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Bank Watch

ARTICLE

Themes from *Bank Director's* 2023 Acquire or Be Acquired Conference

AND

Pay Vs. Performance: 5 Things You Need to Know About the SEC's New Rules

In This Issue

Themes from *Bank Director's* 2023 Acquire or Be Acquired Conference

It's always fun to escape the dreary, late January weather and head to sunny, warm Phoenix to catch up with and learn from my peers at Bank Director's Acquire or Be Acquired Conference ("AOBA"). This year the wintry weather back home resulted in a flight cancellation, allowed for an extra day of sunshine, and illustrated that most things have a silver lining if you can find it.

The 2023 version of AOBA felt bigger than ever, and it was good to see that conferences and large gatherings of industry peers can still thrive after the impacts of the pandemic. Below, I note a few themes from the conference and the sessions that I attended. For those who haven't been to AOBA before, it is a two-and-a-half-day conference that has broadened its M&A offerings over the years to focus on a combination of M&A, growth, and FinTech strategies.

These themes stuck with me the most from the 2023 iteration.

Enhanced Focus on the Balance Sheet

We noted in a **previous article** that the 2023 deal-making outlook was challenged by the potential for heightened interest rate marks (i.e., unrealized losses in fixed-rate assets) and credit marks amidst a combination of a higher rate environment and a softening economic climate and real estate values. This theme was certainly present on the AOBA agenda as several sessions discussed the impact of unrealized bond losses as reflected in the AOCI (accumulated other comprehensive income) on banks' balance sheets. But it also showed up in discussions of how asset sensitive vs. liability-sensitive banks will perform, the need for heightened due diligence on credit risk, and how these themes can impact capital planning, equity valuations, and M&A. While the balance sheet theme was more prominent at the 2023 AOBA, this link between bank balance sheets, earnings, and ultimately valuation is not an entirely new phenomenon. It reminded me of one of my early bank readings as a younger analyst and how the text illustrated that banks' balance sheets tend to drive earnings. It noted how this is a unique trait compared to companies in other industries, whose balance sheets have less of an impact on generating cash flow.

Deposits, Deposits, Deposits

Consistent with discussions around the balance sheets, rising interest rates, and the impact on the banking industry, deposits came up time and time again in sessions. These discussions covered strategies to retain business or consumer deposits, the attractiveness of core deposits for acquirers in the current environment, how to grow deposits organically, how to acquire deposits and pay premiums, rising core deposit intangible valuations, and how to provide your customers with the technology and digital banking solutions to onboard and retain deposits more efficiently. [1]

Digital Banking and FinTech Partnerships

We have previously discussed banks' potential to leverage FinTech to create value and enhance profitability and efficiency. This theme seems to grow each year at AOBA as we see more sessions on structuring and performing due diligence on FinTech partnerships. I've also noticed an increased interest in topics like BaaS (Banking as a Service) opportunities, digital tools from different FinTechs, and case studies on how banks have developed digital strategies or partnered with FinTechs to compete and

[1] For those who may have a deeper interest in this deposit theme, we did a deeper dive on deposits as a valuation driver for banks previously. You can find it **here**.

expand in the current environment. Additionally, the number of FinTech companies attending and presenting at AOBA continues to increase. Opportunities were plentiful for those bankers interested in a demo or introduction to some of FinTech's offerings. In my view, one emerging theme stood out a bit more from the rest: banks developing deeper partnerships with FinTechs and eventually investing with them as partners. We have noted how **valuation issues** and key performance indicators (KPIs) for FinTech companies and tech-forward banks can differ from traditional bank valuation methods and KPIs. I think it will be interesting to watch this trend going forward.

Scale Still Matters and M&A Remains a Strategic Priority for Many

While we noted the turbulence and potential headwinds for bank M&A in 2023, this could present an opportunity for some acquirers with a more long-term perspective. Traditional growth acceleration and inorganic scale strategies such as M&A were still prominent themes in many sessions, as they focused on the nuts and bolts of conventional bank M&A, valuation, due diligence, structuring, and integration. While certain themes change and evolve, the strategy to achieve greater scale and growth through M&A, and to enhance efficiency and profitability that create value over the long run, still persists.

Conclusion

We look forward to discussing these issues with clients in 2023 and monitoring how they evolve within the banking industry over the next year. As always, Mercer Capital is available to discuss these trends as they relate to your financial institution, so feel free to call or email.

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WHAT WE'RE READING

In a speech earlier this month, an OCC official said that the **HHI Index**, a key metric used to assess concentration issues in bank mergers, may be becoming irrelevant. The HHI Index is based on deposit share and may not fully capture the effects of mobile banking, according to the official.

Bank merger agreements for 2022 deals included some unique provisions. Nelson Mullins **reviewed** several merger agreements and highlighted features that buyers and sellers can consider when transacting in an uncertain environment.

The share of outstanding subprime auto debt that was 30 or more days past due **rose to 9.3%** as of year-end 2022, the highest level since 2010, according to Moody's analytics.

Pay Vs. Performance: 5 Things You Need to Know About the SEC's New Rules

In August 2022, the SEC adopted final rules implementing the Pay vs. Performance Disclosure required by Section 953(a) of the Dodd-Frank Act. These rules add a new item 402(v) to Regulation S-K and will go into effect for the 2023 proxy season. What does this mean and how does it apply to you? What are the requirements and why might there be significant valuation challenges involved? This article excerpts some of the highlights from our full article available **here**.

Executive Summary

1. The new SEC proxy disclosure rules introduce several new requirements, including that registrants calculate and disclose a new figure (Compensation Actually Paid), alongside existing executive compensation information. For most registrants, the rules will apply to upcoming 2023 proxy season.

2. A new Pay Versus Performance table will detail the relationship between the Compensation Actually Paid, the financial performance of the registrant over the time horizon of the disclosure, and comparisons of total shareholder return.

3. The newly introduced concept of Compensation Actually Paid will require companies to measure the period-to-period change in the fair value of all equity-based compensation awarded to named executive officers.

4. The type of equity awards that have been granted will determine the complexity of the valuation process. Equity-based awards such as stock options might require updated Black Scholes or lattice modeling, while awards with performance or market conditions may require more complex Monte Carlo simulations.

5. Registrants should understand that if equity awards have been granted on a consistent basis for a period of years, the new rules could require a large number of historical valuations for this initial proxy season and a significant amount of disclosure complexity.

Overview and Background

The **new disclosures** were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and were originally proposed by the SEC in 2015. The rules are intended to provide investors with more transparent, readily comparable, and understandable disclosure of a registrant's executive compensation. The new provisions apply to all reporting companies other than (i) foreign private issuers, (ii) registered investment companies, and (iii) emerging growth companies.

The rules apply to any proxy and information statement where shareholders are voting on directors or executive compensation that is filed in respect of a fiscal year ending on or after December 16, 2022. As such, the vast majority of registrants will be required to include related disclosure for their 2023 proxy statements, though there are relaxed requirements for smaller reporting companies.

The Pay Versus Performance Table

The new rules require registrants to describe the relationship between the Executive Compensation Actually Paid ("CAP") and the financial performance of the registrant over the time horizon of the disclosure. Additional items include disclosure of the cumulative Total Shareholder Return ("TSR") of the registrant, the TSR of the registrant's peer group, the registrant's net income, and a company-selected measure chosen by the registrant as a measure of financial performance.

What is Compensation Actually Paid?

For each fiscal year, registrants are required to adjust the total compensation paid to executives for pension and equity awards that are calculated in accordance with US GAAP.

The equity-based compensation adjustments will require registrants to disclose the fair value of equity awards in the year granted and report changes in the fair value of the awards until they vest. This means that it will be necessary to measure the year-end fair value of all outstanding and unvested equity awards for the PEO and other NEOs under a methodology consistent with what the registrant uses in its financial statements.

What Are the Different Types of Equity Awards?

The procedures used to calculate fair value will vary depending on the type of equity award.

- » For **restricted stock and restricted stock units (RSUs),** fair value can be calculated using observed share prices at the grant date, fiscal year end, and the vesting date. The change in fair value would simply be the difference between these dates.
- » For **stock options and stock appreciation rights (SARs**), fair value at the grant date is often calculated using a Black-Scholes or lattice model. However, care should be taken to ensure that the assumptions reflect the new shorter term and updated market conditions.
- » For **performance shares and performance share units (PSUs)**, the fair value calculations may be more complex due to the presence of a performance condition (e.g., the award vests if revenues increase by 15% and EBITDA margin is at least 20%) or a market condition (e.g., the award vests if the registrant's total shareholder return over a three-year period exceeds its peer group by at least 5%). The performance condition will require updated probability estimates at year-end and at the vesting date. Awards with market conditions are typically valued at their grant date using Monte Carlo simulation and so a reassessment at subsequent dates using a consistent simulation model with updated assumptions will be necessary.

Special Considerations for Market Condition Awards Using Monte Carlo Simulation

Market condition awards come in many different flavors. The three most common types of awards vest based upon performance in the registrant's own stock, relative total shareholder return measured against a benchmark index, or relative total shareholder return ranked against a group of peer companies.

When performing a subsequent year-end or vesting date fair value analysis, each of the grant-date assumptions will need to be reevaluated. For example, for a relative TSR plan with a three-year term, the subsequent year-end valuations will necessarily have shorter terms (2-year and 1-year), which will require new inputs for volatility and correlation factors.

Regardless of the type of plan, it is important for registrants to understand how even a relatively simple award, if granted consistently for a period of years, can lead to a large number of Monte Carlo simulations for this initial proxy season and a significant amount of disclosure complexity. For example, if a company has made annual PSU grants (with a market condition) for each of the last five years, then up to eight Monte Carlo valuations could be required to calculate the CAP in each period.

Summary and Next Steps

While the new SEC Pay vs. Performance disclosure rules can seem daunting, we believe they can be managed with proper planning and a systematic approach. For the CAP disclosures, registrants need to understand the details of all equity awards that have been awarded to named executive officers (how many and what type of award). The award characteristics will determine which valuation method is most appropriate and how many valuations need to be performed.

If you have questions about the valuation techniques used for the various types of equity compensation awards or would like to discuss the process, please contact a Mercer Capital professional.

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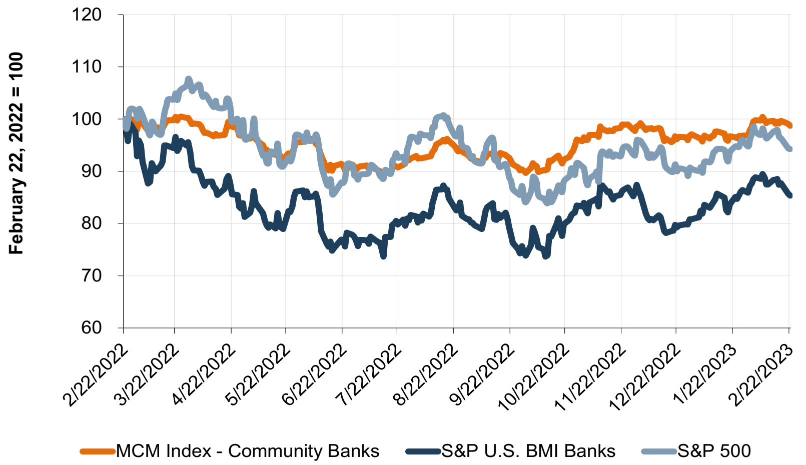
If you wish to read the full article on this topic
CLICK HERE

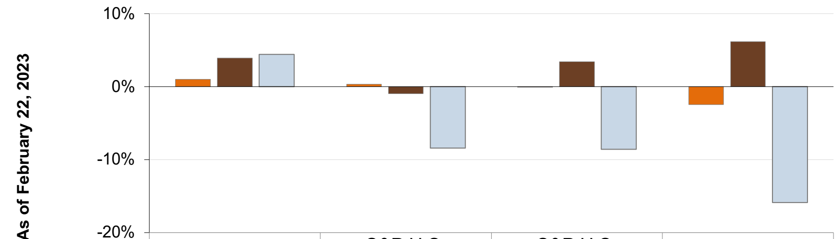
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



	S&P U.S. Banks Market Cap Under $250 Million	S&P U.S. Banks Market Cap Between $250 Million - $1 Billion	S&P U.S. Banks Market Cap Between $1 Billion - $5 Billion	S&P U.S. Banks Market Cap Over $5 Billion
Month-to-Date	0.99%	0.34%	-0.07%	-2.47%
Year-to-Date	3.90%	-0.95%	3.40%	6.17%
Last 12 Months	4.43%	-8.41%	-8.58%	-15.87%

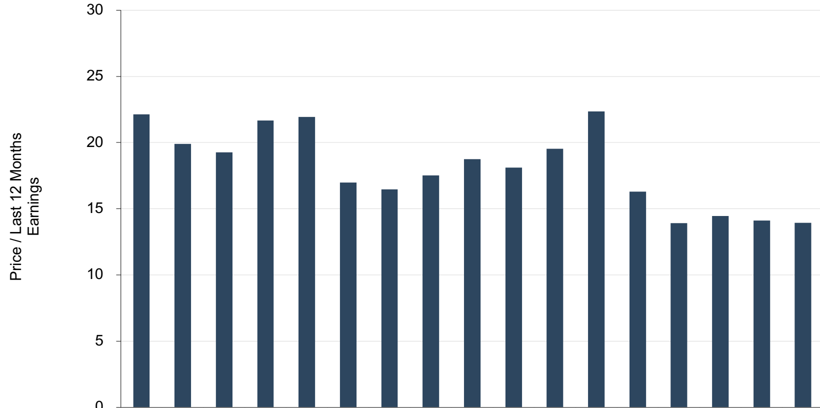
Source: S&P Capital IQ Pro.

	Total Return			Regional Index Data as of February 22, 2023					
	Month-to-Date	Year-to-Date	Last 12 Months	Price / LTM EPS	Price / 2023 (E) EPS	Price / 2024 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	1.7%	1.1%	-7.2%	9.7x	8.8x	8.0x	125%	132%	2.6%
Midwest Index	1.2%	-0.8%	-0.9%	9.8x	8.8x	8.8x	113%	138%	3.2%
Northeast Index	-0.7%	2.4%	3.9%	9.4x	9.1x	8.6x	122%	126%	3.0%
Southeast Index	0.7%	1.3%	0.0%	9.1x	10.4x	10.9x	109%	126%	2.8%
West Index	1.5%	3.5%	-2.7%	9.9x	8.9x	8.4x	119%	128%	2.7%
Community Bank Index	0.8%	1.7%	-1.3%	9.7x	9.2x	8.8x	119%	128%	2.9%
S&P U.S. BMI Banks	-2.1%	5.6%	-14.6%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

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

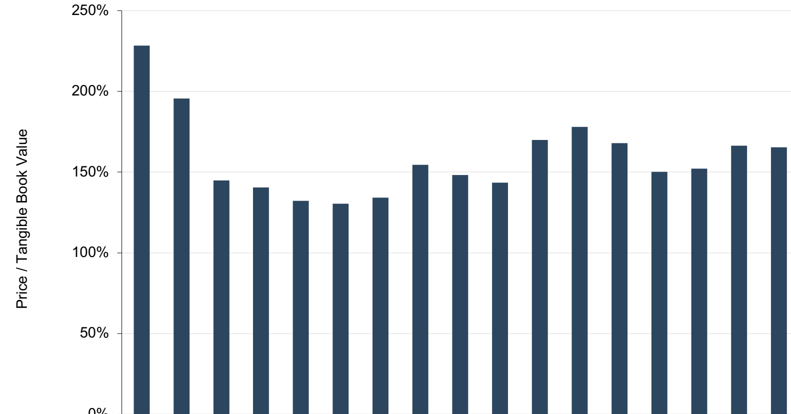


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5	18.8	18.1	19.5	22.4	16.3	13.9	14.5	14.1	13.9

Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

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

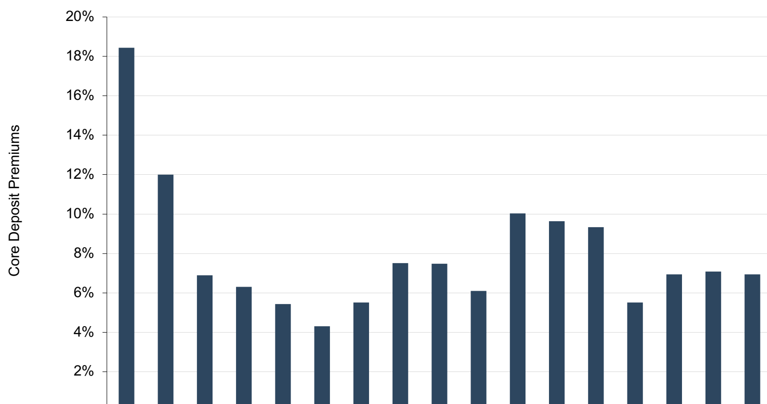


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	228%	196%	145%	141%	132%	130%	134%	155%	148%	143%	170%	178%	168%	150%	152%	166%	165%

Source: S&P Capital IQ Pro.

Median Core Deposit Premiums

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



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	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%	7.1%	6.9%

Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

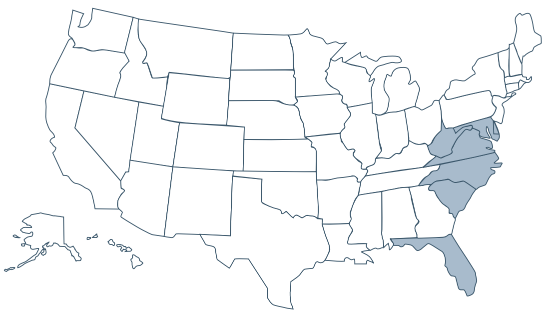
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended February 24, 2023

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	13.0x	182%	9.4%	15	139.5	689,345	10.2%
Midwest	13.5x	152%	6.9%	53	66.9	191,411	10.4%
Northeast	13.1x	128%	4.1%	7	63.0	544,087	9.3%
Southeast	13.8x	176%	7.4%	18	150.1	333,421	13.2%
West	16.6x	190%	10.5%	10	86.8	403,927	11.5%
National Community Banks	13.8x	165%	7.0%	103	105.0	330,400	10.6%

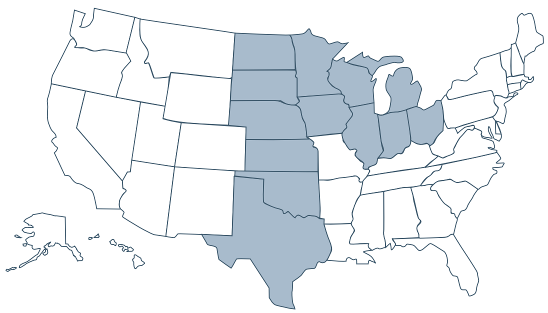
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

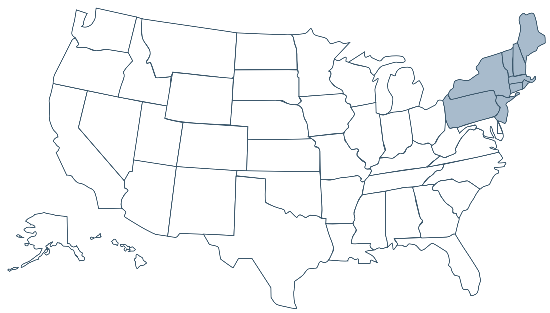
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



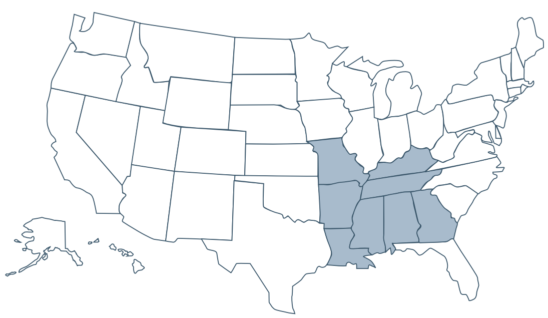
Atlantic Coast



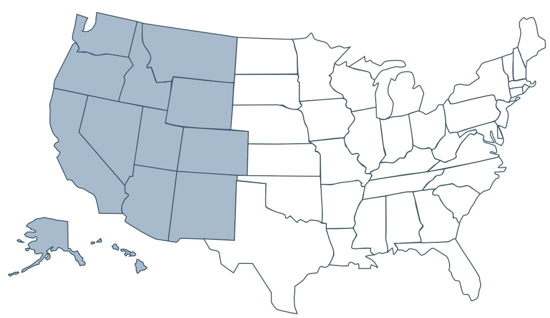
Midwest



Northeast



Southeast



West

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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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