MERCER CAPITAL

Bank Watch

June 2016

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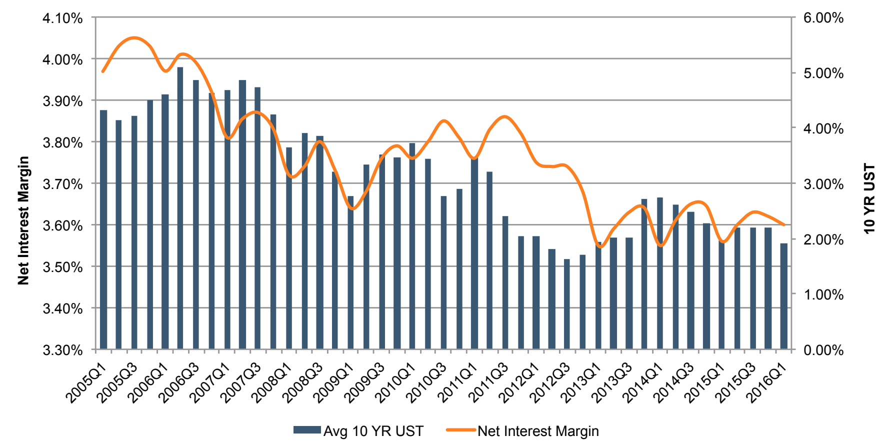
A Watched Pot Never Boils

Still Waiting on Margin Relief

As expected after lackluster job gains in May, the Federal Open Market Committee declined to raise the Fed Funds target at the latest policy meeting on June 15th. While the majority of policymakers still expect the Fed to boost rates twice before the end of this year, the number of officials who forecast just one rate hike increased from one to six from the previous forecasting round in March. In addition, Fed officials lowered their expectations for future years, now expecting the fed funds rate to rise to 1.6% by year-end 2017, down from the 1.9% estimate in March, and 2.4% in 2018, down from the previous estimate of 3.0%. During a press briefing on June 3rd, members of the Economic Advisory Committee of the American Bankers Association said they still expect the Fed to boost rates twice before the end of this year, but after years of speculation regarding timing of rate increases, when that will happen remains anyone's best guess. The bond market never believed the forecasts.

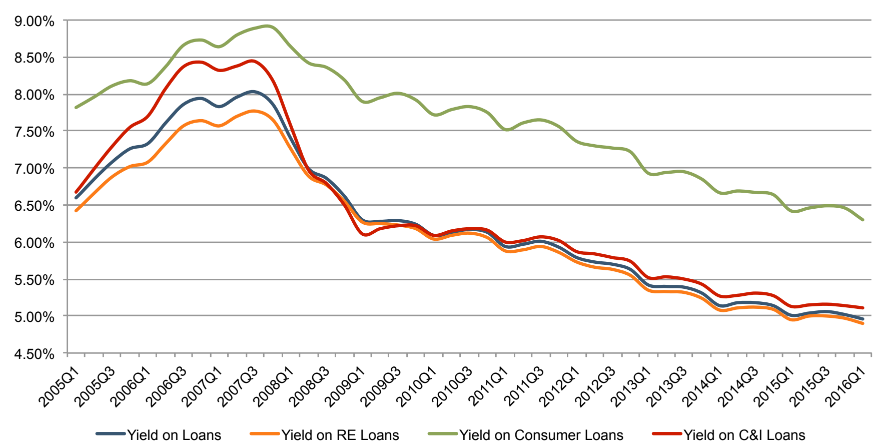
Rate increases are long awaited by community bankers as banks are facing profitability challenges. Net interest margins continue to compress and loan growth remains stymied by intense competition for high quality loans. Margin relief remains out of the grasp of most community banks, absent further rate hikes beyond the December 2015 hike. After rebounding modestly in the third and fourth quarter of 2015, the median net interest margin of community banks (defined as those with assets between $100 million and $5 billion), ticked down modestly in the first quarter of 2016 as intense competition for quality loans drove down loan yields and the decline in long-term rates put downward pressure on securities' yields (Charts 1 and 2). Overall, median net interest income continued to increase as growth in loans offset margin compression, but intense competition raises concerns over how much credit standards have been relaxed to drive loan growth.

Chart 1: Trend in Net Interest Margin



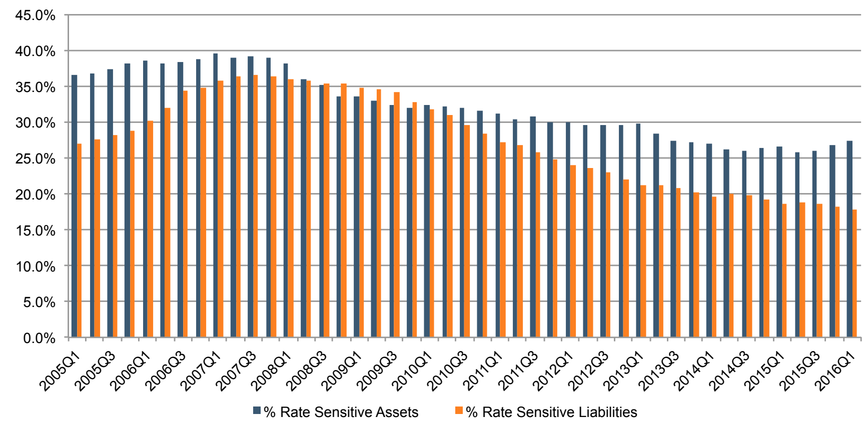
Source: S&P Global Market Intelligence

Chart 2: Loan Yield Trends



Source: S&P Global Market Intelligence

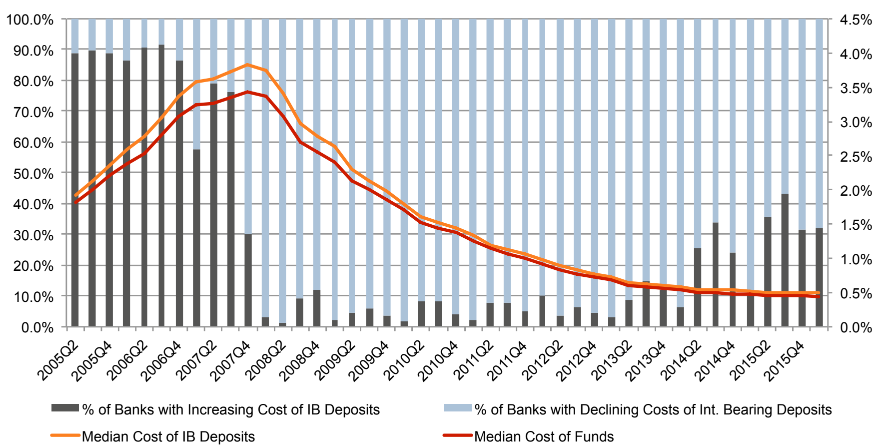
Chart 3: Interest Rate Sensitivity



* % of assets (liabilties) expected to mature or reprice within 1 year

Source: S&P Global Market Intelligence

Chart 4: Trend in Interest Bearing Deposit Costs



Source: S&P Global Market Intelligence

Although the majority of banks' balance sheets are poised to take advantage of rising rates, the lift to net interest margins is dependent on asset yields rising faster than the cost of funds (Chart 3). While deposits costs essentially reached a floor several quarters ago, data suggests the threat of rising deposit rates may limit margin expansion in a rising rate environment. As shown in Chart 4, the percentage of banks reporting quarter-over-quarter increases in the cost of interest bearing deposits has been trending upward over the last eight quarters. In a higher rate environment, customers are more likely to shop around for higher rates. The increase observed in interest bearing accounts could reflect the fact that higher loan growth has compelled some banks to raise rates or perhaps an effort to build goodwill with customers in anticipation of rising rates and increased rate sensitivity. For banks with asset sensitive balance sheets, the benefit of rising interest rates will be greater the stickier low cost deposits are.

While net interest margin is a key metric for banks, focusing on other drivers of profitability is one way to combat margin compression in the face of further delays in interest rate hikes or upward pressure on deposit costs. Consider the following:

» **Look for opportunities to grow non-interest income.** One strategic option may be to expand bank offerings into non-traditional bank business lines that are less capital intensive and offer prospects for non-interest income growth such as acquisitions or partnerships with insurance, **wealth management**, specialty finance, and/or financial technology companies. FinTech's consumer-focused technology and ability to quickly adapt can pair well with community banks who can provide an established customer base and knowledge of the regulatory process and environment. For more information, we recently wrote **an article on why current market conditions may be ripe for FinTech partnerships**.

» **Leverage technology to curb efficiency ratios.** Compliance and regulatory costs continue to rise and represent a bigger burden to

What We're Reading

FASB's long-awaited standards update for credit losses was released in mid-June. Read more about it at the following links:

- "**FASB Releases New Financial Instruments Standard on Accounting for Credit Losses**" by Michael Cohn on *AccountingToday*
- "**FASB Issues Final Loan Loss Accounting Standard**" by *ABA Banking Journal*

One great way to start preparing for CECL implementation is to strengthen your bank's stress testing process. For more information on stress testing, see a **recap of our presentation**.

Rick Childs of Crowe Horwath has an interesting article on "**How Community Banks Can Fund M&A**" using holding company debt.

The *Wall Street Journal* had a thought provoking piece entitled "**Small Banks Are in Good Shape, So Why Aren't They Doing Better**" by Michael Rapoport.

We also took a look at some of the factors driving partnerships between banks and FinTech companies in a piece entitled "**Are Market Conditions Driving More FinTech Partnerships and M&A?**"

community banks who lack the scale to accommodate these expenses in comparison to their larger peers. **A recent article from *American Banker*** included data presented by Chris Nichols, chief strategy officer of CenterState Banks, at a recent fintech conference in Atlanta that shows why engaging customers digitally is more efficient. Furthermore, **a recent article published on SNL** highlights how, in some regards, community banks can be quicker to adopt new technology than larger peers. While size may limit what projects are feasible for community banks, agility has its benefits.

- **Increase scale.** Create economies of scale and improve profitability organically or by merging with a larger company. Organic loan growth is an obvious cure to the margin blues, but must be achieved while maintaining credit quality and holding adequate capital. M&A remains a classic solution to revenue headwinds in a mature industry, and bank acquirers can potentially have savings beyond expense synergies with some NIM relief resulting from potential accretion income on the acquired assets, which are marked to fair value at acquisition.

Mercer Capital has a long history of working with banks and helping to solve complex problems ranging from valuation issues to considering different strategic options. If you would like to discuss your bank's unique situation in confidence, feel free to contact us.

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Yadkin Financial Corp. May Not Be a Slam Dunk

Jeff K. Davis, CFA, Managing Director of Mercer Capital's Financial Institutions Group, is a regular editorial contributor to SNL Financial. This contribution was originally published June 3, 2016, at SNL Financial. It is reprinted here with permission.

Bloomberg News reported on May 25 that Raleigh, N.C.-based **Yadkin Financial Corp.** has hired Sandler O'Neill & Partners LP to explore a sale. Following the news, analysts and investors were generally not surprised the board could be moving to sell for several reasons. Avoiding the cost of crossing the Dodd-Frank Rubicon of $10 billion of assets was cited as one reason. I would add no one goes broke taking a profit. There seems to be disagreement what the shares might command in an acquisition.

I am offering my two bits.

Yadkin could be a compelling strategic acquisition. Almost all of its $5.2 billion of deposits are domiciled in North Carolina where it had the seventh-largest market share position as of June 30, 2015. It does not have a dominating presence in the major MSAs, but enough to be meaningful, I think, to a wide array of potential acquirers such as First Horizon National Corp. Synovus Financial Corp. and possibly PNC Financial Services Group Inc. and Fifth Third Bancorp.

Given its deep roots in the state, a lower Wall Street profile (there is no analyst coverage) and perhaps a longer-term view of investing than a "typical" publicly held bank, Raleigh-based First Citizens BancShares Inc. might be the most logical acquirer. An in-market acquirer should be able to realize the most synergies and rationalize a higher acquisition price.

An alternative transaction might entail a merger-of-equals or quasi MOE. My non-legal opinion is that boards are not required to run auctions to solicit the highest price as long as there is a reasonable plan to create long-term value when contemplating a course of action. MOE partners might include South State Corp., Capital Bank Financial Corp. or United Community Banks Inc. In a year or so, BNC Bancorp might be an option, too, once it has consummated and integrated its pending acquisitions of Southcoast Financial Corp. and High Point Bank Corp.

MOEs can be compelling transactions if execution risks are manageable, earnings accretion is sizable and the merged entity is viewed by investors as having a higher growth rate and strategic value (in a sale) than the two banks on stand-alone basis. If so, investors should be able to justify a higher P/E on the higher pro forma EPS. That is an ideal scenario for an MOE; others might describe it as a unicorn. MOEs also are ideal when one or both parties do not have a potential acquirer. There are other advantages, too, such as potentially enhanced dividends and improved share liquidity.

Yadkin's institutional investors might flip out over an MOE if they were convinced a large bank that would be deemed an acquirer could pay a sizable premium. Wall Street usually is for maximum realizable value now rather than waiting patiently for value to be created when given the option. The carping among shareholders about the pending MOE between Chemical Financial Corp. and Talmer Bancorp Inc. is an example of investor angst over "price" versus long-term "value" creation potential in an MOE. If Coach Bryant were a bank investor rather than a football coach, he might describe an MOE like "kissing your sister," which is how he described ties before college football adopted the playoff format years after his death.

Although Yadkin seemingly will have a number of attractive options, I see two potential related issues that may pre-empt a slam dunk in terms of a price that excites the Street.

The obvious one is valuation. As of June 1, Yadkin's shares traded for 19.6x consensus 2016 earnings, 13.7x 2017 consensus earnings and 222% of tangible book value. The shares are expensive. I realize the jump in projected earnings between 2016 and 2017 reflects the anticipated synergies to be realized from the March 1 acquisition of NewBridge Bancorp. Nevertheless, I think the shares are rich and thereby will impact the potential premium absent a bank such as First Citizens being able to realize large expense synergies.

The second issue follows from the first: earning power. Yadkin represents a recent roll-up of a number of banks. Many (or most) publicly traded banks are roll-ups when viewed over 10 or 20 years, but Yadkin has added a lot of assets the past few years. The March acquisition of NewBridge added \$2.8 billion of assets, which equates to about 37% of Yadkin's \$7.4 billion of assets as of March 31. NewBridge added nearly \$550 million of assets through two acquisitions that closed in April 2014 and February 2015. During July 2014 Yadkin added \$2 billion of assets via an MOE with VantageSouth Bancshares Inc., which in turn had acquired about \$900 million of assets through the April 2013 acquisition of ECB Bancorp Inc.

In short, there is no earnings history for Yadkin as currently constituted for even a one-year period after synergies have been realized from recent transactions much less through a full business and credit cycle. The earning power issue is further clouded by purchase accounting from past acquisitions.

Yadkin's first quarter GAAP NIM was 4.05% compared to the core NIM that excludes all purchase accounting impacts of 3.70%.

The earning power question, I think, will matter one way or the other to an acquirer or merger partner. While the issue(s) can be modeled, the degree of confidence will not be the same as observing a historical track record. After all, it is a lot easier to get paid for what a bank has made compared to what it plans to make, much less what analysts say it will make in 2017.

Assuming the Bloomberg report is correct, the timing to move to sell the company now raises another issue. Why now rather than waiting until 2017 to start the process? I am sure there is a good reason, but I do not know what it may be other than the M&A environment for well-situated sellers is good today even though Yadkin's timing is not 100% optimal. Markets and the economy may not be as favorable next year.

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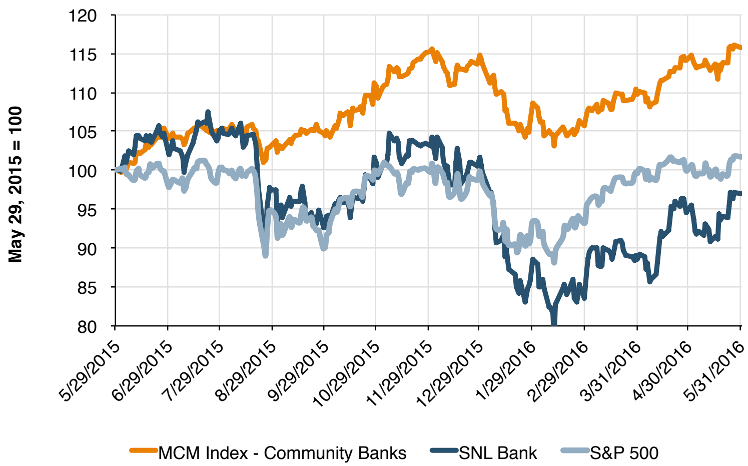
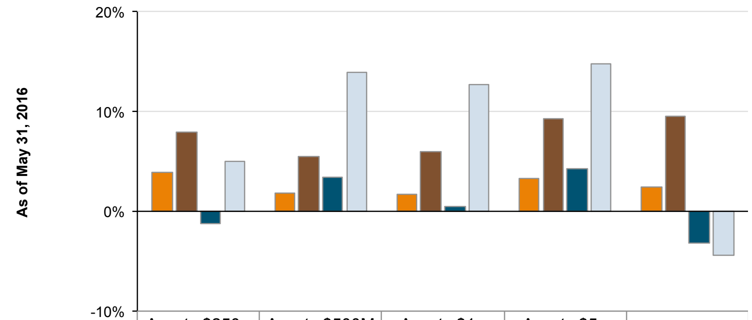
Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



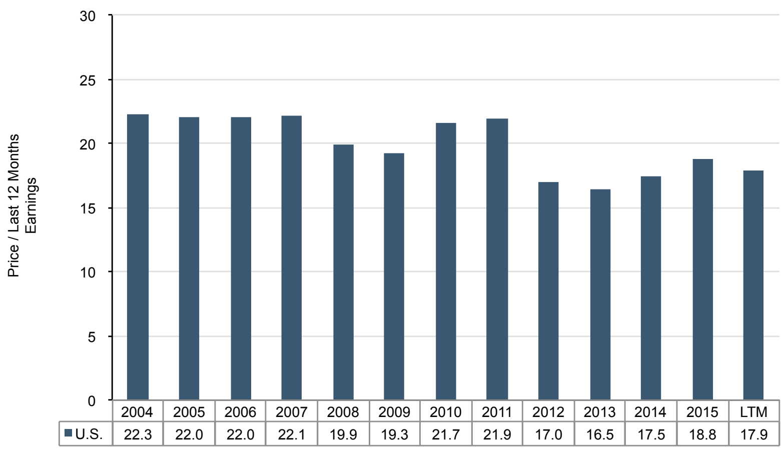
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	3.92%	1.85%	1.68%	3.24%	2.42%
Quarter-to-Date	7.89%	5.55%	5.99%	9.25%	9.53%
Year-to-Date	-1.17%	3.46%	0.44%	4.30%	-3.24%
Last 12 Months	4.96%	13.95%	12.75%	14.76%	-4.40%

Median Valuation Multiples

	Median Total Return				Median Valuation Multiples as of May 31, 2016					
Indices	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2016 (E) EPS	Price / 2017 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast	1.08%	4.97%	3.51%	19.86%	16.5x	15.3x	13.8x	114%	129%	2.0%
Midwest	2.45%	7.24%	3.03%	17.31%	14.3x	14.0x	12.7x	117%	137%	2.2%
Northeast	1.58%	4.38%	1.93%	10.36%	14.3x	13.1x	11.4x	113%	124%	3.3%
Southeast	1.30%	5.20%	-1.35%	13.53%	14.7x	15.0x	13.2x	107%	117%	1.5%
West	1.75%	7.01%	1.85%	18.28%	15.2x	14.8x	13.1x	118%	127%	2.5%
National Community Banks	1.54%	5.54%	1.89%	15.82%	15.0x	14.7x	13.0x	115%	129%	2.2%
SNL Bank Index	**2.42%**	**9.37%**	**-2.76%**	**-3.09%**						

Median Price/Earnings Multiples

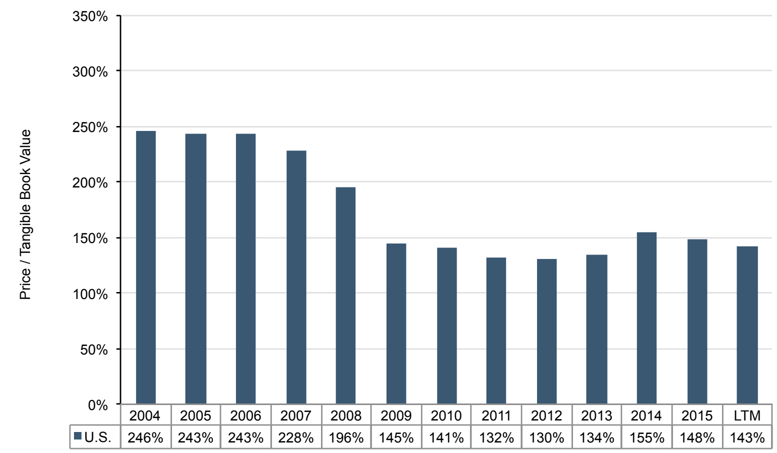
Target Banks' Assets <$5B and LTM ROE >5%



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	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	18.8	17.9

Median Price/Tangible Book Value Multiples

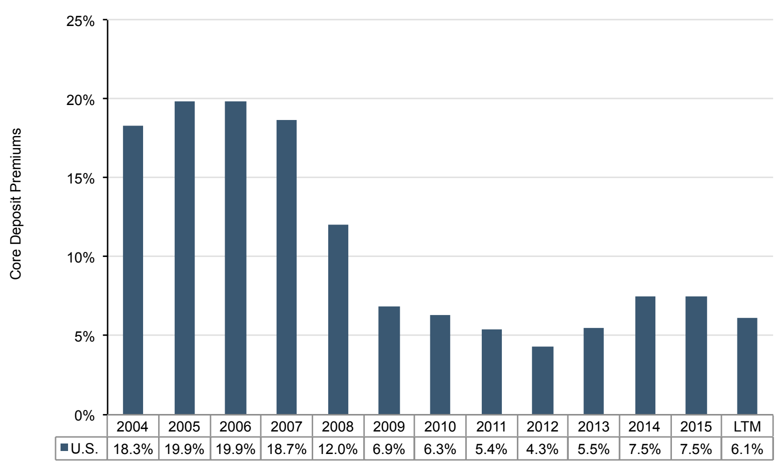
Target Banks' Assets <$5B and LTM ROE >5%



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	LTM
U.S.	246%	243%	243%	228%	196%	145%	141%	132%	130%	134%	155%	148%	143%

Median Core Deposit Multiples

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



	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	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%	6.1%

Median Valuation Multiples for M&A Deals

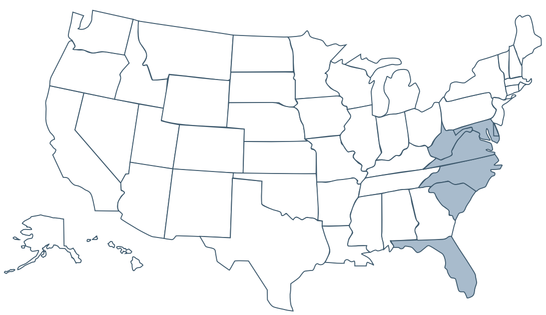
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended May 2016

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	17.8x	147%	6.0%	22	57.66	424,074	7.83%
Midwest	17.5x	134%	4.9%	66	20.20	137,292	8.60%
Northeast	21.5x	139%	7.2%	9	48.62	395,284	6.69%
Southeast	16.6x	145%	9.0%	24	58.71	223,333	11.15%
West	16.1x	141%	6.7%	14	41.25	242,061	10.41%
National Community Banks	**17.9x**	**143%**	**6.1%**	**135**	**36.74**	**196,960**	**8.67%**

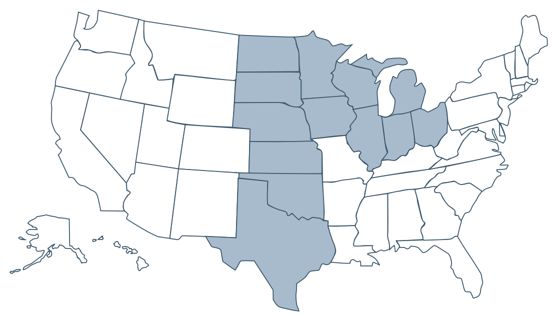
Source: Per SNL Financial

Mercer Capital's Regional Public Bank Peer Reports

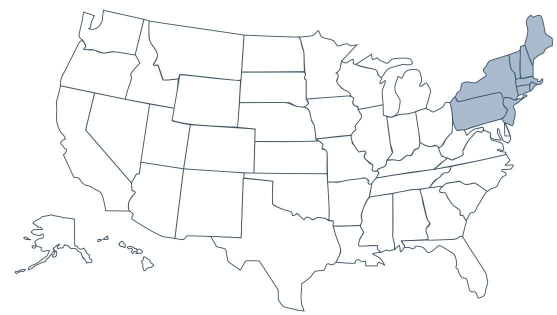
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



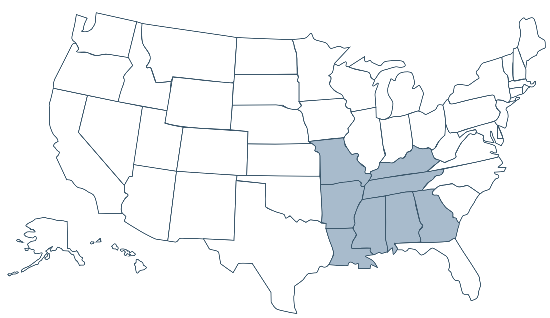
Atlantic Coast



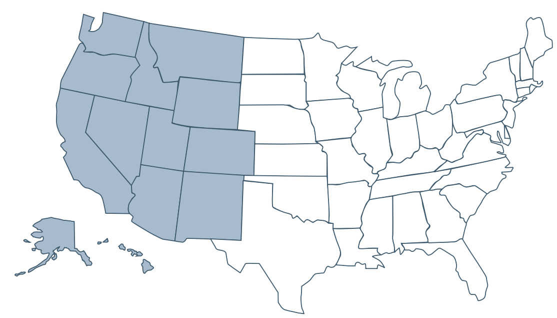
Midwest



Northeast



Southeast



West

Mercer Capital

Financial Institutions Services

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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.

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- Goodwill impairment
- Litigation support
- Stress Testing
- 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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