GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Michigan, Minnesota, Iowa, Indiana, Pennsylvania, Missouri, Vermont, Mississippi, and Kansas!

SUBCHAPTER S

As most regular *Musings* readers know, we are big proponents of Subchapter S as one of the best ways to enhance the value for your shareholders. As a practical matter in a Subchapter S, generally the holding company shareholder receives additional after-tax cash flow as well as an increase in stock basis for those earnings that are not distributed to the shareholder. That is a pretty good result from an enhancing shareholder value standpoint.

Although approximately a third of the community banks in the nation have converted to Subchapter S since it became available for banks in 1998, we are currently working with a number of community institutions who are evaluating the possibility of converting to Sub S. The general evaluation process begins with a review of the shareholder list. As most of you know, Subchapter S since 2004 now allows 100 shareholders counting six generations of one family as one shareholder. We have converted many community banks to Subchapter S that had literally hundreds of human being shareholders, yet less than 100 family groups. So if you are contemplating Subchapter S, the place to start is with a review of the shareholder list.

The second step is to run the financials to see if conversion to Subchapter S makes financial sense. We have done that for multiple banks recently. Most of the time when we run numbers on a Subchapter S through our proprietary Subchapter S financial model, the general conclusion is that Subchapter S is a no-brainer for the community bank. We generally inform the board as such.

We have analyzed a couple of Subchapter S conversion situations recently where we were a little less enthusiastic. The lack of enthusiasm for Subchapter S was simply due to the strained capital position of the community bank that was contemplating converting. In most of these cases, the strained capital position was solely the result of artificial balance sheet inflation due to the government stimulus. If we could assure the boards of these community banks that the balance sheet would deflate fairly rapidly and the capital ratio would go up and we could use some of the excess capital to cash out at fair value some of the shareholders that need to come out in the Subchapter S, it would be one thing. Unfortunately, neither we nor anybody else can make that guarantee. As such, in the couple of recent Subchapter S presentations we have made, the board has taken a wait-and-see attitude with regard to the conversion. They generally recognize the benefits of Subchapter S for their shareholders for the long term. They just want to see what is going to happen in the short term with respect to the balance sheet and capital needs. They are also concerned about some of the current Biden Administration's tax proposals. With respect to the Biden tax proposals, our general recommendation for those banks contemplating converting to Subchapter S, as well as for those banks already operating in Subchapter S, is to wait and see and then evaluate the impact on Subchapter S. It is good to see these boards making smart decisions.

THE DISCIPLINED ACQUIRER

Over the past couple weeks, we have been very involved in helping a potential acquirer "run the numbers" on an acquisition opportunity. As we finished the financial analysis, we moved to drafting the Indication of Interest. The potential acquirer talked with us about their thoughts as it relates to transaction pricing. They presented a number that was on the lower side of the range we discussed and asked us what we thought about the bid. We indicated that we thought it likely there would be other bidders that would pay a higher amount. The acquirer said they were completely fine with that because this is the bid amount that made sense for them under the circumstances.

That response was absolutely music to our ears! We love to see a disciplined acquirer. Kudos to this particular organization for giving real thought and strategic discussion to the transaction specifics that make sense for them. If the transaction works out for them, that will be great. If it does not, they will sleep well knowing that they were disciplined in their approach to the potential acquisition. We think the Board and management group deserved recognition for their discipline in the transaction.

DIFFERING APPROACHES

We are in a very busy community bank M&A environment. Right now we are assisting a number of different clients in M&A transactions on both the buy and sell side. We recently had an interesting discussion with one of our clients about the alternate views of the buyer and the seller, both before and after signing a Merger Agreement.

In this particular situation, we were assisting a client in negotiating a Merger Agreement. We would not describe the negotiations as hostile, but there was hearty discussion on both sides related to a number of issues. We were able to successfully work through those issues with the other party and their counsel and recently arrived at a Merger Agreement that was satisfactory to everyone. That Merger Agreement was executed, and we are now moving forward with the transaction.

What is interesting about this situation, which is really true of all situations of this type, is that once the Merger Agreement is executed each party should take an alternate view of the other party to the deal. What we mean is that once the parties arrive at a transaction agreement that is acceptable and executed, it means each party is at least happy enough to contractually commit themselves to the deal. Once that is the case, we view it as everyone being on the same team and working toward a common goal. We believe under that scenario the seller wants to sell and the buyer wants to buy based on the terms and conditions in the Agreement. Everyone's interests are aligned, and all should work together to achieve that common interest.

Negotiations of a Merger Agreement can be spirited. However, once they are over, everyone needs to be on the same page and work together to try and get the deal closed as quickly and with as little fanfare as possible. We see that as being in the best interest of all involved.

GEOGRAPHIC EXPANSION

We were recently meeting with a board of directors of a well-run closely-held community bank. At its last strategic planning session, this group had decided it wanted to be proactive with respect to bank acquisitions. We endorsed that strategy. The purpose of this particular meeting was to delve into that particular area of geographic expansion through branching, acquisition, or otherwise. The first part of the discussion involved the fact that, as a community bank, the bank has limited resources. In other words, it has to pick and choose very carefully where to spend its human and financial resources. It cannot be in a position of just doing any deal. It has to get the right transaction because accomplishing more than one acquisition transaction every two or three years is highly unlikely.

The second issue is that the Board needs to be very selective. One acquisition transaction discussed involved a target in a rural, non-growing area (as many do these days). The board seemed to be very interested in this particular target. We asked whether they would put a branch there if they had the opportunity. The response was a unanimous, "of course not." The discussion then involved, if you wouldn't put a branch there, why would you pay a premium to acquire a small rural bank in that particular dying community? The general consensus was they were still interested in the opportunity, just not at any significant premium. We advised them that the approach should be for the holding company to bid what the board thinks it is worth to the organization so that if the holding company is successful, the board and shareholders are happy. Do not overpay, however, because the board needs to take the long view of acquisitions and consider whether the bank really wants to be in that community in that situation 10 years from now. Good decisions by the board.

HIGH-PERFORMING BANKS

We have been with a number of extraordinarily high-performing banks lately. The banks are ticking along like clockwork, producing returns on assets well north of 2% and returns on equity in the 20+% range. That is pretty good in anybody's book. These high-performing banks have got the banking part down pat. They know how to make money, serve their customer base, and serve their markets. They do not always have a good handle on their shareholder base and shareholder succession issues, however.

We have had a number of meetings of late with high-performing banks that need to begin to focus on shareholder succession issues if they are going to remain independent. A high-performing bank makes both a good target and a bad target for a potential buyer. It is a good target, obviously, because it makes a lot of money and would do so for the acquiror. It is a bad target because it will cost the buyer a lot of money. Nevertheless, if that high-performing bank does not address shareholder succession issues, then it will likely end up selling just like any other bank. Don't forget the basics.

NONINTEREST INCOME

For most community banks these days, the long-term business strategy is a focus on profitability with little, if any, balance sheet growth. For most community banks, the balance sheet has artificially grown simply due to the government stimulus. For most, the path toward profitability is a reallocation of assets from cash and securities into loans.

In connection with the profitability discussion, however, noninterest income is always addressed. This includes fees and fee waivers, as well as other lines of business. The other line of business discussion is generally interesting because it varies so much community bank to community bank. Some community banks in markets that are growing rapidly follow the strategy of "let's stick to our core banking business." We endorse that if the market can provide profitable business due to the market expansion itself. If not, then the bank may need to look at other diversification of the income stream.

Over the years, we have found that if a community bank gets involved in securities brokerage, trust, wealth management, or any other area, the success of that particular other line of business will be solely dependent upon the personnel that the bank hires to run it. In other words, if you have a good securities broker working for the bank, that will likely be successful. If you have a good insurance agent working in the bank's agency, the agency will likely be successful, and the like. Unfortunately, with these other lines of business, we generally hear how they are struggling and barely profitable for most banks. We are not sure whether that is lack of knowledgeable management by the bank over the other line of business or simply that it is difficult to attract and retain "the best of the best" in that line of business in a bank environment. In any event, the board of directors should focus on other lines of business as a way to generate additional noninterest income, realizing there are pitfalls.

MANAGEMENT SUCCESSION

In addition to ownership transition and succession, we have also had multiple discussions recently with multiple community banks regarding management succession. Some of these community banks have had the same long-term Chief Executive Officer who has been very successful and with whom the board has utmost confidence. We often hear in these situations that "we want a successor who is exactly like the CEO we currently have." Obviously, that is impossible (we still don't believe cloning is permitted in the U.S.). Getting succession in that CEO slot that has some of the same positive characteristics of that particular manager, however, is not impossible.

We have had multiple community banks over the last year where the board has basically indicated that when the CEO is "done," they are "done." In other words, they will plan to sell the bank when it comes time for CEO succession.

Sometimes this situation in a community bank is where the board simply does not have confidence that they could ever find someone in whom they would have the same level of confidence as they have in the current CEO. Sometimes it is simply that they do not want to go through the hassle of breaking in a new CEO. Sometimes all of those factors converge with the age of the board and ownership, and it is just time to go.

Our advice is don't give up on CEO succession. There are some good bankers available that would appreciate the opportunity to move up into a CEO slot at a new and larger bank.

THE STOCK LIQUIDITY STRATEGY

We recently facilitated the strategic planning session of a larger, well-run community bank. This bank checks many of the boxes in terms of performance and profitability. One area where the group wanted to focus a good amount of discussion was that of stock liquidity. The holding company shareholders had not experienced much market liquidity, notwithstanding the holding company's performance, and the Board wanted to discuss strategies to see if they could improve that area.

The holding company has around 500 stockholders. They are currently traded on an OTC market. At the planning session, the Board discussed the possibility of "moving up" the market hierarchy and voluntarily taking on SEC reporting obligations in an effort to try to get on the NASDAQ. The thought, at least coming into the planning session, was that becoming an SEC reporting company would significantly increase market trading.

In talking through the issues, it was agreed that voluntarily taking on SEC reporting obligations would not likely give them the desired result of market liquidity. The discussion was essentially that the number of holding company shareholders has a much greater impact on market liquidity than does whether or not the company is SEC reporting. It was agreed that even if the holding company took on SEC reporting obligations, with only 500 shareholders, there likely would not be a meaningful increase in market liquidity such that the Board would get the number of trades between shareholders they desired.

Rather than leaving the planning session with a strategy of becoming SEC reporting, the Board adopted a strategy of looking at alternatives to significantly increase the number of holding company shareholders. The thought is that an increase in the number of shareholders will have a much greater impact on true market liquidity. We agree completely with this approach. We think the number of shareholders has a much greater impact on market liquidity than does whether the company is SEC reporting.

CORPORATE EFFICIENCIES

Over the past couple weeks, we have had the opportunity to help a couple different multi-bank holding companies. What is interesting about these situation is how completely opposite they approach the issue of being a multi-bank holding company and the related issues of corporate efficiencies. As you likely know, being in a multi-bank holding company typically does not result in the most efficient corporate structure. Often multi-bank holding companies could consolidate one or more of their subsidiary charters and gain some efficiencies and cost savings. Obviously, not every multi-bank holding company chooses to do so.

When working with multi-bank holding companies, the discussion often turns to why they are willing to leave the cost savings and efficiencies on the table. The answer is pretty straight forward – they believe the benefits of being a multi-bank holding company outweigh the forgone cost savings and efficiencies that would be realized if the charters were combined. What are those benefits? They are different in every situation, but they often involve local autonomy and decision making, brand and name recognition, historical preferences, and similar issues.

It is true that a multi-bank holding company likely is not in the most efficient corporate structure. However, that is not always a bad thing. The real issue is whether the Board has given strategic consideration to the benefits of a multi-bank holding company and compared those to the benefits of combining the subsidiary charters. If the Board has done so and has made the strategic decision that the multi-bank holding company is the preferred structure, we see no reason to question that decision.

CONCLUSION

It is the end of July 2021 already. We hope many of you are getting some well needed vacations and time with the family. School starts soon, and temperatures will drop as fall approaches. We look forward to seeing many of you in the coming weeks.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars:

- August 13, 2021 – Oregon Bankers Association Northwest Bank Directors Series – "Governance, Director Liability and Strategic Planning: What You Really Need to Know" (Greyson E. Tuck) Registration link: Governance, Director Liability and Strategic Planning
- August 26, 2021 – Western Bankers Association Webinar – "Financial Analysis of Bank M&A Transactions" (Greyson E. Tuck) Registration link: Financial Analysis of M&A Transactions

