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

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Dear Subscriber:

Greetings from Alabama, Georgia, Florida, Tennessee, Iowa, Minnesota, and Missouri!

GROWING PUBLIC

Musings readers may have noticed the title of this article and thought it was perhaps a "misspeak." The fact is, it really involves growing public, not going public. We have been involved with several banks recently that have grown out of the Small Bank Holding Company Policy Statement, notwithstanding the fact that the threshold was raised to $3 billion in assets as a result of the recent regulatory relief legislation to $3 billion in assets. Once your consolidated organization is above that $3 billion level, then your bank and holding company are consolidated for capital purposes, and the Federal Reserve expects to see something in the consolidated capital ratio range between 5% and 6%. You can still leverage a large bank holding company to about 30% debt to equity and maintain an appropriate consolidated capital ratio, but you cannot go much beyond that.

Several of the banks we have been with lately have grown or are about to grow through the Small Bank Holding Company Policy Statement level. They have been nicely leveraging capital into their banks to support balance sheet growth, do acquisitions, and the like, but that is going to be changed up a little bit in the future. A couple of them are simply going to do Initial Public Offerings and become very public all at once. Some of them are simply going to grow through the $3 billion asset level and conduct private placements as a way to generate equity for the holding company and cash for the subsidiary banks to support capital.

As most *Musings* readers know, we are not much in favor of community banks becoming public, SEC-reporting bank holding companies unless they get some benefits out of it. These couple of clients we have been with recently will get the benefits of real access to the public capital markets and real market liquidity for their shares (both will end up at more than 3,000 shareholders in their companies). Those are good reasons to go public. If you can get the benefits of going public, then the expense of doing so is likely worth it, particularly once you exceed that $3 billion level.

LONG-TERM PLANNING

As most *Musings* readers know (many of you met us this way), we facilitate a sizeable number of community bank long-term planning sessions each year. We are glad to be able to have the knowledge and national viewpoint to assist the boards and senior management of our community bank client base around the country in setting the direction for their institution. We enjoy dealing with opportunities that long-term planning involves.

We are being contacted and booked for planning sessions in 2019. If your board plans to use one of us in 2019, we would be delighted to get you on the calendar. We do not want you to miss an opportunity for us to facilitate your planning session, particularly if you have a fixed date.

Let us know.

THE MERGER AND ACQUISITION MARKET

As we approach the end of 2018, we thought it would be appropriate to take a backward look at the community bank merger and acquisition market. The year started off very strong the first six months or so, which was due in large part to the roaring economy and roaring stock market, particularly as it related to bank stocks. This has not been the case the second half of the year. An interesting dynamic has resulted. The large banks have become somewhat reluctant to pay for the targets with their stock because prices are depressed. They are also, of course, reluctant to do cash transactions if generating the cash requires a public offering at their depressed stock price. There are still a number of smaller banks ($200 million and under) that are looking for purchasers. Virtually all of those are cash deals. That cash has not really dried up at that deal level because most of the buyers are community banks that are leveraging their holding company $10 million or $20 million and generating the cash necessary to purchase the target. So the odd dynamic is that larger community banks, between $400 million and $1 billion, that may be looking for cash transactions are sitting on the sidelines because the larger banks that would pay them cash in a part-stock/part-cash deal are reluctant to part with either the cash or the stock at what they view is a depressed price of their own stock. The optimists in us suggest that this may reverse itself. We do not think it can come any time too soon.

We also anticipate the merger market for 2019, notwithstanding some of these downdrafts in the economy and the stock market, will remain strong, particularly at the smaller community bank level where there appear to still be lots of sellers and a good number of buyers as well.

2019 DE NOVO BANK PROGNOSTICATIONS

We recently received a call from a reporter for a daily banking publication asking for our thoughts on de novo bank activity in 2019. If you remember back in the summer, we were getting calls on an almost weekly basis from various groups interested in de novo bank charters. That interest has cooled significantly. There are still some groups that are in pursuit of de novo charters, but the level of interest has fallen off sharply.

We believe the cooling of the de novo market will likely continue through 2019 for a couple reasons. First, the Democrats' takeover of the House has decreased the chances of additional significant regulatory relief in the near term. We do not believe a divided Congress is going to produce a bank regulatory relief bill that provides some type of significant change in the regulatory environment. Second, the recent volatility in the stock market, which has created a pretty big downturn in bank stock pricing, has cooled interest.

Overall, we think 2019 will be much like 2018 in terms of de novo bank activity. We think we will see some new banks open and some new charter applications filed, but we do not expect to see a significant increase compared to the approximately 20 charter applications filed this year.

UNREALIZED SECURITIES LOSSES IN ACQUISITION PRICING

We recently received a question from a client regarding the treatment of unrealized losses on a potential target bank's Available-for-Sale Securities in an acquisition transaction. In this particular instance the banker asking the question had received a marketing package for a bank that had decided to solicit expressions of interest. The marketing package essentially provided that in pricing the transaction the acquiring bank could not take into account the target bank's unrealized losses on Available-for-Sale Securities. In other words, those would be added back to equity for purposes of determining transaction pricing and the like. The question was whether this was a standard approach to transaction pricing.

In short, the answer to the question is no, this is not a standard approach to transaction pricing. However, it is one that we are seeing with more frequency due to the rising interest rate environment.

As we have said in *Musings* a number of times previously, a target bank's value is driven by the earnings it provides to an acquirer, not its book value. However, many transactions are priced off of book value. Whether the transaction includes or excludes the target bank's loss on Available-for-Sale Securities is really of little importance. If the losses are excluded such that equity is artificially inflated, the offered purchase price premium simply comes down by some amount to offset that loss. That is expressed either as a lower percentage of book value or in a lower absolute transaction premium. Either way, the purchaser gets purchase price protection from the losses associated with that group of assets.

ANNOUNCING ACQUISITION TRANSACTIONS

Several times recently the question has come up as to when it is appropriate to publicly announce acquisition transactions, either to the target bank employees or the public at large. Over the past several months, we have had several situations where we represent the community bank buyer who has signed an indication of interest for the purchase of another community bank. In these cases, the target community bank wanted to tell the bank employees about the transaction at the time of the signing of the indication of interest. Our advice to our client could pretty succinctly be described as "no."

Acquisition transactions should not be publicly announced until the acquisition agreement for the transaction is fully signed. This is the first point in the transaction where both parties are legally committed to the deal. The transaction should not be publicly announced prior to this time because the chances of the deal falling apart are higher prior to signing the actual agreement. A publicly announced transaction that does not ultimately come together is not good for anyone involved, particularly the selling institution.

If you are thinking of engaging in an acquisition transaction as either a buyer or seller, do not jump the gun on the public announcement. There is simply too much risk for all involved in publicly announcing it prior to the signing of the actual acquisition agreement.

A REAL HEAD SCRATCHER

We recently assisted a community bank in evaluating a potential acquisition transaction. The potential target was a very small community bank in a very rural part of the country. It was also significantly overcapitalized. We evaluated the transaction based on the target bank's earnings and "normalized" capital positions and assisted the client in drafting and submitting an indication of interest for the transaction. Shortly after submitting the indication of interest, we spoke with the advisor that was assisting the bank through the marketing process. The advisor told us we would not be invited to perform due diligence because our bid was not high enough. We asked where we needed to be to get to a point where we would be invited to do due diligence, and the advisor told us that we needed to essentially be at two times book value. We were extremely surprised (to put it politely) at this level of pricing. The target's advisor indicated to us that he too was surprised at where the bids ended up.

We see the level of pricing in this transaction as impossible to justify based on our experience. The good thing is that our client was very willing to walk away from the deal. We had the discipline to price the deal at a level that made sense for our community bank client. When we found out that was not going to chin the bar, they did not make a bad decision and raise the price. Instead, they simply walked away and decided to keep their powder dry for other acquisition opportunities. It was a great decision for them.

CHAIRMAN'S FORUM

As most *Musings* readers know, we facilitate an annual (often twice-a-year) Chairman's Forum for community bank Chairmen, lead directors, CEOs, and other outside director types. The next Chairman's Forum will be in Naples, Florida (sunny and warm) on January 17-18, 2019. For additional information you may visit the following link:

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

The Forum is being sponsored by Barret School of Banking and the ICBA. There are still a couple of slots left for participants in the Forum.

CONCLUSION

We all hope all *Musings* readers and your families had a wonderful Christmas and are looking forward to a great New Year. We wish all of you the best. As we noted, *Musings* is being published today because "*Musings* never sleeps." Thank you for your interest and your business this year. We wish all of you a happy and safe New Year!

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*