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Bank Watch

ARTICLE

Issues for Banks Executing a Hold Strategy in 2020

In This Issue

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"... If you're gonna play the game boy, you gotta learn to play it right. You got to know when to hold 'em, know when to fold 'em, know when to walk away ..."
– Kenny Rogers, *The Gambler*

Community Bank Valuation and Buy, Sell, or Hold Strategies

Being a good investor requires many of the skills that country singer Kenny Rogers sang about in his famous song *The Gambler.* When setting an investment strategy, investors often create rules around when they will buy, sell, or hold a particular stock. Valuation is a key component of assigning those buy, sell, and hold ratings as investors weigh the prospects of an individual stock's future performance versus the valuation reflected in the current market price. Ratings can change as markets move up and down. Key valuation elements can also change – such as a company's financial performance and risk and growth profile.

Mercer Capital has valued thousands of banks across the nation – of all sizes – for a wide range of purposes. Whether we are valuing a portfolio of loans or the whole bank, the basic question is always: What is the value? While we don't assign ratings to bank stocks, our valuation often serves as a starting point for the Board when discussing current and future buy, sell, or hold decisions.

We recently attended the **Acquire or Be Acquired (AOBA) conference** sponsored by *BankDirector*. For those unfamiliar with this three-day event, it brings together over 1,500 bankers, directors, and advisors to discuss pertinent and timely M&A and other issues impacting the banking industry.

Given the name of the conference, there is always much made about the declining number of banks and consolidation topics are always on the agenda at AOBA; however, the vast majority of banks (over 90% assuming a 5% annual industry contraction) will execute the hold decision for 2020. While being a holder could be viewed as taking no strategic action, it is important to note that a Board electing to refrain from buying or selling is a strategic decision in and of itself and presents its own unique blend of strategic considerations.

For the holders who wish to remain independent, we discuss issues important to them in 2020 (many of which were also discussed at AOBA). In the March 2020 issue of this newsletter, we will discuss key issues and themes for banks looking to be buyers and sellers in 2020.

Green Shoots for Growth and Some Recent Multiple Expansion

For those holders, one interesting side effect of the declining number of banks (~5,000 today vs. ~15,000 in the early 90s) is that some green shoots of growth are emerging. With the largest banks focused on the larger metro areas, community banks are finding opportunities in more rural and smaller metropolitan markets. Additionally, many community banks are executing on their "niches to riches" strategy and continuing to offer financial services that fit their strategy, their clients, and their markets. We have even seen some community banks adopt and be rewarded for leveraging FinTech through partnerships to enhance profitability, efficiency, and valuation.

In 2019, the markets reflected some of these positive developments in the smaller banks as the SNL Small- and Mid-Cap Bank Indices had total returns of 21% and 24%. Figure 1 details public market pricing multiples (P/E and P/TBV) for community banks over the 10-year historical period (2008 - 2019). As shown, P/Es and P/TBV multiples for community banks rebounded to be roughly in line with longer term historical averages at year-end 2019 after having experienced a sharp contraction in 2018.

Earnings Improved but Margin Headwinds Persist

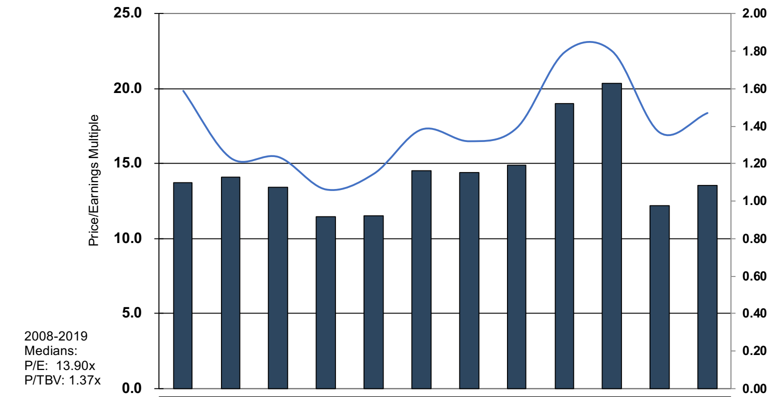
As detailed in Figure 2 and noted in several sessions at AOBA, community bank earnings were healthy in 2019. Key contributors to solid earnings were higher net interest income driven by loan growth, higher fee income[1], and low credit costs.

Despite this year-over-year growth in aggregate net income, there are still some headwinds for the community bank sector and this is evidenced in the data as well. In 2019, median ROA and ROE for community banks was relatively flat at 1.14% and 9.95%, respectively, compared to 1.13% and 10.32% for fiscal 2018. This largely reflected that non-interest expenses continue to rise while earning asset growth has slowed combined with NIMs that peaked mid-year and then eased. NIM pressure likely will continue in 2020 now that the Fed appears to be poised to cut one or more times.

While one could argue that the NIM story is purely a function of the yield curve (i.e. low level of rates and shape), there is also a demographic component to the story. The U.S. population as a whole grew at the slowest rate in decades, and this trend has been even more pronounced in many of the smaller metropolitan and rural markets that community banks serve. Loan growth was a bit slower for the median community bank in 2019 with growth of only 4.5% for the median community bank, compared to 6.0% in 2018.

Figure 1: Median Public Market P/E and P/TBV Multiples

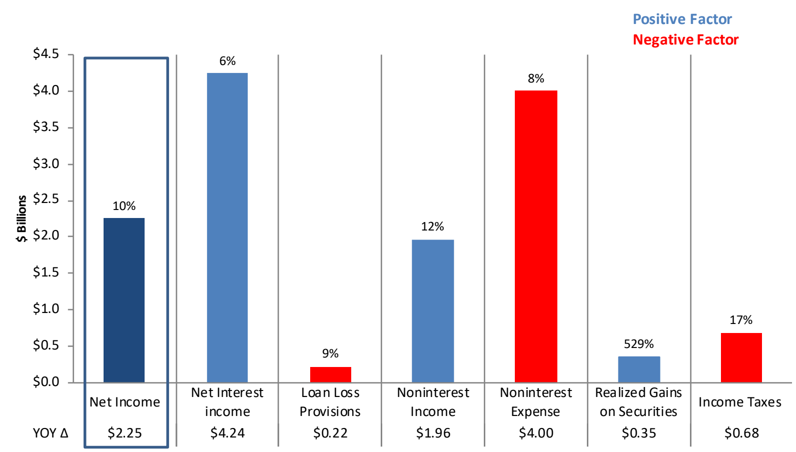
Banks/Thrifts with Assets of $500 Million - $5 Billion & Return on Tang. Equity > 5%



	12/08	12/09	12/10	12/11	12/12	12/13	12/14	12/15	12/16	12/17	12/18	12/19
Price / Earnings	13.7	14.1	13.4	11.4	11.5	14.5	14.4	14.9	19.0	20.3	12.2	13.5
Price / Tang. Book Value	1.59	1.23	1.23	1.06	1.15	1.38	1.32	1.39	1.79	1.80	1.36	1.47

Source: S&P Global Market Intelligence

Figure 2: Community Banks, Savings Banks, & S&Ls Contributions to Year-Over-Year Net Income Change



Source: S&P Global Market Intelligence

Demographic Headwinds Impact Management and Shareholders

For those banks that want to remain independent, it is imperative to consider ways to reward employees and enhance liquidity for shareholders. The demographic headwinds noted previously place a priority on attracting and retaining talent to replace aging management teams. These headwinds also require planning for the potential liquidity and succession needs of the shareholder base and consideration of what shares might seek liquidity during the 2020s.

While that key investor and board member may have always viewed their investment at your bank as a long-term one and has no interest in selling, she may have an issue as it relates to estate taxes and her children and grandchildren may not hold the same view should they inherit the shares. So the bank may need to consider options related to telling their story and engaging with the next generation of shareholders, providing liquidity through buybacks or repurchases, and encouraging **proper estate tax planning** for aging shareholders to ensure a smooth transition occurs. We have provided a number of valuations over the years to banks and their shareholders for estate tax planning and gifting and have resources that may be of interest to those bank directors faced with this issue.

A presenter at AOBA noted that the present time may be "the best tax environment of their lifetime." So for many bank directors and shareholders, now may be an opportune time to consider gift and estate tax planning as well as providing liquidity to shareholders who may have built up large capital gains over the years.

We have written about **ESOPs as an effective tool for employee retention**, aligning shareholder and employee interests, and providing liquidity to shareholders while still remaining independent. For those banks interested in exploring ESOPs further, we have resources that may be of interest.

What We're Reading

The FDIC released its **Quarterly Banking Profile for 4Q19**. Highlights include lower net interest income relative to 4Q18 as asset yields fell more rapidly than funding costs and stable asset quality as loan loss provisions and net charge-offs rose from a year ago.

Ally Financial announced its **acquisition of CardWorks**, one of the 20 largest credit card issuers in the country, for $2.65 billion which will increase Ally's ***scale*** in the credit card market.

After three rate cuts in the second half of 2019, the Fed held the Fed funds rate steady in December in January amid growing optimism about the US economy. However, the **outbreak of the coronavirus has clouded the outlook on future rate moves** and interest rate future markets have increasingly signaled expectations of future rate cuts.

Focusing on Enhancing Fee Income and Efficiency

Larger banks outperform smaller community banks because of their ability to generate higher levels of non-interest income and greater efficiency. So, a viable path to value creation is to focus on fee income and efficiency. Traditional strategies include diversifying the revenue mix into fee generating areas like payments, mortgage lending, insurance, or wealth management as well as increasing efficiency among your branch network. Newer strategies include effective FinTech partnerships so the bank can meet rising customer demands for digital offerings and also leverage technology to complement the high-touch branch staff already in place.

For those banks interested incorporating FinTech into their strategic plan further, it is encouraging to see that a number of resources have emerged, including Bank Director's FinXTech track and demo area at the AOBA conference, a separate FinXTech conference in May, ICBA's ThinkTech accelerator that assists FinTechs and other resources, and the FDIC's recently published piece on FinTech partnerships.[2]

Easing of Holding Company Regulations May Broaden Access to Shareholders to Raise Capital and Also for Banks Looking to Make Minority Investments in FinTechs and/or Non-Banks

The potential influence of regulation and its impact on the banking industry and M&A structures was noted in several sessions at AOBA. In late January 2020, the Fed amended rules related to when a company exercises control over another company for purposes of the Bank Holding Company Act.[3] This new rule was expected to ease the ability of non-bank companies, such as PE firms and others, to invest in banks seeking to raise capital while also enhancing banks' ability to make investments in FinTech companies and other non-financial companies. It will be interesting to see whether the broadening of partnerships between banks and FinTech companies will result in an increase in bank investments in these FinTech companies.

For those bankers who may be considering investments in FinTech companies, we note due diligence and valuation of FinTech companies is vastly different from a community bank. We value FinTech companies across the corporate lifecycle. A FinTech company's valuation metrics tend to be vastly different from a bank's metrics. When valuing a FinTech company, it's important to assess the quality of the company's earnings, understand their unit economics and key performance indicators, and how those impact the reasonableness of their forecast. We have **resources to help** in that area for bankers exploring potential minority investments in FinTechs.

Continued Importance of Managing Credit Risk and Stress Testing

Although the economic environment is strong, a prudent measure for many banks is to enhance stress testing of their loan portfolios. Several discussions at AOBA noted the need to remain vigilant on underwriting standards despite competitive and margin pressures as the last loans prior to the turn in the economic cycle can often be those fraught with the most credit risk during the downturn. With CECL and the potential for a turn in what has already been the longest economic expansion in history, managing credit risk and **stress testing** in an economic and baseline scenario is vitally important to managing credit risk and staying independent when the next turn in the cycle occurs.

Conclusion

We look forward to discussing these issues with clients in 2020 and monitoring how they evolve within the banking industry over the next few years. In the March 2020 issue of *BankWatch,* we will focus on key themes for those banks looking to be buyers or sellers in 2020. As always, Mercer Capital is available to discuss these trends as they relate to your bank, so feel free to call or email.

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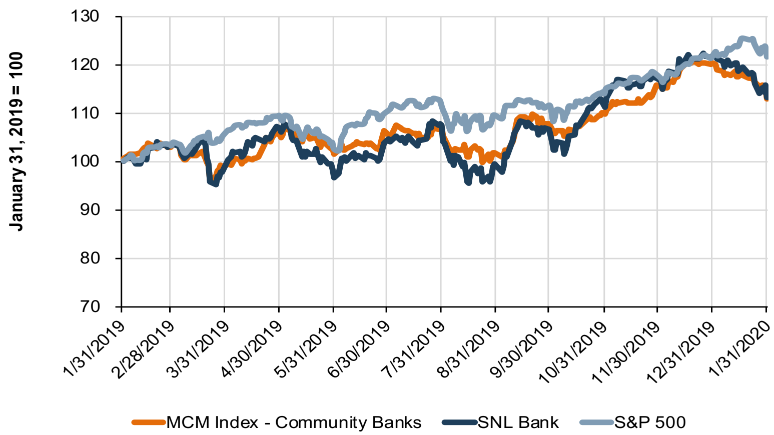
1 Based on data compiled from SNL Financial, there are 3,666 community banks at December 31, 2019 (defined as 3,232 commercial banks, 229 savings banks, and 205 savings and loan associations in the United States with assets between $100 million and $5 billion), excluding those with unusual loan portfolio and revenue composition.

2 https://www.fdic.gov/fditech/guide.pdf?source=govdelivery&utm_medium=email&utm_source=govdelivery | https://www.icba.org/solutions/thinktech | https://www.bankdirector.com/finxtech/ | https://www.fifintech.com/.

3 https://bankingjournal.aba.com/2020/01/fed-finalizes-rule-to-clarify-bank-control-determinations/.

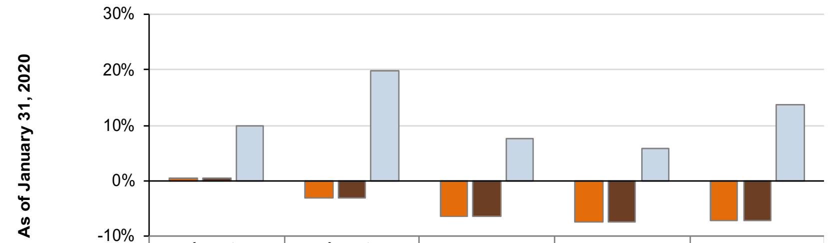
Mercer Capital's Bank Group Index Overview



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	0.57%	-3.19%	-6.41%	-7.36%	-7.10%
Quarter-to-Date	0.57%	-3.19%	-6.41%	-7.36%	-7.10%
Last 12 Months	9.94%	19.72%	7.66%	5.89%	13.66%

Source: S&P Global Market Intelligence

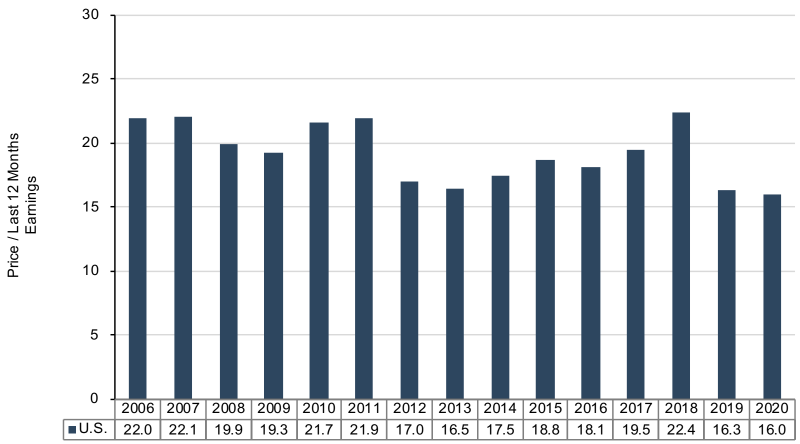
Median Valuation Multiples

	Median Total Return as of January 31, 2019			Median Valuation Multiples as of January 31, 2019					
Indices	Month-to-Date	Quarter-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	-6.9%	-6.9%	10.2%	12.7x	12.6x	13.3x	122%	135%	2.4%
Midwest Index	-6.1%	-6.1%	12.2%	12.6x	12.1x	11.3x	123%	134%	2.4%
Northeast Index	-7.6%	-7.6%	5.8%	12.5x	11.5x	10.8x	112%	127%	2.8%
Southeast Index	-5.3%	-5.3%	6.9%	13.5x	11.6x	10.5x	114%	131%	1.7%
West Index	-4.6%	-4.6%	6.3%	12.2x	12.1x	11.2x	112%	140%	2.3%
Community Bank Index	-6.2%	-6.2%	13.0%	12.6x	12.0x	11.2x	117%	133%	2.4%
SNL Bank Index	**-7.1%**	**-7.1%**	**13.3%**						

Source: S&P Global Market Intelligence

Median Price/Earnings Multiples

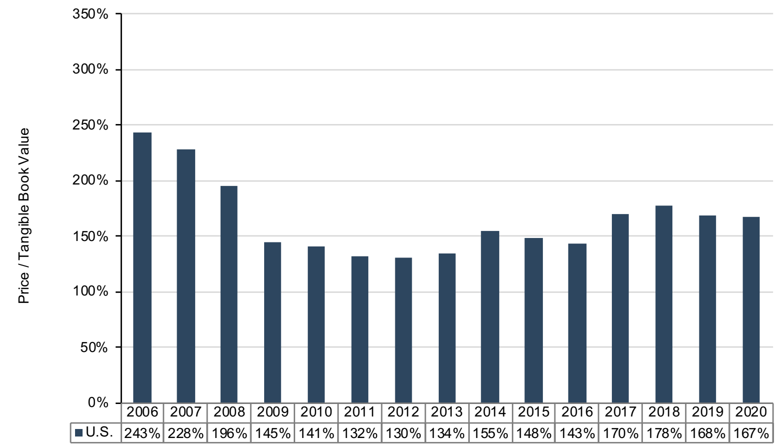
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Global Market Intelligence

Median Price/Tangible Book Value Multiples

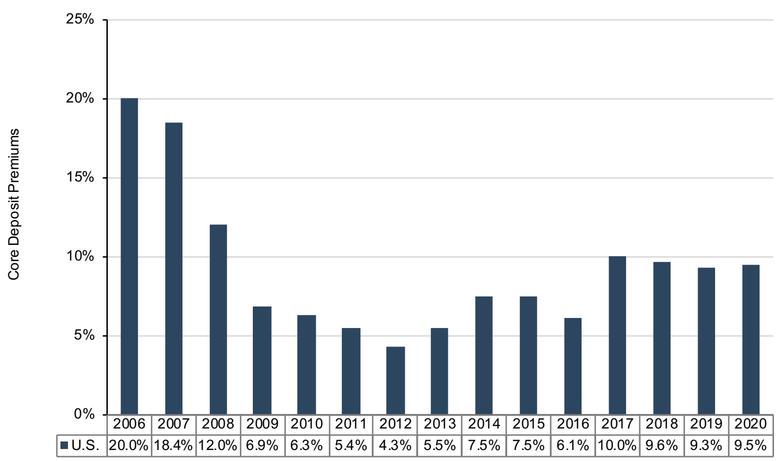
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Global Market Intelligence

Median Core Deposit Multiples

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



Source: S&P Global Market Intelligence

Median Valuation Multiples for M&A Deals

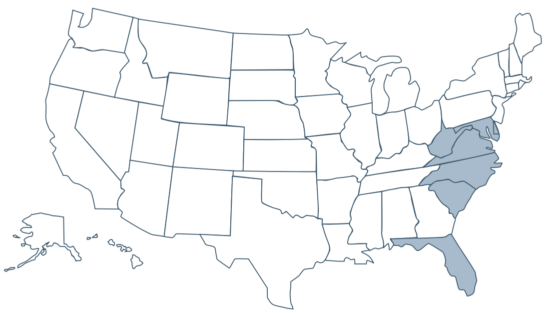
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended January 2019

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	16.6x	168%	9.7%	24	79.2	453,159	10.0%
Midwest	15.9x	168%	10.7%	81	44.9	168,340	10.0%
Northeast	17.3x	173%	9.6%	15	78.0	512,146	10.2%
Southeast	15.2x	154%	8.8%	42	42.4	232,805	10.4%
West	15.6x	181%	12.4%	13	71.1	255,924	12.4%
National Community Banks	**16.0x**	**167%**	**9.5%**	**175**	**64.6**	**241,063**	**10.2%**

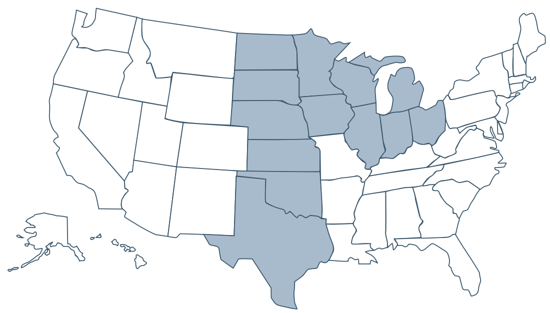
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

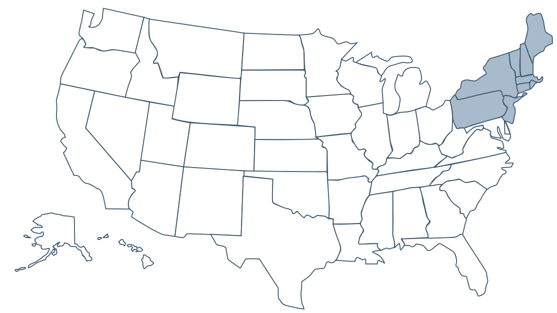
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



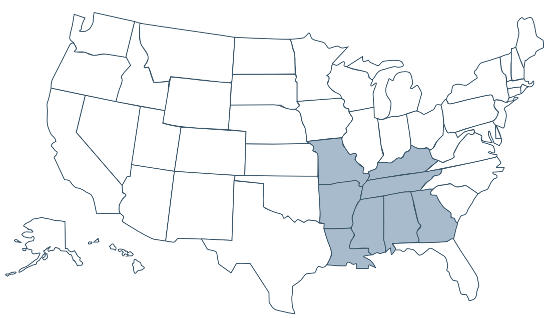
Atlantic Coast



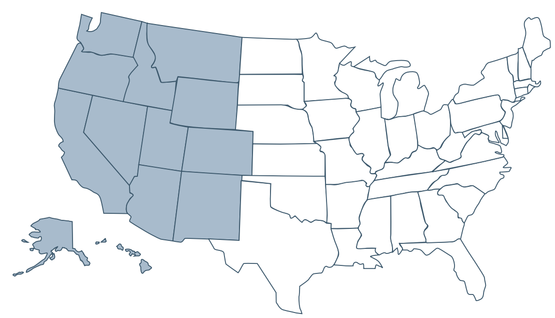
Midwest



Northeast



Southeast



West

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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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