FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss (with Scott McCallum)
DATE: December 31, 2017
SUBJECT: A COMMUNITY BANK DIRECTOR'S ROLE IN BANK M & A: *LESSONS LEARNED*

In November we were asked by the NorthWestern Financial Review (www.northwesternfinancialreview.com/) to write an essay describing insights from 2017 and predictions for 2018. We confessed to the editor and publisher, Tom Bengtson, to missing the target because our thoughts took us elsewhere to the subject set forth above. It was published anyway in the December 2017 issue and is reprinted here with Tom's blessing. On page two you will note that we added (bold face italics) a few words to what we thought was a near perfect essay.

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In the past two years we've experienced the sale of four community banks where we served as directors and investors. Our experience as community bank investors, executives and directors was enriched as each bank engaged in the process.

So what did we learn?

First, strategic shareholder value updates should be on every holding company board's agenda. The board is directly responsible for preserving, protecting and defending the shareholders' interest in your bank's capital account. Most directors are not focused on banking on a daily basis; we need to be reminded regularly of community banking trends and valuations. The bank CEO should be tasked to be the BHC's expert on such matters and invite his favorite investment banking firm in once a year for a full-blown presentation on the environment for bank mergers and acquisitions. (Pssst! They'll do it for free but will expect to be treated fairly when you need the services of an investment banker.) Regular discussions on strategic matters are essential for effective board governance *and* a best practice.

Second, properly motivate the bank's management to focus on strategic matters by enabling them, through vehicles such as performance-based options and grants, to own a meaningful number of shares. Directors need to have a consequential stake. Properly motivate directors by paying a higher portion of board fees in shares instead of cash, and tie the fees to board and committee meeting attendance. Your directors will be more attentive, engaged and effective thereby aligning the interests of management, the board and shareholders. This is another best practice.

Third, if capable, the bank CEO should direct M & A strategy and be responsible for approaching prospective targets. The CEO must *always* engage the board chair and apprise the chair about research of and discussions with potential targets. The CEO and chair partnership is an *absolute* best practice.

Fourth, flexibility is incredibly important. When banks find in-market organic growth limited, acquisitions can bring a greater earnings stream to fund the cost of compliance and additional lenders and deposit gatherers. Increased size allows for larger credit lines, providing the opportunity to serve a bigger chunk of its customers' credit needs and attract larger businesses to its stable of customers. But banks actively seeking to grow through acquisition often find themselves frustrated by their inability to persuade a target to sell. Often this frustration is caused by exacting expectations about the metrics of a worthy target, the buyer's pricing limitations, the buyer's lack of a public currency, or the target's inflexibility regarding the merged organization's business model. Doing the same thing over and over and expecting different results will lead to high levels of frustration.

We can cite four examples as directors where we sent our CEOs out to perform what ultimately turned out to be the impossible. Cultural fits are critical. Examples of botched acquisitions are easy to find. Pricing is critical as well to avoid excessive book value and earnings dilution. All these issues can grow into fixed impediments to an acquisition. Instead, it may be time to consider Plan B.

Fifth, Plan B. Most banks view themselves as acquirers . . . until they're not. Plan B involves a major shift in direction. The bank arrives at Plan B when it simply cannot close an acquisition. The bank has done all it can, but it either cannot find the right cultural or financial fit or it cannot persuade a target to sell. If the decision to become acquisitive was driven ***by*** the need for scale, the best alternative for the bank and its shareholders may be to become a target.

Naturally, the work doesn't stop there. The decision to sell begets a host of decisions beginning with do it yourself or hire an investment banker. Create a full-blown auction or a limited auction or a targeted approach. ***Having an electronic data room set up by the seller for select buyers to access bank financials, management and board reports, selective loan files and asset quality metrics/reports. The data room can obviate the need for developing an information memorandum "book", improve control over the process and lower the risk of "loose lips".*** At the point of a letter of intent, reverse due diligence on an acquirer is imperative. It can discover regulatory compliance issues (e.g., CRA or BSA/AML) that can delay or preclude a transaction from proceeding. But community banks and their shareholders may find the efforts as a seller to yield greater benefits than those of being a buyer, ***and do so with perhaps lower execution risk.***

Today, community banks often conduct their acquisition efforts in a more shareholder-friendly manner. That fact alone has resulted in fewer bank acquisitions in 2017 than expected by analysts. But targets do not always uphold their fiduciary responsibility to their shareholders. When an active acquirer presents financially attractive but unrequited offers to numerous banks, it appears clear that boards are not getting ***the meaning of*** strategic shareholder value or are not insisting upon it. That's a mistake and inconsistent with board fiduciary responsibility.

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