MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES
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Bank Watch

ARTICLE

It's Getting Real(ized)

In This Issue

It's Getting Real(ized)

As has been recently discussed by many, the significant rise in yields across the Treasury curve, with the most notable increase occurring at the short-end of the curve, has resulted in large unrealized losses in bank securities portfolios. From March 2022 through July 2023, the Federal Reserve increased the target Federal Funds rate eleven times for a collective increase of 525 basis points. Since the last 25 basis point increase in July 2023, the Federal Reserve has opted to hold the target Fed Funds rate steady.

To start, we provide an update of a data table we've included in prior versions of *Bank Watch* regarding unrealized losses in bank bond portfolios.

Unrealized losses in available-for-sale ("AFS") designated portfolios range from an average of 8.3% for banks with assets greater than $250 billion to 12.4% for banks with $1 billion to $3 billion of assets and banks with $3 billion to $10 billion of assets. As a percentage of Tier one capital, the range was from 14.2% for banks with assets greater than $250 billion to 29.2% for banks with $100 million to $500 million of assets.

Unrealized Losses in Bank Portfolios as of September 30, 2023

Asset Size	Number of Banks	Assets ($000)	Leverage Ratio (%)	Tier 1 Capital (%)	AFS Sec / Assets (%)	AFS Gain / (Loss) Cost (%)	AFS Gain / (Loss) T1 Capital (%)	HTM Sec / Assets (%)	HTM Gain / (Loss) Cost (%)	HTM Gain / (Loss) T1 Capital (%)
> $250B	12	$1,073,004	8.8%	15.5%	12.7%	-8.3%	-14.2%	15.0%	-13.9%	-30.8%
$100B - $250B	14	$182,059	9.0%	13.4%	12.2%	-9.4%	-16.7%	5.7%	-14.9%	-12.2%
$10B - $100B	104	$27,030	9.9%	14.2%	13.7%	-12.3%	-20.2%	6.9%	-13.5%	-12.2%
$3B - $10B	205	$5,449	10.5%	14.8%	14.6%	-12.4%	-20.9%	5.8%	-12.4%	-12.2%
$1B - $3B	505	$1,702	10.9%	16.5%	15.8%	-12.4%	-23.6%	5.5%	-9.9%	-7.4%
$500M - $1B	637	$701	10.8%	16.6%	18.9%	-11.6%	-26.3%	6.6%	-8.2%	-7.1%
$100M - $500M	1,899	$255	11.7%	18.7%	22.9%	-11.4%	-29.2%	8.1%	-6.9%	-8.7%
< $100M	645	$60	17.4%	46.5%	27.4%	-9.8%	-27.4%	13.9%	-5.6%	-10.7%

This table is based on Call Report data as of September 30, 2023

For additional perspective on the trend in bond portfolio losses, the following table depicts unrealized losses in AFS portfolios for 1Q22, 2Q22, 2Q23, and 3Q23. As shown below, the magnitude of losses has steadily increased for all banks since the Fed began raising rates in early 2022.

Trend in Unrealized Losses in AFS Portfolios

	AFS Gain / (Loss) Cost (%)			
Asset Size	**1Q22**	**2Q22**	**2Q23**	**3Q23**
> $250B	-3.5%	-5.4%	-6.9%	-8.3%
$100B - $250B	-3.8%	-6.3%	-8.0%	-9.4%
$10B - $100B	-4.5%	-7.1%	-10.3%	-12.3%
$3B - $10B	-4.5%	-7.6%	-10.4%	-12.4%
$1B - $3B	-4.7%	-8.0%	-10.4%	-12.4%
$500M - $1B	-4.3%	-7.5%	-9.6%	-11.6%
$100M - $500M	-4.4%	-7.5%	-9.4%	-11.4%
< $100M	-3.4%	-5.7%	-8.3%	-9.8%

In our September publication of *Bank Watch,* my colleague Andy Gibbs covered some **implications of a higher-for-longer rate environment**. In discussing what banks should do with internally generated capital if the return on capital from more aggressive loan growth strategies is diminished, Gibbs wrote:

> *A more controversial strategy would entail using some excess capital to effectuate a partial restructuring of the bond portfolio. Rather than tying up capital with loans earning a relatively low spread over marginal funding costs, a bank could exit some low yielding investments at a loss that could be replaced with investments at current market rates (or used to pay down costly borrowings).*

In the third and fourth quarters of 2023, securities portfolio restructuring is a strategy that appears to be gaining momentum. Mercer Capital reviewed regulatory, SEC, and various public filings for some of the banks that have announced such actions. In the following table, we've summarized some data points of interest for our sample of banks that elected to reposition the securities portfolio in the third or fourth quarter.

	Balance of Securities Sold as % of Total AFS Portfolio (Cost Basis)	Pre-Tax Loss as % of Securities Sold	Average Yield on Securities Sold	Average Yield on Assets Purchased with Proceeds	Estimated Earn-Back Period per Company
Atlantic Union Bank	9%	12%	2.30%	6.00%	NA
Camden National Bank	9%	8%	2.31%	6.06%	2.5 Years
FirstBank	5%	19%	1.36%	6.00%	NA
JD Bank	12%	12%	1.32%	6.67%	2.8 Years
Midland States Bank	7%	7%	2.46%	6.07%	1 Year
Origin Bank	11%	4%	3.08%	NA	1.7 years
Pacific Premier Bank	57%	20%	1.34%	5.00%	NA
SmartBank	27%	4%	1.37%	NA	Just Over 1 Year
Tompkins Community Bank	25%	15%	0.93%	5.12%	NA

Unless rates decrease significantly, losses on securities will be realized in either of two ways: (i) immediately, through losses on sale or (ii) over time, through lower earnings. As illustrated in the table above, one of the potential pros of selling securities immediately is net interest margin enhancement, as proceeds from the sale of underwater securities can be reinvested in higher yielding assets. For the banks that reported the average yield on securities sold and the average yield on assets purchased with the proceeds from the sale, the pick-up in yield ranged from approximately 360 bps to 535 bps.

Another potential pro is the ability to repay high-rate borrowings with the proceeds, which is what OBK chose to do. After selling securities with an average yield of 3.08%, the proceeds were used to pay down outstanding FHLB advances with an interest rate of 5.62%. OBK noted an expected 11 bps pickup in its NIM from the trade. Other potential pros of selling underwater securities include reduced interest rate risk and closure of decisions made in a low-rate environment.

Banks undertaking bond restructurings expect accretion to shareholder value, as higher net interest income leads to higher earnings in 2024 and beyond which supports a higher stock price. In a perfectly efficient market, a bond restructuring should have no impact on a bank's share price, as the market has already discounted the impact of low yielding bonds purchased in a different interest rate environment. But the market is not perfectly efficient.

In our sample, JD Bancshares, Inc., Tompkins Financial Corporation, and Pacific Premier Bancorp, Inc. are the only companies that announced the securities portfolio repositioning separately from earnings. Given limited trading volume for JDVB, we focused on the change in stock price for TMP and PPBI post announcement of the bond portfolio restructuring. From the day prior to the announcement to three days after, TMP's stock price increased 2.0% and PPBI's stock price increased 3.0%. For comparison, the *S&P U.S. BMI Banks Index* declined by 3.9% and 3.2% over the same time periods.

While there are certain benefits to a securities portfolio restructuring, there are also cons to consider. For one, banks must have adequate capital to be able to absorb the hit when previously unrealized losses are realized, and the impact to capital may not be tolerable for some banks. Furthermore, lower capital affects the potential size of the balance sheet, due to minimum capital ratios, and therefore affects earning potential. For example, a reduction in capital from a bond portfolio restructuring could constrain organic growth or M&A opportunities. Finally, beyond the traditional capital ratios, banks should be aware of the impact of a bond restructuring on the CRE loan/capital ratio, which has received greater regulatory focus.

Other potential disadvantages of selling underwater securities and repositioning the portfolio include investor/customer reaction and the uncertainty regarding future rates. Rates could decrease before the securities loss is earned back through higher net interest income. As shown in the table on page 2, the earn-back period in our sample ranged from 1 to 2.8 years, for the companies for which this metric was reported. Some compensation arrangements, if linked to reported net income, may be affected by a bond restructuring.

Finally, banks should monitor accounting developments. An argument exists that if bond sales occur as part of an integrated series of transactions this could result in all, or a significant share of, the available-for-sale securities portfolio being marked to market through earnings rather than shareholders' equity.

WHAT WE'RE READING

A **podcast** by Guggenheim reviewing corporate credit performance this year and the outlook for 2024.

An **article** discussing Goldman's view on markets for the coming year.

A podcast and **related** article from S&P detailing the key points to unlocking M&A activity in the current environment.

Earn-Back Math

The earn-back period calculation appears simple—divide the equity impact of the bond portfolio restructuring by the after-tax earnings enhancement—but is subject to considerable discretion. Digging into the math of a bond portfolio restructuring reveals the following:

1. The pick-up in yield is not as simple as comparing the yield on the bond sold to the yield on the replacement bond. Assume a bank has a bond with a par value of $1,000 with a 2.00% rate, which it sells for $750. The bank receives $750 of cash that it can use to buy a new bond yielding 5%. The pick-up in income is not 3% (the difference between the 5% yield on the new bond and 2% on the old bond). Instead, the bank gives up $20 of income ($1,000 x 2%) and will earn $37.50 going forward ($750 x 5%). That is, the pick-up in income is only $17.50, which is much less than suggested by the spread between the yields on the new and old bonds.
2. The earn-back period is affected by the selection of bonds sold. Holding other factors constant, if a bank desires a short earn-back period, it should sell bonds with shorter durations (and lower losses on sale). Selling long-term bonds with higher losses will produce a longer earn-back period.

   As an example, assume a bank is evaluating two bond portfolio restructurings. The first includes bonds with a 2% yield and a two year duration, while the second liquidates bonds with a 2% yield and a 20-year duration. The denominator in the earn-back calculation (the after-tax earnings enhancement) is likely to be similar in the near-term regardless of which scenario occurs. However, the first scenario would entail a lower loss on sale (which affects the numerator in the earn-back calculation), thereby producing a shorter earn-back period.

If your bank would like a second opinion on the merits of a potential bond restructuring, please contact a member of Mercer Capital's Financial Institutions Group.

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Excerpts From Public Filings For Banks Who Have Pursued Balance Sheet Restructurings In 3Q23-4Q23

TMP, 9/30/23 10-Q

In September 2023, the Company completed a balance sheet repositioning for general balance sheet, portfolio and interest rate risk management, by selling approximately $429.6 million of available-for-sale debt securities, which resulted in a pre-tax loss on the sale of approximately $62.9 million. Though this sale resulted in an operating loss in the third quarter of 2023, the transaction is expected to favorably impact securities revenue in future periods as the securities sold had an average yield of 0.93%, while the proceeds of the sale were largely reinvested into securities with an estimated yield of approximately 5.12%.

AUB, Rob Gorman, CFO, 3Q23 Earnings Call

Concurrent with the sale leaseback transaction, the company restructured a portion of its investment portfolio by selling approximately $228 million in available for sale securities yielding approximately 2.3%, resulting in a pretax net loss of approximately $27.7 million, almost wholly offsetting the net gain recognized from the sale leaseback transaction. The net proceeds from the securities sales and the sale-leaseback transaction have been reinvested into the available-for-sale securities portfolio yielding approximately 6%.

FBK, Christopher Holmes, CEO, 3Q23 Earnings Release

Near the end of the quarter, we sold $76.6 million of available-for-sale securities and reinvested the proceeds of that sale into higher-yielding securities, adding approximately 5% to the yield on those invested funds that will be accretive in the fourth quarter and future periods.

OBK, 3Q23 Earnings Release

While the associated loss resulted in an $0.18 negative impact to diluted EPS for the quarter ended September 30, 2023, the difference between the relatively low yield on securities sold and the higher cost of FHLB advances was an attractive trade-off, with an estimated annualized positive forward impact to fully tax-equivalent NIM of 11 basis points, an estimated annualized forward diluted EPS benefit of approximately $0.11 and an estimated earn-back period of 1.7 years.

SMBK, Ron Gorczynski, CFO, 3Q23 Earnings Call

The security sale was comprised primarily of U.S. treasuries, approximately $100 million, which had maturities in Q1 of '24 and the remainder of which had a weighted average maturity of 2.6 years. The total weighted average yield of these securities sold was 1.37%. Reinvested at current cash yields the sale proceeds provide an additional $6.4 million of annual interest income, which equates to an earn back just over 1 year. Aside from the enhanced liquidity benefits, the securities repositioning provides additional earnings momentum as we move into Q4.

CAC, 3Q23 Earnings Release

The Company repositioned its balance sheet during the third quarter of 2023 to enhance future net interest margin and earnings by selling $66.7 million of investments with a weighted-average yield of 2.31% at a pre-tax loss of $5.3 million. The Company reinvested $30.0 million of the proceeds into investments yielding 6.06% and the remaining proceeds were used to pay-down the Company's borrowings. The estimated earn-back period on tangible book value dilution from the loss on sale of investments is less than three years.

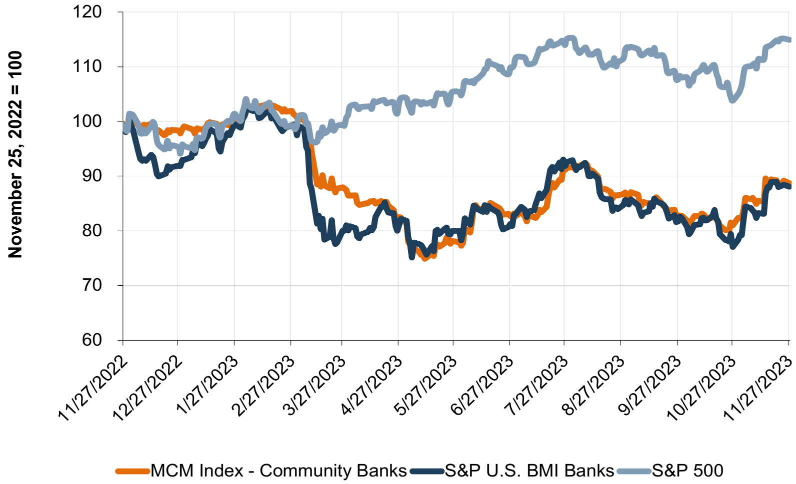
MSBI, 9/30/23 10-Q

The Company took advantage of certain market conditions during the three and nine months ended September 30, 2023 to reposition out of lower yielding securities into other structures, which are expected to result in improved overall margin, liquidity and capital allocations. These transactions resulted in losses of $5.0 million and $6.5 million in the three and nine months ended September 30, 2023, with expected paybacks to occur within a one year period.

JDVB, 11/22/23 Press Release

In November 2023 the Bank initiated a strategic securities transaction by selling approximately $54.7 million of available-for-sale securities consisting entirely of lower-yielding US Treasury securities with an average yield of 1.32% for an estimated pre-tax loss of $6.6 million. The Company expects to deploy the net proceeds into a mix of cash and higher-yielding earning assets with an expected average yield of approximately 6.67%. We estimate that the loss should be earned back in 2.8 years. The strength of our capital position allowed the Company to proactively reposition the securities portfolio, which we anticipate will provide significant future earnings benefit and safeguard against potential interest rate risk as we enter 2024.

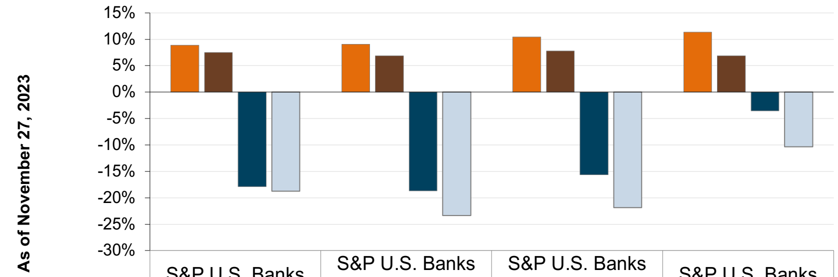
Mercer Capital's Bank Group Index Overview



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	8.90%	9.03%	10.42%	11.33%
Quarter-to-Date	7.53%	6.87%	7.79%	6.85%
Year-to-Date	-17.86%	-18.68%	-15.64%	-3.56%
Last 12 Months	-18.78%	-23.37%	-21.87%	-10.36%

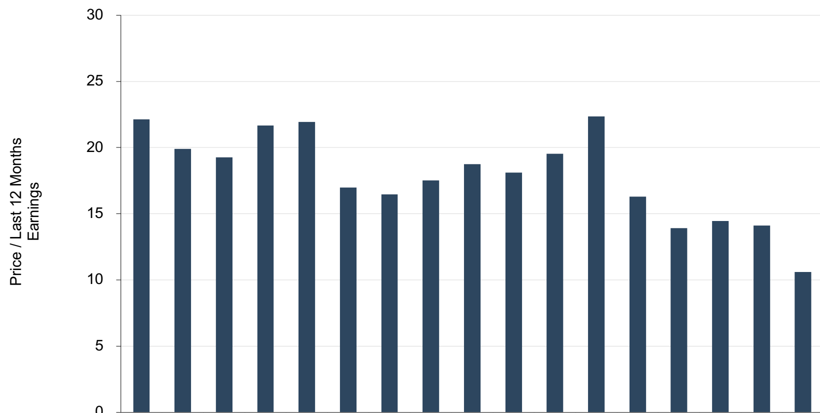
Source: S&P Capital IQ Pro.

	Total Return				Regional Index Data as of November 27, 2023					
	Month-to-Date	**Quarter-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	5.3%	3.4%	-16.8%	-17.1%	8.1x	9.7x	10.3x	102%	112%	3.2%
Midwest Index	10.0%	5.9%	-12.2%	-12.3%	8.2x	8.6x	8.4x	87%	107%	4.1%
Northeast Index	7.8%	10.6%	-5.9%	-7.1%	8.8x	9.2x	9.5x	101%	108%	3.6%
Southeast Index	7.8%	7.0%	-16.4%	-18.1%	8.0x	7.2x	7.5x	94%	109%	3.9%
West Index	7.8%	5.8%	-8.7%	-9.6%	8.0x	8.8x	9.1x	97%	105%	3.4%
Community Bank Index	7.7%	7.2%	-10.5%	-11.3%	8.4x	8.8x	9.3x	97%	107%	3.7%
S&P U.S. BMI Banks	11.1%	6.9%	-5.3%	-11.9%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

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

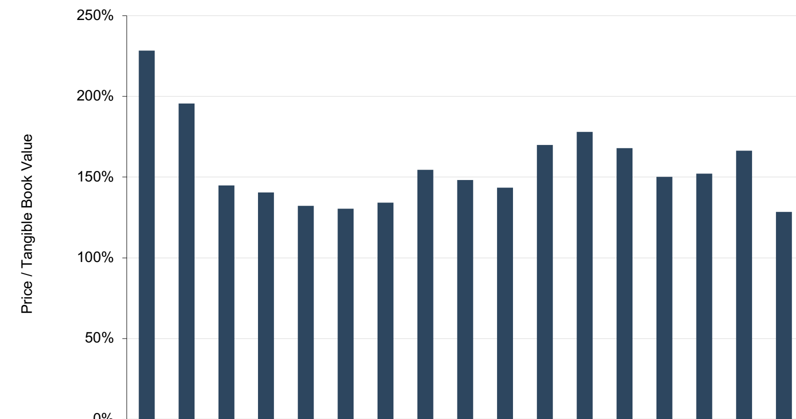


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5	18.8	18.1	19.5	22.4	16.3	13.9	14.5	14.1	10.6

Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

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

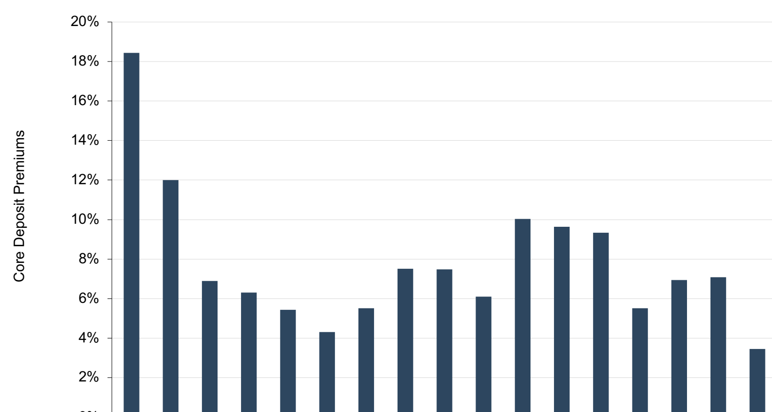


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	228%	196%	145%	141%	132%	130%	134%	155%	148%	143%	170%	178%	168%	150%	152%	166%	128%

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%	3.4%

Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

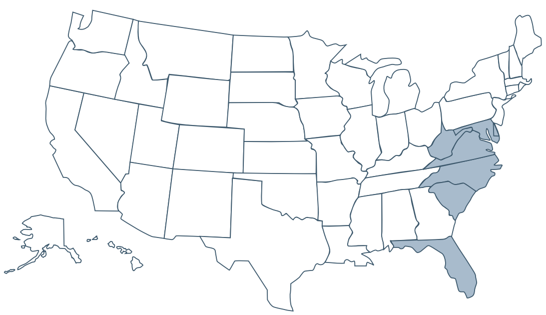
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended November 28, 2023

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	11.2x	131%	3.2%	6	208.5	1,967,117	11.0%
Midwest	10.3x	145%	3.8%	4	78.6	981,382	17.3%
Northeast	12.6x	122%	3.9%	5	59.6	650,870	12.0%
Southeast	10.6x	132%	4.7%	3	73.4	701,819	9.6%
West	8.7x	95%	-0.5%	5	27.9	274,275	9.0%
National Community Banks	10.6x	128%	3.4%	23	66.9	701,819	10.3%

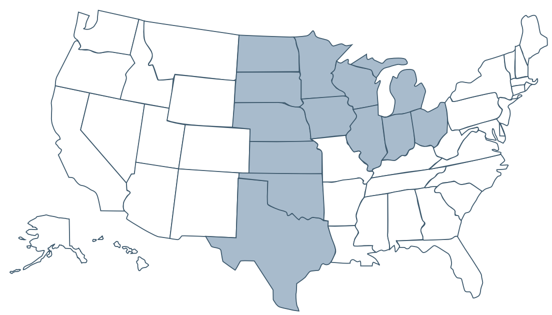
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

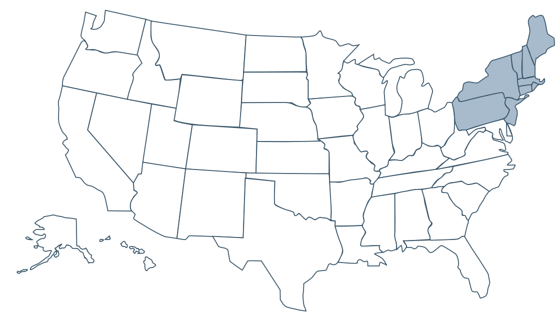
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



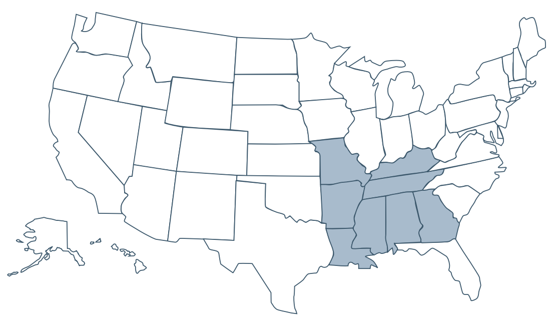
Atlantic Coast



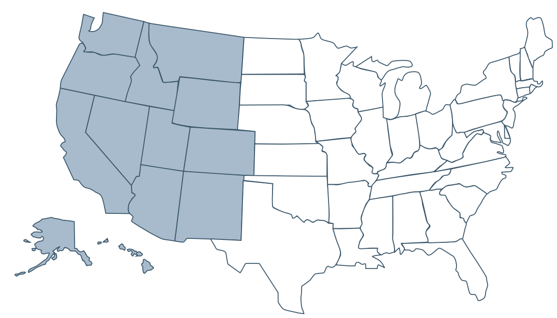
Midwest



Northeast



Southeast



West

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Depository Institutions Services

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- Goodwill impairment
- Litigation support
- Stress Testing
- Loan portfolio valuation
- Tax compliance
- Transaction advisory
- Strategic planning

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