DERIVING YOUR OBJECTIVES:
HOW INCORPORATING DERIVATIVES INTO YOUR BALANCE SHEET STRATEGY CAN DRIVE POSITIVE OUTCOMES

Uncertainty and volatility are currently the operative words in both short-term and long-term fixed-income capital markets for investors and issuers. Whether focusing on the recent spike in the repo rate for short-term funding or the dramatic decline of benchmark Treasury yields over the past year, even with a partial retracement in recent weeks, the actions of the market have deviated from conventional expectations by wide margins, and there appears to be no end in sight. As Chart 2 illustrates presently the 5-year swap rate is inverted to 1- and 3-month LIBOR, a situation that has only occurred 12% of the time over the past 19 years. This rare occurrence may not last long but is clearly an actionable event, considering both balance sheet deleveraging and cash flow hedges. Add in deteriorating international economic conditions and central bank monetary policy uncertainty and we are clearly in an environment that requires a broader perspective and more tools to optimize both sides of your financial institution’s balance sheet and protect earnings.

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“Change is the only constant in life”
Heraclitus, Greek Philosopher
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At PNC, we employ a holistic view of a customer’s balance sheet when developing strategy recommendations. Our SMART approach coordinates the objectives of the loan portfolio, the securities portfolio and the institution’s need for liquidity. The optimal recommendation is one that proves complementary to all elements of the balance sheet. In much the same manner, when analyzing funding and interest rate risk, we employ a top-down approach that aims to minimize the weighted average cost of capital and lessen the unpredictability of liability funding. The main tools utilized to accomplish these objectives, aside from timely capital issuance, are interest rate derivative structures.
Derivative Structures
This article explores several of the common derivative structures that can mitigate interest rate risk and stabilize and potentially lower the cost of funding as well as increase fee income. To begin, let’s take a quick look at the basic building blocks underlying these structures.

Interest rate derivatives consist of futures, forwards, options and swaps. Because of the size and liquidity of these secondary markets, pricing is very efficient and readily available for tracking through common outlets such as Bloomberg and Thomson Reuters. Although pricing information is readily available, what matters most is access and working knowledge. Access requires a strong balance sheet and experience to develop the most cost-efficient yet effective structure. Derivatives can also be used to offer customers favorable commercial loan structures that generate additional fee income for their institution while also mitigating interest rate risk.

Although derivative structures are best customized to the unique needs of each institution, there are several common structures available that utilize pay-fixed rate swaps to deliver desired outcomes, namely hedging pools of fixed-rate prepayable assets, rolling short-term brokered CD hedges and rolling 1- or 3-month FHLB advance hedges, and two alternatives that can be offered to commercial loan customers providing potential marketplace differentiation and incremental fee income.

Let’s take a look at an illustrative example for each popular structure:

**Figure 1 — Hedging Pools of Fixed-Rate, Prepayable Assets**

Scenario:
Bank wants to hedge a portion of their loan/securities portfolio’s exposure to rising interest rates.

<table>
<thead>
<tr>
<th>Portion Affected by Prepayment $100MM</th>
<th>Average Fixed Coupon 4.00%</th>
<th>Bank</th>
<th>Receive 1-Month LIBOR 2.01%</th>
</tr>
</thead>
</table>

Pay-Fixed 10-Y Swap Rate 1.65%

**Indicative Swap Rates | 1-Month LIBOR = 2.01%**

<table>
<thead>
<tr>
<th>Term (Yrs)</th>
<th>Spot</th>
</tr>
</thead>
<tbody>
<tr>
<td>7 Years</td>
<td>1.56%</td>
</tr>
<tr>
<td>10 Years</td>
<td>1.63%</td>
</tr>
</tbody>
</table>

**Results:**
- Bank converts a portion of a closed pool of prepayable fixed-rate loans/securities to floating.
- Receives fixed-rate coupons on hedged item and pays/receives the net swap rate, 0.38%.
- Loan/securities portfolio converts from 4.00% fixed to floating at 1-month LIBOR + 2.37%.
- Using ASC 815 “last of layer” methodology effective portion - carrying value of loans, ineffective portion - interest income / expense.

**Figure 2 — Rolling Short-Term Brokered CD Hedge**

Scenario:
Bank is considering taking out $10 million 5-year fixed-rate term funding but wants a lower rate than is available in the term funding market. Current market environment combined with the efficiency of the swap market allows banks to synthetically create more attractive fixed-rate funding.

|$10 MM Funding w/ 3-Month Rolling Brokered CDs | 10-Month Brokered CD Rate | Bank | 3-Month LIBOR 2.09% |

Proceeds | PNC | 5-Year Fixed-Rate Swap 1.43% |
Indicative Swap Rates 3-Month LIBOR = 2.09%

<table>
<thead>
<tr>
<th>Term (Yrs)</th>
<th>Spot</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 Years</td>
<td>1.44%</td>
</tr>
<tr>
<td>5 Years</td>
<td>1.43%</td>
</tr>
<tr>
<td>7 Years</td>
<td>1.52%</td>
</tr>
</tbody>
</table>

Results:
- Bank continues to pay the 3-month brokered CD rate and pays the 5-year swap rate to PNC.
- Bank receives 3-month LIBOR netting 0.66% (3-month LIBOR 2.09% minus 1.43% 5-year swap).
- Five-year funding is initially locked in at a reduction of 0.66% to the 3-month brokered CD rate.
- Bank has basis risk for the difference between the 3-month CD rate and 3-month LIBOR for the term of the hedge.
- Using ASC 815, this structure is considered a cash flow hedge and therefore the change in hedge value runs through other comprehensive income.

Figure 3 — FHLB Rolling Advance Hedge

Scenario:
Bank is considering taking out a $10 million 5-year fixed-rate term FHLB advance but wants a lower rate available from the FHLB. Current market environment combined with the efficiency of the swap market allows banks to synthetically create more attractive fixed-rate funding.

Indicative Swap Rates 1-Month LIBOR = 2.01%

<table>
<thead>
<tr>
<th>Term (Yrs)</th>
<th>Spot</th>
</tr>
</thead>
<tbody>
<tr>
<td>3 Years</td>
<td>1.44%</td>
</tr>
<tr>
<td>5 Years</td>
<td>1.43%</td>
</tr>
<tr>
<td>7 Years</td>
<td>1.52%</td>
</tr>
</tbody>
</table>

Results:
- Bank continues to pay the 30-day advance rate to FHLB for the term of the swap.
- Bank receives 1-month LIBOR netting 0.58% (3-month LIBOR minus 1.43% 5-year swap rate)
- Five-year funding is initially locked in at a reduction of 0.58% to the 1-month FHLB advance rate, less the difference between 1-month LIBOR and the 1-month FHLB advance rate.
- Using ASC 815, this structure is considered a cash flow hedge and therefore the change in hedge value runs through other comprehensive income.

Many banks utilize these funding strategies in conjunction with restructuring their investment portfolios.
Loan Level Hedging
To this point, the strategies illustrated focus on the internal needs of your institution at the balance sheet level; however, it is also possible to incorporate your customers, leading to potential incremental fee income and a more sophisticated lending offering. Through the PNC FIRST hedging program (PNC’s full-service loan level hedging platform), fixed-rate options can be offered to your commercial loan customers, specifically a traditional fixed structure where you offer a traditional fixed-rate loan to your commercial customers and enter into an offsetting swap with PNC or a direct swap where you offer a floating-rate loan combined with a fixed-rate swap to your commercial customers and enter into an offsetting swap with PNC. The FIRST platform also provides lender product training, lender sales support, indicative pricing and timely market updates.

Addressing Complexities
Although derivatives offer significant advantages, they do come with greater complexities, including market-to-market accounting requirements as well as additional documentation. However, these issues should not impede your consideration.

We have touched on just a small sampling of structures available for consideration in this article. Additional popular hedging strategies for community banks include the following:

- Trust-Preferred Securities
- Index-Linked Deposits
- Term Brokered CDs
- Floating-Rate Loans with Embedded Floors
- Partial-Term Hedges
- Pools of Floating-Rate Loans

In times of heightened uncertainty, it makes strategic sense to expand the tools utilized to manage internal interest rate risk, stabilize attractive funding costs, hedge cash flows and potentially enhance fee income while externally offering broader commercial loan solutions. Derivative structures are the answer to many of these ongoing balance sheet challenges. In the current rare market environment, they are even more compelling with longer rates inverted to short-term floating rates. PNC has full capabilities to advise and support your needs whether you are considering balance sheet, cash flow or loan level hedging structures for your institution, and we look forward to the opportunity to discuss solutions with your institution. We’ll take the time needed to analyze your current situation and offer customized recommendations.

PNC offers full support to include operational support, regulatory support, website access, documentation and accounting support, featuring monthly position reports to provide accounting entries, access to Reval® hedge accounting support and consulting services.
Short-term challenges and opportunities require immediate attention, but many community bankers consider the ability to efficiently deliver personalized products and services the key to long-term success. Lucrative strategies and expertise that community-based institutions emphasize include specialized lending niches (i.e., commercial real estate, commercial business, residential mortgage, consumer, etc.), noninterest income product lines (i.e., trust, wealth management, mortgage banking, etc.) and core deposit generation.

We live in a society exquisitely dependent on science and technology, in which hardly anyone knows anything about science and technology.

Carl Sagan
Investment in Technology Is Vital

No matter what the specialty or how efficiently customers are served, all community banks need to reckon with ongoing and significant investments in financial technology. Or — said differently — community banks will ultimately resemble financial technology companies with a banking charter.

• Many community banks do not have a formal, long-term plan with interim targets to accommodate customers’ desire for digital versus branch banking.

• Technology has arguably made it harder for smaller banks to compete with larger organizations.

The nation’s largest banks spend around 18% of their noninterest expense, or about 10% of revenue, on technology. Information technology includes infrastructure, cybersecurity and innovation.

• Community banks typically rely more on vendors and outside consultants than larger institutions that have in-house developed systems.

• Anecdotal evidence suggests that some recent merger and acquisition transactions considered the need to use technology more effectively.

• Independent-minded institutions should strongly consider issuing debt to help finance in-house technology investments or an acquisition of a fintech firm.

• The capital markets regarding debt issuances are almost ideal: interest rates are very low, credit spreads have not widened, and demand for bank-issued debt products is nearly insatiable.

Banks’ response to demographic shifts and changes in customer preferences will likely require a substantial change in culture along with significant technological investments over many years. This is a challenge given the initial outlays required to upgrade information technology (IT) systems and personnel while continuing to generate acceptable shareholder returns. Due to the commitment and relatively large amount of IT expenditures, a bank’s board of directors should be intricately involved in the strategic planning process.

The Role of M&A

Included among the many reasons why banks decide that selling is preferable to remaining independent is the escalating cost of financial technology. (Approximately 3,000 banks were sold since 2008.) Other reasons that lead to mergers (banks are sold, not bought) include earnings challenges, regulatory and accounting burdens, succession issues, and attractive merger premiums. As we go to press, there have been 218 deal announcements in 2019, compared with 214 announcements at this time last year. There were 259 and 256 announced mergers in 2018 and 2017, respectively.

Mergers afford the combined institution with more scale to make changes to improve digital delivery systems as part of the integration process. This investment can be crafted as part of a branch rationalization program. Along with restructuring charges incurred from closing physical branches, investments in digital delivery and marketing, analytics, and robotic process automation, the expected savings can be redeployed into IT. Depending upon the bank’s shareholder base, Investor Relations departments may be challenged to justify that the longer-term benefits outweigh the initial outlays.

Transactions announced in 2019 that noted the importance of technology include:

• Kelly King, Chairman and CEO of BB&T Corporation (NYSE: BBT), cited technology as one of the underlying reasons for the merger with SunTrust Banks (NYSE: STI). King described the combination as giving the organization the ability to invest $100 million in technology, with the intention to enhance customer relationships.

• Rodger Levenson, President and CEO of WSFS Financial Corporation (NASDAQ: WSFS), noted the importance of technology on its August 8, 2018, call regarding the acquisition of Philadelphia-based, Beneficial Bancorp, Inc. Levenson stated that approximately 50% of the annual cost savings from branch closures associated with the merger would be reinvested in technology.

Financing Technology Investments

Independent-minded and forward-thinking community banks should find that a good tactic to finance financial technology investments is through bank debt (senior and subordinated). Pricing is very attractive in the current environment. The new issuance market is near-perfect due to a supply/demand imbalance, low Treasury yields and relatively tight credit spreads. Absent capital raises, it could be difficult to allocate funds from existing cash flows for IT-related investments.

Due to its position within the capital hierarchy, debt may be preferable to equity given that common shareholders will not be diluted and there are no voting rights attached to these debt instruments. Due in part to its tax-deductibility, the cost of capital on debt is often lower than that of equity capital for community banks. The ability to issue debt facilitates the use of cash to fund acquisitions (including fintech firms), which is significant as common equity raises can be more difficult for smaller institutions.

The aggregate amount that U.S. banks will spend on technology in 2019 is believed to be approximately $67 billion. Of that amount, it is estimated that JPMorgan Chase (NYSE: JPM), Wells Fargo & Company (NYSE: WFC) and Citigroup Inc. (NYSE: C) will spend around $11 billion, $9 billion and $8 billion, respectively. Due to the lack of scale to absorb the necessary fixed costs, regional and smaller banks spend relatively more of their revenue on technology compared with large institutions. About 60% of the total...
technology expense for larger banks typically goes to core existing infrastructure (network, data, support, security). Innovation accounts for roughly 40% of the total IT budget, which includes new product development and functional upgrades. New product development includes payments, loan processing and account openings. Functional upgrades include products such as ID verification, electronic signatures and CRM systems.

Community banks may face a lack of resources to comprehensively address IT issues. For instance, technology spending decisions are often made by IT departments with the “need to do what can be done” based on limited budgets. Unless the bank has sufficient scale, it is difficult to develop or purchase the IT system that best suits the bank and its customers. As a practical matter, smaller banks rely more on vendors compared with bigger banks that have in-house developed IT systems. Most community banks use FIS, Fiserv or Jack Henry & Associates. We think it is fair to conclude that community banks typically are not the innovators in financial technology.

Looking to the Future
The time has arrived, or will arrive shortly, when Millennials (those born between 1981 and 1996) drive economic activity. Millennials represent the largest generation in the U.S. workforce and use technology as a major way to communicate and interact with people and businesses. The Millennial generation is comfortable with technology and Generation Z (those born after 1996) is even more connected to the world through mobile devices, Wi-Fi and high-bandwidth cellular service.

Banks, therefore, must be proactive for the economic changes that will occur as baby boomers wind down their earning and spending activity and younger generations dominate economic activity. In general, community banks appear challenged to garner Millennials and Generation Z as depositors; national banks have used their resources to attract and retain younger customers through more effective marketing and branding campaigns. Banks should expect Millennials and Generation Z to require personalized and seamless/on-demand access to the underlying services and products. If banks can’t or won’t meet these conditions, larger banks and fintech companies are eager to meet the next generation’s preferences.
A recent photograph of Queen Elizabeth II could be called a comprehensive and yet simple management succession for the Windsor family business, the monarchy of the United Kingdom and 15 other Commonwealth realms. The photo featured the Queen with her son, Prince Charles; her grandson, Prince William; and her great-grandson, Prince George. Along with the Queen, the photo included the presumed succession to the throne in due course for the next 75 years.

Can a community bank have a plan that is as complete and simple as that line of succession? Yes, it’s possible if the bank is closely held and relatively small.

Some years ago we visited a friend in Orwell, Vermont (population 1,250). As we entered the town on the right was the First National Bank of Orwell, the oldest national bank in New England, dating back to 1863. Attached to it is a house where the bank president and his family have lived for more than 130 years. For five generations, a member of the Young family has led the bank, which today has two branches, 16 employees and $72 million in assets. 72% of the $65 million loan portfolio is to agricultural borrowers. Like the Windsor family, the past suggests that the apparent management succession is the next generation of the Young family.

Most community banks (around 5,700 in number) are substantially larger and require a succession plan appropriate for a management team that does not live next to the bank in a niche market in a corner of Vermont. We might envy the success and professional satisfaction of that small bank but the elements of a succession plan for the typical community bank will be more detailed.
Officers and Management Functions

Most banks have five officers or functions that are essential to its management. They are:

- **Chief Executive Officer (CEO).** The CEO is responsible for many key decisions in the bank's operations and sets a tone for the style and culture of the bank. As Harry Truman said about being president, “The buck stops here.”
- **Chief Financial Officer (CFO).** In many banks, the current CFO is often a contender to be the next CEO. The CFO is the one who knows where the money is made.
- **Senior Lending Officer (SLO).** Potentially the SLO is the bank's chief deal-maker who also has the banking skills and visibility in the community that suggest the SLO may be a good choice as the next CEO.
- **Chief Credit Officer (CCO).** The CCO operates to complement the role of the SLO by ensuring the bank prices the risk of its loans correctly and avoids inappropriate credit risks.
- **Chief Retail Officer (CRO).** A good CRO is an indispensable player in value creation for the bank because the CRO seeks low-cost, stable deposits that are essential and always beneficial for the bank.

In smaller banks like Orwell, some of these positions may be combined with other positions because the bank cannot justify the overhead of five full-time employees. The combination of these roles can create conflicts. For example, there is a potential conflict if both the lending and credit functions are assigned to the same person. The deal-maker wants to grow the loan portfolio and the credit officer must objectively assess the risk. In a smaller bank it may be more practical for the CFO to control the credit assessment because the credit function is influenced by how the finance function allocates capital and monitors both capital adequacy and the achievement of bank goals for return on assets and return on equity.

As a practical matter, the CEO is the key position in any bank succession management plan. Some banks have established a mandatory retirement age for board members and the CEO to force an periodic review and honest discussion about the succession plan. As part of this process, a central question will be “What is the future strategic direction of the bank?”

If the bank has achieved certain growth targets, what is next? If the bank has grown quickly after a series of M&A, the future skill sets and experience of the next CEO may need to be different than those of the current CEO or any potential internal candidates. If the bank has doubled in size and aims to do it again, that is very different than a bank that has grown consistently but more slowly.

If the bank doubled in size to $5 billion in assets and aims to be $10 billion in the near future, the bank will be leaving the community bank ranks to become a regional bank. It may be time to begin a search for a new CEO who has experience in a larger bank that is currently like your future footprint in terms of size and business model. Likewise, the new CEO will probably need to oversee a capital-raising exercise to get the capital needed to do the acquisitions that will follow. Also, there will be increased regulatory requirements as the bank grows.

Two Paths to Growth

Let’s look at two banks, Atlantic Union Bankshares and Investors Community Bank, that have grown in the past 20 years from being de novo banks in the 1990s.

In 2014, Union Bankshares Corporation of Richmond, Virginia, had just acquired StellarOne Corporation and doubled in size to have $7.4 billion in assets by the end of the year. At this point the bank was a large community bank aiming to grow to the next plateau via the merger and acquisition route. Its CEO, William Beale, was thinking about retirement. If the bank wanted to grow above $10 billion in assets, it would enter a new regulatory regime under the Dodd-Frank Law. That meant different requirements, which some banks had found as an obstacle to growth.

The board decided to search for the next CEO outside the bank. In late 2016, John Asbury joined the bank as CEO. He had previously served as CEO of the First National Bank of Santa Fe and had experience with two other major banks in the early years of his career. In 2017, Union Bank acquired Xenith Bankshares and in early 2019 it acquired Access National Corporation. Both banks were around $3 billion in assets. By June 2019, the bank had changed its name to Atlantic Union Bankshares, which now has assets of $17 billion. Atlantic Union is now a regional bank rather than a community bank.
Investors Community Bank was founded in 1997 by four bankers who had worked together at a larger bank in Milwaukee, Wisconsin. They wanted to focus on the agricultural sector as their niche, with particular focus in the dairy industry. That would be a logical strategy to pursue in Wisconsin, which is a major producer of cheese. If Wisconsin were a country, it would be the world’s fourth-largest maker of cheese after Germany. 62% of its loans are to the agricultural sector and there is a strong correlation between the price of milk and the performance of the bank. Most of its asset growth since its founding has been internally generated at a CAGR of 13%. The bank is branch light and, therefore, overheads are lower. The bank went public in 2015 to create liquidity for the shares of older investors seeking to do retirement and estate planning. It enabled the bank to do acquisitions in the future. It made its first acquisition in 2016. At this point, CEO Bill Censky wanted to start the transition to his successor, Timothy Schneider, who has been with bank since its founding. They worked for 2 years as co-CEOs. Today Tim Schneider is the CEO of Investors Community Bancorp and County Bancorp, the holding company that now holds Investors Community Bank. It has assets of $1.5 billion.

Atlantic Union grew via a series of acquisitions since its founding, while Investors Community Bank grew primarily within its niche market in the Wisconsin dairy industry. Each bank addressed the succession differently. Atlantic Union did a search outside the bank, while County Bancorp promoted from within the bank. The decision to do a search for an outside candidate may be more common among smaller, closely held banks because the group of internal candidates is smaller. Nonetheless, many banks follow the example of Ohio-based Park National Corporation, which has selected its last five CEOs internally since 1928. In 2008, they were able to acquire seven banks in Ohio during the financial crisis because they had the capital, confidence and management skills to do it successfully.

The Role of Bank Size in Attracting Staff

Bank size may necessitate the bank to focus on a niche market and achieve good performance, but it may also have to pass on some profitable opportunities because it does not have the management to take advantage of them. Many community banks are based in small towns or rural areas where population growth is low or even declining. Sometimes these communities have experienced a loss of vital services like hospitals. It can be a major challenge to attract staff in order to have the key functions properly fulfilled and to have a deep enough bench to succeed the bank’s leadership when the positions/functions are open.

In many ways, the question can be reduced to this one: “What are you doing to attract, develop and retain entry-level staff who will learn the skills needed to grow the bank?” That is a challenge readily acknowledged by Investors Community Bank. The bank is based in Manitowoc, Wisconsin, a town of 35,000 about 80 miles from Milwaukee on Lake Michigan.

The bank has established a summer internship program to attract younger talent and expose them to credit-related issues in the bank. This is an important outreach for the bank because college students are often attracted to larger banks because of the perception of better compensation, tuition assistance programs and the visibility of large transactions completed by either the commercial banking or investment banking units.

Investors Community Bank has utilized the Graduate School of Banking Program at the University of Wisconsin to develop the future leaders of the bank. The current CEO is a graduate of the program.

More banks should seek to mentor young people who come to work for the bank part time while in college and let them see that the bank is more than number crunching. It is the long-term indispensable partner of many small businesses in the area. That may encourage them to seek a career there and stay in the community.

Furthermore, the demographics of college students today may suggest another opportunity to develop the ranks. 37% of college students are over 25 years old and often part-time students. 25% are parents. Your bank may have full-time staff with future managerial potential that fit this profile. It may be that some assistance with tuition and scheduling accommodation may be all that is needed to help them across the line to finish getting a degree.

The best way to look at succession planning is to focus on the top position of CEO and then build a team in the key functions around the CEO. But all along, it’s necessary to start early to build the ranks from the entry level so there is depth of qualified personnel to fill the senior key roles — CEO, CFO, SLO, CCO and CRO, when the time comes.
After a relatively slow start to the year, bank consolidation across New England — as well as nationally — has accelerated, mainly among smaller and micro-cap institutions. The total number of nationwide bank merger announcements is 231 in 2019 versus 216 for the same period last year, while deal pace has picked up recently as there have been 72 announcements since June 30, 2019.

We believe that more banks have become more accepting of lower premiums than those offered in the past. Lower deal pricing is mainly due to (1) fewer acquirers with capacity (size and currency) and (2) wary shareholders who scrutinize tangible book value dilution and earn-back periods. This is probably good for both sides because more rationally priced stock deals should produce superior long-term returns due to greater potential price appreciation, although modest deal premiums do not create flashy headlines. Social issues can derail mergers, but we haven’t see anything unusual in 2019.

“Change is the law of life. And those who look only to the past or present are certain to miss the future.”

John F. Kennedy
Since the start of 2018, there have been 19 announced bank deals with New England sellers, including seven thus far in 2019. Several fairly large and recently converted thrifts in the region have the capacity to deploy excess capital through acquisitions. On the flip side, institutions often sell between 3 and 7 years after converting to stock form.

New England has 45 publicly traded banks. Eighteen have total assets below $1 billion and about half have total assets less than $2 billion. There are 17 publicly traded banks based in Massachusetts — the most-populous and fastest-growing New England state. Most of the region’s growth occurs in the Boston area and along the southeastern coast, which has more favorable demographics and economic vitality compared with other New England markets.

M&A remain a proven strategy to boost profitability as acquirers can improve efficiency ratios due to better economies of scale. As has been the case for quite some time, many banks lack the scale to successfully meet industrywide revenue, earnings, regulatory, accounting and technological challenges. Along with succession issues, all of these hurdles can be overcome via mergers. Buyers are primarily motivated to efficiently obtain core deposits and gain economies of scale along with synergies. Credit quality appears to remain good and should not impede M&A activity at this time. As is the case with the vast majority of community banks, New England institutions are challenged to better develop customer relationships, achieve a higher earnings growth rate, and gain market share.

Companies with stronger currencies are typically the more active acquirers. Among larger in-region institutions, the more logical buyers of New England’s community banks appear to be Bar Harbor Bancshares, Berkshire Hills Bancorp, Camden National Bancorp, Meridian Bancorp, People’s United Financial and Webster Financial. Among the larger out-of-region institutions, the more logical buyers of New England’s community banks include Community Bank System (NYSE: CBU), NBT Bancorp (NASDAQ: NBTB), and Sterling Bancorp (NYSE: STL) and a few foreign-based banks interested in expanding their presence in the Boston area.

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**Figure 1 — Recent Deals with New England Sellers**

<table>
<thead>
<tr>
<th>Buyer/Target Name</th>
<th>Status</th>
<th>Completion Date*</th>
<th>Deal Value ($MM)</th>
<th>Price/Tangible Book (%)</th>
<th>Price/LTM Earnings (X)</th>
<th>Core Deposit Premium (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Centreville Bank/PB Bancorp, Inc.</td>
<td>Pending</td>
<td>10/22/2019</td>
<td>115.5</td>
<td>148</td>
<td>25.4</td>
<td>NA</td>
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<tr>
<td>People’s United Fin’l, Inc./United Fin’l Bancorp, Inc.</td>
<td>Pending</td>
<td>7/15/2019</td>
<td>758.0</td>
<td>126</td>
<td>13.2</td>
<td>4.4</td>
</tr>
<tr>
<td>Fidelity MHC/Family Federal Savings, F.A.</td>
<td>Pending</td>
<td>6/18/2019</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Hometown Fin’l Group MHC/Millbury Savings Bank</td>
<td>Completion</td>
<td>10/21/2019</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Liberty Bank/SBT Bancorp, Inc.</td>
<td>Completion</td>
<td>10/11/2019</td>
<td>71.4</td>
<td>203</td>
<td>17.1</td>
<td>9.2</td>
</tr>
<tr>
<td>North Shore Bancorp/Beverly Financial, MHC</td>
<td>Completion</td>
<td>10/1/2019</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Berkshire Hills Bancorp, Inc./SI Financial Group, Inc.</td>
<td>Completion</td>
<td>5/17/2019</td>
<td>182.5</td>
<td>119</td>
<td>27.3</td>
<td>2.6</td>
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<tr>
<td>Hometown Financial Group MHC/Abington Bank</td>
<td>Completion</td>
<td>5/17/2019</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>North Easton Savings Bank/Mutual Bank</td>
<td>Completion</td>
<td>4/30/2019</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
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<tr>
<td>Cambridge Bancorp/Optima Bank &amp; Trust Company</td>
<td>Completion</td>
<td>4/17/2019</td>
<td>67.2</td>
<td>204</td>
<td>29.3</td>
<td>10.6</td>
</tr>
<tr>
<td>Equitable Bancorp, MHC/South Shore MHC</td>
<td>Completion</td>
<td>4/1/2019</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Independent Bank Corp./Blue Hills Bancorp, Inc.</td>
<td>Completion</td>
<td>4/1/2019</td>
<td>725.4</td>
<td>186</td>
<td>35.0</td>
<td>19.2</td>
</tr>
<tr>
<td>People’s United Financial, Inc./BSB Bancorp, Inc.</td>
<td>Completion</td>
<td>4/1/2019</td>
<td>328.7</td>
<td>166</td>
<td>14.9</td>
<td>8.0</td>
</tr>
<tr>
<td>Hometown Fin’l Group MHC/Pilgrim Bancshares</td>
<td>Completion</td>
<td>1/31/2019</td>
<td>53.8</td>
<td>157</td>
<td>35.4</td>
<td>14.9</td>
</tr>
<tr>
<td>PeoplesBancorp, MHC/First Suffield Financial, Inc.</td>
<td>Completion</td>
<td>11/30/2018</td>
<td>60.0</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Independent Bank Corp./MNB Bancorp</td>
<td>Completion</td>
<td>11/14/2018</td>
<td>54.3</td>
<td>204</td>
<td>41.4</td>
<td>13.1</td>
</tr>
<tr>
<td>HarborOne Bancorp(MHC)/Coastway Bancorp, Inc.</td>
<td>Completion</td>
<td>10/5/2018</td>
<td>125.6</td>
<td>176</td>
<td>44.1</td>
<td>14.2</td>
</tr>
<tr>
<td>People’s United Fin’l/First Connecticut Bancorp, Inc.</td>
<td>Completion</td>
<td>10/1/2018</td>
<td>552.3</td>
<td>199</td>
<td>29.9</td>
<td>13.0</td>
</tr>
<tr>
<td>Salem Five Bancorp/Sage Bank</td>
<td>Completion</td>
<td>8/20/2018</td>
<td>9.3</td>
<td>113</td>
<td>NM</td>
<td>1.6</td>
</tr>
<tr>
<td>New Hampshire Mutual Bancorp/SB of Walpole</td>
<td>Completion</td>
<td>7/1/2018</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
</tbody>
</table>
### Figure 1 — Recent Deals with New England Sellers (Continued)

<table>
<thead>
<tr>
<th>Buyer/Target Name</th>
<th>Status</th>
<th>Completion Date*</th>
<th>Deal Value ($MM)</th>
<th>Price/Tangible Book (%)</th>
<th>Price/LTM Earnings (X)</th>
<th>Core Deposit Premium (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Patriot National Bancorp, Inc./Prime Bank</td>
<td>Completion</td>
<td>5/10/2018</td>
<td>10.2</td>
<td>123</td>
<td>19.6</td>
<td>4.8</td>
</tr>
<tr>
<td>Bangor Bancorp, MHC/First Colebrook Bancorp, Inc.</td>
<td>Completion</td>
<td>4/6/2018</td>
<td>45.0</td>
<td>185</td>
<td>NM</td>
<td>10.6</td>
</tr>
<tr>
<td>Fidelity MHC/Colonial Co-operative Bank</td>
<td>Completion</td>
<td>4/1/2018</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Brookline Bancorp, Inc./First Commons Bank, NA</td>
<td>Completion</td>
<td>3/1/2018</td>
<td>55.5</td>
<td>158</td>
<td>22.1</td>
<td>11.5</td>
</tr>
<tr>
<td>Atlantic Comm. Bancshares, Inc./BBN Fin’l Corp.</td>
<td>Completion</td>
<td>1/2/2018</td>
<td>17.0</td>
<td>109</td>
<td>36.2</td>
<td>1.1</td>
</tr>
<tr>
<td>Meridian Bancorp, Inc./Meetinghouse Bancorp, Inc.</td>
<td>Completion</td>
<td>12/29/2017</td>
<td>17.9</td>
<td>164</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>South Shore Bancorp MHC/Braintree Bancorp MHC</td>
<td>Completion</td>
<td>10/31/2017</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Berkshire Hills Bancorp/Commerce Bancshare</td>
<td>Completion</td>
<td>10/13/2017</td>
<td>209.2</td>
<td>138</td>
<td>14.6</td>
<td>3.0</td>
</tr>
<tr>
<td>Abington Bank/Avon Co-operative Bank</td>
<td>Completion</td>
<td>10/1/2017</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Salem Five Bancorp/Georgetown Bancorp, Inc.</td>
<td>Completion</td>
<td>5/23/2017</td>
<td>49.2</td>
<td>152</td>
<td>60.5</td>
<td>9.9</td>
</tr>
<tr>
<td>Community Bank System/Merchants Bancshares</td>
<td>Completion</td>
<td>5/12/2017</td>
<td>304.8</td>
<td>203</td>
<td>21.4</td>
<td>NA</td>
</tr>
<tr>
<td>Independent Bank Corp./Island Bancorp, Inc.</td>
<td>Completion</td>
<td>5/12/2017</td>
<td>24.5</td>
<td>152</td>
<td>35.4</td>
<td>5.1</td>
</tr>
<tr>
<td>Abington Bank/Holbrook Co-operative Bank</td>
<td>Completion</td>
<td>4/1/2017</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Marlborough Bancshares, Inc/North Middlesex SB</td>
<td>Completion</td>
<td>4/1/2017</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Bar Harbor Bankshares/Lake Sunapee Bank Group</td>
<td>Completion</td>
<td>1/13/2017</td>
<td>145.6</td>
<td>166</td>
<td>15.8</td>
<td>5.7</td>
</tr>
<tr>
<td>Independent Bank Corp./New England Bancorp, Inc.</td>
<td>Completion</td>
<td>11/10/2016</td>
<td>30.1</td>
<td>136</td>
<td>46.7</td>
<td>5.6</td>
</tr>
<tr>
<td>Westfield Financial, Inc./Chicopee Bancorp, Inc.</td>
<td>Completion</td>
<td>10/21/2016</td>
<td>110.9</td>
<td>123</td>
<td>30.2</td>
<td>4.9</td>
</tr>
<tr>
<td>Randolph Bancorp/First Eastern Bankshares Corp.</td>
<td>Completion</td>
<td>7/1/2016</td>
<td>15.5</td>
<td>123</td>
<td>27.3</td>
<td>10.1</td>
</tr>
<tr>
<td>Investor group/Radius Bancorp, Inc.</td>
<td>Completion</td>
<td>6/7/2016</td>
<td>47.0</td>
<td>82</td>
<td>27.1</td>
<td>-2.3</td>
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<tr>
<td>Spencer MHC/Green Valley Bancorp, MHC</td>
<td>Completion</td>
<td>6/1/2016</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>BNH Financial/Community Guaranty Corporation</td>
<td>Completion</td>
<td>5/6/2016</td>
<td>12.9</td>
<td>162</td>
<td>41.9</td>
<td>5.4</td>
</tr>
<tr>
<td>ESB Bancorp MHC/Hometown Comm. Bancorp</td>
<td>Completion</td>
<td>4/1/2016</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Fidelity MHC/Barre Savings Bank</td>
<td>Completion</td>
<td>4/1/2016</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Mechanics Savings Bank/Biddeford Savings Bank</td>
<td>Completion</td>
<td>1/26/2016</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Liberty Bank/Naugatuck Valley Financial Corp.</td>
<td>Completion</td>
<td>1/15/2016</td>
<td>77.8</td>
<td>127</td>
<td>35.5</td>
<td>5.2</td>
</tr>
<tr>
<td>Merchants Bancshares, Inc./NUVO Bank &amp; Trust Co.</td>
<td>Completion</td>
<td>12/4/2015</td>
<td>21.7</td>
<td>141</td>
<td>46.8</td>
<td>7.7</td>
</tr>
<tr>
<td>South Shore Mutual Holding Company/Satuit MHC</td>
<td>Completion</td>
<td>12/4/2015</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>North Shore Bancorp/Merrimac Savings Bank</td>
<td>Completion</td>
<td>11/1/2015</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
<td>NA</td>
</tr>
<tr>
<td>Adams Community Bank/Lenox National Bank</td>
<td>Completion</td>
<td>10/16/2015</td>
<td>14.3</td>
<td>170</td>
<td>NM</td>
<td>14.3</td>
</tr>
<tr>
<td>Camden National Corporation/SMF Financial, Inc.</td>
<td>Completion</td>
<td>10/16/2015</td>
<td>131.2</td>
<td>153</td>
<td>NM</td>
<td>8.0</td>
</tr>
</tbody>
</table>

**Median**

|                  | 57.8 | 153 | 29.6 | 8.0 |

**Deals announced through October 31, 2019**

*Announcement date is listed for pending deals

Source: S&P Global Market Intelligence
Examples of recent deals with New England sellers as follows:

- On July 15, 2019, Bridgeport, Connecticut–based, People’s United Financial agreed to acquire Hartford, Connecticut–based United Financial Bancorp, Inc. United Financial has total assets of $7.3 billion and 58 branches in Connecticut, Massachusetts and Rhode Island. The all-stock deal was valued at approximately $758 million, which equated to 125% of tangible book value and 13.2x trailing 12-month earnings. The core deposit premium was 4.4%.

- On May 17, 2019, Boston-based Berkshire Hills Bancorp completed its acquisition of Willimantic, Connecticut–based SI Financial Group. Berkshire Hills expanded in Connecticut by 18 branches and entered Rhode Island with five branches. At completion, the all-stock deal value was approximately $178 million, which equated to 111% of tangible book value and 16.1x trailing 12-month earnings. The core deposit premium was 4.4%.

- On April 1, 2019, People’s United completed its acquisition of Belmont, Massachusetts–based BSB Bancorp through a cash-and-stock deal valued at $333.5 million. The transaction was valued at approximately 166% of tangible book value and 14.9x trailing 12-month earnings. The core deposit premium was 8.4%. BSB completed its IPO and standard conversion to stock form in 2011.

- On April 1, 2019, Rockland, Massachusetts–based Independent Bank Corp. completed its acquisition of Norwood, Massachusetts–based Blue Hills Bancorp through a cash-and-stock deal valued at $673.7 million (at completion). The acquisition expanded Independent’s presence in Massachusetts by 11 branches. The deal was valued at approximately 186% of tangible book value and 35.0x trailing 12-month earnings. The core deposit premium was 16.0%. Blue Hills completed its IPO and standard conversion to stock form in 2014.

- On February 27, 2019, Easthampton, Massachusetts–based Hometown Financial Group MHC agreed to acquire Millbury, Massachusetts–based Millbury Savings Bank. The combined bank will operate 24 branches in Massachusetts and five branches in Connecticut. Because this is a merger of mutual institutions, no consideration will be exchanged.

On January 31, 2019, Hometown Financial Group MHC acquired Cohasset, Massachusetts–based Pilgrim Bancshares in an all-cash deal valued at approximately $54 million. Pilgrim, which converted to stock form in 2014, had total assets of $265.1 million.
BANK EXECUTIVES HAVE AN OPPORTUNITY TO BENEFIT FROM DISRUPTION IN THE EQUITY RESEARCH MARKETPLACE

By Jack E. Payne, CFA, CFP | Managing Director

In today’s business world, “disruption” has become a popular buzzword. Merriam-Webster’s dictionary defines disruption as follows: to break apart or alter so as to prevent normal or expected functioning.

Industries of all types have been affected by new technologies and unconventional upstart business models that have, in some cases, radically changed the way things get done, spawning new industries in the process. In other cases, these factors have challenged traditional business methods and altered the economics of trade based on changing centers of influence. To a lesser but still significant extent, new regulations and, in some instances, deregulation have also contributed to shifting business practices.

This article examines the changing landscape of sell-side equity research, from the perspective of the issuer. We believe that the current disruption in equity research with its specific focus on sell-side coverage, gives senior executives a great opportunity to assess the approach being used to market your story to investors. We list alternative methods of reaching investors that may prove more effective than traditional sell-side research, which can also limit analyst time demands and avoid indirect pressure to suboptimally award new business to justify keeping sell-side coverage in place. Moreover, we provide a list of key parameters that can help determine the incremental value being offered to an issuer from each analyst providing coverage.

A survey of the academic and professional literature yields numerous studies conducted in recent years that attempt to identify the key deliverables of a valuable equity research report from the perspective of the investor, but very little has been written so far from the issuer’s point of view. Many bank executives invest considerable time with sell-side analysts. Are the benefits of those relationships worth the time invested? This article attempts to broaden the perspective. We start off with a high-level review of the equity research marketplace, then focus on what investors want from sell-side research.
The Equity Research Marketplace

To provide a common understanding related to terminology and positioning, let’s first define key participants in the research universe as it has been structured historically. Figure 1 shows a simplified schematic diagram of the equity research marketplace. Investors and issuers come in all shapes and sizes, each with different goals and objectives, but the process of gaining access to capital for issuers and new equity investment opportunities for investors is largely generic at the macro level.

For purposes of this discussion, issuers represent for-profit entities of all sizes, such as community banks. In practice, larger organizations typically have greater market visibility in terms of investor awareness. For smaller firms whose business is regional or even local, there are more challenges getting the story out to investors, but the goal for both large and small firms is to generate interest in equity ownership.

Investors can be idiosyncratic with unique goals and objectives. This group includes individuals, mutual funds, foundations, endowments, family offices, hedge funds and private-equity firms.

In one way or another, all investors share the goal of achieving superior risk-adjusted return on invested capital. In this discussion, we’ll focus primarily on long-term non-activist investors rather than short-term investors (or perhaps more properly defined as “traders”) looking to trade in and out of equity positions.

Focusing on the interior of Figure 1, we see the research intermediaries. These are the firms that bring new opportunities to market or follow existing equities trading in the secondary market by providing financial updates, strategic insight, forward-looking earnings-per-share guidance, and target share prices as well as buy, hold and sell ratings. The group is further broken into two subsets: buy-side analysts and sell-side analysts.

Buy-side analysts can be independent or internal employees of an investment company or fund. The clear objective of this group is to filter out the best opportunities from all available opportunities in the equity universe.

On the other side of the marketplace are sell-side analysts who most often align with issuers. These individuals are typically employed by broker-dealers or investment banks and focus on promoting the issuers’ strategic story, dividend-paying capacity and future growth potential as directed by company management. Given the competitiveness to earn new capital market assignments, the sell-side analysts often tilt their reports in an optimistic fashion so as not to impede the overall relationship with issuers. This can create challenges in maintaining objectivity. Anytime objectivity is in question, it discounts the value of the sell-side research.

As a result of the marketplace positioning, buy-side analysts have an inherent advantage with respect to guiding investors. They can filter through numerous sources of sell-side research on a particular equity, build their own valuation models, and conduct their own due diligence without the risk of harming management relationships. In theory (and often in practice), this leads to a more objective opinion regarding the equity’s merit.
Establishing Senior Executive Priorities
As a senior executive, the demands on your time are enormous. Anecdotally, we have witnessed many situations where executives are investing a substantial amount of time addressing sell-side analyst inquiries. There can be a huge opportunity cost. Given the disruption that has occurred in the world of equity research in recent years, now is a good time to examine the potential cost benefits to a new approach to how you deal with sell-side analysts.

Historically, the majority of organizations have relied upon sell-side analysts working for financial intermediaries to lead the public awareness effort. Although this practice is still central to the capital raising and secondary market-trading process, the research industry is being “disrupted” as a result of regulatory changes, technological advancements and competitiveness, driving available profit margins for research producers to razor-thin levels. In addition to margin compression, investors are demanding more extensive content and greater service from sell-side analysts, and they put management access at the top of the list. At the end of the day, the analysts need more of your time to do their jobs and more of your business to justify their existence.

Evolving Trends
The Financial Times reports that, worldwide, the number of sell-side equity research analysts employed by the 12 largest investment banks in the world is down 10% over the past decade.4 Starting with the introduction of Regulation Fair Disclosure (Reg FD) in August 2000 and further exacerbated by the $1.4 billion settlement between Wall Street securities firms and the SEC in August 2003,5 sell-side analysts have come under increasing competition as their grip on material proprietary information has slipped.

Investors no longer need to rely solely on sell-side analysts for key insight and direction when it is accessible directly from management in many cases for little if any cost. In fact, a recent study conducted by Thomson Reuters indicated that more than 40,000 research reports are generated each week but only 1% of them may actually be read.

In Europe starting in 2018, Markets in Financial Instruments Directive (MiFID) II regulations went into effect that require investment banks to break out specific pricing for equity research that heretofore has been offered “free of charge” but covered via other revenue streams such as trading commissions or advisory fees.

Having to disclose a price for equity research could open a Pandora’s box for investment banks and broker-dealers. Set the price too high and risk losing subscribers, set it too low and be overwhelmed with requests at unprofitable levels. Concurrently, investors are demanding more from each sell-side analyst report — as we discuss next.

What Do Investors Want From Equity Research?
A recent study based on a buy-side perspective of third-party sell-side equity research analysts highlighted the following benefits derived from these reports/relationships:

1. Access to senior management
Investors highly value the opportunity to talk one-on-one with senior executives. In this intimate setting, investors get to ask key questions beyond earshot of other investors, which can provide useful insight into a particular issue that other investors may have missed or ignored. While executives must comply with regulations, FD investors can get answers to the questions they see as critical success factors driving future results. In addition, hearing senior executives convey a strategic initiative directly can give a deeper understanding of the rationale and intent of any particular decision.

2. Deeper company insight
As pointed out under access to management, getting to ask key questions and hear management’s response firsthand gives investors deeper company insight.

3. The outsourcing of tedious, low return on investment (ROI) work
This item is clearly driven by scalability. Sell-side analysts who build and maintain detailed models to track a particular equity — a tedious, time-consuming effort — allow investors to off-load that responsibility, freeing up time to consider more opportunities. This also expands the number of equities that can be followed beyond the capability of an internal staff, thereby increasing scale.
4. The opportunity for new idea generation beyond internal scope
Internal research capabilities are not infinite, so sell-side analysts who cover smaller companies can extend the possible investment universe beyond that which can be monitored by using just internal resources.

5. Historical context of performance in different market cycles
A seasoned sell-side analyst who has followed a company for many years can share this experience to educate new investors of cyclical or seasonal aspects of equity performance that might otherwise be misinterpreted.

6. Red flags raised related to governance issues, changes in reporting and off-balance sheet developments
A byproduct of building a detailed model is the need to closely follow developments that may appear only in footnotes or changes in accounting methods that could indicate future issues that investors may want to consider or avoid.

Interestingly, in today’s world, many of the most highly valued benefits can be delivered through multiple channels, including directly by senior executives working in conjunction with trusted advisors and investor relations resources. The gatekeeper function that sell-side analysts have enjoyed for many years is being eroded, giving senior executives greater flexibility to prioritize and allocate the time devoted to keeping these individuals up to date. As more companies explore alternatives that are consistent with their own preferences for getting their story out to the investor universe, the traditional compensation structure and incentives will continue to come under pressure.

Compensation and Incentives
For direct investors or, more specifically, agent portfolio managers who work on behalf of beneficiaries, the incentives are clear: meet return objectives within the parameters and constraints defined by the ultimate beneficiary of the money invested. Consistently achieving the stated objectives largely guarantees ongoing business development and higher revenue. Compensation is typically tied to assets under management, so incentives to produce positive results are completely aligned.

Issuers are incentivized to meet the organizational goals previously discussed. Maximizing shareholder returns includes productively managing and growing assets while minimizing the cost of capital and efficiently utilizing balance sheet leverage. Compensation can be — and often is — tied to equity performance, but base salaries set by the board of directors and approved by shareholders also reflect successful achievement of the organization’s goals.

Whether buy-side analysts work directly for institutional investors or represent independent research firms (examples would include Morningstar, Value Line and Argus Research), the incentive is to develop a selection process that consistently identifies the best equity opportunities for investors to pursue. These analysts are typically paid salaries and bonuses tied directly to their performance. Just like the investors who employ them, their incentives are completely aligned.

As for sell-side analysts, the incentives and compensation structures are more complicated and often less transparent. The Financial Industry Regulatory Authority (FINRA) encourages these analysts to be compensated through the equity sales and trading process. In practice, particularly in today’s environment where competition, new technology and lower trading volumes have compressed direct margins, the ability to fully absorb the cost of equity research is compromised. Herein lies the major challenge facing the equity research marketplace today.

With investors demanding more from each research report while sponsors are struggling to find revenues to support the resources needed to deliver the desired content, these coexisting trends are forcing many sell-side research firms to look for other sources of revenue to subsidize the cost of research. This, in turn, adds pressure on issuers for more one-on-one time and to award other business, such as capital markets or M&A advisories, in order to maintain research coverage. If issuers fail to make enough time available or to allocate additional business, research can be suspended, thereby affecting investor awareness and share liquidity. The practice has become so widespread that FINRA is making it a priority to crack down on these “pay-to-play” schemes.

It is clear that the positioning of sell-side analysts creates conflicts of interest related to incentives. From the standpoint of the investor, the coverage universe seems to be shrinking as companies are dropped. Issuers may be forced to make suboptimal business decisions, feeling compelled to select firms that provide research coverage when other service providers or advisors are better qualified to meet the needs they have. This can negatively affect their ability to maximize shareholder value and/or minimize the cost of capital.

Implications for Senior Executives
The declining influence of sell-side analysts and the emergence of alternative methods to reach potential investors have major positive implications for senior executives. You are no longer held hostage by sell-side analysts as the only option for having your bank’s stock marketed to potential investors; now is the time to look closely at the sell-side analyst relationships you maintain to assess if the value proposition is still compelling. Although the following list is not exhaustive, we do believe it is a good starting point for evaluating whether spending time with each analyst that follows your equity is justified.
1. Does the analyst’s institutional following bring unique investors into ownership that would otherwise not consider a position?

2. Does the sponsoring firm actually provide regular liquidity to the market in support of the share price?

3. Are conversations two-way? What insights and suggestions has the analysts offered to help sell your story in a more effective manner?

4. If the coverage is dropped by a particular firm, would your marketability decline? Would investors exit positions? Does the trading volume generated by new or updated research enhance price support?

5. Have you asked the analysts to justify their existence in quantitative terms?

6. Are research reports insightful or are they nothing more than glorified press releases?

We are not suggesting the need to end all relationships with sell-side analysts. The good ones who measure up to many of the questions above will continue to be valuable partners in meeting business objectives. However, with the flaws in the historical industry model now becoming more apparent, senior executives may finally be in position to relieve the unnecessary pressure that comes with having to award business that justifies the cost of keeping all sell-side equity analysts content. We believe there is redundant effort being spent using conventional practices, which bears little if any incremental fruit to a company’s equity value. Conventional wisdom says the more equity analysts that are covering your stock the better; however, in today’s evolving marketplace, the time needed to keep all analysts’ content could very well exceed the benefits received in return.

Interestingly, some senior executives have already started dictating terms more aggressively. The Wall Street Journal recently published a report that highlights a trend to block access for any analyst who fails to rate an equity as a buy, thus forcing an opinion that might not reflect the true belief of the analyst. This practice jeopardizes the analyst’s credibility in the eyes of investors, forcing them to push for even greater management access in an attempt to differentiate their reports.

**Alternatives to Sell-Side Research Coverage**

A number of alternatives do exist to present your story to the investment community on a direct basis, which include the following:

1. Nondeal road shows produced internally with the guidance of a trusted advisor

2. Podcasts made available directly to the public via online stores such as iTunes or the company website

3. Collaboration with experts experienced in crafting press releases and earnings updates

4. Presentations at industry conferences

5. Hosting on-site investor days that bring interested parties directly to you with no strings attached

All of these methods take time and do require out-of-pocket expenses, but the cost is known and the follow-on obligations are much less than dealing with the pressure to award business that may ultimately exceed the actual business available to award. Furthermore, all are within the senior executive’s control.

**Conclusions**

GEICO insurance’s advertising states that “15 minutes can save you 15 percent or more on car insurance,” a statement that could analogously apply to senior executives at this time relative to the equity research process. Recent trends indicate the traditional equity research marketplace is being disrupted, making this an ideal time to evaluate how well you are allocating your time to this endeavor. There is a growing list of direct alternatives that present efficient methods of getting your story into the investor community, meeting investor expectations without adding pressure to award business in a less-than-optimal fashion, or give all sell-side analysts equal attention and further management access.
The Commonwealth realms are the nations like Canada and Australia that still recognize Queen Elizabeth as their sovereign and head of state. Prince Philip once observed that he and the Queen “lived over the shop” at Buckingham Palace.

StellarOne was doing an external search for a new CEO when Union approached the bank, offering to buy them. The succession planning process for a new CEO may well end with a merger, especially if there is shareholder pressure for improved performance and a higher share price.

In 2018, the Crapo Act reduced these requirements considerably.


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