GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Tennessee, Michigan, Wisconsin, Georgia, Minnesota, Colorado, and Pennsylvania!

LIBOR TERMINATION

A couple months ago in *Musings* we referenced the forthcoming termination of the London Interbank Offered Rate in 2021. We mentioned that community bank holding companies with Trust Preferred Securities still on their books need to be thinking about how they are going to transition away from LIBOR. Apparently the Federal Reserve agrees with us. Recently in a speech, the Federal Reserve Vice Chairman for Supervision Randall Quarles discussed the termination of LIBOR and recommended that companies begin working to move away from LIBOR. The general belief is that LIBOR is going to be replaced by a new benchmark known as the Secured Overnight Funding Rate.

If you are a community bank holding company that has Trust Preferred Securities on its books, or any other credit instrument tied to LIBOR for that matter, our recommendation is that your community bank and holding company get out in front of this. We have assisted a number of holding companies in amending their Trust Preferred documents. The process is not quick or easy. It is made even more difficult when the Trust Preferreds are held in a pooled offering, known as a Collateralized Debt Obligation, which most are.

If you have Trust Preferreds outstanding, our recommendation is that you begin now thinking about the transition away from LIBOR. Please let us know if we can help.

FINTECHS ON THE PROWL

Several times over the past month or so, we have received telephone calls from what are essentially fintech companies looking for a bank charter. These companies typically fit the same mold. They generally call and identify themselves as startups that are looking to acquire a small bank charter with an existing management team that can stay in place to use as a platform to launch their digital strategy, whatever that may be. Some of the usual suspects include digital payments and cross-border money transmission.

The common bond between each of these fintech type acquirers is the fact that they are looking for a bank charter at the cheapest point of entry. They all want to buy as small a bank as possible in order to get into the charter at the cheapest cost possible. As we have told many of these inquiring fintechs, the problem is there simply are not many charters out there that fit the bill. We ran a screen the other day, and there are less than 500 banks in the country with $50 million or less in total assets. When you add into the mix the requirement for an existing management team to stay in place, the list of potential targets contracts to a pretty small number. Even if you are able to identify a charter to buy, what can often be more difficult (but not impossible) is getting the regulatory approval to take what are these typically small banks and use them as a platform to launch into some new digital strategy.

If you have (or know a friend) that has a bank around this asset size, know that there are people on the prowl looking for those types of charters. This is particularly true if there is an existing management team that can stay in place. Also, as we have told many of these fintech acquirers, finding the charter to buy is difficult.

THE VALUE OF DEPOSITS

We are currently assisting a number of community banks with the potential sale of their organization. Two of these sellers, in particular, have low loan-to-asset ratios. This balance sheet structure typically hamstrings the organization’s earnings. Historically, lower earnings have turned potential buyers off from a deal, and it does make getting a nice premium on the bank more difficult. However, today’s environment is different. There are a number of banks that have very high loan-to-asset ratios and are clamoring for excess liquidity to satisfy loan demand. This excess liquidity is very desirable for many banks in today’s environment and is creating essentially a deposit value premium for seller community banks with low loan-to-asset ratios.

Earnings have been and will continue to be of significance in valuing an acquisition transaction. From about 2008 until the end of 2017, excess liquidity had virtually no value. That is very different in today's environment. Excess liquidity is desirable, and the market is willing to pay a premium to get it.

ESOP EMERGING LIABILITIES

We have completed several ESOP Emerging Liabilities Studies over the past couple months. If you are not familiar, an ESOP Emerging Liabilities Study is essentially a detailed set of financial projections that forecasts the ESOP's liquidity demands and needs over the next ten years. From a 30,000 foot level, it takes each ESOP participant's current balance, applies an appropriate growth rate to that balance, and then forecasts the participant's withdrawal from the ESOP, which is the point at which the participant has essentially a put option to the ESOP or the holding company to buy the shares. Based on the size of the account, the individual is typically either bought out all at once or over a structured payout.

In a C corporation setting, the ESOP participants often have the choice of either taking the stock from their ESOP account or taking cash in lieu of the stock. For S corporations, the ESOP almost always requires the participant to take cash (as a protection against exceeding 100 shareholders/family groups). Regardless of whether your community bank holding company is a C or an S, it is important you keep the ESOP emerging liability in mind. It is vital to be able to understand the anticipated cash flow needs for the ESOP. Let us know if we can assist.

MANDATORY RETIREMENT?

We were recently visiting with a client about issues related to mandatory retirement. It was clear during the visit that they did not favor mandatory retirement (neither do we for the most part). They did have an interesting concept, however. They had a mandatory age above which you could not join the Board. In other words, if you were over (pick a number) 55, then you were not eligible to become a board member.

We thought that was a pretty interesting concept to have articulated. Most boards are looking for youth, but we have not run into many that have a maximum joining age. Food for thought.

BOARD GOVERNANCE

We have found a renewed interest in board governance issues lately (finally!). We have been pounding the table for a while about a number of these issues. Two that seem to be predominant involve the use of a consent agenda and the related shortening of the current financial part of the board meeting and adding discussion of strategic and risk issues. Our general recommendation as a best practice (unless your bank is in trouble and the regulators expect you to pay more attention) is to use a consent agenda. This should, in fact, shorten your meeting by 20 or 30 minutes (in most cases), which then allows the board to utilize those 20 or 30 minutes to deal with strategic and risk issues (i.e., forward-looking issues).

Also, this only works if your board of directors receives its board package, either paper or through a board portal, well in advance of the meeting. Our thought is best practice is the board needs to get the information at least three or four days in advance of the meeting. That allows them to review the information and be prepared for the meeting so that the use of a consent agenda makes sense.

If any *Musings* readers would like a Memorandum to Clients & Friends on the use of a consent agenda, please let us know.

THE DEADLOCKED BOARD

What do you do when you have a deadlocked board? Recently, we were involved with a 10 person board with five on each side not able to agree, for whatever reason, on any issue. Some of you *Musings* readers may be in this position. It is not all that unusual, frankly. It usually results from family issues, personal issues, and the like, as opposed to material disagreements over strategic issues. Our general recommendation when the board is locked like that is that one side take a run at buying the other side out, assuming there is a large stock component on both sides, which there typically is. Generally, a frozen board is not conducive to much of anything. Somebody needs to take over and sell to the other. Often, this is approached through a "I'll buy you at this price, or you buy me at this price." Either way, in order to do the best for the community bank and its community, somebody needs to have control over the board. If you are in that situation, think about how best to resolve it, and be prepared for the purchase if it becomes available.

RETENTION BONUS AGREEMENTS

As many *Musings* readers know, particularly those who have engaged in acquisitions or have seriously thought about it, in virtually every acquisition transaction, the selling bank provides certain of its employees with retention bonus agreements. These are simply agreements entered into between the bank and the employee indicating that if the employee is employed and has not been fired for cause or terminated voluntarily prior to the time that the acquisition transaction involving the bank closes, then the employee will receive a certain sum of money. In other words, there are two purposes for retention bonuses: 1) to bribe the employee to stay until the deal closes - i.e., not to run off and take another job, which could upset the deal - and 2) to make sure the employee is happy and encouraged to get the deal closed. The latter of course primarily refers to executive officers that have the ability to influence whether the deal closes or not simply due to their responses and attitudes during due diligence. The retention bonus typically goes a long way toward incenting those individuals to encourage the deal and make sure that it gets closed.

Retention bonuses, as a practical matter, are simply a cost of doing an acquisition transaction, same as financial advisory and legal fees. Don't be penny-wise and pound-foolish when it comes to protecting your transaction. The retention bonus should be in an amount that is enough to get the attention of the employee and to incent the senior officers in particular to get the deal done.

THE PROVERBIAL MERGER OF EQUALS

Many of you *Musings* readers have heard us (or read us) ragging on about mergers of equals. We are not against mergers of equals; we just think that the parties need to go in with their eyes wide open. We have assisted many like-size banks in coming together, and most of those were very successful over the long term. In connection with this type of merger of equals, both parties need to know that somebody has to be in charge. Technically, for accounting purposes, one holding company or the other will deem to be the acquiror. One entity's management will be dominant, as will its board. This simply all needs to be sorted out ahead of time.

As we often put in *Musings*, in any acquisition transaction, but particularly in one in which the parties view themselves as "equals," social issues are paramount. These include who is going to run the resulting company, what the Board is going to look like, where the world headquarters is going to be, what the name will be, and the like.

Those of you who have been following the trade press know that BB&T and SunTrust are coming together. This has been billed as a merger of equals with a big mix of management, mixed board, and a new name. So those of you who were dead set on renaming your bank Truist Bank, we're sorry, it's taken. That is going to be the new name of BB&T and SunTrust. We only wonder how much money they spent having someone come up with that particular (silly) name.

TODAY'S M&A ENVIRONMENT

Our firm was recently having an internal discussion regarding today's M&A environment. The summary of the discussion is that we label the current community bank M&A environment as "interesting." Based on the approximately dozen or so current deals we have in process in our firm, probably four or five are what we consider "traditional" community bank M&A transactions. These are where one community bank is acquiring another community bank and there are generally no unique or novel issues involved. The remainder of the bunch, probably seven or so, all involve some type of unique transaction issue or issues. These issues run the gamut from non-traditional (to put it lightly) transactional structures to legacy Trust Preferred issues.

The current community bank M&A environment is active. Based on what we are seeing, only about half of these deals are traditional deals that "fit in the box." The remainder involve unusual transaction issues. If you are thinking about being a buyer or seller and you have some of these issues present, do not think that those issues are deal killers. It is just important to make sure you have the knowledge involved in the deal to work through them.

CONCLUSION

It is currently mid-June. Things have definitely warmed up around the country. It is good to see the snow finally gone (for the most part). For many of you, vacations will be coming. Enjoy the summer months.

Also, we have also been informed that there are two slots available for next week's M&A Workshop in Downtown St. Louis, Missouri. If you would like to join us, please following this link to register:

Mergers & Acquisitions Workshop

See you in two weeks.

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