MERCER CAPITAL

Bank Watch

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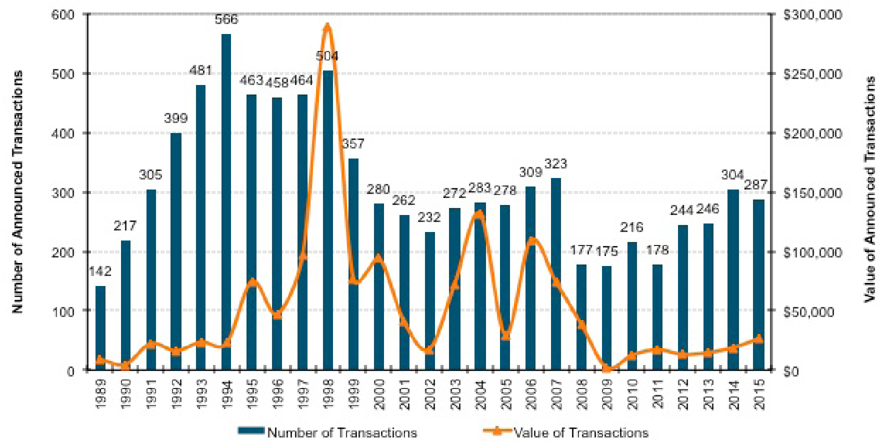
Bank Watch

2015 Bank M&A Recap

Statistics can be deceptive. The bank M&A market in 2015 could be described as steady, bereft of any blockbuster deals. According to SNL Financial 287 depositories (253 commercial banks and 34 thrifts) agreed to be acquired in 2015 compared to 304 in 2014 and 246 in 2013. Since 1990, the peak in M&A transactions occurred in 1994 (566) followed by 1998 (504). For those who do not remember, 1998 was the blockbuster year when NationsBank/Bank of America, Norwest/Wells Fargo, Bank One/First Chicago NBD and SunTrust Banks/Crestar Financial among others agreed to merge (Figure 1).

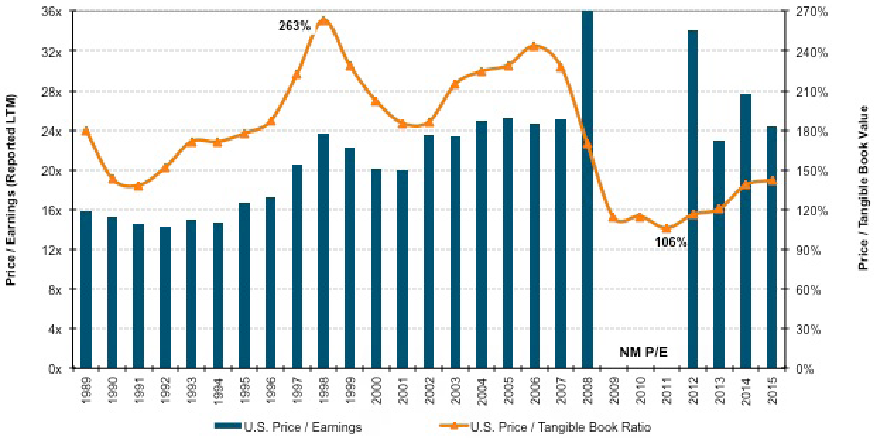
There has been a cumulative impact of M&A activity over the years. As of September 30, 2015, there were 6,270 insured depositories compared to about 18,000 institutions in 1985 when interstate banking laws were liberalized. M&A activity when measured by the number of transactions obviously has declined; however, that is not true on a relative basis. Since 1990, the number of institutions that agreed to be acquired in non-assisted deals ranged between 1.4% (1990) and 4.6% (1998) with an overall median

Figure 1



Source: SNL Financial

Figure 2



Source: SNL Financial

Figure 3

	2015 Median (Asset Sort)			2015 Median (ROE Sort)		
	P/TBV	P/E	Assets	P/TBV	P/E	ROE
Decile 1	112%	18.8x	$70,727	109%	45.2x	-1.7%
Decile 2	137%	25.2x	$137,150	131%	39.4x	3.2%
Decile 3	128%	22.1x	$239,659	139%	23.2x	5.8%
Decile 4	156%	20.2x	$495,016	169%	22.3x	8.0%
Decile 5	178%	23.0x	$1,215,905	162%	15.3x	12.0%

Source: SNL Financial

of 3.2%. Last year was an active year by this measure, with 4.4% of the industry absorbed, as was 2013 (4.5%).

What accounts for the activity? The most important factors we see are (a) good asset quality; (b) currency strength for many publicly traded buyers; (c) very low borrowing costs; (d) excess capital among buyers; and (e) ongoing earnings pressure due to heightened regulatory costs and very low interest rates. Two of these factors were important during the 1990s. Asset quality dramatically improved following the 1990 recession while valuations of publicly traded banks trended higher through mid-1998 as M&A fever came to dominate investor psychology.

Today the majority of M&A activity involves sellers with $100 million to $1 billion of assets. According to the FDIC non-current loans and ORE for this group declined to 1.20% of assets as of September 30 from 1.58% in 2014. The most active subset of publicly traded banks that constitute acquirers is "small cap" banks. The SNL Small Cap U.S. Bank Index rose 9.2% during 2015 and finished the year trading for 17x trailing 12 month earnings. By way of comparison, SNL's Large Cap U.S. Bank Index declined 1.3% and traded for 12x earnings. Strong acquisition currencies and few(er) problem assets of would-be sellers are a potent combination for deal making.

Earnings pressure due to both the low level of rates (vs. the shape of the yield curve) and post-crisis regulatory burdens are industry-wide issues. Small banks do not have any viable means to offset the pressure absent becoming an acquirer to gain efficiencies or elect to sell. Many chose the latter. The Fed may have nudged a few more boards to make the decision to sell by delaying the decision to raise short rates until December rather than June or September when the market expected it to do so. "Lift-off" and the attendant lift in NIMs may prove to be a non-starter if the Fed is on a path to a one-done rate hike cycle.

As shown in Figure 2, pricing in terms of the average price/tangible book multiple increased nominally to 142% in 2015 from 139% in 2014. The more notable improvement occurred in 2014 when compared to 2013 and 2012, which is not surprising given the sharp drop in NPAs during 2011-2013. The median P/E multiple was 24x, down from 28x in 2014 and comparable to 23x in 2013. The lower P/E multiple reflected the somewhat better earnings of sellers in which pricing was reported with a median ROA of 0.65% compared to 0.55% in 2014. Although the data is somewhat murky, we believe acquirers typically pay on the order of 10-13x core earnings plus fully-phased-in, after-tax expense savings.

Figure 3 provides perspective on pricing based upon size and profitability as measured by LTM ROE. Not surprisingly, larger and more profitable companies obtained better pricing in terms of the P/TBV ratio; however, as profitability increases the P/E multiple tends to decline. That is not surprising because a higher earning bank should have fewer issues that depress current earnings.

The other notable development in 2015 was the return of non-SIFI large banks to the M&A market after largely being absent since the financial crisis as management and regulators sorted through the changes that the Dodd-Frank Act mandated. BB&T Corporation, which is among the very best acquirers, followed-up its 2014 acquisitions for Bank of Kentucky Financial Corp. and Susquehanna Bancshares with an agreement to acquire Pennsylvania-based National Penn Bancshares. The three transactions added about $30 billion of assets to an existing base of about $180 billion. Other notable deals included KeyCorp agreeing to acquire First Niagara ($39 billion) and Royal Bank of Canada agreeing to acquire City National Corporation ($32 billion). Also, M&T Bancorp was granted approval by the Federal Reserve to acquire Hudson City Bancorp ($44 billion) three years after announcing the transaction.

What We're Reading

If you weren't able to attend AOBA at the Arizona Biltmore this year, catch a recap of the action from several videos from *Bank Director.*
http://mer.cr/1miciTp

Matt Crow and Brooks Hamner spoke at AOBA. View their slide deck on "How Banks Build Value via Trust and Wealth Management Franchises"
http://mer.cr/1X0a2NO

The *Worcester Business Journal Online* had an interesting piece entitled "Community Banks Embrace Fintech to Meet Technology Demands"
http://mer.cr/1NUeoyT

To get a sense as to how the world has changed, consider that the ten largest transactions in 2015 accounted for $17 billion of the $26 billion of transaction value compared to $9 billion of $19 billion in 2014. The amounts are miniscule compared to 1998 when the ten largest transactions accounted for $254 billion of $289 billion of announced deals that year.

Law firm Wachtell, Lipton, Rosen & Katz ("Wachtell") noted that with the approval of several large deals this year there is more certainty to the regulatory approval process and there is no policy to impede bank mergers x-the SIFI banks. A key threshold for would-be sellers and would-be buyers from a decision process has been $10 billion of assets (and $50 billion) given enhanced regulatory oversight and debit card interchange fee limitation that applies for institutions over $10 billion. Wachtell cited the threshold as an important consideration for National Penn's board in its decision to sell to BB&T.

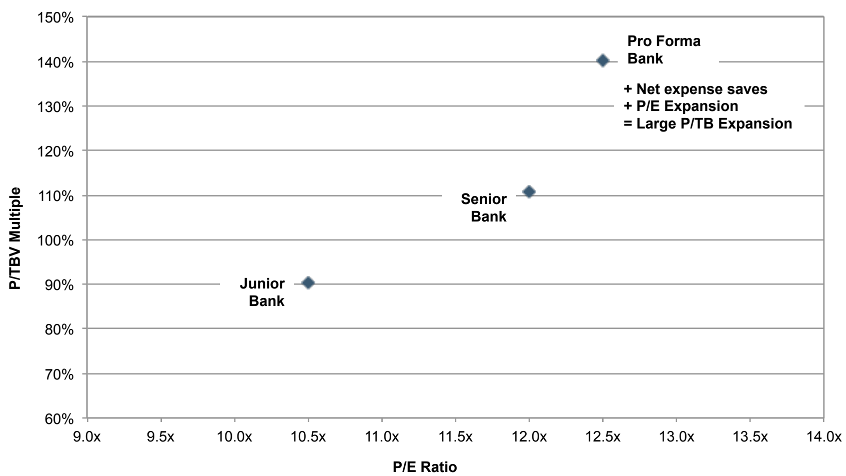
There were a couple of other nuances to note. While not always true, publicly-traded buyers did not receive the same degree of "pop" in their share prices when a transaction was announced as was the case in 2012 and 2013. The pops were unusual because buyers' share prices typically are flat to lower on the news of an announcement. Several years ago the market view was that buyers were acquiring "growth" in a no-growth environment and were likely acquiring banks whose asset quality problems would soon fade.

Also, the rebound in real estate values and resumption of pronounced migration in the U.S. to warmer climates facilitated a pick-up in M&A activity in states such as Georgia (11 deals) and the perennial land of opportunity and periodic busts—Florida (21). The recovery in the banking sector in once troubled Illinois was reflected in 25 transactions followed by 20 in California.

As 2016 gets underway, pronounced weakness in equity and corporate bond markets if sustained will cause deal activity to slow. Exchange ratios are hard to set when share prices are volatile, and boards of sellers have a hard time accepting a lower nominal price when the buyer's shares have fallen. Debt financing that has been readily available may be tougher to obtain this year if the market remains unsettled.

Whether selling or merging, we note for the surviving entity a key goal should be something akin to Figure 4 in which there is shared upside for both the acquirer's and seller's shareholders (assuming a merger structured as a share exchange). A well-structured and well-executed

Figure 4



Source: SNL Financial

transaction can improve the pro forma bank's profitability and growth prospects. If so, all shareholders may benefit not only from EPS accretion, but also multiple expansion.

We at Mercer Capital have over 30 years of experience of working with banks to assess transactions, ranging from valuation to issuing fairness opinions in addition to helping assess the strategic position (e.g., sell now vs. sell later). Please call if we can help your institution evaluate a significant corporate transaction.

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Stress Testing for Banks with Energy Exposure

As we enter 2016, banks with significant energy exposure should consider adding stress testing to their goals this year. Energy-focused banks are facing a stressed economic environment in light of the prolonged ~70% decline in oil prices over the past 18 months. Banks with meaningful oil and gas exposure as a group built reserves to roughly 3-7% of their portfolio with elevated provisioning in the fourth quarter. Some on Wall Street have questioned whether the provisioning was sufficient. The direction of oil prices and time will be the arbiter, although these larger banks generally have a strong level of pre-tax, pre-provision to fund additional reserve building if needed. Recent regulatory commentary also suggests the growing importance of stress testing within the regulatory toolkit and the potential for increased regulatory focus on energy-exposed loan portfolios. For example, consider the following:

» A recent *Wall Stress Journal* article noted that energy-exposed banks are facing regulatory reviews of loans to oil and gas firms.[1]

» The OCC's Spring 2015 Semiannual Risk Perspective noted that the OCC's National Risk Committee is monitoring several risk issues that "warrant awareness among bankers and examiners. These risks have the potential to develop into broader systemic issues and may already raise concern at individual institutions." One risk that the OCC's NRC was focused on is "exposure to oil- and gas-related industries (e.g., services, office and hotel sectors) as well as direct exposure to producers. The significant decline in oil prices in 2014 could put pressure on loan portfolios in the oil and gas production and services sector and on areas of the United States that are heavily depending on this type of economic activity." [2]

» A 2015 Sageworks Exam Survey found that over 75% of bank and credit union respondents (99% of which were below $10 billion in assets) are either already implementing stress tests, have been asked to expand their stress testing, or have been asked to start stress testing by examiners.[3]

» Both the FDIC and OCC have noted the importance of stress testing to the regulatory toolkit. [4]

While the potential regulatory benefits of stress testing are notable, we believe stress testing should be viewed as more than just a regulatory check-the-box exercise, particularly for energy-focused banks. Similar to stress tests performed by cardiologists to determine the health of a patient's heart, bank stress tests can also provide a variety of benefits that could serve to ultimately improve the health of the bank before a fatal event happens. By providing a forward-looking analysis of the bank's financial and capital position in a stressed environment that will see higher loan losses, stress testing can help enhance strategic decisions, improve risk management and capital planning, and ultimately increase the value of the bank. For example, a stronger bank may determine that it has sufficient capital to withstand a depressed energy sector for some time and thus can consider acquisitions of weaker banks, special dividends, or buybacks. Alternatively, a weaker bank may determine that considering a sale or capital raise is the optimal path forward. Additionally, estimating loan losses embedded within a sound stress test can provide the bank with a head start on the pending shift in loan loss reserve accounting from the current "incurred loss" model to the more forward-looking approach proposed in FASB's CECL (Current Expected Credit Loss) model.

We acknowledge that community bank stress testing can be a complex exercise because it requires the bank to essentially perform the role of both doctor and patient. For example, the bank must administer the test, determine and analyze the outputs of its performance, and provide support for key assumptions/results. There are also a variety of potential stress testing methods and economic scenarios for the bank to consider when developing their test. In addition, the qualitative, written support for the test and its results is often as important as the results themselves. For all of these reasons, it is important that banks begin building their stress testing expertise sooner rather than later.

In order to assist community bankers with this complex and often time-consuming exercise, we developed three potential solutions to make the process as efficient and valuable as possible.

» Provide your bank with the appropriate tools and analytical/modeling support such that you can prepare your own stress test as quickly and efficiently as possible.

» Evaluate your bank's existing stress test process/model/outputs to validate or enhance your stress test.

» Design and prepare your bank's stress test entirely should you desire to outsource more of the process and perform a test more quickly.

Mercer Capital is uniquely focused to assist energy-focused banks with stress testing as we have a unique combination of deep industry expertise in the both the energy and banking sectors.

» Within the energy sector, we have significant experience valuing both underlying assets (such as oil and gas reserves, including both working interests and royalty rights) and companies in the energy industry, primarily oil and gas, bio fuels and other minerals.

» Within the banking sector, we provide a broad range of valuation and specialized advisory services. We have analyzed and valued a number of loan portfolios and individual loans ranging from clean to highly distressed, with portfolio sizes ranging from a few million up to several billion in unpaid principal balance. The process to value an individual loan or portfolio of loans is relatively similar to certain techniques utilized for stress testing including analyzing relevant economic and credit cycle trends and outlooks, historical loss performance, as well as expectations for future performance.

If you do elect to focus on stress testing in 2016, we created a timeline that can help your bank develop a stress testing process and framework appropriate for the size and complexity of your institution For more information about stress testing or to discuss your bank's specific situation and stress testing goals in greater detail, do not hesitate to contact us.

Jay Wilson, Jr.

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2016 Stress Testing Timeline

1Q16

Discuss internally who at the bank should be on your **stress testing team**

Identify what (if any) **external support/service providers** should be part of the team and begin discussions with them as appropriate

Attend Mercer Capital's Webinar

COMMUNITY BANK STRESS TESTING: WHAT YOU NEED TO KNOW

MARCH 1, 2016 | 12:00PM - 1:00PM CST

In this webinar, **Jay D. Wilson, CFA, ASA, CBA** will cover the basics of community bank stress testing, review the economic scenarios published by the Federal Reserve, provide detail on the key steps to developing a sound community bank stress test, and discuss how to analyze and act upon the outputs of your stress tests.

Register Today

2Q16

Implement/design the stress testing **framework/process** at your institution

Perform the stress test and **provide quantitative and qualitative support** for the results

3Q16

Complete the stress testing process and **share the results** with your Board/senior management

Determine additional areas/tests for consideration in future stress tests

4Q16

Prepare for 2017 Stress Testing Process –
What worked? What didn't? What can be improved?

Compare results of 2016 Stress Test projected performance versus actual

Identify ways to further implement stress testing into your **strategic planning/value** creation process

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[1] "Energy Lending Caught in a Squeeze" http://www.wsj.com/articles/energy-lending-caught-in-a-squeeze-1443050639.

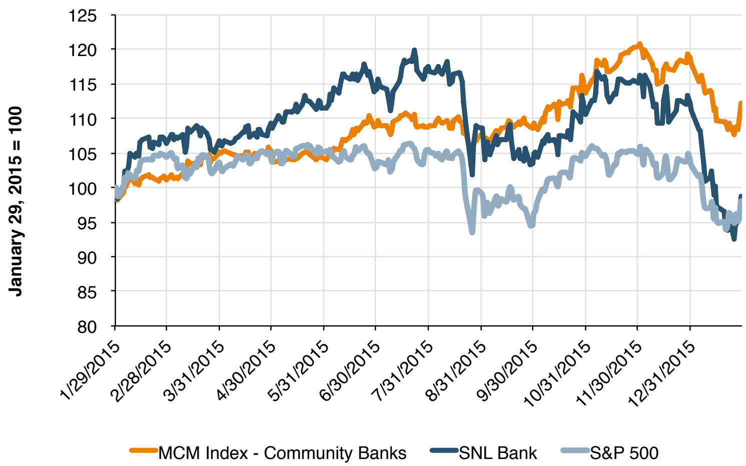
[2] "Spring 2015 Semiannual Risk Perspective" http://www.occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2015.pdf.

[3] "Sageworks Survey: What Examiners Are Examining" as of July 22 2015. https://www.sageworks.com/pressreleases.aspx?article=321&title=.

[4] "Supervisory stress testing has fundamentally changed the way we think about capital adequacy. The need to specify scenarios, loss estimates, and revenue assumptions--and to apply these specifications on a dynamic basis--has immeasurably advanced the regulation of capital adequacy and, thus, the safety and soundness of our financial system. The opportunities it provides to incorporate macroprudential elements make it, in my judgment, the single most important advance in prudential regulation since the crisis." FDIC Governor Daniel K. Tarullo speaking at the Federal Reserve Third Annual Stress Test Modeling Symposium, Boston, Massachusetts Jun 25, 2014: Speech accessed here: http://www.federalreserve.gov/newsevents/speech/tarullo20140625a.html.

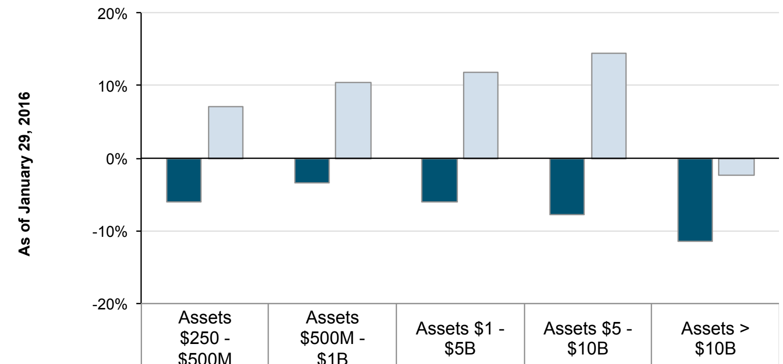
The OCC noted in October of 2012 that "some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis to be a key part of sound risk management for community banks." http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-33.html.

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



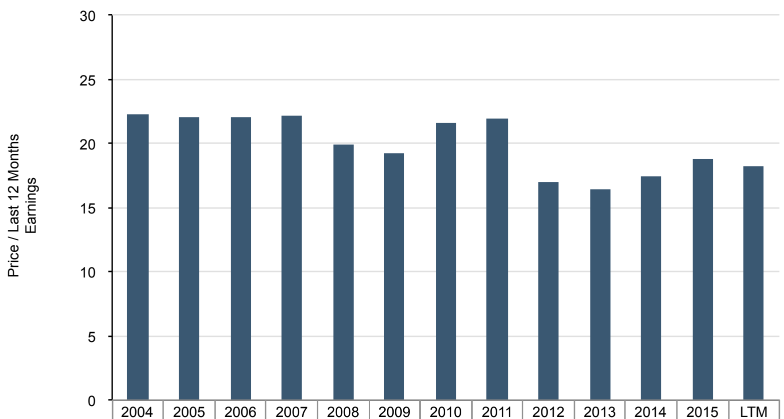
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Year-to-Date	-5.97%	-3.42%	-6.04%	-7.84%	-11.47%
Last 12 Months	7.06%	10.43%	11.82%	14.40%	-2.35%

Median Valuation Multiples

	Median Total Return		Median Valuation Multiples as of January 29, 2016					
Indices	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2016 (E) EPS	Price / 2017 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast	-3.56%	19.31%	17.04	14.57	13.20	106.7%	114.2%	2.2%
Midwest	-5.78%	10.87%	14.02	12.22	11.35	114.1%	134.4%	2.3%
Northeast	-3.44%	8.64%	14.16	12.86	11.54	113.4%	126.8%	3.1%
Southeast	-9.16%	5.88%	13.11	14.02	13.02	103.5%	104.6%	2.1%
West	-4.90%	15.19%	15.34	13.85	12.46	116.7%	123.8%	2.6%
National Community Banks	-4.80%	12.14%	14.81	13.60	12.33	111.4%	121.3%	2.4%
SNL Bank Index	**-11.10%**	**-1.25%**						

Median Price/Earnings Multiples

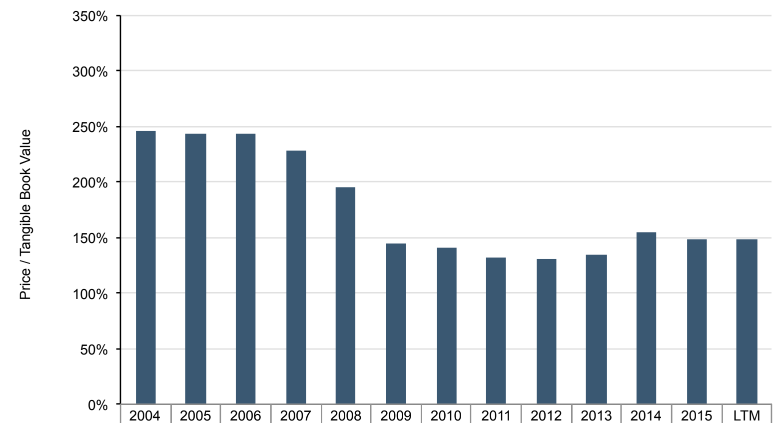
Target Banks' Assets <$5B and LTM ROE >5%



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	LTM
U.S.	22.3	22.0	22.0	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5	18.8	18.2

Median Price/Tangible Book Value Multiples

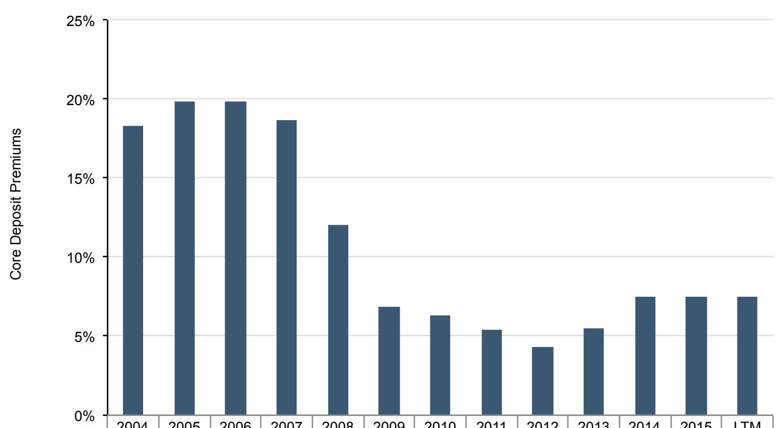
Target Banks' Assets <$5B and LTM ROE >5%



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	LTM
U.S.	246%	243%	243%	228%	196%	145%	141%	132%	130%	134%	155%	148%	148%

Median Core Deposit Multiples

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



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	LTM
U.S.	18.3%	19.9%	19.9%	18.7%	12.0%	6.9%	6.3%	5.4%	4.3%	5.5%	7.5%	7.5%	7.5%

Median Valuation Multiples for M&A Deals

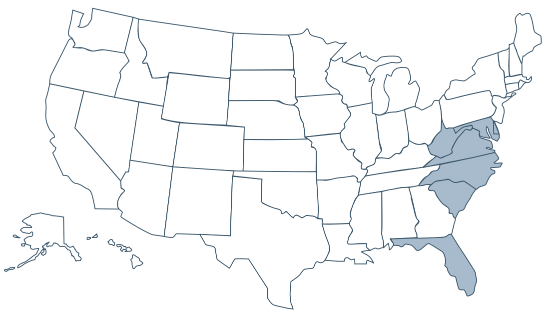
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended January 2016

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	20.16	1.56	8.6%	22	96.06	512,613	7.49%
Midwest	18.60	1.52	7.4%	65	23.98	121,420	8.84%
Northeast	22.58	1.39	7.3%	7	48.62	395,284	6.69%
Southeast	16.27	1.46	9.0%	25	36.70	239,214	9.06%
West	15.19	1.44	6.9%	17	48.75	199,991	9.31%
National Community Banks	**18.20**	**1.48**	**7.5%**	**136**	**42.18**	**196,439**	**8.68%**

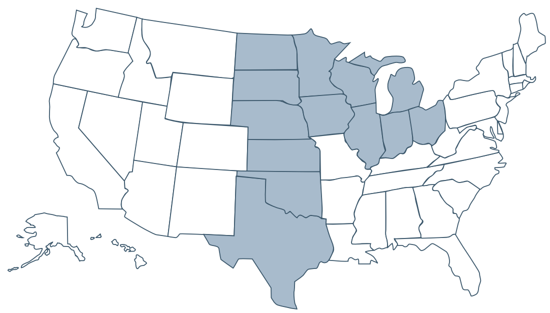
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

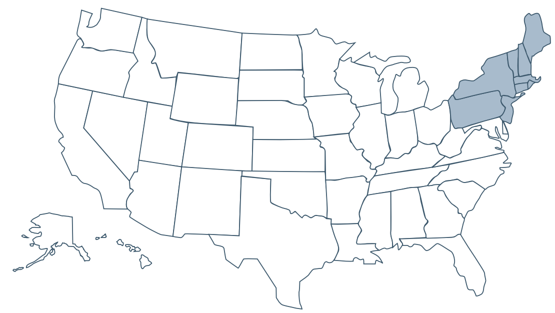
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



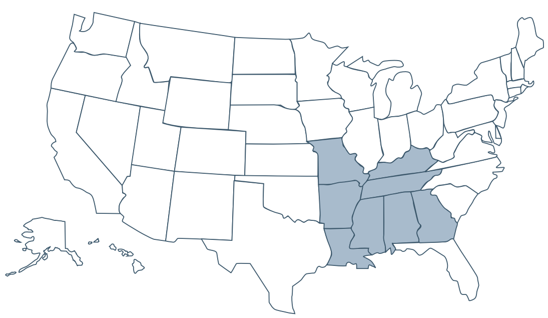
Atlantic Coast



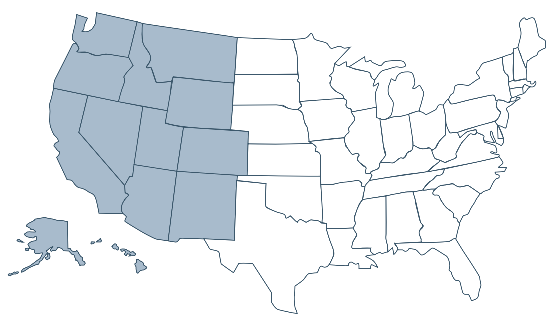
Midwest



Northeast



Southeast



West

Mercer Capital

Financial Institutions Services

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.

- » Bank valuation
- » Financial reporting for banks
- » Goodwill impairment
- » Litigation support
- » Stress Testing
- » Loan portfolio valuation
- » Tax compliance
- » Transaction advisory
- » Strategic planning

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*, *Acquiring a Failed Bank*, *The Bank Director's Valuation Handbook*, and *Valuing Financial Institutions*, Mercer Capital professionals speak at industry and educational conferences.

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

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