Breakout 1:
Bank Director 101: M&A Primer

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M&A Primer

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MERCER CAPITAL
BUSINESS VALUATION & FINANCIAL ADVISORY SERVICES

Why Consider M&A?

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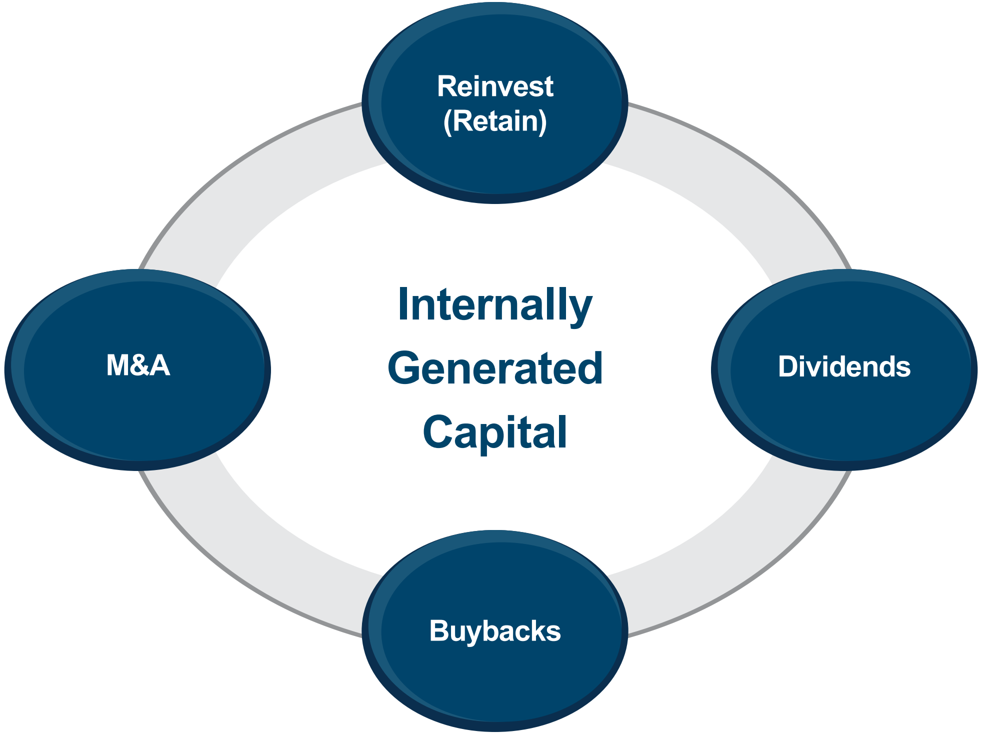
Buyers	Sellers
Accomplishing growth objectives that would otherwise take years to achieve	Merger consideration exceeds the returns that investors could expect to achieve over the intermediate term
Moving the needle on profitability more quickly than achievable via organic growth	Provide liquidity to shareholders, particularly if no trading market exists
Entering new markets or new lines of business; that is, increasing growth opportunities	Addresses management succession issues
Access new sources of deposits	Resolution of strategic disagreements / board or controlling owner group tensions
Improve diversification	Seller is unable to resolve technological limitations, compliance expectations, or the like
Enhance operational efficiencies	Investment diversification by selling shareholders
Be a survivor	Capital limitations (inadequate capital to execute strategic plan)
Management compensation	

When Is M&A Not a Solution?

Buyers	Sellers
"Don't make someone else's problem your own"	Reinvestment options offer lower returns than those generated by the bank
Dilution of the buyer's own performance	An adequate succession plan, technology, etc. exists. That is, the bank can compete successfully
Distraction from organic growth objectives	Desire to maintain continuity in markets served
Risk of "asymmetric" information – the seller knows more than the buyer about the target bank	Expect better exit opportunities in the future
Additional regulatory scrutiny is created (see New York Community Bank)	
The buyer trades a low price/earnings multiple	
Opportunities exist to hire teams of experienced relationship managers	
Cultural incompatibilities exist	

Allocating Capital to M&A

Does the board have a well-thought strategy?



Valuation Basics

Rule of Thumb

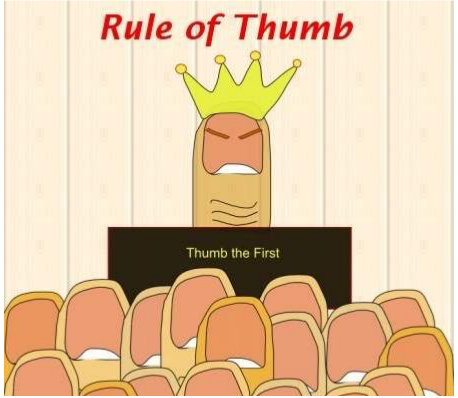
All industries have rule-of-thumb valuations

Most indirectly speak to economics

Price / tangible book value (P/TBV)

What's the relevant range and why?

Business model entails leveraging capital 9-12x with to produce return on equity (ROE)



Equity per se is not the point; what matters is the a) earnings stream; b) the risk profile of the business to produce the earnings; and c) expected growth over time

High Level Math

Price / Tangible Book Value = Return on Equity x Price / Earnings Multiple

	Return on Equity		Price / Earnings Multiple	
Determinants	Return on Assets x	Leverage	Risk Profile	Growth
Components	$\frac{\text{Net Income}}{\text{Assets}}$	$\frac{\text{Assets}}{\text{Equity}}$	Credit, Operational, Market, Etc.	Markets, Business Lines, Etc.
Primary Influencer of Components	Bank Mgmt. (Strategies, Risk Mgmt., Personnel, Capital Mgmt.)		Market Primarily Sets the P/E Based on Perceived Risk and Growth	
Secondary Influencer of Components	Market (Interest Rates, Economic Conditions)		Bank Mgmt. Influences P/E (Growth Trajectory, Risk Mgmt.)	

		Return on Equity		
		8%	12%	16%
Price / Earnings Multiple	8x	0.64x	0.96x	1.28x
	10x	0.80x	1.20x	1.60x
	12x	0.96x	1.44x	1.92x
	14x	1.12x	1.68x	2.24x

Values in the table represent P/TBV multiples, assuming different ROEs and P/Es. *Focus on ROE to drive a higher P/TBV.*

Concept of Earning Power

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

- **Earning power is derived from an analysis of historical core earnings combined with an earnings forecast over the next 1-2 years**
  - The most significant variables for a bank will be:
    a) net interest margin
    b) volume of loans and core deposits
    c) the expected range of credit losses
  - 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)

Earning Power x Reasonable P/E Multiple = Value

Measuring Risk

There is no return without risk

Risk is harder to measure than historical or even prospective growth

There are many risk factors that investors will consider to calibrate a reasonable valuation

- Amount of capital and capital structure
- Type of credits
- Hold positions
- Liquidity / sources of funding
- Interest rate sensitivity
- M&A execution
- Key man/woman dependency
- Data integrity
- Customer, industry, or market concentrations (not typical for banks)
- Operational risk and regulatory exposures (see banks with banking as a service strategies)

Why Risk and Growth Matter

+ Yield to Maturity on 10 Yr UST		3.85%
+ Equity Premium	5.50%	
x Company Beta	0.95	
=Beta Adj Equity Premium		5.23%
+ Small-Mid Cap Equity Premium		2.50%
+ Company Specific Premium		1.50%
+ Company Specific Risks		***2.00%***
= Discount Rate (Equity Cost of Capital)		**15.08%**
- Long-Term Growth Rate (G)		***-5.00%***
= Capitalization Rate		10.08%
= Multiple (1 / Cap Rate)		**9.9x**

Ongoing Earning Power Estimate	$100,000
x Price/Earnings Ratio	9.9x
= Capitalized Earnings Value	$990,000

Multiples are negatively correlated with risk …
higher risk = ⬇ P/E

Multiples are positively correlated with growth …
higher G = ⬆ P/E

Growth matters a lot to value, but so does risk

Acquisition Accounting

Target's Balance Sheet Marked-To-Market by Buyer

Asset / Liability Category	Balance Sheet Treatment	Income Statement Treatment
Loans*	Buyer Recognizes at Fair Value	Discounts Accreted / Premiums Amortized Through Interest Income
Allowance for Credit Losses (ACL)*	Buyer Establishes ACL for Acquired Loans (Double Counting Issue for Expected Credit Losses)	
Securities	Recognized at Fair Value (As If Unrealized Losses Are Realized)	Going Forward, Yield Will Reflect Current Market Yields, Not the Yield on the Securities at the Original Purchase Date
Customer Relationship Intangible Asset (Core Deposit Intangible Asset)	Buyer Recognizes at Fair Value	Amortized Via an Expense over Useful Life
Liabilities (CDs, FHLB Advances, Holding Company Borrowings)	Buyer Recognizes at Fair Value	Marks Will Be Accreted or Amortized Through Interest Expense
Fixed Assets	Buyer Recognizes at Fair Value	New Basis in Asset Will Affect Depreciation Expense

** We have omitted a complete discussion of the accounting for acquired loans*

Excess of the purchase price over net assets acquired is goodwill

Larger asset marks reduce net assets acquired and therefore increase goodwill (holding the purchase price constant). Higher goodwill, in turn, reduces tangible common equity and regulatory capital

M&A Valuation Techniques

Comparable M&A Transactions

Evaluates the pricing of comparable M&A transactions selected based on factors such as (a) transaction announcement date, (b) asset size, (c) geographic region, (d) profitability

Indications of value can be obtained using multiples of earnings, tangible book value, core deposits, etc.

Pros	Cons
Derived from actual, market-based transactions	Perfectly comparable transactions do not exist
Easy to understand and communicate	Difficult to use in periods of rapid change in the industry, such as in 2022 when interest rates began increasing

EPS Accretion

Evaluates EPS before and after the transaction. What is the percentage change in EPS resulting from the transaction?

Pros	Cons
Correlates with the importance of EPS growth to creating shareholder value. Therefore, a transaction that is $0.10/share accretive to EPS would add $1.00 to share value, assuming the buyer's stock trades at 10x earnings	Post-merger change in EPS is influenced by the accretion of purchase accounting marks. Consider using EPS absent such accounting adjustments Difficult to evaluate the appropriate level of EPS accretion: is 6%, 8%, 10% too little? Cash deals generate higher EPS accretion than stock deals. Is the bank receiving an appropriate return on the capital committed to the transaction?

Tangible Book Value Per Share Earn-Back

TBVPS earn-back analyses require two forecasts: (a) the buyer's TBVPS without the acquisition and (b) the buyer's TBVPS with the acquisition. As a result of purchase accounting marks and deal pricing factors, the buyer's TBVPS immediately after the acquisition generally falls below its TBVPS absent the transaction

Under the cross-over method, earn-back occurs at the point when pro forma TBVPS exceeds stand-alone TBVPS

Pros	Cons
Very important to investors in the public markets Effectively a governor of deal pricing, which could be a pro or a con Demonstrates that the buyer is better off undertaking the transaction Exacts a penalty for deal-related charges	Dependent on the accounting for the transaction, rather than the economics. Larger purchase accounting marks drive greater TBVPS dilution, which extend the earn-out period

Discounted Cash Flow Analysis

The discounted cash flow method requires a projection of the target's future financial performance, usually including synergies that may be realized from the transaction (or a portion of the synergies that is "credited" to the seller in the deal value). Value is a function of (a) interim cash flows, or dividends, generated by the target and (b) a terminal value representing the value of all future cash flows

Pros	Cons
Value is correlated closely with the target's future earnings contribution to the buyer	Dependent on a long-term forecast—every deal looks good in a spreadsheet
Value is driven by the economics of the transaction, not the accounting	Difficulty in estimating the terminal value, which is normally a significant part of the overall value. That is, assuming a terminal value multiple of 10x, 12x, or 14x earnings will significantly influence value
Can be used to evaluate, for a given purchase price, how much earnings contribution is needed from the target	
Less subject to the ebbs and flows of the market	

Internal Rate of Return

The internal rate of return is the return that equilibrates (a) the purchase price with (b) future cash flows generated by the target entity. That is, discounting the future cash flows at the IRR results in a present value amount that equals the purchase price.

Pros	Cons
Easy to compare the IRR to the expected shareholder return	Dependent on a long-term forecast, like the DCF analysis
	Difficulty in estimating the terminal value, which is normally a significant part of the overall value. That is, assuming a terminal value multiple of 10x, 12x, or 14x earnings will significantly influence value

Conclusion

Typical Pricing Parameters

Maxim: Value is quoted as a multiple of tangible book value, but value is a function of the product of earning power with (conservative) expense savings and an appropriate P/E multiple subject to governors (e.g., pro forma capital, TBVPS)

Pricing: 6-9x pro forma earnings with 100% after-tax expense saves

Expense Saves: 10-20% for out-of-market deals, 20-40% in-market

Revenue Synergies: Good luck!

Acceptable TBVPS Dilution: Earn-back within 2-3 years via the “cross-over” method

EPS Accretion: Threshold varies, but 4-5% usually the *minimum* accretion

Internal Rate of Return: Comfortably above the buyer’s cost of capital

Bank Capital: Varies but day one leverage ratio 9-10% and > 10% CET1 ratio for the consolidated entity

Parent Capital Structure: Significant flexibility for small BHCs

Pay-to-Trade P/TBV: Public acquirers typically try to price P/TBV < their public market P/TBV

What Can Go Wrong?

Asset quality surprises

Unexpected interest rate movements

Loss of employees

Greater regulatory scrutiny (NYCB)

Culture clashes (bigger risk with mergers of equal)

Deposit attrition or migration to higher rate products

Integration and conversion issues

Adverse stock market reaction to deal

Litigation deemed immaterial during due diligence evolves into material exposure

Director Preparedness

1. **Regular (periodic) assessment and preparation**
   - **Management analysis**
   - **Summary review with the board**

2. **Who are your logical acquirers?**
   - **How many and what is the plan if one or more are acquired**
   - **Capacity to pay-up**
   - **Ability to finance**
   - **Taking the buyer's shares—would you and how valued?**

3. **Assessment**
   - **Contract termination costs**
   - **Fair value estimates—credit and rates**
   - **Core deposits—concentration issues**
   - **Loan portfolio issues**
   - **Management and employees (who is critical for a buyer and who's not; C-o-Cs in place)**
   - **High-level expense save analysis**

Director Preparedness

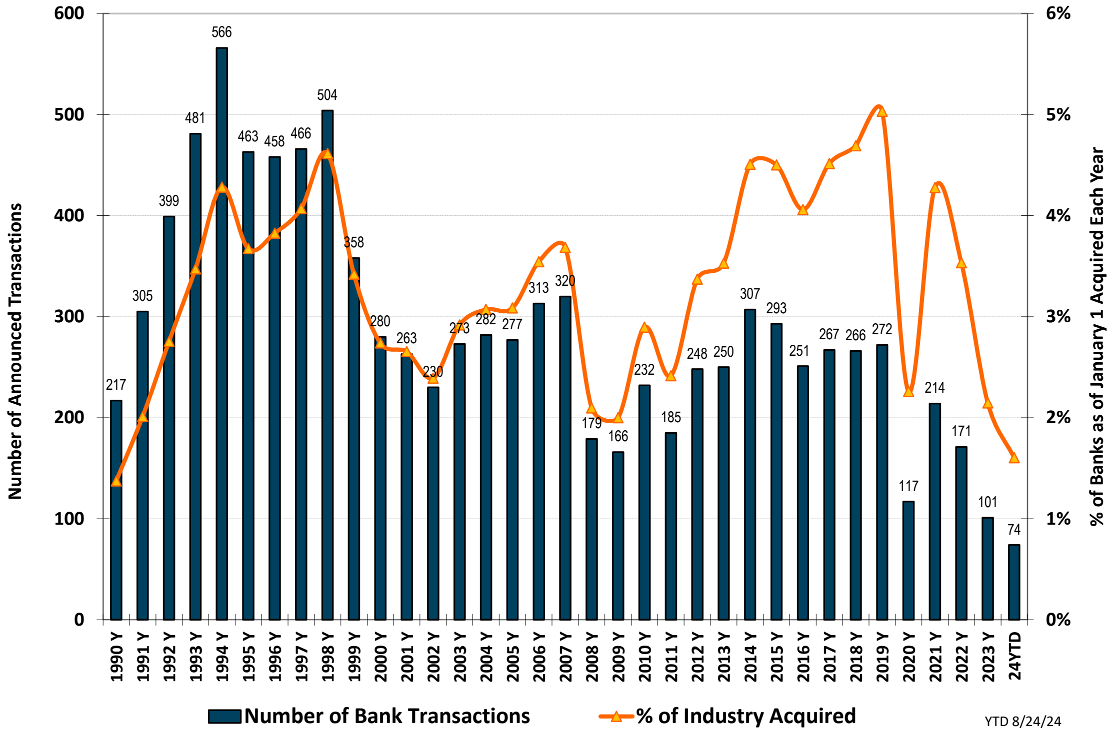
4. **6x – 9x pro forma earnings (what is your range of value?)**

5. **Three-year projections**

6. **Making a habit of reviewing publicly announced deals**
   - **8-K**
   - **What to look for in the investor deck**
   - **SEC filing – review the definitive agreement**
   - **How did the market react**

7. **Review of the public market for bank stocks and M&A**

1990-2024 M&A Activity



1990-2024 M&A Pricing

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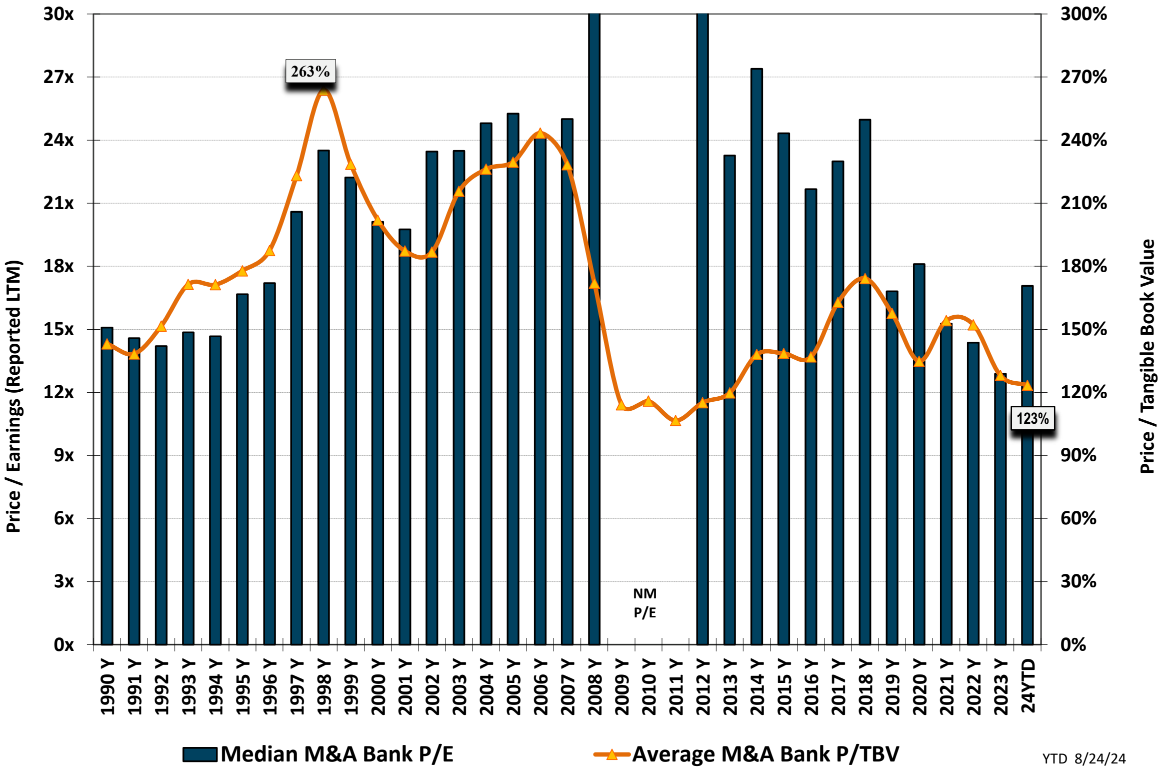

YTD 8/24/24

Questions?

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Andrew K. Gibbs leads Mercer Capital's Depository Institutions Group. Andy provides valuation and corporate advisory services to financial institutions for purposes including mergers and acquisitions, employee stock ownership plans, profit sharing plans, estate and gift tax planning and compliance matters, corporate planning and reorganizations.

He leads projects involving compliance with ASC 805 and ASC 350, which entail, for example, the identification and valuation of intangible assets under ASC 805 and impairment testing under ASC 350.

He also works with financial institutions in merger and acquisition advisory engagements. He assists buyers in evaluating the attractiveness of acquisition candidates, determining a price for the target institution, structuring the transaction, and evaluating different forms of financing. For sell-side clients, Andy analyzes the potential value that the institution may receive upon a sale, assists in locating potential buyers, and participates in negotiating a final transaction price and merger agreement.

Andy is a frequent speaker on topics related to community bank valuation and co-authored the following books: *The ESOP Handbook for Banks: Exploring Alternatives for Liquidity While Maintaining Independence, The Bank Director's Valuation Handbook: What Every Director Must Know About Valuation,* and *Acquiring a Failed Bank: A Guide to Understanding, Valuing, and Accounting for Transactions in a Distressed Environment*, published by Peabody Publishing, LP.

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Jeff K. Davis is the Managing Director of Mercer Capital's Financial Institutions Group. The Financial Institutions Group works with banks, thrifts, asset managers, insurance companies and agencies, BDCs, REITs, broker-dealers and financial technology companies.

Prior to rejoining Mercer Capital, Davis spent 13 years as a sell-side analyst providing coverage of publicly traded banks and specialty finance companies to institutional investors evaluating common equity and fixed income investment opportunities. Jeff was most recently Managing Director of Guggenheim Securities, LLC, and was previously head of the Financial Institutions Group at FTN Equity Capital Markets. His work covering commercial banks was recognized for earnings accuracy and stock picking by Starmine/Forbes in 2005, 2007 and 2009, while his stock selection was ranked second for commercial banks in 2007 by the Wall Street Journal as part of its "Best on the Street" annual ranking of sell-side analysts. While at Mercer Capital in the 1990s, Jeff led the firm's financial institutions practice, providing valuation and transaction advisory services.

Jeff is a speaker at industry gatherings, including University of Virginia's annual analyst training seminar, the ABA, various state banking meetings as well as security industry gatherings. Additionally, he regularly makes presentations to boards of directors and executive management teams. He is periodically quoted in the *American Banker*, *Bloomberg News*, and other media outlets. Presently, he is an editorial contributor to S&P Global.

Transaction Advisory Services

Mercer Capital has experience assisting depository institutions with significant corporate transactions. Whether considering an acquisition, a sale, or simply planning for future growth, Mercer Capital has the experience required to help financial institutions accomplish their financial objectives.

Merger & Acquisition Advisory

Mercer Capital can efficiently and effectively analyze the target institution, evaluate the financial effects of the transaction on the buyer, and determine a reasonable valuation range. Mercer Capital assists in negotiating the transaction and evaluating alternative financing mechanisms.

Branch acquisition opportunities are complicated by the occasional lack of data regarding the subject branches and the potentially significant capital impact of the transaction. Mercer Capital can assist in reducing this financial uncertainty by analyzing and modeling the potential financial effects of a branch acquisition, as well as by providing appropriate valuation support.

Fairness Opinions

Mercer Capital has experience rendering fairness opinions in complex scenarios, such as recapitalizations or related party transactions. Further, Mercer Capital has provided second fairness opinions in situations where a perceived conflict of interest may exist between an institution and an investment banking firm.

Distressed Institutions Assistance

Our experience in assessing the issues facing challenged banks in combination with applying valuation and accounting principles, gives us a unique perspective. Furthermore, we are actively engaged with capital market participants, including private equity funds which have made bank investments.

Solvency Opinions

As lenders, banks may fund significant leveraged transactions that give rise to the need for a solvency opinion. Mercer Capital renders solvency opinions for transactions involving the issuance of debt to fund acquisitions, dividends, or other significant changes to the borrower's capital structure.

Board Presentations

Mercer Capital has advised boards of directors in a wide range of matters. Topics for these board presentations have included selling now versus selling later, repurchasing stock, managing capital, and comparing the subject institution's financial performance against its peers.

Recent Transactions