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Bank Watch

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Is Tangible Book Value per Share Dilution an Insurmountable Investor Fixation?

__Jeff K. Davis, CFA__, Managing Director of Mercer Capital's Financial Institutions Group, is a regular editorial contributor to __SNL Financial__, a subsidiary of __S&P Global Market Intelligence__. This contribution was originally published August 8, 2016, at SNL Financial. It is reprinted here with permission. Some links require a subscription to S&P Global Market Intelligence.

H. Rodgin Cohen, one of the top banking attorneys in the U.S., gave an interesting **interview** to American Banker recently in which he offered thoughts on banking M&A. One part of the interview surely resonated with bank investors: Tangible book value per share dilution incurred by buyers and the time it takes to recover it. Cohen called "investor fixation" on TBVPS dilution a new problem and observed that it is hard to pay a price that investors demand and keep the earnback period within five years.

Not to put words in his mouth, but I think it might be better stated that investors have to get real about dilution in larger deals if buyers are going to strike a deal. Math is math, depending upon the assumptions. The same thought applies to the sellers. As a group, they often become the largest investor in the buyer to the extent a transaction entails a meaningful amount of common-share consideration. Push the buyer to the limit and the market may punish the buyer's shares more than what negotiations achieved in obtaining the last increment of pricing.

Some recent deals come to mind that have entailed a lot of dilution to the buyers' TBVPS, including **KeyCorp-First Niagara Financial Group** (-12%), **Huntington Bancshares Inc.-FirstMerit Corp.** (-12%), FirstMerit-**Citizens Republic Bancorp Inc.** (-6.9%) and F.N.B. Corp.-**Yadkin Financial Corp.** (-8.5%). Investors were put off by the dilution and pricing. The buyers' shares sold off the day after the announcement by 7% to 11%. While I imagine the bankers told the buyers to expect "some" pressure on their shares, I doubt any told their clients "upwards of 10%." If they had, the deals probably would have gone to the cover bids.

Earnback periods quoted for these deals ranged from 2.5 years to "north of six years" for KeyCorp when excluding revenue synergies. I am not so sure investors are hung up on the earnback period per se, whether calculated as a simple recapture of the initial dilution or the higher hurdle reflected in the crossover method. I think they are hung up on pricing that creates sizable TBVPS dilution today and EPS accretion later.

Sizable dilution requires sizable savings and reasonably good execution to recover. Deal charges and dilution are certain; execution, EPS accretion, and therefore TBVPS recovery, are less certain. The corporate landscape is littered with transactions that failed to live up to billing at announcement. Acquisitions — at least large, fully priced transactions compared to bottom-of-the-cycle bargain purchases — tend to disappoint investors and easily can produce permanent dilution if the assumptions are off-base.

When a deal is announced, pro forma EPS estimates for the out years usually reflect Street consensus estimates for the buyer and seller, fair value accounting accretion and after-tax expense savings. Accounting accretion for fair value marks and expense savings may have a reasonable degree of certainty, but Street estimates for out years tend to be optimistic, except when credit is getting better. And earnings accretion from fair value marks eventually ends. It is a recipe for disappointment for skeptical investors who have seen the rodeo before.

Cohen is right that investor sensitivity to TBVPS dilution and the earnback period are relatively new; however, investors should be more sensitive after watching TBVPS melt for many banks as a result of massive credit losses and equity raises at very low prices in the aftermath of the financial crisis. Also, the TBVPS math was not so onerous pre-crisis when ROTCE for many banks was in the high teens or better. TBVPS dilution could be recovered faster than today when returns are on the order of 10% to 13%.

I see another issue raised indirectly by Cohen's observation: Is TBVPS sacrosanct? One might get that impression based upon how investors and bankers typically quote valuations in terms of TBVPS rather than earnings. Maybe that is easier because earnings can be volatile depending upon provisioning and the contribution of cyclical business lines, such as mortgage banking and capital markets.

I suppose TBVPS is sacrosanct in the sense that it is at the core of the business model in which tangible equity is levered to produce an earnings stream; however, it is not in the sense that TBVPS as a stand-alone metric conveys nothing about return on capital or the riskiness of the assets and, therefore, the "hardness" of TBVPS. Golden West Financial Corp., a pre-crisis leader in option ARM lending, produced ROEs of 19% to 21% during 2001 through 2005 that drove TBVPS to $28.15 by year-end 2005 from $13.77 per share at year-end 2001. In 2006, Golden West was acquired by Wachovia Corp., which in turn avoided failure by agreeing to a fire sale to Wells Fargo & Co. in 2008 as a result of its incredibly ill-advised acquisition. To borrow

What We're Reading

Crowe Horwath's Michael Budinger and Ryan Michalik have a nice piece on "**Adapting to CECL**."

John Maxfield's timely piece discusses "**The Promise and Perils of Forecasting the Future**" for community banks.

Bank Director's **2016 Technology Survey** reports some interesting findings including that 81% surveyed say that their core processor is slow to respond to innovations in the marketplace.

Jeff Davis of Mercer Capital remarks on the recent events at Wells Fargo in "**Don Regan on Executive Knowledge**."

a phrase famously coined-by Tom Brown, legacy First Union's serial dilution caught up with it by 2008 when it totaled nearly 100%.

Although I am not a fan of TBVPS without any context related to ROE/ROTCE and risk, there is something to be said for TBVPS as a tracking metric through time. Unlike EPS, there are no add-backs for deal charges and other bad stuff the Street ignores to derive operating EPS and a bridge to next year's higher earnings estimates.

Is TBVPS dilution acceptable? Of course it is as long as there is a reasonable plan to recover it; the projected return on invested equity capital is well above the buyer's cost of capital; the loan portfolio is not marked by salesmen; and the transaction produces a more valuable company that rewards the buyer's shareholders, too. None of that can be guaranteed. The only thing that can be controlled by the buyer is the price paid. Modest acquisition prices create a margin of safety, but modest acquisition prices are only obtainable when the credit and earnings cycle are closer to a trough than a cyclical peak.

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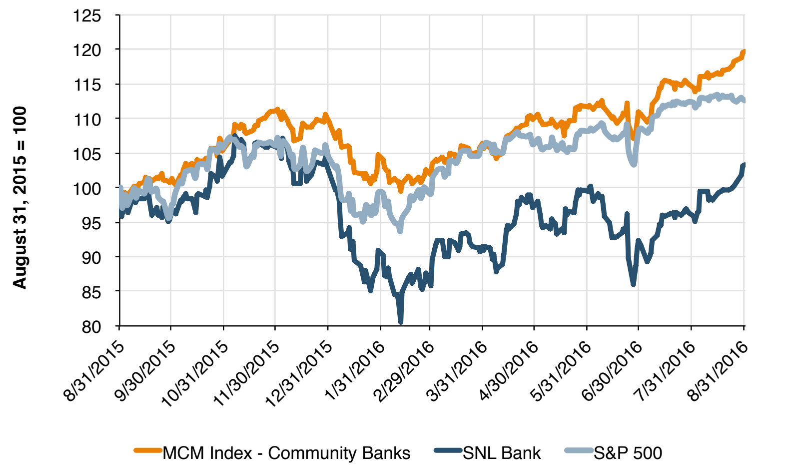
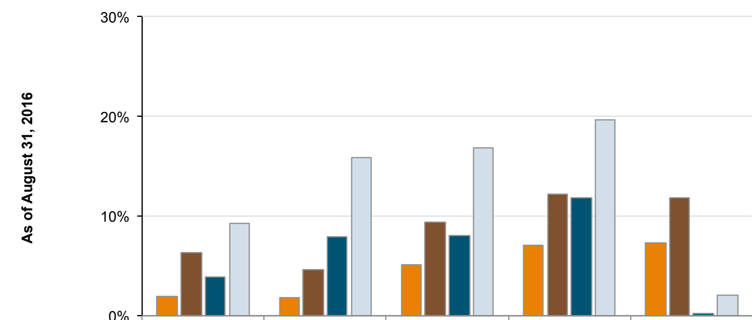
Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



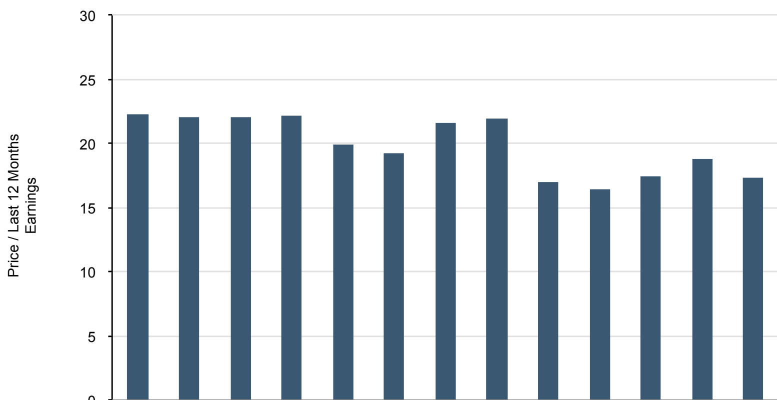
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	1.90%	1.85%	5.08%	7.00%	7.29%
Quarter-to-Date	6.36%	4.62%	9.44%	12.19%	11.82%
Year-to-Date	3.94%	7.92%	8.03%	11.88%	0.22%
Last 12 Months	9.27%	15.80%	16.87%	19.59%	2.08%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of August 31, 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	3.57%	7.09%	9.24%	19.64%	16.8x	15.9x	14.1x	114%	124%	1.9%
Midwest	3.66%	8.53%	11.01%	22.93%	14.7x	14.8x	12.9x	125%	142%	2.0%
Northeast	4.06%	7.40%	11.91%	19.73%	14.9x	14.5x	12.7x	121%	128%	3.0%
Southeast	3.02%	7.26%	4.87%	16.46%	14.9x	16.3x	14.5x	103%	115%	1.5%
West	5.41%	7.96%	7.25%	17.37%	16.7x	16.1x	14.2x	122%	135%	2.3%
National Community Banks	4.10%	7.83%	9.19%	19.58%	15.5x	15.5x	13.6x	120%	132%	2.1%
SNL Bank Index	**7.18%**	**11.73%**	**1.02%**	**3.31%**						

Median Price/Earnings Multiples

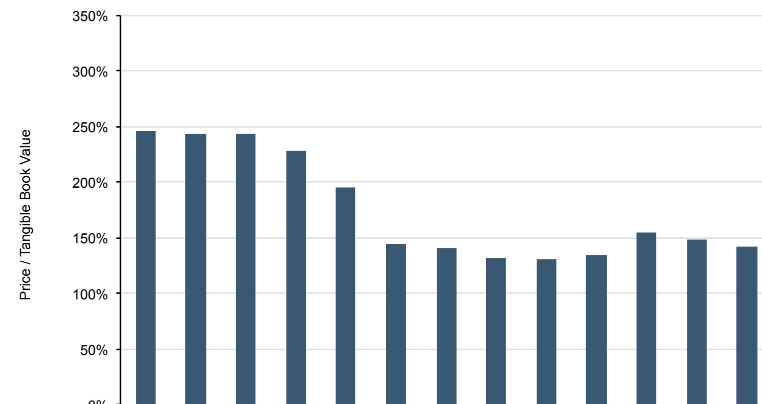
Target Banks' Assets <$5B and LTM ROE >5%



	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	17.3

Median Price/Tangible Book Value Multiples

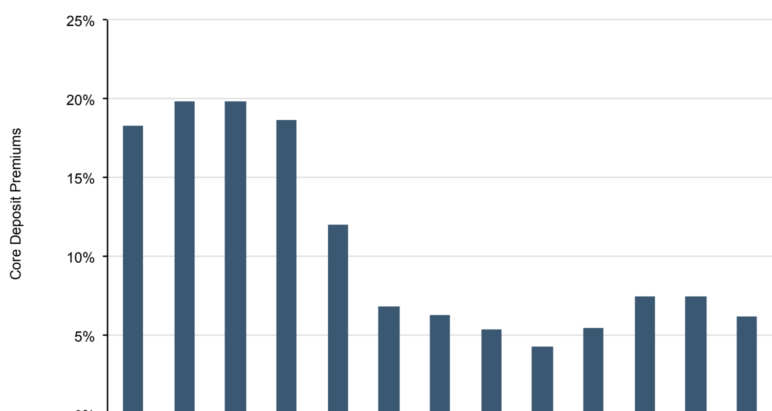
Target Banks' Assets <$5B and LTM ROE >5%



	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

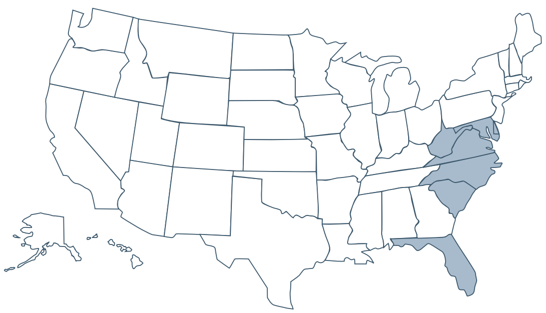
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended August 2016

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	146%	6.0%	22	57.66	455,934	8.18%
Midwest	17.2x	141%	6.0%	70	23.20	123,598	8.78%
Northeast	21.4x	151%	10.1%	6	101.64	522,346	6.85%
Southeast	15.5x	142%	8.8%	27	58.56	186,063	11.02%
West	16.1x	141%	8.7%	14	56.25	218,543	11.05%
National Community Banks	**17.3x**	**143%**	**6.3%**	**139**	**39.20**	**184,113**	**9.07%**

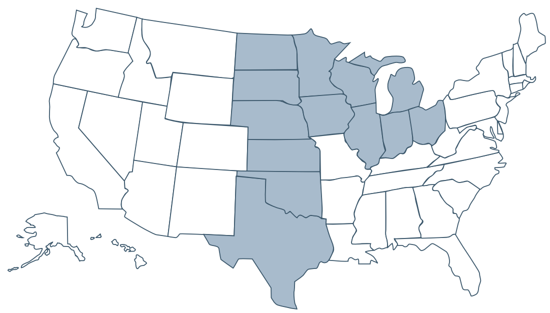
Source: SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

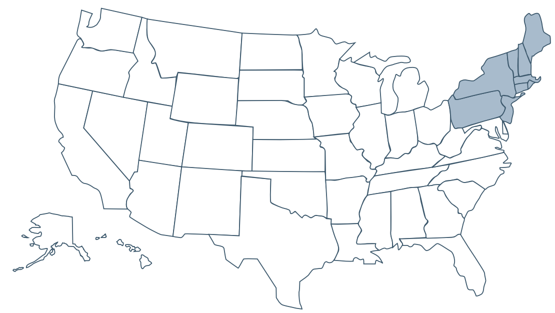
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



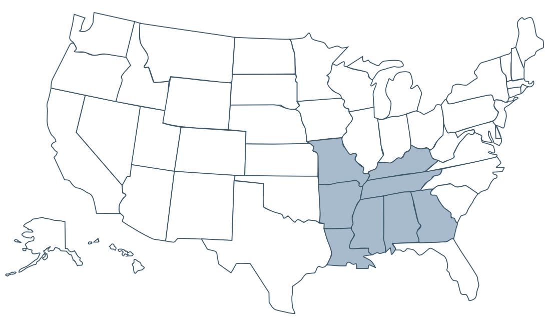
Atlantic Coast



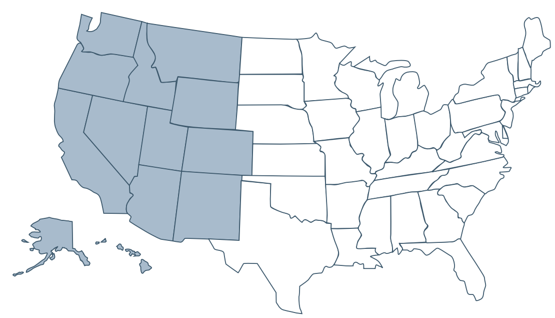
Midwest



Northeast



Southeast



West

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