The

Chairman's Forum

Newsletter

Opening the door to new ideas

Gerrish Smith Tuck, Consultants and Attorneys

October 2018

In this month's edition of *The Chairman's Forum Newsletter*, we tackle a current headline related to demands being placed on a community bank, we look at the benefits, both emotional and economical, for stock repurchase transactions, and we highlight the role of strategic planning in the ongoing daily success of organizations. You may find that we take a bit of a different position than you might expect on some of these issues which are borne out of our unique experiences day in and day out in dealing with the real issues that Chairmen and Board members face. We hope this information is not only enlightening to you, but helpful to you as you guide your organizations. We look forward to seeing many of you in the coming months and, for the rest of you, give us a call sometime and we would love to have the opportunity to come out and visit with you as well.

Happy Reading!

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Chairman's Summary

- Can you have too much capital?
- Are the benefits of stock repurchase programs only emotional?
- Consider strategic planning issues monthly.
- Update on 2019 Chairman's Forum.

Can You Have Too Much Capital?

Some of you are reading this question and chuckling with a comment of something like "Not according to my regulators!" And that is probably very true. While we always tend to focus on ensuring that financial institutions, particularly community banks, have enough capital, not enough focus is paid to addressing the question of when an organization has too much capital. Take, for example, the recent story that made headlines where an investor of a large community bank, who owns a whopping 1% of the outstanding stock, demanded that capital be returned to stockholders in a form of extra dividends or implementing stock repurchase transactions. This demand was made under the theory that the organization was retaining too much capital.

The investor also tried to make the argument that in his opinion, one of the reasons the organization was retaining excess capital was to deter suitors. As you might suspect, the next comment from the investor was that, while the investor is not pushing for a sale, he would certainly be happy with that kind of decision. So, let's look at this argument and make a couple of points.

First of all, the general point about our organizations retaining too much capital is not totally without merit. Regardless of what our friends the regulators may think, it is our opinion that an organization can, in fact, have too much capital, at least from a stockholder value perspective. There is an old saying that the responsibility of the Board and management is to provide return <u>on</u> equity (ROE) or return <u>of</u> equity (often in the form of dividends). So, the general point is perhaps not totally invalid, but the way a Chairman of the Board should lead a discussion about this type of capital issue is not in determining how to respond to a 1% stockholder, but rather the discussion should be focused on the Board's risk tolerance levels and capital comfort levels.

Often, when we facilitate strategic planning sessions, we ask Boards what their minimum capital comfort level is and they often have a pretty quick answer, normally something in the 8% or 9% range. However, when asked how much capital would constitute too much capital whereby they would need to take specific steps to deploy that capital, the answers do not come as quickly. It is often a question they have never considered because, candidly, many organizations have never had the luxury of the concern for too much capital. So, as Chairman, ask your Board to consider both ends of the spectrum and it would be appropriate to set some type of general understanding of the upper and lower limits of capital where you want to operate.

A second point, though, relates to the idea that having too much capital could be a deterrent to potential suitors and serve as an antitakeover mechanism. We do not generally believe that argument holds much substance. Our experience has shown that in community bank deals, many targets are often overcapitalized, at least from the perspective of the buyer. That can even happen where a target may have only 9.5% or 10% tier 1 capital, but the buyer is not interested in paying a premium for that "extra" capital. In those circumstances, the buyer does not refuse to make the acquisition, but they simply agree to either bring the excess capital into the deal on a dollar for dollar basis (no premium) or they allow the seller to pay an extraordinary dividend out to its stockholders in advance of the closing so that the buyer does not pick up the extra capital. But, in short, it rarely is an impediment to getting a deal done. Below, we look at how stock repurchase transactions can play into these scenarios as well.

Are the Benefits of Stock Repurchase Programs Only Emotional?

Stock repurchase programs are a great way for non-public organizations that have little liquidity in their stock (or even publicly traded organizations that have limited liquidity, for that matter), to create a market, on their own, in their shares. However, we often hear bankers talk about implementing stock repurchase programs under the idea that it creates a "perception of liquidity". Somewhat of the thought behind that comment is that stock repurchase programs are intended to create an emotional response by the stockholder of feeling that the company is doing something for their benefit, that the company is offering these stockholders a liquidity event that they otherwise might not have, or that the company is going out of its way to serve stockholders by offering to repurchase shares. All of those things may, in fact, be true, but from a Board of Directors' standpoint, there are multiple reasons beyond those "soft" reasons that might make a stock repurchase transaction highly beneficial for overall financial performance and the organization's financial metrics.

Initially, the decision by a Board to pursue a stock repurchase transaction is an allocation of capital decision because the organization will be funding stock repurchases either through a dividend from the bank to the holding company or by the holding company borrowing funds to repurchase shares. That capital allocation decision is often made by considering the economic benefits that a repurchase transaction would have versus deploying that capital to some other strategy such as buying another institution, investing in new products or services or other strategies. But, using existing capital or even borrowed funds to acquire shares from stockholders at a reasonable value can create tremendous economic benefits.

A stock repurchase program does, in fact, provide a liquidity event for the selling stockholders, and since the stockholders are voluntarily agreeing to sell their shares, they must be pleased with the value and the liquidity event. But, for all remaining stockholders, earnings per share increase, return on equity increases, dividends per share may increase if the same dollar amount of dividends are paid over fewer shares, and, perhaps most importantly, all remaining stockholders have their ownership percentage increased without spending any of their own money to acquire a greater ownership percentage. So, while the transaction may have some "emotional" benefits to selling stockholders and may also have some soft benefits to the company such as giving the perception of a price support for the shares, a well-structured stock repurchase transaction certainly provides tangible economic benefits to the organization and the remaining stockholders as well. As Chairman, you should give consideration to that type of strategy as an alternative to your other capital allocation decisions.

Consider Strategic Planning Issues Monthly

As we are into the fourth quarter of the year, we are spending a large part of our time facilitating year-end strategic planning sessions for community banks all across the country. Recently, a question came up in one of these sessions from a director asking how often they should “do” strategic planning. Our response was that the question was not totally appropriate. The more appropriate question is how often should the Board members be considering strategic planning issues. Our response to the latter question was to consider the issues at least monthly. We suggested that a formal strategic planning session probably should be conducted at least yearly, but that you cannot simply put your strategic plan on the shelf and pull it out a month before the following year’s session. Rather, strategic planning matters should become a part of your monthly Board meetings. We suggest simply adding an element to your standard agenda that might say something such as “consideration of strategic issues”. Then, you can include in the Board packet the action plan or summary of strategic findings or whatever similar document you have from your planning session which should outline some of the key initiatives the Board and management decided to undertake throughout the year. In that way, you can revisit it, see where you are in terms of your strategic endeavors and provide an ongoing and constant monthly update to your strategic planning efforts rather than only doing that once a year.

As Chairman of the Board, it is your responsibility to lead the charge with strategic planning and have your Board "on board" with that process. If you think your Board is not up to that task or you personally do not think that is the way to go because your past strategic planning sessions have been a colossal waste of time and money, we would love to talk to you about how to make your event educational, informative and interesting.

Update on 2019 Chairman's Forum

We are pleased to announce that the 2019 Chairman's Forum is off the ground and we are already having Chairmen, directors and senior management sign up. The 2019 event will be held January 17 and 18 at the beautiful Ritz-Carlton in Naples, Florida. For information on how you and your Board members can sign up, please click on the following link.

https://barret.ws/landing/chairman/

If you are not familiar with the Chairman's Forum, it is a one of a kind unique open forum discussion for Chairmen, directors and others from across the nation facilitated by Jeff Gerrish and Philip Smith. You can find more information on the link or if you would like to hear directly from us, please give us a call. Space will be limited, so early registration is encouraged.

Meeting Adjourned

You will see from this month's newsletter that we often take a bit of a different position on community bank issues than what you hear in the standard conferences or presentations. That is really borne out of the fact that community bank work is not something we dabble in, but something that we are immersed in on a daily basis and our continuing daily involvement with real Board members and real issues throughout the country gives us a perspective to highlight how unique community banking is and how you as Chairman and your Board members can continue to operate within that environment in a way that produces stockholder value, notwithstanding some of the negative pundits out there. We hope this newsletter continues to provide helpful information in that regard.

Until next time,

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