MBA

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Tax Reform in Action:

From Policy to Practical Application

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Important Disclaimer

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The following information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

Application of the information to specific situations and clients is subjective and subject to uncertainty

Nothing in the following is intended to be political commentary

Presentation Outline

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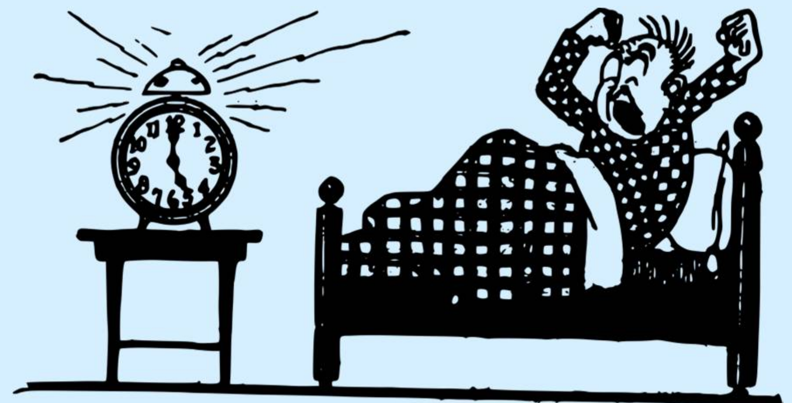
- Banking Landscape and the Role of Tax Reform
- Implications for Banks
- Implications on Businesses and Individuals (Bank Customers)
- Trends and Reactions Early in the Game
- Setting the Stage for 2019 and Beyond



The Evolving Banking Landscape

- The last year has been a period of transition:
  - From "Trump Bump" to tax reform
  - Low rates and flat yield curve to higher rates and (hopefully) a steeper yield curve
  - Loan and asset focused to core deposit and funding focused
  - Move from chasing lower valuations to justifying and defending higher valuations

- Tax reform helped continue the post-election rally into 2018, with uncertainty around domestic and geo-politics, tariffs and potential trade wars heightening volatility:
  - ***How much of the benefit of tax reform will fall to the bottom line and how much will banks compete away (the market has priced in a meaningful impact)?***

- The Economic Growth, Regulatory Relief and Consumer Protection Act provided long-expected relief from Dodd-Frank, but tangible benefits for smaller community banks seem limited:
  - Increase in small bank holding company threshold
  - Community bank leverage ratio as an off-ramp to Basel III compliance
  - Relief from bank-run DFAST stress testing (for larger community banks)
  - Other mortgage banking and operational simplifications

Themes Since The Presidential Election

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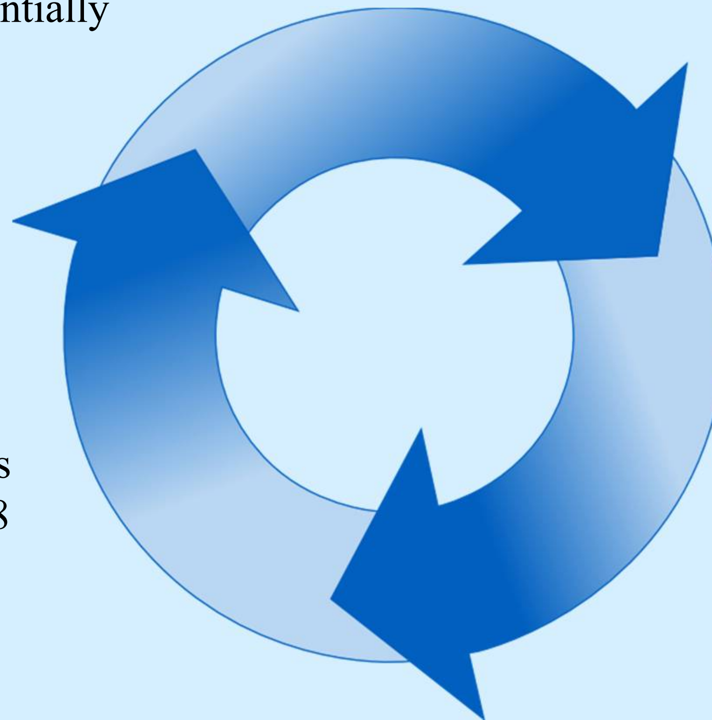
Cautious Optimism
- Tax reform actually happened
- Potential for earnings improvement
- Hope for growth stimulus
- Rising rates but also potentially steeper yield curve
- Regulatory relief

Hopefulness
- Continuity in a Republican House, Senate, and the White House
- Economic stimulus
- Deregulation
- Taxes



Acceptance
- Tired of waiting on policy
- Limited regulatory relief
- Go back to focus on challenges
- Likely pickup in M&A in 2018

Uncertainty
- Health care, immigration
- Federal Reserve rate stance
- Fed and Regulatory openings
- Domestic and Geo-Political Environment

Change
- Focus from loans to deposits
- Financial technology
- Cybersecurity
- Bitcoin

Volatility
- Yield curve flatter, not steeper
- Washington unpredictable
- Stronger focus on the impact of rising rates on deposit pricing

Economic Growth, The Fed and Interest Rates

- Consensus estimates have the Fed tightening a total of 3 to 4 times this year
- March plus two more (for a total of 3) rate increases anticipated for 2018
- In 2019, the market anticipates 2 more tightening / rate increases
- The Treasury Curve is expected to follow suit, first steepening, then leveling off
- Recent Fed minutes outline the possibility that rates may have to be hiked more quickly to fight inflation, only to acknowledge the ongoing developments around U.S. tariffs as a risk to GDP growth

Bloomberg Economist's consensus forecast Survey: May 2018

Current: 1.50% - 1.75%

		2018			2019			2020		
	2Q	3Q	4Q	1Q	2Q	3Q	4Q	1Q	2Q	3Q
# Replies	71	71	71	69	65	52	52	33	32	29
Median	**2.00%**	**2.25%**	**2.25%**	**2.50%**	**2.75%**	**3.00%**	**3.00%**	**3.00%**	**3.25%**	**3.25%**
Average	1.97%	2.17%	2.38%	2.58%	2.76%	2.92%	3.01%	3.03%	3.20%	3.18%
High	*2.25%*	*3.00%*	*3.00%*	*3.25%*	*3.25%*	*3.50%*	*3.50%*	*3.75%*	*4.00%*	*5.24%*
Low	*1.75%*	*1.75%*	*1.75%*	*1.75%*	*1.75%*	*1.50%*	*1.50%*	*1.50%*	*1.50%*	*1.25%*

The Impact of Tax Reform | The Big Picture

- Improved economy, wages, investment performance and taxable income should increase consumer net worth, liquidity and consumer loan portfolio quality
- Higher growth means higher interest rates, which along with a steeper yield curve, are generally positive for bank performance (higher growth results in higher valuation)
- Eliminates or reduces certain deductions, including for certain compensation arrangements, and the loss of deductibility of FDIC premiums, starting in part for banks over $10 billion and fully non-deductible when total assets exceed $50 billion
- Banks are the highest taxed industry in the S&P 500, so earnings should be impacted by 10-15% according to market estimates, however . . .
  - Will banks pay out or compete away a lot of that benefit?
  - Will stronger income and retained earnings be reinvested in higher loan growth, particularly at this late stage of the credit cycle?
  - Will a stronger economy and higher earnings increase or reduce the need for customers to leverage?
- *For community banks, tax reform is much more about your bank clients than your bank itself*

A Recalibration of Valuation | P/E Ratio

Price / LTM EPS (2018 earnings are MRQ annualized)

P/E ratios have returned to long term averages of 12-15x

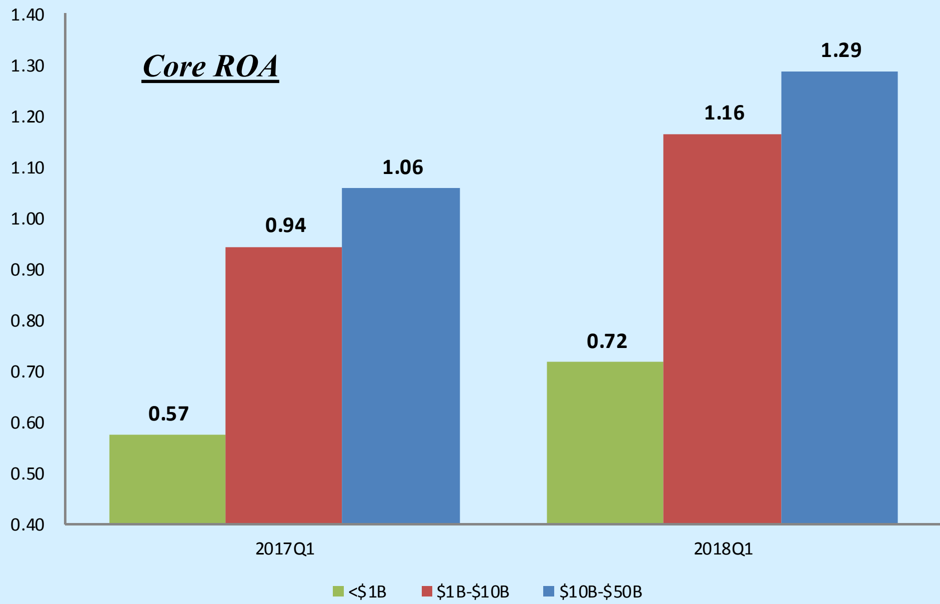
26
24
22
20
18
16
14
12
10

2016Q3 2016Q4 2017Q1 2017Q2 2017Q3 2017Q4 2018Q1

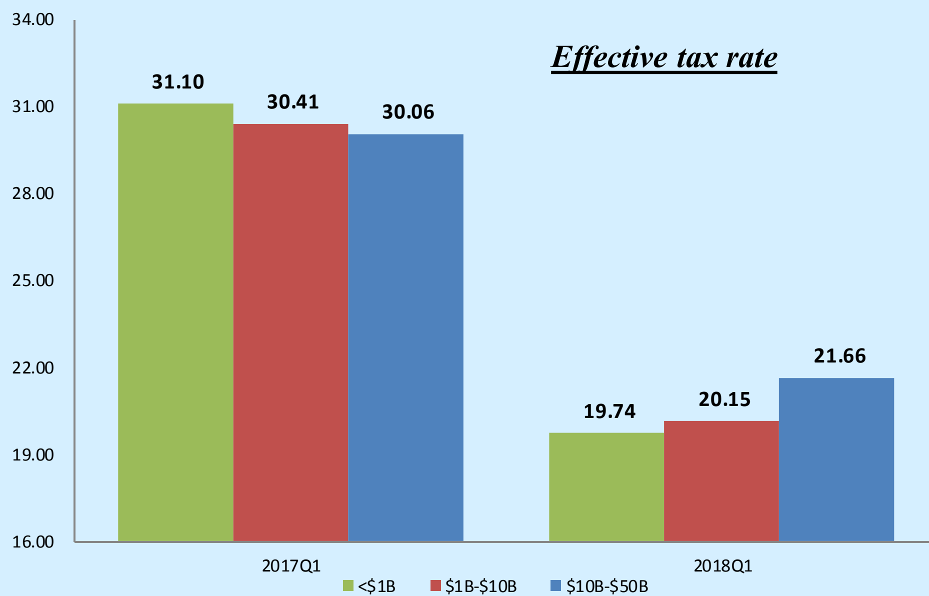
<$1B $1B-$10B $10B-$50B

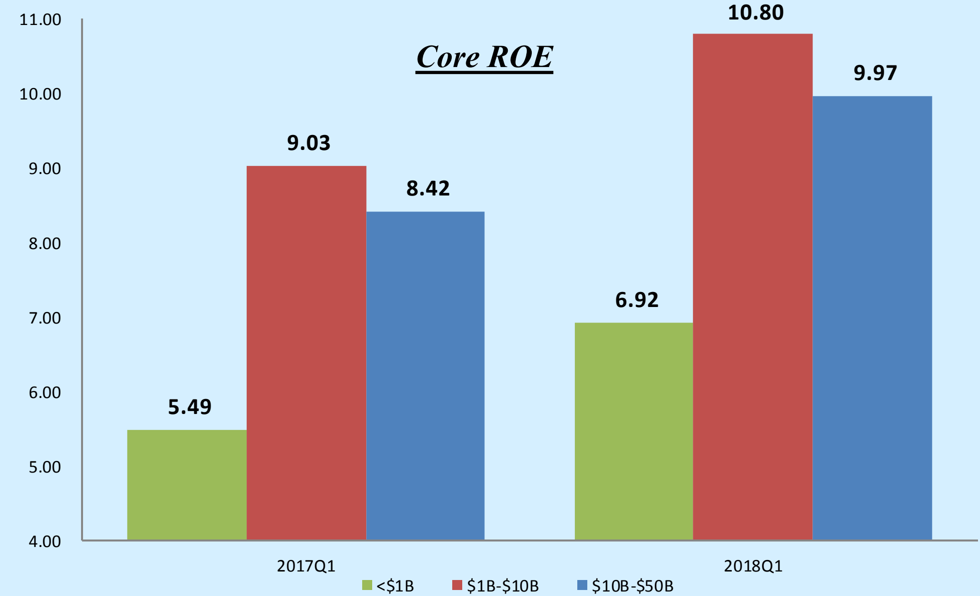
Source: S&P Global Market Intelligence. All banks traded on a national exchange as of 3/31/2018. For P/LTM EPS, Q1 2018 earnings are annualized.

A Recalibration of Performance | ROA and ROE



A reduction in the effective tax rate is the primary driver behind significant earnings improvement year-over-year





Source: S&P Global Market Intelligence. All banks traded on a national exchange as of 3/31/2018.

Deploying the Benefit of Tax Reform

According to the American Bankers Association, within the first 60 days of the passage of tax reform, more than 75 U.S. banks announced plans for employee raises and bonuses, plus stock-dividend increases and increased charitable giving, a number which is clearly higher today (and does not include those who have not publicly announced their efforts)

- Increasing common dividends
  - Of 103 publicly traded banks in the Northeast that pay a dividend, approximately 58% have increased their quarterly cash dividend since the third quarter of 2017
- Special dividends
- Increasing wages for employees and/or paying one-time bonuses
- Contributing to charitable foundation

- *Don't be in too big a hurry to give away the benefits of tax reform*
- *Lower taxes generate capital, capital is king and capital planning is critical*
- *Economic stimulus should prolong the credit cycle, but we are in very late stages of a longer than traditional recovery, and if interest rates rise too far too fast, asset values will be impacted*

The Impact of Tax Reform | Lending

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Commercial lending

- Increased corporate customer liquidity, earnings, and capital results in stronger bank credit quality for C&I loans, and immediate expensing should result in additional loan volume, however . . .
- Corporate cash, including repatriated cash, could dampen loan demand, particularly for larger banks (65% of CEOs in a recent BAML poll said they would use repatriated cash to pay down debt)
- Loss of deductibility of interest expense will adversely affect corporate loan volume somewhat over time, especially when coupled with higher interest rates
  - Lease financing, or possibly preferred stock, for a borrower who can't deduct interest

Residential lending

- The rising rate environment that results from economic stimulus and a favorable outlook for growth has a negative impact on housing, with volumes of both new and existing home sales contracting;

The Impact of Tax Reform | Lending

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Residential lending

- The limitation on deductibility of mortgage loan interest coupled with a doubling of the standard deduction will adversely impact growth in mortgage lending
  - Particularly higher end jumbo mortgages, but also at the first home level where the deductibility "enticement" may not be present
- The cap on state and local tax deductions, particularly in the Northeast, will adversely affect homeowners in states with high state income and property values, adversely impacting home values (benefit for purchase money, less equity for refinance business)
- The non-deductibility of home equity loan interest, other than for substantial home improvements, will reduce that business line and perhaps cause rates to drop, but may help increase demand to refinance into qualifying mortgages
  - However, a higher standard deduction may mean many of those affected are no longer itemizing deductions

The Impact of Tax Reform | Other Considerations

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- Assets under management and trust income should increase as customer disposable net income and net worth increases and stock market values continue to increase:
  - Increase in estate tax exclusion and retention of step up in basis also contribute to increase in assets under management and trust income
  - Could see reduction of use of certain types of trusts by taxpayers under new higher exclusion, but should see substantial increase in multigenerational trusts to take advantage of higher exclusions before return to lower exclusions

- Tax exempt investment portfolios will likely decrease in value as after-tax returns go up on taxable investments, and private activity bonds lose their tax exemption, pressuring new tax free issuances to compete by increasing their rates;
  - Banks will look to corporates (taking credit risk) or longer duration MBS or munis (interest rate risk) to increase yield

- Value of certain CRA investments may fall due to repeal of the 10% rehab credit
  - The 20% portion survived, as did the low income housing credit (LIHC)

- Value of BOLI and other tax favored products may go down with a lower corporate tax rate

The Impact of Tax Reform | Capital Management

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- Banks will accrue capital at a faster rate than ever before given reduced tax expense:
  - Earn back tangible book value dilution from DTA revaluation over a relatively short period
  - Will investors have adjusted expectations for "core" capital?
- Will dividend policy change as earnings grow?
  - Banks generally pay out 30% to 50% of earnings, yet a higher growth environment would argue for higher capital retention
  - Will banks build capital in the late innings of a credit cycle?
- Share repurchase activity:
  - Bank valuations at cyclical highs and a lack of clarity around how valuations will be impacted by tax reform argue that repurchase activity could be muted
- Common equity capital raising:
  - Reduced income tax expense serves somewhat as an at-the-market ("ATM") offering by adding capital slowly over time
  - The "winners" who realize the anticipated growth will need capital to fund that growth, and the question will be the valuation at which investors look to participate

The Impact of Tax Reform | Individual Customers

Individual Taxes *(Partial List – all changes expire 12/31/2025)*

- Lowered ordinary rates
- Doubled standard deduction
- Eliminated personal exemption
- Eliminated 2% floor deductions
- Modified AMT (higher exclusion and exclusion phase out)
- Modified mortgage interest deduction and eliminated HELOC interest deduction
- Limited personal SALT deduction to $10,000 (MFJ) $5,000 (individual)
- Eliminated phase-out of itemized deductions that survived (e.g. charitable)
- Reversed tax impact of alimony payments
- Limited deduction of “active” losses against other income
- Enhanced child tax credit (larger credit and much higher phase-out)
- 7.5% AGI threshold on medical expense deduction for 2017 & 2018 (10% beginning 2019)
- Eliminated deductions/exclusions for moving expenses except military

The Impact of Tax Reform | Individual Customers

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- New 20% deduction (sec. 199A) for individuals, trusts, and estates of their share of "qualified domestic business income", from each partnership, S Corp, sole proprietorships, REITs, qualifying cooperatives, and qualifying publicly traded partnerships

Estate Gift and GST Taxes

- Increased the federal estate, gift, and GST tax exclusion to $10,000,000 (with inflation adjustments from 2017, about $11,200,000); effective for decedents dying and gifts/transfers made after 2017; $22,400,000 "portable" exclusion for married couple
- "Stepped-up" income tax basis at death retained
- No repeal of estate, gift or GST tax at any point in the future
- Proposed regulations that would have further restricted valuation discounts have been withdrawn
- In 2026, exclusion reverts back to 2017 amount ($5,490,000/$10,980,000), adjusted for inflation

The Impact of Tax Reform | Businesses Customers

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- Immediate expensing of up to $1 million of new or used equipment and improvements to qualifying real property as long as such expenditures do not exceed $2.5 million in that year
  - More CAPEX from immediate expensing would lead to higher PP&E balances

- New interest expense limitation provision expands former Section 163(j) to limit interest expense deductions to an amount which equals interest income plus 30% of "adjusted taxable income" (ATI)

- Several provisions to provide simplification relief to businesses under $25 million of annual receipts, including ability to use cash method and not use inventory accounting

- Research & development ("R&D") costs must be amortized over 5 years instead of immediate expense (effective after 2021), but R&D credit still allowed

- Permanently repeals the domestic manufacturing deduction (former Sec 199) which takes away an approximate 3 point tax rate advantage historically enjoyed by manufacturers

- Repealed deductibility of entertainment expenses, including club dues, as well as several other employee fringe benefits, and expanded 50% limitation on deductible meals for employees

The Impact of Tax Reform | Businesses Customers

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- Improved accounts receivable collectability: improved economy, consumer wages, investment performance and taxable income, and lower individual rates on that income, should result in increase in consumer net worth, liquidity and customer creditworthiness

- Leaner inventory levels result from increased consumer demand

- Repeal of like kind exchange treatment on equipment may mean higher current tax expense on realized gains that no longer can be deferred
  - Will this lead to more outright purchasing of new and used equipment to take advantage of immediate expensing to offset gains that have to be recognized anyway?

- For multi-nationals:
  - The transition tax liability on deemed repatriation must be expensed in period of enactment
  - The various base erosion provisions may put pressure on their effective rate until new planning and restructuring can be executed
  - Many companies never reported any DTL on their unremitted foreign earnings taking the position that such earnings are indefinitely reinvested, and now have to record a material current and long term liability under the deemed repatriation tax

The Impact of Tax Reform | Businesses Customers

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- Impact on value of US dollar (should strengthen) from increased economic growth, and from repatriation of foreign denominated earnings, could create realized foreign currency losses

- Demand for debt financing will theoretically be dampened by the influx of cash, including repatriated cash, and the possible applicability of currently nondeductible interest expense.
  - The interest expense disallowance provision is not that severe, especially if the business has sufficient "adjusted taxable income" or the loan relates to real estate or to dealer floor plan financing, or the borrower is a regulated public utility, or the business has under $25 million of receipts. If disallowed, it is only temporary until earnings recover.

The Impact of Tax Reform | Pass Through Businesses

- "Pass-throughs" make up 95% of all businesses, generate half of the reported taxable income, and employ half the workforce (99% of them have under $10 million in sales)
- The gap in the C-Corp federal rate vs individual federal rates has motivated businesses to seek pass through treatment. The combined federal tax on distributed C-Corp earnings before tax reform was **50.5%**, vs. a max rate of **39.6%** for pass-through income, and appreciation taxed only at 23.8%
- With the lowering of the C-Corp rate to **21%**, the new deduction for pass through income attempts to keep the same advantage of being in pass through form vs being a C-Corp before tax reform
- The new 20% deduction on pass through income has a maximum marginal ordinary rate of **37%**, so the effective federal marginal rate on such income is now 29.6% (about 10% lower after tax reform)
- Deduction will generally not apply to "specified service businesses" or the "trade or business of performing services as an employee"
    - ". . . services in the fields of health, law, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees or owners . . ."
    - The deduction will be available to taxpayers with income less than $315K (MFJ) and $157.5K (S). This exception is phased out over the next $100,000/ $50,000 respectively

The Impact of Tax Reform | Strategic Considerations

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- Will additional capital encourage organic growth? Strategic growth through acquisitions?

- Will owners wait out for even better valuations as their earnings improve and at lower tax rates, i.e. 21% C Corps and effective 29.6% rate for pass-throughs? Or cash out now at low rates compared to what may happen in the future?

- Many businesses will want to change their legal and tax structure to optimize current after tax earnings at new lower rates, i.e. stay a C Corp at 21% plus the additional tax on any distributions, or later gain on sale, for a total new effective rate of 39.80%, or convert to LLC or S Corp to take advantage of the 20% pass through deduction for an effective federal rate of 29.6%. But state tax rates must of course also be considered

- Also should model out after tax cash proceeds in the event of a sale of stock vs assets:
  - Consider PV of asset acquisition recovery at new rates, vs seller gain at new rates on ordinary portion (capital gain rates the same for individuals, but 21% for corps)
  - Asset deals (direct or through tax code elections) now trigger a bit more PV to both seller and buyer under immediate expensing provisions, including for used equipment
  - Therefore, if circumstances fit, i.e. NOL carryovers to offset seller corp gain, or seller corp is an S Corp, or a sub of a parent group, then an asset sale begins to make more sense

So What Has The Reaction Been To Date?

- According to a study of the S&P 500
  - Capital expenditures have grown by 21.4% since December 22, 2017
  - Share buybacks are up 46% over 2017
    - Anchored by Apple ($100 billion), PepsiCo., Wells Fargo, etc.
    - According to Goldman Sachs, S&P 500 companies are on pace to announce $650 billion of buybacks this year, which would break the previous record of $589 billion set in 2007

- More announcements of big stock repurchases and dividend increases are expected from the banks, once the Federal Reserve completes its annual (CCAR) stress tests

- Dividend increases are also up significantly
  - Led by Exxon Mobil, many have chosen to focus on their dividend
  - Many regional and community banks have followed this trend

First Quarter 2018 Bank Performance

- Community banks grew net income 17.7% in 1Q18 vs. 1Q17
- Average net interest margins rose to 3.32% from 3.19% in 1Q17
- Overall, FDIC-insured institutions saw loan balance rise 4.9% vs. the year ago quarter, consistent with recent trends, not noticeably elevated over pre-tax reform levels
  - All loan categories up with the exception of credit cards (down 5.5% YOY)
  - C&I jumped 1.9%
  - Nonfarm nonresidential loans up 0.8%
  - Residential mortgage loans grew 0.4%
- Loan growth among the top 20 banks was 0.3% on a linked quarter basis and 2.7% on a YOY basis
  - 8 of the top 20 reported quarter over quarter declines.
  - Many citing elevated pay downs as the reason for net growth rates lagging expectations
  - Borrowers are sitting on cash and tax reform will add to cash flow
  - Seasonal component to lending in some markets during winter months
- Trends are solid but no noticeable difference due to tax reform . . . . . too early to tell.

The Impact on Price Performance

Since November 2, 2017, when initial tax legislation introduced in the House

15
10
5
0
(5)

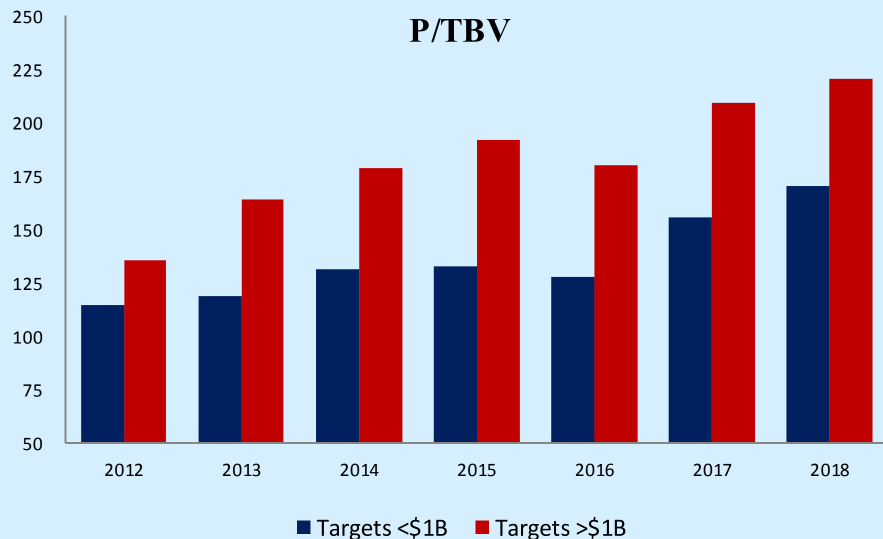
11/02/17 11/23/17 12/14/17 01/04/18 01/25/18 02/15/18 03/08/18 03/29/18 04/19/18 05/10/18

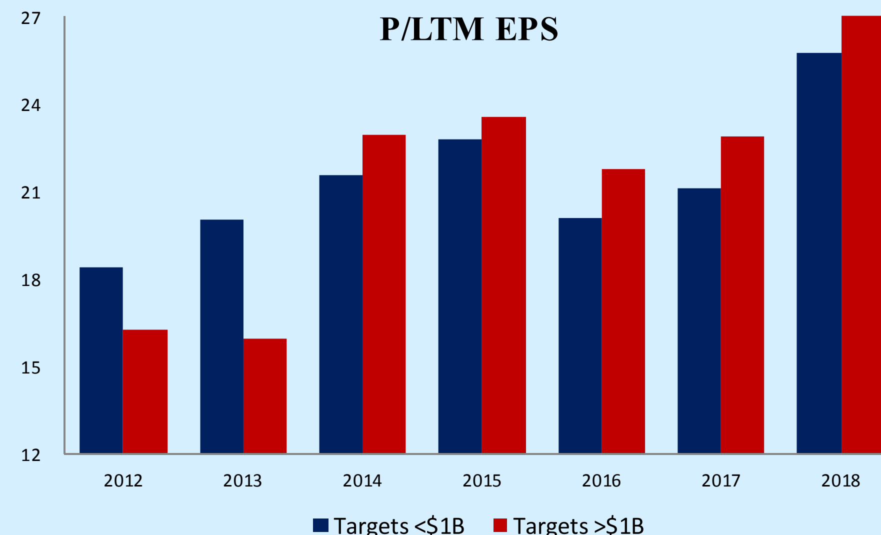
8.5%
5.5%
5.3%

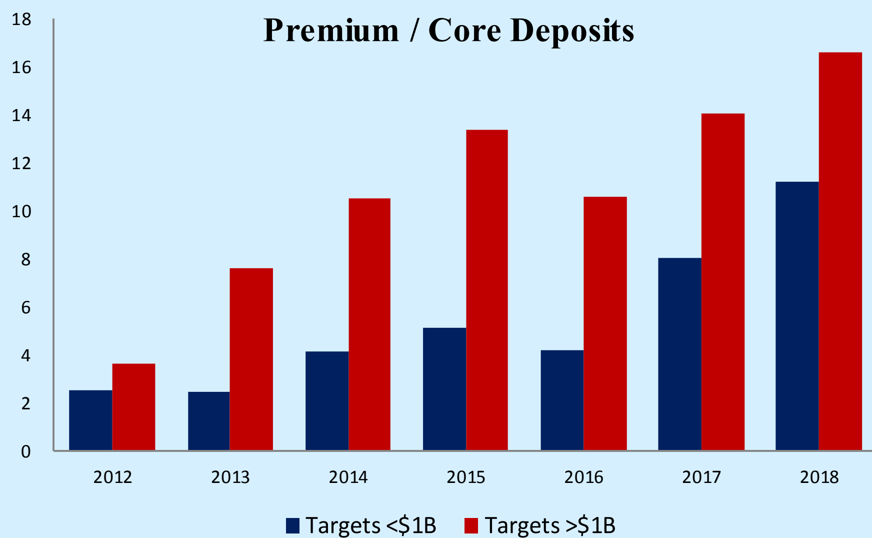
DJIA S&P 500 NASDAQ Bank

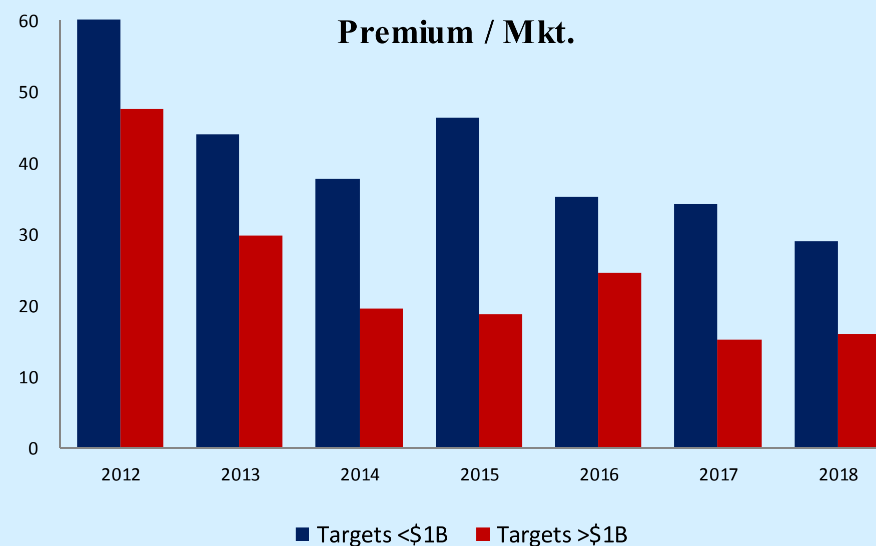
Source: SNL Financial as of 5/25/2018

M&A Pricing Continues To Expand









Source: S&P Global Market Intelligence. May contain normalized information.
Includes announced bank and thrift acquisitions from 1/1/2012-4/30/2018 Does not include terminated transactions.

Looking Ahead to 2019 and Beyond

- Near term, loan growth my lag expectations, but longer term a tailwind that will extend the economic cycle for a few years
- Asset quality will hold and serve as a prop for the economic cycle
- Share buyback announcements will drive the headlines but most stock companies will continue to manage shareholder expectations via dividend increases
- Higher rates and increased competition will force NIMs lower, knowing ROA's will hold via lower effective tax rates
- Capital issuance will be selective and used for real strong growers and for strategic intentions
- M&A may pause momentarily but resume at higher valuations
- What we can't predict
  - Will the mid-term elections reverse the trend?
  - Will tax reform be amended or possibly overturned?
  - Will a developing trade war mitigate the real and perceived benefits of tax reform?

Conclusions

- Tax reform is a "game-changer" but its impact will take time to be fully realized
  - We are still VERY EARLY in the process of understanding who the real winners and losers will be, both individual and corporate, from tax reform
  - Much of tax reform is not permanent, so how long will it take for the market to begin to doubt the longevity of these provisions
- The magnitude of the impact will depend in large part on the composition of individual local economies – many blue collar, manufacturing based economies are feeling material benefit from the reform package already
- Tax reform is being funded by an already bloated deficit, with growth in the outer years helping pay for the cuts – rising debt loads in a rising rate environment carry their own set of risks
- Tax-related stimulus is only one component of broader economic policy – too much stimulus could cause interest rates to rise too fast which risks impacting asset prices and leading to recession
- For community banks, tax reform is more about understanding the impact on your customers than the impact on your bank – being out front of tax reform related issues with your customer base will help you serve clients well, anticipate issues before they occur and differentiate yourself from other financial institutions not thinking about these matters.

Speaker Biography

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Mr. Quad is a Senior Managing Director and Head of the Financial Institutions Group at Griffin Financial, where he is a trusted advisor to management teams and boards of directors of banks largely $10 billion in assets and below in the Northeast and other select geographies. Mr. Quad joined Griffin in August 2012, prior to which he was most recently Managing Director and Head of U.S. Financial Institutions M&A for RBC Capital Markets, where he had been since 2001. Mr. Quad joined RBC following its acquisition of Tucker Anthony Sutro, where he was a Vice President in its Financial Institutions Group.

Mr. Quad has completed buy-side and sell-side acquisitions, common stock, preferred and trust preferred offerings, and general advisory engagements for clients throughout the northeast United States. Some of the assignments that Mr. Quad has completed include the sale of Lake Sunapee Bank Group to Bar Harbor Bankshares, the purchase of Chicopee Bancorp by Westfield Financial Inc., purchases of Lake National Bank and FC Bank by CNB Financial Corporation, the $50 million issuance of investment grade subordinated debt by CNB Financial Corporation; the sale of Connecticut River Bancorp to Mascoma Mutual Financial Services Corporation, the sale of RBC Bank USA to PNC Financial Corporation, the FDIC-assisted acquisitions of Wakulla Bank and Gulf State Community Bank by Home BancShares, Inc., the merger of Westborough Financial Services, Inc. into Assabet Valley Bancorp, the sale of Capital Crossing Bank to Lehman Brothers; the sale of Community Capital Bank to Carver Bancorp, Inc.; the sale of Mystic Financial, Inc. to Brookline Bancorp; the sale of specialty lender AmeriFee Corporation to Capital One Financial Corporation; the acquisition by Richmond County Financial Corporation of seven branches from FleetBoston Financial Corporation; and the acquisitions of North American Bank Corporation and thirteen branches of Shawmut Bank for Banknorth Group, Inc. while running Bankorth’s internal M&A function.

Prior to joining Tucker Anthony Sutro, Mr. Quad was a Vice President in the Financial Institutions Group at Advest, Inc., where he also worked with financial institutions clients. Preceding Advest, Mr. Quad was Vice President and Director of Mergers and Acquisitions for Banknorth Group, Inc., at the time a $2 billion bank holding company headquartered in Burlington, Vermont, where he founded the company’s internal M&A function and coordinated the bank’s first two acquisitions and an internal restructuring of the company’s trust subsidiaries. At Banknorth, Mr. Quad also gained valuable experience in cost accounting and budgeting, asset/liability management, consolidation accounting and SEC and regulatory reporting.

Mr. Quad holds a B.S. in Business Administration from The University of Vermont, magna cum laude, and an M.B.A. from Cornell University, with distinction. Mr. Quad is a Series 7 and Series 63 registered representative.

Speaker Biography

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Mr. Jozwiak is a Senior Vice President of Griffin Financial Group, LLC with a 25-year career in retail, commercial and investment banking. Mr. Jozwiak has three years of wealth management sales with Dean Witter Discover & Co.. He also has fourteen years of commercial banking experience with regional bank, managing areas within corporate treasury related to forecasting, ALCO, capital management, regulatory and rating agency relationships, where he was instrumental in modeling, funding and/or capitalizing over 14 M&A transactions, two transformational branch acquisitions, the issuance of debt, hybrid equity, equity, and securitization transactions. Mr. Jozwiak has been at Griffin for eight years, advising banks, thrifts and specialty lenders on a variety of capital markets, strategic advisory and M&A assignments in the Mid-Atlantic, Northeastern and Midwest regions of the United States

While at Griffin, Mr. Jozwiak has advised on equity and debt offerings (sizing, timing, pricing), buy-side and sell-side M&A transactions, branch purchases and sales, transactions involving secured creditors and trustees in connection with IRC 363 sales, as well as instrumental in marketing over $1BN in credit in the form of whole loan sales, both performing and non-performing.

In addition to transactional work, Mr. Jozwiak works closely with management teams and Boards of Directors providing advisory and expertise on industry themes and trends, participating in Board educational sessions as an industry expert, facilitating board and management strategic planning sessions, focusing particularly on strategic, growth and profitability improvement initiatives.

Mr. Jozwiak co-manages the FIG analytics team responsible for analyzing national, regional and company specific trends, identifying key industry themes that are used in the FIG advisory practice.

Mr. Jozwiak holds a Bachelors of Science in Quantitative Business Analysis from The Pennsylvania State University. He has represented Griffin at conferences with national and regional industry groups, national and regional accounting and advisory practices, regional bankers banks as well as SNL Financial to discuss the state of banking, the M&A environment, and capital related hot topics including Dodd-Frank and Basel III related issues, and holds the Series 7, 63 and 79 licenses from FINRA.

Disclosure Statement

This presentation is not considered complete without the accompanying oral presentation made by Griffin Financial Group, LLC ("Griffin").

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