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MERCER CAPITAL

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Focus On

Financial Institutions

PLUS Buy-Sell Agreements for Investment Management Firms

About
Mercer Capital

Mercer Capital is one of the largest independent business valuation and financial advisory firms in the nation serving both private and public companies, financial institutions, and high net-worth families. We offer a broad range of services including gift and estate tax valuation, corporate valuation, financial reporting valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting.

Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation in connection with engagements involving their clients.

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Community Bank Stress Testing

by Jay D. Wilson, Jr. CFA, ASA, CBA

While community banks may be insulated from certain more onerous stress testing and capital expectations placed upon larger financial institutions, recent regulatory guidance suggests that community banks should be developing and implementing some form of stress testing and/or scenario analyses. The OCC's supervisory guidance in October 2012 stated "community banks, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial conditions."[1] Further, the OCC's guidance considers "some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis to be a key part of sound risk management for community banks."[2] A stress test can be defined as "the evaluation of a bank's financial position under a severe but plausible scenario to assist in decision making with the bank."[3]

The hallmark of community banking has historically been the diversity across institutions and the guidance from the OCC suggests that community banks should keep this in mind when adopting appropriate stress testing methods by taking into account each bank's attributes, including the unique business strategy, size, products, sophistication, and overall risk profile. While not prescriptive in regards to the particular stress testing methods, the guidance suggests a wide range of effective methods depending on the Bank's complexity and portfolio risk. However, the guidance does note that stress testing can be applied at various levels of the organization including:

» **Transaction Level Stress Testing.** This method is a "bottom up" analysis that looks at key loan relationships individually, assesses the potential impact of adverse economic conditions on those borrowers, and estimates loan losses for each loan.

» **Portfolio Level Stress Testing.** This method involves the determination of the potential financial impact on earnings and capital following the identification of key portfolio concentration issues and assessment of the impact of adverse events or economic conditions on credit quality. This method can be applied either "bottom up," by assessing the results of individual transaction level stress tests and then aggregating the results, or "top down," by estimating stress loss rates under different adverse scenarios on pools of loans with common characteristics.

» **Enterprise-Wide Level Stress Testing.** This method attempts to take risk management out of the silo and consider the enterprise-wide impact of a stress scenario by analyzing "multiple types of risk and their interrelated effects on the overall financial impact."[4] The risks might include credit risk, counter-party credit risk, interest rate risk, and liquidity risk. In its simplest form, enterprise-wide stress testing can entail aggregating the transaction and/or portfolio level stress testing results to consider related impacts across the firm from the stressed scenario previously considered.

Further, stress tests can be applied in "reverse" whereby a specific adverse outcome is assumed that is sufficient to breach the bank's capital ratios (often referred to as a "break the bank" scenario). Management then considers what types of events could lead to such outcomes. Once identified, management can then consider how likely those conditions are and what contingency plans or additional steps should be made to mitigate this risk.

Consider the timeline below as guidance for constructing your stress testing plan.

Stress Testing Timeline

Q1

Discuss internally who at the bank should be on your stress testing team

Identify what (if any) external support/service providers should be part of the team and begin discussions with them as appropriate

Q2

Implement/design the stress testing framework/process at your institution

Perform the stress test and provide quantitative and qualitative support for the results

Q3

Complete the stress testing process and share the results with your Board/senior management

Determine additional areas/tests for consideration in future stress tests

Q4

Prepare for the Next Year's Stress Testing Process –
What worked? What didn't? What can be improved?

Compare results of 2016 Stress Test projected performance versus actual

Identify ways to further implement stress testing into your strategic planning/value creation process

Regardless of the stress testing method, determining the appropriate stress event to consider is an important element of the process. Little guidance was provided although the OCC's guidance did note that the scenarios should include a base case and a more adverse scenario based on macro and local economic data. Examples of adverse economic scenarios that might be considered include a severe recession, downturn in the local economy, loss of a major client, or economic weakness across a particular industry for which the bank has a concentration issue.

The simplest method described in the OCC guidance as a starting point for stress testing was the "top-down" portfolio level stress test. The "Hypothetical Stress Testing Example" that follows provides an illustrative example of a portfolio level stress test based largely on the guidance and the example provided from the OCC.

What Should We Do with the Stress Test Results?

The answer to this question will likely depend on the bank's specific situation. For example, let's assume that your bank is relatively strong in terms of capital, asset quality, and recent earnings performance and has taken a proactive approach to stress testing. A well-reasoned and documented stress test could serve to provide regulators, directors, and management with the knowledge to consider the bank's capital levels more than adequate and develop and approve the deployment of that excess capital through a shareholder buyback plan, elevated dividend, capital raise, merger, or strategic acquisition. Alternatively, let's consider the situation of a distressed bank, which is in a relatively weaker position and facing heightened regulatory scrutiny in the form of elevated capital requirements. In this case, the stress test may be more reactive as regulators and directors are requesting a more robust stress test be performed. In this case, the results may provide key insight that leads to developing an action plan around filling the capital shortfall (if one is determined) or demonstrating to regulators and directors that the distressed bank's existing capital is adequate. The results of the stress test should enhance the bank's decision-making process and be incorporated into other areas of the bank's management of risk, asset/liability strategies, capital and strategic planning.

How Mercer Capital Can Help

Having successfully completed thousands of community bank engagements over the last 30 years, Mercer Capital has the experience to solve complex financial issues impacting community banks. Mercer Capital can help scale and improve your bank's stress testing by assisting your bank in a variety of ways, ranging from providing advice and support for assumptions within your Bank's pre-existing stress test to developing a unique, custom stress test that incorporates your bank's desired level of complexity and adequately captures the unique risks facing your bank. Regardless of the approach, the desired outcome is a stress test that can be utilized by managers, directors, and regulators to monitor capital adequacy, manage risk, enhance the bank's performance, and improve strategic decisions. Feel free to call Mercer Capital to discuss your bank's unique situation in confidence.

Jay Wilson, Jr.

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Endnotes

[1] OCC 2012-33 "**Supervisory Guidance**" on Community Bank Stress Testing dated October 18, 2012.

[2] Ibid.

[3] "Stress Testing for Community Banks" presentation by Robert C. Aaron, Arnold & Porter LLP, November 11, 2011.

[4] OCC 2012-33 "**Supervisory Guidance**" on Community Bank Stress Testing dated October 18, 2012.

An All-Terrain Clause for Your RIA's Buy-Sell Agreement

by Matthew R. Crow, ASA, CFA

Clients writing new buy-sell agreements or re-writing existing ones frequently ask us how often they should have their RIA valued. Like most things in life, it depends. We usually recommend having a firm valued annually, and most of our clients usually do just that. "Usually," though, is subject to many specific considerations.

How many shareholders are there in the RIA? The more owners you have, the more transactions will occur and the more useful a semi-annual or quarterly valuation might be. Small firms with only a couple of owners typically don't need to know their value on an annual basis, but checking in on some scheduled basis – such as every two or three years – is helpful to keep track of firm performance, update any life insurance coverage, and to plan for succession issues or sale of the firm.

Is your firm growing rapidly? If so, an annual valuation might become stale very quickly. Mature firms probably only need to look at their valuation metrics once per year to see how their performance and outlook compares with the greater market for investment management firms.

Even annual valuations can be inadequate, however, when an RIA experiences big increases or decreases in assets under management. Since we have been operating

Figure 1

	At 12/31	At 9/30
AUM	$2,000,000,000	$1,600,000,000
Effective Fees	0.60%	0.60%
Run-rate Revenue	$12,000,000	$9,600,000
Operating Costs (Excl.Depr./Amort.)	7,200,000	7,200,000
EBITDA	$4,800,000	$2,400,000
Multiple	9.0x	9.0x
Enterprise Value	$43,200,000	$21,600,000
EBITDA Margin	*40%*	*25%*

WHITEPAPER

Buy-Sell Agreements for Investment Management Firms

An Ounce of Prevention Is Worth a Pound of Cure

If you are an owner of an investment management firm and have not reviewed your buy-sell agreement recently, you're not alone.

Buy-sell agreements are frequently the most forgotten corporate document in the file. No one thinks about buy-sell agreements until a triggering event, and then it becomes the only thing they think about. Partners are often surprised by the language in the contract they signed many years before, and too often a serious dispute breaks out between partners over what the words in the agreement mean, or were intended to mean. The purpose of this whitepaper is to equip ownership to understand the consequences of their buy-sell agreements before a controversy arises, and to make informed decisions about the drafting or re-drafting of the agreement that promote the financial health and sustainability of their firm.

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in a low volatility market (at least for U.S. equities) for some time, it's easy to forget that normal, but nonetheless major, market swings can have a material impact on profitability and valuation. In the case of a market swoon, even a mature RIA with healthy margins can lose ground rapidly, and a valuation that looked reasonable six months earlier may no longer be practical. Consider an equity manager with $2 billion of AUM, realized fees of 60 basis points, and a 40% EBITDA margin. If the regular annual valuation is prepared at an effective EBITDA multiple of 9x, then enterprise value would come in at around $43 million.

One might expect that a valuation such as that would satisfy the needs of an investment management firm over the course of a year, until the time came for the next update. Markets are fickle, though. Imagine the same RIA endures a significant market downturn late in the summer, and then an event happens which triggers the buy-sell. AUM drops 20% versus the start of the year, nothing changes in the expense base, and the valuation multiple is steady. Because of the inherent operating leverage in the asset management business, the profit margin drops from 40% to 25% on 20% lower revenue, and because of that compounding effect value declines by half (Figure 1 on page 7).

This example has more simplifying assumptions than not, and most firm valuations would not move so dramatically just because of a 20% downturn in AUM. That said, market events and client whims can have an outsized impact on RIA profits and, consequently, valuation, such that an annual valuation may not hold up over the course of a year.

So what's a firm to do? One option, of course, is to accept the vagaries of the market – any unusual events during the course of the year may be just as temporary as conditions at the annual valuation date. One of the functions of the buy-sell agreement is to get the parties to agree to what they are willing to live with, and what they are willing to live without. Many firms do just that.

This brings me to the subject of the photo above. European rally car races have always fascinated me, although I've never been brave enough to actually attend one. During the 1980s Audi ruled the rally scene with the Ur-quattro. The Ur-quattro was a hatchback that Audi developed after the racing rules were changed in the late 1970s to allow four-wheel drive. The Audi could handle anything, and to underscore that point the manufacturer used both Italian ("quattro" for four wheel drive) and German ("Ur" for primordial or original) to name it. Regardless of snow, mud, gravel, flat curves or deep hills, the

Ur-quattro couldn't be beat. Audi's rally reputation was such that they started to offer the quattro system in all of their passenger cars, and all-wheel drive has become commonplace today – from Subaru to Lamborghini.

A client of ours that is drafting a new buy-sell agreement recently brought us an idea which we think offers a similar level of preparation for any circumstance. In their agreement, they've added a provision which would call for an interim update to their otherwise annual valuation if 1) the prospect of a transaction arises and 2) AUM is more than 10% higher or lower than at the time of the previous valuation. The annual valuation is important to set a pattern of expectations for parties to the buy-sell of how they'll be treated in a transaction, and most of the time will suffice when a transaction occurs. Adding the update provision is a simple way to prepare for the possibility of substantial changes in the financial performance of the RIA. Even if they never use the provision, having it offers peace of mind for parties to the agreement that they'll be treated fairly if the company's performance changes radically over the course of the year.

In the decades since the Ur-quattro was introduced, Audi has sold cars with quattro to millions of people whose morning commute is nothing like a rally race. Most people buy all-wheel drive cars for that "just-in-case" moment that will make the added expense worth it. Like all-wheel drive, you may never need an event-based update provision in your buy-sell agreement. It's nice to know, though, that your buy-sell is all-terrain ready, no matter how rough the ride gets.

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RIA VALUATION INSIGHTS BLOG

What's Stopping Banks from Getting into Wealth Management and How to Overcome It

Much like Porsche discovered fifty years ago, many banks are responding to regulatory changes by opting for a hybrid model that pairs trust and wealth management operations with traditional banking. The advantages of banks developing their investment management operations are pretty easy to see: it produces a more stable and diverse revenue stream, it provides more touch points for customer relationships, and it can substantially improve a bank's return on equity.

Of course, opportunity is a two way street, and banks looking to venture into investment management, especially by acquisition, typically encounter a couple of major obstacles: balance sheet dilution and culture clash. Both of these challenges arise from the main difference between traditional banking and asset management. Whereas banking is asset heavy and personnel light, asset management requires not much of a balance sheet, but plenty of expensive staffing. It's a significant difference that can only be managed head on.

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RIA Valuation Insights Blog

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Are Market Conditions Driving More FinTech Partnerships and M&A?

by Jay D. Wilson, Jr. CFA, ASA, CBA

It has been an interesting few weeks for FinTech. Coming off recent years where both public and private FinTech markets were trending positively, the tail end of 2015 and the start to 2016 have been unique as performance has started to diverge. The performance of public FinTech companies has been relatively flat through the first quarter of 2016 (see **Public Market Indicators on page 3 of the First Quarter 2016 FinTech newsletter**), and signs of weakness have been observed in alternative/marketplace lending, as well as some of the more high profile FinTech companies that have gone public recently. The median return of the FinTech companies that IPO'd in 2015 was a decline of 16% since IPO (through 3/31/16). For perspective, Square, OnDeck, and Lending Club are each down significantly in 2016 (down 28%, 53%, and 64%, respectively from 1/1/2016 to 5/18/2016). Also, the broader technology **IPO slowdown** in late 2015 has continued into 2016 and no FinTech IPOs have occurred thus far in 2016.

However, optimism for FinTech still abounds, and the private markets continue to reflect that with robust investor interest and funding levels. In 2016, 334 FinTech companies raised a total of $6.7 billion in funding in the first quarter (compared to 171 companies raising $3.2 billion in the first quarter of 2015), and Ant Financial (Alibaba's finance affiliate) completed an eye-popping **$4.5 billion capital raise** in April.

While the factors driving this divergence in performance between public and private markets are debatable, the divergence is unlikely to continue indefinitely. A less favorable public market and less attractive IPO market creates a more challenging exit environment for those "unicorns" and other private companies. Headwinds for the private markets could develop from more technology companies seeking IPOs and less cash flow from successful exits to fund the next round of private companies.

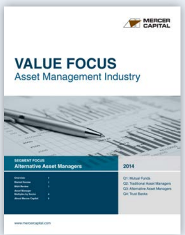
Consequently, other strategic and exit options beyond an IPO should be considered such as partnering with, acquiring, or selling to traditional incumbents (banks, insurers, and money managers). The potential for M&A and partnerships is even more likely in FinTech, particularly here in the US, due to the unique dynamics of the financial services industry including the resiliency of traditional incumbents and the regulatory

MERCER CAPITAL

Industry Newsletters

Mercer Capital's industry publications are featured below. Having built a substantial client base in various industries, we have formalized our research efforts to provide a regular, detailed overview of pertinent issues and relevant current events in each covered industry. These industry newsletters also offer a regular perspective on valuation issues pertinent to various industry groups and sectors.

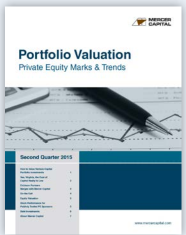
Financial Institutions



Asset Management

FinTech

Banks

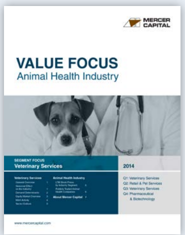


Portfolio Valuation: Private Equity Marks & Trends

Insurance

Operating Companies

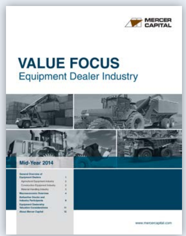
Agribusiness



Animal Health

Convenience Stores

Energy



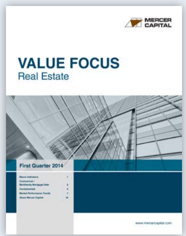
Equipment Dealers

Healthcare Facilities

Laboratory Services

Medical Device

Medical Technology



Real Estate

landscape. For example, consider a few of the inherent advantages that traditional banks have over non-bank FinTech lenders:

- **Better Access to Funding.** Prior to 2016, the interest rate/funding environment was very favorable and limited the funding advantage that financial institutions have historically had relative to less regulated non-financial companies. However, the winds appear to be shifting somewhat as rates rose in late 2015, and funding availability for certain FinTech companies has tightened. For example, alternative lenders are dependent, to some extent, on institutional investors to provide funding and/or purchase loans generated on their platform, and a number have cited some decline in institutional investor interest.

- **Banks Still Have Strong Customer Relationships.** While certain niches of FinTech are enhanced by demand from consumers and businesses for new and innovative products and technology, presently, the traditional institutions still maintain the majority of customer relationships. As an example, the 2015 Small Business Credit Survey from the Federal Reserve noted that traditional banks are still the primary source for small business loans with only 20% of employer firms applying at an online lender. The satisfaction rate for online lenders was low (15% compared to 75% for small banks and 51% for large banks). The main reasons reported for dissatisfaction with online lenders was high interest rates and unfavorable repayment terms.

- **Regulatory Scrutiny and Uncertainty related to FinTech.** Both the Federal Reserve and the OCC have made recent announcements and comments about ways to regulate financial technology. In the online lending area specifically, regulatory scrutiny appears to be on the rise with the **Treasury releasing a white paper** discussing the potential oversight of marketplace lending and the **CFPB signaling the potential to increase scrutiny** in the area. The lack of a banking charter has also been cited as a potential weakness and has exposed certain alternative lenders to lawsuits in different states.

At the same time that FinTech companies are increasingly considering, or being forced to consider, strategic options beyond an IPO, traditional incumbents are starting to realize that they must develop a strategic plan that considers how to evolve, survive, and thrive as technology and financial services increasingly intersect. For example, a number of banks are looking to engage in discussions with FinTech companies. A **recent survey** from *Bank Director* noted that boards are focusing more on technology with 75% of respondents wanting to understand how technology can make the bank more efficient and 72% wanting to know how technology can improve the customer experience.

FinTech presents traditional financial institutions with a number of strategic options, but the most notable options include focusing on one or some combination of the following: building their own technology solutions, acquiring a FinTech company, or partnering with a FinTech company. One area where we have started to see more FinTech partnerships and M&A already start to play out is wealth management and the industry's response to robo-advisory. Robo-advisers were noted by the CFA Institute as the FinTech innovation most likely to have the **greatest impact on the financial services industry** in the short-term (one year) and medium-term (five years). Consider the following announcements in this area over the last few years; on the acquisition front, **BlackRock's acquisition of FutureAdvisor** in August 2015, **Invesco's acquisition of Jemstep**, and **Ally Financial's acquisition of TradeKing** in April 2016. On the partnering front, Motif and **J.P. Morgan announced a partnership** in October

2015, **UBS announced a major partnership with SigFig** in May 2016, and **Betterment and Fidelity** announced a partnership in October 2014. Community banks will also have an opportunity to enter the robo-advisory fray as Personal Capital announced a partnership with Alliance Partners that will allow over 200 community banks offer digital wealth advisory tools.

While we do not yet know which strategy will be most successful, discussions of whether to build, partner, or buy will increasingly be on the agenda of boards and executives of both financial institutions and FinTech companies for the next few years. The right combination of technology and financial services through either partnerships or M&A has significant potential to create value for both FinTech companies and traditional financial institutions. Any partnership or merger should be examined thoroughly to ensure that the right metrics are utilized to examine value creation and returns on investment.

Transactions and significant partnerships also have significant risks and potential issues will need to be discussed. For example, significant issues with M&A and potential partnerships can include: execution and cultural issues, shareholder dilution, whether the partnership is significant enough to create shareholder value and provide a return on investment, contingent liabilities, and regulatory pressures/issues. These issues must be balanced with the potential rewards, such as customer satisfaction/retention, shareholder value creation, and return on investment.

If you are interested in considering strategic options and potential partnerships for your financial institution or FinTech company, contact Mercer Capital. Financial institutions represent our largest industry focus for over thirty years. We have a deep bench with experience with both FinTech companies and traditional financial institutions (banks, asset managers, and insurance companies). This uniquely suits us to assist both as they explore partnerships and potential transactions.

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