GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Montana, Georgia, North Carolina, Tennessee, Indiana and Illinois!

CAPITAL COMFORT LEVEL

I was with a bank in the last couple weeks having a discussion about what to do with their life. That type of discussion always follows the bank's decision to remain independent and typically involves a discussion of whether the community bank has any excess capital to allocate toward a strategic opportunity. This particular bank had a 12% leverage ratio. Its asset quality was clean, and its earnings were good. The bank had been through the recession, however, and the directors' memories were still fresh as it related to the nasty time they had with their friendly federal regulator. When I asked them what their capital comfort level was, they responded that it was basically 12%. Now keep in mind that the nastiest of friendly federal regulators typically require something around 9% leverage and 12% total risk-based. If the regulator is hung up on "peer numbers," then peer for most community banks is slightly over a 10% leverage ratio. This board, however, was ultra conservative because they had been burned in the past without enough capital to support their declining asset quality. There is no right answer to "what's your comfort level for capital?" For this group, it was 12%, and there was "no excess." They did have other sources, but they are going to maintain that capital level at 12%. What this means, of course, is that as the balance sheet grows $10 million, it will take $1.2 million in capital (typically retained earnings) to support that.

ARE YOU READY FOR AN ACQUISITION?

Recently I was with a high-performing, large-size community bank. Part of their plan was to grow through acquisition. They had, in the last couple years, completed a couple of acquisitions already. My question to them was, "are you ready for another?" I could see some of the operations' people blanch a little bit at the question (i.e., they were still tired from the last two deals). Everyone in the room, directors and officers alike, however, felt that uniformly they needed to strike while the iron was hot (or whatever lousy analogy you want to use) and take advantage of opportunities. In other words, they did not want to be reactive to opportunities. They wanted to be proactive while they had a currency to utilize and a staff who could integrate. For that particular bank, it was a good decision.

I was with another bank recently with not quite as good numbers and not quite the same experience who in the same context indicated it would probably be a year to 18 months before they could be ready for an acquisition from an internal organizational infrastructure standpoint. There is no universal answer for community banks.

DIRECTOR EMERITUS

I have had lots of discussions with multiple community banks lately about the issue of director emeritus. Director emeritus is basically viewed as a way to promote some of your more mature directors out of their regular director status and into an honorary status. The benefit for the director is they no longer have any legal liability. The benefit for the bank is it opens up a director slot to bring in new, younger and/or more diverse schools of thought. I have found that if you structure the director emeritus program to be basically identical to the director program, except without a vote, then it is often much more palatable to the more mature director who is to move into that status. In other words, compensation for the director emeritus should be the same as a real director, the director emeritus should get the same information as a real director, and the director emeritus should come to meetings and discuss issues. The director emeritus has the opportunity to provide his or her full input and corporate knowledge, he or she simply does not have his or her vote recorded. It seems to be a structure that should work for most community banks.

ADVISORY BOARDS

I have also had the issue of advisory boards come up in several meetings over the last month. Many of you have tried advisory boards unsuccessfully in your banks. I am convinced that advisory boards can work primarily if they are designed to work as a "farm team" for future board members and as a marketing arm with eyes and ears in the community. If you decide to set up an advisory board, however, please make sure that it is small (probably less than five), it is established on the front-end with term limits (probably two years, at which point the director would roll off unless they are invited to stay), and there is one senior officer (typically the CEO, COO or EVP rank) that is fully responsible for the care of, feeding of and meeting with the advisory board. Most advisory boards do not die a sudden death, they just fritter away because no one pays attention to them once they are established. That could be a real negative in your organization instead of the positive for which an advisory board is designed.

MAKE THE INVESTMENT BANKERS MAD

I was asked to give a speech recently to a directors' conference. There were about 180 people in attendance in this particular conference. I was the kick-off speaker, and my topic was, as a practical matter, "you don't have to sell your bank." Now what was interesting to me was that the CEO of this particular trade association told me that he was thrilled that I was coming and he loved the topic because all his members hear from the investment bankers is that they have to sell their bank. They have to get bigger. They cannot survive at whatever size they are at. (The magic size, of course, is twice what you are now.) He was thrilled that somebody was up there telling people they did not have to sell their bank. I am not sure the investment bankers were quite as thrilled. Even though through our consulting firm we provide financial advisory services for community banks, we never push the sale alternative unless that is the client's desire or there is no other alternative. Put us in the independent, third-party advisor category.

MERGER OF EQUALS

As many of you who are regular *Musings* readers know, I am a big proponent of the fact that there is no such thing as a merger of equals. There are a lot of banks that come together, however, and spin it that way when it is really not. We were in one transaction where the two banks came together. One was nearly twice the size of the other. The smaller bank got 35% of the resulting company. The larger bank got 65%. The smaller bank CEO became the "city president" (branch manager) at the location in the town of the smaller bank. The larger bank maintained all the senior management positions. The chairman of the bank of the larger bank remained chairman, and the smaller bank got two board seats on a 12-person board. Notwithstanding those facts, when you read the press release, this sounded like the most incredible merger of equals made in heaven that you have ever seen. I hate to break it to these guys, all of whom I know well, but that was not a merger of equals – it was an acquisition. Let's call it what it is.

IS CHANGE REQUIRED?

I have met with a couple banks lately for strategic planning. They were high-performing, excellent banks. I typically start off a meeting with a bank like that saying that I am not there suggesting that everything has to change. Their strategies are obviously working. It is only a question of whether they need to be tweaked, slightly adjusted or modified in view of the changing current environment. Many of those meetings simply serve as a confirmation that the bank's existing strategy is a good one, that its business model works and it will likely work into the future. The fact that you don't have a ton of changes coming out of your strategic planning should not be a disappointment for you. The goal is to appropriately allocate capital, set strategies, enhance shareholder value, and continue to move forward. If you are doing that by doing what you have been doing, then the planning session can simply serve as a confirmation of that.

STOCK SALES PRICE

We are currently assisting a number of community banks around the country that are considering raising additional capital through the sale of common stock or some other equity instrument. One of the issues that must be considered in any such transaction is the appropriate sales price for the equity instrument being sold. As you likely know, there is no set rule that must be followed. The board of directors is free to set the price at any level it determines appropriate.

Our advice to directors that are wrestling with the appropriate price at which to sell equity is to allow all of the competing interests to balance themselves out. The board must be sure to sell the stock at a price at which purchasers will actually be enticed to purchase the shares, but also at a price which is not so low that it unnecessarily dilutes the current shareholders. Most boards rely on some type of professional assistance in making this determination. Whatever the case, the important thing to remember is that the sales price must be balanced based on the competing factors.

RESALE OF COMMON STOCK

We are currently assisting a holding company in evaluating the options for the potential sale of holding company common stock it is working to repurchase from a large shareholder. Once it repurchases the common stock, the holding company has the option of doing nothing, selling the shares in a limited offering or selling the shares through a more widespread, public offering, either registered or not. We have assisted the board in evaluating the pros and cons, and they have decided they are going to take a “middle ground” approach. They do not want to just sit on the stock, as doing so would be a pretty significant reduction in capital. They also do not want to unnecessarily incur the time and expense associated with a more widespread offering (registered with the SEC or not). The board has chosen a middle ground approach of reselling most of the shares to individuals that require essentially no disclosure (i.e., directors, officers and employee stock ownership plan). This will allow the board to replace the capital that will run out when repurchasing the shares while minimizing the time, expense and risk associated with the offering. A good decision in my opinion.

THE DIFFICULT ACQUISITION

We are currently assisting one of our clients in evaluating the potential acquisition of what I would describe as a very troubled community bank. The potential target bank has had all kinds of problems over the last seven to eight years. These problems have resulted in years of negative earnings for this bank, which includes the present.

One of the central questions that must be answered in an acquisition of a bank in this shape is what changes need to be made to reverse the income statement and bring the bank back to profitability. Our general experience when considering the acquisition of this type of institution is that both the selling bank’s officers and the investment bankers working the deal are armed and ready with a list of changes, cost cuts and the like that can be implemented by the acquirer to return the bank to a normal level of profitability. Unfortunately, that is not the situation here. We have asked the bankers and the investment bankers a number of times what they see as the path to return to profitability. We have yet to get any sort of satisfactory response. As you can imagine, this does not inspire a lot of confidence, and may very well cause our client to walk away completely.

If you are thinking about selling a troubled bank, be sure you have the path to improved profitability figured out before you go to market. Scrambling around during the marketing process trying to figure it out is not a good plan for anyone involved.

DEFERRED TAX ASSETS

On a related note, this troubled bank transaction, as well as a couple others we are working on, involve a target that has deferred tax assets. These assets used to be relatively easy to value. They are becoming less so today because of the uncertainty related to the future of corporate tax rates.

To sum it up, the value of the deferred tax asset is essentially tied to the value of the taxes that will be saved in the future. With previous administrations in office, it was relatively safe to assume a 35% or so effective corporate income tax rate. Following President Trump's election, the future corporate income tax rate is less certain. He has made no secret that he would like that rate lowered.

Keep the uncertainty in mind if you are thinking about an acquisition that involves deferred tax assets. The last thing you want to do is overvalue these assets in you acquisition analysis.

CONCLUSION

The ICBA Convention starts tomorrow in San Antonio, Texas. I hope to see many of you *Musings* readers there. If you spot me or Greyson Tuck, or our other two partners, Philip Smith or Doc Bodine, please come and say hello to us. In fact, each of us will be providing workshops during the Convention. I will also be leading off the Directors Current Issues Conference starting at 10:00 a.m. on Wednesday. Please check the schedule and come join us. It should be fun.

Jeff Gerrish *and* *Greyson Tuck*