Fire On The Mountain - Don’t Let The Earn-Back Period Imperil Your Deal

“I know it when I see it.” – United States Supreme Court Justice Potter Stewart

Bank merger announcements can spark critical analyst and investor reaction even when deal metrics include favorable attributes such as lofty internal rates of return (“IRR”), strong earnings accretion projections, and sound business strategies. Why? One reason is the heightened concern regarding the length of time that it may take to recover the pro forma dilution to the acquirer’s tangible book value. As is the case with Justice Potter Stewart’s failure to define “hard core pornography”, analysts and investors do not specify exactly when the earn-back period reaches a tipping point, but they know it when they see it!

- The pro forma impact on tangible book value ranks among the top concerns of analysts and investors when analyzing merger transactions;
- There are a few methods used to calculate the earn-back period, but the common goal is to recognize the time needed for the earnings accretion to offset the initial book value dilution;
- The earn-back period bridges the gap between the income statement (earnings accretion) and the statement of financial condition (book value);
- Improved earnings growth is needed to counterbalance tangible book value dilution. Based on anecdotal evidence, analysts and investors generally prefer earn-back periods of up to five years, although market sentiment does vary.
- Purchase accounting rules under generally accepted accounting principles (GAAP) are convoluted, nearly incomprehensible, and have led to widespread use of the earn-back calculation. Although affected by GAAP purchase accounting rules, tangible book value is not a GAAP concept, but tangible book value is more straightforward and generates easier comparisons between deals/companies vs. fair value accounting or discounted cash flows.

We believe acquirers should pay attention to the earn-back period, even though discounted cash flow (DCF) analysis – including the IRR calculation - may be theoretically superior with better predictive ability. Two common criticisms regarding the use of an earn-back period are: (1) the computations (described more fully below) are opaque and (2) accurate recordkeeping of the actual vs. the projected earn-back period is extremely difficult and rarely happens. The real-world, however, suggests that earnings accretion, tangible book dilution, and the earn-back period matter and it is probably best to leave it at that. Said differently, “it is what it is.”

We believe the May 3, 2016 merger announcement by Investors Bancorp, Inc. (NASDAQ: ISBC) illustrates the importance of the projected earn-back period. Investors, an experienced acquirer,
prominently disclosed key information in its press release regarding the earn-back period associated with its acquisition of Bank of Princeton. The recent deal announcement between Westfield Financial Inc. (NASDAQ: WFD) and Chicopee Bancorp (NASDAQ: CBNK) provides additional evidence that tangible book value dilution and the earn-back period matter. Subsequent to the deal announcement on April 4, 2016, supplemental information regarding the calculation of the earn-back was delivered through a Form 8-K filed on April 6, 2016.

**Acquisitions are typically accretive to the buyer’s earnings.** If not, a deal is unlikely. Based on pro forma assumptions and projections (which generally exclude merger-related and other associated one-time costs), most bank deals are earnings accretive within 12 months of completion. One-time, merger-related charges typically include employment agreements, severance, data systems conversions, and branch closings. Earnings projections are usually presented without enhancements and synergies are explained by footnote. The earnings per share accretion/dilution can be expressed in dollars or as a percentage increase/decrease for the acquirer on a stand-alone basis.

**The immediate impact upon tangible book value is generally not positive, however, because the deal premium and impact of purchase accounting rules tend to cause immediate dilution.** Tangible book value excludes intangible assets, including goodwill, which may arise as a part of the merger transaction. One-time merger charges also dilute tangible book value, but may not be initially disclosed in the pro forma tangible book value calculation.

The type of consideration (i.e., stock vs. cash) paid to the seller has a significant impact on pro forma tangible book value and earn-back period. Banks that trade at higher valuations have greater flexibility to use stock as the “deal currency” and avoid or lessen tangible book value dilution. Stock deals, moreover, have less of an impact on capital ratios vs. cash deals. Cash deals, on the other hand, generally result in higher tangible book value dilution, but provide greater earnings per share upside as long as the target generates income. As is the case with earnings, accretion/dilution to tangible book value per share can be expressed in dollars or as a percentage increase/decrease for the acquirer on a stand-alone basis.

**The three major ways to calculate earn-back periods are the cross-over, earnings per share accretion, and static methods.** Each approach has specific strengths and weaknesses, but potential acquirers should be cognizant of each method to better address potential market concerns. We generally believe that analysts and investors focus on the earn-back period under the cross-over and earnings accretion methods.

**Cross-over Method**

The cross-over, or dynamic, method compares the buyer’s projected stand-alone performance and resulting tangible book value with the combined companies’ pro forma financial performance and resulting tangible book value performance. The earn-back is defined as the period when pro forma tangible book value per share meets or exceeds the stand-alone forecast.

The cross-over method includes all restructuring charges when incurred, and should not include any stock repurchases. The merger-related charges at the closing are reflected in the initial tangible book value dilution, but any additional charges are passed through to the projected tangible book value in the period when incurred.

**A potential problem with the cross-over method is that longer-term forecasts become too subjective.** We opine, however, that the cross-over method is no different than any forecast (including discounted cash flow analysis), which use assumptions such as growth rates, terminal value multiples, and/or
discount rates. Consider Yogi Berra’s, the former Yankee catcher and philosopher, observation, “It’s tough to make predictions, especially about the future.”

Another common complaint regarding the cross-over method is that the payback period extends (creating poor optics) when the stand-alone company (buyer) grows much faster than the acquired company. Acquisitions, therefore, are best viewed at what is being bought vs. the stand-alone company.

Earnings Accretion Method

The two common ways to use the earnings accretion method are: (1) earnings accretion including only the merger expenses at the time of closing; or (2) earnings accretion with all merger expenses (pre-closing and post-closing). We opine that the second method is better. It is more conservative because the first method excludes about 75% of the deal fees that are not incurred until after closing and will understate the earn-back period.

An advantage of the earnings accretion method is its relative simplicity compared with the cross-over method. The calculation is total tangible book value dilution divided by earnings per share accretion.

The earnings accretion method estimates the earn-back period based on the one-year, fully-phased-in earnings per share accretion of only the acquired company. This method projects the tangible book value per share of the combined company on a pro forma basis. Total restructuring charges should be reflected in the adjusted tangible book value, although this is not always the case. **The earn-back is defined as the period when pro forma tangible book value per share meets or exceeds the standalone at close (pre-dilution).**

Static Method

The static method is not highly regarded by analysts and investors primarily because the earnings of both companies are included as part of the payback period. As is the case with the earnings accretion method, the static method projects the tangible book value per share of the combined company on a pro forma basis. **Under the static method, restructuring charges that are incurred after closing will not be reflected in the initial tangible book value dilution.** Also, the buyer’s tangible book value remains constant over the life of the earn-back model. The earn-back is defined as the period when pro forma tangible book value per share meets or exceeds the standalone at close (pre-dilution).

Contacts:

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<td>Matt Resch</td>
<td>Rob Pachence</td>
<td>Dave Danielson</td>
<td>John Putman</td>
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<td>610.724.7133</td>
<td>610.351.1633</td>
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