GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Wisconsin, Minnesota, Tennessee, Texas, Missouri, Kansas, Colorado, and North Dakota!

RAPID BALANCE SHEET GROWTH

We have been with a couple of well-run community banks in the last couple of months that have established a strategy to grow the balance sheet more rapidly than is "customary." Customary balance sheet growth for most community banks across the country is in the 3% to 5% range per year. Each of these well-run banks is looking at balance sheet growth in the 10% to 20% range. Our advice to each of these banks is that if the market will support that type of growth in a safe and sound manner (with core deposits and continued good credit underwriting and pricing), then why wouldn't you go for it? Obviously, there are capital issues associated with that. Most community banks cannot grow their balance sheet at that rapid rate with retained earnings only. That is where your small bank holding company comes in. Leveraging the holding company to provide capital to the subsidiary bank is one of its primary purposes.

If you are an outside director, do not necessarily "freak out" when management suggests a rapid balance sheet growth strategy. As an outside director, the concern should be whether the bank/management is appropriately managing risk. As long as the community bank is not growing just for growth's sake, and so long as the growth is profitable and safe and sound, then balance sheet growth in and of itself should be viewed as a good thing.

SUBCHAPTER S REVISITED

We continue to work with a number of community banks around the nation that are still contemplating conversion to Subchapter S. There are multiple reasons why these particular institutions had not yet converted, but they are now looking seriously at Subchapter S. One of the bigger questions is the tax treatment under the new Tax Act. As we have indicated in *Musings* previously, C Corporation status still involves significant double taxation. S Corporation status, particularly with the 20% income exclusion for Subchapter S shareholders, is still the best way for a community bank to enhance shareholder value. Subchapter S also gives the converting bank holding company a tremendous opportunity to restructure its shareholder base. In most Subchapter S conversions the board of directors of the holding company uses the conversion process to eliminate those shareholders who do not support the bank by living in the local community or doing business with the bank. Subchapter S is still a great strategy from a financial after-tax cash flow standpoint for your shareholders, and to keep the independent community bank independent.

THE OLDER BOARD

For those of you who think this particular *Musings* article might include more of my incessant ragging on older board members, rest assured, it does not. I was recently with a board of directors who had some older board members. "Older" these days is a relative term, but most of these folks had an "8" in front of their age. The interesting thing is, notwithstanding a lengthy meeting, they were all alert and contributed. In fact, one of the oldest directors seemed to be one of the sharpest. He was pretty insightful as to many of the issues that were being discussed. As I have often indicated in *Musings*, mandatory retirement causes a company to lose some well-seasoned directors. The tradeoff is that it also gives the board some new blood. It seems to me there should be a happy medium. The competent, bright, and engaged older director should stick around, and the directors of any age who are not bright, competent, and engaged, should get off the board.

THE AUDIT COMMITTEE

We were recently visiting with the Chair of an Audit Committee with respect to the functions, duties, and responsibilities of the Audit Committee Chair and the Committee's members. Many of the training sessions for Audit Committee members and Chairs are directed toward non-community banks. Most of the seminars involve SEC issues, reporting, internal controls attestation, and things like that. In other words, things that do not really, as a practical matter, give much consideration to community banks.

The Audit Committee serves an important function in community banking. The Committee should certainly have a Charter and a good idea of what its responsibilities are. If anybody wants a sample charter, please let us know.

OPERATIONAL AND TACTICAL PLANNING

As we have alluded to previously in *Musings* a number of times, one of the areas that keeps us very busy this time of year is the facilitation of strategic planning sessions. These are typically sessions with the board and executive officers to establish the strategic direction and action items for the holding company and bank over the next 12 to 36 months. The idea behind strategic planning is that the board sets the strategic direction for the organization and then management takes responsibility for developing the actual nuts and bolts plan to achieve the specified action items.

This past week we had the opportunity to facilitate an operational and tactical planning session for what we would describe as a very well-run, approximately $1 billion bank. What is an operational and tactical planning session? It is a follow-up session to the strategic session that brings the bank's officers and other key employees together to formulate the specific action plans for achievement of the action items. Put simply, it is the opportunity for the bank's officers to "build the roadmap" to achieve the strategic plan.

The operational and tactical session is a very logical and beneficial follow up to the board's strategic session. As we put it to the group, the operational and tactical planning session is the appropriate time to get into the weeds of the details and action items relative to the bank.

If you are engaging in an effective strategic planning session, be sure not to lose sight of the management operational and tactical follow-up session as well. Pairing these two together optimizes the chances for achieving the specified action items.

SHOULD WE TERMINATE THE ESOP?

Within the past couple weeks I facilitated a strategic planning session for a very solid community bank. Overall, this bank really did not have any problems per se. They had good earnings and good asset quality, and they checked all the boxes relative to enhancing shareholder value. The one "issue" in the bank that yielded quite a bit of discussion during the planning session was the bank's Employee Stock Ownership Plan.

At some point in the past this board had a little misstep relative to their ESOP. The rule is that an ESOP may not purchase shares for the benefit of bank employees at a price that exceeds the fair market value for the shares as determined by an independent appraisal. In the past this particular ESOP violated this rule because the ESOP was purchasing at the higher of the fair market value as determined by the independent appraiser or book value, which is the share repurchase price set annually by the board of directors for the walk-in stock repurchase program. There were a couple instances where the ESOP purchased at book value, which was slightly more than the fair market value as determined by the independent appraisal.

This bank is currently taking steps to remedy this issue. However, the directors were a little shell shocked at having to spend the time, money, and effort to remedy the situation. At the planning session we had a discussion as to whether the ESOP was worth it or whether it ought to just be terminated so they do not have this type of problem again. My advice was to keep the ESOP. I understand they are a little jaded by the current events relative to the ESOP, but overall I see it as a significant employee benefit. I also see this bank as a great candidate for Subchapter S, so I told them about the significant benefits of an ESOP in an S corporation. We will see what ultimately transpires, but if I had a vote it would be in favor of keeping the ESOP.

THE YOUNG BANKERS SURVEY

Two of our partners, Greyson Tuck and Doc Bodine, recently had the opportunity to be presenters at the ICBA Lead FWD Summit. If you are not familiar with this summit, it is the ICBA's annual gathering of younger leaders within the community banking industry. It started about six years ago and has evolved into a great couple days for community bankers.

This year they took a little different approach to the presentation session. Instead of doing the more standard PowerPoints and lecture type presentation, they surveyed all of the Lead FWD participants by asking 25 questions related to the current and future community banking environment. They then took those results and presented them through use of (with apologizes to Steve Harvey) the Community Banking Feud. It was a Family Feud style game show.

The game show ended up being fun. What was really beneficial was the insight of young community bankers into the current and future community banking environment. Overall there were some things they expected and a couple surprises along the way. Based on the responses, we think the best description of these bankers' views towards the future of community banking is that it is evolving but will still be completely relevant 20 years from now.

They are currently working to take these survey results and distill them into a report for public distribution. Keep your eyes open for that report, because we think all bankers will have some interest in taking a look.

THE LINGERING EFFECTS OF THE RECESSION

For most community banks the recession is now a distant memory. By and large the industry has recovered from the significant economic turmoil beginning in 2008. However, over the past couple weeks we have unfortunately been reminded that not all community banks are out of the woods yet.

We have a small handful of community banks that are still struggling to recover from the recession. The characteristics of each of these banks are similar. They all had highly leveraged holding companies and are located in areas of the country that were very hard hit by the recession.

The upside to each of these situations is that these bankers have not lost the drive. In each of these instances, the banks' management teams continue to persevere and work hard to try and find a solution to their problems. We are hopeful that in each of these situations we will be able to craft something together that saves the community bank. If it does not happen, it is certainly not for a lack of effort on behalf of these bankers. We just need to combine this hard work with a little bit of luck, and I think we will be able to make something good happen in each of these instances.

CONCLUSION

The air is crisp in most places we have been traveling to, particularly up north. Fall apparently is on its way, which means the snow can't be too far behind.

Enjoy it while it is still comfortably cool. See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

P.S. As indicated in prior *Musings*, we are conducting a Merger & Acquisition Workshop for community banks only, sponsored by the ICBA, on October 29th and 30th. Set forth below is the registration link. We hope to see many of you there.

Mergers & Acquisitions