Dear Subscriber:

Greetings from South Dakota, North Carolina, Wisconsin, Pennsylvania, and Florida!

DEBT AT THIS AGE?

We were recently approached by a long-time client that has been presented the opportunity to consider an acquisition of another community bank. This particular holding company is majority-owned by one family. Things in their organization are humming along quite well, and the holding company is debt free. In discussing this transaction with the principals, they mentioned that they would not entertain anything but a cash transaction because they would not dilute themselves to a less than majority ownership position. With that in mind, we ran the numbers on the transaction assuming a portion of the cash to complete the transaction came from excess bank capital and a portion came from holding company debt. The transaction looked really good on paper. While discussing the transaction, the principal owner made the comment that he “sleeps really good at night without a lot of holding company debt.” That is certainly understandable. He has worked long and hard for a number of years to pay down the debt he incurred in buying and growing his organization. I see no harm in wanting to keep it that way. I have worked with many other owners that take the “out of debt, out of danger” approach.

THE INVESTMENT BANKER

Over the past couple months we have been assisting a community bank that is looking to engage in a stock-for-stock swap with another community bank. We are not serving as legal advisor or the “investment banker” in the deal. Instead, the outside board members have brought
us on as somewhat of a neutral third-party just to review the transaction, keep an eye on the investment bankers, and provide our overall advice.

During a recent discussion with the board of directors, one of the investment bankers in the deal kept talking in what I would consider very “Wall Street” terms. This investment banker was talking about how the analysts would accept the acquirer’s tangible book value dilution created as a result of the transaction and that the analysts would be very impressed with the projected accretion to earnings per share. This seemed very well-rehearsed. The problem is that it was not practical. The reality of this transaction is that it is an approximately $200 million community bank with a concentrated ownership group that is acquiring about a $100 million community bank with a concentrated ownership group. The combined organization will have about $300 million in total assets, a concentrated ownership group, and no real market liquidity. There are no analysts that are following these stocks or analyzing this transaction in order to make recommendations as to whether you ought to buy, hold, or sell the stock.

Following the investment banker’s nice presentation, it was our turn to provide our comments. We took a little different slant and essentially recommended that the board analyze the transaction by considering whether the benefits of the transaction were such that it made it attractive to trade an illiquid community bank stock they control for an illiquid community bank stock they do not control. We, of course, talked about the duty to enhance shareholder value and analyzed the characteristics of the stock they currently hold versus the characteristics of the stock they will hold incorporating the appropriate exchange ratio. We think these to be much more practical considerations to the decision at hand.

SAME SONG, DIFFERENT VERSE

We have been serving as financial advisor and attorneys for one of our community banks in connection with analyzing a potential acquisition of what can only be described as a very troubled institution. This particular bank, which has been marketing itself for some time, is undercapitalized and losing quite a bit of money. Our client has previously offered what we consider to be an appropriate purchase price for an institution in this shape. The sellers thought it was worth much more than we did, so a deal never came together. We thought the transaction was dead. Apparently that was not the case.

The sellers’ representatives contacted us recently to let us know they were putting the bank back out to bid. There have been some changes to the institution that are for the better, but we do not consider these changes to be material. We asked the sellers’ advisors whether there
was anything that was materially better today than the last time we looked at the bank. Their answer was essentially no. We also asked whether their pricing expectations were different during this marketing period than the last one. Again, their answer was essentially no.

This is certainly an interesting marketing strategy. They have gone out and marketed this bank two or three times and have never found anyone willing to pay a purchase price they consider acceptable. If they are serious about selling the bank, it seems to me that they ought to be willing to get realistic about the value of the asset they have. We will let you know if that happens.

**MERGER TRANSACTIONS**

As most of you know, most merger transactions are completed as a result of a merger of the holding companies typically followed by a merger of the banks (although it does not have to work that way – the target bank could remain a separate bank under the acquirer’s holding company). As many *Musings* readers understand, mergers are far different than P&A transactions in that the acquirer acquires all assets and liabilities, as well as contingent, known, and unknown liabilities.

Because of this, as it relates to a couple of target banks that have a little “hair on them,” we have structured a couple of acquisitions this year that are really whole bank acquisitions, but they are structured as purchase and assumption transactions similar to a branch acquisition. The benefit is similar to a branch acquisition in that you get what you agree to purchase and assume those liabilities you agree to assume and no others. A whole bank P&A is a good way to limit exposure to the unknowns, particularly if the target bank is having some difficulty.

**OBJECTING OWNERS**

For those of you who are not in Subchapter S and have some of your shares held in brokerage accounts, you know that you can have NOBOs – non-objecting owners – who do not care who knows that they are holding their shares in a brokerage account, and OBOs – objecting owners – those owners who do care and do not want anybody to know that their shares are held by that particular broker.

We are in the process of converting a Subchapter S now that has a significant number of both NOBOs and OBOs. The NOBOs we can, of course, contact directly and advise them what is going on. The OBOs we have to depend on the broker to pass the information along to the underlying owner of the securities in the brokerage account. The broker has an obligation to do
that, but in my experience, the broker’s primary obligation appears to be to themselves to sell securities. Their primary obligation does not appear to be to pass on “paper” to their beneficial owners (i.e., the brokerage customers), which may result in the securities being taken away from the brokerage. In this particular case we decided to put as much of a hammer on the brokers as we can and communicate with them multiple times between now and year-end when the Subchapter S will consummate. If they fail to communicate with the owner of the shares in the brokerage accounts, then the owners will be cashed out and be none too happy with the broker. Hopefully they will be happy with the bank when we can show them we communicated with the broker multiple times.

**TIME TO SELL**

I had an interesting conversation with a client this week. This is a smaller bank in a rural area. Most of the rural area is dedicated to one type of farming. The client indicated that some of the agricultural producers from out of state came in and scooped up all the farmland, which resulted in elimination of most of the business from the bank. His agricultural customers no longer need to borrow money because they are flush with cash, which is good for them and bad for the bank.

He is wondering if now is the time to sell. I did not quite say it, but my guess is that two or three years ago would have been the time for him to sell. We talked about the fact that he needed to drive core earnings of the bank as best he could and let us put it up for sale. I think he is looking at the beginning of 2018. This coincides with a number of things, including some significant management succession issues, board succession issues, as well as an older shareholder base. We will see if they pull the trigger. If they do, it will be interesting to see if we can find a buyer for that little rural bank.

**THE USE OF SUBORDINATED DEBT**

There is still a significant amount of confusion as to whether in connection with capital planning community banks should look to subordinated debt for their holding company. As I have indicated in prior *Musings*, subordinated debt is generally at a higher rate than straight debt. That is the obvious disadvantage. The advantage is it is usually interest-only for ten years or so, has a five year call, and documentation is fairly simple.

Many community banks are confused (even some with some fairly sophisticated executives) and think that they need subordinated debt because it counts as capital at the holding
company level. Unless your bank is over $1 billion in total assets, you do not need to worry about capital at the holding company level. All you need to worry about is how to generate cash for the holding company that can be used to be either down-streamed into the bank or for other corporate purposes, such as share redemptions and the like. There is no consolidated capital test at the holding company level.

Most of our clients, unless they have cash flow stress, will opt for a traditional bank stock loan or a loan from a rich and smart director. These loans are generally at Prime rate or so.

**MUTUALITY**

Most of the community banks in the country are stock held. Some of them are very closely held by one family or extended family. Some of the stock-held institutions that we work with are also public SEC-reporting companies. Several hundred institutions in the country are in mutual form. They have no shareholders (don’t be too jealous). Mutuals are great. We have worked with a number of mutuals this year and over the last several years. The commitment to mutuality for most of them is paramount. They make a profit like everyone else, pay taxes like everyone (except the credit unions who are also mutuals), and significantly serve their community. I have talked to a lot of stock bankers who wish they could become mutuals, which is not going to happen, but the mutuals seem happy and with a bright future going forward. We generally recommend for mutual banks that they get in a mutual holding company. This is not converting to stock or even a partial first step conversion. This is simply a mutual holding company that they can leverage the exact same way a stock community bank would leverage its holding company to support the growth of the bank or for any other reasonable purpose.

**INCENTIVE PLANS**

We are assisting a number of our clients in relooking at their overall bank incentive plans. In part, this is due to the Wells Fargo disaster. Keep in mind you get what you incent. Keep in mind the Wells Fargo incentive plan also was a wild success. They just incented the wrong thing (i.e., opening accounts for non-existent human beings, among other things). A number of our clients who view Wells Fargo and then view the regulatory pronouncements over the last couple years on incentive plans are relooking at the whole incentive issue. (By the way, if anybody wants a copy of our Memorandum to Clients & Friends about regulatory guidance on incentive plans, just email us.)
Many of the community bank boards considering incentive plans are looking for a way to get ownership in the hands of employees. We are creating a number of omnibus or comprehensive equity or equity-like plans that allow the board to grant incentive stock options to employees, non-qualified stock options to directors or employees, restricted stock (i.e., stock grants) to employees or directors, phantom stock, or stock appreciation rights. The board’s selection of any or all of these often depends on, among other things, the question of whether the board is willing to experience ownership dilution for the holding company’s shareholders. The use of employee stock ownership plans and KSOP plans are also part of the discussion.

The good news we see in all of this is that the boards are currently contemplating what is the best way to look at shareholder value through incenting employees to be and think like owners. That is the fundamental premise.

CONCLUSION

This year has really flown by. It is hard to believe that we are at the middle of May, 2017 already. The good news is that most community bankers that we deal with are optimistic with respect to the future and looking to take advantage of opportunities to appropriately allocate capital. The other good news is spring has definitely sprung in all parts of the country.

See you in two weeks.

Jeff Gerrish and Greyson Tuck