GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Arkansas, Texas, Georgia, Tennessee, Louisiana, Mississippi, Iowa, and Colorado!

EXCUSE ME?

We have been with multiple bank leaders recently, both Chairmen and CEOs, who have cautioned "the troops" not to use the coronavirus as "an excuse for poor performance." As we have mentioned in *Musings* previously, we have heard of some individuals using COVID-19 as a "disease of convenience." If they want to go someplace it's not a problem. If they don't, then they can't because of the pandemic. We also agree with the Chairmen and CEOs who caution their management staff not to use the disease as a convenient excuse for poor performance of the bank.

Realistically, however, all of them realize that this year has been disrupted (to say the least) and, for most, performance will be "off." (That is not to say there won't be some exceptions.) We are all optimistic that this year, from a financial standpoint and otherwise, will simply be an aberration that we will look back on historically with some fondness? We will see.

LONG-TERM PLANNING IN THE CURRENT ENVIRONMENT

As many of you know, we facilitate dozens of long-term planning sessions for community banks across the nation each year. While many of the strategic planning sessions originally scheduled for March, April, and May have been postponed to the fall, those scheduled in June, July, August, and beyond seem to be going forward as planned. The interesting impact of the current environment on long-term planning, however, is that most banks and boards, as well as senior management teams, understand that to plan for the long term, we first must ensure the short term. As we told a group recently, we feel like we are back in the Great Recession with asset quality/troubled banks where their goal was to not so much to focus on long-term success but to focus on short-term survival. We are not quite at the "survival" point in this pandemic and do not anticipate getting there. Nonetheless, the reality is if we do not succeed in the short term, there will be no long term. Part of that short-term planning is to look at what occurred as a result of the pandemic and pick those best practices or things that we "thought we could never do in our community bank" and figure out how to utilize those going forward. Should we now allow community bank personnel to work remotely? Does this put us in a better situation (particularly as a rural community bank) to attract personnel who may be more metro-oriented? Those types of things should be explored as part of a short-term impact of the pandemic in connection with long-term planning.

SHARE LIQUIDITY

Share liquidity seems to be a regular topic for *Musings* because we regularly get calls from banks, large and small, who are concerned about their aging shareholder base. If you have a 90 year old shareholder who controls 28% of your holding company, then you definitely need to be thinking about this. The board should develop a strategy that anticipates sources of capital to buy that shareholder's estate out or, alternatively, the possible restructuring of the characteristics of the holding company stock so that it will be attractive enough for the heirs, whoever they may be, to want to hold. In other words, can we turn that stock into more of a cash cow than it is now so the heirs would not even want to sell it because they could not replace it with anywhere near as good an investment?

In any event, as the population ages and our shareholder base ages, it is critical to consider how we take care of these shareholder liquidity needs, particularly if the long-term strategy is to remain independent (which it is for most of you). Typically, once we determine the sources of capital and capital availability, then it simply a question of the mechanism used to transfer the stock from the shareholder's estate someplace else. That someplace else can always be a holding company repurchase, purchase by an ESOP or a KSOP (either existing or newly formed), or a transfer into the hands of a new, yet friendly, shareholder. The important thing is to plan for it and preserve some "powder" before your community bank holding company needs it.

RETIRING COMMUNITY BANK CEOs

We have had multiple conversations over the year with numerous community bank CEOs about their retirement plans. This often comes up in the context of a long-term planning session (where management succession at the bank should always be a topic). The typical discussion involves inquiring of the CEO his or her current age and then asking the CEO to provide either a ballpark of when they are going to retire or a commitment to provide the board notice at least 24 months prior to their retirement (provided health and other things allow).

With respect to the "when are you going to retire" question, we have received numerous and varied answers. We have had some situations where the CEO may be 55 years old and indicate he or she wants to retire in five years. We have had some where the CEO is 68 years old and indicates that he or she wants to continue to work at least until they are in their early seventies. There is certainly no "one size fits all" for retirement from the CEO position at a community bank. Interestingly, some of them, although not ready to retire, realize they need to make room for the next generation and are willing to step aside in order to do that. The board's first issue with respect to a retiring CEO involves whether there is an appropriate replacement. What we hear most often from the board is that the board wants someone "exactly like" the retiring CEO. We generally advise that human cloning is not permissible, so they are not going to get someone exactly like the current CEO. Once the board determines they do have a replacement, however, then the next decision is what involvement, if any, does the retiring CEO have in the ongoing operations at the bank. We have seen some boards that indicate once you retire as a CEO you're gone. Others indicate you can continue on the board. We have seen it work well both ways. We have also seen it work poorly in many circumstances where the former CEO remains on the board and/or has an office in the bank.

Management succession and CEO retirement is an interesting and difficult issue for boards. That is primarily why we ask a retiring CEO to provide at least 24 months' notice to his or her board before they are going to retire, so the board can work through the issues in a deliberate manner.

BOARD OF DIRECTORS SUCCESSION – RETIRING BOARD MEMBERS

Similar to the previous *Musings* article about retiring CEOs, retiring board members also need to be addressed. Many banks have mandatory retirement. In some cases that is good. Our general preference, though, is not to have mandatory retirement, but for the Chairman in particular to make the hard decisions when it is time for a board member to come off the board. Board members are not generally asked to give much notice of their pending retirement. This is simply because the board member is only one of many members of the board of directors. Not that they can be easily replaced, but their absence is not nearly as significant as the immediate absence of a Chief Executive Officer of the bank.

Board succession still needs to proceed in an orderly manner, however. The board should be polled as to retirement plans, whether arising from planned retirement or mandatory retirement, and a schedule of when board members will need to be replaced should be created. A committee should be formed to determine the characteristics of the ideal board member and to determine if there are any available individuals with those ideal characteristics who could fill the slot. The board selection process should be similar to the management selection process in that the board wants an individual with the appropriate skillsets and value-adding capabilities, as well as the ability to contribute to the board. Culture is also important.

ACQUISITION SOCIAL ISSUES

We recently had a discussion with a couple community bank executives whose bank completed an acquisition of another community bank within the past couple years. We were talking about a number of different strategic issues, and we of course asked how the acquisition has been working out. These bankers said overall they were very pleased with the acquisition; however, with the benefit of hindsight, they mentioned they wished they had been more direct with the target bank employees on who was the acquiring institution and how the combined institution was going to be run.

Our response was, not so jokingly, that community bank acquisitions should be much more akin to a benevolent dictatorship than they are to a democracy. We think this important to ensure there is a clear line of authority where there are no misgivings about whose ideas and directions are going to control.

We have said many times previously in *Musings* that community bank acquisitions involve both financial and social issues. We have also said, and will go on record again here, that we view the financial issues as much easier to navigate than the social issues. Successful community bank acquirers are those that do particularly well at the social issues while also not missing on the financial issues. If you are thinking about making an acquisition, be sure that you give plenty of strategic thought and effort towards the social issues in the acquisition. Doing well in that area significantly improves the overall benefits of the transaction.

REGULATORY APPROVALS

Over the past couple months our firm has received a number of different regulatory approvals for various strategic transactions. These primarily relate to M&A transactions and notices of change in control. The good news is that we can report there is apparently no type of unspoken moratorium on regulatory approvals. The bad news (if it qualifies as such) is that the regulatory approval process is typically taking a little bit longer than normal. This is not altogether unexpected.

Every regulatory application has somewhat of a life of its own. Historically, a good rule of thumb is that most regulatory applications were typically approved within 30 to 45 days. The current environment has slowed that timeline down just a bit. We are seeing approval timelines more in the neighborhood of 50 to 70 days, although some are taking even longer than that.

If your community bank is considering making a regulatory application, keep the timing in mind. Our general experience right now is that you can get approval, assuming it is warranted, but it may not come quite as quickly as you would like. There are just a number of different factors, such as unknowns related to COVID-19 and remote working setups, that are slowing the timeline by what appears to be a few weeks.

TRANSACTION FUNDING

We are currently working with a number of different community banks that are thinking about M&A transactions. One of the initial issues that is always present in thinking about a deal is how to pay for it. The options are pretty easy to name: existing "excess capital," bank holding company debt, or the sale of common stock or other equity interests. Deciding exactly which one or combination of these funding sources will be utilized is not quite as easy.

We believe the decision about how a strategic transaction is going to be funded can essentially be boiled down into three steps. First, identify how much funding is needed to complete the transaction and compare that to existing resources. Second, determine the goals of the transaction, which generally should be to improve earnings per share and return on equity. Third, run the numbers on the various available alternatives to determine how the funding mix works towards or against achieving the identified goals, keeping in mind other relevant considerations, such as minimum capital requirements, debt to equity limitations, and similar regulatory concerns.

There will be certain internal and external factors that will influence the decision on how to fund a particular strategic transaction. However, we think the above roadmap is a pretty good starting point towards determining the funding mix.

THE SUPERCHARGED ASSET GROWTH STRATEGY

We were recently contacted by a community bank whose Board has adopted what we classify as a supercharged asset growth strategy. This bank expects to achieve about 50% asset growth this year, and it is looking to grow between 25% and 40% per year for the next four or five years. The overall strategy is to increase assets about tenfold in a ten-year period. The bank asked us to assist in developing strategies to ensure this asset growth could be achieved in an appropriate manner, particularly as it relates to the regulators.

We identified two major issues that the Board needs to consider as it looks to achieve this recently adopted supercharged asset growth strategy. The first is asset quality. Obviously, it is of utmost importance for the bank to grow with quality deposit and lending relationships. We all know the old adages. There are never bad loans put on the books, but rather good loans that go bad. Also, it is not hard to loan money, the hard part is collecting it. This bank's adopted strategy will come to a screeching halt if they are growing the bank with poor quality assets or "hot money" deposits.

The second issue is one of capital. This bank does not have the existing capital to support this growth. Although they anticipate profitable growth, the projected profitability and increase in retained earnings is not enough to keep pace with the asset growth. Accordingly, we developed a comprehensive capital strategy that will support the growth over the next ten years. This strategy involves a combination of initially leveraging the bank holding company and then following up with a capital raise a couple years later.

The strategy of significant asset growth is not, in and of itself, a bad strategy. However, a supercharged asset growth strategy does involve more risk than a slow and steady wins the race strategy. Any strategy that involves significant asset growth has to be accompanied with adequate forethought on the regulatory, asset quality, and capital issues. If there is a miss in any of these areas, the strategy will be derailed, and the bank will have a whole new set of issues on its hands.

IMPACT OF THE VIRUS ON INDIVIDUALS

As we are back on the road visiting in person with bank directors and officers, generally in the context of long-term planning, we have had multiple interesting discussions with respect to the impact of COVID-19 on the individuals. For some it has been a disaster. Some have had loved ones that have been locked away in long-term care facilities that they can't even see. Some have had loved ones, friends, and neighbors who have gotten sick. Yet others advise that COVID-19 is the best thing that ever happened to their family. Many, particularly those with young teenagers, have expressed that without COVID-19 and the lockdown, they would have never had the opportunity to spend that much time with their kids where otherwise under normal circumstances everyone is playing sports, taking music or dance lessons, and the like that kids do at that age. For many it has been a wonderful family time. We are happy for those and sympathetic for the others. As we tell our community bank clients around the country, this too shall pass.

CONCLUSION

Here we are midway through the third quarter of 2020. Interesting year thus far. Some of the kids and grandkids will be going back to school. Others will be locked down, tapped into virtual learning. To say we need to continuously "roll with the punches" is an understatement.

Have a great two weeks.

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Upcoming Webinars:

- "Organizational Structures to Enhance Shareholder Value" for ICBA – Philip Smith – August 20, 2020. Registration Link: [Register - Organizational Structures to Enhance Shareholder Value]

