

SEPTEMBER 2021

Bank Watch

ARTICLE

Fairness Opinions - Evaluating a Buyer's Shares from the Seller's Perspective

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Fairness Opinions - Evaluating a Buyer's Shares from the Seller's Perspective

Depository M&A activity in the U.S. has accelerated in 2021 from a very subdued pace in 2020 when uncertainty about the impact of COVID-19 and the policy responses to it weighed on bank stocks. At the time, investors were grappling with questions related to how high credit losses would be and how far would net interest margins decline. Since then, credit concerns have faded with only a nominal increase in losses for many banks. The margin outlook remains problematic because it appears unlikely the Fed will abandon its zero-interest rate policy ("ZIRP") anytime soon.

As of September 23, 2021, 157 bank and thrift acquisitions have been announced, which equates to 3.0% of the number of charters as of January 1. Assuming bank stocks are steady or trend higher, we expect 200 to 225 acquisitions this year, equivalent to about 4% of the industry and in-line with 3% to 5% of the industry that is acquired in a typical year. During 2020, only 117 acquisitions representing 2.2% of the industry were announced, less than half of the 272 deals (5.0%) announced in pre-covid 2019.

To be clear, M&A activity follows the public market, as shown in Figure 1 (on the next page). When public market valuations improve, M&A activity and multiples have a propensity to increase as the valuation of the buyers' shares trend higher. When bank stocks are depressed for whatever reason, acquisition activity usually falls, and multiples decline.

The rebound in M&A activity this year did not occur in a vacuum. Year-to-date through September 23, 2021, the S&P Small Cap and Large Cap Bank Indices have risen 25% and 31% compared to 18% for the S&P 500. Over the past year, the bank indices are up 87% and 79% compared to 37% for the S&P 500.

Excluding small transactions, the issuance of common shares by bank acquirers usually is the dominant form of consideration sellers receive. While buyers have some flexibility regarding the number of shares issued and the mix of stock and cash, buyers are limited in the amount of dilution in tangible book value they are willing to accept and require visibility in EPS accretion over the next several years to recapture the dilution.

Because the number of shares will be relatively fixed, the value of a transaction and the multiples the seller hopes to realize are a function of the buyer's valuation. High multiple stocks can be viewed as strong acquisition currencies for acquisitive companies because fewer shares are issued to achieve a targeted dollar value.

However, high multiple stocks may represent an under-appreciated risk to sellers who receive the shares as consideration. Accepting the buyer's stock raises a number of questions, most which fall into the genre of: *what are the investment merits of the buyer's shares?* The answer may not be obvious even when the buyer's shares are actively traded.

Our experience is that some, if not most, members of a board weighing an acquisition proposal do not have the background to thoroughly evaluate the buyer's shares. Even when financial advisors are involved, there still may not be a thorough vetting of the buyer's shares because there is too much focus on "price" instead of, or in addition to, "value."

Figure 1

	\$50-\$250M Deals	Price / Earnings					Price / Tangible Book Value				
		M & A		SNL Index		Relative M&A P/E / Index P/E	M & A		SNL Index		Relative M&A P/TBV / Index P/TBV
		\$50-\$250M Deal Value	Standard Deviation	Small Cap Bank Index	Standard Deviation		\$50-\$250M Deal Value	Standard Deviation	Small Cap Bank Index	Standard Deviation	
1997	53	21.1x	5.9x	17.8x	1.7x	1.19	270%	58%	252%	23%	1.07
1998	58	25.7x	8.8x	20.9x	1.4x	1.23	392%	113%	294%	23%	1.34
1999	50	23.0x	6.0x	18.1x	0.8x	1.28	325%	79%	249%	9%	1.30
2000	33	20.6x	6.4x	12.9x	0.6x	1.60	304%	93%	207%	9%	1.47
2001	36	19.7x	7.7x	14.5x	0.7x	1.36	248%	77%	217%	9%	1.15
2002	30	21.0x	6.5x	16.5x	0.9x	1.27	267%	95%	236%	13%	1.13
2003	36	12.4x	19.2x	16.0x	1.1x	0.78	302%	77%	248%	19%	1.22
2004	37	26.7x	9.8x	18.2x	1.0x	1.47	301%	97%	290%	15%	1.04
2005	39	26.3x	9.6x	17.9x	0.7x	1.47	302%	73%	289%	9%	1.05
2006	55	23.9x	8.6x	18.0x	0.5x	1.32	306%	55%	290%	6%	1.06
2007	58	23.8x	8.1x	15.9x	1.3x	1.50	283%	73%	242%	19%	1.17
2008	13	22.0x	6.8x	14.7x	1.2x	1.49	214%	66%	196%	12%	1.09
2009	4	8.4x	0.0x	16.0x	1.4x	0.53	106%	27%	145%	12%	0.73
2010	13	20.5x	5.3x	16.0x	1.5x	1.28	126%	58%	149%	8%	0.85
2011	7	34.6x	18.5x	14.8x	0.6x	2.34	172%	26%	147%	15%	1.16
2012	21	23.5x	12.0x	14.4x	0.5x	1.63	134%	36%	144%	4%	0.93
2013	26	19.7x	11.6x	15.5x	0.9x	1.27	147%	51%	159%	12%	0.92
2014	47	21.4x	9.5x	17.8x	0.6x	1.20	184%	73%	167%	6%	1.10
2015	42	21.2x	9.2x	17.7x	0.7x	1.20	175%	53%	166%	3%	1.06
2016	33	22.1x	10.5x	17.3x	1.4x	1.27	161%	28%	164%	14%	0.98
2017	50	20.0x	6.9x	20.3x	0.8x	0.98	187%	35%	199%	5%	0.94
2018	48	25.7x	11.6x	20.9x	2.0x	1.23	186%	35%	192%	13%	0.97
2019	55	17.7x	8.3x	14.5x	0.7x	1.22	175%	33%	157%	6%	1.11
2020	15	13.8x	3.1x	11.9x	1.6x	1.16	139%	30%	121%	16%	1.15
2021	29	17.1x	6.6x	14.2x	1.1x	1.20	155%	26%	145%	9%	1.07

The public market multiples are based upon daily observations of the SNL Small Cap Bank Index's P/E (LTM) and P/TBV

Source: S&P Capital IQ Pro

A fairness opinion is more than a three or four page letter that opines as to the fairness from a financial point of a contemplated transaction; it should be backed by a robust analysis of all of the relevant factors considered in rendering the opinion, including an evaluation of the shares to be issued to the selling company's shareholders. The intent is not to express an opinion about where the shares may trade in the future, but rather to evaluate the investment merits of the shares before and after a transaction is consummated.

Key questions to ask about the buyer's shares include the following:

- **Liquidity of the Shares** - What is the capacity to sell the shares issued in the merger? SEC registration and NASDAQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently. OTC traded shares should be scrutinized, especially if the acquirer is not an SEC registrant. Generally, the higher the institutional ownership, the better the liquidity. Also, liquidity may improve with an acquisition if the number of shares outstanding and shareholders increase sufficiently.
- **Profitability and Revenue Trends** - The analysis should consider the buyer's historical growth and projected growth in revenues, pretax pre-provision operating income and net income as well as various profitability ratios before and after consideration of credit costs. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated. This is particularly important because many banks' earnings in 2020 and 2021 have been supported by mortgage banking and PPP fees.
- **Pro Forma Impact** - The analysis should consider the impact of a proposed transaction on the pro forma balance sheet, income statement and capital ratios in addition to dilution or accretion in earnings per share and tangible book value per share both from the seller's and buyer's perspective.
- **Tangible BVPS Earn-Back** - As noted, the projected earn-back period in tangible book value per share is an important consideration for the buyer. In the aftermath of the GFC, an acceptable earn back period was on the order of three to five years; today, two to three years may be the required earn-back period absent other compelling factors. Earn-back periods that are viewed as too long by market participants are one reason buyers' shares can be heavily sold when a deal is announced that otherwise may be compelling.
- **Dividends** - In a yield starved world, dividend paying stocks have greater attraction than in past years. Sellers should not be overly swayed by the pick-up in dividends from swapping into the buyer's shares; however, multiple studies have demonstrated that a sizable portion of an investor's return comes from dividends over long periods of time. Sellers should examine the sustainability of current dividends and the prospect for increases (or decreases). Also, if the dividend yield is notably above the peer average, the seller should ask why? Is it payout related, or are the shares depressed?
- **Capital and the Parent Capital Stack** - Sellers should have a full understanding of the buyer's pro-forma regulatory capital ratios both at the bank-level and on a consolidated basis (for large bank holding companies). Separately, parent company capital stacks often are overlooked because of the emphasis placed on capital ratios and the combined bank-parent financial statements. Sellers should have a complete understanding of a parent company's capital structure and the amount of bank earnings that must be paid to the parent company for debt service and shareholder dividends.
- **Loan Portfolio Concentrations** - Sellers should understand concentrations in the buyer's loan portfolio, outsized hold positions, and the source of historical and expected losses.

- **Ability to Raise Cash to Close** - What is the source of funds for the buyer to fund the cash portion of consideration? If the buyer has to go to market to issue equity and/or debt, what is the contingency plan if unfavorable market conditions preclude floating an issue?
- **Consensus Analyst Estimates** - If the buyer is publicly traded and has analyst coverage, consideration should be given to Street expectations vs. what the diligence process determines. If Street expectations are too high, then the shares may be vulnerable once investors reassess their earnings and growth expectations.
- **Valuation** - Like profitability, valuation of the buyer's shares should be judged relative to its history and a peer group presently and relative to a peer group through time to examine how investors' views of the shares may have evolved through market and profit cycles.
- **Share Performance** - Sellers should understand the source of the buyer's share performance over several multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.
- **Strategic Position** - Assuming an acquisition is material for the buyer, directors of the selling board should consider the strategic position of the buyer, asking such questions about the attractiveness of the pro forma company to other acquirers.
- **Contingent Liabilities** - Contingent liabilities are a standard item on the due diligence punch list for a buyer. Sellers should evaluate contingent liabilities too.

The list does not encompass every question that should be asked as part of the fairness analysis, but it does illustrate that a liquid market for a buyer's shares does not necessarily answer questions about value, growth potential and risk profile. The professionals at Mercer Capital have extensive experience in valuing and evaluating the shares (and debt) of financial and non-financial service companies garnered from over three decades of business. Give us a call to discuss your needs in confidence.



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Recent Representative Transaction

Mercer Capital's transaction and advisory services include:

- M&A representation for both the sell-side and buy-side
- Fairness opinions
- Solvency opinions
- Bankruptcy and restructuring advisory
- Financial advisor to board of directors, special committees and trustees regarding significant corporate transactions



KYZEN Corporation
Nashville, TN

Cash-Out Merger

Mercer Capital served as financial advisor to the board of directors to establish a range of value at which certain shareholders would receive cash and rendered a fairness opinion in a go-private transaction

– August 2021 –

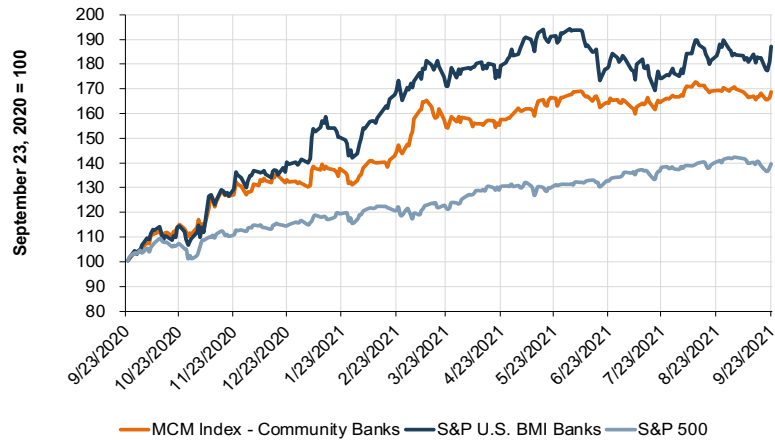
WHAT WE'RE READING

U.S. Bancorp's acquisition of MUFG Union Bank's regional banking franchise from Mitsubishi UFJ Financial Group for approximately \$8 billion will make US Bank the 5th largest depository institution in California, an increase from 10th. **Deals announced in 2021** total more than \$54 billion, up from \$17 billion at this point last year.

Coinbase, the cryptocurrency exchange, plans to expand into traditional financial services by allowing customers to deposit paychecks directly to their online Coinbase accounts.

As Jerome Powell's first term as the chair of the Federal Reserve nears the end, **Senator Elizabeth Warren intends to oppose a second term** for Powell which indicates a potential divide among Democrats over the Federal Reserve's future.

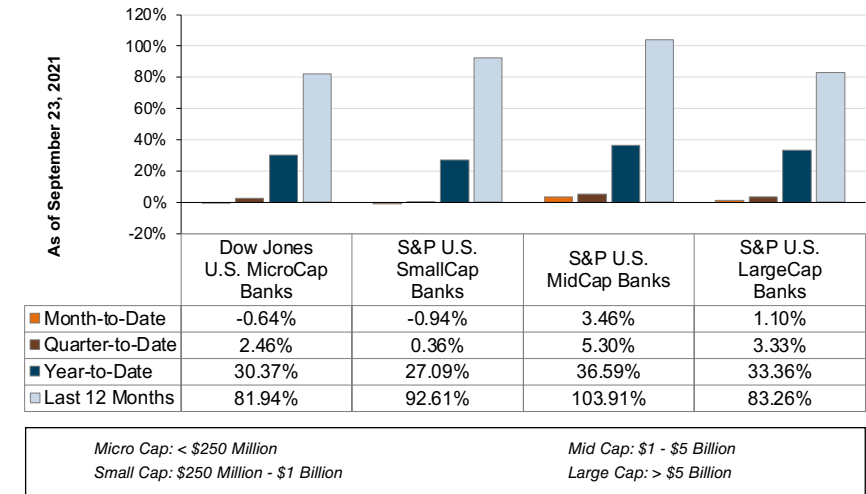
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



Micro Cap: < \$250 Million
Small Cap: \$250 Million - \$1 Billion
Mid Cap: \$1 - \$5 Billion
Large Cap: > \$5 Billion

Source: S&P Capital IQ Pro.

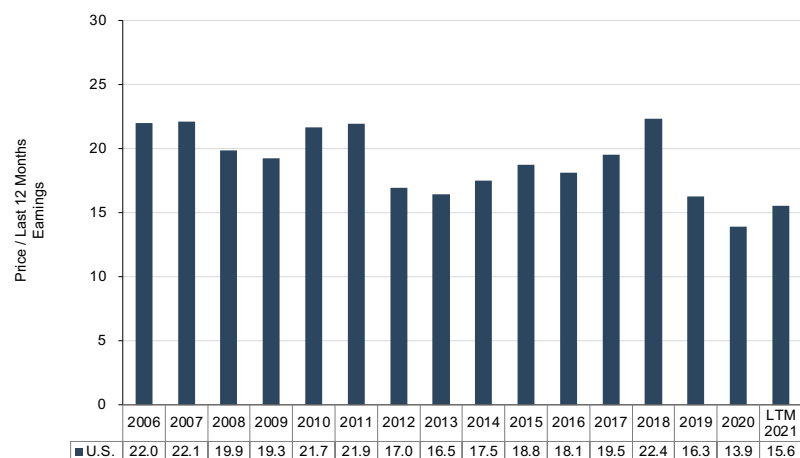
Regional Index Data

	Total Return				Regional Index Data as of September 23, 2021					
	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/LTM EPS	Price / 2021 (E) EPS	Price / 2022 (E) EPS	Price / Book Value	Tangible Book Value	Dividend Yield
Atlantic Coast Index	-1.4%	2.8%	41.0%	91.0%	12.0x	11.4x	13.4x	116%	120%	2.5%
Midwest Index	-1.2%	1.8%	17.3%	52.2%	9.7x	9.2x	10.9x	106%	117%	2.5%
Northeast Index	-1.1%	2.8%	27.3%	66.5%	9.5x	9.5x	9.9x	105%	113%	3.0%
Southeast Index	-0.3%	2.4%	26.2%	63.4%	11.6x	9.9x	10.6x	111%	116%	2.3%
West Index	1.7%	4.9%	33.8%	80.5%	11.0x	10.4x	10.9x	119%	126%	2.4%
Community Bank Index	-0.6%	2.9%	28.2%	68.9%	10.4x	10.1x	10.9x	109%	119%	2.5%
S&P U.S. BMI Banks	0.9%	2.8%	32.2%	87.0%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

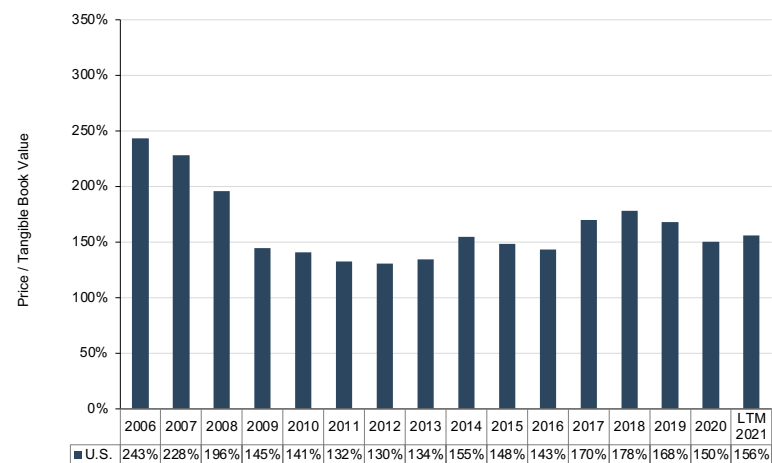
Target Banks' Assets <\$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

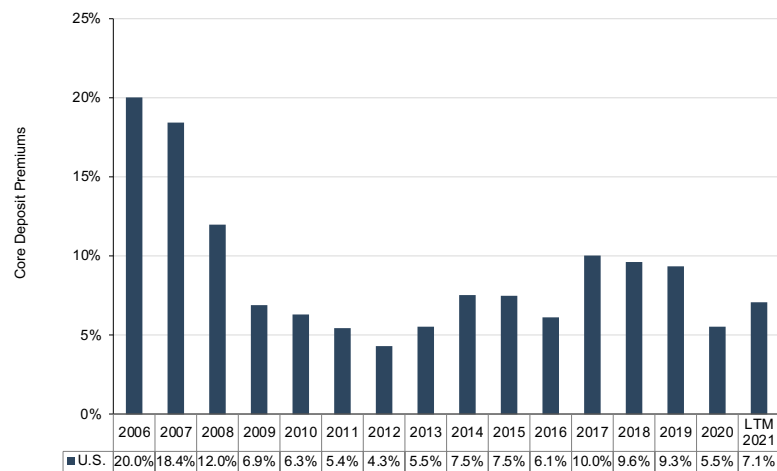
Target Banks' Assets <\$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Core Deposit Multiples

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



Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

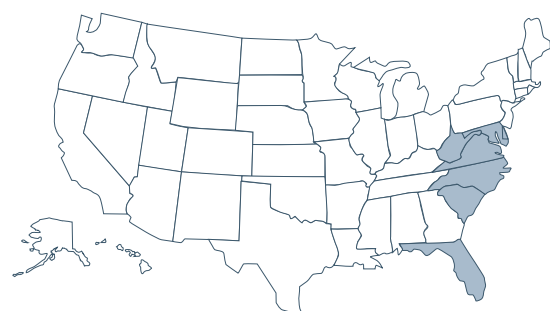
Target Banks' Assets <\$5B and LTM ROE >5%, 12 months ended September 28, 2021

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	15.5x	167%	8.5%	14	118.6	704,154	10.0%
Midwest	17.1x	156%	7.3%	45	114.7	155,749	8.7%
Northeast	14.9x	156%	6.5%	4	220.2	875,081	10.5%
Southeast	14.1x	153%	6.9%	27	84.0	388,790	10.4%
West	14.7x	159%	6.9%	16	150.2	757,929	10.0%
National Community Banks	15.6x	156%	7.1%	106	114.7	361,334	10.3%

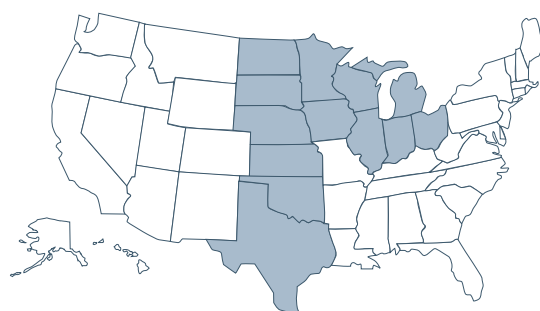
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

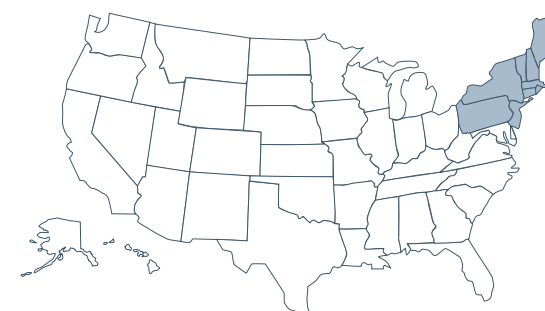
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



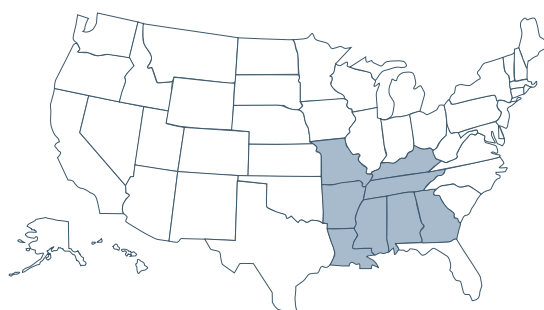
Atlantic Coast



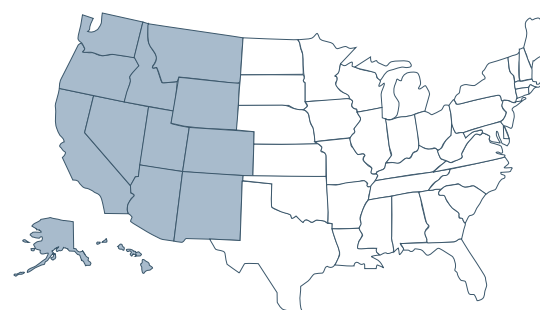
Midwest



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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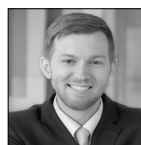
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