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Know What You Are Worth

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We always find that our community bank clients more easily make the right decisions when the question at hand is considered in the proper context. What surprises us is the number of community banks that do not take the steps required to develop that context. Mark Twain understood the importance of placing decisions within their proper backdrop when he said, "Get your facts first, and then you can distort them as much as you please." In our present operating environment, we believe it is critical that a board know what the bank is worth before that unsolicited offer comes across the chairman's desk or before the board considers the question of seeking a strategic partner or other significant business decision. Save inflating your bank's value until the facts are gathered and then you can at least make your distortion knowingly.

Know your Metrics
The starting point for understanding what your institution is worth, is knowing how investors value a financial institution. A detailed discussion of valuation methodology is well beyond the scope of this article. Suffice it to say, the fundamental valuation of any business is grounded in its future earnings capacity. For publicly traded common stock, an institution's share price should reflect the market's estimation of future earnings power based on publicly available information. A discounted cash flow model is often used to create such an estimation and place a current value on a future earnings stream. It also is common to utilize financial ratios such as a price to earnings ratio, or p/e, which measures current share price against historical earnings, and a price to book (or tangible book) ratio to measure share price against a bank's book value, to establish a quick and dirty valuation. Ratios such as these also are useful in comparing a firm's share price to peers.

For banks (and bank holding companies) traded in the over-the-counter market, volatile trading volumes often reflect volatile share prices, which means the most recent closing price likely is not the best indicator of the current going concern value of the bank. If your institution is listed on a national stock exchange, the situation likely is better. However, many community banks (or their holding companies) that are listed on a national exchange still do not have sufficient trading volume for the previous day's closing price to be the perfect proxy for worth. Perhaps more important for understanding your firm's worth is the fact that trading prices can only reflect the current information available to the public.

An internal valuation is critical for the board and must be based on management's expectations of performance in the foreseeable future. In other words, for a board to make well informed business decisions it must understand the institution's expected worth if the current business plan is carried out. This is where valuation techniques like a discounted cash flow model are utilized. While this analysis is equal parts art and science, having a reasonable valuation of the bank based on expected future performance gives the board something against which to measure strategic decisions.

Being Prepared for the Unsolicited Offer
Clients often ask us, "Do I need to take this unsolicited offer to sell our bank to our

shareholders?" We also hear, "How do I respond to this unsolicited offer?" Our advice to clients is to begin by understanding what they are worth on a stand-alone basis so there is something to measure the offer against. If the board is properly armed with a current valuation of the bank based on its business plan, the decision becomes less complicated. If the unsolicited offer is higher than the valuation, then there is perhaps something to talk about with the potential acquirer. Whether you feel obligated to have a discussion is, of course, dependent on a variety of other variables besides valuations. If the offer is lower, then the board can reasonably make the decision to pass and remain focused on executing its business strategy.

Informing your Decision on Strategic Alternatives

Understanding your worth also gives you a gauge against which to measure major strategic decisions for your bank. If you are considering growing through acquisition, you need to understand your present worth, and how a potential acquisition will affect your bank. Will that acquisition be accretive or dilutive to earnings, and for how long. If you are on the selling side of the equation, you must know your current worth on a stand-alone basis to make an informed decision about the impact of partnering with another bank. A selling board must be able to answer the question, "Is there more for our shareholders in selling or in remaining independent?"

Conclusion

To avoid potential liability, board decisions on major strategic matters must be defensible. This is particularly true when robust growth is not easily at hand, and plaintiff's lawyers appear readier than ever to question a board's decision making. The first line of defense is understanding what your bank is worth today based on its expected future earnings. With that knowledge in hand, a board can place decisions in the proper context and move forward more confidently.

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