Community Bank Update

2021 Virtual Bank Directors Conference

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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 300 financial institutions nationwide. Most are community banks ranging from $50 million to $30 billion in assets.

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Who We Are

- Top 10 law firm in M&A every year since 2001
  - No. 1 in 2020, 2019, 2018, 2017, 2016 and 2015
- No. 1 law firm nationally in community bank capital raising transactions since 2000
- Largest practice group nationally dedicated exclusively to representing financial institutions
  - 21 Attorneys, including 18 Partners
  - Represent 300+ financial institutions, 100+ mutual institutions, 70+ SEC reporting companies; 40 + NY banks.

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Agenda for Discussion

1. M&A and Capital Market Updates

2. Regulatory Environment

3. Compensation – Impact of COVID-19 on Performance Metrics

M&A AND CAPITAL MARKETS UPDATES

Current Bank M&A Environment

- Not surprisingly – M&A generally down substantially in 2020/2021
- The major "reasons" to downturn
  - Declining stock prices has significantly limited buyers' ability to utilize their currency to fund transactions.
  - COVID-19 uncertainty – hard to gauge pro forma deal metrics - potential goodwill impairment, earnings accretion, TBV dilution and earnback of the TBV dilution.
  - Impact of fed government/pumping money into the economy (are near-term earnings artificial?)
- <u>Biggest concern</u> – margin compression and impact on core earnings
- Larger bank merger transactions happening – Regional Banks looking to challenge the "big 4."

M&A Emerging Trends

Merger of Equals/Strategic Stock Mergers

- Primary consideration is stock
- Minimum premium (focus is long-term value of combined companies)
- Substantial representation of target bank board & management.

Challenges:

- Strong mutual commitment/understand the pros of price restraint
- Making the social issues “work” (two parties are never truly equal)
- Finding “sweet spot” on pricing (balance of earnings accretion/cultural v. having enough cost saves to make the numbers work).

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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

M&A – Deal Pricing

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

- <u>EPS Accretion/Dilution</u> – 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)
- <u>Tangible Book Value Per Share Dilution</u> – 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 Emerging Trends

Cash Transactions

- Provides selling shareholders with pricing certainty.
- The roles of the two parties are more clear-cut/defined (less expectation on social issues; asset disparity between the parties is greater).
- Short-term valuation of seller is more important (since no long-term upside/"reinvestment" in the combined institutions).
- Well-capitalized banks can be players.
- Expect more credit union acquisition activity.

M&A Emerging Trends – Measured Acquisitions

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).
- Needs to be well-crafted in the Purchase Agreement (performance period/metrics well-defined; dispute resolution mechanisms).

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).

Prevalent Sources of Capital – Subordinated Debt

<u>What is it?</u>: Legally – it is a debt security. Practically speaking, it is a series of borrowings from investor lenders by the holding company/bank that receives favorable regulatory capital treatment (if certain requirements are met).

<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.

<u>Issues to Consider</u>

- 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.

Prevalent 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.

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.

What to do next/strategic considerations?

1. Understand/refresher on your 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.

What to do next/strategic considerations

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.”

Pricing/valuation considerations

- 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).

What to do next/strategic considerations?

2. Maximize your "tools in the toolbox."

Optimal corporate structure?

- Holding company to better facilitate raising capital or merger transactions?
- Operating/financial subsidiaries for non-bank transactions?
- Assess charter (state v. federal; savings v. commercial/national bank; mutual v. stock)?

Align Capital Plan w/ Strategic Plan

- Support growth; provide liquidity stock;
- Mitigate "just in time capital"

What to do next/strategic considerations?

3. Get your regulatory house in order

- Need 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
- For strategic transactions – regulators will focus on pro forma capital levels (deal assumption credibility is important).

What to do next/strategic considerations?

4. Incentivize your key executives/employees

- Can be achieved through compensation/benefit arrangements (employment/change in control/severance agreements and equity plans). Should be in place well in advance of a deal.
- 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)
  - Have counsel review and update all employment and change in control agreements, SERPs, etc. before any process is underway/a transaction is announced.

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What to do next/strategic considerations?

5. Succession Planning

- Important that succession planning has a “home”, and the board understands its roles and responsibilities with the process.
- Shareholder succession greatly important.
- Can bank provide a liquidity event to selling shareholder without selling?
  - ESOP could be an effective tool.
  - Raise capital to buy back stock.
  - Succession plan should be aligned with strategic plan.

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.

Impact of COVID-19 **(causing regulatory uncertainty)**

- Banks substantially building ALLL as forbearances in loan portfolios has created uncertainty about asset quality.
- Bank stock prices are depressed/trading below TBV
- Core earnings flattening – NIM compression and increased provisions.

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 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, particularly with the impact of COVID.
- Likely more challenging environment to get larger bank merger deals completed (possibility that CFPB approval would be needed).
- Taxation of Credit Unions?

Likely Regulatory Focus

1. Consumer Protection

- NYSDFS has been really focused on fair lending issues.
- Be careful with more “high risk” consumer-related matters (i.e., indirect auto lending, fee-based income from overdrafts).
- Greater emphasis from CFPB – more resources being invested/staff being hired (could trickle down down to community banks).

Likely Regulatory Focus

2. Cybersecurity/Vendor Management

- Proposed Rule – Must notify primary federal regulator of certain "computer-security incidents" within 36 hours.
  - EX) (1) disruption of customer access for more than 4 hours; (2) widespread outages to core banking platform; (3) computer hacking incidents that disable banking operations; (4) material malware attacks.
- Important/be mindful of "unauthorized access" of customer information (may not be a breach under federal law but may require notification to NY/other state attorney generals per applicable state law).
- Governance is important/board needs to be informed of cyber incidents/risks.

Likely Regulatory Focus

3. Capital Planning/Capital Adequacy – Risk Management

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; entered new lines of business without well-defined strategy; COVID-19 pandemic.

Aligning Risks with Capital Adequacy:

- Assess access to capital and sources that are feasible. Evaluate "affirmative" capital raising measures (i.e., issuing stock v. debt) v. "defensive" capital raising measures (i.e., selling branches or business units; limiting growth).
- Important to consider financial/economic environment and stress test (e.g., prolonged NIM compression).
- Regulators will expect higher capital levels beyond minimum thresholds, particularly if engaged in riskier behavior.
- Board oversight is important and that capital expectations/goals/risk tolerances are documented.

Capital Planning - Considerations

- **Know the goals of your constituents**
  - ➢ shareholders, board and management
  - ➢ offensive capital and/or defensive capital
- **Know the sources of capital**
  - ➢ Board; local community/customers; institution shareholders
  - ➢ Understand what is feasible in terms of capital?
- **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).
  - ➢ Strategic goal may determine type of capital raised (debt v. common equity)
- **Which regulatory capital structure is most advantageous?**
  - ➢ Community Bank Leverage Ratio Framework v. Basel III.
  - ➢ Should you have a holding company if you don't have one?

COMPENSATION – IMPACT OF COVID-19 ON PERFORMANCE METRICS

Compensation Planning During COVID-19

- Three approaches to consider if adjusting performance results due to COVID-19:
    - Adjust actual performance results to exclude the effects of COVID-19 (so underlying performance goals for 2020 would not change).
    - Establish New Performance Goals (relative and more individualized performance goals).
    - Pay Discretionary Bonuses to offset losses outside of executive's control.

Other Key Compensation Considerations:

1. Review bonus plan documents:

- Do plan documents allow for the exclusion of the effects of COVID-19?
- If not – would a plan amendment be required?
- For public companies – changes to bonus plan documents/awards may require public disclosure on a Form 8-K.

Other Key Compensation Considerations:

2. Quantifying the effects of COVID-19 on performance:

- Non-interest expenditures due to COVID-19 (i.e., new air filters, plexiglass shields and technology upgrades for remote working) are easily identifiable.
- Determining COVID-19 impact on quantitative performance metrics more challenging (i.e., COVID-19 impact v. low interest rate environment or depressed housing market, which are viewed as the "cost of doing business" as a bank).

Other Key Compensation Considerations:

3. Accounting Implications

- Modified cash-based or equity-based awards could trigger an accounting charge or result in accrual changes.
- Vet any changes with your accountants.

Other Key Compensation Considerations:

4. Long-Term Performance Goals

- Greater caution should be exercised in modifying longer-term incentive goals.
- Extended performance period provides greater likelihood that performance will be “smoothed-out over time” and, therefore, may be unnecessary.
- For public companies – modification of long-term performance goals will warrant greater scrutiny.

Other Key Compensation Considerations:

5. Public Company Considerations

- Changes to performance goals will be scrutinized by proxy advisory firms.
- Must be prepared to explain 2020 compensation decisions in 2021 proxy statement and should provide clear/detailed disclosure regarding the reasoning for executive pay decisions.

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