

# Bank Watch

## Evaluating a Buyer's Shares

Depending upon who answers the question, U.S. M&A activity runs the gamut from ho-hum to good. Few will answer that it is outstanding even though market observers have expected activity to accelerate across industry sectors because financing costs are low, corporate cash is high and revenue growth is sluggish in many industries.

Yet another foundation for increased M&A activity fell into place in 2013 when equity markets staged a strong rally as the S&P 500 rose 30% (32% with dividends) and the Russell 2000 increased 37% (39%). The rally further reduced the cost to finance acquisitions because the vast majority of stocks experienced significant multiple expansion rather than material growth in EPS. As of year-end, the S&P 500's P/E based upon trailing earnings (as reported) was 19.4x compared to a long-term average of 15.5x (Source: <http://www.multip.com>). As of March 14, 2014, the median P/E based upon trailing 12-month earnings for publicly traded banks with \$2 billion to \$10 billion was 16.4x, up from about 13x at year-end 2012 based upon data compiled by SNL Financial. High multiple stocks represent stronger currencies to issue fewer shares to achieve a targeted dollar value.

M&A activity among U.S. banks was unchanged from 2012 with 244 whole-bank acquisitions in 2013 according to SNL Financial. The current pace is absorbing about 3% of the nation's banks annually—a rate that has been fairly consistent for many years. What is missing are the mid-size and large deals.

Although cash consideration is used much more widely since “pooling accounting” was phased-out in 2000, the issuance of common equity to sellers continues to be the predominant means to finance bank acquisitions. 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 as obvious as it seems, even when the buyer's shares are actively traded.

Our experience is that most boards 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. For some sellers during the past two years, asking the questions about the buyer's investment merits seemingly has not been required. The mantra among many institutional investors focused on small- and mid-cap banks has been to “buy the buyers” the past two years. Acquirers such as First Financial (SCBT), Renasant Corporation (RNST), and FirstMerit (FMER) have seen their shares substantially outperform their benchmark index in a

reversal of past history when the buyer's shares usually declined on the announcement of an acquisition.

The outperformance of buyers the past two years reflects several factors, the most important being relative value and (purchased) growth. Many buyers are issuing shares where the valuation approximates or exceeds the multiples obtained by the seller. It is a form of valuation arbitrage. That may not seem right, but buyers have the upper-hand in the banking sector because there are many would be sellers and not that many buyers, especially buyers with liquid shares. Also, investors are rewarding the buyers for revenue and earnings growth at a time when most banks are exhibiting little organic growth.

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 even NASDAQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently. Generally, the higher the institutional ownership, the better the liquidity. Also, liquidity should improve with consummation of the acquisition because the number of shares outstanding and shareholders increase.
- » **Capital.** Is the pro-forma capital level acceptable given the buyer's asset quality history and growth aspirations? Because of enhanced regulatory oversight of the pro forma capital position as part of the merger application process, there may be more margin of safety in the capital calculus post-transaction than prior to the financial crisis. Nevertheless, sellers and their advisors should address the issue.
- » **Parent Company Capital Structure.** A second capital-related question that gets asked much less frequently is: what does the parent company capital structure look like and how much of the bank's earnings are required to be passed upstream via a dividend for debt service and preferred stock dividends? If the answer is relatively high, then the margin of safety for the common dividend may not be as high as presumed.
- » **Ability to Raise Cash to Close.** What is the source of funds for the buyer to fund the cash consideration? If the buyer has to go to market to issue debt, what

is the contingency plan if unfavorable market conditions preclude floating an issue? Is there a back-up correspondent lender? Is a large dividend required from the Bank? If so, will regulators approve it?

- » **Asset Quality.** Asset quality is an obvious issue to address. Historical results are always an important consideration, but "what-if" questions are important to consider, too. In the lead-up to the financial crisis many buyers and sellers failed to grasp the implication of rapid growth in residential mortgage, C&D and income-CRE portfolios. Even large sophisticated buyers were not immune. Wachovia Corporation and Wachovia's investment bankers, Merrill Lynch and Wells Fargo Securities, badly misjudged Golden West Financial Corporation's large option-ARM portfolio, which had performed well for twenty years. Two years after acquiring Golden West, Wachovia was sold at a fire-sale price to Wells Fargo.

## What We're Reading

Frank Cicero of Jefferies & Company wrote an interesting article on *BankDirector.com* entitled "The Merger Window for Small Regional Banks is Already Closing."

<http://mer.cr/NnXoJA>

Trevor Hunnicutt authored an article in *Investment News* discussing how banks have been adopting the RIA model to build wealth units.

<http://mer.cr/1fD2Nn7>

"Getting to Strong: Should Your Bank Acquire?," by Tim Johnson of KPMG LLP, appeared on *BankDirector.com*.

<http://mer.cr/OoVYQg>

John Ginovsky, contributing editor of the *ABA Banking Journal*, had a piece analyzing the implications from BBVA's recent acquisition of Simple, a non-bank startup

<http://mer.cr/1ecmk1r>

- » **Profitability.** A full assessment of profitability should be conducted, ranging from loan yields to cost structures to loss rates through a full credit cycle. The underlying question should be whether current profitability is sustainable. As an example, profitability of a buyer may be structurally lower than it appears if mortgage banking was an important source of earnings during the past few years. Also, above average loan yields represent a source of risk if the low rate environment persists for several more years.
- » **Consensus Analyst Estimates.** If the buyer is publicly traded and has analyst coverage, consideration should be given to Street expectations of achievable earnings over the next one or two years 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.
- » **Growth History and Prospects.** Sellers should consider the buyer's historical growth and prospects for continued growth. Over time, investors tend to bestow higher valuations on banks that can consistently grow than those that cannot or those that primarily rely upon acquisitions to do so.
- » **Funding Risks.** While most commercial banks predominantly rely upon core deposits for funding, the seller should have a full understanding of the buyer's funding strategies and under what circumstances pressure might develop.
- » **Dividend History and Prospects for Future Increases.** 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. If the dividend yield is notably above the peer average, the seller should ask why? Is it payout related, or are the shares depressed? Worse would be if the market expected a dividend cut. These same questions should also be asked in the context of the prospects for further increases.
- » **Valuation.** Like profitability, the valuation of the buyer's shares should be judged relative to the buyer's historical valuation—i.e. are the shares rich, cheap or in-line with history? Likewise, valuation should be compared to a peer group and

the peer group through time—i.e., has the buyer typically traded at a discount, a premium or in-line with peer multiples.

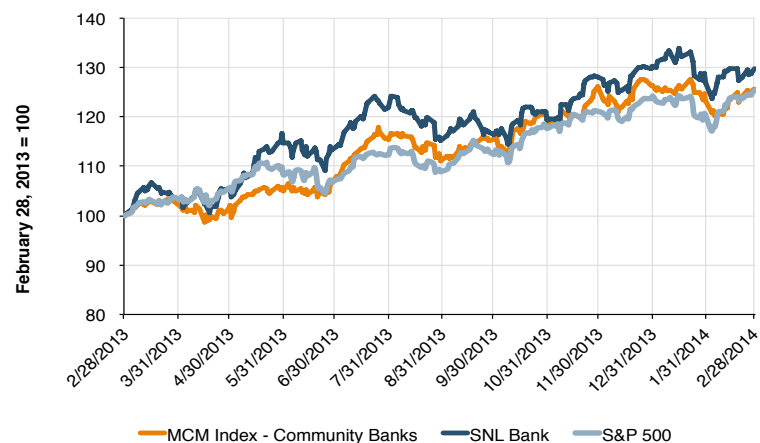
- » **Share Performance.** Sellers should understand the source of the buyer's shares performance over several multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or is it because the shares were depressed at the beginning of the measurement period for some reason and since then the valuation has reverted to a normalized level? Likewise, underperformance may signal bad management, or it may reflect a starting point valuation that was unusually high.
- » **Strategic Position.** During the 1990s, investors in small banks were focused on the potential for a "double-dip" or even a "triple-dip" whereby the buyer later agreed to be sold. That mentality is not as prevalent today, but directors of the selling board should consider the strategic position of the buyer, asking such questions about the attractiveness of the franchise to other acquirers?
- » **Contingent Liabilities.** Contingent liabilities are a standard part of due diligence punch list for a buyer, but sellers should evaluate contingent liabilities too. The debacle in mortgage banking is a stark example.

The list does not encompass every question that should be asked, 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. We 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. Please call if we can help you answer these and more questions related to a transaction you may be considering.



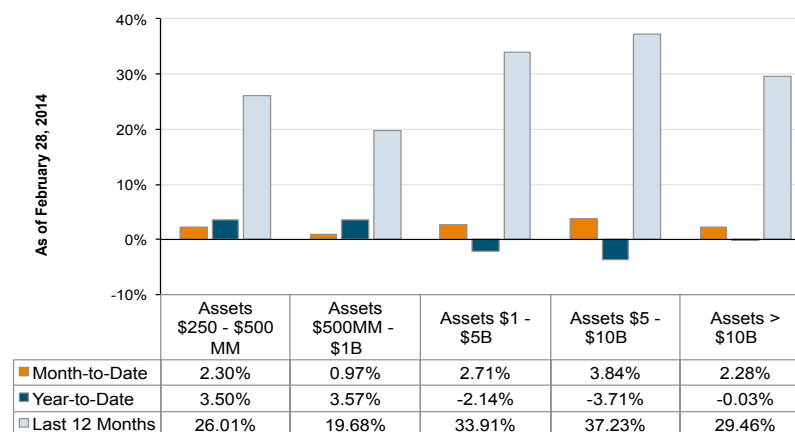
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Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size

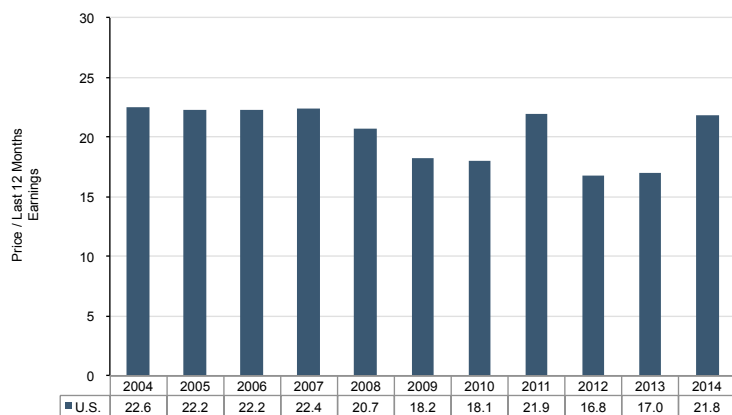


Median Valuation Multiples

Indices	Median Total Return			Median Valuation Multiples as of February 28, 2014					
	Month-to-Date	Year-to-Date	Last 12 Months	Price / LTM EPS	Price / 2014 (E) EPS	Price / 2015 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	1.93%	0.65%	19.27%	14.12	16.37	13.21	109.8%	119.9%	2.0%
Midwest Index	3.13%	3.04%	36.88%	13.59	14.01	12.27	115.8%	126.7%	2.0%
Northeast Index	1.92%	-2.13%	22.52%	14.32	14.21	12.67	124.9%	130.4%	3.4%
Southeast Index	0.90%	-2.90%	21.33%	13.44	14.43	12.96	124.9%	130.4%	1.9%
West Index	3.05%	1.43%	30.96%	16.92	17.15	13.95	132.4%	142.7%	1.8%
Community Bank Index	2.13%	-0.50%	25.70%	14.27	15.10	13.20	118.6%	128.9%	2.1%
<b>SNL Bank Index</b>	<b>2.35%</b>	<b>-0.23%</b>	<b>29.81%</b>	<b>na</b>	<b>na</b>	<b>na</b>	<b>na</b>	<b>na</b>	<b>na</b>

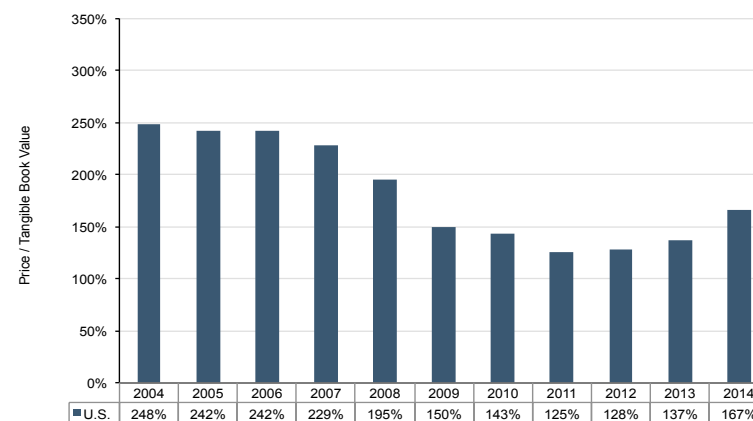
### Median Price/Earnings Multiples

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



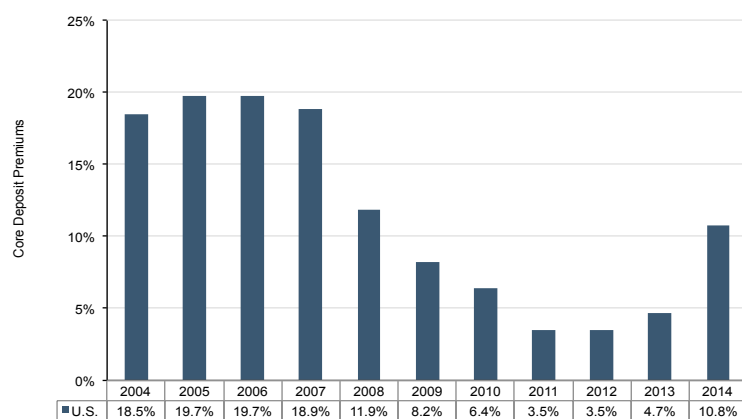
### Median Price/Tangible Book Value Multiples

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



### Median Core Deposit Multiples

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



### Median Valuation Multiples for M&A Deals

Target Banks Assets <\$5B and LTM ROE >5%, through February, 2014

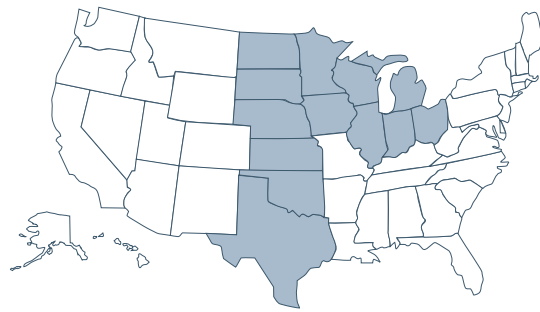
Regions	Price / LTM Earnings	Price / Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value	Target's Median Assets	Target's Median LTM ROAE (%)
Atlantic Coast	nm	nm	nm	0	nm	nm	nm
Midwest	25.83	2.08	12.5%	8	169.41	109,283	7.24%
Northeast	21.82	1.79	14.8%	1	239.70	1,242,673	8.96%
Southeast	15.83	1.73	12.5%	3	157.78	856,664	10.52%
West	25.69	1.33	4.7%	5	37.50	157,034	6.37%
<b>Nat'l Community Banks</b>	<b>21.82</b>	<b>1.67</b>	<b>10.8%</b>	<b>17</b>	<b>112.00</b>	<b>157,034</b>	<b>8.44%</b>

# Mercer Capital's Regional Public Bank Peer Reports

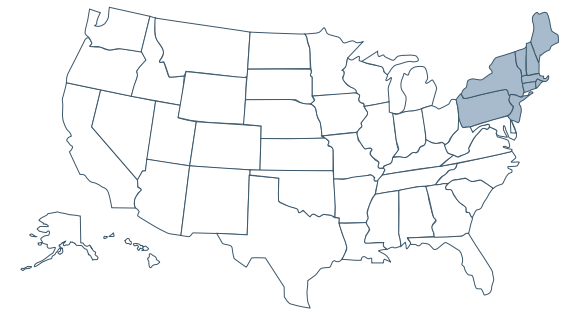
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



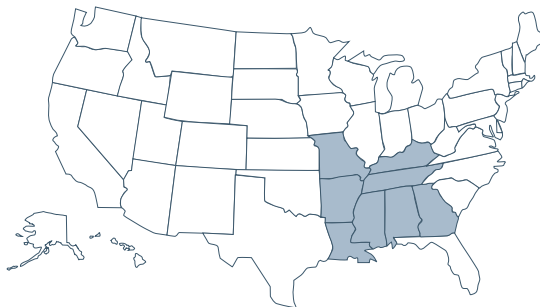
**Atlantic Coast**



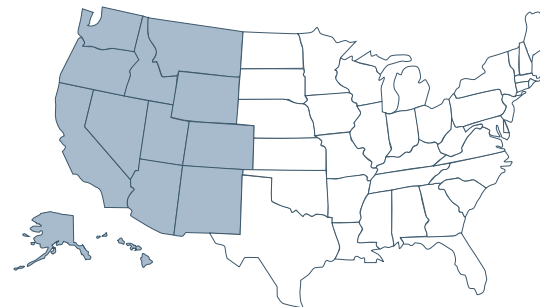
**Midwest**



**Northeast**



**Southeast**



**West**

# Mercer Capital

Financial Institutions Services

Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transactional 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.

Mercer Capital is a thought-leader among valuation firms in the banking industry. In addition to scores of articles and books, *The ESOP Handbook for Banks* (2011), *Acquiring a Failed Bank* (2010), *The Bank Director's Valuation Handbook* (2009), and *Valuing Financial Institutions* (1992), Mercer Capital professionals speak at industry and educational conferences.

The Financial Institutions Group of Mercer Capital publishes *Bank Watch*, a monthly e-mail newsletter covering five U.S. regions. In addition, Jeff Davis, Managing Director, is a regular contributor to SNL Financial.

For more information about Mercer Capital, visit [www.mercercapital.com](http://www.mercercapital.com).

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**SIMPLE**

Venture Capital Case Study

Simple's acquisition by BBVA



## Venture Capital Case Study



**Simple** created a digital interface for banking through web and mobile apps. Absent any physical branches, **Simple** was able to attract customers through digital bank offerings. Revenue was generated through interchange fees as well as interest on customer deposits.

Timeline	Significant Corporate Events
2009	<p>In mid-July 2009, the email that started <b>Simple</b> was sent where one of the founders posed the question of starting a “really, boring simple bank” that could accomplish the four key tasks of a bank as he saw it: 1) Hold money 2) Electronic payments and transfers 3) Lend cash for a risk-adjusted return, and 4) The opposite of 3 = borrowing</p> <p><b>Seed Round (\$190 thousand invested in November)</b></p>
2010	<p>In 2010, <b>Simple</b> began taking invite requests to bank with them from customers; Roughly 20,000 invite requests as of August; Developed staff and certain partnerships</p> <p><b>Series A Round (\$2.9 million invested in September)</b></p>
2011	<p>Additional partnerships were formed; By mid-year, beta testing of product began with first <b>Simple</b> debit cards issued to employees/directors; 50,000 customers had requested an invitation by May; Name and logo change from BankSimple to <b>Simple</b>; Late 2011, <b>Simple</b> began inviting first non-employee customers</p> <p><b>Series B Round (\$10 million invested in August)</b></p>
2012	<p>Released a number of products including IOS Mobile banking application, photo check deposit, Reports (which allows for trend analysis of customer financial data and Goals (a money saving/budgeting application)</p>
2013	<p>Released Android mobile application, Instant (allows for instant money transfers across <b>Simple</b> customer accounts); Experienced relatively rapid customer growth – 20,000 customers in January; up to 40,000 customers by mid-year; up to 100,000 customers by year-end; Processed \$1.7 BN in debit card transactions in 2013</p> <p><b>Series C Round (\$2.2 million invested in June)</b></p>
2014	<p><b>Simple Sold to BBVA for \$117 Million</b></p>

## Venture Capital Case Study



### Top 3 Takeaways for Bankers

**1. Digital banking provides a template for account growth absent traditional branch banking model.**

- In roughly four years and with total funding of \$15 million, **Simple's** deposit accounts grew to 100,000 in all U.S. states with zero branches and had another 250,000 invite requests.
- R&D is fairly well-understood in other corporate fields. Should bankers incorporate a similar mindset with their digital bank platform?
- Would bank management and stakeholders be happy with investing \$15 million over a four-year period for a digital banking platform that can generate and service deposit accounts at a comparable level?

**2. Investing in digital bank offerings can generate shareholder value.**

- Consider that **Simple's** customer acquisition costs were \$150 (\$15 million invested divided by 100,000 customers). **Simple's** customer acquisition costs were below traditional bank customer acquisition costs.
  - Prior reports indicate customer acquisition costs for traditional banks range from \$250 to \$450. (Source: "Free Checking Isn't Cheap for Banks": AmericanBanker.com)
- Once developed, the digital banking platform is scalable and customer acquisition and accounting servicing costs should be lower than the traditional bank retail model.
  - Consider that **Simple** added 100,000 accounts in 2013 with a minimal capital raise (\$2M).

**3. It is possible for digital banking to compete on customer service and not just interest rates.**

- **Simple** differed from prior digital bank offerings in that it attracted depositors absent offering higher interest rates.
- A Deloitte survey of bank customers released in 2013 indicated that a digital banking plan that provides a limited level of in-person services in exchange for reduced fees was the most popular option among customers (Source: "Retail Bank Pricing": Deloitte, February 6, 2013).

## Venture Capital Case Study



### Top 3 Takeaways for FinTech Entrepreneurs

#### 1. Importance of partnerships.

- Almost at the outset, **Simple** developed a number of partnerships that enabled it to scale up quickly and focus on improving their digital bank platform and customer experience. For perspective, consider the partnerships **Simple** developed:
  - FDIC Insurance on Deposits (product) – The Bancorp Bank (partner)
  - ATM Network – Allpoint
  - Debit Cards & Payments – VISA
  - Core Processing – TxVia
  - Attach image, PDF, or text file to transactions – Dropbox
  - Mobile Payments – Braintree/Venmo Touch
  - Funding/Capital – Several venture capital funds

#### 2. VC interest is high and will likely grow following the BBVA deal, particularly if banks follow BBVA's lead and show interest in doing FinTech investments/acquisitions.

- Consider the returns implied: Approximately \$15 million invested in **Simple** across funding rounds. **Simple** ultimately sold for \$117 million which implies the following:
  - Internal rate of return: 147%
  - Cash-on-cash: 7.7x
  - Return on investment: 665%
  - Customers acquired at cost of \$150 and sold for \$1,170

#### 3. Find a niche early as it is difficult to match all services provided by traditional banks.

- **Simple** demonstrated the ability to generate deposit customers through a digital platform but never offered other products such as lending, credit cards, insurance, wealth management, etc.

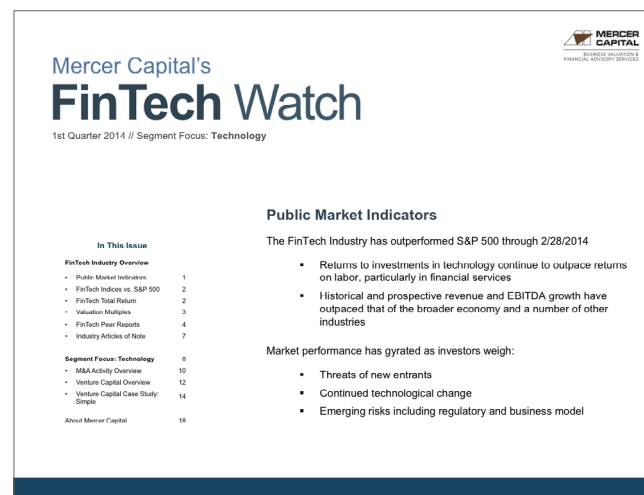
MERCER CAPITAL's

# FinTech Watch

Mercer Capital's **FinTech Watch** is a quarterly publication covering the financial technology industry.

**FinTech Watch** includes market performance and valuation multiples for public fintech companies along with industry articles of interest from around the web.

In addition, each issue focuses on one fintech segment (payment processors, technology, or solutions companies) examining general economic and industry trends for the segment, as well as a summary of M&A and venture capital activity for the segment.



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