GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Missouri, New Mexico, Arizona, Minnesota, New York, Vermont, New Hampshire, and Maine!

THE MORTGAGE BUSINESS

I recently had a discussion with a client about whether a community bank should be involved in the mortgage business at all. By mortgage business, I mean originating first mortgages on single-family residences, which the community bank would then either portfolio or sell in the secondary market. A number of our community bank clients exited the mortgage business back when the QM (Qualified Mortgage) Rules came on (i.e. the verification of income, ability to repay, etc.). Another bundle of our community bank clients exited when the Truth in Lending and RESPA requirements were combined (TRID). So what are the triggering factors as to whether a bank should decide to stay or go from the mortgage business?

It seems to me the real answer to the question is this: when a customer comes into your bank and asks for a first mortgage home purchase loan or refinance, does your community bank have a "solution" for the current customer or potential customer's need? If the community bank does have a solution and that solution is its own mortgage operation, great. If it is a legitimate referral under RESPA to another company from your community bank, great. But it seems to me we are community banks and that mortgage piece is important. The real question, of course, is does your community bank have enough volume to be profitable. Keep in mind that any community bank board of director's goal must be to enhance shareholder value. Part of this means to continually grow earnings per share. If your community bank is losing money on the mortgage business, that is not helpful with respect to the profitability analysis. Generally there are a couple of choices: your community bank gets out of the mortgage business altogether, the community bank outsources it someplace (which hopefully will be seamless), or the community bank ramps it up.

MANDATORY RETIREMENT

Over the past several months, I have been with several community banks that have a mandatory retirement age for their directors. The age varies from as young as 70 to as high as 80. I always kid the boards that have mandatory retirement that they simply put it in because they do not have the "fortitude" to make the hard decision to tell one of the older directors that he or she is no longer productive and needs to get off the board. Of course, the counter to that problem is that the community bank also locks in non-productive directors until they get to that mandatory retirement age.

On some of the boards I have recently been with, the retiring director is one of the better directors on the board. Of course, these long-time directors have significant institutional/corporate knowledge, but they also have real world experience and general wisdom. I fully understand and agree with the need to continue to refresh the board with younger members with different skillsets, but still I am not a firm believer that mandatory retirement is the way to do that.

DUE DILIGENCE ADJUSTMENTS

In the course of a "normal" community bank acquisition, the potential acquirer submits a non-binding Indication of Interest that outlines the general terms of the transaction that is being proposed. The Indication of Interest is always subject to due diligence. What typically happens is the seller accepts the Indication of Interest and then allows the buyer to come in and complete due diligence to confirm their Indication of Interest or, in some instances, revise the contemplated terms, typically downward.

If I were to take a guess, I would say that probably 75% to 80% of the time the acquirer comes in and confirms the terms of their Indication of Interest. Maybe 20% to 25% of the time the terms of the Indication of Interest are adjusted based on the due diligence review. In these instances, the adjustments are typically not enough to kill the deal. My experience has always been that if due diligence is really that bad, the acquirer simply walks away because it is not buying what it thought it was actually bidding on.

We are currently assisting a seller in figuring out how to address a significant change to an Indication of Interest based on due diligence. In this instance, an acquirer came in and proposed a purchase price the board was willing to accept. Following the execution of the Indication of Interest, the acquirer came in and did due diligence, and then came back and said they were going to reduce the purchase price by 25%. That is a significant amount of money. We are working through the process. However, I told my client that I thought this was very unusual based on what I have seen in other transactions. I really wonder whether this acquirer was genuine in their original offer or whether they were just "buying their way into the winner's slot" with the thought that they would significantly reduce the purchase price following due diligence. Not a really great approach. I will keep you updated.

THE "MERGER OF EQUALS"

I assume many of you, like me, read with interest the recent announcement regarding the "merger of equals" between Chemical Financial and Talmer Bancorp, two Michigan bank holding companies. I also read with interest a summary of Talmer's investors' comments related to the transaction. To put it kindly, Talmer's shareholders were less than enthused.

In the interest of full disclosure, our consulting and law firms are not representing either of the parties to this transaction. However, the press release had plenty of information to figure out what is going on. In the transaction, Talmer is selling to Chemical in a 90% stock and 10% cash transaction. At the end of the deal, Chemical's current shareholders are going to own 55% of the combined organization's common stock. Chemical's current board of directors will make up seven of the 12 directors of the combined organization.

Talmer has worked very hard to publicly acknowledge this transaction as a merger of equals. From an outsider's perspective, I do not see this as a merger of equals. In my opinion, this is a sale of Talmer to Chemical, plain and simple. After the transaction, Chemical's shareholders and directors are going to control the majority of the stock and the majority of the board seats. I see that as an acquisition.

I have seen this scenario play out in community banks many times. It is not terribly uncommon for two parties to sell a transaction as a "merger of equals" to make the selling shareholders feel like they are getting more in the deal than they really are. Apparently it works on big bank transactions as well. It is probably not a bad deal for Talmer at all. It is simply not a true merger of equals.

THE STRUCTURAL TRADEOFF

We are currently working with a community bank that is looking to make an acquisition of a smaller, troubled institution. The target really has quite a few difficulties. It includes the usual suspects, such as problem loans, OREO, compliance issues, etc. It is not a "squeaky clean" institution by any means.

In any bank acquisition, the parties have two structural alternatives. The first is to structure the transaction as a whole bank merger, where you simply merge the target bank into the acquiring bank and the acquirer operates as a combination of the two organizations. The second alternative is a purchase of assets and assumption of liabilities transaction, where the acquirer purchases certain assets and assumes certain liabilities of the target. In this second type of transaction, any asset that is not purchased or liability that is not assumed remains with the seller.

Both of these transaction structures have positives and negatives. In the merger transaction, the positive is that the merger of the target into the acquirer is a fairly simply process that, once completed, leaves no loose ends for the seller to tie up. The tradeoff is that the acquirer takes the target "warts and all" and is responsible for any and all of the target's liabilities, both known and unknown. In a purchase of assets and assumption of liabilities transaction, the opposite is true. The target has a little bit of cleanup work left to do after the transaction in terms of dissolving the organization, and the acquirer is only responsible for the liabilities for which it expressly assumes responsibility. If there are any unknown liabilities, such as a lawsuit that pops up six months after closing, it is the target, not the acquirer, that has to deal with that. There are also positives and negatives from a tax perspective.

In one of the acquisitions we are currently working on, we are assisting the acquirer in weighing all of these options. Based on the condition of the target, it appears the purchase of assets and assumption of liabilities is the more appropriate structure. There are some financial reasons that it would make sense to structure this as a merger transaction, but those reasons are outweighed by the benefits of selecting only the assets the acquirer wants to purchase and limiting any future unknown liability. This analysis comes up in almost every community bank acquisition we evaluate, but it just seems to be a little more magnified in this situation.

ICBA NATIONAL CONVENTION

As most of you know, the ICBA National Convention will be held March 6th through 10th in New Orleans. The recent ICBA daily email indicates the "early bird" registration ends February 5th. From our standpoint, the ICBA National Convention is an opportunity for us to visit with many of you. This year our firm will be making a number of different presentations at the Convention. Both of us (Jeff and Greyson) and our partners, Philip and Doc, will all be doing breakout sessions on various topics. We hope to see you there!

CONCLUSION

You will note from the "Greetings" line that we have crisscrossed the country in the last couple weeks. Miraculously we avoided Snowmagedeon in the D.C. and upper Northeast area. In fact, other than some flight delays trying to get in through some of the hubs, we managed to get to all of our client meetings.

Keep an eye out for spring. It is around the corner. See you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*