Getting It Right

Loan Valuation and Credit Marks in Today's M&A Market

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Outline of Presentation

» Introduction

» Market Perspective

» Practical Implementation Guidance

» Post-Acquisition Date Issues

» Future Evolution

Introduction

Introduction

- All assets acquired and liabilities assumed are marked to their fair values
- Fair value (ASC 820) defined as the price received/paid by market participants in an orderly transaction
- Most significant mark typically relates to the loan portfolio, followed by a depositor customer relationship (core deposit) intangible asset
- Any residual of the purchase price over net assets acquired recorded as goodwill

Target	Pre-Acquisition	At Fair Value
Loans	75	70
Goodwill	0	12
Other Assets	25	25
TOTAL ASSETS	**$100**	**$107**
Deposits	90	92
Total Equity	10	15
TOTAL LIABILITIES & EQUITY	**$100**	**$107**

Target acquired for 150% of book value, or $15

Buyer	Pre-Acquisition	Post-Acquisition
Loans	750	820
Goodwill	0	12
Other Assets	250	260
TOTAL ASSETS	**$1,000**	**$1,092**
Deposits	900	992
Total Equity	100	100
TOTAL LIABILITIES & EQUITY	**$1,000**	**$1,092**

Assumes buyer pays purchase price ($15) in cash

Macro-to-Micro

- Although M&A remains largely an expense synergy and execution proposition, properly assessing and pricing credit represents a primary deal risk
- A target's loan portfolio is to be evaluated on its own merits, but markets provide perspective on where the cycle is and whether the trend is toward or away from Graham's "margin of safety"

"The pricing of credit forever is cyclical"

Jim Grant of Grant's Interest Rate Observer

"There are two key concepts investors should master: value and cycles"

Howard Marks, Chairman Oaktree Capital Group

Market Perspective

Spreads

» Credit spreads provide perspective on …

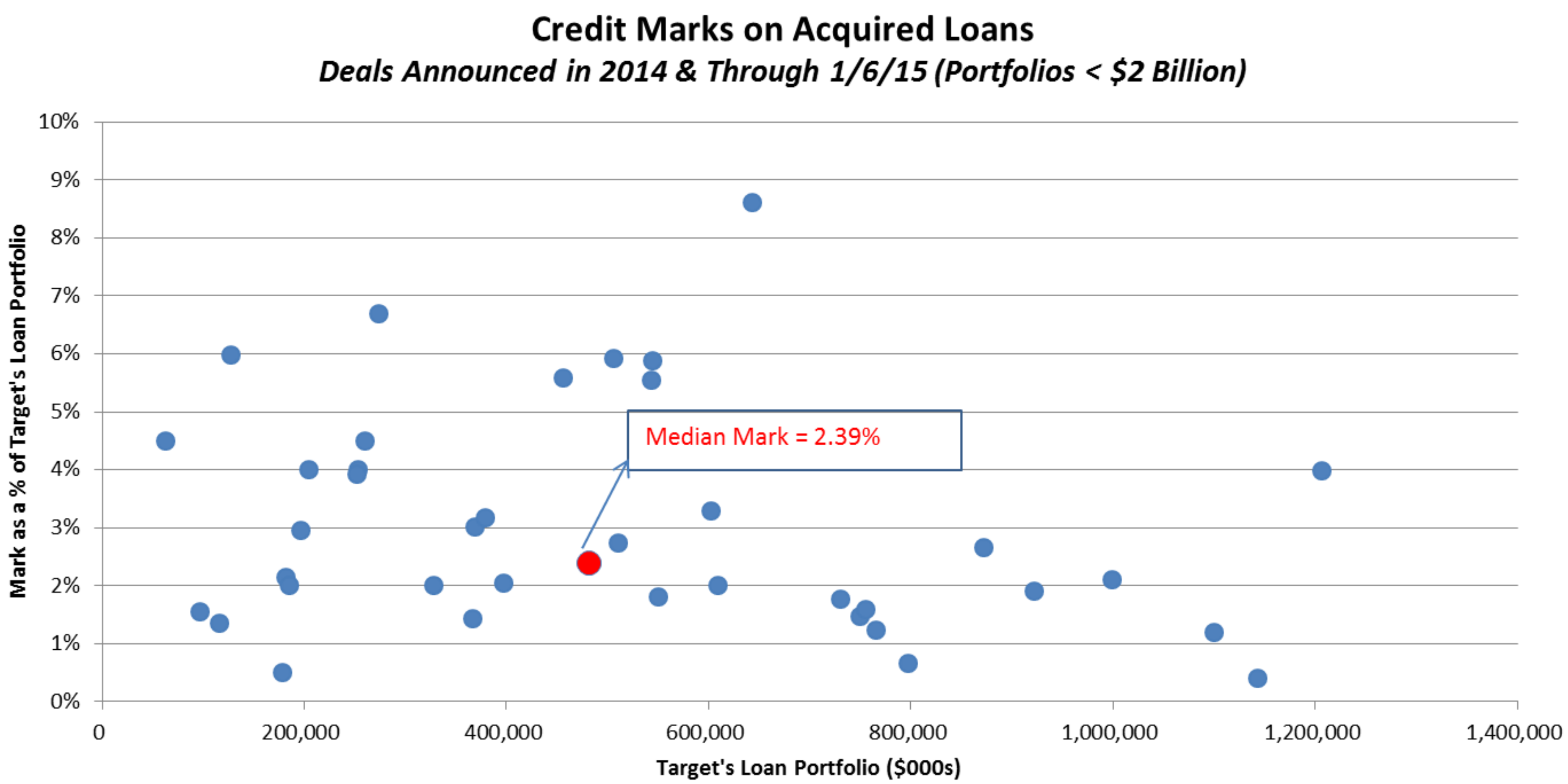
- where the cycle has been and where momentum is headed
- relative value if historical relationships remain relevant
- have typically led the loss (and M&A) cycle for banks by 12-18 months
- potential portfolio issues at a target when there are no apparent issues

Full Circle Cycle

Announced	Buyer / Seller	Portfolio Mark Credit	Portfolio Mark Rate	Portfolio Mark Total	Observation
May-06	Wachovia / Golden West	na	na	**na**	GDW 15-yr avg NCO 0.05%
Sep-08	JPMorgan / Washing Mutual Bank	na	na	**19%**	27% mark for WaMu's home lending portfolio
Oct-08	PNC Financial / National City Corp.	na	na	**18%**	55% of mark for 20% of NCC's portfolio
Oct-08	Wells Fargo / Wachovia	na	na	**15%**	GDW Pik-A-Pay marked 26%, 43% of total mark
Nov-10	M&T / Wilmington Trust	na	na	**13%**	C&D mark 32%
Dec-10	Bank of Montreal / M&I	na	na	**13%**	
Dec-10	Hancock Holding / Whitney Holding	na	na	**6%**	Street questioned, but mark proved to be ok
Sep-12	FirstMerit / Citizens Republic	na	na	**7%**	42% of mark for HELOC book
Sep-12	Columbia Banking / West Coast	na	na	**5%**	
Jan-13	United Bankshares / VA Commerce	na	na	**4%**	
Feb-13	Renasant / First M&F	na	na	**5%**	In-market deal … both knew each well
Jul-13	MB Financial / Taylor Capital	na	na	**4%**	In-market deal … both knew each well
Sep-13	Umpqua Holdings / Sterling Financial	na	na	**3%**	
Jul-14	Bank of Ozarks / Intervest	na	na	**6%**	Income CRE-focused NY-based lender
Oct-14	IBERIABANK / Old Florida	na	na	**1%**	Portfolio built post 2009; largely Orlando area
Oct-14	IBERIABANK / Georgia Commerce	na	na	**2%**	NPL ratio only 0.8%

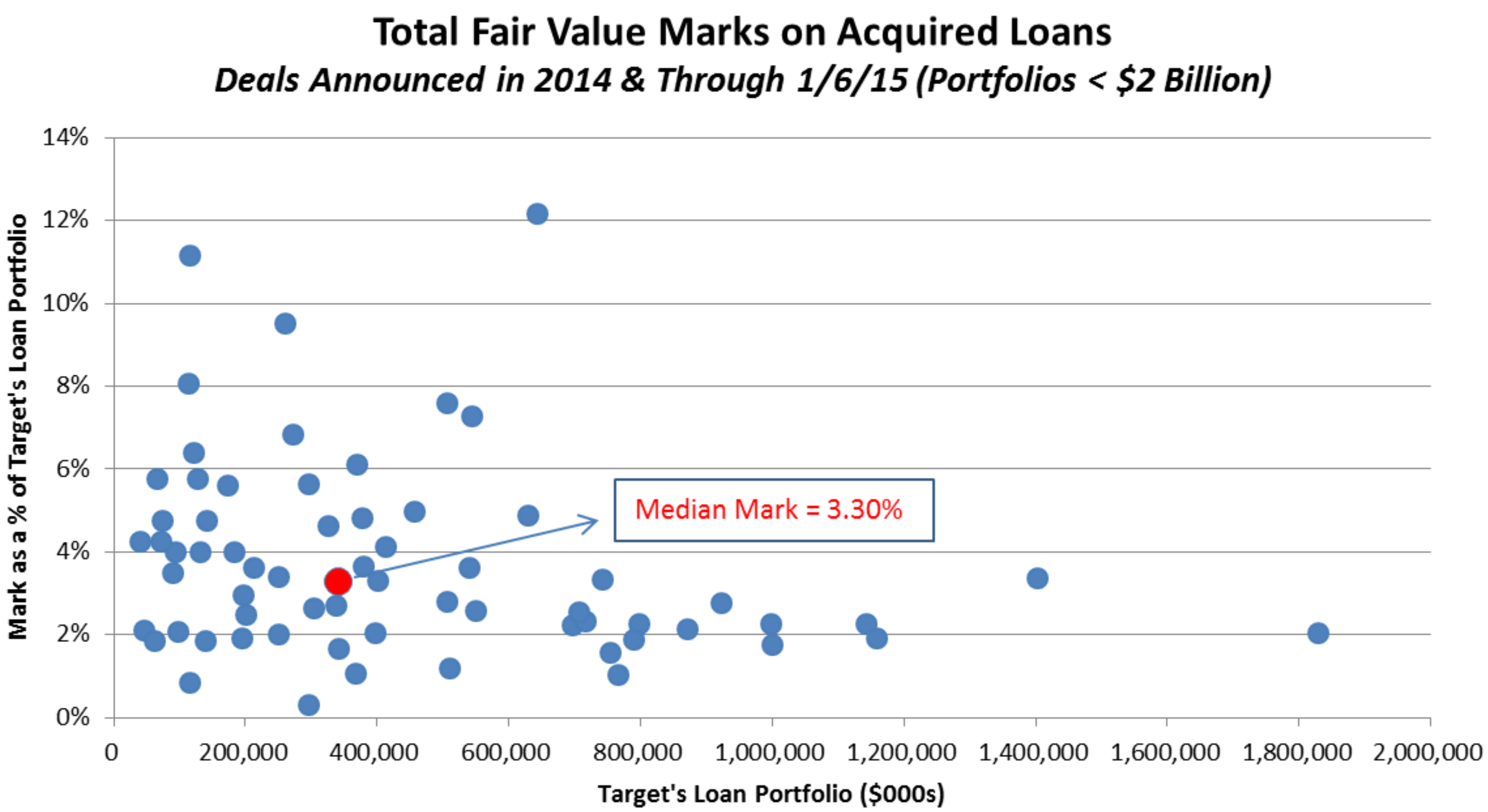
Source: SNL Financial

Recent Trends in Fair Value Marks



Source: Mercer Capital research, company SEC filings, company investor presentations

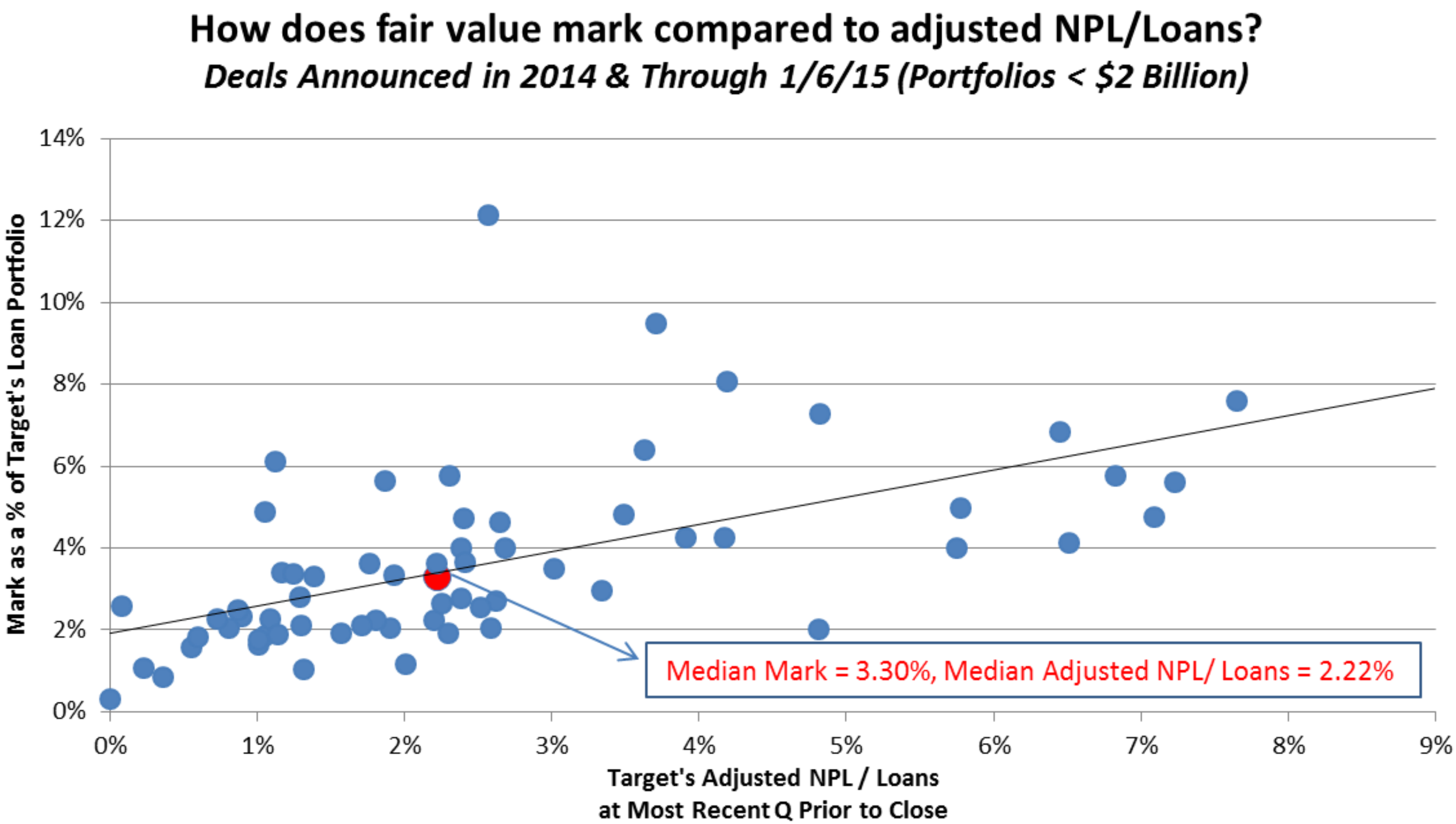
Recent Trends in Fair Value Marks



Note: Credit mark not distinguished from the total fair value mark in certain companies' filings; accordingly, this chart includes more transactions than the chart presenting only credit marks

Source: Mercer Capital research, company SEC filings, company investor presentations

Recent Trends in Fair Value Marks



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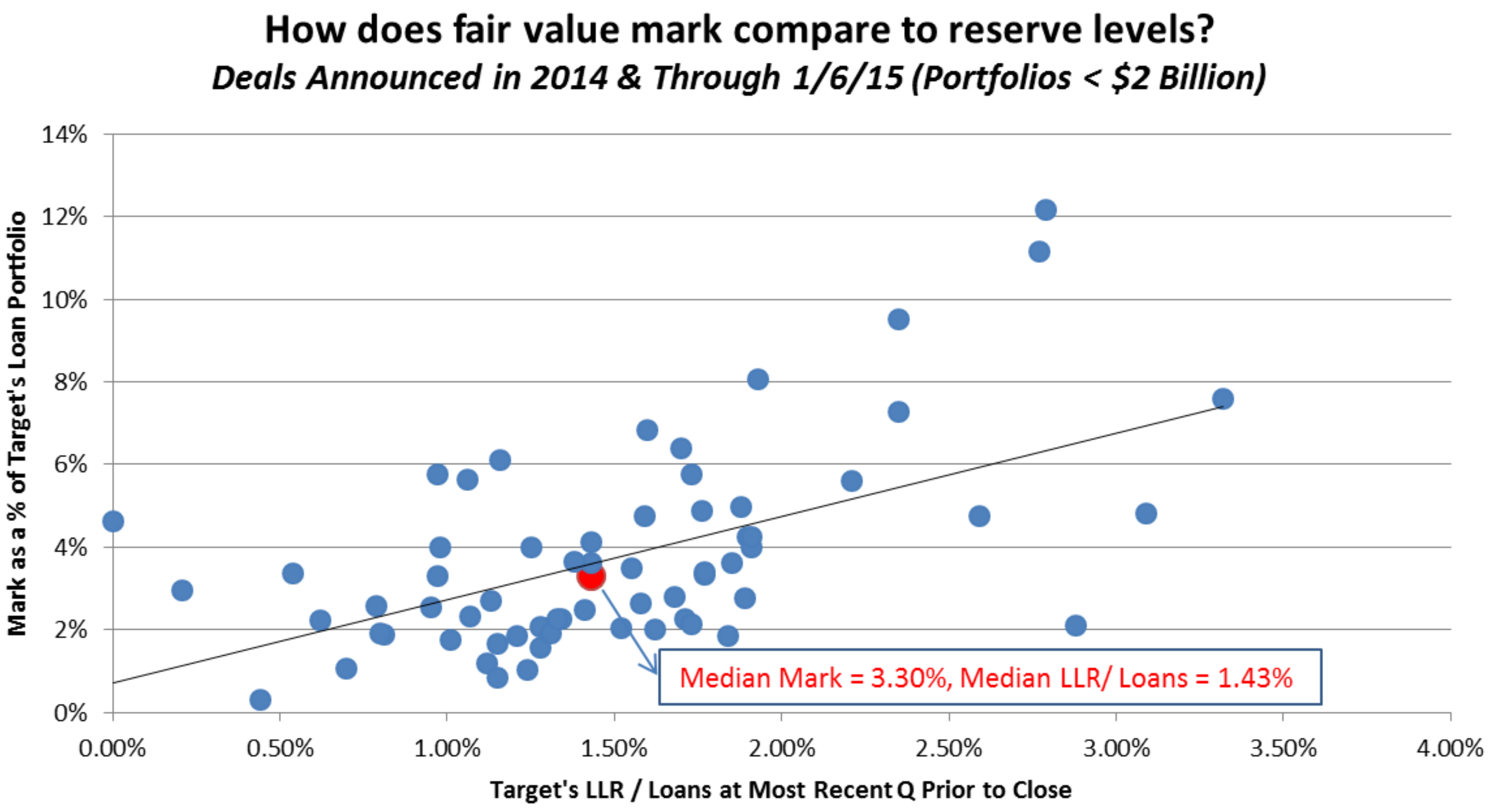
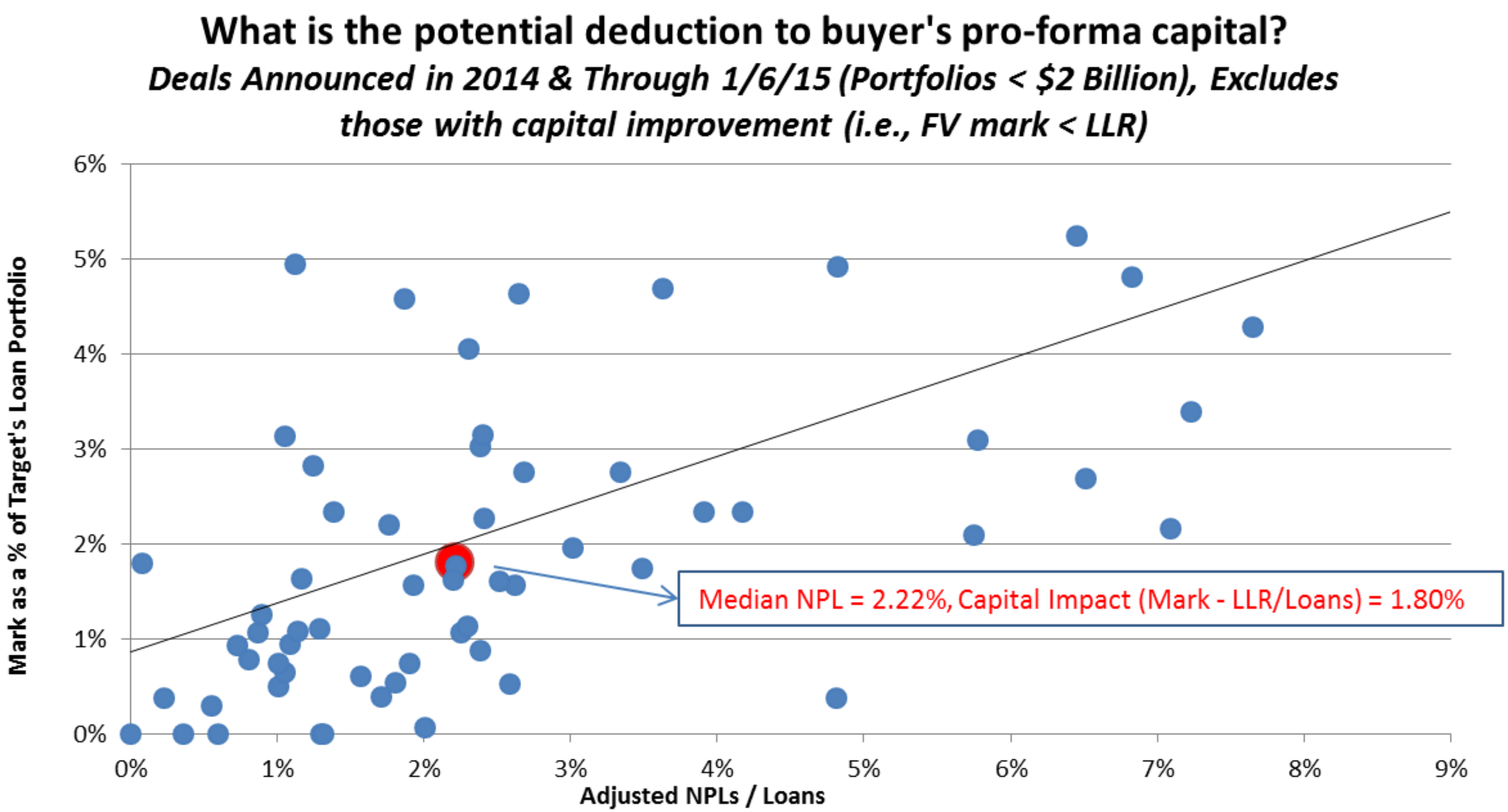
Recent Trends in Fair Value Marks



Source: Mercer Capital research, company SEC filings, company investor presentations

Recent Trends in Fair Value Marks



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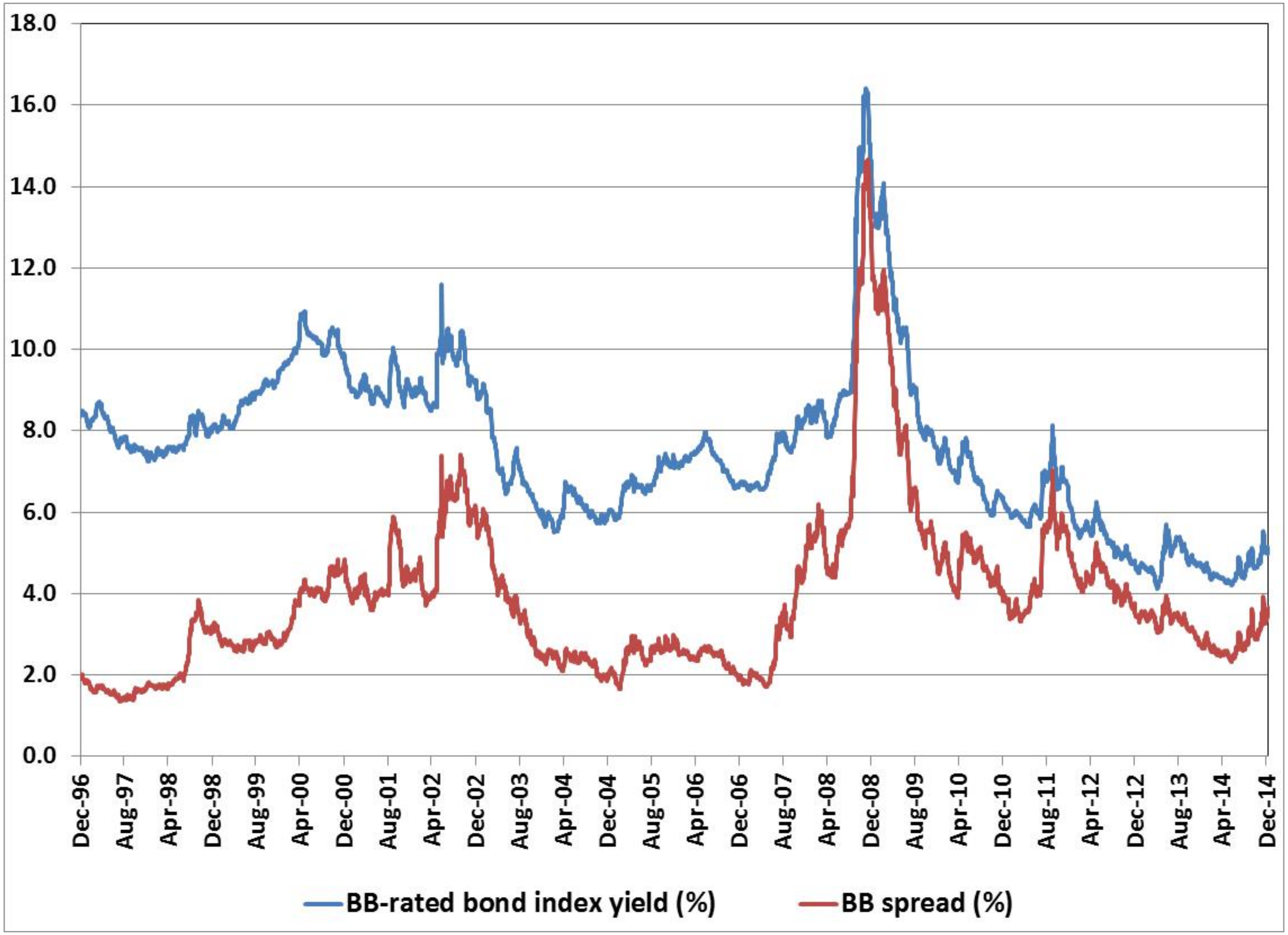
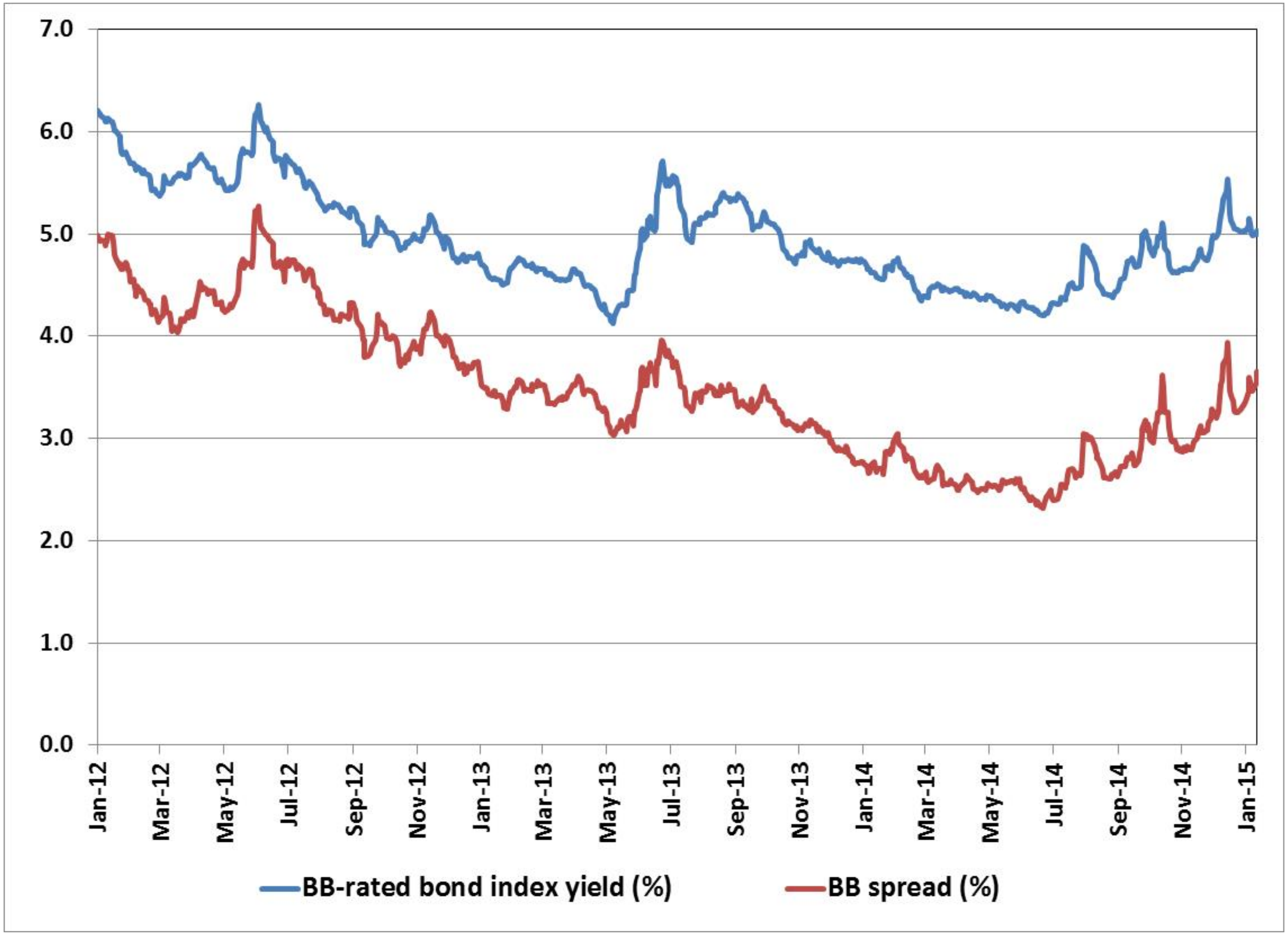
Long View – BB Credit



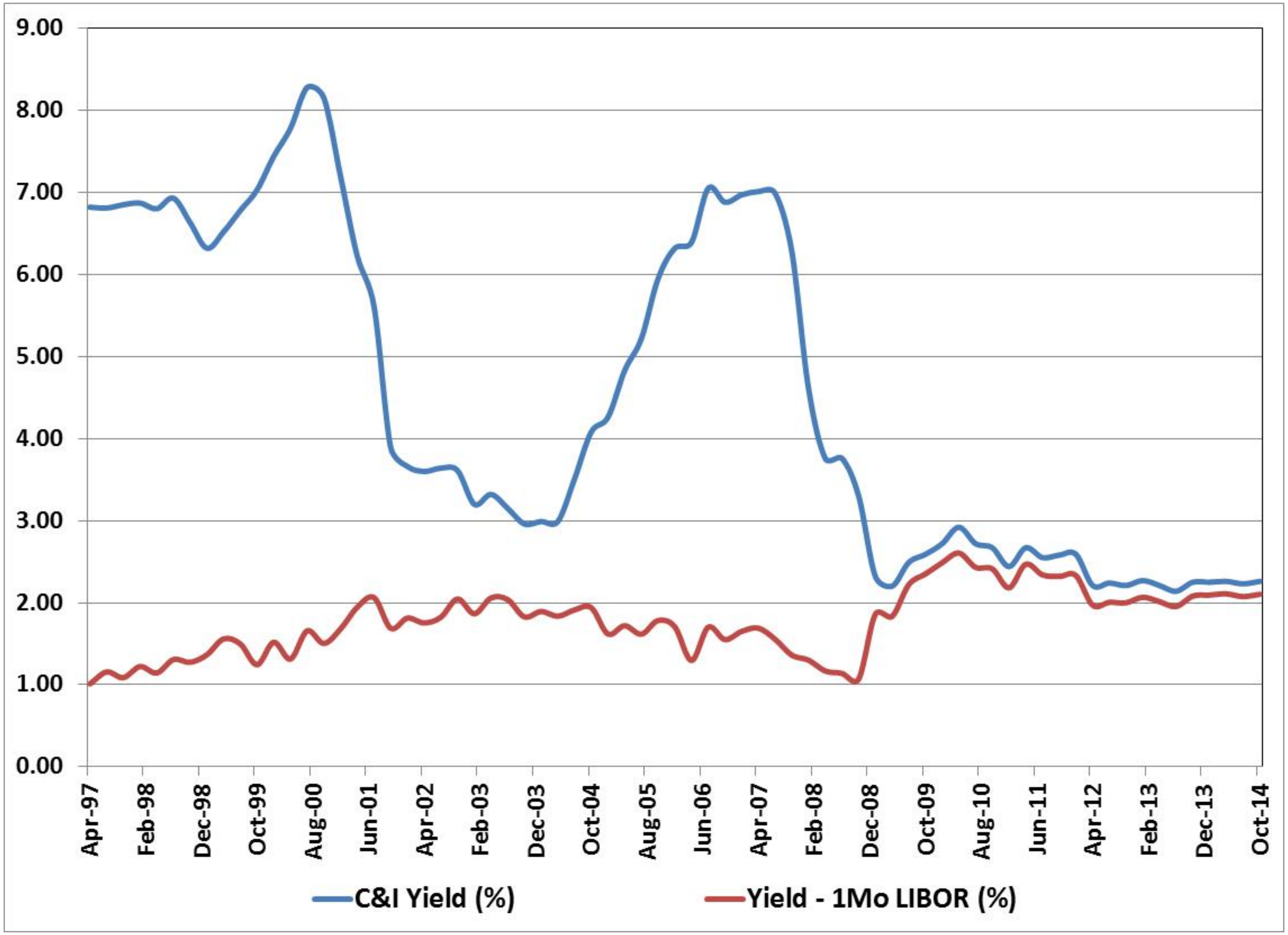
Source: Bank of America Merrill Lynch BB High Yield Index per St. Louis Federal Reserve

Spreads Turn Up June 2014



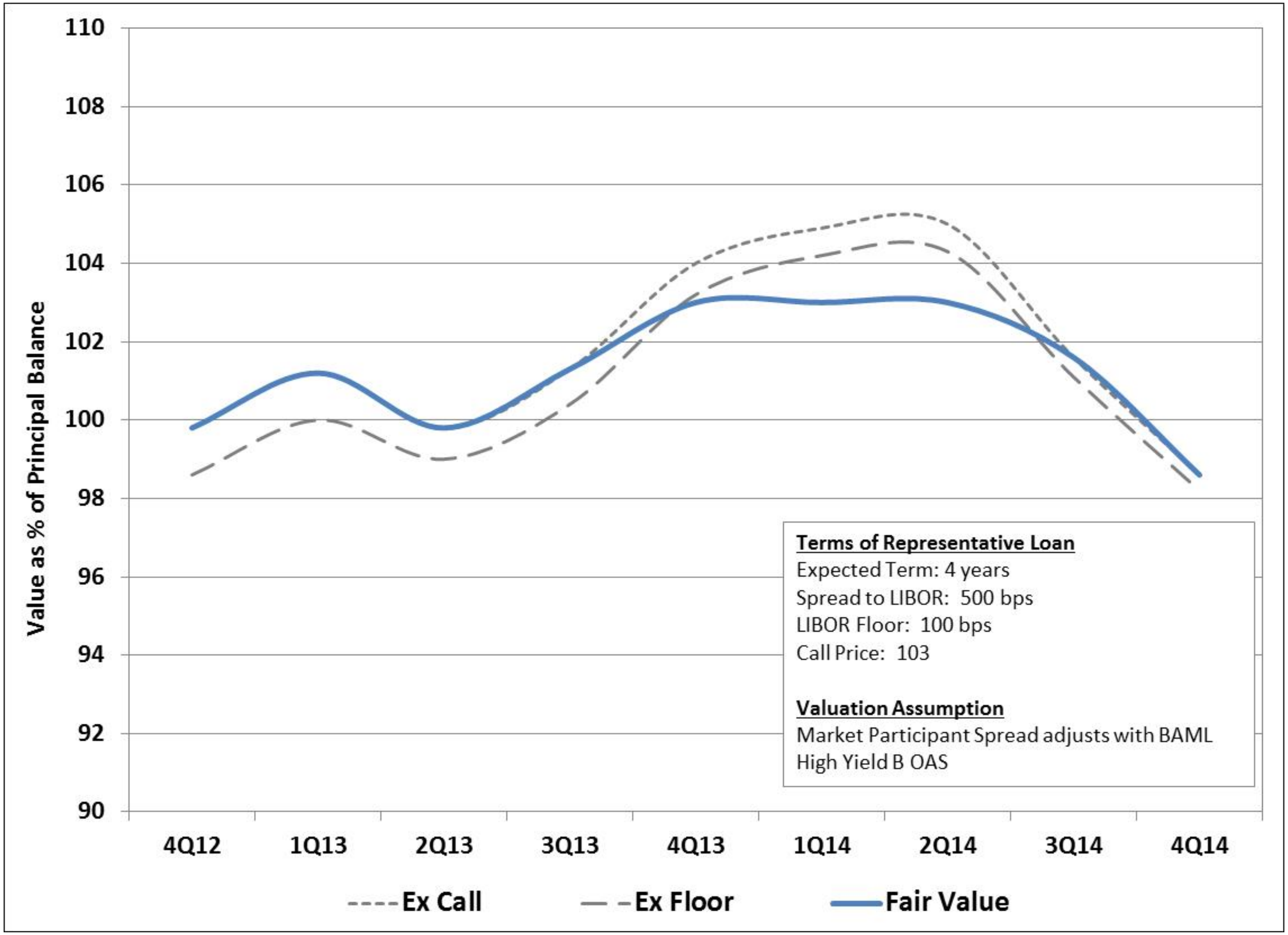
Source: Bank of America Merrill Lynch BB High Yield Index per St. Louis Federal Reserve

Perspective on Market Yields



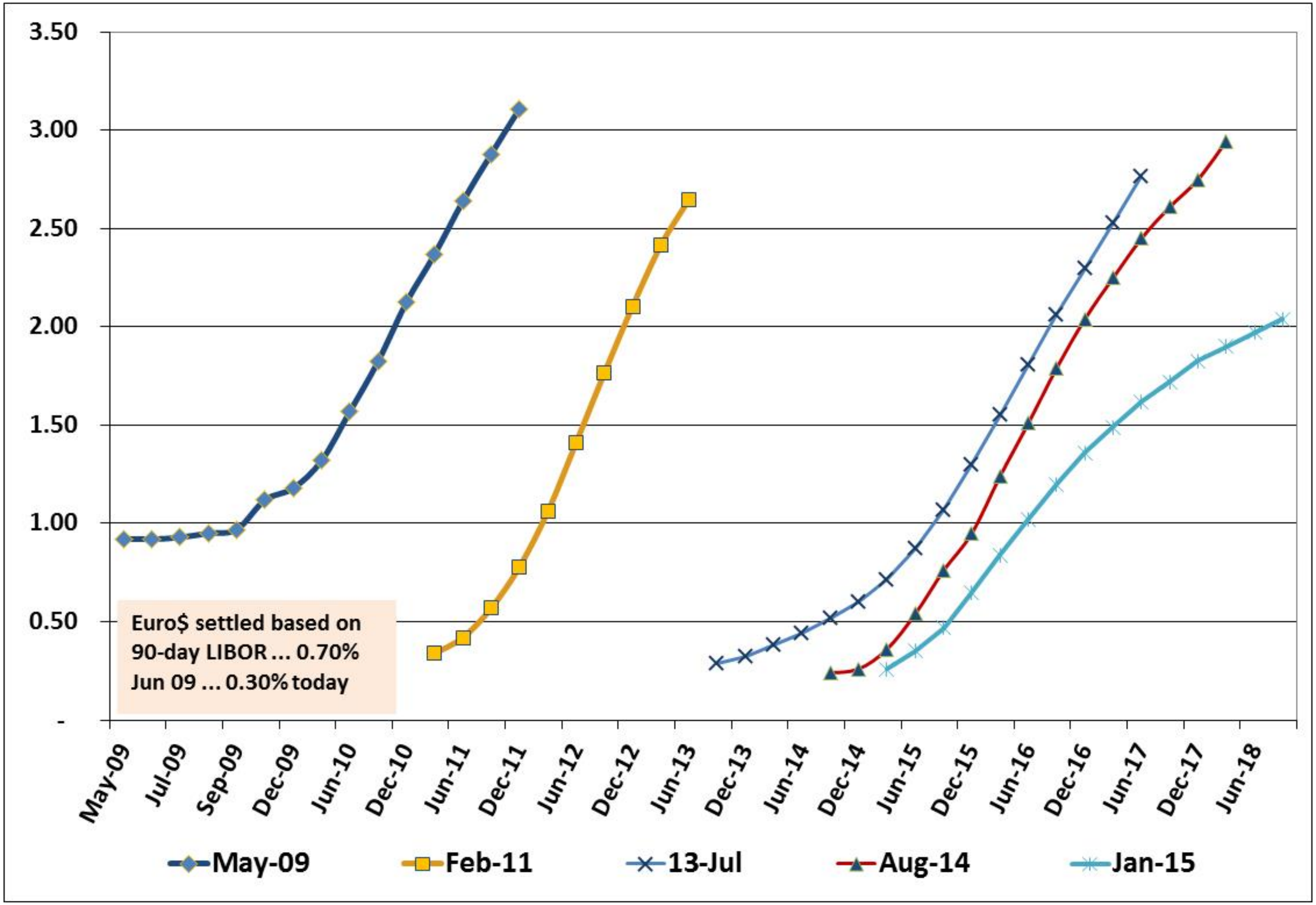
Source: Bank of America Merrill Lynch BB High Yield Index per St. Louis Federal Reserve

Pricing Models



Source: Mercer Capital

Forward 3Mo LIBOR Curve



Source: Bloomberg and WSJ

Implementation Guidance

Process

- Marks determined as of the closing date of the transaction
  - Often, the buyer requests a preliminary analysis prior to closing for purposes of preparing pro forma financial statements, regulatory applications, or SEC filings
- Designate post-acquisition accounting treatment of acquired loans
  - ASC Topic 310-30 (formerly Statement of Position 03-3) applies to loans with evidence of credit deterioration
  - ASC Topic 310-20 (formerly SFAS 91) applies to other acquired loans

Process

» Obtain relevant information for valuing loans from target to project cash flows on acquired loans

- Loan-level data should reconcile to the total balances acquired
- Information to obtain:

Payment Structure	Interest Rate Structure	Performance
Amortizing	Fixed/Adjustable Rate	Historical Delinquencies
Interest-Only	Index Rate (Prime, LIBOR)	Loan Grade
	Repricing Interval	Credit Score
	Rate Floor/Ceiling	

- Information obtained from target, except that loan grades may be buyer's ratings, rather than target's

Process

» Some loans may be pooled for valuation purposes, simplifying the initial and ongoing accounting

» Regulators have objected in some instances to pooling loans without sufficiently homogenous characteristics. For example,
  - Fixed and floating rate loans
  - Pass-rated and criticized loans

<u>Possible Stratifications</u>

» Loan Type (Residential Real Estate, CRE, C&I, Consumer, Etc.)

» Payment or Interest Rate Structure (per prior slide)

» Loan Grade

» Credit Score

» Delinquency Status

» Vintage

Valuation Techniques

» After pooling the loans, the next decision concerns the approach to valuing the loans

<u>Market Approach</u>

- » Transactions involving comparable loans
- » Often difficult to apply to community bank loan portfolios
- » May be more applicable to loans salable in the secondary market (conforming residential mortgages, SBA loans)
- » How to apply Day 2 accounting for problem loans?

<u>Income Approach</u>

- » Requires a projections of cash flows collected from each loan over its lifetime
- » Key inputs:
  - Contractual cash flows
  - Prepayments
  - Loan holding period
  - Credit Losses
  - Discount Rate

1. Loan Holding Period

- It is unlikely that the scheduled payments will be received exactly as required under the loan due to:
  - Prepayments
  - For problem loans, the borrower's inability to repay the loan upon maturity

<u>Prepayments</u>

- Market data exists for some types of loans such as residential mortgage-backed securities
  - Potential need for adjustment, reflecting differences between securitized and subject loans
- Data from the target's or buyer's existing loan portfolios

<u>Extension</u>

- Nature of exit strategy
  - Foreclosure
  - Workout
- Impact on payments (if terms modified)
- Projected cash flows could stretch beyond contractual maturity

2. Credit Losses

» Potential credit losses over the *lifetime* of the acquired loans should be reflected in the fair value measurements. Potential sources of loss estimates:

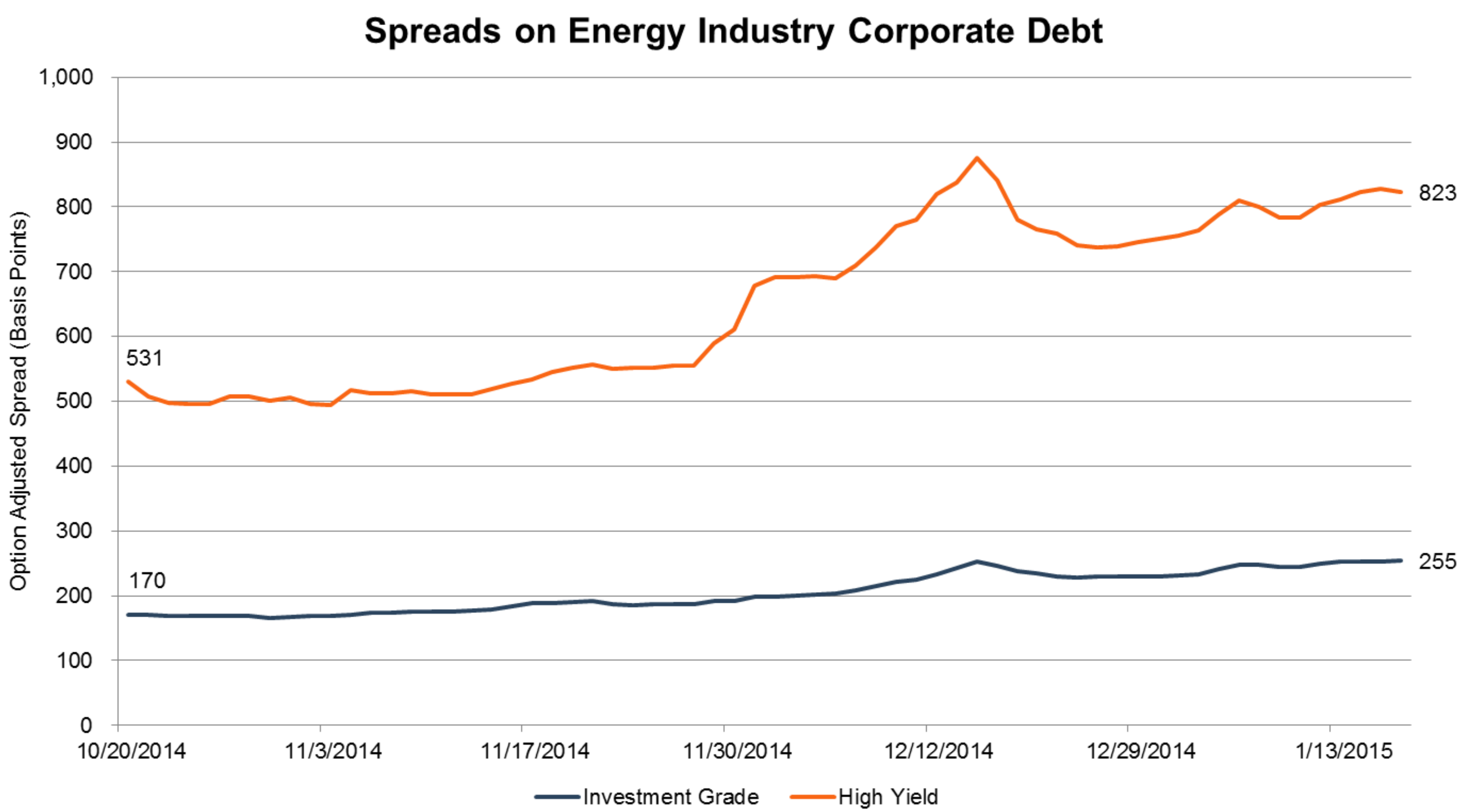
- Buyer's due diligence
- Target's historical losses (for example, by loan type)
- Buyer's historical experience
- Collateral value estimates
- Ratings agency loss estimates
- Qualitative considerations (for example, the quality of the target's underwriting)

» Note that the target's existing loan loss reserves are not "carried over" to the acquirer's financial statements

» Analysis may use a probability of default/loss given default analysis, which for specific loans may consider criteria such as loan/value ratios, debt service coverage ratios, guarantor support, or payment structure

2. Credit Losses

» In developing credit loss estimates, how much emphasis is placed on historical data?



Source: Bank of America Merrill Lynch Global Index System

3. Discount Rate

- Projected loan cash flows, net of defaults, are discounted to the present. Discount rates developed relative to:
  - Yields available on assets with similar characteristics traded in the marketplace (such as mortgage-backed securities)
  - Funds transfer pricing techniques
  - Yields on recently originated loans
- Loan servicing costs can be forecast as a component of the cash flow estimates or considered within the discount rate derivation
- Analysis may consider the relative illiquidity of the target's loan portfolio, relative to more liquid alternative investments

Post-Acquisition Date Issues

Post-Acquisition Accounting

- The discount or premium on the acquired loans affects the buyer's income statement after the transaction closes:
  - For the loans that are not "purchased credit impaired," the discount or premium generally is recognized as an adjustment to interest income over the life of the loans
  - For the purchased credit impaired loans, initially the loans yield the discount rate used to derive the fair value of the loans

Future Cash Flows Exceed Initial Estimates	Future Cash Flows Fall Below Initial Estimates
Prospectively Adjust the Yield on the Acquired Loans	Record a Loan Loss Provision

Post-Acquisition Accounting

- Post-acquisition accounting emphasizes the yield earned on the asset, as opposed solely to the recovery of the principal balance

Ongoing Accounting for Purchased Credit Impaired Loan	
Unpaid Principal Balance	$1,000
Interest Rate	3.50%
Discount Rate	7.00%
Initial Recovery Estimate in Year 5	30%
Adjusted Recovery Estimate in Year 5	60%

1. Determine Fair Value of Loan		Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flows		35	35	35	35	335
Fair Value of Loan	$357					
2. Determine Discount Accretion						
Beginning Carrying Value		$357	$347	$337	$325	$313
+ Accretion @	7.0%	25	24	24	23	22
- Payments by Borrower		(35)	(35)	(35)	(35)	(335)
= Ending Carrying Value		$347	$337	$325	$313	$0

At end of year 2, acquirer obtains new information and expects to recover 60% of the principal

3. Update Accretion		Year 1	Year 2	Year 3	Year 4	Year 5
Cash Flows			($337)	$35	$35	$635
Adjusted Yield on Loan	30.0%					
Beginning Carrying Value				$337	$403	$489
+ Accretion @	30.0%			101	121	146
- Payments by Borrower				(35)	(35)	(635)
= Ending Carrying Value				$403	$489	$0
4. Income Comparison						
Initial Estimate		$25	$24	$24	$23	$22
Updated Estimate		$25	$24	$101	$121	$146

Future Evolution

Future Evolution

» The Financial Accounting Standards Board has released an exposure draft regarding credit losses on financial instruments

» Proposed standard supersedes ASC Topic 310-30 (purchased credit impaired loans)

» Acquirer essentially records a reserve against the acquired loans

» Relevant guidance states as follows:

> . . . a related allowance for credit losses should be recognized for expected credit losses at the date of acquisition on the basis of the current amount of expected credit losses considering contractual cash flows not expected to be collected (that is, the expected credit losses embedded in the purchase price at acquisition). The expected credit losses embedded in the purchase price for purchased credit-impaired financial assets should never be accreted into interest income. [Exposure Draft, p. 111]

Final Thoughts

- » Credit is always cyclical – price a deal accordingly, though FV marks may differ given where the cycle is
- » Prepare early to address the fair value measurements
- » Ongoing accounting can be complex

Mercer Capital's Experience

- Mercer Capital has completed dozens of loan portfolio valuation engagements representing billions of dollars of unpaid principal balance
- Mercer Capital has a team of professionals experienced in loan portfolio valuation engagements and other financial reporting engagements
- Financial institutions are the largest industry concentration of Mercer Capital
- We have completed over 1,000 engagements since the founding of the firm in 1982

Q & A

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About Mercer Capital

Mercer Capital is a national business valuation and financial advisory firm. Financial institutions are the cornerstone of Mercer Capital's practice.

Founded in 1982, in the midst of and in response to a previous crisis affecting the financial services industry, Mercer Capital has witnessed the industry's cycles. Today, as in 1982, Mercer Capital's largest industry concentration is financial institutions.

Despite industry cycles, Mercer Capital's approach has remained the same – understanding key factors driving the industry, identifying the impact of industry trends on our clients, and delivering a reasoned and supported analysis in light of industry and client specific trends. The Financial Institutions Group of Mercer Capital provides a broad range of specialized advisory services to the financial services industry.

The Financial Institutions Group broadly assists:

» Depository institutions
» Insurance companies
» Investment funds
» Private equity, hedge funds, and traditional asset managers
» Specialty finance and real estate investment companies

The unifying element of Mercer Capital's services for financial institutions is its in-depth industry knowledge, gleaned from 30 years of experience and over 1,000 engagements.

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» **Advisory Services**

- Strategic consulting
- Buy-side and sell-side financial advisory services
- Fairness/Solvency opinions
- Advisory and consultation regarding capital transactions (raising, deploying, and restructuring capital)

» **Corporate Valuation Services**

- Equity transactions (share repurchases, issuances, and conversions)
- Corporate transactions (recapitalizations, divestitures, reorganizations, and the like)
- Employee benefit plans (ESOPs, KSOPs, stock option plans, and restricted stock)
- Tax compliance (income, estate, and gift)
- Buy/sell agreement consulting and the valuation of securities with contractual restrictions on transfer
- Valuation of complex securities (convertibles, options, warrants, and the like)
- Litigation support

» **Financial Reporting Services**

- Purchase price allocations (ASC 805)
- Stock-based compensation (ASC 718)
- Goodwill impairment (ASC 350)
- Illiquid financial instruments (ASC 820)
- Portfolio investments held by business development companies, private equity firms, and the like

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