

MERCER CAPITAL

The Market Will Pay You for Low-Cost Deposit Growth

Deposit Mastery Summit

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**Core deposits
– *not book value* –
drive your institution's
franchise value**

Know Your Deposit Demographics

Demographics of depositors

Concentrations

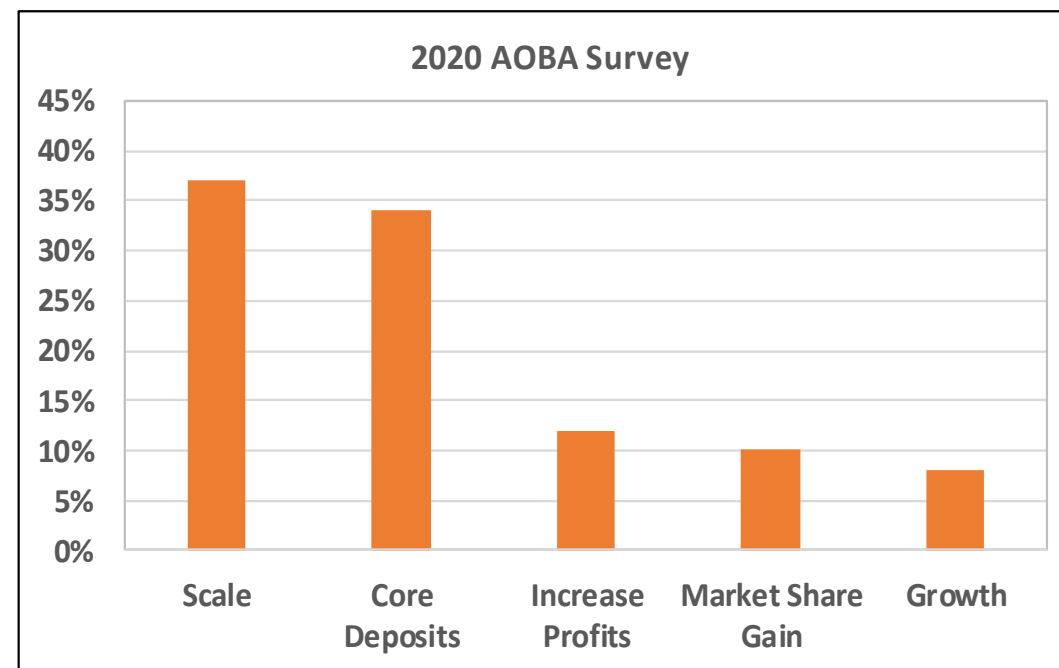
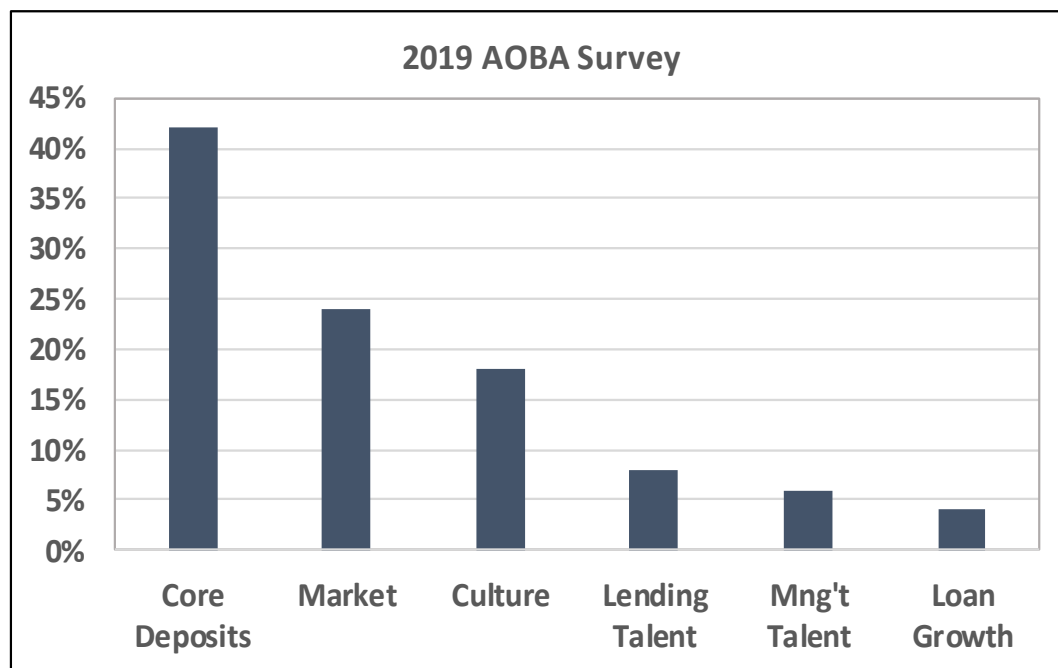
Other product ties to the bank

What happens to large deposits when:

- ***The depositor passes?***
- ***The business is sold?***

Why Acquire?

Results of Acquire or be Acquired Conference 2019 and 2020 Bank Executive and Director Poll



Core Deposit Framework

What Matters?

Rate paid

Alternative funding rate

Deposit retention rate

Fees generated

Cost to service


Deposit Account Type	Gross Balance	Fair Value % of Total Balance		
		Current	+ 0.25 bps	- 0.25 bps
NIB Demand Deposits	\$27,225,059	2.39%	2.59%	2.05%
Interest-Bearing Demand	19,386,292	1.70%	1.87%	1.02%
Money Market Deposits	22,064,356	1.38%	1.63%	1.12%
Savings Deposits	10,292,343	3.60%	4.31%	2.90%
IRAs	5,273,589	2.96%	3.51%	2.41%
Time Deposits	44,433,685	1.23%	1.45%	1.01%
Subtotal	\$128,675,324	1.83%	2.10%	1.46%
Public Funds	10,313,707	0.00%	0.00%	0.00%
Internal Accounts	296,254	0.00%	0.00%	0.00%
Brokered CDs	na	0.00%	0.00%	0.00%
QwickRate CDs	na	0.00%	0.00%	0.00%
TOTAL	\$139,285,285	1.69%	1.94%	1.35%


Valuation Framework

Core Deposits Drive Earning Power and Impact P/E Via Risk and Growth



Why Risk and Growth Matter

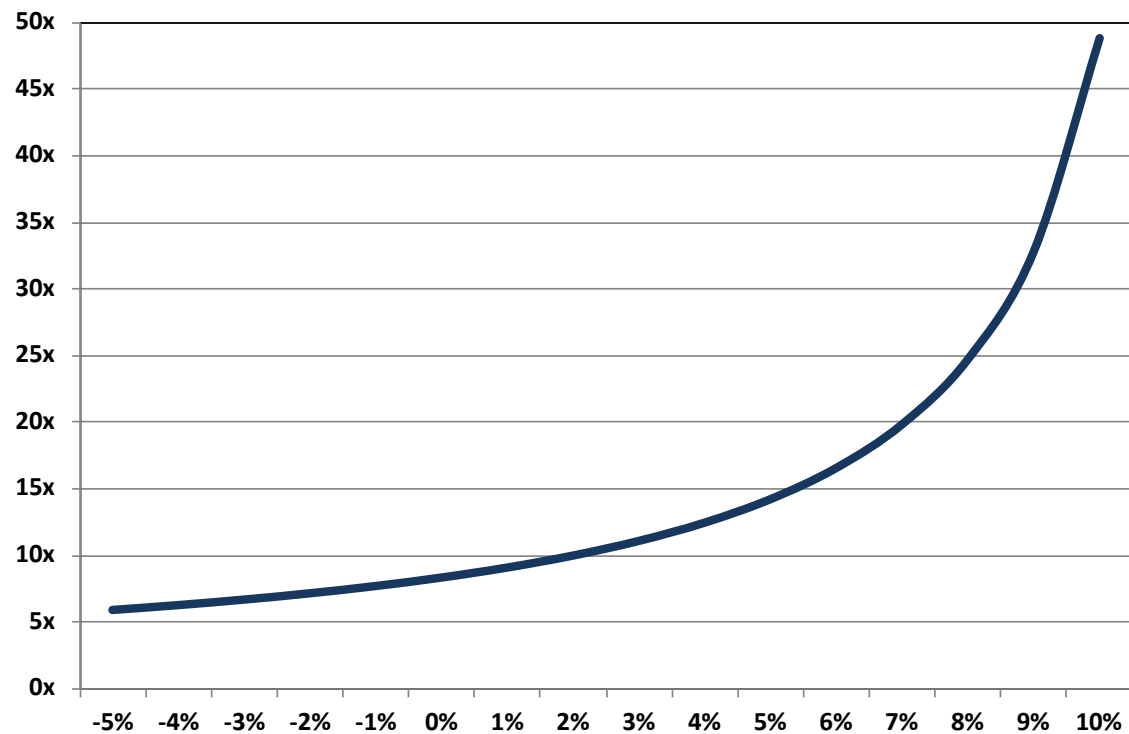
Multiples are negatively correlated with risk ...*higher risk* =  P/E

Multiples are positively correlated with growth ...*higher G* =  P/E

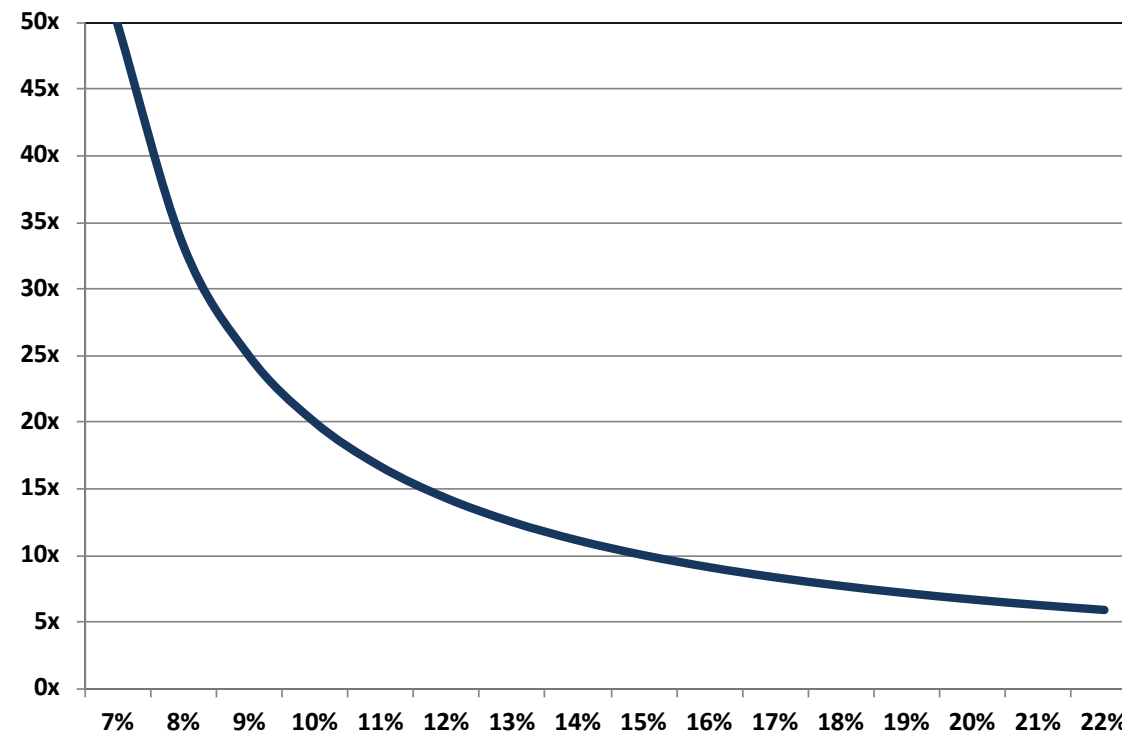
Point in the cycle matters re what investors care about the most

+ Yield to Maturity on 10 Yr UST	2.00%
+ Equity Premium	5.50%
x Company Beta	<u>1.10</u>
=Beta Adj Equity Premium	6.05%
+ Small-Mid Cap Equity Premium	2.50%
+ Company Specific Risks	<u>1.50%</u>
= Discount Rate (Equity Cost of Capital)	12.05%
- Long-Term Growth Rate (G)	<u>-5.00%</u>
= Capitalization Rate	7.05%
= Multiple (1 / Cap Rate)	<u>14.2x</u>
Ongoing Earning Power Estimate	\$100,000
x Price/Earnings Ratio	<u>14.2x</u>
= Capitalized Earnings Value	<u><u>\$1,420,000</u></u>

P/E - Growth vs Risk



— P/E (12% Cost of Capital vs Long-Term Growth Rate)



— P/E (5% Constant Growth vs Cost of Capital)

P/TBV as Rule of Thumb

Every industry has a valuation rule of thumb

Most only indirectly speak to economics

Business model entails leveraging capital
~10x to produce an earnings stream

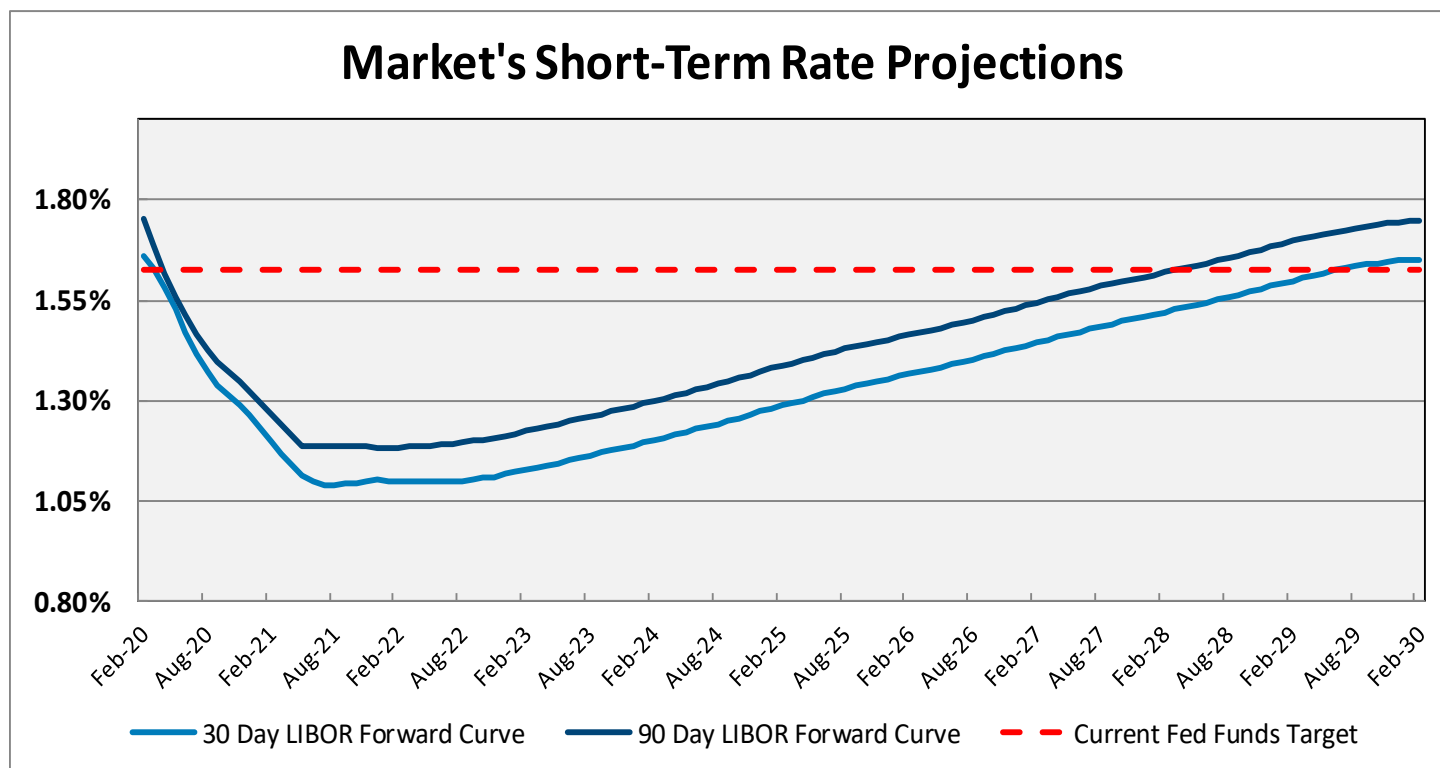
Earnings and P/E drive value

P/TBV is a byproduct ($P/E \times \text{ROTE} = P/TBV$)



Market's vs. Fed's Rate Forecast

Market forecast is more NIM pressure to come



Fed's Forecast of Future Fed Funds Rate

Rates	2019	2020	2021	2022	2023
Median	1.625%	1.625%	1.875%	2.125%	2.500%
1.625%	17	13	5	1	
1.875%		4	4	5	
2.000%					1
2.125%			5	3	
2.250%					2
2.375%			3	4	
2.500%					8
2.625%				2	
2.750%					2
2.875%				2	
3.000%					1
3.250%					1

Fed Dot Plot as of 12/11/19, Forward USD LIBOR curves as of 1/31/20

Source: Chatham Financial

Strategies to Offset NIM Pressure

Leverage excess capital with securities

Grow Loans

Reduce deposit rates

Grow non-interest bearing deposits (get deposits regardless of loan demand!)

Capital and Cash Flow Considerations

\$1.0 Billion Asset Bank Faces 10bps of NIM Pressure in 2020 – What to Do?

Leverage Excess Capital: Add Securities	
Bonds	2.75%
Wholesale Funding	1.75%
Spread	1.00%
Spread Revenues at Risk	\$1,000
Bonds to be Added	\$100,000
Capital Allocation @ 9.0%	\$9,000
Capital Allocation if 20% RWA	\$1,800
Market or Acquirer Pay for Leverage Earnings?	No

Leverage Excess Capital: Add Loans	
Loans	5.00%
Wholesale Funding	1.75%
Spread	3.25%
Spread Revenues at Risk	\$1,000
Loans to be Added	\$30,769
Capital Allocation @ 9.0%	\$2,769
Capital Allocation @ 100% RWA	\$2,769
Market or Acquirer Pay for Loan Growth?	Yes +/-

Grow NIB and Low-Cost Core Deposits	
Marginal Cost of New Core Deposits	0.50%
Retire Wholesale Funding	1.75%
Spread	-1.25%
Spread Revenues at Risk	\$1,000
Wholesale Funding Replaced	(\$80,000)
Capital Allocation @ 9.0%	No Incremental Capital
Capital Allocation @ 100% RWA	Capital
Market or Acquirer Pay for Core Deposit Growth?	Absolutely

Low Rate Environment Dangers

Inflated asset values (collateral, etc.)

Less spread between NIB and low cost deposits vs wholesale funding

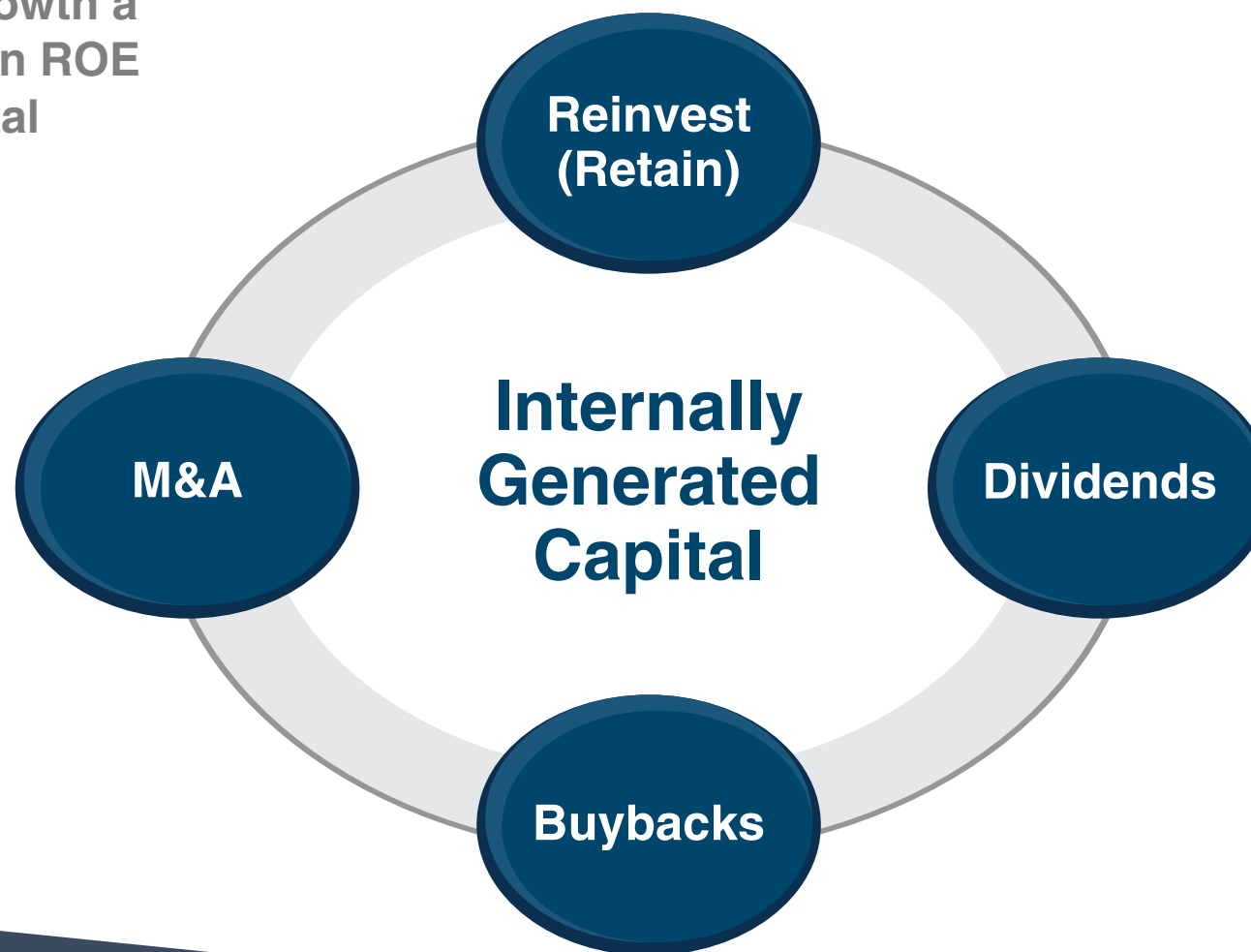
Easy route to fund incremental assets with wholesale funding

But, core deposits (customer relationships) is where the real value resides

Public market investors generally assume strong deposit franchise banks have less risk than banks that have a high amount of purchased funding

Capital Allocation

Low cost deposit growth a significant variable in ROE produced from capital retention



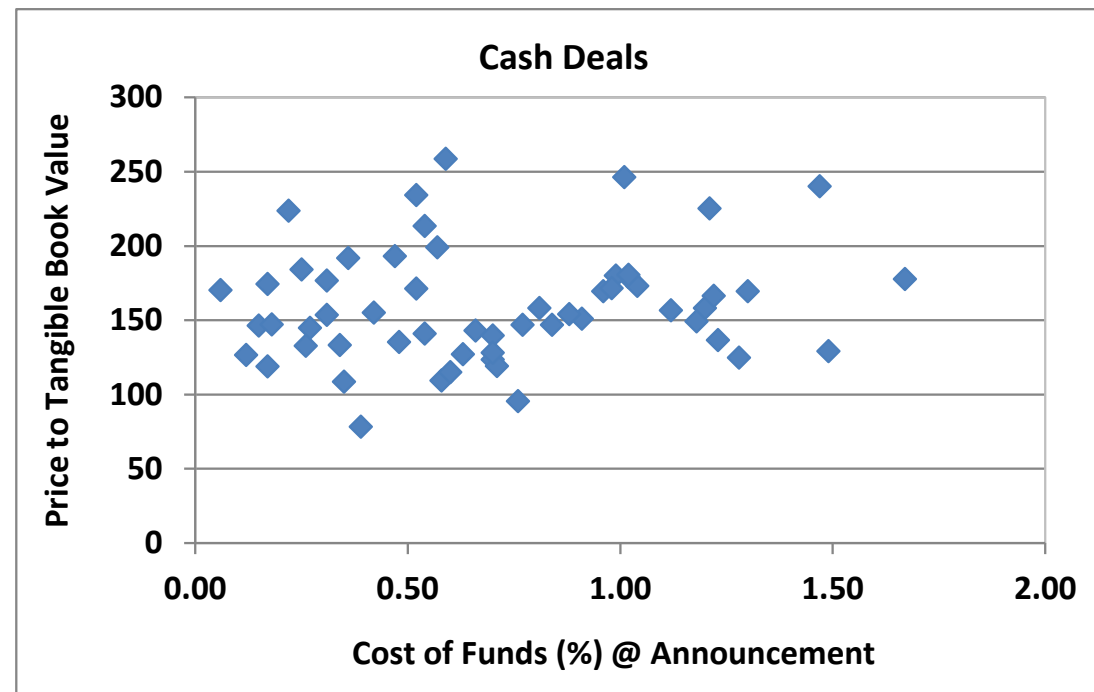
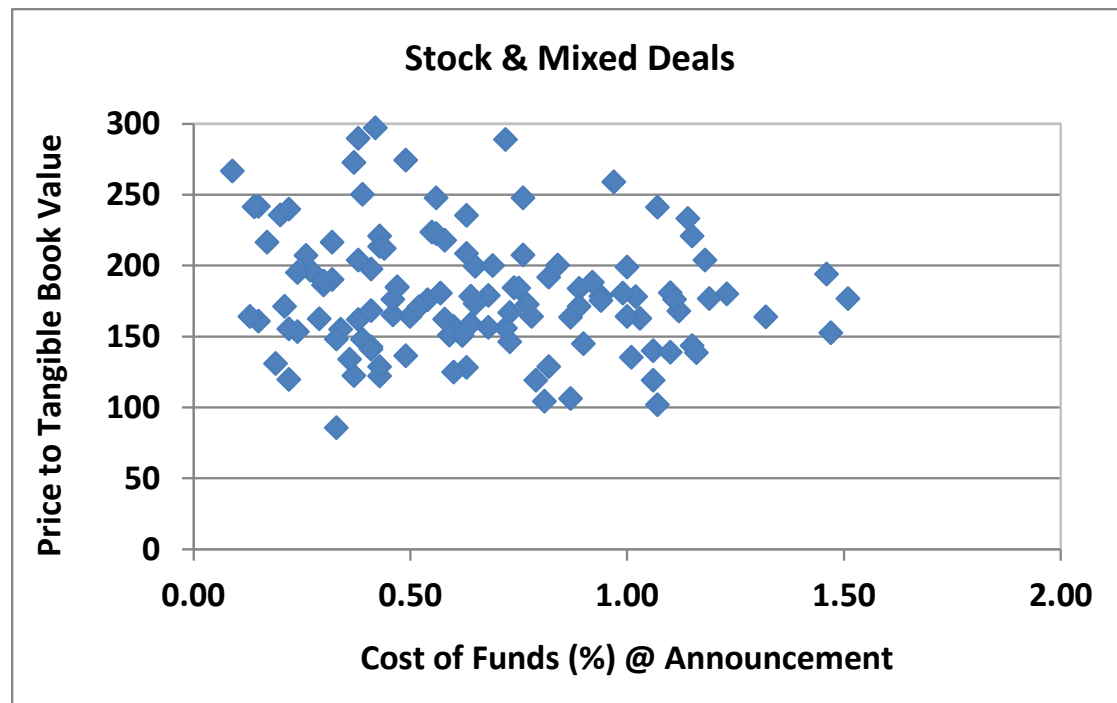
Market Rewards Low Cost Core Deposit Franchises

Publicly Traded Banks with \$1 Billion - \$10 Billion of Assets												
	Assets (\$000)	Cost of Deposits	Cost of Funds	NIM	Efficiency Ratio	Loans/ Deposits	ROA	ROE	ROTCE	P/E (20E)	P/BV	P/TBV
Top Quintile												
Median	2,068,796	1.56	1.67	3.25	56.8	98.2	0.97	9.4	10.0	11.7	113	127
Average	3,184,688	1.60	1.72	3.23	58.2	100.5	1.12	10.2	11.1	13.6	120	131
2nd Quintile												
Median	2,473,691	1.20	1.32	3.46	63.2	98.4	1.04	9.2	12.1	12.1	114	129
Average	3,904,177	1.20	1.33	3.41	62.8	99.2	1.00	9.0	11.2	14.3	119	138
3rd Quintile												
Median	3,341,290	0.98	1.09	3.40	63.2	95.1	1.04	8.7	11.1	12.7	116	137
Average	3,923,393	0.96	1.08	3.42	63.3	92.1	1.04	9.0	11.3	13.7	121	146
4th Quintile												
Median	3,019,919	0.73	0.81	3.61	60.8	89.7	1.18	10.1	12.2	12.2	121	144
Average	3,567,954	0.73	0.83	3.72	62.0	88.3	1.16	9.8	12.2	12.5	128	154
Bottom Quintile												
Median	2,671,413	0.44	0.53	3.91	59.7	84.6	1.29	10.5	13.8	13.5	132	155
Average	3,639,683	0.45	0.52	3.91	60.5	84.0	1.30	10.7	13.3	13.8	142	171

Source: S&P Global Market Intelligence; pricing as of 1/31/20

Acquirers are Buying Core Deposits (Earnings) & Markets

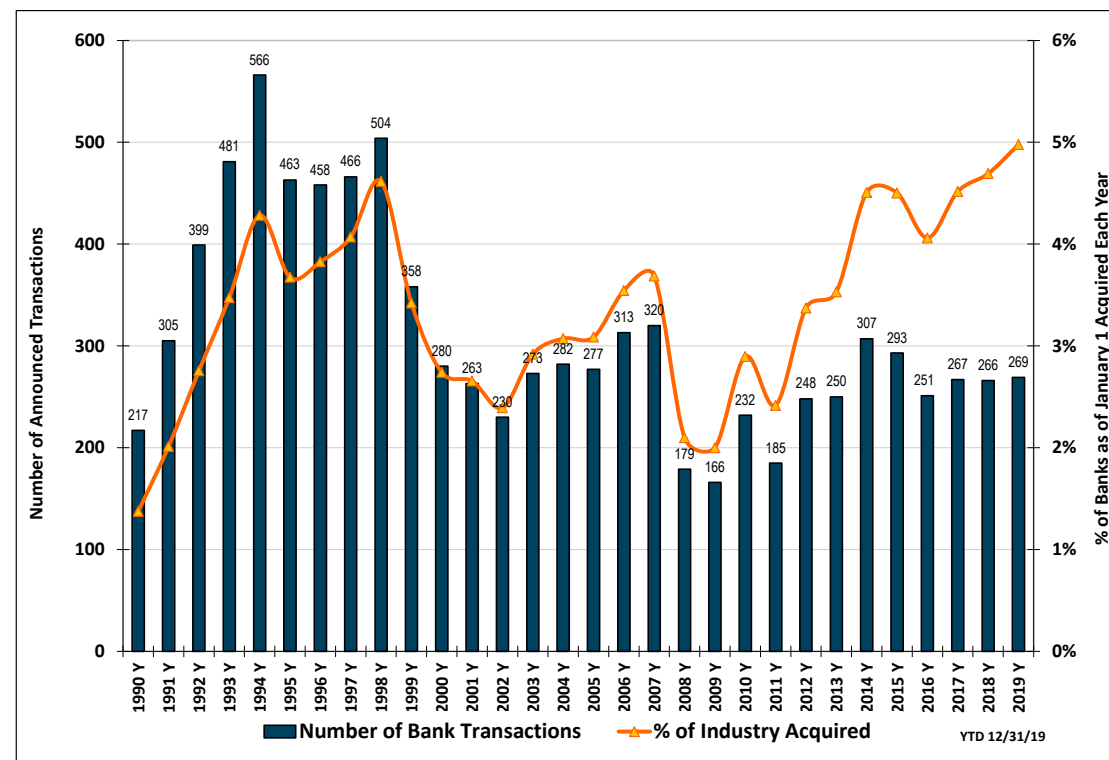
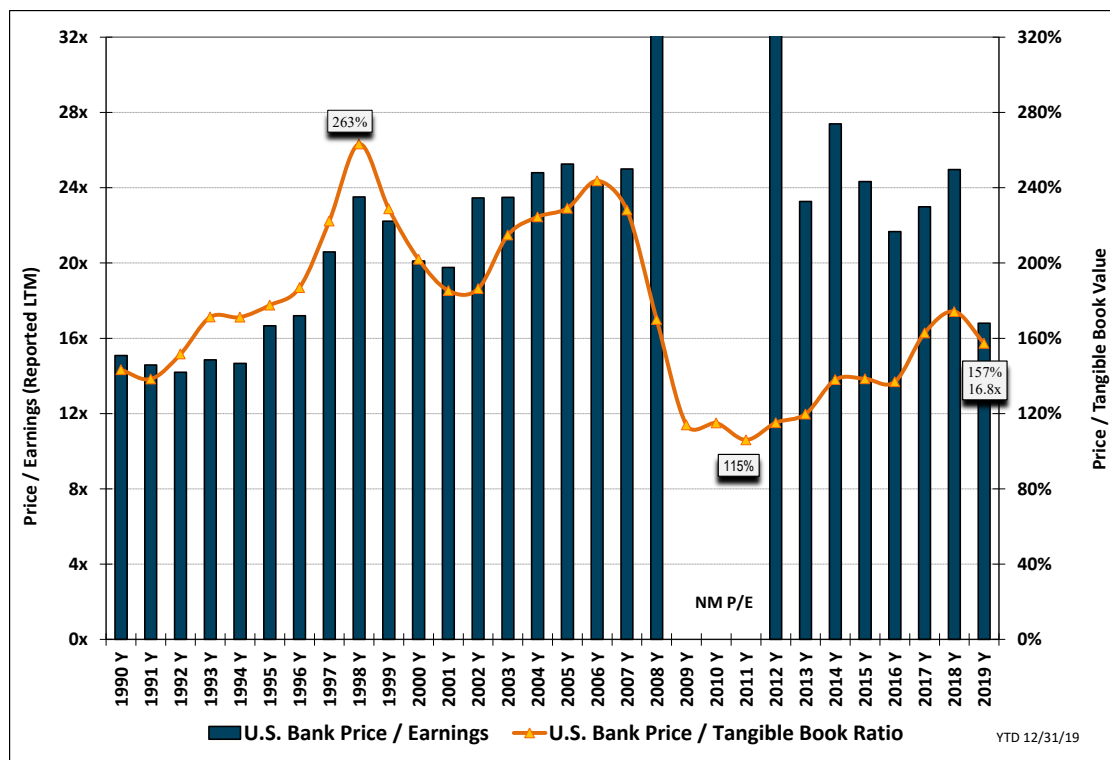
General Trend to Higher Multiples for Lower COF Though Data More Nuanced vs. Public Markets



Data based upon M&A transactions announced since Jan 2018 with disclosed pricing
 Source: S&P Global Market Intelligence

US Bank M&A Market

Valuation Multiples Vary Through Time, Activity Not So Much



Source: S&P Global Market Intelligence

Key Takeaways

Core deposits are the primary driver of franchise value

Non-interest bearing (and near NIB) deposits matter a lot when rates fall, too

Reducing COF vs adding assets to offset NIM pressure is value accretive

Growing core deposits should improve both earning power and the P/E

Price / TBV multiple is a data point

Questions?

About the Presenter



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Jeff Davis is Managing Director of Mercer Capital's Financial Institutions Group (FIG). Jeff primarily works with financial 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, Jeff analyzes the potential value that the institution may receive upon a sale, assists in locating potential buyers, and negotiating a final transaction price and merger agreement.

Jeff also spent over a decade as a sell-side analyst covering small-, mid- and large-cap banks and specialty finance companies. He has been an editorial contributor to *S&P Global Market Intelligence (SNL Financial)* since 2012 and holds the Series 7, 63 and 79 securities licenses. ²⁰

Jeff is a graduate of Rhodes College (BA) and Vanderbilt University (MBA).

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