MERCER CAPITAL

Bank Watch

January 2015

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Fairness Opinions
Evaluating a Buyer's Shares from the Seller's Perspective

M&A activity in the U.S. (and globally) has accelerated in 2014 after years of gradual improvement following the financial crisis. According to Dealogic, M&A volume where the target was a U.S. company totaled $1.4 trillion YTD through November 10, the highest YTD volume on record and up 43% from the same period last year. Excluding cross-border acquisitions, domestic-only M&A was $1.1 trillion, which represented the second highest YTD volume since 1999 and up 27% from last year. Healthcare and telecommunications were the first and second most targeted sectors.

The improvement has taken a long time even though corporate cash is high, financing costs are very low and organic revenue growth in most industries has been sluggish. Aside from improving confidence, another key foundation for increased M&A activity fell into place in 2013 when equity markets staged a strong rally as the S&P 500 rose 30% (32% with dividends) and the Russell 2000 increased 37% (39%). The absence of a meaningful pullback in 2014 and a 12% advance in the S&P 500 and 2% in the Russell 2000 have further supported activity.

The rally in equities, like low borrowing rates, has reduced the cost to finance acquisitions because the majority of stocks experienced multiple expansion rather than material growth in EPS. It is easier for a buyer to issue shares to finance an acquisition if the shares trade at rich valuation than issuing "cheap" shares. As of November 24, the S&P 500's P/E based upon trailing earnings (as reported) was 20.0x compared to 18.2x at year-end 2013, 17.0x at year-end 2012 and 14.9x at year-end 2011. The long-term average P/E since 1871 is 15.5x (Source: http://www.multpl.com).

High multiple stocks can be viewed as strong acquisition currencies for acquisitive companies because fewer shares have to be issued to achieve a targeted dollar value. As such, it is no surprise that the extended rally in equities has supported deal activity this year. However, high multiple stocks may represent an under-appreciated risk to sellers who receive the shares as consideration. Accepting the buyer's stock raises a number of questions, most which fall into the genre of: what are the investment merits of the buyer's shares? The answer may not be as obvious as it seems, even when the buyer's shares are actively traded.

Our experience is that some, if not most, members of a board weighing an acquisition proposal do not have the background to thoroughly evaluate the buyer's shares. Even when financial advisors are involved there still may not be a thorough vetting of the buyer's shares because there is too much focus on "price" instead of, or in addition to, "value."

A fairness opinion is more than a three or four page letter that opines as to the fairness from a financial point of a contemplated transaction; it should be backed by a robust analysis of all of the relevant factors considered in rendering the opinion, including an evaluation of the shares to be issued to the selling company's shareholders. The intent is not to express an opinion about where the shares may trade in the future, but rather to evaluate the investment merits of the shares before and after a transaction is consummated.

Key questions to ask about the buyer's shares include the following:

- **Liquidity of the Shares.** What is the capacity to sell the shares issued in the merger? SEC registration and even NASDAQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently. Generally, the higher the institutional ownership, the better the liquidity. Also, liquidity may improve with an acquisition if the number of shares outstanding and shareholders increase sufficiently.

- **Profitability and Revenue Trends.** The analysis should consider the buyer's historical growth and projected growth in revenues, and operating earnings, (usually EBITDA or EBITDA less capital expenditures) in addition to EPS. Issues to be vetted include customer concentrations, the source of growth, the source of any margin pressure and the like. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.

- **Pro Forma Impact.** The analysis should consider the impact of a proposed transaction on revenues, EBITDA, margins, EPS and capital structure. The per share accretion and dilution analysis of such metrics as earnings, EBITDA and dividends should consider both the buyer's and seller's perspectives.

- **Dividends.** In a yield starved world, dividend paying stocks have greater attraction than in past years. Sellers should not be overly swayed by the pick-up in dividends from swapping into the buyer's shares; however, multiple studies have demonstrated that a sizable portion of an investor's return comes from dividends over long periods of time. If the dividend yield is notably above the peer average, the seller should ask why? Is it payout related, or are the shares depressed? Worse would be if the market expected a dividend cut. These same questions should also be asked in the context of the prospects for further increases.

- **Capital Structure.** Does the acquirer operate with an appropriate capital structure given industry norms, cyclicality of the business and investment needs to sustain operations? Will the proposed acquisition result in an over-leveraged company, which in turn may lead to pressure on the buyer's shares and/or a rating downgrade if the buyer has rated debt?

- **Balance Sheet Flexibility.** Related to the capital structure should be a detailed review of the buyer's balance sheet that examines such areas as liquidity, access to bank credit, and the carrying value of assets such as deferred tax assets.

- **Ability to Raise Cash to Close.** What is the source of funds for the buyer to fund the cash portion of consideration? If the buyer has to go to market to issue equity and/or debt, what is the contingency plan if unfavorable market conditions preclude floating an issue?

What We're Reading

The Dealbook section of *The New York Times* had an interesting piece about a small bank in Kansas (CBW) that got new ownership and is undertaking an innovative, technology focused growth strategy.

http://mer.cr/1AtaWds

The Ideas Issue of *AmericanBanker* has "10 Big Ideas for Banking in 2015."

http://mer.cr/1DyRqeb

Two principals of Equias Alliance (David Shoemaker and Ken Derks) have an interesting article on Performance Driven Retirement Plans, a compensation plan that attempts to align shareholder interest and retain key executives.

http://mer.cr/1Kn6KPJ

Emily McCormick of *BankDirector* has an infographic entitled: "Bigger Banks More Focused on M&A."

http://mer.cr/143c6hq

- **Consensus Analyst Estimates.** If the buyer is publicly traded and has analyst coverage, consideration should be given to Street expectations vs. what the diligence process determines. If Street expectations are too high, then the shares may be vulnerable once investors reassess their earnings and growth expectations.

- **Valuation.** Like profitability, valuation of the buyer's shares should be judged relative to its history and a peer group presently as well as relative to a peer group through time to examine how investors' views of the shares may have evolved through market and profit cycles.

- **Share Performance.** Sellers should understand the source of the buyer's shares performance over several multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.

- **Strategic Position.** Assuming an acquisition is material for the buyer, directors of the selling board should consider the strategic position of the buyer, asking such questions about the attractiveness of the pro forma company to other acquirers.

- **Contingent Liabilities.** Contingent liabilities are a standard item on the due diligence punch list for a buyer. Sellers should evaluate contingent liabilities too.

The list does not encompass every question that should be asked as part of the fairness analysis, but it does illustrate that a liquid market for a buyer's shares does not necessarily answer questions about value, growth potential and risk profile.

We at Mercer Capital have extensive experience in valuing and evaluating the shares (and debt) of financial and non-financial service companies garnered from over three decades of business. Feel free to contact us to discuss your situation in confidence.

Jeff K. Davis, CFA
jeffdavis@mercercapital.com

Recent Transaction

To discuss a transaction need in confidence, contact Jeff Davis at 615.345.0350.

SBT
State Bank of Texas
Dallas, Texas

acquired from the FDIC certain assets and liabilities of

The National Republic Bank of Chicago
Chicago, IL

Mercer Capital provided financial advisory and loan portfolio valuation services to State Bank of Texas.

Articles of Interest

Jeff K. Davis, Featured in *BankDirector*

Jeff K. Davis, CFA, in the Second Quarter 2014 "Analyst Forum," shares with readers about one of his favorite bank stocks, Investbanc Shares Corp. View his comments at **http://mer.cr/1vHxC1Q**.

In the Third Quarter 2014 *BankDirector*, Davis reflects on Investbanc Shares Corp.'s performance. Subsequent to publishing the update, Intervest agreed to be aquired by Bank of the Ozarks. View his comments at **http://mer.cr/1DhTvyH**.

In the Fourth Quarter 2014 publication, Davis provides insight on IPOs and Franklin Synergy Bank in Emily McCormick's article "Is It Time to Take the IPO Plunge?" The Franklin-based bank plans an IPO within the next year due to its high-growth trajectory. Davis remarks on the nature of the IPO market and why financial institutions pursue IPOs. He warns, however, that going public means increased costs, risks, and scrutiny for financial institutions.
Read the full article at **http://mer.cr/1GpInvY**.

Mercer Capital's Resources for Depository Institutions

The Financial Institutions Group of Mercer Capital works with hundreds of depository institutions and other financial institutions annually providing a broad range of specialized resources for the financial services industry.

Newest Webinar

Sponsored by SNL Financial
Presenters from Mercer Capital and Sutherland Asbill & Brennan

An Introduction to Business Development Companies

In the hunt for yield, investors are increasingly setting their sights on business development companies (BDCs), which offer public equity investors access to portfolios of private equity investments. This webinar explored the features that have contributed to the growth in BDCs, underlying asset classes to which BDCs offer investors exposure, and highlighted the key performance metrics for evaluating BDCs. Our panel discussed relevant regulatory developments affecting BDCs, reviewed the portfolio valuation procedures and assumptions that influence quarterly profits, and explored the relative performance of key market benchmarks.

View webinar on SNL Financial's site at http://mer.cr/ZnauO7
Complimentary Download of Slides at http://mer.cr/1tuwzal

Webinars Available for Replay

An Overview of the Leveraged Lending Market and Bank Participation in the Market

There has been a flurry of media reports this year that regulators—especially the OCC—are intensifying scrutiny of leveraged lending. In this webinar we took a look at one of the fastest growing markets that has emerged post crisis.

View webinar on SNL Financial's site at http://mer.cr/VRc9JV

Understanding Deal Considerations

Key issues that we see when banks combine as it relates to valuing and evaluating a combination are reviewed. This is particularly critical when the consideration consists of shares issued by a buyer (or senior merger partner) whose shares are either privately held or are thinly traded.

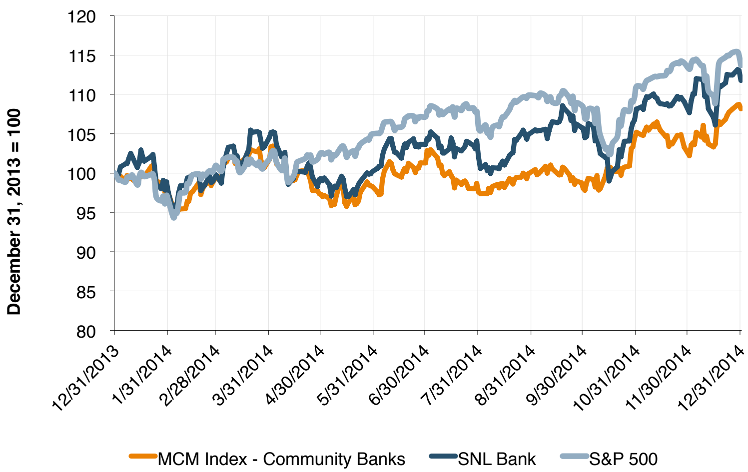
View replay at http://mer.cr/bnkweb2

Basel III Capital Rules Finally Final: What Does It Mean for Community Banks?

Finalized at last, the regulations provide direction for bank capital management decisions. This webinar, co-sponsored by Mercer Capital and Jones Day, reviews the final rules and assesses their impact on community banks.

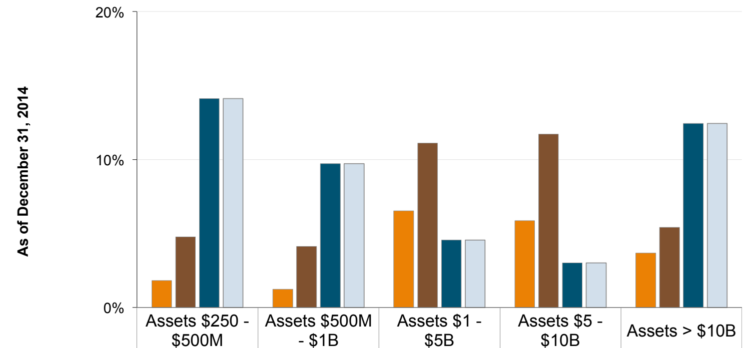
View replay at http://mer.cr/capital-rules-webinar

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



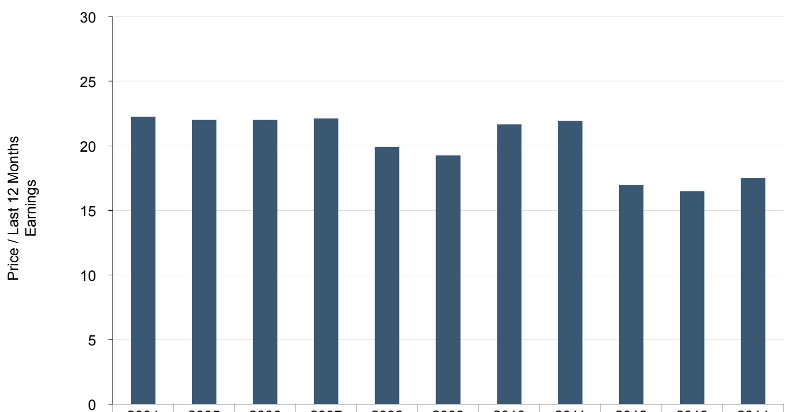
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	1.82%	1.24%	6.53%	5.87%	3.67%
Quarter-to-Date	4.77%	4.13%	11.11%	11.72%	5.41%
Year-to-Date	14.11%	9.71%	4.56%	3.01%	12.43%
Last 12 Months	14.11%	9.71%	4.56%	3.01%	12.43%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of December 31, 2014					
Indices	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2014 (E) EPS	Price / 2015 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	4.71%	11.46%	10.36%	10.36%	16.33	21.10	15.43	111.6%	128.3%	2.1%
Midwest Index	6.02%	7.38%	8.86%	8.86%	14.71	14.60	13.32	121.2%	135.8%	2.1%
Northeast Index	5.94%	11.11%	6.91%	6.91%	14.46	15.15	12.93	121.3%	126.4%	2.7%
Southeast Index	5.13%	9.46%	11.26%	11.26%	13.22	14.19	13.89	110.2%	117.7%	1.6%
West Index	6.19%	9.38%	9.28%	9.28%	16.26	17.83	14.94	127.3%	138.3%	1.9%
Community Bank Index	5.86%	10.31%	8.19%	8.19%	15.16	16.05	14.14	117.7%	130.0%	2.1%
SNL Bank Index	**3.83%**	**5.78%**	**11.78%**	**11.78%**						

Median Price/Earnings Multiples

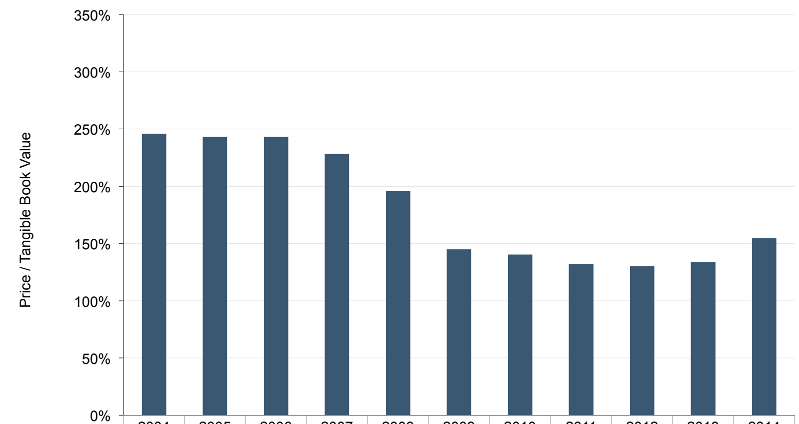
Target Banks' Assets <$5B and LTM ROE >5%



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
U.S.	22.3	22.0	22.0	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5

Median Price/Tangible Book Value Multiples

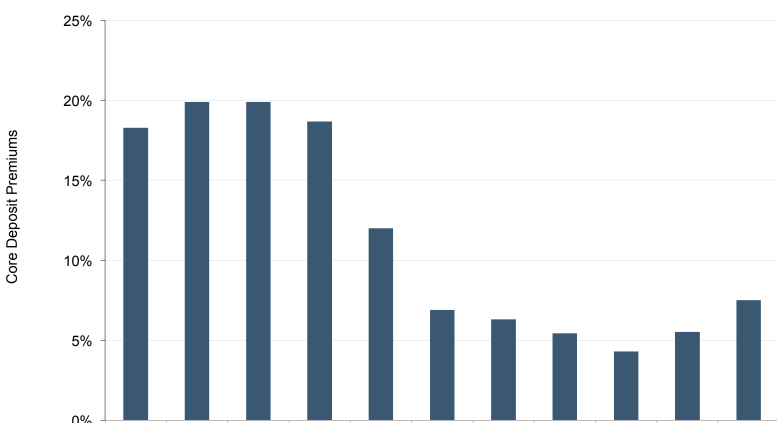
Target Banks' Assets <$5B and LTM ROE >5%



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
U.S.	246%	243%	243%	228%	196%	145%	141%	132%	130%	134%	155%

Median Core Deposit Multiples

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



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
U.S.	18.3%	19.9%	19.9%	18.7%	12.0%	6.9%	6.3%	5.4%	4.3%	5.5%	7.5%

Median Valuation Multiples for M&A Deals

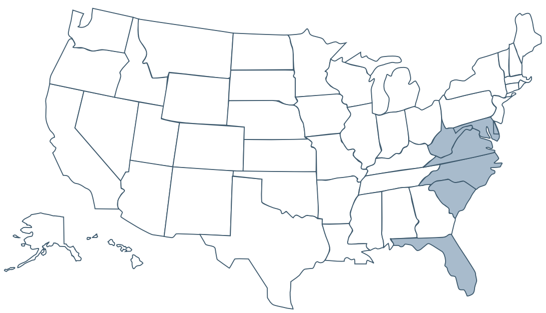
Target Banks' Assets <$5B and LTM ROE >5%, through December 2014

Regions	Price / LTM Earnings	Price / Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value	Target's Median Assets	Target's Median LTM ROAE (%)
Atlantic Coast	19.03	1.65	8.3%	10	56.40	381,762	9.09%
Midwest	18.03	1.57	7.1%	64	47.20	114,357	8.92%
Northeast	18.97	1.77	8.9%	10	106.07	615,348	7.93%
Southeast	15.59	1.54	7.3%	31	70.49	227,358	8.94%
West	19.00	1.45	6.6%	17	59.83	407,960	8.52%
Nat'l Community Banks	**17.51**	**1.55**	**7.5%**	**132**	**57.00**	**224,003**	**8.93%**

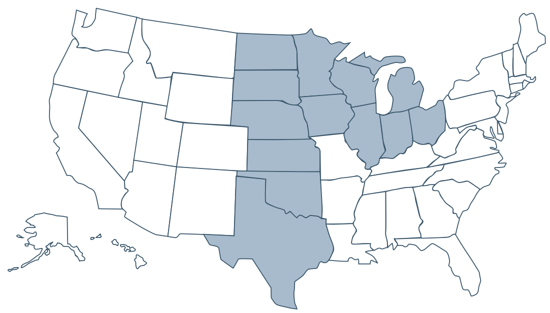
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

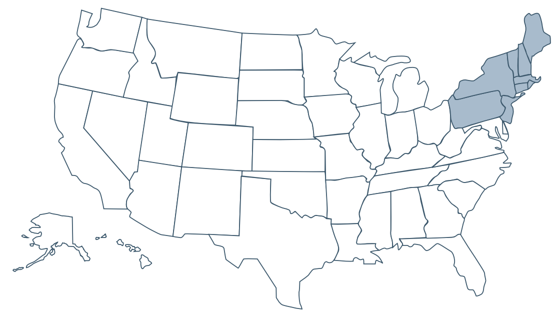
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



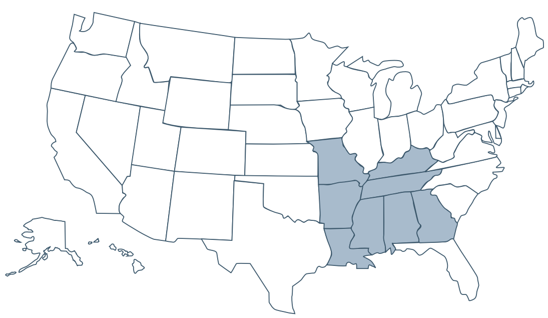
Atlantic Coast



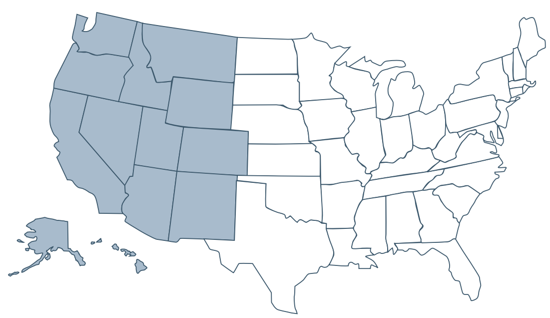
Midwest



Northeast



Southeast



West

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Financial Institutions Services

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

Mercer Capital pairs analytical rigor with industry knowledge to deliver unique insight into issues facing banks. These insights underpin the valuation analyses that are at the heart of Mercer Capital's services to depository institutions.

Mercer Capital is a thought-leader among valuation firms in the banking industry. In addition to scores of articles and books, *The ESOP Handbook for Banks* (2011), *Acquiring a Failed Bank* (2010), *The Bank Director's Valuation Handbook* (2009), and *Valuing Financial Institutions* (1992), Mercer Capital professionals speak at industry and educational conferences.

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.

Contact Us

Jeff K. Davis, CFA
615.345.0350
jeffdavis@mercercapital.com

Andrew K. Gibbs, CFA, CPA/ABV
901.322.9726
gibbsa@mercercapital.com

Jay D. Wilson, Jr., CFA, ASA, CBA
901.322.9725
wilsonj@mercercapital.com

Mercer Capital
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120 (P)

www.mercercapital.com