MAY 2020

# Bank Watch

## ARTICLE

## Top Three Valuation Considerations for Credit Unions When Contemplating a Bank Acquisition

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### In This Issue

# Top Three Valuation Considerations for Credit Unions When Contemplating a Bank Acquisition

After five or six years of strong bank M&A activity, 2020 slowed drastically following the onset of COVID-19. Eventually, we expect M&A activity will rebound once buyers have more confidence in the economy and the COVID-19 medical outlook. In that case, there will be greater certainty around seller's earnings outlook and credit quality, particularly for those loan segments more exposed in the post-COVID-19 economic environment.

The factors that drive consolidation such as buyers' needs to obtain scale, improve profitability, and support growth will remain as will seller desires to exit due to shareholder needs for liquidity and management succession among others.

## Credit Unions as Bank Acquirers

One emerging trend prior to the bank M&A slowdown in March 2020 was credit unions ("CUs") acquiring small community banks. Since January 1, 2015, there have been 36 acquisitions of banks by CUs of which 15 were announced in 2019.

In addition to the factors favoring consolidation noted above, credit unions can benefit from diversifying their loan portfolio away from a heavy reliance on consumers and into new geographic markets. In addition to diversification benefits, bank acquisitions can also enhance the growth profile of the acquiring CU.

From the first quarter of 2015 through the second quarter of 2019, CU bank buyers grew their membership by ~23% compared to ~15% for other CUs according to S&P Global Market Intelligence. A positive for community bank sellers is that CUs pay cash and often acquire small community banks located in small communities or even rural areas, that do not interest most large community and regional bank acquirers.

## Valuation Issues to Consider When a Credit Union Acquires a Commercial Bank

There are, of course, unique valuation issues to consider when a credit union buys (or is bidding for) a commercial bank.

» **Transaction Form and Consideration.** Transactions are often structured as an asset purchase whereby the CU pays cash consideration to acquire the assets and assume the liabilities of the underlying bank.

» **Taxes (CU Perspective).** CUs do not pay corporate income taxes, and this precludes them from acquiring certain tax-related assets and liabilities on the bank's balance sheet, such as a deferred tax asset.

- **Taxes (Bank Perspective).** If a holding company owns a bank that is sold to a CU, then any gain will likely be subject to taxation prior to the holding company satisfying any liabilities and paying a liquidating distribution to shareholders.
- **Expense Synergies.** CUs often extract less cost savings than a bank buyer because bank acquisitions are often viewed as part of their membership growth strategy whereby the transaction expands their geographic/membership footprint and there will be no or fewer branch closures.
- **Capital Considerations.** CUs must maintain a net worth ratio of at least 7.0% to be deemed "well capitalized" by regulators. The net worth ratio is akin to a bank's leverage ratio and the pro-forma impact from the acquisition on the net worth ratio should be estimated as the increase in assets from the acquisition can reduce the post-close net worth ratio of the CU. Some CUs may be able to issue sub debt and count it as capital but CUs often rely primarily upon retained earnings to increase capital.
- **Other.** CU acquisitions can often take longer to close than traditional bank acquisitions and, thus, an interim forecast of earnings/distributions may need to be considered for both the bank and CU to better estimate the pro forma balance sheet at closing.

## Valuation Considerations for Credit Unions When Contemplating Acquiring a Bank

Based upon our experience of working as the financial advisor to credit unions that are contemplating an acquisition of a bank, we see three broad factors CUs should consider.

1. **Developing a Reasonable Valuation Range for the Bank Target**

Developing a reasonable valuation for a bank target is important in any economic environment but particularly so in the post-COVID-19 environment. Generally, the guideline M&A comparable transactions and discounted cash flow ("DCF") valuation methods are relied upon.

In the pre-COVID-19 environment, transaction data was more readily available so that one could tailor one or more M&A comp groups that closely reflected the target's geographic location, asset size, financial performance, and the like. Until sufficient M&A activity resumes, timely and relevant market data is limited. Even when M&A activity resumes, inferences from historical data for CU deals should be made with caution because it is a small sample set of ~35 pre-COVID-19 deals where only 75% of announced deals since 2015 included pricing data with a wide P/TBV range of ~0.5x to ~1.7x (with a median of ~1.3x).

While deal values are often reported and compared based upon multiples of tangible book value, CU acquirers are like most bank acquirers in which value is a function of projected cash flow estimates that they believe the bank target can produce in the future once merged with their CU.

A key question to consider is: What factors drive the cash flow forecast and ultimately value? No two valuations or cash flow estimates are alike and determining the value for a bank or its branches requires evaluating both qualitative and quantitative factors bearing on the target bank's current performance, outlook, growth potential, and risk attributes.

The primary factors driving value in our experience include considering both qualitative and quantitative factors. In a post-COVID-19 valuation, a

 

CU may have a high degree of confidence in expense savings, but less so in other aspects of the forecast—especially related to growth potential, credit losses, and the net interest margin ("NIM").

2. **Developing Accurate Fair Value Estimates of the Loan Portfolio and Core Deposit Intangible**

   It is important for CUs to develop reasonable and accurate fair value estimates as these estimates will impact the pro forma net worth of the CU at closing as well as their future earnings and net worth. In the initial accounting for a bank acquisition by a CU, acquired assets and liabilities are marked to their fair values, with the most significant marks typically for the loan portfolio followed by depositor customer relationship (core deposit) intangible assets.

   » **Loan Valuation.** The loan valuation process can be complex before factoring in the COVID-19 effect on interest rates and credit loss assumptions. Our loan valuation process begins with due diligence discussions with management of the target to understand their underwriting strategy as well as specific areas of concern in the portfolio. We also typically factor in the CU acquirer's loan review personnel to obtain their perspective. The actual valuation often relies upon a) monthly cash flow forecasts considering both the contractual loan terms, as well as the outlook for future interest rates; b) prepayment speeds; c) credit loss estimates based upon qualitative and quantitative assumptions; and d) appropriate discount rates. Problem credits above a certain threshold are typically evaluated on an individual basis.

   » **Core Deposit Intangible Valuation.** Core deposit intangible asset values are driven by both market factors (interest rates) and bank-specific factors such as customer retention, deposit base characteristics, and a bank's expense and fee structure. We also assess market data regarding the costs of alternative funding sources, the forward rate curves, and the sensitivity of the acquired deposit base to changes in market interest rates. Simultaneously, we analyze the cost of the acquired deposits relative to the market environment, looking at current interest rates paid on the deposits as well as other expenses

## What We're Reading

Matthew Klein at *Barron's* reviews recent bank activity – **banks are tightening lending** at a rate similar to 2008 and **smaller banks have accounted for the bulk of Paycheck Protection Program lending.**

**The Fed has temporarily granted additional lending capacity** to the largest banks as balance sheets have swelled with the influx of deposits. Additionally, the **Fed's Raphael Bostic** said that he is disinclined to penalize banks for emergency lending choices.

According to a McKinsey study, t**he COVID-19 pandemic has accelerated the shift to digital banking** by a couple of years.

required to service the accounts and fee income that may be generated by the accounts. We analyze historical retention characteristics of the acquired deposits and the outlook for future account retention to develop a detailed forecast of the future cost of the acquired deposits relative to an alternative cost of funds.

3. **Evaluating Key Deal Metrics to Model Strength or Weakness of Transaction**

   Once a valuation range is determined and the pro forma balance sheet is prepared, the CU can then begin to model certain deal metrics to assess the strength and weaknesses of the transaction. Many of the traditional metrics that banks utilize when assessing bank targets are also commonplace for CUs to evaluate and consider, including net worth (or book value) dilution and the earnback period, earnings accretion/dilution, and an IRR analysis. These and other measures usually are meaningfully impacted by the opportunity cost of cash allocated to the purchase and retention estimates for accounts and lines of business that may have an uncertain future as part of a CU.

   One deal metric that often gets a lot of focus from CUs is the estimated internal rate of return ("IRR") for the transaction based upon the following key items: the cash price for the acquisitions, the opportunity cost of the cash, and the forecast cash flows/valuation for the target inclusive of any expense savings and growth/attrition over time in lines of business. This IRR estimate can then be compared to the CU's historical and/or projected return on equity or net worth to assess whether the transaction offers the potential to enhance pro forma cash flow and provide a reasonable return to the CU and its members. In our experience, an IRR estimate 200-500 basis points (2-5%) above the CUs historical return on equity (net worth) implies an attractive acquisition candidate.

## Conclusion

Mercer Capital has significant experience providing valuation, due diligence, and advisory services to credit unions and community banks across each phase of a potential transaction. Our services for CUs include providing initial valuation ranges to CUs for bank targets, performing due diligence on targets during the negotiation phase, providing fairness opinions and presentations related to the acquisition to the CU's management and/or Board, and providing valuations for fair value estimates of loans and core deposit prior to or at closing.

We also provide valuation and advisory services to community banks considering strategic options and can assist with developing a process to maximize valuation upon exit by including a credit union in the transaction process. Feel free to reach out to us to discuss your community bank or credit union's unique situation in confidence.

Jay Wilson, Jr.

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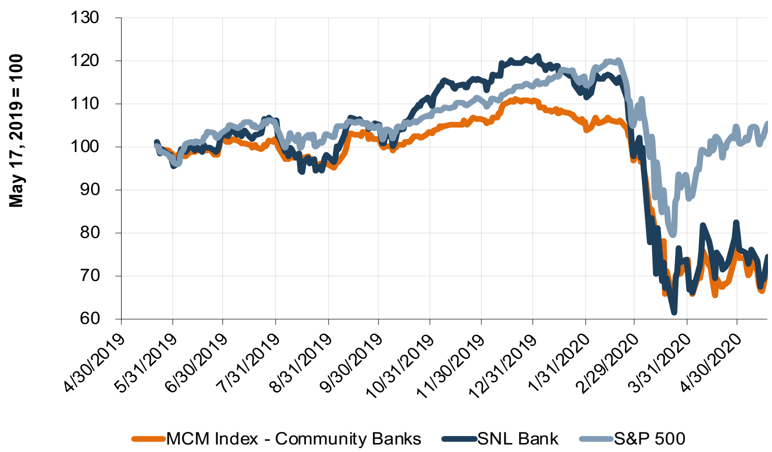
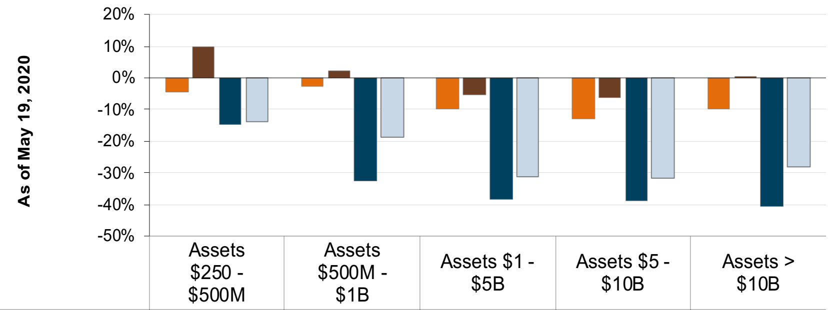
### Mercer Capital's Bank Group Index Overview




*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 | -4.50% | -2.50% | -9.78% | -12.93% | -9.79% |
| Quarter-to-Date | 9.87% | 2.11% | -5.26% | -6.37% | 0.55% |
| Year-to-Date | -14.82% | -32.33% | -38.43% | -38.56% | -40.44% |
| Last 12 Months | -13.61% | -18.57% | -31.08% | -31.70% | -28.12% |

*Source: S&P Global Market Intelligence*

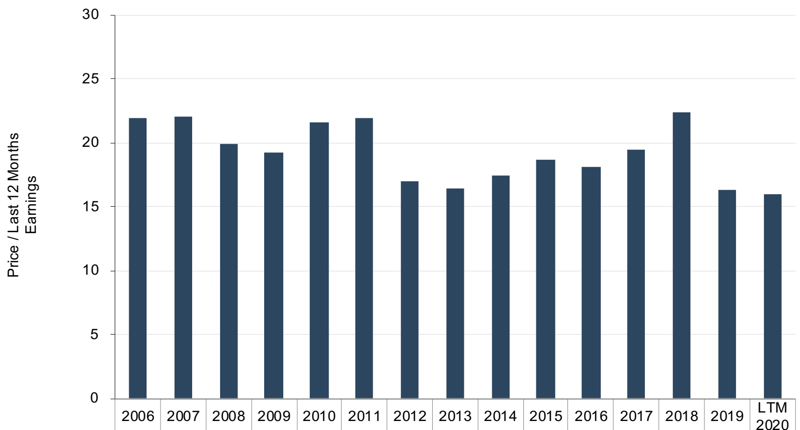
### Median Valuation Multiples

| | Median Total Return | | | | Median Valuation Multiples as of May 17, 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 | -9.8% | -10.1% | -39.1% | -31.7% | 8.7x | 10.8x | 11.3x | 75% | 86% | 3.9% |
| Midwest Index | -5.6% | -1.2% | -32.2% | -23.3% | 9.0x | 9.6x | 10.3x | 87% | 98% | 3.3% |
| Northeast Index | -9.6% | -9.9% | -39.4% | -34.1% | 9.3x | 9.7x | 9.0x | 78% | 86% | 4.3% |
| Southeast Index | -6.5% | -3.5% | -38.1% | -31.4% | 9.5x | 10.2x | 9.1x | 73% | 85% | 3.0% |
| West Index | -8.6% | -1.1% | -36.8% | -31.3% | 8.3x | 10.5x | 11.5x | 77% | 92% | 3.2% |
| Community Bank Index | -8.0% | -5.5% | -37.0% | -30.2% | 9.0x | 10.2x | 10.3x | 78% | 88% | 3.8% |
| **SNL Bank Index** | **-9.9%** | **0.1%** | **-40.3%** | **-28.3%** | | | | | | |

*Source: S&P Global Market Intelligence*

## Median Price/Earnings Multiples

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

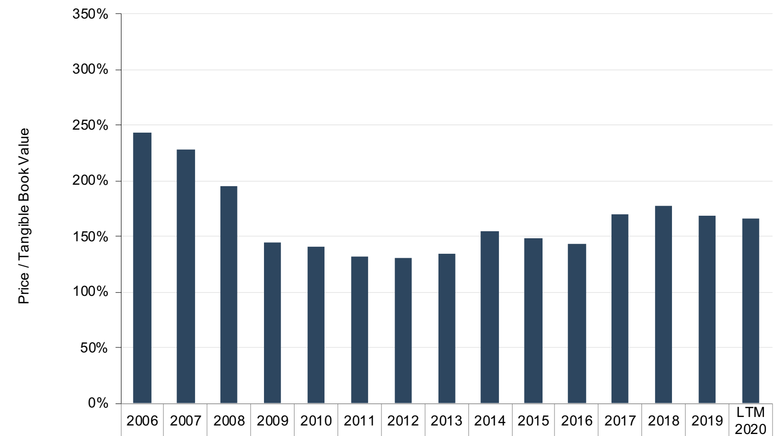



| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | LTM 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| U.S. | 22.0 | 22.1 | 19.9 | 19.3 | 21.7 | 21.9 | 17.0 | 16.5 | 17.5 | 18.8 | 18.1 | 19.5 | 22.4 | 16.3 | 16.1 |

*Source: S&P Global Market Intelligence*

## Median Price/Tangible Book Value Multiples

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

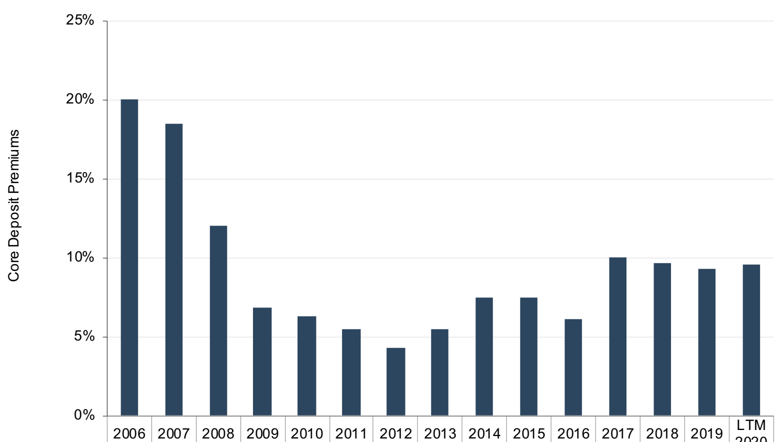



| | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | LTM 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| U.S. | 243% | 228% | 196% | 145% | 141% | 132% | 130% | 134% | 155% | 148% | 143% | 170% | 178% | 168% | 166% |

*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% | 9.6% |

*Source: S&P Global Market Intelligence*

## Median Valuation Multiples for M&A Deals

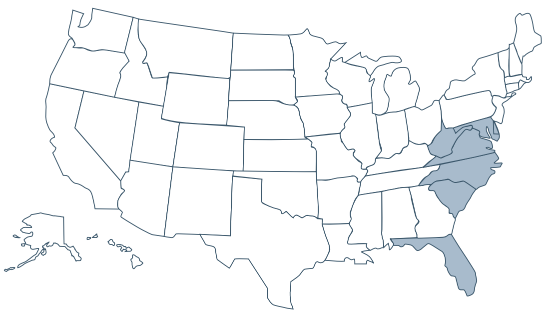
*Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended April 2020*

| 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 | 16.8x | 163% | 9.7% | 20 | 75.0 | 453,159 | 9.4% |
| Midwest | 16.0x | 169% | 10.8% | 75 | 44.9 | 175,480 | 9.9% |
| Northeast | 17.3x | 171% | 9.6% | 15 | 79.3 | 527,235 | 10.2% |
| Southeast | 15.4x | 155% | 9.0% | 36 | 41.4 | 232,805 | 11.3% |
| West | 15.6x | 168% | 12.4% | 11 | 71.1 | 255,924 | 12.4% |
| **National Community Banks** | **16.1x** | **166%** | **9.6%** | **158** | **65.6** | **249,233** | **10.1%** |

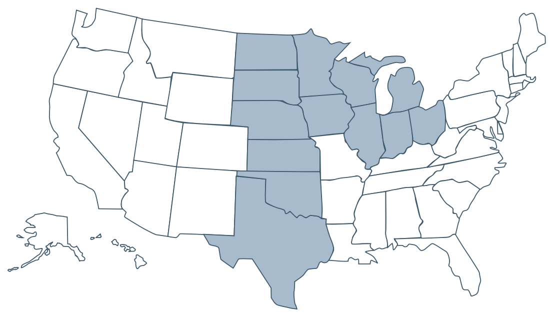
*Source: S&P Global Market Intelligence*

# Mercer Capital's Regional Public Bank Peer Reports

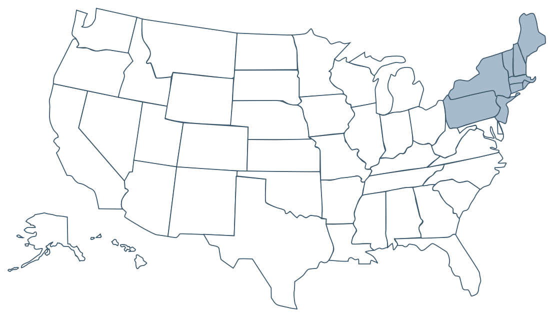
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



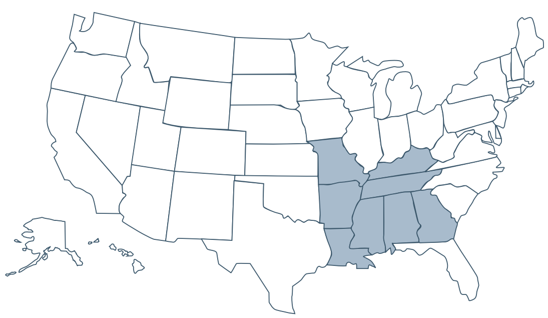
**Atlantic Coast**



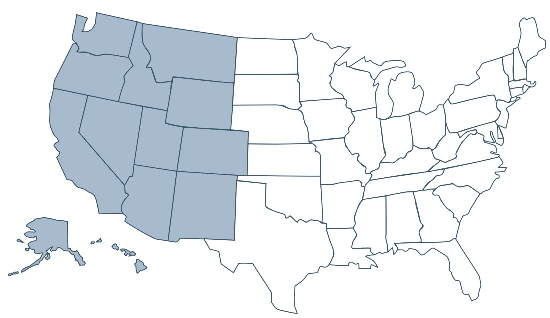
**Midwest**



**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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