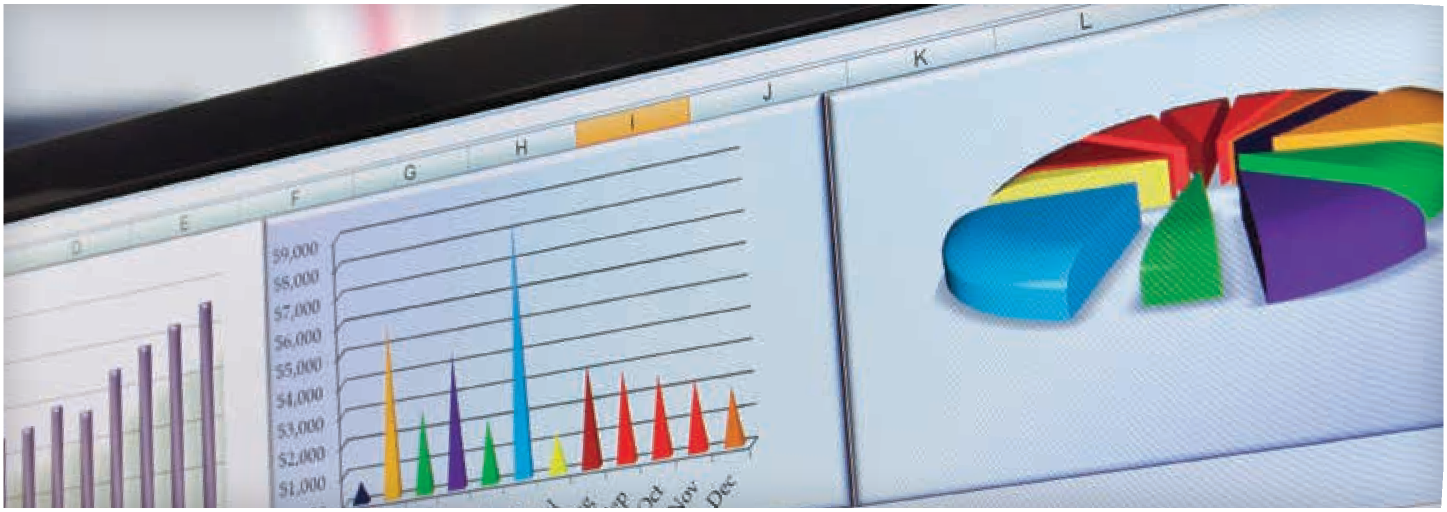


Valuation as Part of Due Diligence

“Rules of Thumb” Can Lead to Unpleasant Surprises

By Daniel L. McConaughy, Ph.D., ASA, and R. Chad Kellar, CPA

Bank acquisitions following the 2008-2009 credit crisis have drawn increased scrutiny. Regulators and investors alike are closely monitoring how well management’s initial projections compare with the final valuations at closing.

Unfortunately, all too often the acquirer’s management is surprised by the difference between its pro forma balance sheet projections and the final independent, third-party valuations. These unexpected changes in valuation could have a significant impact on the acquiring institution’s regulatory capital requirements and future earnings potential.

To avoid such last-minute surprises, more institutions with extensive acquisition experience are involving their third-party valuation teams earlier in the process – during the due diligence phase – in order to provide preliminary valuations. Involving valuation teams earlier in the process has grown popular as the pace of Federal Deposit Insurance Corporation-assisted acquisitions slows and banks accelerate the pace of open-bank transactions, which allow more time for planning and due diligence.

As this occurs, it is important that an acquiring bank’s management team has a clear understanding of the valuation issues that are likely to arise and that all those involved – appraiser, auditor, and bank executives – communicate clearly before and during the due diligence process.

Overview of the Issue

To assure objectivity, auditors for all publicly traded financial institutions and most privately held banks require an acquiring bank to use a third-party valuation team. Traditionally, the actual acquisition price is negotiated between the parties based upon the acquirer's due diligence. The outside valuation team is then engaged to determine the fair values of the acquired assets and liabilities as of the date when they are recognized on the acquiring institution's financial statements.

This traditional sequence of events often leads to unpleasant surprises, however. The third-party valuation team's valuations do not always align with management's expectations and judgments. The underlying causes for this misalignment relate to fundamental differences in approach. For example, the bank's perspective on the value of a loan is not necessarily fair value (or what a third-party buyer would be willing to pay), which is what the valuation team must consider.

Moreover, as part of their due diligence considerations, many acquirers apply generic "rules-of-thumb" to valuing items on the acquired balance sheet and make broad assumptions about how earnings will be affected by these valuation adjustments. Management's opinions also might be affected by the overall strategic value of the acquisition, such as specific transaction-related synergies.

While such considerations certainly are valid when negotiating the terms of the deal, they often do not factor into the valuation team's work, which is governed by three primary accounting standards:

1. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 805 – formerly Financial Accounting Standard (FAS) No. 141(R), "Business Combinations" – provides general guidance for acquisition accounting.
2. FASB ASC 820 – formerly FAS 157, "Fair Value Measurements" – addresses issues related directly to valuation practices.
3. FASB ASC 310-30 – formerly American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer – provides guidance on how to account for credit-impaired loans. It is important to perform the loan valuations in a manner that effectively accommodates these accounting requirements going forward.

According to these standards, the valuation team values the acquired assets and liabilities at fair value as of the date of the acquisition. Because this valuation can have such a significant effect on the acquiring institution's regulatory capital and financial results, management should bring in a third-party valuation team as early as possible during the due diligence process.

While there usually is not sufficient time to conduct an early valuation during a failed bank acquisition, in a normal bank transaction, the acquirer often has more control over the timing. By involving the valuation team early, management will have a clearer understanding of the valuation of the bank's loan portfolio and the intangible value of its core deposit base.

Loan Portfolio Valuation

Since a bank's loan portfolio generally is its largest asset, valuing this portfolio consumes the majority of the valuation team's effort. Achieving consensus on its fair value can be challenging, as there's not an observable market price for most bank loan portfolios. The valuation of the loan portfolio primarily is performed using a discounted cash flow methodology and various assumptions (such as probability of default, loss given default, prepayment speeds, and required market rates of return on the projected loan cash flows) that require consensus from all parties involved.

In many cases, management relies heavily on the credit review due diligence team to assign the marks on the loan portfolio. Credit review teams generally use an identified loss approach that is more applicable to an allowance for loan loss methodology. Alternatively, a range of life-to-date loss projections can be presented as a best-case/worst-case scenario to evaluate the overall merits of the transaction. The simple credit mark approach often neglects the timing of loan cash flows as well as the market-required rates of return on those cash flows, which must be considered in order to arrive at a true fair value that complies with FASB's accounting standards. As a result, when the valuation team presents its final fair value numbers, the loan valuations might be lower than initially anticipated.

Achieving consensus on a portfolio's fair value can be challenging, as there's not an observable market price for most bank loan portfolios.

Why does management tend to overvalue relative to the valuation team? Following are two basic examples that illustrate why the numbers vary.

Consider a loan on the books for $1 million, with a loan-loss allowance of $500,000. Assume that as part of the acquiring bank's due diligence the credit team reviews the loan and finds the reserve to be reasonable based on the collateral value underlying the loan.

When the valuation team approaches that loan, however, it must consider that in the event of default, the $500,000 net likely would not be recovered for an additional 18-24 months while the collateral is sold. A buyer in the market (a market participant) would further discount the ultimate cash flow amount to generate a reasonable holding period return while the buyer held the asset. As a result, the valuation team might value the same loan at $420,000.

Alternatively, consider a $1 million, 10-year, 4 percent loan with collateral far in excess of any possible liquidation value, and where management does not apply any credit mark to the loan. However, based on changes in the interest rate environment since the loan was originated, the valuation team could determine that the market participant's required rate of return should be 6.5 percent, resulting in a valuation of $840,000.

These basic examples illustrate how the valuation team's findings can produce a lower number than management anticipated and perhaps had already reported to regulators or investors. In these instances, the differences would add $80,000 and $160,000 to goodwill.

Multiply this across the entire loan portfolio and the effects could be enormous. Adding sizable sums to goodwill can have serious implications for the acquiring bank's regulatory capital requirements.

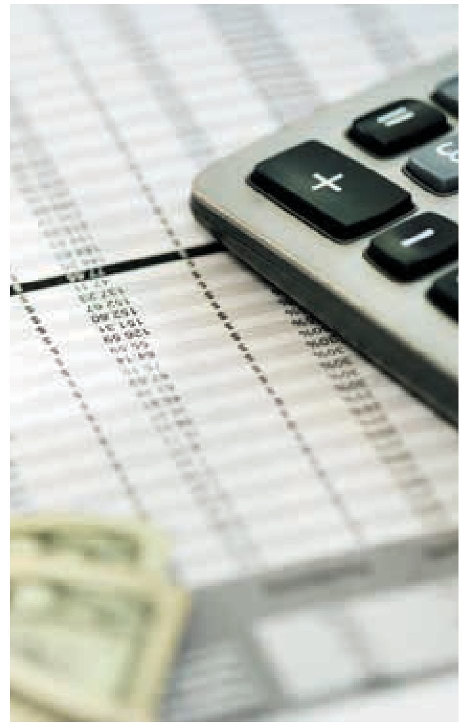
Core Deposit Intangibles

Although valuing the loan portfolio consumes the most time and attention of the valuation team, other issues must be addressed as well. Among these are core deposit customer relationships, including savings accounts, money market accounts, and noninterest-bearing and interest-bearing checking accounts.

These deposit accounts are an attractive, low-cost source of funds compared with alternative sources, such as time deposits and Federal Home Loan Bank (FHLB) advances. The value of core deposits as a low-cost source of capital is offset to some extent by the cost of maintaining branches and other administrative costs. Nevertheless, these core deposit accounts present a significant intangible value that is being acquired.[1]

The most appropriate method for determining this intangible value is the discounted cash flow method, which recognizes that economic value is based on anticipated future cost savings. The estimated future cash flows are converted to present value using a discount rate. The valuation team also factors in the nature of the business, the overall level of risk, the expected attrition rate of core depositors, and other factors such as the alternative cost of funds in the marketplace.

The result of these numerous assumptions and calculations is a core deposit intangible asset recorded on the balance sheet on day one. While this intangible asset has no immediate effect on a bank's capital requirements, it generally is amortized over a 10-year period, which can have a significant effect on future earnings projections.



Here again, the accepted rules of thumb can lead to unexpected differences between due diligence assumptions and the ultimate valuation. For example, in today's record-low interest rate environment, the relative value of this low-cost source of funds, compared with the cost of alternative funding, is significantly diminished.

Yet it is not uncommon to find banks still estimating core deposit intangibles to be equal to 3 to 4 percent of the core deposit base. In the case of an acquisition with a $100 million core deposit base, that would mean booking a $3 million to $4 million intangible asset, which is then amortized as an expense on an accelerated basis over seven to 10 years at the rate of $300,000 to $500,000 in the first few years.

With the projected low interest rates for the coming years, however, a more appropriate intangible value in this environment might be closer to 1 percent of the deposit base. This means the acquiring bank would be amortizing an expense of only $100,000 to $200,000 in the early years. This $200,000 to $300,000 difference in annual expense could change the bank's assumptions about how accretive the transaction will be going forward.

Liability Valuation

In general, the fair values of less complex liabilities – such as time deposits, FHLB advances, and other borrowings – are estimated using an income approach and well-established formulas. In most cases, the valuation of these liabilities is relatively straightforward and noncontroversial, and most banks' internal models already comply with fair value requirements.

One exception relates to trust preferred securities, which for many years were a popular way for bank holding companies to raise required regulatory capital. With rates pegged to common indices, trust preferred securities are a low-cost source of capital, but because of the risk associated with these debt instruments, the market currently demands a significantly higher rate of return. As a result, such liabilities often are valued at a significant discount to par, which has a beneficial effect on the opening balance sheet.

On the other hand, to comply with U.S. generally accepted accounting principles (GAAP) requirements, the bank ultimately must accrete that value to the original par amount by recording a higher interest expense. The effect, then, is positive in terms of its impact on regulatory capital requirements, but it ultimately will have a negative impact on future earnings.

Big Picture Versus Fair Value

When management evaluates a potential acquisition, it rightfully takes a big picture view, considering factors such as expected cost savings and synergies, the opportunity to add or combine branches, and the ability to gain access to a new market and new revenue sources. For financial reporting purposes, however, assets and liabilities must be considered in terms of their fair values to market participants, not as part of a specific transaction to a specific buyer. The fair value standard may have a significant effect on capitalization requirements and projected earnings – two metrics of particular interest to regulators and investors.

In addition to helping to align these two viewpoints, bringing in the third-party valuation team early in the due diligence process also provides other advantages. Performing a preliminary valuation gives management time to work through vendor selection prior to closing. It also provides time for management and the valuation team to review expected methodologies and deliverables well in advance – another valuable step in eliminating surprises. It also can produce some cost savings, because some of the preliminary steps associated with valuation can be completed in advance. These cost savings can offset some the costs of bringing in the valuation team early.

Because valuation can have such a significant effect on an acquiring institution’s financial results, early involvement of the valuation team is an effective way to help minimize unexpected surprises.

An early, preliminary valuation also helps the acquirer’s accounting team get an early start on formulating the appropriate accounting policies for integrating the acquired assets and liabilities. Accounting for those items presents many complexities for accounting personnel and the senior management team responsible for asset quality and financial reporting.

Above all, however, because of the potential complexities of the process, and because valuation can have such a significant effect on the acquiring institution’s financial results, early involvement of the valuation team is an effective way to help minimize unexpected surprises and provide the management team with a clear understanding of the time and resources that will be required for a smooth transaction.

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[1] For more information, read "Valuing Core Deposit Customer Intangibles," by Daniel L. McConaughy and Rick L. Childs, July 2011, http://www.crowehorwath.com/folio-pdf/ASR11966_FBCCArticle.pdf.

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