
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Arkansas, Arizona, Tennessee, California, Wisconsin and Florida!

SMOOTH CLOSINGS

As I have noted in *Musings* previously, we do a lot of community bank acquisition work, both on the sell side and the buy side. We have had a couple of closings lately that went very smoothly, which is always good. One of those was an extraordinarily complex transaction. In the acquisition business, of course, it is good to know what you are doing. It is also good to have somebody who knows what they are doing on the other side of the transaction. It makes it much more productive.

THE INVESTIGATION

In my 40 or so years in working with community banks, both with the FDIC and after, I have conducted many investigations of community bankers whose board of directors thought may have done something wrong. I remember one investigation involved the senior lender for a bank that was heavily into commercial real estate. He would order a number of appraisals on the real estate. If the appraisal came in and he liked it, he put it in the file. If the appraisal came in and he did not like it, he put it in a box under his desk. When the examiners came in to examine, he indicated that the appraisals he did not like “had not been received by the bank yet.” He got sentenced to prison.

In any event, I have conducted dozens of investigations over my career and am currently in process with a couple of others involving some pretty interesting issues. I will let you know how they turn out.

DE NOVO BANKS

For a couple of years, even during the recession, I was one of the few “pundits” who thought that there would eventually be a resurgence of de novo banks. As most of you know, when there is a period of consolidation, it is typically followed by a period of new community bank entrances. We have been in a period of consolidation for a couple of years now. We are just beginning to see a “flicker” of activity in connection with de novo banks. There are new banks being chartered in several states. The FDIC, which must approve an application for deposit insurance for every new bank, has also created a 30-some-odd-page booklet that would be of interest to anyone who wants to charter a de novo bank.

Where would the de novos come from? How about bankers who have recently sold their banks. Most of the community bank acquisition transactions require the directors to sign what we typically call a “Joinder” in which they agree to vote their shares in favor of the transaction and agree not to compete for a period of time (usually two years). Those folks are locked out of taking their winnings and forming a de novo bank for at least a couple of years, but not after that. Back in the day, it was not unusual for selling shareholders who figured they were playing at least with a portion of “house money” to start up a another bank. We are beginning to see a little of that as well this time around. If any of you are such a shareholder considering starting a new bank, keep in mind you will need these three basic things: (1) a senior management team that knows what it is doing, (2) a board of directors with banking experience, and (3) initial capital at formation to last the bank three years on whatever growth track is taken so the bank has an 8% leverage ratio at the end of three years.

If anyone wants any additional information about starting a new bank, let me know.

DATA BREACH

As I mentioned in previous *Musings*, we have had a couple of clients who have suffered a data breach at their community bank. They were not the cause of the data breach. The friendly federal regulator was. As I noted in prior *Musings*, the regulators were pretty contrite about it. We sent a demand letter on behalf of the banks, as you would to any other vendor, to the particular friendly federal regulator. The friendly federal regulator responded to all of our

demands, except the one requiring the regulator to pay the bank's fees (our firm's) for assisting with the investigation and dealing with the regulators. We are still pursuing them on behalf of one of the banks. It will be interesting to see if the friendly federal regulator ever ponies-up any money.

LEGAL LENDING LIMIT

There are a couple of legal lending limit issues that have come up recently at our community banks. As all of you know (or should know), the legal lending limit is a state, or federal if you are a national bank, limitation on how much the bank can loan to one borrower or inter-connected borrowers. Legal lending limit issues are not always easy to figure out. We get called in on the tough ones. My general recommendation to our client base is to have an "in-house" limit that is significantly lower than the legal limit. That way, unless there is a big problem, you can mitigate the risk of exceeding the legal lending limit. The problem with a loan in excess of the legal lending limit is that it, in most states, is "strict liability" for the board of directors. That is to say the board is on the hook for any loss associated with that credit up to the full amount of the credit (not just the excess portion). That could be some pretty significant exposure. You might check and see how your loan policy addresses the maximum loan the bank can make to related borrowers.

BRIGHT MINDS

Once a year, I have the opportunity to spend one day with some of the brightest minds regarding community banking in the nation. This group of practitioners from all parts of the community banking industry met within the last two weeks. It has been interesting to watch over the last couple of years how the group has become progressively more optimistic toward the future for community banks. Not surprising.

THE CAPITAL PLAN

As any of you that have gone through a strategic planning process over the last couple of years knows, often what "spins out" of a strategic plan is basically the creation of multiple specific plans. We have been asked over the last couple of weeks to specifically create capital plans for a couple of our clients. This is, of course, an interesting exercise because it actually forces the boards to forward-think as to their capital needs over a period of years, as opposed to simply currently or for a one-time transaction, such as an acquisition. It also identifies sources

and uses of that capital during that time period. It is always a good exercise, particularly as you are “tuning up your bank” for the next couple of years.

MINORITY STOCK VALUATIONS

We recently received an interesting question concerning minority stock valuations. The question was whether larger blocks of stock that do not represent a majority of the shares outstanding (i.e., the block is less than 50% of shares outstanding) command a higher or lower per share price than smaller blocks of stock. The individual asking the question posed two alternative scenarios. One was that a larger block of stock was more valuable because it represented a larger piece of the shares outstanding and afforded more control of the company. The alternative theory was that a larger block of stock would be less valuable because the seller would be willing to give some kind of “quantity discount.”

From a valuation perspective, the first line of thinking is correct. A larger block of stock that does not represent at least a majority of the shares is more valuable than a smaller block of stock. This is because the “minority discount” applied to the value of the shares is lower when a larger block of stock is sold.

Keep this in mind if you are thinking about buying or selling a larger block of stock. The more shares, the more valuable the stock becomes because the closer to control the purchaser will be following closing. Keep also in mind that this is really a theoretical discussion, because ultimately the value of the stock is going to be decided by a willing buyer and a willing seller through a negotiation. In the real world, this often results in a larger block selling at a discount in a closely-held community bank holding company.

INTEREST RATE RISK MANAGEMENT TRAINING

Following the election of President Trump, interest rate risk management has taken on a renewed importance in community banking. The regulators certainly are moving interest rate risk management up the priority list. One of the key components to effective interest rate risk management is making sure your board understands the various components to interest rate risk management and the various options for controlling the associated risk. We have recently had a couple boards ask us to assist with board training by spending an hour or two with the board to discuss the practical aspects of interest rate risk management and what the board should be looking at and considering in determining how to respond to changes or anticipated changes in

interest rates. Please let us know if it would be helpful for your board to have a similar training session. We are happy to help.

DEAL PRICING

I recently read with interest an article in the *American Banker* that announced Pinnacle Financial's acquisition of BNC Bancorp in High Point, North Carolina. Pinnacle is a bank that is headquartered in Nashville, Tennessee, that has very publicly stated they want to be the premier banking franchise in the Southeast. They have been on what I consider a very aggressive acquisition streak lately. In the interest for full disclosure, we were not involved in this deal and have not been involved in any other Pinnacle deal in the past.

What struck me most about Pinnacle's acquisition of BNC Bancorp was the transaction pricing. It is a 100% stock deal where Pinnacle has agreed to pay \$1.9 billion for BNC Bancorp. According to the article I read, that values BNC at 291% of tangible book value. At the time, Pinnacle was trading at about 3.2 times tangible book value. The high level of Pinnacle's price-to-tangible book value ratio partially explains the high transaction pricing.

Does this signal a return of transaction pricing to 2005 levels? I cannot say for certain, because one deal does not make a trend. However, I can very comfortably say that this is one of the strongest priced deals we have seen over the last ten years or so. It has been quite some time since we have seen a transaction that is almost three times tangible book. My belief is that true "community banks" (i.e., not multi-billion dollar banks) are not likely to see pricing at this level again.

HAPPY HOUR

It is apparently happy hour in Washington. As *Musings* goes to press, President Trump has issued an Executive Order basically indicating that for every new regulation an agency issues, it must delete two. "Two-for-one," if you will. Unfortunately, my preliminary reading of the material indicates it does not apply to the banking agencies, but that will remain to be seen. It is good that a fellow who doesn't drink (i.e., President Trump) understands the meaning of happy hour.

CONCLUSION

It is surprising how fast time flies. During the last couple of weeks, I have been to a couple of places that should have been what you would think of as warmer, such as Arizona and Central California. Neither one of them really was. Hopefully, Spring will come early this year.

Have a great two weeks.

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and

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