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# Bank Watch

## ARTICLE

**Themes From the 2024 Acquire or be Acquired Conference**

AND

**Pay vs. Performance: What's New in Year 2**

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# Themes From the 2024 Acquire or Be Acquired Conference

For those who haven't been to *Bank Director's* Acquire or Be Acquired conference (AOBA) before, it is a two-and-a-half-day conference in the desert (Phoenix) that typically includes great weather, golf at the end, and has broadened over the years to focus on a combination of M&A, growth, and FinTech strategies.

## Cautious Optimism

While the 2024 version of AOBA included a number of discussions around headwinds facing the sector, there was optimism for 2024 when compared to 2023. For example, the banking audience was asked during the conference: How do you feel about 2024 compared to your experience in 2023? ~90% responded that they felt more optimistic about 2024 when compared to 2023. Additionally, several sessions noted that optimism exists for an uptick in deal activity in the second half of 2024.

## Traditional Bank M&A Tailwinds and Headwinds

While the turbulence and potential headwinds for bank M&A that slowed deal activity in 2023 continue to persist at the outset of 2024, traditional bank M&A remained a much discussed topic at the 2024 AOBA conference. Discussions focused on the nuts and bolts of M&A from valuation to due diligence to structuring and ultimately to integration. While certain themes change and evolve, the strategy to achieve greater scale and growth through M&A and to enhance efficiency and profitability that create value over the long run, persist. The challenging M&A landscape could present an opportunity for acquirers with the balance sheet and capacity to engage in a transaction, and the silver lining for those acquirers may be less competition for sellers as some buyers focus internally during the challenging operating environment.

## Balance Sheets in Focus

There were definitely more sessions this year discussing balance sheets. A number of sessions noted that one key to dealmaking in the current environment was managing the balance sheet, and several discussed the impact of fair value marks on sellers and pro forma combined balance sheets and the impact on deal activity. For acquirers, a strong balance sheet and capital level can position their institution to be able to take advantage of the current deal environment. For sellers, having a balance sheet that is less impacted from the fair value marks to loans and bonds and with more valuable deposits enhances their attractiveness to potential acquirers. In one session, my colleagues Jeff Davis and Andy Gibbs discussed the impact of taking a loss today on low-coupon bonds that are worth less than the current market price versus holding the bonds to maturity on the value of a bank's equity. They also reviewed an intermediate strategy referred to as the installment method.

## Deposits, Deposits, Deposits

Consistent with discussions around the balance sheet, the interest rate environment, and impact on the banking industry & M&A, discussions about deposits came up often. These discussions covered strategies to retain business or consumer deposits, the attractiveness of core deposits for acquirers in the current environment, how to grow deposits organically (some of the largest banks are even turning back the clock and building branches again), trends in core deposit intangible valuations, and how to provide your customers with the technology and digital banking solutions to onboard and retain deposits more efficiently. One question discussed in several sessions that will be interesting to see the answer to in 2024 was: Has the cost of funds peaked?

## Technology Brings Opportunities

Over the last few years, technology has been an increasing topic discussed during sessions of AOBA. Technology topics discussed included leveraging payments to enhance retail and small business banking, using software and/or digital banking to more efficiently make loans and/or open deposit accounts and best practice for developing and managing risk of FinTech partnerships. Even AI, the market's favorite topic of 2024, was discussed. A consensus on how best to leverage AI in banking has not yet emerged in my view but topics discussed included leveraging AI to enhance loan growth or efficiency of common tasks in the back office. Traditional M&A has historically focused on the potential diversification benefits of combining loan portfolios, deposit portfolios, and geographic footprints but increasingly the tech stacks of buyers and sellers are being compared to see what diversification benefits exist and what the cost may be to combine the tech stack after closing.

## Technology Also Brings Potential Risks

One challenging aspect of technology for banks was how best to balance the potential benefits of technology with the risks inherent in them, particularly new technologies and FinTech partnerships. Tech-forward banks and their valuations were also discussed. As we have noted in the past, this tech-forward bank group has seen increased volatility in market performance than their peers as the market digests some of the tech-oriented business models (such as banking-as-a-service) and weighs the potential for higher growth and profitability against the potential risk of these business models and regulatory scrutiny.

## Non-Traditional Deals

Similar to traditional bank deals, bank acquisitions in non-traditional areas like specialty finance, insurance, and asset management have been modest and challenging given the difficult operating environment, higher cost of debt, and opportunity cost of excess liquidity. However, there were some discussions around best practices and lessons learned from specialty finance transactions and that additional opportunities may emerge as non-bank lenders also deal with the challenging funding and interest rate environment. Additionally, Truist recently announced the sale of its insurance business to book a gain, focus on core banking, and enhance capital. The announced bank acquisitions by credit unions and private investors also illustrate that non-traditional deals remain a part of a bank's strategic playbook.

## Conclusion

We look forward to discussing these issues with clients in 2024 and monitoring how they evolve within the banking industry over the next year. As always, Mercer Capital is available to discuss these trends as they relate to your financial institution, so feel free to call or email.



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# Pay Versus Performance: What's New in Year 2?

## Executive Summary

1. The 2024 proxy season marks Year 2 under the SEC's new Pay Versus Performance disclosure framework for public companies.
2. The SEC issued additional guidance over the last year which clarified the requirements and commented upon registrants' proxy filings from 2023. We discuss several of these items pertaining to valuation and equity-based compensation in this article.
3. Newly public companies and those private companies aspiring to list in the future should be aware of the disclosure and valuation requirements related to Compensation Actually Paid for senior executives.
4. With respect to equity-based awards such as stock options and performance shares with market conditions, the rules continue to point to alignment with ASC 718 and require the disclosure of any significant change in valuation techniques and assumptions.
5. Registrants and their advisors should pay particular attention to the impact of changes in key assumptions on the fair value of equity awards, including volatility, realized performance, and changes in the composition of total shareholder return (TSR) peer groups.

## Introduction

The SEC's Pay Versus Performance disclosure rules introduced significant new valuation requirements related to equity-based compensation paid to company executives. As the 2024 proxy season gets underway, what lessons have been learned and what guidance has the SEC provided to registrants? We discuss some of the SEC's recent Compliance & Disclosure Interpretations and share some best practices as companies gear up for Year 2 of the new Pay Versus Performance framework.

To recap how we got to this point, the new disclosures were mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act and were originally proposed by the SEC in 2015. These rules added a new item 402(v) to Regulation S-K and are intended to provide investors with more transparent, readily comparable, and understandable disclosure of a registrant's executive compensation. The new provisions apply to all reporting companies other than (i) foreign private issuers, (ii) registered investment companies, and (iii) emerging growth companies.

The rules apply to any proxy and information statement where shareholders are voting on directors or executive compensation that is filed in respect of a fiscal year ending on or after December 16, 2022. As such, the vast majority of registrants were required to include these disclosures in their 2023 proxy statements, with scaled-down disclosures for smaller reporting companies.

For a more technical discussion of the rules, see our earlier article [\*\*5 Things to Know About the SEC's New Pay Versus Performance Rules\*\*](#).

## Valuation-Related Takeaways from the SEC Guidance

The Pay Versus Performance rules require registrants to disclose the fair value of equity awards to certain senior executives in the year granted and to report changes in the fair value of the awards until they vest. Practically speaking, this means that it is necessary to measure the year-end fair value of all outstanding and unvested equity awards under a methodology consistent with what the registrant uses in its financial statements (e.g., ASC 718, Compensation – Stock Compensation).

In 2023, the SEC issued a series of **Compliance & Disclosure Interpretations (C&DIs)** relating to the Pay Versus Performance disclosure requirements. The roughly 30 C&DIs issued in 2023 are structured in a question-and-answer format. While the questions address many different aspects of the requirements, we focus our summary on those that pertain to valuation-related issues. In the sections that follow, we summarize each question and answer for clarity.

### Question 128D.14 (Treatment of Awards Granted Prior to a Restructuring or Spin-Off)

*Should awards granted in fiscal years prior to an equity restructuring, such as a spin-off, that are retained by the holder be included in the calculation of executive compensation actually paid?*

**Answer:** Yes. All stock awards and option awards that are outstanding and unvested at the beginning of the covered fiscal year or are granted to the principal executive officer and the remaining named executive officers during the covered fiscal year should be included in the CAP table.

### Question 128D.15 (Using Private Company Prices for Newly Public Companies)

*For a newly public company (e.g., IPO or SPAC) complying with the proxy statement rules for the first time, should the change in fair value of awards granted prior to IPO be based on the fair value of those awards as of the end of the prior fiscal year for purposes of determining executive compensation actually paid?*

**Answer:** Yes. For outstanding stock awards and option awards, the calculations required by Regulation S-K should be determined based on the change in fair value from the end of the prior fiscal year. The fair value of these awards should not be determined based on other dates, such as the date of the registrant's IPO. This means that prior private company valuations (such as for 409A or ASC 718) could come into play when preparing future Pay Versus Performance disclosures.

### Questions 128D.16-17 (Inclusion of Market Conditions in Fair Value)

*How should awards with a market condition consider that condition in determining whether the applicable vesting conditions have been met in performing the CAP calculations?*

**Answer:** The effect of a market condition should be reflected in the fair value of share-based awards with such a condition. Until the market condition is satisfied, registrants must include in executive compensation actually paid any change in fair value of any awards subject to market conditions. Similarly, registrants must deduct the amount of the fair value at the end of the prior fiscal year for awards that fail to meet the market condition during the covered fiscal year if it results in forfeiture of the award. However, awards that remain outstanding and have not yet vested should not be considered forfeited.

**Question 128D.20 (Use of a Different Valuation Technique)**

*Can a registrant use a different valuation technique for Pay Versus Performance calculations than what was used for grant date fair value?*

**Answer:** Yes, as long as the valuation technique would be permitted under ASC 718, including that it meets the criteria for a valuation technique and the fair value measurement objective. For example, another valuation technique might provide a better estimate of fair value subsequent to the grant date. The rules require disclosure about the assumptions made in the valuation that differ materially from those disclosed as of the grant date. A change in valuation technique from the technique used at the grant date would require disclosure of the change and the reason for the change if such technique differs materially.

**Question 128D.21 (Use of Non-GAAP Methods or Shortcuts)**

*Is it ever acceptable to value stock and/or option awards as of the end of a covered fiscal year based on methods not prescribed by GAAP?*

**Answer:** No. The fair value of equity awards must be computed using methodology and assumptions consistent with ASC 718. For example, the expected term assumption to value options should not be determined using a “shortcut approach” that simply subtracts the elapsed actual life from the expected term assumption at the grant date. Similarly, the expected term for options referred to as “plain vanilla” should not be determined using the “simplified” method if those options do not meet the “plain vanilla” criteria at the re-measurement date, such as when the option is now out-of-the-money.

**Assumptions to Watch in Year 2 Fair Value Disclosures**

The procedures used to calculate fair value vary depending on the type of equity award. For stock options and stock appreciation rights (SARs), fair value is often calculated using a Black-Scholes or lattice model. When rolling prior grant valuations forward, care should be taken to ensure that the expected term appropriately considers moneyiness of the options at the new date.

Performance shares and performance share units often include a performance condition (e.g., the award vests if revenues increase by 10%) or a market condition (e.g., the award vests if the registrant's total shareholder return over a three-year period exceeds its peer group by at least 5%). The performance condition will require updated probability estimates at year-end and at the vesting date. Awards with market conditions are typically valued using Monte Carlo simulation and so a reassessment at subsequent dates using a consistent simulation model with updated assumptions will be necessary. For awards with market conditions, key assumptions to watch in Year 2 updates include:

- **Volatility** – The volatility input should be updated to match the remaining term of the award. If the award is benchmarked to an index or group of peer companies, then the volatility (and correlation factor) for the benchmark should also be reevaluated. Shorter terms might also mean that forward-looking option-implied volatility could be more appropriate than historical approaches.
- **Realized Performance** – When updating the fair value of a three-year award after one year of performance, one-third of the ultimate return (and potential payoff) is already locked in. For companies whose stocks have performed well (either individually or against their peer group), this could lead to a substantial increase in the fair value of the award. On the other hand, a company whose stock price has lagged its peer group could see the value of the award decline drastically, with little likelihood of favorable outcomes possible in the simulation model.



- **Relative TSR Peer Group Changes** – For awards that link payouts to the performance of a group of peer companies or an index, some of the peers may have been acquired or merged since the grant date. The plan documentation will often describe the steps to be taken when the composition of the peer group changes or there is a change in the benchmark index. A different group (or number) of companies will affect the correlation assumption as well as the percentile calculations in a ranked plan.

These are just a few of the assumptions used in the **valuation of equity awards**. Ultimately, the valuation professional should assess the concluded values for reasonableness and be able to explain why the fair value moved as it did. This understanding provides the link to the calculation of Compensation Actually Paid (and the company's explanation for it) in the Pay Versus Performance disclosures.

## Summary and Next Steps

With Year 2 of the Pay Versus Performance framework underway, registrants and their advisors now have an understanding of what is expected. Further, the SEC's additional guidance clarified several areas of potential confusion around the valuation of equity awards with market conditions and situations faced by newly public companies. Companies should pay particular attention to the impact of changes in key assumptions on the fair value of equity awards, including volatility, realized performance, and changes in the composition of total shareholder return (TSR) peer groups.

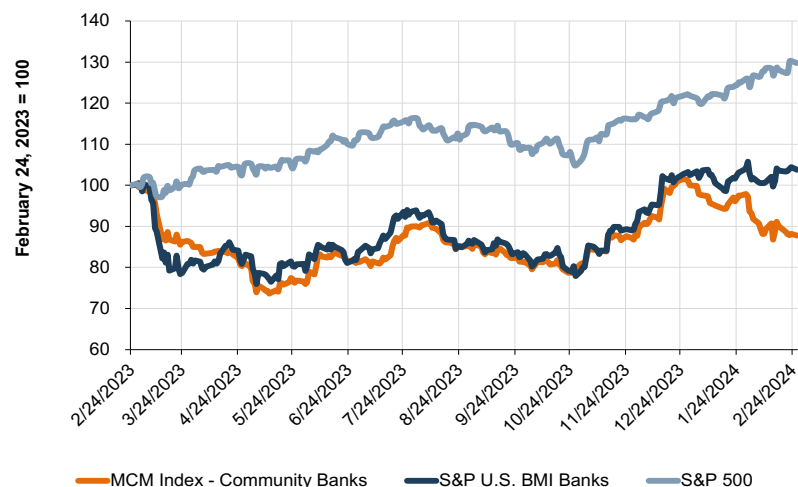
The complexity of implementing the Pay Versus Performance rules in Year 2 will vary by firm. We have already assisted clients with the transition from the initial Year 1 implementation to a roll-forward of previously-valued equity awards. And we certainly understand how the disclosure rules can seem daunting for those new firms who will be complying with the rules for the first time. Ultimately, the individual equity award characteristics will determine the complexity of the valuation process and the number of valuations that need to be performed.

If you have questions about the valuation of equity awards and how they are incorporated into the Pay Versus Performance disclosure framework, please contact a Mercer Capital professional.



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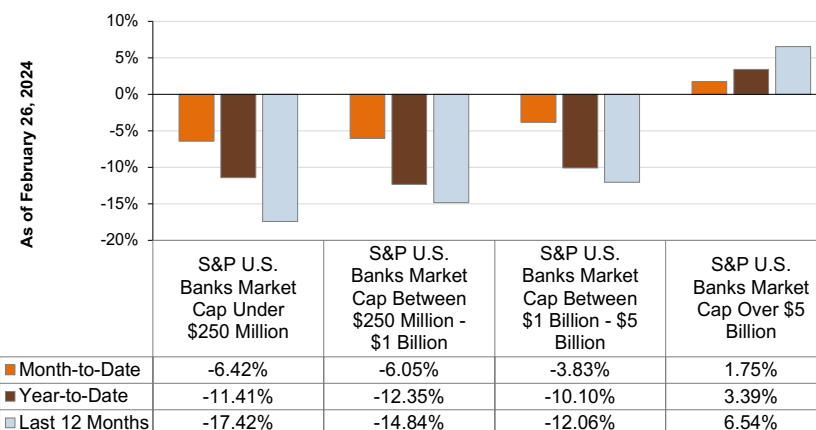
### Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

### Return Stratification of U.S. Banks

by Market Cap



Source: S&P Capital IQ Pro.

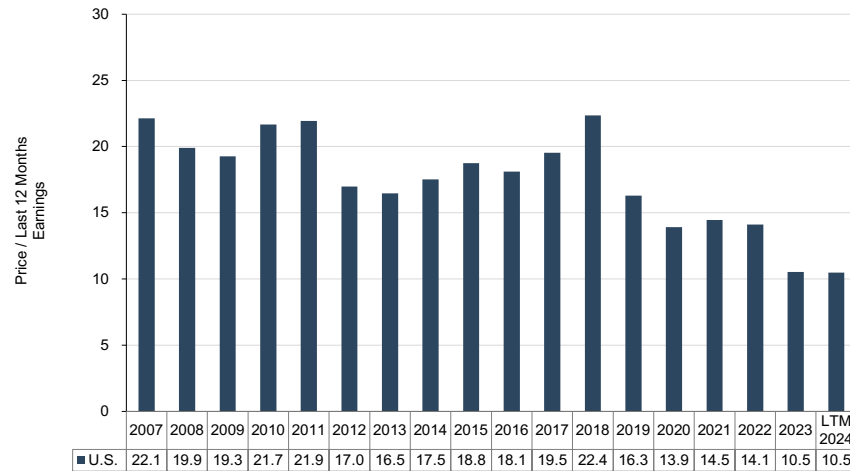
	Total Return			Regional Index Data as of February 26, 2024					
	Month-to-Date	Year-to-Date	Last 12 Months	Price / LTM EPS	Price / 2024 (E) EPS	Price / 2025 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	-6.5%	-15.2%	-19.5%	10.9x	10.2x	8.6x	98%	106%	3.3%
Midwest Index	-4.7%	-6.6%	-9.3%	9.3x	9.7x	8.8x	89%	103%	3.7%
Northeast Index	-6.5%	-13.2%	-10.0%	8.7x	10.0x	8.7x	89%	105%	4.1%
Southeast Index	-5.7%	-7.8%	-11.3%	13.4x	8.5x	7.6x	93%	101%	3.1%
West Index	-7.2%	-13.2%	-10.9%	8.6x	9.6x	8.0x	97%	103%	3.4%
Community Bank Index	-6.3%	-12.2%	-12.3%	9.4x	9.7x	8.2x	94%	105%	3.4%
S&P U.S. BMI Banks	0.9%	1.3%	3.8%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.



### Median Price/Earnings Multiples

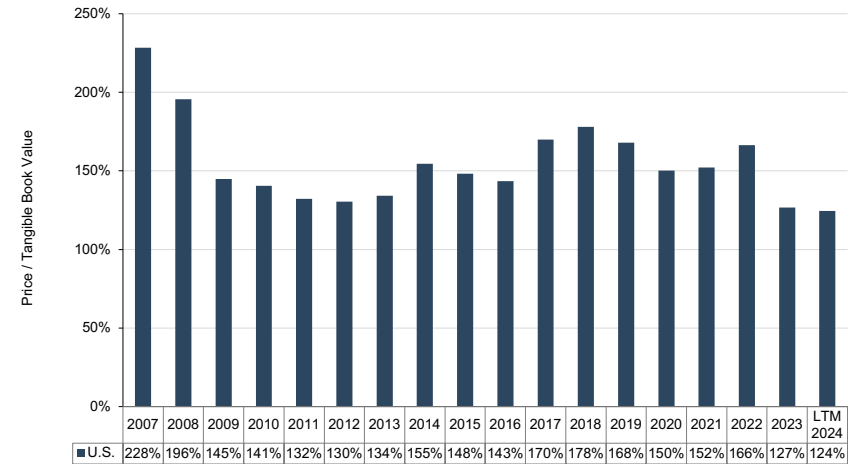
Target Banks' Assets <\$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

### Median Price/Tangible Book Value Multiples

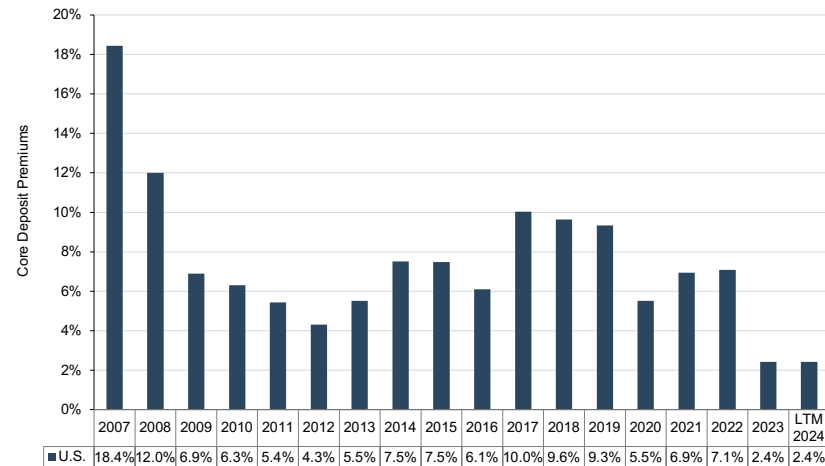
Target Banks' Assets <\$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

### Median Core Deposit Premiums

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



Source: S&P Capital IQ Pro.

### Median Valuation Multiples for M&A Deals

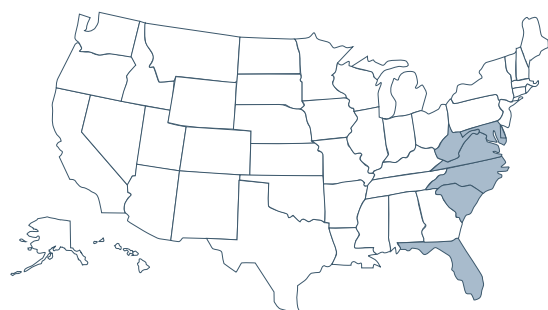
Target Banks' Assets <\$5B and LTM ROE >5%, 12 months ended February 27, 2024

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	11.9x	114%	1.6%	4	214.7	1,898,912	11.0%
Midwest	9.7x	145%	4.2%	2	66.3	897,454	17.3%
Northeast	9.2x	118%	1.7%	4	93.9	1,256,371	12.5%
Southeast	11.8x	130%	3.6%	4	58.9	553,750	8.7%
West	9.3x	124%	3.0%	7	32.6	383,276	9.0%
National Community Banks	10.5x	124%	2.4%	21	59.6	684,661	10.3%

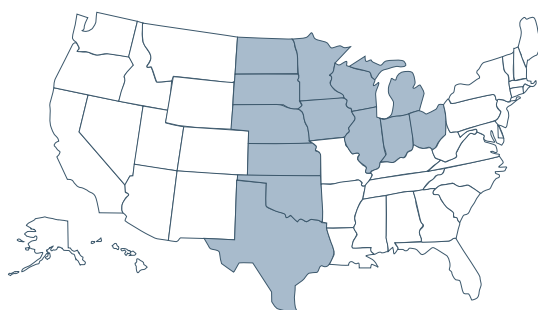
Source: S&P Capital IQ Pro.

## Mercer Capital's Regional Public Bank Peer Reports

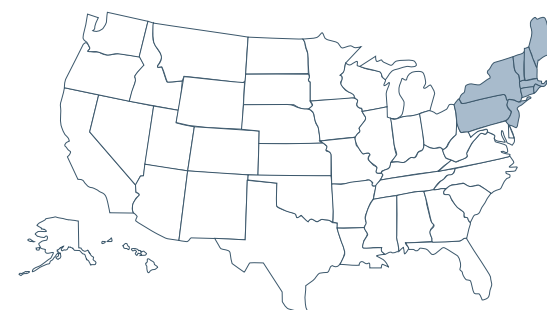
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



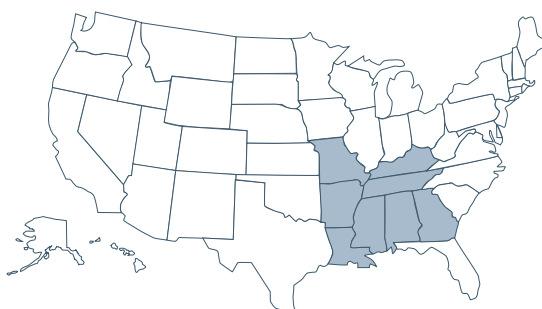
**Atlantic Coast**



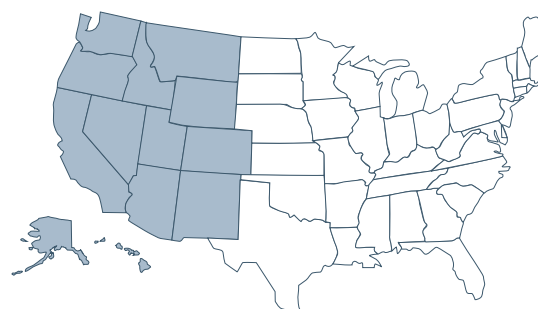
**Midwest**



**Northeast**



**Southeast**



**West**

**MERCER CAPITAL**

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

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