MERCER CAPITAL

Bank Watch

September 2015

August Market Performance & Augustus Caesar — 1

Noncompete Agreements for Section 280G Compliance — 3

Public Market Indicators — 5

M&A Market Indicators — 6

Regional Public Bank Peer Reports — 7

About Mercer Capital — 8

Erickson Partners Merges with **Mercer Capital** — 9

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Bank Watch

August Market Performance & Augustus Caesar

In contemplating August's market activity, our thoughts drifted to Roman times. In 45 B.C., the Roman Senate honored Julius Caesar by placing his name on the month then known, somewhat drably, as Quintilis. Later, the Senate determined that Augustus Caesar deserved similar recognition, placing his name on the month after July. But this created an immediate issue in the pecking order of Roman rulers – up until then, months alternated between having 30 and 31 days. With July having 31 days, poor Augustus' stature was diminished by placing his name on a month having only 30 days. To rectify this injustice, the Senate decreed that August also have 31 days, accomplished by borrowing a day from February and shifting other months such that September only had 30 days (to avoid having three consecutive 31-day months).

We provide this historical interlude to illustrate that, while July and August now are equivalent in terms of the number of days, the market environment in these two months during 2015 bore few similarities. In August, volatility returned, commodity prices sank, and expectations of Federal Reserve interest rate action in September diminished.

Figure 1: Change in Index

	Change in Index Between:		
	12/31/14 - 7/31/15	12/31/14 - 8/31/15	7/31/15 - 8/31/15
DJIA	-0.7%	-7.3%	-6.6%
S&P 500	2.2%	-4.2%	-6.3%
NASDAQ	8.3%	0.9%	-6.9%
Russell 2000	2.8%	-3.8%	-6.4%
SNL U.S. Bank > $10B	5.5%	-2.3%	-7.4%
SNL U.S. Bank $5B-$10B	9.8%	5.0%	-4.4%
SNL U.S. Bank $1B-$5B	4.9%	2.2%	-2.5%
SNL U.S. Bank $500M-$1B	4.8%	3.9%	-0.8%

Source: SNL Financial, Mercer Capital research

Figure 2: Median Share Price Change

	Median Share Price Change Between:		
	12/31/14 - 7/31/15	12/31/14 - 8/31/15	7/31/15 - 8/31/15
LA, TX, OK Banks	8.5%	6.8%	-4.7%
2015 IPO Banks	na	na	-5.5%
Asian American Banks	14.7%	9.9%	-4.2%
All 212 Banks	3.9%	2.9%	-1.1%

Source: SNL Financial, Mercer Capital research

Most broad stock market indices declined between 6% and 7% in August, taking the indices generally to negative territory year-to-date in 2015. As indicated in Figure 1, except for the largest banks, publicly-traded banks generally outperformed the broader market, both year-to-date in 2015 and in August specifically.

For the year, banks benefited from several factors. First, investors appear to expect that rising interest rates will, if not enhance banks' earnings, at least prove to be a neutral factor. Other sectors of the market, though, may be less fortunate, as companies face higher interest payments or other adverse effects of higher interest rates. Second, banks generally reported steady growth in earnings per share, as assisted by a benign credit environment.

Within any index, though, the performance of individual companies may vary greatly. Seeking to isolate factors influencing the August market performance, we focused on publicly-traded banks with assets between $500 million and $5 billion. Given the market backdrop, these 212 banks performed relatively well in August, with a median share price depreciation of only 1.1% (see Figure 2). For the year, the median bank reported a 2.9% increase in its stock price.

While linking company-specific factors to market performance during a volatile period is difficult, we identified three groups of banks that underperformed in August:

» After losing investor favor in the second half of 2014, banks in the oil patch states of Louisiana, Oklahoma, and Texas performed well in 2015, advancing by 9% between December 31, 2014 and July 31, 2015. However, oil prices falling below $40/barrel dealt these banks a setback in August, as the median share prices of banks in these states fell by 5%.

» All the banks that completed IPOs during 2015 fell during August, with a median depreciation of 6%. Nevertheless, post-IPO performance remains favorable, as all the banks reported share prices at August 31, 2015 that exceeded their IPO prices by 10% to 20%. Investors in these banks may have wished to realize profits during a volatile period.

» Banks identified with Asian American communities also suffered, owing to their perceived greater exposure to slowing economies in China and throughout the Asian region. Even after the August decline, though, these banks have reported solid performance in 2015.

Several risks that influenced August's volatility have not dissipated, including uncertainty surrounding China's opaque (and potentially over-leveraged) economy and the effect of any Fed policy tightening. Analyst estimates for 2016 EPS often suggest favorable growth over 2015, and such estimates bear watching to the extent that the recent market volatility spills over into the real economy.

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What We're Reading

Safwan Zaheer has an interesting piece on *The Financial Brand* entitled "How Banks Can Out-Innovate Start-Ups and Tech Firms."

http://mer.cr/1N67B8Z

Jonathan Hightower of Bryan Cave LLP has a nice piece on how buyers can structure their due diligence process efficiently and effectively on *BankDirector* entitled "Doom Diligence: Don't Let Your Due Diligence Hurt You."

http://mer.cr/1Kun4B0

Jack Milligan takes a look at a key question facing many community bankers today: "Should Community Bankers Worry About Digital Transformation?"

http://mer.cr/1FITK8c

Noncompete Agreements for Section 280G Compliance

Golden parachute payments have long been a controversial topic. These payments, typically occurring when a company undergoes a change-in-control, can result in windfalls for senior executives and in some cases draw the ire of political activists and shareholder advisory groups. Golden parachute payments can also lead to significant tax consequences for both the company and the individual. Strategies to mitigate these tax risks include careful design of compensation agreements and consideration of noncompete agreements to reduce the likelihood of excise taxes.

When planning for and structuring an acquisition, companies and their advisors should be aware of potential tax consequences associated with the golden parachute rules of Sections 280G and 4999 of the Internal Revenue Code. A change-in-control (CIC) can trigger the application of IRC Section 280G, which applies specifically to executive compensation agreements. Proper tax planning can help companies comply with Section 280G and mitigate significant tax penalties.

Golden parachute payments usually consist of items like cash severance payments, accelerated equity-based compensation, pension benefits, special bonuses, or other types of payments made in the nature of compensation. In a CIC, these payments often are made to the CEO and other named executive officers (NEOs) based on agreements negotiated and structured well before the transaction event. In a single-trigger structure, only a CIC is required to activate the award and trigger accelerated vesting on equity-based compensation. In this case, the executive's employment need not be terminated for a payment to be made. In a double-trigger structure, both a CIC and termination of the executive's employment are necessary to trigger a payout.

Adverse tax consequences may apply if the total amount of parachute payments to an individual exceeds three times (3x) that individual's "Base Amount." The Base Amount is generally calculated as the individual's average annual W-2 compensation over the preceding five years.

As shown in Figure 1, if the 3x threshold is met or crossed, the excess of the CIC Payments over the Base Amount is referred to as the Excess Parachute Payment. The individual is then liable for a 20% excise tax on the Excess Parachute Payment, and the employer loses the ability to deduct the Excess Parachute Payment for federal income tax purposes.

Several options exist to lessen the impact of the Section 280G penalties. One option is to design (or revise) executive compensation agreements to include "best after-tax" provisions, in which the CIC payments are reduced to just below the threshold only if the executive is better off on an after-tax basis. Another strategy that can lessen or mitigate the impact of golden parachute taxes is to consider the value of noncompete provisions that relate to services rendered after a CIC. If the amount paid to an executive for abiding by certain noncompete covenants is determined to be reasonable, then the amount paid in exchange for these services can reduce the total parachute payment.

According to Section 1.280G-1 of the Code, the parachute payment "does not include any payment (or portion thereof) which the taxpayer establishes by clear and convincing evidence is reasonable compensation for personal services to be rendered by the disqualified individual on or after the date of the change in ownership or control." Further, the Code goes on to state that "the performance of services includes holding oneself out as available to perform services and refraining from performing services (such as under a covenant not to compete or similar arrangement)."

Figure 2 illustrates the impact of a noncompete agreement exemption on the calculation of Section 280G excise taxes.

Figure 1

Illustration of Section 280G Penalties	Penalty NOT Triggered	Penalty Triggered	
Base Amount (CEO's 5-yr Avg. Comp.)	$500,000	$500,000	**A**
Threshold (3x Base Amount)	1,500,000	1,500,000	
Hypothetical Change-in-Control Payments	1,499,999	1,500,000	**B**
Are CIC Payments ≥ Threshold?	No	Yes	
Excess Parachute Payment (CIC Payment - Base)	None	1,000,000	**C = B - A**
Excise Tax Penalty to CEO (20% Excess)	0	200,000	**C x 20%**
Lost Corporate Tax Deduction (40% Excess)	0	400,000	**C x 40%**
Total Additional Costs Due to Penalties		$600,000	

Figure 2

Allocation of Value to Noncompete Agreement in CIC Payment Structure	Base Case	Exemption for Noncompete	
Base Amount (CEO's 5-yr Avg. Comp.)	$500,000	$500,000	**A**
Threshold (3x Base Amount)	1,500,000	1,500,000	
Hypothetical Change-in-Control Payments	1,500,000	1,500,000	
- Exemption for Noncompete payments	0	(400,000)	
Adjusted Total CIC Payments	1,500,000	1,100,000	**B**
Are CIC Payments ≥ Threshold?	Yes	No	
Excess Payment (CIC Payment - Base)	1,000,000	None	**C = B - A**
Excise Tax Penalty to CEO (20% Excess)	200,000	0	**C x 20%**
Lost Corporate Tax Deduction (40% Excess)	400,000	0	**C x 40%**
Total Additional Costs Due to Penalties	$600,000	$0	

How can the value of a noncompete agreement be reasonably and defensibly calculated? Revenue Ruling 77-403 states the following:

"In determining whether the covenant [not to compete] has any demonstrable value, the facts and circumstances in the particular case must be considered. The relevant factors include: (1) whether in the absence of the covenant the covenantor would desire to compete with the covenantee; (2) the ability of the covenantor to compete effectively with the covenantee in the activity in question; and (3) the feasibility, in view of the activity and market in question, of effective competition by the covenantor within the time and area specified in the covenant."

A common method to value noncompete agreements is the "with or without" method. Fundamentally, a noncompete agreement is only as valuable as the stream of cash flows the firm protects "with" an agreement compared to "without" one. Cash flow models can be used to assess the impact of competition on the firm based on the desire, ability, and feasibility of the executive to compete. Valuation professionals should consider factors such as revenue reductions, increases in expenses and competition, and the impact of employee solicitation and recruitment.

Unlike a technology company, for example, where the company's value often lies in its intellectual property, the value of a bank is attributable in large part to its employees' relationships with customers, other employees, and the community at large. Therefore, the value of a noncompete agreement is proportional to a covered executive's ability to disrupt these relationships, absent an effective noncompete agreement. To evaluate the effect of potential competition by a banking company's executive officers, a valuation analysis focuses on factors such as:

» Customer relationships developed by the covered executive or maintained by his or her ongoing interactions with the customers

» Employee relationships developed through the covered executive's involvement in recruiting efforts or otherwise fostered by multiple years of working together

» Community relationships influenced by the covered executive's stature in the community, particularly to the extent these may lead prospective customers to develop relationships with the bank

Mercer Capital provides independent valuation opinions to assist companies with IRC Section 280G compliance. Our opinions are well-reasoned and well-documented, and have been accepted by the largest U.S. accounting firms and various regulatory bodies, including the SEC and the IRS.

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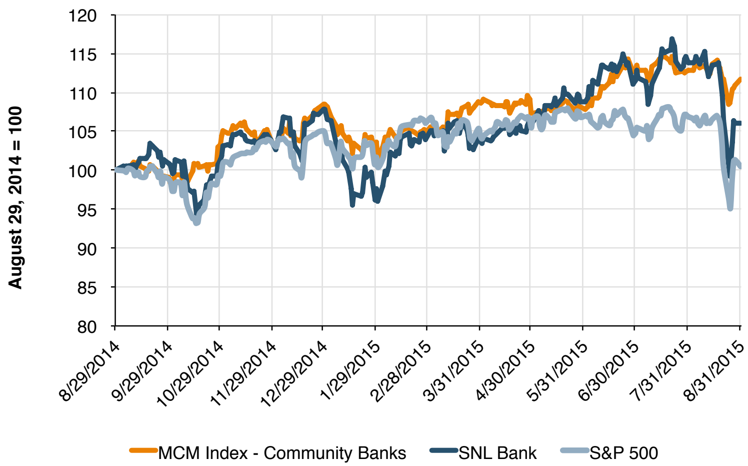
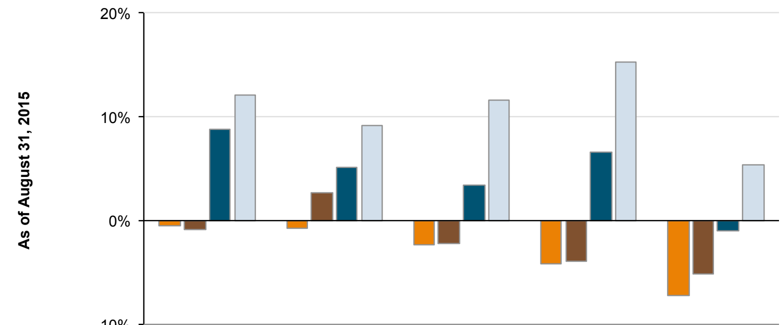
Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



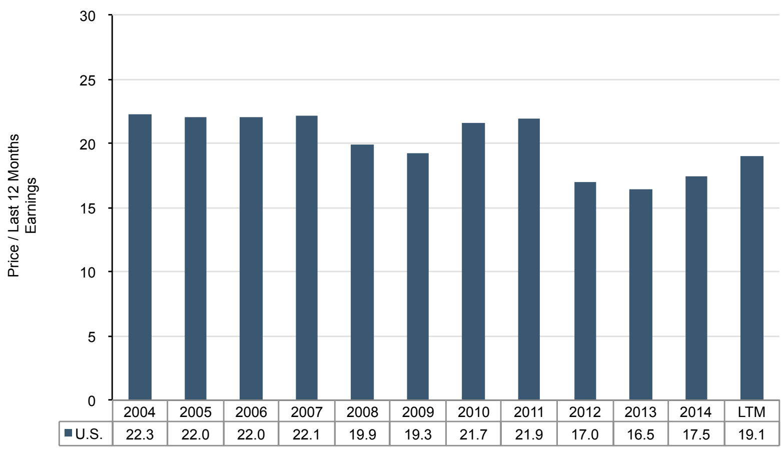
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	-0.51%	-0.70%	-2.37%	-4.22%	-7.22%
Quarter-to-Date	-0.89%	2.68%	-2.21%	-3.88%	-5.13%
Year-to-Date	8.82%	5.16%	3.47%	6.57%	-1.01%
Last 12 Months	12.07%	9.11%	11.63%	15.28%	5.43%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of August 31, 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	-0.15%	1.04%	6.00%	15.62%	15.42	14.79	13.08	102.6%	112.3%	2.3%
Midwest Index	-1.91%	-2.72%	3.56%	10.71%	14.10	13.86	12.26	115.2%	122.8%	2.3%
Northeast Index	-0.98%	-1.43%	0.54%	6.72%	14.18	14.39	12.60	114.3%	123.4%	3.0%
Southeast Index	-0.72%	-2.21%	3.89%	18.71%	12.78	14.46	12.93	111.3%	117.9%	1.7%
West Index	-0.64%	1.51%	5.59%	12.27%	15.50	15.86	13.82	120.3%	128.6%	2.5%
Community Bank Index	-1.06%	-1.07%	3.33%	11.67%	14.47	14.66	12.88	111.3%	119.9%	2.5%
SNL Bank Index	**-6.94%**	**-4.97%**	**-0.57%**	**5.98%**						

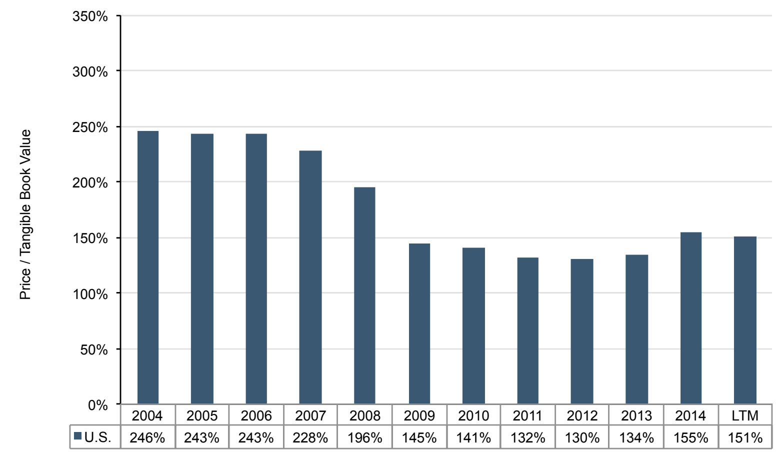
Median Price/Earnings Multiples

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



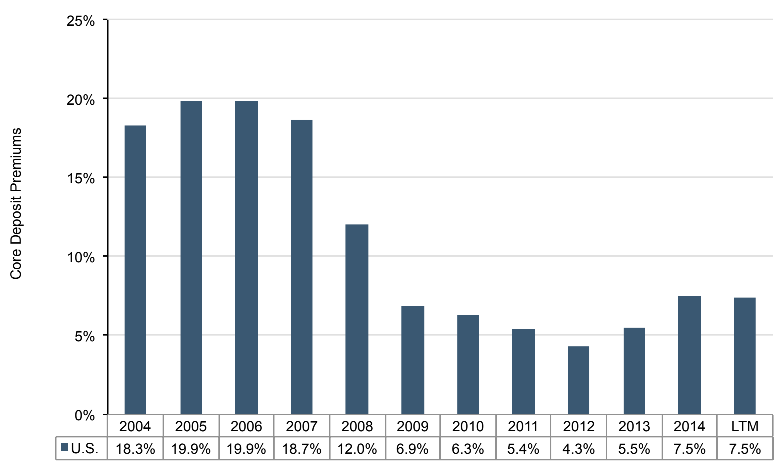
Median Price/Tangible Book Value Multiples

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



Median Core Deposit Multiples

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



Median Valuation Multiples for M&A Deals

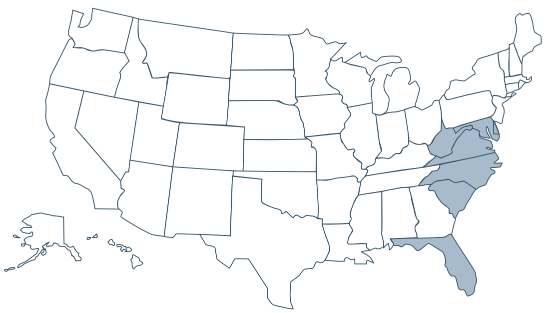
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended August 2015

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	21.17	1.68	8.2%	14	88.30	489,067	7.89%
Midwest	17.69	1.57	7.4%	71	33.55	107,691	8.77%
Northeast	21.24	1.58	5.2%	8	90.62	493,509	7.21%
Southeast	17.85	1.40	6.1%	27	29.78	187,485	8.14%
West	21.41	1.48	7.8%	16	59.83	227,300	9.18%
Nat'l Community Banks	**19.08**	**1.51**	**7.5%**	**136**	**42.17**	**186,681**	**8.26%**

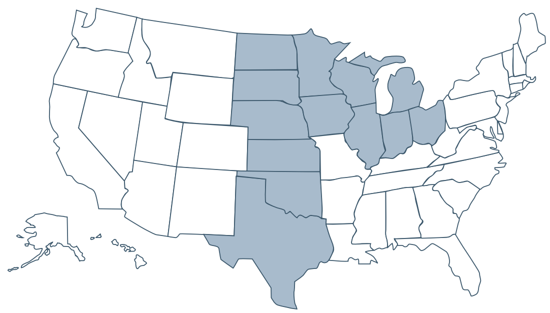
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

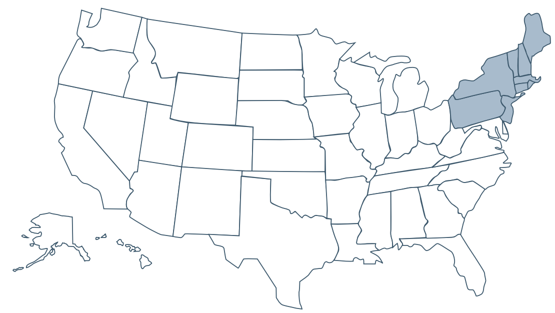
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



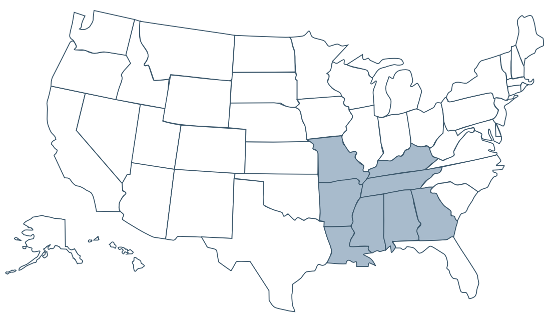
Atlantic Coast



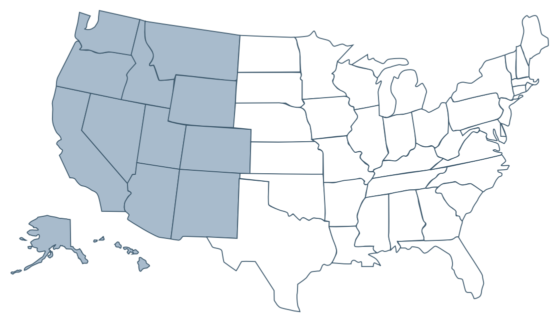
Midwest



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.

- Bank valuation
- Financial reporting for banks
- Goodwill impairment
- Litigation support
- Loan portfolio valuation
- Tax compliance
- Transaction advisory
- Strategic planning

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*, *Acquiring a Failed Bank*, *The Bank Director's Valuation Handbook*, and *Valuing Financial Institutions*, Mercer Capital professionals speak at industry and educational conferences.

For more information about Mercer Capital, visit www.mercercapital.com.

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Erickson Partners Merges with Mercer Capital

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ERICKSON | PARTNERS
Valuation & Advisory Services

Mercer Capital, a national business valuation and financial advisory firm specializing in Corporate Valuation, Litigation Support, Financial Reporting Valuation, and Transaction Advisory Consulting, and **Erickson Partners, Inc.**, a Texas-based Valuation and Litigation Support firm, announce their merger effective July 1, 2015.

Mercer Capital, with its strong presence throughout the Southeast and Midwest, and Erickson Partners, with its strong presence in Texas and Oklahoma, are a perfect fit.

Both firms maintain the highest standards of quality for financial analysis and client service and believe deeply in hiring and developing the best professionals.

"The culture of both firms is so similar and that was important to us. The professionals of Erickson Partners are well-known in the valuation profession as some of the best and brightest. Their work product and reputation are stellar. This merger not only allows us to broaden our geographic reach but also our industry expertise," said **Matt Crow**, President of Mercer Capital.

Erickson Partners enhances Mercer Capital's broad base of industry concentrations with their exceptional history working with and knowledge of professional sports franchises and the energy sector.

"Over our 30 plus year history, Mercer Capital has developed several industry concentrations. By adding the knowledge, insight, and expertise of Don Erickson, Bryce Erickson, and the rest of the professionals of Erickson Partners, we now bring deep experience and insight to a broader range of industries than we could as separate firms," said **Chris Mercer**, CEO of Mercer Capital.

"Combining with Mercer Capital, we will now be able to offer new or expanded services that complement our existing services, as well as additional industry expertise," said **Bryce Erickson**, Managing Director of Erickson Partners. "In addition to our sports franchise and energy industry concentrations, we will be able to offer deep industry concentrations in construction and building materials, agribusiness, manufacturing and financial institutions, which includes depository institutions, insurance companies, fintech companies, asset management firms, and PE firms."

"The combined firm will have over 40 valuation professionals positioned in five markets throughout the southwest and southeast. Such a deep bench will provide us with a tremendous opportunity to better serve the expanding needs of our clients," said **Don Erickson**, President of Erickson Partners. "Joining with Mercer Capital gives us national resources that will benefit our clients in Texas and beyond."

About Mercer Capital

Mercer Capital is a national business valuation and financial advisory firm offering corporate valuation, litigation support, financial reporting valuation, and transaction advisory consulting services to a national client base. Clients include private and public operating companies, financial institutions, asset holding companies, high-net worth families, and private equity/hedge funds.

About Erickson Partners, Inc.

Erickson Partners is a professional valuation and advisory firm specializing in business valuation, litigation support, financial investigations and strategic corporate advisory services. Founded by Don & Bryce Erickson, Erickson Partners has served large and small clients by providing complex financial and economic analysis, leading to reasonable valuation opinions that withstand scrutiny.

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