Bank Watch

June 2015

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MERCER CAPITAL

Bank Watch

Using Employee Stock Ownership Plans

Helping Community Banks with Strategic Issues

In our view, Employee Stock Ownership Plans (ESOPs) are an important omission in the current financial environment as a number of companies and banks lack a broader, strategic understanding of the possible roles of ESOPs as a tool to manage a variety of strategic issues facing community banks. Given the strategic challenges facing community banks, we strive to help our clients, as well as the broader industry, fill this gap, and discuss some common questions related to ESOPs in the following article.

We will be glad to discuss your bank's current situation as well as the role an ESOP can play in detail. If you are interested in learning more about ESOPs, **click here** for a complimentary electronic copy of our book, ***The ESOP Handbook for Banks: Exploring an Alternative for Liquidity and Capital While Maintaining Independence*** (available for a limited time only). In addition, if you would like to speak to a Mercer Capital professional, contact Jay Wilson at 901.685.2120 or **wilsonj@mercercapital.com**.

For those less familiar with ESOPs, we answer a few basic questions related to ESOPs. For those more familiar with ESOPs, skip to the question entitled "**How can an ESOP help the bank deal with strategic issues?**".

What Is an ESOP and How Does It Work?

ESOPs are a written, defined contribution retirement plan, designed to qualify for some tax-favored treatments under IRC Section 401(a). While similar to a more typical profit-sharing plan, the fundamental difference is that the ESOP must be primarily invested in the stock of the sponsoring company (only S or C corporations). ESOPs can acquire shares through employer contributions (either in cash or existing/newly issued shares) or by borrowing money to purchase stock (existing or newly issued) of the sponsoring company. Once holding shares, the ESOP obtains cash via sponsor contributions, borrowing money, or dividends/distributions on shares held by the ESOP. When an employee exits the plan, the sponsoring company must facilitate the repurchase of the shares, and the ESOP may use cash to purchase shares from the participant. Following repurchase, those shares are then reallocated among the remaining participants.

What Are Some Tax Benefits Related to ESOPs?

Similar to other profit-sharing plans, contributions (subject to certain limitations) to the ESOP are tax-deductible to the sponsoring company. The ESOP is treated as a single tax-exempt shareholder. This can be of particular benefit to S corporations, as the earnings attributable to the ESOP's interest in the sponsoring company are untaxed. The tax liability related to ESOP planholder's accounts is at the participant level and generally deferred similar to a 401(k) until employees take distributions from the plan.

Who Can Sponsor an ESOP?

Both publicly traded and private banks/holding companies (C or S-Corps.) can sponsor ESOPs, but the benefits are often more profound for private institutions that are not as actively traded, as the ESOP can promote a more active market and enhance liquidity more for the privately-held shares.

» **Augmenting capital**, particularly for profitable institutions facing limited access to external capital. Though an ESOP strategy generally builds capital more slowly than a private placement alternative or a public offering, it provides certain tax advantages and may result in less dilution to existing shareholders. For additional perspective, consider the following example. Let us assume that the holding company has $5 million of debt or preferred stock (this example could also include TARP or SBLF funding) with a five year term and an interest rate of 5%. Assuming that the subsidiary bank is the holding company's primary source of cash (which is often the case for most community banks), the typical option to service this holding company obligation would be dividends from the bank to the holding company. However, an ESOP is another option that might be worth considering as ESOP contributions are tax-deductible expenses and this allows the bank's capital position to benefit.

How Can an ESOP Help The Bank Deal With Strategic Issues?

While not suitable in all circumstances, an Employee Stock Ownership Plan may provide assistance in resolving a number of strategic issues facing community banks and can offer benefits to plan participants, existing shareholders, and the sponsor company, including:

Figure 1: H/C Debt Strategy Comparison (ESOP vs. Bk Dividends)

	Today	Year 1	Year 2	Year 3	Year 4	Year 5	Cumulative
H/C Debt Outstanding at Year-End	5,000	4,000	3,000	2,000	1,000	-	
Principal Payments		1,000	1,000	1,000	1,000	1,000	5,000
Interest Payments (5% Rate)		250	200	150	100	50	750
Cash Flow from Bank to Service Debt		1,250	1,200	1,150	1,100	1,050	**5,750**
Comparison of Impact on Bank Equity							**Cumulative**
After-Tax ESOP Contributions (Contribution * 0.65)		(813)	(780)	(748)	(715)	(683)	(3,738)
Bank Dividends to H/C		(1,250)	(1,200)	(1,150)	(1,100)	(1,050)	(5,750)
Difference		**438**	**420**	**403**	**385**	**368**	**2,013**
Bank Equity (ESOP)	20,000	19,188	18,408	17,660	16,945	16,263	
Bank Equity (Non-ESOP)	20,000	18,750	17,550	16,400	15,300	14,250	
Difference ($)		**438**	**858**	**1,260**	**1,645**	**2,013**	
Difference (%)	**0%**	**2%**	**5%**	**8%**	**11%**	**14%**	

Source: Mercer Capital FIG Group Research

In the ESOP strategy, cash contributions received by the ESOP are used to purchase newly issued shares of the sponsor's common stock (in this case, the holding company), providing liquidity that the bank holding company then uses to service holding company's debt. As detailed in the table below, the ESOP strategy provides the necessary cash flow to the holding company for its obligations but results in approximately $2 million of added bank capital (approximately 35% of the cash needed to service the holding company obligation) at the end of the five-year period. This higher capital could be used in a variety of ways by the underlying bank, either to fund future earning asset growth organically or through acquisitions, pay additional distributions to the holding company for shareholder dividends, or as a cushion against adverse events such as credit losses. However, there is a trade-off to augmenting the bank's capital using the ESOP strategy, as the holding company's shares outstanding will increase thereby causing dilution to existing shareholders.

» **Facilitating stock purchases and providing liquidity absent a sale of the bank to outsiders** by creating an "internal" stock market whose transaction activity can promote confidence in stock pricing. The ESOP offers the further advantage of providing a vehicle to own shares that is "friendly" to the existing board of directors. For example, the ESOP can offer an alternative exit strategy beyond selling the bank to outside investors through an IPO or acquisition by providing a liquidity avenue that allows for ownership transition while maintaining independence. For C-corporations, the shareholder may even have the ability to sell his or her shares in a tax-free manner subject to certain limitations related to a Section 1042 rollover, including the ESOP owning 30% or more of each class of outstanding stock after the transaction and the seller reinvesting the proceeds into qualified replacement property from 3 to 12 months after the sale; and,

» **Providing employee benefits and increasing long-term shareholder value.** ESOPs provide a beneficial tool in rewarding employees at no direct cost to themselves by providing common stock and tying their reward to the long-term stock performance of the bank/company, which can serve to increase employee morale and shareholder value over time. For example, a recent study by Ernst & Young found that the total return for S Corporation ESOPs from 2002 to 2012 was a compound annual growth rate of 11.5% compared to the total return of the S&P 500 over the same period of 7.1%.[1] The measure of S ESOP returns considers cumulative distributions as well as growth in value of net assets, net of those distributions (i.e., growth in underlying value per share).

What We're Reading

C.K. Lee of Commerce Street Capital has an interesting video on BankDirector.com that discusses risks related to in-market mergers.

http://mer.cr/1JzTZmp

Jeff Davis of Mercer Capital has some interesting takeaways in an article entitled "Nuances of M&A Accounting for Banks: Investors Will Have No One to Blame But Themselves."

http://mer.cr/1H8YFhf

Ernst & Young had an interesting study detailing how S-Corporation ESOPs have provided better returns for plan holders than the broader market entitled "Contribution of S ESOPs to Participants' Retirement Security: Prepared for the Employee-Owned S Corporations of America" dated March 2015.

http://mer.cr/1T7SgaM

Dave Martin, Executive VP of Financial Supermarkets, Inc. takes a look at the role of bankers and branches as technology transforms the industry in an article entitled "The Branch of the Future is Only as Good as Its Bankers".

http://mer.cr/1G81soE

What Is the First Step for Those Considering an ESOP?

For those considering implementing ESOPs, the first step is generally a feasibility study of what the ESOP would actually look like once implemented at your bank. Parts of the study would include determining the value of the company's shares, the pro-forma implications from the potential transaction/installation, as well as what after-tax proceeds the seller might expect. This will help determine whether the bank should proceed, wait a few years to implement, or move to another strategic option. There are typically a number of parties involved in implementations including among others an appraiser/valuation provider, trustee, attorney or plan designer, and administrative committee.

What Are Some Potential Drawbacks to ESOPs?

ESOPs are subject to both tax and benefit law provisions (such as the ERISA act of 1974). Certain negatives associated with them can include:

- The costs of setting up and maintaining the plans
- The repurchase obligation for the sponsoring company as employees retire or exit the plan
- Regulatory issues with the Deportment of Labor serving as primary regulator and the IRS being able to review plan activities
- Fiduciary roles associated with ESOP trustees
- Potential complexities related to shareholder dilution from issuing new shares

Are There Any New Developments for ESOP Trustees to Consider?

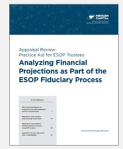
For existing ESOPs, two recent legal and regulatory developments have brought up important issues for trustees to consider as well.

Dudenhoeffer

In 2014, the Supreme Court ruled on the case of *Fifth Third Bancorp v. Dudenhoeffer*, which involved a public company that matched employee contributions to a 401(k) plan by contributing employer stock to an ESOP that was part of the plan. The ruling states that the standard of prudence applicable to all ERISA fiduciaries also applies to ESOPs, though ESOP fiduciaries are not required to diversify the ESOP's holdings. The Court ruling was focused on public company ESOPs, but its implications for private company ESOPs are unclear. However, trustees should consider ensuring an investment policy statement is in place for the ESOP, stating that the policy is to invest primarily in employer stock in accordance with the purpose of the Plan; and, if applicable, the policy statement could potentially clarify that employees have diversification options through other benefit plans such as a 401(k) plan.

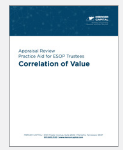
Appraisal Review Practice Aids for ESOP Trustees

By Timothy R. Lee, ASA, Managing Director of Corporate Valuation and Current Member of the ESOP Association Valuation Advisory Committee



ANALYZING FINANCIAL PROJECTIONS AS PART OF THE ESOP FIDUCIARY PROCESS

This whitepaper focuses on the use of financial projections in ESOP valuations. The use (or misuse) of financial projections is often the most direct cause of over- or under-valuation in ESOPs.

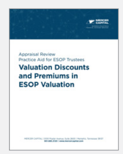


CORRELATION OF VALUE

In this whitepaper, we provide insight on the functional processes and analytical considerations underlying the determination of a correlated indication of value.

THE MARKET APPROACH

This whitepaper provides an overview of the primary elements of comparability and adjustments under the three primary categories of market methodology.



VALUATION DISCOUNTS AND PREMIUMS IN ESOP VALUATION

Debate over discounts and premiums in business valuation persists. Nowhere is this truer than with the marketability discount (or DLOM). Within the ESOP community, much of the confusion over DLOMs is mitigated due to the presence of put options. However, a legacy of concern over control premiums has now become an acute issue.

GreatBanc Trust

Scrutiny related to ESOPs, particularly as it relates to certain valuation issues, has increased in recent years, with the DOL bringing a number of cases against trustees and other parties. In the case of Perez, *Secretary of the DOL v. GreatBanc Trust Company*, there is a process agreement that we encourage ESOP companies and their trustees to review. While the process requirements are only specific to GreatBanc, the case has received a lot of attention in the ESOP community.

In October 2012, The U.S. Department of Labor filed a lawsuit against GreatBanc Trust Co. and Sierra Aluminum Co. in the U.S. District Court for the Central District of California. Among other issues identified in the suit, the DOL alleged that GreatBanc violated the Employee Retirement Income Security Act by breaching its fiduciary duties to the Sierra Aluminum Employee Stock Ownership Plan when it allowed the plan to pay more than fair market value for employer stock in June 2006. The suit also named the ESOP's sponsor, Sierra Aluminum, as a defendant. The sponsor's indemnification agreement with GreatBanc allegedly violated ERISA regulations. The suit focuses on the quality of the appraisal on which the trustee relied, particularly on the supportability of the assumptions used in the cash flow projection.

As part of the settlement negotiations, the DOL and GreatBanc have agreed upon a specific set of policies and procedures as trustee of an ESOP. While specific to GreatBanc, the transaction procedures are presumed to be applicable to all Trustees and related appraiser relationships. The process requirements cover the following areas:

- Selection and Use of Valuation Advisor
- Oversight of Valuation Advisor
- Financial Statements
- Fiduciary Review Process
- Preservation of Documents
- Fair Market Value
- Consideration of Claw-Back
- Other Professionals

In general, the process agreement makes clear that trustees must ensure that ESOP valuations are well documented with thoroughly supported assumptions.

How Can Mercer Capital Help?

Mercer Capital has been providing ESOP appraisal services for over 25 years and has extensive ESOP experience through providing annual valuations, installation advisory, feasibility studies, financial expert services related to legal disputes, and fairness opinions. Our appraisals are prepared in accordance with the Employee Retirement Income Security Act ("ERISA"), the Department of Labor, and the Internal Revenue Service guidelines, as well as Uniform Standards of Professional Appraisal Practice ("USPAP"). We are active members of The ESOP Association and the National Center for Employee Ownership (NCEO). Our professionals have been frequent speakers on topics related to ESOP valuation throughout our 32-year history. Mercer Capital professionals also co-authored the publication, ***The ESOP Handbook for Banks*** (2011), which provides insight into key ESOP-related issues affecting banking organizations.

Again if you are interested in learning more about ESOPs, **click here** for a complimentary electronic copy of our book, ***The ESOP Handbook for Banks: Exploring an Alternative for Liquidity and Capital While Maintaining Independence*** (available for a limited time only). In addition, if you would like to speak to a Mercer Capital professional, contact Jay Wilson at 901.685.2120 or **wilsonj@mercercapital.com**.

For additional ESOP resources, view our whitepapers **Insights on ESOPs** and **Choosing a New ESOP Appraiser**.

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[1] Contribution of S ESOPs to participants' retirement security: Prepared for Employee-Owned S Corporations of America March 2015) Report can be accessed at: http://www.efesonline.org/LIBRARY/2015/EY_ESCA_S_ESOP_retirement_security_analysis_2015.pdf

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.

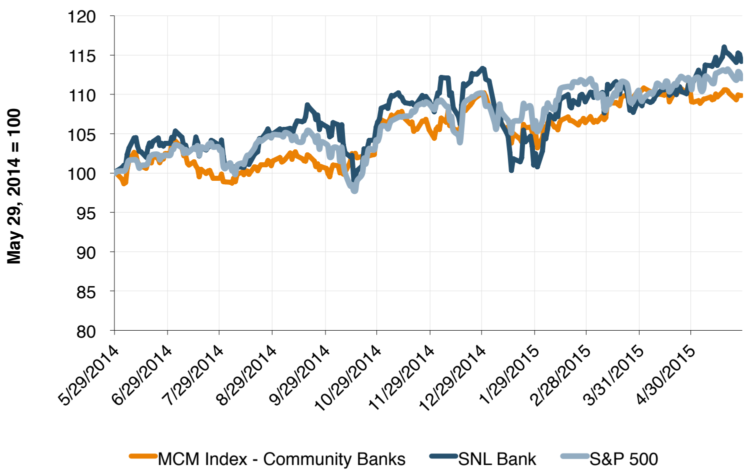
View replay at http://mer.cr/bnkweb2

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.

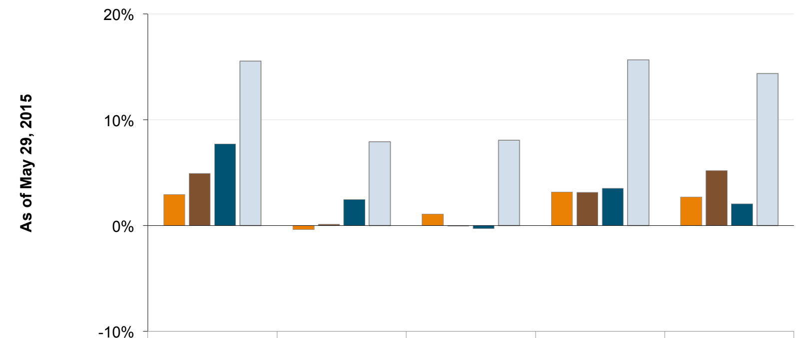
View replay at http://mer.cr/capital-rules-webinar

Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



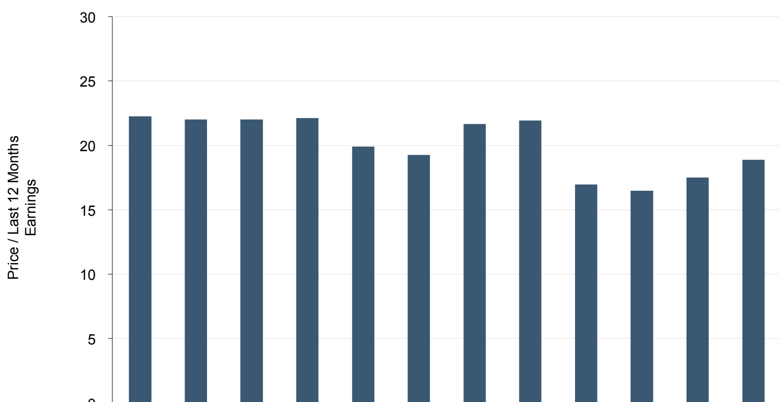
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	2.94%	-0.38%	1.08%	3.17%	2.70%
Quarter-to-Date	4.92%	0.13%	-0.06%	3.15%	5.20%
Year-to-Date	7.73%	2.47%	-0.28%	3.53%	2.05%
Last 12 Months	15.55%	7.93%	8.08%	15.68%	14.38%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of May 29, 2015					
Indices	Month-to-Date	Quarter-to-Date	Year-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	1.69%	-0.29%	1.07%	12.23%	15.05	15.74	12.81	105.9%	115.7%	2.2%
Midwest Index	1.76%	2.37%	1.96%	11.59%	14.06	13.77	12.46	114.0%	125.2%	2.4%
Northeast Index	-0.94%	-1.57%	-1.90%	3.60%	14.58	14.04	12.56	113.0%	123.5%	3.0%
Southeast Index	1.01%	-0.56%	0.97%	19.60%	12.95	14.62	12.24	105.9%	117.3%	1.6%
West Index	0.95%	-0.98%	-0.09%	9.96%	15.51	15.69	13.04	120.4%	124.7%	2.4%
Community Bank Index	0.71%	-0.45%	0.08%	9.84%	14.51	14.62	12.81	111.6%	121.5%	2.3%
SNL Bank Index	**2.65%**	**4.93%**	**2.04%**	**14.19%**						

Median Price/Earnings Multiples

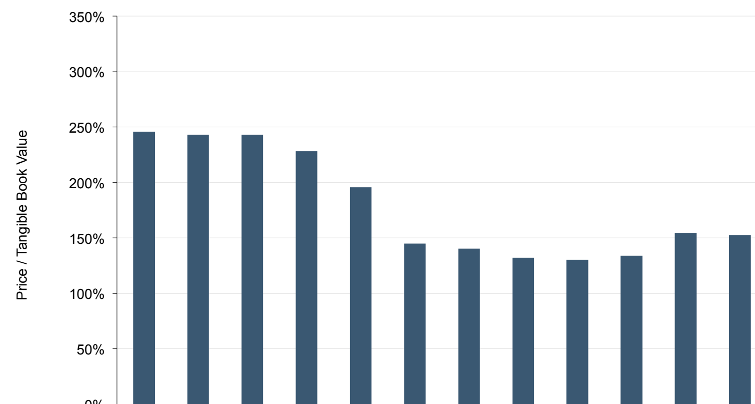
Target Banks' Assets <$5B and LTM ROE >5%



	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	18.9

Median Price/Tangible Book Value Multiples

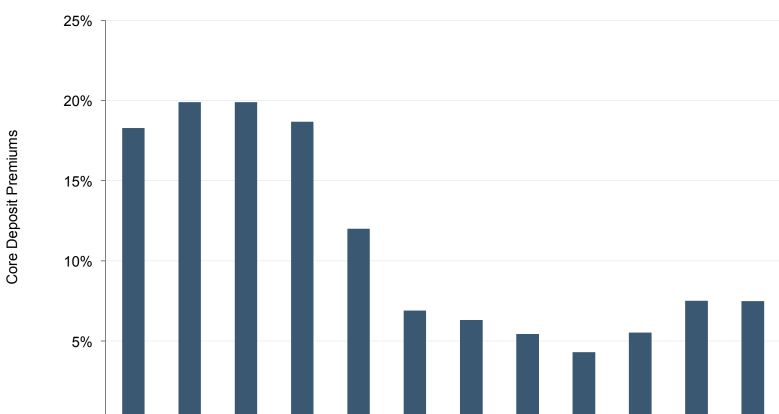
Target Banks' Assets <$5B and LTM ROE >5%



	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%	153%

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

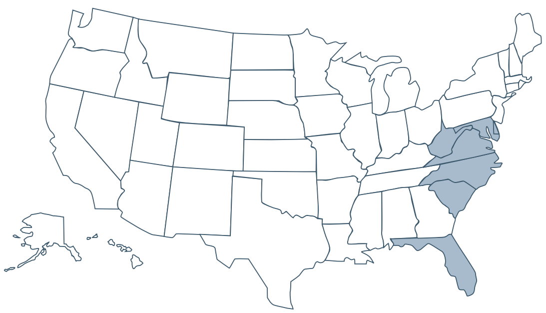
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended May 2015

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	20.06	1.66	8.5%	14	71.16	479,979	8.61%
Midwest	17.69	1.55	7.1%	73	41.47	104,786	8.93%
Northeast	18.41	1.71	12.4%	6	133.64	676,218	8.05%
Southeast	17.14	1.36	5.8%	28	34.45	186,921	8.19%
West	18.92	1.50	7.8%	18	83.16	383,962	9.68%
Nat'l Community Banks	**18.89**	**1.53**	**7.5%**	**139**	**51.60**	**186,356**	**8.86%**

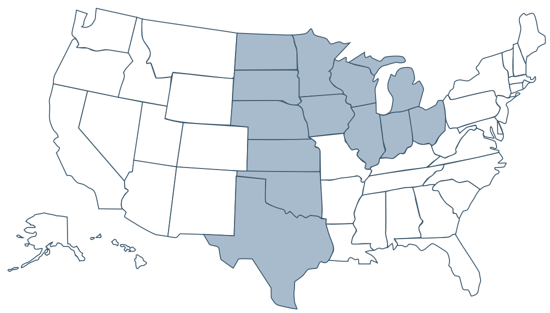
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

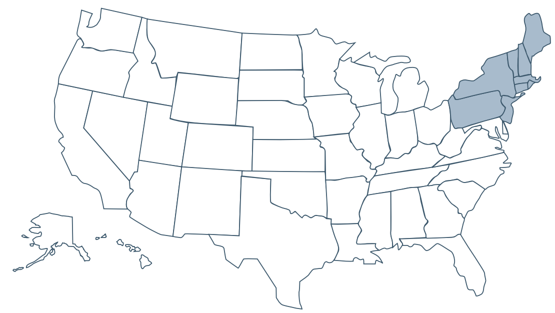
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



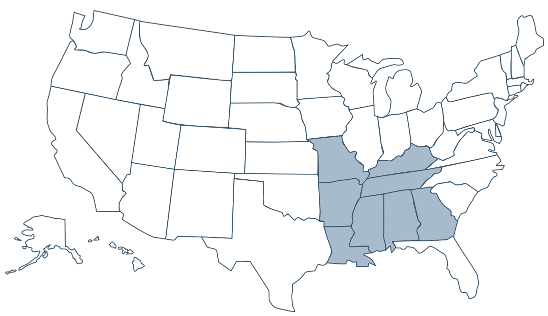
Atlantic Coast



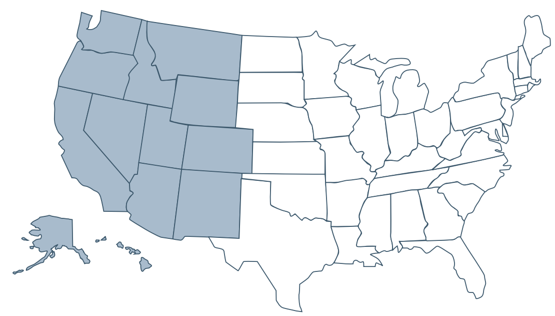
Midwest



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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