Notes from the Ambassador Bank Vault **January 5, 2018**

M&A Trends: Core Deposits Should Become Even More Valuable

"All generalities are false including this one."- Mark Twain

The value of a community bank typically rests in its core deposit base, which always strikes us as counter-intuitive given that deposits are accounted for as liabilities. (We define core deposits as all deposits excluding certificates of deposit or other time deposits.) The advantage of core deposits, however, has been muted since the Great Recession due to extremely low interest rates across all funding categories. **Franchise value along with earnings, however, should benefit enormously for banks with strong core deposits (particularly noninterest-bearing) if and when rates rise further.**

Banks are challenged to grow revenue largely due to net interest margin pressure caused by the flattening yield curve. As of January 4, 2018, the spread between two and ten-year Treasury Notes was only 50 basis points *versus* 125 basis points a year ago. The banking industry's general response to the tight spreads between short- and long-term rates is to seek loan growth, which has intensified competition and created even more pricing pressure. Despite revenue challenges, bank earnings for 2018 should be good largely due to lower corporate tax rates and solid asset quality, which shows little, if any, signs of deterioration at this point in the credit cycle.

- It appears that the biggest risk that banks face in 2018 is where longer-term interest rates will end up at year-end. Although the Fed indicated three interest rate hikes will occur in 2018 – following three rate increases in 2017 – longer-term rates haven't moved much over the past year or so.

- Changes in funding composition and the cost of funds should be reviewed carefully. Noisy fourth quarter results are expected due to income tax adjustments and will probably command most of the headlines. Given the rise in short-term rates (about 75 basis points over the past year), we believe that funding deserves more attention than in the recent past.

- As of September 30, 2017, the percentage of core deposits relative to total deposits has remained stable (78%), but over the past nine months, the median cost of funds increased six basis points to 0.54% for publicly traded banks with assets between $1 and $10 billion across the nation.

- One of the primary M&A drivers for 2018 should be the increased desire for lower-costing and stable deposits. The median core deposit premium was 9.1% for 2017, compared with 5.1% for 2016, and 5.6% for 2015.

- The cost of equity capital has grown closer to that of debt due to tax reform legislation. Although subordinated debt remains a viable form of financing, particularly for smaller institutions, some banks may prefer to take advantage of relatively high stock valuations and generate capital through common stock offerings.

- Ambassador Financial recommends that most banks construct a balanced investment portfolio with a mix of Libor or Prime-based floaters paired with longer duration assets. Please see Notes from the Ambassador Bank Vault *Asset Liability Management and Accounting – December 2017* and *Stay Ahead of the Curve – November 2017*.

The wildcard will be whether Fed interest rate hikes will cause core deposits to erode and/or funding costs to rise significantly. We opine that there is little assurance that core deposits, which increased when interest rates were at historically low levels, will be maintained in a higher rate environment. As shown in the figures below, banks generally maintained or slightly increased their net interest margins despite a slight rise in the weighted average cost of funds from January 1, 2017 through September 30, 2017 (the most recent available financial data).

Figure 1*

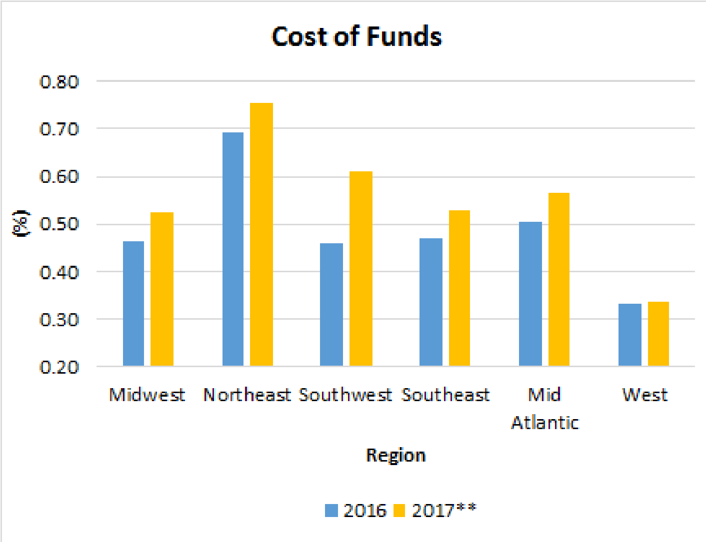
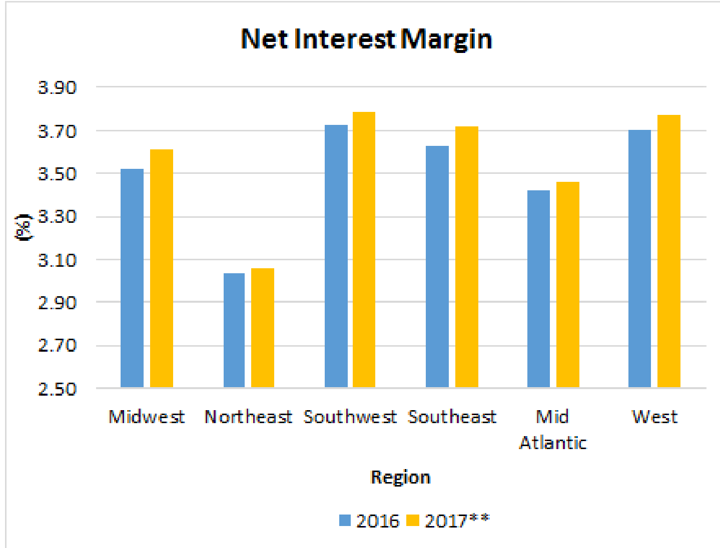


Figure 2*



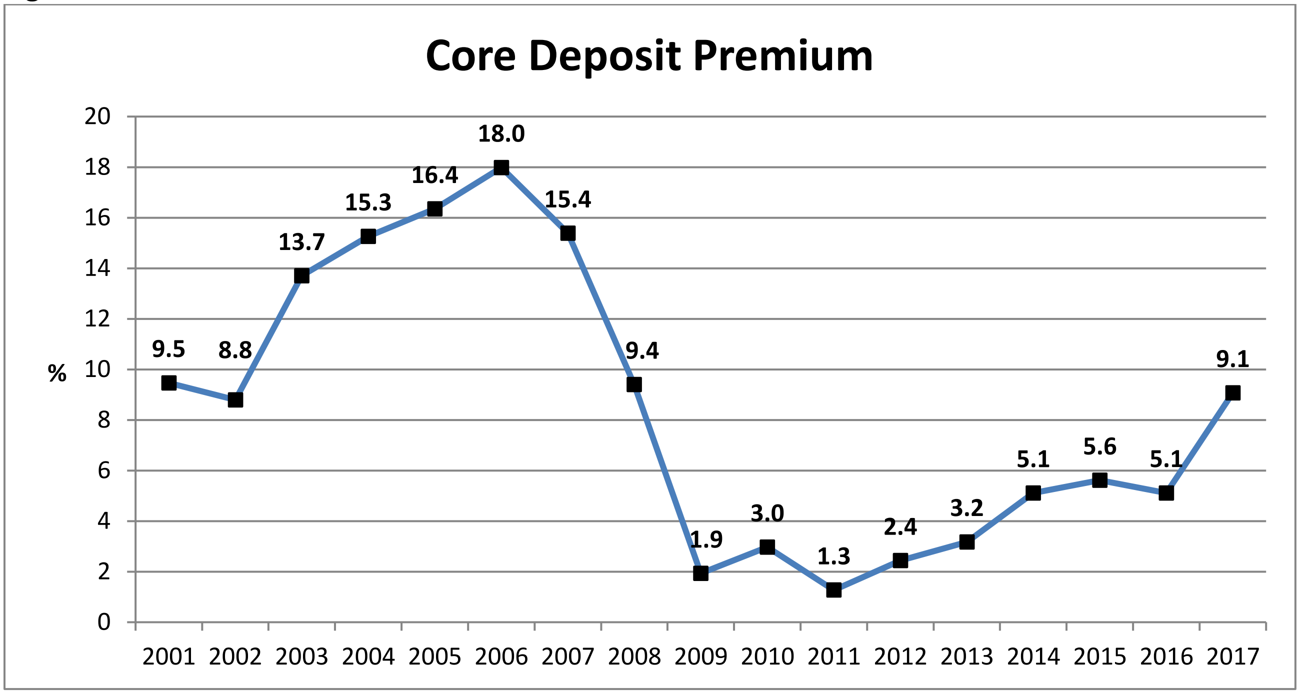
*Medians for publicly traded banks between $1 billion and $10 billion in assets
**Annualized for the nine months ended Sept. 30, 2017
Source: S&P Global Market Intelligence

As is the case with banks with moderate loan-to-deposit ratios, institutions with strong core deposits and solid commercial lending platforms have much greater flexibility regarding asset/liability management ("ALM") decisions vs. banks without these attributes. Regulators and bank investors appreciate proactive ALM which employs a funding structure that more or less matches the expected duration or maturities of assets. This conservative approach minimizes risk while tempering earnings today, for safety tomorrow. Banks often create problems for themselves when they try to boost earnings to achieve market expectations, rather than to meet sustainable growth. As a means to complement a barbell investment strategy – which Ambassador recommends for most community banks – institutions should consider more proactive funding strategies. Depending upon the characteristics of your bank, this could include lengthening the maturities of time deposits and/or FHLB advances, issuing debt or common stock.

We think the quest for core deposits will be a driver for deals in 2018. Bank acquisition (including deposit) premiums (see Table 2 below) increased in 2017 as buyers have taken advantage of stronger currencies that make higher-priced deals more financially viable. Another reason for the higher core deposit premiums is that buyers anticipate greater loan demand (use of funds) along with higher interest rates that will increase the value of core deposits. Because a primary reason for bank deals is the opportunity to gain customer relationships through core deposits, the core deposit premium should be viewed as important as other commonly-used metrics when evaluating the merits of an acquisition. Buyers are generally more willing to pay premiums for core funding, but less so for lending relationships.

<u>Core deposit premium = (Acquisition Price – Tangible Common Equity)/Core Deposits</u>

Figure 3



Source: S&P Global Market Intelligence

Please feel free to call or e-mail Rob Pachence, Matt Resch, Rick Weiss, or Ryan Walker at (610) 351-1633 or rpachence@ambfg.com, mresch@ambfg.com, rweiss@ambfg.com or rwalker@ambfg.com with any questions or comments.