GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from California, Florida, Tennessee, Iowa, Pennsylvania, Wisconsin, and Illinois!

EXECUTIVE SESSIONS REVISITED

Apparently the last *Musings*, which contained an article on executive sessions, struck a nerve with many *Musings* readers. Some of those readers were outside directors wondering why they had never heard of an executive session. Others were insiders concerned about an executive session. And yet others were Chairmen wondering about the content of an executive session and whether their community bank should take the leap. To refresh *Musings* readers' recollections, an executive session is simply a session of the independent, outside directors of the Bank. The session is led generally by the Chairman if the Chairman is an outsider. If the Chair is not an outsider, then typically a "lead" director is appointed to chair the executive session.

The term "executive session" is a bit misunderstood in community banking. Some of the community banks we have worked with use the term simply to refer to a session of directors only, both inside and outside. In other words, a session where you kick out all non-director management. The true executive session, however, (i.e. the one you would have to hold if you are an SEC-reporting company, which you are probably not), would be simply directors who are defined as outside, non-management directors.

The purpose of the executive session is to avoid the proverbial "parking lot meetings" or the meetings at the Chairman's house when there is a problem with the direction of the bank or the direction of the CEO. The executive session gives the outside directors the opportunity to have an unfettered discussion with respect to various topics.

With respect to the agenda for an executive session, it is crystal clear what should not be included on the agenda. Anything that is a matter for full board consideration/deliberation should not be included in the executive session. In other words, do not use the executive session to have a board meeting and make decisions without the CEO, who is also a director. The executive session should primarily be reserved for discussion of the CEO's performance or the Bank's performance, or the initiation of strategies, or the failure of the CEO and his or her executive team to initiate strategies, and the like. The executive session is not a substitute for the regular board meeting.

Also, it is important that after the executive session the Chairman of the Board or lead director (whoever conducts the session) circle back immediately to the CEO to let him or her know generally what was discussed in the executive session. Also, it is important to keep at least cryptic notes from an executive session. Once the regulators note the board went to executive session, they will be looking for some kind of minutes, so accommodate them and provide some brief minutes that the board adjourned into executive session and discussed X.

As noted in previous *Musings*, some banks are adjourning into executive session at each meeting, some have an executive session only quarterly, and some only on the call of the Chair or any outside director. Do what works for your community bank.

IDENTIFYING THE BASIC BUSINESS STRATEGY

As many *Musings* readers know, we have the opportunity to facilitate dozens of community bank strategic planning sessions around the country each year. We generally approach the facilitation of strategic planning sessions with the belief that the directors and officers need to reach consensus on the company's strategy relative to independence and its basic business strategy. We believe each is essentially a spectrum, and the board and officer group should have discussion and reach consensus on where they fall on each spectrum.

The spectrum related to each of these issues is pretty straightforward. For independence, proactive pursuit of acquisitions is on one side of the spectrum, and proactive pursuit of the sale of the organization is on the other. The middle is being neither a buyer nor seller. For basic business strategy, active pursuit of balance sheet growth is on one side of the spectrum, and active pursuit of profitability is on the other. The middle of that spectrum is what we often refer to as community bank nirvana, which is profitable growth.

During a recent planning session, we had an interesting discussion with a community bank board as it relates to where they fell on the basic business spectrum. At the onset of the discussion, they very much identified themselves as a profit-oriented bank. However, throughout the discussion, where they fell on the spectrum became a little less clear. Although they identified themselves as actively pursuing profit, their last couple years they had made significant investments in the establishment of new branches, which had reduced their near-term profitability. This led to quite a bit of discussion about whether they view themselves as profit-oriented, but were actively pursuing growth.

The board's discussion was lengthy, but in the end, what ultimately came out of the discussion was an agreement on the importance of core profitability. It was recognized and agreed that earnings drive value, and the ultimate goal of their organization is to improve sustainable core profitability. This group decided they are not totally willing to forego the pursuit of asset growth, but that the primary objective is one of making the bank as profitable as possible, while still making investments that will pay off long term.

This blended strategy is what we see as the most common among community banks. Frankly, we also view it as the most viable path to enhance shareholder value and remain independent.

CAPITAL RAISING ALTERNATIVES

We recently had an interesting meeting with a community bank CEO on various capital raising alternatives. The discussion was pretty straightforward. This particular bank is looking to raise about $5 million in capital to support additional bank growth and to satisfy the regulators. We talked about the alternatives of selling stock versus leveraging the holding company.

One of the discussion topics involving the potential sale of this community bank holding company stock was the level and pricing of recent trading (such as it was) in their shares. The community bank holding company does not have much liquidity for its shares, and the shares were recently trading at a fairly substantial discount to book value. As soon as we heard this, we recommended taking the sale of shares off the table as an alternative. Based on our discussion, we think the market is undervaluing these shares, but it is a reality that will make it difficult to sell shares at their fair market value or what we consider to be intrinsic value. The problem is that the offering materials will have to disclose recent trades in the shares, and those trades would certainly be priced lower than the appropriate sales price in a capital raise. Among other problems, the sale of shares below book value would create significant book value dilution for the remaining shareholders, as well as ownership dilution.

Given the realities of the characteristics of this community bank holding company's stock, our recommendation was that the holding company essentially look for short-term debt (or a longer-term instrument that could be prepaid with no penalty) that will increase the bank's capital and allow it to further improve its performance. This should equate to an improved stock price. Once that happens, the board can evaluate the alternative of selling additional shares to pay off the financing. We see this as the best alternative to solve the dilution and fair market value problem created by the sale of common stock.

If your community bank holding company is considering raising capital, it is important to understand the alternatives of selling stock (and all its varieties) and using holding company debt (and its various alternatives). It is also important to make sure all of the collateral issues and alternatives are considered. Your community bank holding company certainly does not want to pursue a transaction that increases capital but is ultimately more detrimental than it is beneficial to the community bank holding company shareholders.

UNSOLICITED OFFERS

Unsolicited offers (which are different than hostile offers/takeovers) are not all that uncommon in today's community bank environment. An unsolicited offer is simply an offer for an acquisition that is presented to a community bank or community bank holding company that is not actively soliciting such offers. It comes from an active acquiror that has determined they are ok making offers to banks that are not soliciting them to see if they have an interest in doing a deal.

We have said previously that unsolicited offers presented on the buy side should come with their best foot forward. What are the issues related to the receipt of an unsolicited offer? What should the board consider in determining how to respond?

If your community bank holding company is in receipt of an unsolicited offer, the central issue is whether the financial terms presented in the unsolicited offer are a better financial alternative for your shareholders than the alternative of remaining independent. In other words, is the amount of cash, stock, or combination of cash and stock offered by the acquirer such that it puts the shareholders in a better position today and over the long term, than they would be by continuing to own the holding company shares? If the answer to that question is "no," the unsolicited offer should generally be turned down. If the answer is "yes," the unsolicited offer should be further considered or the board should develop an achievable plan to make the financial alternative of independence as least as attractive as what was proposed in the unsolicited offer. If an unsolicited offer appears attractive, there are also a number of other considerations, such as whether the acquirer can get the deal done, whether the offer should be vetted to see if there is a better offer out there, and the like.

If your community bank holding company is in receipt of an unsolicited offer, the first question is whether it "chins the bar" to potentially offer a better alternative for the community bank holding company shareholders than that of remaining independent. If it does not, the analysis is over. If it does, there is more work to be done to figure out how to respond. The second question to be considered is whether the buyer can get the deal closed.

CHARTER AND BYLAWS UPDATE

A year or so ago we suggested in *Musings* that your community bank and holding company review and update its Charter/Articles of Incorporation and Bylaws to fit the modern times. We assisted many *Musings* readers in connection with that task. The important thing on updating your Charter and Bylaws is that you update it before you need it. Once you are in a difficult situation with respect to an acquisition, a misbehaving director, or anything similar, then it is really too late to make the update.

It is not a difficult process to perform the update, it is simply something the board should consider to do sooner rather than later.

Please let us know how we might assist.

LENDINGCLUB ACQUISITION

We normally do not address in *Musings* significant public announcements by various companies with respect to their acquisitions. We are mentioning the LendingClub announced acquisition of Radius Bank, however, because of its unique nature. Many of you are familiar with LendingClub, the online lender. It has made an acquisition offer that has been accepted, subject to regulatory approval, to acquire Radius Bank (a digital, FDIC insured community bank with 20,000 plus ATMs, as well as online and mobile banking) based in Boston.

We recently received an inquiry from a community bank client as to why LendingClub thought an acquisition of this particular bank was advantageous. For LendingClub this was really a no-brainer. Without the acquisition, LendingClub is required to use a variety of funding sources to fund the loans that it makes to its various customer bases. The cost of funds from third parties in connection with funding those loans is nowhere near as cheap as the cost of deposit funding. With LendingClub's acquisition of Radius Bank, they will pick up a massive, cheap (compared to their cost of funds now) deposit base. No surprise there.

This is the first true Fintech acquisition of a bank that seems to make sense. The parties have indicated they feel the regulatory approval track will be 12 to 15 months. Depending on how well it was vetted ahead of time, we are not sure it will take that long. Keep an eye out for similar transactions, however. Our firm is still receiving a couple of contacts a month from fintechs looking for bank charters simply for the low cost of funds. This one seemed perfect for LendingClub since both operations – LendingClub and Radius Bank – are basically Internet-based.

CONCLUSION

Enjoy your extra day of February this year since it is Leap Year. For those of you born on February 29th, please acknowledge that you are at least four times older than the number of birthdays you may have had on the calendar.

We look forward to seeing many of you *Musings* readers in Orlando at the ICBA Annual Convention in another week or so. Also, mark your calendars to sign up for the ICBA sponsored/Gerrish Smith Tuck produced Mergers and Acquisitions Workshop to be held in Minneapolis on June 15 and 16, 2020. This workshop is really "hands-on." It is perfect for community bank CEOs, Chairpersons, outside directors, and certainly CFOs. Please follow the link below to sign up.

M and A Workshop Registration

See you in two weeks.

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