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# Business Combinations in a Banking Context

2024 Spring Forensics Institute

# Meet the Presenters

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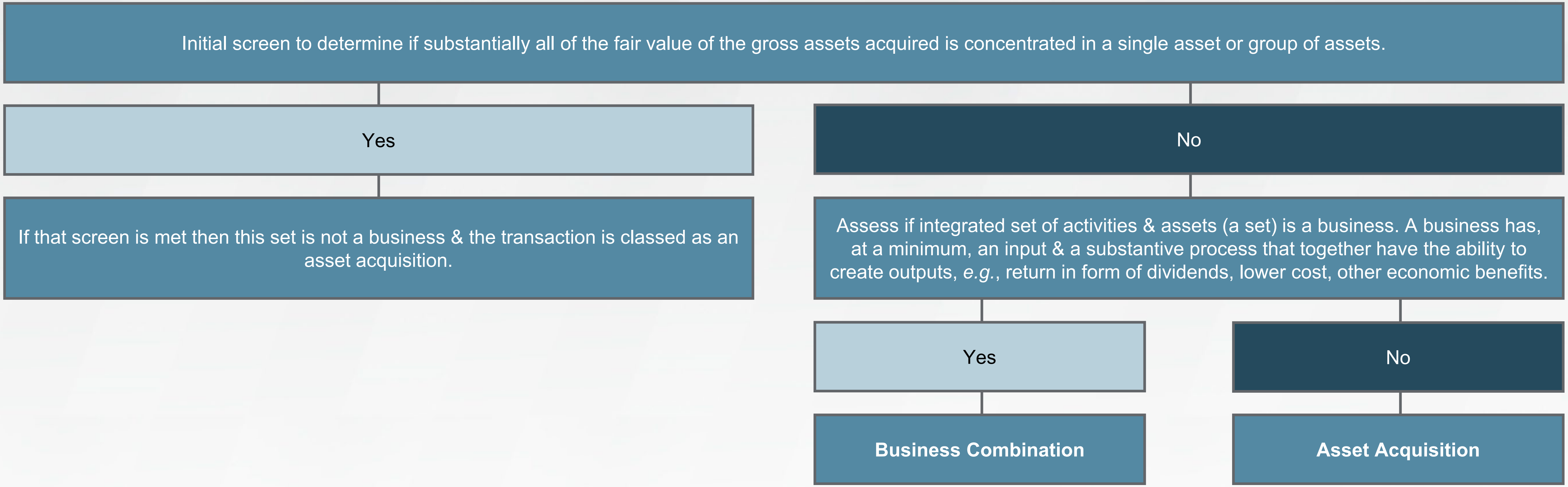
# Objectives

To provide an overview of:

- Current trends in bank mergers & acquisitions
- The major asset/liability classes valued as part of a bank transaction
- Valuation trends related to the assets/liabilities typically valued as part of a business combination

# Business Combination?

- A transaction or event in which an acquirer obtains control of one or more businesses.
- Assets acquired & liabilities assumed must constitute a business to be classed as a business combination




- In a banking context a business combination would include whole bank transactions, branch transactions, acquisitions of group of assets or liabilities that satisfy the definition of a "business."

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# U.S. Macro-Economic Environment

**Strong Gross Domestic Product (GDP) growth**

**High interest rate environment**

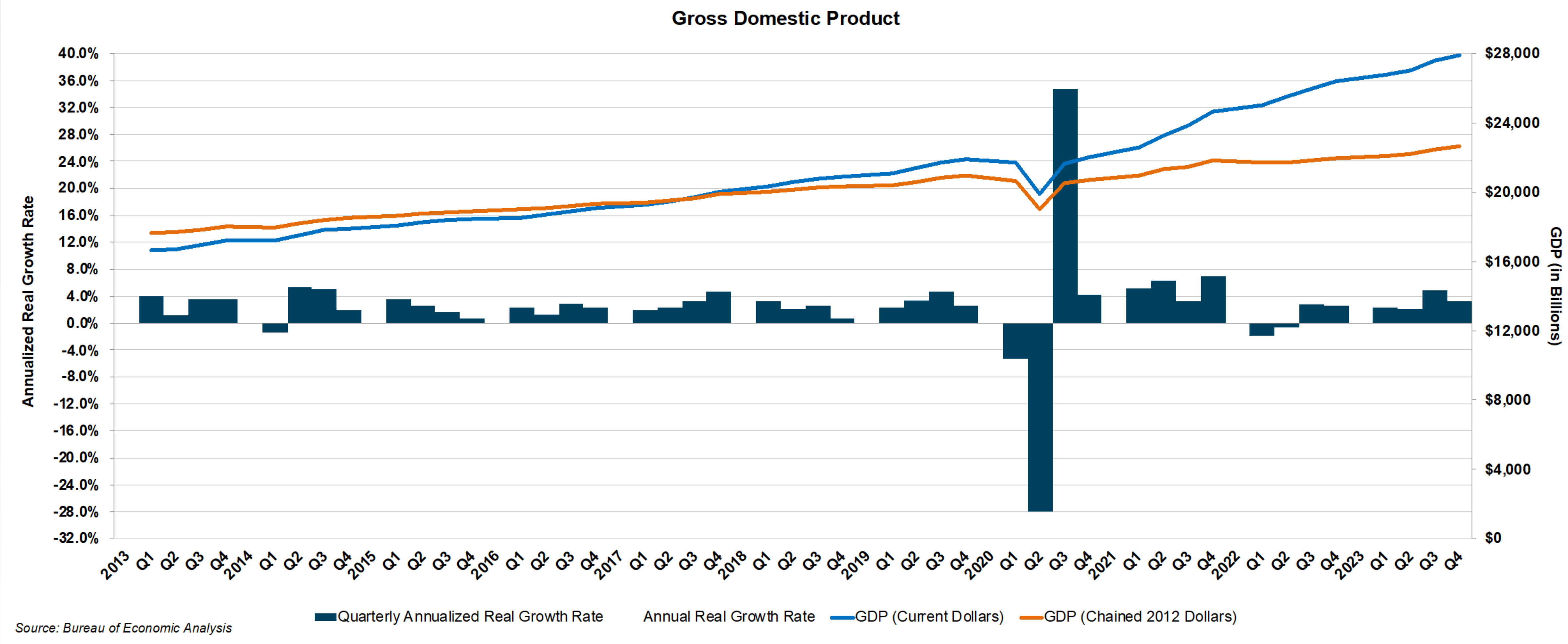
- Inverted yield curve

**High & sticky inflation**

**Soaring stock market**

- Volatile bank stock prices

# U.S. Macro-Economic Environment – GDP Growth

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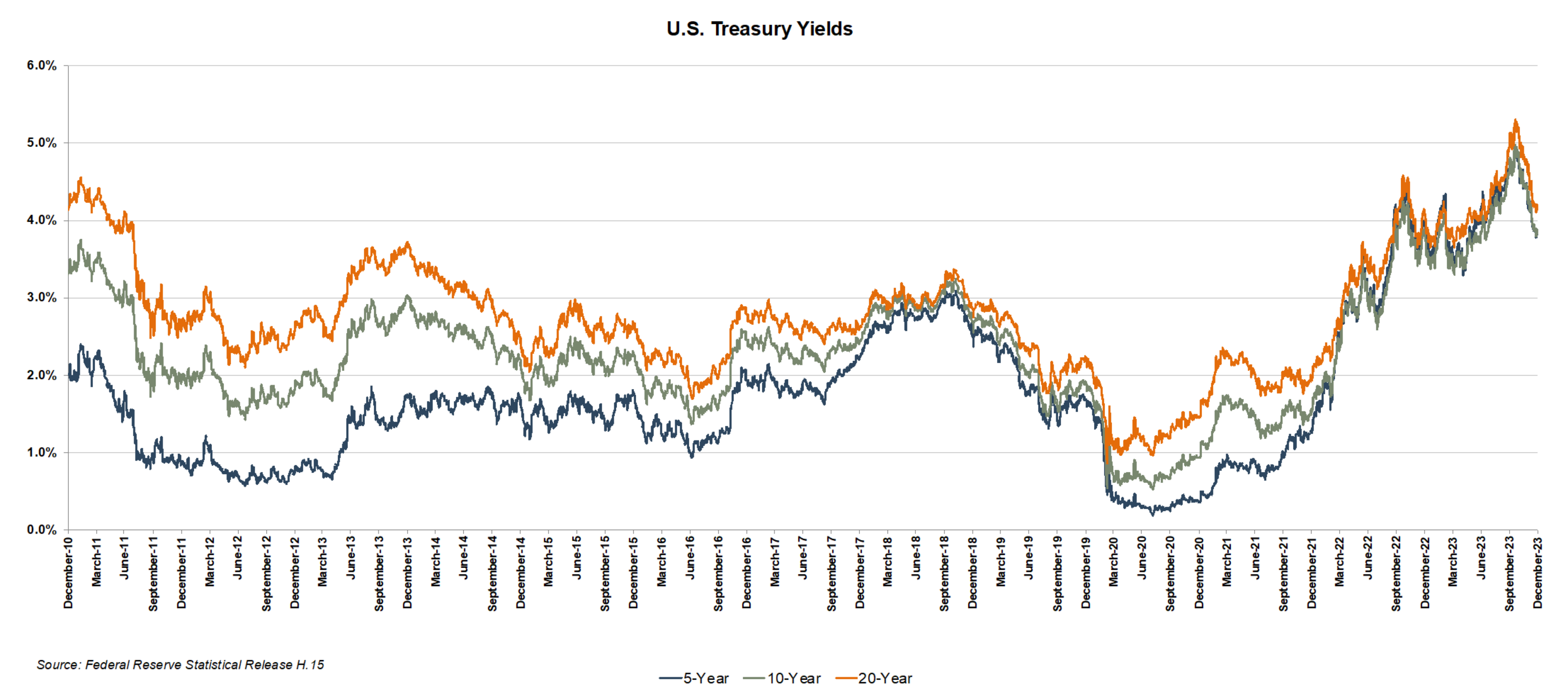
# U.S. Macro-Economic Environment – Interest Rates

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# U.S. Macro-Economic Environment – Equity Returns

## Market Index – Total Returns


Source: S&P Capital IQ Pro

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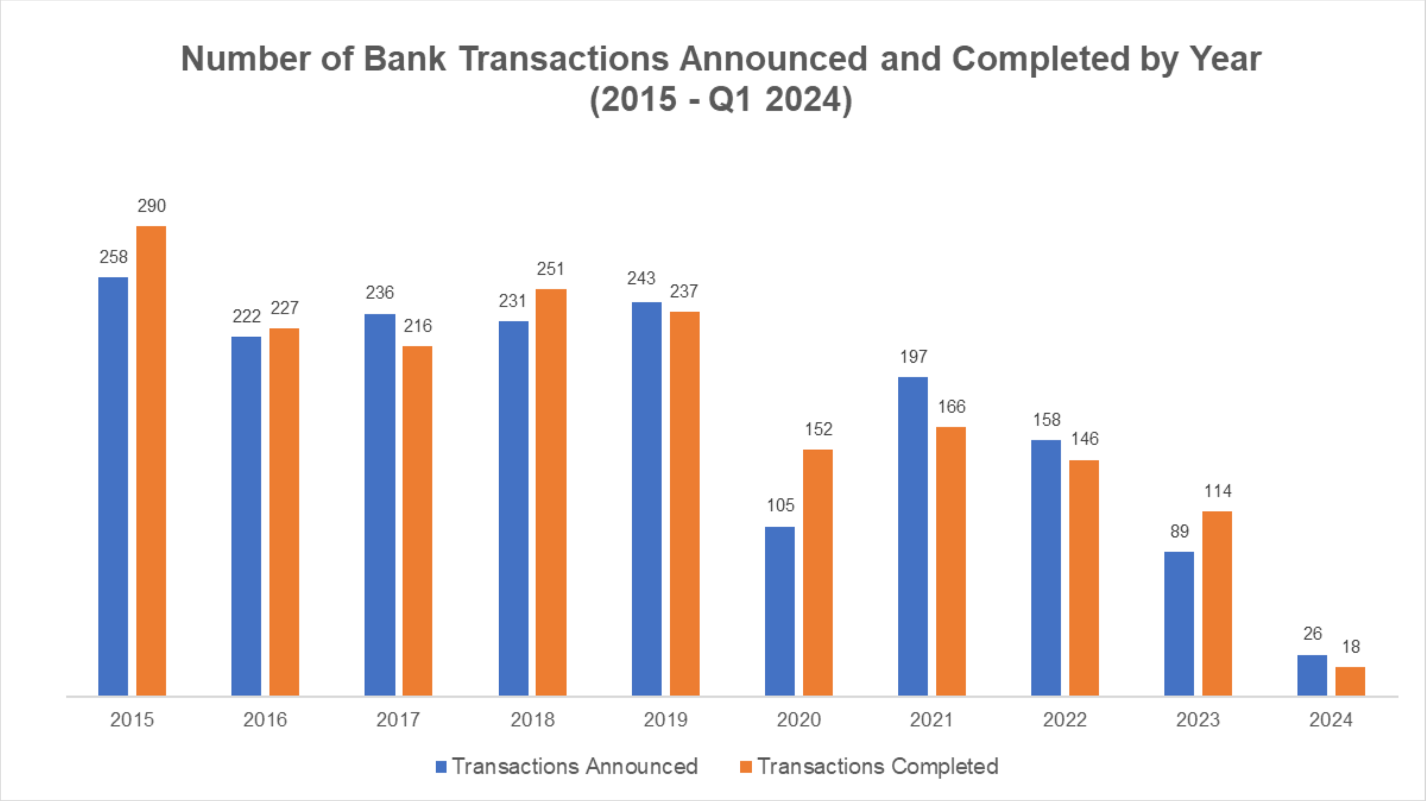
# Trends in Bank Mergers & Acquisitions

- Overall M&A activity during 2023 was significantly lower than the prior year
  - Announced deals in 2023 fell to the lowest yearly total since 2000
- Initial expectations for M&A transactions in 2024 projected increased activity; however, activity continues to be slow through Q1
  - Increased regulatory scrutiny for bank deals
  - Continued high interest rate environment




Source: S&P Capital IQ Pro

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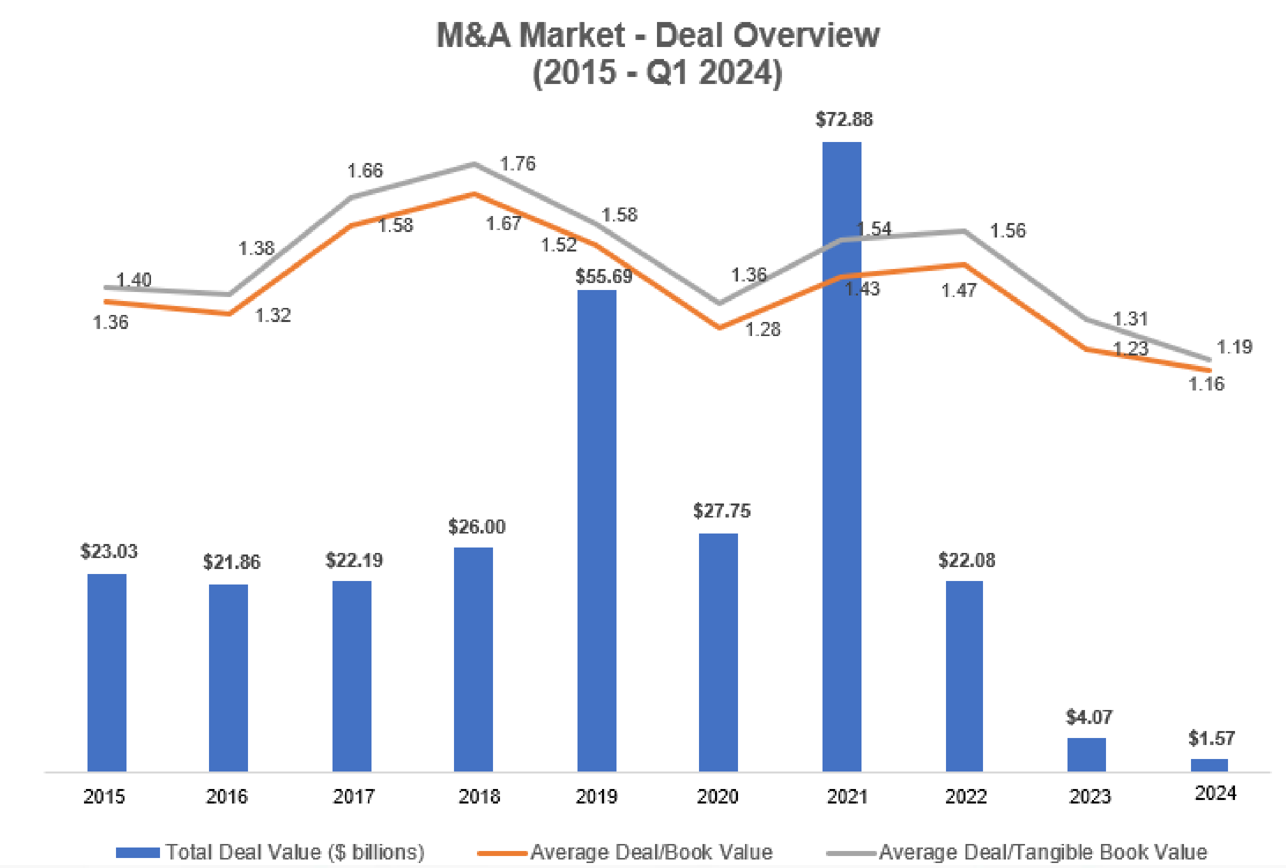
# Trends in Bank Mergers & Acquisitions

- Total deal value in 2023 & 2024 (so far) significantly down from 2021
- Multiples have come down from 2021 & highs in 2018
- Deal value, volume, & multiples are down for 2024 with average multiples paid down to 1.1 to 1.2x P/B & P/TB respectively
  - Continued high interest rates
  - Continued regulatory scrutiny on transactions




Deal value shown at announcement
Source: S&P Capital IQ Pro

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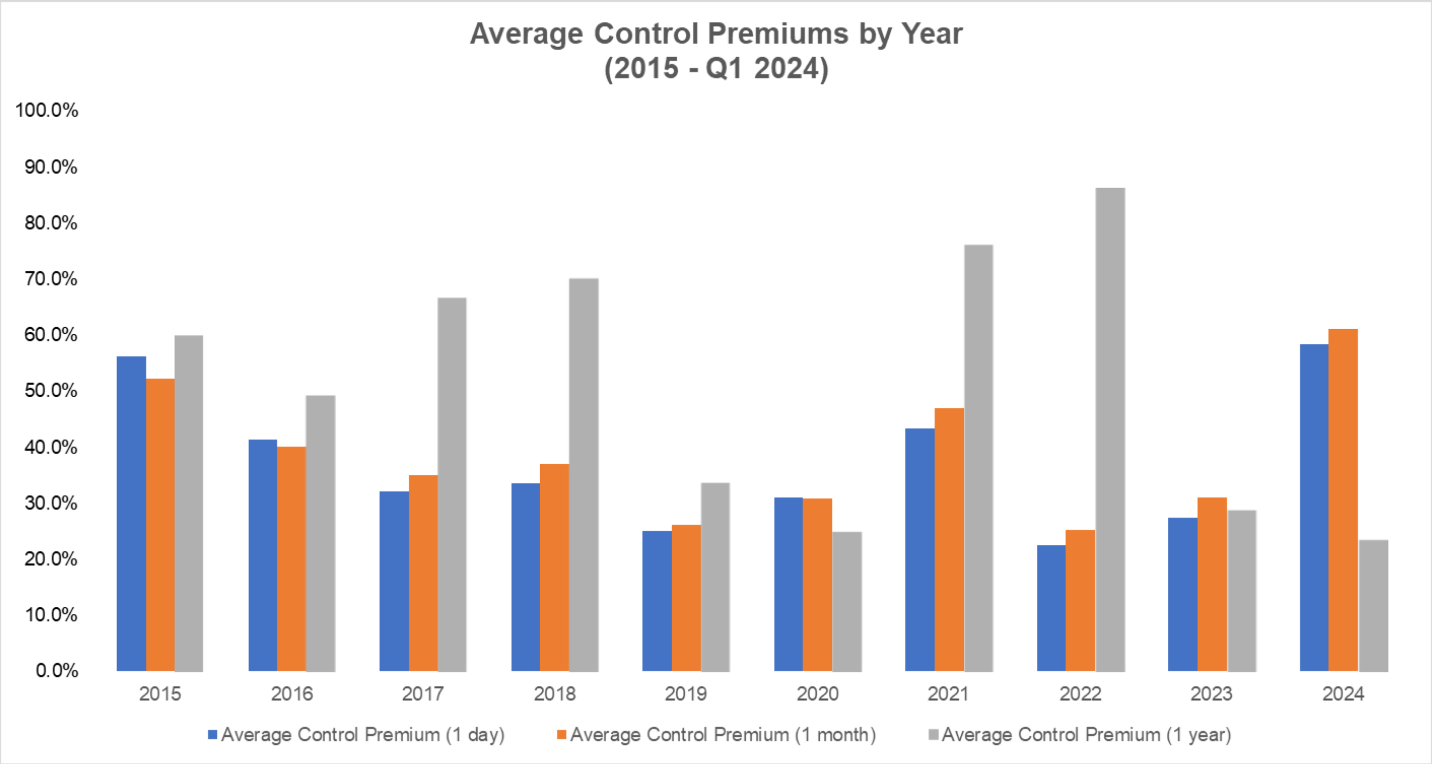
# Implied Control Premiums in Bank Transactions

- Conceptually represents the prerogatives of control that facilitate:
  - Economic benefits through cost savings, enhanced revenue growth & higher margins
  - Lowered required returns through capital structure optimization, scale, diversification, & investment strategy improvements
- Control premiums have come down from highs of 2021 & 2022 & now hover at around 50% on average for bank transactions




Source: S&P Capital IQ Pro

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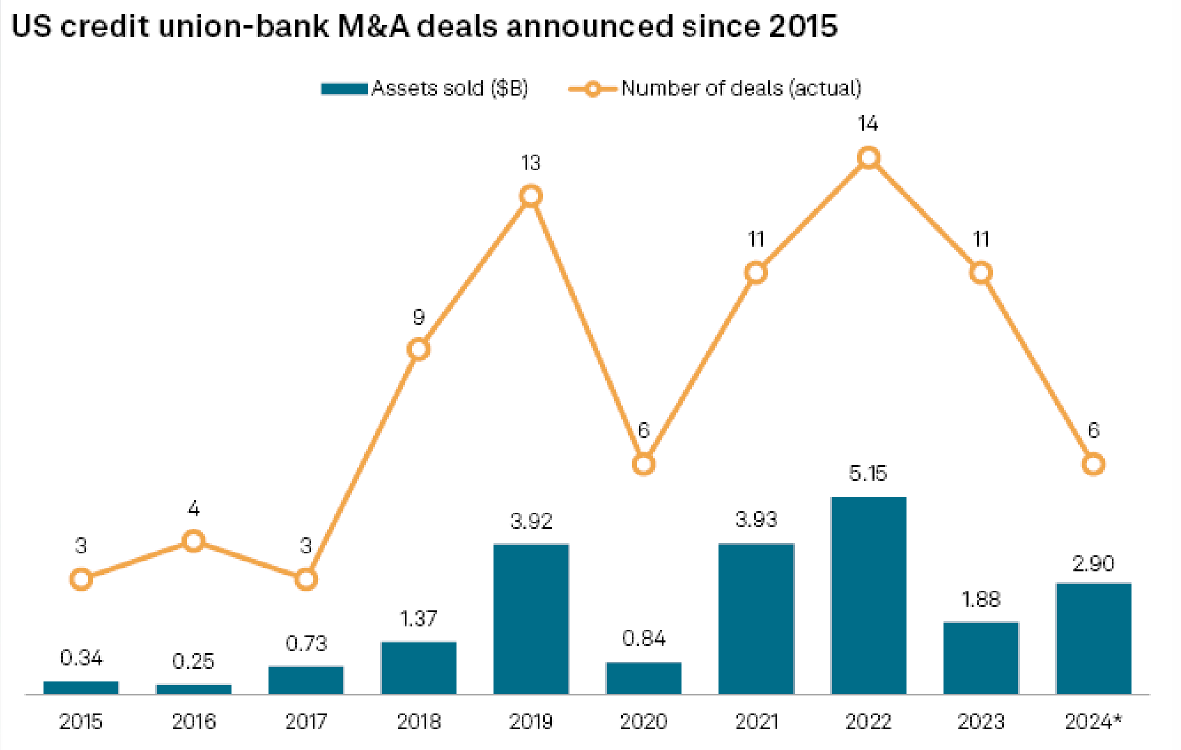
# Bank – Credit Union Mergers

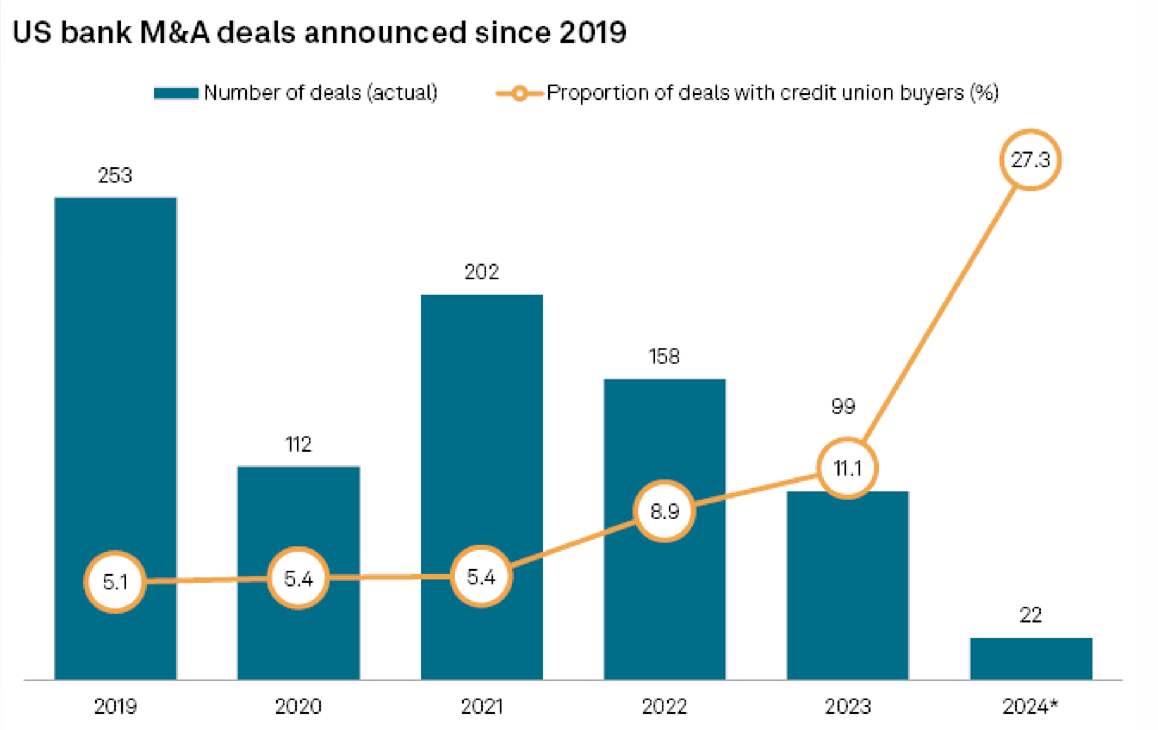
- Credit Unions have increasingly been purchasing banks to:

  - Expand into new geographic areas
  - Grow membership
  - Diversify their balance sheet
  - Add expertise
  - Drive economies of scale

- Credit Unions typically purchase banks at significant premiums (for cash), in part, due to:
  - Higher legal costs from greater complexity & regulatory scrutiny
  - Adverse tax consequences, particularly for shareholders of a C-Corp

# Bank – Credit Union Mergers




Source: Capital IQ Pro
*Data through March 15, 2024

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# Bank Assets & Liabilities

## Financial instruments

- Loan portfolio
- Fixed term deposits
- FHLB Advances, Sub-debt, etc.

## Equity

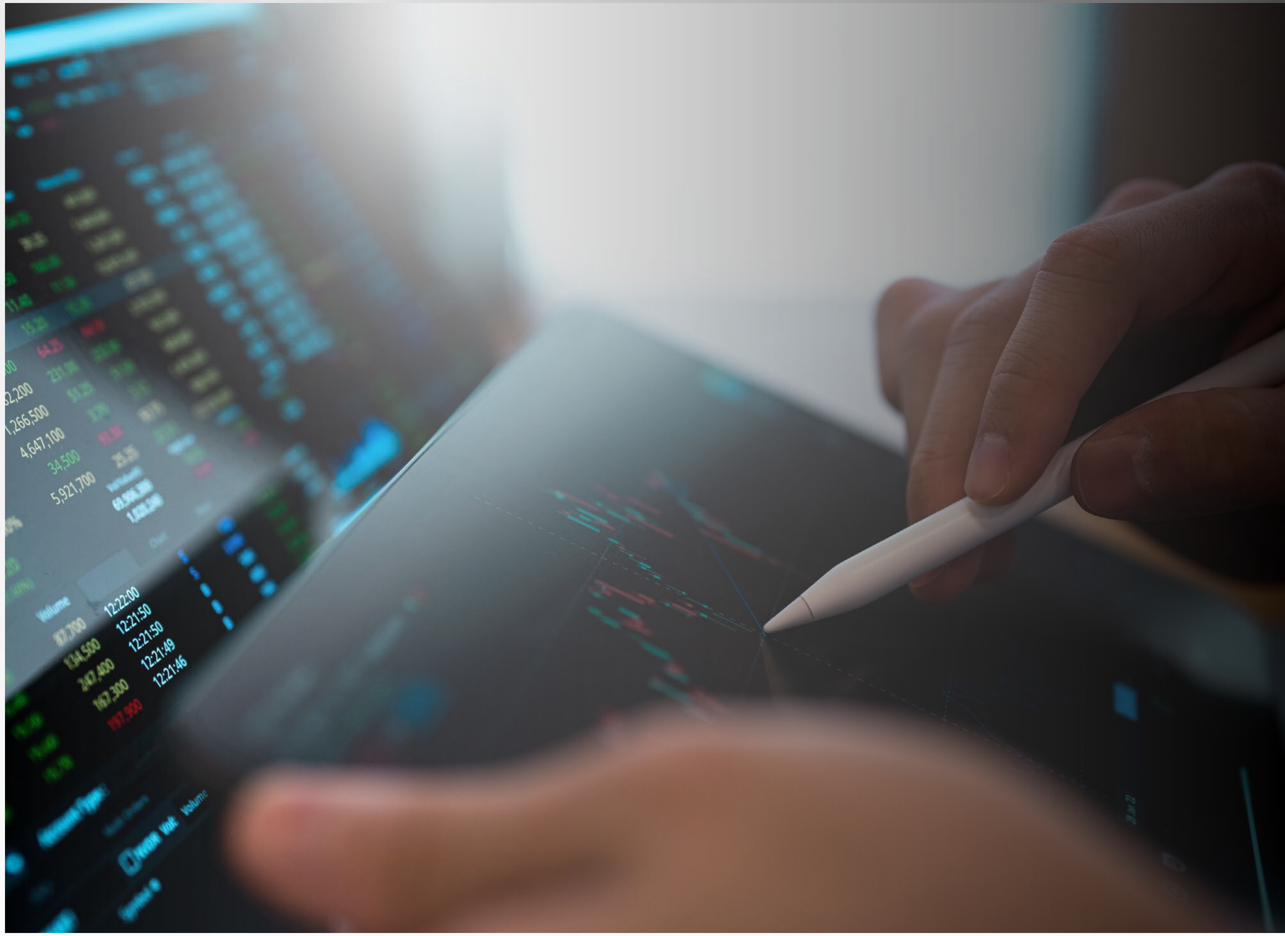
- Preferred Stock, *e.g.*, ECIP
- Common Stock

## Intangible assets

- Core Deposit Intangible (CDI)
- Non-compete Agreements
- Servicing assets

# Loan Portfolio Valuation

- Monthly principal & interest cash flows for each loan/pool are projected based on the contractual terms of the loans. Each loan/pool is then adjusted for:
  - Prepayments
  - Credit losses
- Discount rates are developed based on the relative risk of the cash flows, taking into consideration:
  - Market rates as of the Valuation Date
  - Rate type, *e.g.*, fixed, floating, etc.
  - Liquidity expectations
- Monthly principal & interest cash flows for each pool are discounted to present value & summed to arrive at the fair value of the loan portfolio.



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# Loan Portfolio Valuation – Purchased Credit Deteriorated

- Loans classed as Purchased Credit Deteriorated (PCD) may be identified by:
  - Borrower's delinquency status
    - Days past due
    - Nonaccrual status
    - TDR Status
  - Credit Quality Indicators
    - Borrower risk rating or FICO score decline
    - Changes in LTV
    - Changes in debt service coverage
    - Qualitative, industry, or macroeconomic factors
- Valuation approaches range from modified discounted cash flow to collateral expedient asset-based approaches

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# ASC 820 vs. ASC 326 Credit Loss

| Characteristic | ASC 820 | ASC 326 |
|---|---|---|
| Life of Loan | Yes | Yes |
| Market Participant | Yes | No |
| Exit Price | Yes | No |
| Entity Specific | No | Yes |
| Measurement Method | DCF | Multiple |
| Measurement Base | Principal Balance | Amortized Cost |
| Measurement Approach | Individual &/or pooled * | Individual &/or pooled* |

* Note:

- Segmentation may differ
- Both include qualitative & quantitative estimates, but presented differently

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# Loan Portfolio Valuation – Purchased Financial Assets

- Proposed Accounting Standards Update (ASU) for purchased financial assets (PFA):
  - Proposes a single model to account for financial assets acquired in a business combination
  - Proposes accounting for all PFA using the “gross-up” method (vs. just PCD assets)
  - Eliminates the “double-dip” treatment on non-PCD assets
  - Eliminates “gross up” on AFS debt securities
  - PFA acquired outside a business combination must meet a bright line seasoned test, *i.e.*, acquired more than 90 days after origination & acquirer was not involved in origination
  - ASU requires companies to apply accounting as of the first year they adopted CECL
    - May be overly burdensome for some companies
- Comment period ended August 28, 2023
- On February 28, 2023, FASB directed the staff to perform additional research & analysis on feedback received

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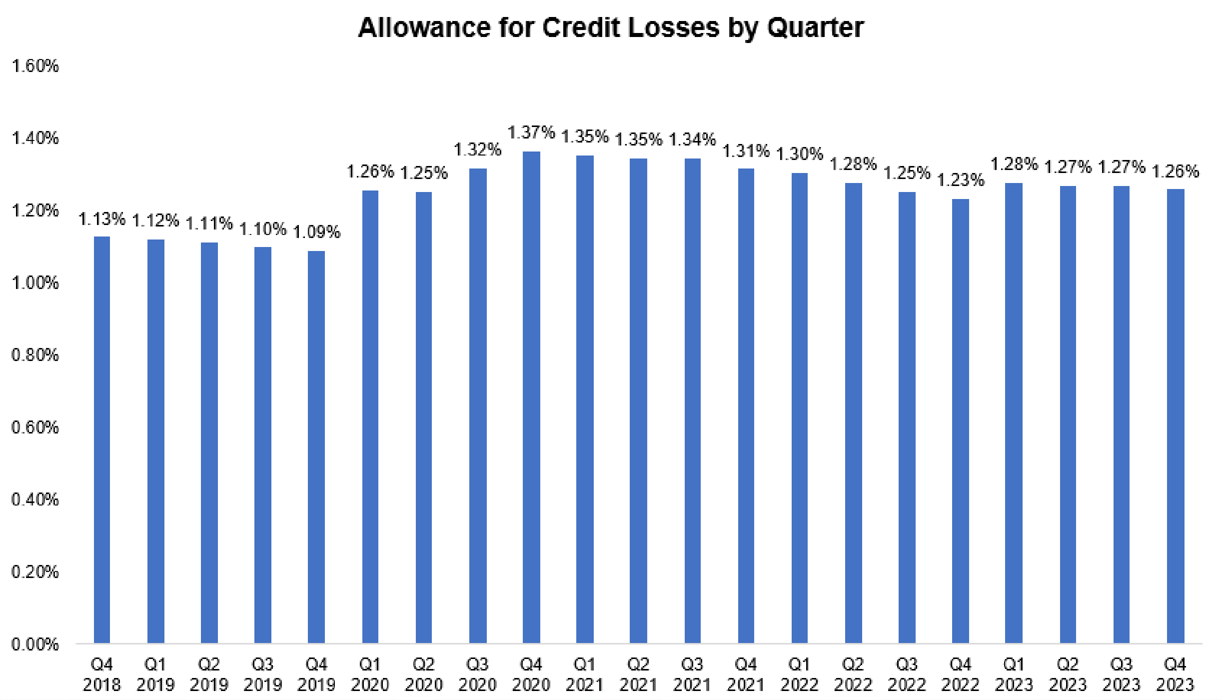
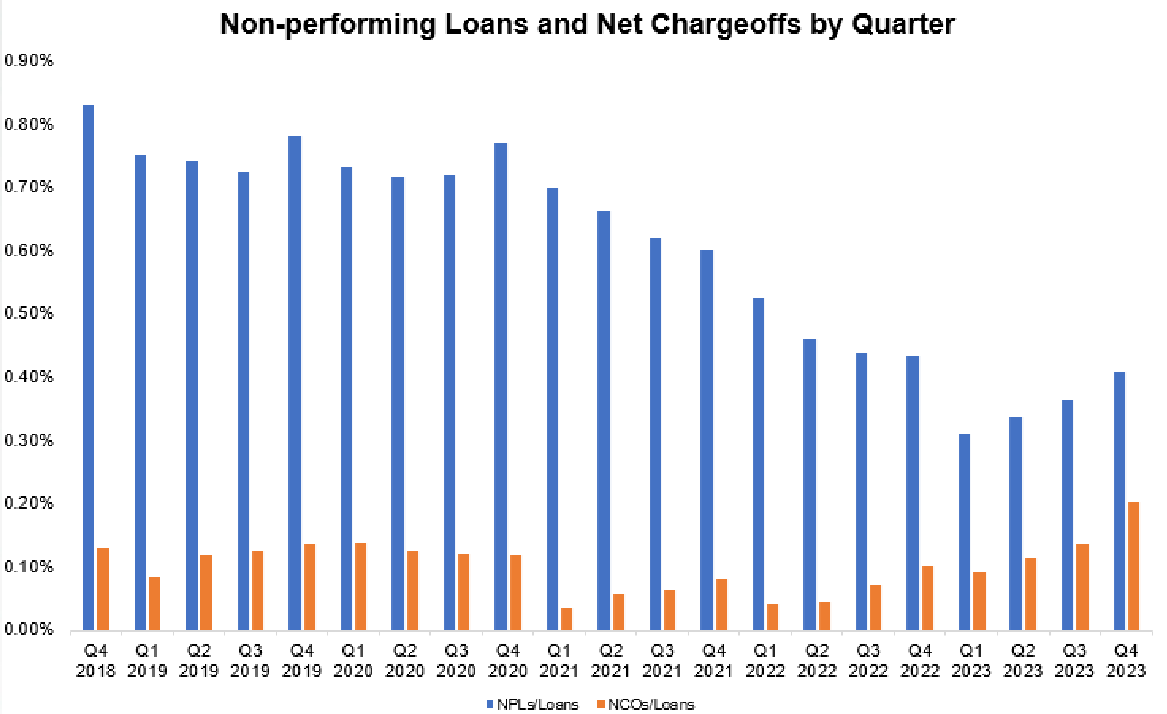
# Loan Portfolios – Credit Trends




Source: S&P Capital IQ Pro

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# Fixed Term Deposits

- Pays interest in exchange for the customer agreeing to leave a lump-sum deposit that cannot be withdrawn without penalty for a predetermined period
  - Fixed term deposit types:
    - Retail CDs
    - Brokered CDs
    - Jumbo CDs (>$100k)
- Project monthly cash flows (interest & balloon principal repayment) based on balance, remaining maturity, & interest rate for each deposit category
- Discount rate should reflect CD market rates for deposits of equivalent maturity in a similar region

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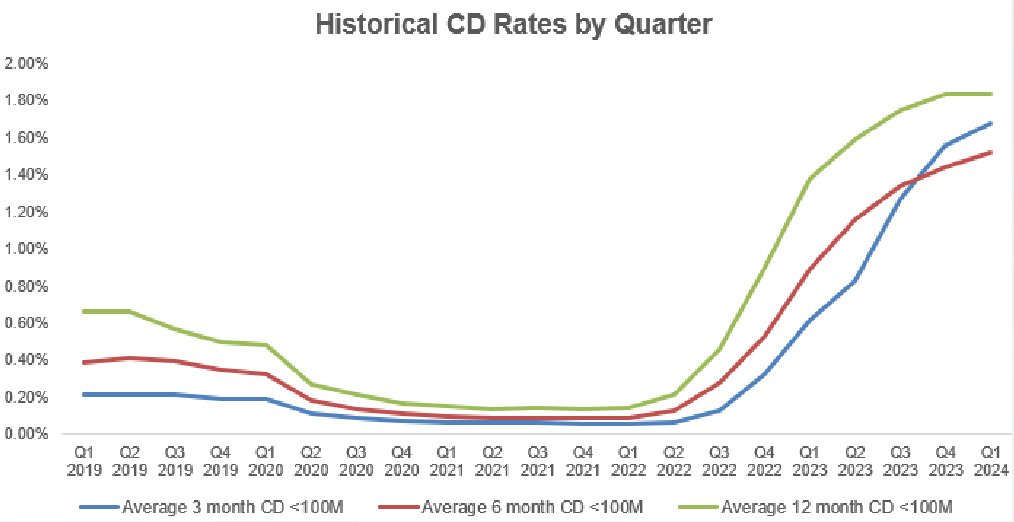
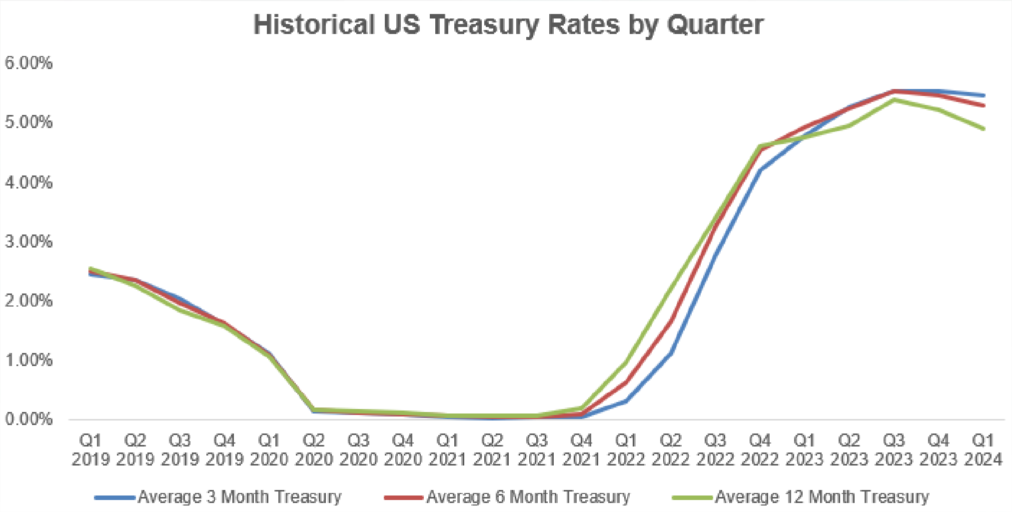
# Fixed Term Deposits – Valuation Trends

- CD rates reached historic lows during the COVID-19 pandemic but significantly increased in 2023 as the Fed funds rate increased
- Funds continue to move out of noninterest-bearing deposits & into higher-interest products
- High interest rate environments mean greater discounts on older vintage CDs valued as part of a business combination

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# Emergency Capital Investment Program (ECIP)

- Created by DOT to encourage Community Development Financial Institutions (CDFIs) or minority depository institutions (MDIs) to support lending in underserved communities
- Securities Purchase Agreement requires recipients to submit Quarterly Supplemental Report (QSR) If a participant completes a business combination, qualified lending of the acquired institution is included in the participant’s QSR in the first full quarter after the business combination
- QSR is used to:
  - Calculate Eligibility for rate reductions
  - Collect data required for the Treasury to assess & evaluate the program
- Investments in the form of preferred stock (C-Corps) or subordinated debt (S-Corps)
- Typically valued using an income-based approach
  - Project quarterly cash flows based on balance, remaining maturity, & interest rate
  - Discount rate based on market participant long-term sub-debt or trust preferred issuances
- The disparity between market participant long-term debt issuances & ECIP rates may lead to deep valuation discounts, particularly for perpetual preferred stock investments

# Core Deposit Intangible (CDI) Valuation

- The CDI is an intangible asset, not a financial instrument.
- Derives its value from the difference between the cost of maintaining the bank's deposit base & an alternative funding source.
  - Core Deposit Types

**Demand deposit account (DDA)**

**Negotiable order of withdrawal (NOW)**

**Savings accounts**

**Money market deposit accounts (MMDA)**

**Certificate of deposit <$100K (CD)**

# CDI Valuation

- Valued using a cost savings method, which is a variation of income approach.
- Attrition rates for each deposit type
- Weighted average cost of deposits
  - Cost of reserves
  - Cost of float
  - Cost of alternative funds (blended)
    - Retail CD rates
    - Brokered CD rates
    - FHLB Advance rates

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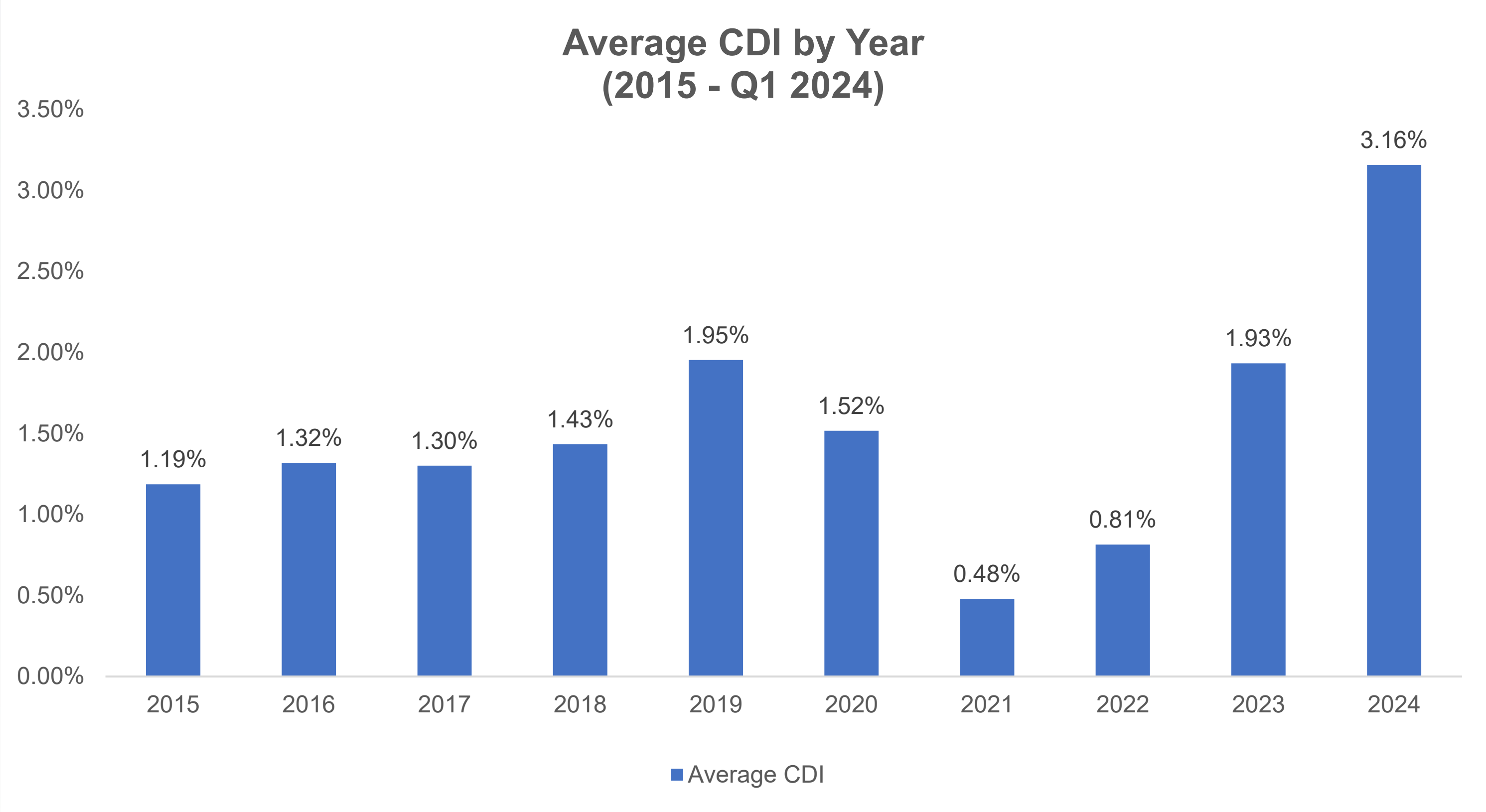
# CDI Valuation – Valuation Trends




Source: S&P Capital IQ Pro

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# Other Asset Valuations

## Non-Compete Agreements (NCA)

- Typically valued using an income-based approach (with & without method)
- Derives its value from the differential between a "with" scenario where the NCA exists (the base scenario) & the "without" scenario where the NCA does not exist & the executive competes
- Federal Trade Commission's proposed rule to ban non-competes may limit the enforceability of NCA but potential litigation may keep NCAs relevant in the near term
  - May also have implications for "golden parachute" calculations under 280G

## Servicing Assets

- Does not meet the definition of a financial instrument
- Derives its value from the right to service an underlying financial asset, *e.g.*, mortgage, SBA/Other loan portfolio, for a fee
  - May be an asset or a liability based on the economics of the contract
- Typically valued using an income-based approach

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# Thank You!

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