
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, Illinois, Iowa, Nevada, Tennessee and Florida!

COMMUNITY BANKING

We recently received an email from a long-time, good client to let us know they had received a community bank service award for their state, which is obviously a big deal since only three banks in this state (where there are lots of banks) received the award. What an incredible honor! This is a great example of a community bank that puts in every effort, from the top management to the staff, to make sure that the word “community” is actually a part of their bank.

Congratulations to this particular bank and to all the banks who, although not recognized, make significant contributions in their community. That is what it is all about.

M&A CAPACITY

Over the past few weeks we have been contacted by multiple community banks who are interested in getting into the merger and acquisition game. The initial concern of the banks is they do not fully understand what their “capacity” is to acquire another bank. For the most part, they are pretty understanding of their human resources capacity with respect to an acquisition – that is, whether they have the human resources to do the analysis, help with the due diligence, and integrate the new institution (particularly as it relates to cultural issues). Many community bank boards of directors (even those with what we would term an acquisition bias), however, do not fully understand the bank’s financial capacity to acquire.

Generally, when talking about acquisition capacity, the human resource part is a little bit easier to eyeball than the financial piece. The financial capacity to acquire requires an analysis of a number of different issues, including the board's appetite for risk, the board's appetite for leverage, management succession/financial capacity, and other issues. For these several banks that have inquired in the last couple of months, we have engaged in an exercise to help them demonstrate the financial capacity by running hypothetical acquisitions of potential target banks. This allows the senior management and board not simply to consider "an acquisition" void of any true facts, but instead consider an actual transaction (i.e., what it would look like if they decided to move forward). It has been a pretty useful exercise. If you are interested in knowing what your bank's capacity might be in the M&A game, please let us know. We can help you figure it out.

APPETITE FOR LEVERAGE

We were recently meeting with a community bank board of directors that was contemplating its acquisition strategy. The bank is a good size, healthy, well managed institution with an engaged board. The board really wanted to expand geographically through acquisition, so they asked us what we thought they could afford from a financial standpoint. We ran through the numbers and came out with what we thought excess capital was and how we thought additional cash could be generated through leverage and possibly sale of stock. The interesting thing about this situation is that the board was less concerned about the sale of additional stock and the resulting ownership dilution than it was about the possibility of leverage. Significantly leveraging their holding company (\$20 to \$30 million or so) did not sit well with this particular board. One of them indicated they had "flashbacks" to the Great Recession and were glad they did not have that type of leverage on the holding company's balance sheet at that time.

We anticipate this group will resolve its issues and determine to move forward probably with reduced leverage and increase the sale of equity. We will let you know.

FINTECHS AGAIN

As we have mentioned in *Musings* over the last year or so, we have received numerous contacts from fintech companies, both startups and mature companies, looking for a bank charter. Most of them are looking to make an acquisition of a small bank. One of them is actually looking to charter a new bank. While this company's business model is not "on the bleeding edge," it is different from the traditional community bank model. It is narrow and

heavily focused on technology, not necessarily focused on community. The de novo charter for this bank is going to be tough at best. While the FDIC has been granting deposit insurance at a much more rapid pace than it has in the past (not saying much), it is still granting insurance primarily for traditional community banks. We will see if this group wants to go forward with the time, effort, and money it is going to take to try to get a bank charter (likely from the OCC with deposit insurance from the FDIC), which is where the general hang up comes.

REGULATORY SCRUTINY

We had a recent situation where one of our banks received significant regulatory scrutiny at its last examination. Our friendly federal regulators were not very friendly. In our opinion this is primarily due to the fact that the bank has a “dominant” owner who seems to like to “poke the bear in the eye.” Although nothing major came out of the exam, it was a continued litany of complaints with respect to transactions involving the dominant owner in one way or another. Most of the complaints are unfair based on our research.

We have no problem poking the bear (i.e., the federal regulators) at all. We have been doing that on behalf of clients for years. We think you do need to pick your fights, however.

INSIDER TRADING

One of the questions that often comes up when a bank or holding company is considering some type of material strategic transaction is whether that transaction disqualifies the directors, executive officers, or other insiders with knowledge of the potential transaction from trading in the common stock. Generally, the answer is yes, absent appropriate disclosure of the potential transaction to the seller of the stock. The insider trading laws essentially look at parity of information between the buyer and seller. If one side of the transaction is privy to material information that is not publicly known and is not disclosed to the other side, there is no parity of information, and one party is acting on insider information. Obviously this is a bad situation in which to find one of your directors, officers, or other insiders.

If you are in pursuit of a material strategic transaction, be certain that your insiders are aware of the insider trading rules. The ideal situation is to simply halt all trading by the insiders in the common stock until the strategic transaction is publicly announced. A less ideal requirement is to make the insider disclose the existence of the potential strategic transaction (on a confidential basis) to the seller as part of the transaction. Also keep in mind these rules extend to the repurchase of shares by the holding company or bank, not just the individual insiders.

SHARE REPURCHASE PLANNING

In a recent *Musings* we relayed our recent conversations with a bank holding company whose “time has arrived” for share repurchase transactions. As a quick reminder, this particular bank was formed about 40 years ago, and many of the original investors are now reaching an age where they need liquidity. Some are requesting it for themselves, while other requests are coming from their heirs.

We recently had a lengthy discussion with the holding company board to establish an appropriate share repurchase strategy. We came out of the meeting with what could be described as a four-tier strategy, which is essentially the priority of the source of funds for these shares repurchase transactions. The priority is: (i) use of existing excess capital; (ii) bank holding company line of credit; (iii) establishment of KSOP to use existing employee 401(k) funds for purchase of shares; and (iv) alternative sources of cash, such as the issuance of subordinated debentures, sale of additional common stock, and the like.

This share repurchase strategy makes a lot of sense to us. We see it as the appropriate use of funds for the repurchase of shares and provision of liquidity for these shareholders. If your community bank holding company anticipates share liquidity needs coming your way, give this order of priority some thought.

BROKERED DEPOSITS ARE NOT EVIL

A client recently provided to us an academic study by several individuals at Auburn University that was published through the Utah Center for Financial Services at the University of Utah. This particular study takes a new and pretty in-depth look at brokered deposits and really digs into whether they serve as a material source of risk. Although it is difficult to summarize a 60+ page report in *Musings*, we will take a shot.

The general gist of the report is that the current regulations and regulatory view towards brokered deposits is outdated. The authors essentially argue that the regulators need to take a new view towards brokered deposits, treating them no differently than other bank deposits. Please feel free to email us if you would like a copy of the study. We are happy to send it on.

ACQUIRING TALENT

We recently received a call from a community bank Chairman that had been approached by another community bank about a possible merger transaction. This particular transaction was brought to our client and pitched as somewhat of a “merger of equals.” Looking at the two banks, this is not a merger of equals. This is one bank proposing to acquire another bank in a part-stock, part-cash swap. The interesting thing about this particular transaction is that it seems to be driven just as much by the desire to acquire talent as it is anything else. Our client, who is the proposed target in the transaction, has a young and very capable CEO. The potential acquirer has a CEO who has one foot out the door on the way to retirement with apparently no management succession plan.

This type of transaction is not novel in today’s environment. There are many community bank acquirers that are looking to make acquisitions of talent. If your community bank has a young and talented CEO, keep in mind that that is a very valuable commodity. Your board may want to think about what steps your organization is taking to protect that valuable commodity, if any, because a potential acquirer may look to either buy your whole bank to get the talent or simply come in and steal it by giving the young CEO an offer he or she cannot refuse.

CONCLUSION

Mid-July and mid-2018. Time flies when you are “living the dream.” We hope all *Musings* readers are having a great summer and getting some vacation time with friends and family. We will all try to do the same as well. See you in two weeks.

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