Community Bank Mergers
Creating the Potential for Shared Upside
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In this whitepaper we review financial issues arising when community banks merge or sell to a larger, public institution. It is not intended to answer every question and, in some instances, our intention is to raise questions for directors and managers to evaluate. In a series of follow-up papers and webinars we will address specific topics that merit further scrutiny.

The bank M&A market has defied predictions since 2010 of a broad-based consolidation wave, but M&A activity nonetheless remains steady. A confluence of factors, which could be derailed by a slump in the economy and/or capital markets, ensure in our view that significant consolidation will occur even though the pace is uncertain. In time we expect upwards of one-half of institutions with less than $1 billion of assets to merge. As of September 30, 2012, there were 7,181 commercial banks and thrifts according to the FDIC, compared to 8,534 at year-end 2007 when the financial crisis began unfolding. There were about 18,000 institutions when the June 1985 Supreme Court decision Northeast Bancorp, Inc. v. Board of Governors of Federal Reserve upheld regional interstate banking compacts.

Would-be buyers among public institutions seem to be coalescing around 2014 as the year that activity will become more pronounced as regulators write more rules to codify Dodd-Frank. Also, valuation challenges created by credit marks presumably will be less of an issue to the extent real estate values firm a bit and sellers have another year to mark credits themselves. Still, one catalyst has to be overcome to see a pick-up in activity: would-be sellers’ resistance to the reality of today’s pricing, which is a function of lower profitability relative to the pre-crisis era. While circumstances can change, much of the industry may see ROE ease further in coming years in spite of another round of cost cutting initiatives. For buyers, the most important controllable variable that determines the return on investment is the price paid.
Unlike the frantic activity of the 1990s and to a lesser extent the years leading up to the financial crisis, we believe bank M&A will be dominated by the merger of privately held small banks with each other rather than large-scale, roll-up activity by regional banks. That is not to say regional banks will not be active, but most have a minimum asset threshold of $500 million to $1 billion of assets that precludes acquisition of broad swaths of small institutions. Only 559 of the 7,181 FDIC-insured institutions as of September 30, 2012 had assets greater than $1 billion.

This trend is reflected in M&A metrics for 2012 in which there were 239 non-assisted acquisitions of banks and thrifts, which was the highest number since 2007 when 323 transactions occurred; however, aggregate acquired assets of $142 billion was the second lowest total in the past ten years, eclipsed only by the $95 billion of assets acquired in non-assisted deals during 2009. The aggregate deal value was modest too at $14 billion in 2012 as shown in Figure 1.

**Figure 1: Non-Assisted Bank & Thrift Acquisitions 1990-2012**

As for large bank deals, public policy now explicitly discourages the largest banks from getting bigger—at least until the next crisis. Even Capital One Financial (COF) had trouble getting regulatory approval for its February 2012 acquisition of ING Direct, which had $77 billion of internet-based deposits compared to $128 billion for Capital One. The combination of the two was hardly the next JP Morgan Chase (JPM).

Many bank M&A attorneys regularly remark that the current regulatory environment is the toughest they have ever seen. There also appear to be too few banks rated “2” or better to have a robust M&A market with plenty of
buyers, though perhaps the exam cycle over the next 12 to 18 months will entail a notable migration of “3” rated banks to “2” with improving asset quality and credit metrics.

Catalysts for Community Bank M&A Activity

Buying and selling will not be the appropriate action for many community banks, but we think boards should ask the basic question, “What if we do nothing?” Even if the bank in which an individual has an interest—as a manager, director, or shareholder—“does nothing,” competitors may not adopt the same philosophy.

We do not see a return to the high deal prices that drove M&A activity in the late 1990s and mid-2000s being a catalyst in the current wave of consolidation. Rather, we think six forces are going to push returns for many banks to unacceptably low levels, even though minimal credit costs in the next few years may mask the erosion in core profitability, thereby creating conditions ripe for industry consolidation. How long such conditions may persist is unknown. Worse, in our view, the lack of a public market for privately held banks means there is no price signal to indicate that returns are unacceptable. In some instances, boards and significant shareholders may fill the market’s role of highlighting the issue, but our experience is that this is usually not the case. Many boards are not fully informed about industry and market conditions, while management may not be inclined to highlight the issue.

The catalysts that increasingly will weigh on returns are:

1. Net interest margin (NIM) pressure from the Fed’s policies of keeping short rates anchored near zero and bond buying to suppress intermediate- and long-term rates;

2. Tepid loan demand for a variety of reasons, though some areas of the country such as the existing and recently emerged energy belts are faring better;

3. Higher compliance costs;

4. Reduced profitability of branch networks due to less value attributable to core deposits in the current rate environment and technological transformation as transactions migrate to electronic venues;

5. Declining mortgage refinancing volumes and (most likely) gain-on-sale margins; and

6. Requirements that institutions hold more equity capital, while reworked risk-weighted asset formulas under Basel III penalize residential mortgages, home equity and CRE—assets that community banks are heavily exposed to.

Overlaid upon economic factors are issues involving CEO succession and shareholder need for liquidity that always have been a consideration in bank M&A.

The Fed’s interest rate policies are of particular note. The financial press tends to focus on the shape of the yield curve as a key determinant of NIMs. While that is largely true for Wall Street and wholesale-oriented banks, community and regional bank NIMs reflect a combination of bank-specific factors, including the types of loans; loan spreads over LIBOR; the mix of core deposits; and the amount, type and duration of securities and wholesale funding.

As of year-end 2012, the spreads of 5-year Treasuries to the Federal funds rate and of 10-year Treasuries to 2-year Treasuries were 0.55% and 1.48%, respectively, compared to 20-year averages of 1.05% and 1.15%. One might
infer that the direction of NIMs should not be a major factor in pressuring profitability; however, we believe the NIM “issue” will become increasingly severe over the next few years, absent a change in Fed policy. The industry’s fundamental problem is that the cost of funds is near a floor, but yields continue to ease. Bond cash flows are being reinvested at 1-2% at most institutions vs. portfolio yields that in many instances that are closer to 3% than 2%. Though it is not clear from Call Report data, we suspect reinvestments are occurring at longer durations, too.

Furthermore, super-regional banks have pushed C&I loan yields below 4%, while income-CRE loan terms increasingly entail terms of up to ten years and rates in the vicinity of 4%. These rates compare to yields reported in the Uniform Bank Performance Report for peer group #2 (assets of $1-3 billion) of 5.48% and 5.51%, respectively, for C&I and commercial real estate loans for the year-to-date period ended September 30, 2012. Community banks can choose not to follow market rates set by larger players—and maybe multi-year fixed-rate commitments—but the cost will be a loss of loans at a time when balance sheets are liquid and bond investments are unappealing.

Figure 2: Large Banks Eventually Will Pressure Small Bank Loan Yields

<table>
<thead>
<tr>
<th></th>
<th>Assets $300M - $1B</th>
<th>Assets &gt; $10B</th>
<th>Commerce Bank ($20B)</th>
<th>KeyBank ($82B)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>YTD</td>
<td>LYTD</td>
<td>∆</td>
<td>YTD</td>
</tr>
<tr>
<td>C&amp;I Yield</td>
<td>5.77%</td>
<td>5.94%</td>
<td>-0.17%</td>
<td>4.68%</td>
</tr>
<tr>
<td>CRE Yield</td>
<td>5.63%</td>
<td>5.77%</td>
<td>-0.14%</td>
<td>4.98%</td>
</tr>
<tr>
<td>1-4 Secured</td>
<td>5.58%</td>
<td>5.76%</td>
<td>-0.18%</td>
<td>4.72%</td>
</tr>
<tr>
<td>Total Loans</td>
<td>5.67%</td>
<td>5.94%</td>
<td>-0.27%</td>
<td>5.09%</td>
</tr>
<tr>
<td>Total Securities (TE)</td>
<td>2.79%</td>
<td>3.28%</td>
<td>-0.49%</td>
<td>2.63%</td>
</tr>
<tr>
<td>COF - IB Deposits</td>
<td>0.79%</td>
<td>1.07%</td>
<td>-0.28%</td>
<td>0.50%</td>
</tr>
<tr>
<td>Net Interest Margin</td>
<td>3.84%</td>
<td>3.87%</td>
<td>-0.03%</td>
<td>3.55%</td>
</tr>
</tbody>
</table>

Source: FDIC; Commerce Bank – Kansas City (2011 Treasury & Agency yield impacted by TIPS income); KeyBank – Cleveland

Against a backdrop of yield-induced NIM pressure is an uncompetitive cost structure for many community banks. According to the FDIC, the efficiency ratio in the third quarter of 2012 for banks with less than $100 million of assets was 76%, while banks with $100 million to $1 billion of assets reported a 70% ratio. The NIMs for these two groups approximated 3.80% compared to 3.33% for banks with assets greater than $10 billion. If the NIM for the smaller banks declines by 20bp to about 3.60%, then the efficiency ratios for the less than $100 million and $100 million to $1 billion asset groups would increase to 78% and 72%, assuming constant expenses. The median efficiency ratio for banks with more than $10 billion of assets was 59%. And, while the largest banks face additional NIM pressure, we suspect it will be less than what small banks face because loan yields for large banks have less room to fall.

For smaller banks, the cost disadvantage is not a function of excessive branches or pay; rather, it reflects the much lower operating leverage that comes with scale. Also, larger banks typically generate operating earnings from wealth management, mortgage banking, and for some, insurance agencies on a scale that small banks do
not come close to replicating. Absent actions by bank management, we think the cost structure and therefore the ROE gap will widen between small and large banks.

**Figure 3: Small Banks Cost Structure (Efficiency Ratio) is Uncompetitive**

![Diagram showing cost structure efficiency ratio for different asset size categories over years 1998, 2005, and 2012.](image)

*Source: FDIC*

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**Returns on Equity: Cause & Effect**

The preceding litany of factors challenging the profitability of banks in general and community banks in particular is crystallized in the return on equity. As Figure 4 illustrates, while ROEs have improved as credit costs have waned from improving asset quality, ROEs remain well below the averages reported through the 1990s and the first half of the 2000s. Further, there are no evident drivers of community banking profitability that would cause ROEs to revert to the historical level.
What is an acceptable return? It depends upon whom you ask. An academic answer probably would describe an institution that produces returns on invested capital equal to or above its cost of capital, which is estimated using some variation of the Capital Asset Pricing Model (CAPM). Although results will vary, most community banks will have a cost of capital that is in the low to mid-teens. If an institution is seeking new capital, chances are an informed institutional investor is going to heavily discount a potential investment, relative to book value, where the return on capital does not exceed—much less approach—the cost of capital. Stated differently, there may be a large gap in the bid-ask spread between the bank and investor. By discounting the potential investment, the investor assures that his or her return reaches the cost of capital deployed.
Another view of what constitutes an acceptable return can be triangulated from relative returns, similar to how fixed income investors evaluate a bond relative to other bonds. Returns on common equity can be compared to returns on other capital instruments, moving up the capital structure (e.g., common vs. preferred vs. subordinated debt, etc.) and then transitioning to government bonds. Spread relationships are intuitive, though they do not necessarily answer the question of how much return is appropriate for the investment. Also, each institution’s credit risk, interest rate management, and operational strategies create unique risks that relative returns may not fully explain.

Nevertheless, relative returns are a starting point for boards when thinking about their institutions. We calculated the spread between quarterly ROE as reported by the FDIC and that quarter’s average 10-year U.S. Treasury yield. The results are summarized in Figure 6, grouped by asset size as segregated by the FDIC.

The analysis indicates a base ROE on the order of 5-6% over 10-year Treasury yields for banks with $100 million to $10 billion of assets, measured over the entire period from 1984 to 2012. The data is based upon banks rather than
holding companies, so holding companies may produce a slightly better spread than their operating subsidiaries given the use of debt and preferred equity to leverage the parent’s common equity. Nevertheless, the historical spread data implies management and boards of institutions in the $100 million to $10 billion asset groups should be thinking about *minimum* ROEs in the 7-8% range given the 10-year yield that is below 2%.

A threshold ROE of 7-8% may not pass the “smell test” given average spreads of nearly 8% during 1990-1999 and 9% during 2000-2007 for banks with $1-10 billion of assets; however, the 5-6% spread observed over the 1984-2012 period encompasses two major credit crises and one minor credit cycle in 2001. In any event, we think many community banks are not earning their cost of capital. By not doing so, we do not believe a line is breached that implies a board needs to sell the bank; however, it does imply that if the condition persists shareholders will be earning sub-optimal risk-adjusted returns.

**Valuation Impact of Lower Returns on Equity**

Every industry has a rule of thumb, or a benchmark that allows for comparing pricing through time. For depositories, the common metric is tangible book value (TBV). It is a logical metric because the basic banking model entails leveraging capital to fund loans and securities on which a spread is generated. Further, the public markets today have a bias toward banks with excess capital, though we think this reflects some crediting of such institutions with future earnings that will be generated once the excess capital is used to acquire assets. In effect, high capital ratios and low nonperforming assets (NPAs) can be equated to strategic flexibility.

If TBV multiples are how buyers and, especially, sellers quote bank pricing, then it is important to understand the components of this multiple that impact valuation. Broadly, value can be expressed as the product of profitability, leverage and the earnings multiple (P/E).

\[
\frac{\text{Net Income}}{\text{Assets}} \times \frac{\text{Assets}}{\text{Tangible Equity}} = \frac{\text{Net Income}}{\text{Tangible Equity}}; \text{ or,}
\]

\[
\text{ROA} \times \text{Leverage} = \text{ROE}
\]

and

\[
\frac{\text{Price}}{\text{Net Income}} \times \frac{\text{Net Income}}{\text{Tangible Equity}} = \frac{\text{Price}}{\text{Tangible Equity}}; \text{ or,}
\]

\[
\frac{\text{P/E}}{\text{ROE}} = \frac{\text{P}}{\text{TBV}}
\]

While the board and management of would-be sellers intuitively understand that returns in the industry have declined post-crisis, some may not understand how much returns have compressed and why it matters so much in terms of a “rule-of-thumb” valuation. Ultimately, acquirers are buying assets (and deposits) that will produce earnings that equal or exceed the buyer’s cost of capital. It is easy to see how two banks with similar capitalization will produce differing P/TBV multiples if profitability (ROA) differs materially before considering qualitative factors.

Because bank earnings tend to be highly cyclical based upon the credit cycle, P/Es can be inflated or deflated for a given period based upon credit quality, and earning power may thus provide better perspective based upon
through-the-cycle profitability. Over time, bank P/Es are positively correlated with consistent growth, earnings consistency, franchise attractiveness, and the amount of earnings derived from asset management and other non-capital intensive activities. Also, P/Es are negatively correlated with investor perceptions of the riskiness of lending and the degree of reliance on non-core funding.

P/TBV multiples therefore tend to be derived from the buyer’s valuation process rather than being a starting point for assessment.

Figure 7 presents a hypothetical bank that experienced a contracting loan portfolio, tightening net interest margin, and weaker efficiency ratio between 2006 and 2012. The 2006 performance, with a return on assets of 1.15%, implies a price/tangible book value multiple in the 2.00x range. Weaker returns in 2012, coupled with lower price/earnings multiples attributable to the weaker growth outlook for banks, implies a price/tangible book value multiple only in the 125% range in 2012.

### Figure 7: Pre-Crisis vs. Post Crisis Multiple Math

<table>
<thead>
<tr>
<th>FDIC $100M - $1B Assets</th>
<th>2006</th>
<th>2012</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Securities</td>
<td>$275,000</td>
<td>$325,000</td>
<td>18.2%</td>
</tr>
<tr>
<td>Loans</td>
<td>650,000</td>
<td>600,000</td>
<td>-7.7%</td>
</tr>
<tr>
<td>Earning Assets</td>
<td>925,000</td>
<td>925,000</td>
<td>0.0%</td>
</tr>
<tr>
<td>Total Assets</td>
<td>994,624</td>
<td>994,624</td>
<td>0.0%</td>
</tr>
<tr>
<td>Equity</td>
<td>100,306</td>
<td>97,454</td>
<td>-2.8%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2006 P/TBV Math (ROA and P/E Variables)</th>
</tr>
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<tbody>
<tr>
<td>0.76%</td>
</tr>
<tr>
<td>10.0x</td>
</tr>
<tr>
<td>12.5x</td>
</tr>
<tr>
<td>15.0x</td>
</tr>
<tr>
<td>17.5x</td>
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<tr>
<td>20.0x</td>
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<table>
<thead>
<tr>
<th>2012 P/TBV Math (ROA and P/E Variables)</th>
</tr>
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<tbody>
<tr>
<td>0.50%</td>
</tr>
<tr>
<td>10.0x</td>
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<tr>
<td>12.5x</td>
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<tr>
<td>15.0x</td>
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<tr>
<td>17.5x</td>
</tr>
<tr>
<td>20.0x</td>
</tr>
</tbody>
</table>

| Net Interest Income       | $32,278 | $34,873 | -6.5% |
| Fee Income                | 12,234  | 11,538  | -5.7% |
| Total Revenues            | 49,511  | 46,410  | -6.3% |
| Operating Expenses        | 31,499  | 32,255  | 2.4%  |
| Operating Income          | 18,012  | 14,155  | -21.4%|
| Loan Loss Provision       | 1,705   | 3,157   | 85.1% |
| Pre-Tax Income            | 16,307  | 10,998  | -32.6%|
| Taxes @ 30%               | 4,892   | 3,300   | -32.6%|
| Net Income                | $11,415 | $7,699  | -32.6%|

| NIM                      | 4.03%      | 3.77%      | -0.26% |
| Fees / Assets            | 1.23%      | 1.16%      | -0.07% |
| Efficiency Ratio         | 63.6%      | 69.5%      | 5.88%  |
| Net Charge-Offs          | 0.16%      | 0.57%      | 0.41%  |
| Provision / NCOs         | 164.0%     | 92.3%     | nm     |
| Op Income / Assets       | 1.81%      | 1.42%      | -0.39% |
| ROA                      | 1.15%      | 0.77%      | -0.37% |
| ROE                      | 11.38%     | 7.90%      | -3.48% |

Source: Mercer Capital and the FDIC (for operating metrics for banks with $100 million - $1 billion of assets)
Public Market Perspective

For community bankers, not all is glum. Larger community and regional banks face similar revenue and cost pressure at a time when capital is building. Further, with somewhat better valuations, buyers have stronger acquisition currencies. As a result, most of these institutions eventually will have a reason and capacity to acquire, just as many smaller institutions have a reason to sell.

One question comes to mind: if banks are cheap, then would it not be better to wait to sell? Maybe, but the reality of today’s public and M&A market is that banks are only cheap vs. history based upon P/TBV multiples. That cannot be said for P/E multiples, excluding the largest banks that trade for 10-11x earnings. Further, it is our view that public market investors largely have transitioned back to valuing banks based upon near-term earnings, perceptions of earning power in the current rate environment, and P/E multiples rather than P/TBV multiples now that most institutions have seen credit costs drop.

Community and regional banks presently trade for approximately 14x the latest 12-month (LTM) earnings and about 12x FY13 consensus estimates. Given the high likelihood that estimates are too high across the board, P/Es based upon FY13 estimates probably approximate LTM multiples as earnings growth likely will be flat for the two groups.

Figure 8: Public Market Pricing – P/Es Near Long-Term Average
But Public Market P/TBV Multiples Remain Below Long-Term Average, Especially Small Banks

Source: SNL Financial

It is possible that valuations could further improve, but we think that outcome requires a stronger economy. If one were to focus on widely quoted bank indices, such as the Philadelphia Bank Index (BKX), one would conclude it was a banner year for bank stocks. The BKX rose 28% for the year; however, the BKX, as is the case with most indices, is weighted based upon market capitalization. With a recovery in housing, declining NPAs, and a Fed-induced boom in mortgage banking, “big uglies” had a banner year. Bank of America, which has the second largest market cap among U.S. banks, rose 105% in 2012.

Community and regional bank stocks had a good year, but not a banner year. The SNL Small Cap and Mid Cap U.S. bank indexes rose 12% and 8%, respectively. Assuming share prices remain relatively stable, the potential for these banks to be more active acquirers is better than it was in 2011 when stocks (i.e., acquisition currencies) plummeted during the third quarter following the debt ceiling debacle in D.C. and the seizure in the intra-European bank funding markets. Given this backdrop, we think market conditions are supportive for many community and regional banks to engage in M&A. Institutional investors, who face the prospect of owning positions in companies that are not growing, can be expected to be highly supportive of reasonably priced acquisitions that add to potential growth and earning power and that are not excessively dilutive to capital and tangible book value per share.
M&A Market Perspective

By historical standards, acquisition P/TBV multiples at 117% look low relative to pre-crisis history, as is the case with public market multiples; however, P/E multiples are higher than in the past, which reflects weak earnings. The 2012 median P/E for bank deals (i.e., excluding thrifts) was 28x, which compares to the 2003-2007 average of 25x. Including thrifts, the median 2012 P/E is 34x. If profitability for sellers improves notably over the next few years, then we would expect acquisition P/E multiples to moderate, while P/TBV multiples increase. Given the Fed’s zero interest rate policy and a sluggish economy, that outcome seems unlikely for the time being, although the mix of acquisition targets may change in favor of fewer distressed sellers. Again, we emphasize that the most important variable that buyers (and all investors) control in determining the return on an investment is the entry price. Absent buyer conviction that industry profitability is going to improve there is no reason to “pay up,” other than for trophy institutions.

Figure 9: M&A Multiples - P/E and Price/TBV

Source: SNL Financial
Conclusion

Our intent is not to guide management and directors into thinking that buying or selling is the only way to create value for shareholders; however, we believe many community banks risk destroying value by not partnering with another institution because prospective returns have been impaired by an interest rate and regulatory environment that is beyond the institution's control. Broadly, we would think about the issue in terms of a window with uncertainty as to how long and how wide it will be open. In light of this uncertainty, we believe directors and managers should ask the following questions:

- Has the board made a realistic assessment of the bank's historical performance, measuring performance relative to peers and relative to potential (i.e., what was the propensity to positively perform or underperform vs. expectations over the years)?
- Has a comparable forward-looking assessment beyond a one-year budget been made? How does it compare to the past history and peers, and what does it imply for shareholders?
- What is the trend in branch traffic and transactions?
- What is the outlook for the local and regional economy?
- What is the institution's competitive position and how has it evolved over the past few years?
- Can the institution generate loan growth? The lack of lending in a zero-rate environment can be equated with a lack of revenue growth.
- Has executive management succession been addressed?
- To the extent the board is considering selling (or partnering), what is the time horizon to do so?
- If there is contemplation of selling/merging within a few years, are management and the board prepared for an extension of the timeline to do so if the economy and/or the bank suffer a setback?
- Who are the logical acquirers or partners, and what is their interest level? What is the risk that they will move on to other opportunities or sell?

If the conclusion is to sell or merge, then the next question should be with whom and under what terms? For institutions that have a strong strategic position and a number of potential larger suitors, the process may be straightforward if there is a desire to sell for cash. The acquirer should be the institution that can pay the highest price with certainty of being able to close the transaction.
Case Study #1

Mercer Capital has represented a number of prospective buyers and sellers over the firm's history and the decision of what type of consideration (cash, stock, or some combination) to receive in the transaction is often a tricky one for sellers. About 15 years ago, we represented a southeast-based community bank where the majority shareholder made a decision to sell to diversify the family's assets. There were a number of interested parties, which ranged in size from publicly traded community banks to regional banks with market capitalizations that comfortably exceeded $1 billion. After receiving initial expressions of interest, the buyer list was narrowed to a couple of institutions. Ultimately one institution was clearly interested in paying the most to obtain our client. But, a wrinkle occurred when the dominant shareholder informed us that he wanted cash, not common stock. This was when pooling of interests was the primary means to account for an acquisition, and pooling required that the consideration consist primarily of common stock.

Our response was that asking for 100% cash would require accepting a haircut to the price. Our client did not care. He did not trust bankers generally and the buyer in particular. Ultimately, the buyer agreed to a cash deal, but at a 25% discount to the stated value of a stock swap. It was a good call, and the cash price was near 3x tangible book value. The negotiations occurred in 1998 when banks were trading at a multi-generational high that has not been seen since, including in 2005. Our client could have accepted the buyer's shares based upon a price that was close to 4x tangible book value and then leaked the shares into the market under 144/145 restrictions; he had no such interest. Cash to him was important for estate planning reasons, and it was a value that was not subject to debate. In his mind, he discounted the buyer's NYSE-traded shares.

Unfortunately, most bank boards that elect to sell in the coming years will not have the option of selling for all cash, or even selling predominantly for cash. And, boards can forget about 3x tangible book value—and all but the most desirable, profitable banks in growing MSAs can forget about 2x tangible book value, too.

Although excess capital is building, most buyers of community banks will be larger community and small regional banks, and in most instances, these institutions will not want to see their capital ratios dip too much for a given transaction. Hence, we think in most instances stock will be dominant form of consideration given. Stated transaction multiples may entail just a modest premium to tangible book value, but credit marks can result in significant goodwill being created. Plus, the Federal Reserve's modus operandi, at least for larger institutions, has been for buyers to maintain stout capital immediately after a transaction closes without crediting capital for asset discounts that will be accreted into capital over a relatively short period of time.

The Community Bank Merger Alternative

With all cash transactions becoming more scarce for all but the smallest community banks, due to rising capital expectations, and fewer natural publicly traded acquirers of size targeting smaller community banks, privately held community banks may turn to an alternative, merging with another privately-held institution.

There are many factors to consider in a merger whereby the primary consideration is common shares. Aside from entering a transaction in which both parties are fully informed about the financial position of their respective partner, we believe the number one objective should be “shared upside” rather than “price” and deal multiples.

Generally, such transactions will reflect relative ownerships that approximate relative contributions of capital, core deposits, pre-tax/pre-provision income and the like. (See Figure 10 below.) If one party has an attribute that the other does not (e.g., significant earnings from a higher-earnings multiple business such as trust or lower-multiple business such as mortgage banking), then ownership percentages may differ from a first pass of relative
contributions. Nevertheless, the intent is to create a situation whereby both parties share in the upside from expense saves and possible revenue synergies. Further, certain other less quantifiable enhancements to the franchise can result from a combination such as a more attractive footprint and/or a more diversified loan and deposit mix. We recognize that it is hard for the seller (or junior merger partner) to accept such an approach over “price,” but investors typically have responded well to such deals involving larger, publicly traded entities.

Figure 10: Relative Contribution Summary

<table>
<thead>
<tr>
<th></th>
<th>Junior Bank</th>
<th>Senior Bank</th>
<th>Combined Bank</th>
<th>Shared Synergies</th>
<th>Pro Forma Bank</th>
</tr>
</thead>
<tbody>
<tr>
<td>$</td>
<td>$%</td>
<td>$</td>
<td>$%</td>
<td>$%</td>
<td>$%</td>
</tr>
<tr>
<td>Securities</td>
<td>$300,000</td>
<td>30%</td>
<td>$700,000</td>
<td>70%</td>
<td>$1,000,000</td>
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<tr>
<td>Loans</td>
<td>625,000</td>
<td>24%</td>
<td>2,000,000</td>
<td>76%</td>
<td>2,625,000</td>
</tr>
<tr>
<td>Earning Assets</td>
<td>925,000</td>
<td>26%</td>
<td>2,700,000</td>
<td>74%</td>
<td>3,625,000</td>
</tr>
<tr>
<td>Total Assets</td>
<td>1,000,000</td>
<td>26%</td>
<td>2,919,000</td>
<td>74%</td>
<td>3,919,000</td>
</tr>
<tr>
<td>Core Deposits</td>
<td>735,000</td>
<td>23%</td>
<td>2,500,000</td>
<td>77%</td>
<td>3,235,000</td>
</tr>
<tr>
<td>Borrowings</td>
<td>170,000</td>
<td>52%</td>
<td>156,290</td>
<td>48%</td>
<td>326,290</td>
</tr>
<tr>
<td>Tangible Common</td>
<td>95,000</td>
<td>27%</td>
<td>262,710</td>
<td>73%</td>
<td>357,710</td>
</tr>
</tbody>
</table>

Net Interest Income $37,000 27% $101,250 73% $138,250 (1,500) $136,750
Service Charges 7,350 25% 22,000 75% 29,350 29,350
Mortgage Banking 3,125 24% 10,000 76% 13,125 (3,000) 10,125
Trust 8,000 67% 4,000 33% 12,000 500 12,500
Other 3,000 50% 3,000 50% 6,000 6,000
Fee Income 21,475 36% 39,000 64% 60,475 (2,500) 57,975
Total Revenues 58,475 29% 140,250 71% 198,725 (4,000) 194,725
Operating Expenses 42,102 31% 92,565 69% 134,667 (15,000) 119,667
Operating Income 16,373 26% 47,685 74% 64,058 11,000 75,058
Loan Loss Provision 4,688 27% 13,000 73% 17,688 17,688
Securities Gain/(Loss) 0 nm 0 nm 0 0
Other 0 nm 0 nm 0 0
Pre-Tax Income 11,686 25% 34,685 75% 46,371 11,000 57,371
Taxes @ 30% 3,506 25% 10,406 75% 13,911 3,300 17,211
Net Income $8,180 25% $24,280 75% $32,459 $7,700 $40,159

ROA 0.82% 0.83% 0.83% 1.07%
ROE 8.6% 9.2% 9.1% 11.2%
Op Income / Assets 1.64% 1.63% 1.63% 1.99%
NIM 4.00% 3.75% 3.81% 3.94%
Efficiency Ratio 72% 66% 68% 61%
Provision / Loans 0.75% 0.65% 0.67% 0.67%
Loans / Assets 62.5% 68.5% 67.0% 69.6%
Tangible Equity / Assets 9.5% 9.0% 9.1% 9.5%

Source: Mercer Capital
Perhaps the best example of a well-executed “merger-of-equals” (MOE) was the 1994 merger when Southern National and BB&T entered into an MOE that today is a top-performing, super-regional bank. Among the keys to the transaction was clarity as to who would be running the combined company (Southern National management). Others were panned by the market, such as the 1994 merger of Cleveland-based Society National and Albany-based KeyCorp. The combined company struggled with a bloated cost structure and a blended management team that reflected very different operating styles.

Boards that choose to sell to a larger institution or enter into a transaction that is more akin to an MOE in which the consideration received consists of the buyers' common shares face a valuation question. For the selling bank (or junior merger partner), the first question to be answered is: what is our institution worth? The second question to be answered is: what is the value of the buyer’s shares? And the third question is: what is the value of the buyer’s shares on a pro forma basis including our institution, assuming the seller will constitute more than an inconsequential amount of the buyer?

Ideally, the seller will conduct an evaluation to gauge a range of value for the institution with the caveat that factors such as the number of interested buyers, type of consideration (i.e., cash vs. stock), market conditions, and the like can lead to a fairly wide range. If a board then moves forward with some form of an auction or even limited market check in which a few potential buyers are contacted, the analysis gains more credence. The pre-auction/market check should ground board expectations in the reality of the current market.

If the targeted partner is publicly traded, on the surface the value of the buyer’s shares is known; however, many publicly traded banks are thinly traded and have little, if any, institutional ownership. In such instances the board should take a skeptical view of accepting the publicly traded value at face value. A detailed analysis similar to what the seller performed prior to starting the process might lead to a conclusion that the buyer’s shares are under-valued or over-valued vis-à-vis peers and relative to its historical and prospective performance.

If the buyer (or larger merger partner) is privately held, the valuation analysis is all the more important. The basic premise remains the same: assessing the value of the shares and the value of the proposed consideration. Mergers based upon adjusted book-to-book multiples may not reflect significant earning power differences between two institutions.

The third piece of the analysis entails valuing the pro-forma organization. As noted, we think the primary objective for two banks that are merging in today’s tough environment should be shared upside. If the transaction is properly structured and executed, both sides potentially will see an increase in value. The analysis should consider each institution as a stand-alone entity, including the value of the organization, vs. each party’s pro forma position in the new company and claim on pro forma value. The analysis should entail more than comparing earnings per share, tangible book value per share and dividends per share, though these are important measures to compare to stand-alone metrics.

Other considerations include:

» Profitability relative to peers, history of each organization and projected profitability once expense savings are fully realized;

» Diversity in the loan portfolio by type and geography;

» Issues that may exist in the loan portfolios as a result of the credit evaluation of both portfolios, though only the seller’s portfolio will be marked;
» The ability to optimize funding;

» Improved liquidity in the shares given a larger shareholder base and larger institution that may merit interest by institutional shareholders; and

» Capacity to engage in additional transactions as a larger institution with improving liquidity for its shares.

In theory, the increase in value will be equal to the present value of after-tax expense savings and, possibly, revenue synergies. If the market judges the transaction to be successful, not only should value increase by the present value of the after-tax enhancement to earnings, but a pro forma organization that is perceived as being larger, stronger, having better growth potential, and the like may experience multiple expansion too. This is particularly true for community banks that have a propensity to be modestly valued. We think the merger route oftentimes will create a win-win situation for both parties, but navigating the process and each side’s expectations is usually a difficult proposition.

Figure 11: Shared Upside of Profitability and Multiple Expansion

Source: Mercer Capital
Case Study #2

One example of a well-executed “merger-of-equals” (MOE) that benefited both community banks involved Signature Bancshares, Inc. and City Bancorp, Inc. In late 2003, the two institutions announced a transaction that could be characterized as a “merger-of-equals” since the relative financial contributions between City and Signature were fairly similar and the primary consideration was common shares. For the twelve months ended December 31, 2003, Signature reported $325 million in assets, $22 million in tangible equity, $2.3 million in net income while City reported $262 million in assets, $21 million in tangible equity, and $1.9 million in net income.

Certain benefits of the transaction for both City and Signature included the following:

» Absent the merger, asset and deposit growth of this magnitude would potentially take a number of years for each institution individually.

» While the two banks’ separate deposit market shares ranked them near the middle of the community bank competitive set in the Springfield, Missouri market, the combined entity ranked first among its community bank competitors by mid-2005.

» The post-merger entity was a better candidate for a public offering or future sale than either bank on a stand-alone basis.

» Merger synergies and expense savings allowed for an improvement in return on equity and operating leverage as measured by the efficiency ratio.

Following the merger-of-equals transaction in early 2004, the surviving entity (City Bancorp, Inc.) received an unsolicited offer from a third party in mid-2006. City then was marketed for sale more broadly, multiple bids were received, and City's board elected to pursue a transaction with BancorpSouth, Inc. (BXS) in a deal that closed in the first quarter of 2007. The consideration paid for City by BancorpSouth, Inc. was $170 million in the form of 50% cash and 50% stock. At announcement, the consideration paid represented approximately 3.0x tangible book value and 20x earnings. While pricing levels for banks may not return to those levels experienced in the mid-2000s, the transaction demonstrates the potential value that can be created for shareholders through a well-executed merger of equals.

Mercer Capital was retained by Signature Bancshares, Inc. to provide financial advisory services related to the initial transaction and by City Bancorp, Inc. to provide similar services for the BancorpSouth transaction.
Jeff K. Davis, CFA

Jeff K. Davis is the Managing Director of Mercer Capital's Financial Institutions Group. Prior to rejoining Mercer Capital, Davis spent 13 years as a sell-side analyst providing coverage of publicly traded banks and specialty finance companies to institutional investors evaluating common equity and fixed income investment opportunities. Davis was most recently Managing Director of Guggenheim Securities, LLC, and was previously head of the Financial Institutions Group at FTN Equity Capital Markets. While at Mercer Capital in the 1990s, he led the firm’s financial institutions practice, providing valuation and transaction advisory services.

Davis is a speaker at industry gatherings, including SNL Financial/University of Virginia’s annual analyst training seminar, the ABA, various state banking meetings as well as security industry gatherings. He is a periodic guest on CNBC, Bloomberg TV and Bloomberg Radio and is quoted in American Banker, the Wall Street Journal, Reuters, Forbes and other media outlets. Presently, he is an editorial contributor to SNL Financial.

Davis holds the Chartered Financial Analyst (CFA) designation from the CFA Institute.

Andrew K. Gibbs, CFA, CPA/ABV

Andrew K. Gibbs leads Mercer Capital’s Depository Institutions practice. He provides valuation and corporate advisory services to banks, thrifts, and credit unions for purposes including ESOPs, mergers and acquisitions, profit sharing plans, estate and gift tax planning, compliance matters, and corporate planning. In addition, Gibbs directs projects related to the valuation of intangible assets under Accounting Standards Codification (“ASC”) 805 and impairment testing under ASC 350.

Gibbs has extensive experience working with depository institutions in merger and acquisition advisory engagements. He assists buyers in evaluating the attractiveness of acquisition candidates, determining a price for the target institution, structuring the transaction, and evaluating different forms of financing. For sell-side clients, Gibbs analyzes the potential value that the institution may receive upon a sale, assists in locating potential buyers, and participates in negotiating a final transaction price and merger agreement.

Gibbs holds the Certified Public Accountant/Accredited in Business Valuation (CPA/ABV) designation from the American Society of Appraisers and Chartered Financial Analyst (CFA) designation from the CFA Institute.

Jay D. Wilson, Jr., CFA, CBA

Jay D. Wilson, Jr., vice president, is a senior member of Mercer Capital’s Depository Institutions practice. He is involved in the valuation of banks, thrifts, and credit unions for purposes including ESOPs, mergers and acquisitions, profit sharing plans, estate and gift tax planning, compliance matters, and corporate planning.

Wilson has extensive experience providing public and private clients with fair value opinions and related assistance pertaining to goodwill and intangible assets, stock-based compensation, loan portfolios, and other financial assets and liabilities. He also directs projects in a litigated context, including tax disputes, dissenting shareholder actions, and ESOP related matters.

Wilson holds the Chartered Financial Analyst (CFA) designation from the CFA Institute and Certified Business Appraiser (CBA) designation from the Institute of Business Appraisers.
Mercer Capital
Services for Depository Institutions

Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transactional advisory services, and other strategic decisions.

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» Clients range from the rural to the metropolitan, the troubled to the most successful, and the simplest in terms of capital structure to the most complex
» More than 1,000 valuation opinions rendered for depositories

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» Financial reporting for banks
» Goodwill impairment testing
» Litigation support
» Loan portfolio valuation
» Tax compliance
» Transaction advisory

Thought Leadership

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.