MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Bank Watch

November 2016

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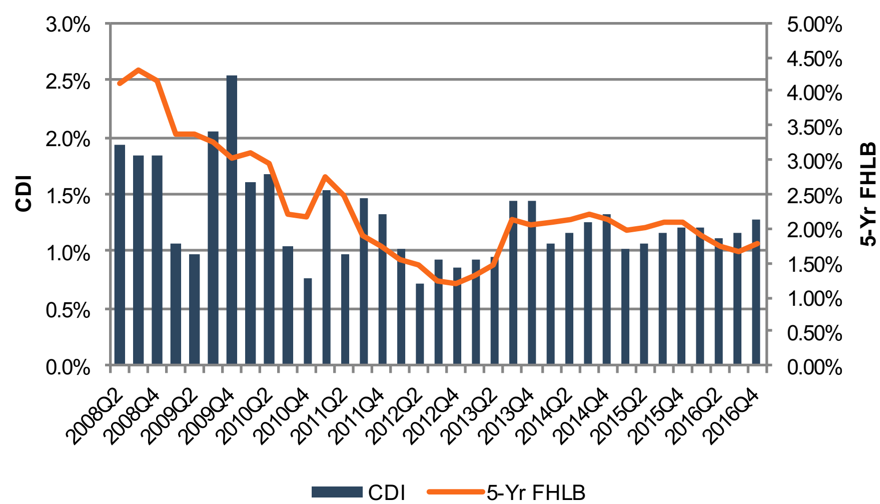
Core Deposit Intangible Asset Values Remain Low

Other than goodwill, core deposit intangible assets are the most commonly recorded intangible assets in bank acquisitions, representing the benefit of having a low-cost, stable funding source. However, CDI values have decreased since the financial crisis, as deposits have less worth, so to speak, in a very low rate environment than in a "normal" environment that existed before the crisis. Using data compiled by S&P Global Market Intelligence, we analyzed trends in CDI assets recorded in whole bank acquisitions completed from 2008 through November 1, 2016. We compared CDIs recorded as a percentage of core deposits acquired to 5-year FHLB rates over the same period.

Since the start of the financial crisis, CDIs recorded in acquisitions have fallen from 1.5%-2.0% to stabilizing at approximately 1.0%-1.25% in the 2014-2016 period. As interest rates declined in the years following the crisis, the cheaper cost of alternative funds has made banks' core deposit bases less valuable as a stable, cheap source of funding. Low rates also led to less attractive alternative investments for consumers, which has resulted in rising deposit balances and less competition for funds. In short, low rates have made funds easier and cheaper to access, reducing the value of core deposit intangible assets.

Despite the FOMC's decision to begin a gradual increase in interest rates in late 2015, the cost of alternative funds such as FHLBs has not increased meaningfully

Chart 1: CDI as % of Acquired Core Deposits



Source: S&P Global Market Intelligence since then. While the narrative around the economy and rates has shifted since the November 8th presidential election, it is unclear whether rates will increase more than the gradual pace the Fed has targeted since late 2015.

When interest rates were higher pre-crisis, both CDI levels and deposit premiums paid in acquisitions were higher than the levels observed in today's environment. If rates do move meaningfully higher over the next few years, then deposit premiums should too (as would net interest margins).

What We're Reading

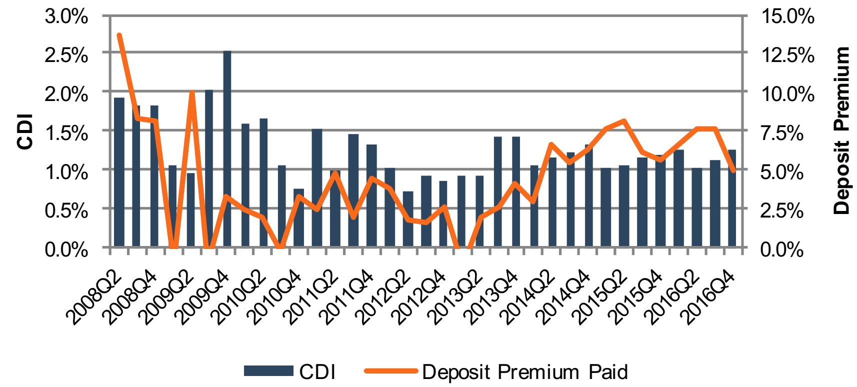
Bill Streeter tells a story about community banks and FinTech partnerships entitled "**Agile Tech for Community Bank Investment**."

With the election behind us, this article by Tara Jeffries looks to outline some implications for banks entitled "**Small, Regional Banks Hope Trump Will Treat Them Well**."

Jeff Davis of Mercer Capital comments on the election's impact on the banking industry in his SNL article, "**Credit Costs Should Be Part of Banking Industry's Post-Nov. 8 Narrative, Too**."
(subscription required)

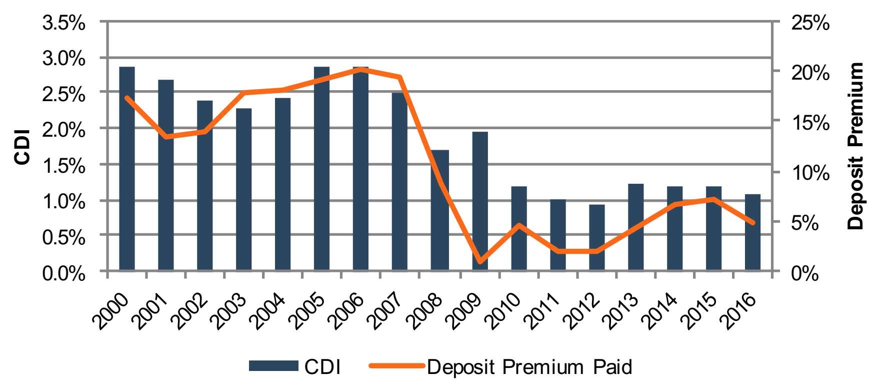
Mark Kanaly and Bo Griffith, two attorneys with Alston & Bird, have a nice piece for those banks considering M&A strategies entitled "**Six Tips for Negotiating a Successful M&A Transaction**."

Chart 2: CDI Recorded vs. Deposit Premiums Paid



Source: S&P Global Market Intelligence

Chart 3: CDI Recorded vs. Deposit Premiums Paid



Source: S&P Global Market Intelligence

Since the start of the financial crisis, improved deal values have resulted in some increase in deposit premiums paid in the past several years. However, the declining trend in CDI values has persisted even as deposit premiums have begun to tick back up (Chart 3 on the previous page).

For our analysis of industry trends in CDI values, we defined core deposits as total deposits, less accounts with balances over $100,000. In analyzing core deposit intangible assets for individual acquisitions, however, a more detailed analysis of the deposit base would consider the relative stability of various account types. In general, CDs tend to be more rate sensitive and less stable. Even in cases where a CD base is considered a stable customer base, given their relatively higher cost compared to non-time deposits, CDs often do not contribute to the core deposit intangible asset recorded. Furthermore, account types such as brokered or Qwickrate accounts and certain public funds that may be subject to a competitive bidding process are generally excluded from core deposits when determining the value of a CDI.

For more information about Mercer Capital's core deposit services, feel free to contact us.

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RECENT TRANSACTION

Mercer Capital Provides Financial Advisory Services To Little River Bancshares, Inc.

First Community Bancshares, Inc.
Batesville, Arkansas

has agreed to acquire

Little River Bank

Little River Bancshares, Inc.
Lepanto, Arkansas

Mercer Capital served as a financial advisor on behalf of Little River Bancshares, Inc.

October 2016

Learn more about our Transaction Advisory Services for Banks

On October 14, 2016, Batesville, Arkansas-based First Community Bancshares, Inc. ("FCB") announced that it had entered into a stock purchase agreement ("Agreement") with Lepanto, Arkansas-based Little River Bancshares, Inc. ("LRBI"), the parent company of Little River Bank ("LRB"), in which FCB will acquire LRBI. Terms of the Agreement were not disclosed. Mercer Capital served as a financial advisor to LRBI.

Harry "Tri" Watkins, Chairman of LRBI, said, "We have worked with Mercer Capital and Jeff Davis the past two years to evaluate the best course of action for LRBI and LRB in order to realize value for shareholders in what is a challenging operating environment for small banks. Our Board and I appreciate their thoughtful insight about shareholder value creation, the banking industry, the market for banks and FCB." The transaction is expected to be consummated by year-end.

First NBC Provides a Bank Investing Primer

***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 November 8, 2016, at SNL Financial. It is reprinted here with permission. Some links require a subscription to S&P Global Market Intelligence.*

If you have not read HoldCo Asset Management's Oct. 25 **letter** to the board of directors of **First NBC Bank Holding Co.**, it is a wickedly good read for bank investors and a reminder to pay close attention to a bank's assets and the parent company's liquidity and capital structure. That may be an obvious statement given what transpired during 2008-2010, but greed and fear are powerful emotions, and the fear of the crisis has passed. Carrying the thought a step further, investors should always review a bank's and its parent company's financial statements on a stand-alone basis in conjunction with (or prior to) an analysis of the consolidated statements.

First NBC is in a jam, even though neither the company nor the subsidiary bank is critically undercapitalized. The company's leverage ratio as of June 30 was 6.0% (the Sept. 30 Y-9LP will presumably be filed in a few days), and the bank's leverage ratio as of Sept. 30 was 7.3%. Nevertheless, the Atlanta Fed deemed the company to be in "troubled condition." Among the restrictions the Fed imposed on the parent company was a prohibition to incur debt, make interest or principal payments on its subordinated debt or pay dividends on its preferred and common equity. The Fed, in effect, handcuffed the parent company.

The handcuffs are a problem because the parent company is levered. The parent company capital structure as of June 30 entailed $349 million of tangible common equity, of which $281 million constituted Tier 1 common capital, $60 million of subordinate debt and $38 million of preferred equity. Interest on the sub debt is due Feb. 18 and Aug. 18 each year. Although the parent company had about $5 million of cash as of June 30, the Fed's order precludes the use of that money to make the approximately $2 million interest payment unless the Fed is petitioned and waives the restriction. Missing an interest payment is an event of default.

Parent company capital structure issues typically do not become an issue until asset quality problems at the subsidiary bank preclude upstream dividends necessary for debt service and dividend payments. Rating agencies and debt investors, in theory, focus intensely on this relationship. HoldCo has done so in the case of First NBC. Equity investors, in my view, usually do not, even though parent-only FR Y-9LP and FR Y-9SP financials are readily available.

Accounting firms do not help because they seem to only sporadically include "consolidating" and parent-only statements in the audits.

First NBC's parent company capital structure would not be an issue if the bank did not have asset and capital issues. The asset issues have been gestating for a while. Rather than problem C&D and CRE loans, the issue is the value attributable to

$171 million of tax credit-related investments and a $253 million deferred tax asset as of June 30. These are big opaque assets in relation to the bank's regulatory capital. HoldCo points out the negative feedback loop in which DTAs curtail regulatory capital under Basel III, while the tax credit investments contribute to the DTA. One may argue with the haircut HoldCo applies to the assets in its analysis, but I think the analysis summarizes the calamity of over-investing in a nontraditional asset that seemed to be predicated upon tax minimization vis-à-vis traditional lending.

HoldCo does not sugarcoat its view of the company's predicament: accept a prepackaged bankruptcy that would wipe out existing common shareholders in which ownership is split among existing sub debt and preferred equity investors and $68 million of new common equity; or risk a worse outcome by "swinging for the fences" to save the existing common.

HoldCo has informed the market where it stands. It is short the common and long the sub debt, which it acquired for 74% of par, and it indicated a willingness to provide up to $30 million of the $68 million of new common equity it believes the company will need in the prepackaged bankruptcy scenario. So far it is a winning trade. The company's shares set a 52-week high on Nov. 30, 2015, of $43.52 per share; they closed on Nov. 4, 2016, at $5.50 per share. If the plan is accepted, the sub debt will be valued at par. The trade is reminiscent of the capital stack arbitrage trades from 2007-2008. Many such trades were big-time winners when common shareholders were wiped out or massively diluted, while an infusion of new capital caused heavily discounted debt and preferred instruments to rebound.

I doubt management and the board views its task as swinging for the fences, and I am sure they are acutely aware of duties to creditors and equity holders. In any event, I think First NBC will find the basic adage of capital markets to be true in that when a company absolutely has to have capital (or a buyer), it is hard to come by or, if available, the price is punitive. Conversely, when capital or a buyer is not needed, plenty of offers can be found.

HoldCo points out correctly that First NBC's capital-raising challenges are magnified by the hoops it and investors will have to jump through to avoid limitations on the NOL carryforwards. The tax issue is tough, though I think it is not insurmountable.

As for selling the company, a buyer would probably put a sizable mark on the investment tax credit-related assets, as it would on the DTA. As an aside, Mike Mayo used to get a lot of press for questioning the value **Citigroup Inc.** assigned to its DTAs. Regardless, I am not convinced First NBC is a must-have property for other regional banks. **Hancock Holding Co.** has not gotten any high-fives from Wall Street for its acquisition of Whitney Holding Corp. in 2011. Plus, it appears divestitures would be required because a combination would push Hancock to the No. 1 deposit market share position. **IBERIABANK Corp.** could be a possibility, but there seemingly would be no reason for CEO Daryl Byrd to bend over backwards. As for a new entrant: why? New Orleans is an American gem, but it is not a high-growth Sunbelt city.

How does it play out? The market has predicted not well with the collapse in the share price. There could be a surprise, however. In HoldCo's analysis, the existing common is wiped out. If the market is assigning a 50% probability to that outcome, then an alternative outcome would be one in which the company successfully raises capital or the company is sold for more than a negligible value. If a handful of investors conclude the hole is not as big as HoldCo thinks it is or the Fed will be agreeable to a resumption of interest payments given a certain amount of equity, then First NBC may have a way out at a price that may be higher than the current share price. Nevertheless, existing shareholders are set to incur sizable dilution or worse.

Jeff K. Davis

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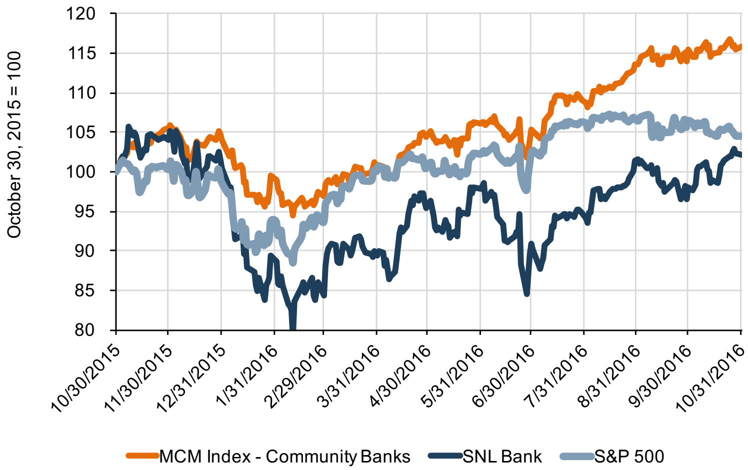
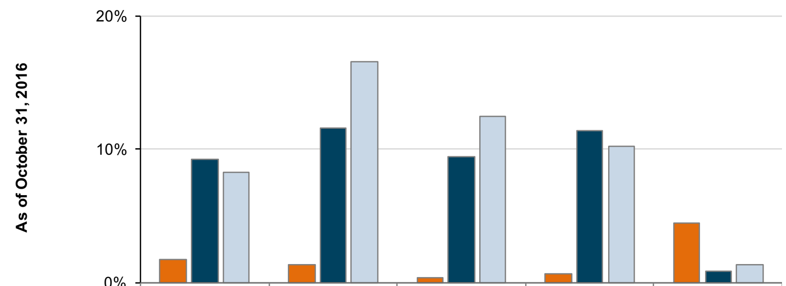
Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



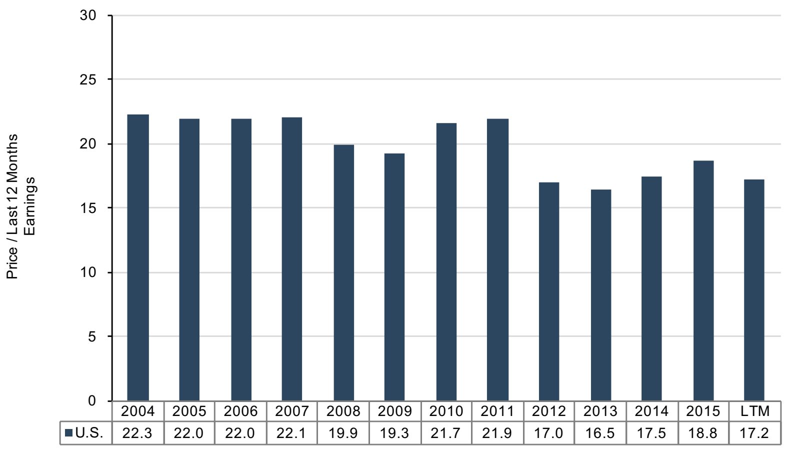
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	1.70%	1.31%	0.33%	0.71%	4.48%
Year-to-Date	9.29%	11.65%	9.50%	11.44%	0.84%
Last 12 Months	8.27%	16.59%	12.48%	10.21%	1.37%

Median Valuation Multiples

	Median Total Return as of October 31, 2016			Median Valuation Multiples as of October 31, 2016					
Indices	Month-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 Index	1.68%	12.51%	19.54%	16.4x	15.9x	14.7x	113%	131%	1.9%
Midwest Index	-0.93%	12.99%	18.74%	14.8x	15.1x	13.2x	121%	143%	2.1%
Northeast Index	0.10%	14.65%	15.80%	15.2x	15.1x	12.7x	124%	136%	2.8%
Southeast Index	0.70%	8.07%	13.08%	15.3x	16.5x	15.1x	116%	116%	1.6%
West Index	0.31%	7.38%	10.82%	15.8x	16.2x	13.9x	125%	127%	2.1%
Community Bank Index	0.22%	11.25%	15.80%	15.4x	15.5x	14.0x	120%	132%	2.1%
SNL Bank Index	**4.15%**	**1.63%**	**2.18%**						

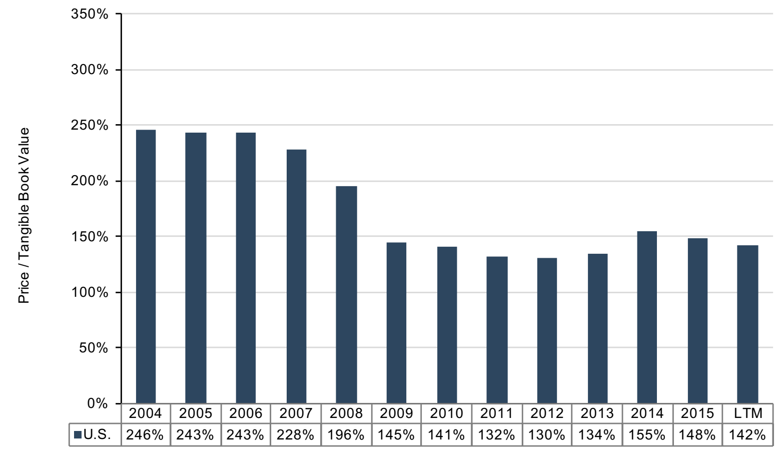
Median Price/Earnings Multiples

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



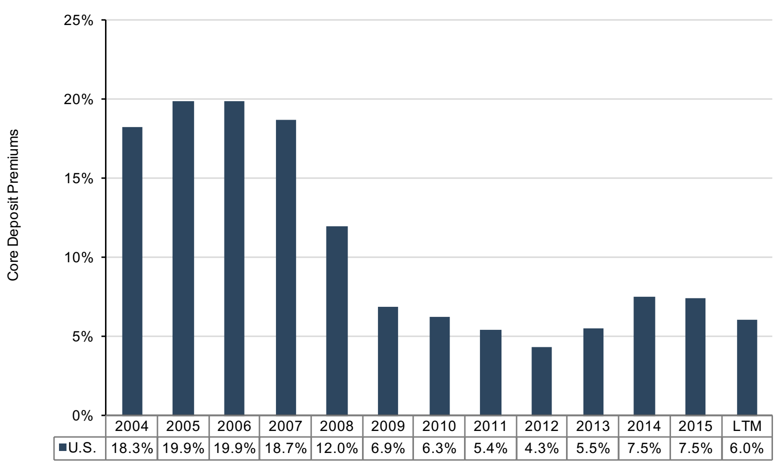
Median Price/Tangible Book Value Multiples

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

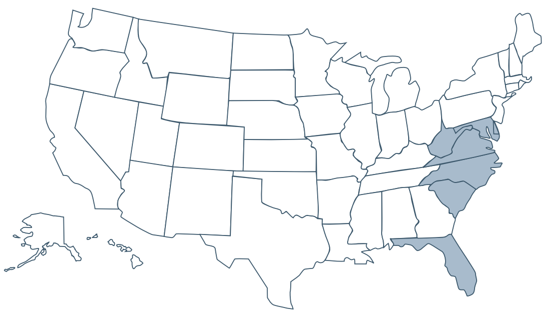
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended October 2016

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	19.0x	151%	7.0%	18	75.00	548,856	8.40%
Midwest	17.2x	138%	5.2%	63	23.20	119,094	8.23%
Northeast	21.0x	152%	9.3%	7	101.64	649,408	7.06%
Southeast	15.5x	144%	6.0%	25	63.36	202,364	10.92%
West	14.5x	141%	6.6%	15	34.24	187,513	11.11%
National Community Banks	**17.2x**	**142%**	**6.0%**	**128**	**37.65**	**175,354**	**9.28%**

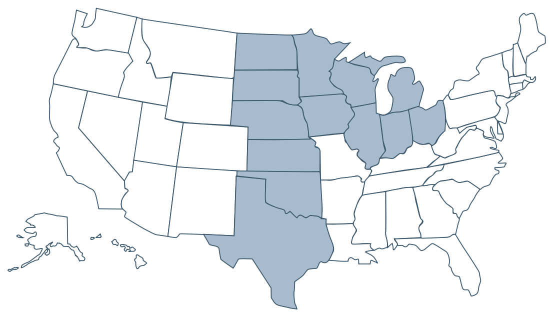
Source: SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

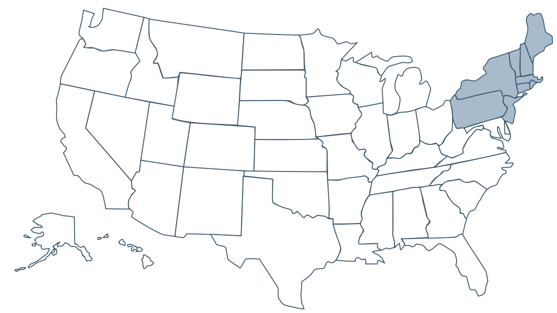
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



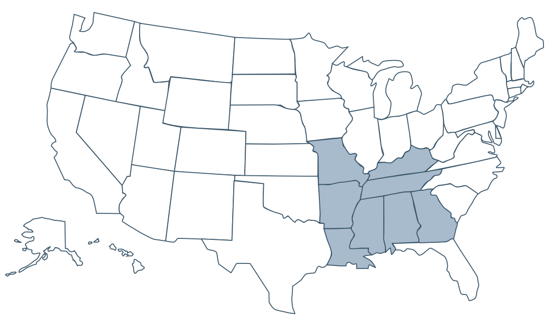
Atlantic Coast



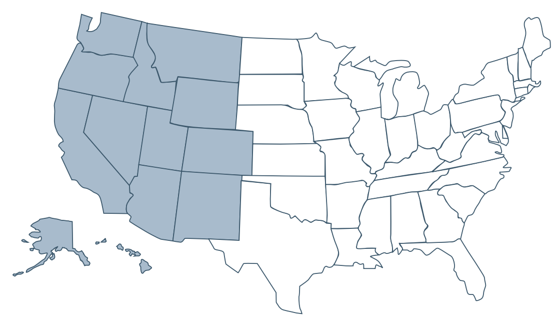
Midwest



Northeast



Southeast



West

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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