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Bank Watch

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Can Getting into Wealth Management Save Community Banking?

A Follow Up to the 2016 Acquire or Be Acquired Conference

*This article originally appeared on Mercer Capital's blog **RIA Valuation Insights** on February 8, 2016. To subscribe, visit **mer.cr/ria-vi**.*

*Aston Martin DB4GT owned by **Don Rose** at **RM Sotheby's** (at the auction, but not for sale)*

In February 2016, Brooks Hamner and I spoke at Bank Director's **Acquire or Be Acquired Conference** in Scottsdale about **how banks can build value** through their trust and wealth management businesses. Our session got a great response, probably because we were some of the only speakers offering the banking community some hope. Most of the sessions at AOBA this year were, on balance, fairly gloomy. Between a yield curve that is entirely inhospitable to net interest margins and technology that threatens to denude the value of expensive branch networks, session after session seemed targeted at one message to bankers: sell.

Just before AOBA began, RM Sotheby's held one of its annual collector car auctions at the same resort, and conference attendees could wander outside between sessions and watch the Sotheby's auction "winners" load their precious iron onto car carriers to ship them home. I was reflecting on one of the more pessimistic conference sessions while watching a late 60s Aston Martin being loaded onto a truck, and it reminded me of a project I worked on early in my career.

What We're Reading

Steve Cocheo's article on "Expecting the Unexpected in M&A" details the importance of preparation including documented strategic plans and board discussions about valuation in order to prepare for the potential of M&A either as a buyer or seller.
http://mer.cr/1WcKIWr

Bank Director notes that a number of banks are focused on Cybersecurity in a piece entitled "2016 Risk Practices Survey: Banks Beef Up on Cybersecurity."
http://mer.cr/1q6NoIt

Jackie Stewart of *American Banker* has an interesting piece entitled "Bank Exams Hone In on Strategic Plans."
http://mer.cr/1YfcJei

CNBC discusses the desire of community banks to partner with FinTech companies.
http://mer.cr/1VxkOMt

James Bond and the Future History of Banking

About fifteen years ago, I was sitting in the boardroom at David Brown Group in Huddersfield, England, while the management team eulogized what was once one of the greatest industrial companies in the U.K. The boardroom still felt like the British seat of power it had once been, with a massive Scottish oak conference table and oil paintings of successive generations of David Browns (some of them knighted) looming from the walls. Next door was a vast factory that had, at its peak around World War II, employed 40,000 workers building tractors and heavy industrial equipment. The company was so successful that Sir David Brown was able to indulge one of his hobbies, buying Aston Martin in 1947 and investing in it heavily to return England to competitiveness in auto racing. It's because of David Brown that many Aston Martins still carry the "DB" series badges (one current model is a **DB9**) even though David Brown sold Aston Martin in 1972. The automaker was never profitable, but Brown had accomplished his goal anyway: Aston Martin was a prominent name in racing in the 1950s and 60s, and even James Bond favored the marque (much to the chagrin of Bentley and Jaguar).

The David Brown Group I consulted with wasn't even a shadow of its former self: technological change and a global recession got the best of the company in the 1960s, and after a series of damaging restructurings and neglectful owners, all that was left was a niche manufacturer with about 200 employees, operating as a mostly-forgotten unit of an American conglomerate.

Fifty years from now, we may look back on the threat to banking today as being as severe as what David Brown faced in the 1960s. Banks won't fix this by getting into sports car racing, but one opportunity is wealth management. It's no secret that many banks treat their trust departments like an afterthought. We estimate that maybe a third of bank trust franchises are profitable, and the excuses for hanging onto an underperforming trust department are pretty similar bank to bank:

1. Trust complements other lines of business by maintaining major relationships.
2. There's no easy solution as to whom to sell trust to or how to unwind it.
3. Trust is staffed by loyal and long term employees of the bank whom management wants to support.

But trust, if ignored, can become an earnings-dilutive cauldron of liability. Legacy relationships maintained by trust can become abusive of the time and attention of trust staff. And long term employees, while loyal in one sense, can become more focused on self-preservation than supporting their institution. Those are just the problems trust departments can face in good times.

Are Trust Franchises an Asset or a Liability?

If net interest margins were headed up and returns on equity were solid, unprofitable and possibly risky trust operations would be easier to ignore. The reality today, of course, is very different. Banking is in a race to rationalize operations, and from talking with community bankers from across the country at the AOBA conference, it sounds like a lot of bankers are looking for ways to either get out of trust or to refocus on the business to make it a viable (if not vital) part of their business. It won't surprise you to hear that we suggest the latter approach.

A seemingly obvious solution is to acquire existing wealth management companies to bulk-up and supplement trust. Greater scale brings better expertise to customers, and margins to the bank. For over-capitalized banks trying to boost ROE, acquiring a wealth management firm is an opportunity to invest some equity for a high returning asset (swapping some "E" for more "R"). AUM-based fees are largely uncorrelated from the credit cycle, and wealth management customers have different decision cycles than, say, commercial loan clients. Trust and wealth management (we look at these interchangeably because both are revenue streams supported by client assets) don't require large ongoing capital commitments, and the costs of these operations are largely embedded in staffing. On the surface, it seems like a perfect way for many community banks to diversify their financials and grow despite a tough environment for banking.

As for the seller's perspective, the RIA industry is facing a physical cliff, with more practicing series-7 registered reps over the age of 70 than under the age of 30. Many, if not most, of the 11,000 RIAs in the U.S. have inadequate ownership/leadership transition plans and will ultimately have to sell to a more established institution with experience in growing talent for senior roles. Many RIAs are not suitable acquisition candidates for banks, but many are.

So why aren't banks rushing to buy RIAs? It's risky to make sweeping generalizations, but based on our experience there are two obstacles banks must overcome to acquire an RIA: culture clash and balance sheet dilution. Both are inevitable, but both are also manageable. More on that in May's ***Bank Watch***.

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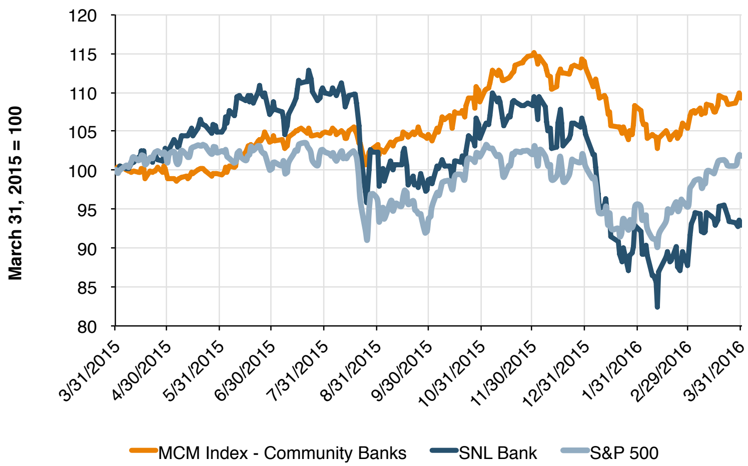
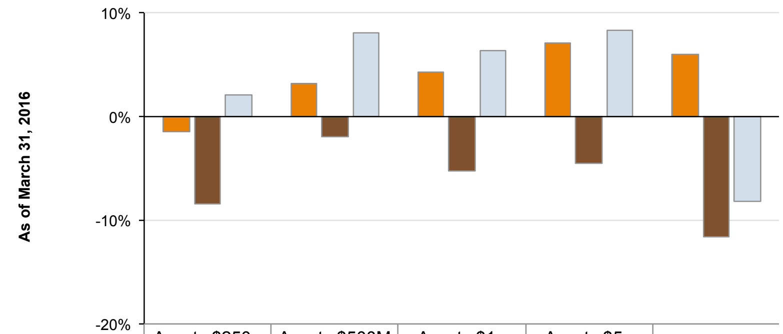
Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



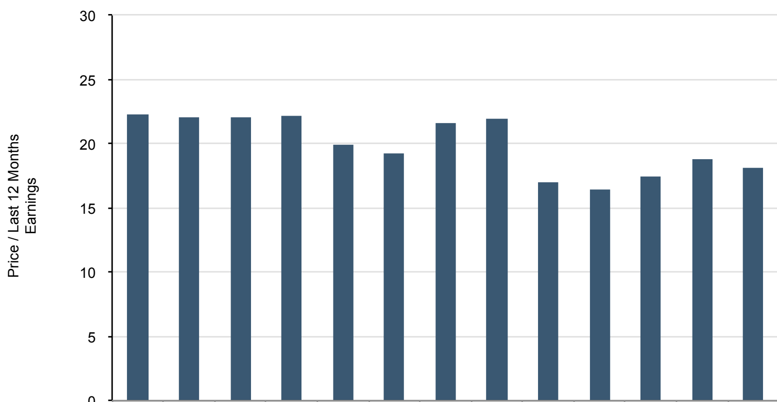
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-1.49%	3.21%	4.31%	7.05%	6.03%
Quarter-to-Date	-8.39%	-1.98%	-5.24%	-4.53%	-11.65%
Last 12 Months	2.08%	8.11%	6.31%	8.35%	-8.17%

Median Valuation Multiples

	Median Total Return			Median Valuation Multiples as of March 31, 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	4.94%	-1.40%	13.95%	16.16	14.49	13.60	105.7%	118.5%	2.2%
Midwest	3.65%	-3.91%	11.21%	13.84	13.31	11.65	114.3%	130.8%	2.4%
Northeast	2.77%	-2.37%	4.36%	13.50	12.77	11.54	109.3%	119.5%	3.3%
Southeast	4.06%	-6.22%	8.95%	13.85	13.65	13.11	112.8%	119.3%	1.9%
West	3.06%	-4.82%	8.55%	15.20	13.90	12.10	119.3%	119.3%	2.6%
National Community Banks	3.77%	-3.46%	9.30%	14.61	13.93	12.55	110.7%	121.6%	2.4%
SNL Bank Index	**6.01%**	**-11.09%**	**-7.02%**						

Median Price/Earnings Multiples

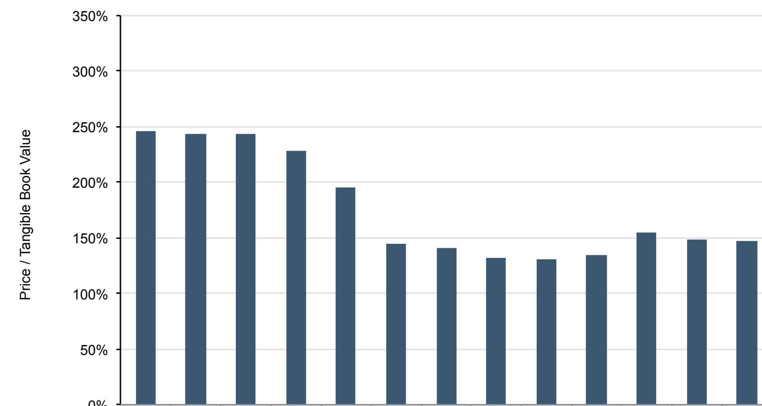
Target Banks' Assets <$5B and LTM ROE >5%



	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

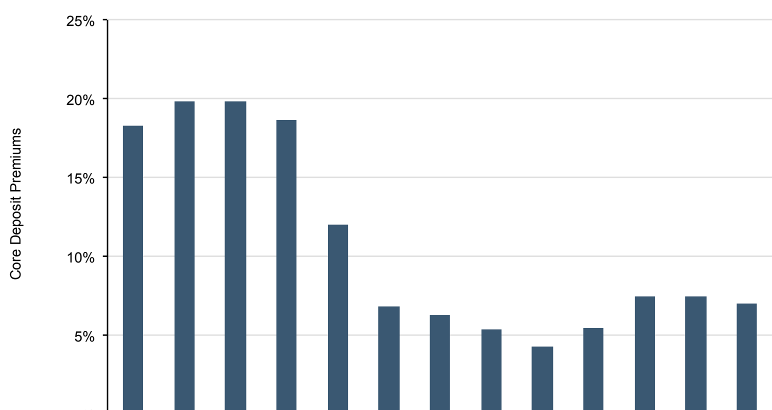
Target Banks' Assets <$5B and LTM ROE >5%



	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%	147%

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%	7.0%

Median Valuation Multiples for M&A Deals

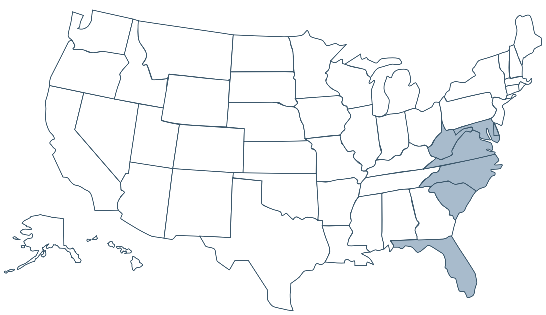
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended March 2016

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	18.16	1.51	8.4%	21	95.48	505,647	7.44%
Midwest	17.69	1.44	5.9%	68	21.60	130,323	8.75%
Northeast	22.44	1.30	5.2%	8	41.94	374,607	6.63%
Southeast	16.27	1.43	8.9%	26	36.70	205,443	9.46%
West	16.05	1.48	7.0%	13	56.25	252,547	11.10%
National Community Banks	**18.17**	**1.47**	**7.0%**	**136**	**41.25**	**189,329**	**8.53%**

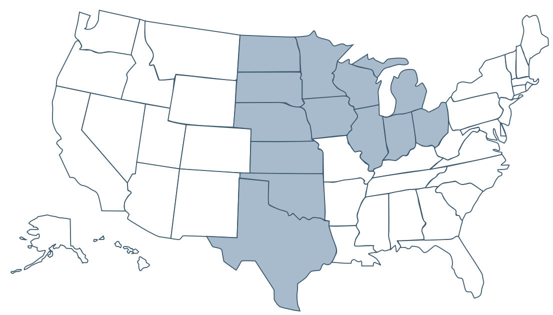
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

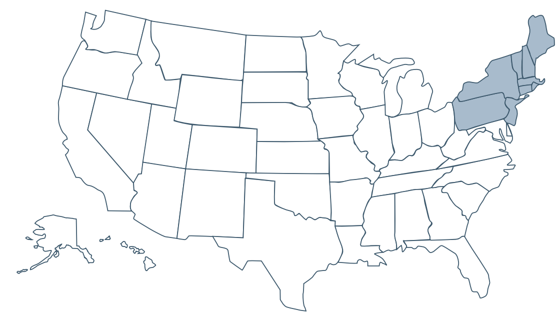
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



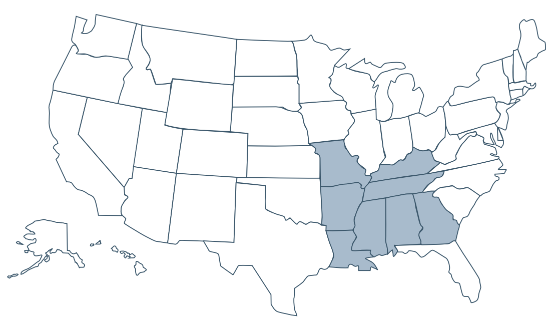
Atlantic Coast



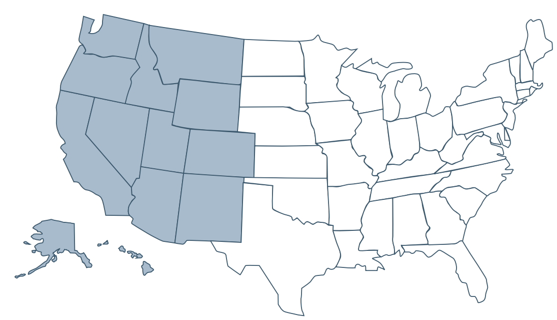
Midwest



Northeast



Southeast



West

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