MERCER CAPITAL

Bank Watch

Complacent Investors May Need to Reassess the Earning Power of Some Acquirers

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Portfolio manager Grant Williams remarked at John Mauldin's Strategic Investment Conference in mid-May that there may be a bubble in complacency. Maybe so with the CBOE Volatility Index (VIX) below 12, high yield credit trading at tight spreads to Treasurys and other risk measures that are comparable to the period leading up to the 2007-2009 financial crisis.

The recent drop in the 10-year yield to about 2.4% from around 2.7% in late April has begun to raise questions about the economy with some investors. Bank stocks have underperformed this quarter even though the rally in bonds may produce better gains on the sale of mortgages and bonds than expected. The SNL U.S. Bank Index declined 4.9% quarter-to-date through May 30 compared to a 2.6% gain in the S&P 500. I think the complacency surrounding the prospects for most banks' earnings is finally catching up with reality that returns are as good as they are going to get in the current low-rate, low-credit cost environment.

Investors may have a greater sense of urgency as it relates to the Wall Street banks given the widespread coverage of the decline in fixed income trading; however, the issue is not new. The *Wall Street Journal's* "Heard on the Street" column on May 23 highlighted how Bank of New York Mellon Corp. and State Street Corp. disappointed investors after a run in their shares during 2013 on expectations that a more favorable rate environment would emerge and thereby drive earnings. The same could be said about Comerica Inc. and a number of other rate sensitive banks whose shares, I think, have priced in an expanding net interest margin from short-term rate hikes by the Fed.

But where the complacency may be painful is among smaller regional banks that emerged from the financial crisis as big winners. One of the hallmarks of these institutions was the acquisition of failed and troubled banks for nominal prices during 2009-2011. These acquisitions may have been cheap and even produced big bargain purchase gains, but the accounting made it tough to discern earning power. Many of these institutions still have NIMs that are significantly above peer margins due to accretion of loans that were marked down for both credit and rate characteristics. Eventually the accretion will end as discounted loans are repaid, refinanced or charged off. In some instances costs associated with collecting these loans may provide some offset, but the reality of the lending market is that new commercial and industrial and commercial real estate loans generally entail rates that are only 3% to 4%.

CIT Group Inc. provides a road map as a result of the fresh start accounting that was adopted when the company emerged from bankruptcy in late 2009. Fresh start accounting was confusing, resulting in sizable marks and accretion for both assets and debt financing. As a result, analysts struggled to get their arms around CIT's core earnings capacity. Within the last year, the impact of fresh start accounting substantially dissipated. In the year-ago quarter the net finance margin was 4.43% as reported and 4.64% on an adjusted basis. During the first quarter of 2014 the reported and adjusted net finance margins were 3.66%. Not coincidentally, the 2014 consensus estimate declined to $3.11 per share as of May 30 from $3.90 per share a year ago. CIT's shares have underperformed both the SNL U.S. Bank Index and the SNL U.S. Specialty Lender Index, declining more than 5% over the last year compared to gains of approximately 10% for both indexes as of May 30.

I think a similar outcome awaits a number of the 2009-2011 acquirers that still have a well above average NIM. The Street may argue that higher short rates will offset the loss of accretion income, but absent higher short rates I see this as a huge issue given my view that NIMs for most institutions are headed toward the low 3% level over the next two years. Acquisitions and loan growth, both of which utilize excess capital, can partially offset, but probably not entirely.

There are many banks that face this issue. Most have attempted to be transparent with investors. Old National Bancorp's investor material clearly shows the difference between the first-quarter reported NIM of 4.22% and the core NIM excluding accretion of 3.36%. Hancock Holding Co. does so, too (4.06% vs. 3.37%). But are investors really processing the information and is the sell-side willing or even capable of doing so? After all, the bias for forward estimates is almost always higher. Stocks look cheaper that way. And who wants to buy shares of a bank whose earnings are going to fall?

In theory, an efficient market would discount the loss of accretion earnings if not disregard it, but I do not believe that is the case for small cap stocks with limited analyst coverage. So the punchline is this: a number of well-managed banks are poised to experience underperformance in their shares as the Street will be forced to revise lower 2015 estimates and general earning power expectations as the accounting accretion from the post-crisis deals wanes. Conversely, the low NIM banks may be poised to outperform on a relative basis, at least for a while.

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What We're Reading

The *American Banker* released their "2014 Summer Reading List for Bankers."

http://mer.cr/1l1eQSw

Al Dominick had a summary of key takeaways from Bank Director's recent "Audit and Risk Committee" conference.

http://mer.cr/1lQd4nv

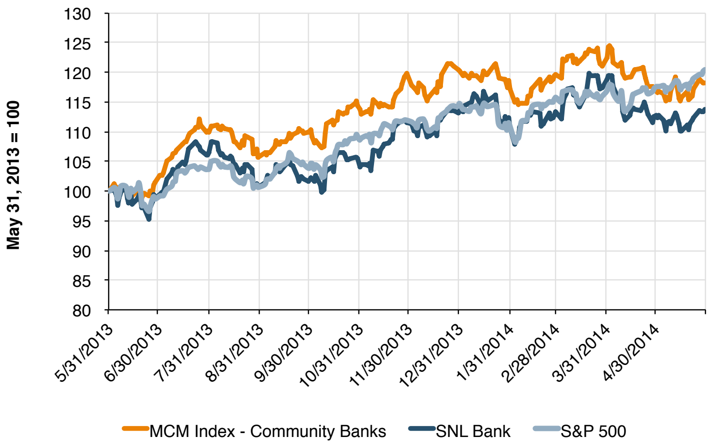
SNL Financial published an interesting article entitled "Investors and Bank Buyers Prioritize P/E" (SNL Subscription Required).

http://mer.cr/1lwHzzO

Kevin Tweddle of FiServ's Bank Intelligence Solutions gave a quick overview of the findings from their recent study of high growth banks.

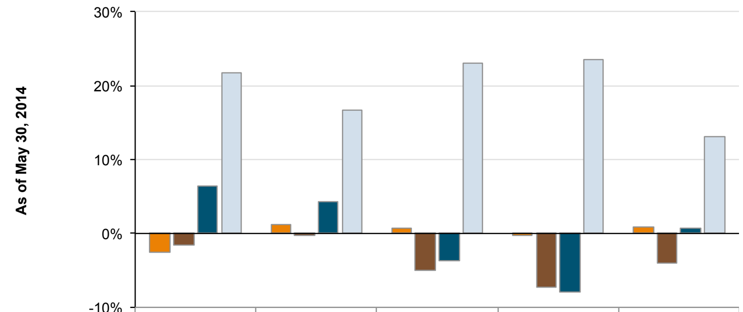
http://mer.cr/1yfH7du

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



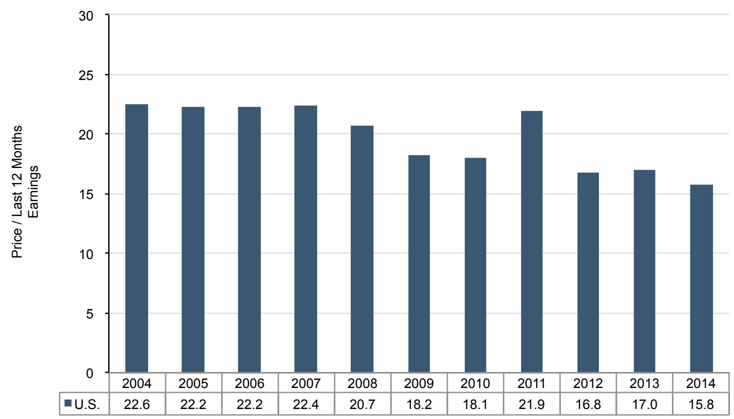
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-2.62%	1.27%	0.68%	-0.24%	0.96%
Quarter-to-Date	-1.62%	-0.22%	-4.93%	-7.34%	-4.08%
Year-to-Date	6.40%	4.30%	-3.70%	-7.94%	0.65%
Last 12 Months	21.67%	16.62%	23.11%	23.49%	13.13%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of May 30, 2014					
Indices	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2014 (E) EPS	Price / 2015 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	0.27%	-2.77%	-0.47%	16.93%	14.12	17.09	12.88	111.5%	117.4%	2.2%
Midwest Index	0.86%	-3.97%	0.85%	26.90%	13.27	13.46	12.28	111.5%	124.6%	2.1%
Northeast Index	2.61%	-1.51%	-0.71%	16.21%	14.38	13.91	12.53	124.6%	131.8%	2.7%
Southeast Index	-0.06%	-4.84%	-4.46%	8.74%	12.78	13.19	12.63	112.8%	116.9%	1.9%
West Index	0.25%	-5.68%	-2.40%	20.55%	15.24	17.24	13.20	121.7%	133.3%	1.9%
Community Bank Index	0.97%	-3.45%	-1.72%	18.18%	13.81	15.25	12.62	116.6%	124.7%	2.2%
SNL Bank Index	**0.90%**	**-4.22%**	**0.18%**	**13.75%**						

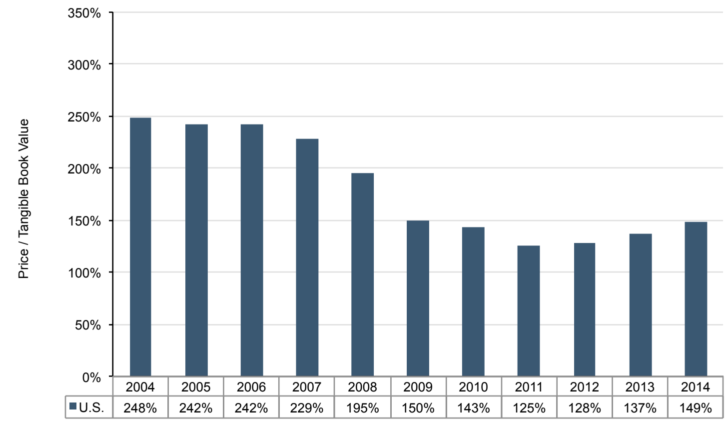
Median Price/Earnings Multiples

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



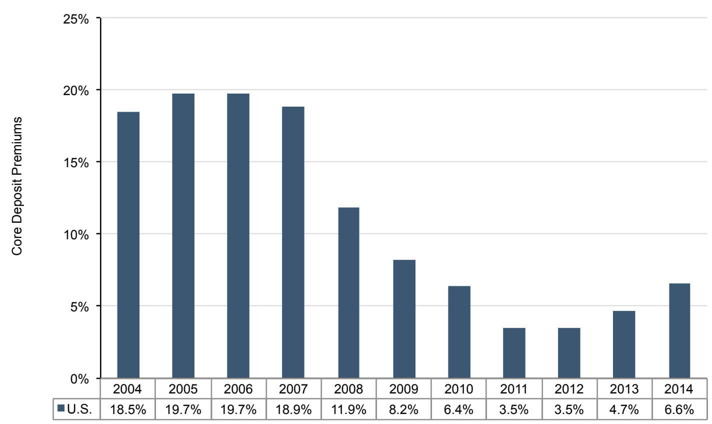
Median Price/Tangible Book Value Multiples

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



Median Core Deposit Multiples

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



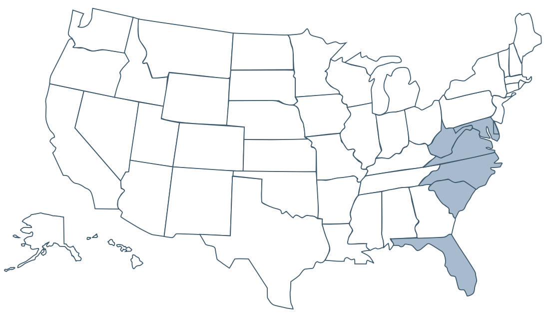
Median Valuation Multiples for M&A Deals

Target Banks Assets <$5B and LTM ROE >5%, through May 2014

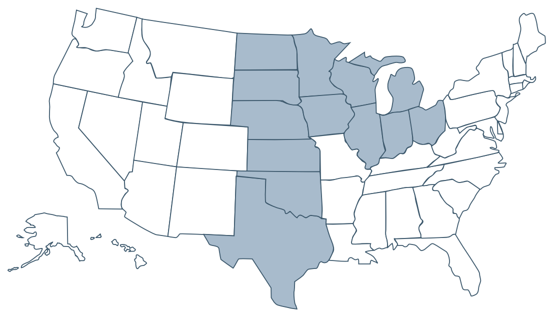
Regions	Price / LTM Earnings	Price / Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value	Target's Median Assets	Target's Median LTM ROAE (%)
Atlantic Coast	14.04	1.46	5.3%	1	42.96	312,005	9.19%
Midwest	19.62	1.57	7.4%	21	37.67	125,862	8.31%
Northeast	21.82	1.79	8.0%	5	28.47	221,343	7.49%
Southeast	13.99	1.64	8.0%	13	89.24	383,554	9.96%
West	20.93	1.19	3.2%	8	18.00	157,077	7.42%
Nat'l Community Banks	**15.81**	**1.49**	**6.6%**	**48**	**40.32**	**207,396**	**8.31%**

Mercer Capital's Regional Public Bank Peer Reports

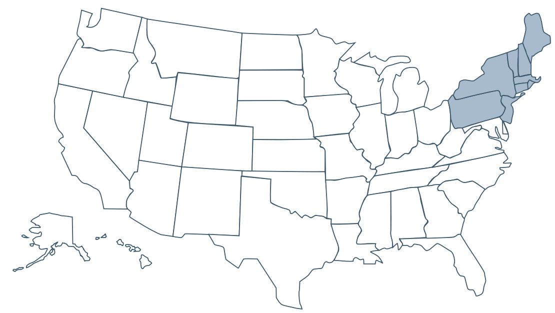
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



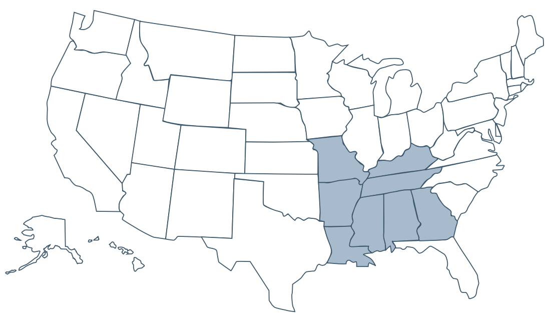
Atlantic Coast



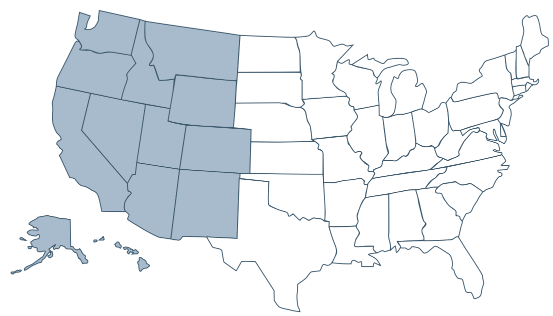
Midwest



Northeast



Southeast



West

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Financial Institutions Services

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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.

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.

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