GERRISH'S MUSINGS

Jeffrey C. Gerrish
Greyson E. Tuck
Gerrish Smith Tuck
Attorneys/Consultants
700 Colonial Road, Suite 200, Memphis, TN 38117
♦ (901) 767-0900 ♦ Fax: (901) 684-2339
♦ Email: jgerrish@gerrish.com ♦ gtuck@gerrish.com ♦ www.gerrish.com

October 13, 2017, Volume 354

Dear Subscriber:

Greetings from Kentucky, Florida, Illinois, Missouri, Delaware, Maryland, and South Dakota!

HOW OUR BANK WORKS

I was recently reviewing a file to prepare for facilitating a planning session for a good size community bank. In my normal course of events I typically provide the participants with access to an online questionnaire. They fill out the questionnaire, which gives me a good idea of what some of the issues are at the bank that need to be addressed during the long-term planning session. I was recently reviewing the raw data produced by the answers to the questionnaires in connection with preparing an agenda for the session when I came across one answer to a question about how the bank operated. The answer was, "We operate according to the "Doctrine of Prior Decisions." I fully understand what this meant. This particular individual is answering that their bank operates the way it does because "that is the way it always has" (i.e., the Doctrine of Prior Decisions). I thought that was a nice way to put it.

THE DIFFICULT ACQUISITION

We were recently engaged to assist in the potential acquisition of a small community bank. The interesting thing about this potential transaction is the acquirer's strategy. This is not like most community bank acquisitions where another community bank is buying the target bank to enter new markets, gain size, efficiencies, or the other benefits traditionally associated with acquisitions. Instead, this acquirer wants to use the acquisition of this community bank as a platform that will eventually end up in what can best be described as a fintech company.

During the preliminary discussions on the transaction, I mentioned to our client that the difficulties would be two-fold. First, the target bank is not squeaky clean. It is certainly not in terrible shape, but it is under an enforcement action and is subject to heightened regulatory scrutiny. To get this transaction approved the regulators are going to be keenly interested in what the acquirer is going to do to fix the bank's existing problems on a very quick timeframe. My experience has always been that the regulators want the acquirer of a troubled bank to clean it up in very short order.

Second, the concept of using a bank charter as a platform for a fintech company will likely be met with significant regulatory scrutiny and some public opposition. It is going to be critical for the bank's business plan to be specific as to the exact business activities the bank will engage in and how those activities are appropriate for an FDIC-insured financial institution.

This will certainly be an interesting project for us to work on. We will keep you updated on the progress and whether this acquirer is able to complete the acquisition and use this troubled community bank as a platform for some pretty advanced technologies.

ABANDONING STOCK DIVIDENDS

We have a long-time client that has been issuing stock dividends for a number of years. This particular bank has never paid a cash dividend. The problem with the stock dividend is that this holding company has very little liquidity in its common stock. The shareholders have essentially been getting pieces of paper that say you now have more shares in a company, but they really have not had any opportunity to convert those shares to cash. This has been a nice psychological benefit for the shareholders, but the practical reality is that the stock dividend has not done much for them.

The board has recently come to the conclusion that the stock dividend is really of no benefit to the shareholders. Following this epiphany, the board has changed course and is going to implement cash dividends. The interesting thing is that the board has decided they are going to go through a transitional period where this year they are going to issue a part-stock and part-cash dividend. The board has adopted this transitional strategy to ease the shareholders away from the stock dividend and into the cash dividend. Beginning next year, the holding company is going to pay only a cash dividend. The payment of the cash dividend will go much further toward enhancing shareholder value for the shareholders.

DIVIDEND REINVESTMENT PLANS

I was recently approached by a new client that wanted to talk about the merits of a dividend reinvestment plan. A dividend reinvestment plan essentially allows shareholders the opportunity to forego a cash dividend and instead receive a stock dividend. This seems simple enough in concept, but the legal intricacies of dividend reinvestment plans are complex.

The securities laws view a dividend reinvestment plan as a shareholder having received cash and then making an investment decision to use the cash towards the purchase of company stock. This is an issuance of the company stock that must either be registered or made pursuant to a valid securities registration exemption. This causes a dividend reinvestment plan to present a pretty good amount of legal compliance risks, because you have to be sure to meet the requirements of an exemption in light of all the shareholders that choose to reinvest their cash dividend towards the purchase of stock.

My recommendation to this client was that they stay away from a dividend reinvestment plan. The company is not SEC-reporting, and it is simply too difficult to ensure compliance with a securities registration exemption for the issuance of the shares.

ACQUISITION ESCROWS AND EARN OUTS

We are currently working to assist the owners of a small community bank in the sale of their institution. The deal is very likely going to include some earn outs and escrows for a number of loans in the target bank's loan portfolio. This is a little bit unusual in today's environment because many of the asset quality issues that made escrows and earn outs popular during the height of the economic recession are no longer lingering around today. However, in this particular circumstance the escrows and earn outs make sense, because the owners of the selling bank have conviction in the ultimate collectability of these loans.

If you are thinking about buying or selling a bank, keep in mind that there are a lot of options available at your disposal. Just because many deals today are not including some type of escrow or earn out does not mean that they should not be considered. If it makes sense for your transaction, by all means go for it.

THE GOOD DEAL

I have visited with a lot of boards over the last couple of weeks about the possibility of being a buyer in the current acquisition environment.

I had one director ask me how I could tell if something was a "good" or "bad" deal for them. Although I have done a blog on this (which you can find at BankingExchange.com), the succinct answer is, if the buyer's shareholders are better off after the deal than before, then it fits in the category of a "good deal." This is generally considering a number of metrics, including earnings per share growth, return on equity, share liquidity, cash flow coming off the shares, book value dilution, and consideration of execution risk. Not every community bank acquisition transaction is a good deal, but it is pretty easy to tell when one should be if the execution is appropriate.

THE HOLDING COMPANY STOCK PRICE

How do you make sure that your stock price trades at a reasonable value? For most *Musings* readers, their bank holding company shareholders have no share liquidity through any type of a realistic market. Even those who are listed or traded over-the-counter on the pink sheets really have no liquidity. In fact, I was with a "public company" the other day that was listed on an exchange and was trading at a whopping 1,700 shares a day on average, with at least five days a month having no trades at all.

So for a community bank holding company, how do you maintain a reasonable (north of book value) stock price? The answer is simple: the holding company keeps control of the stock price so that a floor is established. Most companies do this through an ongoing repurchase program. That program will establish a floor on the stock price. If it trades outside through an exchange or a listing service, then typically it will trade at least at that price or higher.

The greatest danger you can have is to let some external market forces create the apparent "value" of your stock at some artificial level. I was recently with a high-performing small public company whose stock was trading on the over-the-counter market at 65% of book value. The problem is they had let external forces control the price of their stock. That clearly was not a realistic value, but it was the only indication of value they had. What happens when they get an unsolicited offer at book value?

In any event, part of our job as directors and officers of our community banks is to create share liquidity and provide support for the stock price at some level at which the board is comfortable.

GOING PRIVATE

I was with a small public company in the last few weeks that was contemplating going private. Most people think I am anti-public company. I am really not. I am anti-wasting money. If you are a small community bank holding company and are a public company, you should only remain in that ownership structure at long as it provides some benefit to the company and its shareholders. Most small public companies do not have any liquidity in their shares, as noted above. They also do not have access to public capital markets. So unless you just have tremendous affection for your lawyers and accountants who want to make sure they can put their kids through college, why would you remain a public company? This is particularly so now that the procedure for becoming a private, i.e. non-SEC reporting company, is to file a short, one-page piece of paper called a Form 15 with the SEC and suspend your public company reporting. This particular company also had a dividend reinvestment plan that will probably need to go by the wayside as well if they suspend registration.

CAPITAL ALLOCATION

I have visited with many of you about our obligations as directors and officers of our community bank holding companies to appropriately allocate capital to enhance shareholder value. I was recently with a Subchapter S that had, in its entire history, only paid out a tax distribution. For those shareholders at less than the maximum tax rate, there was some additional after-tax cash flow associated with that tax distribution. For those shareholders at the higher tax rate, however, theirs was just a pass-through of the tax to the taxing authority. This particular board was deliberating about whether to increase the distribution beyond just the tax distribution. In other words, should they provide a dividend equivalent distribution above the tax distribution. This is simply an allocation of capital issue. If you need all your capital to pay debt service or support the balance sheet growth of the bank, then probably it would not be appropriate to create a dividend equivalent distribution. If you have excess capital, a high capital ratio, the balance sheet is not growing very fast, or no other needs for that capital, then by all means, increase the distribution, even if it is only a one-time special dividend/distribution and may not be maintained for good. As we generally say in our firm, it is the obligation of the board to either provide a decent return on equity or a return of equity to the shareholders through share redemptions or distributions.

CONCLUSION

In connection with the previous issue of *Musings* (September 29, 2017), some of you got quite a surprise. We distribute *Musings* through Constant Contact. Apparently, the link from the email you get to *Musings* through Constant Contact was corrupted so that many of you were redirected to an inappropriate (adult related) website. Although we have heard many of you express to me through email that you "enjoyed it," we did not do it intentionally and have made sure it will not happen again. For those you who were offended by this error on Constant Contact's part, we apologize.

I marvel every two weeks in *Musings* about how quickly the year has gone. It is already mid-October and well into the fourth quarter. We hope everyone has a great two weeks.

Jeff Gerrish *and* Greyson Tuck