Notes from the Ambassador Bank Vault **June 14, 2018**

A Fresh Look at the Earn-Back Analysis

"Sometimes we don't even realize what we really care about, because we get so distracted by the symbols."
– Tom Wolfe, *The Electric Kool Aid Acid Test*.

Rightly or wrongly, an earn-back period analysis is widely used to help determine the merits of bank mergers. (The earn-back is defined as the length of time projected to recover the pro forma dilution to the acquirer's tangible book value.) Management and deal teams, therefore, must be aware that merger announcements will likely continue to spark negative analyst and investor reaction when the earn-back period is deemed excessive. Critical reaction can occur even when deal metrics include favorable attributes such as lofty internal rates of return ("IRR"), strong earnings accretion, and sound business strategies.

The Tax Cut and Jobs Act ("Tax Act") significantly changed initial tangible book value dilution and operating earnings assumptions. The effect of significantly lower tax rates begs the question of whether acceptable earn-back periods will change accordingly. Based on anecdotal evidence, however, analysts and investors generally continue to prefer earn-back periods less than 4.5 years, although market sentiment does vary. **Depending upon the specific company and deal metrics (such as the deferred tax/liability position and assumed earnings), earn-back periods could swing either higher or lower than comparable pre-Tax Act deals.** For example, sellers with deferred tax assets would contribute less tangible book value to the buyer today (thus a higher tangible book value dilution for the buyer all else equal) vs. that before the Tax Act which causes a longer earn-back period. On the other hand, projected earnings are higher (all other things remaining equal) due to lower tax rates, and thus make earn-back periods shorter.

Recent deal announcements illustrate the importance of the earn-back period to analysts and investors. The May 13, 2018, merger announcement by Cadence Bancorporation (NASDAQ: CADE) associated with its acquisition of State Bank Financial Corporation prominently disclosed earn-back information (less than three years) in its investor presentation and press release. The investor presentation provided by Fifth Third Bancorp (NASDAQ: FITB) associated with its recent acquisition of MB Financial (NASDAQ: MBFI) had earn-back data (6.8 years). On June 12, 2018, Northwest Bancshares, Inc. (NASDAQ: NWBI), an experienced acquirer, prominently disclosed the projected earn-back period (less than four years) in its press release and investor presentation regarding its announced acquisition of Donegal Financial Services. Ambassador Financial Group, Inc. served as financial advisor to Northwest.

Even though considered important when deals are announced, we doubt that most analysts or investors track the progress of earn-back period calculations. This is probably not a bad thing in light of the Tax Act, which turned most pre-Tax Act earn-back analyses into fantasy. Those analyses became materially skewed because (1) deferred tax assets/liabilities valuations changed significantly, which affected the initial tangible book value calculations and (2) future earnings streams are higher (assuming all other things remain equal) than initially projected. This significantly impacts the time needed for the earnings accretion to offset the initial book value dilution.

We, at Ambassador Financial, conclude that despite several shortcomings, earn-back period analysis will remain an important deal metric as long as the pro forma impact on tangible book value ranks among the top concerns

of analysts and investors. The use of the earn-back period calculation has become widespread because it bridges the gap between the income statement (earnings accretion) and the statement of financial condition (tangible book value). This is probably necessary because purchase accounting rules under generally accepted accounting principles (GAAP) are convoluted and nearly incomprehensible. Although affected by GAAP purchase accounting rules, tangible book value, which is not a GAAP concept, is more straightforward and generates easier comparisons between deals/companies *vs.* fair value accounting or discounted cash flows.

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 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.

<u>Cross-over Method</u>

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 <u>forecast</u>.**

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.

<u>Earnings Accretion Method</u>

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 <u>only</u> 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).

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.

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