

## The four-part harmony that builds shareholder value

Despite everything that's changed in banking, success still depends on four key metrics (plus two others)

How do you know if your community bank and its board of directors are doing their job in the current environment? How can you tell if you have been successful? What is your job anyway? The job of directors and officers of community banks is to enhance the value for shareholders (over the last two years, I have dropped back to suggesting that the directors' and officers' real job is to "maintain" shareholder value, but the concept is the same). For 25 years, I have suggested four metrics to determine whether the board and officers are actually enhancing shareholder value. These metrics (the four-part harmony) are:

1. Grow earnings per share;
2. Maintain a decent return on equity;
3. Provide liquidity for your shares, i.e. the ability of a shareholder to sell a share of stock at a fair price at the time they want; and
4. Provide cash flow off the shares—meaning some type of reasonable dividend policy.

Notwithstanding the current environment, those metrics still hold. Community banks should grow earnings per share in the 8% to 10% range because earnings drive value. Earnings per share can grow by either growing earnings or reducing shares. Community banks should have a decent return on equity. For 25 years, I have always pegged that at 15%. That number, however, is no longer reasonable because the regulators are "Forever Demanding Increased Capital" (FDIC). A 10% to 12% return on equity range is now much more reasonable. The metrics of liquidity for the shares and cash flow coming off the shares have not changed. The creation of share liquidity and cash flow simply involves a capital allocation question for the board. Is the best use of the organization's limited capital to create liquidity for the shares or provide cash in the hands of the shareholders, or to do something else, such as offset losses or support growth?

In the current environment, I have added a couple of considerations in addition to those set forth above, which factor into whether or not the board is doing its job as it relates to enhancing shareholder value. One of them is asset quality. I was in a board meeting the other day when one of the outside directors asked, "If we could only focus on one thing at this bank, what do you recommend it should be?" My answer: asset quality.

This is simply because if directors and officers do not focus on this factor such that the bank maintains good asset quality, then the "snowball effect" impacts the rest of the bank. The snowball effect occurs when the bank has not recognized its asset quality issues and the examiner recognizes them for the bank. The regulator then requests that the bank make a significant expense provision to the reserve, earnings then go south immediately, the bank is no longer augmenting capital, and management—including the board—which has been brilliant for 20 years, is now totally deficient. The snowball effect!

As community bankers, we need to get back to the basics of how we make money and focus on profitability. I have recently been sharing regularly the "secret" formula of how community banks make money: Revenue minus Expenses equals Profit.

We also need to keep an eye on the efficiency ratio. The efficiency ratio for these purposes is, in its simplest terms, how much does the bank have to spend to generate a dollar's worth of revenue. Lots of factors can go into the efficiency ratio, including the expense overlay from a number of branch locations, for example.

In any event, we still need to test whether we are doing our job as community bank directors and officers. I suggest the four-part harmony set forth above, plus two.

#### About the Author

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