GERRISH'S MUSINGS

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Dear Subscriber:

Greetings from Alabama, Illinois, Kentucky, Minnesota, Montana, Oklahoma, Tennessee, and Washington!

THE PROBLEM WITH PROFITS

Those in the 50 or younger crowd likely remember Notorious B.I.G.'s 1997 smash hit "Mo Money Mo Problems." While a recitation of the full lyrics is both outside the scope of *Musings* and not particularly appropriate for this publication, a portion of the chorus recently came to mind during a client discussion. In his song, Notorious B.I.G. emphasizes "the more money we come across, the more problems we see..."

Based on a recent discussion with a bank management group, Notorious B.I.G.'s point can, at times, be applicable to community banking. The reality is there are certain circumstances where profitability presents problems. This point was emphasized in a recent discussion regarding an ESOP's liability in repurchasing participant shares. The longtime bank president participating in the discussion pointed out that the bank's liability had grown to a meaningful amount because the bank had a long history of profits and performance. In other words, the investment performed well, which was great for almost everything, except the repurchase price associated with buying out longtime ESOP participants.

We have said before that earnings cure all ills. We generally believe that to be true, but two things can be true at once. In certain circumstances, profits can present problems. When a bank holding company is either legally (in the form of an ESOP put option) or practically (with a need to provide share liquidity) faced with the repurchase of shares that have gained significant value, the situation can be seen as somewhat problematic because of the capital needed to complete the transaction. It is likely not the worst problem in the world to have, but it can still be seen as a problem.

THE "DISAPPOINTED" EXECUTIVE

We recently had a discussion with a long-time client whom we euphemistically refer to as the "disappointed executive." This individual has been involved with her community bank as both an executive and owner for a number of years. In a recent conversation, she stated, somewhat tongue-in-cheek, that she was disappointed no other bank had ever presented an unsolicited offer or otherwise tried to make a run at the bank. She asked why we thought no other bank had ever expressed interest in such a transaction.

Given that the bank is a solid performer, our response was not based on a lack of performance or value. Instead, our response pointed to the corporate structure and the steps previously taken to signal to the outside world that this bank has a solid strategy of long-term independence.

The bank has a concentrated ownership group in which the owners have specifically taken steps to transfer ownership to the "next generation" of family. That is all reflected in the FR Y-6 and indicates a strategy of long-term independence. The bank also has a young management team that is well positioned for the future and has elected to be taxed as a Subchapter S corporation. The bank also exhibits strong community support, providing both employee time and meaningful corporate resources as donations and similar support.

Putting all of this together, our view is that this bank exhibits to the outside world a strong resolve toward ongoing independence. These actions have likely led any would-be acquirer to see an unsolicited offer or other attempted run at the bank as having a near-zero probability of success. Although the long-term executive may indicate she is "disappointed" in the lack of an expression of interest or other attempted takeover, we believe she is quite pleased with the steps that have been successful in preserving long-term independence.

S ELECTION TERMINATIONS

For some time now, approximately one-third of the FDIC-insured banks in the country have been taxed as Subchapter S corporations. Generally speaking, we view this as the more favorable tax structure for community banks that can meet the requirements to be taxed as a Subchapter S corporation.

Every now and then, one of our community bank clients asks us whether it may be advantageous to terminate the S election. We received this question frequently about nine years ago, when the 2017 Tax Act reduced the top corporate income tax rate to 21%. At the same time, other changes were made to the Tax Code, including the 20% qualified business income deduction, which allows shareholders of eligible Subchapter S corporations to basically disregard 20% of taxable net income allocated to them. Our general recommendation at that time was that Subchapter S still provided significant tax advantages for community banks and their holding companies.

In our view, the circumstances in which the termination of an S election makes sense are pretty well defined: the bank has a change in capital, distribution, and growth strategy, with a high focus on capital retention. In other words, if a Subchapter S corporation is paying very little or no "dividend equivalent" distributions because it is looking to grow retained earnings and Tier 1 capital as much as possible, termination of the S election may very well make sense. Generally speaking, the tax burden to move gross income to retained earnings is less as a C corporation than it is as an S corporation. The opposite is true when you move gross income to the shareholders' pockets.

The continuation of a previous S election is a strategic decision that S corporations should re-evaluate as part of their overall strategic planning. Assuming the current strategy is fairly consistent with the strategy at the time the S election was deemed appropriate, continuation probably makes sense. However, if there has been a change in strategy and the focus is much more on capital retention than shareholder after-tax cash flow, the termination of the S election may make sense.

THE FOX IN THE HEN HOUSE

One of our recent client discussions related to capital strategies and shareholder composition highlighted the problems of activist investors. This particular bank holding company is looking for capital and is generally open to all options that could provide it. However, the Board was clear that it would not allow a fox into the hen house.

As you may be able to surmise, the Board's strategy is one of ensuring its view of ongoing independence is not jeopardized by a shareholder that has a different long-term view of the investment. The Board has established a strategy of independence and is generally willing to consider investors that share that strategy. However, the Board was very clear it would not be agreeable to activists or similar investors that have a limited investment horizon and a goal of simply yielding profits in the short term. To us, the thought of aligning the shareholder base with the goal of long-term strategic independence makes perfect sense.

THE PROBLEM BANK LIST

The FDIC, in its recently published FDIC Quarterly (a creative name), indicated that the Problem Bank List is down to 47 banks. If you are not familiar, the Problem Bank List is a confidential regulatory record of troubled FDIC-insured financial institutions. Generally speaking, a bank will find itself on the Problem Bank List if it has a CAMELS rating of 4 or 5.

The FDIC does not publicize the banks on the Problem Bank List. It provides only aggregate numbers in terms of the total number of banks and total assets. This is to avoid the public negatively reacting and causing a run on a bank that is on the list.

As noted, there are 47 institutions currently on the list. That represents about 1 in 100 FDIC-insured banks. That means 99 out of 100 banks are rated 3 or better and do not warrant special supervisory concern. In our view, that represents a pretty healthy industry. It certainly beats 1987, when the number of banks on the Problem Bank List was 1,575, representing roughly 10% of all FDIC-insured banks.

SOME SHAREHOLDERS JUST WANT CASH

A number of our prior *Musings* have been dedicated to shareholder liquidity strategies and the benefits of a bank holding company repurchasing its own shares. Our general view is that liquidity is the ability of the shareholder to convert their shares to cash at a fair price in a timely manner. We see stock liquidity as one of the essential elements of shareholder value.

Every now and then, we run across circumstances where shareholders do not want liquidity in the sense that we define it. Instead, these shareholders just want cash in a timely manner. They are not really concerned about the fair price element of our definition.

Every now and then, we run across clients that, due to capital constraints or otherwise, are not particularly compelled to purchase shares. If that is the case, the price at which the company is willing to repurchase shares is often lower than the shareholder could likely receive from another purchaser. In our experience, the shareholder often does not care. They are not worried about maximizing the sales price of their stock. Instead, they are worried about getting rid of it quickly and getting cash in their hands.

There is nothing inherently wrong with purchasing shares at a price that is less than fair market value. If the shareholder is fully informed of the alternative to potentially obtain a higher price elsewhere and simply chooses to sell quickly at a lower price, the transaction typically leaves everybody walking away happy.

PURCHASE AND SALE PRICES

Speaking of liquidity strategies, one of the issues we sometimes run across is that of the purchase price and sale price for a community bank that is both buying and selling its stock (selling its stock, of course, in full compliance with all appropriate securities laws). For the most part, we see holding companies that buy and sell at the same price. As an example, a holding company might repurchase 2,000 shares at $50.00 per share, and then turn around and resell 1,400 shares at $50.00 per share. But that is not always the case.

Every once in a while, we run across a company that has a strategy of realizing equity gains through repurchase and resale price arbitrage. Going with our prior example, the holding company might choose to repurchase 2,000 shares at $50.00 per share, and then turn around and resell 1,400 shares at $56.00 per share. That transaction would result in a net increase to the company's equity of $8,400 because it sold 1,400 shares at $6.00 more than it paid for them.

In our view, banks and bank holding companies are in business to build capital through earnings, not share price arbitrage. We do not advocate for a strategy of trying to repurchase shares at one price and then turning around and reselling the shares at a higher price. We recognize the price will not stay static forever, and price changes with time are appropriate. But, for transactions that happen contemporaneously, absent some unique circumstances, we think the best practice is to buy and sell at the same price.

CONCLUSION

The next two weeks will include Labor Day and the unofficial end of summer. It seems just a short time ago we were mentioning Memorial Day and the unofficial beginning of summer. How time flies when you're having fun!

See you in two weeks.

Jeff Gerrish *Philip Smith* *Greyson Tuck*

Upcoming Webinars and In-Person Presentations:

- *September 10 & 11, 2026 – Independent Community Bankers of America, "Enhancing Organizational Value Conference" (Philip K. Smith and Greyson E. Tuck presenting) Registration: Enhancing Organizational Value Conference

***Use code EDU-100-D for $100 registration discount.**

- September 15, 2026 – Independent Community Bankers of America, "Regulation O for Community Banks" (Cliston V. "Doc" Bodine, III presenting) Registration: Regulation O Webinar

- September 16-18, 2026 – Community Bankers of Michigan 2026 Annual Convention & Expo – Directors' College, held at Grand Traverse Resort, Traverse City, Michigan. "Ask Me Anything…" (Sept. 16) (Philip Smith, presenter). Registration: Community Bankers of Michigan - Directors' College

- October 6, 2026 – Independent Community Bankers of America, "Regulation W for Community Banks" (Cliston V. "Doc" Bodine, III presenting) Registration: Regulation W Webinar

- October 19-21, 2026 - Southwestern Graduate School of Banking at Southern Methodist University SMU Cox School of Business, National Certified Community Bank Directors' (NCCBD) Program. "Corporate Governance and the Role of a Board Member, Board Culture" and "Board Members, Board Committees, Board Composition." (Oct. 19) (Philip Smith, Presenter) Registration: National Certified Community Bank Directors' Program

Acquisition Pricing:
All Bank Transactions

	All Deals in the U.S. Over the Past 12 Months Where the Target Has:		
	Less than $250 Million in Total Assets	Between $250 Million and $1 Billion in Total Assets	Between $1 Billion and $5 Billion in Total Assets
Number of Deals	113	44	36
Average Price/Book (%)	151.17	135.70	137.68
Average Price/Tangible Book (%)	152.79	140.09	154.03
Median Price/Earnings (x)	17.24	14.85	14.02
Average Price/Assets (%)	18.54	13.97	13.31
Average Price/Deposits (%)	21.27	17.36	15.77
Median Premium/Core Deposits (%)	8.50	4.94	6.38

* Through August 27, 2026
** Source: S&P Global Market Intelligence

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