THE FUTURE OF BANK CONSOLIDATION

The Capital Corporation
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BANK VALUATION CONSIDERATIONS

In our most recent newsletter, ***The Future of Bank Consolidation - What it means for the Midwest Market***, we discussed the number of individual bank charters in the Midwest compared to the charter number of other states. That newsletter generated a lot of feedback and discussion so we thought that we would expand further on how we see it impacting valuation.

As stated in our last newsletter because the Midwest accounts for approximately half of the charters in the United States, we believe about half of all of the consolidation will occur in the Midwest states. This consolidation will have a noticeable impact on community banking in our region.

We also believe consolidation has, and will continue to have, a direct impact on bank values. We believe this has the potential of leaving some banks with limited value while leaving a few others with an increased valuation because of size, scale and scarcity.

Directly or indirectly we are involved in bank valuations on a daily basis. We do an increasing amount of formal valuation work for boards, shareholder agreements, ESOPs and estate planning. Additionally, all merger and acquisition work involves bank valuation for both buyers and sellers.

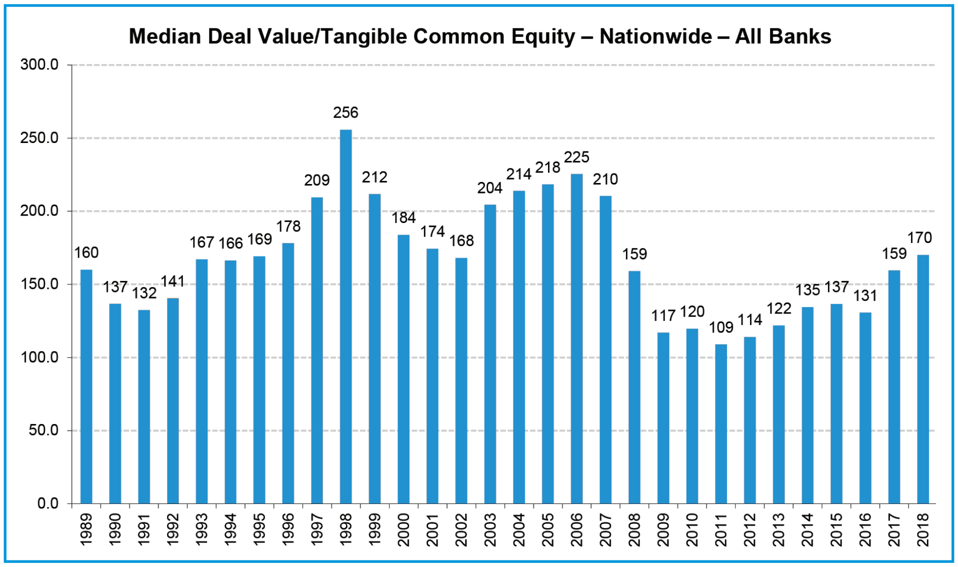
Bank valuations are very case-specific. While we all look at bank pricing multiples, we need to remember that multiples are not values. They are simply a way to compare deal pricing and provide a framework for the industry. We do, however, believe that there are four primary high-level items that can impact value.

1. Industry Valuations
2. Asset Size
3. Future Earnings Stream
4. Number of Buyers

INDUSTRY VALUATIONS

In the cycles of economic growth and optimism, bank valuations rise as they do with most industries. However, in recessions or periods of pessimism, bank values drop. These cycles are clear in the chart that follows.

What is also clearly shown is that overall industry pricing is falling. You will note in the chart below that the peaks and valleys of each of the cycles continue to drop since the peak of 1998. Obviously there will be a point where values can't go any lower, but we also believe that we are unlikely to see the future peaks exceed some of the previous high points.



Source: S&P Global Marketing Intelligence

Again, valuations are specific to each bank, but industry pricing as a whole does serve to keep individual valuations in particular ranges at the valuation time period.

ASSET SIZE IMPACT

We regularly report market pricing multiples broken down by asset size because we see a consistent difference in values. We believe this is caused primarily by the fact that as the target's asset size increases the buyers are larger, and in many instances publicly traded. During times when financial stocks are strong, a public buyer has currency to use that in many instances allow it to pay higher multiples.

Additionally, larger banks typically have a larger footprint, a more diversified customer base, and more assets per location that all enhance value. The larger size, however, does not automatically drive a higher valuation. Size needs to be based on core assets, not hot money or a leveraged balance sheet. Additionally, it needs to have market or better yields, costs and expense structures. Buying the growth with low loan rates or high deposit rates will not help a valuation.

The table and chart below show the impact of the target's asset size on the median pricing of transactions for the year ended December 31, 2018.

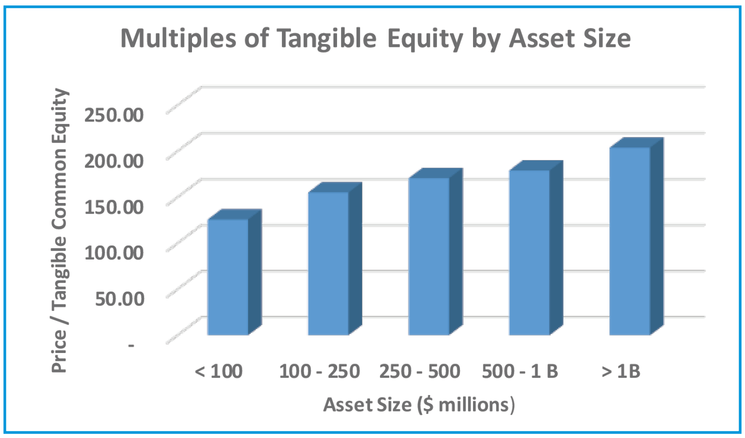
MEDIAN M&A MARKET STATISTICS

Target Assets Range Min ($M)	Target Assets Range Max ($M)	# of Deals	Price/TCE (x)	Price/Earnings (x)	Premium on Core Deposits
Below	100	73	125.63	19.07	4.13
100	250	80	155.01	24.14	8.67
250	500	44	170.46	20.97	9.13
500	1,000	30	178.82	28.06	12.97
Above	1,000	32	203.61	24.19	14.60

Source: S&P Global Marketing Intelligence

As of December 31, 2018

Shown a different way:



Source: S&P Global Marketing Intelligence

As mentioned above, value is determined on a case-by-case basis on specific factors of the institution. Multiples are simply the reflection of values, not the driver of values.

In addition to having more charters than the other regions in the country, the Midwest has more banks with smaller asset size than these regions as well. This tends to skew down overall market valuations in this region.

State	Banks Under $100 Million	Banks Under $1 Billion	Total Charters	% Under $1 Billion
Arkansas	20	81	93	87.10%
Illinois	138	388	436	88.99%
Iowa	88	269	286	94.06%
Kansas	109	225	235	95.74%
Minnesota	129	284	293	96.93%
Missouri	75	234	256	91.41%
Nebraska	69	161	169	95.27%
North Dakota	30	66	75	88.00%
Oklahoma	75	191	201	95.02%
South Dakota	23	51	62	82.26%
Wisconsin	38	183	201	91.04%
TOTAL	**794**	**2,133**	**2,307**	**91.44%**
				(average)

Source: S&P Global Marketing Intelligence As of December 31, 2018

Based on the market multiples by asset size, along with the fact that over 90% of the banks in the Midwest are under $1 billion in assets, we expect that, on average, we will see lower market pricing than other regions of the country.

FUTURE EARNINGS STREAMS

A key component in any valuation of an operating business is that entity's future earnings stream. This is commonly referred to as discounted cash flow ("DCF"). DCF analysis uses future cash flow projections discounted back to a present value using the time-value of money. An investment's worth is equal to the present value of all projected future cash flows.

Today's buyers, more so than in the past, are looking at a bank's ability to drive future earnings. Current and historical earnings are important, but the ability for a bank to sustain earnings over the long term impacts value in the market for a buyer. This is also true when using a discounted cash flow method of valuation for an institution that is not selling. With compliance and other fixed costs consistently increasing, size is becoming more important to a bank's ability to sustain and grow earnings.

We see two areas where asset size can influence forecasting future cash flow. First, smaller institutions have less revenue inflow therefore items such as problem loans, increased regulatory requirements, shrinking margins or additional hiring can all have an outsized impact on the earnings of a small institution. The impact of a $100,000 expense in a bank with $500,000 of earnings has a much bigger effect than that same expense in a bank with $5,000,000 of earnings.

Second, many of the smaller institutions in the Midwest are in smaller, rural communities which overall have a decreasing population basis and a noticeable lack of younger bank customers. The combination of demographics and technology raise concerns of future earnings for certain smaller institutions.

As the older generation passes on, it is difficult to sustain and grow future earnings without a younger generation in the market with a desire to continue to bank locally.

How often have we heard the story (probably embellished, but based on facts) from a small town banker where a long time customer has passed away and after the funeral, on their way back from the cemetery, the children stop off at the bank to close the parents' accounts before they leave town   Are you replacing your older customers with new, younger customers?

NUMBER OF BUYERS

Internally, when we discuss a bank's value one of the first items we discuss is how many potential buyers exist.   Valuation is determined based on a variety of items – size, location, capital, and reoccurring and future earnings. However, also included in this is demand - the number of potential buyers.

We consider this, to some extent, in pure valuation work even if the bank is not a potential seller because a fair market value should include the "market" along with the other components mentioned. A bank with no buyers has limited value. Whether that is reflected in a marketability discount or an impact to market statistics, this should be a component of valuation.

We will address this factor in a future newsletter that will allow us an opportunity to expand on what we are seeing on the horizon in more detail. With a lot of supply (large number of banks) there needs to be a high demand (large number of buyers) to maintain and grow valuations in the market.

CONCLUSION

Therefore, while asset size is important for a lot of reasons in today's regulatory and compliance world, we believe in most cases it is also important for your value. But again, that does not mean that larger automatically equates to a higher valuation.

As we mentioned above, we believe that while certain banks have a real risk in losing value over time, we also believe that others have an opportunity to increase their valuation.

Pricing multiples are not values, however values are used to determine pricing multiples. Size has an impact and we see that, on average, larger banks have higher valuations which is reflected in the higher multiples shown in industry transactions. Therefore, core growth in assets should positively impact a bank's value. Additionally, consistent and growing earnings increase valuation.

We believe that these are two of the largest risks smaller and rural banks face in future valuations. Unfortunately, in many markets the demographics are a significant obstacle to future growth in both asset size and future earnings.

However, we do believe that if an institution is capable of growing its asset base, whether organically or by acquisition, along with growing its future revenue and net income it will provide a good opportunity to increase its future valuation. There is no question that community banking is changing, but it is not going away in our lifetimes.

As always, the only thing that we are advocating is that you think strategically and have a plan. We believe, particularly as the banking industry changes, that your strategic thinking should go beyond just including your bank, shareholders and community, but to also include the industry conditions as a whole.

If you have any questions or comments, please feel free to give us a call. We would be happy to discuss any of these issues with you.

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