GERRISH'S MUSINGS

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June 15, 2018, Volume 370

Dear Subscriber:

Greetings from Minnesota, Wisconsin, Tennessee, Illinois, New York, and Florida!

THE FAMILY OWNED BANK

As noted in prior *Musings*, simply due to the nature of the community bank sector of the financial services industry, we have the opportunity to work with a number of closely-held family-owned banks. Family-owned banks have their own unique issues with some common threads. I enjoy seeing family-owned banks where they have mastered the difficult issues of ownership transition and management succession to leave the bank in the family for the next generation and hopefully in perpetuity. Not all have managed to do that, understandably, but we continue to assist the many who desire to do so, or alternatively, to liquidate their investment if ownership transition and management succession are not in the cards.

SHARE REDEMPTIONS

We have had a number of conversations with clients over the last month or so about creating liquidity for their shareholders. As most of you know, we constantly pound the table that the primary job of the Board and senior management is to enhance the value for your shareholders. Part of that is creating liquidity for the shares. Most *Musings* readers' bank holding companies do not have any true market liquidity (maybe on the pink sheets, but even then not much). As such, the holding company serves as the primary market maker, or at least it should. Don't get yourself (particularly you CEOs) into the position of being an unlicensed broker. The smart way to do things is for the holding company to redeem shares. If the holding company then wants additional shareholders, the appropriate way to handle it would be to do a private placement under a securities registration exemption with appropriate disclosure. It is not appropriate for the Chief Executive Officer or any officer in the bank to serve as the conduit to match buyers and sellers. That is basically the definition of an unlicensed broker.

In connection with holding company redemptions, there are a number of issues, such as: How much capital should be allocated? What price per share should the holding company pay? Should the holding company be reactive or proactive as it relates to approaching the shareholders? All those issues can be worked through once the board understands its obligation to create share liquidity and its need to do so through the holding company.

As an aside, if you don't have a holding company, you can still create liquidity and redeem shares - it is just much much more difficult. It requires regulatory approvals, shareholder approvals, and the like. A share redemption at the holding company level, as a practical matter, requires no regulatory approval in most cases, and definitely no shareholder approval.

YOU GET WHAT YOU NEGOTIATE

We were visiting recently with a community banker who was looking at a target bank and wanted to pick our collective brains with respect to valuation issues. The particular target bank had a significant number of loans it had originated and sold as participations. The purchasing bank had a lot of capital and a lot of on-balance-sheet liquidity, such that those loans could be brought back into the fold post-acquisition, thereby boosting income significantly. Who gets credit for that income when you are trying to formulate the purchase price? We can make arguments both ways - that it should be the bank that originated the credits, or that it should be the bank that is supplying the liquidity and the capital to allow those credits to come back on the balance sheet. The bottom line here is that you will get what you negotiate.

THE SQUEAL FACTOR

I was recently in a meeting to negotiate the sale of a community bank. The buyer was one of those serial acquirors who has acquired a lot of banks and had a lot of experience. Notwithstanding their ability to pay significantly more, they had a certain squeal factor that they expressed as a multiple of tangible book value. Fortunately, in this case we are optimistic that the squeal factor will not squelch the deal because the squeal factor itself is lined up pretty closely to our holding company board's thoughts on an appropriate sale price for the institution.

It is not unusual in community bank mergers and acquisitions for an acquiror, particularly a serial acquiror, to use price to book, or even price to earnings multiples, as some type of "guardrails" for the transaction. They certainly do not want it to look, for the most part, like they have "gone off the rails" if they price a transaction that is so far outside of comparable transactions that they would look foolish. They also don't want to set unrealistic expectations for the next deal. From a serial acquiror's standpoint, however they price one transaction, the next seller is going to want the exact same thing plus 10%.

DE NOVO BANKS

As we hope all of you know, our firm members are passionate about the continued independence of community banks. We are also excited to see some beginnings of what appear to be a small ripple of de novo banks again. In connection with that, we have recently prepared an article on the formation of de novo banks. This will likely be published in a variety of the state trade association magazines. If any *Musings* readers would like a copy, please email us and let us know.

GEOGRAPHIC EXPANSION

I was recently with a bank that had a very strong, proactive geographic expansion strategy. They were going to continue to branch into a variety of different cities. The new branches will certainly be different structures than their current locations. This is certainly understandable in the current day and time when technology seems to be driving certainly all the transactional banking activities. The Chairman, however, had an interesting approach to the entry into a new market. It was basically that the bank needed to obtain a "toehold" through a franchise player in that market, then expand that to a "foothold," and then further expand that to a "stranglehold" on the market.

I thought that summed it up pretty well for this bank's strategy.

THE VALUE OF A BANK CHARTER

For some time we have been assisting a smaller community bank that continues to have lingering problems from the economic recession. This particular community bank has all of the usual suspects from the downturn, including a decent amount of other real estate and festering loan problems. Sometime ago I met with the board to basically lay out the alternatives, which included the alternatives of raising capital or simply selling the bank. The board of this family-owned bank has thought about this extensively, and they have authorized us to move ahead with trying to find not necessarily a buyer but some type of strategic partner.

In response to the board's decision, we have been in discussions with what I would describe as some non-traditional community bank acquirers. Instead of going out and marketing the bank to other community banks, we are starting by looking for someone that will place more value in the bank charter. This includes fintech companies, investment groups, and the like.

The response from the market has been strong. There are a number of non-traditional acquirers that have expressed interest in the acquisition. These folks are looking to get into a bank charter so they can try and fulfill some type of strategy they have established. It has been a solid reminder of the value of the bank charter and the fact that there are many entities that are looking to get into a bank charter for one reason or another. This demand and supply mismatch has really worked to the benefit of our client.

UNDERSTAND THE TAX IMPLICATIONS OF A CHANGE IN CONTROL

We are currently assisting a community bank through a sale transaction that has a pretty decent amount of net operating loss carryforwards left over from the recession. The value of these net operating loss carryforwards was lowered with the reduction in the corporate tax rates, but they are far from meaningless. In discussions regarding the transaction, I reminded both our client and the purchaser about the rules relative to change in control transactions for loss corporations. The considerations of tax implications on a change in control were much more prevalent in transactions eight or so years ago, but I thought a quick summary was worth repeating.

In summary, an acquirer who purchases a company with net operating loss carryforwards is limited in the amount of annual income that can be earned tax-free. The rule essentially provides that the amount of income that can be earned tax-free on an annual basis is equal to the value of the loss corporation at the time of the change in control multiplied by the long-term tax-exempt rate, which is currently about 4%. This means that if you acquire a bank that has an acquisition value of $20 million, you can earn $800,000 per year tax-free until the target bank's net operating loss is completely used.

If you are thinking about acquiring a bank that has net operating loss carryforwards, keep this important rule in mind. If you are a bank that has net operating loss carryforwards that is looking to raise capital, also keep this in mind. The rules regarding a change in control are complex, but the worst place you can find yourself is forgetting them and then losing the economic benefit of the net operating loss carryforwards.

THE POSSIBILITIES ARE ENDLESS

A couple weeks ago, a client came to me and asked that we “run the numbers” on a potential acquisition transaction. This is a small community bank that is thinking about making an acquisition of a much smaller community bank. When we sat down to run the numbers and evaluate the transaction, we saw something that is pretty rare in community banking. This particular community bank has about two-thirds of its assets in cash. This is a knife that cuts both ways. The obvious downside to maintaining this much cash is a lack of earnings. This bank did not have terrible earnings, but they certainly were not great. The upside is the amount of earnings that can be brought into the combined organization when the acquirer gets ahold of that cash and puts it to good use. It was an interesting discussion with the board because we spent quite a bit of time talking about all of the possibilities for using that much cash.

I cannot recall a situation where we saw another community bank that was that liquid. It is certainly a conservative banking strategy. It is also one that provides the acquirer a host of opportunities.

PATIENCE IN WAITING

This past week we (finally) signed an acquisition agreement for a bank that displayed an incredible amount of patience in waiting. The indication of interest for this particular transaction was signed back in the Fall. We worked with the buyer and their counsel to draft the definitive merger agreement. For one reason or another, the process moved pretty slowly. Nevertheless, the board and owners had a significant amount of patience in waiting. Their patience paid off this past week when they signed an acquisition agreement for a deal they like very much. Congratulations to this board and ownership group for having patience. Some banks may have walked away, but this group stayed the course and ended up with a deal they like. They would have liked to have had it completed quicker, but the reward was worth the wait.

M&A WORKSHOP

It was great to see many of you at the M&A Workshop held at the historic St. Paul Hotel in St. Paul, Minnesota this past week. It is clearly apparent in our consolidating industry that the mystery behind mergers and acquisitions for community banks needs to be unveiled. We ran this workshop as the anti-"acquire or be acquired conference." It was by community banks for community banks led by the three of us, who are passionate about independent community banks. The feedback we received from the participants was all positive. They enjoyed the practical aspect of the workshop. Stay tuned. There may be another M&A Workshop prior to year-end in a different part of the country.

CONCLUSION

It is nice that summer is now well underway, although you wouldn't actually know it if you are spending any time in the northern part of the U.S. where it is still fairly cool. The 4th of July, and for many of you, a vacation, is right around the corner. Be safe.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*