MERCER CAPITAL

Bank Watch

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Fairness Considerations for Mergers of Equals

When asked about his view of a tie years before the NCAA instituted the playoff format in the 1990s, Coach Bear Bryant famously described the outcome as "kissing your sister." If he were a portfolio manager holding a position in a company that entered into a merger of equals (MOE), his response might be the same. Wall Street generally does not like MOEs unless the benefits are utterly obvious and/or one or both parties had no other path to create shareholder value. In some instances, MOEs may be an intermediate step to a larger transaction that unlocks value. National Commerce Financial Corporation CEO Tom Garrott once told me that part of his rationale for entering into a $1.6 billion MOE with CCB Financial Corp. in 2000 that resulted in CCB owning 47% of the company was because bankers told him he needed a bigger retail footprint to elicit top dollar in a sale. It worked. National Commerce agreed to be acquired by SunTrust Banks, Inc. in 2004 in a deal that was valued at $7 billion.

Kissing Your Sister?

MOEs, like acquisitions, typically look good in a PowerPoint presentation, but can be tough to execute. Busts from the past include Daimler-Benz/Chrysler Corporation and AOL/Time Warner. Among banks the 1994 combination of Cleveland-based Society Corporation and Albany-based KeyCorp was considered to be a struggle for several years, while the 1995 combination of North Carolina-based Southern National Corp. and BB&T Financial Corporation was deemed a success.

The arbiter between success and failure for MOEs typically is culture, unless the combination was just a triumph of investment banking and hubris, as was the case with AOL/Time Warner. The post-merger KeyCorp struggled because Society was a centralized, commercial-lending powerhouse compared to the decentralized, retail-focused KeyCorp. Elements of both executive management teams stuck around. Southern National, which took the BB&T name, paid the then legacy BB&T management to go away. At the time there was outrage expressed among investors at the amount, but CEO John Allison noted it was necessary to ensure success with one management team in charge. Likewise, National Commerce's Garrott as Executive Chairman retained the exclusive option to oust CCB's Ernie Roessler, who became CEO of the combined company, at the cost of $10 million if he chose to do so. Garrett exercised the option and cut the check in mid-2003 three years after the MOE was consummated.

Fairness Opinions for MOEs

MOEs represent a different proposition for the financial advisor in terms of rendering advice to the Board. An MOE is not the same transaction as advising a would-be seller about how a take-out price will compare to other transactions or the company's potential value based upon management's projections. The same applies to advising a buyer regarding the pricing of a target. In an MOE (or quasi-MOE) both parties give up 40-50% ownership for future benefits with typically little premium if one or both are publicly traded. Plus there are the social issues to navigate.

While much of an advisor's role will be focused on providing analysis and advice to the Board leading up to a meaningful corporate decision, the fairness opinion issued by the advisor (and/or second advisor) has a narrow scope. Among other things a fairness opinion does not opine:

- The course of action the Board should take;
- The contemplated transaction represents the highest obtainable value;
- Where a security will trade in the future; and
- How shareholders should vote.

What is opined is the fairness of the transaction from a financial point of view of the company's shareholders as of a specific date and subject to certain assumptions. If the opinion is a sell-side opinion, the advisor will opine as to the fairness of the consideration received. The buy-side opinion will opine as to the fairness of the consideration paid. A fairness opinion for each respective party to an MOE will opine as to the fairness of the exchange ratio because MOEs largely entail stock-for-stock structures.

Explaining the benefits of an MOE and why ultimately the transaction is deemed to be fair in the absence of a market premium can be challenging. The pending MOE among Talmer Bancorp Inc. (45%) and Chemical Financial Corp. (55%) is an example. When the merger was announced on January 26, the implied value for Talmer was $15.64 per share based upon the exchange ratio for Chemical shares (plus a small amount of cash). Talmer's shares closed on January 25, 2016 at $16.00 per share. During the call to discuss the transaction, one analyst described the deal as a "take under" while a large institutional investor said he was "incredibly disappointed" and accused the Board of not upholding its fiduciary duty. The shares dropped 5% on the day of the announcement to close at $15.19 per share.

What We're Reading

In a recent meeting with the FDIC, many community bankers voiced their fears about the **potential disruption that fintech** could have on their business models.

American Banker examines small businesses' calls for their banks to adopt more up to date technology in "**Cost-Conscious Small Businesses Want Better Bank Tech**."

American Banker notes possible reasons behind an **uptick in bank lending in the second quarter** of this year, despite a low growth economic environment.

Bank Director takes a look at the **potential for the M&A process for banks to evolve** in the post Dodd-Frank era of regulation.

A **report from SNL** highlights the plight of smaller community banks' growth and earnings, as they have often ended up paying much of the cost of recent regulatory burdens placed on community banks. (subscription required)

Was the transaction unfair and did the Board breach its fiduciary duties (care, loyalty and good faith) as the institutional shareholder claimed? It appears not. The S-4 notes Talmer had exploratory discussions with other institutions, including one that was "substantially larger"; yet none were willing to move forward. As a result an MOE with Chemical was crafted, which includes projected EPS accretion of 19% for Talmer, 8% for Chemical, and a 100%+ increase in the cash dividend to Talmer shareholders. Although the fairness opinions did not opine where Chemical's shares will trade in the future, the bankers' analyses noted sizable upside if the company achieves various peer-level P/Es. (As of mid-July 2016, Talmer's shares were trading around $20 per share.)

Fairness is not defined legally. The Merriam-Webster dictionary defines "fair" as "just, equitable and agreeing with what is thought to be right or acceptable." Fairness when judging a corporate transaction is a range concept. Some transactions are not fair, some are in the range—reasonable, and others are very fair.

The concept of "fairness" is especially well-suited for MOEs. MOEs represent a combination of two companies in which both shareholders will benefit from expense savings, revenue synergies and sometimes qualitative attributes. Value is an element of the fairness analysis, but the relative analysis takes on more importance based upon a comparison of contributions of revenues, earnings, capital and the like compared to pro forma ownership.

Investment Merits to Consider

A key question to ask as part of the fairness analysis: are shareholders better off or at least no worse for exchanging their shares for shares in the new company and accepting the execution risks? In order to answer the question, the investment merits of the pro forma company have to be weighed relative to each partner's attributes.

» **Profitability and Revenue Trends.** The analysis should consider each party's historical and projected revenues, margins, operating earnings, dividends and other financial metrics. Issues to be vetted include customer concentrations, the source of growth, the source of any margin pressure and the like. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.

» **Expense Savings.** How much and when are the savings expected to be realized. Do the savings come disproportionately from one party? Are the execution risks high? How does the present value of the after-tax expense savings compare to the pre-merger value of the two companies on a combined basis?

» **Pro Forma Projected Performance.** How do the pro forma projections compare with each party's stand-alone projections? Does one party sacrifice growth or margins by partnering with a slower growing and/or lower margin company?

» **Per Share Accretion.** Both parties of an MOE face ownership dilution. What is obtained in return in terms of accretion (or dilution) in EBITDA per share (for non-banks), tangible BVPS, EPS, dividends and the like?

» **Distribution Capacity.** One of the benefits of a more profitable company should be (all else equal) the capacity to return a greater percentage of earnings (or cash flow) to shareholders in the form of dividends and buybacks.

» **Capital Structure.** Does the pro forma company operate with an appropriate capital structure given industry norms, cyclicality of the business and investment needs to sustain operations? Is there an issue if one party to an MOE is less levered and the other is highly levered?

- » **Balance Sheet Flexibility.** Related to the capital structure should be a detailed review of the pro forma company's balance sheet that examines such areas as liquidity, funding sources, and the carrying value of assets such as deferred tax assets.

- » **Consensus Analyst Estimates.** This can be a big consideration in terms of Street reaction to an MOE for public companies. If pro forma EPS estimates for both parties comfortably exceed Street estimates, then the chances for a favorable reaction to an MOE announcement improve. If accretion is deemed to be marginal for the risk assumed or the projections are not viewed as credible, then reaction may be negative.

- » **Valuation.** The valuation of the combined company based upon pro forma per share metrics should be compared with each company's current and historical valuations and a relevant peer group. Also, while no opinion is expressed about where the pro forma company's shares will trade in the future, the historical valuation metrics provide a context to analyze a range of shareholder returns if earning targets are met under various valuation scenarios. This is particularly useful when comparing the analysis with each company on a stand-alone basis.

- » **Share Performance.** Both parties should understand the source of their shares and the other party's share performance over multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.

- » **Liquidity of the Shares.** How much is liquidity expected to improve because of the MOE? What is the capacity to sell shares issued in the merger? SEC registration and even NASADQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently.

- » **Strategic Position.** Does the pro forma company have greater strategic value as an acquisition candidate (or an acquirer) than the merger partners individually?

Conclusion

The list does not encompass every question that should be asked as part of the fairness analysis for an MOE, but it points to the importance of vetting the combined company's investment attributes as part of addressing what shareholders stand to gain relative to what is relinquished. We at Mercer Capital have over 30 years of experience helping companies and financial institutions assess significant transactions, including MOEs. Do not hesitate to contact us to discuss a transaction or valuation issue in confidence.

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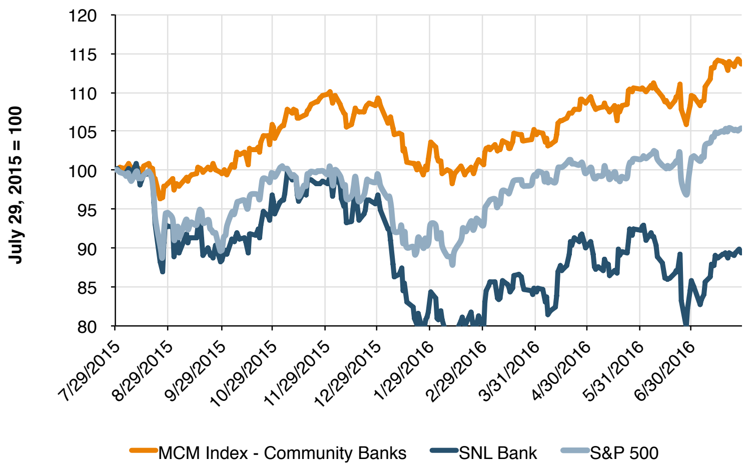
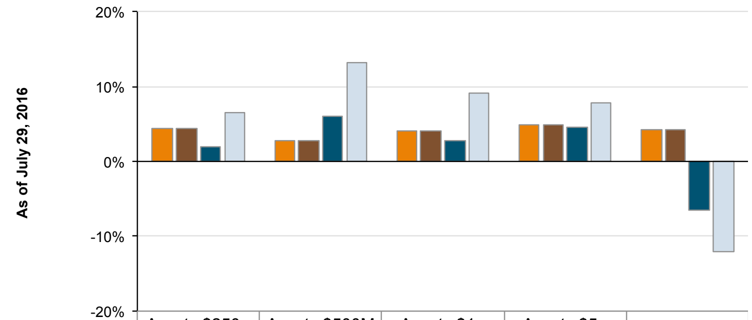
Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



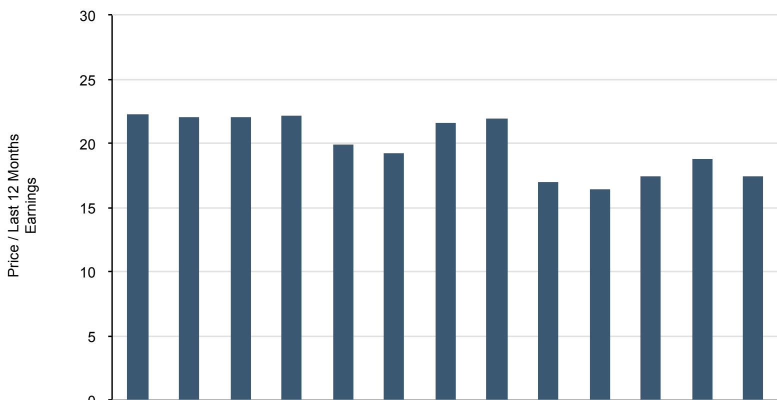
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	4.37%	2.72%	4.15%	4.85%	4.23%
Quarter-to-Date	4.37%	2.72%	4.15%	4.85%	4.23%
Year-to-Date	2.00%	5.96%	2.81%	4.56%	-6.59%
Last 12 Months	6.60%	13.23%	9.05%	7.83%	-12.08%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of July 29, 2016					
Indices	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 16(E) EPS	Price / 17(E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast	3.40%	3.40%	5.43%	14.68%	16.6x	16.1x	14.5x	113%	129%	2.0%
Midwest	4.70%	4.70%	7.10%	17.55%	14.5x	14.5x	12.9x	118%	138%	2.1%
Northeast	3.23%	3.23%	7.54%	12.90%	14.5x	14.2x	11.9x	115%	128%	3.0%
Southeast	4.12%	4.12%	1.80%	11.77%	14.6x	15.0x	13.8x	102%	111%	1.5%
West	2.42%	2.42%	1.75%	10.83%	15.3x	15.0x	12.7x	120%	128%	2.4%
National Community Banks	3.58%	3.58%	4.89%	13.57%	15.1x	15.0x	13.1x	115%	128%	2.1%
SNL Bank Index	**4.26%**	**4.26%**	**-5.75%**	**-10.59%**						

Median Price/Earnings Multiples

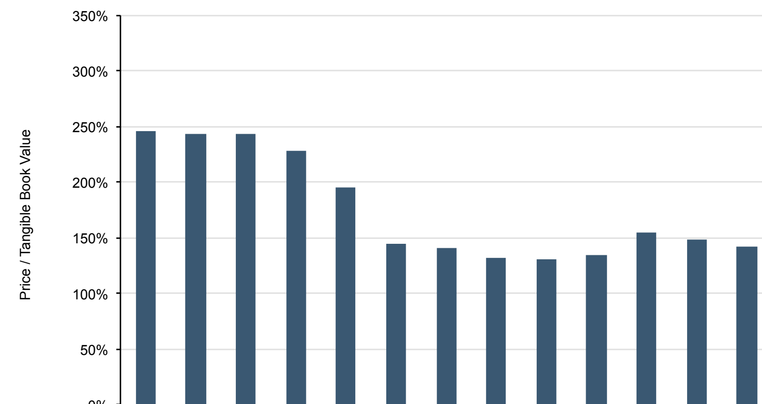
Target Banks' Assets <$5B and LTM ROE >5%



	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	17.5

Median Price/Tangible Book Value Multiples

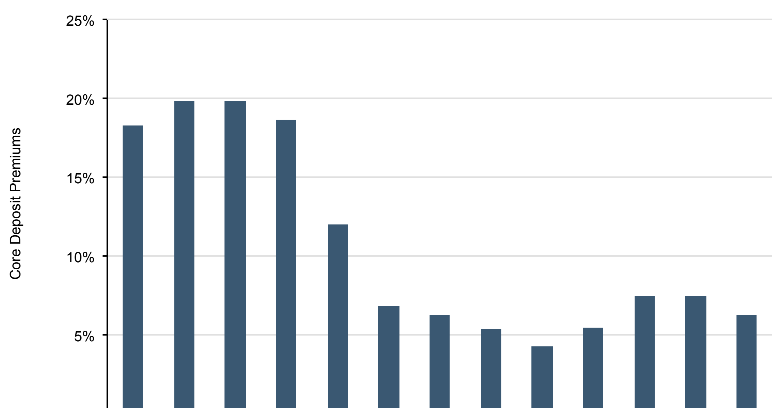
Target Banks' Assets <$5B and LTM ROE >5%



	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%	143%

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%	6.3%

Median Valuation Multiples for M&A Deals

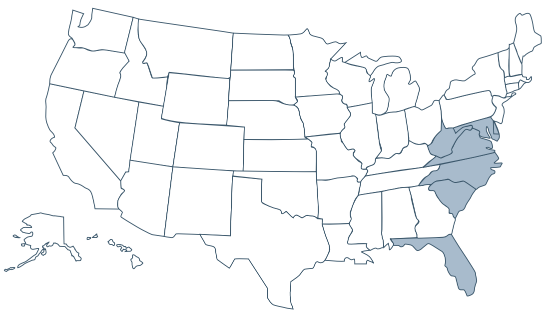
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended July 2016

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	17.7x	145%	6.0%	21	65.10	501,856	8.27%
Midwest	17.3x	141%	6.0%	71	23.20	136,536	8.72%
Northeast	21.9x	149%	9.3%	9	78.47	495,016	7.12%
Southeast	15.5x	142%	8.8%	25	58.71	184,113	11.02%
West	16.1x	141%	8.7%	14	56.25	218,543	11.05%
National Community Banks	**17.5x**	**143%**	**6.3%**	**140**	**41.58**	**195,874**	**8.87%**

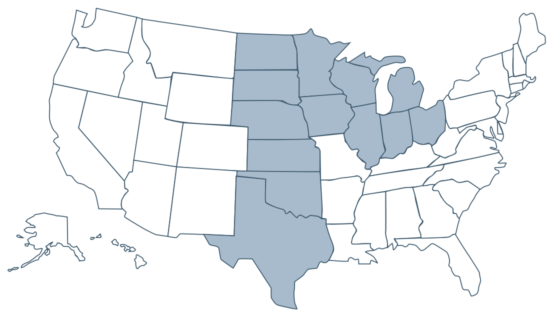
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

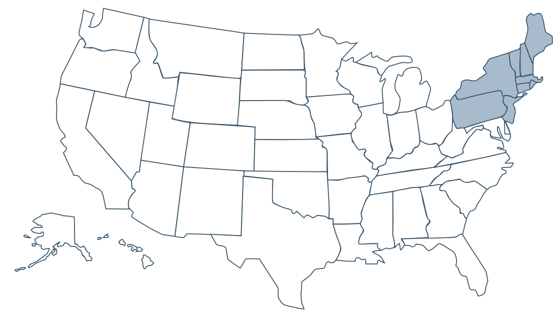
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



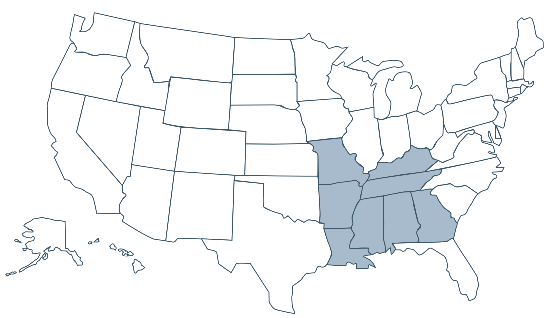
Atlantic Coast



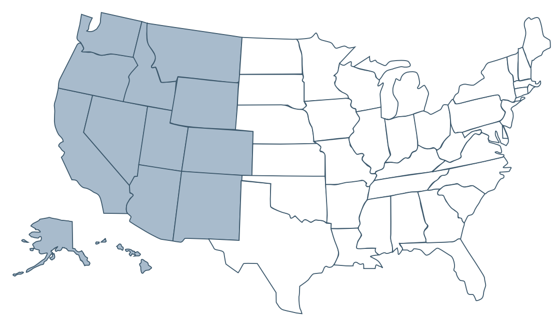
Midwest



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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