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

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Dear Subscriber:

Greetings from Ohio, Pennsylvania, Georgia, South Carolina, Kansas, and Iowa!

WHY DOES YOUR BANK EXIST?

This sounds to be a fairly "touchy-feely" esoteric question coming from a group of folks who are both lawyers and financial advisors and are used to talking numbers and financials. The reality, though, is we have been in several meetings lately where the issue that the board needs to address is, why does the bank exist? Does it exist to serve its community? Does it exist solely to enhance shareholder value? Should it be in the top 10% of its peer group from a financial performance standpoint? Does the board care? Does it just need to make enough money to be able to satisfy the shareholders and spend money supporting the community? Why does the bank exist? A fundamental question that the board needs to answer in connection with setting its plans and giving direction to management.

If the bank exists solely to enhance shareholder value (which we have pounded the table about for years), then financial performance and profitability should be the driver of every decision that is made. If the bank's job is to enhance shareholder value at an appropriate level - maybe not high performance, but enough to serve the community - then it may mean a lower level of profitability and a higher level of expenditures in the community. It seems to us the board needs to decide which one is the overall purpose of the bank. From that can flow financial targets and other appropriate issues.

IS NOW THE TIME TO SELL THE BANK?

The question often asked early on in planning sessions is, "Is now the time to sell the bank?" We are pleased to report that most of the time boards of directors answer this question in the negative. We often ask, however, and follow up with those boards at planning sessions as to what would cause them to change the independence strategy. The general responses we get are identical to those banks that indicate they are ready to sell. What is driving the sale of community banks in this environment are simply the traditional reasons - lack of management succession, lack of board succession, lack of share liquidity, no exit for the larger shareholders who need it, no interest in the younger generation, no ownership succession, and the like. To keep our banks independent, we must guard against those issues. This generally requires the board to deal with board succession, management succession, ownership succession, and providing liquidity at a fair price for those who want it.

AVAILABLE INVESTMENT ALTERNATIVES

We recently facilitated a strategic planning session for a community bank that firmly fits within the category of a strong performer. This particular bank has plenty of capital at the bank and a very strong accumulation of cash at the holding company. They are very profitable, asset quality is good, and they have a very satisfied and concentrated ownership group that is firmly committed to long-term independence.

As noted, this holding company has a pretty healthy cash balance at the holding company level. One of the discussion topics at the planning session was the deployment of the cash at the holding company. The group specifically asked what type of investments could be made up at the holding company level in order to maximize return on the cash. The short answer is that the holding company is able to invest in pretty much any company it wants to invest in, as long as the investment represents a minority, passive interest. This generally means that the investment should not exceed 5% of the total ownership of the company or assets and that the holding company should not be actively participating in the management of the company in which the investment is made.

The investment alternatives opened up some new possibilities for this group. They are now giving serious consideration to different investments that could be made to diversify their income and create additional revenue and wealth for the owners. If you have any excess capital in your organization and are looking for ways to put it in use, be sure you understand the alternatives for investment at the holding company level. The opportunities are just about endless.

STOCK REPURCHASES

As we have often indicated in Musings, repurchasing holding company stock is generally an incredibly good allocation of available capital. It benefits the selling shareholders who receive the cash, pay their taxes, and go on their merry way. It also benefits the non-selling shareholders because it is typically accretive to earnings per share, improves return on equity, provides instant liquidity, and does not impair (and may even improve) cash flow. An often overlooked benefit of the holding company repurchasing shares is that it also sets a floor on the stock price. We have been with many banks over the years who set a floor on the stock price of 90% of the book value. We have been with some banks that have set a floor on the stock price that is almost twice book value. Nevertheless, no matter where the holding company board sets the repurchase stock price, it becomes a floor on the stock price, which is a good thing and a good defense to any kind of lowball unsolicited offer. Think about it.

THE IMPORTANCE OF LIQUIDITY

Numerous times in previous *Musings* we have harped on the importance of share liquidity. In this context, liquidity is the ability of the shareholder to convert their shares to cash at a fair price in a timely manner. We had a meeting in the past couple weeks with a board of directors that is a prime example of the importance of liquidity and the threat that the inability to provide liquidity poses to independence. In short, this particular holding company has a number of aging shareholders that desire liquidity in their shares. We assisted the holding company in evaluating a number of different alternatives for satisfying the liquidity need, such as leveraging the holding company or establishing an ESOP or a KSOP. After fully reviewing these issues, the Board decided the "internal liquidity opportunities" were not enough to satisfy the need. With this in mind, the board decided to move forward with a sale of the bank.

The importance of liquidity cannot be understated. It is critical, particularly so if you have a strategy of independence. Simply put, failing to provide for real liquidity in the common stock represents a threat to your ability to maintain independence. If your bank holding company is struggling with share liquidity, please make sure you give specific consideration to the various alternatives.

ACQUISITION ACCOUNTING

Almost every merger and acquisition transaction must be accounted for in accordance with the acquisition accounting rules. The only ones that are not are a combination of entities under common control. For those transactions that are subject to acquisition accounting, the most important aspect of the accounting rules is the requirement that the target's assets and liabilities be marked at their "fair value" as of the date of acquisition. This essentially requires the acquiror to mark the entire target bank's balance sheet to market. The area that is most often impacted by the acquisition accounting requirements is the target bank's loan portfolio. The applicable requirements require each of the target bank's loans to be recorded at their fair value. There are a number of different factors that impact the fair value of the loan, including rate, borrower strength, repayment history, collateral, and the like.

The current COVID environment has had an impact on acquisition accounting, particularly as it relates to a target bank with a concentration of loans in tourism or hospitality industries. Given the current difficulties associated with these loans, the fair value of the loan is lower than in normal times. This has a number of different implications on the financial aspects of the deal.

If you are thinking of engaging in a merger or acquisition transaction as either a buyer or seller, be sure you understand the acquisition accounting requirements and how the current environment will impact the fair value of the assets. We have a helpful memorandum that discusses the issue in full. Please let us know if you would like a copy. We are happy to provide it.

RESTRICTED SECURITIES

Most community bank holding companies that raise capital through the sale of common stock do so utilizing a securities registration exemption. The most common securities registration exemption is provided in Regulation D, Rule 506. When a community bank holding company sells stock pursuant to a securities registration exemption, the shares are Restricted Securities. This is because the shares are received from the bank holding company as the issuer in an unregistered private placement.

As the name implies, Restricted Securities are subject to certain transfer restrictions. The general rule is that Restricted Securities may only be transferred in accordance with Rule 144. This generally imposes a one-year holding period, as well as certain other requirements that must be met in order for the ownership of the shares to be properly transferred. These rules are all in place to protect against an individual acting as an underwriter of securities by acquiring the securities from the holding company and then turning around and reselling those securities without ever having actual investment intent.

The rules related to Restricted Securities are complex and extensive. However, keep the issues related to the transfer of Restricted Securities in mind if any of your holding company shares are Restricted Securities. This is particularly important if you act as your own Registrar and Transfer Agent.

REMOTE WORKING

We have facilitated numerous planning sessions for community banks since the beginning of the pandemic in March. The recent sessions, most (not all) of which have been conducted in person, put an initial focus on the short term and the short-term impact of the pandemic. While there is still a significant amount of uncertainty, we generally try and focus on the benefits to the bank from the pandemic. These generally involve the early (or at least earlier than otherwise) adoption of technology and the newfound ability of bank personnel to work remotely and service their customers remotely. With respect to bank personnel working remotely, we always ask whether that is going to continue on in the future. Some banks respond affirmatively. In fact, for some, it solves some of their space needs by allowing employees to continue to work remotely. Some banks we have been in where the bank has been shut down - or lobbies have been for prolonged periods of time and 100% of the employees have, as a practical matter, worked remotely - have basically indicated that that is not a standard for future operations. The general concern is the inability to communicate face-to-face and the lack of teamwork and camaraderie that comes from everyone working remotely. Based on our anecdotal "survey," we anticipate when the pandemic is finally gone, through vaccine or otherwise, that working remotely will always be an option but not the best practices gold standard.

DIRECTOR MICROMANAGEMENT

Many *Musings* readers are outside directors of community banks. These outside directors have often heard us preach that their job is oversight of management, not to manage the bank (that's management's job). As we have often indicated, that amounts to "noses in, fingers out." Even if you are a former banker and have more knowledge than a typical outside director, your job is not to micromanage. If you feel you must micromanage your management, then that tells us you do not have confidence in your management, and you need to either correct that situation or move on to new management. We do not often see micromanagement in our community banks. When we do see micromanagement, it tends to be destructive and debilitating for morale, both for the Board and the management group. Address the issues that are causing the micromanagement and move back into a director's role.

COMMUNITY BANKING IN 2021 AND BEYOND

Over the past couple weeks, our firm jointly presented with the Barret School of Banking an hour long discussion on the current and future community banking environment. The presentation took a quick look back at the environment over the past six or so months but focused heavily on community banking considerations over the next 12 to 18 months. The presentation was recorded, and you can click here for a complimentary replay of the hour long session.

CONCLUSION

We hope all of you had a wonderful Thanksgiving (although we anticipate pared down for a number of you) with your families. We hope you also recharged your batteries over the Thanksgiving holiday and are ready to make a strong finish for the last four weeks of the year. Stay safe.

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*