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BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES
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Bank Watch

ARTICLE

2021 M&A Outlook: Slow Transition to a Potentially Big Year

In This Issue

2021 M&A OUTLOOK

Slow Transition to a Potentially Big Year

What a difference a year can make. As shown in Figure 1, Bank M&A activity during the past five quarters resembles the public markets in which "normal" activity and pricing observed in 4Q19 collapsed in 2Q20 due to the short but very deep COVID-19 recession. Since then, a partial rebound has occurred that may become pronounced by the second half of 2021 if the economy does not lapse into recession and if credit issues remain contained.

For the full year, bank M&A activity fell sharply to 116 announced transactions as of December 28 from about 250 to 300 transactions per year during 2012-2019. The number of 2020 deals represented about 2% of the 5,177 of the institutions that existed as of the beginning of the year compared to a more typical 3-5% of the industry that is absorbed each year.

Pricing fell for the second consecutive year as measured by the average price/tangible book value ("P/TBV") multiple of 133% compared to 157% in 2019 and 172% in 2018. The median 2020 P/E multiple of 17.7x compares to 16.4x in 2019 and 24.4x in 2018 (many sellers' trailing 12-month earnings were depressed due to deferred tax asset write-downs in 4Q17).

Figure 1

Last 5 Quarters	4Q19	1Q20	2Q20	3Q20	4Q20
Announced Deals	63	45	10	32	29
Total Value ($Bil)	$11.2	$6.7	$0.1	$1.2	$19.9
Assets ($Bil)	$74.5	$43.3	$2.6	$15.4	$216.8
P/TBV	133%	147%	106%	114%	116%
P/E (LTM)	17.9x	17.3x	NM	21.0x	23.0x
Core Dep Premium	10.0%	7.6%	1.7%	3.3%	1.8%

Last 5 Years	2016	2017	2018	2019	2020
Announced Deals	252	269	265	271	116
Total Value ($Bil)	$27.1	$26.6	$30.2	$58.4	$27.9
Assets ($Bil)	$194.4	$157.8	$170.8	$429.0	$278.2
P/TBV	136%	163%	172%	157%	133%
P/E (LTM)	21.0x	22.6x	24.4x	16.4x	17.7x
Core Dep Premium	4.7%	8.8%	9.9%	8.3%	5.1%

** P/E based upon LTM earnings (P/E to buyer with exp saves much lower)*

Source: S&P Global Market Intelligence

Public Market Buttresses the M&A Market

Public markets staged a dramatic rebound from the March 23 low when the Fed announced additional measures to support markets, including the purchase of corporate bonds for the first time ever—a decision that required some legal maneuvering by the Fed to implement.

Banks rebounded, too, but are on track to finish the year down 15-20% compared to gains of ~15% for the S&P 500 (large caps), ~20% for the Russell 2000 (small caps), and ~40% for the tech-heavy NASDAQ.

Figure 2

From: / To:	09/30/20 12/28/20	03/23/20 09/30/20	12/31/19 03/23/20	12/31/19 12/28/20	11/08/16 12/28/20
SNL Micro Cap US Bank	17.7%	-2.8%	-35.7%	-26.4%	3.6%
SNL Small Cap US Bank	34.5%	11.4%	-43.7%	-15.6%	17.1%
SNL Mid Cap US Bank	45.9%	17.2%	-48.6%	-12.2%	6.3%
SNL Large Cap US Bank	30.7%	25.6%	-49.2%	-16.6%	32.0%
Russell 2000	32.4%	50.4%	-39.9%	19.6%	67.0%
S&P 500	11.1%	50.3%	-30.7%	15.6%	74.6%
NASDAQ	14.7%	62.8%	-23.5%	42.7%	146.6%

Source: S&P Global Intelligence, change in price excluding dividends

Of note is the performance of bank stocks during 4Q20. Other than the micro-cap bank index, bank indices increased 30-45% and easily outpaced the 11% increase in the S&P 500 and 15% increase in the NASDAQ. Much of the outperformance occurred after the Pfizer vaccination announcement on November 8.

Investors rotated into small caps (Russell 2000 +32%), banks, cyclicals, and other value stocks as the probability that the economy would perform better than expected in 2021 increased and that outsized credit losses not covered by existing reserves decreased. Also, the rotation likely reflects a view by some investors that tech shares had become substantially overvalued.

The 4Q20 rally, if sustained, has set the stage for a pick-up in bank M&A all else equal because would-be acquirers' shares trade at higher multiples and thereby can support higher offers (though not value) to would-be sellers. Nonetheless, only large cap bank stocks have rebounded to their long-term average P/TBV multiple while the other indices were trading at 75-80% of the long-term average multiple.

On a P/E basis, the mid- and large-cap bank indices were trading above their respective long-term average P/Es based upon the trailing 12-month earnings because most index members incurred heavy loan loss provision expense to build loan loss reserves. Many micro- and small-cap banks have not built loan loss reserves as much because many have not adopted CECL and because many (or just some) do not have outsized exposure to businesses that were severely impacted by COVID.

Figure 3

Spot P/E (LTM EPS) and P/TBV vs Multi-Year Medians

	12/28/20	03/23/20	12/31/19	5 Yr	10 Yr
SNL Micro Cap US Bank	12.0x	9.3x	14.2x	15.3x	14.6x
SNL Small Cap US Bank	13.9x	8.2x	14.8x	17.0x	16.3x
SNL Mid Cap US Bank	16.1x	7.7x	13.8x	16.5x	17.2x
SNL Large Cap US Bank	16.3x	6.7x	12.9x	12.8x	13.4x
SNL Micro Cap US Bank	102%	88%	133%	134%	123%
SNL Small Cap US Bank	127%	97%	162%	163%	161%
SNL Mid Cap US Bank	156%	107%	194%	195%	191%
SNL Large Cap US Bank	161%	103%	194%	174%	164%

Source: S&P Global Market Intelligence (5-yr and 10-yr median multiples are based on daily observations)

More Urgency for M&A Activity

While M&A in the industry has been ongoing for ~35 years, there is more urgency for banks to engage in M&A now. The industry suffers from massive over-capacity of physical branches that has intensified with the accelerated adoption of digital banking this year. It is just one signpost among many on the intersection of technology and banking, but the partnership between Google and Citigroup Inc. to offer digital deposits as part of the Google Pay app is emblematic of the potential disruption to core deposit relationships.

The capacity issue is made worse by revenue pressure due to intense pressure on net interest margins ("NIMs") now that short-term policy rates are near zero again and because loan demand is weak. A slow growth world in which rates are pinned to the floor for years implies lenders will compete heavily on rate to originate loans because the bond market offers little yield.

What We're Reading

An article at *Bank Director* argues that banks should **take advantage of the elevated level of deposit balances** and core deposit growth to rebalance their funding profiles.

***Banking Exchange* reviews** the uncertain outlook for ag lending after a turbulent 2020.

As part of the latest coronavirus stimulus package, the **Paycheck Protection Program is getting rebooted** for another round. **Cross River Bank** was one bank that was able to take advantage of the first round of the PPP due to multiple relationships with fintech companies.

Stock Swaps May be Favored

While the environment is conducive to a pick-up in M&A activity, it is not yet supportive for a rebound in pricing to 2018 or even 2019 levels. Most banks make less money even with normalized provision expense due to lower NIMs, and robust mortgage earnings will ebb one day, too. Likewise, public market valuations for most active acquirers are lower than they were two years ago.

Some boards that would like to sell may have a hard time accepting a lower price versus what was obtainable a couple of years ago. One way to bridge the bid-ask gap is to consider transactions with more rather than less consideration consisting of the buyer's common shares.

Cash deals "cash-out" shareholders who then reinvest after-tax proceeds. Stock deals allow the target's shareholders to remain invested in a sector that still trades cheap to longer-term valuations. Also, there is the capital gains tax issue when shares are sold. If the Biden Administration follows its platform, it will push for a much higher capital gains tax rate in the new Congress.

Transactions structured as a stock swap or where the majority consideration consists of the buyer's shares can benefit both shareholder groups via:

- EPS accretion
- TBVPS accretion once day one dilution is recaptured via EPS accretion
- Multiple expansion
- Improved liquidity for the shares
- Greater potential value in a sale (size, better markets, etc.)
- Management depth

- » Revenue diversification
- » Dividend increase (sometimes)

Mergers of equals ("MOEs") and quasi-MOEs (or low premium transactions) may see more interest in 2021 given the need to cut costs. The four largest transactions announced thus far in 2020 reflect an MOE (South State-CenterState and Bridge Bancorp-Dime Community) and quasi-MOE (First Citizens-CIT and Huntington-TCF). These transactions follow four of the larger transactions of 2019 in which the transactions were MOEs or quasi-MOEs.

Whether structured as an MOE or not, the four transactions highlighted in Figure 4 indicate an increase in EPS, TBVPS, and ROTCE absent a transaction and assuming execution is good enough and the economy performs well enough.

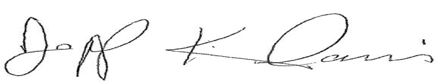
Figure 4

	SSB-CSFL	Bridge-Dime	FCNC-CIT	HBAN-TCF
Announced	1/27/20	7/1/20	10/16/20	12/13/20
Ownership	47 / 53%	48 / 52%	61 / 39%	61 / 39%
Deal Value ($M)	$3,212	$498	$2,159	$5,925
Price / TBV	201%	97%	44%	148%
Price / LTM Earnings	13.7x	16.1x	0.0x	Price/ LTM
P/E with Exp Saves	*NA*	*NA*	*NA*	*6.5x*
Buyer 5-Day Change	-11.6%	-17.6%	33.6%	-4.2%
Seller 5-Day Change	1.9%	-6.4%	26.7%	6.2%
Exp Saves-% of Target	NA	NA	NA	37%
Exp Saves-% of Both	10%	15%	10%	NA
Buyer EPS Accretion	20%	10%	50%	18%
Buyer TBVPS Accr/(Dil)	-2%	5%	30%	-7%
TBVPS Earn-Back	*<1 Yr*	*NA*	*NA*	*~3 Yrs*
Div'd / Share - "Seller"	25%	11%	-93%	29%
Credit Mark	1.1%	2.1%	3.4%	2.4%

Source: S&P Global Market Intelligence

Summing It Up

We expect the pace of M&A to pick-up in 2021 provided there is no double-dip recession, credit quality remains relatively stable, and bank stocks hold (or add to) their recent gains. Mercer Capital has worked with banks as buyers and sellers for nearly four decades as a financial advisor.



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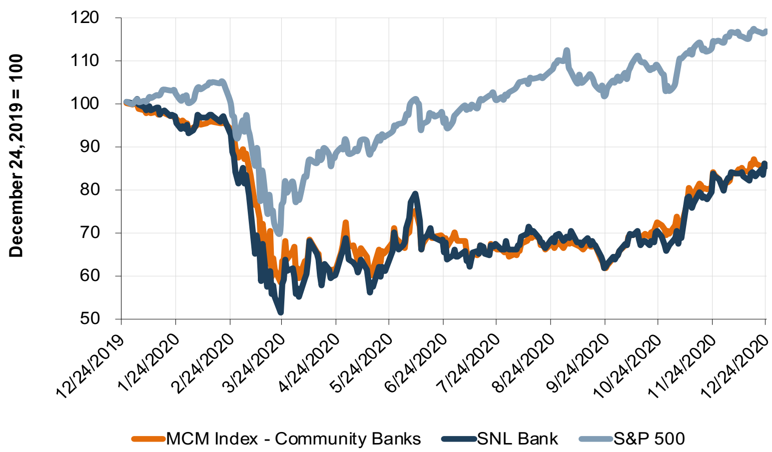
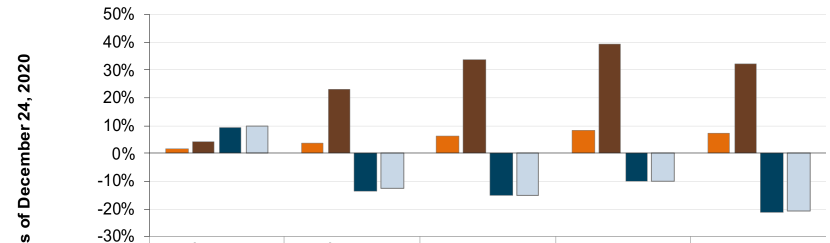
Mercer Capital's Bank Group Index Overview



Source: S&P Global Market Intelligence

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	1.90%	3.92%	6.45%	8.23%	7.22%
Quarter-to-Date	4.19%	22.82%	33.76%	39.24%	32.35%
Year-to-Date	9.29%	-13.47%	-15.37%	-9.88%	-21.00%
Last 12 Months	9.96%	-12.70%	-15.33%	-10.25%	-20.75%

Source: S&P Global Market Intelligence

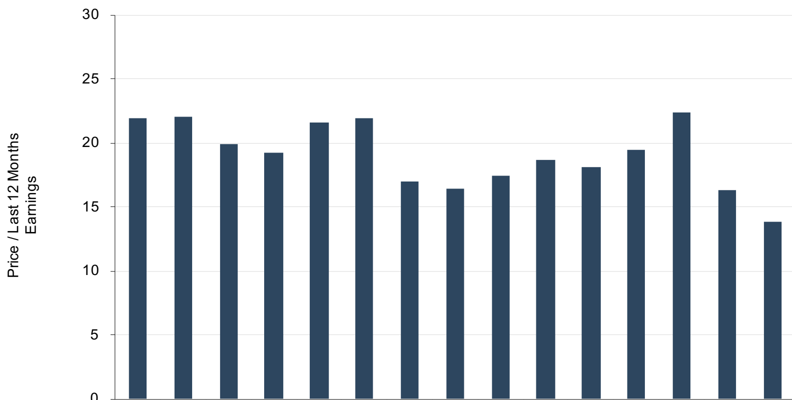
Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of December 24, 2020					
	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/LTM EPS	Price / 2020 (E) EPS	Price / 2021 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	5.7%	32.4%	-21.3%	-21.4%	11.2x	12.7x	13.1x	94%	105%	3.3%
Midwest Index	4.6%	25.3%	-13.3%	-13.1%	10.5x	10.1x	11.7x	99%	114%	2.8%
Northeast Index	3.6%	28.7%	-20.4%	-20.2%	10.6x	10.3x	10.0x	89%	100%	3.5%
Southeast Index	5.0%	26.2%	-16.0%	-15.4%	12.9x	11.1x	11.7x	96%	110%	2.3%
West Index	14.0%	57.3%	1.2%	0.7%	11.4x	11.6x	11.3x	97%	104%	2.7%
Community Bank Index	6.4%	33.0%	-14.5%	-14.4%	11.2x	11.3x	11.6x	95%	106%	3.0%
SNL Bank Index	**7.2%**	**32.6%**	**-14.6%**	**-14.4%**						

Source: S&P Global Market Intelligence

Median Price/Earnings Multiples

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

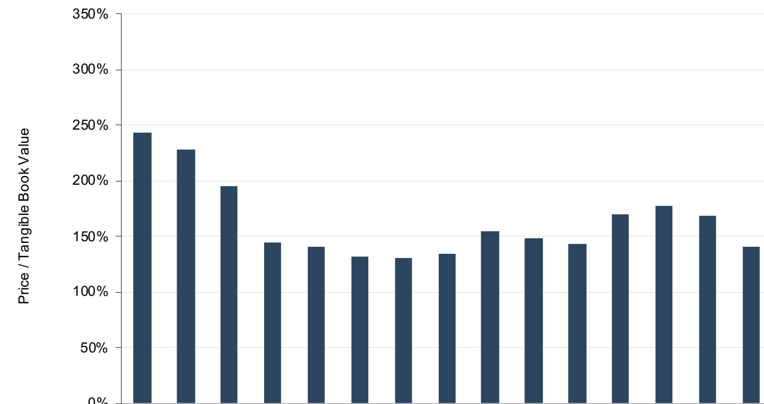


	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	LTM 2020
U.S.	22.0	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5	18.8	18.1	19.5	22.4	16.3	13.9

Source: S&P Global Market Intelligence

Median Price/Tangible Book Value Multiples

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

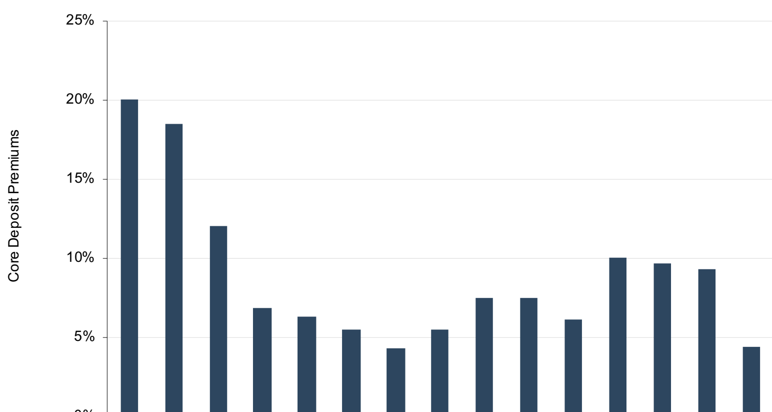


	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	LTM 2020
U.S.	243%	228%	196%	145%	141%	132%	130%	134%	155%	148%	143%	170%	178%	168%	140%

Source: S&P Global Market Intelligence

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	LTM 2020
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%	4.4%

Source: S&P Global Market Intelligence

Median Valuation Multiples for M&A Deals

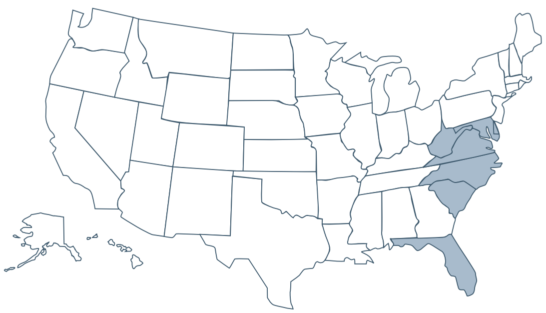
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended December 23, 2020

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	12.5x	102%	2.1%	5	62.5	378,333	8.8%
Midwest	18.3x	160%	8.1%	30	26.4	118,159	10.2%
Northeast	14.0x	140%	10.4%	4	71.5	517,018	11.7%
Southeast	12.3x	115%	2.6%	12	93.2	183,880	11.6%
West	10.5x	151%	5.5%	2	157.4	702,084	9.4%
National Community Banks	**13.9x**	**140%**	**4.4%**	**53**	**62.8**	**172,071**	**10.5%**

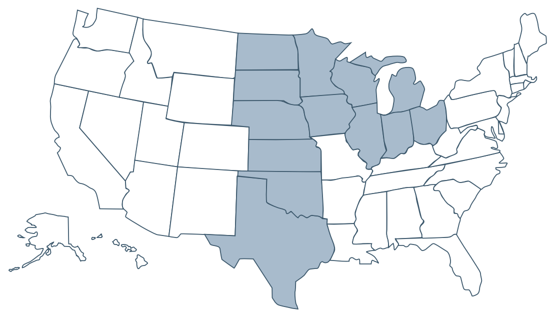
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

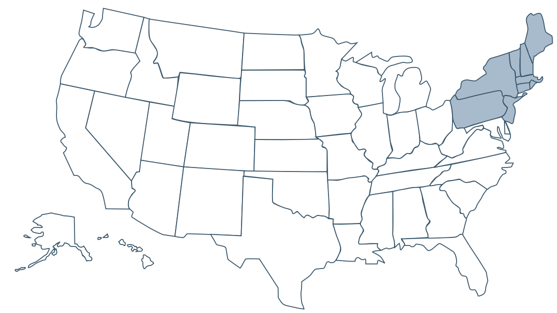
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



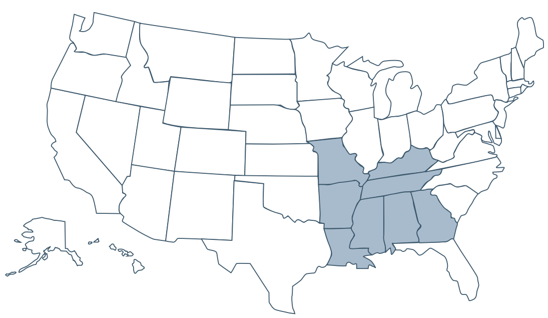
Atlantic Coast



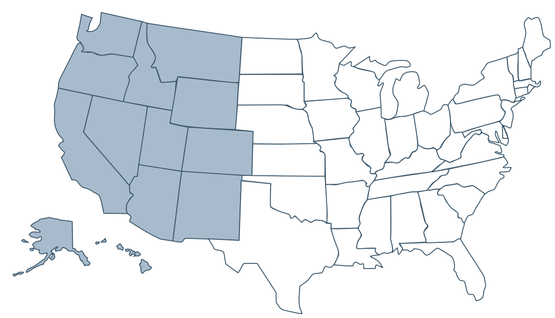
Midwest



Northeast



Southeast



West

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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.

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