GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Ohio, New York, Wisconsin, Minnesota, Iowa, Colorado, and Mississippi!

CAPITAL RATIO CONCERNS

There are currently a number of community banks across the nation that are somewhat fretting over their capital ratios. We have a number of clients that had perfectly acceptable "pre-pandemic" capital ratios who now have ratios that are lower than they would like. A typical example would be a community bank that had about a 9.5% Tier 1 Leverage Ratio at December 31, 2019 whose Tier 1 Leverage Ratio is now around 7.5%. For banks in this position, the typical problem is not a reduction in capital or significant growth in the loan portfolio. Instead, banks in this position are generally experiencing supercharged asset growth in the form of increased cash due to significant increases in deposits, which results in the banks having more capital than they had 15 to 18 months ago. The imbedded risk in their bank operations has not significantly increased since that time, but their Tier 1 Leverage Ratios have materially dropped due to an increase in cash and deposits.

A number of banks in this position have reached out to us to assist in reviewing their capital strategies. The central question for these banks is whether they should take any significant steps to increase capital given the recent changes to the balance sheet. Of course, there are numerous factors that go into making the decision as to what, if anything, to do to increase capital. The general thought process and balancing of competing interests looks at the need to enhance shareholder value, the organization's risk tolerance, and the director and officer group's outlook on the extent to which these increased deposits will stay in the bank.

If the board of directors of your community bank finds itself wrestling with what to do with lower than typical capital ratios, keep in mind that there are numerous available strategies to remedy the problem if that is needed. If your community bank has a holding company (as it should), the holding company can borrow funds at the holding company level to downstream into the bank and increase bank capital. This can be in the form of drawing on a line of credit, taking secured debt, or taking out a subordinated debenture. If your community bank is in a "bank-only" structure, you do not have this capital raising alternative. Regardless of if you are a holding company or bank, you also have the option of selling common stock or another equity instrument. Of course, there are significant corporate and securities issues related to any such sale. Finally, one option is to do nothing and operate at lower than typical capital levels. This has some regulatory risk, as the regulators may not agree that a Tier 1 Leverage Ratio of less than 8% represents safe and sound banking operations.

If the board believes your community bank may be in need of additional capital, be sure you give consideration to the various issues and available alternatives in determining how it is that you want to proceed. The one thing to absolutely avoid is engaging in any capital strategy that ultimately turns out to be to the detriment of shareholder value.

MANAGEMENT STUDIES

Our firm members have conducted dozens of management studies for community banks over the years. Many times, particularly during the last recession, these were regulatorily mandated (typically by your friendly federal regulator). Lately, the management studies have been requested by the board of directors. Often there is a specific reason for the board to request a study, such as a management succession issue, a management performance issue, or something similar.

A management study generally involves a top to bottom review of the senior management team and its interaction with the board of directors. The study involves whether the bank has the proper bus in place, the proper seats on the bus, and the proper individuals in those seats. We have been told that it is helpful from the community bank board's perspective because most of the board members, particularly those outside directors who are not bankers, do not know what a good organizational structure should look like in a bank or whether the bankers occupying the various slots are performing appropriately.

We always discourage the board from attempting to micromanage the bank in any respect, but their job is still oversight. The management study generally provides the type of oversight the board is supposed to give at a 30,000 foot level. The regulators love management studies, particularly when a bank is in trouble, because it checks that box and the board is forced to evaluate whether the community bank has the appropriate management in place. Outside a regulatory issue, a management study can provide insight to the board as to the existing organizational structure and management performance. As we concluded recently in one management study, we thought that the appropriate individuals were in place but that one senior manager in particular was "not always correct in her thinking, but never in doubt."

BRANCHING

For the past 25 years or so we have heard and listened to the talk that community bank branching is "dead." "Dead" meaning it is irrelevant, irresponsible, a waste of good money, and no longer necessary with all the digital offerings. In fact, the internet-only banks that started dozens of years ago were based on the theory that no customer or potential customer of a community bank needed a brick and mortar branch.

What we are finding, based on our community bank client base across the country, is of course that is not true. We have a number of clients who are contemplating establishing new brick and mortar branches currently. Naturally, the footprint for these branches is much smaller, they are loaded with technology, light on human beings (but still have some), and big on service, either electronically or in person. Even the large (super large) banks are continuing to establish brick and mortar branches, though. They are primarily going into big cities they view as growing rapidly such as Orlando, Atlanta, Chicago, and other places. This too presents an opportunity for the community banks as the large banks pull out of some of the more rural areas. Whether the large bank simply closes its branch in your community, lets it go completely "dark" and ultimately sells the real estate, or is willing to sell off the branch (i.e., the deposits and any loans that may be attributed to it) is really immaterial. Either way, it is going to benefit the community bank that remains behind in that community.

Also, in connection with branching, do not let state lines be an artificial barrier. There are some issues with respect to branching across state lines, but just as interstate banking operated multiple years ago, interstate branching is now alive and well - the rule being basically that your community bank can branch into another state to the same extent that a bank in that state can branch. Keep in mind, some states still maintain the old "home office" protection rule, so there are some limitations. In any event, from a strategic standpoint, do not automatically eliminate branching as a possible means of geographic expansion.

SELLING THE BANK

As most *Musings* readers know, we are staunchly supportive of independent community banks. We also realize that for some banks there comes a time when it is time to go ahead and partner-up with someone or just take cash and go on your merry way. Either of these choices still must be within the umbrella of enhancing shareholder value. The question we often get from community bank boards when they reach this decision (and the decision is generally the result of what we consider traditional factors - lack of management succession, lack of board succession, lack of share liquidity, and the like) is whether it is necessary to go through some broad-based marketing process (in other words, peddle the bank on the open market). Our general response is that it is the board's obligation on behalf of the shareholders to receive the best price in the best currency for its shareholders once it has decided to sell the bank. Often, that involves not necessarily a broad-based marketing process but at least discussing the issues and marketing to at least a couple of potential buyers. Can the community bank sell when it is only contemplating one potential purchaser? Absolutely, provided that potential purchaser provides a "preemptive" offer. This is an offer that far and away can be justified to the shareholder base based on its price, terms, and ability to close.

OWNERSHIP STRATEGIES

As we have previously indicated in *Musings*, it is part of the board of directors' job to determine what the ownership of your community bank holding company should look like. The board could determine that it wants the holding company to be SEC-reporting, public, and listed on an exchange such as NASDAQ. It could determine it wants to be a Subchapter S. Or it could simply determine that ownership needs to be consolidated into the customer base or into shareholders living within the main geography in which the bank operates. Any of those possible alternatives (with the exception of going or remaining public and listed on an exchange) likely would involve the consolidation of ownership into a core group. Certainly, Subchapter S would, with the limitation of 100 shareholders (counting six generations of one family as one shareholder), or if the board determines to consolidate into the customer base and geography of the bank's primary locations. Each one of those transactions would involve a "force out" of shareholders. Keep in mind, a force out transaction is perfectly legal. The shareholders who are forced to take cash in exchange for their stock receive the price of their stock at "fair value" under state law. Although "fair value" is not necessarily an enterprise (i.e., sale) type value, it is also not typically deeply discounted. The benefit currently, however, is that valuations of community bank stocks in particular are slightly down as a result of the pandemic and other issues. In other words, it may be a good time to contemplate eliminating some of those minority or other shareholders that over the long term the board determines are not within the community bank holding company's best strategic interest.

CEO SUCCESSION

As all of us get older, the issue of succession for the community bank's Chief Executive Officer keeps bubbling to the top. The question we often get from boards of directors is either "what do we do if we do not know when the CEO is going to retire?", or :if we do know when the CEO is going to retire how much in advance of that should we begin looking for the next CEO?" The answer to the first question is that the board needs information from the CEO as to when he or she is going to retire. A best practice is for the retiring CEO to give the board at least 24 months' notice of their prospective retirement date (absent health problems or otherwise). That timeframe is also an appropriate one for the board to begin contemplating CEO succession. They may not want to have a 24 month overlap, but the process of getting that new CEO vetted and in place is still a critical and potentially long-term issue. Appropriate CEO succession is certainly an issue if the bank's strategy is to remain independent.

RESOURCE ALLOCATION

We recently had the opportunity to facilitate a strategic planning session for a community bank on the smaller end of the asset size spectrum. This is a well-functioning and profitable community bank with appropriate capital ratios. They also have a pretty young (mid-30s) executive officer that is highly energetic and qualified. We see this individual as a real asset to the organization, as we have seen many community banks that have had difficulty attracting and retaining young talent.

The planning session saw the director and officer group discuss and adopt a number of specific strategies for the organization. Our only concern relative to these strategies was the allocation of human capital towards their accomplishment. The discussion almost always involved this young executive being the individual responsible to complete the various strategic action items.

About halfway through the planning session, we pointed out what we saw as the problem with this human capital allocation. We basically commented that the single executive could not successfully complete all of these strategic action items and continue to appropriately run the bank on a day-to-day basis. We commented that the discussion seemed to reflect a supercharged version of the proverbial 80/20 rule, where 80% of the work was being completed by 20% of the organizational talent.

We recommend keeping in mind these resource allocation issues in determining your strategic plan and otherwise. We just do not see it as sustainable when one individual has responsibility for completing essentially all of the strategic action items in the organization. We think a much better system is to appropriately spread the work throughout the organization so that everyone contributes their fair share towards the overall accomplishment of the strategic and other objectives.

TRANSACTION SOCIAL ISSUES

We have had the opportunity to be involved in numerous community bank M&A transactions as both financial advisor and legal advisor on the buy and sell side. Being involved in both the legal and financial side of this many deals has given us a unique perspective on what typically does and does not work well in community bank acquisitions. Of course, it is impossible to boil all of this experience down into a short statement, but in general our experience leads us to believe that in community bank M&A transactions there are financial considerations and social considerations, and the social considerations are more important in determining the success of the acquisition.

What are the social issues in a transaction that we view as so important? Simply put, it is the treatment of people. This involves the shareholders, customers, employees, and the communities for each of the entities that are involved in the transaction. We have found that the ultimate success of a transaction depends on how each of these groups are treated. If the buyer gets too far out of balance in how they treat one of these groups, we anticipate the transaction will have problems and will ultimately not reach its full potential.

If your community bank is involved in an M&A transaction, particularly as a buyer, keep the people issues top of mind. We have found it is an ill-advised acquirer that thinks they are best served by gutting a target bank's employee base in the interest of cost savings. We understand that may aid the income statement on the expense side, but we have seen it enough times to believe that those types of decisions have an outsized negative impact on the revenue portion of the income statement.

CONCLUSION

It is certainly beginning to heat up around the country, both literally and figuratively. We hope all of you get to enjoy the warm and sunny weather in virtually the entire nation and have the opportunity to spend time with friends and family.

We will see you again shortly before the 4^{th} of July. See you in two weeks.

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