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Bank Watch

ARTICLE

Community Bank Valuation (Part 5)

Valuing Controlling Interests

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Community Bank Valuation (Part 5)

Valuing Controlling Interests

To close our **series on community bank valuation**, we focus on concepts that arise when evaluating a controlling interest in another bank, such as arises in an acquisition scenario. While the methodologies we described with respect to the valuation of minority interests in banks have some applicability, the M&A marketplace has developed a host of other techniques to evaluate the price to be paid, or received, in a bank acquisition.

In the "Valuing Minority Interests" segment of this series, we discussed that valuation is a function of three variables: a financial metric, risk, and growth. From a buyer's standpoint, the ultimate goal of a transaction, of course, is to enhance shareholder value, which would occur if the target entity can, on balance, enhance (or at least not detract from) the buyer's financial metrics, risk, and growth. This can be achieved in several ways:

- The direct earnings contribution of the target, or the accretion to the buyer's earnings per share if the consideration consists of the buyer's stock. In a bank M&A scenario, this accretion often derives from cost savings resulting from eliminating duplicative branches, back office functions, and the like.
- An acquisition can provide diversification benefits, such as different types of loans, additional geographic markets, or new funding sources. If these characteristics of the target reduce any concentrations held by the buyer, the acquirer's overall risk may lessen. However, numerous buyers have regretted entering lines of business or new markets via acquisition with which the buyer's management team lacked the requisite familiarity.
- Accessing new markets or lines or business lines through acquisition gives the buyer more "looks" at new customers and transactions. For many banks, moving the needle on asset size or growth means looking outwardly beyond its existing markets or products, and the needle moves faster with an acquisition strategy versus a de novo market expansion strategy.

These benefits are not without risks, though. Some of the more significant acquisition risks include:

- **Credit surprises.** One or two unexpected losses usually do not affect the underlying rationale for a transaction, although it may create some uncomfortable conversations with investors regarding the buyer's due diligence process. A more significant risk is that the buyer's risk tolerance differs from the seller's approach, leading to a potentially significant disruption to future revenues as risk appetites are synchronized. However, credit surprises often cannot be detached from the prevailing economic environment. In a post mortem, many transactions closed in the 2006 time frame look ill-advised given the subsequent financial crisis. Ultimately, factors outside the buyer's control may have the most impact on post-transaction credit surprises.

» **Cultural incompatibility.** While sometimes difficult to detect from the outside, differences small and large between the cultures of the buyer and target can jeopardize the anticipated post-merger benefits. More often than not, this is manifest in personnel issues. Mergers are like chum in the water to competitors; buyers can expect competitors to look for any opening to attract personnel from the target bank.

Similarities to Valuations of Minority Interests

The previous installment of this series introduced the comparable company and discounted cash flow methods to bank valuations. Both of these methods remain relevant in assessing a controlling interest in a bank, meaning an interest of sufficient size to dictate the direction of the bank. Most often, controlling interest valuations arise in the context of an acquisition.

Comparable Transactions Method

In a controlling interest valuation, the comparable company method can be used. However, the resulting values often would be adjusted by a "control premium," which is measured by reference to the value of historical M&A transactions relative to a publicly traded seller's pre-deal announcement stock price. This approach has the advantage of synchronizing the controlling interest valuation to current market conditions, which can be a drawback of the comparable transactions approach.

More often, though, the comparable company method morphs into the comparable transactions method in an M&A setting. Comparable M&A transactions can be identified by reference to geography, asset size, performance, time period, and the like. Ideally, the transactions would be announced close in proximity to the date of the analysis; however, narrowly defining the financial or geographic criteria may mean accepting transactions announced over a longer time period. The computation of pricing multiples, such as price/earnings or price/tangible book value, is facilitated by the widespread data availability regarding targets and the straightforward deal structures that usually allow analysts to identify the consideration paid to the sellers. That is, contingent consideration, like earn-outs, is rare. However, deal values are not always publicly reported for transactions involving privately-held institutions.

While the comparable transactions approach is intuitive – by measuring what another buyer paid for another entity in an industry with thousands of relatively homogeneous participants – the most significant limitation of the comparable transactions method is created by market volatility. Buyers' ability to pay is correlated with their stock prices, and most bank M&A transactions include a stock component. Deals struck at a certain price when bank stocks traded at 16x earnings would not occur at that same price if bank stocks trade at 12x earnings without crushing dilution to the buyer. Thus, prices observed in bank M&A transactions need to be viewed in light of the market environment existing at the time of the transaction announcement data relative to the valuation date.

Discounted Cash Flow Method

We introduced the discounted cash flow method as a forward-looking approach to valuation reliant upon a projection of future performance. In an M&A scenario, buyers usually start with the target's stand-alone forecast, unaffected by the merger. Acquirers then add layers to the forecast reflecting the impact of the transaction, such as:

» **Expense savings.** In a mature industry, realization of cost savings typically is a significant contributor to the transaction economics, with buyers often announcing cost savings equal to 30% to 40% of the target's operating expenses. These are derived primarily from eliminating duplicative branches, back office functions, and the like. As the expense savings estimates increase, there often is a rising risk of customer attrition, with cuts going beyond the back office into activities more noticeable to customers, like branch hours or staffing.

While buyers may expect a certain level of expense savings, it is not clear that buyers "credit" the seller with all of the expense savings the buyer takes the risk of achieving. That is, the risk of achieving the expense savings effectively is split between the buyer and seller, with the favorability of the split in one direction or the other dictated by the negotiating power of the buyer and seller.

» **Revenue enhancements.** Buyers may expect some revenue enhancements to occur from the transaction, such as if the buyer has a more expansive product suite than the target or a higher legal lending limit. However, buyers often are loathe to include these in transaction modeling, and revenue enhancements are seldom reported as driver of the EPS accretion expected from a transaction.

What We're Reading

***The Wall Street Journal* reviews the new CECL rules** for accounting for potential loan losses for public companies as investors may begin to focus more on credit quality, especially among consumer loans. Additionally, **Capital One's fourth quarter results** did not indicate any major looming consumer credit problems.

***S&P Global Market Intelligence* is forecasting** U.S. community bank M&A to increase from $18 billion to over $22 billion in 2020 due to earnings headwinds and a benign credit environment. **CenterState and South State recently announced a merger of equals** valued at approximately $6 billion which would create the eighth largest bank in the Southeast. (subscription required)

***Banking Exchange* reviews important indirect effects of student loan debt** on retail banking as the average debt load has risen to $30,000 among over 40 million indebted adults and wage rises have not kept pace with increases in debt.

» **Accounting adjustments.** While fair value marks on assets acquired and liabilities assumed should not drive the economics of a transaction, they can affect the near-term earnings generated by the pro forma entity. Therefore, buyers usually are keenly aware of the accounting implications of a transaction.

One advantage of a discounted cash flow approach is that it allows the buyer to evaluate, for a given price, the level of earnings contribution needed from the target to justify that price. While if you torture the numbers long enough they will confess to anything, as a statistics professor of mine was fond of saying, buyers should not lose sight of the reality of implementing the modeled business strategies.

Additional Considerations

While the comparable transactions and discounted cash flow models crossover – no pun intended with another valuation approach we describe below – from a minority interest valuation environment, several valuation techniques are unique to M&A scenarios.

Tangible Book Value Earn-Back

After the financial crisis, investors became focused on the tangible book value per share earn-back period, sometimes to the point of seemingly ignoring other valuation metrics. There are several ways to compute this, but the most common is the "crossover" method. This requires two forecasts:

» The buyer's tangible book value per share, absent the acquisition

» The buyer's pro forma tangible book value per share with the target

The analyst then calculates the number of periods between (a) the current date and (b) the date in the future when pro forma tangible book value per share exceeds stand-alone tangible book value per share. Ultimately, the earn-back period is driven by factors like:

» The price/earnings or price/tangible book value multiples of the buyer's stock relative to the multiples implied by the transaction value

» The extent of the merger cost synergies

The tangible book value earn-back method also exacts a penalty for deal-related charges, as a higher level of deal charges extends the earn-back period. From an income statement standpoint these charges often are treated as non-recurring and, in a sense, neutral to value. However, these charges represent a real use of capital, which the TBV earn-back approach explicitly captures.

Investors often look favorably upon transactions with earn-back periods of fewer than three years, while deals with earn-back periods exceeding five years often face a chilly reception in the market. The earn-back period often is the real governor of deal pricing in the marketplace, which investors often like because it overcomes some limitations posed by EPS accretion analyses.

Earnings per Share Accretion

As for the tangible book value per share earn-back period analysis, an EPS accretion analysis requires that the buyer forecast its EPS with and without the acquired entity. EPS accretion simply is the change in EPS resulting from the transaction. The attraction of this analysis lies in the correlation between EPS and value. For a buyer trading at 12x earnings, a deal that is $0.10 accretive to EPS should enhance shareholder value by $1.20 per share, holding other factors constant.

But how much accretion is appropriate? Should a deal be 1% accretive to be a "good" deal, or 10% accretive? It is difficult to answer this question in isolation. This is especially true for a deal comprised largely of cash, where the buyer is forgoing the use of its capital for shareholder dividends or share repurchases in favor of an

M&A transaction. Recent deal announcements often indicate EPS accretion from the mid-single digits to the teens with fully phased-in expense savings.

Contribution Analysis

A contribution analysis is most useful in transactions involving primarily stock consideration. It compares the buyer and seller's ownership of the pro forma company with their relative contribution of earnings, loans, deposits, tangible equity, etc. In a merger of equals transaction, where the two merger parties are roughly similar in size, this type of analysis is important in setting the final ownership percentages of the two banks.

Conclusion

A valuation of a controlling interest may take many forms; fortunately, the strengths of certain valuation methods described here offset the weaknesses of others (and vice versa). Value ultimately is a range concept, meaning that there seldom is a single value at which a deal fails to make economic sense. There are good deals, reasonable deals, and dumb deals. Evaluating a number of valuation indications puts a buyer in the best position to slot a transaction into one of these three categories and to negotiate a deal that accomplishes its objective of enhancing financial performance, controlling risk, and developing new growth opportunities. It is crucial to remember, though, that deals are tougher to execute in reality than in a spreadsheet.

This concludes our multi-part series examining the analysis and valuation of financial institutions. While approximately 5,000 banks exist, the industry is not monolithic. Instead, significant differences exist in financial performance, risk appetite, and growth trajectory. No valuation is complete without understanding the common issues faced by all banks – such as the interest rate environment or technological trends – but also the entity-specific factors bearing on financial performance, risk, and growth that lead to the differentiation in value observed in both the public and M&A markets.

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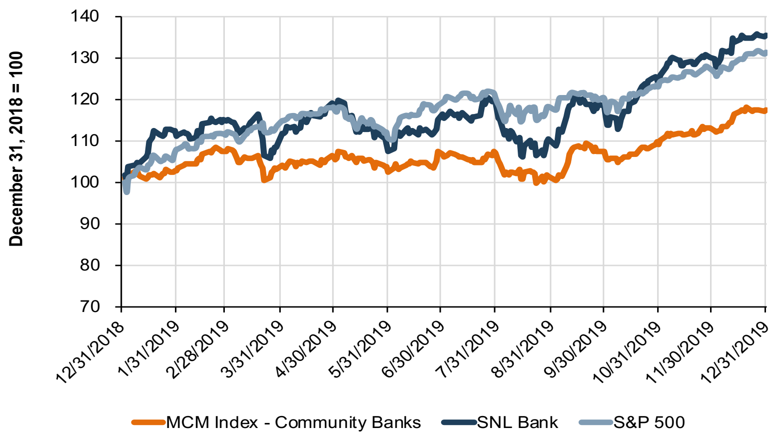
Recent Transaction

Mercer Capital rendered a fairness opinion on behalf of the Special Committee of Independent Directors of the Bank of Waynesboro in Waynesboro, Tennessee.

Mercer Capital has significant experience assisting banks throughout the U.S. with significant corporate transactions. Whether considering an acquisition, a sale, or simply planning for future growth, Mercer Capital can help you accomplish your financial objectives.

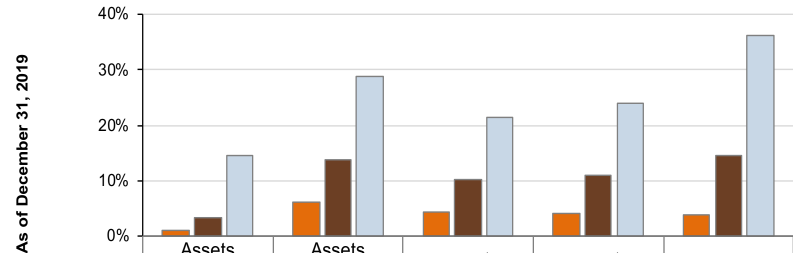
Learn more about Mercer Capital's Transaction Advisory Services >

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



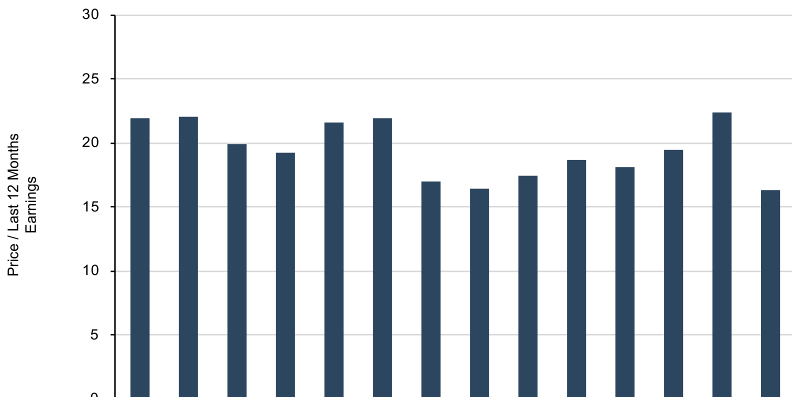
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	1.00%	6.17%	4.25%	4.15%	3.92%
Quarter-to-Date	3.37%	13.73%	10.34%	10.95%	14.58%
Last 12 Months	14.65%	28.80%	21.56%	23.91%	36.27%

Median Valuation Multiples

	Median Total Return as of December 31, 2019			Median Valuation Multiples as of December 31, 2019					
Indices	Month-to-Date	Quarter-to-Date	Last 12 Months	Price/LTM EPS	Price / 2019 (E) EPS	Price / 2020 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	3.0%	7.8%	22.9%	13.5x	14.0x	13.5x	132%	145%	2.2%
Midwest Index	4.7%	11.5%	24.2%	13.5x	12.9x	12.6x	139%	155%	2.2%
Northeast Index	4.2%	8.3%	14.8%	14.0x	13.3x	12.4x	127%	140%	2.5%
Southeast Index	3.4%	6.3%	16.8%	14.9x	13.0x	12.6x	122%	140%	1.6%
West Index	2.2%	5.9%	8.4%	13.3x	13.0x	13.4x	122%	134%	1.9%
Community Bank Index	3.8%	9.2%	17.4%	13.6x	13.2x	12.8x	128%	144%	2.2%
SNL Bank Index	**3.9%**	**14.3%**	**35.4%**						

Median Price/Earnings Multiples

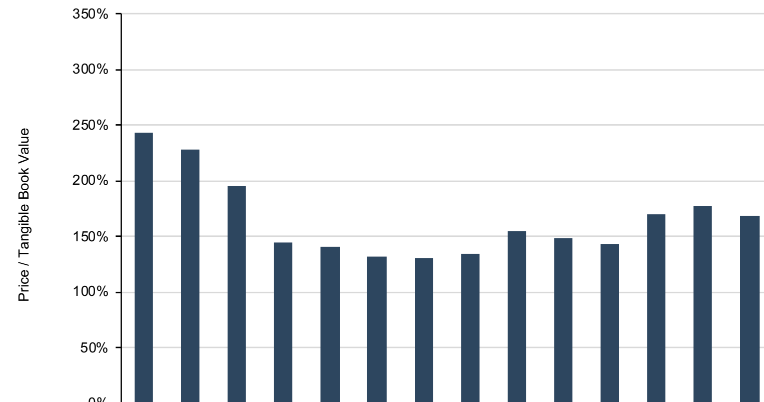
Target Banks' Assets <$5B and LTM ROE >5%



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
■ U.S.	22.0	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5	18.8	18.1	19.5	22.4	16.3

Median Price/Tangible Book Value Multiples

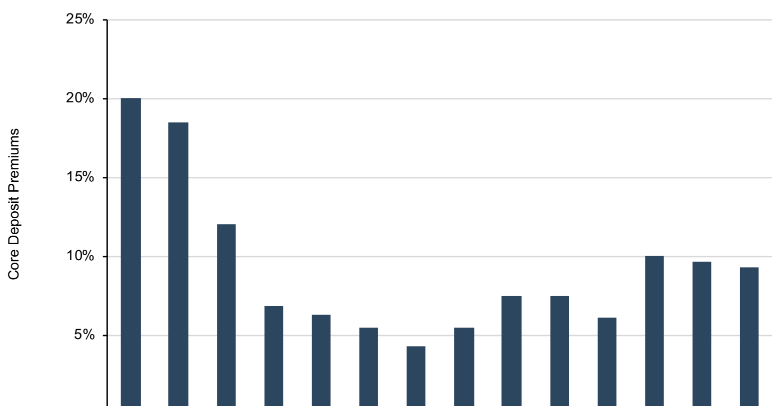
Target Banks' Assets <$5B and LTM ROE >5%



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
■ U.S.	243%	228%	196%	145%	141%	132%	130%	134%	155%	148%	143%	170%	178%	168%

Median Core Deposit Multiples

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



	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
■ U.S.	20.0%	18.4%	12.0%	6.9%	6.3%	5.4%	4.3%	5.5%	7.5%	7.5%	6.1%	10.0%	9.6%	9.3%

Median Valuation Multiples for M&A Deals

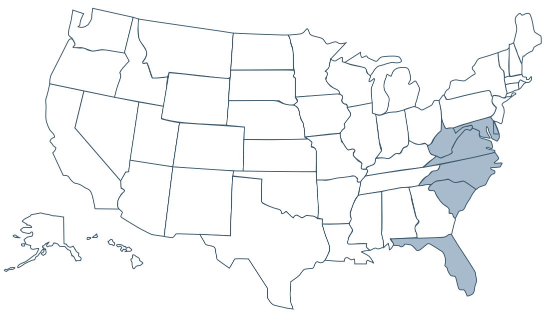
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended December 2019

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	17.3x	173%	9.7%	23	84.3	455,303	10.1%
Midwest	16.0x	169%	9.7%	82	55.2	180,570	10.0%
Northeast	17.3x	173%	9.5%	15	78.0	527,235	10.1%
Southeast	15.2x	149%	8.4%	37	42.4	248,139	10.1%
West	15.6x	181%	12.4%	15	71.1	255,924	12.4%
National Community Banks	**16.3x**	**168%**	**9.3%**	**172**	**65.7**	**250,636**	**10.1%**

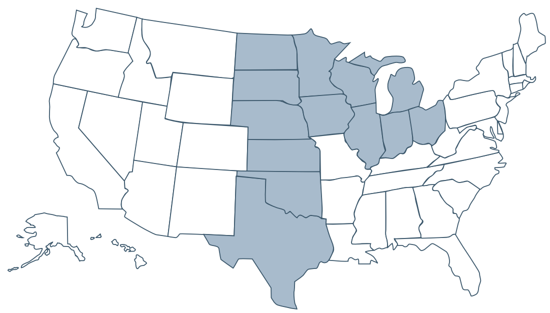
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

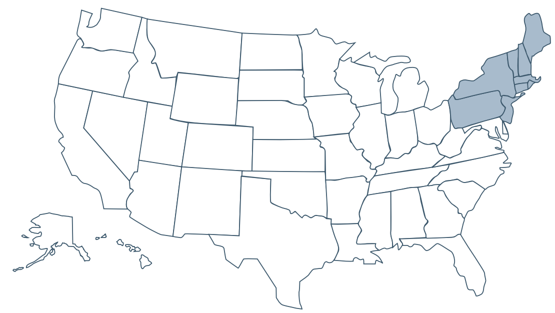
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



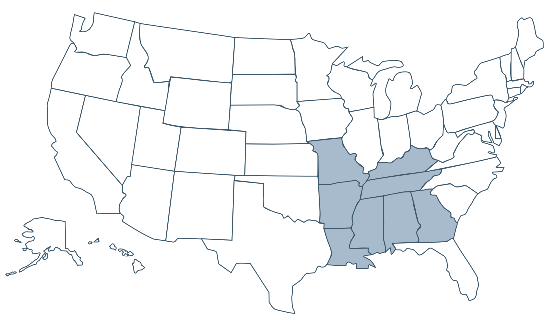
Atlantic Coast



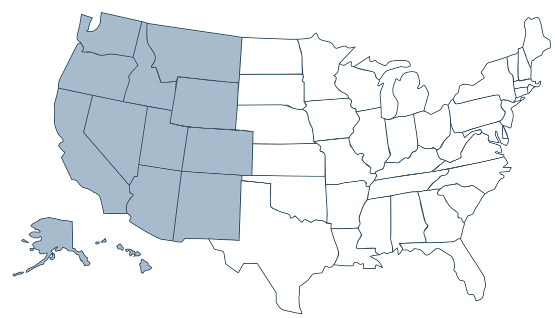
Midwest



Northeast



Southeast



West

MERCER CAPITAL

Depository 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

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