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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Bank Watch

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Purchase Accounting Considerations for Banks Acquiring Asset Managers

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As banks of all sizes seek new ways to differentiate themselves in a competitive market, we see many banks contemplating the acquisition of an existing asset management firm as a way to expand and diversify the range of services they can offer to clients. Following a transaction, the bank is required under accounting standards to allocate the purchase price to the various tangible and intangible assets acquired. As noted in the following figure, the acquired assets are measured at fair value.

	Value of Total Assets *(Implied by the transaction)*
-	Fair Value of Tangible Assets *(Measured at the transaction date)*
-	Fair Value of Intangible Assets *(Measured at the transaction date)*
=	**Residual Goodwill**

Transaction structures between banks and asset managers can be complicated, often including deal term nuances and clauses that have significant impact on fair value. Purchase agreements may include balance sheet adjustments, client consent thresholds, earnouts, and specific requirements regarding the treatment of other existing documents like buy-sell agreements. Asset management firms are unique entities with value attributed to a number of different metrics (assets under management, management fee revenue, realized fee margin, etc.). It is important to understand how the characteristics of the asset management industry, in general, and those attributable to a specific firm, influence the values of the assets acquired in these transactions.

Common intangible assets acquired in the purchase of a private asset manager include the trade name, existing customer relationships, non-competition agreements with executives, and the assembled workforce.

Trade Name

The deal terms we see employ a wide range of possible treatments for the **trade name** acquired in the transaction. The bank will need to make a decision about whether to continue using the asset manager's name into perpetuity or only use it during a transition period as the asset manager's services are brought under the bank's name. This decision can depend on a number of factors, including the asset manager's reputation within a specific market, the bank's desire to bring its services under a single name, and the ease of transitioning the asset manager's existing client base. However, if the bank plans immediately to take asset management services under its own name and discontinue use of the firm's name, then the only value allocable to the tradename would be defensive.

In general, the value of a trade name can be derived with reference to the royalty costs avoided through ownership of the name. A royalty rate is often estimated through comparison with comparable transactions and an analysis of the characteristics of the individual firm name. The present value of cost savings achieved by owning rather than licensing the name over the future period of use is a measure of the value of the trade name.

Customer Relationships

The nature of relationships between clients and portfolio managers often gives rise an allocation to the existing customer relationships transferred in a transaction. Generally, the value of existing customer relationships is based on the revenue and profitability expected to be generated by the accounts, factoring in an expectation of annual account attrition. Attrition can be estimated using analysis of historical client data or prospective characteristics of the client base. Many of the agreements we see include a clause that requires a certain percentage of clients to consent to transfer their accounts in order for the deal to close at the stated price. If the asset manager secures less than the required amount of client consents, the purchase price may be adjusted downward or the deal may be terminated entirely. Due to their long-term nature and importance as a driver of revenue in the asset management industry, **customer relationships** may command a relatively high portion of the allocated value.

Non-Competition Agreements

In many asset management firms, a few top executives or portfolio managers account for a large portion of new client generation and are often being groomed for succession planning. Deals involving such firms will typically include non-competition and non-solicitation agreements that limit the potential damage to the company's client and employee bases if such individuals were to leave.

What We're Reading

In light of potential banking regulation reform, the Federal Reserve Bank of St. Louis' **survey** highlights current bank compliance costs and economies of scale.

The Wall Street Journal provides an analysis of the competition for deposits in "**The Biggest Banks Are Gobbling Up Deposits. Here's Who's Not**."
(subscription required)

Nathan Stovall at S&P Global Market Intelligence discusses the current state of the mergers and acquisitions market in "**What's Driving M&A Now?**".

These agreements often prohibit the individuals from soliciting business from existing clients or recruiting current employees of the company. In certain situations, the agreement may also restrict the individuals from starting or working for a competing firm within the same market. The value attributable to a non-competition agreement is derived from the expected impact competition from the covered individuals would have on the firm's cash flow and the likelihood of those individuals competing absent the agreement. In the agreements we've observed, a restricted period of two to five years is common.

Assembled Workforce

In general, the value of the assembled workforce is a function of the saved hiring and assembly costs associated with finding and training new talent. However, in a relationship-based industry like asset management, getting a new portfolio or investment manager up to speed can include months of networking and building a client base, in addition to learning the operations of the firm. Employees' ability to establish and maintain these client networks can be a key factor in a firm's ability to find, retain, and grow its business. An existing employee base with market knowledge, strong client relationships, and an existing network often may command a higher value allocation to the assembled workforce. Unlike the intangible assets previously discussed, the assembled workforce is valued as a component of valuing the other assets. It is not recognized or reported separately, but rather as an element of goodwill.

Goodwill

Goodwill arises in transactions as the difference between the price paid for a company and the value of its identifiable assets (tangible and intangible). Expectations of synergies, strategic market location, and access to a certain client group are common examples of goodwill value derived from the acquisition of an asset manager. The presence of these non-separable assets and characteristics in a transaction can contribute to the allocation of value to goodwill.

Earnouts

In the purchase price allocations we do for banks and asset managers, we frequently see an earnout structured into the deal as a mechanism for bridging the gap between the price the bank wants to pay and the price the asset manager wants to receive. Earnout payments can be based on asset retention, fee revenue growth, or generation of new revenue from additional product offerings. Structuring a portion of the total purchase consideration as an **earnout** provides some downside protection for the bank, while rewarding the asset management firm for continuity of performance or growth. Earnout arrangements represent a contingent liability that must be recorded at fair value on the acquisition date.

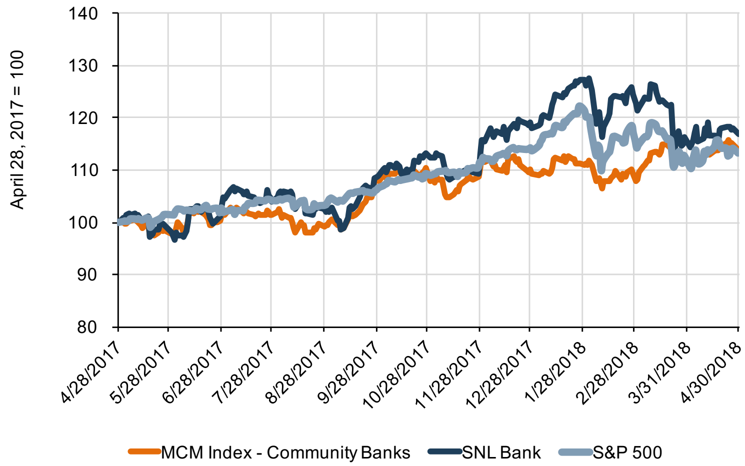
Conclusion

The proper allocation of value to intangible assets and the calculation of asset fair values require both valuation expertise and knowledge of the subject industry. Mercer Capital brings these together in our extensive experience providing fair value and other valuation work for financial institutions. If your bank is involved in or is contemplating a transaction, call one of our professionals to discuss your valuation needs in confidence.

Megan E Richards

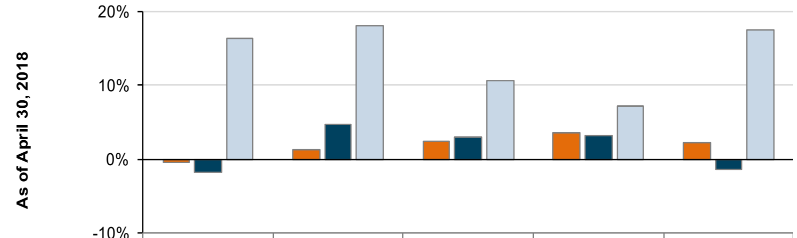
Megan E. Richards
901.322.9767
richardsm@mercercapital.com

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



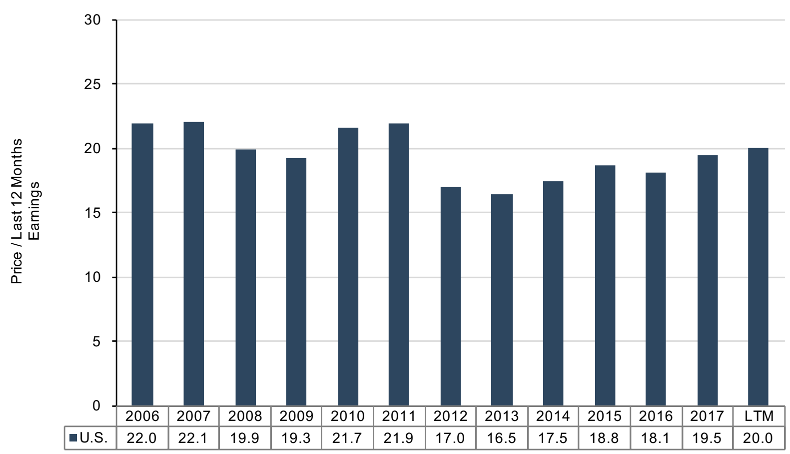
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-0.4%	1.3%	2.5%	3.5%	2.2%
Year-to-Date	-1.8%	4.8%	3.1%	3.2%	-1.3%
Last 12 Months	16.5%	18.2%	10.6%	7.2%	17.5%

Median Valuation Multiples

	Median Total Return as of April 30, 2018			Median Valuation Multiples as of April 30, 2018					
Indices	Month-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	0.4%	4.2%	13.0%	24.5x	15.2x	13.1x	140%	162%	1.9%
Midwest Index	1.7%	4.1%	13.7%	18.3x	13.5x	12.3x	154%	186%	2.0%
Northeast Index	1.1%	4.6%	14.6%	20.0x	13.8x	12.3x	153%	170%	2.1%
Southeast Index	2.7%	3.5%	10.5%	24.0x	15.6x	13.3x	142%	158%	1.3%
West Index	1.5%	5.3%	18.0%	18.6x	15.4x	13.6x	157%	185%	1.4%
Community Bank Index	1.4%	4.3%	13.9%	20.7x	14.4x	12.7x	149%	170%	1.9%
SNL Bank Index	**0.4%**	**-1.0%**	**16.8%**						

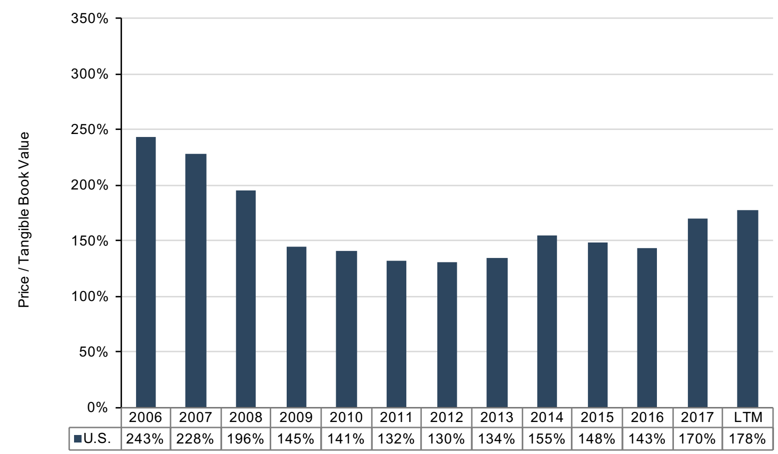
Median Price/Earnings Multiples

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



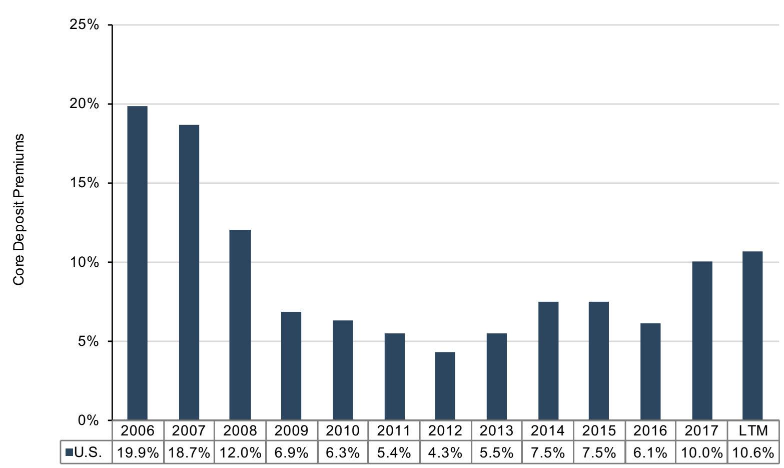
Median Price/Tangible Book Value Multiples

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

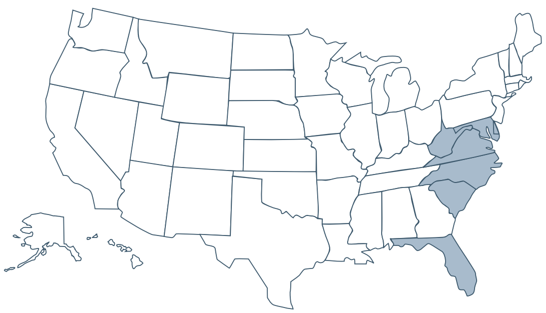
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended April 2018

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	18.3x	171%	12.2%	14	106.9	597,952	10.1%
Midwest	19.3x	184%	10.2%	65	59.3	210,215	10.1%
Northeast	20.8x	164%	11.3%	6	73.0	467,915	6.8%
Southeast	17.8x	165%	10.5%	35	57.7	200,108	9.0%
West	23.8x	195%	11.7%	27	63.5	353,059	9.1%
National Community Banks	**20.0x**	**178%**	**10.6%**	**147**	**62.8**	**305,609**	**9.3%**

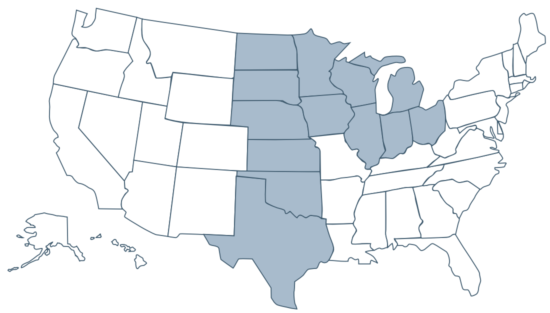
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

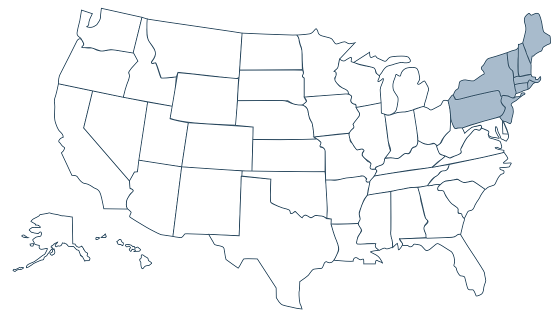
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



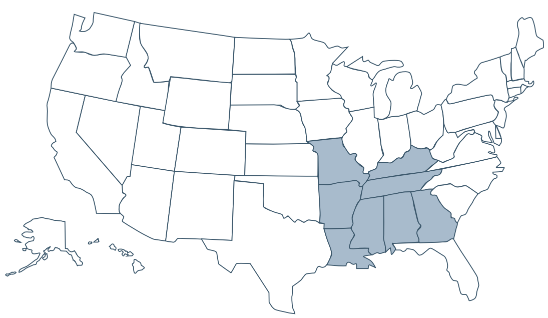
Atlantic Coast



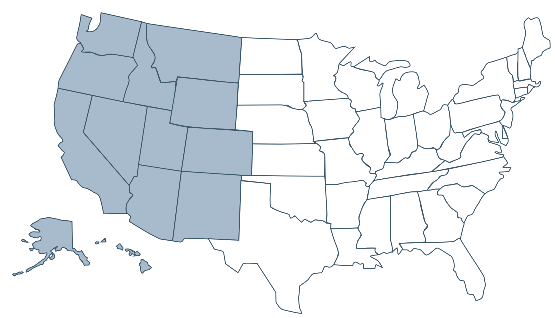
Midwest



Northeast



Southeast



West

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- Litigation support
- Stress Testing
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- Tax compliance
- Transaction advisory
- Strategic planning

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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