Companies Include:

- Invesco/Jemstep, Goldman/Honest Dollar, Blackrock/Future Advisor

"Banking and brokerage should be together so you can save and invest—and easily move money between the two."

– Don Montanaro
TradeKing, CEO

"We have a good composition of customers across all demographic segments, from affluent boomers to millennials… Our customers have been happy with our deposit products, but are asking for more from the online bank."

– Diane Morais
Ally Bank, CEO

What We've Covered Today

Community banks are facing challenging market conditions

Large banks do outperform community banks but there is hope

FinTech can help create strategic value for your community bank

Explored how to develop a FinTech framework

Discussed build, buy, or partner (and possibly invest) strategies

Creating Strategic Value Through Financial Technology

New Book

While many bankers view FinTech as a potential threat, FinTech offers the potential to improve the health of community banks for those banks that can selectively leverage FinTech to enhance performance, customer satisfaction, and improve profitability and returns. FinTech can also help level the playing field for community banks to compete more effectively with larger banks and non-bank lenders.

Creating Strategic Value Through Financial Technology illustrates the potential benefits of FinTech to banks, both large and small, so that they can gain a better understanding of FinTech and how it can create value for their shareholders and enhance the health and profitability of their institutions.

The book contains 13 chapters broken into three sections. Section I introduces FinTech. Section II explores FinTech niches such as bank technology, alternative lending, payments, wealth management, and insurance niches. Section III illustrates how both community banks and FinTech companies can create strategic value.

For more information, visit
http://mercercapital.com/product/creating-strategic-value-through-financial-technology/

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How Mercer Capital Can Help

To help both banks and FinTech companies execute their optimal strategies and create maximum value for their shareholders, Mercer Capital has a number of solutions. We have a book that provides greater detail on the history and outlook for the FinTech industry, as well as containing targeted information to help bankers answer key strategic questions.

Mercer Capital has a long history of working with banks. We are aware of the challenges facing community banks. With ROEs for the majority below 10% and their cost of capital, it has become increasingly difficult for many banks to deliver adequate returns to shareholders even though credit costs today, are low. Being both a great company that delivers benefits to your local community, as well as one that delivers strong returns to shareholders is a difficult challenge. Confronting the challenge requires a solid mix of the right strategy as well as the right team to execute that strategy.

Mercer Capital can help your bank craft a comprehensive value creation strategy that properly aligns your business, financial, and investor strategy. Given the growing importance of FinTech solutions to the banking sector, a sound value creation strategy needs to incorporate FinTech and Mercer Capital can help.

- We provide board/management retreats to educate you about the opportunities and challenges of FinTech for your institution.
- We identify which FinTech niches may be most appropriate for your bank given your existing market opportunities.
- We identify which FinTech companies may offer the greatest potential as partners for your bank.
- We provide assistance with valuations should your bank elect to consider investments or acquisitions of FinTech companies.

No one understands community banks and FinTech as well as Mercer Capital. We are happy to help. Contact us at 901.685.2120 to discuss your needs.

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Thank You for Attending Today's Webinar

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