MERCER CAPITAL

# Bank Watch


## May 2016



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# What's Stopping Banks from Getting into Wealth Management and How to Overcome It

## Final Thoughts on AOBA

*This article originally appeared on Mercer Capital's blog **RIA Valuation Insights** on February 15, 2016. To subscribe, visit **mer.cr/ria-vi**.*

*1968 Porsche "soft-window" Targa. Is it a convertible or a coupe? Yes.*

In the mid-1960s, the Department of Transportation was considering banning the sale of convertibles in the U.S. because of safety concerns for occupants in the event of roll-overs. What we now know as the "sun-roof" became a popular response to this regulatory threat,

## What We're Reading

Robert Barba of *American Banker* recaps the Crossroads: Banking and FinTech conference that we attended in Atlanta in mid-April in an article entitled "**Are Fintech and Community Banks a Perfect Match?**"

The *OCC* published a white-paper examining FinTech entitled "**Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective**"

For those bankers interested in the FinTech sector, subscribe to receive Mercer Capital's quarterly **FinTech newsletter**.

In early April, FDIC Chairman discussed ways the FDIC would support the establishment of new community banks. **This blog post on *Bank Lawyers Blog*** examined the issue in greater detail.

Jerome Lemmon had an interesting article on *BankDirector.com* entitled "**How to Protect Your Bank in a Sale: Reverse Due Diligence**."

*AccountingWeb* provides an update on CECL entitled "**FASB Stays on Course for Standard on Credit Losses**."

but Porsche went one step further and developed a version of its popular 911 series that had a removable roof and a removable (plastic) rear window known as the "Targa." Essentially, the Targa was a convertible with a cosmetically-integrated roll-bar, or a cross between a coupe and a convertible that provided the open-air experience of one with the (relative) safety of the other.

The DOT never actually banned the sale of convertibles in America, but Porsche pressed on and the potential for regulation spawned a response that, over time, became recognized as an iconic design. Other automakers quickly followed suit, and a trend was born. Porsche still offers the 911 in a Targa configuration, although the mechanism for removing the roof has become **considerably more elaborate**.

## Do Regulations Suggest a New Model for Banking?

As discussed **in last month's article**, economic circumstances and technological change, to say nothing of Dodd-Frank, are forcing banks to reconsider their business models. For many, the opportunity in this lies in another piece of legislation: the repeal of Glass-Steagall. Much like Porsche discovered fifty years ago, many banks are responding to regulatory changes by opting for a hybrid model that pairs trust and wealth management operations with traditional banking. The advantages of banks developing their investment management operations are pretty easy to see: it produces a more stable and diverse revenue stream, it provides more touch points for customer relationships, and it can substantially improve a bank's return on equity.

Some see this opportunity very clearly. Last year, I attended a reception at a successful trust bank and overheard a conversation between the CFO's mother and a new employee at the bank, whom she told "we just used the lending function to pay bills until we could ramp up the wealth management practice." I decided that evening that when a corporate executive's relatives can express the strategic plan perfectly in twenty five words or less, it's a good plan.

Of course, opportunity is a two way street, and banks looking to venture into investment management, especially by acquisition, typically encounter a couple of major obstacles: balance sheet dilution and culture clash. Both of these challenges arise from the main difference between traditional banking and asset management. Whereas banking is asset heavy and personnel light, asset management requires not much of a balance sheet, but plenty of expensive staffing. It's a significant difference that can only be managed head on.

## ROE > TBV

From the perspective of a typical money manager, banker obsession with tangible book value can seem without merit, particularly in an era where net interest margins are evaporating and pursuing return on assets can seem Quixotic. But at some level, banking is what it is, and without TBV to leverage, there's no bank. For a bank with excess equity, even today it can look much more attractive to buy another bank instead of an RIA.

Despite our current era of low and declining NIMs, TBV dilution for an acquiring bank paying 50% more than tangible book can be earned back in three or four years, thanks to the opportunities for expense saves in the right merger. RIAs often transact for lower pre-tax multiples than banks, but the price to book multiples can be nearly incalculable. A wealth manager might sell for eight or nine times pre-tax net income (the real range is larger), but 90% of that transaction is ultimately allocable to intangible assets. There is little in the way of expense saves in combining, say, an existing wealth management firm with a bank's trust operations. The earn-back period on tangible book dilution for an investment management acquisition can stretch to a decade, absent favorable markets or other growth catalysts, which is more than a lot of banks are willing to bear.

There's plenty of reason to absorb the TBV dilution, though, and for banks to do RIA acquisitions anyway. Most banks are starved for ROE these days, and there's no quicker path to improving ROE than trading some book value for the recurring earnings that only an asset management shop can provide. Bank mergers may be easier to digest financially on the front end, but after the dust settles, it's just more bank, which doesn't solve the problem of how to make money when the environment for banks is as negative as it is currently.

While the dilution to TBV can't be avoided, some of the dilution can be mitigated (or at least justified), by paying for a substantial portion of the acquisition with a performance-based earn-out. It isn't uncommon to pay one-third or more of the purchase price of an asset management firm acquisition using contingent considerations. While there's still a down payment, or initial consideration, to be paid in an investment management firm acquisition, an earn-out consideration can at least allow the bank to experience part of the TBV diminution at the same time that earnings are being produced to justify the balance sheet impact.

This model works even better when the contingent consideration is paid as compensation (bonuses), so book value dilution is avoided altogether, and the acquirer gets the real time tax benefit of salary expense. Few selling investment managers are willing to agree to this because of the tax impact to them, but it's a negotiating point worth remembering.

## Managing (Accepting) Culture Clash

It's not an exaggeration to say that investment management firms brag about how much they pay their people, and banks brag about how little they pay their people. The regulatory item that requires banks to disclose their average compensation – where lower is considered better – has never existed in the investment management community (where the material trappings of success were the ultimate performance ratio).

Banks acquiring asset management firms have to accept the fact that they can't put a bunch of investment managers on a bank's compensation plan without enduring value-killing turnover and customer attrition. An RIA's business model is inescapably different than a bank, and the rigid work environment and salary structure that is endemic to banking simply won't work in the investment management community.

This can make integrating an RIA acquisition into an existing trust operation especially challenging, and at some level there has to be acceptance on the front end that the wealth managers will probably make more than the lenders, but that their impact on the bank's P&L will justify it. It isn't unusual to see personnel costs in a well-run, mature RIA sum to half of revenue. The revenue and profit per employee of an RIA is simply much greater than the same metrics applied to a bank, and compensation is higher.

So while the mixture of Mazdas and Maseratis in the employee parking lot may be awkward at first, in the long run, a bank with a successful trust or wealth management franchise will provide growth opportunities and earnings stability that benefit all of a bank's stakeholders.

## Eyes Wide Open

It remains to be seen whether the either/or business model of banks with wealth management practices (or wealth management practices with banking operations – depending on your perspective) will endure like the Targa design of the 1960s. But the banking environment today demands something of a response, and developing a revenue stream from investment management offers banks a path to remain relevant and independent in spite of a lousy lending and regulatory environment. We just recommend bankers accept the challenges that come with RIA acquisitions and face them head on. In some regards, the issues of tangible book value dilution and culture clash stem from the very reason banks should be getting into investment management – a high margin, capital light financial service that is difficult to commoditize. In the end, the challenges of acquisition/integration are actually the sources of upside – so long as you're willing to accept a little wind in your hair.

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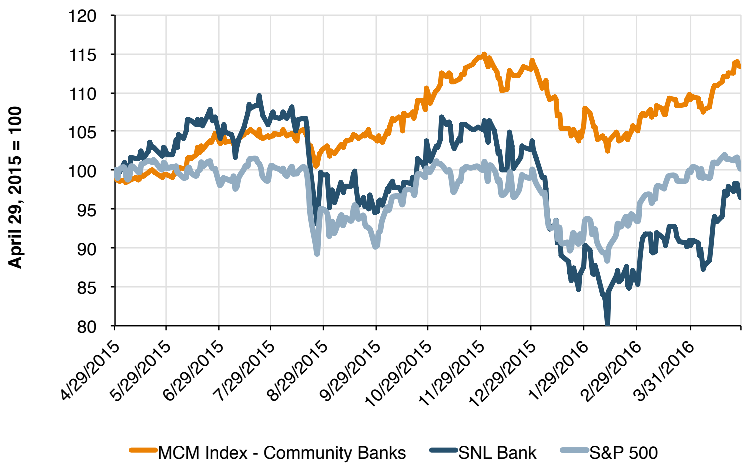
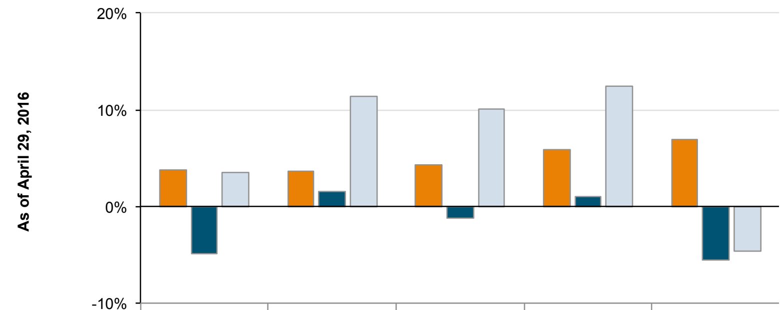
## Mercer Capital's Bank Group Index Overview




## Return Stratification of U.S. Banks

by Asset Size



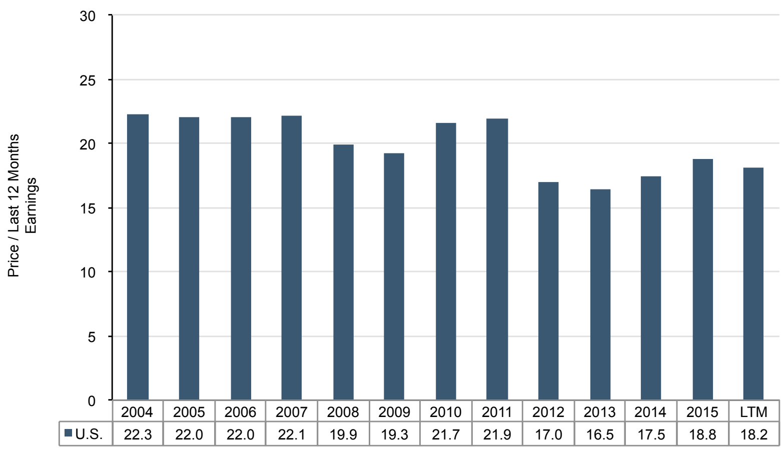

| | Assets $250 - $500M | Assets $500M - $1B | Assets $1 - $5B | Assets $5 - $10B | Assets > $10B |
|---|---|---|---|---|---|
| Month-to-Date | 3.76% | 3.63% | 4.24% | 5.82% | 6.94% |
| Year-to-Date | -4.95% | 1.58% | -1.22% | 1.03% | -5.52% |
| Last 12 Months | 3.48% | 11.35% | 10.08% | 12.38% | -4.63% |

## Median Valuation Multiples

| | Median Total Return | | | Median Valuation Multiples as of April 30, 2016 | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Indices | Month-to-Date | 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 | 3.84% | 2.39% | 18.90% | 16.09 | 15.15 | 13.67 | 108.2% | 117.3% | 2.0% |
| Midwest | 4.68% | 0.57% | 14.01% | 13.60 | 13.61 | 12.50 | 114.0% | 134.7% | 2.2% |
| Northeast | 2.76% | 0.35% | 6.65% | 14.37 | 13.03 | 11.54 | 113.1% | 121.0% | 3.1% |
| Southeast | 3.84% | -2.61% | 12.97% | 14.68 | 15.20 | 12.60 | 110.6% | 115.0% | 1.4% |
| West | 5.17% | 0.10% | 15.23% | 15.20 | 14.55 | 12.60 | 120.3% | 127.5% | 2.4% |
| National Community Banks | 3.93% | 0.35% | 13.38% | 15.01 | 14.37 | 12.67 | 112.9% | 123.8% | 2.2% |
| **SNL Bank Index** | **6.79%** | **-5.06%** | **-3.46%** | | | | | | |

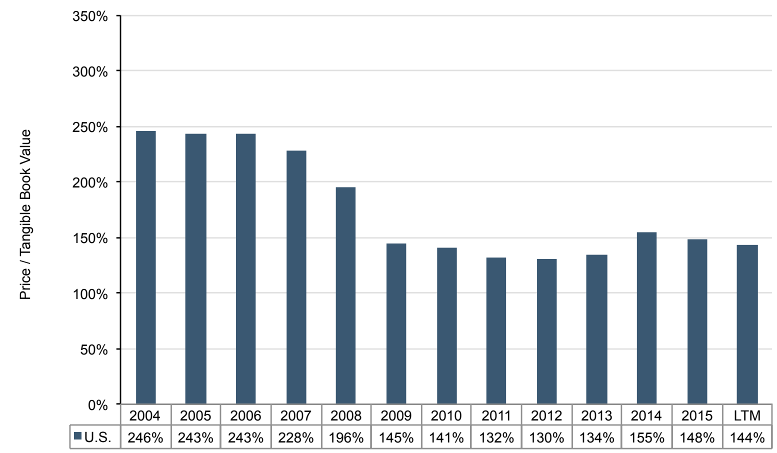
## Median Price/Earnings Multiples

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



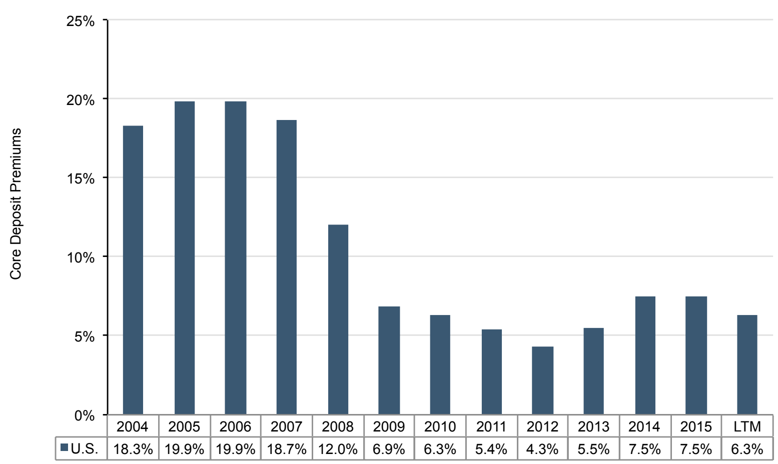

## Median Price/Tangible Book Value Multiples

*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

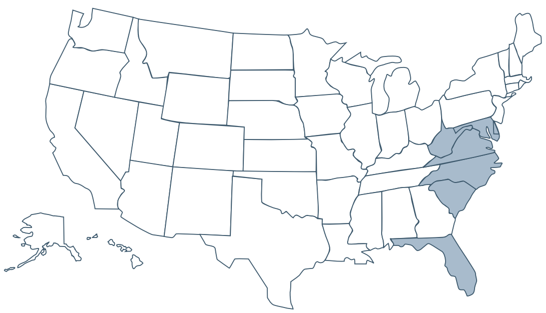
*Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended April 2016*

| 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 | 18.02 | 1.49 | 8.2% | 20 | 89.03 | 503,752 | 7.76% |
| Midwest | 18.21 | 1.36 | 5.0% | 66 | 17.00 | 131,601 | 8.53% |
| Northeast | 22.44 | 1.30 | 5.2% | 8 | 41.94 | 374,607 | 6.63% |
| Southeast | 16.02 | 1.43 | 8.9% | 25 | 36.70 | 207,452 | 10.10% |
| West | 15.26 | 1.44 | 6.9% | 16 | 48.75 | 242,061 | 11.04% |
| **National Community Banks** | **18.17** | **1.44** | **6.3%** | **135** | **34.20** | **195,831** | **8.53%** |

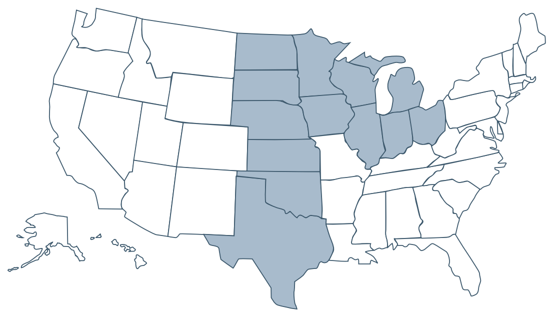
*Source: Per SNL Financial*

# Mercer Capital's Regional Public Bank Peer Reports

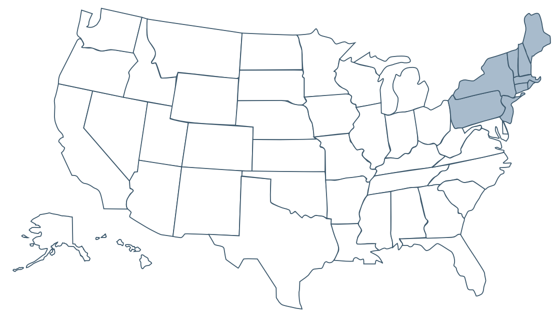
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



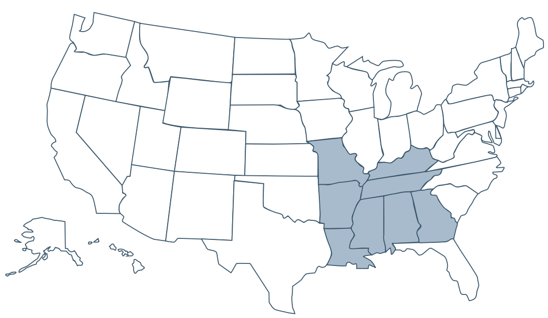
**Atlantic Coast**



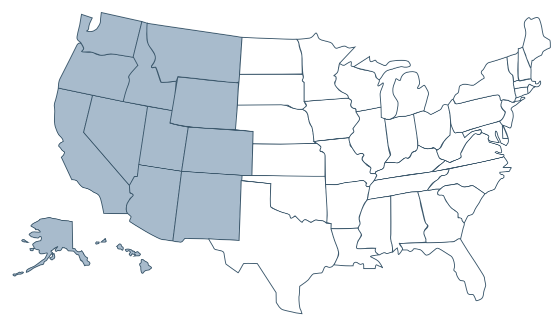
**Midwest**



**Northeast**



**Southeast**



**West**

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