

# Bank Watch

## Midwest

## Old National: Repositioning via M&A While Many Others Sit Still

by Jeff K. Davis, CFA

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Sy Jacobs of Jacobs Asset Management was featured in this week's Barron's ("Bullish on Community Banks"). He was quoted as having a "slightly bullish bias" on small cap banks, primarily because credit trends are positive and pending M&A. Jacobs also noted the sector's revenue conundrum due to intensifying pressure on loan yields at a time when the country is over-banked and over-branched. Among his picks was Old National Bancorp, of which his fund held 2.0 million shares (2.0%) as of year-end 2012 per the 13F. Jacobs cited Old National as an active, accretive acquirer as the crux of his investment thesis.

I agree with Jacobs on the strategic positioning of Old National. CEO Robert Jones has moved on opportunities while many have sat on their hands; however, the shares, like most, are not a layup given the need to continue to execute on future deals, a liquid balance sheet at a time when loan demand is not robust, and a valuation that is middle of the road rather than inexpensive at 1.6x tangible book value and 13x full-year 2013 consensus EPS. Old National, like other acquirers, has one other hurdle that may limit its shares in the near-term: Street expectations. Old National has a wide gap between its GAAP net interest margin and NIM ex-accretion. I do not think the Street focuses on the issue until the narrowing of the differential is material to earnings. Old National's NIM in the first quarter was 4.04% compared to 4.20% a year earlier; ex-accretion for three deals it was 3.31% versus 3.52%. To Old National's credit and stated goal to be as transparent as possible, this is plainly laid-out for investors.

The same issue could be ascribed to many acquisitive banks. Both PNC Financial Services Group Inc. and Wells Fargo & Co. had to navigate this issue as accretion burned off from their respective late 2008 acquisitions of National City Corp. and Wachovia Corp. The same is true of BB&T Corp. as it relates to accretion from the 2009 acquisition of Colonial Bank. In the case of Wells Fargo, massive

earnings generated from its market-leading mortgage banking unit eclipsed the issue — at least through 2012. Most, including PNC, do not have such a lever. Hancock Holding Co. is a case in point. The Street recently decided that its estimates for the second half and 2014 were not achievable as purchase accounting accretion from the Whitney deal fades and NIM support from rising short rates is pushed further into the future. A year ago, the mean 2013 estimate for Hancock was \$2.75 per share; today it is \$2.25 per share. As shown in the accompanying table, Hancock has been a notable underperformer even though it has a better-than-average franchise in better-than-average markets, in my view.

I point this out because if there is a shortfall relative to expectations in 2014, I expect it to be the Street's fault rather than Old National's. Maybe that will not come to pass because Old National will add about \$750 million of earning assets, almost all of which will be bonds, later this year via its announced acquisition of 24 southeast Michigan and Indiana branches from Bank of America Corp. Another deal could occur, too.

Jones has a lot of credibility with institutional investors because he is a straight talker, doing what he said he would do. Old National's credit performance going into and coming out of the financial crisis was vastly superior to peers. During 2012, net charge-offs of 0.17% equated to the 20th percentile of Old National's regulatory peer group as reported in its Bank Holding Company Performance Report. Nevertheless, the shares have lagged the SNL U.S. Bank Index of banks with \$5 billion to \$10 billion of assets the past three and five years through May 8 via producing respective total returns of 12% versus 28% and negative 10% versus 2%. I believe the shortfall reflects Old National not falling as much as many banks did during the crisis, leaving less room for recovery. Also, Old National's footprint has not yet produced as much loan growth as other areas of the country as investors shift their focus to revenue growth.

In the asset management business, timing is everything. Being right on a stock but getting the timing wrong is tantamount to just being wrong. In a sense, Jones has had challenging timing in that he arrived at Old National in late 2004 rather than late 2008. Prior management tried to force Old National to grow at a rate which it could not do so given its footprint. In 2004, Old National reported earnings of 90 cents per share and year-end tangible book value of \$10.16 per share. The shares traded within an approximate band of \$20-25 per share, which equated to 2.6-3.3x TBVPS and 22-28x EPS. Where is the upside in those multiples? There was only downside. Jones' initial years of retooling Old National to reduce its credit risk profile, instill more

management discipline and deliver higher-quality earnings was overlaid on a period in which Old National's and the industry's valuations reset at a lower level. Thus, the shares seemingly have lagged when in a sense they have not; the starting point was too high.

## Where From Here?

Post-crisis, Old National has been a consolidator with limited competition in and around its core Indiana footprint. The pinnacle of this positioning was the July 2011 acquisition of Integra Bank NA via a failed-bank transaction. Integra was a crosstown rival that provided about \$1.3 billion of core deposits and \$1.9 billion of assets, of which \$1.2 billion were loss-protected. Cost saves were dramatic with all but a couple of Integra's 52 offices having been consolidated or sold. (Old National has closed or sold 122 of 151 offices acquired since 2004.)

Two other deals were accretive to franchise value, but not as substantive as Integra. The acquisition of Monroe Bancorp earlier in January 2011 moved Old National to the No. 1 market share position in Bloomington, which is where Indiana University is located. The September 2012 acquisition of Indiana Community Bancorp in Columbus added density in a part of the state where Old National had a thin presence following an election (I think) not to bid on the failed Irwin Union Bank and Trust Co. in September 2009.

Old National may get a shot at another transaction that may prove to be accretive to earnings and the franchise. Louisville, Ky.-based Porter Bancorp Inc. is struggling having posted \$140 million of net losses in 2011 and 2012. Although the tangible equity ratio was 4.0% at March 31, the vast majority of equity consisted of TARP. The balance of the parent company's capital includes \$25 million of trust preferred. Dividends on both have been deferred since December 2011. The subsidiary bank's leverage ratio of 6.0% was above the FDICIA 2.0% live/die threshold, but below 9.0% as mandated by a consent order with regulators. Further, NPAs represented 25.3% of loans and ORE and the Texas ratio was 200% at March 31.

It is unclear to me if Porter will (a) be recapitalized (again); (b) remain in a holding pattern until late 2016 when the fifth anniversary of the trust preferred deferral passes; (c) sell Porter Bank in a 363 transaction as part of a bankruptcy; or (d) lose Porter Bank to the FDIC. If the latter two occur, Old National presumably will be interested. Porter offers seven offices and about \$700 million of deposits in the Louisville MSA compared to just five offices with \$172 million of

## 2013 Estimate and Price Change for Old National Bancorp and Other Selected Acquirers

Company (ticker)	Price (\$)	3-month price change (%)	1-year price change (%)	Current 2013 EPS estimate (\$)	Year ago 2013 EPS estimate (\$)	1-year change in EPS estimate (%) <sup>1</sup>	Price/EPS estimate (x) <sup>2</sup>	Price/TBVPS (%) <sup>3</sup>	Dividend Yield (%)
Ameris Bancorp (ABCB)	15.59	14.63	27.47	0.94	1.16	-19.40	16.7	147.51	0.00
Bank of the Ozarks (OZRK)	41.76	11.09	36.20	2.39	2.13	12.15	17.7	288.23	1.63
First Financial Bancorp (FFBC)	15.60	0.26	-6.98	1.04	1.26	-17.22	14.9	n/a	6.15
FirstMerit Corp. (FMER)	17.66	16.53	3.98	1.26	1.35	-6.38	14.0	162.99	3.63
Hancock Holding Co. (HBHC)	28.57	-7.15	-10.07	2.25	2.75	-18.28	12.6	142.25	3.36
Home BancShares Inc. (HOMB)	41.25	18.16	43.58	2.54	2.26	12.26	16.1	268.79	1.45
IBERIABANK Corp. (IBKC)	46.41	-10.18	-8.08	2.88	3.20	-10.09	16.1	n/a	2.93
<b>Old National Bancorp (ONB)</b>	<b>12.83</b>	<b>-6.49</b>	<b>1.99</b>	<b>0.99</b>	<b>1.08</b>	<b>-8.33</b>	<b>13.0</b>	<b>155.91</b>	<b>3.12</b>
Simmons First Natl. Corp (SFNC)	24.76	-2.79	-0.28	1.64	1.74	-5.75	15.0	119.45	3.39
State Bank Financial Corp. (STBZ)	15.31	-4.43	-8.32	0.49	1.22	-59.48	31.3	118.11	0.78
Wintrust Financial Corp. (WTFC)	36.63	-1.66	1.81	2.49	2.47	0.91	14.8	105.42	0.49
<b>Median</b>		<b>-1.66</b>	<b>1.81</b>			<b>-8.33</b>	<b>15.0</b>	<b>147.51</b>	<b>2.93</b>
<b>Average</b>		<b>2.54</b>	<b>7.39</b>			<b>-10.87</b>	<b>16.5</b>	<b>167.96</b>	<b>2.45</b>
<b>SNL U.S. Bank \$5B-\$10B<sup>4</sup></b>	<b>661.92</b>	<b>1.00</b>	<b>14.81</b>						
<b>S&amp;P 500</b>	<b>1,632.69</b>	<b>7.56</b>	<b>19.72</b>						

Data is as of May 8, 2013 // Source: SNL Financial

<sup>1</sup> FactSet Mean EPS estimate is used.

<sup>2</sup> FactSet EPS estimate of current year is used to calculate the price-to-earnings ratio.

<sup>3</sup> TBVPS = tangible book value per share

<sup>4</sup> Includes all major exchange-traded banks in SNL's coverage universe with \$5 billion to \$10 billion in assets of most recent financial data

deposits for Old National. Porter's western Kentucky offices would fit well with Old National's franchise, too. Strategically, such a deal would push Old National into more metro markets that offer better lending and growth opportunities than its rural legacy markets. Even if Old National does not obtain Porter Bank, I think there are a lot of would be sellers knocking on Old National's door.

The cliff note for the accompanying chart says that even for well-managed and positioned banks, M&A is not a panacea for positive shareholder returns, at least in the short-run. Buying cheap, executing and avoiding credit issues drive returns over time, even if Street estimates imply the opposite has occurred over the short-run.



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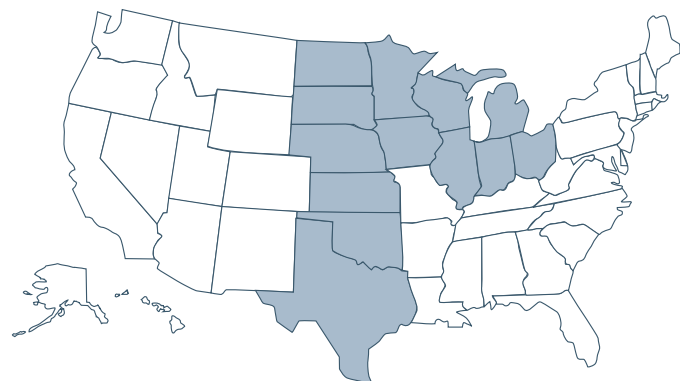
## Complimentary Whitepaper



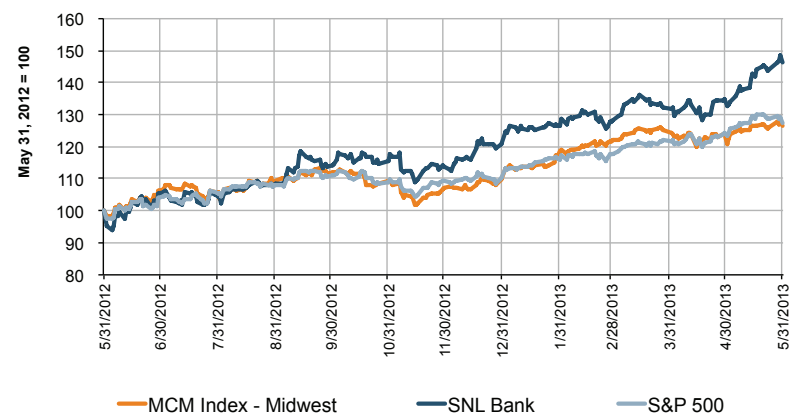
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Community Bank Group Index Overview



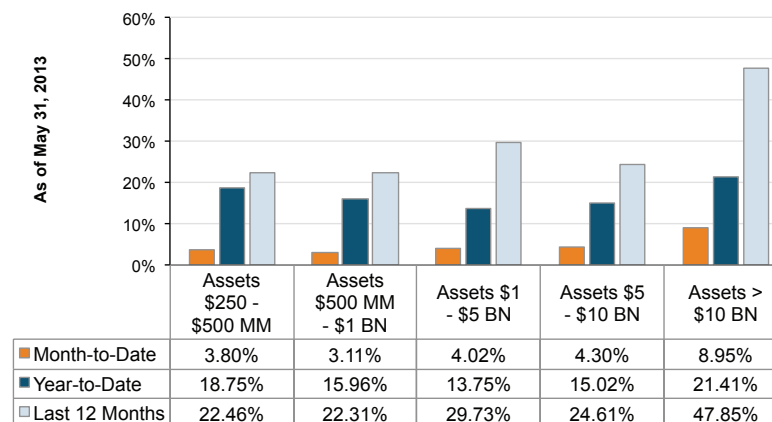
Median Valuation Multiples

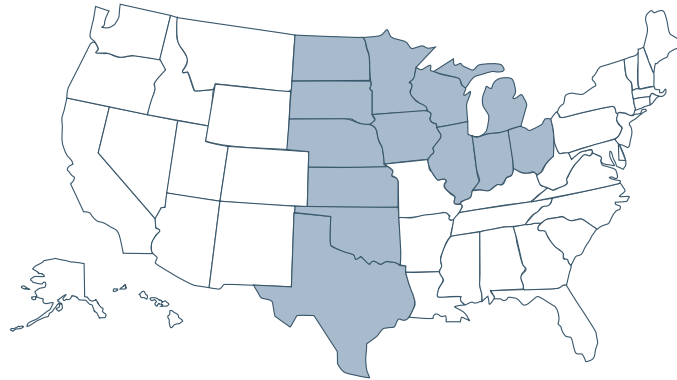
as of May 31, 2013

	Midwest Community Bank Index	National Community Bank Index
Price / LTM EPS	11.12	12.79
Price / 2013 (E) EPS	11.78	13.37
Price / 2014 (E) EPS	12.07	12.86
Price / Book Value	99.29%	104.75%
Price / Tangible Book Value	110.12%	112.25%
Dividend Yield	2.14%	2.55%

Return Stratification of U.S. Banks

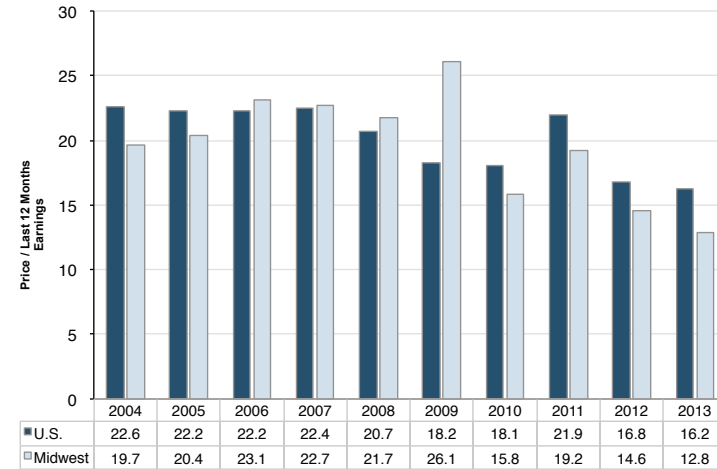
by Asset Size





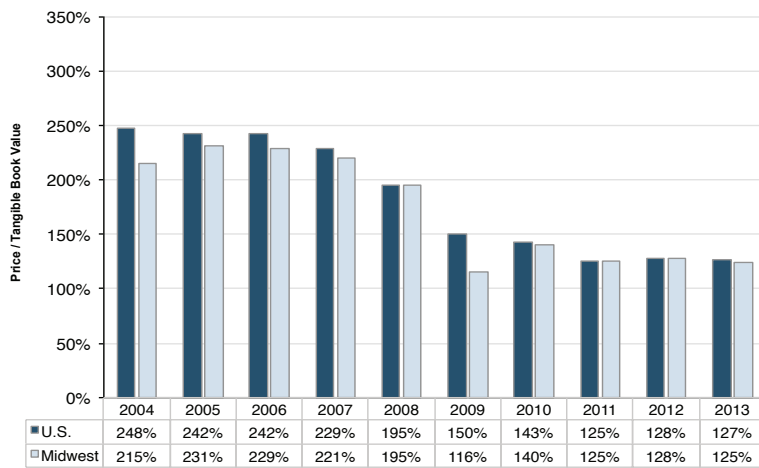
**Median Price/Earnings Multiples**

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



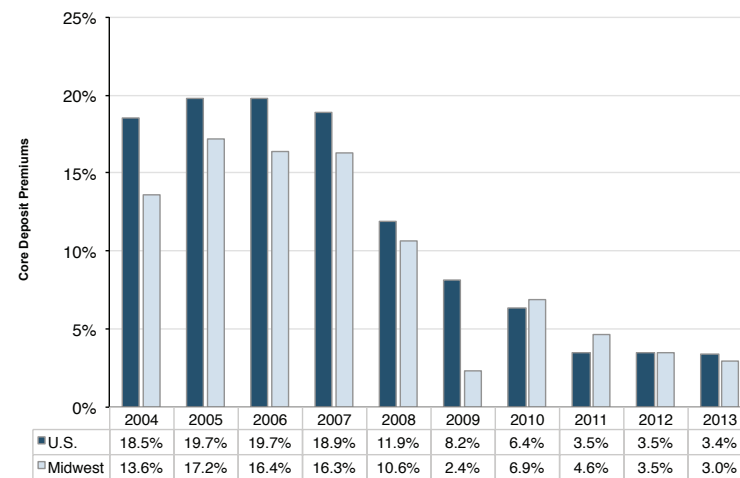
**Median Price/Tangible Book Value Multiples**

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



**Median Core Deposit Multiples**

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









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