GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from New York, Michigan, Iowa, Illinois, Indiana, Kentucky, South Carolina, and Georgia!

IMPACT OF THE PANDEMIC

With a year into the pandemic now, it is clear community bankers have stepped up to the plate with PPP, service to their customers, safety for their employees, and the like. Fortunately, virtually all our community bank clients across the nation are open for business. The boards are back meeting in person and conducting strategic planning sessions in person, instead of via Zoom, or not at all. Based on the results of those planning sessions - which always involve some kind of a "what did we learn from the pandemic?" - we believe community banks learned a lot and that the experience, notwithstanding the death and destruction, was a positive one. Most community banks found their employees could effectively work remotely. Most rapidly adopted new technology. Most found they could provide the same level of customer service (or in some cases, better) through the drive-thru or through remote service at the customer's home or office location. Community banks learned to do a lot of things they thought they never could or would have to do, and they did it well. Community bank customers also discovered they could bank remotely.

When you are contemplating strategy going forward, it is important to contemplate what the bank "life lessons" were from the pandemic. The important part is whether those life lessons are worth continuing from a strategic standpoint going forward.

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PROACTIVE OR REACTIVE

Spring and fall are generally known as the "strategic planning seasons." This is especially the case this spring when we are seeing the doubling up of sessions that were previously scheduled with the rescheduling of postponed sessions. Most of these sessions start out with a brief discussion of what the board and senior officers' obligation is as it relates to strategic planning. From the 30,000 foot standpoint, the obligation is to figure out how to allocate human resources and financial resources to enhance the value for the shareholders. If the bank and holding company enhance the value for its shareholders, then the organization will likely remain independent, be able to be the good corporate citizen, the employer of choice, and economic engine in the community.

Often in the planning session, the group must decide whether to be proactive or reactive with respect to the implementation of a particular strategy. The acquisition of another bank is a good example. We were recently facilitating a planning session at which the board was adamant that the bank be proactive with respect to identifying and attempting to acquire another community bank. Once the board determined that the strategy was to be proactive, we asked the board what they no longer wanted the CEO to do. The response was a little bit quizzical on their part. We explained that by being proactive, they had just assigned the CEO an additional job. In this bank, the CEO was already working 12 hours a day. If they were going to be proactive looking for acquisitions, what didn't they want the CEO to do? The board finally understood that strategic planning is not just the allocation of financial resources the bank and holding company has or can get, but also the allocation of human resources and human time (in this example, the CEO's). Being reactive to opportunities is not necessarily a bad thing – it just depends on where you want to put the resources.

NONINTEREST INCOME

Most of our community bank clients are continuing to focus on improving profitability of their organizations. There is not much focus currently on balance sheet growth. In fact, most of the concern is the artificially inflated balance sheets that community banks around the country are saddled with due to the significant economic stimulus. The focus on profitability, however, needs to deal not just with the growth of the loan portfolio to absorb some of that cash and securities, but

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also noninterest income. Noninterest income can generally be considered in two categories. The first is fees, and the second is other lines of business. With respect to fees, each community bank needs to evaluate its culture. Is the bank a "fee charging" or a "fee waiving" community bank? Second, does the community bank want to engage in any activities to generate noninterest income that are outside of its core banking business? We generally define the core banking business as consumer lending, commercial lending, and mortgage. Wealth Management, Trust, securities brokerage, real estate brokerage (where it is allowed), title insurance, insurance agencies, and the like are generally the other lines of business community banks contemplate. If a community bank is trying to improve its profitability, then it seems it should give some serious consideration to expanding its noninterest income. This will generally mean contemplating acquiring or initiating a line of business other than its core banking business. Our primary caution to community banks in this regard is to make sure you understand that business before you venture off into it or acquire it.

EFFICIENT BOARD MEETINGS

We have been in multiple boardrooms lately on a variety of issues from acquisitions to long-term planning and had discussions with boards about governance issues such as their meetings, the material they get in their board package or on their portal, and the like. We have had multiple boards lament the fact that they believe their board meetings are inefficient and backward-looking (instead of forward-looking and strategic) and that the information they get (between 300 and 700 pages) is simply too much. Our recommendation in those cases is to take a fresh look at the information provided to the board, provide more dashboards or executive summaries, and reevaluate the board meeting agenda such that the bank uses a consent agenda and addresses strategic and risk issues. One of our clients further lamented the fact that they did address strategic and risk issues but they were always at the end of the board meeting when everybody is ready to get home and have dinner. Our solution (brilliant) was to flip their agenda so they dealt with strategic and risk issues first, then the consent agenda, and then the rest of the board agenda. That way you deal with the forward-looking items while the board is still fresh.

The moral of the story, however, is just because your community bank has been using the same board agenda and providing the same board material to your board every single month for a number of years does not mean it doesn't need to be reviewed. Also, if you move to a consent

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agenda, that should free up time in your board meeting for the more substantive strategic and risk issues. If any *Musings* reader would like a Memorandum to Clients & Friends with respect to the use of a consent agenda, please let us know.

PENT-UP DEMAND

It is not exactly breaking news that the COVID-19 global pandemic pretty much put a halt to community bank mergers and acquisitions. There were a very small number of transactions in the second and third quarters of 2020. The community bank M&A market began to thaw a little in the fourth quarter, and that thaw accelerated through the first quarter of 2021. Based on our assessment of the landscape, we believe there is a tremendous amount of pent-up demand, and that community bank M&A activity is going to rapidly gain speed going forward. We base this assessment on the number of deals that have been recently announced, as well as the number of deals we are currently working in our office that are in a preannouncement stage.

As we have noted in previous *Musings*, deals are taking a little longer today to go from inception to announcement. This is primarily due to the acquirer's due diligence being a little more thorough than the due diligence reviews "pre-pandemic."

In summary, we characterize the current M&A environment as an active M&A environment that is rapidly progressing towards a very active M&A environment. We also believe there are many more potential buyers than potential sellers, which is going to rapidly drive up the price of acquisitions.

ACQUISITION FINANCIAL PROJECTIONS

As noted in prior *Musings*, our firm is currently assisting a number of community bank acquirers in pursuing acquisition opportunities. Some of these potential acquirers are existing community banks. Others are individuals or groups of individuals looking to make an acquisition. Regardless of the status of the potential acquirer, the importance of the financial projections related to the acquisition is the same. The primary purpose of the financial projections is to project out the pro forma income that will be realized as a result of the acquisition, and then use that income to calculate a return on investment. Both of these help to determine an appropriate acquisition price.

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Pre-pandemic, most community banks had fairly steady core earnings, which gave predictability to anticipated future net income. 2020 threw a significant wrench in community bank core profitability. In projecting net income for acquisition opportunities today, it is not possible to simply take 2020 net income and make some minor adjustments to assume net income going forward. There are four major issues that make that impossible, being (1) the significant level of non-recurring net income realized by many community banks in 2020 (think PPP origination fees and secondary market mortgage originations), (2) a shrinking net interest margin, (3) a reduction in non-interest income due to lower overdraft and related fees, and (4) potential asset quality deterioration in the target bank's loan portfolio.

If your holding company is thinking about making an acquisition, be certain you are taking these factors into account. Whoever is responsible for running the financial model needs to make sure they really dig into the target bank's 2020 net income to fully understand its composition of net income for that year. On a going forward basis, the projected net income also needs to be appropriately adjusted to remove non-recurring net income and to properly account for margin compression, reductions in non-interest income, and any asset quality deterioration that may be experienced. If these items are not properly accounted for, the financial projections will likely overstate pro forma net income, resulting in an actual return on investment that is lower than projected.

THE VENDOR-FRIENDLY ENGAGEMENT LETTER

We are currently assisting a community bank holding company in the issuance of subordinated debentures. In this transaction, the community bank is using a third-party investment banker to help place the debt. This investment banker provided the community bank with their proposed engagement letter. We were asked to review the engagement letter. Not to our surprise at all, the initial proposal letter is what we would classify as "vendor-friendly."

This proposed engagement letter was like many similar proposals we have seen. Our biggest complaint against the engagement letter was the allocation of risk. The initial engagement letter proposed that the bank holding company would fully indemnify and hold harmless the investment banker for any losses the investment banker may suffer as a result of the engagement, unless the loss was suffered by the investment banker's gross negligence or willful misconduct (which is a very high legal standard to prove). On the flip side, the engagement letter provided

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that our client bank holding company waived any and all claims the company may have against the investment banker and contained absolutely no provision where the investment banker agreed to indemnify the holding company for any losses the holding company may suffer as a result of the investment banker's actions.

We, of course, said this setup would not work for our client. We do not see it as appropriate at all for this investment banker to have full indemnification coverage from our client where the client did not have the benefit of their indemnification. More importantly, as we told their counsel, we would not agree to a setup where an outside entity was in the marketplace selling millions of dollars of our debt where we have waived any and all claims we may have against that entity.

We made the appropriate revisions to the engagement letter, and those were accepted by the investment banker. It was a good result for our client. We have been in similar situations in the past where that has not been the case. Not too long ago, we were involved in a circumstance where an investment banker simply would not agree to any change in the engagement letter. They basically said the indemnification had to be as presented or there would be no engagement. In that particular instance, we went out and found another investment banker that was able to issue the same subordinated debentures but that had a more reasonable approach to the indemnification.

If you are thinking about engaging a third-party to assist in the issuance of subordinated debentures (or any other professional assistance for that matter) be sure you pay close attention to the details of the contract. The risk allocation is of utmost importance. You do not want to find yourself in a situation where you are fully indemnifying the counterparty and you have no protection of your own.

SHAREHOLDER AGREEMENT PROVISIONS

We recently met with two business partners that are wrestling with how to treat the ownership of their company, both currently and in the event of their death. This is somewhat of a classic story, where these two individuals built the company from the ground up and are now thinking about how to preserve the company and its business operations for the benefit of them personally as well as their heirs. This particular company is not a bank holding company, but it is in a related industry.

At the inception of their business relationship, these two individuals executed what we would describe as a very complicated Shareholders Agreement. It has very complicated provisions

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about the allocation of profits, the distribution of cash, the transfer of shares, and the like. Their basic comment was that they wanted to simplify all of that to make things easier on them and their estates should they pass. One of the central questions they had for us is what options are available.

Given the circumstances, our response was that the available options include anything on which the two individuals can agree. As the sole owners of the business, and the sole parties to the existing Shareholders Agreement, they can amend the agreement in any way they want.

The answer for these two business owners is the same as it would be for a community bank holding company in a similar situation. The general rule is that the treatment of shares, whether it be related to distributions, transfers of ownership, or similar matters, can be conformed to any requirements to which each of the parties agree. We anticipate as community bank owners continue to mature and progress in their ownership that some of these thoughts will become more prevalent. If you are thinking about these issues, keep in mind that almost anything is possible if each of the owners agrees to it.

SUCCESSION PLANNING

In *Musings,* we often address succession planning. When we do, we are referring both to management and board succession. The obligation to plan for board succession falls on the Chairman and the board of directors of the holding company and the bank. Where does the obligation for management succession planning fall? The easy answer is, it depends. Some issues associated with management succession are obligations of the board. Some are obligations of senior management. Where do you draw the line? The only line we like to draw is that the board of directors is responsible for assuring that there is succession for the Chief Executive Officer. It may extend even beyond that to maybe the Chief Operating Officer or even the Chief Financial Officer. Succession planning for other positions in the bank is the responsibility of the Chief Executive Officer. It is not the board's job to deal with succession planning for those positions. It is the board's job to make sure that management has provided for succession planning. In other words, the board provides oversight, not operational and tactical insight.

Over the last 20 years or so, we have seen our community bank clients across the nation significantly improve their processes with respect to both board and management succession planning. That is certainly a positive development.

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MERGER AND ACQUISITION WORKSHOP

We often discuss community bank mergers and acquisitions in *Musings*. If members of your executive management team or board of directors want to really understand the community bank merger and acquisition game from the big picture to the granular (i.e., how do you price a deal, what do you look for, etc.), please sign up for the Merger and Acquisition Workshop sponsored by the ICBA and conducted virtually by the three of us. You may register for the May 4th and 5th Workshop here: ICBA Mergers & Acquisitions Workshop. Although this Workshop has historically been in person, due to the COVID issues, it is being conducted virtually this year. We look forward to "seeing you" there.

CONCLUSION

Today is April 15th. This is normally the day by which all good taxpaying U.S. citizens are to have our federal taxes filed. As with most of the past 12 or 13 months, nothing is "normal." Enjoy the delay for tax filing.

See you in two weeks!

Jeff Gerrish | *Philip Smith* | *Greyson Tuck*

Upcoming Webinars and Workshops:

- April 18, 2021 – Kentucky Bankers Association 2021 Spring Conference – "Dusting Off the Crystal Ball – Community Banking Past, Present and Future" (Greyson E. Tuck) Registration link: Kentucky Bankers Association 2021 Spring Conference
- April 21, 2021 – Graduate School of Banking at the University of Wisconsin-Madison – Webinar: "Maintaining Community Bank Independence in a Consolidating Environment" (Greyson E. Tuck) Registration link: Maintaining Community Bank Independence
- May 4-5, 2021 – ICBA Mergers & Acquisitions Workshop. (Jeff Gerrish, Philip Smith and Greyson Tuck) Registration link: ICBA Mergers & Acquisitions Workshop

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