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MARCH 2019

Bank Watch

ARTICLES

Scale for Another Reason

Fairness Considerations for Mergers of Equals

In This Issue

Scale for Another Reason

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I count myself among the consensus view that the merger of equals (MOE) between Chemical Financial Corp. and TCF Financial Corp. makes a lot of sense for both companies. It makes so much sense that the industry should see hundreds of MOEs and quasi-MOEs among banks in the coming years because scale — or operating leverage — is important to drive returns. The explicit assumption is that MOE transactions are good for both companies' shareholders, though not always in proportion to the relative ownership.

The market seems to think MOEs make sense, too. Shares of both Chemical and TCF rose more than 5% on the day of the announcement, which contrasts with announcements during the past year by Synovus Financial Corp., WSFS Financial Corp., Fifth Third Bancorp and Ameris Bancorp in which the buyer's share prices were hammered on the news of a major acquisition. The market thought these companies overpaid, and in some instances, potentially incurred credit issues with the target's loan portfolio.

Setting aside the issue of a premium to the current market price, an MOE is like an acquisition in that the bulk of the EPS accretion comes from expense savings. In the case of the Chemical-TCF deal, projected expense savings approximate 13% of the combined companies' expense base, which does not seem like a heroic amount. The result is projected EPS accretion of 17% for Chemical and 31% for TCF once the expense saves are fully realized. Earnback of dilution to tangible book value per share is projected to be less than three years. The return on average tangible common equity is projected to be 19% in 2020 on a pro forma basis, assuming a full phase-in of the cost savings.

What's not to like with the projected numbers? Nothing, as long as they are realized, which as an aside raises the issue that the projected EPS accretion for 2020 is based upon the analysts' consensus estimates rather than management forecasts.

Whether the 2020 consensus estimates are in the ballpark or not, TCF, Chemical and the industry have to obtain greater scale to drive costs lower. In the short run, scale will drive ROE higher. Over the long run I suspect improved scale may be required to protect existing returns rather than enhance them because the Amazon effect will apply to deposit pricing, too. Informed depositors with mobile technology will force deposit pricing to become more competitive.

That's what has happened to the asset management business. Widely available information for increasingly cost conscious investors, easy-to-use technology and a push to lower fees by behemoth Vanguard has upended the industry's pricing model. There is no reason that cannot happen to banks, too, in which the spread between rates paid for core deposits and what the funds would cost if obtained in the capital markets cannot narrow dramatically.

Wall Street Journal reporter Jason Zweig recently ran a column about how a small subset of banks — mostly online ones — were offering rates in the range of 2% to 2.5%, which is close to the rate you can get from short-term U.S. Treasuries. Both are risk-free returns. He speculated — and I think most of you reading this would agree — that inertia and until recently a very low opportunity cost of doing nothing has led to a lot of lazy money sitting in banks and brokerage accounts that still earns very little.

What We're Reading

Tupelo, MS-based **BancorpSouth Bank's M&A strategy** of acquiring smaller banks receives positive reviews from analysts.

(subscription required)

A new court decision could have **important ramifications for bank M&A**. The December 2018 ruling in Akorn v. Fresenius Kabi is the first in Delaware to rule that a material adverse effect ("MAE") had occurred in a merger transaction.

The National Bank of Delaware County's acquisition of a Bank of America branch in upstate New York highlights the potential **challenge for small-town banks** of keeping customers who prefer large lenders and online transactions.

Zweig touched on a secular change that is afoot rather than the cyclical nature of deposit pricing that ebbs and flows with loan demand: Depositors who are empowered with information and mobile technology are in a position to sweep excess deposits from their primary bank to institutions that pay much more competitive rates. In effect everyone can be a corporate treasurer.

The secular issue I see will intensify with time as deposits and other financial assets transition from baby boomers and their parents to tech-savvy millennials and Gen Z. Banks are going to be forced by technology to pay rates on core deposits that are closer to the capital market rate for an equivalent maturity. Scale to improve operating leverage is the only offset I see.

MOEs are a logical, often-overlooked and sometimes disdained transaction that can achieve scale for both companies' shareholders. However, like all transactions, execution is what really matters, because creating scale and accretion with spreadsheets is easy.

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Fairness Considerations for Mergers of Equals

When asked about his view of a tie years before the NCAA instituted the playoff format in the 1990s, Coach Bear Bryant famously described the outcome as "kissing your sister." If he were a portfolio manager holding a position in a company that entered into a merger of equals (MOE), his response might be the same. Wall Street generally does not like MOEs unless the benefits are utterly obvious and/ or one or both parties had no other path to create shareholder value. In some instances, MOEs may be an intermediate step to a larger transaction that unlocks value. National Commerce Financial Corporation CEO Tom Garrott once told me that part of his rationale for entering into a $1.6 billion MOE with CCB Financial Corp. in 2000 that resulted in CCB owning 47% of the company was because bankers told him he needed a bigger retail footprint to elicit top dollar in a sale. It worked. National Commerce agreed to be acquired by SunTrust Banks, Inc. in 2004 in a deal that was valued at $7 billion.

Kissing Your Sister?

MOEs, like acquisitions, typically look good in a PowerPoint presentation, but can be tough to execute. Busts from the past include Daimler-Benz/Chrysler Corporation and AOL/Time Warner. Among banks, the 1994 combination of Cleveland-based Society Corporation and Albany-based KeyCorp was considered to be a struggle for several years, while the 1995 combination of North Carolina-based Southern National Corp. and BB&T Financial Corporation was deemed a success.

The arbiter between success and failure for MOEs typically is culture, unless the combination was just a triumph of investment banking and hubris, as was the case with AOL/Time Warner. The post-merger KeyCorp struggled because Society was a centralized, commercial-lending powerhouse compared to the decentralized, retail-focused KeyCorp. Elements of both executive management teams stuck around. Southern National, which took the BB&T name, paid the then legacy BB&T management to go away. At the time there was outrage expressed among investors at the amount, but CEO John Allison noted it was necessary to ensure success with one management team in charge. Likewise, National Commerce's Garrott as Executive Chairman retained the exclusive option to oust CCB's Ernie Roessler, who became CEO of the combined company, at the cost of $10 million if he chose to do so. Garrett exercised the option and cut the check in mid-2003 three years after the MOE was consummated.

Fairness Opinions for MOEs

MOEs represent a different proposition for the financial advisor in terms of rendering advice to the Board. An MOE is not the same transaction as advising a would-be seller about how a take-out price will compare to other transactions or the company's potential value based upon management's projections. The same applies to advising a buyer regarding the pricing of a target. In an MOE (or quasi-MOE) both parties give up 40-50% ownership for future benefits with typically little premium if one or both are publicly traded. Plus there are the social issues to navigate.

While much of an advisor's role will be focused on providing analysis and advice to the Board leading up to a meaningful corporate decision, the fairness opinion issued by the advisor (and/or second advisor) has a narrow scope. Among other things a fairness opinion does not opine:

- The course of action the Board should take;
- The contemplated transaction represents the highest obtainable value;
- Where a security will trade in the future; and
- How shareholders should vote.

What is opined is the fairness of the transaction from a financial point of view of the company's shareholders as of a specific date and subject to certain assumptions. If the opinion is a sell-side opinion, the advisor will opine as to the fairness of the consideration received. The buy-side opinion will opine as to the fairness of the consideration paid. A fairness opinion for each respective party to an MOE will opine as to the fairness of the exchange ratio because MOEs largely entail stock-for-stock structures.

Fairness is not defined legally. The Merriam-Webster dictionary defines "fair" as "just, equitable and agreeing with what is thought to be right or acceptable." Fairness when judging a corporate transaction is a range concept. Some transactions are not fair, some are in the range—reasonable, and others are very fair.

The concept of "fairness" is especially well-suited for MOEs. MOEs represent a combination of two companies in which both shareholders will benefit from expense savings, revenue synergies and sometimes qualitative attributes. Value is an element of the fairness analysis, but the relative analysis takes on more importance based upon a comparison of contributions of revenues, earnings, capital and the like compared to pro forma ownership.

Investment Merits to Consider

A key question to ask as part of the fairness analysis: are shareholders better off or at least no worse for exchanging their shares for shares in the new company and accepting the execution risks? In order to answer the question, the investment merits of the pro forma company have to be weighed relative to each partner's attributes.

- **Profitability and Revenue Trends.** The analysis should consider each party's historical and projected revenues, margins, operating earnings, dividends and other financial metrics. Issues to be vetted include customer concentrations, the source of growth, the source of any margin pressure and the like. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.
- **Expense Savings.** How much and when are the savings expected to be realized? Do the savings come disproportionately from one party? Are the execution risks high? How does the present value of the after-tax expense savings compare to the pre-merger value of the two companies on a combined basis?
- **Pro Forma Projected Performance.** How do the pro forma projections compare with each party's stand-alone projections? Does one party sacrifice growth or margins by partnering with a slower growing and/or lower margin company?
- **Per Share Accretion.** Both parties of an MOE face ownership dilution. What is obtained in return in terms of accretion (or dilution) in EBITDA per share (for non-banks), tangible BVPS, EPS, dividends and the like?

- **Distribution Capacity.** One of the benefits of a more profitable company should be (all else equal) the capacity to return a greater percentage of earnings (or cash flow) to shareholders in the form of dividends and buybacks.

- **Capital Structure.** Does the pro forma company operate with an appropriate capital structure given industry norms, cyclicality of the business and investment needs to sustain operations? Is there an issue if one party to an MOE is less levered and the other is highly levered?

- **Balance Sheet Flexibility.** Related to the capital structure should be a detailed review of the pro forma company's balance sheet that examines such areas as liquidity, funding sources, and the carrying value of assets such as deferred tax assets.

- **Consensus Analyst Estimates.** This can be a big consideration in terms of Street reaction to an MOE for public companies. If pro forma EPS estimates for both parties comfortably exceed Street estimates, then the chances for a favorable reaction to an MOE announcement improve. If accretion is deemed to be marginal for the risk assumed or the projections are not viewed as credible, then reaction may be negative.

- **Valuation.** The valuation of the combined company based upon pro forma per share metrics should be compared with each company's current and historical valuations and a relevant peer group. Also, while no opinion is expressed about where the pro forma company's shares will trade in the future, the historical valuation metrics provide a context to analyze a range of shareholder returns if earning targets are met under various valuation scenarios. This is particularly useful when comparing the analysis with each company on a stand-alone basis.

- **Share Performance.** Both parties should understand the source of their shares and the other party's share performance over multiyear holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.

- **Liquidity of the Shares.** How much is liquidity expected to improve because of the MOE? What is the capacity to sell shares issued in the merger? SEC registration and even NASDAQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently.

- **Strategic Position.** Does the pro forma company have greater strategic value as an acquisition candidate (or an acquirer) than the merger partners individually?

Conclusion

The list does not encompass every question that should be asked as part of the fairness analysis for an MOE, but it points to the importance of vetting the combined company's investment attributes as part of addressing what shareholders stand to gain relative to what is relinquished. We at Mercer Capital have over 30 years of experience helping companies and financial institutions assess significant transactions, including MOEs. Do not hesitate to contact us to discuss a transaction or valuation issue in confidence.

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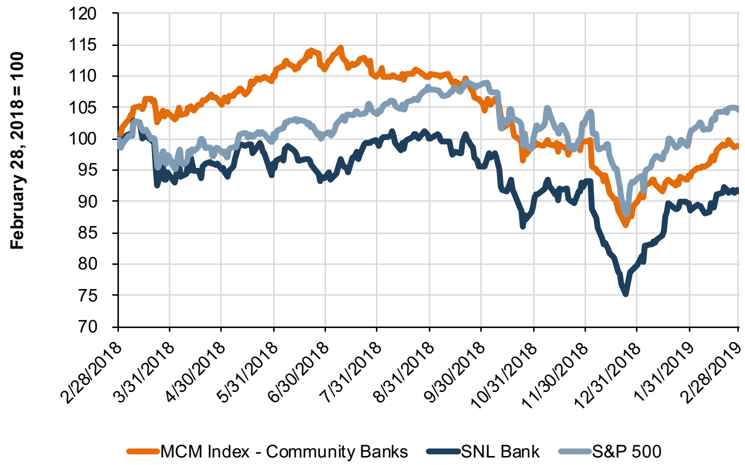
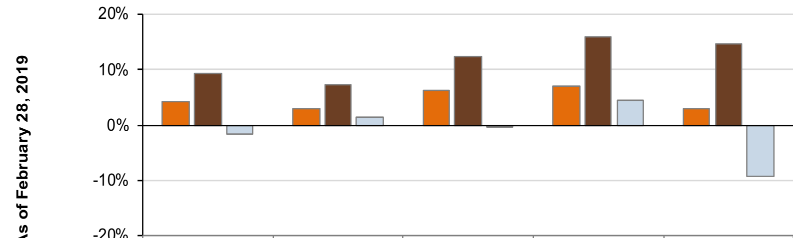
Mercer Capital's Bank Group Index Overview



Return Stratification of U.S. Banks

by Asset Size



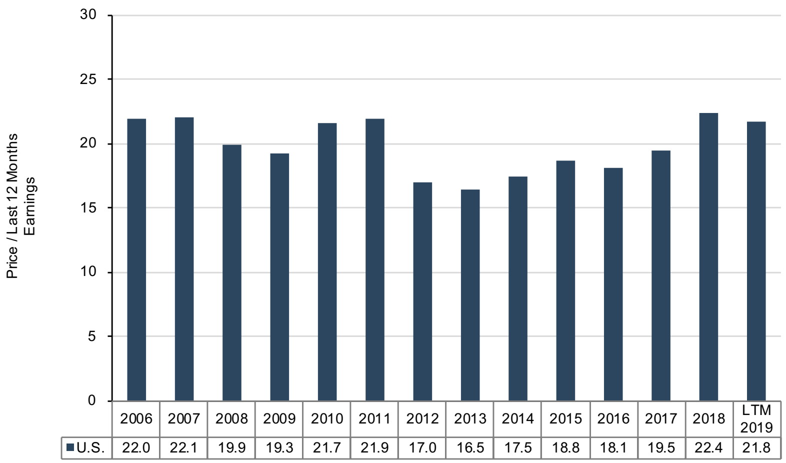
	Assets $250 - $500M	Assets $500M - $1B	Assets $1 - $5B	Assets $5 - $10B	Assets > $10B
Month-to-Date	4.23%	3.08%	6.27%	6.95%	3.03%
Quarter-to-Date	9.31%	7.35%	12.31%	15.94%	14.76%
Last 12 Months	-1.72%	1.36%	-0.05%	4.48%	-9.26%

Median Valuation Multiples

	Median Total Return as of February 28, 2019			Median Valuation Multiples as of February 28, 2019					
Indices	Month-to-Date	Quarter-to-Date	Last 12 Months	Price/ LTM EPS	Price / 2019 (E) EPS	Price / 2020 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	5.7%	9.3%	-5.1%	13.8x	12.3x	11.6x	119%	127%	2.2%
Midwest Index	6.0%	13.3%	-0.7%	13.8x	11.8x	11.1x	128%	155%	2.5%
Northeast Index	5.6%	6.8%	-1.3%	13.7x	12.2x	10.5x	125%	141%	2.5%
Southeast Index	3.5%	10.0%	0.7%	14.2x	12.3x	11.6x	127%	142%	1.6%
West Index	5.1%	9.9%	1.8%	12.8x	13.0x	11.9x	125%	136%	1.9%
Community Bank Index	5.4%	9.9%	-1.1%	13.7x	12.2x	11.3x	125%	142%	2.2%
SNL Bank Index	**3.2%**	**14.7%**	**-8.5%**						

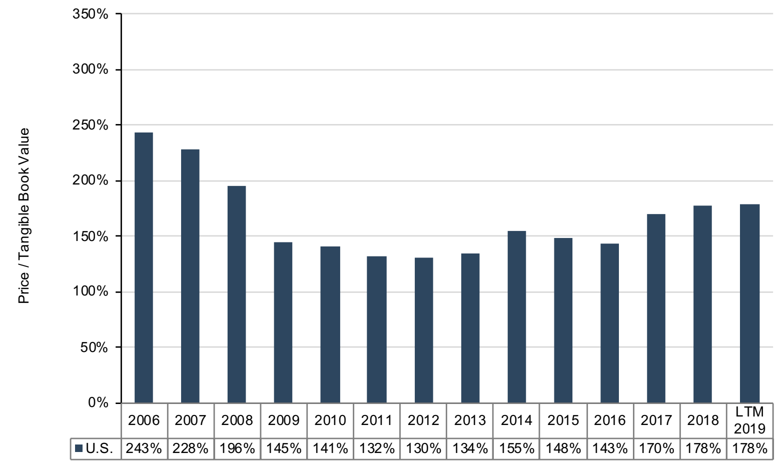
Median Price/Earnings Multiples

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



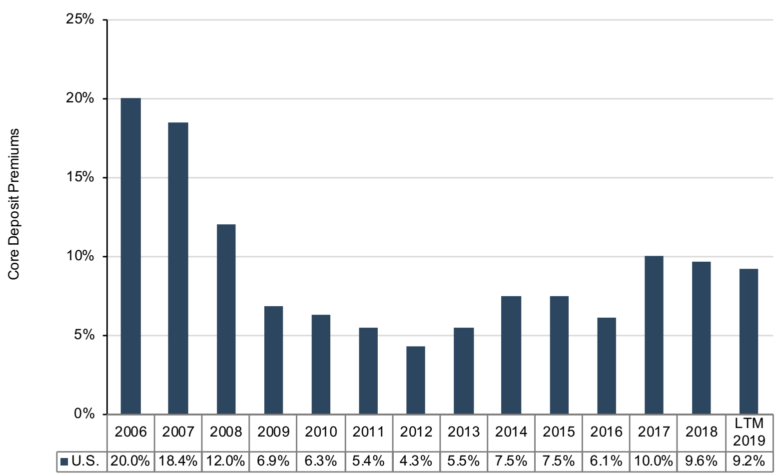
Median Price/Tangible Book Value Multiples

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

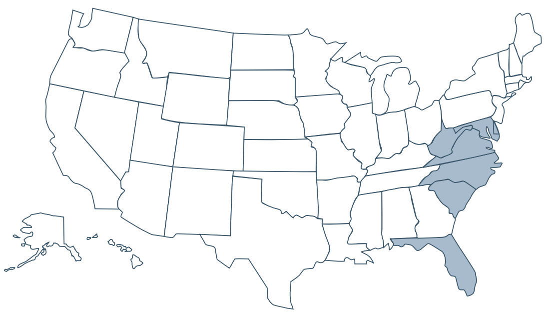
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended February 2019

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value ($M)	Target's Median Assets ($000)	Target's Median LTM ROAE
Atlantic Coast	21.3x	179%	11.0%	12	96.0	380,064	9.2%
Midwest	19.1x	164%	7.4%	81	38.7	143,480	10.4%
Northeast	23.9x	188%	11.6%	11	62.0	495,306	7.2%
Southeast	22.2x	181%	9.7%	31	52.0	258,311	9.8%
West	24.3x	208%	11.4%	20	76.0	259,228	8.5%
National Community Banks	**21.8x**	**178%**	**9.2%**	**155**	**54.7**	**218,638**	**9.6%**

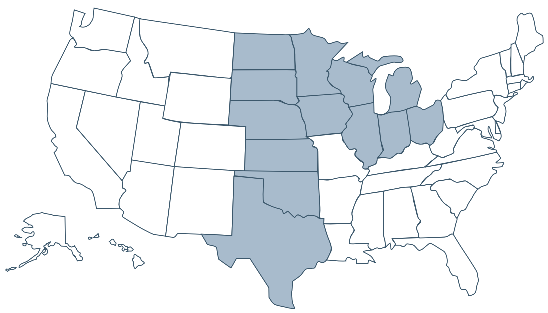
Source: S&P Global Market Intelligence

Mercer Capital's Regional Public Bank Peer Reports

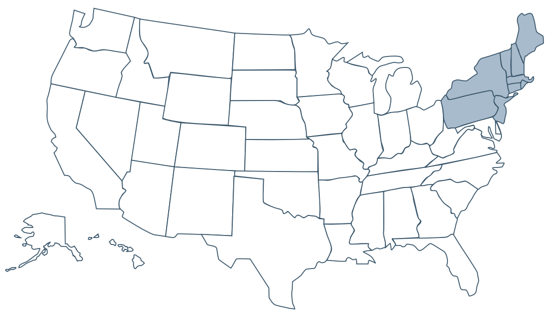
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



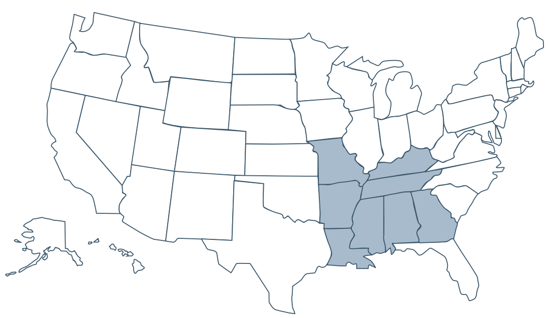
Atlantic Coast



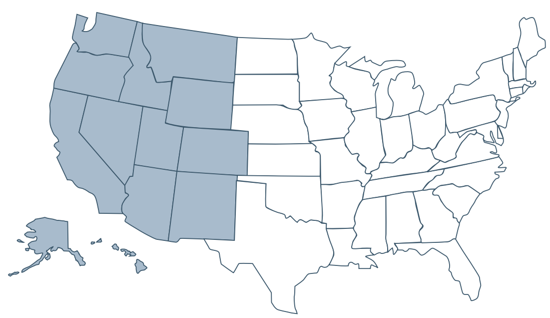
Midwest



Northeast



Southeast



West

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Depository Institutions Services

Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transaction 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.

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- Goodwill impairment
- Litigation support
- Stress Testing
- Loan portfolio valuation
- Tax compliance
- Transaction advisory
- Strategic planning

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