GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Texas, Kansas, Georgia, Iowa, California, New Mexico, and South Carolina!

MERGER AND ACQUISITION ENVIRONMENT

As we have previously expressed in *Musings*, contrary to popular belief, the merger and acquisition environment for community banks under $750 million in total assets appears to be strong. We define "strong" as showing "lots of interest" on both the buy and sell side. The interest is strong because many community banks, notwithstanding the pandemic, are overcapitalized, and the buyers are looking for an appropriate place to deploy that capital to enhance shareholder value. As we have expressed previously, community banks either need to provide a good return on equity for their shareholders or a return of equity to their shareholders.

Based on emails, Zoom meetings, and in-person meetings we have had lately, M&A activity is still fairly top of mind for community banks.

TRANSACTION PRICING

As noted above, we are currently in the midst of a very active community bank M&A environment. It is true that there are not many new deals being announced. However, there is much churning under the water. We are assisting many potential buyers in "running the numbers," completing due diligence, negotiating agreements, and the like. It is just taking a little longer in this environment to bring the deals from these stages in the transaction to announcement.

One of the common questions we receive from buyers is how the pricing in their potential transaction compares to average pricing multiples. Although we always are happy to provide this information, we do so with the caveat that the average pricing multiples for unrelated deals has little impact on the price the buyer should pay in their specific transaction. This is particularly true in today's environment.

There are numerous reasons why average and median pricing multiples really do not have much bearing on the value of a potential target organization. They are unreliable; they are only applicable if the target bank is an "average" bank; they all reflect past transactions; and, particularly in this environment, there are too few to actually form a viable basis for a reliable value determination. Simply put, pricing a deal is not about what others paid in other transactions. It is about what the transaction means to the acquirer and the anticipated return on investment.

If you are thinking about doing a deal, we recommend not thinking of pricing the deal in terms of averages. Be more strategic and intentional in your thinking, and price it based on what the transaction means to you.

PROVIDE SHARE LIQUIDITY OR SELL

We have had several contacts from community banks around the nation over the last couple of months asking for our assistance in analyzing the situation of whether the community bank holding company can provide adequate liquidity to its shareholders who are looking for an exit, or whether the best alternative is to sell the bank and holding company. As most *Musings* readers know, we have assisted numerous community banks in connection with sales of their institutions, although our predisposition is to encourage community banks to remain independent. For the banks that we are assisting with the share liquidity versus sale decision, the issues primarily involve questions of how much stock can the holding company buy back, at what price, and how much leverage is available. If the answer is that the company cannot buy back enough stock to make a meaningful difference for those who want to exit, and the ones who want to exit are still going to need to exit, then it seems that the default strategy is a sale or possibly the sale of these "exiting" shares to new shareholders. Although the pandemic has created uncertainty in all the markets, including mergers and acquisitions, it has not resulted in a meaningful drop in purchase price (at least as much as you might think) in connection with M&A sale transactions.

WHAT'S HAPPENED TO MY CAPITAL RATIO?

We were recently visiting with a community bank whose leverage ratio had dropped from its peer level (not that that's relevant to anyone other than your friendly federal regulator) of about 10% to just over 7%. The reduction in the leverage ratio was not due to reduced income, increased loan loss reserves, or asset quality problems in particular. It was simply due to growth of the balance sheet primarily due to the PPP loans and the pandemic. As with most community banks, the PPP borrowers have left their money sitting in the bank. This inflates the bank's balance sheet. This particular community bank was wondering whether its holding company should generate some additional capital or what their alternatives were. We suggested to them their smartest alternative is probably to wait and see what the regulators do. The regulators have expressed some indication of "tolerance" (we can't believe we are even using the word "tolerance" and "regulators" in the same sentence) with respect to pandemic issues. The question is how long that will last. We doubt your friendly federal and state regulators will be satisfied with a 7% capital ratio forever, but maybe something in the 8% to 9% range over the long term might work, depending on the bank's balance sheet composition, asset quality, and the like.

CAPITAL CONFUSION

Some of the boards we have met with recently have determined that now, for a variety of different reasons, may be an appropriate time to raise capital. We found one fundamental misunderstanding on virtually all those boards. We don't know if this misunderstanding is a result of seeds sown by investment bankers or others, but the misunderstanding is that the holding company needs to have a capital instrument that qualifies as "capital" for regulatory purposes. Unless the holding company has consolidated assets greater than $3 billion, that is simply not true.

For most community banks considering raising capital, the issue that needs to be considered by the Board is what is the least costly (from both issuance and long-term), quickest, and most efficient way to generate cash into the holding company. Once that cash is in the holding company, it then can be down streamed into the bank and shows up as capital in the bank for regulatory purposes. When the board considers generating cash, it could be from the sale of common or preferred stock (not usually the choice due to the dilution of ownership). It could be through borrowing from a bankers' bank, correspondent bank, or other community bank (the issue here is that the debt will be secured by 100% of the bank stock). It could be borrowing from a rich and smart director or other bank customer depositor. It could be a leveraged ESOP. It could be a note issuance at the holding company. It could be the investment banker's favorite: "subordinated debt." Considering the best way to generate cash, particularly if cash is going to be generated through some type of debt financing, then obviously rate, terms, collateral, cash flow, and everything else needs to be considered. A public offering of subordinated debt may be appropriate for your holding company to generate cash. After all, the subordinated debt offerings are generally unsecured, ten years interest-only with a fixed interest rate for five, and an adjustable rate for the other five. A loan from a rich and smart director would generally be a one-page unsecured note where terms are negotiated. You get the drift. Any way to generate cash that makes sense, is available, and is not too costly is the way to go if your community bank holding company is less than $3 billion in consolidated assets. Once that cash is generated and contributed to the bank, it will magically show up for regulatory purposes as tier 1 capital at the bank.

UNREASONABLE REGULATORS

What do you do when the regulators are being unreasonable? We have had a lot of experience in this regard. We have a couple clients now dealing with regulatory issues that do not have anything to do with asset quality but are still significant to the bank. The regulators have demanded various actions they believe the bank should take. The Bank has objected to these unreasonable demands.

Our recommendation to these community bank clients is for us to continue to move up the food chain at the friendly federal regulator. Our experience has been that eventually the bank will reach that regulator who has some degree of common sense and realizes what the bank has been asked to do makes no sense. Don't poke the bear in the eye; just continue communicating.

DISGRUNTLED SHAREHOLDERS

For whatever reason, the pandemic apparently has brought out the worst in our community bank holding companies' disgruntled shareholders. We have had multiple situations in the last couple of months where the board is wrestling with the dissident/disgruntled/unhappy/whiney shareholder. Based on our experience, most of these shareholders are simply trying to make enough noise and be enough aggravation to get bought out. Perhaps the pandemic has brought this on because their own businesses are failing and they need the cash. We're not sure, but it appears to be a phenomenon none the less.

From the board's standpoint, keep in mind, most of these disgruntled shareholders do not go away. At least they do not go away until they either get their way or are "jammed" into doing what the board wants them to do. The board needs to understand its options, and, for the most part, deal with the situation head on.

SHAREHOLDER ACCESS TO CORPORATE RECORDS

Several times over the past couple months, we have assisted clients in responding to a shareholder's request for access to corporate records. These requests are typically received from a disgruntled shareholder that is unhappy for some reason or another. The disgruntled shareholder typically wants access to the shareholder list in order to rile up the other shareholders and gain support for what the disgruntled shareholder thinks is some grand idea relative to the operation of the holding company or bank.

If you receive a request from a shareholder for access to corporate records, our recommendation is to immediately look to the holding company's state of incorporation's corporate statutes (assuming you have one, or the bank if you do not). The corporate statutes for virtually every state have a specific statute that deals with a shareholder's right of access to corporate records. Almost all require the shareholder's request to be stated in writing and for the written request to specifically specify the proper purpose for which the disgruntled shareholder seeks access to the corporate records. Whatever specifically is required of your state, our recommendation is that you follow the statute to a T. We recommend against deviating from the requirements of the statute in order to avoid a situation where you have set an ill-advised precedent relative to a shareholder's right of access to corporate records.

Hopefully you will not receive a request from a disgruntled shareholder seeking access to corporate records. If you do, we recommend you identify the specific statutory requirements and follow them. Essentially, the position to take is that your community bank holding company will do whatever it is the law requires it to do, as long as the shareholder does whatever the law requires them to do.

CAPITAL POLICY CONCERNS

We recently assisted the Board of Directors of a holding company and bank in drafting a Capital Policy and Contingency Plan. This plan provides the holding company and bank guidance in determining the appropriate levels of capital, certain triggers that may require consideration of capital raising alternatives, and the like. The plan we drafted is heavily reflective of the regulatory capital considerations that are applicable to all community banks. However, there is a very individualized component to the plan as well, which is based completely on the Board's risk tolerance.

Capital risk tolerance is one of the primary issues that you should consider as a director or executive officer. This is essentially the decision on what is the minimum capital comfort level for your organization. It is different for every organization because every organization's risk tolerance is different. Some Boards are quite happy with an 8% Leverage Ratio. Others have heart palpitations and begin looking for more capital at 12%.

We assume your community bank and its holding company have a Capital Policy and Contingency Plan. If you do not, we suggest you get one put in place before your next examination. If you do, and you have not done so recently, we suggest you take a look at it to ensure the Policy is reflective of the Board's risk tolerance within the current environment. COVID-19 has changed a lot of things, and it may be that it has also shifted your organization's minimum capital comfort level.

FINRA NOTICES

We have recently been reminded of the requirement for certain holding companies and banks to provide notice of certain corporate actions to FINRA. Although the details of the rule are complex, the general rule is that if your holding company or bank common stock is traded on any established market, including the OTC markets such as the Pink Sheets, you have an obligation as the issuer of those shares to provide notice of certain corporate actions. This includes dividends or distributions, mergers, acquisitions, holding company reorganizations, and the like.

It is not all that uncommon for a holding company that is traded on an established market, particularly if they are thinly traded, to forget this notice requirement. Please consider this as your friendly reminder. If you fail to provide timely notice of the corporate action, which is generally notice at least ten days prior to the effective date of the corporate action, the fee associated with the notice goes up. The fee, which we believe is really a penalty, for providing after-the-fact notice is $5,000. Hopefully this friendly reminder will help you avoid that.

CONCLUSION

Things are certainly interesting around the country. We are now into the fourth quarter - only a few weeks away from the Presidential election. Uncertainty associated with the pandemic and other issues abounds. Nevertheless, we are happy to report, based on our experience, community banks continue to do what they do best - serve their communities.

See you in two weeks.

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