

Managing The Value of Your Bank

Turn a “Fold” to a “Hold” Through Increased Earnings

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Too many bankers are selling out cheap!

For crying out loud, if America is to lose its network of community banking institutions, don't sell it cheaply!

It is high time that we expose the mystery surrounding bank valuation. Find out what's being said in those hushed conversations that take place between investment bankers and their holding company clients.

Every institution should know how to establish acquisition value - either its own or that of potential targets. Boards of directors and management teams shouldn't have to anguish about every purchase offer to come down the pike. Many of these offers are simply out-of-the-money+ and can be rejected out of hand. Of course coming up with the exact acquisition value is not usually possible, since unknown elements of franchise value, both positive and negative, often lie in the beady little eyes of an acquirer. We can, however, examine the process used to determine acquisition value.

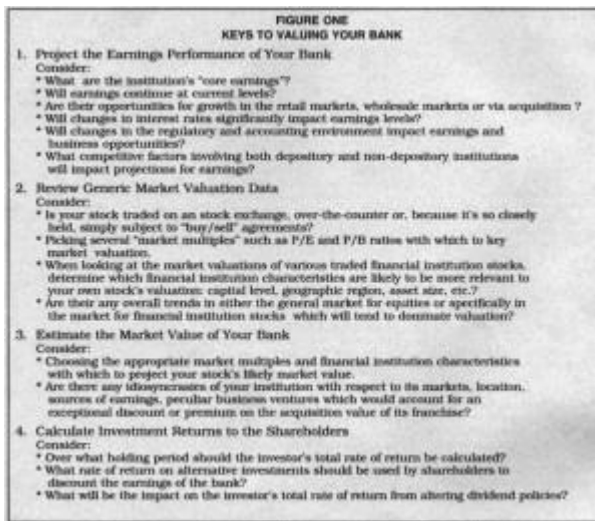
I suspect that as we describe the process of determining franchise value, management will see many ways to increase the return to shareholders through continuing to operate the bank! Improving earnings performance is a sure way to increase franchise value regardless of whether the decision is to hold or to fold.

Listen to me Directors! Even the smallest community bank can produce very competitive returns to shareholders. You need to spend as much of your time discussing how to make money with your community bank investment as you spend at seminars discussing directors' duties and liabilities.

The autonomy of community bank franchises can only be protected in the long run through achieving competitive returns. Even closely owned banks must eventually produce a competitive return. Eventually, some investor will want or need to liquidate a large portion of bank stock. Unless the new owners receive a competitive return on the price that they paid for the stock, they may choose to agitate for the sale of the bank. It is also important for bank management to consider some of the mechanisms that are used to transfer ownership of closely held banks without triggering the sale of the bank. Even a high performing bank can wind up on the auction block, unless provisions are made to provide for an orderly disposition of the bank's stock.

Let me say a word to mutually owned institutions. Recognize that the competitive return on equity required by stock institutions impacts your institution. The urgency to produce a competitive return defines the pace of market competition. This competition affects everything from the relentless pressure to grow, to the way in which institutions price, package and market their products and services. Mutual institutions may have more flexibility in responding to market pressures, but they ignore these pressures at their own peril.

As we discuss the keys to the financial valuation of your bank, we'll refer too many of the same factors that an independent appraiser would consider when rendering a fairness opinion regarding a proposed offer for the bank. Figure 1 lists these factors.



There are four steps in evaluating whether a bank's stock should be held or sold. The first step is to project the core earnings of the institution.

Second, we review financial and market pricing-statistics from a selected group of financial institutions to arrive at some ratios that will help us assess how present and potential stockholders will value the earnings. Third, we must estimate the market value and the potential acquisition value (sale price) of the institution.

Finally, we calculate the alternate rates of return to the shareholder. We examine several investment strategies. Our most important analysis compares two strategies. In one strategy the investor holds the stock of the institution over a specific holding period and then sells the bank. In the alternate strategy the investor sells the institution now and finds another investment vehicle in which to invest the proceeds over the same holding period. The discussion of these strategies provides the answer to the hold-or-sell dilemma.

Projecting the Earnings of the Bank

Figures 2 through 5 are the financial forecasts and calculations for a hypothetical institution. We'd call it Tom\$ Bank.

Figure Two
Tom's Bank Financial Projections (000's)

Financial Projections	Current	Year 1	Year 2	Year 3	Year 4	Year 5
Total Assets (000)	300,000	320,000	345,000	360,000	375,000	410,000
Cumulative Growth Rate		6.67%	7.03%	5.80%	5.21%	5.87%
Net Income (000)	3,000	3,200	3,450	3,600	3,750	4,100
Dividends (000)	1,000	1,000	1,000	1,000	1,000	1,000
Capital Injection (Repurchase)	0	0	0	0	0	0
Total Equity	30,000	38,300	40,650	43,250	46,000	49,100
Capital/Assets	12.00%	11.94%	11.79%	12.01%	12.27%	11.98%
ROA		1.03%	1.04%	1.02%	1.02%	1.04%
Equity Multiplier	8.36	8.43	8.40	8.24	8.25	8.25
ROE		8.63%	8.75%	8.59%	8.40%	8.62%
Internal Capital Growth Rate		5.93%	6.21%	6.20%	6.10%	6.52%
Per Share Information	Current	Year 1	Year 2	Year 3	Year 4	Year 5
Book Value Per Share	\$7.20	\$7.64	\$8.13	\$8.65	\$9.20	\$9.82
Earnings Per Share	\$0.60	\$0.64	\$0.69	\$0.72	\$0.75	\$0.82
Dividends Per Share		\$0.20	\$0.20	\$0.20	\$0.20	\$0.20

Figure 2 lists the financial projections for Tom\$ Bank for our assumed holding period of five years. Tom\$ starts out as a \$300 million bank and is projected to grow to \$410 million over five years. The rate of growth is slightly uneven, varying between five and seven percent per year. The ROA at the bank is expected to stay right around one percent. Given the expected annual \$1 million dividend payout, the capital/asset ratio of the bank remains about 12%.

Figure 2 also displays the earnings and accumulated equity position of the bank on a per share basis. With earnings per share trending-up from \$0.60 to \$0.82, net of the dividend payout, the book value per share grows from \$7.20 to \$9.82.

The seemingly straight-forward financial projection shown in Figure 2 presumes that management has reviewed a host of considerations in order to give credibility to these projections.

Notice that I specified a five-year holding period over which we forecast earnings. The length of this holding period is purely subjective and often an area of contention between management and shareholders. Shareholders often have investment alternatives, or they die and their heirs do. Sometimes directors (and managers) who are shareholders simply get old, tired, or both. They want to cash out and go sit in the sun. Management often wants a holding period long enough to accumulate salary, benefits and stock so they can eventually cash out and go sit in the sun too.

Remember, also, that management often has an optimistic view of what it can accomplish during this holding period while shareholders often have a more skeptical view. Figure 1 lists several questions that need to be answered when earnings are being forecast.

What are the Institution's core earnings? We want to subtract the income or loss associated with nonrecurring business transactions. For instance we would subtract the gains or losses associated with non-recurring security sales or other balance sheet transactions. Even fee income associated with unusual levels of transactions, such as a flurry of mortgage refinancings,

would represent the type of earnings that we might not want to consider as part of an expected ongoing stream of earnings. Core earnings are those from sources that we can reasonably expect to provide a consistent flow of earnings over the holding period.

Will earnings continue at current levels? Apart from the changing level of interest rates (which bears special consideration) what business factors may affect future earnings? Consider the introduction of new products and services or the loss of the same. Consider the institution's capacity to adopt different competitive strategies and develop the management talent to ensure the continued flow of earnings from the institution's standard business lines.

Are there opportunities for growth in the retail markets, wholesale markets or via acquisition? The fall out of customers from the acquisition of community banks by out of market banks and holding companies is providing growth opportunities for the remaining locally owned banks. Community banks are in a position to take advantage of the void in local underwriting and servicing. Efficiently priced loans and deposits can provide a real retail base for the necessary leveraging of the community bank franchise. Retail loan growth may be desirable even if the funding required to support this growth comes from borrowing wholesale funds.

Some banks pursue strategies to augment the growth of the bank via various matched investment transactions. These strategies produce earnings that are directly dependent on the slope of the yield curve and the extent of the interest rate risk taken by the bank. Banks whose balance sheets are dominated by investment securities need to be especially sensitive to interest rate forecasts when projecting earnings.

Unless a bank has established a consistent track record in doing acquisitions, it's usually not wise to project acquisitions as a means of leveraging the bank's balance sheet. If a specific acquisition is being proposed, then consider the earnings impact. It's usually speculative to count an acquisition chickens before they've hatched.

Will changes in interest rates significantly impact earnings? The market still perceives that bank stocks will be sensitive to fluctuations in the interest rate cycle. Investors will typically look for and reward consistency in earnings. It's important to convince investors that your bank can maintain reasonable and consistent interest margins throughout an interest rate cycle. Otherwise, the investor may expect that the holding period will contain an interest rate cycle that could adversely impact earnings.

Will changes in the regulatory and accounting environment impact earnings and business opportunities? When considering regulatory and accounting changes, we need to identify onetime shocks to the balance sheet and income statement. We also need to identify those changes that will produce more enduring impacts on performance.

For instance, both accountants and regulators have recently become fixated on marking-to-market portions of the balance sheet. Their decisions have resulted in one-time adjustments to income statements that are not at all representative of any earnings trends.

Similarly, the proposed assessment of a 85-90 basis point premium to move SAIF insured deposits to BIF insurance will be a one-time charge that should, however, reduce on-going deposit expenses annually by approximately 20 basis points. Most investors will view the market value impact of this regulatory change as a wash.

On the other hand, an institution may seek to adopt a particular banking charter, e.g., state or federal, which permits the development of certain business lines that may have a longer-lasting impact on earnings.

What competitive factors involving both depository and non-depository institutions will impact projections for earnings? How is the bank planning to compete for retail funding with the increasingly competitive mutual funds? How is the bank planning to compete for loan originations with mortgage bankers and a whole host of brokers of homogenized and pasteurized asset products from commercial leasing to auto paper to equity lines?

I know. I know. The process of answering all of these questions makes it sound as if you have to write a damn strategic plan just to be able to lay out a simple income projection. Bingo! Somewhere along the line the institution must demonstrate to the investor's satisfaction that earnings forecasts won't be blind-sided by events that should have been considered.

We'll assume that the financial forecasts for Tom's Bank, shown in Figure 2 passes the credibility test. Next we must project how investors will value the bank over the holding period.

Reviewing Generic Market Valuation Data

Let's be clinical for a moment and view your bank as an investment. Consider the bank an asset which throws off an earnings stream that is either paid out as dividends or accumulated as an accretion to shareholder's equity. As is the case with evaluating the performance of all investments, investors should focus on the total rate of return from holding the bank's stock over a specified period of time. Evaluating total rate of return involves valuing both cash flows received during the holding period as well as the capital gains (or losses) at the end of the holding period.

I realize that your bank is a business producing jobs for employees as well as benefits for the community. You insist that your bank's franchise value is full of intangibles that resist being distilled to a present value. However, viewing the bank as a pure investment will give us some insight about how the market forms expectations about the value of the bank. So, let's try it.

A Look At Trading Value

Figure 3 lists summary data on the market valuation of those banks for which there is regular, updated information. Typically it means that these banks will be traded either over the counter by brokers or listed on one of the stock exchanges. Of course many banks are not traded actively at all and may be so closely held that no broker even makes a market in the stock. Still, the market data on traded institutions remains representative of how investors value the banking business.

Figure 3 lists two of the statistical ratios, the price/earnings ratio and the price/book value ratio, that are commonly used to reflect the market's valuation of bank stocks. Why should we use P/E and P/B ratios as indices of market value? Usually earnings will drive the market valuation of the stock of a bank or of any business enterprise. The P/E ratio is a ratio of the price of a share of the bank's stock to the annualized earnings per share of this stock. The significance of the P/E ratio may be more easily understood by viewing it as the inverse of the required rate of return of the investor, expressed as E/P.

**Figure Three
Market Valuation of Bank Stocks**

Financial & Pricing Characteristics - Publicly Traded Banks	Banks - Normal				Banks Acquisitions			
	# of Inst	P/E	P/B	% Alloc	# of Inst	P/E	P/B	% Alloc
All Publicly Traded	394	13.2	166.7	0.00%	29	17.1	210.7	100.00%
Mean								
NYSE Banks	52	12.4	203.5	0.00%	0	0	0	0.00%
OTC Banks	323	13.3	164.5	15.00%	0	0	0	0.00%
AMEX Banks	19	12.9	133.3	0.00%	0	0	0	0.00%
Super Regional Banks	15	12.5	243.7	0.00%				0.00%
With Dividends	131	13.2	172.8	0.00%				0.00%
Without Dividends	63	13.0	136.4	0.00%				0.00%
Financial Stratification								
Assets < \$200 Million	58	14.7	133.4	0.00%				0.00%
Assets \$200-750 Million	141	13.1	102.4	20.00%				0.00%
Assets \$750-4,000 Million	112	13.3	178.3	0.00%				0.00%
Assets > \$4,000 Million	83	12.5	106.1	0.00%				0.00%
Tangible Equity < 0.00%	20	12.8	189.4	0.00%				0.00%
Tangible Equity 0.00%-0.00%	223	12.9	171.3	0.00%				0.00%
Tangible Equity 0.00%-14.50%	140	13.6	161.8	50.00%				0.00%
Tangible Equity > 14.00%	10	13.8	110.3	0.00%				0.00%
Regional Stratification								
Mid-Atlantic	97	13.1	163.0	0.00%	9	17.26	134.9	0.00%
Mid-West	96	13.6	181.0	15.00%	3	15.31	119.0	0.00%
North-East	52	11.7	158.1	0.00%	3	17.48	133.7	0.00%
South-East	53	13.8	178.2	0.00%	5	18.79	146.6	0.00%
South-West	15	14.1	166.0	0.00%	5	17.01		0.00%
Western States	42	14.4	133.0	0.00%	4	16.36	127.3	0.00%
Results from Table								
Weighted Average P/E		13.5				17.1		
Weighted Average P/B			166.7				210.7	
Total Percent Allocated			100.00%				100.00%	

For instance, a price-earnings multiple of 13.5 to 1 is equivalent to an earnings to price ratio of (1 / 13.5) or a rate of return of 7.4%. Thus, if investors are willing to pay a price for a share of stock equal to 13.5 times the bank's annual earnings per share, it is equivalent to saying that investors demand a 7.4% current return on their investment. An investor's demand for the stock is also driven by the potential for capital gains from the sale of the bank. This potential to realize acquisition value may drive up the price of the stock and result in higher P/E multiples. The investor's return from bank earnings is reduced as they await the kick to their total rate of return from the anticipated capital gain.

We can view the price/book ratio as a measure of the market's belief that the management of the institution can convert the capital of the institution into a consistent source of earnings. (We can

actually listed the price to tangible book value as the appropriate ratio in order to capture the impact of any goodwill attached to the balance sheets of banks. Accounting goodwill is often the result of acquisitions where the acquirer pays a premium to book value. Goodwill inflates book equity and deflates earnings while it's being amortized. For banks that have no goodwill, tangible book value and book value are one and the same; it's therefore a non-issue.) If the market perceives extraordinary interest rate risk, credit risk, regulatory risk, or anything that threatens the earnings potential of the capital of the institution, it will pay a lower multiple of book value for the stock of the bank.

Many banks maintain capital well in excess of that required by regulators for considerations of safety and soundness. In such situations the market may become convinced that the bank will never use the excess capital to generate increased earnings. Thus, investors will value the excess capital at book. This will result in substantially overcapitalized banks being valued at considerably lower P/B ratios. Figure 3 clearly illustrates those banks with capital/asset ratios in excess of 14% trade at prices only averaging 110% of book value.

A Look At Acquisition Value

Figure 3 also displays the PIE and P/TB ratios on those banks that have announced that they are being sold to an acquirer. The trading multiples currently reflect the acquisition premium, or what is often referred to as a control premium, being paid by the acquirer. Owning a controlling interest in a bank is worth more than only owning a share of stock. How much more? Well, during the time period covered by the data in Figure 3, the end of January 1996, the average P/E ratio paid for acquired banks was 17.1. Compared to the trading average PIE of 13.2, this represents an acquisition premium of about 29.5% based on earnings. The P/E premium did vary substantially across regions from a low of around 12% in the Midwest to a high of almost 50% in the northeast. Of course these averages are based on such a small number of transactions, they could be skewed. They are current marketplace transactions, however, and must be considered.

Acquisition prices averaged 210.7% of TB. This amounted to about a 26.4 % average acquisition premium. Acquisition premiums based on book value also varied by region.

It is noteworthy that both earnings based and book value based valuation techniques produced similar 25%-30% estimates of acquisition premiums.

Estimating The Market Value of Your Bank

Currently the actual trading price of Tom's Bank stock is \$8.07. This represents a pricing multiple of 13.45 times earnings and 1.12 times book value. Now, what I need to do is identify some peer bank groups from which I can extrapolate market price multiples that can be applied to my earnings forecasts.

For instance, Tom's Bank is traded over the counter, has an asset size in the \$250 million to \$750 million category, has a capital/asset ratio in the 9.0%-14.0% category and is located in the mid-west. I then subjectively weigh the percentage of importance of each peer group (see the allocation % column) to come-up with a weighted average market multiple. These averages, a 13.5 P/E ratio and a 165.3% P/TB ratio based off normal trading prices, are shown in the bottom of Figure 3.

These are the market multiples that I will use to estimate the market values for each year of the five-year holding period for Tom's Bank assuming no acquisition. Figure 4 displays the estimated market values, which are shown calculated separately based off P/E and P/B multiples. For example, using a P/E multiple of 13.5 and an earnings per share forecast of \$0.64 in year one, I estimate a market valuation based off earnings of \$8.64 in year one. However, when I used a P/TB multiple of 165.3% and a book value per share forecast of \$7.64 at the end of year one, I estimated a market value based off book value of \$12.63 at the end of year one. Next I apply another subjective judgment about the weight to assign to the P/E and P/B estimates of market value to arrive at a weighted average estimate of market value.

Oh boy. Wouldn't you just know that right out of the box I'm giving you an example that's going to be squirrelly? Because I don't like the 165% P/B assumption applied to Tom's Bank, I'm giving it a weight of zero and giving the P/E-based estimate of market value a weight of 100%. Don't get cranky on me, I told you this weighting was subjective.

So, you say, in what examination of animal entrails do you base this judgment, almighty Seer of Market Values. Well, for one, the actual market price is currently trading at only 112% of book value. This discrepancy of P/B from my peer group average is most likely due to the over-capitalized condition of Tom's Bank. In fact, if Tom's Bank were only carrying a capital/asset ratio of 7.0%, the resulting book value per share of \$4.20 would produce a price to book multiple of 168%. This ratio would be right on target with the peer average for that capital/asset grouping.

You know, if I had some additional data besides the summary tables shown in Figure 3, I might have searched for a better peer group and come up with more reasonable estimate of market value based on book value. But I feel OK about the 100% weight given to the estimate of market value based on earnings.

Using the P/E multiple, I estimate the market value of the bank would increase from its current price of \$8.07 to a price of \$11.07 at the end of year five.

Figure Four
Market Values Based on P/B and P/E

Estimated Market Value	Current	Year 1	Year 2	Year 3	Year 4	Year 5
With No Acquisition Premium						
F/E Assumption	13.455	13.500	13.500	13.500	13.500	13.500
Market Value Based on P/E	\$8.07	\$8.04	\$9.32	\$9.72	\$10.13	\$11.07
Weight Allocated to P/E	100.00%	100.00%	100.00%	100.00%	100.00%	100.00%
F/B Assumption	165.34	165.30	165.30	165.30	165.30	165.30
Market Value Based on P/B	\$11.50	\$12.63	\$13.44	\$14.30	\$15.21	\$16.23
Weight Allocated to P/B	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
No Acquisition Premium Price	\$8.07	\$8.04	\$9.32	\$9.72	\$10.13	\$11.07
With Acquisition Premium						
F/E Assumption	17.1	17.1	17.1	17.1	17.1	17.1
Market Value Based on P/E	\$10.26	\$10.94	\$11.80	\$12.31	\$12.83	\$14.02
Weight Allocated to P/E	75.00%	75.00%	75.00%	75.00%	75.00%	75.00%
F/B Assumption	210.7	210.7	210.7	210.7	210.7	210.7
Market Value Based on P/B	\$15.17	\$18.10	\$17.13	\$18.23	\$19.38	\$20.69
Weight Allocated to P/B	25.00%	25.00%	25.00%	25.00%	25.00%	25.00%
Acquisition Premium Price	\$11.49	\$12.23	\$13.13	\$13.79	\$14.46	\$15.69

In order to derive estimates of market values that include an acquisition premium I've assumed an acquisition P/E of 17.1 and an acquisition P/B of 210.7%. These estimated market values are also shown in Figure 4. I repeat the process of separately calculating market values and weighting them. In this instance, however, I do assign a 25% weight to the estimate of market value based on book value. My guess is that even the %excess+capital at Tomç Bank will have some value when employed by an acquirer either in this or some other market.

The estimated acquisition value of Tomç Bank increases from \$11.49 currently to a price of \$15.69 at the end of year five.

Would my projections of market value change if my assumptions changed regarding the P/E and P/B multiples? Of course. But is there any reason why I would expect these pricing ratios to trend up or down substantially over the holding period? Are these ratios sitting at historically high or low levels? Not that I could tell. I suppose anybody who wants to make a case for selling the bank now can argue that these pricing ratios are going to trend down in the future. But in the absence of any information to the contrary, I'm going to assume these pricing ratios remain constant over the holding period.

Calculating Alternative Rates of Return

Figure 5-A shows the total rates of return which accrue to shareholders for each year over a five-year time horizon for three different investment strategies.

Figure 5-A
Stockholder TRR for Three Investment Strategies

Stockholder Return if Held	Current	Year 1	Year 2	Year 3	Year 4	Year 5
Bank Doesn't Sell						
Stock Sale Price	\$8.073	\$8.640	\$9.315	\$9.720	\$10.125	\$11.070
Return on Investment		9.50%	8.81%	8.72%	8.11%	8.72%
Bank Sells Later						
Stock Sale Price	8.073	12.332	13.132	13.790	14.465	15.689
Return on Investment		54.00%	29.70%	21.64%	17.72%	16.15%
Bank Sells Now vs Later						
Stock Sale Price	\$11.488	\$12.232	\$13.132	\$13.790	\$14.465	\$15.689
Return on Investment		8.32%	8.69%	7.92%	7.53%	7.99%

First we examine the result of simply holding on to the stock of Tomç Bank, receiving whatever dividends are being paid and reaping the implicit gain from the projected increase in the market value of the %normally-traded+stock. The bank is not assumed to be sold at any point of the

holding period, so no acquisition premium is ever factored into our calculation. Because of the slight variation in the projected earnings stream of the bank over time, the rate of return to investors starts out at 9.50% at the end of year one and wobbles a bit before arriving at a return of 8.72% for a full five-year holding period.

Is this 8% to 9% return on investment good? Well, compared to what other investment alternative for which investors? The expectations of a professional investor in bank equities may be substantially different from the expectations of the proverbial little old person who plans to sit on their shares of bank stock until they hatch. And they both differ from the expectations of owner-managers who substantially augment their investment returns with salaries and benefits that are a function of their continued ownership! Apart from this later owner-manager group, returns to the investment in bank equities need to be in the range of 12% to 15% to be considered competitive with risk-adjusted alternative investments for most investors.

This 12% to 15% level seems to be the long-term requirement of investors in bank stocks. It surely can vary over short periods of time. It's possible that the general characteristics and risk profile of the banking business may change enough in the future to change investors required rates of return. But for now, I'd be concerned to be satisfied targeting an investment return of less than 12%. It's my call. Argue with it, if you want.

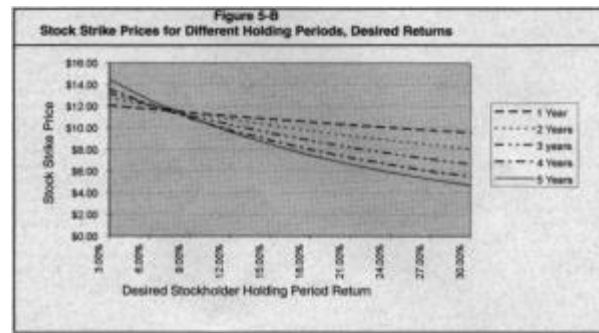
The second-rate of return calculation assumes that the bank is sold for its acquisition value at the end of either year one, two, three, four or five. *Mama mia,* look at that rate of return! 54% at the end of year one, 29% at the end of year two! Sell now! Don't wait! Heck, I can see why acquisition value almost becomes a self-fulfilling prophecy. Bid up the price because I think the bank is going to sell, thereby establishing an acquisition premium that produces the pressure to sell. This may be an investment strategy that fits the profile of some professional investors. They continually buy and sell bank stocks that have a short expected holding period and a high potential for sale of the bank. But for many investors, it doesn't answer the question of what do I do with my money after I sell. For this I need to do another return on investment calculation.

The third calculation produces a rate of return at which the investor is indifferent between the decision to continue to own the stock of the bank and the decision to sell the bank.

Let's assume the investor has a three-year holding period. Currently the investor owns a stock that if the bank were sold today would bring a price of \$11.49 per share. This \$11.49 would have to be immediately re-invested for the remainder of the three-year holding period. (I'm going to hold the question of taxes aside for now by assuming the investor gets paid with another stock as opposed to cash. The assumption can be dropped as long as we tax effect all of the appropriate cash flows.

On the other hand, if the investor holds onto the stock for the full three years and then the bank is sold, the shares sell for a price of \$13.79. So the question becomes: What rate does the investor have to earn on \$11.49 over the next three years to emerge with a future value of \$13.79? Keep in mind that while the investor is holding the stock he will be receiving dividend cash flows. The answer is 7.92%. At this reinvestment rate the investor is indifferent between the option of holding the bank for now and holding the bank at the end of three years, and the option of holding the bank now and reinvesting the proceeds for three years.

This implicit rate of return from holding the bank's stock and selling at some point in the future is shown at the bottom of Figure 5-A for each of five holding periods. It hovers around 8%. Not so good, at least if one considers my 12% alternative investment return to be our target.



In fact, if we look at the graph in Figure 5-B we will see just what the acquisition price of Tom's Bank has to be TODAY (the bank's strike price) to make me indifferent about holding on to the bank's stock if the investor's alternative re-investment rate is 12% over a specified holding period, which, in this case is three years. Exhibit 5-B shows this strike price for a variety of holding periods and required rates of return. With my 12% desired return and my three-year holding period, if I can solicit an offer of greater than \$10.30 per share, you're history, baby. An offer of \$10.30 would represent an offer just over 17 times earnings or about 143% of book value. For a bank? Yeah, this offer looks doable. I'll tell you this, it's too close for my sense of management comfort.

Figure 5-B reinforces some interesting little lessons about finance. The strike price or the price we have to be offered in order to sell the bank increases as the return on alternative investments decreases. This makes intuitive sense. If our investment alternatives are lousy, we might as well keep the bank. Hmmm. That's what we need, a bunch of investors with lousy alternatives. I'm joking, I'm joking. But there is something to be said for managing the investor group so that it reflects a more homogeneous set of investment strategies and holding periods. You see there's a nice way to say anything.

Note also in Figure 5-B that when the investor's alternative rate of return is better than the return from holding the bank, the strike price decreases as the holding period lengthens. Conversely,

when the investor's alternative rate of return is less than the return from holding the bank, the strike price increase as the holding period lengthens.

So, what marvelous management insight can we glean from reviewing Figure 5-B? I shall call it Dr. Tom's %Hold or Fold+Rule of Management: Maintain a return on an investment in the bank's stock equal to or greater than the return on your investor's alternatives. Do this and you'll keep running the bank.

If the management at Tom's Bank wants to remain independent they better get busy increasing those earnings that will in turn raise the %strike price+at which the bank gets sold. Far too many banks are accumulating stores of excess capital. This is capital that could be used to generate earnings and produce the rates of return required to keep the bank independent. Watch what Mr. Farin does with Tom's Bank!