



BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

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Bank Watch

ARTICLE

Mortgage Banking Lagniappe

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Mortgage Banking Lagniappe

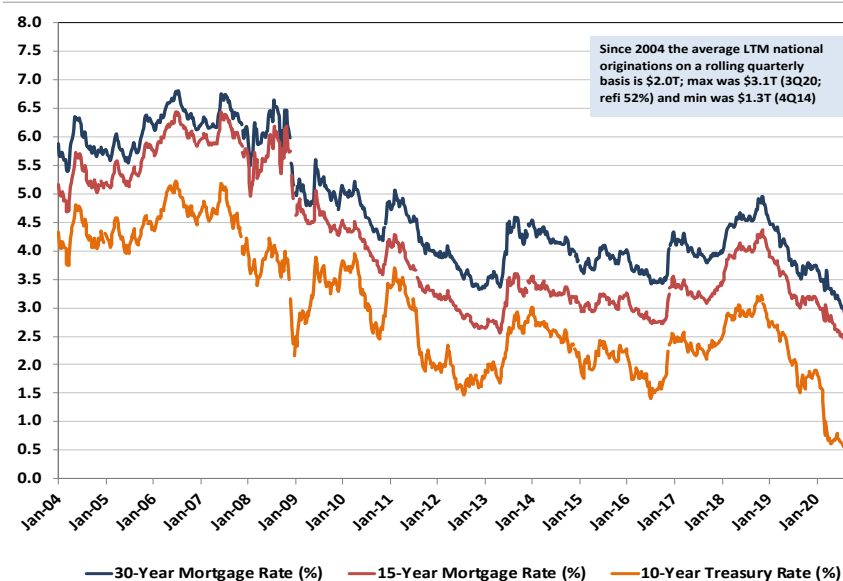
2020 was a tough year for most of us. Schools and churches closed, sports were cancelled, and many lost their jobs. There were a select few, however, that thrived during 2020. Jeff Bezos and Elon Musk saw a meteoric rise in their personal net worth over the past 12 months. Mortgage bankers are another group showered with unexpected riches last year (and apparently this year).

As shown in Figure 1, long-term U.S. Treasury and mortgage rates have been in a long-term secular decline for about four decades. Last year, long-term rates fell to all-time lows because of the COVID induced recession after having declined modestly in 2019 following too much Fed tightening in 2018. The surprise was not an uptick in refinancing activity, but that it was accompanied by a strong purchase market too. Housing was and still is hot; maybe too hot.

Overlaid on the record volume (the Mortgage Bankers of America estimates \$3.6 trillion of mortgages were originated in 2020 compared to \$2.3 trillion in 2019 and \$1.7 trillion in 2017 and 2018) was historically high gain on sale ("GOS") margins. The industry was capacity constrained after cutting staff in 2018 when rates were then rising.

Private equity and other owners of mortgage companies set their eyes on the public markets after many companies attempted to sell in 2018 with mixed success at best. During the second half of 2020, Rocket Mortgage (\$RKT) and Guild Mortgage (\$GHLD) made an initial public offering and began trading while seven other non-bank mortgage companies have either filed for an IPO or announced plans to do so. Also, United Wholesale Mortgage (\$UWMC) went public by merging with a SPAC.

Figure 1 :: Mortgage Rates v. Treasury Rates



Source: S&P Global Market Intelligence

The inability of several (or more) mortgage companies to undergo an IPO at a price that was acceptable to the sellers has an important message. The industry was accorded a low valuation by Wall Street on presumably peak earnings even though many mortgage companies will produce an ROE that easily exceeds 30%. The assumption is that earnings will decline because rates will rise and/or more capacity will reduce GOS margins.

While it is likely 2020 will represent a cyclical peak, no one knows how steep (or gentle) the descent will be and how deep the trough will be. Mortgage companies may produce 20% or better ROEs for several years. One may question the multiple to place on 2020 earnings, but book value could double in three or four years if conditions remain reasonably favorable.

Community and regional banks with mortgage operations have benefited from the mortgage boom, too. Although various bank indices were negative for the year, it could have been much worse given investor fears surrounding credit losses and permanent impairment to net interest margins given the collapse in rates. In a sense, outsized mortgage banking revenues funded reserve builds for many banks and masked revenue weakness attributable to falling NIMs.

The average NIM for banks in the U.S. with assets between \$300 million and \$1 billion as of September 30, 2020 is shown in Figure 2. The NIM fell 45bps from 3Q19 to 3Q20 due to multiple moving pieces but primarily reflected an increase in liquid assets because deposits flooded into the banking system and because the reduction in the yield on loans and securities was greater than the reduction in the cost of funds.

Unless the Fed is able (and willing) to raise short-term policy rates in the next year or two, we suspect loan yields will grind lower as lenders compete heavily for assets with a coupon (i.e., loans) because liquidity yields nothing and bonds yield very little. Deposit costs will not offset because rates are or soon will be near a floor.

Fee income and expense management are more critical than ever for banks to maintain acceptable profitability. When analyzing the same group of banks (assets \$300M - \$1B), banks with higher GOS revenues

Figure 2 :: Net Interest Margin Analysis

	3rd Qtr Sep-20	2nd Qtr Jun-20	1st Qtr Mar-20	4th Qtr Dec-19	3rd Qtr Sep-19
PEER GROUP:					
Interest Income (FTE) / Avg Assets	3.80%	4.08%	4.35%	4.49%	4.50%
Interest Expense / Average Assets	0.51%	0.60%	0.79%	0.85%	0.87%
Net Interest Inc (FTE) / Avg Assets	3.29%	3.48%	3.57%	3.64%	3.64%
Yield on Avg Eam Assets (FTE)	4.01%	4.31%	4.61%	4.75%	4.87%
Cost of Interest-Bearing Funds	0.76%	0.90%	1.13%	1.22%	1.27%
Net Spread (FTE)	3.26%	3.42%	3.48%	3.53%	3.59%
Yield on Avg Eam Assets (FTE)	4.01%	4.31%	4.61%	4.75%	4.87%
Cost of Average Earning Assets	0.54%	0.63%	0.84%	0.90%	0.94%
Net Interest Margin (FTE)	3.48%	3.68%	3.77%	3.86%	3.93%

Source: S&P Global Market Intelligence

What We're Reading

While the **outlook for credit issues has improved since the initial stages of the pandemic**, earnings headwinds such as lower net interest margins and weak loan demand are expected to weigh on bank earnings in 2021. **Three of the country's biggest banks released reserves in the fourth quarter** as credit quality and expectations for an economic recovery have improved. (subscription required)

After a year of accelerated changes due to the pandemic, the payments industry is **set to continue to evolve in 2021**. Additionally, seven U.S. challenger banks grew users from 28 million in 2019 to 39 million as of September 30, 2020 (a 39.3% increase).

The pandemic has forced changes throughout the economy that could lead to higher labor productivity gains in the future such as a more efficient retail industry, the reduction of commutes by people working from home, and the conversion of offices and hotels to living spaces.

Figure 3 :: Profitability Analysis (Pre-Tax)

Pre-Tax / Avg. Assets (\$300M - \$1B)				
Types	Number of Banks	1st Quartile	Median	3rd Quartile
GOS / Revenues < 10%	1,075	0.98%	1.31%	1.62%
GOS / Revenues > 10%	179	1.12%	1.50%	1.98%

Source: S&P Global Market Intelligence

as a percentage of total revenue tended to be more profitable. As shown in Figure 3, median profitability was ~15% greater in the trailing twelve months for banks more engaged in mortgage activity than those that were not.

Selling long-term fixed-rate mortgages for most banks is a given because the duration of the asset is too long, especially when rates are low. The decision is more nuanced for 15-year mortgages with an average life of perhaps 6-7 years. With loan demand weak and banks extremely liquid, most banks will retain all ARM production and perhaps some 15-year paper as an alternative to investing in MBS because yields on originated paper are much better.

As for 30-year mortgages, net production profits for 3Q20 increased above 200bps according to the MBA for the first time since the MBA began tracking the data in 2008. Originating and selling long-term fixed rate mortgages has been exceptionally profitable in 2020.

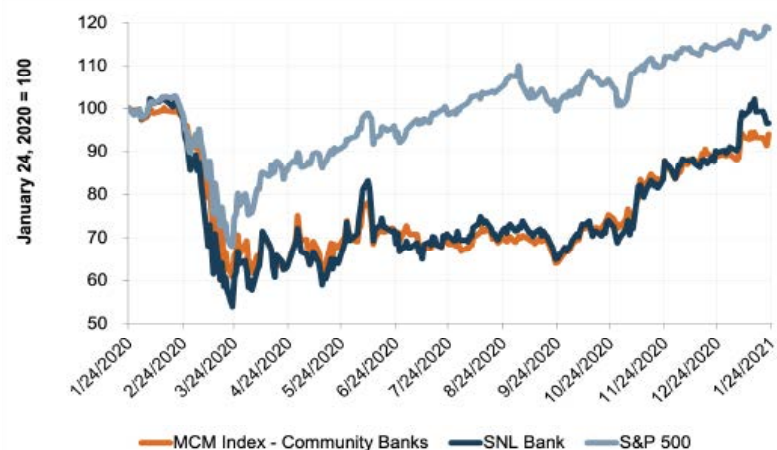
Mortgage banking in the form of originations is a highly cyclical business (vs servicing); however, it is a counter cyclical business that tends to do well when the economy is struggling and therefore core bank profitability is under pressure. We have long been observers of the mortgage banking conundrum of “what is the earnings multiple?” It is a tougher question for an independent mortgage company compared to a bank where the earnings are part of a larger organization. Even when outsized mortgage banking earnings may weigh on a bank’s overall P/E, mortgage earnings can be highly accretive to capital.

In the February issue of Bank Watch we will explore how to value a mortgage company either as a stand-alone or as a subsidiary or part of a bank to understand in more detail the true valuation impacts of mortgage revenue.



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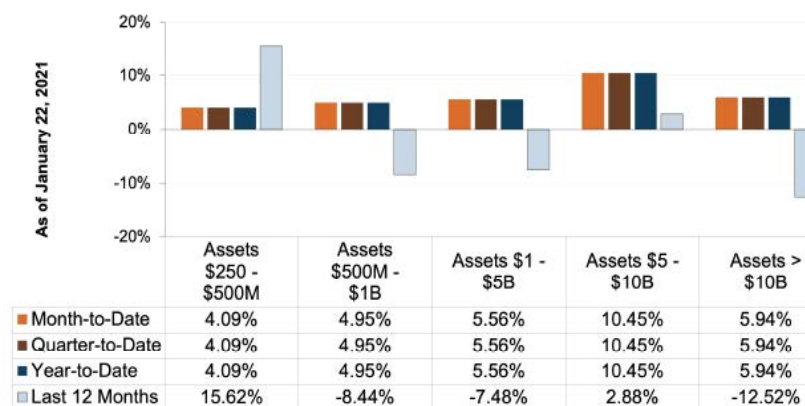
Mercer Capital's Bank Group Index Overview



Source: S&P Global Market Intelligence

Return Stratification of U.S. Banks

by Asset Size



Source: S&P Global Market Intelligence

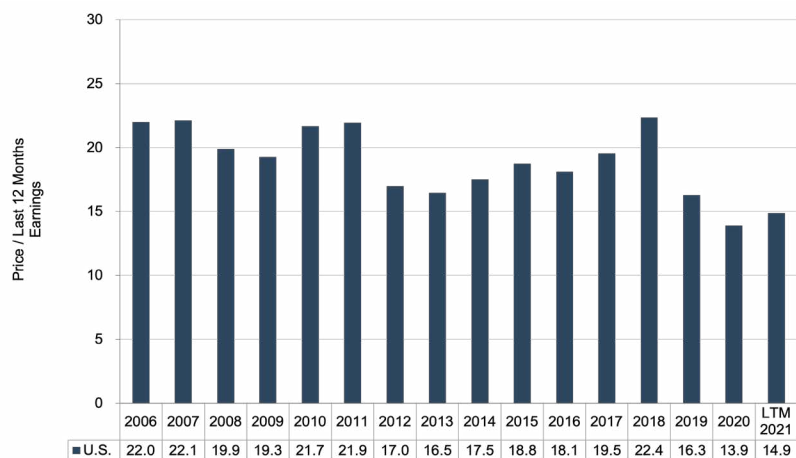
Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of January 22, 2021					
	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	6.6%	6.6%	6.6%	-12.9%	11.5x	12.8x	13.0x	97%	104%	3.1%
Midwest Index	3.4%	3.4%	3.4%	-6.5%	10.7x	10.6x	12.0x	99%	113%	2.8%
Northeast Index	5.2%	5.2%	5.2%	-13.4%	11.2x	10.8x	10.2x	91%	97%	3.5%
Southeast Index	5.0%	5.0%	5.0%	-9.1%	13.0x	11.9x	11.3x	99%	112%	2.2%
West Index	6.4%	6.4%	6.4%	15.7%	11.8x	12.7x	12.2x	99%	111%	2.5%
Community Bank Index	5.2%	5.2%	5.2%	-6.0%	11.5x	11.8x	11.8x	94%	109%	2.9%
SNL Bank Index	6.1%	6.1%	6.1%	-3.5%						

Source: S&P Global Market Intelligence

Median Price/Earnings Multiples

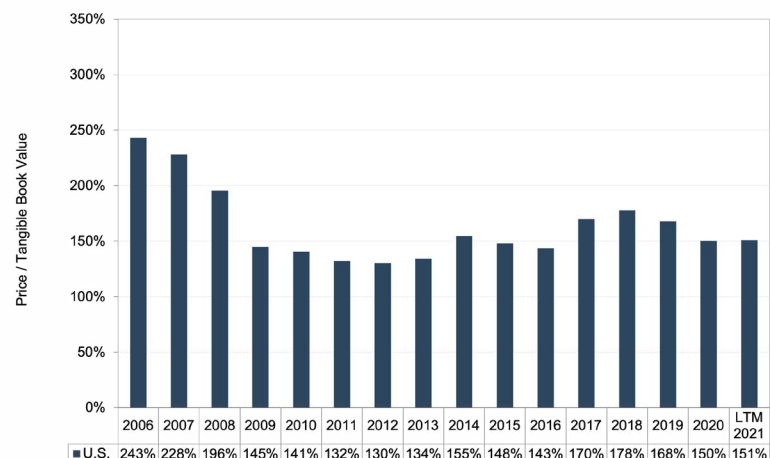
Target Banks' Assets <\$5B and LTM ROE >5%



Source: S&P Global Market Intelligence

Median Price/Tangible Book Value Multiples

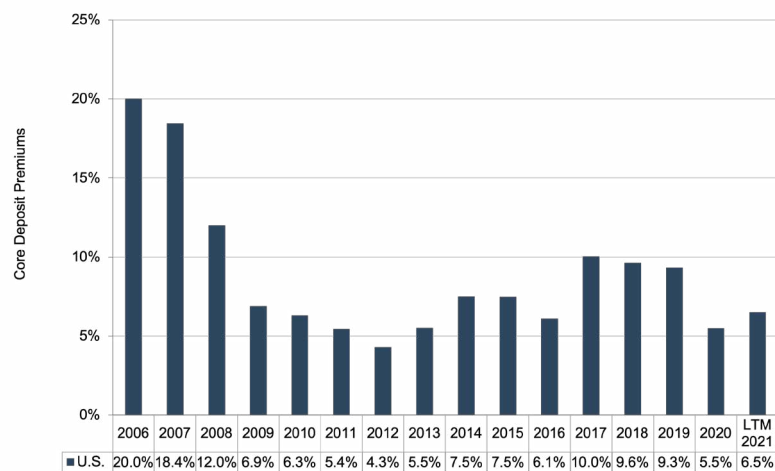
Target Banks' Assets <\$5B and LTM ROE >5%



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

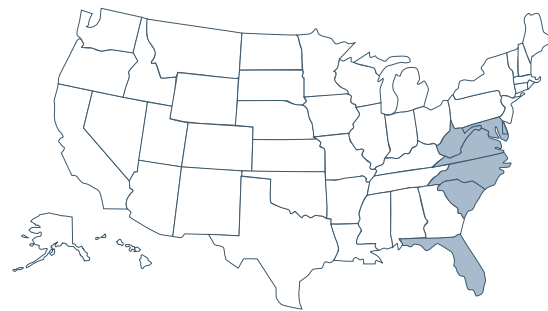
Target Banks' Assets <\$5B and LTM ROE >5%, 12 months ended January 25, 2021

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%	3	62.5	840,286	8.8%
Midwest	15.8x	163%	8.1%	26	32.2	123,439	10.0%
Northeast	13.0x	131%	4.3%	3	63.0	596,948	11.7%
Southeast	18.6x	152%	6.5%	13	41.1	179,210	9.8%
West	10.5x	151%	5.5%	2	157.4	702,084	9.4%
National Community Banks	14.9x	151%	6.5%	47	62.6	175,480	9.5%

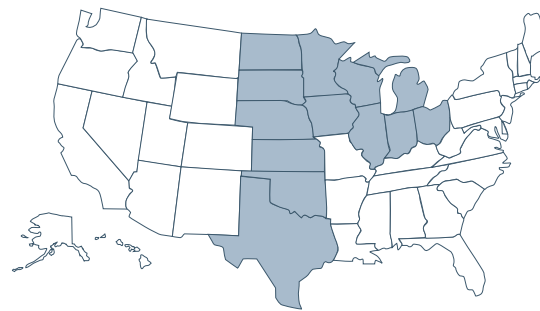
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

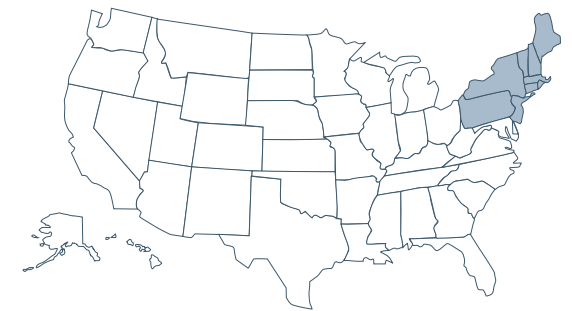
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



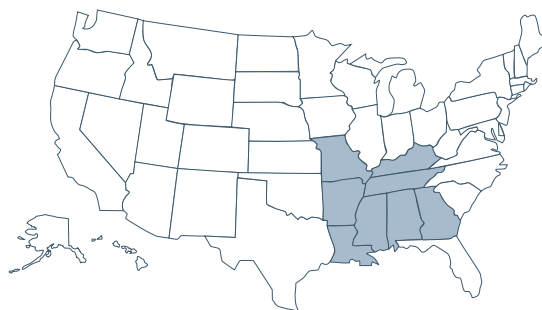
Atlantic Coast



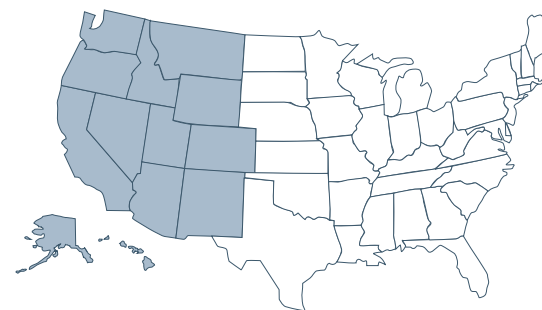
Midwest



Northeast



Southeast



West

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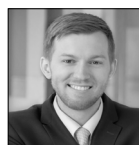
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