MERCER CAPITAL

BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

Bank Watch

October 2018

Views from the Road

What Do Community Banks, FinTech, and Buffalo Have in Common?

In the last few weeks, I presented at two events geared towards helping community banks achieve better performance: the Moss Adams Community Banking Conference in Huntington Beach, California and the FI FinTech Unconference in Fredericksburg, Texas. The FI FinTech Unconference had a recurring visual theme of the buffalo, which struck me as an insightful image for a FinTech conference.

Much of the discussions at both conferences focused on the ability of community banks to adapt, survive, and thrive rather than thin out like the once massive North American buffalo herd. Both events had several presentations and discussions around FinTech and the need for community banks to evolve to meet customer expectations for improved digital interactions. Beyond thinking that I will miss the great views and weather I had for both trips, I came away with a few questions bankers should consider.

How Can Community Banks Compete with Larger Banks?

Larger banks are taking market share from smaller banks and have been gathering assets and deposits at a faster pace than community banks (defined as banks with less than $10 billion of assets) the last few decades. For example, banks with assets greater than $10 billion controlled around 85% of assets in mid-2018 compared to 50% in 1994. This is a significant trend illustrating how much market share community banks have ceded. Further, larger banks are producing higher ROEs, largely driven by higher levels of non-interest income (~0.90% of assets vs ~0.55%) and better operating leverage as measured by the efficiency ratio (~59% vs ~66%). The larger banks may widen their lead, too, given vast sums that are being spent on digital enhancements and other technology ventures to improve the client experience.

Can FinTech Serve as a Value Enhancer and Help Community Banks Close the Performance Gap with Larger Banks?

Most community banks are producing an ROE below 10%—an inadequate return for shareholders despite low credit costs. As a result, the critical role that a community bank fills as a lender to small business and agriculture is at risk if the board and/or shareholders decide to sell due to inadequate returns. Confronting this challenge requires the right team executing the right strategy to produce competitive returns for shareholders. FinTech solutions, rather than geographic expansion through branching and acquisitions, may be an option if FinTech products and processes can address areas where a bank falls short (e.g., wealth management).

What We're Reading

Joe Mantone of *The Pipeline* tracks investment banking activity for banks in Texas in the article "**Bank i-Banking Competition Bigger in Texas**."
(subscription required)

Christopher Whalen at *The Institutional Risk Analyst* examines **tightening spreads and growing liquidity risk** in anticipation of Q3 '18 bank earnings.

Barron's has a summary of **interviews and analysis** reflecting on the 10th anniversary of the Lehman Brothers collapse.
(subscription required)

Demand from investors for bank equity remains strong despite less need as banks are enjoying stronger capital positions and improved earnings according to Jack Milligan at *Bank Director*.

Can Community Banks Hold Ground and Even Win the Fight for Retail Deposits?

Many community bank cost structures are wed to physical branches while customers—especially younger ones—are increasingly interacting with institutions first digitally and secondarily via a physical location. This transition is occurring at a time when core deposits are increasing in value to the industry as interest rates rise. In response, several larger banks, such as Citizens Financial, have increased their emphasis on digital delivery to drive incremental deposit growth. Additionally, as funding costs increase, some FinTech companies are being forced to consider partnerships with banks. Thus far, the digital banking push and the formal partnering of FinTech companies and banks are incremental in nature rather than reflective of a wholesale change in business models. Nonetheless, it will be interesting to see whether community banks can adapt and effectively use technology and FinTech partnerships to compete and win retail deposit relationships in a meaningful way.

How Can Community Banks Develop a FinTech Framework?

Against this backdrop, I see four primary steps to developing a FinTech framework:

1. **Identify attractive FinTech niches** such as deposits, payments, digital lending, wealth management, insurance, or efficiency (i.e., tech initiatives designed to reduce costs)

2. **Identify attractive FinTech companies** in those niches
3. **Develop a business case for different strategies** (estimate the Internal Rates of Returns and IRRs)
4. **Compare the different strategies and execute the optimal strategy**

What Are Some Immediate Steps that Banks Can Take Regarding FinTech?

The things that banks can do right now to explore FinTech opportunities are:

- Get educated. There are an increasing number of events for community bankers incorporating FinTech into their agenda and we have a number of resources on the topic as well
- Begin or continue to integrate FinTech into your strategic plan
- Determine what your customers want/need/expect in terms of digital offerings
- Seek out FinTech partners that provide solutions and begin due diligence discussions

How Mercer Capital Can Help

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

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

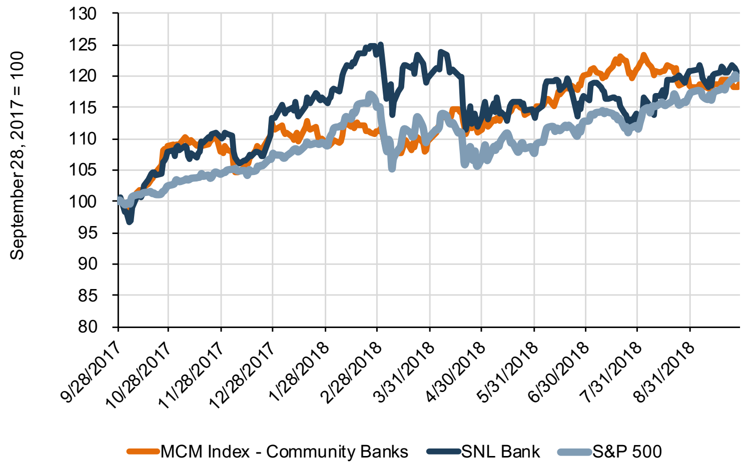
- Help your bank identify which FinTech niches may be most appropriate for your bank given your existing market opportunities
- Help your bank identify which FinTech companies may offer the greatest potential as partners for your bank
- Help provide assistance with valuations should your bank elect to consider investments or acquisitions of FinTech companies

We are happy to help. Contact us at 901.685.2120 to discuss your needs.

Jay Wilson, Jr.

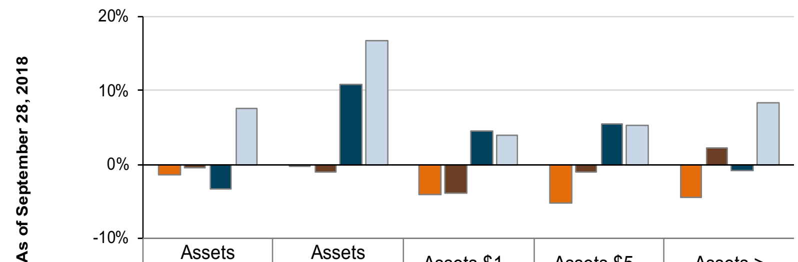
Jay D. Wilson, Jr., CFA, ASA, CBA
469.778.5860 | **wilsonj@mercercapital.com**

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



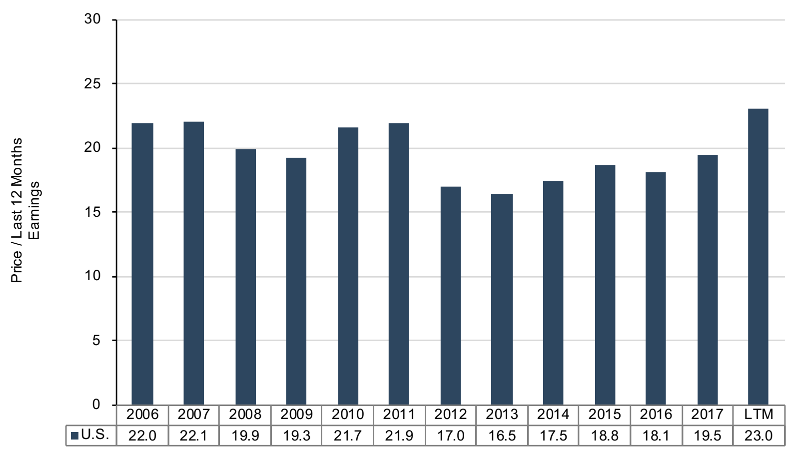
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-1.28%	-0.23%	-4.03%	-5.26%	-4.38%
Quarter-to-Date	-0.51%	-0.91%	-3.79%	-0.96%	2.28%
Year-to-Date	-3.35%	10.89%	4.51%	5.53%	-0.78%
Last 12 Months	7.55%	16.71%	3.97%	5.30%	8.41%

Median Valuation Multiples

	Median Total Return as of September 28, 2018				Median Valuation Multiples as of September 28, 2018					
Indices	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2018 (E) EPS	Price / 2019 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	-4.0%	-5.0%	3.4%	4.1%	22.2x	14.4x	13.4x	138%	159%	1.9%
Midwest Index	-3.2%	-4.2%	4.3%	4.8%	17.3x	13.9x	12.2x	151%	175%	2.1%
Northeast Index	-2.2%	-3.4%	5.6%	5.2%	19.1x	14.2x	12.7x	145%	162%	2.2%
Southeast Index	-4.4%	-4.6%	4.1%	6.7%	23.8x	15.4x	12.9x	141%	157%	1.4%
West Index	-5.3%	-5.4%	8.0%	10.1%	18.5x	14.7x	14.2x	153%	165%	1.5%
Community Bank Index	-3.5%	-4.3%	4.9%	5.7%	19.4x	14.3x	12.8x	145%	164%	1.9%
SNL Bank Index	**-4.4%**	**2.0%**	**-0.4%**	**8.2%**						

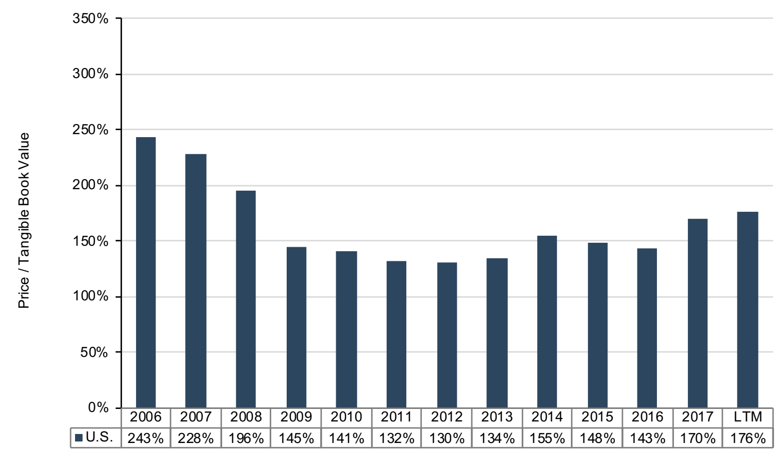
Median Price/Earnings Multiples

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



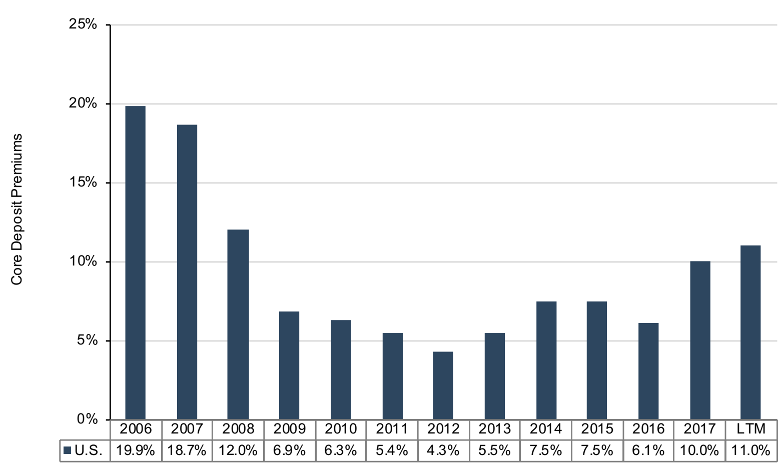
Median Price/Tangible Book Value Multiples

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

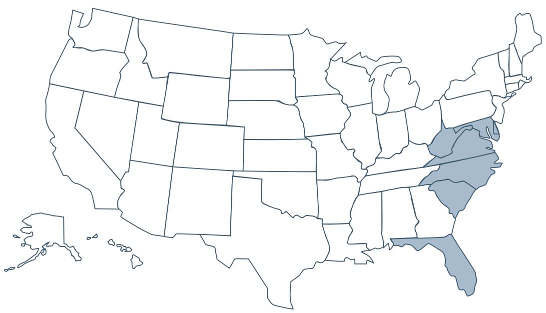
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended September 2018

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value ($M)	Target's Median Assets ($000)	Target's Median LTM ROAE
Atlantic Coast	23.1x	176%	11.2%	11	81.8	480,403	8.1%
Midwest	20.2x	173%	9.2%	79	57.6	143,480	9.8%
Northeast	26.9x	189%	11.7%	9	54.3	347,773	6.2%
Southeast	23.1x	171%	10.9%	31	50.8	222,826	9.0%
West	24.0x	205%	12.1%	24	97.6	376,801	9.2%
National Community Banks	**23.0x**	**176%**	**11.0%**	**154**	**58.9**	**228,321**	**9.2%**

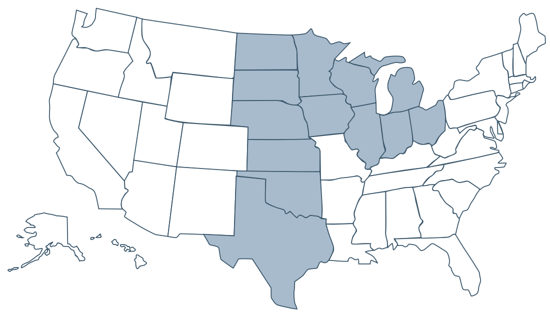
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

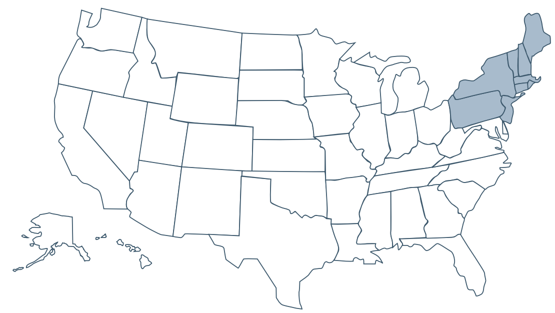
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



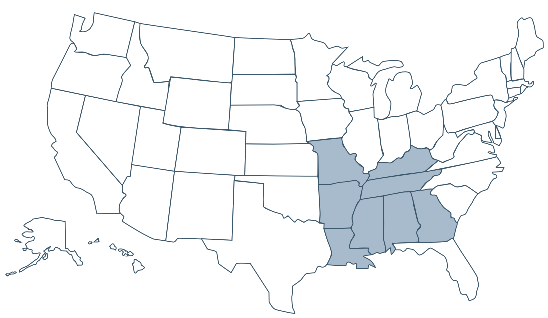
Atlantic Coast



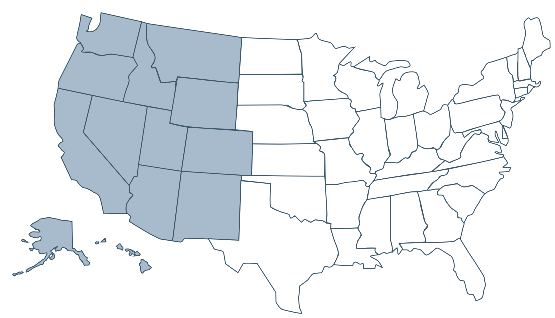
Midwest



Northeast



Southeast



West

Mercer Capital

Financial Institutions Services

Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transaction 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, *Creating Strategic Value Through Financial Technology, 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**.

Contact Us

Jeff K. Davis, CFA
615.345.0350
jeffdavis@mercercapital.com

Andrew K. Gibbs, CFA, CPA/ABV
901.322.9726
gibbsa@mercercapital.com

Jay D. Wilson, Jr., CFA, ASA, CBA
469.778.5860
wilsonj@mercercapital.com

MERCER CAPITAL

Memphis
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120

Dallas
12201 Merit Drive, Suite 480
Dallas, Texas 75251
214.468.8400

Nashville
102 Woodmont Blvd., Suite 231
Nashville, Tennessee 37205
615.345.0350

www.mercercapital.com