Bank Watch

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Activist Investors, Optionality and Comerica

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Dallas-based Comerica Inc. is having a rough go of it in 2016. Oil cannot find a bottom, and the Street's pipe dream for Fed rate hikes that would push the bank's NIM higher has been replaced with a term that entered the mainstream media's lexicon last week: NIRP, or negative interest rate policies. Neither is good news for Comerica or U.S. banks, though low gas prices should support consumer credit portfolios even if consumers bank the savings rather than spend it. I do not know where to start with NIRP. It is a fraudulent proposition to me — something one could expect from European socialists, but not here.

In the whatever category, S&P downgraded the company's long-term issuer rating to BBB+ on February 9th due to its energy-sector exposure. The headline may not sound great, but the parent company retained an investment grade rating.

The backdrop occurs as Comerica and CIT Group Inc. have become the target of Hudson Executive Capital LP, a relatively new hedge fund with an impressive roster of executive advisers. CEO partners from the financial services industry include Bill Harrison (JPMorgan Chase & Co.) Richard Kovacevich (Wells Fargo & Co.) and Howard Milstein (New York Private Bank & Trust). These are not hacks; they are highly accomplished bankers and investors. Hudson's mission statement discusses value creation through constructive engagement with a target rather than a public contest and proxy battle.

Comerica is among the larger banks to come under fire to sell of late, joining Ally Financial Inc., CIT and two that pulled the trigger: Astoria Financial Corp. and First Niagara Financial

Group Inc. Depending upon when the position was established, Hudson may have lost part of its shirt. Comerica's shares are down 21% year-to-date (and 29% over the past year), as of February 12th.

According to media reports, Hudson views Comerica as being too small to incur the cost of being a SIFI. Other reports spoke to the cheapness of the shares, which were trading for about 11x 2016 consensus EPS and 84% of tangible book value, as of February 12th. The P/E multiple is higher than peers such as Huntington Bancshares Inc., Regions Financial Corp., and Fifth Third Bancorp, although the P/TB multiple for most peers is higher. The difference in book multiples reflects a somewhat lower ROE and ROTE. Comerica posted ROE and ROTE of 7.1% and 7.7% in 2015, down from 8.0% and 8.7% in 2014.

Hudson's approach may be softer than Lion Point Capital LP's cage rattling of Ally, but it is useful. There is nothing wrong with shareholders who make boards take an intense look at strategy, historical performance, prospective performance, realizable value if sold, and the like. I am not a corporate securities attorney. My take on board governance is that boards are not required to make decisions for a short-term gain (e.g., sell) if there is a reasonable plan to create long-term value. The "business judgment rule" has served corporate America, its shareholders, and U.S. capitalism well by giving boards the benefit of the doubt as long as directors make informed decisions in good faith that are believed to be in shareholders' best interest.

Comerica is not an illogical choice for Hudson to target based on ROE and ROTE; however, the gap with peers is not that wide given the rate environment and Comerica's business bank model that focuses on C&I lending with a high level of non-interest bearing deposit funding. ROE for the YTD period through September 30 was in the 34th percentile (i.e., 66% were above) according to the regulators' bank holding company performance report; it was 48% in 2014.

Middling ROE notwithstanding, I think management has done a good job over the years by avoiding the trap door that is the key arbiter in bank performance over long periods of time: credit. Maybe the highly cyclical nature of the southeast Michigan economy taught management how to navigate lending cycles a little bit better. Or, maybe it instilled more conservatism in management.

Unlike some peers, Comerica was not forced to raise a massive amount of common equity in the aftermath of the financial crisis. Its sole raise was a 25 million share offering in March 2010 on what was then about 150 million shares outstanding. In a testament to how far bank stocks have fallen the past few months, that offering six years ago priced above the current price at $35.00 per share. At the time, investors were banking on an improvement in credit (correct) and Fed rate hikes that would push the NIM and EPS higher (wrong then, too).

Also, I think management has done a good job in managing the cost structure. The efficiency ratio in 2015 was 67%, which is roughly unchanged over the past few years. That is not a great number and may speak to Hudson's views about the cost structure and ROE; however, it is not bad considering that the NIM was 2.60% in 2015 compared to 3.19% in 2011. That is a lot of foregone net interest income and ROE.

What We're Reading

Bloomberg BNA had a piece entitled "Community Banks Continue to Stabilize in 2015."
http://mer.cr/1Ldku3f

Bank Director's President, Al Dominick, has "Three Questions to Ask About Your Bank's DNA."
http://mer.cr/1TMqRgY

American Banker had an interesting piece entitled "Try to Be Customers' Favorite Bank, Not Their Only One."
http://mer.cr/1pgREFm

Comerica is not an island. It has to operate in the same rate and competitive environments as its peers. Unlike some peers, the company does not have a big consumer lending franchise, processing business, and asset management unit to counter the impact that ZIRP has on the NIM. ZIRP is brutal for banks. It is especially brutal when one of the key tenants of a business model is LIBOR-based commercial lending that relies on a high level of non-interest bearing deposit funding. Competition has compressed the margin at which businesses can borrow over LIBOR, while non-interest bearing deposits add little to the NIM compared to when short rates are "normal." Comerica's loan yields are low; there is no easy or obvious offset to change that.

I have no idea what the board's thoughts are about staying the course versus selling (or buying). The company would appeal to a number of banks, I think. Its geography that encompasses Michigan, Texas and California with smaller outposts in Arizona and Florida is attractive. The eventual retirement of long-time CEO Ralph Babb, age 66, may cause the board to re-evaluate the path regardless of Hudson's engagement. If I were on the board I would want to see how the energy book performed this year. The shares have a high degree of optionality in terms of oil prices moving higher and the dying dream of the Fed being able to "normalize" short rates. On the other hand, NIRP would be an unmitigated disaster for Comerica and its competitors. Hudson's engagement has occurred at an interesting time when the optionality of "where from here" is very high.

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Preferences and FinTech Valuations

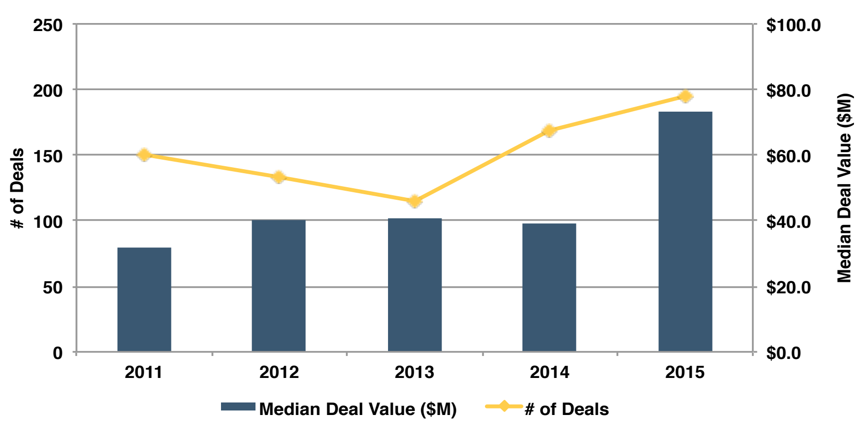
Originally published in the Fourth Quarter 2015 issue of Mercer Capital's ***Value Focus: FinTech*** *industry newsletter. Subscribe at* ***mer.cr/fintech-nl****.*

2015 was a strong year for FinTech. For those still skeptical, consider the following:

- All three publicly traded FinTech niches that we track (Payments, Solutions, and Technology) beat the broader market, rising 11 to 14% compared to a 1% return for the S&P 500;
- FinTech M&A volume and pricing rose sharply over recent historical periods with 195 announced deals and a median deal value of $74 million in 2015 (Figure 1);

Figure 1: FinTech M&A Overview

2011 – 2015



Source: SNL Financial

- A number of notable fundings for private FinTech companies occurred with roughly $9.0 billion raised among approximately 130 U.S. FinTech companies in larger funding rounds (only includes raises over $10 million).

One of the more notable FinTech events in 2015 was Square's IPO, which occurred in the fourth quarter. Square is a financial services and mobile payments company that is one of the more prominent FinTech companies with its high profile founder (Jack Dorsey, the Twitter co-founder and CEO) and early investors (Kleiner Perkins and Sequoia Capital). Its technology is recognizable with most of us having swiped a card through one of their readers attached to a phone after getting a haircut, sandwich, or cup of coffee. Not surprisingly, Square was among the first FinTech Unicorns, reaching that mark in June 2011. Its valuation based on private funding rounds **sat at the top** of U.S.-based FinTech companies in mid-2015.

So all eyes in the FinTech community were on Square as it went public in late 2015. Market conditions were challenging then (compared to even more challenging in early 2016 for an IPO), but Square had a well-deserved A-list designation among investors. Unfortunately, the results were mixed. Although the IPO was successful in that the shares priced, Square went public at a price of $9 per share, which was **below the targeted range** of $11 to $13 per share. Also, the IPO valuation of about $3 billion was sharply below the most recent fundraising round that valued the company in excess of $5 billion.

In the category its great pay if you can get it, most Series E investors in the last funding round had a ratchet provision that **provided for a 20% return on their investment**, even if the offering price fell below the $18.56 per share price required to produce that return. The ratchet locked in through the issuance of additional shares to the Series E investors. The resulting dilution was borne by other investors not protected by the ratchet.

On the flip side the IPO was not so bad for new investors. Square shares rose more than 45% over the course of the opening day of trading and then traded in the vicinity of $12 to $13 per share through year-end. With the decline in equity markets in early 2016, the shares traded near the $9 IPO price in mid-February.

IPO pricing is always tricky—especially in the tech space—given the competing demands between a company floating shares, the underwriter, and prospective shareholders. The challenge for the underwriter is to establish the right price to build a sizable order book that may produce a first day pop, but not one that is so large that existing investors are diluted. **According to *MarketWatch***, less than 2% of 2,236 IPOs that priced below the low end of their filing range since 1980 saw a first day pop of more than 40%. By that measure, Square really is a unique company.

One notable takeaway from Square's experience is that the pricing of the IPO as much as any transaction may have marked the end of the era of astronomical private market valuations for Unicorn technology companies. The degree of astronomical depends on what is being measured, however. We have often noted that the headline valuation number in a private, fundraising round is **often not the real value for the company**. Rather, the price in the most recent private round reflects all of the rights and economic attributes of the share class, which usually are not the same for all shareholders, particularly investors in earlier fundraising rounds. As Travis Harms, my colleague at Mercer Capital **noted**: "It's like applying the pound price for filet mignon to the entire cow – you can't do that because the cow includes a lot of other stuff that is not in the filet."

While a full discussion of investor preferences and ratchets is beyond the scope of this article, they are fairly common in venture-backed companies. **Recent studies by Fenwick & West of Unicorn fundraisings** noted that the vast majority offered investors some kind of liquidation preference. The combination of investor preferences and a decline in pricing relative to prior funding rounds can result in asymmetrical price declines across the capital structure and result in a misalignment of incentives. John McFarlane, Sonos CEO, noted this when he stated: "If you're all aligned then no matter what happens, you're in the same boat… The really high valuation companies right now are giving out preferences – that's not alignment."

A **real-world example of this misalignment** was reported in a *New York Times* story in late 2015 regarding Good Technology, a Unicorn that ended up selling to BlackBerry for approximately $425 million in September 2015. While a $425 million exit might be considered a success for a number of founders and investors, the transaction price was less than half of Good's purported $1.1 billion valuation in a private round. The article noted that while a number of investors had preferences associated with their shares that softened the extent of the pricing decline, **many employees did not**. "For some employees, it meant that their shares were practically worthless. Even worse, they had paid taxes on the stock based on the higher value."

As the Good story illustrates, the valuation process can be challenging for venture-backed technology companies, particularly those with several different share classes and preferences across the capital structure, but these valuations can have very real consequence for stakeholders, particularly employees. Thus, it is important to have a valuation process with formalized procedures to demonstrate compliance with tax and financial reporting regulations when having valuations performed. Certainly, the prospects for scrutiny from auditors, SEC, and/or IRS are possible but very real tax issues can also result around equity compensation for employees.

Given the complexities in valuing venture-backed technology companies and the ability for market/investor sentiment to shift quickly, it is important to have a valuation professional that can assess the value of the company as well as the market trends prevalent in the industry. At Mercer Capital, we attempt to gain a thorough understanding of the economics of the most recent funding round to provide a market-based "anchor" for valuation at a subsequent date. Once the model is calibrated, we can then assess what changes have occurred (both in the market and at the subject company) since the last funding round to determine what impact if any that may have on valuation. Call us if you have any questions.

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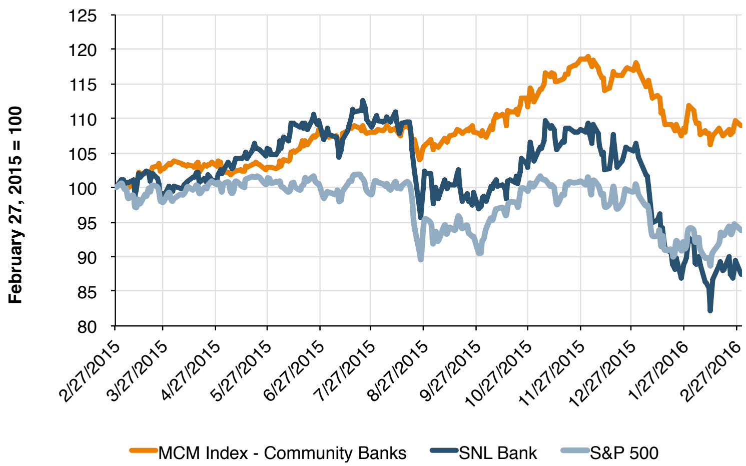
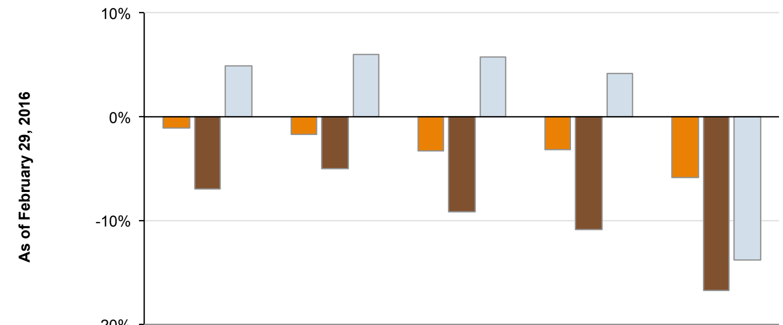
Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



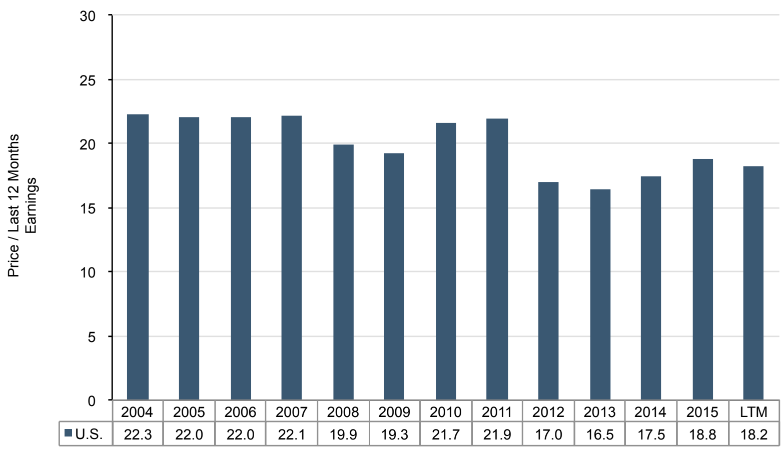
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-1.10%	-1.67%	-3.32%	-3.22%	-5.88%
Quarter-to-Date	-7.01%	-5.04%	-9.16%	-10.81%	-16.68%
Last 12 Months	4.90%	5.99%	5.78%	4.16%	-13.82%

Median Valuation Multiples

	Median Total Return			Median Valuation Multiples as of February 29, 2016					
Indices	Month-to-Date	Quarter-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	-2.74%	-6.03%	12.83%	16.83	14.22	12.95	106.1%	117.6%	2.2%
Midwest	-2.77%	-7.32%	10.35%	13.56	13.11	11.68	112.8%	126.5%	2.5%
Northeast	-2.79%	-5.00%	4.63%	13.38	13.05	11.75	109.3%	114.7%	3.4%
Southeast	-2.34%	-9.87%	7.07%	13.53	13.22	11.72	106.0%	110.3%	2.0%
West	-2.70%	-7.64%	8.86%	15.49	13.34	12.11	115.9%	124.1%	2.5%
National Community Banks	-2.71%	-6.97%	8.86%	14.23	13.33	12.07	109.6%	119.2%	2.5%
SNL Bank Index	**-5.66%**	**-16.13%**	**-12.49%**						

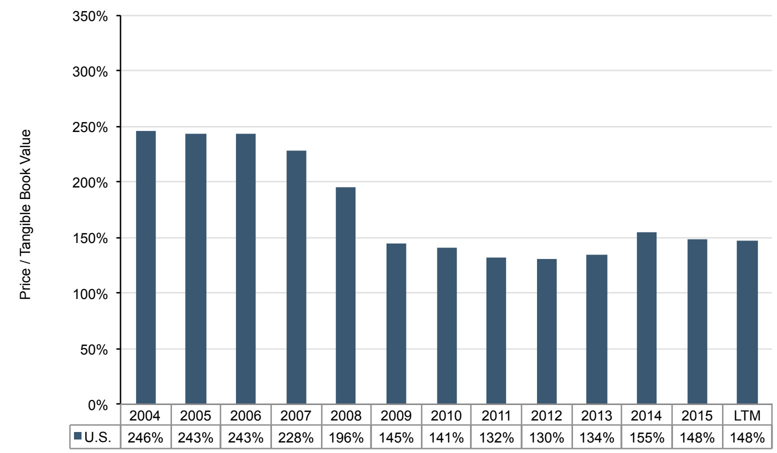
Median Price/Earnings Multiples

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



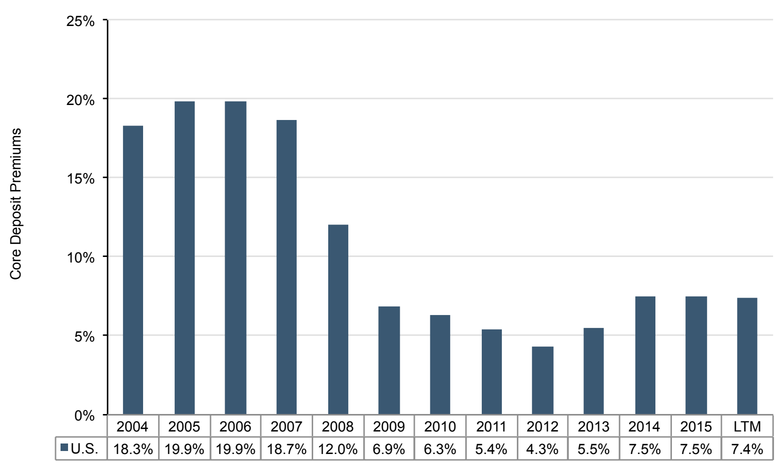
Median Price/Tangible Book Value Multiples

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

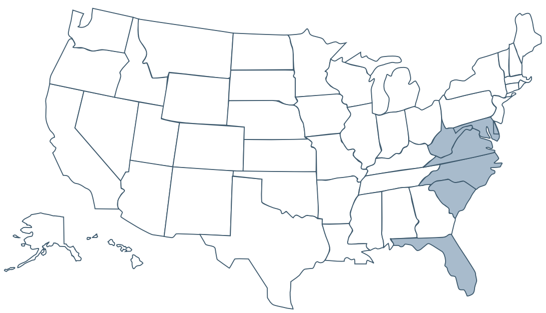
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended February 2016

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	22.16	1.51	8.4%	23	95.48	505,647	7.44%
Midwest	17.95	1.50	6.9%	70	21.48	130,323	8.95%
Northeast	22.44	1.30	5.2%	8	41.94	374,607	6.63%
Southeast	16.27	1.43	8.9%	25	36.70	239,214	9.06%
West	17.45	1.44	6.9%	14	48.75	229,029	10.52%
National Community Banks	**18.22**	**1.48**	**7.4%**	**140**	**41.02**	**196,439**	**8.63%**

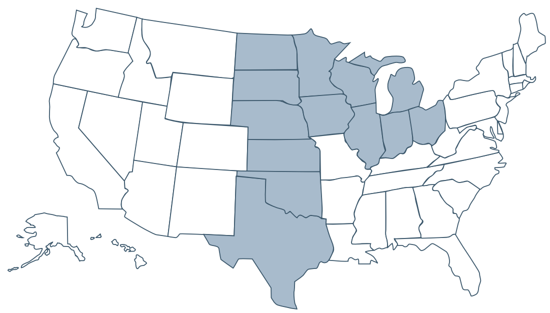
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

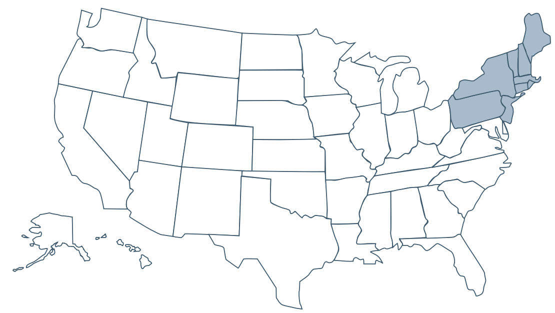
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



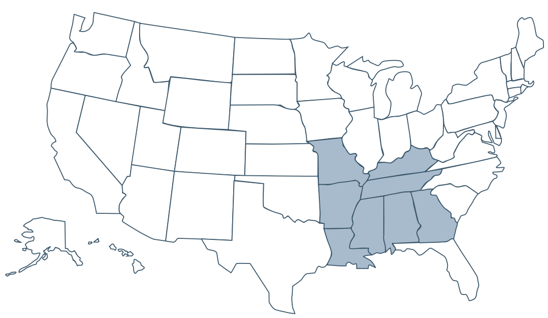
Atlantic Coast



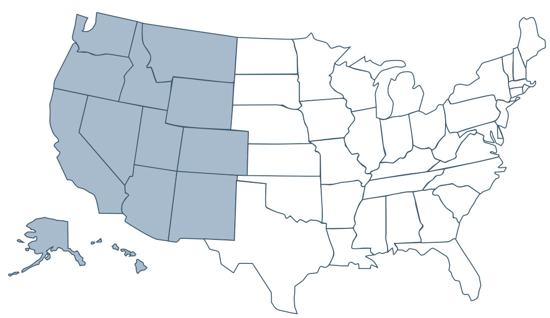
Midwest



Northeast



Southeast



West

Mercer Capital

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