GERRISH'S MUSINGS

Jeffrey C. Gerrish
Philip K. Smith
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ Phone: (901) 767-0900 ♦ Fax: (901) 684-2339 ♦
♦ Email: jgerrish@gerrish.com ♦ psmith@gerrish.com ♦ gtuck@gerrish.com ♦
Website: www.gerrish.com

September 30, 2020, Volume 425

Dear Subscriber:

Greetings from Illinois, Wisconsin, Texas, Florida, Michigan, Ohio, and West Virginia!

AN EASIER WAY TO ROB A BANK

As most *Musings* readers know, we try and keep up with the "PPP fraud cases." These are situations where individuals or businesses have typically used fraudulent documents to apply for PPP loans and have actually been caught by the federal criminal authorities and indicted.

We read with interest one recent indictment with respect to a gentleman from Rhode Island (we use the "gentleman" term loosely). According to the press release, this individual in 2010 was convicted of fraud and received a sentence of 24 months of supervised release. During his term of supervised release, he was convicted of four counts of bank robbery. He was on supervised release when he made the criminal applications on the PPP for nonexistent businesses.

Our only guess is that he found that PPP was an easier way to rob a bank than what he had previously been doing, which we can only assume was the old fashioned way. Interesting.

If anybody wants a copy of the press release, please let us know.

INDEPENDENCE

At every strategic planning session we facilitate for a community bank, we address the strategic issue of whether the bank is to remain independent or whether now is the time for the bank to sell. We have a strong bias in favor of independence, but we realize there are two sides to every equation. We generally address this on the front end of a planning session, for obvious reasons. If the decision is to sell the bank, then the plan will likely be different than if the strategic decision was to remain independent over the long term. Keep in mind, even with an "independence" strategy, the best the board can realistically hope for is that the bank remain independent over the long term subject to the receipt of an unsolicited offer, in which case the board will appropriately exercise its fiduciary duty in favor of the shareholders. A strategy to remain independent does not mean the bank will never ever sell. It simply means that the plans going forward will assume the bank will remain independent. If there is a better alternative for the shareholders, then the board will appropriately consider it and exercise its fiduciary duty for the benefit of all shareholders.

As we have mentioned in previous *Musings,* we are currently running the numbers for multiple community bank acquisitions where one community bank is looking to target a smaller community bank for a cash acquisition. Although some of these will have been solicited (i.e., bid packages out) or worked on for years (i.e., significant courting and will be no surprise to the target), some of them will involve unsolicited offers. An unsolicited offer is not the preferred way to do business, even in this day and time, but it does get the issue on the table. The best defense to an unsolicited offer is strong financial performance of the target community bank. The real question is whether the bank holding company's shareholders are better off holding the holding company's common stock, or the stock and/or cash offered by whoever is buying. The "test," as set forth above, as simple as it sounds, is of course a little more difficult in the execution. Let us know if we can help you address these issues.

INDEPENDENCE II

One of the recent strategic planning sessions we facilitated involved a fairly lengthy discussion regarding independence. As noted above, we believe the strategy relative to independence is one of the fundamental decisions that has to be made as part of the strategic planning process, since the strategy relative to independence has such a significant impact on all other strategic plans. In this particular situation, we provided information and pricing ratios to the board in connection with recent community bank M&A deals, noting that since the pandemic broke there have been a limited number of deals announced and many of those deals are announced at prices that are below or essentially equal to the target's book value. One of the outside directors asked the question why a bank would choose to sell at or below book value.

The short answer is that the Board believes the alternative of selling at or below book value in this current environment is a better strategic alternative for the shareholders than the alternative of remaining independent. The reasons behind that line of thinking are varied. It may be concerns over asset quality, lack of succession planning, the inability to generate profits, or other fundamental business concerns. Regardless of the reason, the decision is made because the Board does not believe the future prospects for the investment (the ownership of the holding company common stock) present a better alternative for the shareholders than the alternative of taking the transaction consideration, whether it be cash, stock, or a mixture of the two. A related contributing factor is the inability of the seller to generate a plan that provides a better strategic alternative for the shareholders than pursuing the sale of the bank.

Sale transactions priced at or below book value are not the norm in the industry. However, they become much more prevalent in challenging times. It is simply because the Board believes the alternative of selling the bank at little or no premium is a better alternative for the shareholders than remaining independent.

UNDERVALUED SHARES

We have recently been working with multiple community bank holding companies in various parts of the country whose stock, for whatever reason, is undervalued in the marketplace. Frankly, most of these community bank holding companies do not have a "market" for their stock. Some of them are listed over-the-counter/pink sheets. Some are listed in the CEO's "desk drawer." Others just trade sporadically. The common thread for all these community bank holding companies, however, is that the stock is trading (such as it is) at a significant discount to book value. When we visit with the community bank boards, they are generally concerned that the stock is trading at such a low value. They want to know what they can do to get the value up. That is a discussion for another *Musings*.

Community bank holding company stock trading at such low value, however, presents an excellent opportunity for the company to buy back its own stock. This is certainly the case if the bank and holding company have excess capital on their balance sheet currently. It may also be the best strategy even if the holding company has to leverage to redeem the shares. If you could buy back your community bank holding company's stock at 60% to 80% of book value, why wouldn't you? With a stock buyback, as with any other strategic transaction, the real issue - assuming we have not cheated the selling shareholders (i.e., the shareholders have sold voluntarily and with full disclosure) - is the impact on the remaining shareholders. A buyback at less than book value has the following impact: a) ownership goes up, b) book value goes up, c) earnings per share goes up, d) return on equity goes up, e) liquidity has been created for those who want to sell, and f) if distributions or dividends are calculated as a percentage of earnings, then those will go up as well. Basically, a win-win for everybody.

As a result of the pandemic, some of the big banks have received political pressure not to buy back shares, pay dividends, or make other similar distributions. That is not the case for smaller community banks. Our job is to allocate capital appropriately to enhance shareholder value. A share buyback, particularly when you can buy it back at book value or less, is pretty much a no-brainer.

THE CULTURE WAR

"The Culture War." No, this is not about Congress. It is about a community bank client we were recently working with who is looking at a target bank, got fairly far into the due diligence, and simply decided that the cultures could not be appropriately meshed post-acquisition, in a way that would give our client, the buyer, what it is looking for.

On the surface, when we started the transaction, everything looked great. We ran the numbers. The price our community bank client was willing to pay and the price that the community bank seller was willing to sell at meshed. The transaction was significantly accretive to earnings per share for the purchasing community bank. Even partly into due diligence things seemed to go great. When our client, the buyer, began to do due diligence on the credit portfolio, however, even though the credit quality was good, the credit culture was so different that after thinking long and hard about it, they simply decided there was no way they could mesh the two cultures, particularly on the credit side.

We often say that sometimes the deal that you back out of or don't do is the best one you will ever do. Having a deal break up is not always a bad thing. In this case, it is probably a good thing, certainly for our client, the community bank buyer.

UPDATING STRATEGIC PLANS

2020 has upended strategic planning for many of our clients across the country. Most of those planning sessions scheduled for the spring of 2020 of course have been postponed to the fall. Some of our clients only have a formal planning session every three years. We certainly do not object to that, but we do recommend that the plan be updated on an annual basis. It is not a static, but dynamic document. Although a long-term planning session may last anywhere between four and eight hours or more, sometimes spread over a couple of days, the update session can generally be completed in a couple of hours. We recommend that all of our clients, even in their "off years," update their plans. Think about it with respect to your bank.

SHARE LIQUIDITY II

Over the past couple weeks we have had numerous discussions with a number of different clients regarding the need and importance of share liquidity. Longtime *Musings* readers will know that we define liquidity as the ability of the shareholder to convert their shares to cash at a fair price in a timely manner. In other words, it is providing a mechanism to allow the shareholder to sell their stock and (hopefully) monetize their return on the investment in a quick and efficient manner.

Very few community banks in the country have true market liquidity, which is an active group of buyers and sellers that represent a functioning marketplace for the shares. Instead, most community banks that have market liquidity do so by the organization supporting liquidity in the common stock. This typically happens in a number of different ways, such as share repurchase programs, ESOPs, KSOPs, or similar strategies.

We do not believe the importance of share liquidity can be overstated. We also believe this will only become more important as the average age of the typical community bank shareholder increases. If you do not have true liquidity in your common stock, we recommend putting effort towards establishing a strategy to provide it. We see a number of potential problems and threats in failing to do so.

SHAREHOLDER SUCCESSION PLANNING

A recent strategic planning session we facilitated involved an extensive discussion regarding shareholder succession issues. This particular holding company has a single individual that holds a pretty good block of stock. This shareholder is endeared to and very involved with a 501(c)(3) organization. During the discussion on shareholder succession, the group expressed some frustration with the situation, as it was believed the only real strategic option was to buy out this significant shareholder, which was prohibitive to other capital allocation strategies. During the discussion we offered another potential solution, which was to possibly transfer ownership of the shares from the shareholder to the 501(c)(3) at an appropriate time. The group had never considered this strategy because they were under the impression that a 501(c)(3) was not a qualified Subchapter S shareholder. That is not the case.

The revelation of a 501(c)(3) being a qualified Subchapter S shareholder opened up some potential new opportunities for this group. They were very excited about this information because it opened up some avenues for exploration they once thought not possible. If your holding company is going through anything similar, be sure you are armed with all of the relevant facts. It may be that there are alternatives that are available to you that you simply have not previously known.

MERGER AND ACQUISITION WORKSHOP

Over the last several years, the three of us have presented a day and a half onsite, in person, Community Bank Merger & Acquisition Workshop sponsored by the ICBA. That is going to continue this year, except it is going to be virtual and in a little different format. It will be four segments via Zoom on October 13, 15, 21 and 22. The segments will deal with everything from big picture (figuring out do we even want to do an acquisition), to the nuts and bolts of financial models, and the like. Please follow the link to register. M&A Workshop We look forward to "seeing you" there.

UPCOMING COMMUNITY BANKING CHAIRMAN'S FORUM

As many of you know, Gerrish Smith Tuck facilitates and the Barret School of Banking sponsors the Community Banking Chairman's Forum. This is a forum designed for community bank Board Chairpersons, Vice Chair, Directors, and Chief Executive Officers. This meeting is a "forum," not a lecture or seminar type event. It is primarily discussion facilitated by the three of us. The Forum will be held January 14-15, 2021 in person at the Ritz-Carlton in Naples, Florida. The Ritz-Carlton provides a large enough venue to allow for social distancing and the like. We fully intend for the Forum to go forward as an in-person event. If you would like to register for the Forum, please follow the link: Community Banking Chairman's Forum. Although in view of the pandemic and other issues, we will need to limit attendance, there are still several slots remaining. We hope to see you there.

CONCLUSION

We are finally at the end of the third quarter. There may be a few of us who want a "do over." We don't think there are any of us who want a "do again." It has been an interesting year. The next 30 days before the national elections we are sure will make it even more interesting.

Have a safe and healthy two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*