# Bank Watch


## February 2015



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## Recent Trends in the Fair Value of Community Bank Loan Portfolios

Although successful bank acquisitions largely hinge on deal execution and realizing expense synergies, properly assessing and pricing credit represents a primary deal risk. Additionally, the acquirer's pro forma capital ratios are always important, but even more so in a heightened regulatory environment and merger approval process. Against this backdrop, merger-related accounting issues for bank acquirers have become increasingly important in recent years and the most significant fair value mark typically relates to the determination of the fair value of the loan portfolio.

Fair value is guided by ASC 820 and defines value as the price received/paid by market participants in orderly transactions. It is a process that involves a number of assumptions about market conditions, loan portfolio segment cash flows inclusive of assumptions related to expected credit losses, appropriate discount rates, and the like. To properly evaluate a target's loan portfolio, the portfolio should be evaluated on its own merits, but markets do provide perspective on where the cycle is and how this compares to historical levels.

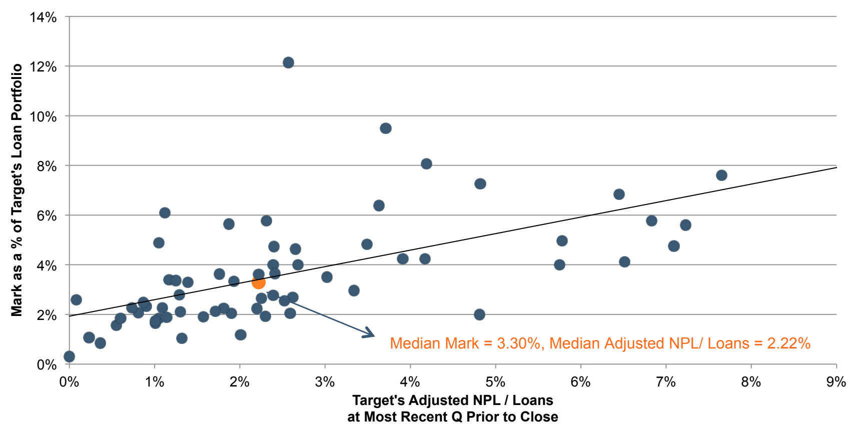
We reviewed fair values of recently announced community bank deals to determine if any trends emerged. As detailed in Figure 1, the fair value mark (i.e., the discount based on the estimated fair value compared to the reported gross loan balance) in recent deals appears to increase as the level of problem assets increases. However, the range remains quite wide and rarely hits the trendline, which could partially reflect the unique nature of isolated community bank loan portfolios. Overall, the median fair value mark observed was 3.30% while the median level of adjusted non-performing loans (as a percentage of loans) was 2.22%.

The recent fair value marks were generally below those reported in deals during (2008-2010) and immediately after the financial crisis (2010-2012). This trend reflects a number of factors including:

- **Stable to improving macro-economic trends.** While contracting during the financial crisis, real GDP growth was relatively stable in 2013 and 2014 at approximately 2.20%. Real disposable income also increased 1.70% in 2014 after remaining relatively flat in 2013. Additionally, employment considerations have continued to improve in recent periods with the unemployment rate down to 5.7% in January of 2015 compared to 7.9% and 6.6% in January of 2013 and 2014, respectively.

**Figure 1: Fair Value Mark Compared to Adjusted NPL/Loans**

*Deals Announced in 2014 & Through 1/6/15 (Portfolios < $2 Billion)*




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

- **Higher real estate collateral values.** While the 20-city S&P/Case-Shiller Home Price Index remains about 15% below its peak in mid-2006, it has increased about 25% since year-end 2011. Additionally, economic data from the Federal Reserve of St. Louis indicated that commercial real estate prices have been increasing year-over-year since year-end 2010 and were up 7.3% over the 12 months ended September 30, 2014.
- **Reduced levels of noncurrent loans.** As detailed in Figure 2, credit migration continued to be positive and levels have declined to almost pre-financial crisis levels (third quarter 2014 levels approximated early 2008 levels).
- **Reduced Credit Spreads**. Credit spreads provide perspective on a number of factors, including where the credit cycle has been and where it is headed, as well as potential portfolio issues at a target when there are no apparent issues. While credit spreads did increase in mid-2014, they have generally declined since the financial crisis as economic conditions as well as investor sentiment have improved. For example, BB credit spreads have declined from 5.0% in January

## What We're Reading

*The Washington Post's* article, "New Study finds that Dodd-Frank has promoted industry consolidation and killed community banks" summarizes a new study by Marshall Lux and Robert Greene of the Harvard Kennedy School that examined the fate of community banks since Dodd-Frank was enacted.

**http://mer.cr/1Bnesa4**

Robert Giltner of R.C. Giltner Services has an article related to the outlook for new CFPB rules on overdrafts entitled "New Crunch on Overdraft Fees Coming."

**http://mer.cr/1FuHMgf**

*The American Banker* has an interesting piece entitled "Community Banks Warned: Be Innovative or Be Toast" (subscription required).

**http://mer.cr/1A73WC5**

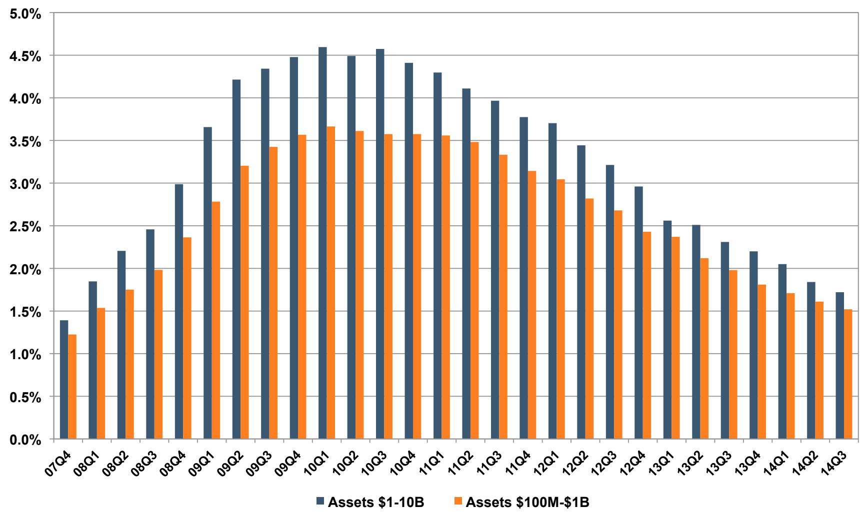
Lucas Parris of Mercer Capital has a timely piece for banks negotiating M&A transactions entitled "Noncompete Agreements for Section 280G Compliance."

**http://mer.cr/1CBYrgR**

Chris Mercer of Mercer Capital has a presentation that may be of interest to those bankers and lenders whose clients have a significant amount of their wealth in private-held companies and need to consider options related to managing and unlocking that private company wealth.

**http://mer.cr/1zPK4Fo**

**Figure 2: Noncurrent Loans as a % of Total Loans and Leases**




of 2012 to 3.5% in January of 2015. All else equal, reduced credit spreads serve to lower the discount rate applied to the expected cash flows for a target's loan portfolio, thereby increasing the fair value of the loan portfolio.

Mercer Capital has provided a number of valuations for potential acquirers to assist with ascertaining the fair value of acquired loan portfolio. In addition to loan portfolio valuation services, we also provide acquirers with valuations of other financial assets and liabilities acquired in a bank transaction, including depositor intangible assets, time deposits, and trust preferred securities. Feel free to give us a call or email to discuss any valuation issues in confidence as you plan for a potential acquisition.

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Recent Bank Speech

## Andy Gibbs and Jeff Davis Present "Getting It Right: Loan Valuation and Credit Marks in Today's M&A Market"

Andrew K. Gibbs, CFA, CPA/ABV, and Jeff K. Davis, CFA, spoke at *Bank Director's* 2015 Acquire or Be Acquired Conference in January 2015 on the topic of loan portfolio valuation.

Although investors and perhaps bankers are not as focused on credit as was the case several years ago, properly assessing credit risk and determining appropriate credit marks remains the key arbiter in determining whether a deal is destined to struggle or meet/exceed expectations. This session looked at the evolution of loan portfolio valuations as part of due diligence and M&A pricing since the financial crisis. Davis and Gibbs provided insight into some of the nuances around the evaluation process and what to look for in terms of potential potholes regarding potential acquisitions.

Download the slides at **http://mer.cr/1BoLb9C**.

# 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.

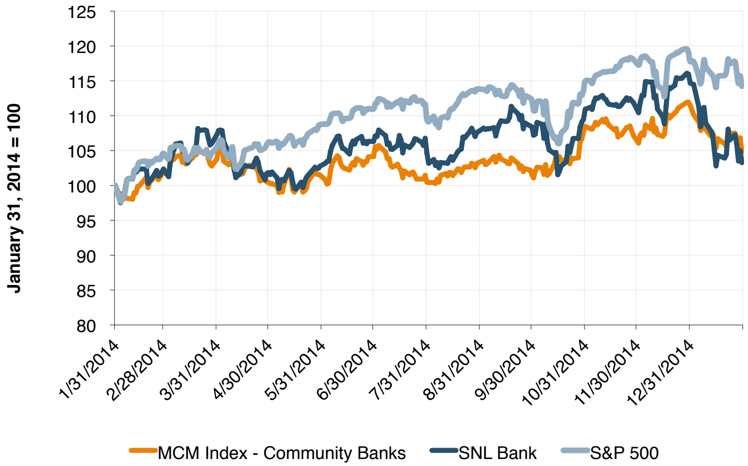
*View replay at http://mer.cr/bnkweb2*

### 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.

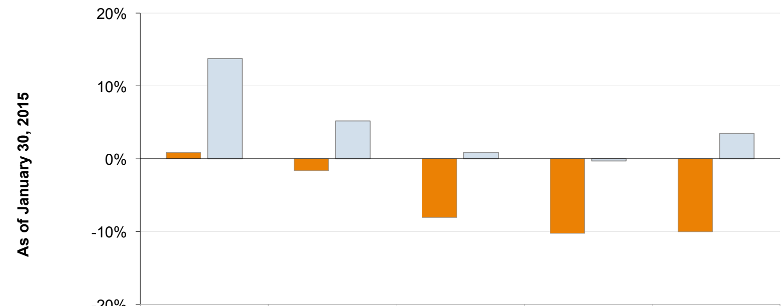
*View replay at http://mer.cr/capital-rules-webinar*

## Mercer Capital's Bank Group Index Overview




## Return Stratification of U.S. Banks

by Asset Size



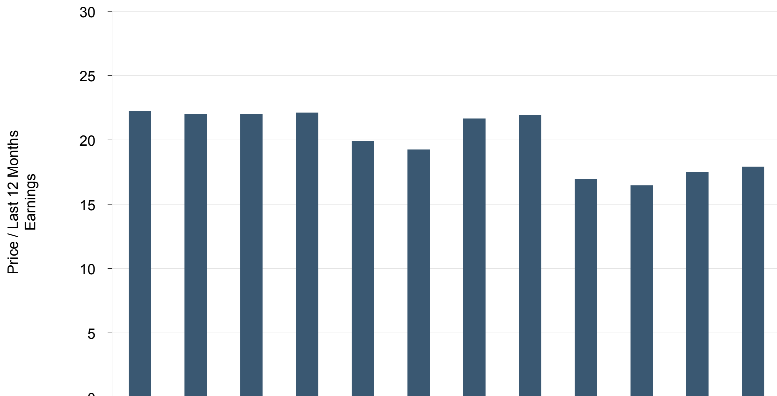

| | Assets $250 - $500M | Assets $500M - $1B | Assets $1 - $5B | Assets $5 - $10B | Assets > $10B |
|---|---|---|---|---|---|
| Month-to-Date | 0.86% | -1.65% | -8.08% | -10.26% | -10.04% |
| Last 12 Months | 13.75% | 5.19% | 0.88% | -0.32% | 3.48% |

## Median Valuation Multiples

| | Median Total Return | | Median Valuation Multiples as of January 30, 2015 | | | | | |
|---|---|---|---|---|---|---|---|---|
| Indices | Month-to-Date | Last 12 Months | Price/ LTM EPS | Price / 2015 (E) EPS | Price / 2016 (E) EPS | Price / Book Value | Price / Tangible Book Value | Dividend Yield |
| Atlantic Coast Index | -4.71% | 6.66% | 14.71 | 14.75 | 12.89 | 104.1% | 113.8% | 2.2% |
| Midwest Index | -5.61% | 5.57% | 14.01 | 12.80 | 11.52 | 106.3% | 116.0% | 2.5% |
| Northeast Index | -6.15% | 3.43% | 13.91 | 13.40 | 11.94 | 111.0% | 118.4% | 3.2% |
| Southeast Index | -5.41% | 11.70% | 12.28 | 13.06 | 11.49 | 100.0% | 105.1% | 1.6% |
| West Index | -6.58% | 2.47% | 14.90 | 13.52 | 12.43 | 118.3% | 128.7% | 2.3% |
| Community Bank Index | -5.97% | 4.82% | 14.20 | 13.76 | 12.06 | 109.3% | 116.3% | 2.5% |
| **SNL Bank Index** | **-9.94%** | **3.27%** | | | | | | |

## Median Price/Earnings Multiples

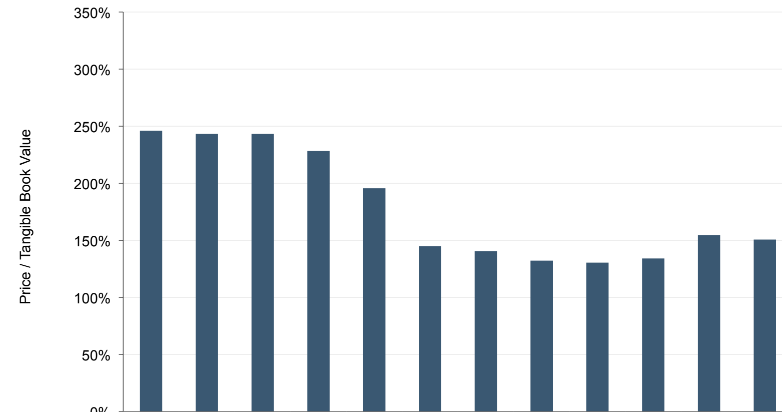
*Target Banks' Assets <$5B and LTM ROE >5%*




| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | LTM |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| U.S. | 22.3 | 22.0 | 22.0 | 22.1 | 19.9 | 19.3 | 21.7 | 21.9 | 17.0 | 16.5 | 17.5 | 17.9 |

## Median Price/Tangible Book Value Multiples

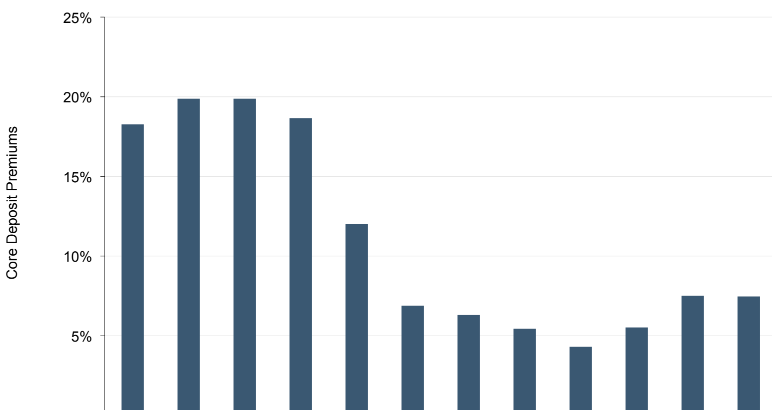
*Target Banks' Assets <$5B and LTM ROE >5%*




| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | LTM |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| U.S. | 246% | 243% | 243% | 228% | 196% | 145% | 141% | 132% | 130% | 134% | 155% | 151% |

## Median Core Deposit Multiples

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




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

## Median Valuation Multiples for M&A Deals

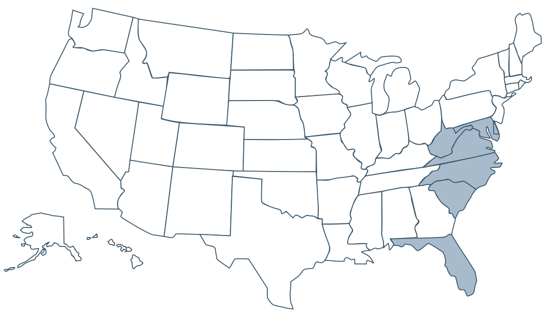
*Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended January 2015*

| Regions | Price / LTM Earn-ings | 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 | 1.61 | 8.3% | 10 | 56.40 | 462,003 | 9.23% |
| Midwest | 18.75 | 1.57 | 7.1% | 63 | 41.47 | 117,155 | 8.93% |
| Northeast | 18.97 | 1.71 | 8.9% | 10 | 101.87 | 431,132 | 7.61% |
| Southeast | 15.21 | 1.41 | 6.1% | 32 | 48.12 | 199,160 | 8.33% |
| West | 18.46 | 1.45 | 7.8% | 16 | 65.51 | 410,128 | 8.52% |
| **Nat'l Community Banks** | **17.92** | **1.51** | **7.5%** | **131** | **52.52** | **221,343** | **8.77%** |

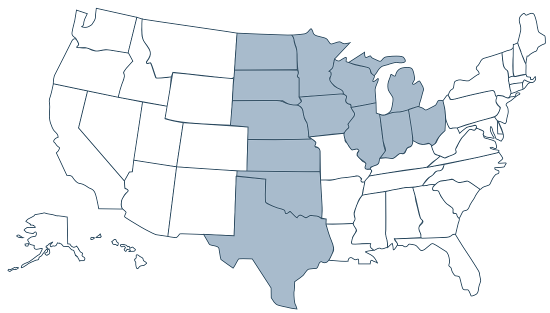
*Source: Per SNL Financial*

# Mercer Capital's Regional Public Bank Peer Reports

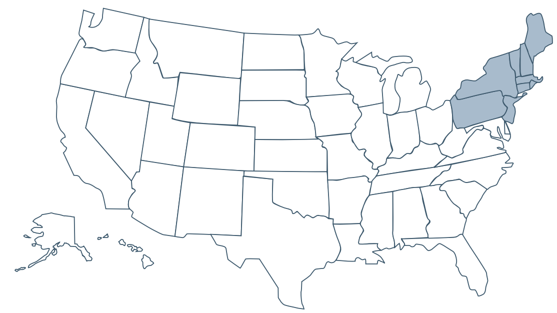
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



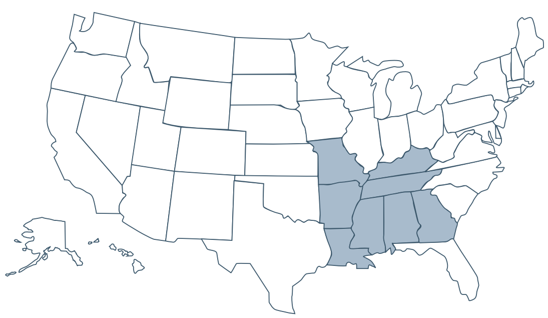
**Atlantic Coast**



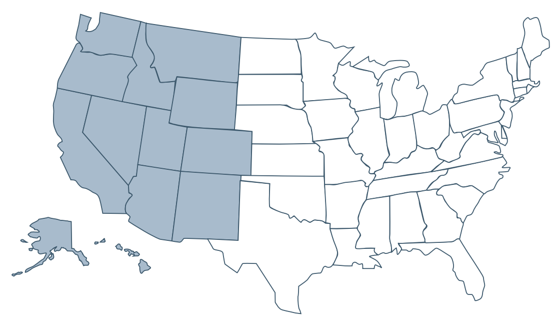
**Midwest**



**Northeast**



**Southeast**



**West**

# Mercer Capital

## 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.

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