GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, Tennessee, Texas, Nevada, Utah, and California!

THE NEW LOAN OFFICER

In many planning sessions that we conduct, the community bank desiring to expand has a strategy of "lifting out" loan officers (or entire lending groups) with a book of business and support staff from another bank. We recently became aware of a situation in Wyoming involving a loan officer moving from one bank to another and a CEO assisting that loan officer in developing business to bring the loan officer's current bank lending customers over to the new bank. The bank from which the loan officer departed did not appreciate the efforts of these two and sued them in civil court. The court awarded the bank from which the loan officer left a $1.2 million judgment against the loan officer and an approximately $1 million judgment against the CEO of the new bank.

This was a Federal Reserve member bank, and the Federal Reserve did not take very kindly to the situation – in part because it cost the bank $150,000 plus in legal fees to defend these two. The Fed is making a move to remove both of them permanently and ban them from banking.

The strategy of lifting out, particularly commercial lenders, from another bank is a good one. The execution of that strategy, however, is important.

DIVIDEND STRATEGY

We were with a number of strong community banks at year end that were in the process of determining a dividend strategy going forward. Dividends, in our view, are simply a return of capital for the investors. Dividends are not a "have to" allocation of capital, unlike balance sheet growth. If your community bank is going to grow its balance sheet 10% and the board wants to maintain the capital ratio at 10%, then the bank will need to retain sufficient earnings to support that balance sheet growth. Dividends are not like that. Theoretically, they are discretionary. For most community banks, it is only once they start paying a dividend that it becomes more of a “have to.”

So, how do you set the dividend? There are a lot of different ways to do it. Some of our clients around the country simply take a percentage of earnings. That allows the dividend to vary year to year, quarter to quarter, or however frequently they pay it. Some take the position that they simply want the dividend to continue to accelerate (i.e., add a penny a year going forward, even if some years that is a larger percent of earnings and some years it is a smaller percent). Some of our community bank clients peg the dividend to the return on book value. For example, they want a 2%, 3%, 4% cash return on the book value invested. For family controlled or owned banks, my general response when asked about an appropriate dividend policy is that the bank should determine the family’s cash needs and make sure that is provided through the dividend or distribution (in a Sub S). Once the family needs are determined, then you can determine whether it makes sense for the rest of the bank (i.e., supporting balance sheet growth and the like). Dividends are more an art than science. Understand the philosophy behind it, and it will be much easier for the board to determine.

BOARD INVOLVEMENT

As most *Musings* readers know, we often address board obligations with respect to community banks. One of those obligations is to develop business. Another one is to be a “credible challenge” (the regulator’s words, not ours) to management. We were recently visiting with the CEO of a mid-sized, high performing bank. The CEO was lamenting that his board did not seem engaged. He wanted to figure out how to get them engaged or get some new board members who would be engaged. We, of course, cautioned him to “be careful what you wish for.” This is only partially tongue in cheek. When your board determines to be engaged, either as a result of “simply waking up” or a regulatory push, they need to make sure they do not move the pendulum too far one direction or the other. In other words, an unengaged board is not good, but a micromanaging board is often worse. As we often tell boards of directors, if they feel they have to micromanage the Chief Executive Officer, they need to get a new Chief Executive Officer. As the board becomes more engaged, make sure the line demarking engagement versus micromanagement is clear.

RENAMING / REBRANDING

Year-end brought a lot of thoughtful consideration from a number of our community banks as to whether they wanted to rebrand the bank or change the name or both. It has been interesting to watch the deliberations. Rebranding and name changing issues are always difficult in community banks generally because of the history and emotional attachment to the status quo. We have watched many of our clients rebrand over the years. Particularly when they are Bank of "Hometown" and begin to expand geographically far away from "Hometown." Many of these community bank names are not exportable to other communities, so they rebrand and change. We were conferring recently with one of those total name changer rebrands from almost ten years ago. The CEO indicated that the name change and rebranding was one of the best things their bank had ever done.

Our recommendation on the whole rebrand / name change issue is to take a long view. What is in the long-term best interest of the bank, its franchise, and its shareholders? If it is to continue under the same brand and name, then that is what should occur. If it is to rebrand, then serious thought should be given to that alternative as well.

CHAIRMAN'S ROLE

We have often discussed in *Musings* and in our companion newsletter, *The Chairman's Forum Newsletter*, the special role of the Chairman. As a practical matter, we have been emphasizing since the beginning of the "Great Recession" that the Chairman's role has taken on new meaning and new obligations. No longer is it sufficient to have a "figurehead" Chairman of the bank and holding company. The Chairman has real fiduciary responsibilities in a variety of areas. The Chairman is not only in most cases the face of the bank and the disciplinarian for the board, but it should also be the strategic thinker. We will have the opportunity at the end of the week to facilitate the discussion at the Chairman's Forum in Naples, Florida. We anticipate these Chairmen and lead directors will have a number of new ideas, which we will share both in *Musings* and *The Chairman's Forum Newsletter*. We will keep you posted.

GOING PUBLIC

We visited with a number of banks at year-end with respect to going public with their bank holding company. These are bank holding companies that are not SEC reporting, not publicly traded, yet they are contemplating taking the big step and going public. As a practical matter, going public means registering the bank holding company's shares with the SEC (typically on a Form S-1) and listing those shares on one of the various NASDAQ alternatives.

Going public is a strategic issue. We are certainly not opposed to community bank holding companies going public. We are opposed, however, to community banks and their holding companies wasting money. Going public is an expensive process, and staying public is a long-term expensive process. In order to justify the expense it seems to us that there needs to be some benefit from being in public company status. Typically the benefit includes access to public capital markets and market liquidity for the shares. Unfortunately, most community bank holding companies, unless they are going to go "really public" and have 3,000 to 5,000 shareholders, will not ever achieve market liquidity for the shares. We also question for most of them whether they will ever have any better access to the public capital markets than they do now (which as a practical matter is pretty good even as a non-public community bank).

Nothing wrong with being a public SEC reporting NASDAQ listed company as long as there is some offsetting benefit to the cost.

CORPORATE VALUE

Over the last couple months we have been particularly busy in "running the numbers" on potential acquisition transactions. We recently had what we thought was an interesting discussion with a client on a financial analysis we completed. In this particular deal, we ran the numbers assuming a purchase price of a little bit less than 150% of book value, which was right about 25 times the holding company's consolidated net income for 2018. During our discussion on the analysis, one of the directors remarked that he thought the purchase price as a percent of book value would be higher than that. Our immediate response was that the target's earnings did not justify any higher purchase price.

Making a bank acquisition is typically a large allocation of capital. If you are going to make an acquisition, you want to make sure you are being appropriately compensated for the associated risk. In other words, it is important to ensure you are going to receive an appropriate return on investment. Banks that have higher levels of capital but lower earnings should sell for a lower percentage of book value. Otherwise, you are not allocating your capital to its highest and best use and are probably leaving money on the table.

FAIRNESS OPINIONS

Over the last several weeks, we have issued several Fairness Opinions in connection with community bank acquisition transactions. For those of you that are not serial acquirers, you may ask "what is a Fairness Opinion?" A Fairness Opinion is simply the opinion of a qualified third-party that the financial terms of an acquisition transaction are fair to the shareholders from a financial point of view. Fairness Opinions are typically issued to the board of directors of the selling company (as was the case here), but they can also be issued to the board of directors of the buying company, which is more prevalent when stock consideration is involved.

What is interesting about a Fairness Opinion is what it is not. A Fairness Opinion is not an opinion of the financial advisor that the offered consideration represents the highest and best price the company could get. It is also not a valuation. Instead, a Fairness Opinion is simply an opinion that the shareholders or whoever is beneficiary of the opinion are being treated fairly in the transaction.

MARIJUANA BANKING

We recently received an email from a client outlining a set of facts that we anticipate will likely become more and more prevalent as we move into the future. This client relayed to us a particular scenario that involved a commercial borrower that applied for a loan a number of years ago to buy a retail storefront for a number of different commercial tenants. This was a fairly run of the mill commercial strip center property. Fast forward a couple years, and this particular state's legislation has changed to allow for the distribution of medical marijuana. This retail strip center now has a state legalized and licensed marijuana dispensary as one of its tenants.

What is the bank to do in this situation? The tenant is operating in compliance with state law. However, the tenant is engaging in a federal crime under federal law by distributing a Schedule I narcotic. The bank's dilemma is whether it should call the loan, allow it to continue without change, or do something different.

Obviously there are a host of issues and considerations here, the details of which are beyond the scope of this *Musings*. However, it is sufficient to say the research has been very interesting, and we expect this will only become more prevalent as time goes on. We think the only way this dichotomy is going to be finally resolved is through some action by the legislators or a change in federal law. We will see if we ever get either of those.

CONCLUSION

We hope all of you and your families are off to a wonderful start for the New Year. As usual, Gerrish Smith Tuck is off to a running start on the New Year. We will have some significant deal announcements coming up soon. We also look forward to seeing many of you at the upcoming national community bank conventions.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

