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Breakout III: Credit Union/Bank Transactions: Non-Traditional Growth Opportunities and Valuations

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#AOBA23

2023 Acquire or Be Acquired

Credit Union/Bank Transactions, Non-Traditional Growth Opportunities, and Valuations

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Outline for Today's Presentation

Background & Key Reasons for the Trend?

SECTION I

Background on the Trend

While still making up a small proportion of overall deal activity (<10% of total deal volume in 2021/2022), acquisitions of banks by CUs have been increasing in recent years

16 CU/Bank transactions were announced in 2022, up from both the prior peak in 2019 (14 transactions announced) and 2021 (13 transactions)

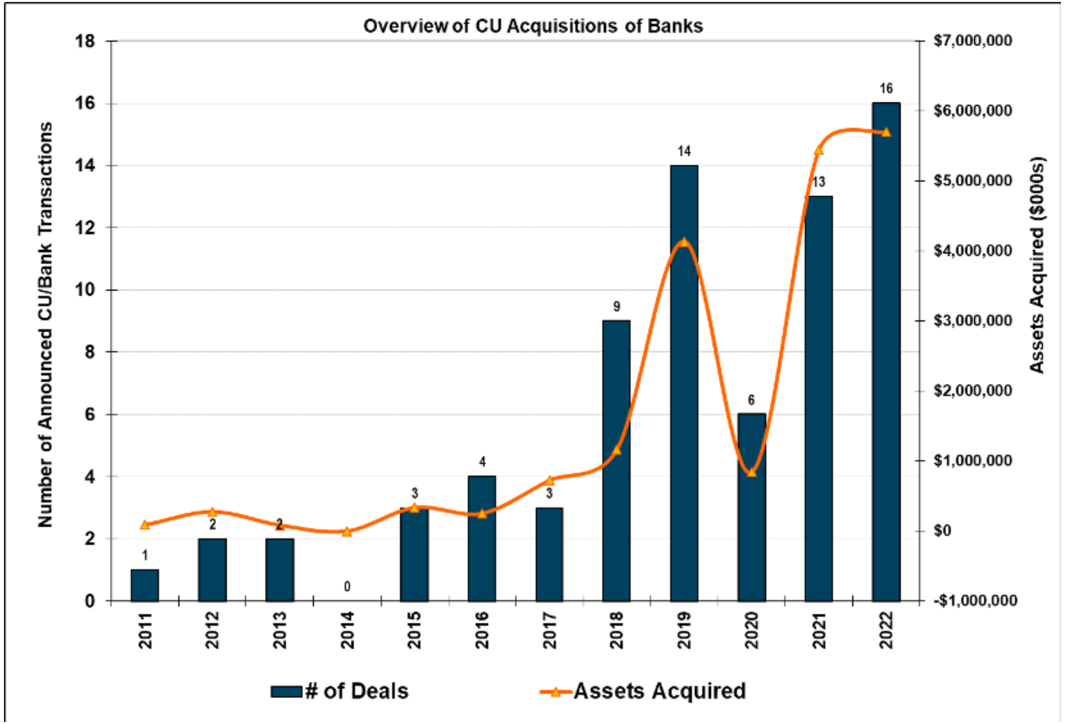
The first credit union to acquire a bank occurred in 2011/12

Since then, ~73 CU/Bank transactions have been announced

This emerging breed of bank acquirers provides bank sellers with an additional pool of potential buyers to consider when evaluating strategic options and liquidity events

Credit Union/Bank Acquisition Trends

Why is this trend emerging?



Source: S&P Global Market Intelligence

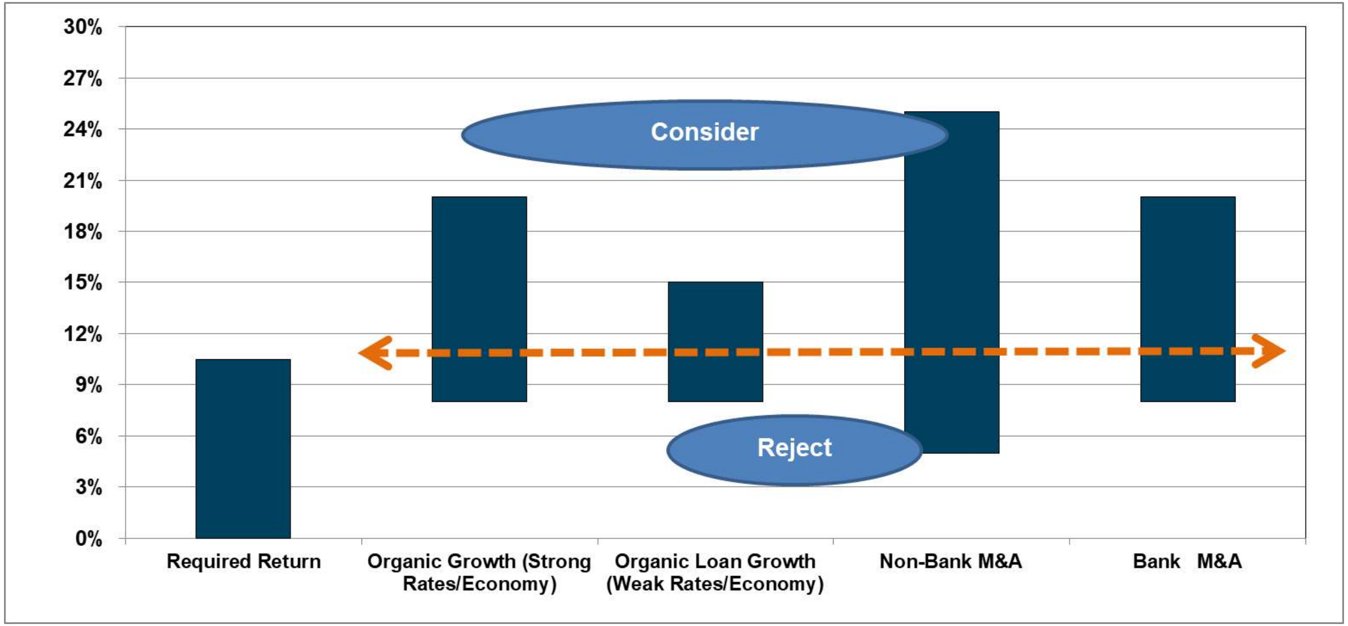
Strategic Considerations

For Credit Unions

- Market Growth / Expansion
    - Organic growth alone can be challenging and slower vs. acquisition
- Loan Portfolio Diversification & Expansion
- Enhanced Scale / Efficiency
- Defensive - In Response to Perceived Threats from FinTech and Larger Banks

Financial Considerations

Generate a Solid Return on Investment



Market/Industry Conditions

Will Continue to Drive M&A in 2023

Revenue/profitability pressures remain

- NIM – asset sensitive banks benefited from rising interest rate environment in ‘22 but potential pressure from rising deposit costs to limit deposit outflows could emerge
- Loan demand weak and economic growth slowing in some parts of the country while price competition remains intense
- Mortgage income pressured from higher rates and service charges are soft

Credit conditions pressured from potential to build reserves in light of slower economy and higher interest rates

Interest rate environment pressures securities portfolio values and fair value marks an acquired assets

FinTech / digital challenge continues to accelerate

Aging depositor and shareholder demographics (for some)

Community bank M&A activity also slowed in ‘22 relative to ‘21 and was still below ‘18/’19 levels

- However, core deposits and the additional scale/growth that M&A can provide remain attractive for acquirers

Positives to Bank Seller from This Trend

Added interest from CUs expands pool of acquirers and has potential to broaden marketing process and increase demand for selling bank and ultimately price/proceeds for bank shareholders

Typically, CU/Bank transactions are structured as all cash deals

- Provides certainty of proceeds/liquidity to seller

Additionally, for transactions involving CUs:

- Retention of most, if not all, staff
- Most, if not all, branches remain open
- Communities remain an integral part of the business plan/mission for CU acquirers

Overview of Key Valuation Issues in CU/Bank Transactions

SECTION II

Valuation Overview

Every industry has a rule-of-thumb for valuation and a preferred valuation metric; most only indirectly speak to economics

Banking's metric is tangible (common) equity and the most widely quoted metric is P/TBV

However, the base of the business model is key – what matters is the a) earnings stream; b) the risk profile of the business to produce the earnings; and c) expected growth over time

P/Es vary within the industry and are impacted by risk vs. growth considerations

- Low P/Es reflect riskier biz models, limited growth or lower quality earnings
- Above average P/E usually reflects better than average growth and consistently higher ROEs

Valuation approaches tend to include both a market approach (comp transaction multiples applied to subject bank) and an income approach (discounted cash flow model)

A reasonable valuation also considers both quantitative and qualitative factors

Top Three Financial Considerations

1. Developing a Reasonable Valuation Range for the Target

2. Appropriately Consider the Strategic Fit/Earning Power of the Target

3. Evaluating the Key Deal Metrics Implied by the Bank Acquisition

Value Drivers

Intrinsic (Investment) Value

Return on Equity (ROE)

- Profitability (ROA)
- Leverage (Capital)

Growth

- Organic (primary)
- Acquisition

Earnings Multiple (P/E)

- Cost of Capital
- Long-term growth rate

Deal Considerations

Employment agreements, vendor contract terminations, expense savings/synergies

Franchise Value

- Management (long-term execution)
- Markets
- Core deposits
- Loan origination capacity
- Loss history (yield less net charge-offs)
- Operating leverage (ER)
- Non-interest income (fee businesses)

CU Specific Drivers

1. Geography/Markets
2. Assets/Liabilities
3. Employee Talent & Organization Capability
4. Leveraging CU products/services post-closing

Earning Power Overview

Earning power reflects an estimate of ongoing earnings through a full business/credit cycle

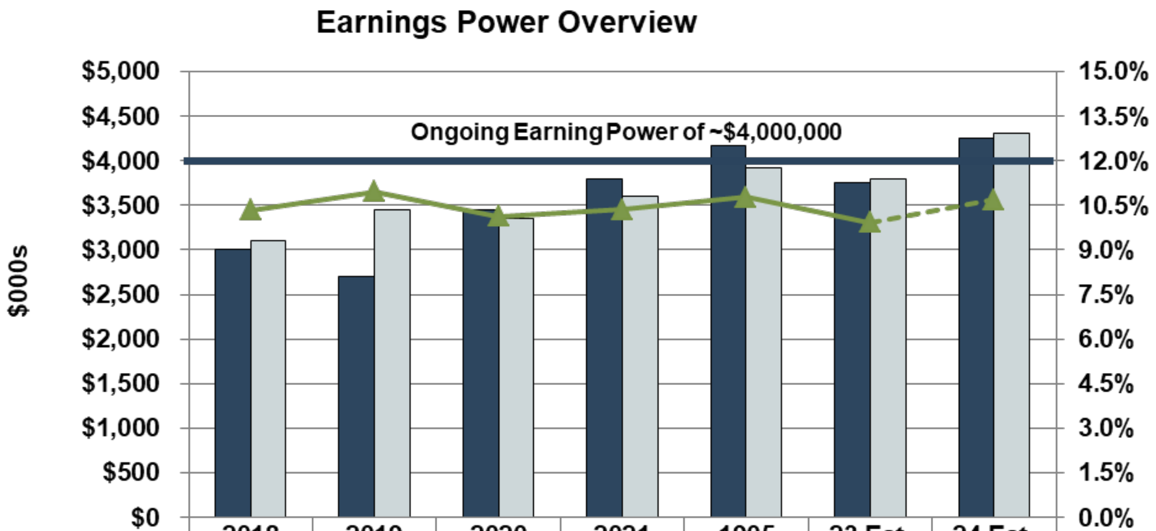
Earning power is derived from an analysis of core earnings over the past 3-5 years combined with an earnings forecast over the next 1-2 years

The most significant variables for a bank will be a) the expected range of credit losses; b) net interest margin (NIM); and c) volume of loans and core deposits

The challenge of estimating a bank's earning power is that credit losses tend to be episodic (i.e., very low for years then very big) and the rate environment can be volatile and impactful but also difficult to forecast with precision

In valuing a bank target, an additional challenge can be estimating cost savings/synergies and earning power inclusive and exclusive of synergies

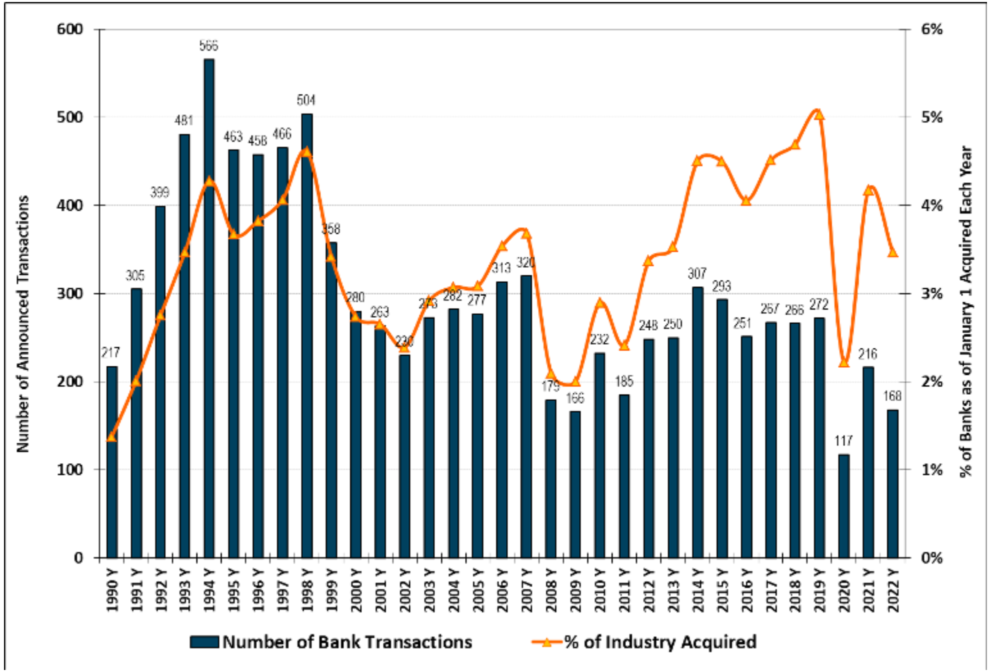
Core Earning Power Example



	2018	2019	2020	2021	1905	23 Est.	24 Est.
Reported Earnings	$3,000	$2,700	$3,450	$3,795	$4,175	$3,750	$4,250
Adjusted Earnings	$3,100	$3,450	$3,350	$3,595	$3,925	$3,800	$4,300
Adjusted ROTE	10.3%	11.0%	10.1%	10.4%	10.8%	9.9%	10.7%

Market Approach

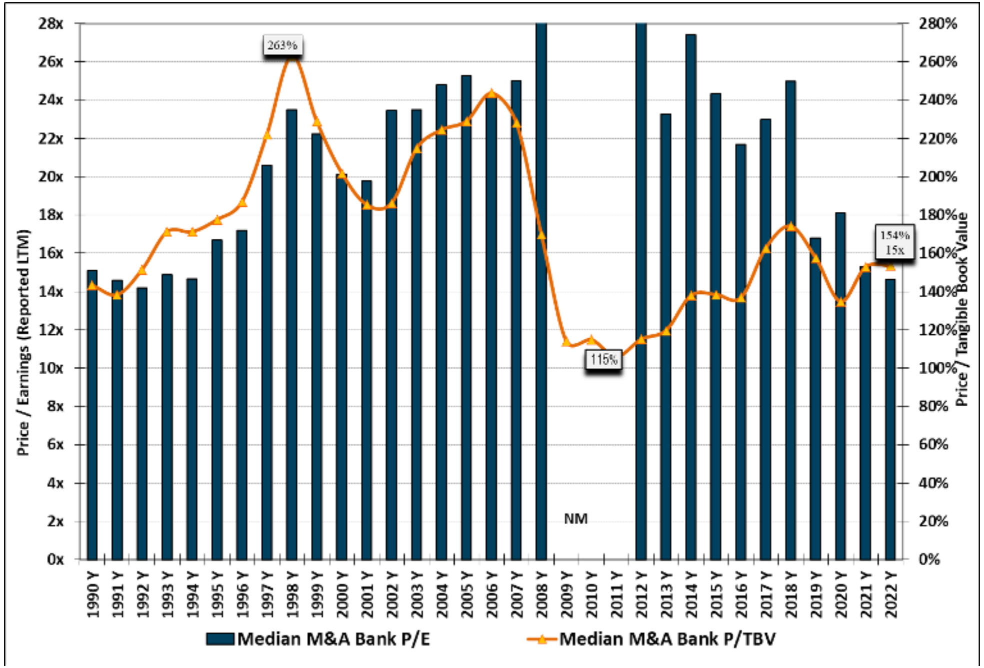
Where Are We in the Cycle? Volumes and Activity Are Down in ‘22 vs. ‘21 and Still Below Pre-COVID Levels



Source: S&P Global Market Intelligence

Market Approach

Pricing Reflects a Similar Trend with P/TBV Multiples Up in ‘21/‘22 Relative to ‘20 But Below ‘18/‘19 Levels; P/Es Varied Over Time

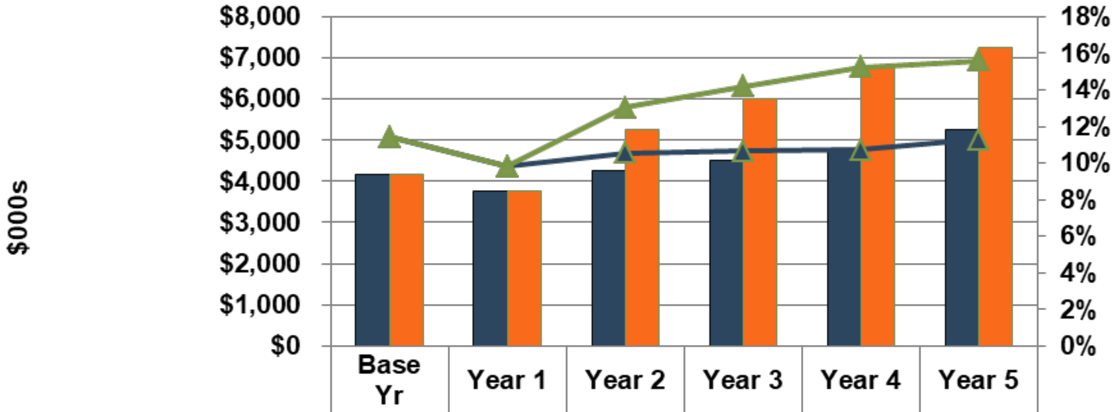


Source: S&P Global Market Intelligence

Income Approach

Discounted Cash Flow Analysis Develops a Valuation Range by Considering Future Earning Power of Target

Projected Income Statement Overview



	Base Yr	Year 1	Year 2	Year 3	Year 4	Year 5
Net Income (x Synergies)	$4,175	$3,750	$4,250	$4,500	$4,750	$5,250
Net Income (w Synergies)	$4,175	$3,750	$5,250	$6,000	$6,750	$7,250
ROAE (x Synergies)	11.44%	9.80%	10.56%	10.65%	10.73%	11.29%
ROAE (w Synergies)	11.44%	9.80%	13.04%	14.20%	15.25%	15.59%

Typical Pricing Parameters

Pricing: Consider multiples of earnings (with & without expense saves) and multiples of book value

Expense Savings: Still a primary factor but may be less for CU acquirers than traditional banks as many CU acquisitions are strategic, out-of-market deals

Revenue Synergies: Sometimes but may be more common with CU acquirers than traditional bank acquirers

Capital Dilution & Earn-Back: Still a primary focus for CU acquirers

Internal Rate of Return: Typically targeted to be comfortably above the acquirer's cost of capital (which may vary for CUs vs Banks)

Capital/Net Worth: Varies but often targeted to be at or above the 8-9% of total assets range for CU acquirers

Non-Traditional Growth Opportunities & Valuations

SECTION III

Non-Traditional Growth Opportunities

While facing challenges from non-traditional competitors, banks are increasingly presented with non-traditional growth opportunities

Some of these non-traditional growth opportunities include building or acquiring niche business lines. Some non-traditional niches for banks include:

- Wealth Management / Trust
- Insurance
- Mortgage
- FinTech
- Specialty Finance (including equipment financing/leasing)

Benefits of developing a non-traditional niche include diversifying revenue and earnings

Non-Traditional Growth Through Acquisition

The strategies for banks seeking to grow in these non-traditional niches include: building, acquiring, and/or partnering

If acquisitions are pursued as part of the strategic plan, strategies can include:

- Acquiring a bank that has already built this expertise in a particular niche; or
- Acquiring a non-depository company (i.e., acquiring a pure play wealth management, insurance company/agency, specialty finance company/lender, and/or FinTech company)

For the acquisition strategy, care should be taken as due diligence, valuation, and structuring of these transactions can involve unique issues and differences from acquiring a more traditional community bank

In the following, we will provide an overview of valuation issues and key considerations for non-traditional niches generally as well as focus in on a few specific issues for some of the more common non-traditional niches (wealth management, insurance, specialty finance, and FinTech)

Acquiring Non-Traditional Growth

Benefits vs. Issues

Benefits

- Deployment of excess capital to drive growth
- Revenue and earnings growth and diversification achieved more quickly than building or partnering
- Improve return on capital
- Provide more financials services to existing clients/customers
- Can improve valuation (higher ROE and more revenue diversification => higher valuation/multiple)

Issues

- Execution risk
- Culture
- Dilution (ownership, focus, and franchise value)
- Enough scale to matter
- Contingent liabilities
- Will key principals still work hard after deal closes?
- Limitations on size of the niche vs size of the bank
- Regulatory/compliance risk of niche business

Important to Understand both Valuation Issues and Industry/Market Valuation Trends for the Non-Traditional Niche Being Pursued

Overview of Valuation Methods

Two most common approaches to determine value are the market and income approaches. Valuation methods are typically weighted to provide a value range for the company

Market Approach

Determines value by utilizing valuation metrics from transactions in comparable public companies or acquisitions of private companies

Transparency on deal pricing is often more limited

Market's reaction to the niche industry can often be more volatile and different from traditional bank market

Income Approach

Considers business' expected cash flows, risks, and growth prospects

Most common methods are:

- Capitalizing earning power (with a capitalization factor), or
- The discounted cash flow (DCF) method where value is derived from projecting expected profitability and discounting those cash flows to the present at a required rate of return. Forecast for DCF can involve considering multiple scenarios and probability weighting potential indications of value from those scenarios

Acquiring Non-Traditional Growth

Three Key Elements of Valuation for Both Market and Income Approaches

Cash Flow

Key elements to consider:

- Earning Power - History vs. forecast
- Concentrations
- Sustainability
- Margin drivers
- Careful w/ synergies
- Where in the business/economic cycle? What is potential impact on company/industry?

Risk

Key elements to consider:

- Targets in non-traditional niches can often generate higher returns/IRRs
- Offset is that they often have a higher risk/required rate of return, typically above bank's cost of capital

Growth

Key elements to consider:

- Understand Market Opportunity/Industry Dynamics
- History vs. Forecast – Is it achievable?

Acquiring Non-Traditional Growth: Insurance

Benefits & Key Valuation Issues

Benefits

- Can diversify bank earnings and enhance non-interest income
- Generally stable, renewal-based revenue stream
- Price/valuation often based on agency fundamentals, not synergistic growth

Key Valuation Issues

- Revenue model (Commission vs. Fee Based)
- Expenses (People & Overhead)
- Ability to grow/scale
  - Organic growth (invest in new producers, product, geographies)
  - Future acquisitions such as Bolt-On Agencies
- Drivers of revenue/industry trends
  - Rate (hard vs. soft market)
  - Macro/Industry factors
- Customer/Producer/Carrier concentrations
- Technology, compliance issues
- Industry/Market valuation trends

Acquiring Non-Traditional Growth: Specialty Finance

Benefits & Key Valuation Issues

Benefits

- Can provide higher yielding loans
- Potential lift in profitability from funding loan portfolio with lower cost excess deposits
- Offers a venue to further diversify loan portfolio
- Bring in new customers/relationships while also expanding offerings to existing customers

Key Valuation Issues

- Origination model (direct, purchase, hybrid)
- Seasonality and cyclical issues with originations
- Pricing model and where the industry is in the pricing cycle
- Loss model and loss cycle
- Source of contingent liabilities
- Industry/Market valuation trends

Acquiring Non-Traditional Growth: Wealth/Asset Management

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Benefits & Key Valuation Issues

Benefits

- Enhance non-interest fee income – can be easily accretive
  - Although significant intangible portion of value can be an issue
- Revenue diversification but still sensitive to market/interest rates
- Minimal capital requirements, which can improve ROE
- Attractive internal rates of return (IRRs) with recurring revenue and substantial margins
- Provides additional financial services to existing customers while also adding new customers/relationships

Key Valuation Issues

- Understand firm / asset manager economics
  - Returns to Capital vs. Returns to Labor (Owners and Producers)
- AUM growth (excluding impact of market)/Composition/Concentrations
- Realized fee schedule
- Scheduled distributions (for example payouts to trusts/clients/pensions)
- Unscheduled asset attrition (Rebalancing/Manager Termination)
- Industry/Market valuation trends

Acquiring Non-Traditional Growth: FinTech

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Benefits & Key Valuation Issues

Benefits

- Can enhance non-interest fee income
- Can expand or enhance FinTech offerings to customers via a lower cost and more efficient high-tech delivery
- Can have minimal capital requirements and offer attractive internal rates of return (IRRs) with recurring revenue and substantial margins

Key Valuation Issues

- Distribution model (B2C, B2B)
- Trends in FinTech niche and total addressable market
- History vs. Forecast
  - Is growth/margin achievable? At what cost?
- Capital needs to scale/acquire customers
- Earnings/Revenue model
- Unit Economics
  - Customer Lifetime Value LTV, Customer Acquisition Cost CAC, Churn/Retention
- Key Partnerships/Technology solutions
- Regulatory/Compliance issues
- Industry/Market valuation trends

Acquiring Non-Traditional Growth: FinTech

Illustration of Important of Understanding Industry / Market Trends

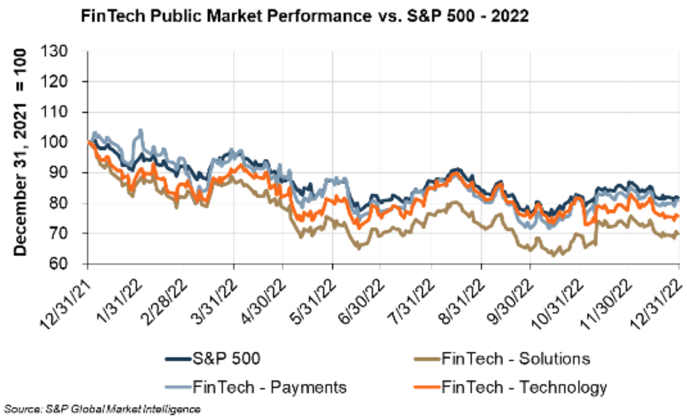
Certain niches like FinTech can be more volatile and perform differently than both traditional community banks and the broader market

Thus, it is important to understand the valuation and market trends/outlook of the FinTech niche when considering potential acquisition opportunities and determining the Target's valuation

Valuation & Returns of Tech Forward Banks vs. Community Banks

	Price to:				Price Change	
	LTM EPS	2023 EPS (E)	2024 EPS (E)	TBV	2021	2022
Median - Tech Forward Banks*	13.0x	8.0x	7.6x	170%	84%	-56%
** Identified as tickers AX, CCB, GDOT, LC, LOB, MVBF, CASH, SI, SIVB, TBBK, TFIN.*						
Median - Community Banks	9.5x	9.0x	8.6x	141%	38%	-1%
** Identified as banks with assets between $500 million and $5 billion.*						

Source: S&P Capital IQ Pro; Market data as of 12/31/22



Acquiring Non-Traditional Growth: Other Issues

- **Structure of transaction can be different**
  - Earnouts (i.e., contingent consideration based upon future performance) are common in acquisitions of non-depositories and can be a meaningful portion of deal value
  - Employment/retention/non-compete agreements for key employees can also be a common feature of these acquisitions
- **Due diligence can also be different**
  - May be more focused on identifying cultural issues/differences and focusing on key staff retention
  - Key customer/producer concentration and retention issues may be more impactful
  - Quality of Earnings assessments/studies can be more common
  - Assessing technology/compliance/integration issues can be more challenging but still vital
- **Key deal metrics such as IRR, capital earn-back period, and accretion/dilution are still important considerations**

Takeaways

SECTION IV

Takeaways from CU/Bank Transactions

1. In 2022, CU/Bank acquisitions increased and a number of the bank targets were larger, more profitable, and in bigger metros in 2021/22 relative to prior years

2. Although some unique factors impacting a bank's valuation can emerge, CU acquirers often focus on similar valuation approaches and deal metrics to other bank acquirers

3. The structure of CU/Bank transactions continues to be predominately all cash, which is often viewed attractively by the selling bank

4. Added interest from CUs expands pool of acquirers and has potential to broaden marketing process and increase demand for selling bank and ultimately price/proceeds for bank shareholders

Takeaways from Non-Traditional Growth Opportunities & Valuation

1. While facing challenges from non-traditional competitors, banks are increasingly presented with non-traditional growth opportunities

2. Non-traditional growth opportunities can include: Mortgage; FinTech; Wealth Management / Trust; Specialty Finance; and Insurance

3. Banks seeking to grow in these non-traditional areas can consider strategic options such as building, acquiring, and/or partnering in these non-traditional areas

4. In approaching acquisitions of banks with a significant niche business line or acquisitions of non-depositories, care should be taken as due diligence, valuation, and structuring of these transactions can involve unique issues and differences from acquiring a more traditional community bank

Q&A

SECTION V

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Jay D. Wilson is Senior Vice President of Mercer Capital and a senior member of the firm's Financial Institutions and FinTech practice.

Mr. Wilson regularly works with financial institutions (Banks & CUs) in valuation and M&A engagements. He assists banks and CUs in evaluating the attractiveness of acquisition candidates (whole banks, branches, or merger partners), determining a valuation for the target, structuring/modeling the transaction, and estimating fair value marks for financial assets (loans, core deposit intangibles) and liabilities (CD portfolio) acquired for financial statement reporting purposes.

Mr. Wilson also values financial institutions and FinTech companies for a variety of other purposes including, estate and gift tax planning, profit sharing or option plans such as ESOPs, corporate/strategic planning, and compliance matters.

He also publishes articles on the community bank, credit union, and FinTech industry and is the author of *Creating Strategic Value Through Financial Technology* (John Wiley & Sons, 2017).