GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Florida, Tennessee, Minnesota, Iowa, Wisconsin, West Virginia, and Pennsylvania!

ROLE OF TECHNOLOGY

Each of us understands the need for current, up-to-date technology in our community banks. As we have indicated in *Musings* before, there is significant frustration on the part of community banks in dealing with their core providers. It really does not seem to matter which of the main core providers the bank uses - none of the community banks seem to be happy.

It seems that in addition to simply the frustration with the core provider, the bank needs to determine and define the role of the Technology group in the bank. Are they there simply to support the ideas of the rest of the bank as to how things could be done more efficiently or better through technology, or is the Technology group's job to be proactive and make suggestions as to technology? If the community bank wants them to be proactive, we guarantee you they will bring you all kinds of "cool" new technology to look at. If your community bank simply wants them to be reactive to identified needs from the rest of the bank, then they need to know that as well.

BUYING A BANK

Consolidation of the industry is still fairly active based on our experience over the last month or so with various clients asking us to help them provide financial analysis and prepare a bid/Indication of Interest on target banks that are being "peddled" in various parts of the country. When trying to decide what to pay for a target bank, the most critical issue is to determine the target bank's core sustainable earnings stream post-acquisition (after your community bank acquires it). Once you determine that earnings stream, then you analyze that compared to what your community bank holding company has to pay to obtain that earnings stream. Once we reach a point at which the earnings per share for our bank post-acquisition is significantly accretive and the return based on discounted cash flow analysis of the target is in a range we are comfortable with, generally 7% to 10%, then it is easy to identify the maximum purchase price we are willing to pay. Interestingly, once the deal is cut and a purchase price is announced, then everyone's friends at S&P Global Market Intelligence (formerly SNL Financial) will translate that into a multiple of book value and a multiple of earnings. Please note, pricing a bank acquisition does not work the other way around (i.e., the average multiple of earnings 20 times, so that is what we should pay). Multiples of book value and multiples of earnings do serve somewhat as "guardrails" as to expectations on a transaction, but that is not how pricing is determined. Pricing is based on what you get for what you have to give up, as well as the return that your bank expects out of the transaction. A very fundamental issue.

FAMILY CONTROLLED INSTITUTIONS

Over the last several months we have worked with multiple family-controlled institutions. These vary from institutions that are literally controlled by a matriarch or patriarch to those that are controlled by multiple families. Some of these bank holding companies had buy/sell agreements that are, in essence, the last to die buy/sell. In other words, if one of your partners or a family member died, then you or the holding company was able to buy the stock back at some nominal value, e.g. book. The goal is to be the last person standing. We believe there is probably a better way to handle buy/sell in family closely-controlled banks.

It is often the case in a family-controlled bank that although the families may not want to sell the bank, some of the individual family members may want to sell their shares. The usual outlets for a sale of shares in those circumstances is a redemption by the holding company or a sale to an ESOP or a KSOP. We think either one of those is preferable to a sale to a third party. A sale to the holding company consolidates the ownership within the remaining family members. The sale to an ESOP or KSOP transfers the ownership into additional friendly hands (i.e., the employees), with the families as Trustees of the ESOP or KSOP still controlling the vote, as a practical matter.

As hard as it is to believe, some family members who would really like to sell their shares do not want to do so at any value other than what they would get for the sale of the entire bank. They would anticipate, for example, if they sell their shares back to the holding company at book and a quarter, that the very next day the remaining family members will go out and sell the entire company for book and a half. There are ways to protect against that happening, at least for a period of years, for a seller. If anybody needs any further information, please let us know.

MANAGEMENT SUCCESSION

As we continue to "harp" on management succession in our publications, speeches, and meetings with directors, we continue to receive multiple common questions. One of those questions is, should the former Chief Executive Officer remain on the board of directors post-retirement? Our definitive answer to that is "maybe." In our opinion, the "maybe" depends almost totally upon the thought process of the incoming CEO.

We have been with a number of incoming CEOs who basically indicate they do not want the former CEO on the board because they do not want to continuously be second-guessed or viewed as second in authority when they are running the bank. Others welcome the former CEO's continued participation in the bank, both from a historical experience standpoint and from an ongoing support standpoint – that is, they get along well, and the former CEO will support the new CEO in his or her decision making.

The "maybe" under this scenario really depends on all the facts and circumstances surrounding the CEO transition. In this area, it is more of an art than a science. What do the two personalities involved want? What does the board think is in the best interest of the bank? How does the new CEO become the most effective CEO the bank can have? All of those questions need to be answered, but it is certainly a common issue.

DE NOVO BANKS

As many of you know, there has been a serious lack of de novos, at least compared to the historical number of de novos during and following a period of consolidation in the community bank sector. Historically, the country would see north of 100 de novos a year during a period of consolidation. This was primarily due to the fact that communities without banks and with capital and active business people wanted their own banks and would form a new bank. Currently, that is not happening. Since 2010, there have been 24 charters granted. A primary stumbling block has been the amount of capital necessary to start a de novo and the regulators' insistence (understandably so) that the de novo have experienced community bank management and experienced board members. That, and the long runway for a return on investment and ultimate liquidity in that investment, are all hindering factors.

Without some change in some of those critical factors, it is not likely the number of de novos will skyrocket. We do see it climbing slightly, but not materially. This is unfortunate considering the significant interest in formation of new banks by many in the industry. Our firm has received much interest from fintechs, in particular, both inside and outside the country. We will see whether any of those materialize.

EFFICIENT STRATEGIC PLANNING SESSIONS

This fall we have facilitated numerous different community bank strategic planning sessions. A handful of these planning sessions are what we characterize as extremely efficient. What is it that makes these planning sessions so efficient compared to the rest? It is all of the prior "spade work" and the previous Board planning sessions.

For those planning sessions that we view as extremely efficient, the common bond is the fact that this is not the first time these groups have been through the exercise. Instead, these groups generally have their strategy set. These planning sessions are extremely efficient because the group is not spending time trying to figure out the basics relative to corporate strategy. Instead, the discussions at the retreat are focused on how they are executing their current strategy and what changes need to be made in order to further refine the strategy. For many of these groups, it is much like trying to figure out how to go from 100 to 115 miles per hour.

Facilitating these types of efficient planning sessions is a lot of fun. We think for the most part the participants enjoy it as well.

TRANSACTION CLOSINGS

We have closed three large transactions over the past three weeks. One of these deals was a very involved share repurchase transaction from a couple different, somewhat difficult shareholders. The other two were bank acquisitions where we represented the buyer in each. The common bond in each of these transactions is that the actual day of closing went off without a hitch. That is generally because the closing of these types of deals is "anti-climactic." All of the difficult work comes up in the week or two prior to closing.

If you have not been through a closing in today's digital age, they are not like they were in the good old days. Rather than everyone getting around a hotel conference room with a stack of papers, everything now is done electronically. Essentially what happens is all the documents are signed well in advance of the closing and then exchanged by the attorneys to be held in escrow. This means that on the actual day of the closing there is very little that takes place. If all goes as planned, it is typically a short phone call that simply confirms all items to closing have been completed and documents can be released from escrow. We personally miss the big "victory" dinners.

MILLENNIAL ADVISORY COMMITTEES

We were recently speaking with a group regarding how their community bank attracts and deals with millennials. We were talking about all the usual suspects, such as fintech, P2P payments, digital banking, and the like. During the discussion, the banker mentioned his bank's millennial advisory committee, leading us to ask how that was put into practice. The banker's response was essentially that the board, being advanced in age, was not in the best position to figure out what technologies millennials demanded and how to reach them. Instead, this bank uses a group of its millennial employees to advise the board on what resonates with millennials. Hence the term, millennial advisory committee. We do not recall running across this particular setup previously, but it makes all the sense in the world to us.

LEGAL LENDING LIMITS

A client recently contacted us to ask a specific question related to the bank's legal lending limit. This particular holding company is getting ready to repurchase a large block of shares, and the board is considering how to best fund that repurchase. They can either use holding company debt, existing bank capital, or a combination of the two. The bank's question was essentially whether there would be a violation of the legal lending limit if the bank paid a special dividend to the holding company and reduced bank capital and the bank legal lending limit to a point where they had credit extensions in excess of the legal lending limit after the reduction.

As a preliminary matter, it is important to keep in mind that the answer to the question is dependent on the state law for the state in which your community bank is incorporated or if your community bank is a national bank, the National Bank Act. Nevertheless, the general rule is that compliance with the legal lending limits is tested at the time of the loan's inception, but is also tested at the time of any subsequent renewal or further extension of credit if new funds are advanced. It is generally tested against the capital as shown in the previously filed Call Report. In other words, most states and the OCC generally provide that a reduction in capital and an accompanying reduction in legal lending limit does not automatically result in a violation of the legal lending limit for existing credits. However, if the loan amount is increased at renewal or when further extensions are made, the new legal lending limit typically applies.

If you are thinking about making a special dividend or otherwise experiencing a reduction in bank capital, be sure to keep this in mind. You certainly do not want to run afoul of the legal lending limit rules. Violations of the legal lending limit are considered "strict liability" for the directors and officers involved. They are on the hook for the full amount of the loan, not just the excess. A topic for another day.

CONCLUSION

This will be the last Musings before the Thanksgiving Holiday. We all want to wish you and yours a wonderful Thanksgiving. We hope everyone gets a few days off and spends quality time with friends and family.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*