GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Minnesota, Wisconsin, Texas, Michigan, Florida, Massachusetts and Vermont!

OREO DISPOSALS

I recently facilitated a strategic planning discussion for a community bank that by all accounts is doing pretty well. This particular bank is making a good amount of money and was recently able to complete a transaction that significantly improved their holding company debt position. The only real "black eye" on this bank right now is its OREO, which currently is valued at about 25% of the Bank's capital. The bank currently has a number of pieces of raw ground that have been on the books for some time. Each of these properties is being carried at the appropriate carrying value, which is all supported by appraisals. The problem is that moving these properties at those prices in any timely manner has proven difficult.

During the planning retreat we discussed the available options. At one end of the spectrum is the option of continuing to hold the properties and dispose of them over a couple years. This strategy will result in some loss along the way. The other option is to "dump" the properties in a quick manner in order to clean up the bank and remove this last remaining black eye. Obviously, there will be some loss associated with this strategy as well. However, it was agreed the loss resulting from this strategy would probably not be significantly different than the strategy of continuing to hold them.

We talked through these two strategies, and the group adopted somewhat of a blended approach of looking to move these properties quickly, but not doing a wholesale dump of them. The group essentially agreed that getting the properties off the books and the classified assets out of their lives was more important and provided more benefit than might be provided by continuing to hold them for two or three more years and realizing a little bit more in terms of sales price. Given the relatively minor difference in capital, this strategy of getting the "black eye" gone as quickly as possible made sense to me.

CAREER PATH

I was recently in an interesting meeting with a group of senior officers who were assisting the Board in determining what to do with the bank's life. As part of the miscellaneous discussion, one of the younger officers indicated the importance (to millennials in particular, but I suppose any other employees also) of understanding where that individual's career path is in the bank.

This was not an oversized community bank, but it was still important for that individual to be able to visualize her future as it related to that institution. You may want to think about that for your own bank as we not only need to focus on obtaining the millennial generation as customers but also retaining them in our banks as employees.

OWNERSHIP DILUTION

In the current community bank consolidating environment, I have been with a number of boards of directors of community banks discussing the topic of whether the holding company should be proactive in connection with trying to acquire another community bank. The topic always involves a discussion of "how are we going to pay for this." Several banks I have been with lately have indicated that they certainly would not want to use stock even if someone would take it (we have seen some targets show interest in taking stock in Subchapter S institutions that are good earners with good after-tax cash flow). These institutions do not want to give up stock because they do not want any ownership dilution. Even when there is not a sizeable ownership block at the holding company level, the stock represented on the Board often does not want any dilution.

However, a couple holding companies I have been with in the last few weeks having the exact same discussion did not care about ownership dilution. These are basically banks where they did not have any shareholder, including any board member, that had more than 5% to 8% ownership. The issuance of shares and reducing the ownership from 8%, for example, down to 6% or 5% really did not matter to them. In that circumstance, what mattered more was whether they would have a "gorilla in their midst," i.e. a large shareholder coming from that target bank, particularly if it was closely-held or family-owned, and whether that individual would fit with the culture of the Board and the bank. Interesting discussions.

20% GROWTH

Can you really get 20% balance sheet growth in this day and time? I was recently with a community bank - healthy, active, in a good metropolitan market - that believes they can do just that. The question was not the growth or the loan demand. The question was, how do we get the capital to support the growth? For this particular institution, capital planning is critical. If you can grow healthy and profitably at a 20% per year clip, you still need to have the capital to support it, and it may not all come from retained earnings. This group did have a couple of creative ways to supply the capital for that, as it is needed.

NEW MARKETS

How tough is it to go into a totally new market? Well, for one bank I was with recently, it does not appear that it is going to be too difficult. The bank already has a fairly decent presence in an adjacent market and some presence in the new market, so hopefully it will just be an extension. They also importantly picked up the franchise player to staff the new market's branch office. I anticipate it will go well for them, although it will take a little bit of ramp up time.

HOLDING COMPANY LEVERAGE

As many of you consistent *Musings* readers know, I generally recommend to our client base that holding company leverage is the best way to generate capital for banks under $1 billion in consolidated assets. This is simply because you get to take advantage of the Small Bank Holding Company Policy Statement.

The question, however, is how much holding company leverage is too much. This was raised at a recent meeting I attended. The holding company had about a 30% debt-to-equity ratio. I was asked my opinion on this. I suggested that 70% or so would be appropriate provided that the holding company can demonstrate it can service the debt without putting undue strain on the bank. Most boards I meet with are not necessarily averse to leverage of the holding company, as long as it is for a good reason, (i.e., all the stars align, and it is a perfect deal). Do not be afraid of leverage for your holding company, or your ESOP or KSOP for that matter. Just make sure that our firm or somebody else runs the numbers for you to make sure that it all works.

As noted, my general preference for capital support for the bank is let's look at holding company debt leverage first. The second place to look would be existing shareholders for common or preferred equity. The third place to look would be new shareholders.

SHARE LIQUIDITY

I have received numerous recent emails with respect to creating liquidity for the shareholders of the community bank holding company. We will be working with a number of banks on this specific issue over the next few weeks. In order to remain independent, our community bank holding companies need to provide those shareholders who want to liquefy their investment with a mechanism to do so. This generally involves a couple of different things, all of which involve the holding company as the market maker for the shares and the floor for the stock price. Generally, my recommendation is for community banks to have a "walk-in" program so that any shareholder desiring to sell his or her shares comes to the holding company and the holding company cuts them a check. If they want more than is being paid, they are certainly (unless the Subchapter S Agreement, for example, prohibits it) free to go somewhere else. That, however, creates a base liquidity and a base price for the shares.

If the company wants to get more aggressive, then it can also have a proactive stock repurchase plan where the holding company allocates a certain amount of capital to go out to the shareholder base and offer to purchase shares on a voluntary basis. Again, the company sets the price for the stock, the shareholders are not required to sell, and the redemption of shares by the holding company is a win-win for both parties.

In the share liquidity category it is also possible to do some type of discriminatory cash-out merger to really reorganize the shareholder base. We have a couple of community bank holding company clients who, as part of their long-term independence strategy, are trying to get rid of shareholders who either are not local, do not do business with the bank, or something similar, all of which can also be accomplished through a discriminatory cash-out merger.

There are a lot of ways to create share liquidity, either voluntarily or forced. You may want to think about whether it is time to contemplate creating liquidity for your shareholders or restructuring your holding company's shareholder base as well.

DIRECTOR CONFIDENTIALITY

I recently encountered a situation that once again reminded me of the importance of the director duty of confidentiality. In the current situation, one of our clients' directors took private corporate information and disclosed it in a personal mediation proceeding. The information contains some regulatory communications (luckily no exam reports) and some other private corporate information. The information was marked confidential when disclosed and was subject to a protective order. These are nice safeguards, but they are not foolproof. These disclosures were made known to the bank after the fact.

The disclosure of confidential corporate information by any of the directors presents a serious risk to the institution. This may be a good time to remind all of your directors and employees about the duty of confidentiality. We do not expect this situation will present any significant adverse effects as a result of this disclosure. However, as the old saying goes, an ounce of prevention is worth a pound of cure.

SHARE REPURCHASES

We recently received a call from a client that asked about pricing share repurchases from existing shareholders. This has become a familiar question over the years. Many times we have been asked the appropriate share repurchase price for a repurchase transaction from an existing shareholder. Our answer has always been the same: there is no magic formula to determine the appropriate share repurchase price. What is important is to address all of the competing factors. We certainly need to price the transaction in a way that provides the selling shareholder fair and appropriate consideration for what they are giving up. However, it cannot be priced so high as to be a detriment to the remaining shareholders. Striking this balance typically takes some outside assistance and financial analysis. The real question is whether the selling and remaining shareholders are going to be better off as a result of the transaction. If the answer to that is yes, whatever share repurchase price that is chosen is appropriate.

THE CONSENT ORDER MODIFICATION

We were recently contacted by a new client that is what can only be described as being in seriously troubled condition. This bank has been under a Consent Order for a very long time and has not been able to regain its solid footing from the Great Recession. The bank has a very low Tier 1 leverage ratio and very elevated levels of problem loans and other real estate.

The Bank's primary federal regulator has had the bank under a Consent Order for almost 10 years. This Order has been in place since that time without change. The bank recently underwent an examination, and the regulators decided they needed a Modification to the Order. As you might suspect, this Modification contained a number of items with which the board knew they were not going to be able to comply, the most egregious of which required the bank to restore its Tier 1 leverage ratio to above 10% within 60 days of signing the Modification.

The Board asked our advice on what to do in this situation. Should the board sign the Modification when it knows it cannot comply with its terms? Unfortunately, this is not the first time we have seen this situation. Our advice is that the most important thing to do in this situation is to appropriately document the board's objections to the request in writing. This is important in the event the bank fails because it establishes in the record that the board knew it could not comply with the requirements of the Order.

In this situation, we essentially sent the regulators a letter that said the board would sign the Modification but would do so "under protest" giving full disclosure that it would not be able to meet the capital and several of the other requirements. This made the regulators happy because it gave them their Modification to the Order that they wanted. It was also good for the directors because they have written into the record the fact that the capital provisions of the Order cannot be complied with. This will provide an insurance policy of sorts in the event the bank fails and the directors are sued because it will be a significant blow to any argument by the FDIC that the board committed to obtaining the capital levels outlined in the Modification to the Order.

CONCLUSION

Today, as most of you know, is Halloween. Look out for the little ghosts and goblins traipsing through your neighborhoods in search of goodies.

I hope everyone stays safe and has a good time. See you in two weeks.

Jeff Gerrish *and* *Greyson Tuck*

