

Bank Watch



April 2018

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Spreadsheets Never Disappoint

*Jeff K. Davis, CFA, Managing Director of Mercer Capital's Financial Institutions Group, is a regular editorial contributor to **SNL Financial**, a subsidiary of **S&P Global Market Intelligence**. This contribution was originally published February 27, 2018, at SNL Financial. It is reprinted here with permission. Some links require a subscription to S&P Global Market Intelligence.*

This weekend I read Warren Buffett's letter to shareholders of **Berkshire Hathaway Inc.** The letter, which was not especially long this year, never fails to deliver common sense truths about investing. One phrase he used this year stood out to me in a way many of you reading this post will understand: "spreadsheets never disappoint."

Buffett's spreadsheet comment related to acquisitions. About 2,000 years earlier Julius Caesar offered a similar comment about the human psyche when he said men will believe what they wish to believe is true. Assumptions about growth, margins, synergies, or mana from heaven can be tweaked to produce projected performance that justifies the price paid for an acquisition or investment in a public or private company.

Berkshire did not make any big stand-alone acquisitions last year even though one corporate goal is to "substantially" boost earnings derived from non-insurance businesses. While I am certain Buffett and partner Charlie Munger were shown plenty of interesting companies that met some or all of their criteria for competitive strength, management, profitability, and growth prospects, all apparently failed on pricing.

Buffett was not willing to change assumptions about the businesses or borrow a lot of money to make the spreadsheets reconcile to the asking price. (As an aside, Buffett did not comment on how lower corporate tax rates that were enacted at year-end implicitly reduced the valuation of acquisitions made by others earlier in the year; though he did note \$29 billion of the \$65 billion increase in the Company's equity during 2017 was attributable to the change in the tax code.)

The Wall Street maxim Buffett has followed for decades is "bought right is half right." Price paid matters a lot in terms of future returns, and it is the one variable that investors exercise absolute control over. Buffett, in effect, printed a blank tombstone as it relates to a large whole-company acquisition, though there were smaller investments made by the various businesses that make-up Berkshire's portfolio of operating companies. As a result, the war chest of cash and U.S. Treasury Bills climbed to \$116 billion at year-end 2017 from \$86 billion a year earlier.

We are taught that patience is a virtue. Buffett and Munger are patient. I do not think impatience or actuarial certainties will burn a hole in their pockets if the valuation-

return equation they employ does not improve anytime soon. At least the cash will earn upwards of \$1 billion of more interest in 2018 than 2017.

Another observation I had reading the letter relates to earnings before interest, taxes, depreciation and amortization and spreadsheets geared to Caesar's way of thinking. Buffett comments about the importance of investing in businesses to power growth. Without mentioning EBITDA, he notes that capital expenditures for the non-insurance businesses totaled \$11.5 billion compared to \$7.6 billion of depreciation and \$1.3 billion of amortization expense.

What We're Reading

The Wall Street Journal provides a synopsis of a "**new regulatory relationship with the nation's banks**" as described by Comptroller of the Currency Joseph Otting.

Banking Exchange's recent article argues that bank M&A activity in 2018 will likely be aimed at targets that are flush with core deposits.

As President Trump's proposed tariffs on agricultural products continue to be a topic of debate, *American Banker* **examines ag lenders' potential concerns** about said tariffs. (subscription required)

Although EBITDA is the universal profit or cash flow metric for most businesses excluding banks and other lenders, it easily can be a misleading measure. I attended a conference for private credit investors last year in which one panel debated whether EBITDA had become a joke because "normalizing" pro forma adjustments and capex estimates were viewed as being out of control. In effect, some or maybe many private credit lenders are using spreadsheets to construct a bridge for credit committees to approve the loan. Let us hope the same is not true among commercial banks.

One final observation from Buffett's letter relates to irony, whether intentional on his part or my interpretation. Buffett commented that he and Munger sleep well because of their aversion to leverage, though had they employed more leverage over the years Berkshire's returns would have been better. The first page of Berkshire's letter compares the increase in Berkshire's book value and market value per share to the S&P 500 with reinvested dividends from 1965 to 2017. The comparative compound annual growth rates are tremendous at 19.1% (book value of equity per share) and 20.9% (market value per share) compared 9.9% for the S&P 500, and the differences are staggering on a cumulative basis after 50+ years of compounding.

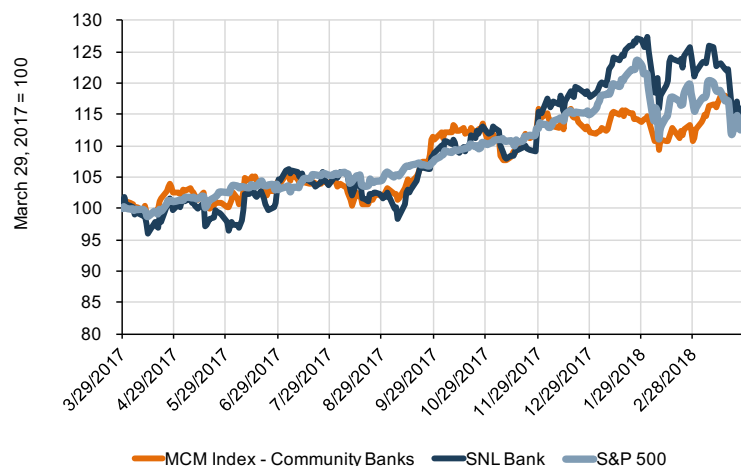


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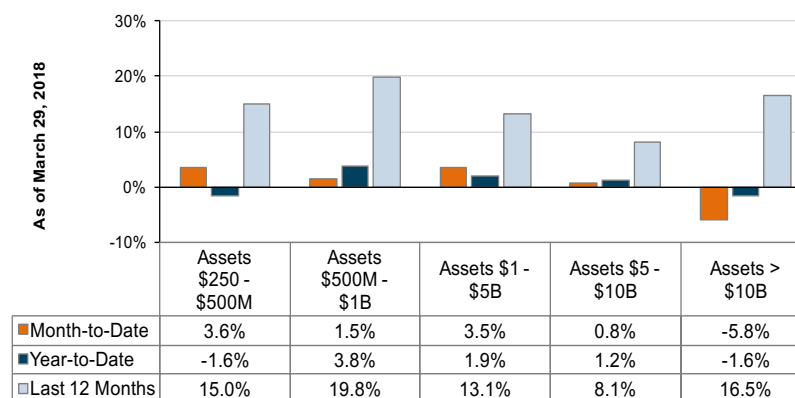
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Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



Median Valuation Multiples

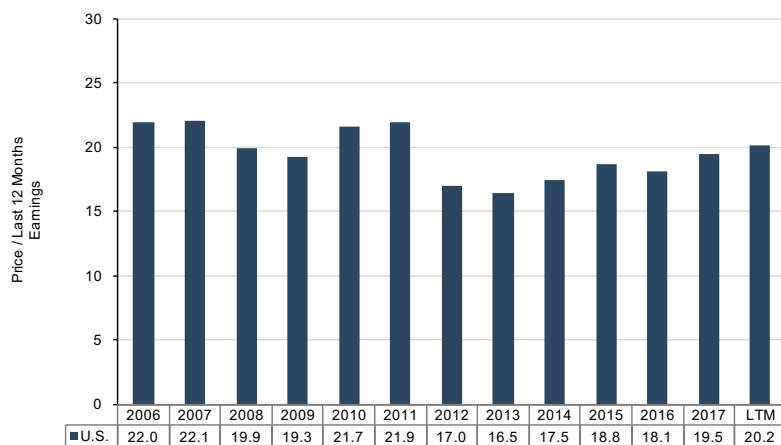
Median Total Return as of March 29, 2018

Median Valuation Multiples as of March 29, 2018

Indices	Median Total Return as of March 29, 2018			Median Valuation Multiples as of March 29, 2018					
	Month-to-Date	Year-to-Date	Last 12 Months	Price / LTM EPS	Price / 2018 (E) EPS	Price / 2019 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	5.7%	4.0%	16.7%	27.7x	14.9x	13.1x	146%	167%	1.8%
Midwest Index	3.3%	2.4%	15.4%	19.4x	13.9x	12.5x	152%	180%	2.0%
Northeast Index	4.1%	3.5%	16.5%	20.3x	13.5x	12.2x	150%	166%	2.1%
Southeast Index	3.4%	0.8%	9.0%	22.9x	15.3x	13.0x	146%	161%	1.4%
West Index	4.3%	3.7%	18.9%	20.8x	14.7x	13.6x	154%	177%	1.4%
Community Bank Index	4.2%	2.9%	15.5%	21.4x	14.5x	12.6x	149%	166%	1.8%
SNL Bank Index	-5.3%	-1.4%	16.1%						

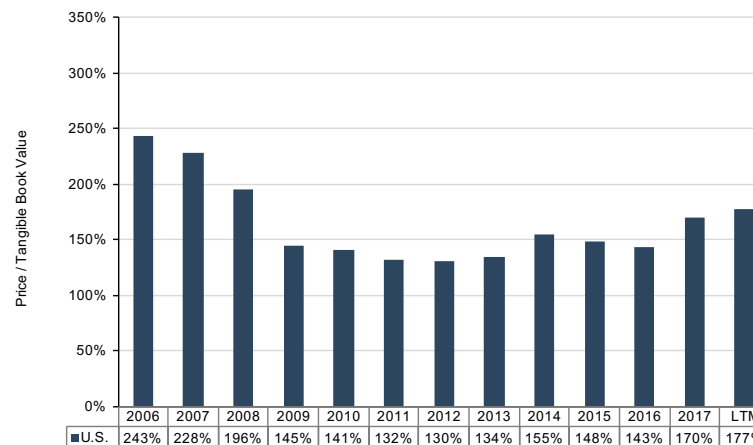
Median Price/Earnings Multiples

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



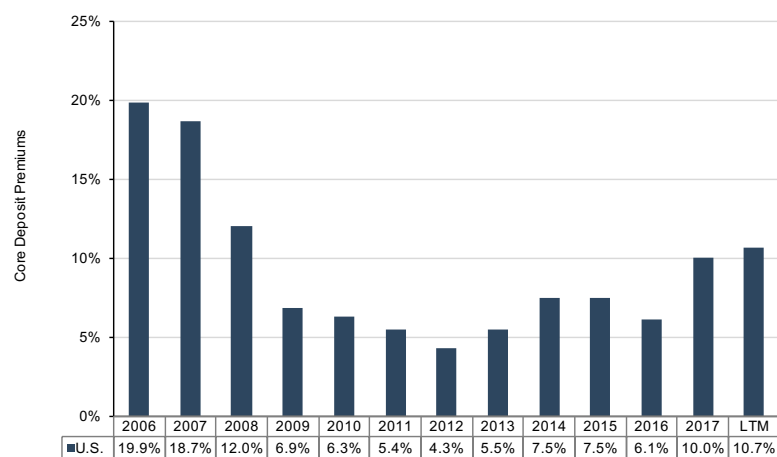
Median Price/Tangible Book Value Multiples

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%, 12 months ended March 2018

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	21.7x	181%	12.3%	17	124.6	650,787	9.6%
Midwest	18.4x	185%	10.6%	58	62.8	219,126	9.5%
Northeast	20.8x	158%	8.6%	8	52.4	422,000	6.3%
Southeast	18.0x	162%	9.5%	31	41.8	196,778	8.8%
West	23.8x	194%	11.7%	29	59.1	336,416	8.6%
National Community Banks	20.2x	177%	10.7%	143	59.9	305,609	9.0%

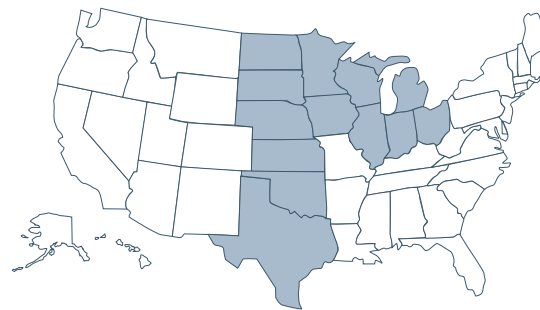
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

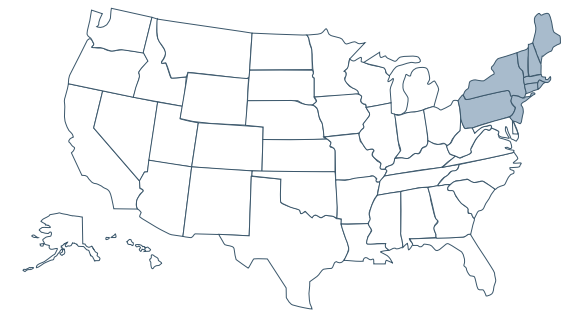
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



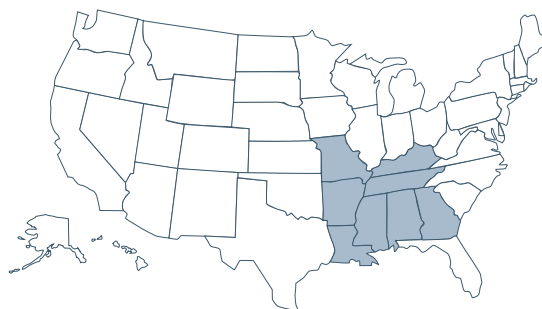
Atlantic Coast



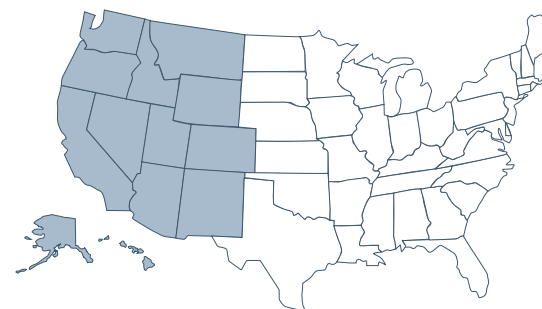
Midwest



Northeast



Southeast



West

Mercer Capital

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

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For more information about Mercer Capital, visit www.mercercapital.com.

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