GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Wyoming, Wisconsin, Minnesota, Florida, Georgia, Indiana, Kentucky, and Texas!

ACQUISITION STRATEGY

In most planning sessions we conduct, the issue of geographic expansion is on the agenda. The question is, what should the bank's acquisition strategy be? Identifying this strategy always begins with a discussion of how to best enhance shareholder value. It then moves on to the capital resources and human resources necessary to execute on an acquisition plan. The Board's choices with respect to an acquisition strategy are primarily 1) to be totally reactive (i.e., wait for somebody to bring a deal to you), 2) be totally proactive (meaning we assign somebody in the bank to scout out acquisitions, build relationships, do the "courting" necessary to bring a bank acquisition in), or 3) to be "mildly" proactive with respect to acquisitions.

Many of our clients lately have chosen the third route (i.e., the mildly proactive route). This basically means that the CEO is to be out scouting deals, but it is not a 50% of his or her time job. It is to continue to build relationships and slowly get a target in a position where they are interested in doing something. Most boards realize if they establish a totally "proactive" acquisition strategy, then it has the consequence of taking up a lot of the CEO's or CFO's time.

SO YOUR "BOARD" WANTS YOU FIGURE OUT HOW TO BUY A BANK

So your board wants you figure out how to buy at bank? Not an unusual situation. In fact, over the last year we have been retained by multiple banks and holding companies to assist them in finding a bank to buy, analyzing it, preparing the financial model on pricing, and getting the Letter of Intent to the target. The usual scenario is that the board of directors of the community bank holding company decides at their strategic planning session to be "proactive" in connection with bank acquisitions. That is all well and good, but if the community bank holding company has never done a deal before, it really puts the Chief Executive Officer in a tough spot because he or she typically needs some help. That's where we step in and help develop the acquisition strategy, identify the targets, vet the targets, run the numbers, and begin negotiation of the deal. Often, a bank will put a lot of hooks in the water. Once it gets a bite, then we assist in reeling it in and performing legal services to get it closed. As we like to say, if you are moving down a road that you have not been on before, make sure you get professional help now, or you may need professional help of a different type later.

BALANCE RISK MANAGEMENT/COMPLIANCE AND LENDING

Multiple community banks we have been with recently, particularly some of the larger ones, have had healthy discussions with respect to an appropriate balance between risk management/compliance and lending. There are some Risk Management people, of course, that feel there can never been enough compliance and assessment of the risk. The Lenders, of course, feel that they are slowed down because of the unnecessary burden of trying to be 100% compliant. We have had numerous discussions with banks as to where this balance lies. Does the community bank really need a 1 rating in Compliance, or will a 2 be sufficient? The general consensus is it depends on the cost. If a 2 rating means the bank has done a poor job on fair lending, for example, then the general consensus is that a 2 rating is not appropriate. That would create too much risk and simply put the bank in the penalty box. If the community bank is being willing to suffer some minor violations cited by the regulators but able to get loans on the books quicker, then the balance generally goes to the Lenders. We did have one Senior Risk Manager tell us recently that he understands there needs to be a balance between compliance/risk management and lending, but he sure hopes that the bank does not create another "obstacle removal task force" or something like that between the Lenders and Compliance. We thought that was an interesting way to put it.

EXPAND OR CONTRACT OWNERSHIP

A common issue for community bank holding company boards of directors is the ideal or desired ownership composition - that is, what do you want the shareholder base to look like? The first issue for the board to understand is that controlling the ownership of the institution (or shaping it) is a board job. For most community bank holding companies, the strategy is to consolidate ownership into a smaller group of shareholders. The general goal is to "do business with people who do business with us" and consolidate into a smaller group of shareholders that actively support the bank. On occasion, though, some community banks want to expand that ownership net. We were recently with a couple of these types of institutions who, notwithstanding a control ownership that would be diluted by an expansion of the shareholder base, did not mind that particular result from execution on the strategy. The point is, no matter what the board decides, it is the board's job to control ownership. The community bank holding company board should focus on whether the strategy is to consolidate ownership, to leave it the way it is, or to expand it. What is the best strategy for your community bank?

CAPITAL ALLOCATION

We recently had an interesting discussion with a community bank holding company board of directors regarding capital allocation. This particular community bank is profitable and very clean with a significant amount of excess capital. This community bank has a Tier 1 Leverage Ratio in excess of 12%, which is above the Board-identified minimum.

Our discussion was really a discussion of the various available strategic alternatives. Given the bank's current condition, the organization could certainly buy another community bank if it wanted to do so. There is also an insurance agency they have had their eye on for a couple years that they are thinking about making a run at. They also have an aging shareholder base and some shareholders they think would sell some larger blocks of stock given the opportunity to do so.

Several times throughout the discussion we talked about the allocation of capital to its highest and best use. The group recognized that many of these strategic alternatives were mutually exclusive, so it really was a question of which alternative would realize the best return on the investment. This is not a novel concept, but we thought it to be a good reminder. Almost every community bank strategic decision is really about the allocation of capital and resources to their highest and best use. We see it as a great framework for strategic decision making.

LEGAL VERSUS PRACTICAL CONCERNS

Several times over the past couple weeks we have been reminded of the reality of legal versus practical concerns. We certainly see these two as distinct. A legal concern is, as the name implies, a concern as to the legality of some action, whether it be through contract, statute, regulation, or the like. We view practical concerns as more aligned with business risks. They are not necessarily legal issues, but the decisions certainly have ramifications.

Over the past couple weeks we have seen an instance where a community bank buyer and seller have had, at least according to one of the parties, less than ideal communication regarding various aspects of a deal. Although the lack of communication may not immediately rise to the level of a legal concern, it is certainly a practical concern. One of the parties is losing enthusiasm for the deal because it feels as though the other is not appropriately communicating material items in the transaction. In another instance - this one related to share repurchases - we discussed with a board a disparity between their offered repurchase price per share and what we thought was likely the fair market value for the shares. Our belief that the board might be "underpaying" was not necessarily a legal concern, but we do see practical implications that at least need to be considered.

Some situations involve only legal risk. Other situations involve only practical risk. Some situations involve both. Regardless, we think it important to understand each of these risks, as well as the distinction between the two.

STAY THE COURSE

We recently received a call from a community bank holding company client that has some concerns over their recent profitability. This particular bank has always been a very strong earner. Over the last three or four years they have made a couple strategic decisions that have involved expansions into new markets and acquisitions of other branches. They knew each of these strategic actions would involve investment, which is a polite way of saying reduced earnings for (hopefully) a short amount of time. However, now that they are seeing the numbers on the Call Reports rather than financial projections, the "investments" are a little bit harder pill to swallow.

The banker called to ask our advice on the situation. In talking through the issues, the banker indicated they are completely on budget, things are happening as they expected them to happen, and the like. The banker wondered aloud whether they ought to jump ship and abandon some of these strategies. Our advice was to stay the course. The actual numbers are largely reflecting what was projected, and the expectations are now coming to fruition. They may be a little harder to swallow than anticipated, but they are not different than what was expected.

Change, particularly for a bank executive that has not gone through much of it, is never easy. However, if a decision that is made on a fully informed basis is working as anticipated, we recommend to stay the course. The expectation was a little bit of short-term pain for the benefit of long-term gain. Just because you are in the short-term pain part of the process does not mean you ought to change strategies.

FRACTIONAL SHARES

We recently received a call from a client that is experiencing some problems with fractional shares. The fact that the community bank company has fractional shares in and of itself is not that big of a deal. The problem comes in the administration of the fractional shares. There have apparently been a number of shareholders that have wanted to transfer shares from one brokerage account to another brokerage account, or some similar situation, and the fractional shares have created problems in doing so. The board does not see any real benefit to these fractional shares, so they want them gone.

Is there a quick and efficient way to eliminate fractional shares? We think so. This particular state has a statute that essentially provides the board may arrange for the disposition of fractional shares. What exactly does it mean to "arrange for the disposition" of fractional shares? We can interpret the language, but in this particular state, a court has never interpreted the statute in question. As a result, all we have to rely on is the plain language of the statute.

Based on our reading of the statute, we think the company can simply eliminate fractional shares by cashing out the fractional shares and essentially rounding down each shareholder to the next whole number. We are working with the board to evaluate such action. We will keep you updated. If you have fractional shares that are causing any type of problem for you, this might be an appropriate solution.

CONCLUSION

Labor Day Weekend is upon us. This is a good time to catch up with old friends and spend time with family. We hope you all have a wonderful Labor Day Weekend.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*