Bank Watch

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The Importance of Size, Profitability, and Asset Quality in Valuation

The question for most financial institutions is not if a valuation is necessary, but when it will be required. Valuation issues that may arise include merger and acquisition activity, an employee stock ownership plan, capital planning, litigation, or financial planning, among others. Thus, an understanding of some of the drivers impacting your bank’s value is an important component in preparing for these eventualities.

Data Analysis & Quantitative Factors Affecting Your Bank’s Value

Determining the value of your bank is more complicated than simply taking a financial metric from one of your many financial reports and multiplying it by the relevant market multiple. However, examination of current and long term public pricing trends can shed some light on how certain quantitative factors may affect the value of your bank.

To analyze trends, we focus our discussion on P/TBV ratios since this is one of the most commonly cited metrics for bankers. While all banks can be affected by overall macroeconomic trends like inflation rates, employment rates, the regulatory environment, and the like, we explore relative value in light of three factors we consider in all appraisals – size, profitability, and asset quality.

Size

Size differentials generally encompass a range of underlying considerations regarding financial and market diversity. A larger asset base generally implies a broader economic reach and oftentimes a more diverse revenue stream which can help to mitigate harmful effects of unforeseen events that may adversely affect a certain geographic market or industry. Furthermore, larger banks tend to have access to more metropolitan markets which have better growth prospects relative to more rural markets. Figures 1 and 2 on the next page illustrate that, to a point, larger size typically plays a role in value, as measured by price / tangible book value multiples. The sweet spot for asset size seems to be between $5 and $10 billion in total assets. Banks in this category traded at the highest P/TBV multiple as of September 30, 2017 and have generally outperformed all other asset size groups over the long term.
Figure 1 | Pricing Multiples at 9/30/2017: Asset Size Sort

<table>
<thead>
<tr>
<th>Asset Size</th>
<th>P/E</th>
<th>P/TBV</th>
<th>Discount / Premium to Group Median P/E</th>
<th>Discount / Premium to Group Median P/TBV</th>
<th>Number of Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>250M-500M</td>
<td>20.2</td>
<td>1.32</td>
<td>7.4%</td>
<td>-30.5%</td>
<td>10</td>
</tr>
<tr>
<td>500M-1B</td>
<td>17.7</td>
<td>1.36</td>
<td>-5.9%</td>
<td>-28.3%</td>
<td>36</td>
</tr>
<tr>
<td>1B-5B</td>
<td>18.9</td>
<td>1.63</td>
<td>0.8%</td>
<td>-3.2%</td>
<td>146</td>
</tr>
<tr>
<td>5B-10B</td>
<td>20.1</td>
<td>2.33</td>
<td>7.1%</td>
<td>23.3%</td>
<td>43</td>
</tr>
<tr>
<td>10B+</td>
<td>18.1</td>
<td>2.02</td>
<td>-3.8%</td>
<td>6.8%</td>
<td>88</td>
</tr>
<tr>
<td>Group Median</td>
<td>18.8</td>
<td>1.89</td>
<td>323</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 3 | Pricing Multiples at 9/30/2017: Profitability Sort

<table>
<thead>
<tr>
<th>LTM ROATE</th>
<th>P/E</th>
<th>P/TBV</th>
<th>Discount / Premium to Group Median P/E</th>
<th>Discount / Premium to Group Median P/TBV</th>
<th>Number of Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>0-5</td>
<td>40.2</td>
<td>1.30</td>
<td>113.7%</td>
<td>-31.2%</td>
<td>13</td>
</tr>
<tr>
<td>5-10</td>
<td>19.7</td>
<td>1.53</td>
<td>4.6%</td>
<td>-19.4%</td>
<td>79</td>
</tr>
<tr>
<td>10-15</td>
<td>18.5</td>
<td>2.08</td>
<td>-1.6%</td>
<td>9.6%</td>
<td>146</td>
</tr>
<tr>
<td>15+</td>
<td>18.3</td>
<td>2.74</td>
<td>-2.5%</td>
<td>44.9%</td>
<td>26</td>
</tr>
<tr>
<td>Group Median</td>
<td>18.8</td>
<td>1.89</td>
<td>323</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Figure 2 | Long Term P/TBV Trend by Asset Size

Figure 4 | Long Term P/TBV Trend by Return on Average Tangible Equity
Profitability

To examine how profitability affects the value of your bank, we compare median P/TBV multiples for four groups of banks segmented by return on average tangible equity (Figures 3 and 4 on the prior page). A bank’s return on equity can be measured as the product of the asset base’s profitability (or return on assets) and balance sheet leverage. Balancing these two inputs in order to maximize returns to shareholders is one goal of bank management. A bank’s return on equity measures how productively the bank invests its capital, and as one would expect, the banks with the highest returns on equity trade at the highest P/TBV multiple.

Asset Quality

Inferior asset quality increases risk relative to companies with more stable asset quality and may limit future growth potential, both of which may negatively impact returns to shareholders. In addition, it makes sense that a bank with high levels of non-performing assets might trade below book value. Book value of the loans (or other non-performing assets) may not reflect the true market value of the assets given the potential for greater losses than those accounted for in the loan loss reserve and the negative impact on earning potential. Figure 5 illustrates how pricing is affected by higher levels of non-performing assets. As shown in Figure 6, P/TBV multiples plummeted at the start of the economic recession and have yet to recover to pre-crisis levels.
Conclusion

Size, profitability, and asset quality are factors to consider in your bank’s valuation. From an investor’s perspective, your bank’s worth is based on its potential for future shareholder returns. This, in turn, requires evaluating qualitative and quantitative factors bearing on the bank’s current performance, growth potential, and risk attributes.

Mercer Capital offers comprehensive valuation services. Contact us to discuss your valuation needs in confidence.

What We’re Reading

Bank Director has an interesting piece from Rick Childs of Crowe Horwath providing considerations for sellers whose proceeds include stock of the acquirer.

Pymnts.com’s piece discusses how the community banking model must adapt and consider revenue sources beyond interest income.

American Banker’s article “Digital Investments Give Small Banks Deeper Borrower Pool” discusses how community banks are leveraging technology to enhance performance.

Bank Director’s article, “Banking Blockchain: Making Virtual Currencies a Reality for Your Bank” addresses how banks can leverage the new technology of blockchain.
Mercer Capital’s Bank Group Index Overview

Return Stratification of U.S. Banks by Asset Size

<table>
<thead>
<tr>
<th>Indices</th>
<th>Month-to-Date</th>
<th>Year-to-Date</th>
<th>Last 12 Months</th>
<th>Price/ LTM EPS</th>
<th>Price / 17(E) EPS</th>
<th>Price / 18(E) EPS</th>
<th>Price / Book Value</th>
<th>Price / Tangible Book Value</th>
<th>Dividend Yield</th>
</tr>
</thead>
<tbody>
<tr>
<td>Atlantic Coast Index</td>
<td>1.43%</td>
<td>16.62%</td>
<td>45.64%</td>
<td>21.6x</td>
<td>19.6x</td>
<td>16.6x</td>
<td>148%</td>
<td>164%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Midwest Index</td>
<td>0.23%</td>
<td>7.58%</td>
<td>41.17%</td>
<td>17.9x</td>
<td>17.6x</td>
<td>16.2x</td>
<td>148%</td>
<td>172%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Northeast Index</td>
<td>-0.37%</td>
<td>8.30%</td>
<td>38.64%</td>
<td>17.8x</td>
<td>17.7x</td>
<td>15.7x</td>
<td>154%</td>
<td>171%</td>
<td>2.2%</td>
</tr>
<tr>
<td>Southeast Index</td>
<td>-1.57%</td>
<td>1.80%</td>
<td>28.89%</td>
<td>18.4x</td>
<td>21.1x</td>
<td>17.7x</td>
<td>143%</td>
<td>145%</td>
<td>1.2%</td>
</tr>
<tr>
<td>West Index</td>
<td>-0.35%</td>
<td>12.25%</td>
<td>51.38%</td>
<td>17.8x</td>
<td>19.4x</td>
<td>16.6x</td>
<td>152%</td>
<td>161%</td>
<td>1.7%</td>
</tr>
<tr>
<td>Community Bank Index</td>
<td>0.05%</td>
<td>9.08%</td>
<td>41.14%</td>
<td>18.7x</td>
<td>19.0x</td>
<td>16.5x</td>
<td>148%</td>
<td>167%</td>
<td>1.7%</td>
</tr>
<tr>
<td>SNL Bank Index</td>
<td>2.88%</td>
<td>12.36%</td>
<td>39.69%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Mercer Capital’s M&A Market Indicators

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 October 2017

Source: S&P Global Market Intelligence
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.
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