

WHEN THEY SHOW THE COLOR OF THEIR MONEY

Third in a series: What the Board must do when unasked-for offer gets concrete

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This is the third in a series of blogs on merger and acquisition matters. Blog #2 dealt with the issue of what constitutes an unsolicited offer and provided preliminary information as to the board's obligations with respect to that type of activity. The purpose of this blog is to tell you what you really need to do.

First, let's assume that the bank has actually received an unsolicited offer.

"The Letter" arrives

This could be a brief letter from another bank, with which your bank has held various discussions. The letter might simply indicate:

"Please consider this our holding company's expression of interest in acquiring 100% of the stock of your bank and holding company. Subject to due diligence and further discussions, we are prepared to pay, in our holding company's stock or a mix of stock and cash, a range of \$X to \$Y (or a multiple of book value however it is stated). Please respond at your earliest convenience. We look forward to hearing from you."

That is a typical "expression of interest letter" after you have had some discussions.

Sometimes, the expression of interest letter can be much longer. Often it includes a "sales pitch" by the buyer as to why your shareholders should take the stock of the buyer. The buyer will talk up what an extraordinarily good company it is. Typically, the expression of interest letter is not much longer than noted above.

What are directors' duties?

The big issue is "What is the Board's obligation?" once directors receive that type of letter, assuming that it provides some kind of "credible" offer in this environment.

(Credible, by the way, in this environment, typically would be anything north of 1.25 x book, depending on where your bank is located, how well capitalized it is, and the like.)

So, once the Board has established that the unsolicited offer is in the "ballpark," what does the Board do?

The first task (and no, this is not solely shameless self-promotion) is find some firm to assist in analyzing the offer. Unless the management team is sophisticated in weighing acquisition offers, the Board probably needs some outside help in figuring out whether the offer is worthy of further consideration.

No, the Board cannot simply "punt" the offer to the shareholders, as many board members have suggested to me over the years.

When they suggest that, "We cannot decide. Let's just send it on to the shareholders," I make them stop and realize that "This is what they get paid the big bucks for." Making such decisions defines directorship.

As a practical matter, no acquisition offer will go to the shareholders unless the Board recommends it.

Evaluating the pricing proposed

The Board's job is simple. Is what is being offered better for the shareholders over the long term than it would be if shareholders continued to hold their own bank holding company's stock?

Here is the down and dirty on figuring out the answer to that.

1. Run a baseline financial performance for your own bank.

Use reasonable assumptions of earnings, balance sheet growth rate, product mix, margin, expansion opportunities, return on equity, dividends, share liquidity, and the like. We generally like to run the analysis out over a minimum five-year period, but more likely a ten-year period. (And yes, that is very difficult to project with any accuracy.)

2. Run the same type of baseline for the potential acquiror.

You cannot review all of the potential acquiror's inside information the way you can your own, so you have to do the best you can. You can get their projected earnings per share from the analysts and you can make some assumptions, based on their historical performance, of what they might look like going forward in the future.

Will it be exact? No. But, will it help? Absolutely.

3. Examine the proposed pricing range.

Once you get the baseline for your bank and the baseline for the potential acquiror, you then need to look at the range of prices the acquiror is going to pay; assume they will pay at the bottom of the range; figure out the exchange ratio for the stock; and then look at the characteristics of what your shareholders get.

The latter you will base on whose earnings per share is growing faster; what is the comparative return on equity; whether there is more liquidity in the purchaser's stock than in your own, and whether the shareholders obtain a greater cash flow off the purchaser's stock than they would off the shares they are holding in the current bank holding company.

For example ...

- • Growth. If the analysis reflects that the target's earnings per share are growing at 4% and the buyer's earnings per share are growing at 10%, "advantage buyer."

- • ROI. If the analysis reflects the target's return on equity is 6%, the buyer's return on equity is 12%, "advantage buyer."

- • Liquidity. If the liquidity for the target's shares is nonexistent and the liquidity for the buyer's shares is 50,000 shares a day, "advantage buyer."

- • Cash flow. If the analysis reflects the cash flow coming off the target's shares is \$1 per share but the cash flow coming off the acquired shares at the calculated exchange ratio is \$4 per share, "advantage buyer."

In this sample analysis, the advantage is clearly to the buyer and the target's shareholders would appear to be far better off holding the stock offered by the buyer than they would of the stock of their own bank holding company.

Does that mean the target has to sell to the buyer? Not necessarily.

Why not? Stay tuned for the explanation of that point.

In the next blog, I will provide some ideas on what the target board needs to do once it receives the analysis, no matter what it shows, i.e. advantage buyer or advantage seller.

You can also catch the article, "Don't slouch towards sale: Put your bank's best face forward for buyers" in the ABA BJ November 2012 Digital Magazine.

About Jeff Gerrish

Jeff Gerrish is chairman of the board of Gerrish McCreary Smith Consultants, LLC, and a member of the Memphis based law firm of Gerrish McCreary Smith, PC, Attorneys. He is a frequent contributor to ABA Banking Journal and ABA Bank Directors Briefing, and frequently speaks at ABA events and telephone briefings.

Gerrish's consulting and law firms have assisted over 1,500 community banks in all 50 states across the nation since their formation in 1988. Gerrish formerly served as regional counsel for the Memphis regional office of the FDIC and with the FDIC in Washington, D.C. with nationwide responsibility for litigation against directors of failed banks. Currently, Gerrish's practice involves mergers and acquisitions, strategic planning, capital raising, and general consulting with community financial institutions

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