



Considering Capital and M&A in the Strategic Plan

2019 Directors Conference

April 16 and 17, 2019

Presented By:
Jeffrey M. Cardone, Esq.
jcardone@luselaw.com
Luse Gorman, PC
www.luselaw.com
(202) 274-2033

Who We Are

Luse Gorman, PC is a law firm that specializes in representing community banks and other financial institutions.

We are a national leader in representing community banks in mergers and acquisitions, capital raising transactions, corporate governance, executive compensation, regulatory and enforcement and general corporate and securities law.

We represent over 250 financial institutions nationwide. Most are community banks ranging from \$100 million to \$30 billion in assets.

Who We Are

- Top 10 law firm in M&A every year since 2001
 - No. 1 in 2009, 2011, 2012, 2015, 2016, 2017 and 2018
- No. 1 law firm nationally in community bank capital raising transactions since 2000
- Largest practice group nationally dedicated exclusively to representing financial institutions
 - 25 Attorneys, including 5 attorneys specializing in executive compensation/employee benefits
 - Represent 250+ financial institutions, 100+ mutual institutions, 90+ SEC reporting companies

Agenda for Discussion

1. Industry Update – How M&A and capital alternatives fit into the strategic plan.
2. M&A fundamentals.
3. Phases of an M&A Transaction – key terms and considerations.
4. Critical Elements of a Successful Transaction/Common Pitfalls.

INDUSTRY UPDATE

Industry Update

Banks, by the Numbers:

- 5,359 FDIC insured banks – down more than 30% in last 10 years.
- Average US bank - \$2.9B (up from \$1.2B in 2005)
- Consolidation expected to continue and reduce overall numbers and lead to increasing average bank size
- Scale will continue to be important as costs increase (highest costs for technology and anti-fraud measures.)
- Small bank replacement wave not expected:
 - De novo activity not robust, small increase, particularly in Southeast. (1 de novo v. 50 mergers in 2019)

Regulatory Environment – Dodd Frank

- Higher capital requirements (Basel III; risk-weighting of assets).
- Additional consumer disclosure and compliance procedure.
- Greater emphasis on corporate governance.
- Unintended consequences:
 - Increased pressure on banks to grow (improve scale).
 - Increased pressure on banks to consolidate (lack of scale).
 - Growth opportunities available to those with “excess” capital.
 - More regulation by enforcement action; downgrading of CAMELS rating.
 - Overall effect – more costly to operate, more capital needed, more emphasis on scale.
- Dodd-Frank rolled back by the Regulatory Relief Act passed in 2018 (“pendulum is swinging back”).

Capital/Health of Banking Industry

- Banks are at their highest capital levels on a macro-level, particularly banks < \$1.0 billion in assets. Good news for regulators and bad news for investors trying to earn a return on capital.
- Regulatory Capital Options Expanded by the Regulatory Relief Act:
 - (1) new community bank leverage ratio: Banks < \$10.0 billion in assets can opt out of Basel III capital framework if tangible equity to total consolidated assets is greater than 9.0%.
 - (2) BHCs and SLHCs <\$3.0 billion are now considered “small bank holding companies” by FRB (so no capital requirements at the BHC or SLHC).

General Reasons for Increased M&A Activity

Despite strong health of banks, M&A is expected to continue for various reasons, including:

- Need to find new sources of earnings and growth.
- Stabilization of credit outlook, slight uptick in credit quality overall.
- Merger more attractive than dilutive capital raise.
- **Older management teams/boards - lack of succession planning.**
- Regulatory costs, particularly technology and anti-fraud/cybersecurity.

Key Takeaways – Strategic Plan

- M&A/consolidation is expected to continue, so there may be opportunities to deploy excess capital/grow.
- Capital is “still king” and it is important to have “gas in the car” to fund future growth (whether organically or through M&A).
- M&A and capital planning should be a component of your strategic plan (even if no imminent plans, it is important to be informed on what is happening).

Strategic Plan - Capital

- Important to understand difference sources of capital:
 - **Common Stock/Equity:**
 - Advantages - Purest Form of Capital/Increases Tangible Common Equity.
 - Disadvantages - Dilution to existing stockholders.
 - **Subordinated Debt:**
 - Advantages - Existing stockholders not diluted; BHC/SLHC can leverage unsecured debt at the holding company and downstream proceeds to bank (which is treated as Tier 1 capital at the bank).
 - Disadvantages - Must “service” the debt; must structure debt as Tier 2 capital if >\$3.0 billion.

Strategic Plan - How to Approach Raising Capital

- Know the goals of your constituencies (shareholders, board, regulators and management) (e.g., create more liquidity for stock or have key customers become stockholders)
- Know the sources of capital (institutional investors, retail investors, board of directors/management)
- What are investors looking for? (Capital appreciation, dividend income, time horizon).
- What is your story/value proposition? (Earnings growth, asset growth, valuation and/or attractive geographic markets).
- What do you want to use the capital for? (support growth, acquisitions, refinance/replace existing debt/equity(SBLF, TARP or debt/trust preferred with higher interest rates)
- Which regulatory capital framework is most advantageous?

Strategic Plan – M&A

- Understand whether you want to be a Buyer, a Seller or just do nothing in the M&A space – this is a conversation that every board should have. Questions that should be asked include:
 - Can we survive and thrive as an independent bank?
 - Do we have the personnel and drive to be a Buyer?
 - Do we operate in a market with organic growth potential?
 - Do we have the capital to support a growth/acquisition strategy?
 - Are we ready to execute an M&A transaction if there is an opportunity?

M&A Fundamentals

M&A – Deal Structure

Important to understand that not all “mergers” are structured the same.

- Purchase and Assumption– Any purchase that does not involve the purchase of the target company’s equity (e.g., branch sales or bulk purchases of loans, along with the assumption of deposits). Taxable transaction to the seller.
- Merger – Purchase of all the target company’s stock/equity. Generally tax-free to seller (but not to stockholders if they receive cash).
 - Traditional Merger – Merge the target bank directly into Buyer Bank
 - Acquisition – Target bank becomes a separate subsidiary of the Buyer Bank’s holding company (allows target bank to have autonomy, although still “controlled” by buyer.
 - Merger of Equals – Buyer has less than 60% control of combined equity after transaction. Seller bank has substantial representation on combined board.

M&A – Deal Pricing

Important to understand that not all deals are “priced” the same.

- Price/Tangible Book Value (“TBV”) – This (and not price/earnings) is the driving metric for bank merger pricing for investors.
- Deal consideration can be all stock, all cash or a mix of stock and cash (or for mutual-to-mutual mergers, there is no consideration).
- Understand for stock transactions, it can set at a “fixed exchange” vs. a “fixed price.”
- Price protections – caps, floors or collars.

M&A – Deal Pricing

- Price to TBV – what is it?

Cash/Invest.	\$75	Deposits	\$400
Loans	385	Borrowings	40
Allowance	(5)	Other Liab.	<u>10</u>
Intangibles	10	Total Liab.	450
Other Assets	<u>35</u>	Equity	<u>50</u>
	\$500		\$500

- Shares outstanding = 2,500,000
- \$3.5 million in earnings in 2018
- $\$50\text{M Equity} / 2,500,000 = \20 book value per share.
- $\$40\text{M Equity (less } \$10\text{M in intangibles)} / 2,500,000 = \16 TBV per share

M&A – Deal Pricing

- Now assume a buyer offers \$26 per share.

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- Shares outstanding = 2,500,000
- \$3.5 million in earnings in 2018
- **A \$26 per share offer equals:**
 - \$65 million deal ($\$26 \times 2,500,000$ shares)
 - 130% of “book” ($\$26/\$20 = 130\%$)
 - **163% of “tangible book” ($\$26/\$16 = 163\%$)**
 - 18.6 times 2018 earnings ($\$3.5\text{M}/2.5\text{M}$ shares) = \$1.40 EPS
 $\$26/\$1.40 = 18.6\text{x}$ earnings.

M&A – Deal Pricing (S&P Global)

Year	Announced Deals	Aggregate Deal Volume (\$millions)	Median			
			Deal Value (\$millions)	Deal Value/Tangible Book (%)	Core Deposit Premium (%)	Deal Value/Earnings (x)
2000	254	93,770	20.2	178	11.2	18.1
2001	251	40,423	21.4	177	9.5	18.7
2002	209	16,944	13.9	166	8.8	19.2
2003	262	72,378	25.4	210	13.7	21.3
2004	269	130,777	31.5	221	15.3	22.5
2005	269	29,181	27.3	223	16.4	22.6
2006	300	108,868	25.1	230	18.0	22.6
2007	285	71,402	26.7	214	15.5	22.6
2008	144	35,606	13.5	160	9.4	22.7
2009	110	1,308	7.3	117	1.9	18.3
2010	181	10,011	10.0	120	3.0	22.2
2011	150	17,150	15.5	109	1.1	25.3
2012	221	12,824	18.0	117	2.4	18.6
2013	224	14,391	25.4	124	3.4	18.8
2014	282	19,003	32.5	135	5.0	21.3
2015	278	24,510	29.7	137	5.7	22.3
2016	240	26,800	31.1	133	4.6	20.2
2017	260	26,466	46.9	160	9.1	22.7
2018	259	29,649	54.1	170	9.6	23.9

M&A – Deal Pricing (S&P Global)

2018 Regional Details	Announced Deals	Aggregate Deal Volume (\$millions)	Median			
			Deal Value (\$millions)	Deal Value/Tangible Book (%)	Core Deposit Premium (%)	Deal Value/Earnings (x)
Midwest	115	8,761	34.0	160	8.1	19.8
Southeast	52	8,812	44.7	176	10.1	25.1
Southwest	37	4,233	59.8	188	9.4	20.9
West	23	3,288	76.6	191	11.4	26.3
Mid Atlantic	20	2,399	57.5	164	8.8	24.6
Northeast	12	2,156	95.2	176	13.0	32.4

M&A – Deal Pricing

Pro Forma metrics – (1) EPS Accretion/Dilution; and (2) TBV Per Share Dilution.

- EPS Accretion/Dilution – Does the earnings per share on a combined basis (net cost saves) exceed the Buyer's earnings per share on a standalone basis? (most deals are accretive within the first 12 months after the transaction)
- Tangible Book Value Per Share Dilution – How much are Buyer Stockholders' ownership interest going to be diluted on a combined basis? When will EPS accretion eliminate the tangible book value per share dilution? (i.e., the earn back period).

The form of consideration to be paid for a target bank's stock (buyer stock v. cash) will impact the pro forma metrics.

M&A –Types of Consideration

Understand Fixed Price v. Fixed Exchange Ratio

- Fixed Price - The total number shares of Buyer to be issued in transaction depends on the Buyer's market value at closing. (Seller does not participate in upside/downside of Buyer).
- Fixed Exchange Ratio – Seller receives a fixed number of Buyer shares for each share of seller.
 - Most common structure because pro forma calculations can be calculated because the number of shares to be issued by the Buyer is fixed (i.e., deal economics are locked in).
 - Seller participates in upside/downside of Buyer.
 - Combo of cash w/ fixed exchange ratio for more price certainty.

M&A – Understand Board Fiduciary Duties

Is there a duty to sell?

- The board does NOT have a duty to accept an acquisition proposal offer (even if the offer contains a premium over market price).
- The board may determine in good faith that being independent is in the long-term best interest of the company.
- The board is not obligated to abandon a corporation's strategic plan for short-term stockholder profit.
- Directors are not obligated to facilitate a sale of the corporation.

M&A – Understand Board Fiduciary Duties

Is you decide to consider a sale of the bank, do you have to take the highest offer?

- No, unless there is a “sale of control.”
- If a “sale of control” occurs, the Seller Board must exercise its fiduciaries to obtain the best price reasonably available for stockholders (“Revlon duties” – Delaware case law followed by most states).
- “Sale of control” – a cash transaction or a transaction which results in a controlling stockholder.
 - A stock-for-stock merger is generally not a “sale of control” (seller stockholders are “investing” in buyer).
 - Hybrid merger with significant cash consideration is a “grey area.”

PHASES OF AN M&A TRANSACTION

Life Cycle of a Merger Transaction

- Planning phase.
- Due diligence of potential target bank.
- Negotiating/executing a definitive merger agreement.
- Required regulatory and/or stockholder/depositor approvals, depending on type of transaction.
- Closing of the transaction/integration of target bank/employees/customers.

Planning Phase - Buyer

- Consider possible acquisition targets and market areas for expansion.
- Consider who your M&A competitors are and their ability to pay, particularly if you are only willing to pay cash.
- Pricing analyses by investment banker enable management and the board to be informed and make informed decisions (are you going to offer stock or cash/how much can you pay/do you have the necessary capital?)
- Should you have a relationship with an investment banker/should your business plan be updated?
- Know your shareholders/take into account shareholder concerns (e.g., tangible book value dilution or would deal create more liquidity for your stock?)

Planning Phase - Buyer

- Buyer needs to address any unresolved supervisory issues and communicate with your regulator regarding your strategic plans
 - Have all MRAs in most recent ROE been addressed?
 - Any outstanding regulatory action, whether a formal action or MOU, may be a bar to regulatory approval
 - A less than satisfactory compliance or management rating may prevent a Buyer from obtaining approval, even if overall CAMELS rating is “2” or better
- Keep in mind that it is not uncommon for a regulatory examination to occur between the date a deal is announced and the closing date – this adds to deal uncertainty.

Planning Phase - Seller

- Understand what you can realistically get in terms of pricing.
 - Board and management need to manage expectations, not just assess market pricing but what bank is really worth and to whom (e.g., geographic location, earnings, excess capital impact pricing).
 - Understand that for stock deals (as compared to cash deals) you are not selling the bank – you are trading/investing into another currency.
 - Understand that the highest price is not always the best price - a stock deal that is too good for the seller may adversely affect the currency of buyer and, therefore, hurt merger consideration received by seller.
 - Know your shareholders/what do they want? (liquidity v. future investment in another currency).

Planning Phase - Seller

- Have counsel review and update all employment and change-in-control agreements and benefit plans
 - Do this before process is underway and certainly before transaction is announced.
 - Important to quantify severance costs and potential adverse tax consequences.
- Executive compensation and employee benefits are important components of every transaction and involve tax, accounting, ERISA, legal and regulatory issues
 - Golden Parachute Rules (Part 359; IRC §280G); Deferred Compensation Limitations (IRC § 409A)

Planning Phase - Seller

- Understand the termination costs of significant contracts, e.g., data processing, SERP agreements.
- Make sure your directors understand their fiduciary duties
 - Duty of loyalty, duty of care; cash transaction versus stock or part cash/part stock transaction.
- Consider any regulatory/ROE issues that could impact transaction.

Planning Phase – Social Issues

Principal Social Issues:

- Board and committee composition:
 - Combine boards based on equity, assets, income contribution.
 - Separate boards.
- CEO/key officer succession:
 - Who will be the CEO, CFO
 - Affected by retirement and succession plans
- Chairman/Vice Chairman of the Board
- Name of resulting bank and headquarters

Planning Phase – Social Issues

- Branch Closings and Business Line Consolidations
- Combine or Keep Banks Separate:
 - Understand costs of keeping separate banks.
 - Consider concept of a “division” of acquirer.
- Compensation and Benefits:
 - Employee and directors plans and payments.
 - Pre - and post merger arrangements.
 - How will you incentivize key target employees to remain employed until closing/systems conversion date?

Marketing Process and Strategy

Several solicitation processes that can be utilized by a seller for an M&A transaction:

- Strategic combination
 - Exclusive negotiation with single buyer that presents a unique, strategic opportunity. Consideration must be primarily stock; very common for mutual-to-mutual mergers.
- Limited shop (most common)
 - Contact a carefully selected limited number of potential buyers who are determined to be most interested in a transaction and have the ability to pay the highest price
- Private auction (very rare)
 - Contact a wider pool of potential buyers on a confidential basis.

Limited Shop Solicitation

- Board approves parties to contact (parties selected are based on 1) ability to pay; 2) prior acquisition activity; 3) ability to execute; and 4) prior expressed interest).
- Investment banker contacts parties and requests each to enter into confidentiality agreement.
 - Parties are provided with a “solicitation book” or confidential information memorandum about the target bank.
- If interested, Buyer provides a “non-binding indication of interest” or letter of intent.
 - Sets for key business terms (price, structure, etc.)
 - Sets forth key social issues (board seats, officers)

Due Diligence

- Generally there is an “exclusivity period” to “look under the hood” and conduct due diligence of target bank before signing merger agreement.
- Review loan portfolio/asset quality.
- Understand adverse regulatory issues of target bank.
- Review board/key committee minutes.
- Management interviews of target bank (i.e., ask questions about business, reports of examination and CAMELs ratings).
- Vendor agreements/termination fees.

Due Diligence

- Must be thorough before signing - typically very high standard to terminate (Material Adverse Effect - MAE) for errors in representations.
- Diligence findings may: kill a deal, substantially affect pricing, or result in special merger agreement terms.
- Seller loan portfolio usually biggest diligence/pricing issue, also benefit plans and contract termination costs.
- Buyer financial advisor and/or counsel will prepare a "due diligence list" and deliver to seller.
- Seller will respond/set up a virtual data room or produce copies/schedule off-site review. Buyer will typically have key officer interviews.
- Seller will do due diligence on the Buyer, particularly if currency is stock.
- Diligence will continue up until signing of the merger agreement.

Due Diligence – Areas of Concentration

- **Legal / Regulatory**
 - Regulatory/compliance
 - Benefit plans cost and termination/integration
 - Significant contracts
 - Corporate structure
- **Financial**
 - Balance sheet valuations – loan portfolio, securities portfolio, deposit base, borrowings
 - Cost savings; earnings dilution/accretion; book value dilution/accretion; earn back
 - Pricing determinations – stock/cash; caps/collars
- **Cultural / People**
 - Assessing “fit” and caliber of people you are acquiring for purposes of potential integration and what you are actually buying

Negotiating/Entering into Merger Agreement

- Key provisions of a typical merger agreement:
 - Price/price adjustments (if target is stock bank)
 - “Walk” provisions.
 - Social issues – board of directors; senior management; employee benefits; severance payments; etc.
 - Due diligence protection provisions – representations and warranties (i.e., factual statements about seller in writing as of signing)
 - Restrictive covenants (i.e., restrictions/rules from signing until closing).
 - Termination fees and “no-shop” provisions (limits seller’s ability to shop the company for a better bid).
 - Conditions/shareholder approvals/regulatory approvals.

Regulatory Approvals

Regulatory approval is needed from federal/state regulator of Buyer Bank (Seller Bank's regulator generally not involved).

Regulators generally consider:

- Effect on depositors and shareholders.
- Effect on competition, deposit concentrations, and public convenience.
- Pro forma capital ratios/financial impact.
- Regulatory compliance (CRA, BSA especially).
- Protection of depositors.
- Compensation plans and programs and severance payments.

Closing of the Transaction

- Complete all closing items required to consummate the merger.
- Payment of the merger consideration to shareholders (if acquiring a Stock Bank).
- Payout of change in control benefits, as required by contracts and arrangements of the target institution.
- Integration of Seller Bank with Buyer Bank - Systems Conversion is paramount.

Critical Elements of a Successful Transaction/Common Pitfalls

Getting The Deal Done – Take-Aways

- Current banking landscape offers Buyers, particularly those with a strong stock currency, opportunities to expand their franchise and enhance value through acquisitions.
- Earnings, pressures, regulatory/compliance costs, and the impact of technology will continue to make it more difficult for banks to compete and be profitable (which will affect smaller banks disproportionately), which will continue to generate consolidation.
- Both Buyers and Sellers need to have their “regulatory houses” in order before beginning the deal process.
- Planning is essential for both Buyers and Sellers.

Identify Key People

- Identifying and locking up key people (Seller)
 - Need to incent key players to stay through sale process and closing well in advance of sale discussions.
 - Delicate balance between providing too much leverage and running risk of defections.
 - Consider employment/change in control agreements for officers.
- Identifying and locking up key people (Buyer).
 - Need to identify through due diligence interview process.
 - Need to lock up (as best possible) before merger agreement is executed (e.g., non-compete).

Execution and Delivery

- Promptly file regulatory applications and address significant diligence and regulatory concerns.
 - Time period between filing and approval is shortening.
- Employee integration and satisfaction is key to customer retention.
- Deliver to shareholders
 - Under promise and over deliver as to cost savings, earnings accretion and book value dilution earn back.

LUSE GORMAN, PC

ATTORNEYS AT LAW

TELEPHONE (202) 274-2000

FACSIMILE (202) 362-2902

www.luselaw.com