

Community Bank Investing

Community Bank Whitepaper | November 2019

CUTLER
Capital Management

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Introduction

This whitepaper has two parts. The first is a brief overview that describes Cutler's basic approach to community bank investing. This overview includes several of the critical themes we see in the market today. The second part gets into substantially more detail, both quantitative and conceptual, while reemphasizing some of the themes in the first part. It focuses on how merger activity is dominating community bank investing and explains why. We recommend readers begin with the overview and then, as time permits, follow up with the expanded second section. We believe the time will be well spent.

Part I. Overview

Community Bank Investing: The Cutler Way

You might say that Cutler has a head start in the world of buying community bank stocks. After all, our founder, Mel Cutler, was starting his own local banks well before he founded Cutler Capital Management. But a head start means very little without a process.

Management

As you might expect, our process begins with a bank's management. Nothing is more important with most investments, and it's even truer for community banks. We look for management teams that are actively involved in their communities. They all may claim to be, but we try to make sure it's not just talk. Are the bank's commercial borrowers keeping their funds in-house in low-interest or non-interest-bearing accounts, or does the bank still have to lure depositors with high rates and expensive CD's? Talk, after all, is cheap.

Speaking of talk, we like to make sure that top management is accessible and knowledgeable. If a bank doesn't return our calls, it's a bad sign. What don't they want us to know? If a CEO needs to be surrounded by a team when we want to meet one-on-one, we get concerned. The ability to delegate is a good thing, but it's no substitute for a thorough understanding at the top.

A strong CEO knows the community and brings in the most profitable customers. Alongside we want to see a strong CFO who knows how to assemble the right kind of balance sheet. Palmer Proctor and Charles Christy of Atlanta's Fidelity Southern, for example, moved the bank's asset base away from indirect auto loans toward commercial and small business loans, reducing dependency on high-risk, low-margin business, and making it a more attractive merger candidate. The indirect lending business has been depressed in part by credit unions, which use their tax-exempt status to make low-interest auto loans. Ameris Bancorp, of Jacksonville, paid a 27% premium for Fidelity Southern thanks largely to Mr. Proctor and Mr. Christy's efforts. Even with the premium, Ameris got Fidelity Southern at a significant but manageable premium to tangible book value (TBV) of about 80%. We'll see where that number fits in shortly.

We've been doing this for a while, so we know there's no substitute for getting into the markets the bank operates in and trying to understand the communities there. For many investment managers, this is too time-consuming, especially for investments in which one can only put a relatively modest amount of capital to work. For these managers easy liquidity often trumps value.

But that's why we feel we have an advantage. We're small enough to make it worthwhile to spend the shoe leather exploring community banks and figuring out which ones have the best growth opportunities relative to their valuations. We don't just go to investor presentations. We attend seminars in which bankers talk about how they make loans and manage their balance sheets. We make sure that people in the community are working and spending. Knowing that consumers are getting more technologically savvy, especially in high-growth areas, we test out the bank's website and other technology to make sure it will appeal to depositors. We get to know the local educational institutions. We also like to look for banks that may have been oversold because of one or two high-profile loans gone bad if we think the overall profile remains solid.

In an era of consolidation, we want to make sure banks understand the markets they're buying into. We don't mind a wide geographical spread if the loan types are similar. Conversely, we get uncomfortable even when banks are nearby if the loan profiles are significantly different, and they don't have the right lending team in place.

More on Valuation

It's been said that there are no bad stocks or bonds, only bad prices. In general, it's probably unwise to buy a community bank at much more than 150% of its tangible book value (TBV). In other words, don't pay much more than 50% of what you'd get if everything went wrong. Clearly the good banks have a lot of brand value that makes them worth considerably more than TBV. But it's always wise to have a reasonable margin of safety. There have been times when banks have regularly traded at over two or three times TBV, and these periods have not generally ended well.

When we think about valuation, we also consider an important qualitative aspect. We want to see local ownership. As one of our senior advisors likes to say, “If a bank can’t get its own community to invest, they’ll never get the community’s business or become a real community bank.” Similarly, we want to see significant management stock ownership. As shareholders, we insist on managers being our partners, not just our employees.

The Credit Union Effect

Speaking of credit unions, as we did above regarding their auto-loan presence, it’s important to pay attention to the fact that credit unions have been actively buying community banks. The bank lobby is fighting this—credit unions, given their tax status, can pay more than banks, so they’re making it more difficult (and expensive) for banks to buy other banks. But this benefits bank investors, as it helps broaden the group of potential acquirers.

Credit unions, for the uninitiated, are non-profit, tax-exempt bank-like institutions owned by their members and designed to make low-interest loans available to those members. Historically, members were required to live in certain neighborhoods, work for certain organizations, and so forth, but those requirements have been somewhat relaxed in recent years.

More on Mergers

We’d never buy a community bank that we wouldn’t be happy to own on its own merits on a standalone basis. But that doesn’t mean we’re not looking for takeover candidates. It’s an essential part of the strategy. After all, consolidation has been and will be a key theme for this sector. It costs a lot less to run one bank with a billion dollars in assets than two with half a billion each. According to compliance consultant Trupoint Partners, compliance expenses represent three times as large a percentage of non-interest expenses for the smallest banks (under \$100 million in assets) as for midsized ones (\$1-\$10 billion)¹.

Smaller banks also simply do not have the necessary resources to spend on technology the way larger banks do. The biggest money-center banks typically spend 15-20% of their overall budget on technology. For banks with assets under \$1 billion, the percentage is only about a third as much. It’s not hard to see that smaller banks will fall further and further behind if they’re unable to rationalize their operations.

There were nearly 16,000 banks in the United States in 1990. Nearly two-thirds of them are gone now, mostly through consolidation. If current trends continue, there will only be about 4,000 banks in the country several years from now. Even then, the US will be overbanked by international standards. To put the numbers in perspective, the US banking industry serves a population of about 325 million people. By comparison, Canada, the United Kingdom, France, Spain, China, and Brazil – with a combined population exceeding 2 billion – have about a quarter as many banks as the US.

Consider also the distribution of assets. More than 80% of US banks have assets of under \$1 billion, but 70% of the country’s banking assets are held by the 34 banks (well under 1% of the total banking population). Put another way, over 80% of the banks have in aggregate well under 10% of the total assets. This suggests that even with all the consolidation that has taken place, a lot more is still to come.

What do we (and potential buyers) look for in a merger candidate? Many of the same things we’d look for in a standalone investment—management, a strong & liquid balance sheet, growth opportunities, a good brand name in the community. We often also like to see a good succession plan. It’s not uncommon to see top management step down when a bank is acquired, so it’s important that the bank has a strong bench ready to step up. At the same time, banks without good succession plans may also turn out to be targets precisely because if management is looking to exit it has no viable alternative. It’s also important that the buyer and seller know each other or, if not, can develop a friendly rapport quickly. Courtship periods are important, but the longer they take, the lower the return.

On valuation: we’ve already noted that it’s a good idea not to pay much above a 50% premium to TBV when buying a community bank. This leaves room for a meaningful acquisition premium in the 15-30% range while still keeping the overall consideration below 200% of TBV. When banks pay more than this, they run the risk of an unpleasant market reaction. Premiums these days are tiny compared with the heyday of bank mergers in the 2004-2008 run-up to the financial crisis as well as in some earlier periods. One banker gave a tongue-in-cheek description of a negotiation: “I just kept stacking billion-dollar bills on the table until Mac said yes.”²

Still, if a valuation is already rich, investors hoping for a big return from a takeover may be sorely disappointed. Prosperity Bancshares

recently announced a deal to buy LegacyTexas at 216% of tangible book value. The market thought this was too much, especially in light of some credit issues mentioned by D.A. Davidson and other brokerages. Prosperity's stock fell 7% the day of the announcement, hurting its own shareholders and largely obliterating the benefits to LegacyTexas holders.

About three-quarters of the consideration in the LegacyTexas deal was in Prosperity's shares. Once upon a time bank deals were typically 100% stock. But with banks having stronger capital positions these days, they are in the position of using some cash when buying other banks. This is probably more attractive for the buyers, who want to minimize dilution, than the sellers, who have tax exposure on the cash portion of the consideration.

Bank deals do typically involve dilution, almost by definition, since the buyer generally must pay a premium to the seller's TBV. Offsetting this over time, though, is the earnings accretion that comes from the efficiencies of combining duplicate operations and gaining access to more low-cost deposits. Ideally, it will take less than three years for the acquiring bank to recapture the dilution with its improved earnings. Aggressive buyers will be willing to take four to five years or more to regain the dilution incurred, but the market tends to frown on this.

Putting it all Together

At Cutler, we look for community banks that we'd be happy to own in their present condition for the long term. We make sure, of course, to initiate positions at attractive premiums relative to the banks' tangible book values. But we focus on sound, responsive management and cost-effective operations—as long as these are in place, subsequent market appreciation has a way of taking care of itself.

We also look for attractive dividends, typically in the 2-4% range. In today's interest-rate environment, such dividends compete favorably with traditional fixed-income investments.

We emphasize again that we invest with a view to the long term. That said, we acknowledge that a strong merger tailwind is helping boost community-bank performance. Our portfolios have benefited from holdings being acquired at significant premiums to tangible book value. In other situations, banks we own have been able to add shareholder value by acquiring other banks on terms that become additive to earnings within relatively short periods.

We encourage you to continue to Part II of this whitepaper, which gets into substantially further detail about how the merger environment is affecting the community-bank market and helping to enhance returns.

About Cutler Capital Management

Cutler Capital Management is an independent, registered investment advisor. We are a 100% employee-owned firm dedicated to the management of under researched, underutilized investment opportunities. We specialize in Convertible and equity-linked securities, Community Bank investments, and Real Estate Investment Trusts. We add value through our rigorous research process, using a bottom-up approach that starts with a proprietary screen to generate ideas, followed by detailed structural, credit and fundamental analysis. We exploit being a niche player in inefficient markets.

We offer our investment strategies to high net worth individuals, endowments, foundations, corporate pensions and family offices through Limited Partnerships and Separately Managed Accounts. Our Wealth Management offering, serving high net worth individuals, includes comprehensive financial planning and investment management.

Part II. A Deeper Dive

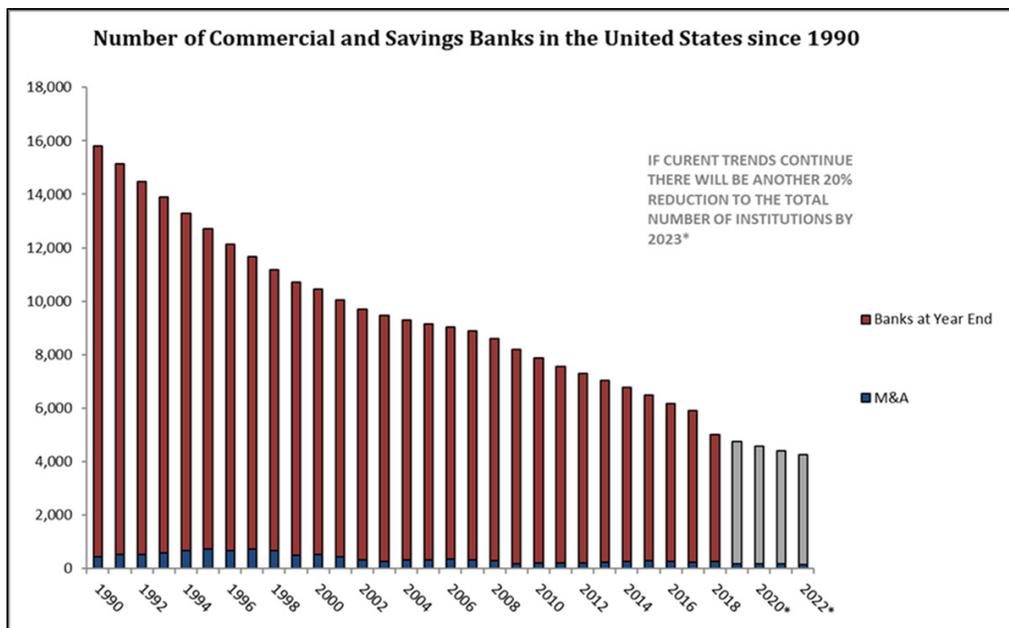
How the Recent Banking Environment Has Been Driving M&A

Steady merger and acquisition activity in banking, especially among community banks, has led to compelling investment opportunities with attractive risk/reward profiles. We review the concepts presented in the first section and dig deeper here.

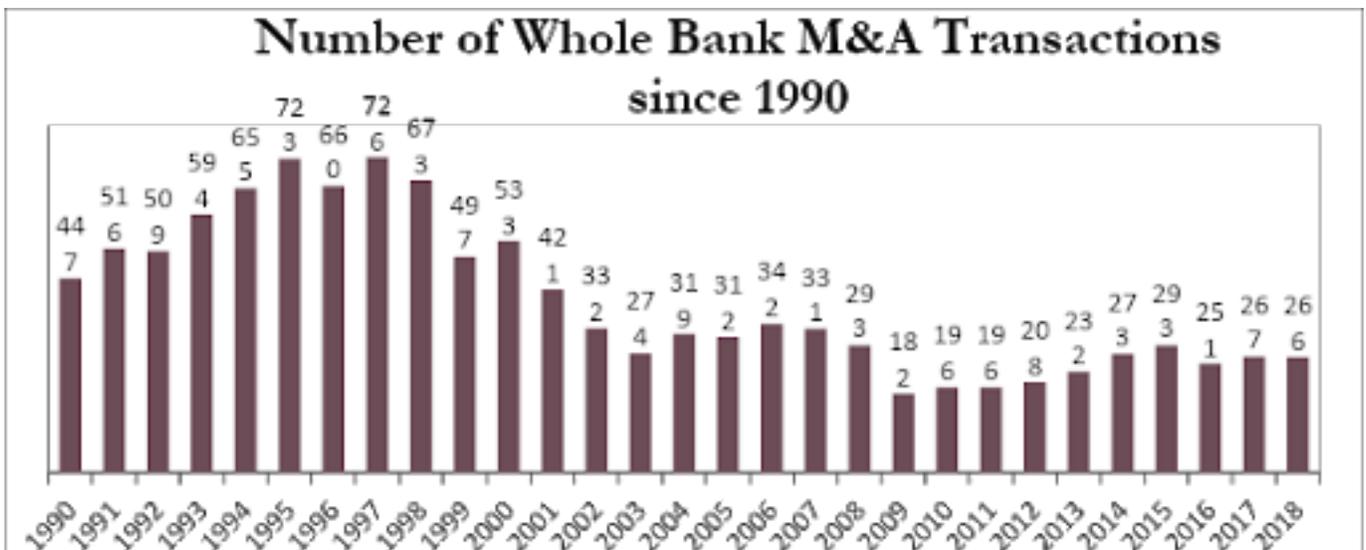
M&A in Context

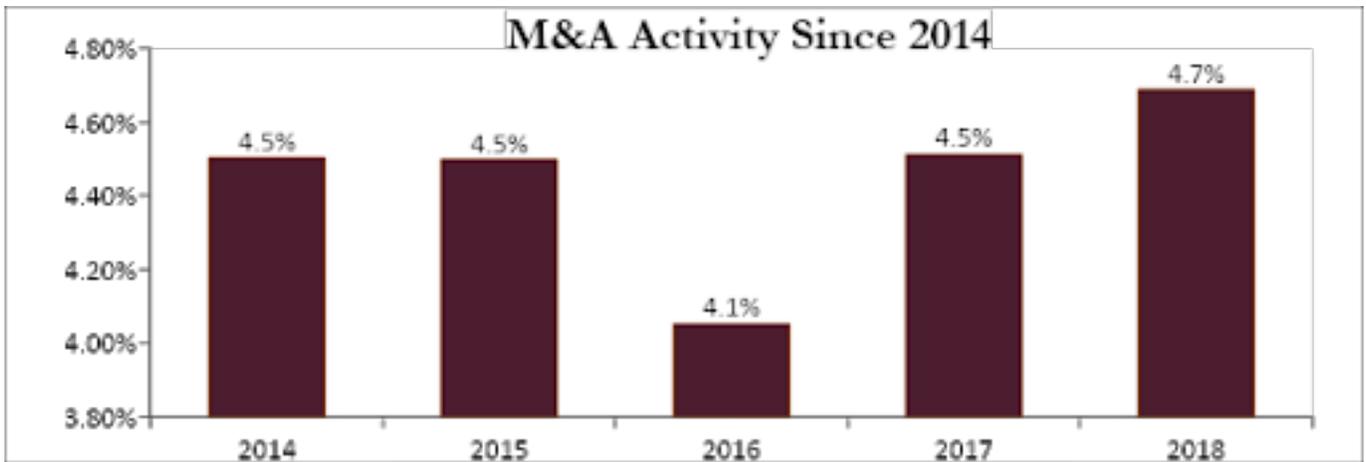
As we've noted, the US is far overbanked compared with the rest of the world. The US has a population of about 325 million people and 5,700 banks. Compare this with Canada³, the United Kingdom, France, Spain⁴, China, and Brazil⁵ who combined have a population of about 2 billion people and only 1,432 banks⁶. That's over six times as many people with only a quarter of the banks. US GDP growth is generally estimated at 2-2.5% for the next several years, so if a bank wants to grow at a rate of 6-8% per year, the only way is to take market share from competitors or to buy one or more other institutions.

The banking sector has been consolidating at an average rate of 4.2% annually since 1990⁷. Given the current interest rate and regulatory environments, as well as the industry's focus on efficiency, we expect this trend to continue.



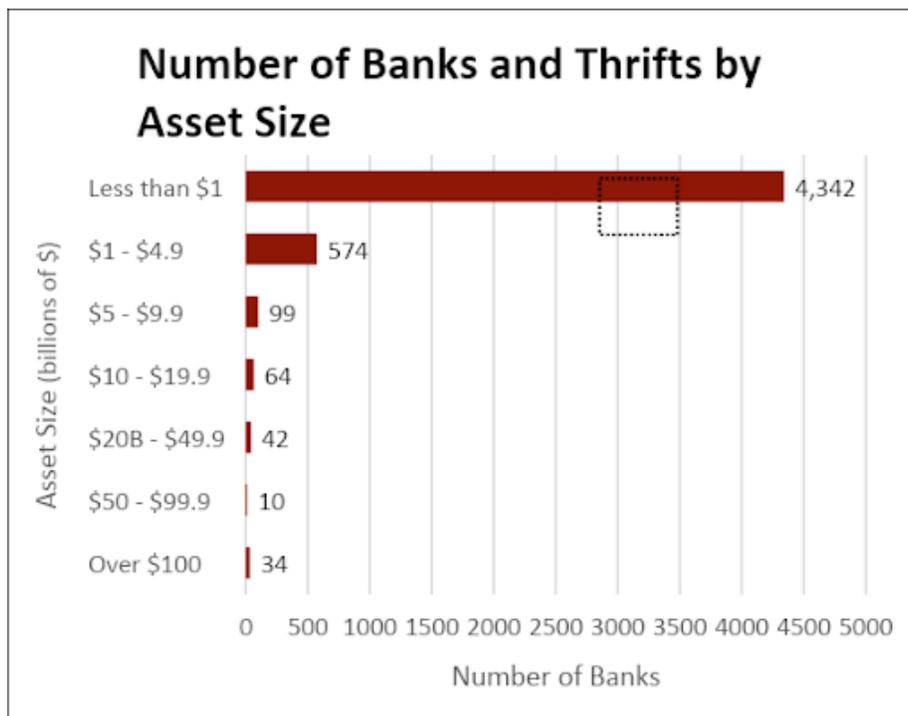
According to the FDIC historical data, over 1,000 deals have been announced since 2015, with over 200 announced each year.

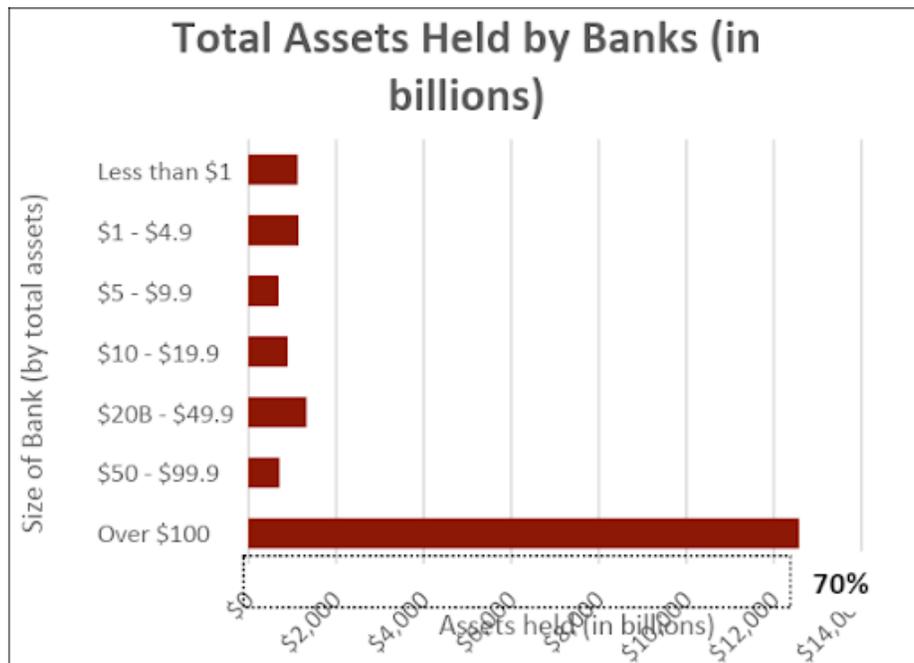




What is driving the consolidation?

The low interest rate environment since the global financial crisis has challenged the operating philosophy of many banks. It has become more difficult to maintain net interest margins without growing loan balances. We expect this trend to continue as we enter a lower-for-longer, downward rate cycle in the second half of 2019. Buyers are looking for targets to achieve scale, gain access to new and better geographic markets, and to restructure their balance sheets to become more profitable. Technology costs are also helping to drive consolidation, as larger banks are able to spend more on technology and spread regulatory costs across a larger asset base and are therefore more efficient than smaller banks. As seen in the charts below the majority of banks are quite small, with less than \$1 billion in total assets. A few larger players hold the majority of the industry's assets. The 34 largest banks control 70% of the assets.





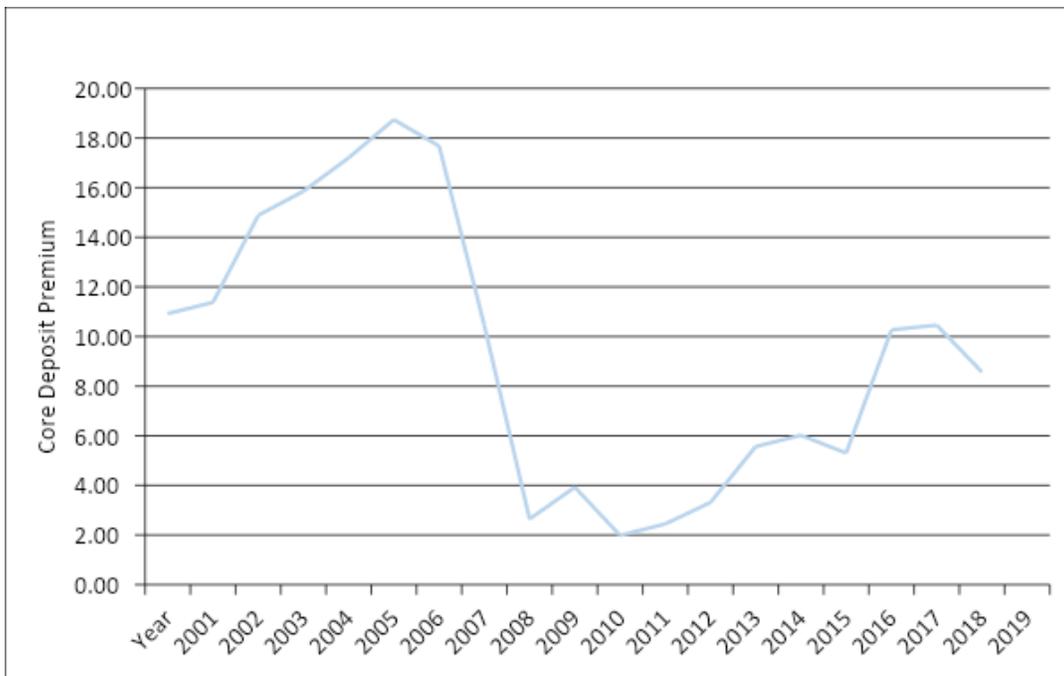
Source: S&P Global Market Intelligence (SNL)

The need for deposits

During the financial crisis and in the subsequent years, customer deposits surged into zero interest, non-maturity deposit products. These deposits largely stayed “asleep⁸” in these accounts until the Fed began its tightening cycle in December 2015.

Loan growth which had been muted since the crisis began picking back up in mid-2013 and really took off in 2014 and 2015. As the Fed continued to increase rates, deposits “woke up⁹” and customers began searching for yield. Banks with high loan growth began acquiring deposit-rich franchises to fund their loan growth. Franchises with stable core deposits, low cost of funds, and lower-end loan-to-deposit ratios became valuable targets. Core deposits, as defined in the Uniform Bank Performance Report User Guide, are the sum of demand deposits, all negotiable order of withdrawal (NOW)¹⁰ and automatic transfer service (ATS) accounts, money market deposit accounts (MMDAs), other savings deposits, and time deposits under \$250,000, excluding any brokered deposits. Core deposits are considered stable and lower cost than other deposits, and generally reprice slower when interest rates rise. These deposits typically come from long-term, local customers that also have other relationships with the bank. Such deposits are considered among the most valuable funding sources in the banking industry. We consider an 80% core deposit/total deposit ratio and 25% noninterest bearing deposits/total deposits as guidelines as solid benchmarks in evaluating the strength of a bank’s deposit base, with higher ratios indicating stronger customer relationships. Of the deals since 2015 59% of targets have had core deposits/total deposits ratios of greater than 80%.

In the last several years banks have generally paid a premium for strong deposit franchises. The premium over tangible book value paid by the acquirer for a target bank represents the core deposit premium. Core deposit premiums reflect the value of the depository customer relationships obtained in a bank acquisition, and banks with a high percentage of core deposits are generally valued at higher multiples relative to peers.



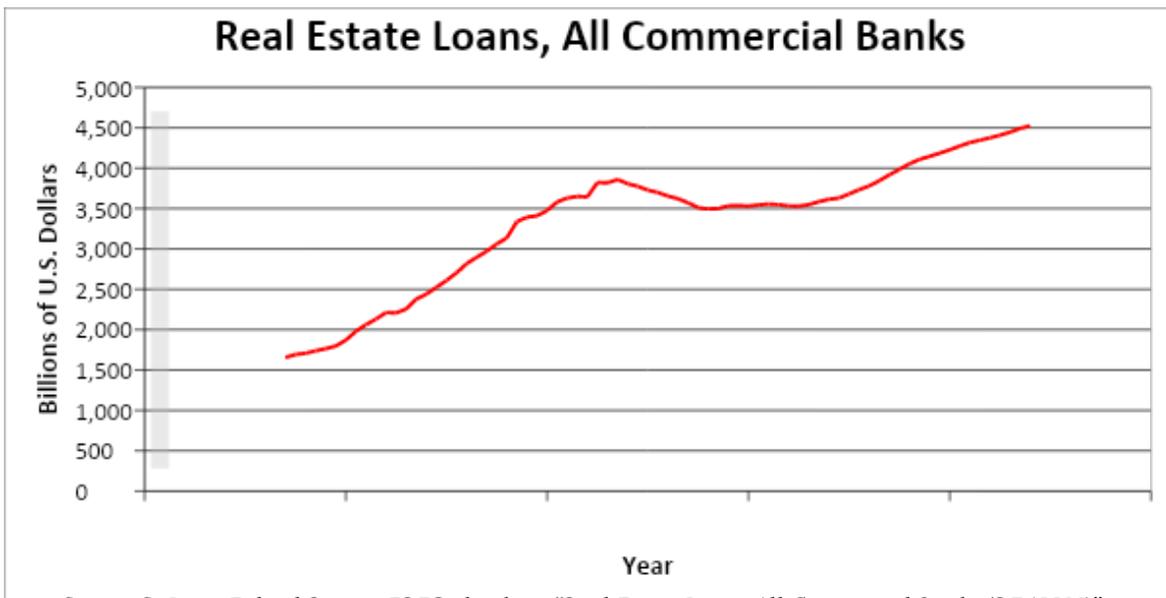
Source: S&P Market Intelligence

Merger & Acquisition Pricing Trends - U.S. Banks & Thrifts

	2010	2011	2012	2013	2014	2015	2016	2017
Median Price/Book (x)	1.16	1.02	1.12	1.18	1.27	1.35	1.26	1.56
Median Price/Tang. Book (x)	1.12	1.05	1.16	1.25	1.34	1.41	1.30	1.60
Median Price/Earnings (x)	22.2	25.2	18.8	19.1	21.4	24.4	20.0	21.7
Median Core Deposit Premium (%)	3.00	0.30	2.40	3.30	4.80	5.70	4.90	8.90

Source: Independent Community Bankers Association¹¹

The loan/deposit ratio represents the percent of a bank’s loans funded by deposits. We find that banks generally target a loan/deposit ratio of 85%-90%, though some are comfortable operating at higher loan/deposit ratios. The higher the loan to deposit ratio above 95%, the greater the pressure on deposit rates and other funding costs. Of the deals since 2015, 78% of targets have had loan/deposit ratios of less than 95%.



Source: St Louis Federal Reserve FRED database, “Real Estate Loans, All Commercial Banks (REALLN)”

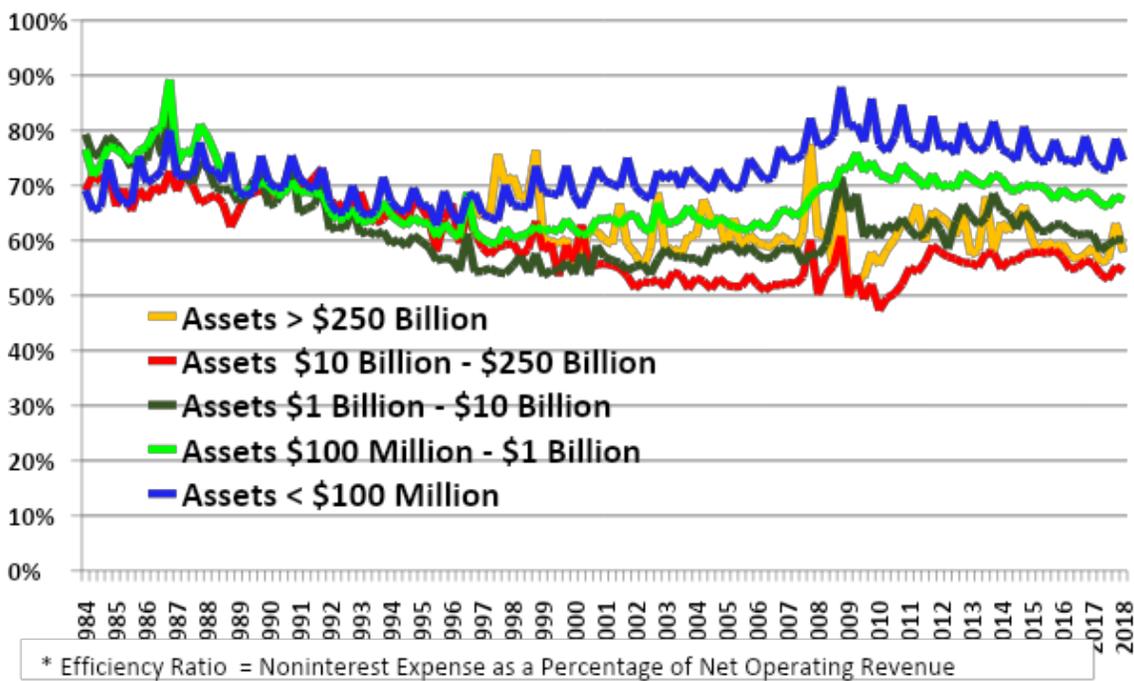
Cost Savings

Regulatory costs have been increasing since the early 2000s and have picked up significantly after the financial crisis. The cost of complying with the Patriot Act, Dodd-Frank, and the numerous consumer lending regulations is a heavy burden for many banks, and the smaller the bank the more burdensome these regulations. These regulations present a cost to the bank that does not relate to revenue generation. Hiring a Bank Secrecy Act (BSA) analyst to review wire transactions increases the cost of processing that wire transfer. Likewise, hiring additional compliance staff to review data integrity of the additional Home Mortgage Disclosure Act (HMDA) fields required to be reported increases the cost of originating a residential mortgage. With residential mortgages rates largely set by the market, the yield curve, and Fannie and Freddie, the bank is unable to pass on the increased cost to the customer. Scale is becoming increasingly important to clear higher regulatory spending hurdles¹².

The type of merger – in market, market expansion, and partial overlap, largely determines the potential cost savings. Geographic overlap offers the ability to merge and reduce costs. It is not unusual for in-market mergers to be able to cut 20% to 40% of noninterest expense out of the target’s cost base. Out-of-market acquisitions generally have less potential for cost savings from branch closure and staff reductions, but can have many other growth-related benefits.

The flat yield curve of 2018 and temporarily inverted yield curve of 2019 have further emphasized the need to achieve efficiencies through economy of scale. The flat and inverted yield curves have forced management to focus on increasing earnings by cutting noninterest expenses. Because of economies of scale, larger banks generally are more efficient than smaller banks, as evidenced by their efficiency ratio. The efficiency ratio is calculated by dividing the bank’s noninterest expenses by its net income: the lower, the better. A 55% efficiency ratio¹³ means that it costs a bank \$0.55 of noninterest expense to generate \$1 of income. For banks with the traditional deposit and lending product business model, we view 50% efficiency ratio as a benchmark for the optimal efficiency ratio. As seen in the chart below, banks with less than \$1 billion in total assets tend to be the most inefficient¹⁴.

Quarterly Efficiency



Source: FDIC

The decoupling in efficiency beginning in the mid-1990s and widened in the early 2000s stems from the growing importance of technology in banks interacting with customers. In 1994, the internet was becoming more common in households and online bill pay began to be offered by the largest banks. As smartphones became common in the early 2000s and customers demanded 24/7 connectivity, customers began to initiate more and more banking transactions through their smartphones and the internet. The more customers initiate and transmit their transactions through the internet, the lower the cost to the bank of processing that transaction, and the more efficiently banks operate.

Larger banks were able to invest more resources in technology that can service their entire customer base (regionally, nationally, globally) and close physical branches which have a much more limited reach. Technology also allowed larger banks to use technology to automate processes such as cashing a check. This allowed banks to eliminate the manual aspects of the process, or have the customer perform parts of the process, and therefore lowered the cost to the bank of cashing the check. Today, most companies with revenue in excess of \$5 million utilize treasury management tools such as remote deposit capture to deposit checks and millions of customers utilize mobile deposit to scan and “cash” checks through mobile banking applications.

Since 2015, 70% of banks acquired had efficiency ratios above 65% and 31% of banks acquired had efficiency ratios above 80%. For example, County Bank Corp had \$616 million in total assets and operated with a 65% efficiency ratio prior to its 2019 sale. County Bank Corp was acquired by Choice One Financial Services in March 2019 as part of Choice One’s market expansion into eastern Michigan. Similarly, Fidelity Southern Corporation had \$4.8 billion in total assets and operated at a 78% efficiency ratio for the twelve months prior to it being acquired by Ameris Bancorp in December 2018. Ameris Bancorp, with \$11.9 billion in total assets prior to the deal, projected 40% cost savings in the deal announcement.

Mergers allow banks to achieve economies of scale, enhance revenues and cut costs through operational efficiencies. They also enable diversification by expanding business lines or geographic reach. Acquired banks are generally smaller, less profitable, less efficient, and in weaker condition than their non-acquired peers. Ninety percent of the mergers since 2007 involved a bank with less than \$1 billion in assets¹⁵. We expect the majority of the consolidation going forward to be in the sub \$1 billion in assets range, consistent with this trend.

All else equal, banks with higher efficiency ratios can make potentially better targets because more cost savings can be achieved from a deal. For deals announced for the period January 2015 – August 2019 with reported cost savings, targets with efficiency ratios higher than 90% had an estimated average and median cost savings at deal announcement of 37%. For the same period, targets with efficiency ratios lower than 55% had an estimated average cost savings at deal announcement of 30% and median estimated cost savings of 28%.

In market acquisitions and partial market overlap acquisitions, we often see significantly higher-than-average cost savings. For example, the in-market acquisition of Mother Lode Bank by Oak Valley Bancorp reported an estimated cost savings of 60%. Mother Lode Bank’s efficiency ratio for the twelve months prior to the deal announcement was 100.54%. Likewise, First Midwest Bancorp’s partial market overlap acquisition of Bridgeview Bancorp reported an estimated cost savings of 40%. Bridgeview Bancorp’s efficiency ratio for the twelve months prior to the deal announcement was 91%.

Efficiency through scale will continue to drive M&A in the current interest rate environment. As the yield curve remains flat-to-inverted and net interest margins continue to compress, banks will need to grow earnings by cutting noninterest expenses and becoming more efficient. The higher the efficiency ratio of the target, the greater the potential for cost savings, especially for those in market deals.

Efficiency ratios and estimated cost savings of select targets are illustrated below.

Target Name	Target Total Assets	Target LTM Efficiency Ratio	Buyer Name	Acquirer Total Assets	Acquirer LTM Efficiency	Deal Announcement Date	Total Estimated Cost Savings
Orange County Business Bank	199,991	95	HomeStreet, Inc.	4,866,248	83	2015	60
Bridgeview Bancorp, Inc.	1,259,879	91	First Midwest Bancorp, Inc.	14,961,499	58	2018	40
Gibraltar Private Bank & Trust Co.	1,578,561	90	IBERIABANK Corporation	27,976,635	60	2017	60
Sun Bancorp, Inc.	2,255,773	89	OceanFirst Financial Corp	5,196,340	60	2017	53
High Point Bank Corporation	796,370	86	BNC Bancorp	5,201,118	57	2015	50
Hometown of Homestead Banking Company	347,098	84	CenterState Banks, Inc.	3,933,072	64	2015	50
Grand Bank, National Association	196,935	84	First Bank	1,711,159	55	2019	45
Tri-Valley Bank	147,155	80	Heritage Commerce Corp	2,843,948	53	2017	50
Fidelity Southern Corporation	4,812,056	79	Ameris Bancorp	11,428,994	56	2018	40
Northern States Financial Corporation	487,091	76	First Midwest Bancorp, Inc.	14,379,971	59	2018	50
First Security, Inc.	586,452	76	German American Bancorp, Inc.	3,125,018	56	2018	38
Clover Community Bankshares, Inc.	130,221	73	Carolina Trust BancShares, Inc.	446,610	77	2018	47
Citizens First Corporation	475,982	68	German American Bancorp, Inc.	3,929,090	57	2019	33

“Total estimated cost savings” shows the total estimated noninterest expense savings at the deal announcement date.

Geographic expansion

Banks may also engage in M&A to expand into new markets. In a classic “build or buy” decision, it can be more cost effective and faster to enter a market through M&A than to enter a market by opening up a de novo branch, which requires significant investments into marketing, hiring, customer acquisition, and customer relationship development. Community banking is an inherently local activity and M&A offers the opportunity to partner with established members of a community.

Technology

Technology is an increasing cost for banks as customers demand more sophisticated support, on-demand services, and generally easier methods of doing business with the bank. The largest banks spend more on technology each year than most community banks earn in income. The heavy spending allows them to offer their customers state-of-the-art digital products such as artificial intelligence-powered chat bots, mobile phone account opening, and cardless ATMs.

BB&T and Suntrust cited the need to leverage economies of scales for technology spending in their February 2019 merger of equals, reporting that the increased technology spend will allow them to invest in transformative technologies that will create a more distinctive client experience. The deal will allow the new bank, Trust, to spend more on technology and develop better technology than either bank could on its own. The Wall Street Journal reported that the merger is expected to help close a widening digital gap between the banks and their larger rivals. “The deal...underscores the urgency facing regional banks to invest heavily in client-facing and back-end technology to continue attracting consumer and corporate customers.”¹⁶ When we speak with management teams, we hear the ability to compete with new technologies repeatedly mentioned as one of the greatest strategic risk to the banking industry.

It is more efficient for one \$500 billion bank to spend \$1 billion on technology than for two \$250 billion banks to spend \$700 million each. The same goes for spending on regulatory compliance costs. Banks with less than \$1 billion in total assets reported that they spent between 6-9% of their expenses on technology in 2018.

Current Technology Budgets of Top Banks

	Total Tech Budget	Total Assets	% of Noninterest Expense
J.P. Morgan Chase	\$11.5B	\$2.6T	17%
Bank of America	10B	2.4T	18%
Citigroup	8.4B	1.9T	20%
Wells Fargo	8.2B	1.9T	17%
US Bancorp	2.5B	467B	20%
PNC Financial Services	1.8B	382B	17%
BB&T	1B	226B	14%

Source: Morningstar, earnings calls, presentations, financial filings

Filing in product gaps

Banks have been operating in a flat to inverted yield curve environment for over twelve months as of the date of this paper. In a difficult yield curve environment, non-interest income sources and product scope become increasingly important. Banks are engaging in M&A to restructure their balance sheets and diversify their revenue streams to include more noninterest income sources. CZWI, a former largely residential lender, has completed three acquisitions since 2017 to remix its balance sheet to higher yielding, more relationship-driven commercial and industrial (C&I) loans. Banks have also engaged in M&A to acquire banks with significant noninterest income from trust and wealth management services, insurance companies, and mortgage banking, among others. Product capabilities can be complementary or may result in additional cross-selling opportunities.

Succession Planning/Talent Needs

Banks have been trying to add and retain key talent through mergers and acquisitions. It is difficult for smaller banks to have the right people to take on senior management roles. Because of their size, these small banks may have a limited bench to replace retiring executives. M&A enables potential sellers to avoid filling leadership roles from within and allows buyers to add talent. CenterState Bank Corp., WesBanco Inc. and Prosperity Bancshares Inc. are just a few that have engaged in this strategy recently. With today's low unemployment rate this is especially true.

Credit Unions Enter Bank M&A

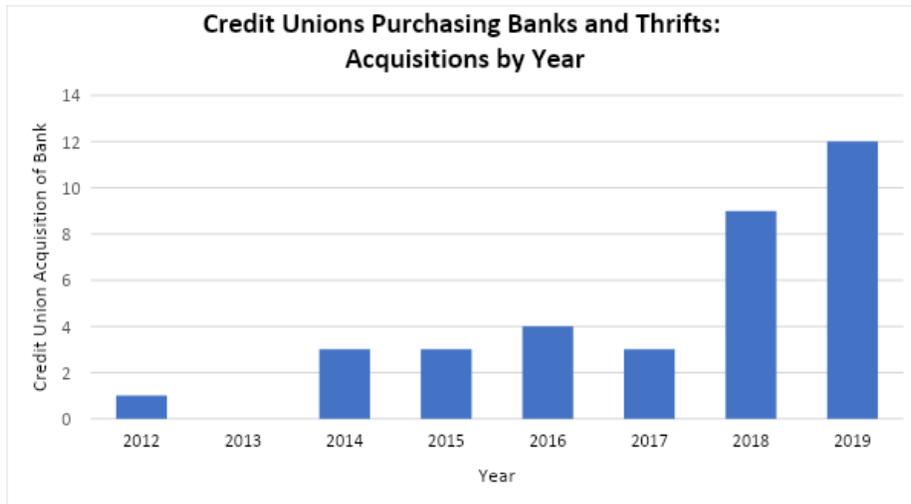
As we discussed briefly in the overview, credit unions have also realized the need to scale up as they face a similar interest rate and regulatory compliance environment as banks. Historically credit-union growth was constrained by membership requirements (a common bond or community bond), but these restrictions have relaxed over time, giving them more options and incentive for growth. Since it is generally faster to grow through acquisition than organically, credit unions have jumped on the M&A train. In the past this was limited to credit unions buying other credit unions. In recent years, though, credit unions have also been buying banks. Banks have also become more receptive to the idea of being purchased by a credit union, particularly since credit-unions are all-cash buyers (since they have no equity) potentially willing to pay above-market prices for the bank.

Banks selling to credit unions are also in the sub-\$1B range, consistent with the bank-to-bank M&A trend. All but one of the banks purchased by a credit union since 2012 was under \$400 million in total assets, with the outlier still only having \$733M. Credit unions are attractive partners for banks as they may be willing to pay a higher price because of their favorable tax treatment – unlike banks, credit unions' profits are not taxed. C corporation bank profits are taxed twice – once at the corporate level and then at the shareholder level when the corporation distributes dividends to its shareholders. In its recent sale to Verve Credit Union, South Central Bank Chairman and CEO Marc Grayson said an investment banker presented many potential acquirers, but the bank chose to sell to Verve because Verve was willing to pay more than any commercial bank. Florida has been the hottest market for this type of activity, with 10 of the 31 credit-union deals since 2015 involving acquisitions of Florida based banks.

The low interest-rate environment the last ten plus years, coupled with rising deposit costs since 2015, has limited the prof-

itability of residential mortgage lending, a credit union's bread and butter. This has incentivized credit unions to look outside their traditional business lines of residential mortgages and auto loans and into more traditionally bank products such as business lending. The quickest way to get into the business lending business and to increase business loans as a percent of the loan portfolio is to purchase a bank with a significant business lending portfolio. Business lending relationships also generally have associated low-cost deposits. Acquiring a bank also gives a credit union expertise and relationships in the business lending area.

We expect credit unions to continue acquiring banks given that M&A remains attractive in the current yield-curve environment, size and scale remain important factors in achieving operational efficiency, and a number of smaller community banks face succession planning concerns.



Appendix: Case Study: ABCB Acquisition of LION

Deal Profile

Buyer: Ameris Bank (ABCB)

Seller: Fidelity Southern (LION)

Announcement: 12/17/18

Deal Value: \$751M

Valuation: 181% P/TBV

1 Day Deal Premium: 27%

Buyer Expectation

Market share in Atlanta – Post merger, the combined company ranks 7th in deposit market share in the Atlanta market, with 2.8% of the market's deposits, and 6th in deposit market share in the Jacksonville market with 2.9% of the Jacksonville markets deposits. Atlanta is the largest metropolitan statistical area (MSA) in the southeast by GDP and the second wealthiest by household income at \$69k. It is also one of the fastest growing MSAs in the country by population – the estimated population growth through 2025 is 6.5%, which is well above the 3.6% national average.

EPS Accretion – Estimated EPS is \$4.02 for 2019 and \$4.72 for 2020. Analysts' pro forma EPS estimates are more in 2020 than adjusted pre-merger expectations.

Cost Savings – Ameris estimated 40% of LION's projected noninterest expense as cost savings in the deal announcement, with 50% of the projected savings realized in 2019.

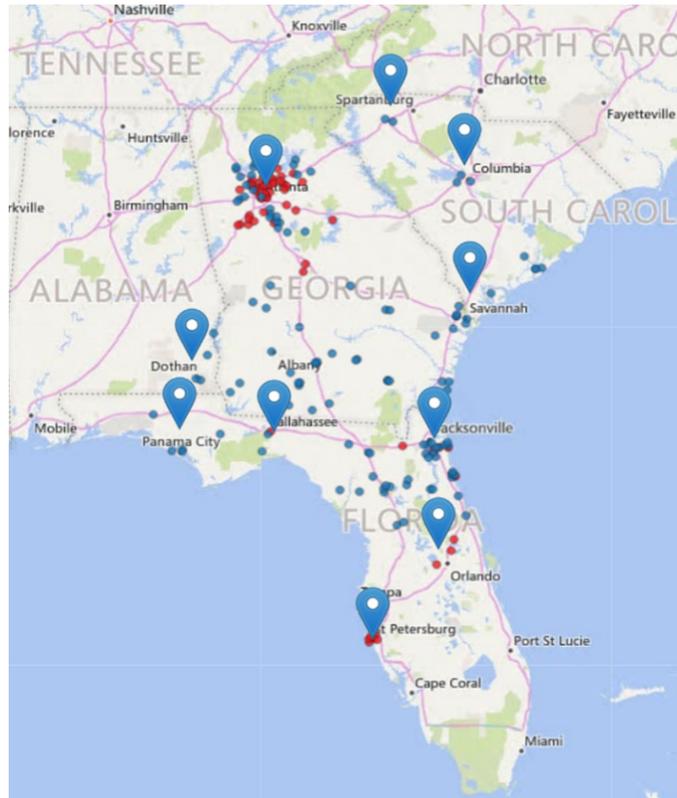
Earnback – Ameris estimates less than 3% dilution to tangible book value per share which will be earned back within 2.5 years.

Transaction Rationale

The deal reinforces Ameris' position as the premier banking franchise in the Southeast with one of the most recognizable brands in the Atlanta and Jacksonville markets. LION was the largest independent community banking franchise headquarters in the Atlanta MSA at the date of deal announcement, as well as a strong deposit footprint in St Petersburg, Jacksonville, Orlando, and Tallahassee. The bank had a true relationship banking business model and a strong deposit franchise as evidenced by its 31% noninterest bearing deposits and 0.56% cost of funds the quarter prior to the deal announcement (9/30/18). LION has pristine asset quality with net chargeoffs/average loans of only 11bp for 2018 and a diversified loan portfolio comprised of residential, consumer, and commercial loans. It also possesses a strong management team.

Deal Map

Pro Forma Branch Footprint



ENDNOTES

¹ *TruPoint Partners report, November 2017.*

² *The Washington Post, March 22, 1997. The deal in question was First Union buying Signet, and the speaker was First Union's chairman and CEO, Edward Crutchfield. "Mac" was Malcolm MacDonald, the chairman and CEO of Signet. First Union continued its aggressive acquisition strategy, acquiring Wachovia in 2001 to eventually become the fourth largest bank holding company in the United States based on total assets. Though First Union was the acquirer, it took the Wachovia name. Wachovia subsequently got into trouble in 2008 and was acquired by Wells Fargo in a government forced sale to avoid Wachovia's failure.*

³ *Canadian Bankers Association.*

<https://cba.ca/fast-facts-the-canadian-banking-system#targetText=Number%20of%20banks%20in%20Canada,owned%20ABMs%20across%20Canada%3A%2018%2C640>.

⁴ <https://thebanks.eu/banks-by-country>

⁵ *Banco Central DO Brasil, "Overview of Banking Market".*

⁶ *Source: FDIC Statistics at a Glance for June 30, 2019. <https://www.fdic.gov/bank/statistical/stats/>.*

⁷ *Source: FDIC Statistics at a Glance for June 30, 2019. <https://www.fdic.gov/bank/statistical/stats/>.*

⁸ *Asleep deposits – The decline in the Fed funds rate beginning in 2008 contributed to an increase in non-maturity deposits product account balances which pay zero interest or very low interest rates near zero. Customers sought safety in insured deposits and were more concerned with not losing money than with a high yield. Customers left deposits parked in these low-yielding products while the Fed Funds rate hovered near zero through the second 25bp rate hike in 2016.*

⁹ *Deposits woke up - Rising rates typically trigger outflows of deposit balances from no and low-cost non-maturity deposit products into higher costing money market and CD products. With the third rate hike in December 2017 and the four hikes in 2018 customers began searching for yield and transferred funds out of zero and near zero interest products into higher yielding money market and CD products. Banks began offering CD specials and money market specials as an incentive to lure customers from competitors.*

¹⁰ *Any interest-earning bank account.*

¹¹ <https://www.icba.org/docs/default-source/icba/events-documents/2018-convention-speaker-handouts/mecredy-merger-and-acquisition.pdf?sfvrsn=4>

¹² *Recent financial institution deregulation under the Trump administration has had little impact on community banks' regulatory compliance costs.*

¹³ *Efficiency Ratio = Noninterest Expenses / (Operating income – Loan Loss Provision). The efficiency ratio measures a bank's overhead as a percentage of its revenue.*

¹⁴ *FDIC Quarterly Banking Profile as of December 31, 2019.*

¹⁵ *FDIC and S&P Global Market Intelligence (SNL)*

¹⁶ *"BB&T-SunTrust Tie-Up Brings Tech Budgets Into Focus", <https://www.wsj.com/articles/bb-t-suntrust-tie-up-brings-tech-arms-race-into-focus-11549575429>*

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