
GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Tennessee, Arkansas, Texas, Georgia, Louisiana, Kansas, West Virginia, Illinois, Nebraska, Colorado, Virginia, New York, and Washington D.C.!

STRATEGIC PLANNING COLLABORATION

As most *Musings* readers know, we facilitate dozens of strategic planning sessions every year for community banks. We hope that for all of our clients these sessions are productive in moving the bank forward to the next level and achieving the desired goal of the board and senior management. Most of these meetings are collaborative in nature where both the board and senior management get together to determine the long-term strategies, with management given the obligation to execute on those strategies. Unfortunately, not all are a collaboration. We did have one recently that put the “fun” in the term “dysfunction” by the way that management and the board were, as a practical matter, adversaries on nearly every topic that came up. If the Board wanted growth, for example, management was of the position that they could not do it, they did not have enough human resources, and/or they were not paying their people well enough. If the Board wanted loan growth, then the management team insisted that the underwriting standards be reduced and credit risk issues be intensified. Only a few examples of a very dysfunctional group. That group needs to get on the same page. We worked hard in that meeting to see if we could get them there and did make some progress, but not completely. Unfortunately, the adversarial nature between the management and the board of directors will not help that community bank move forward.

MERGER & ACQUISITION WORKSHOP

As many of you know, the three of us conducted a Merger & Acquisition Workshop for the ICBA at the end of October in Nashville. It was very well attended by interested community bankers. Most were interested in learning how the process worked, although a couple were clearly interested in finding a buyer for their bank or finding a bank to buy. The Workshop started with the big picture and went down into the nitty gritty details of our merger and acquisition financial models. It also discussed some of the interesting issues arising from the Tax Law signed into law by the President last December. One change in the Tax Law allows the significant expensing of certain assets acquired in an acquisition transaction that is treated as an asset purchase. These are basically assets that have a depreciation schedule of less than 20 years. As a result of that, even though transactions are often structured as stock transactions, over the next few years there will likely be an uptick in transactions structured for tax purposes as asset purchases (Section 338(h)(10)) so the purchaser can obtain the benefit of expensing certain assets, while still having to depreciate others.

Keep that in mind as you structure your acquisition transaction. Do not try this alone; get some good help.

GETTING PROFESSIONAL HELP

As we always say in this community bank business, if you do not get professional help when you need it, then you are likely going to need different types of professional (psychiatric) help later on. We recently were facilitating a planning session for a community bank that had always conducted their own sessions since the bank's existence. They had never had any outside help. It had always been either one of the senior managers or the Chairman or CEO who facilitated the discussion. It actually seemed to work pretty well for them until they brought us in to assist in facilitation of the meeting. The general comment was that they did not know what they were missing since they had always done it on their own, and it was so much easier and more productive for them to have some outside third party come in and assist. This is primarily because we did not have any kind of "dog in the hunt" or "ax to grind" or whatever kind of trite saying you want to utilize. We could ask the hard questions without the political ramifications. It seemed to work well for this group and was a refreshing exercise for them.

SUBCHAPTER S

We have had numerous discussions over the last month with several community banks that are still contemplating converting to Subchapter S. Obviously, most of the banks which were easy to convert (i.e., around the dinner table) converted in the beginning of 1998 when it was first permissible for community banks. There are still some holdouts, however, who are not quite sure that Subchapter S makes sense for them. We always encourage them to let us “run the numbers” and show them whether it makes sense in view of their business model, individual tax rates, ownership, and the like. A couple of those are now doing that with the idea that if it makes sense, they will execute during 2019.

As most *Musings* readers know, we still believe that Subchapter S, notwithstanding the changes in the Tax Law, is still the best mechanism available to community banks to enhance shareholder value and retain their independence. If anybody wants any further information, please let us know.

PLANNING FOR MANAGEMENT SUCCESSION

Those of you who are regular *Musings* readers know that we harp pretty regularly on management succession. This is not simply because it is a good corporate business practice. It is simply because we have run into numerous unfortunate situations over the years where management succession had to kick in on a very short-term basis. Those situations where the bank had planned for the unavailability of the CEO - whether through illness, untimely death, or something else - did far better than those banks who went into emergency mode and just stuck somebody in that slot. Unfortunately, bad things happen to even good CEOs. Our recommendation is that you plan well in advance, particularly that unexpected, immediate succession need. Though the long-term need should be planned for as well, if we do not assure the short-term, there may not be a need for the long-term.

THE OVERCAPITALIZED BANK

We were recently visiting with a significantly overcapitalized bank about acquisition opportunities. The bank had an abundance of capital. On its balance sheet, it had somewhere in the neighborhood of 450 basis points of “excess” capital relative to its significant asset size. This isn’t even taking into account its access to significant amounts of capital through debt leverage (its holding company had no debt), and even the possible sale of equity.

As we were working on the possibility of acquisitions, we also discussed with them the possibility of what they were going to do if there were no acquisitions. Our strategy has always been that the community bank needs to provide a decent return on equity for its shareholders or give them a return of equity. A return of equity in this case would be an increase in the dividend or distribution (for Sub S's) or the redemption of shares, assuming no acquisition opportunity pans out. Continuing to grow your equity account just for the sake of growing it is not the best strategy in most cases. Sure, it is nice to have a buffer for the bad times (which we all know are coming), but there is some level at which even that is going to be too much. Think about it.

THE TRANSACTION IS (FINALLY) CLOSING

Tomorrow will see the conclusion of what we can only describe as a very slow community bank acquisition process. Why, you ask, do we call this a slow transaction? Because it has only taken about 15 months from beginning to end. That is slow for a community bank acquisition.

The interesting thing about this transaction is that there really is not any “smoking gun” that has caused the delay. In fact, it is quite the opposite. The banks involved in the transaction are clean banks and have not been looking to slow walk the transaction. On the other hand, neither has been in a particular hurry to get the deal closed. Each decided it wanted to get the transaction closed sometime this year, and that is going to happen.

As we have said a number of times previously in *Musings*, each acquisition transaction typically takes on a life of its own. We closed one a couple months ago that took a little less than five months. We are closing one tomorrow that has taken a little more than 15 months. It is always interesting to see these deals work at their own speed.

Congratulations are due to the owners of the sellers. They have had patience through the transaction, and it is resulting in what we see as a good deal for them. It is always nice to be a part of these types of transactions.

FRUSTRATION ABOUNDS

Speaking of acquisitions, we are currently assisting an acquirer in making an acquisition of a troubled community bank. Working through this process has reminded us of how inefficient the regulatory approval process is, particularly in a troubled bank acquisition. In this particular transaction, we are having to work through each of the friendly federal regulators, as well as the State chartering agency. We do not have a particular gripe against any one of these agencies in

that they are not doing anything to slow down the process. It is just the way that the process works.

As an example, when you are buying a troubled bank, all of the new directors have to go through a full background check for each of the friendly federal regulators involved. That in and of itself is not particularly problematic. What is problematic is the fact that they cannot coordinate the background check process. For example, you have one set of fingerprint cards that you have to do for the Federal Reserve and another set of fingerprint cards that you have to do for the FDIC.

If you have never been through a bank acquisition, be prepared for an inefficient application process. This especially rings true if the target is any type of troubled bank. We wish there was some way where the regulatory agencies could coordinate and work off of one general application filed in association with the transaction. Unfortunately, it is not that type of streamlined process. It is much fragmented.

THE MUTUAL PLANNING SESSION

Over the past couple weeks our firm had the opportunity to facilitate a planning session for a very well-run mutual community bank. The planning session itself was very nice, set at an unnamed fishing lodge right next to a beautiful river where there was a little snow and lots of wildlife present. Although the location itself was great, what was most striking about the planning session was the sincerity with which the directors and officers approached the idea of enhancing member value.

As you likely know, mutuals are different than stock-based institutions due to the fact that they do not have shareholders that have a financial investment. Instead, mutuals have members, which are essentially the depositors in the bank. These members do not make a specific financial investment in the bank. They simply become members due to their status as customers.

Some might think because the members do not have a financial interest in the bank that the directors and officers do not worry so much about that. Our firms' experience with mutuals has been quite the opposite. Virtually every mutual we have ever worked with has been very concerned with doing the right thing for their members. They see it as a certain honor and privilege to do so. This planning session was no exception. It is great that these individuals take so serious their responsibility to act in the best interest of the mutual members in their organization.

THE REST OF THE STORY

In the last edition of *Musings*, we griped about a regulator (surprise, surprise) related to a potential acquisition transaction. If you remember, the gripe was that the regulator was going to require an obscene amount of capital for a proposed transaction without having seen any type of financial projections, business plan, or the like. After the regulator relayed this to our firm, we requested an in-person meeting with the regulator where we sat down and talked through these issues. To the regulator's credit, during the meeting the regulators listened to our plan and thoughts regarding the appropriate level of capital. They did not by any means approve the transaction, but they did indicate an understanding of our position and why we thought our proposed capital levels were appropriate for the business plan.

We consider this somewhat of a regulatory success. When the regulators had a seemingly unreasonable view under the circumstances, we sat down and talked about it. They were willing to listen to what we had to say. Who knows what will ultimately transpire with this transaction, but the chances of success are higher today than they were a couple weeks ago. We will keep you posted.

CONCLUSION

2018 has gone by way too quickly for most of us. We sincerely wish each of you a very Happy Thanksgiving. We hope you get to spend it with your family and friends. We are each going to try and do the same.

See you in two weeks.

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