Community Bank Update

2020 VIRTUAL CONVENTION

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Who We Are

- Largest practice group nationally dedicated exclusively to representing community banks.
  - 22 Attorneys.
  - Areas of focus: (1) corporate; (2) regulatory and (3) executive compensation/benefits, with an emphasis on transactions.
  - Represent 350 financial institutions, 70+ SEC reporting companies.

Some of Our Accomplishments

- Top law firm in number of community bank M&A transactions since 2000
  - ➢ No. 1 for last five consecutive years (completed over 100 community bank merger transactions during last five years)
- No. 1 law firm nationally in community bank capital raising transactions since 2000.
  - ➢ Completed 10 common stock offerings in 2019 alone (1/3 of all common stock capital raises for community banks).
  - ➢ Top 5 law firm in subordinated debt and preferred stock offerings for community banks.

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Agenda

- Mergers and Acquisitions Update
- Regulatory Update
- Capital Planning and Trends
- More Measured Acquisitive Growth Strategies

Mergers and Acquisitions Update

Industry Update

Banks, by the Numbers:

- Less than 5,200 FDIC insured banks - 35% decrease in 15 years.
- Average bank size more than doubled in past 10 years.
- Consolidation expected to continue and reduce overall numbers and lead to increasing average bank size.
- COVID–19 will likely amplify and may accelerate consolidation and need for scale, may create opportunities for well capitalized banks.
- While banks remain more capitalized than ever, capital continues to remain “king.”   It is important to avoid “just in time” capital, particularly in the COVID-19 era.

Industry Update

Current Market Trends in the age of COVID-19:

- Forbearances in loan portfolios has created uncertainty about asset quality in many banks.
- Banks substantially building Allowance for Loan Losses.
- PPP loans driving loan and deposit growth at many banks.
- Bank stock prices depressed and, in many cases, trading below TBV.
- All announced merger activity has slowed but discussions continue.
- Few common stock capital raises.
- Uptick in sub debt and preferred stock offerings by banks to build capital.
- Implementation of cost cutting measures to combat NIM compression, goodwill impairment and increased provisions.

Why the Underperformance of Banks?

- Net Interest Margin (NIM) outlook/earnings compression.
- Reserve build signaling future credit losses (driven by uncertainty of loan forbearance on asset quality/loan portfolio).
- Capital adequacy to withstand charge-offs/further market downturn.
- Dividend/stock repurchases outlook.
- Even as COVID-19 abates – focus will need to be on increasing book value (which is primarily driven by ROE).

M&A Update

- Not surprisingly – M&A down substantially in 2020 (74 mergers YTD; compared to 270 mergers in 2019).
- Declining stock prices has significantly limited buyers' ability to utilize their currency to fund transactions.
- COVID-19 uncertainty – hard to gage pro forma deal metrics - potential goodwill impairment, earnings accretion, TBV dilution and earnback of the TBV dilution.
- Expect curbed transaction flow for near future, although deal-making is happening during the pandemic (MOEs and cash deals).

Deal-Making During COVID-19 – Lessons Learned

Due Diligence

- Must be thorough before signing – typically very high standard to terminate (Material Adverse Effect - MAE) for errors in representations (Added Importance During COVID-19).

- Diligence findings may kill a deal, substantially affect pricing, or result in special merger agreement terms.

- “Credit mark” on seller loan portfolio usually biggest diligence/pricing issue, particularly given the uncertainties of COVID-19 on the loan portfolio.

Deal-Making During COVID-19 – Lessons Learned
<u>Due Diligence</u>

COVID-19-Specific Diligence:

- Emphasis must be placed on potential asset quality issues (need firm grasp of seller's loan modifications/the potential for borrowers to stay current).
- Focus on potential exposure to higher risk industries (retail, hospitality and restaurants).
- Impact of pandemic on liquidity – any increased draws by target on lines of credit; have there been significant changes in deposit activity?
- Did seller adequately determine its ALLL (i.e., will there need to be an increased credit mark on the seller's loan portfolio).
- Need to work through logistics of diligence in light of travel and social distance restrictions and public safety concerns.

Deal-Making During COVID-19 – Lessons Learned

Regulatory

- Pre-filing meeting with regulators important, especially for buyer.
- Comprehensive evaluation of how the pandemic and current economy will impact the resulting institution must be fully documented in the regulatory application process.
- Increased focus by regulators on credit quality deterioration and pro forma capitalization of the resulting institution.

Deal-Making During COVID-19 – Lessons Learned

Merger Agreement Provisions

- Representations and Warranties: Need to adequately address the economic current environment (confirm more extensive due diligence).
- Business Operations of Seller Between Signing and Closing: Seller may need business flexibility to act outside the "normal course of business" with respect to deferring interest and principal payments of a borrower/customer.
  - ➢ Important that flexibility/changes do not fundamentally change the balance sheet/earnings outlook of seller.

Deal-Making During COVID-19 – Lessons Learned
Merger Agreement Provisions

- Material Adverse Effect: Need to be carefully crafted to capture or exclude the impacts of COVID-19, as appropriate.
- Price Protections: Stock deals may cause Seller to focus on price floors, which may lead to more negotiations related to caps, floors and collars for stock consideration.
  - Important that flexibility/changes do not fundamentally change the balance sheet/earnings outlook of seller.
- Minimum Equity Threshold: Established to protect against asset quality deterioration of the seller (could result in a price reduction or "walk away" right for the buyer).

M&A Future Outlook

Potential Drivers of Consolidation

- Economies of scale – to cut costs and have more volume/larger loans to enhance earnings and valuation.
- Succession Planning (or lack thereof).
- Regulatory costs and burdens (which may be enhanced depending on long-term effects of COVID-19 and the 2020 election).

M&A Future Outlook

- Reduced trading prices for financial institution stocks has weakened currency of traditional acquirers to effect acquisitions.
  - Companies with lower trading multiples cannot offer higher premiums, as they will face dilution that the market will penalize.
- Tangible book value dilution is a key factor in pricing for a community bank buyer.
  - Earn back period affects ability to pay and market reception to transaction for buyer.
- Earnings per share accretion/dilution is also critical.
- Cost saves can be critical in pricing analysis.

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M&A Future Outlook

- Likely to see increased MOE/strategic stock mergers, depending on right circumstances:
  - ➢ Strong mutual commitment/must understand the pros of price restraint;
  - ➢ Social issues adequately addressed; and
  - ➢ Focus on long-term value grounded in good faith estimates (and not short-term market fluctuations).
- Uptick in cash deals – provides selling shareholders pricing certainty.
- Well-capitalized banks and credit unions (w/ strong ability to pay cash) will be players.

Regulatory Update

Regulatory Update

Modest Regulatory Relief For Community Banks Since 2016 Election:

- Regulatory Relief Act of 2018 - Modest Rollback of certain Dodd-Frank provisions
- Other Relief:
  - "Change in tone" at the leadership levels of the regulatory agencies.
  - More streamlined regulatory approval application process.
  - Move from a "one size fits all approach" to regulation. Examples:
    - CRA Reform – Interim Final Rule from the OCC and FRB.
    - Brokered deposit regulatory framework modification (proposed FDIC rule).
    - BSA beneficial ownership/fifth pillar relief.
    - SAFE Banking Act – House Bill passed providing safe harbor for banking cannabis-related businesses.

2020 Presidential Election

<u>Trump Reelection</u>:

- Likely to be emboldened and more assertive on deregulatory measures (qualified by the potential long-term effect of COVID-19).
- Less uncertainty for leadership of key regulatory agencies push for less stringent capital requirements for smaller institutions (<$10 billion); e.g., permanent 8% community bank leverage ratio
- Larger bank acquisitions likely to continue (more streamlined application/approval process likely).
- Taxation of Credit Unions?

2020 Presidential Election

Biden Election:

- Questionable how he would govern regarding economic policy and bank regulation – dependent upon influence of liberal wing of Democratic party.
- Push for FRB/regulators to address racial/gender/income inequality issues.
- Appointment of regulators who would support stricter rules (and change tone).
- Greater emphasis on consumer protection; strengthening of the CFPB.
- Potentially more stringent capital requirements.
- Likely more challenging environment to get larger bank merger deals completed (possibility that CFPB approval would be needed).
- Taxation of Credit Unions?

Capital Planning

Capital Plans

Purposes/why?

- Increased importance due to the potential adverse effects caused by COVID-19.
- Helps identify timing of capital needs to avoid "just in time" capital.
- Provides management with reference points for capital alternatives and sources of capital.

Capital Plans – Risk Management

1. **Identifying and Evaluating Risks:**
   - How do potential material risks impact the bank's overall capital adequacy (i.e., credit, operational, interest rate and compliance risks)?
   - EX) High concentrations of CRE; rapid rates growth without appropriate changes to staffing; entering new lines of business without well-defined strategy; COVID-19 pandemic.
2. **Setting and Assessing Capital Adequacy Goals That Relate to Risk:**
   - Recognize short-term/long-term capital needs.
   - Riskier business plans, higher risk exposure, growth plans and /or less access to capital all require higher capital levels.
   - Prepared for changes to financial/economic environment?

Aligning Capital Plan with Strategic Plan

Offensive Capital Planning

- Supporting growth (organic and by acquisition).
- Providing more liquidity in stock.
- Strategically having new shareholders beyond board room (e.g., key customers of the bank).

Defensive Capital Planning

- Serve as a source of strength in case of adverse consequences related to COVID-19 (i.e., increased loan loss provision or goodwill impairment).
- Recalibrate the balance sheet.

Capital Planning - Considerations

- **Know the goals of your constituents** (shareholders, board and management) (offensive capital and/or defensive capital)
- **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(e.g., debt/trust preferred with higher interest rates)
- **Which regulatory capital structure is most advantageous?**

Capital Structure Consideration - Community Bank Leverage Ratio

- Community Bank Leverage Ratio –Pursuant to the CARES Act final rule issued by the banking regulators in August 2020 temporarily revised the CBLR threshold to 8.0% for 2020, 8.5% for 2021 and reverting back to 9.0% on January 1, 2022.
- Effective Date: Second Quarter 2020.
- Under the Final Rule:
  - Qualifying Criteria: Banks with less than $10 billion in consolidated assets and that have a CBLR greater than 8% can elect to opt out of the Basel III regulatory capital framework and into the CBLR framework (no risk-based capital calculations).
  - PCA: If qualifying criteria satisfied, the electing bank will be deemed "well-capitalized."
  - CBLR Ratio: Tier 1 Capital/Average Total Consolidated Assets.
  - On-Going Compliance:
    - If qualifying criteria no longer satisfied (but CBLR is greater than 7%), there is a two-quarter grace period to either meet the qualifying criteria or to comply with the generally applicable capital rules (i.e., Basel III).
    - No grace period if CBLR is 7% or less or qualifying criteria not satisfied due to a merger/acquisition.

Capital Structure Consideration- Small Bank Holding Company Policy Statement

- BHCs and SLHCs with less than $3.0 billion in assets are generally considered "small holding companies" for purposes of the FRB's Small Bank Holding Company Policy Statement.
- No minimum holding company capital requirements if < $3.0 billion in assets.
  - BHC/SLHC is deconsolidated from the subsidiary bank in determining whether minimum capital ratios are satisfied.
  - BHC/SLHC can leverage debt at the holding company level and downstream cash proceeds to the subsidiary bank (which would be treated as Tier 1 Capital at the bank-level) without it adversely affecting regulatory capital ratios.

Sources of Capital – Subordinated Debt

Prevalent source of capital for community banks during COVID-19. Why?

- Quickly enhances regulatory capital amid current economic downturn (offering can be completed in a few weeks).
- <$3 Billion in Assets – debt deconsolidated from bank for regulatory capital purposes.
- Pricing (i.e., interest payable on debt) is cheap given low interest rate environment.
- Politically feasible - Unlike common equity – shareholders are not diluted.
- Interest payments on debt are tax deductible (unlike dividends).

Sources of Capital – Subordinated Debt

<u>Structure of Debt Instrument</u>

- Debt is unsecured
- Tier 2 Treatment at BHC level; Tier 1 Treatment of cash proceeds downstreamed to the bank.
- For Tier 2 treatment – requires minimum 5-year period with no call right. Typically 10-year term.
- Fixed interest rate during 5-year period and then becomes a floating rate.
- Amount treated as Tier 2 Capital decreases by 20% per year during last five years.

<u>Issues to Consider</u>

- Requires minimum 5-year with no call right. Typical 10-year term.
- Amount treated as Tier 2 Capital decreases by 20% per year during last five years.
- Debt-to-equity ratio concerns at BHC level for BHCs with less than $3 billion in total assets.
- Must be able to service the debt.

Sources of Capital – Subordinated Debt

Offering Process

- Generally structured as a private placement issued to accredited investors
  - ➢ Sub-Debt Investors: (1) Banks; (2) Insurance Companies; and (3) Asset Managers.
- Individual Note Purchase Agreements and Notes issued to investors.
- Placement Agent is engaged to obtain optimal pricing.
  - ➢ Characteristics influencing pricing: (1) asset size; (2) credit quality; (3) financial performance; and (4) bond rating.
- Engagement of a Paying Agent/Settlement Agent to administer the Sub Debt.

Rating Considerations

- Obtaining a rating can increase an issuer's investor universe and help obtain more competitive interest rates.
- For smaller deals (<$20M) – rating may not be necessary.
- Rating agencies: (1) Edgan Jones; (2) KBRA and (3) S&P Moody's Fitch.

More Measured Acquisitive Growth Strategies

More Measured Acquisition Strategies

Branch Acquisitions

- Branch consolidation occurring by larger institutions as a result of cost savings initiatives, which has been accelerated by COVID-19.
- Opportunity for smaller banks to capitalize on branch closures with a branch acquisition (core deposits are still valuable, regardless of the environment).

Fee-Based Business Acquisitions

- Worthwhile use of capital to diversify earnings and enhance valuations (reimagine the traditional banking business model).
- Combat NIM pressures; source of revenue that is not reliant on margins and greater opportunity to capture more market share/cross-sell products.

Branch Acquisitions – Key Considerations

- Purchase Price: Deposit Premium paid on deposit liabilities, plus the book value of other tangible assets (i.e., equipment, ATM machines, etc.)
- Other Aspects: (1) loans included?; and (2) real estate or assuming lease?
- Similarities to Whole Bank M&A: (1) Purchase Agreement (P&A); and (2) Regulatory Approval Process.
  - P&A Agreement should be well-crafted regarding logistics of settlement of payments of purchase price and pro-ration of certain shared expenses.
- Consider potential runoff of customers: Need to understand the types of customers (i.e., form of deposit liabilities) being acquired (i.e., conducting in-branch transactions v. "mobile-first" customers).
  - Minimum Deposit Balance at Closing may be warranted.
- Attracting Key Branch Employees is Important: Key customer facing employees may be needed and buyer should have access to the employees prior to closing.

Fee-Based Business Acquisitions – Key Considerations

Purchase Price

- Need to understand how fee-based businesses are valued.
- Generally valued based on a multiple of EBITDA (i.e., income-based approach) based on expected future earnings potential.
- Other factors – working capital adjustments, earnings accretion and ability to gain more market share/cross-sale.

Earn-Out

- % purchase price is paid at closing and remaining % is paid over a designated post-closing period.
- Serves dual purpose: (1) reduces risk of buyer overpaying for underperforming business; and (2) offers seller the opportunity to receive a higher purchase price (and incentivizes seller to assist with the integration).

Fee-Based Business Acquisitions – Key Considerations

Purchase Agreement

- Basic financial parameters of deal need to be well-defined.
- Earn-out needs to be well crafted/precisely reflected in agreement. Should address:
  - Whether certain post-closing revenues/expenses would be adjusted or exempted from earn-out calculation.
  - Defining the continuing line of business/revenue stream that would be subject to the earn-out (particularly if seller is not stand-alone sub or division of bank).
  - Procedures for verifying the earn-out payment; dispute resolution mechanism.

Fee-Based Business Acquisitions – Key Considerations

Due Diligence

- Significant time must be spent verifying the key financial metrics/sustainable earnings of seller.
- Need to assess impact of selling shareholders and key executives on seller's profitability and continuity of key employees.
  - Employment Agreement/Non-Compete Agreement may be needed.

Structure

- Typically structured as a P&A transaction instead of a merger/stock purchase.
- P&A has certain tax benefits: (1) stepped up basis in the assets received and (2) goodwill created can be deducted and amortized.
- For P&A – since bank is not a successor in interest, third-party consents for assigned contracts will likely be needed.

Fee-Based Business Acquisitions – Key Considerations

Regulatory Considerations

- If seller is acquired directly by bank (and not operated through an operating subsidiary) – prior approval of FDIC will be needed.
- If an operating/financial subsidiary is utilized to hold/operate the acquired business, a notice filing with the bank's federal or state regulator may be needed.
- If acquired business is operated as a subsidiary of the holding company, a financial holding company election may be needed (for businesses engaging in broader powers than generally permitted directly at the bank level).

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