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

March 15, 2019, Volume 388

Dear Subscriber:

Greetings from Arizona, Texas, Georgia, Tennessee, Minnesota, West Virginia, Pennsylvania, Florida and Arkansas!

CREDIT UNIONS: THREAT OR OPPORTUNITY?

We have received a number of inquiries lately about what appears to be a trend of credit unions acquiring community banks. A couple of such transactions have been announced in the last few weeks. These are generally large credit unions acquiring smaller community banks. Is this a threat or an opportunity? We suppose it depends on your viewpoint. If you are a small community bank looking to sell, then a credit union is certainly an opportunity. If you are a community bank looking to buy, then credit unions may be a threat in that they, of course, don't pay taxes, have no profit motive, etc. and will likely pay a price that fits into the "stupid" category.

Putting a deal together with a credit union is really not that difficult. Twenty-five years or so ago our firm did the first "community bank / credit union" transaction. It was a branch sale. Just like a whole-bank community bank sale to a credit union, the branch transaction was structured as a purchase of assets and assumption of liabilities.

When we are representing a selling institution, we are always glad to see credit unions in the mix. When we are representing buyers, we hate to see credit unions in the mix because they tend to pay too much. Apparently you can do that when you do not pay taxes and have no profit motive.

USES OF EXCESS CAPITAL

A number of our community bank clients around the nation are struggling with effectively utilizing their excess capital. Should they pay out a dividend or distribution to their shareholders in a special one-time event? Should they try and buy another bank? Should they buy an insurance agency or some other non-core banking business operation? Should they redeem their own shares (i.e., buy themselves)?

The real question is what is the best allocation of capital in that particular circumstance? We are working with a number of banks who have tried other things, including buying other banks and other lines of business, and have finally determined that the most appropriate use of their capital is likely to "buy themselves." For most bank holding companies that are not SEC reporting, this is not a complex transaction. It is actually pretty simple. The Board of Directors of the holding company is in control and can set the price, set the terms, set the conditions and the like. Specific amounts of capital can be allocated for a proactive repurchase plan or the bank holding company may simply want to set up a walk-in program.

The repurchase of shares by the bank holding company should not be viewed as a last ditch effort as a way to use capital. It may be your primary use of excess capital. Redeeming shares by the holding company is almost always a good thing in that it is a win-win for the selling shareholder (gets the shareholder cash, he or she pays the taxes, and moves on). The non-selling shareholders receive an increase in ownership percentage, increase in earnings per share, increase in return on equity, and the illusion of share liquidity (i.e., the stock was bought by the holding company), and increase in cash flow if the company's dividend or distribution policy is a percentage of earnings.

Do not consider stock redemptions by the holding company a bad thing. They are easy to do and a good allocation of capital in most circumstances.

LARGE BANK M&A

By now I am sure all *Musings* readers, from *Musings* or other sources, are aware of the announced merger transaction between BB&T and SunTrust. This will create the sixth largest financial institution in the United States with total assets of about $450 billion. We believe we are likely to see some other fairly large banks combine. We also will probably again see some of the smaller regionals (e.g. $10 billion to $40 billion in assets) begin to combine. For those who have sold to some of these smaller regionals over the years, we will again see the opportunity for a "double" or "triple" dip as the purchasing bank then sells and so on. We anticipate in 2019 and 2020 we will see several more of these large mergers. These large mergers will undoubtedly create nice opportunities for community banks to acquire overlapping branches / darkened bank buildings / customers from the bigs who simply do not want to go to the next new loan officer. We will keep you posted.

KNOW YOUR LIMITS

We are currently working on the buy side with several community banks who are working on their very "first ever" bank acquisition transaction. Fortunately, these buy side banks without experience are smart enough to get some decent professional help. As we like to say, if you don't get professional help now, you may need a different sort of professional help later.

Knowing your limitations, either in knowledge, financial, personnel, or otherwise, is always a big part of making appropriate decisions. These banks knew their limitations getting into these transactions, yet it did not stop them from doing it. They are just beefing up on knowledgeable financial and legal advisors and internal personnel who have been through this process before. Good for them.

EQUITY-BASED PLANS

As attracting and retaining key employees is getting tougher in virtually every market (rural, urban, suburban, etc.), the issue of equity-based compensation plans has again come into focus. A number of our clients are considering everything from plain vanilla stock options for senior officers and directors to synthetic equity plans, stock appreciation rights, and phantom stock as a means to attract and retain key personnel and allow them to share in the increased value of the organization.

Keep in mind that some of these plans, such as incentive stock options, are qualified plans and have to strictly follow the rules, which include only being used for employees and receiving shareholder approval. Others are non-qualified plans that can be used for directors and officers. These include restricted stock plans, stock appreciation rights, phantom stock, and the like. With respect to non-qualified plans, there are really very few rules. These plans can be specifically tailored to meet the bank's needs. Again, if you are marching down the road of equity-based plans, please make sure you get professional help early on.

THE DISCIPLINED ACQUIRER

We recently were with a community bank client whose proactive strategy is to acquire other banks. This particular bank has a keen interest in making an acquisition in a particular larger metro area. The board has done a very nice job of outlining what it is that the bank is looking for in this particular area. They have identified the target's ideal location, size, asset/liability composition and other specific acquisition criteria.

Over the past couple weeks we have assisted the bank in evaluating an opportunity that, on its face, appeared to have a whole lot of potential. The geography was great and the size right. Unfortunately, once we dove further into understanding the bank, it turns out there was much to be desired, at least from this acquirer's perspective. We spent quite a bit of time analyzing and discussing the transaction. Our client ultimately decided to take a pass, because certain aspects of the target bank simply did not line up close enough to the ideal target to make it work.

That is, in our opinion, a disciplined acquirer that has a very smart acquisition strategy. They know exactly what they want. More importantly, they have a well-developed framework for how to evaluate acquisition opportunities. They are also disciplined enough to follow the strategy they have set, which in the end will serve them very well.

DEPOSIT COMPETITION CONTINUES

Over what seems to be the past 15 or so months, competition for deposits has increased tremendously. We are currently in as fierce a competitive environment for deposits as we can remember. For example, we were speaking with a long-time banker a couple weeks ago and he mentioned to us that this is the most competitive deposit environment he has ever seen in his entire banking career. We are not exactly sure how long that spans, but it is close to 50 years if it does not surpass that mark.

We view today's deposit environment much like the loan environment of about six years or so ago. Being present is not nearly enough. The banks that are being successful in gathering deposits are those banks that have specific, active deposit acquisition strategies. Over the last year or so we have seen a number of different deposit gathering programs and strategies, and by far the ones that work the best are the ones that put people out into the street meeting with customers and asking for the business. We have also seen what we consider to be some pretty unique pricing and other account features.

Overall, if you are looking for deposits, our recommendation is that you treat it much like the loan gathering strategies of six or so years ago. In our opinion, the most important factor is getting people out of the bank and in front of customers asking for, in this case, the opportunity to hold the deposits.

CORPORATE VALUATIONS

The first quarter of the year brings our firm the opportunity to conduct a number of holding company and bank valuations. Although each valuation is nuanced based on what type of valuation we are determining, the specifics of the organization and the like, there are generally three key components to determining corporate valuation.

The first component in a corporate valuation is determining overall corporate value based on comparable transactions and then, typically, applying a discount to remove what is referred to as the enterprise or control premiums in whole-bank transactions. The second component of the valuation is to evaluate the characteristics of similarly situated stocks. In other words, we evaluate the trading prices for other banks and bank holding companies and use those trading prices to determine a value for the subject company stock. If we are valuing on a whole-bank basis, those numbers are then adjusted to determine an enterprise or control value. If we are valuing on a minority basis, those adjustments are not included since we are valuing the shares of stock against similarly situated other stocks. The final valuation component is to look at the prior trading prices of the entity being valued. Once again, whether those are adjusted depends on the specific type of valuation being conducted.

Those of you that are familiar with our firm know that we preach the fundamental duty of directors and officers is to enhance shareholder value. This all really boils down to making the stock more valuable in the hands of the shareholders. There are a number of external factors that will impact the value of the investment (see 2009, particularly for banks that weathered that storm well). There are also a number of internal factors, the most important of which is earnings.

Having a basic understanding of the valuation process is important, as it gives you a better understanding of what goes into determining the value of the investment for the shareholders. Please let us know if you have questions or would like to further discuss the specifics of a valuation.

DIRECTOR TRAINING VIDEOS

Philip Smith and Greyson Tuck recently were requested by ICBA to (and did) film some excellent director training videos. While Philip had been through this exercise before, for Greyson, it was certainly an interesting exercise, as he had never "been in front of the camera" before. The videos turned out great. They are essentially a seven-part video series where each of the videos runs between 15 and 20 minutes. Philip and Greyson approached the videos much like a funnel, starting out with general discussions regarding the duties and responsibilities of a community bank director. They then drilled down further into that concept from various different approaches. The final video addresses the need for shareholder, director and management succession.

These videos were professionally filmed and edited. We do not yet know the exact date of the world premiere. We expect there will be much fanfare and an appropriate red carpet party. All are invited. Once those festivities conclude, we will let you know about how to get your hands on the videos if you would like to do so. The idea is to make director training very accessible for all community bank directors by allowing these short videos to be played at board meetings or some other time when the board is all together.

CONCLUSION

The Ides of March is upon us. We look forward to seeing many of you at the ICBA Convention in Nashville starting on Monday. If you are there and you spot us, please come say hello. We would enjoy having the opportunity to visit.

Have a great two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

