GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from South Dakota, Minnesota, Kentucky, Wisconsin, Pennsylvania, Kansas, and South Carolina!

PPP (NOT THE LOANS)

We recently facilitated a strategic planning session for the Board of Directors of a very well-run community bank. One of the discussion topics was that of employee morale and well-being. The group discussed 2020 as a whole, as well as the toll it generally had taken on employee morale and engagement. The group viewed this as a threat, and we gave extensive discussion to opportunities to address the issue.

The discussion moved to PPP. No, we did not talk about the Paycheck Protection Program. Instead, the group talked about the Past the Pandemic Party. As you might suspect, the idea is essentially a big employee party to celebrate once we make it "past the pandemic." The thought is that this is probably a second or third quarter of 2021 event.

We think the idea of a Past the Pandemic Party is pretty great. The title is certainly fitting. More importantly, we really like the concept. 2020 has been hard on everyone, and we think it entirely appropriate for banks to be thinking about ways to get back to normal and reengage the employee base. A party certainly sounds like a great way to do that. Our only hope is that we get an invite!

A WORD ON DATA PROCESSORS

Over the past three or so months, members of our firm have facilitated numerous strategic planning sessions. One item of common discussion for strategic planning sessions is that of technology planning. This typically involves a discussion of both internal and external technology. The central question is whether the bank has the products and services that customers demand and that allow it to operate in an efficient and effective manner.

The technology discussion inevitably turns into a data processor discussion. The truth of the matter is that we have yet to meet a community banker that is fond of their data processor. We cannot recall one instance where a group has gushed about the products and services the data processor provides, the value they get, how important they view the relationship, and the like. Rather, data processors are essentially seen as a necessary evil that are much more worried about protecting their revenue streams than they are about being any sort of meaningful and beneficial business partner.

The biggest frustration we hear with a data processor is the difficulty in moving from one to another. A core conversion is no small task. Further, this typically falls into the "devil you know" type of thinking. Since no one really sees any of the data processors as a great option, most banks simply choose to stick with the devil they know rather than go through a core conversion and go with the devil they do not know. We wish we could offer some silver bullet of wisdom that could remedy this situation, but it seems to be a challenge that will continue to be around going forward.

DATA BREACHES

Data breaches. Most of us don't even want to think about that in our community banks. We have been involved in multiple situations recently that involve data breaches of one sort or another. This may be as simple as bank personnel sending confidential information to their personal email or a spouse's email. It may also be as complicated as having your core processor breached by an outside third party who has malevolent intentions.

Whatever the cause of the breach, the response of the bank needs to be immediate, decisive, and productive. The regulators also need to be kept in the loop on the theory that regulators "don't like surprises." A data breach situation is a high stressor for anybody. The best approach we have found is to tackle it head-on.

ESOP VOTING

We are currently working on a couple different transactions where one of the entities involved in the transaction has an Employee Stock Ownership Plan ("ESOP"). One of the issues related to any shareholder vote is how the shares owned by the ESOP are voted. The answer to this question is controlled by the actual language in the ESOP Plan Document. The typical provision is to allow the ESOP Trustees to direct the voting of the shares on "routine voting matters." For any matter that is not a routine voting matter, the underlying participants typically direct the Trustees on how to vote the shares.

If you have an ESOP that has these typical provisions, the question is what constitutes a routine voting matter. The election of directors is considered a routine voting matter, wherein the Trustees direct the voting of the ESOP shares for the election of directors. For one-off transactions, such as a merger or acquisition, a reverse stock split, approval of incentive stock options, and similar transactions, the underlying participants typically direct the voting of the shares.

If you have an ESOP and are considering a non-routine transaction, keep these approval requirements in mind. You do not want to create a problem for your bank/holding company and jeopardize the approval by unintentionally skipping the requirement that the ESOP participants direct the Trustees on the voting of the shares.

BRANCH PURCHASE PRICING

We are currently assisting several clients in running the numbers and otherwise evaluating a potential branch acquisition. At the onset of the transaction, we are typically asked the level of purchase price premium that should be paid in the transaction. Our response is that the purchase price is determined by the financial analysis.

The central issue in a branch acquisition (or any acquisition for that matter) is return on investment. The purchase price that should be paid is a price that provides an appropriate return given the risk associated with, and benefits of, the transaction. These questions are answered by the financial modeling. An appropriate financial model projects the increase in income that will be realized by the acquisition. That increase in income is then related back to the purchase price to determine the projected return on investment.

In a branch acquisition, the purchase premium is typically expressed as a percent of the deposits assumed. In a whole bank transaction, it is typically expressed as a certain percentage of equity or a multiple of earnings. However it is expressed, the process to get there is the same. You project out the transaction and then determine the premium based on an appropriate return on investment.

PREEMPTIVE RIGHTS

Over the last couple of months, we have assisted multiple community bank holding companies in their desire to raise equity capital. In the process of reviewing the Articles of Incorporation of these holding companies, we have often discovered that many of them maintain preemptive rights. Preemptive rights are the right of an existing shareholder to purchase that shareholder's pro rata percentage of any new offering of securities, typically of the same class (e.g., common stock). Preemptive rights sounds like a fair thing to do in the abstract. In reality, we generally recommend that bank holding companies eliminate preemptive rights from their Articles of Incorporation. Preemptive rights, as a practical matter, are very cumbersome because you have to make the offer to all existing shareholders when, in reality, many of those shareholders will never purchase shares.

We have had a couple of situations lately where we have recommended a holding company eliminate preemptive rights prior to any type of equity offering. We were met, understandably, with pushback based primarily on political reasons with the shareholders. The general statement was that most of the directors felt the shareholders would question the Board as to "What are you guys up to now?". The belief was that any attempt to eliminate preemptive rights in these organizations would be met with skepticism by the shareholders and a lack of trust. Each of these organizations are moving forward with the equity offering with preemptive rights in place.

The existence of preemptive rights, of course, creates some securities law issues. As most *Musings* readers know, any offering of securities by your bank holding company either has to be registered with the SEC or exempt from registration (meaning the holding company needs to determine and execute on the appropriate exemption). If your holding company has hundreds of shareholders located in multiple states, finding an appropriate exemption may not be as easy as if it has 50 shareholders all located in the same state. Preemptive rights do not stop the offering, but they do slow it down and gum up the works just a little bit.

If your holding company is in a position where it can eliminate preemptive rights, we still generally recommend that occur. As a practical matter, if the board goes to issue shares, its first stop is almost always its existing shareholders. Just food for thought for the new year.

KEEPING POWDER DRY

We often meet with community bank/bank holding company boards, either as part of the planning session or as a targeted meeting on capital planning issues. Capital planning primarily involves identifying the sources of capital, both current (e.g., excess capital) or potential (e.g., holding company leverage, equity offering, and the like), as well as uses of capital. The uses of capital discussion generally involves required uses of capital such as to absorb losses and to support balance sheet growth at whatever capital ratio the board targets. A fixed use of capital also, as a practical matter, and certainly in a Subchapter S, is the distribution to the shareholders to cover their taxes. Even in a C Corporation, the bank's current dividend is typically considered a fixed use of capital. Discretionary uses of capital can involve the acquisition of another bank or company or, most often in the current environment, the redemption of holding company shares.

For some reason, over the last couple of months, we have had a multitude of clients with some seriously elderly shareholders. (Elderly as in mid- to late-90's.) Some of these shareholders hold modest amounts of shares - 4% or 5%. Some of them hold significant amounts - 15% or 20%. We have found most of the shareholders of that age who are still coherent certainly do not want to sell their shares. They want to die holding onto those shares so that their heirs get a step up in basis and reduce subsequent taxes when those shares are sold. So, as part of the capital planning process, many community banks will identify sources of capital and then determine looking forward how much "powder" needs to be kept dry when the heirs, the day after the 90 year old dies, walk into the bank looking for cash. Although that may sound like a cynical view (actually, most of the heirs will wait at least until the funeral is over before they approach the bank about obtaining cash), as a practical matter, we have found that most of the heirs do not want to hold onto the stock, and the bank holding company needs to be prepared to purchase those shares at the appropriate time. Consider keeping some powder dry.

STRATEGIC VERSUS OPERATIONAL AND TACTICAL PLANNING

As most *Musings* readers know, members of our firm facilitate dozens of strategic planning sessions for community bank boards and senior officers every year. As part of that process, we typically request that the bank send us its existing plan (unless we are the ones who facilitated it and created it last). Many of the existing plans that are sent to us are really operational and tactical plans created by management, not strategic plans/initiatives directed by the board. We understand that. In some cases, boards are reluctant to get involved in the strategic planning process. In some cases, management is reluctant to get the board involved in the process.

All of the parties, however, need to understand the difference between strategic initiatives, which are conceptual determinations regarding direction, and operational and tactical initiatives, which are how the bank carries out the strategies. Management certainly does not want the board bogged down in anything that is operational and tactical. The board should maintain its direction at a 30,000 foot strategic level and allow management to execute on it without board interference.

DIVERSIFICATION

Community banks and their holding companies often discuss diversification. This can be addressed in a couple different ways. One is diversification of the loan portfolio so that the bank does not have all its eggs in the agricultural, oil and gas, or commercial real estate basket. One could be diversification of the income stream such that the bank is not solely dependent on interest income. Many of our clients, particularly in this low interest environment, are looking for diversification of the income stream. This involves possibly purchasing or creating other lines of business. We have had several clients ask us for advice as to activities in which their holding company is permitted to engage. The answer to that question is certainly well beyond the scope of *Musings* to address, but the general, historical rule has been anything that is "closely related to banking as to be a proper incident thereto." What is closely related to banking is whatever the Federal Reserve says it is. The possibility of utilizing a financial holding company also provides some additional opportunities for bank holding companies electing that designation. In any event, if your bank or holding company has a good opportunity to acquire or start another line of business in which the management has or can obtain some expertise and that would diversify the income stream, do not shy away from it unless you are sure it is not a permissible activity for your holding company. Obviously, we stand ready to evaluate that with you. Please let us know how we can help.

LOAN SALES

Those of you who have troubled loans secured by commercial real estate, troubled loans secured by hospitality industry properties - hotels, restaurants, and the like - or even troubled loans secured by fitness properties such as gyms and workout facilities, may want to take note of a larger $12 billion bank's approach. This bank sold off $81 million of these types of credits at somewhere in the neighborhood of a 20% discount. Would this work for true community banks?

Most *Musings* readers are community banks. Most of those are under $5 billion, and probably the vast majority are under $1 billion. Would that work for your bank just to dump all the credits that have a little bit of hair on them? We think not. If community bankers are, as they profess, relationship bankers, then why would they dump a relationship that has been with the bank for a long time as soon as it gets in trouble? Even worse, why would they dump it to some type of equity investment pool who is not going to do anything but foreclose and sell the real estate? It seems that this approach for a community bank (a true community bank) is a nonstarter.

CONCLUSION

This will be the last *Musings* before Christmas. We wish all *Musings* readers a wonderful holiday season. We hope that you have the opportunity to spend time with your family. The next *Musings* will be on or about New Year's Eve (*Musings* never sleeps).

Enjoy your holiday. See you in two weeks.

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