MERCER CAPITAL

BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

Bank Watch

February 2018

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2018 Trends to Watch in the Banking Industry

Acquire or Be Acquired Conference Recap

For those readers unable to escape the cold to attend Bank Director's *Acquire or Be Acquired* (AOBA) conference in Scottsdale, AZ, we reflect on the major themes: bank M&A and scarcity, tax reform and valuation, and FinTech. For those unfamiliar with the three-day event, over 1,000 bankers, directors, and advisors gather to discuss pertinent industry issues.

Bank M&A and Scarcity

There are fewer than 5,500 banks today, which is roughly half from only 10 years ago when we first attended AOBA. This scarcity was top-of-mind for several panelists who noted variations on the same theme: Scarcity matters to both buyers and sellers as the number of banks dwindles at a rate of 3-4% per annum.

Unlike the 1990s and even the pre-crisis years when a seller could expect multiple offers, banks that sell today often have just one or two legitimate suitors. In our view, this means that sellers need to think more strategically about their valuation today and prospectively if their most logical suitor(s) is acquired. Even if the logical acquirer is unlikely to be acquired, board planning for some institutions should consider the potential to strike a (cash) deal with a credit union. For buyers, scarcity may translate into less desirable banks in targeted markets. If so, scarcity may mean greater emphasis on expansion through lift-outs from other banks, or even a push into non-traditional bank acquisitions/investments such as wealth management that could serve as a nucleus around which traditional banking services are bolted. One key question to watch: Will scarcity impact the pace of consolidation and the valuation of transactions? The short answer is seemingly "yes," but rising acquisition valuations over the past couple of years correspond to the rising value of acquirers' publicly traded shares.

Tax Reform and Valuation

The banking sector was revalued higher in the public markets following the November 2016 elections, reflecting four attributes that would favor banks: regulatory reform, tax reform, faster GDP growth, and therefore, higher interest rates. While the impact (thus far) of regulatory reform and higher interest rates is limited, passage of the Tax Cuts and Jobs Act of 2017 is a highly tangible benefit for banks and customers. With the stroke of a pen, ROE for many banks will rise to or above the institution's cost of capital, returning to pre-financial crisis levels. However, tax reform is not a cure for strategic issues such as whether FinTech may radically disrupt the "core" in the deposit relationship between customers and their banks.

One panelist summed up the debate by noting that management teams who achieve a 10-15% increase in earnings and ROE in 2018 from tax reform are not geniuses; rather, they are around to cash the check. The real winners, as it relates to tax reform, will be banks that leverage the enhanced cash flows to make optimal capital budgeting and strategic decisions. Bankers will have to allocate the additional earnings before some of it is competed away among investments in staff, technology and/or higher dividends, share repurchases and acquisitions. Perhaps in the ideal world, the incremental capital to be created would be used to support faster loan growth, but few at the conference indicated their institution had seen an increase in loan growth as a result of tax reform.

A related theme that emerged in several sessions was the dichotomy in valuations between the "haves" and "have-nots" along key metrics such as size, profitability, core deposits, location, management team, and operating strategy/niche. This divergence could widen further following tax reform as the "haves" effectively take their higher cash flows and reinvest/deploy them more profitably than the "have-nots." Ultimately, these strategic decisions and the trajectory of the bank's performance will drive whether tax reform leads to sustainably higher bank valuations, likely varying case-by-case. For those interested, we discuss implications of tax reform for banks **in greater detail here**.

What We're Reading

During the AOBA conference, Jonathan Hightower and Robert Klinger, moderators of Bryan Cave's "The Bank Account" podcast chatted with our own Jay Wilson about **how banks should explore partnering with FinTech companies**.

Bank Director's recent article "**Well Conceived and Executed Bank Acquisitions Drive Shareholder Value**" summarizes a KPMG study that examined bank acquirers' performance in the last few years.

Banking Exchange presents a thought-provoking piece about the future of community banking entitled "**Yes, We Need to Change**."

As chatter about deposits increases, one mutual in Massachusetts unveiled a unique deposit account as described in "**Socially Responsible Deposits: Mutual Sees Success Matching Local Deposits to Local Development Loans**."

FinTech

While FinTech wasn't even on the agenda when we first made the trip to Scottsdale for AOBA in the mid-2000s, it was all over this year's schedule. One panelist humorously compared bankers' reactions to FinTech with the "Seven Stages of Grief" noting that bankers seemed to have finally progressed beyond the early-stages of anger and denial toward the latter-stage of acceptance. Bankers are considering practical solutions to incorporate FinTech into their strategic plans. Sessions included panel discussions on the nuts and bolts of structuring FinTech partnerships and creating value through leveraging FinTech to enhance profitability. (For those interested in FinTech, learn more about our book on the topic to the right.) Niches of FinTech that garnered particular attention included digital lending, payments (both consumer and business), blockchain, and artificial intelligence. AI in particular was top-of-mind, and one panel noted it as an area of FinTech offering strong potential for banks in the next few years.

We look forward to discussing these three themes with clients in 2018 and monitoring how they evolve within the banking industry over the next few years. As always, Mercer Capital is available to discuss these trends as they relate to your bank – feel free to call or email.

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Creating Strategic Value Through Financial Technology

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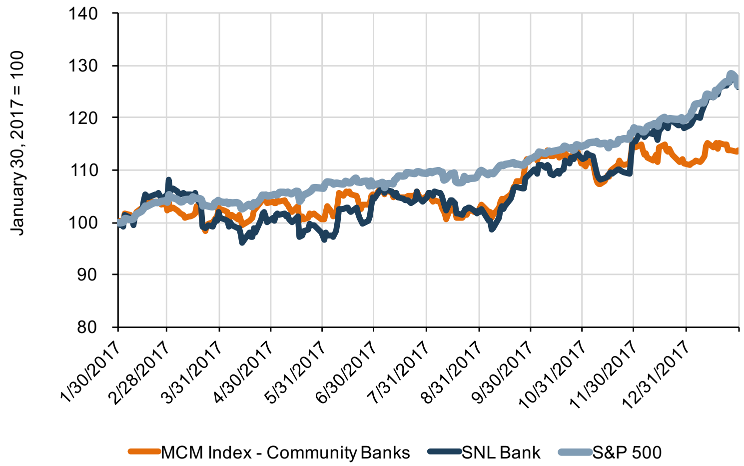
"FinTech is changing the landscape of the banking industry, so bankers need to get up to speed on how to respond. Creating Strategic Value Through Financial Technology is perfect for the community banker seeking to understand FinTech and how their bank might benefit."

—Chris Nichols, Chief Strategy Officer, CenterState Bank

Creating Strategic Value Through Financial Technology illustrates the potential benefits of FinTech to banks, both large and small, so that they can gain a better understanding of FinTech and how it can create value for their shareholders and enhance the health and profitability of their institutions.

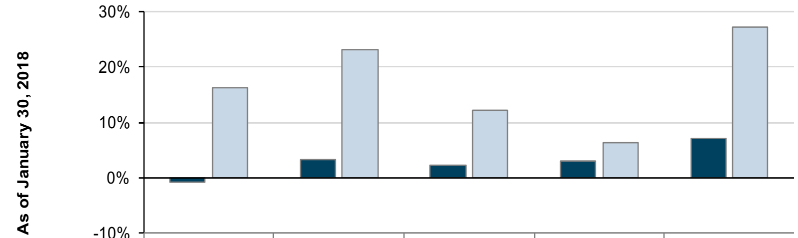
The book contains 13 chapters broken into three sections. Section I introduces FinTech. Section II explores FinTech niches such as bank technology, alternative lending, payments, wealth management, and insurance niches. Section III illustrates how both community banks and FinTech companies can create strategic value.

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



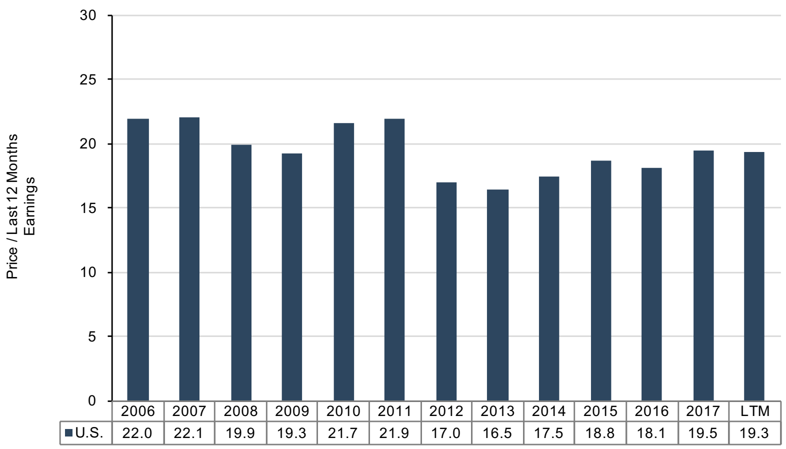
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Year-to-Date	-0.7%	3.2%	2.3%	3.1%	7.1%
Last 12 Months	16.4%	23.2%	12.3%	6.3%	27.2%

Median Valuation Multiples

	Median Total Return as of January 31, 2018		Median Valuation Multiples as of January 31, 2018					
Indices	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	2.8%	16.1%	23.6x	15.1x	13.3x	147%	163%	1.8%
Midwest Index	3.2%	15.3%	19.3x	14.4x	12.8x	145%	166%	2.0%
Northeast Index	1.3%	14.1%	19.0x	14.3x	12.2x	146%	164%	2.3%
Southeast Index	1.1%	7.6%	22.0x	14.6x	13.7x	140%	153%	1.2%
West Index	2.5%	13.1%	20.3x	15.0x	13.2x	145%	174%	1.7%
Community Bank Index	2.3%	13.8%	20.5x	14.6x	13.1x	145%	162%	1.8%
SNL Bank Index	**6.8%**	**25.9%**						

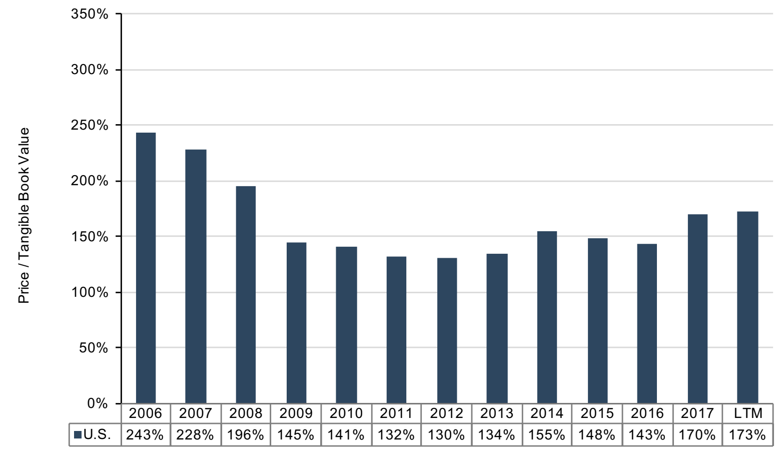
Median Price/Earnings Multiples

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



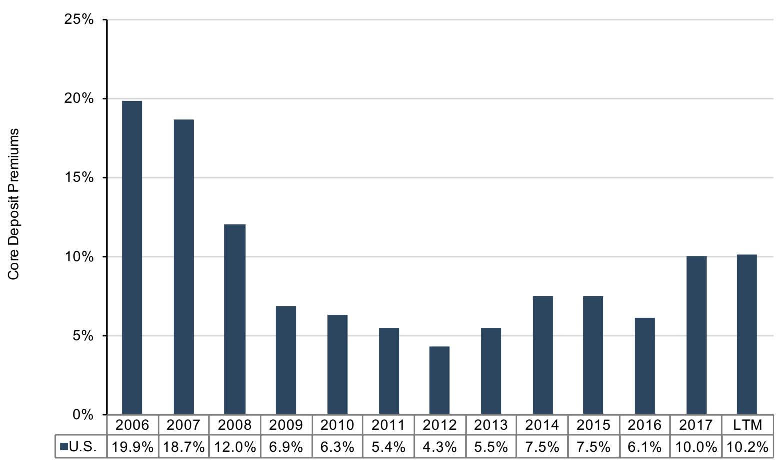
Median Price/Tangible Book Value Multiples

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

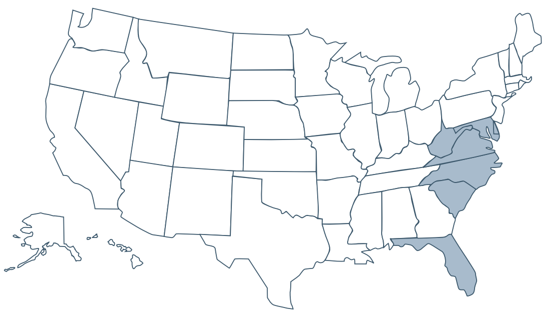
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended January 2018

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	22.3x	179%	12.2%	20	106.9	597,952	8.8%
Midwest	18.6x	188%	11.7%	57	63.2	266,840	10.1%
Northeast	20.7x	158%	8.6%	8	52.4	422,000	6.3%
Southeast	17.8x	154%	8.0%	37	34.5	175,086	8.6%
West	19.2x	187%	10.1%	25	51.5	320,800	10.8%
National Community Banks	**19.3x**	**173%**	**10.2%**	**147**	**56.4**	**270,305**	**9.2%**

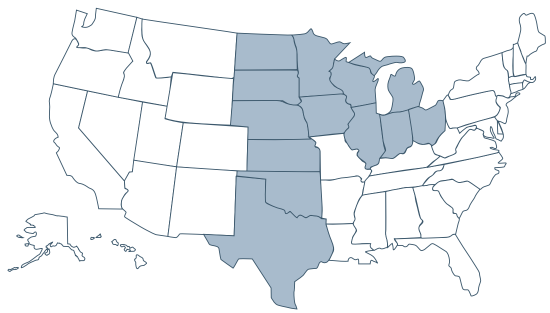
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

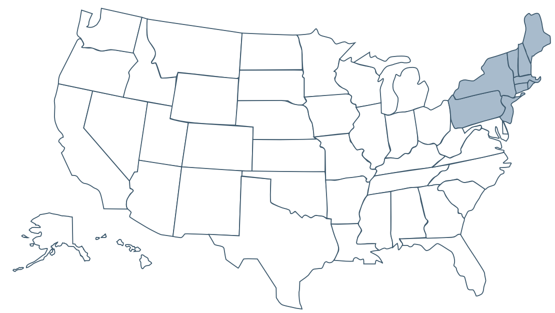
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



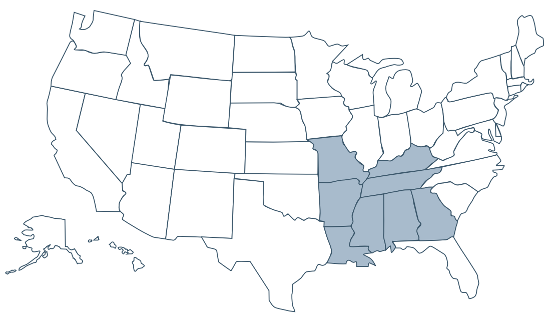
Atlantic Coast



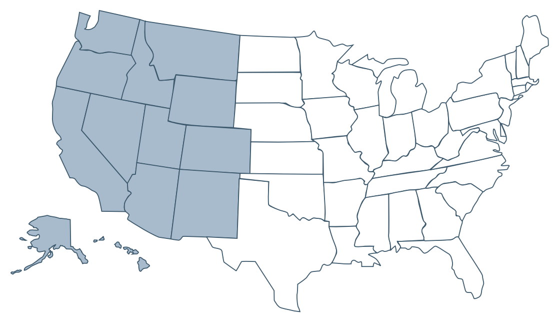
Midwest



Northeast



Southeast



West

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- Litigation support
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- 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**.

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