MERCER CAPITAL

BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Bank Watch

June 2017

This month's *Bank Watch* features an article adapted from the now available book, ***Creating Strategic Value Through Financial Technology.***

For more information about the book see page 4.

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Creating Value at Your Community Bank Through Developing a FinTech Framework

*This discussion is adapted from Section III of the new book **Creating Strategic Value Through Financial Technology** by* **Jay D. Wilson, Jr., CFA, ASA, CBA**.

COMPLIMENTARY DOWNLOAD

Chapter 9: Partnering with a FinTech Company

I enjoyed some interesting discussions between bankers, FinTech executives, and consultants at the FinXTech event in NYC in late April. One dominant theme at the event was a growing desire of both banks and FinTech companies to find ways to work together. Whether through partnerships or potential investments and acquisitions, both banks and FinTech companies are coming to the conclusion that they need each other. Banks control the majority of customer relationships, have a stark funding advantage and know how to navigate the maze of regulations, while FinTechs represent a means to achieve low-cost scaling of new and traditional bank services. So one key question emerging from these discussions is: Who will survive and thrive in the digital age? As one recent *Tearsheet* article that I was quoted in asked: **Should fintech startups buy banks?** Or **as another article discussed**: Will banks be able to compete against an army of Fintech startups?

Build, Partner, or Acquire

Banks face a conundrum of whether they should build their own FinTech applications, partner, or acquire. FinTech companies face similar questions, though the questions are viewed through the prism of customer acquisition rather than applications. Non-control investments of FinTech companies by banks represent a hybrid strategy. Regulatory hurdles limit the ability of FinTech companies to make anything more than a modest investment in banks absent bypassing voting common stock for non-voting common and/or convertible preferred.

While these strategic decisions will vary from company to company, the stakes are incredibly high for all. We can help both sides navigate the decision process.

As I noted in my **recently published book**, community banks collectively remain the largest lenders to both small business and agricultural businesses, and individually, they are often the lifeblood for economic development within their local communities.

Yet the number of community banks declines each year through M&A, while some risk loosened deposit relationships as children who no longer reside in a community where the bank is located inherit the financial assets of deceased parents. FinTech can loosen those bonds further, or it can be used to strengthen relationships while providing a means to deliver services at a lower cost.

Where to Start

In my view, it is increasingly important for bankers to develop a FinTech framework and be able to adequately assess potential returns from FinTech partnerships. Similar to other business endeavors, the difference between success and failure in the FinTech realm is often not found in the ideas themselves, but rather, in the execution.

> Banks face a conundrum of whether they should build their own FinTech applications, partner, or acquire.

While a bank's FinTech framework may evolve over time, it will be important to provide a strategic roadmap for the bank to optimize chances of success. Within this framework, there are a number of important steps:

- Determining which FinTech niche to pursue;
- Identifying potential FinTech companies/partners;
- Developing a business case for those potential partners and their solutions; and
- Executing the chosen strategy.

For a number of banks, the use of FinTech and other enhanced digital offerings represents a potential investment that uses capital but may be deemed to have more attractive returns than other traditional bank growth strategies. Community banks typically underperform their larger brethren (as measured by ROE and ROA) because fee income is lower and expenses are higher as measured by efficiency ratios. Both areas can be enhanced through deployment of a number of FinTech offerings/solutions.

What We're Reading

The attorneys at Bryan Cave gave a **great podcast on ESOPs** and the potential benefits for banks.

Tearsheet had an **interesting piece** on whether FinTech companies might starting buying small, community banks.

American Banker **covered six ways** that community banks are boosting bottom lines. (subscription required)

The Importance of a Detailed IRR Analysis

The decision process for whether to build, partner, or acquire requires the bank to establish a rate of return threshold, which arguably may be higher than the institution's base cost of capital given the risk that can be associated with FinTech investments. The range of returns for each strategy (build, partner, or acquire) for a targeted niche (such as payments or wealth management) provides a framework to help answer the question how to proceed just as is the case with the question of how to deploy capital for organic growth, acquisitions, and shareholder distributions. The same applies for FinTech companies, though often the decision is in the context of whether to accept dilutive equity capital.

"A detailed analysis, including an IRR analysis, helps a bank determine the financial impact of each strategic decision and informs the optimal course"

While each option presents a unique set of considerations and execution issues/risks, a detailed analysis, including an IRR analysis, helps a bank determine the financial impact of each strategic decision and informs the optimal course. A detailed analysis also allows the bank to compare its FinTech strategy to the bank's more traditional growth strategies, strategic plan, and cost of capital. See the table to the right for an example of a traditional community bank compared to a bank who has partnered with a FinTech company.

Community Bank vs.
Community Bank who Partnered with a FinTech Company

	Traditional Community Bank	FinTech Community Bank
Net Interest Income	36,000	36,000
Non-Interest Income	10,000	10,000
Non-Interest Operating Expenses	(31,050)	(28,750)
Pre-Tax, Pre-Provision Income	14,950	17,250
Provision Expenses	(2,160)	(2,160)
Pre-Tax Income	12,790	15,090
Taxes	(4,477)	(5,282)
Net Income	**$8,314**	**$9,809**
Return on Average Assets	***0.83%***	***0.98%***
Return on Tangible Equity	***9.24%***	***10.90%***
Average Equity	90,000	90,000
Average Loans	720,000	720,000
Average Earning Assets	900,000	900,000
Average Assets	1,000,000	1,000,000
Net Interest Margin	4.00%	4.00%
Non-Interest Income / Average Assets	1.00%	1.00%
Efficiency Ratio	67.50%	62.50%
Provision Expenses / Average Loans	0.30%	0.30%

Questions Regarding Partnering

Beyond the strategic decisions and return analyses, some additional questions remain for community banks that consider FinTech partners, including:

- Is the bank comfortable with the FinTech company's risk profile?
- What will the regulatory reaction be?
- Who will maintain the primary relationship with the customer?
- Is the FinTech partnership consistent with the bank's long-term strategic plan (a key topic noted in the **OCC's whitepaper** on supporting innovation)?

Questions Regarding Acquiring

Should the community bank ultimately decide to invest in a FinTech partner a number of other key questions emerge, such as:

- What is the valuation of the FinTech company?
- How should the investment be structured?
- What preferences or terms should be included in the shares purchased from the FinTech company?
- Should the bank obtain board seats or some control over the direction of the FinTech Company's operations?

How Mercer Capital Can Help

To help both banks and FinTech companies execute their optimal strategies and create maximum value for their shareholders, we have a number of solutions here at Mercer Capital. We **have a book** that provides greater detail on the history and outlook for the FinTech industry, as well as containing targeted information to help bankers answer some of the key questions discussed here.

Mercer Capital has a long history of working with banks. We are aware of the challenges facing community banks. With ROEs for the majority below 10% and their cost of capital, it has become increasingly difficult for many banks to deliver adequate returns to shareholders even though credit costs today, are low. Being both a great company that delivers benefits to your local community, as well as one that delivers strong returns to shareholders is a difficult challenge. Confronting the challenge requires a solid mix of the right strategy as well as the right team to execute that strategy.

> No one understands community banks and FinTech as well as Mercer Capital.

Mercer Capital can help your bank craft a comprehensive value creation strategy that properly aligns your business, financial, and investor strategy. Given the growing importance of FinTech solutions to the banking sector, a sound value creation strategy needs to incorporate FinTech into it and Mercer Capital can help.

» We provide board/management retreats to educate you about the opportunities and challenges of FinTech for your institution.

» We can identify which FinTech niches may be most appropriate for your bank given your existing market opportunities.

» We can identify which FinTech companies may offer the greatest potential as partners for your bank.

» We can provide assistance with valuations should your bank elect to consider investments or acquisitions of FinTech companies.

No one understands community banks and FinTech as well as Mercer Capital. We are happy to help. Contact me to discuss your needs.

Jay Wilson, Jr.

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COMPLIMENTARY WEBINAR

Creating Strategic Value Through FinTech

July 11, 2017 | 12:00pm - 1:00pm Central

Join **Jay D. Wilson, CFA, ASA, CBA**, on July 11, 2017, as he presents the webinar "Creating Strategic Value Through FinTech."

Against a backdrop of compressed net interest margins, enhanced competition from non-banks, rising regulatory and compliance costs and evolving consumer preferences regarding the delivery of financial services, many community banks find themselves at a significant inflection point where traditional growth strategies like building or acquiring an expansive, and often expensive, branch network are being reexamined.

This webinar will focus on how community banks can leverage FinTech to create strategic value for the bank. While many bankers view FinTech as a potential threat, FinTech offers the potential to improve the health of community banks for those banks that can selectively leverage FinTech to enhance performance, customer satisfaction, and improve profitability and returns. FinTech can also help level the playing field for community banks to compete more effectively with larger banks and non-bank lenders.

Learning objectives of the webinar include, but are not limited to:

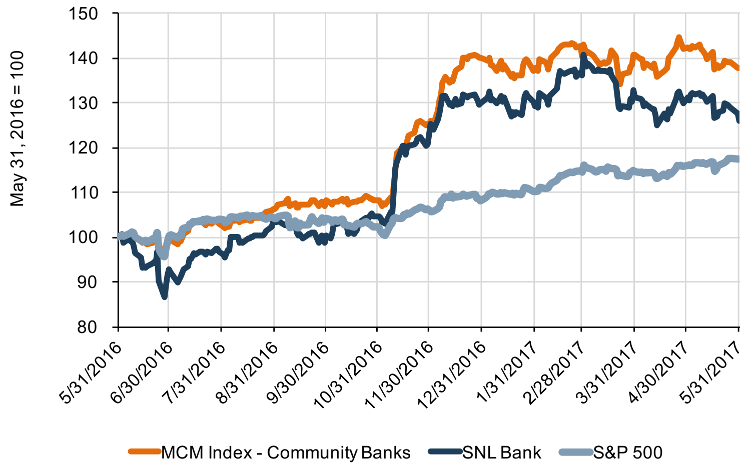
- » Awareness of the unique challenges community banks and FinTech companies are facing and opportunities for symbiotic relationships between the sectors
- » Understanding how FinTech can help a bank create strategic value
- » Identifying the fundamental questions a bank should ask when it considers partnering, building, or acquiring a FinTech company
- » Determining steps a bank should take to build a strategic FinTech framework
- » Reviewing the importance of a detailed Internal Rate of Return (IRR) analysis and how it influences a bank's decision making process in regards to its FinTech options

The information presented in this webinar is adapted from the recent book, ***Creating Strategic Value Through Financial Technology***. For more information about the book, **click here**.

Register Today

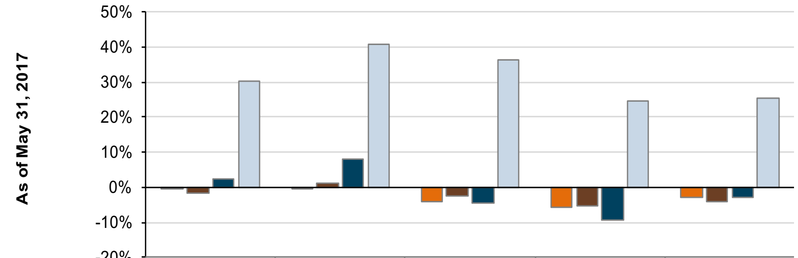
1 hour of CPE Offered

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



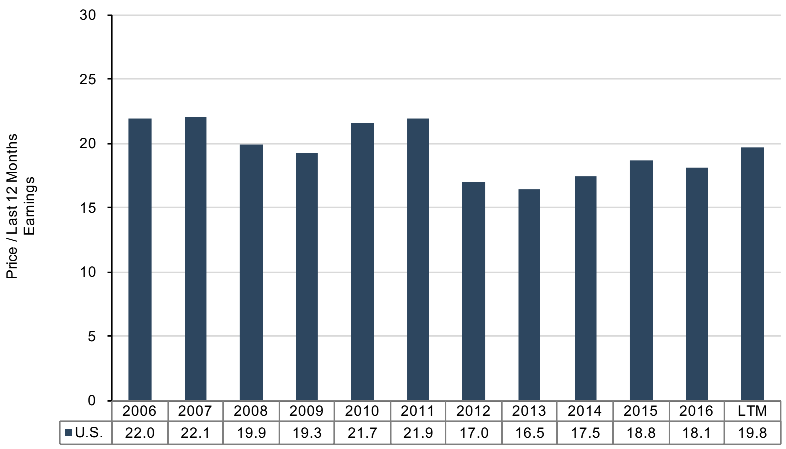
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-0.50%	-0.16%	-4.13%	-5.59%	-3.10%
Quarter-to-Date	-1.68%	1.27%	-2.70%	-5.36%	-4.21%
Year-to-Date	2.51%	7.96%	-4.72%	-9.43%	-2.84%
Last 12 Months	30.15%	40.90%	36.47%	24.41%	25.44%

Median Valuation Multiples

	Median Total Return as of May 31, 2017				Median Valuation Multiples as of May 31, 2017					
Indices	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 17(E) EPS	Price / 18(E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	-1.70%	0.02%	4.75%	40.30%	20.1x	17.4x	15.1x	146%	153%	1.7%
Midwest Index	-3.53%	-2.72%	-3.95%	37.13%	17.6x	16.2x	15.0x	142%	171%	1.9%
Northeast Index	-4.37%	-3.23%	-4.09%	37.38%	16.3x	16.7x	14.5x	142%	156%	2.2%
Southeast Index	-2.95%	-1.69%	-3.26%	32.73%	18.5x	19.4x	16.1x	139%	152%	1.4%
West Index	-2.80%	-3.01%	0.02%	38.59%	16.7x	17.2x	15.0x	151%	156%	1.7%
Community Bank Index	-3.16%	-2.11%	-1.61%	37.72%	17.8x	17.2x	15.0x	143%	155%	1.8%
SNL Bank Index	**-3.23%**	**-4.18%**	**-3.16%**	**25.83%**						

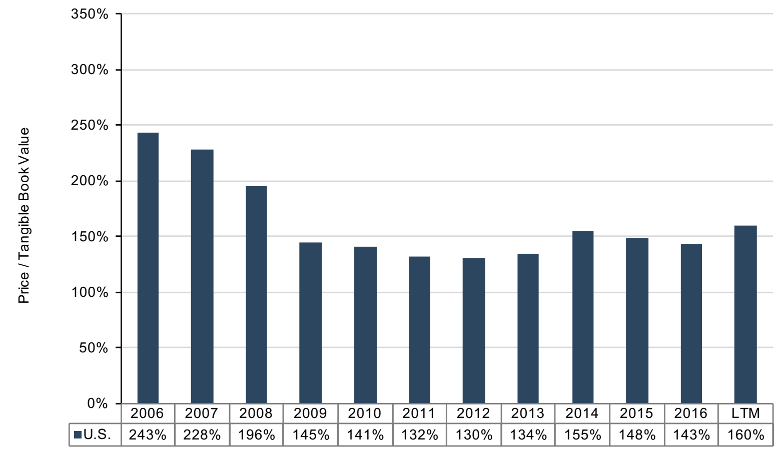
Median Price/Earnings Multiples

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



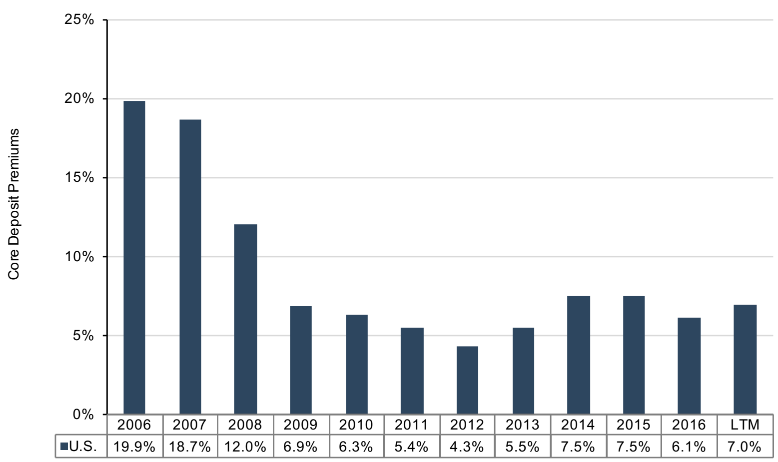
Median Price/Tangible Book Value Multiples

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

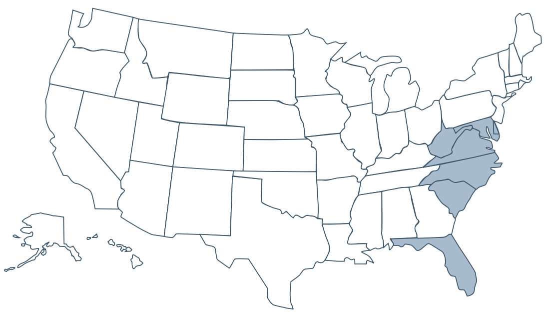
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended May 2017

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	22.4x	164%	9.5%	23	84.90	412,118	7.36%
Midwest	19.2x	157%	9.2%	59	37.65	148,575	8.77%
Northeast	18.2x	155%	5.1%	8	89.75	656,592	7.93%
Southeast	19.6x	138%	6.1%	28	36.13	175,605	7.54%
West	21.1x	172%	7.6%	18	48.82	229,669	8.80%
National Community Banks	**19.8x**	**160%**	**7.0%**	**136**	**48.82**	**219,786**	**8.13%**

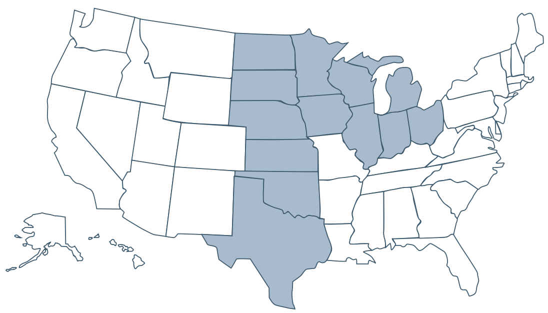
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

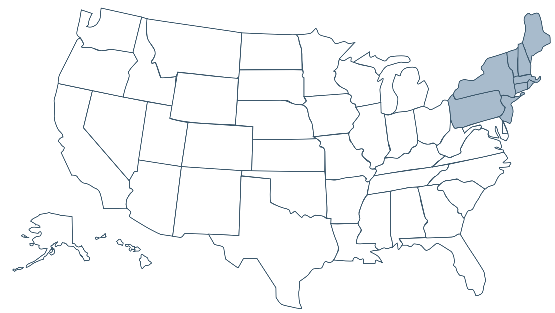
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



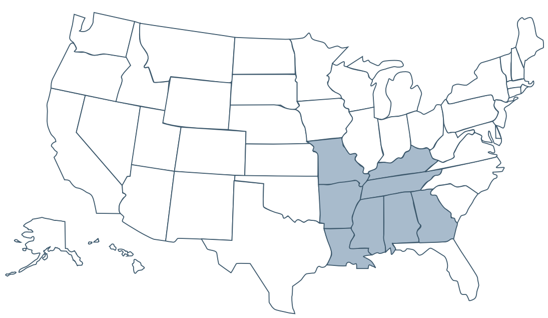
Atlantic Coast



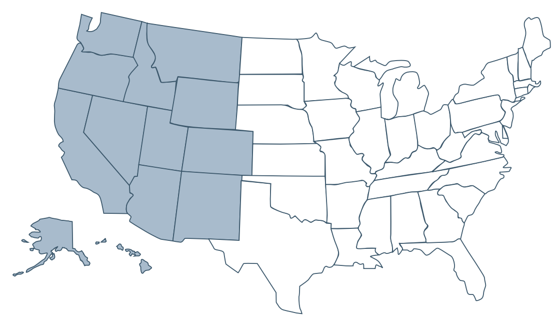
Midwest



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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