MERCER CAPITAL

BUSINESS VALUATION &
FINANCIAL ADVISORY SERVICES

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Bank Watch

ARTICLES

Bank Impairment Testing

In This Issue

Bank Impairment Testing

Bank stocks have underperformed in the broad market since the beginning of the year and many currently trade below book value, which begs the question, is goodwill impaired? We discussed **this topic** most recently in June 2020 as banking stocks (along with the broad market) were pressured in 1Q20 based on fears from the COVID-19 pandemic. However, the market recovered quickly in 2H20 and set new highs in 2021 as interest rates were at historical lows, many banks benefitted from PPP and mortgage banking income, and immense liquidity flooded into the economy via government stimulus.

What once was the solution for the economy in 2020 now is a contributor to headaches for bankers in 2023. A combination of the influx in liquidity to the economy (and banking system) via government stimulus, supply disruptions from COVID and geopolitical events, and pent-up demand from reopenings led to higher inflation in 2021 and 1H22. The Federal Reserve attempted to cool inflation with an increase in short-term policy rates, from a range of 0.00-0.25% in March 2020 to 5.25-5.50% as of July 2023. However, the rise in interest rates led to unrealized losses on bond portfolios and pressure on deposit retention and funding costs.

Public bank stocks performed well when compared to the broader markets in 2022. The median stock price change of the 343 banks and thrifts traded on the NYSE and NASDAQ, was negative 9% in 2022, compared to negative 19% for the S&P 500 and negative 33% for the NASDAQ. However, banking stocks diverged from the broad market in 2023 with declines during the Spring of 2023 (March and April) as concerns about higher cost of funds, unrealized bond losses, and the collapse of three high profile banks (SVB, FRC, and SBNY) arose. Banking stocks generally bottomed during early to mid-May before recovering a portion of the decline more recently.

However, of the nearly 300 banking stocks we analyzed that trade on the NYSE and NASDAQ, approximately half continue to trade below book value as of July 25, 2023. Deal activity also slowed in 2H22 and year-to-date 2023 due to a combination of factors including fair value marks on bonds and loans, widening buyer and seller expectations, and pressures on profitability and public bank stocks. For perspective, there have been 43 whole bank acquisitions announced in the year-to-date period ended July 26, 2023. This compared to 86 deals in the same period in 2022 and 103 transactions in 2021.

Against this backdrop, the remainder of this article will discuss two common questions that arise for companies considering an impairment test.[1]

WHAT WE'RE READING

A **discussion** of private credit, the current lender's environment, and how Goldman prepares to capitalize on the opportunity

A brief **article** touching on the potential future of the bank M&A market, born out of necessity.

Guggenheim's high yield and bank loan **outlook** for 3Q23 hat points to capital rationing given the uncertain trajectory of credit fundamentals.

[1] *A portion of the following text was excerpted from an article from my colleague Lucas Parris entitled "Goodwill Impairment Testing in Uncertain Times" https://mercercapital.com/article/goodwill-impairment-testing-in-uncertain-times/*

Do I Need an Impairment Test?

Goodwill impairment testing is typically performed annually, usually near the end of a Company's fiscal year. In fact, many companies may have completed an impairment test as of year-end 2022. However, the factors noted above may raise questions about whether an interim goodwill impairment test is warranted for many banks.

The accounting guidance in ASC 350 prescribes that interim goodwill impairment tests may be necessary in the case of certain "triggering" events. For public companies, perhaps the most easily observable triggering event is a decline in stock price, but other factors may constitute a triggering event. Further, these factors apply to both public and private companies, even those private companies that have previously elected to amortize goodwill under ASU 2017-04.

For interim goodwill impairment tests, ASC 350 notes that entities should assess relevant events and circumstances that might make it more likely than not that an impairment condition exists. The guidance provides several examples, several of which are relevant for the bank industry including the following:

- Industry and market considerations such as a deterioration in the environment in which an entity operates or an increased competitive environment
- Declines in market-dependent multiples or metrics (consider in both absolute terms and relative to peers)
- Overall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods
- Changes in the carrying amount of assets at the reporting unit including the expectation of selling or disposing certain assets
- If applicable, a sustained decrease in share price (considered both in absolute terms and relative to peers)

The guidance notes that an entity should also consider positive and mitigating events and circumstances that may affect its conclusion. If a recent impairment test has been performed, the headroom between the recent fair value measurement and carrying amount could also be a factor to consider.

How Does an Impairment Test Work?

Once an entity determines that an interim impairment test is appropriate, a quantitative "Step 1" impairment test is required. Under Step 1, the entity must measure the fair value of the relevant reporting units (or the entire company if the business is defined as a single reporting unit). The fair value of a reporting unit refers to "the price that would be received to sell the unit as a whole in an orderly transaction between market participants at the measurement date." For companies that have already adopted ASU 2017-04, the legacy "Step 2" analysis has been eliminated, and the impairment charge is calculated as simply the difference between fair value and carrying amount.

ASC 820 provides a framework for measuring fair value which recognizes the three traditional valuation approaches: the income approach, the market approach, and the cost approach. As with most valuation assignments, judgment is required to determine which approach or approaches are most appropriate given the facts and circumstances. In our experience, the income and market approaches are most commonly used in goodwill impairment testing. However, the market approach may be limited in the current environment given the lower amount of transaction activity in 2023,. In the current environment, we offer the following thoughts on some areas that are likely to draw additional scrutiny from auditors and regulators.

- Are the financial projections used in a discounted cash flow analysis reflective of recent market conditions? What are the model's sensitivities to changes in key inputs

- Given developments in the market, do measures of risk (discount rates) need to be updated?
- If market multiples from comparable companies are used to support the valuation, are those multiples still applicable and meaningful in the current environment?
- If precedent M&A transactions are used to support the valuation, are those multiples still relevant in the current environment?
- If the subject company is public, how does its current market capitalization compare to the indicated fair value of the entity (or sum of the reporting units)? What is the implied control premium and is it reasonable in light of current market conditions?

Concluding Thoughts

At Mercer Capital, we have experience in implementing both the qualitative and quantitative aspects of interim goodwill impairment testing. To discuss the implications and timing of triggering events, please contact a professional in Mercer Capital's Financial Institutions Group.

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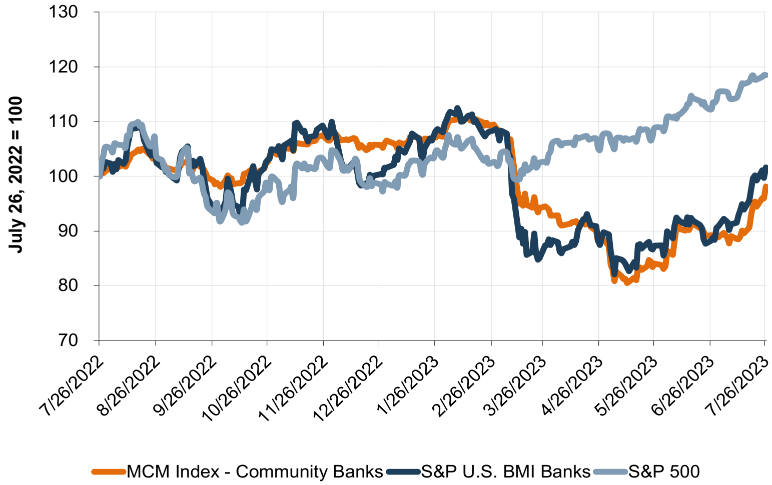
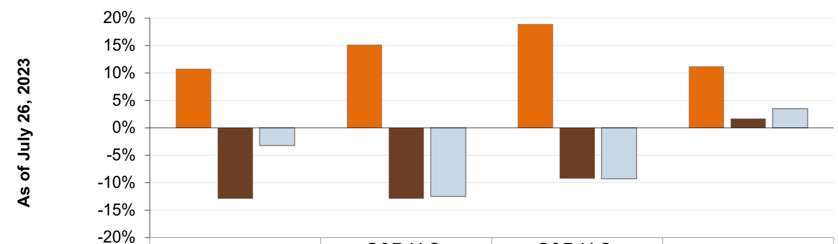
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



	S&P U.S. Banks Market Cap Under $250 Million	S&P U.S. Banks Market Cap Between $250 Million - $1 Billion	S&P U.S. Banks Market Cap Between $1 Billion - $5 Billion	S&P U.S. Banks Market Cap Over $5 Billion
Month-to-Date	10.70%	15.08%	18.88%	11.14%
Year-to-Date	-12.88%	-12.92%	-9.25%	1.63%
Last 12 Months	-3.25%	-12.53%	-9.27%	3.51%

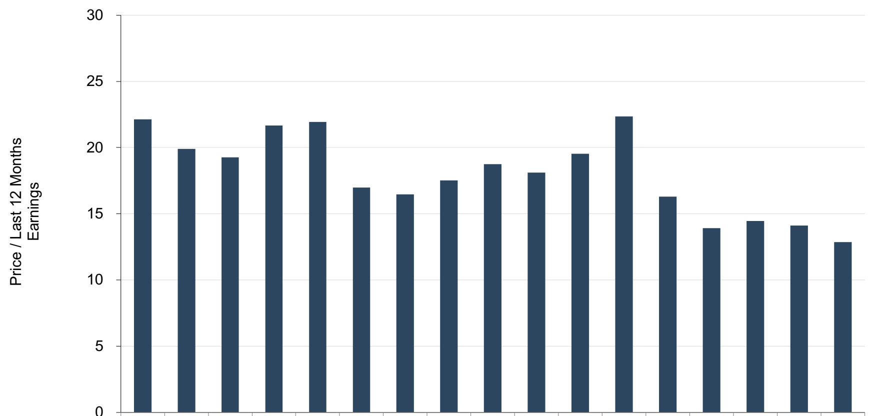
Source: S&P Capital IQ Pro.

	Total Return			Regional Index Data as of July 26, 2023					
	Month-to-Date	Year-to- Date	Last 12 Months	Price / LTM EPS	Price / 2023 (E) EPS	Price / 2024 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	10.1%	-11.9%	-6.6%	8.5x	11.5x	9.8x	106%	114%	3.1%
Midwest Index	9.9%	-6.8%	-0.7%	9.0x	8.4x	8.7x	94%	120%	3.6%
Northeast Index	10.1%	-4.9%	1.4%	8.6x	9.4x	9.3x	108%	114%	3.4%
Southeast Index	9.9%	-15.5%	-18.8%	7.5x	9.0x	10.4x	88%	99%	3.9%
West Index	12.1%	-7.6%	2.5%	8.0x	9.2x	8.6x	104%	105%	2.9%
Community Bank Index	10.5%	-7.9%	-1.9%	8.6x	9.2x	9.0x	102%	111%	3.5%
S&P U.S. BMI Banks	11.9%	0.0%	1.6%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

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

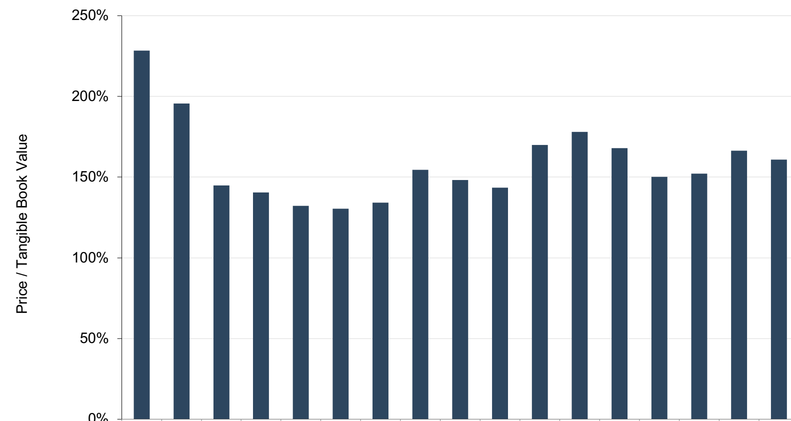


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5	18.8	18.1	19.5	22.4	16.3	13.9	14.5	14.1	12.9

Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

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

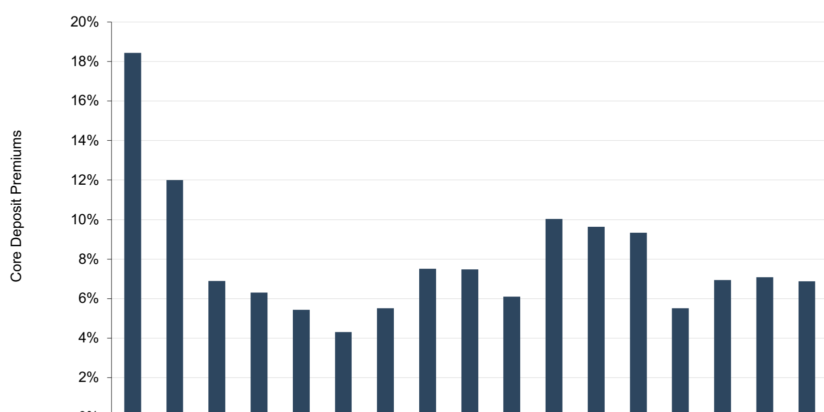


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	228%	196%	145%	141%	132%	130%	134%	155%	148%	143%	170%	178%	168%	150%	152%	166%	161%

Source: S&P Capital IQ Pro.

Median Core Deposit Premiums

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



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	18.4%	12.0%	6.9%	6.3%	5.4%	4.3%	5.5%	7.5%	7.5%	6.1%	10.0%	9.6%	9.3%	5.5%	6.9%	7.1%	6.9%

Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

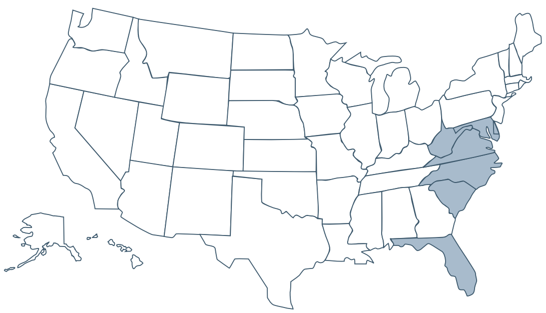
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended July 27, 2023

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	12.9x	184%	6.4%	10	161.5	601,146	9.7%
Midwest	12.1x	156%	5.7%	34	90.3	186,769	11.1%
Northeast	12.6x	129%	4.8%	6	59.6	834,211	12.0%
Southeast	13.8x	182%	9.1%	17	60.5	233,793	13.1%
West	8.4x	95%	-0.4%	9	27.9	177,427	11.8%
National Community Banks	12.9x	161%	6.9%	76	82.1	255,268	11.7%

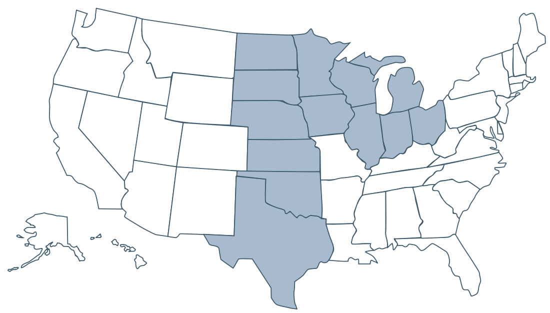
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

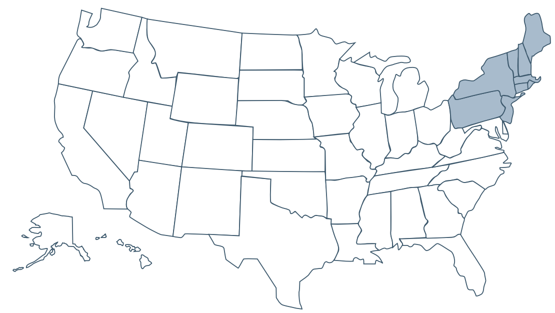
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



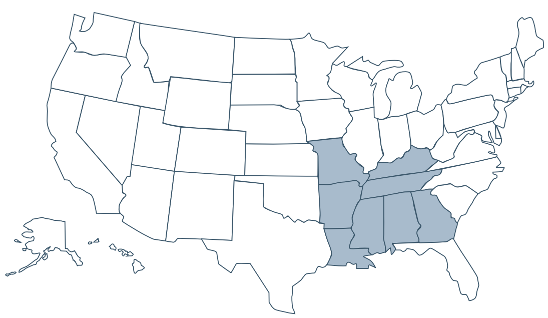
Atlantic Coast



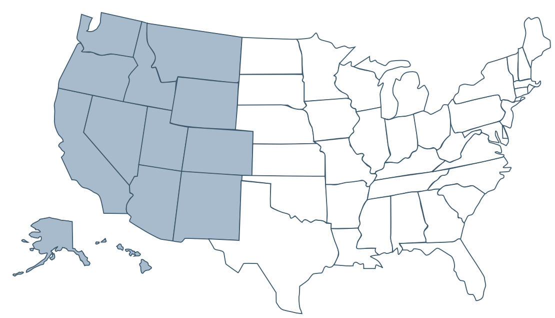
Midwest



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.

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

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