MERCER CAPITAL

BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

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Bank Watch

ARTICLE

Top Considerations for Acquirers When Evaluating a Potential Bank Acquisition

In This Issue

Top Considerations for Acquirers When Evaluating a Potential Bank Acquisition

With year-end approaching, we are starting our annual process of recapping 2021 and considering the outlook for 2022. In doing so, we turned our attention to the bank M&A data to see what trends were emerging. While the number of bank and thrift deals is on pace to roughly double from 2020 levels (117 deals in 2020 vs 199 deals through 11/22/21), the number of deals still remains well below pre-pandemic levels. Valuations at exit illustrate a similar trend with the median price/earnings nationally for announced deals at ~15.0x earnings and the average price/tangible multiple at ~1.54x for the YTD period through mid-November 2021. These valuation multiples implied by YTD 2021 deals are up relative to 2020, roughly in line with 2019 levels, but are still down relative to 2017 and 2018 levels.

A bank acquisition could present an opportunity for growth to acquirers that are facing a challenging rate and market environment. Some recent data confirmed this as almost **half of survey respondents** in *Bank Director's 2022 Bank M&A Survey* say their institution is likely to purchase another bank by the end of 2022 — a significant increase compared to the previous year, and more in line with the pre-pandemic environment.

For those banks considering strategic options, like a sale, 2022 could also be a favorable year, should the improving trends experienced in 2021 continue. These trends include a continued increase in buyer's interests in acquisitions, a continued expansion of the pool of buyers to include both traditional banks and non-traditional acquirers like credit unions and FinTechs, and the tax environment for sellers and their shareholders remaining favorable relative to historical levels.

Against this backdrop of the potential for an active bank M&A environment in 2022, we consider the top three factors that, in our view, should be considered by bank acquirers to help make a successful bank acquisition.

1. Developing a Reasonable Valuation Range for the Bank Target

Developing a reasonable valuation for a bank target is essential in any economic environment, but particularly in the current environment. We have noted **previously** that value drivers remain in flux as investors and acquirers assess how strong loan demand and the rate environment will be. In addition to those factors, evaluating earnings, earning power, multiples, and other key value drivers remain important. ***Bank Director's 2022 Bank M&A Survey*** also noted the importance of valuation in bank acquisitions as pricing expectations of potential targets were cited as the top barrier to making a bank acquisition (with 73% of respondents citing this as a barrier).

Determining an appropriate valuation for a bank requires assessing a variety of factors related to the bank (such as core earning power, growth/market potential, and risk factors). Then applying the appropriate valuation methodologies – such as a market approach that looks at comparably priced transactions and/or an income approach focused on future earnings potential and developed in a discounted cash flow or internal rate of return analysis. While deal values are often reported and compared based upon multiples of tangible book value, value to specific buyers is a function of projected cash flow estimates that they believe the bank target can produce in the future.

Price and valuation can also vary from buyer to buyer as specific buyers may have differing viewpoints on the future earnings and the strategic benefits that the seller may provide. For example, 2021 has seen an emerging trend of non-traditional acquirers such as credit unions and FinTech companies entering the mix. They often have different strategic considerations/viewpoints on a potential bank transaction.

2. Appropriately Consider the Strategic Fit of the Bank Target

As someone who grew up as an avid junior and college tennis player, I have always admired the top pros and found lessons from sports to apply in my personal and business life. With fifteen grand slam titles and fifteen years as the top doubles team globally, the Bryan brothers – Bob and Mike – are often held out as the most successful doubles teams of all time and offer some lessons that we can learn from, in my view. Their team featured a unique combination of a left-handed and right-handed player, which provided variety to challenge their opponents and expand their offensive playbook. It also had many similar intangibles, such as how they approached practicing and playing since they were twins and taught by their father (Wayne) from a young age.

Their success illustrates the importance of identifying both the key similarities and differences of a potential partnership to strengthen the chances for success once combined. Key questions to consider regarding strategic fit and identifying the right partner/opportunity for a bank acquisition include: Does the Target expand our geographic footprint into stronger or weaker markets? What types of customers will be acquired (retail/consumer, business, etc.) and at what cost (both initially and over time)? Is there a significant branch/market overlap that could lead to substantial cost savings? Is the seller's business culture (particularly credit underwriting/client service approach) similar to ours? Will the acquisition diversify or enhance our loan/deposit mix? Will the acquisition provide scale to expand our business lines, balance sheet, and/or technology offerings? What potential cost savings and/or revenue enhancements does the potential acquisition provide?

3. Evaluating Key Deal Metrics Implied by the Bank Acquisition

A transaction that looks favorable in terms of valuation and strategic fit may flounder if other key deal metrics are weak. Traditional deal metrics to assess bank targets include capital/book value dilution and the earnback period, earnings accretion/dilution, and an internal rate of return (IRR) analysis.

Below we focus a bit more on some fundamental elements to consider when estimating the pro forma balance sheet impact and internal rate of return:

Pro Forma Balance Sheet Impact and Earnback Period

To consider the pro forma impact of the bank target on the acquirer's balance sheet, it is important to develop reasonable and accurate fair value estimates as these estimates will impact the pro forma balance sheet at closing as well as future earnings and capital/net worth after closing. In the initial accounting for a bank acquisition, acquired assets and liabilities are marked to their fair values. The most significant marks are typically for the loan portfolio, followed by intangible assets for depositor customer relationship (core deposit). Below are some key factors for acquirers to consider for those fair value estimates:

Loan Valuation. The loan valuation process can be complex, with a variety of economic, company, or loan-specific factors impacting interest rate and credit loss assumptions. Our loan valuation process begins with due diligence discussions with the management team of the target to understand their underwriting strategy as well as specific areas of concern in the portfolio. We also typically factor in the 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 market factors (interest rates) and bank-specific factors such as customer retention, deposit base characteristics, and a bank's expense and fee structure.

Internal Rate of Return

The last deal metric that often gets a lot of focus from bank acquirers is the estimated internal rate of return ("IRR") for the transaction. It is based upon the following key items: the price for the acquisition, 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 acquirer'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 acquirer.

WHAT WE'RE READING

Small banks that typically struggle to garner interest from would-be acquirers have seen an uptick in deal activity this year. *BankDirector* examines recent **FinTech acquisitions** of smaller banks, as bank charters and low-cost deposits have attracted these new acquirers.

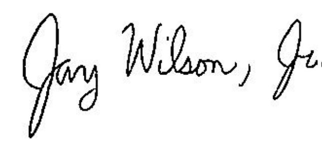
President Biden announced he would **reappoint** Jerome Powell to serve as Chair of the Board of Governors of the Federal Reserve System, while Lael Brainard will be nominated to serve as Vice Chair.

The Federal Reserve, FDIC, and OCC released a **joint statement** announcing their intent to publish new standards and guidance on banks' involvement with cryptocurrencies in 2022.

Mercer Capital Can Help

Mercer Capital has significant experience providing valuation, due diligence, and advisory services to bank acquirers across each phase of a potential transaction. Our services for acquirers include providing initial valuation ranges for bank targets, performing due diligence on targets during the negotiation phase, providing fairness opinions and presentations related to the acquisition to the buyer's management and/or board, and providing valuations for fair value estimates of loans and core deposit before 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. Feel free to reach out to us to discuss your community bank or credit union's unique situation and strategic objectives in confidence.



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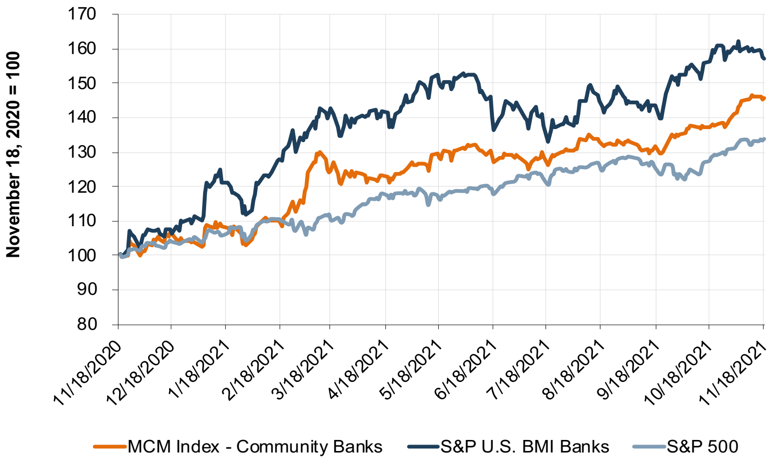
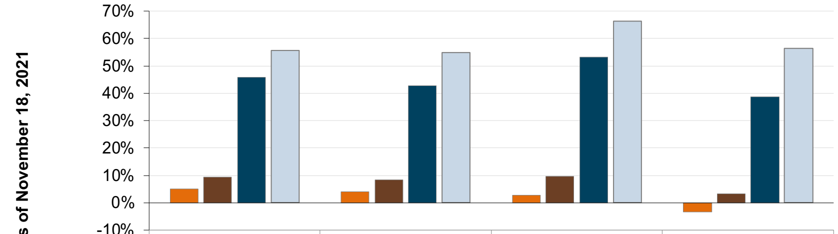
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



	Dow Jones U.S. MicroCap Banks	S&P U.S. SmallCap Banks	S&P U.S. MidCap Banks	S&P U.S. LargeCap Banks
Month-to-Date	5.15%	4.10%	2.90%	-3.26%
Quarter-to-Date	9.38%	8.47%	9.60%	3.36%
Year-to-Date	45.96%	42.83%	53.28%	38.82%
Last 12 Months	55.58%	54.91%	66.27%	56.42%

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.

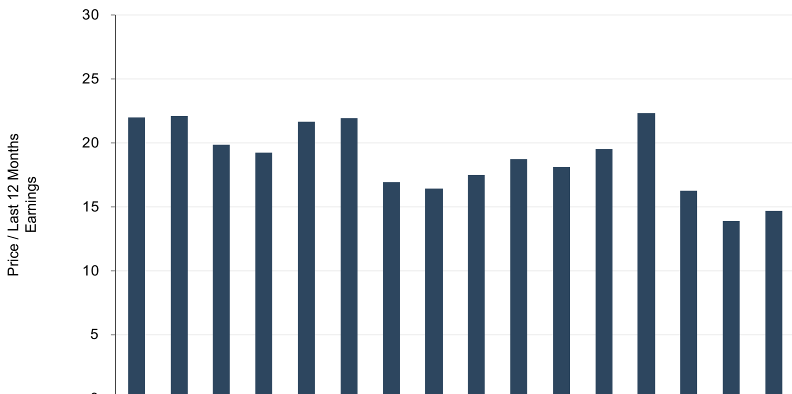
Regional Index Data

	Total Return				Regional Index Data as of November 18, 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	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	5.0%	7.0%	54.0%	64.3%	11.5x	11.7x	13.6x	122%	131%	2.3%
Midwest Index	4.1%	7.9%	28.8%	33.4%	9.8x	10.0x	11.9x	113%	126%	2.4%
Northeast Index	4.4%	7.3%	38.9%	43.2%	10.1x	9.5x	10.5x	112%	119%	2.7%
Southeast Index	5.7%	11.5%	42.9%	48.6%	11.5x	10.8x	11.6x	119%	131%	2.0%
West Index	5.1%	9.5%	46.3%	48.6%	10.1x	10.3x	11.0x	116%	126%	2.2%
Community Bank Index	4.7%	8.3%	40.7%	45.9%	10.2x	10.3x	11.6x	116%	126%	2.4%
S&P U.S. BMI Banks	-1.0%	5.2%	41.1%	57.1%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

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

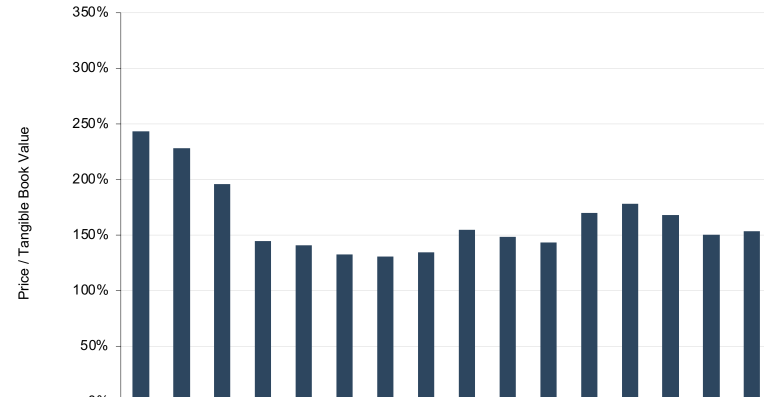


	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	LTM 2021
U.S.	22.0	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5	18.8	18.1	19.5	22.4	16.3	13.9	14.7

Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

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

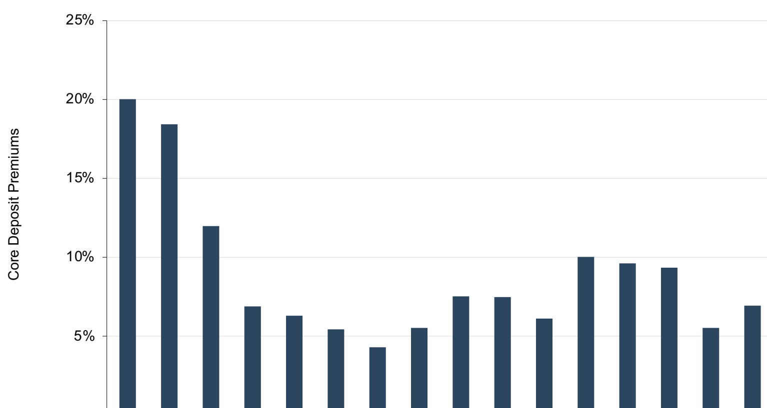


	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	LTM 2021
U.S.	243%	228%	196%	145%	141%	132%	130%	134%	155%	148%	143%	170%	178%	168%	150%	154%

Source: S&P Capital IQ Pro.

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	2020	LTM 2021
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%	5.5%	6.9%

Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

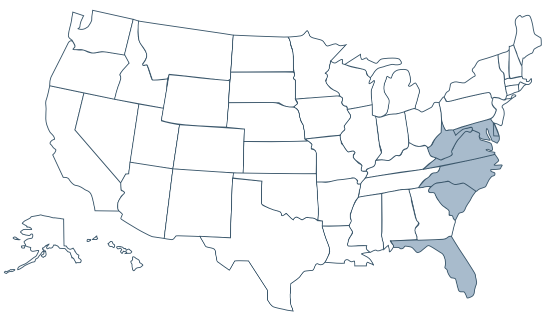
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended November 23, 2021

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	16.1x	179%	9.0%	14	211.5	704,154	10.4%
Midwest	16.8x	156%	6.8%	54	116.6	192,388	9.2%
Northeast	13.5x	148%	5.9%	5	231.9	1,214,741	10.3%
Southeast	13.8x	150%	7.1%	31	96.2	424,031	10.5%
West	14.7x	153%	6.6%	18	134.7	757,929	11.0%
National Community Banks	14.7x	154%	6.9%	122	127.7	389,695	10.4%

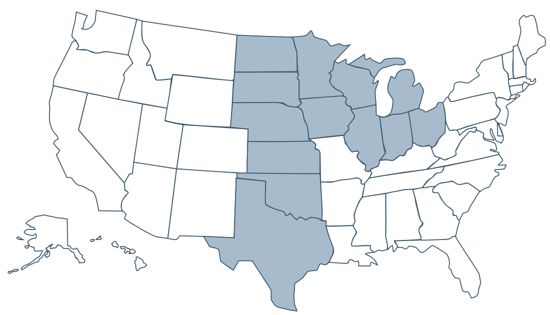
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

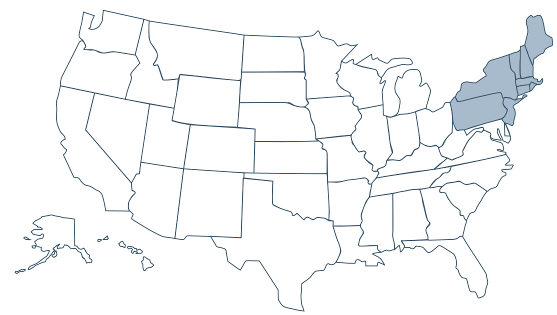
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



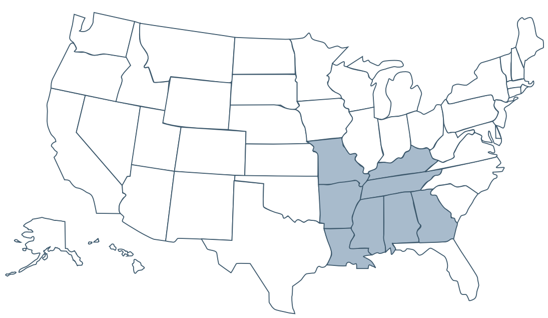
Atlantic Coast



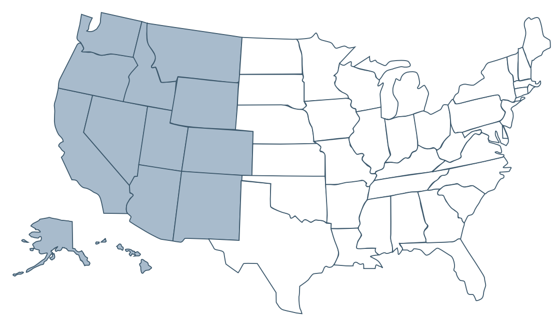
Midwest



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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