Notes from the Ambassador Bank Vault **July 9, 2018**

Driving Franchise Value: Who Needs Assets When You Have Liabilities Like Core Deposits?

"A penny saved is a penny earned."–Benjamin Franklin

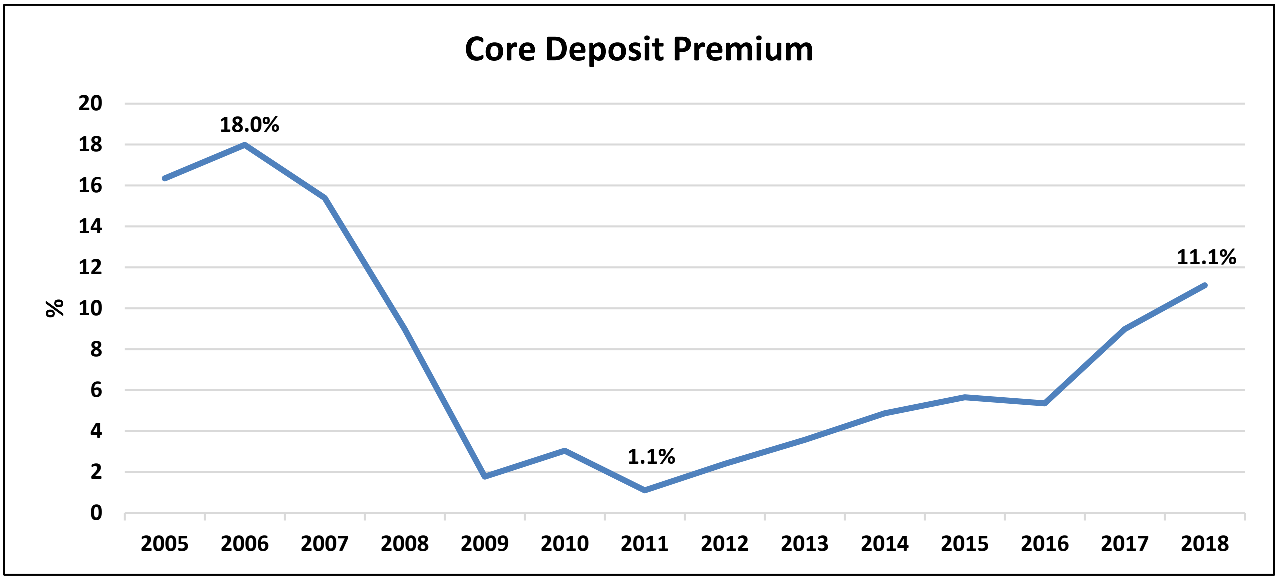
We expect that investors and analysts will take a harder look at community banks' funding sources as second quarter results are reported due to the prospect of further Fed interest rate hikes amid the flattening yield curve. Why? Because the franchise value of community banks often rests in deposits that are classified as liabilities (counter-intuitively) on financial statements. **Core deposits, which we define as all deposits other than certificates of deposit and other time deposits, are especially prized in a rising rate environment due to their greater stability and relatively lower cost of funds.** Core deposits also imply customer relationships that can be used to cross-sell other products and services and reduce interest rate risk.

- Institutions with a high percentage of core deposits typically are accorded higher trading multiples relative to peers.
- Noninterest-bearing deposits are especially treasured by investors and potential merger partners given the extremely positive effect on net interest margins and interest rate risk exposure.
- Not all banks will be able to meet core funding needs organically, and therefore, the quest for core deposits will likely be an important merger and acquisition driver for the foreseeable future.
- Core deposit premiums realized in acquisitions increased significantly since 2015. Please see Figure 1.
- Bank stocks that are valued more on core deposits premiums, rather than earnings, are vulnerable if investors decide those companies are not likely sellers and/or those funds are not deployed into desirable assets.
- Regardless of a bank's funding composition, Ambassador Financial believes the majority of investors favor conservative investment policies. We, therefore, recommend A/L managers deploy a barbell approach with regard to investment portfolios. Treasurers should take advantage of any yield spikes to selectively add duration as part of this strategy with floating rate assets on the short end of the curve.

Bank acquisition deposit premiums have increased since 2015 as buyers have taken advantage of stronger currencies that make higher-priced deals more financially viable. Nationwide, the median core deposit premium paid since January 1, 2018 was 11.1% compared with the low and high marks of 1.1% in 2011 and 18.0% in 2006, respectively. Our analysis uses S&P Global Market Intelligence's definition of core deposits—"deposits, less time deposit accounts with balances over $100,000, foreign deposits, and unclassified deposits."

Figure 1

Core Deposit Premium = (Acquisition Price – Tangible Common Equity)/Core Deposits



Source: S&P Global Market Intelligence

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.

As part of a comprehensive asset/liability strategy, financial officers need to determine the expected run-off, or decay, rate of deposit products that lack a defined maturity date; the costs associated with gathering and maintaining core deposits (i.e., branch network, advertising); and how profitably and quickly these funds can be deployed into interest-earning assets. This valuation is particularly challenging given that core deposits, which increased during the Great Recession when interest rates were at historically low levels, may be more volatile in a higher rate environment. Obtaining core deposits through a merger may be preferable versus organic growth, but potential buyers must consider the possibility of unintentional deposit run-off from acquired institutions.

Growing evidence suggests that stock prices of many institutions are supported by the perceived franchise value on a takeout basis, rather than on earnings power. It seems to us that bank stocks that are valued more on core deposit premiums than on earnings, are vulnerable if investors decide those companies are not likely sellers and/or those funds are not deployed into desirable assets. We view the premiums paid for core deposits as fully valued, given the lack of assurance that core deposits, which increased when interest rates were at historically low levels, will be maintained in a higher rate environment.

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AMBASSADOR FINANCIAL GROUP

Our experienced executives have been advising clients for three decades with an aggregate deal value in excess of $10 billion. Our recent transactions include a subordinated debt offering and several acquisitions.

M&A Advisory
June 2018 | Warren, Pennsylvania

Northwest Bancshares, Inc.

Northwest Bancshares, Inc. has announced the acquisition of Donegal Financial Services Corporation, of Marietta, Pennsylvania.

Announced deal value was $85.0 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, Northwest Bancshares, Inc.

M&A Advisory
May 2018 | Mercersburg, Pennsylvania

First Community Bank of Mercersburg

Mercersburg Financial Corporation has agreed to be acquired by Orrstown Financial Services, Inc., of Shippensburg, Pennsylvania.

Announced deal value was $32.4 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, Mercersburg Financial Corporation.

M&A Advisory
January 2018 | Scottdale, Pennsylvania

The Scottdale Bank & Trust Company | SB&T

The Scottdale Bank & Trust Company has been acquired by Mid Penn Bancorp, Inc., of Millersburg, Pennsylvania.

Announced deal value was $59.1 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, The Scottdale Bank & Trust Company.

M&A Advisory
December 2017 | Belleville, Pennsylvania

KishBank

Kish Bank has acquired Benefits Management Group, Inc., of Lewistown, Pennsylvania.

Ambassador served as financial advisor to Kish Bank.

M&A Advisory
October 2017 | Harrisburg, Pennsylvania

Riverview Financial Corporation

Riverview Financial Corporation has merged with CBT Financial Corporation, of Clearfield, Pennsylvania.

Ambassador served as financial advisor to, and prepared the fairness opinion for, Riverview Financial Corporation.

M&A Advisory
July 2017 | Bowie, Maryland

Old Line Bancshares, Inc.

Old Line Bancshares, Inc. has acquired DCB Bancshares, Inc., of Damascus, Maryland.

Announced deal value was $40.7 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, Old Line Bancshares, Inc.

M&A Advisory
June 2017 | Livingston, New Jersey

Regal Bank

Regal Bancorp, Inc. has completed a $10.0 million subordinated debt offering.

Ambassador served as placement agent to Regal Bancorp, Inc.

M&A Fairness Opinion
June 2017 | Monona, Wisconsin

Monona Bankshares, Inc.

Monona Bankshares, Inc. has acquired Middleton Community Bank, of Middleton, Wisconsin.

Ambassador provided the fairness opinion for Monona Bankshares, Inc.

M&A Advisory
May 2017 | Manor, Pennsylvania

Manor Bank

Manor Bank has been acquired by Nextier, Inc., of Butler, Pennsylvania.

Announced deal value was $2.3 million. Ambassador served as financial advisor to, and prepared the fairness opinion for, Manor Bank.