FJ CAPITAL MANAGEMENT, LLC

Investing in Financial Services for Decades

White Paper

# Booming M&A Cycle Creates Investment Opportunity

October 2017

© 2017 FJ Capital Management, LLC. All Rights Reserved. www.fjcapital.com

FJ CAPITAL MANAGEMENT

# Contents

Executive Summary .......... 1

Review of U.S. Banking Consolidation Trend: 1990 to 2017 and Beyond .......... 2

Common Characteristics of Sellers .......... 3

Buyer Post-Transaction Price Performance – Own the Smart Buyers .......... 5

Bank Consolidation Trend Outlook .......... 7

Why Banks Want/Need to Merge – 2017 in Review .......... 16

Impact of Reduced Regulation on U.S. Banking Consolidation .......... 19

Recent M&A Quotes from Industry Participants .......... 22

Recent Transaction Highlights .......... 23

Appendix .......... 29

FJ CAPITAL MANAGEMENT

## Executive Summary

In our updated white paper discussing the consolidation in the U.S. banking sector, we review M&A activity over the last few decades and update our thesis on this structural trend. In summary, we believe it is still early innings in the consolidation cycle, and the accelerating activity creates compelling investment opportunity in the banking sector, with attractive risk/rewards for long-term investors.

**Bank M&A activity slowed after the last financial crisis, but heated up during the past 5 years,** with 250 transactions announced per year between 2012 and 2017 year-to-date (YTD), compared to only 145 deals per year between 2008 and 2011. The increase since 2012 validates the thesis posited in our 2012 white paper (available upon request), which was that a consolidation boom would drive investment returns in the community and regional bank sector in the coming years.

**Despite the pick-up in acquisitions during past several years, we believe the banking sector is still in the early innings of the M&A cycle.** With nearly 6,000 banks currently, the U.S. still has the most banks of any developed economy around the world. Based on our research, the total number of banks likely will decrease 50% over the next 10 to 15 years. Other key highlights of our outlook for bank consolidation going forward include: the continued rationalization of the size and number of bank branches; fewer new bank formations; the creation of new emerging regional banks; and deposit-rich franchises being more valuable in a rising rate environment.

**What's driving the structural consolidation trend?** We update our thoughts on the key drivers of bank M&A over recent and future decades, which include: profitability challenges; cost savings; management and board fatigue; commercial real estate (CRE) lending concentration; liquidity needs and regulatory reform.

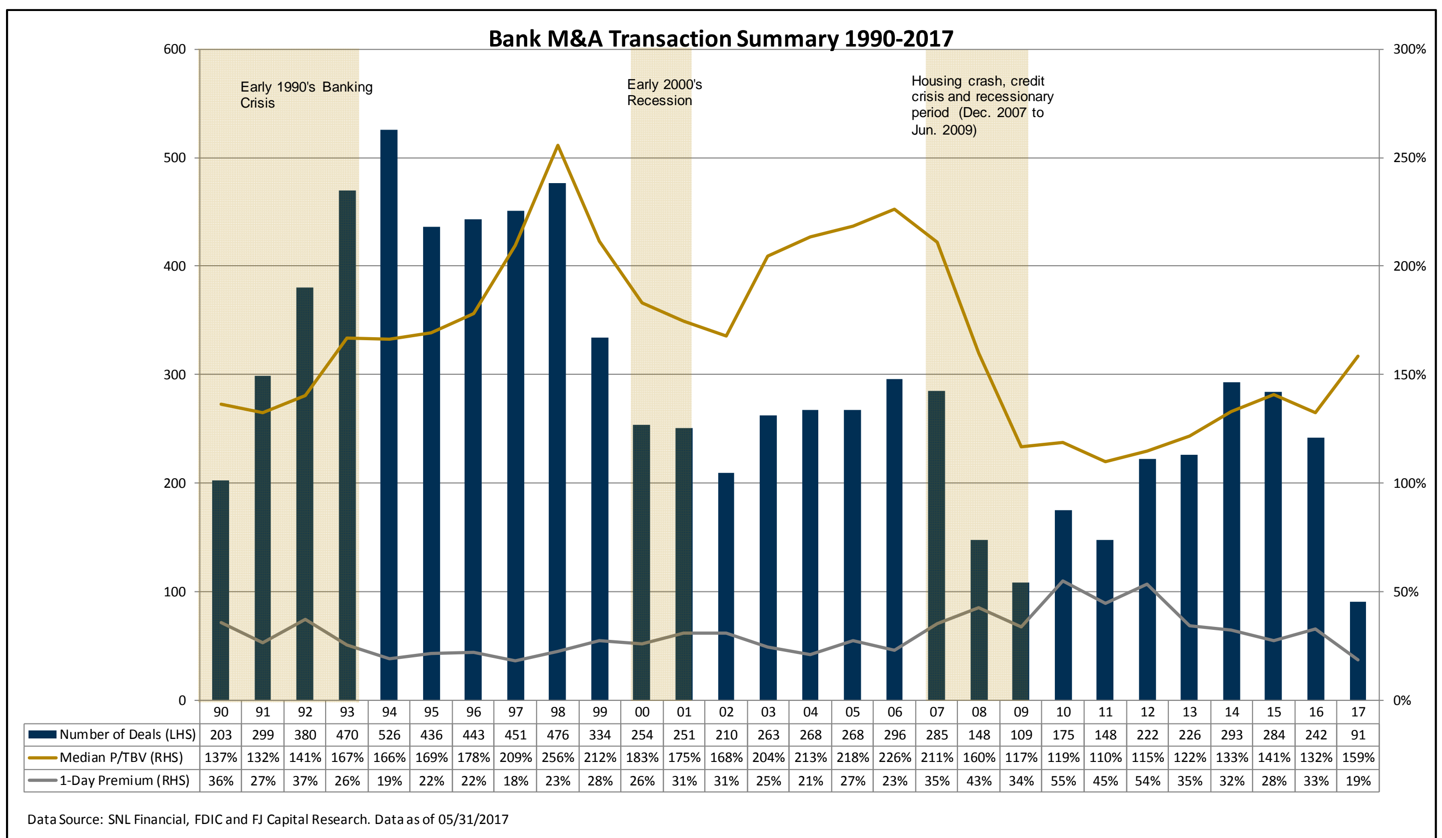
**Finally, we provide thoughts on the possible impact of potential changes from political and regulatory reform after the November 2016 U.S. Presidential election**. The banking sector initially outperformed after the election only to retrace those gains as political volatility called the president's pro-growth agenda into question. Relative to other sectors, the market expects banks will benefit most from initiatives under the *Trump* Administration, including deregulation, normalization of the *Fed's* balance sheet, a gradual increase in interest rates and corporate tax reform. We believe higher bank stock valuations, potential regulatory relief and deposit pressures as rates rise will support accelerating consolidation over the next decade.

FJ CAPITAL MANAGEMENT

# Review of U.S. Banking Consolidation Trend: 1990 to 2017 and Beyond

In *FJ Capital's* 2012 white paper (available on request) we highlighted our outlook for bank M&A. The paper's thesis concluded that a structural consolidation boom was forthcoming and several factors would drive increased consolidation over the coming years. This thesis was validated by the increased transaction volume and valuations over the past 5 years. On average, there were 250 transactions announced per year between 2012 and 2017 YTD, a significant increase from only 145 deals per year between 2008 and 2011.

In addition, transaction valuations have improved markedly over the past 5 years. It is worth noting that takeout valuations increased significantly following the 2016 election due to the rally in bank stocks, with an average P/TBV of 166% versus the average P/TBV of 130% to 140% pre-election. However, as shown in the chart below, current takeout valuations are still below pre-crisis levels. Moreover, the potential benefits under the *New Administration*, including financial industry deregulation, higher interest rates and corporate tax reform, likely could fuel increased takeout valuations. The accelerating activity creates compelling investment opportunity in the sector, with attractive risk/rewards for long-term investors by investing in both sides of the consolidation equation.




| | 90 | 91 | 92 | 93 | 94 | 95 | 96 | 97 | 98 | 99 | 00 | 01 | 02 | 03 | 04 | 05 | 06 | 07 | 08 | 09 | 10 | 11 | 12 | 13 | 14 | 15 | 16 | 17 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Number of Deals (LHS) | 203 | 299 | 380 | 470 | 526 | 436 | 443 | 451 | 476 | 334 | 254 | 251 | 210 | 263 | 268 | 268 | 296 | 285 | 148 | 109 | 175 | 148 | 222 | 226 | 293 | 284 | 242 | 91 |
| Median P/TBV (RHS) | 137% | 132% | 141% | 167% | 166% | 169% | 178% | 209% | 256% | 212% | 183% | 175% | 168% | 204% | 213% | 218% | 226% | 211% | 160% | 117% | 119% | 110% | 115% | 122% | 133% | 141% | 132% | 159% |
| 1-Day Premium (RHS) | 36% | 27% | 37% | 26% | 19% | 22% | 22% | 18% | 23% | 28% | 26% | 31% | 31% | 25% | 21% | 27% | 23% | 35% | 43% | 34% | 55% | 45% | 54% | 35% | 32% | 28% | 33% | 19% |

Data Source: SNL Financial, FDIC and FJ Capital Research. Data as of 05/31/2017

## Common Seller Characteristics

We examined some characteristics of public (trading on *NASDAQ* and *NYSE* exchanges) and quasi-public (trading on *OTC* exchanges) sellers in the past five years. There have been 369 public and quasi-public banks acquired since 2012. Below is a summary of some common characteristics of these sellers.

- **Aging management team and board members.** Among these 369 sellers, the median CEO age is 64 and the median chairman age is 67. The aging of management teams and board members has been a primary driver of bank consolidation over the last decade. As of September 2017, the average age of a public bank CEO and Chairman is 59 and 66, respectively. This demographic alone should drive consolidation activity over the next several years.

- **Significant insider ownership.** The median insider ownership of the sellers is 20%. Community bank management teams and board members usually own a significant amount of stock in the company and therefore have strong financial incentives to maximize shareholder value. We seek companies where there is strong alignment with shareholders and management teams care more about their stock holdings than earning W-2 income.

- **Asset size of sellers remains small.** Based on public and quasi-public transactions, more than 50% of the sellers in the past five years have had assets less than $500 million and 73% of sellers are below $1 billion in assets. We believe the best opportunity to capitalize on the sell side of the consolidation trend remains in owning the small and micro cap banks.

- **Most sellers are under earnings pressure.** Public and quasi-public sellers in the past five years have a median LTM Return on Average Assets (ROAA) of 0.59% and a median LTM Return on Average Equity (ROAE) of 5.75%, below the current median of 0.81% ROAA and 8.13% ROAE for the industry. The higher performing banks that have sold – "Haves", received a median takeout P/TBV of 164% vs. the industry median of 134% over the past five years. Approximately 85% of sellers have an efficiency ratio above 65% and almost 20% of sellers have an efficiency ratio above 90%. Under the intensive regulatory environment following the last financial crisis, many small community banks face increasingly onerous regulatory costs and are operating inefficiently. The inability to generate acceptable ROEs makes these underperforming banks more likely to sell.

- **Overcapitalized banks are more likely to sell.** In the past 5 years, 80% of sellers had a Tangible Common Equity/Tangible Asset (TCE/TA) ratio above 8% (a bank with a TCE/TA ratio less than or equal to 8% is usually considered to be fully levered). Nearly 40% of sellers are in the 10% to 15% TCE/TA range (a bank with a TCE/TA ratio greater than or

equal to 10% is usually considered overcapitalized). These statistics suggest that if a bank is not fully levered and cannot deploy the excess capital on its own, it may need to partner with a larger bank.

- **Credit quality is slightly below average for most sellers, but has been improving over time.** The median NPAs/Assets ratio of sellers over the past five years is 1.64% versus the industry average of 0.79%; and only 30% of sellers had NPAs/Assets below 1%. However, the overall credit quality of sellers has been improving over time as the industry has been moving into a more normalized phase of the credit cycle. The median NPAs/Assets of sellers in 2016 was 0.82%, much improved from 2.03% in 2013 and 3.05% in 2012.

- **Banks with a strong deposit base could be more attractive to buyers as interest rates rise.** Nearly 70% of sellers in the past five years have had a core deposit ratio above 80%. As the *Fed* begins to normalize interest rates, we believe this will increase the demand for low-cost deposit bases and further fuel additional M&A.

## Buyer Post-Transaction Price Performance – Own the Smart Buyers

An M&A transaction is usually accretive to the buyer's earnings power, as the buyer can realize significant cost savings by cutting the target's back office expenses and closing overlapping branches. A smart acquisition is usually a positive catalyst for a buyer's stock performance after the deal is announced. Over the last 25 years, the buyer's stock price performance has been generally positive after a deal's announcement, as illustrated by the table below.

**Median Buyer Price Performance Post-Transaction Announcement**

| Year | 1-Day | 1-Month | 3-Month | 1-Year |
|---|---|---|---|---|
| 1990 | -1.3% | -3.6% | -6.2% | 6.5% |
| 1991 | 1.4% | 3.0% | 8.3% | 30.1% |
| 1992 | 0.7% | 2.4% | 7.5% | 21.8% |
| 1993 | 0.4% | 1.6% | 0.6% | 1.0% |
| 1994 | -0.4% | -0.8% | -0.5% | 12.9% |
| 1995 | 0.5% | 2.5% | 6.9% | 22.5% |
| 1996 | 0.4% | 1.9% | 8.9% | 43.6% |
| 1997 | 0.8% | 3.5% | 10.5% | 24.4% |
| 1998 | -0.8% | -0.5% | -4.4% | -12.4% |
| 1999 | -1.3% | -2.3% | -5.1% | -22.0% |
| 2000 | 0.5% | 2.0% | 3.8% | 19.8% |
| 2001 | 0.5% | 2.2% | 1.7% | 15.2% |
| 2002 | 0.0% | 0.4% | 2.3% | 17.4% |
| 2003 | 0.6% | 1.8% | 6.5% | 16.9% |
| 2004 | -0.1% | 1.1% | 1.5% | 2.7% |
| 2005 | -0.6% | -0.3% | 1.6% | 6.4% |
| 2006 | -0.1% | 0.7% | 0.7% | -5.8% |
| 2007 | -0.5% | -1.8% | -5.6% | -26.8% |
| 2008 | -1.6% | -1.3% | -6.7% | -23.9% |
| 2009 | 2.1% | 0.7% | -0.6% | -0.3% |
| 2010 | -0.9% | 0.3% | 3.9% | -2.7% |
| 2011 | 0.1% | -0.4% | 2.7% | 7.2% |
| 2012 | 0.6% | 0.3% | 1.9% | 21.0% |
| 2013 | 2.7% | 4.2% | 8.6% | 13.2% |
| 2014 | 1.4% | 1.2% | 1.0% | 10.0% |
| 2015 | 0.6% | 0.9% | 1.3% | 7.6% |
| 2016 | 1.6% | 2.9% | 6.7% | 35.8% |
| 2017 | 1.0% | 1.0% | 1.5% | NA |
| **Median** | **0.4%** | **1.0%** | **1.7%** | **10.0%** |

Data Source: SNL Financial and FJ Capital Research. Data as of 05/31/2017

While this table highlights post-transaction announcement performance for all acquisitive banks, stock performance of the successful acquirers is muted by stock performance of the less successful acquirers.

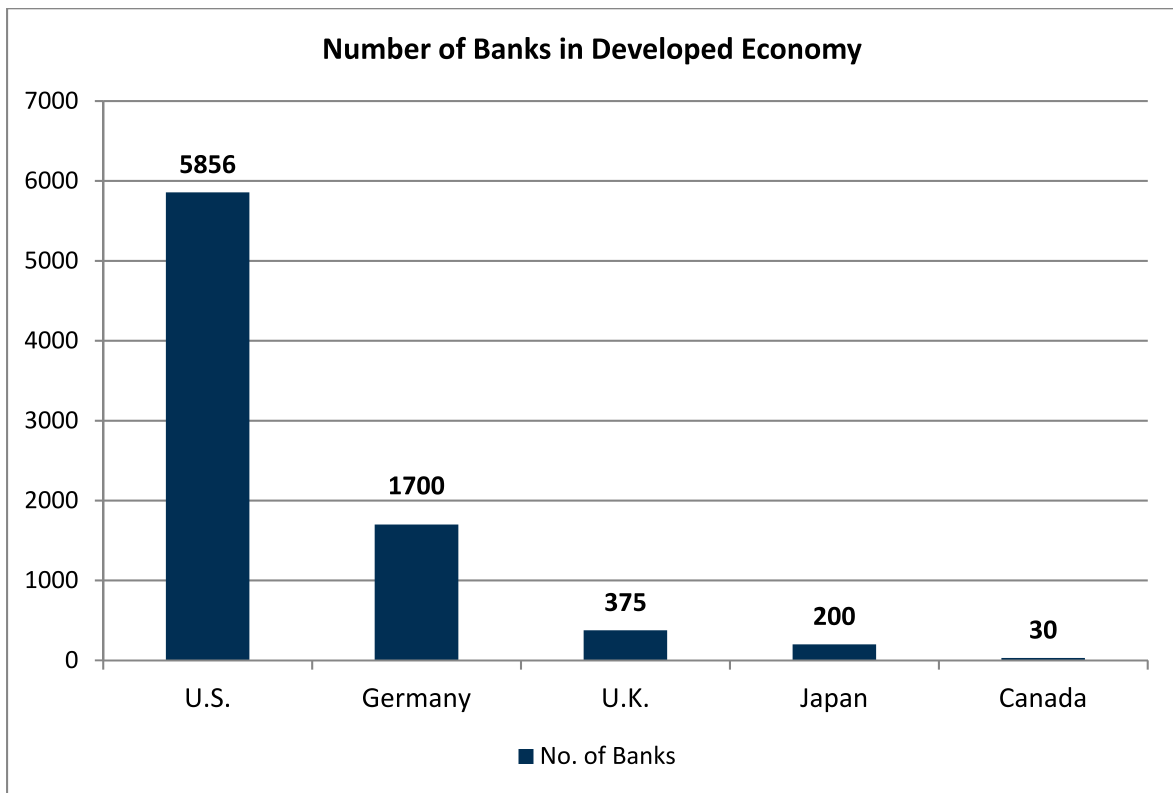
One of the key qualitative factors to judge the potential for financial success of an acquisition is the tangible book value (TBV) dilution payback period, which is defined as the total number of years it will take the buyer to recover the TBV dilution resulting from the acquisition. Put differently, the metric measures the number of years required for the bank's proforma TBV to catch up to the TBV projections prior to the acquisition. Generally, the shorter the payback period, the better an acquisition is received by investors. An acceptable payback period is usually between 3 and 5 years. Investors tend to favor deals with shorter payback periods and meaningful EPS accretion. Smart buyers that can execute well-received transactions have seen much better stock performance than what is shown above.

## Bank Consolidation Trend Outlook

- **Early innings of M&A cycle**

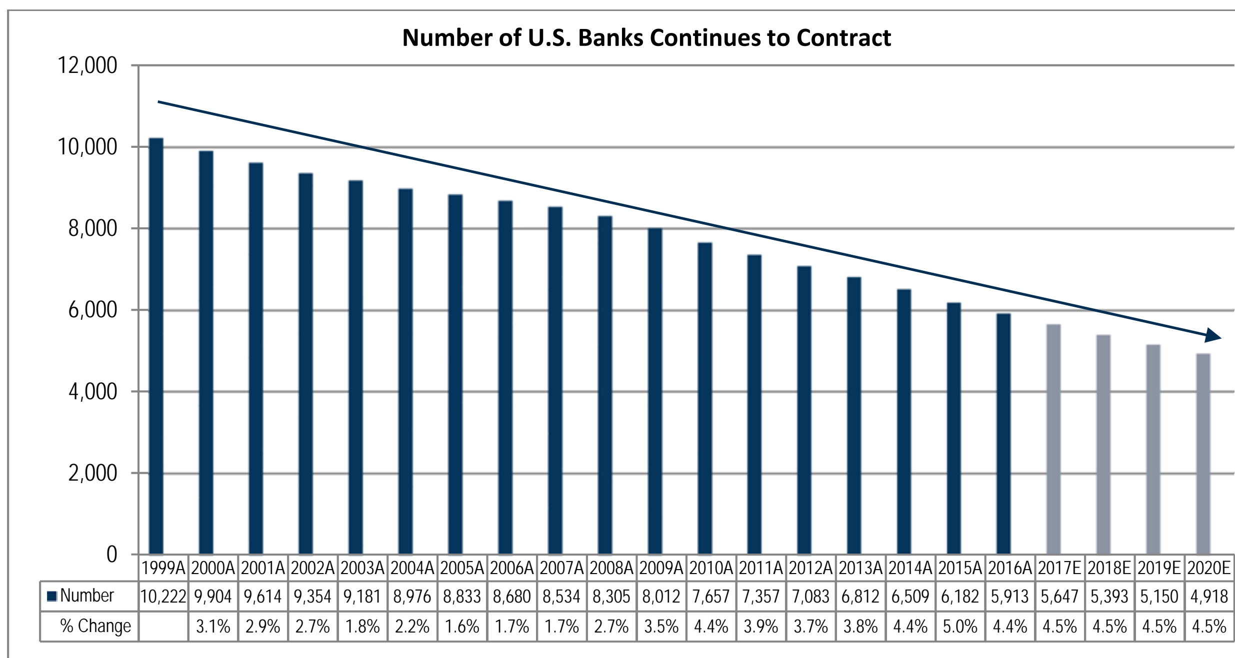
  We believe the banking sector is still in the early innings of the M&A cycle, despite the pick-up in deals over the past several years, as the multitude of consolidation catalysts remain firmly in place. Banking consolidation is not new. In fact, it has been happening for some time, with the total number of banks in the U.S. decreasing by 50% from ~12,000 in the mid-1990s to ~6,000 today. In recent years, the number of banks has decreased by 4% to 5% per year, on average.

  However, the U.S. still has the most banks among the world's developed economies. For comparison, there are only 375 banks in the U.K., 1,700 banks in Germany, 200 banks in Japan and 30 banks in Canada. Moreover, there are another 6,000 credit unions in the U.S. today.




Data Source: FDIC and FJ Capital Research

**How many banks does the U.S. really need? Some notable quotes on the subject from bank executives and leading bankers in the field** - Houston-based *Prosperity Bancshares Inc. Chairman and CEO David Zalman* said during a recent industry conference, "I'd say in 25 years, there may not be 500 banks around. It takes a whole lot to make these banks run. To start off a new bank today... your IT person in compliance would make more than the president does." At a small bank, you just can't pay that much as many bank CEOs, investors and industry practitioners would agree, the ever-intensive regulatory environment after the last financial crisis makes small banks struggle to earn their independence. Based on our research, the number of banks could decline by at least 50% in the next 10 to 15 years. Therefore, the industry would appear to still be firmly in the early innings of the current M&A boom, which should last into the next decade.




| | 1999A | 2000A | 2001A | 2002A | 2003A | 2004A | 2005A | 2006A | 2007A | 2008A | 2009A | 2010A | 2011A | 2012A | 2013A | 2014A | 2015A | 2016A | 2017E | 2018E | 2019E | 2020E |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Number | 10,222 | 9,904 | 9,614 | 9,354 | 9,181 | 8,976 | 8,833 | 8,680 | 8,534 | 8,305 | 8,012 | 7,657 | 7,357 | 7,083 | 6,812 | 6,509 | 6,182 | 5,913 | 5,647 | 5,393 | 5,150 | 4,918 |
| % Change | | 3.1% | 2.9% | 2.7% | 1.8% | 2.2% | 1.6% | 1.7% | 1.7% | 2.7% | 3.5% | 4.4% | 3.9% | 3.7% | 3.8% | 4.4% | 5.0% | 4.4% | 4.5% | 4.5% | 4.5% | 4.5% |

Data Source: SNL Financial, FDIC and FJ Capital Research

**FJ CAPITAL MANAGEMENT**

**Number of Banks by State**

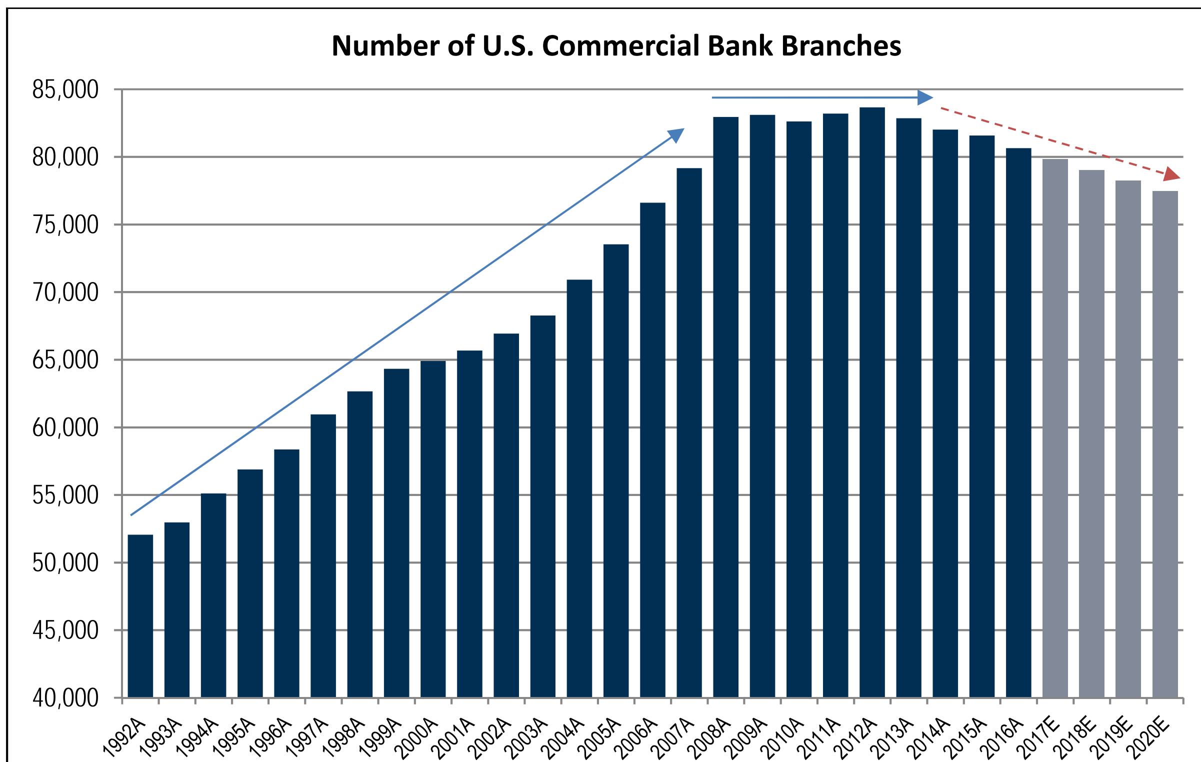
| State | Number of Banks 1990 | 2000 | 2017 | % Reduction 1990 to 2017 |
|---|---|---|---|---|
| IL | 1281 | 827 | 470 | -63% |
| TX | 1320 | 761 | 466 | -65% |
| MN | 655 | 508 | 315 | -52% |
| IA | 602 | 452 | 300 | -50% |
| MO | 619 | 402 | 279 | -55% |
| KS | 591 | 391 | 254 | -57% |
| WI | 535 | 356 | 222 | -59% |
| OK | 448 | 293 | 211 | -53% |
| OH | 498 | 338 | 195 | -61% |
| CA | 618 | 346 | 181 | -71% |
| GA | 477 | 360 | 181 | -62% |
| NE | 408 | 291 | 180 | -56% |
| PA | 471 | 302 | 166 | -65% |
| KY | 395 | 267 | 159 | -60% |
| NY | 344 | 230 | 156 | -55% |
| TN | 306 | 222 | 156 | -49% |
| FL | 560 | 316 | 147 | -74% |
| MA | 338 | 233 | 138 | -59% |
| LA | 296 | 181 | 129 | -56% |
| AL | 252 | 171 | 125 | -50% |
| IN | 397 | 218 | 112 | -72% |
| MI | 274 | 188 | 102 | -63% |
| AR | 276 | 191 | 99 | -64% |
| CO | 474 | 195 | 88 | -81% |
| VA | 245 | 166 | 86 | -65% |
| NJ | 275 | 151 | 85 | -69% |

| State | Number of Banks 1990 | 2000 | 2017 | % Reduction 1990 to 2017 |
|---|---|---|---|---|
| MS | 153 | 105 | 79 | -48% |
| ND | 156 | 114 | 78 | -50% |
| SD | 141 | 108 | 71 | -50% |
| NC | 201 | 118 | 61 | -70% |
| WV | 195 | 77 | 59 | -70% |
| MD | 200 | 136 | 55 | -73% |
| SC | 133 | 107 | 55 | -59% |
| MT | 166 | 89 | 51 | -69% |
| WA | 133 | 101 | 48 | -64% |
| UT | 67 | 63 | 46 | -31% |
| CT | 153 | 71 | 42 | -73% |
| NM | 107 | 62 | 40 | -63% |
| WY | 78 | 49 | 32 | -59% |
| DE | 52 | 42 | 27 | -48% |
| ME | 53 | 39 | 26 | -51% |
| OR | 61 | 47 | 24 | -61% |
| NH | 89 | 37 | 18 | -80% |
| AZ | 44 | 52 | 17 | -61% |
| NV | 27 | 36 | 17 | -37% |
| ID | 30 | 21 | 13 | -57% |
| VT | 36 | 22 | 12 | -67% |
| RI | 20 | 11 | 9 | -55% |
| HI | 27 | 10 | 8 | -70% |
| AK | 10 | 8 | 5 | -50% |
| PR | 24 | 12 | 5 | -79% |
| DC | 23 | 6 | 3 | -87% |

Data as of 2017Q1. Data Source: SNL Financial and FJ Capital Research

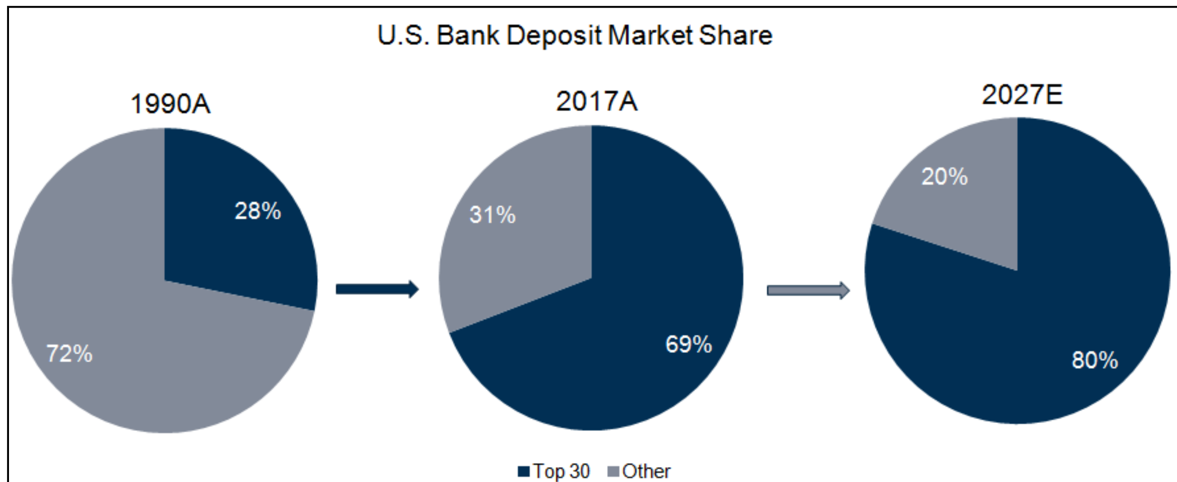
With increased consolidation comes better economics for this commoditized industry. As you can see in the chart above, many states are becoming more rational as consolidation takes hold. This will become even more evident in the return profile over the next 5 to 10 years, all else equal.

- **Branch network rationalization will continue**
  As shown in the chart below, the total number of bank branches in the U.S. began to decline in 2012. With the adoption of new technology, banks continue to shutter branches and consolidate into smaller branches to reduce costs and redirect the savings into their digital platforms. We expect continued rationalization of branch networks over the next 5 to 10 years. The consolidation of banks and bank branches should lead to less competition, higher returns and overall better profitability in the banking industry.



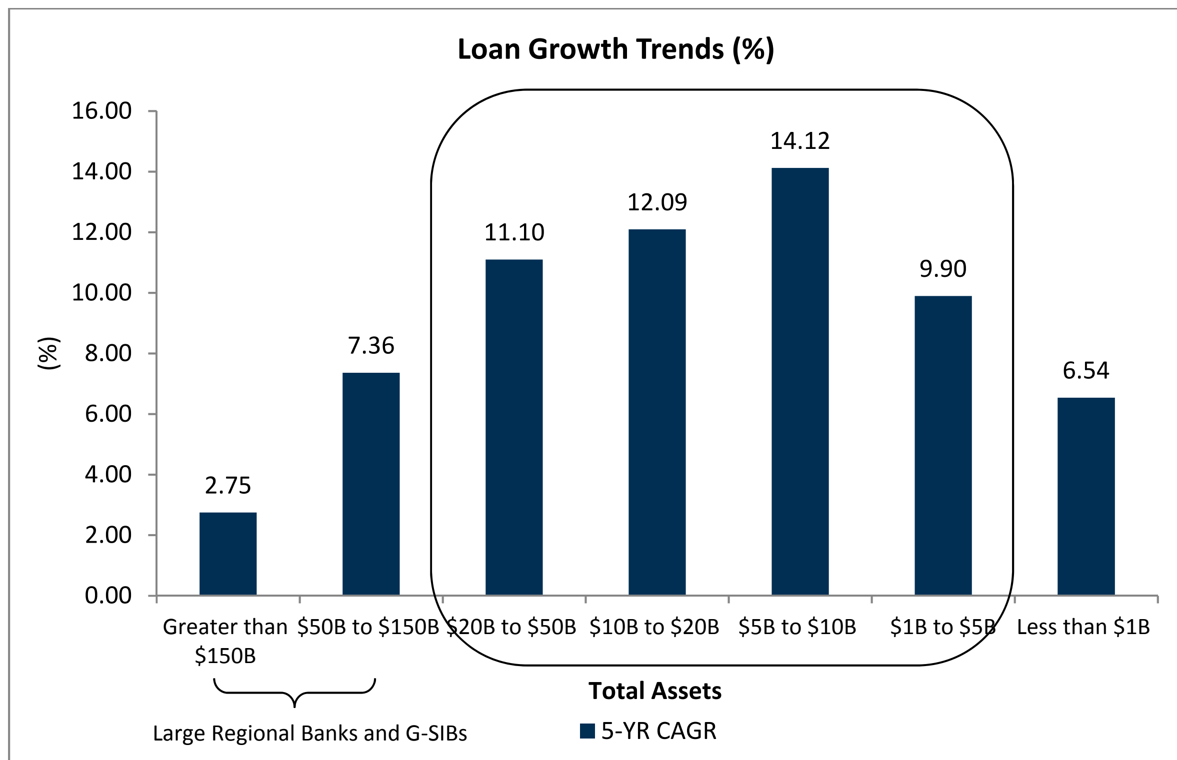

Data Source: FDIC and FJ Capital Research

- **Small banks take market share from big banks.**
  Big banks control a much higher deposit market share today versus 30 years ago, primarily due to consolidation driving an ongoing decline in the number of banks. As shown in the chart below, the 30 largest U.S. banks have a deposit market of approximately 70% today, up 250% from only 28% in 1990. We expect the top 30 banks to increase their share to 80% over the next 10 years as the consolidation trend continues. We also expect to see new, emerging regional banks with $10-$50 billion in assets and a three to four state geographical reach. These banks will be able to service larger customers and compete more nimbly in their geographic focus. As consolidation drives more market share into the hands of the largest banks, this also creates opportunities for the remaining small banks to add smaller customers. These banks are often able to devote much more time and provide greater service to customers that are too small to justify the same effort by larger banks.




Data Source: SNL Financial and FJ Capital Research

Regarding loan growth, small banks have posted a much faster growth rate over the past five years than large regional banks and Global Systemically Important Banks (G-SIBs), as shown in the chart below. Many community banks continue to take market share from larger banks by closing loans faster, structuring loans in more customized ways that fit unique borrower profiles and being very responsive to the customer. Additionally, some key managers, who have operated in a local market for decades, are able to use their reputations and professional networks to attract strong producers who bring with them attractive and profitable books of business.



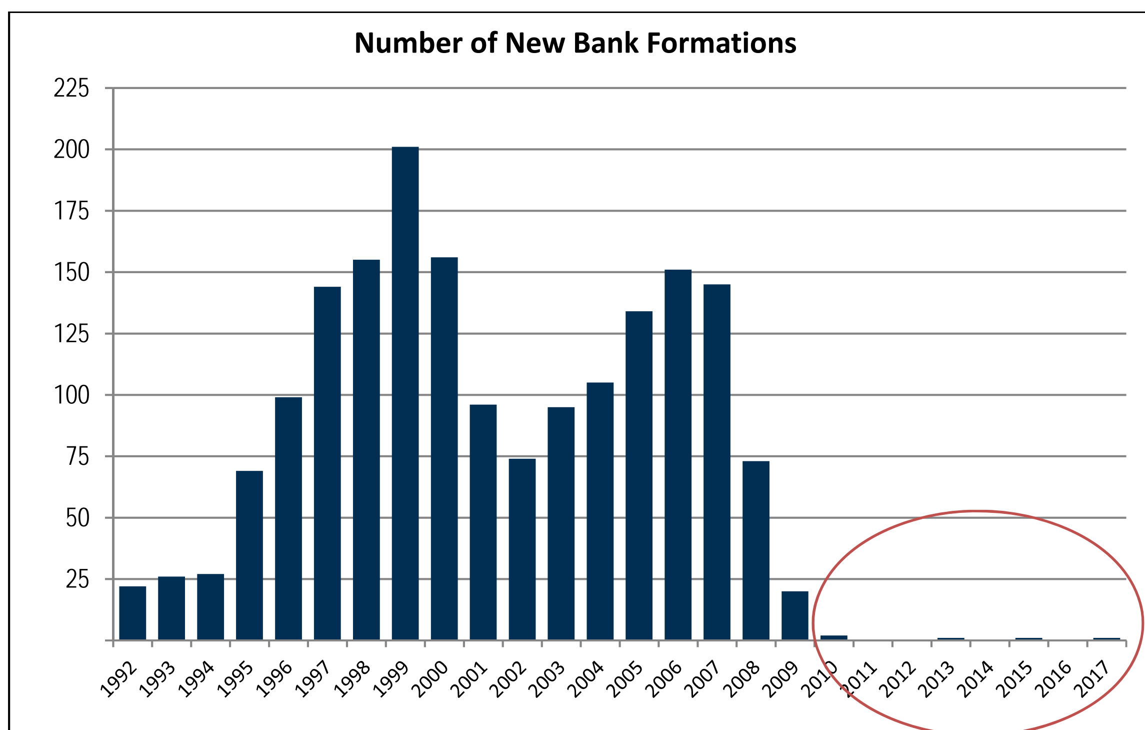

Data Source: SNL Financial and FJ Capital Research

- **New bank formation is difficult**

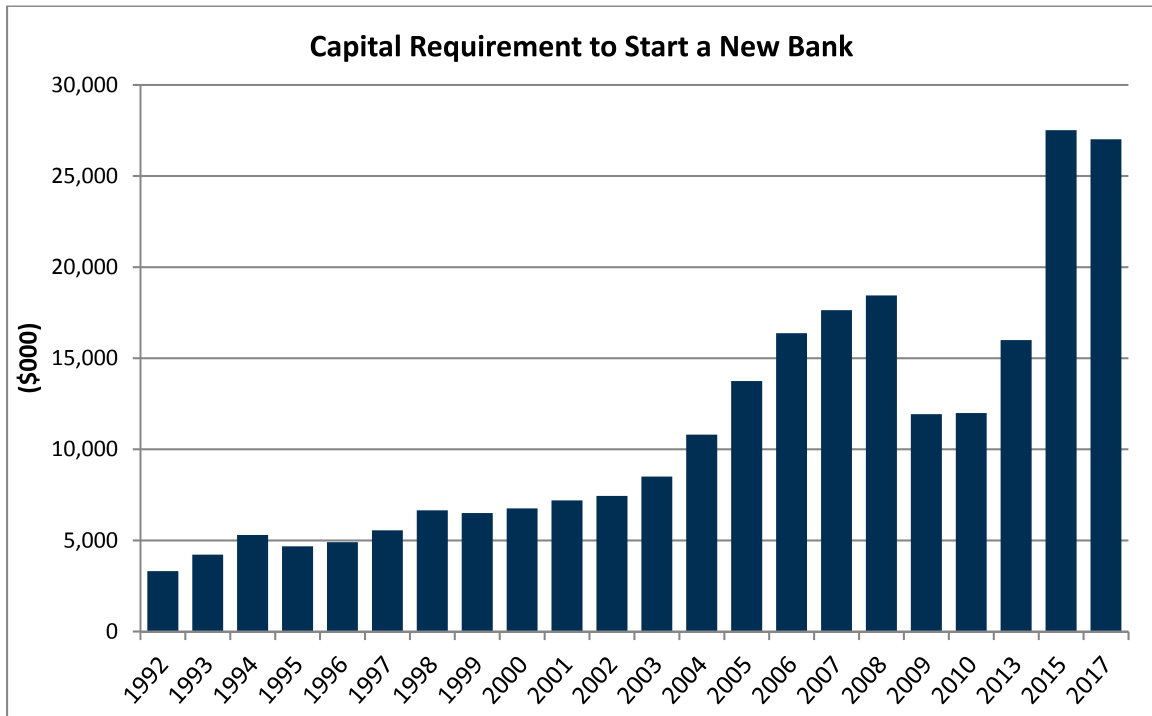
  Historically, it was much easier to start a "de novo" bank (new bank), but since the financial crisis, this process has become increasingly difficult. There were 1,792 new banks created from 1992 to 2009, but only 5 since 2010.

  Higher capital requirements and greater regulatory scrutiny are two key reasons for this dynamic. It takes at least $25 million to start a new bank today, versus only $2 million in the early 1990s. It will take at least 3 to 5 years for a de novo bank to be profitable in today's regulatory and economic environment.

  While we have observed a recent a pick-up in de novo activity, the pace over the last seven years has been very slow. Unless there is a significant reduction in de novo capital requirements or significant regulatory changes, we believe very few new banks will be created over the next 10 to 15 years, indicating that the total number of U.S. banks will continue to decrease as the consolidation trend continues.




Data Source: SNL Financial




Data Source: SNL Financial. Capital requirement is measured by the average equity as of first filing period of De Novo banks in each year

- **Large regional banks are back in the M&A game**

  Large regional banks (banks with total assets larger than $50 billion) were very active in whole bank M&A before the financial crisis, especially during the mid-1990s, but were less active after the crisis. Over past 3 years, larger regional banks have begun to re-engage in consolidation, primarily on the buy-side.

**M&A transactions with a large regional bank as a buyer over past 3 years**

| Announcement Date | Buyer Name/Seller Name | Buyer Ticker | Seller Ticker | Buyer Total Assets ($M) | Seller Total Assets ($M) | Deal Value ($M) | Takeout P/TBV (%) | 1-Day Premium (%) |
|---|---|---|---|---|---|---|---|---|
| 6/29/2016 | Canadian Imperial Bank of Commerce/ PrivateBancorp, Inc. | CM | PVTB | 513,294 | 20,054 | 4,918 | 264.5 | 5.0 |
| 1/26/2016 | Huntington Bancshares Incorporated/ FirstMerit Corporation | HBAN | FMER | 71,045 | 25,525 | 3,371 | 163.8 | 31.0 |
| 10/30/2015 | KeyCorp/ First Niagara Financial Group, Inc. | KEY | FNFG | 95,422 | 39,413 | 4,007 | 168.4 | 9.8 |
| 10/29/2015 (Terminated on 1/1/2017) | New York Community Bancorp, Inc./ Astoria Financial Corporation | NYCB | AF | 49,045 | 15,099 | 1,994 | 148.7 | 9.8 |
| 8/17/2015 | BB&T Corporation/ National Penn Bancshares, Inc. | BBT | NPBC | 191,017 | 9,604 | 1,816 | 219.4 | 18.2 |
| 1/22/2015 | Royal Bank of Canada/ City National Corporation | RY | CYN | 940,550 | 35,576 | 5,373 | 239.3 | 26.0 |
| 11/12/2014 | BB&T Corporation/ Susquehanna Bancshares, Inc. | BBT | SUSQ | 187,022 | 18,583 | 2,507 | 171.6 | 38.9 |
| 9/8/2014 | BB&T Corporation/ Bank of Kentucky Financial Corporation | BBT | BKYF | 188,012 | 1,858 | 379 | 215.9 | 30.9 |

Data Source: SNL Financial

There have been discussions about the potential to raise the asset threshold for **Systemically Important Financial Institutions (SIFIs)**. Financial institutions with $50 billion of assets or more currently are considered SIFIs and are subject to much more intensive supervisions by regulators. Some large regional banks with assets close to $50 billion have not been active in whole bank M&A to avoid becoming a SIFI. The potential increase of the SIFI asset threshold could ease these concerns, allowing these banks to be more acquisitive. Given that large regional banks usually can pay high prices for smaller targets, unleashing this capacity could reignite more M&A and boost community bank valuations.

**Banks near $50 billion in assets that could benefit from the increase of the SIFI asset threshold**

| Institution Name | Ticker | HQ State | Total Assets ($M) |
|---|---|---|---|
| SVB Financial Group | SIVB | CA | 48,400 |
| New York Community Bancorp, Inc. | NYCB | NY | 48,348 |
| People's United Financial, Inc. | PBCT | CT | 43,023 |
| Signature Bank | SBNY | NY | 40,719 |
| First Horizon National Corporation | FHN | TN | 39,468[1] |
| First Citizens BancShares, Inc. | FCNCA | NC | 34,770 |
| Associated Banc-Corp | ASB | WI | 32,437[1] |
| BOK Financial Corporation | BOKF | OK | 32,264 |
| Synovus Financial Corp. | SNV | GA | 30,688 |
| Cullen/Frost Bankers, Inc. | CFR | TX | 30,206 |

1. PF with pending acquisitions

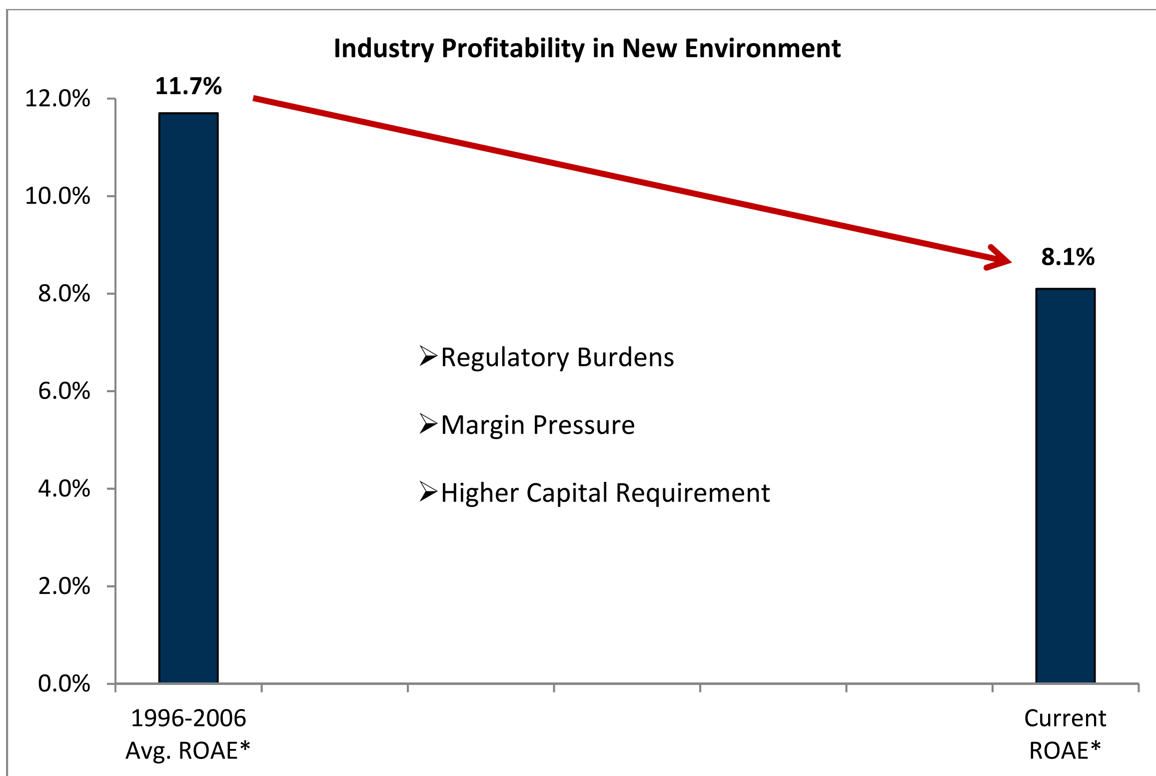
Data Source: SNL Financial and FJ Capital Research

- **Deposits will be more valuable in a rising interest rate environment**
  As the *Fed* progresses further into the tightening phase of the interest rate cycle, banks will find it more difficult to fund loan growth by raising new low-cost deposits. As such, banks with low-cost core deposits will become more valuable over the next few years as banks wrestle with increased funding costs. We strongly believe bank buyers will begin to pay more for core deposits in a rising rate environment, and that this also will lead to higher transaction volumes.

## Why Banks Want/Need to Merge – 2017 in Review

In our previous white paper, we summarized the key factors that drove banking consolidation over the last decade. Generally, the drivers that existed in the early 1990s still exist today. There are, however, new, important drivers of the financial crisis that were not present in the early 1990s. Below, we summarize the major factors that have driven the boom in bank consolidation since the last crisis.

- **Profitability Challenges -** As shown in the chart below, community banks generally have suffered from a significant decline in profitability following the last financial crisis, primarily due to substantially greater regulatory costs, margin pressure from the low interest rate environment and higher capital requirements. Many such small community banks have been so challenged that they have been unable to earn their cost of capital and therefore have chosen to partner with bigger banks.

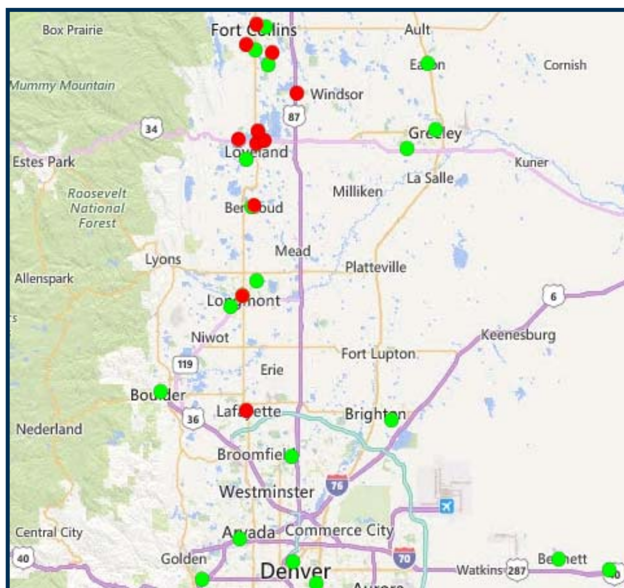



Data Source: SNL Financial. *Average ROAE of Micro & Small Cap Banks & Thrifts

The initiatives from the *New Administration*, including deregulation, higher interest rates and corporate tax reform, could potentially have a positive impact on the earnings power of small community banks. We will address the impact of the *New Administration* on banking consolidation in the next section.

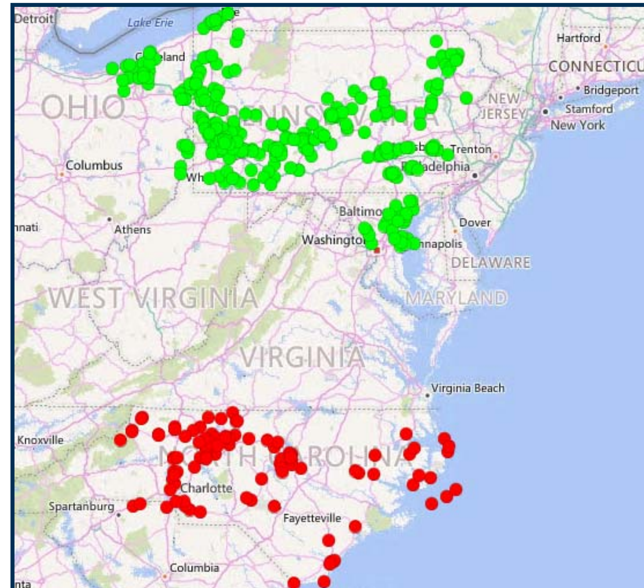
- **Cost Savings** – The typical merger generates cost synergies amounting to 25% to 40% of the target's operating costs, which creates significant earnings accretion for the combined entity. Sources of cost savings usually come from the closure/consolidation of overlapping branches (see examples below) and the elimination of large duplicative costs such as executive/director compensation, back office personal, IT systems and regulatory exam fees. A recent survey conducted by the *Federal Reserve System* and the *Conference of State Bank Supervisors* indicates that the 974 survey respondents incurred 2014 compliance costs of $4.5 billion, which amounted to 22% of their net income. Regulatory costs accounted for 11% of personnel expenses, 16% of data processing expenses, 20% of legal expenses, 38% of accounting and auditing expenses, and 48% of consulting expenses – all expenses that can be reduced significantly via merger.

**40% Cost Savings Example – Significant Branch Overlaps**




Seller Branch Buyer Branch

**25% Cost Savings Example – No Branch Overlaps**




Seller Branch Buyer Branch

- **Management/Board Fatigue** – Sophisticated management teams and bank boards understand that a bank must have a valid business plan in place, one that includes organic growth, acquisitive growth or both. Many leaders have found it difficult to execute their original business plans in the post-financial-crisis economic environment. In addition, the U.S. banking industry has an aging leadership group. The average age of a public bank CEO and Chairman is 59 and 66, respectively. Many of the management teams that survived the last crisis do not want to go through another economic cycle. They also face challenges in succession planning due to the lack of senior management talent in the community banking industry. Therefore, many banking leaders have no other choice than to sell out to a bigger bank.

- **Commercial Real Estate (CRE) Lending Concentration –** Over the past two years, CRE lending concentration levels became an area of focus for bank regulators (the *Office of the Comptroller of the Currency,* notably), primarily due to concerns over rising CRE prices and supply levels in major metro markets. Given that CRE loans are usually the major lending category for small community banks, many small banks with high CRE lending concentrations have fallen under heightened regulatory scrutiny and have been forced to slow their loan growth. Some banks have chosen to partner with bigger banks with lower CRE concentrations to continue their growth. We believe the CRE concentration issue will persist as a new driver for banking consolidation going forward.

- **Liquidity Needs** – Most smaller cap bank stocks tend to have relatively lower trading liquidity than their somewhat larger peers. The boards of such institutions take this liquidity into account as they deliberate over ways to increase shareholder value.

- **Regulatory Reform** – The *Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")* was enacted in 2010 and has become the most important piece of new legislation in the financial industry. This legislation has driven up bank operating costs to a great degree and reduced bank shareholder returns in recent years. Higher capital standards, a significant new burden, have made it much harder for banks to earn ROEs acceptable enough to justify bank independence. Since the 2016 *Presidential Elections*, the markets have become optimistic about the potential repeal or reform of parts of *Dodd-Frank*. Accordingly, the next section of this paper discusses the *New Administration's* potential impact on banking consolidation. Please see the appendix at the end of this white paper for a list of potential regulatory changes that could positively impact consolidation.

## Impact of Reduced Regulation on U.S. Banking Consolidation

Bank stocks initially outperformed the market as market participants developed an expectation that banks likely would be the largest beneficiaries of changes espoused by the *New Administration*, including deregulation, higher interest rates and corporate tax reform. How will the *New Administration* affect the banking consolidation trend? To answer this, we examine views from various industry participants.

*Keefe, Bruyette & Woods (KBW)*, a boutique investment bank in the financial services sector, recently surveyed 137 bank executives to better understand post-election trends and sentiments concerning the M&A market. In summary, most bank executives who participated in the survey indicated that accelerated consolidation activity is supported by higher bank stock valuations, cautious optimism as it relates to potential regulatory relief and deposit pressures as rates rise.

- **Higher stock valuations will fuel M&A activity.** Since the 2016 elections, small and mid-cap banks, the primary pool of buyers, have seen much greater stock appreciation relative to micro cap banks, the primary pool of sellers. This trend should permit buyers to pay higher takeout prices, yet keep the TBV dilution payback period within an acceptable range. Approximately one-third of executives in the survey noted the recent shift in sentiment and share prices raise the odds of an acquisition. Further contributing to a valuation inequality, is that many smaller, potential sellers, have not seen the same strong rally in their share price. This inequality makes smaller banks more inclined to partner with larger cap banks with higher valuation multiples.

- **Regulatory relief is not a threat to banking consolidation, but will boost M&A valuations and activity over time.** The post-election environment marks the first time in nearly a decade that investors believe there will be less, not more, financial regulations. Some have taken this view further, expressing concerns regulatory relief may also slow M&A activity, as the heavy regulatory burden has been a catalyst for consolidation. Specifically, the concern is that some sellers may see potential earnings power improvements from lower regulatory costs and decide to stay independent. While this concern seems valid enough, we do not view regulatory relief as a major threat to bank consolidation. Instead, we believe the relief will have the opposite effect, because buyer valuations should rise, allowing them to pay larger premiums to sellers

  We believe the pendulum likely will swing from an overabundance of regulation to a more moderate level of regulation, during the next few years. This will be accomplished, not by a wholesale change, but rather a surgical approach that ultimately will benefit the smaller community banks over their larger peers. A 2015 community banking survey conducted by the *Federal Reserve System* and the *Conference of State Bank Supervisors* indicated operating costs related to regulation amount to nearly a quarter of community banks' net

income, hence any regulation centered around increased tailoring would directly impact profitability for small banks. Large banks would benefit more from reduced capital requirements. While we are optimistic that regulatory changes will be beneficial, we still see the need for scale to spread the cost of existing regulations and thus, expect smaller banks to continue to look for larger partners that are better equipped to handle the regulatory environment.

Regulatory relief will increase sellers' price expectations as banks become more valuable with the reduced cost. For many banks, however, this higher profitability will probably not change their inclination to sell to a larger bank. The fact that many community bank executives own a significant amount of stock in their banks creates significant alignment between their personal economic interests and those of their shareholders. In fact, they are significant shareholders.

Additionally, even banks that want to remain independent face considerable challenges around succession planning, due to a dearth of emerging, younger executive talent. In recent decades, community banking has neither attracted nor developed younger talent to the degree it did in previous decades.

Based on a confluence of factors, we believe the bid/ask spread has narrowed for bank takeout valuations, which should serve to support an environment of greater consolidation, irrespective of the expected degree of regulatory change. Furthermore, we believe profitability enhancements from regulatory relief will not slow the consolidation trend, but rather, will boost takeout valuations above the already elevated levels driven by the post-election environment. Some sellers appear to share this view. In *KBW's* survey of the 30 banks that regard themselves as sellers, 50% expected to receive a higher price post-election, 37% said the election has not impacted their expectations, 13% said they are considering selling given the higher post-election pricing, while no banks said they are more likely to remain independent.

Furthermore, we believe regulatory relief could ease the approval process for M&A transactions, and that this will encourage more banks to participate in consolidation. Early signs of such potential regulatory relief emerged this year when the Federal Reserve approved the acquisition of *Suffolk Bancorp (SCNB)* by *People's United Financial (NASDAQ: PBCT)*. The *Fed* stated in its approval commentary that it will raise size thresholds used for the determination of which merger transactions are presumed to not raise material financial stability concerns absent other evidence. Previously, the threshold was "an acquisition of less than $2 billion in assets that results in a firm with less than $25 billion in total assets."

The new commentary, however, raises the threshold to "acquisition(s) of less than $10 billion in assets, or that result in a firm with less than $100 billion in total assets."

Another such regulatory development occurred in 2015, when the *Federal Reserve Board* classified more banks as eligible to employ more subordinated debt in acquisitions. Acquirers with $1 billion in assets are now eligible, up from the previous level of $500 million. In May 2017, a *Senate* bill was introduced to raise this threshold again to $5 billion. It is expected to benefit those banks that fall between $1 billion and $5 billion in assets and could spur more M&A.

Although we do not expect these changes to be a game changer for consolidation activity in the near term, they could mark a regulatory inflection point leading to greater support for bank consolidation. Some bank management teams seem to share this view. *KBW's* survey indicates 60% of the executives surveyed say they have not yet noticed any real changes in the regulatory approach toward M&A, although they expect it could happen over time.

- **Higher interest rates expected to pressure deposit costs and escalate M&A activity.** *KBW's* survey cites pressure on deposit costs as interest rates rise as the top reason bank executives believe consolidation will accelerate. This statistic drives home that deposits will become much more valuable as rates rise. In M&A transactions since the election, the two highest bank valuations multiples were paid for banks with the most top-notch, low-cost deposit franchises in the U.S.

## Recent M&A Quotes from Industry Participants

"It's a hard business now if you're not big enough," said *Edward Wehmer*, CEO of *Wintrust Financial Corp*, during the *RBC Financial Institutions Conference* panel in March 2017. "If you don't have scale on the expense side, you can't get the assets. Some of these banks just made it through the cycle by the skin of their teeth. They're starting to make a little money and they can get out now, so they want out."

"Our call is that you are going to see bigger banks doing mergers," *Thomas Michaud*, president and CEO of investment bank *Keefe Bruyette & Woods Inc*., said at *Bank Director's Acquire or be Acquired* conference in January 2017. *Michaud* said many buyers are better equipped this year than last to pursue deals, and better positioned to go after prized targets, because their stocks had risen since the elections.

"Those sellers may now just see the prices they've been holding out for," said *Jefferson Harralson*, former analyst at Keefe Bruyette & Woods Inc., in a November 2016 interview, after the elections. "When you get higher prices, of course, that often translates into more deals getting done," he noted.

Said Mike Daly, CEO of *Berkshire Hills Bancorp*, during a conference call about the company's acquisition of *Commerce Bancshares* in May 2017: "Well, the owner is 90 years old…I mean, this guy loves his customers, he loves his community. They've done a good job and want to be able to provide those customers with additional product and they want to grow. He is a very youthful 90 years old. He is a very energetic man. But you get to a certain age and you have to start thinking about the next step."

FJ CAPITAL MANAGEMENT

## Recent Transaction Highlights

### Deal Profile

- **Buyer:** PacWest Bancorp (PACW)
- **Seller:** CU Bancorp (CUNB)
- **Announcement:** 04/06/2017
- **Deal Value:** $705 million
- **Valuation:** 284% of TBV
- **1-Day Market Premium:** 0%

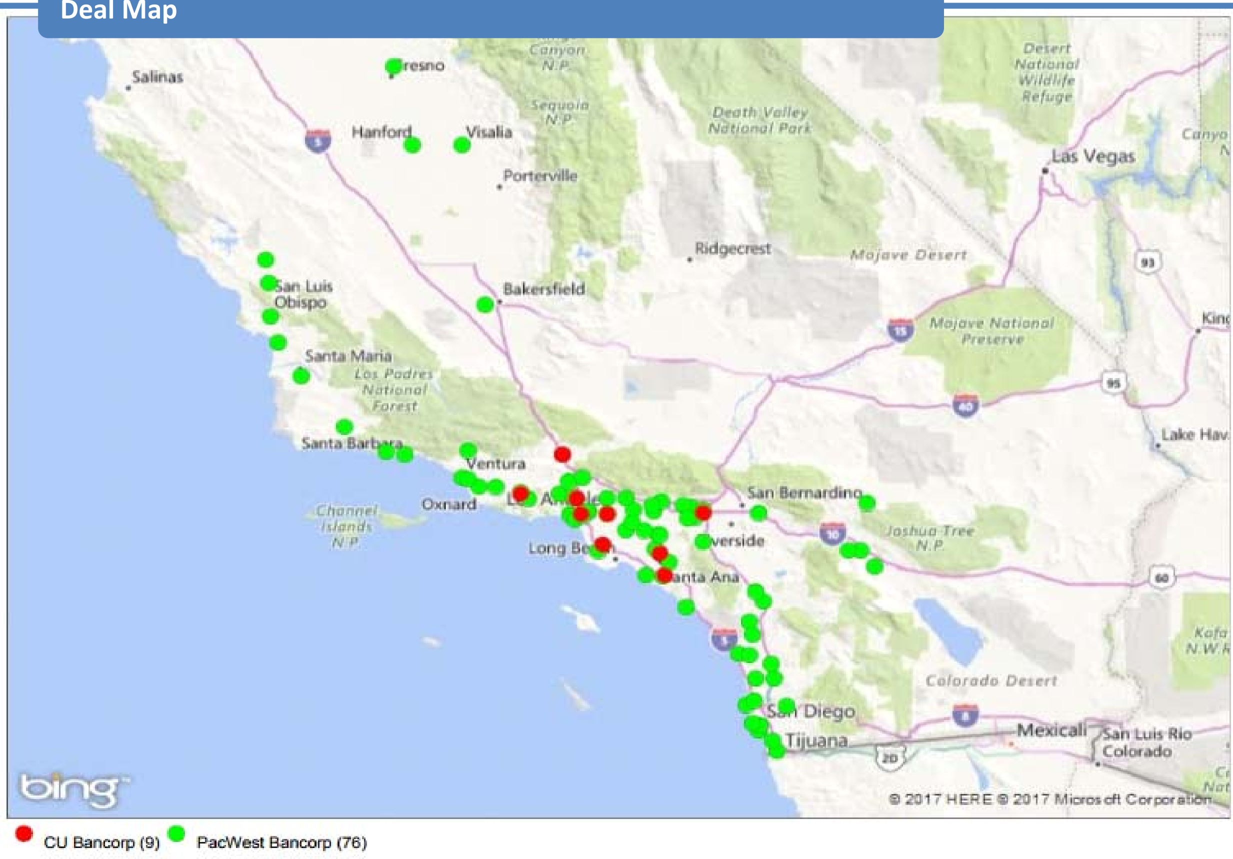
### Buyer Expectation

- **EPS Accretion**: Expected to be 6% accretive to 2018 projected EPS
- **TBV payback period:** 4.5 years

### Transaction Rationale

- An in-market acquisition for *PACW* to add density in Southern California markets. *CUNB* has one of the best deposit franchises in the US, with non-interest bearing deposits comprising 54% of total deposits, which cost a mere 0.10%. The transaction valuation is the 2nd highest since the 2016 election. Banks like *CUNB* with low-cost core deposit bases should become increasingly valuable in a rising rates environment.

### Deal Map



## Deal Profile

- **Buyer:** Pinnacle Financial Partners, Inc. (PNFP)
- **Seller:** BNC Bancorp (BNCN)
- **Announcement:** 01/22/2017
- **Deal Value:** $1.9 billion
- **Valuation:** 270% of TBV
- **1-Day Market Premium:** 2%

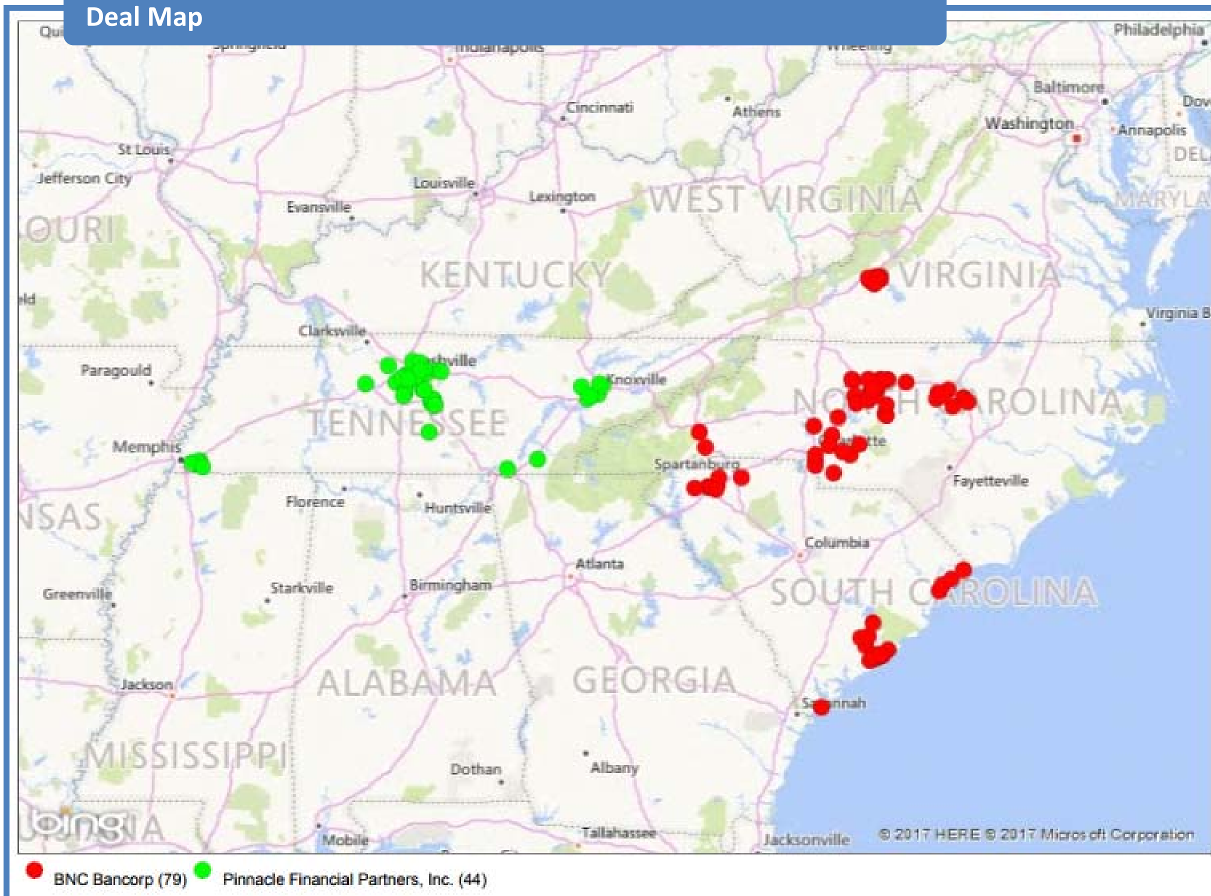
## Buyer Expectation

- **EPS Accretion**: Expected to be 10% accretive to 2018 projected EPS
- **TBV payback period:** The deal is expected to be immediately accretive to TBV

## Transaction Rationale

- Strategic out-of-market acquisition for *PNFP* to expand into 6 of 9 targeted Southeastern markets. The transaction combined two high-performing, commercially focused companies and created one of the most profitable banks in the country.

## Deal Map



## Deal Profile

- **Buyer:** Bryn Mawr Bank Corporation (BMTC)
- **Seller:** Royal Bancshares of Pennsylvania, Inc (RBPAA)
- **Announcement:** 01/31/2017
- **Deal Value:** $126 million
- **Valuation:** 165% of TBV
- **1-Day Market Premium:** 7%

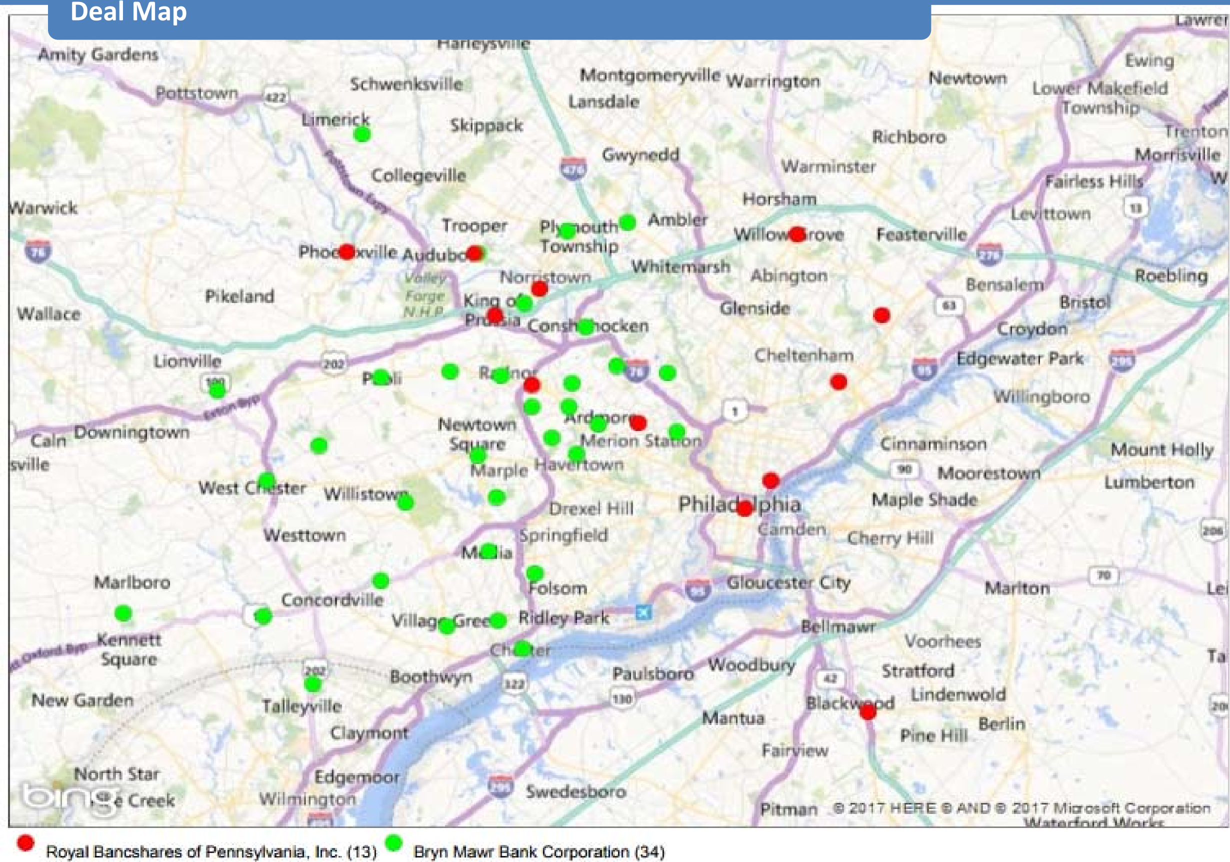
## Buyer Expectation

- **EPS Accretion**: Expected to be mid single-digit accretive to 2018 projected EPS.
- **TBV payback period:** The deal is expected to be immediately accretive to TBV

## Transaction Rationale

- An in-market acquisition for *BMTC* to enhance its market share in the Philladephia MSA with significant cost savings opportunities. The transaction strengthens *BMTC's* position as the largest community bank in Philadelphia's affluent western suburbs and, based on deposits, the 8th largest community bank headquartered in Pennsylvania. *BMTC* also gains entry to the fast growing New Jersey markets.

## Deal Map



FJ CAPITAL MANAGEMENT

## Deal Profile

- **Buyer:** Midland States Bancorp, Inc. (MSBI)
- **Seller:** Centrue Financial Corporation (CFCB)
- **Announcement:** 01/26/2017
- **Deal Value:** $175 million
- **Valuation:** 140% of TBV
- **1-Day Market Premium:** 16%

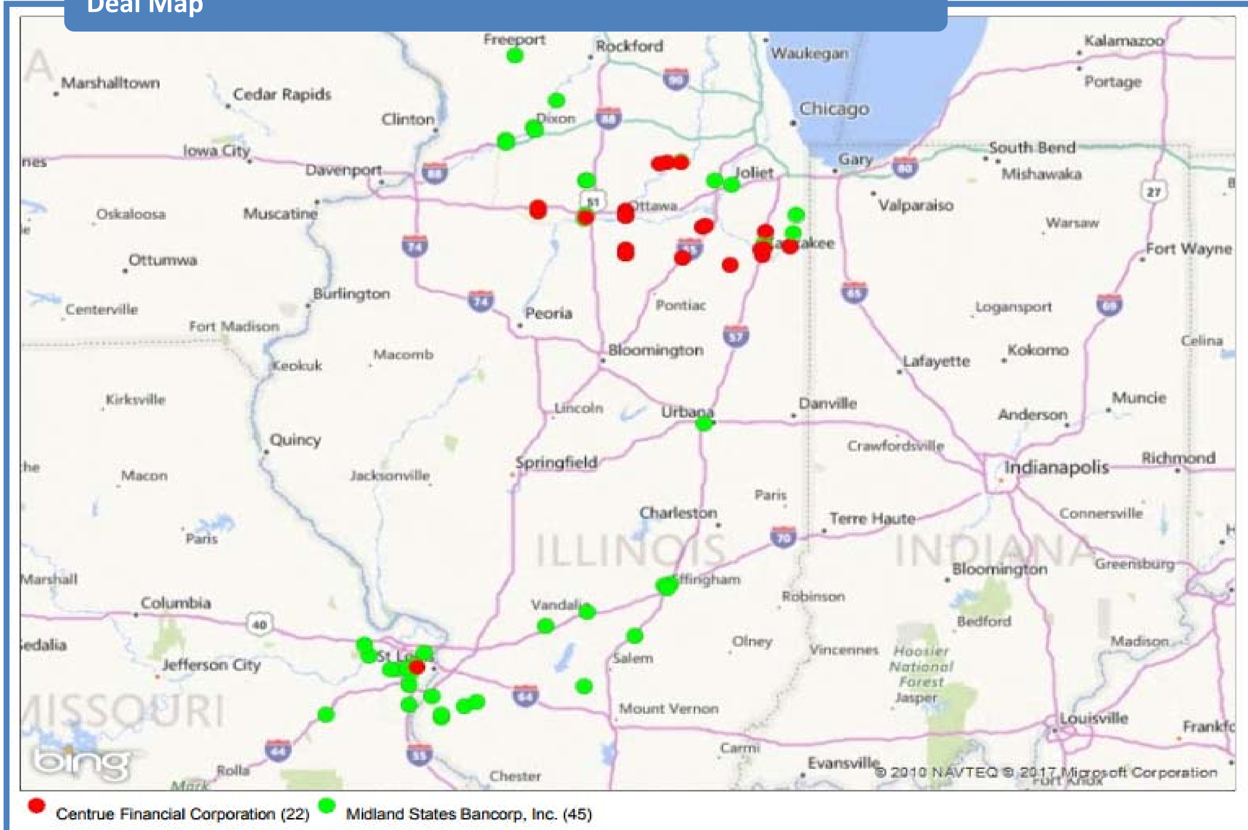
## Buyer Expectation

- **EPS Accretion**: Expected to be 8-9% accretive to 2018 projected EPS.
- **TBV payback period:** 2 years

## Transaction Rationale

- An in-market acquisition for *MSBI* to deploy some of the excess capital raised in its 2016 IPO. The transaction further strengthens *MSBI's* position in its north/central Illinois and St. Louis markets and the combined entity would rank #1 and #2 by deposit market share in the Kankakee and OttawaPeru, IL, MSAs, respectively. The transaction creates the 6th largest Illinois-based bank by total assets.

## Deal Map



FJ CAPITAL MANAGEMENT

## Deal Profile

- **Buyer:** Pacific Premier Bancorp (PPBI)
- **Seller:** Heritage Oaks Bancorp (HEOP)
- **Announcement:** 12/23/2016
- **Deal Value:** $407 million
- **Valuation:** 214% of TBV
- **1-Day Market Premium:** 8%

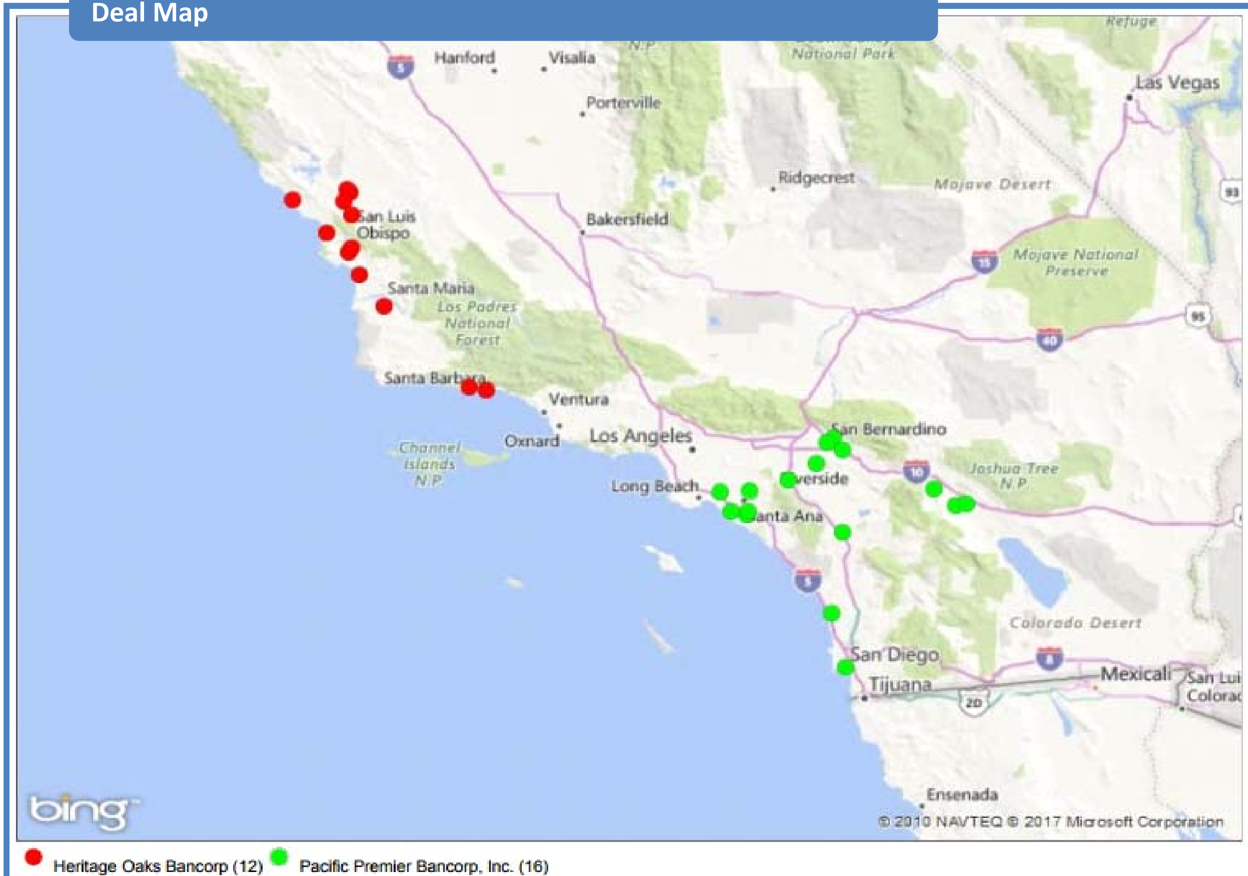
## Buyer Expectation

- **EPS Accretion**: Expected to be 5% accretive to 2018 projected EPS.
- **TBV payback period:** The deal is expected to be immediately accretive to TBV

## Transaction Rationale

- A strategic, out-of-market acquisition for *PPBI* to expand into the deposit-rich Central Coast markets in California. *HEOP's* high-quality core deposit franchise with 35% non-interest bearing depoists is additive to *PPBI's* funding base.

## Deal Map



FJ CAPITAL MANAGEMENT

## Deal Profile

- **Buyer:** First Interstate BancSystem, Inc (FIBK)
- **Seller:** Cascade Bancorp (CACB)
- **Announcement:** 11/17/2016
- **Deal Value:** $589 million
- **Valuation:** 215% of TBV
- **1-Day Market Premium:** 10%

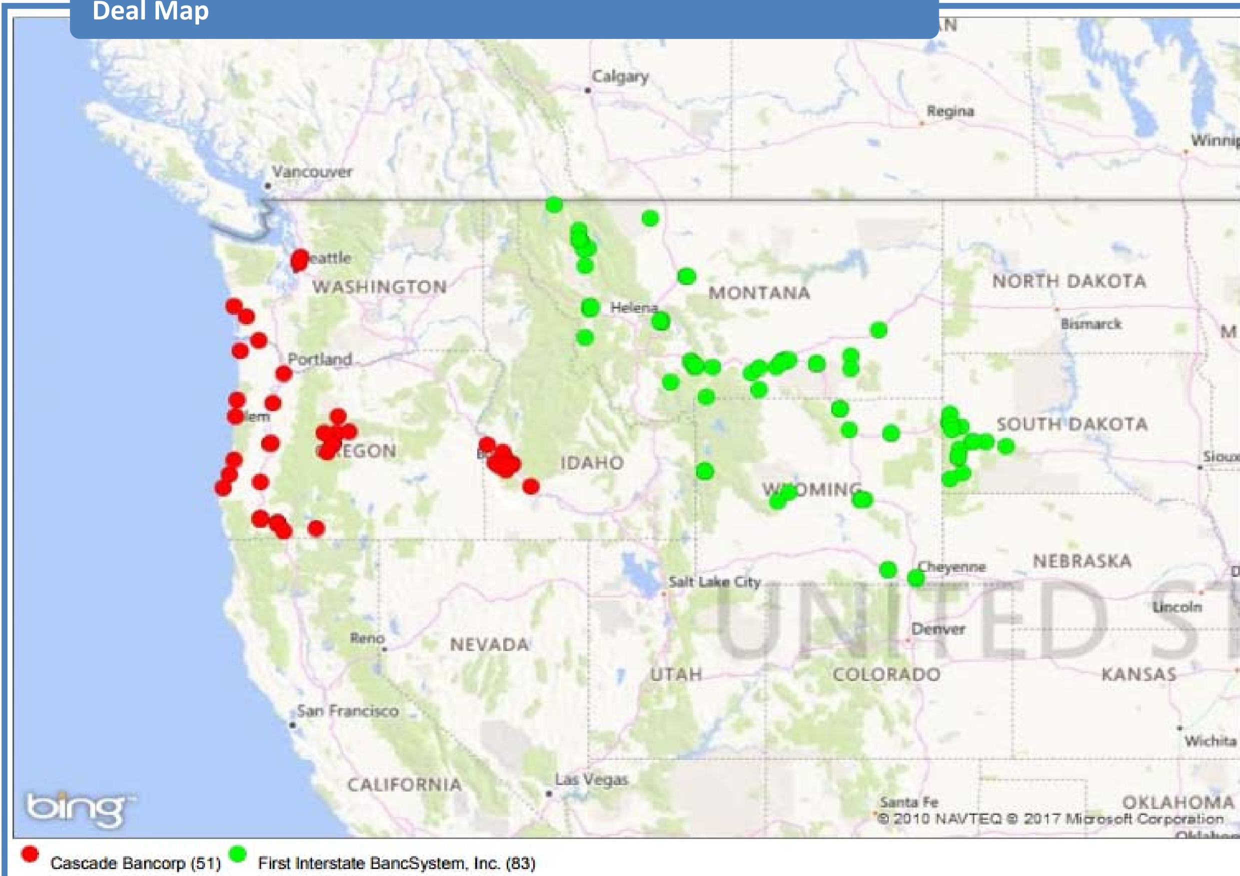
## Buyer Expectation

- **EPS Accretion**: Expected to be 8-10% accretive to 2018 projected EPS.
- **TBV payback period:** 5 years

## Transaction Rationale

- Strategic out-of-market acquisition for *FIBK* to expand into attractive, high-growth markets in Pacific Northwest. The transaction pushed *FIBK* well above the punative $10 billion asset regulatory threshold and allowed it to remain a high-performing bank and add greater potential earnings growth.

## Deal Map



FJ CAPITAL MANAGEMENT

# Appendix

## Appendix I Potential regulatory changes that could positively impact consolidation

| *Category* | Description of reform | Agency | Impact |
|---|---|---|---|
| *2-yr CCAR (Stress testing process)* | Change CCAR to two-year cycle with more frequent reviews to allow revisions to capital plans in case of extraordinary events | FRB | CCAR significantly adds to operational costs within banks above this threshold. Enhanced prudential standards inhibit incremental mergers, as banks try to stay below this key threshold. |
| *Community Development Financial Institutions and Minority Depository Institutions* | Additional flexibility in using subordinated debt or capital (i.e., capital borrowed by holding company and injected into bank). Such capital may include program-related investments (PRIs) received from foundations or impact investors. | FRB, FDIC, OCC | Report does not provide much details, but positive for banks <$10B that would have greater flexibility in raising capital. In 2015, subdebt comprised 30% of all capital raised by community banks -- up from 24% in 2014, and 7% in 2013. |
| *Community Reinvestment Act (CRA)* | Community Reinvestment Act (CRA) compliance - Treasury will assess how banks' CRA investments are measured; Improvement in regulatory review and rating assessment process (frequency of exams, ability of institutions to remediate ratings, and transparency of how overall CRA rating is determined. | FRB, FDIC, OCC | CRA is a major headwind in bank mergers. Improvements in CRA process could reduce regualtory risk for M&A. |
| *Consumer Financial Protection Bureau (CFPB)* | **Adopting procedural reforms to curb excesses and abuses in investigations and enforcement actions:** Bring enforcement actions in federal district court rather than in administrative proceedings; Eliminating duplicative supervisory authority – should be left to FRB and OCC; Ensure regulated entities have adequate notice of CFPB interpretations of law before subjecting them to enforcement actions. Rules before enforcement; Bring CFPB under Congressional oversight and appropriations; Structural reform to make CFPB more accountable to President, Congress—make removal of director "at-will" by President; Raise CFPB regulatory threhold from $10B to $50B (direct examination and reporting requirments) ; Change structure of CFPB to 5-member commission | CFPB | Reduce regulatory risk from enforcement actions that come with headline risk and poses significant headwinds for M&A. |
| *Countercyclical capital rules (Basel III)* | Countercyclical capital requirements should be implemented through existing CCAR and DFAST stress testing processes rather than through countercyclical capital buffer. | FRB, FDIC, OCC | Reduce regulatory capital requirements for the largest banks in the universe. Could lead to higher payouts and in turn higher equity valuations in this space that could drive more super regionals to consolidate pushing more banks beyond the $250B + threshold. |
| *DFAST Threshold* | Raise $10B threshold in DFA to $50B | FRB, FDIC, OCC | Reduce regulatory risk for banks greater than $10B. This could push more banks over this threshold through M&A. |
| *Eliminate mid-year DFAST cycle (Stress testing process)* | Eliminate mid-year DFAST cycle and number of supervisory scenarios from three to two (baseline and severely adverse) | FRB | Reduce regulatory burden for banks with assets $10B+. This could push more banks over this threshold through M&A. |
| *Improving the Regulatory Engagement Model* | Reassess volume and nature of written agreements -- MRAs, MRIAs, and Consent Orders to evaluate impact, consistency, and overlap and to establish consistent interagency standards; Cost-benefit analysis -- Recommends financial regulatory agencies to perform and make public cost-benefit analysis; | FRB, FDIC, OCC | Reduce regulatory risk from enforcement actions that come with headline risk and poses significant headwinds for M&A. |

FJ CAPITAL MANAGEMENT

## Appendix I Potential regulatory changes that could positively impact consolidation

| *Category* | Description of reform | Agency | Impact |
|---|---|---|---|
| *Leveraged Lending* | 2013 leveraged lending guidance should be re-issued for public comment. Guidance should be refined with objective of **reducing ambiguity in definition of leveraged lending** and **achieving consistency in supervision, examination and enforcement.** | FRB, FDIC, OCC | Reduce compliance burden and regulatory risk for banks active in leveraged lending. Regulatory risk could positively impact bank valuations. |
| *Reduce excess burden in CCAR process* | **Assumptions in CCAR process should be reassessed** to better align with firms' unique risk profiles. Results in firms holding excess capital. | FRB | Would reduce stress capital required for CCAR banks. |
| *Residential Mortgage Lending(QM)* | **Adjust and clarify the ATR/QM and eliminate** " QM patch" for GSE-eligible loans; | CFPB | Subject all market participants to the same set of requirements, and provide greater flexibility to QM parameters. |
| *Residential Mortgage Lending(QM)* | **Align regulatory capital framework for structured mortgage products –** align framework with risk of the asset to increase economic attractiveness of PLS. Mitigate harsh treatment of PLS in DFAST and CCAR stress-testing; | CFPB | Benefit banks subject to CCAR. Could provide some competition for community banks that benefited from large bank capital-related pull-back. |
| *Residential Mortgage Lending(QM)* | **CFPB should clarify assignee** liability for secondary market investors related to errors in the origination process where such errors are not apparent on the face of disclosure statement and are not asserted as a defense to foreclosure; | CFPB | Reduce uncertainty and improve functioning of secondary market providing greater liquidity for mortgage banking. |
| *Residential Mortgage Lending(QM)* | **CFPB should place moratorium on additional rulemaking in mortgage servicing** while industry updates its operations to comply with existing rules and transitions from HAMP to alternative loss mitigation options; | CFPB | Reduce regulatory risk by providing covered institutions with time to fully ensure compliance. Positively impact valuations. |
| *Residential Mortgage Lending(QM)* | **Clarify and modify TRID –** allow more streamlined waiver for mandatory waiting period. Allow creditors to cure errors in a loan file within a reasonable period after closing | CFPB | Reduce regulatory risk and operational costs for mortgage lenders. Positively impact valuations. |
| *Residential Mortgage Lending(QM)* | **Flexibility with QM classification –** allow for compensating factors in event loan fails one of criteria | CFPB | Expanded classification of QM allows for increased lending activity positively impacting profitability. |
| *Residential Mortgage Lending(QM)* | **Improve Flexibility and accountability of loan originator compensation rule** - leniency where error is found post-closing – CFPB should establish clear ex ante standards through notice and comment rulemaking, which will clarify its enforcement priorities with respect to the Loan Originator Compensation rule; | CFPB | Reduce regulatory risk and operational costs for mortgage lenders. Positively impact valuations. |
| *Residential Mortgage Lending(QM)* | **Increase max asset threshold for making small creditor QM loans –** from $2B to $5B to $10B to accommodate loans made and retained by small creditors. | CFPB | Expanded classification of QM allows for increased lending activity positively impacting profitability. |
| *Residential Mortgage Lending(QM)* | **Modify Appendix Q –**review of requirements determining borrower debt and income levels to mitigate overly prescriptive and rigid requirements. Esp for self-employed and non-traditional borrowers (retirees, seasonal workers, small business owners). This is the type of Non-QM Flagstar is interested in expanding into. | CFPB | Expanded classification of QM allows for increased lending activity positively impacting profitability. |
| *SIFI Threshold (under Section 165 of DFA)* | Raise $50B threshold in DFA | FRB, FDIC, OCC | Reduce regulatory risk for banks greater than $50B. This could push more banks over this threshold through M&A. |

FJ CAPITAL MANAGEMENT

## Appendix I Potential regulatory changes that could positively impact consolidation

| *Category* | Description of reform | Agency | Impact |
|---|---|---|---|
| *Leveraged Lending* | 2013 leveraged lending guidance should be re-issued for public comment. Guidance should be refined with objective of **reducing ambiguity in definition of leveraged lending** and **achieving consistency in supervision, examination and enforcement.** | FRB, FDIC, OCC | Reduce compliance burden and regulatory risk for banks active in leveraged lending. Regulatory risk could positively impact bank valuations. |
| *Reduce excess burden in CCAR process* | **Assumptions in CCAR process should be reassessed** to better align with firms' unique risk profiles. Results in firms holding excess capital. | FRB | Would reduce stress capital required for CCAR banks. |
| *Simplify and tailor overall capital regime for banks with assets less than $10B.* | Exempt community banks from Basel III RBC rules: Collins Amendment (Sect 171 of DFA) should be amended if required to tailor capital rules for community banks. | FRB, FDIC, OCC | Reduce capital and regulatory reporting burden. |
| *Simplify and tailor overall capital regime for banks with assets less than $10B.* | Allow revising capital treatment of various asset classes including **mortgage servicing assets** and certain types of commercial real estate; simplify and clarify definition of **HVCRE loans** to avoid application of higher risk-weights for loans where it would be unnecessary; | FRB, FDIC, OCC | Benefit banks with **exposure to MSRs;** concern for non-banks (private equity, mreits) that have benefited from marketshare in CRE lending activity gained from banks deleveraging. Otherwise, banks have competitive pricing relative to nonbanks given funding structure. |
| *Simplify and tailor overall capital regime for banks with assets less than $10B.* | Raise threshold on Fed's "Small Bank Holding Company Policy Statement" from $1B to $2B. This would allow small banks to operate with higher levels of acquisition debt. | FRB | Support small bank M&A as it allows banks with assets less than $2B to operate with higher levels of acquisition debt. |
| *Simplify capital framework (for all organizations)* | (1) Soften treatment of **HVCRE;** (2) simplify reg treatment of **mortgage servicing assets** and DTA timing differences; (3) **changes to treatment of minority interest in capital.** | FRB, FDIC, OCC | Reduced capital requirement for banks with **exposure to MSRs and HVCRE assets. Reduce regulatory risk from and positively impact bank valuations.** |
| *Small Business Lending* | CRE lending. Regulators should consider alternatives to assessing concentration risk to allow banks engaged in CRE lending to maximize access to credit for small businesses and optimize balance sheet usage; | FRB, FDIC, OCC | Foster increased CRE lending activity while reducing a key regulatory risk for community banks. This provides for favorable valuations. |
| *Tailoring(DFA)* | Community bank relief from the **Qualified Mortgage and HMDA** rules | CFPB | Issuance of non-QM could increase for banks with assets less than $10B. Reduction in regualtory risk. On net, positively impact valuations. |
| *Volcker rule* | **Simplify prop trading definition – "**purpose test" is subjective and most complex among the three tests. Regulations create a rebuttable presumption that positions held for fewer than 60 days constitutes prop trading. Leads to excessive conservatism in firms' trading activities; | FRB | Reduce compliance burden especially for community banks that are also required to perform the complex tests to comply. |
| *Volcker rule* | **Eliminate regulations' rebuttable presumption for 60 day trade,** and assess whether purpose test needs to be eliminated as well; | FRB | Reduce compliance costs especially for community banks. Positively impact valuations. |
| *Volcker rule(compliance threshold)* | **Banks with $10B or less in assets should be exempt** – currently exempt from rule's compliance program requirements, but still required to expend considerable resources to ensure activities do not constitute prohibited prop trading—i.e., had to verify hedging activities for interest rate and other business risks are permitted under Volcker. | FRB | Reduce regulatory risk for banks greater than $10B. This could push more banks over this threshold through M&A. |

FJ CAPITAL MANAGEMENT

# Appendix II Deregulatory Appointments

| Agency | Position | Incumbent | Term | Announcement | Status | Nominee/candidate | Affiliation | Stance on regulationary relief |
|---|---|---|---|---|---|---|---|---|
| **Fed** | **Vice Chair of supervision** | Vacant | Expired | 7-Sep-17 | Confirmed by Senate Banking Committee; pending Senate confirmation in Oct. | **Randall Quarles** | Cynosure Group | Pragmatic approach to reg reform. Not expected to favor complete overhaul. Expected to focus on Volcker rule and other areas for tailoring bank regulation. |
| **Fed** | **Governor** | Vacant | Expired | 2-Jun-17 | Pre-nomination | **Marvin Goodfriend** | Carnegie Mellon U | Proponent of reining in power of Fed. |
| **Fed** | **Governor (Community bank)** | Vacant | Expired | 5-Jun-17 | Pre-nomination | **Robert Jones** | ONB | |
| **Fed** | **Chair** | Yellen | Feb-18 | 12-Jul-17 | Pre-nomination | **Glenn Hubbard/John Taylor** | | **Yellen may continue after term.** **John Taylor** (a Stanford economist) **Glenn Hubbard**, Columbia Business School dean. PhD from Harvard, co-chair if Committee on Capital Markets Regulation; boards of ADP, BlackRock Closed-end Funds, MetLife. |
| **Fed** | **Vice Chair** | Stanley Fischer | Jun-18 | 6-Sep-17 | Resigned | | | |
| **Fed** | **NY Fed** | Dudley | Mar-21 | | | | | |
| **Fed** | **Governor** | Lael Brainard | Jan-26 | | | | | |
| **Fed** | **Governor** | Jerome Powell | Jan-28 | | | | | |
| **CFTC** | **Chair** | Timothy Massad | Resigned | 3-Aug-17 | Confirmed | **Chris Giancarlo** | | Nonideological dealmaker who would focus on upgrading his agency's capabilities to regulate and monitor increasingly complex markets. |
| **CFTC** | **Commissioner** | Sharon Bowen (D) | Pending resignation | 22-Jun-17 | | | | Sole Dem candidate expressed frustration with CFTC and is expected to step down in the next few months if not sooner. |
| **CFTC** | **Commissioner** | Vacant | | 3-Aug-17 | Confirmed | **Brian Quintenz (R.)** | Fmr. invest prof | Mr. Quintenz founded and ran Saeculum Capital Management before winding it down last year; lengthy stint as a House aide to former Rep. Deborah Pryce (R., Ohio) |
| **CFTC** | **Commissioner** | Vacant | | 2-Aug-17 | Pending Senate Committee hearing | **Dawn DeBerry Stump** | Stump Strategic | President of Stump Strategic, a consulting firm, and is a former vice president at NYSE Euronext. |
| **CFTC** | **Commissioner** | Vacant | | | | | | |
| **SEC** | **Chair** | White | Resigned | 2-May-17 | Confirmed | **Jay Clayton** | | Likely more focus given to capital formation and less enforcement |
| **SEC** | **Commissioner** | Michael Piwowar (R.) | 2018 | | | | | |
| **SEC** | **Commissioner** | Kara Stein (D.) | Expired (June 5, 2017) | | | | | Stein can serve another 18 months or till she is replaced. |
| **SEC** | **Commissioner** | Vacant | | 1-Sep-17 | Nominated | **Robert Jackson (D.)** | Columbia Univ | **Robert Jackson:** Professor of Law at Columbia Law School and Director of the CLS program on Corporate Law and Policy. |

FJ CAPITAL MANAGEMENT

## Appendix II Deregulatory Appointments

| Agency | Position | Incumbent | Term | Announcement | Status | Nominee/candidate | Affiliation | Stance on regulationary relief |
|---|---|---|---|---|---|---|---|---|
| **SEC** | **Commissioner** | Vacant | | 24-Jul-17 | Nominated | **Hester Peirce (R.)** | Fmr SEC counsel | Former U.S. SEC counsel and Senate aide; a research fellow at the Mercatus Center at George Mason University who has been sharply critical of the regulatory expansion enacted in response to the 2008 financial crisis |
| **FHA** | **Commissioner** | na | Expired | 2-Mar-17 | Confirmed | **Ben Carson** | | Proponent of less government and pro market. Could influence zoning reforms at state level. |
| **OCC** | **Director** | Tom Curry | Expired | 27-Jul-17 | Senate Banking Committee hearing | **Joseph Otting** | OneWest (former) | Likely to work hand in hand with Treasury secretary Mnuchin on financial reg reform. |
| **FDIC** | **Director** | Mark Gruenberg | Nov-17 | 28-Jul-17 | Pre-nomination | **Jelena McWilliams** | Fifth Third Bancorp | McWilliams is top candidate to replace Gruenberg. Currently FITB's Chief Legal Officer, and former chief counsel for Republicans on the Senate Banking Committee, and has also worked as an attorney for the Division of Consumer and Community Affairs at the FRB. |
| **CFPB** | **Director** | Cordray | Jul-18 | | | | | |
| **FHFA** | **Director** | Melvin Watt | Jan-19 | | | | | |
| **DOL** | **Secretary** | Thomas Perez | Expired | 27-Apr-17 | Confirmed | **Alexander Acosta** | | Backs administration's initiative to review and scale back regulations. |

FJ CAPITAL MANAGEMENT

## About FJ Capital Management, LLC

*FJ Capital Management, LLC* is a fundamentally driven, *SEC*-Registered Investment Advisor firm founded in 2007 that analyzes and invests in public and privately traded U.S. community and regional banks through private investment vehicles. The firm utilizes proprietary fundamental research to uncover value disparities in the small- and mid-cap bank sector and seeks to take advantage of these disparities by building core positions with longer term holding periods. The firm also seeks to generate attractive, risk-adjusted investment returns by uncovering opportunities with identifiable, near-term catalysts. For more on *FJ Capital* or to further explore opportunities in the bank sector, please visit www.fjcapital.com or contact:

Andrew Jose
O: 703.875.8378
M: 703.408.0394
ajose@fjcapital.com
www.fjcapital.com

FJ Capital Management, LLC
1313 Dolley Madison Blvd.,
Suite 306
McLean, VA 22101

**Important Disclosures:**

This White Paper is provided for informational purposes only, does not constitute investment advice and should not be relied upon as such. It is neither an advertisement for investment advisory services nor an offer to sell or solicitation of an offer to buy securities.

The information presented in this White Paper has been developed internally and/or obtained from resources believed to be reliable; however, *FJ Capital Management, LLC* does not guarantee the accuracy, adequacy or completeness of such information. References to securities or asset classes do not constitute recommendations to purchase or sell any specific securities or asset classes. *FJ Capital* may have investments in securities or asset classes mentioned in this White Paper.