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IN THIS ISSUE

M&A Strategies During the COVID-19 Pandemic

by Mike Murphey

Porter White & Company reviewed almost 4,000 community bank M&A transactions since 2001 to ascertain the impact, by county, of county economic standing (as measured by GDP) on deal activity and transaction pricing. We believe this analysis may be useful as Alabama banks work through the economic impact of the COVID-19 pandemic. A summary of our findings and their implications follow.

- The economic cycle drives M&A across all counties, regardless of economic standing. COVID-19 has dramatically slowed 2020 deal volume.
- When ranking transactions by the economic standing of the headquarter counties of the target, top quartile counties represent the bulk of M&A activity in all economic cycles as they represent 80% of the nation's GDP.
- Top quartile counties have more M&A pricing volatility than deals in smaller GDP counties and have valuation premiums as compared to lesser GDP counties in good times. Such valuation premiums tend to disappear in recessions.
- In good economic times, banks headquartered in smaller GDP counties with a branch presence in larger GDP counties receive M&A premiums similar to banks headquartered in large GDP counties.

Given the above, we believe bankers should consider the following M&A strategies during and after the current COVID-19 induced recession.

- Large GDP county banks should consider avoiding sell-side activity until the economy improves. Well capitalized large GDP county banks may consider purchasing other large GDP county banks at a COVID-19 discount or consider stock transactions.
- Smaller GDP county banks who wish to sell may receive a COVID-19 based "low ball" offer below the 1.00x-1.30x Price/Tangible book these banks typically receive.
- Well capitalized smaller GDP banks should consider expansion into higher growth counties, either de novo or through purchase of divested branches from larger banks, as these assets could improve the banks' Price/Tangible book multiple.

National M&A Activity Since 2001

PW&Co utilized databases from S&P Global Market Intelligence and the Bureau of Economic Advisors to analyze the impact of the local economy on 3,848 Community Bank M&A transactions across the nation since 2001. The S&P database contained deal multiples and the target bank's headquarters location by county. The BEA data provided GDP information by county. We ranked each county in each state by GDP size for every year from 2001-2018 and assigned each county a quartile designation. Counties which produced the top 25% of a state's GDP in a given year were in Quartile One for that year, counties producing 25-50% were in Quartile Two, etc. We then matched target banks headquarter counties with GDP quartile ranking, resulting in an ability to assess GDP impact on deal volume and pricing. Our findings are summarized in graph and chart below.

M&A strategies in a COVID-19 recession

Of the three strategies mentioned above, the first two strategies seem evident from the figure and table below. Our discussion will focus on the third strategy involving Quartile Three or Four banks establishing branch presence in Quartile One counties.

We noted several Quartile Four banks with Price/Tangible Book sales prices in the 1.90x – 2.00x range. These transactions typically involved banks with asset size $200-$500mm, and 5-7 branches with headquarters in Quartile Four counties. However, these banks had adjoining Quartile One counties which held the bulk of the bank's branches and assets. Hence, the Quartile One type valuation.

We believe this relationship would hold true for Alabama banks. The COVID-19 environment may reduce asset values in Quartile One counties and that many Alabama Quartile Three and Four banks have abundant capital to purchase these assets, and low loan/deposit ratios to support growth in those assets. This could be a winning combination.

For More Information

For additional information and insights on this topic, including a breakout of Alabama counties and banks by Quartile, visit the Porter White & Company Website (https://www.pwco.com). Call Mike Murphey at 205-252-3681 with any questions or comments.

Michael S. Murphey is a financial analyst who supports Porter White's Community Banking practice. He has spent forty years in the southeastern US banking industry in various capacities related to commercial lending, including relationship management, underwriting, credit, and portfolio management.

Figure 1: Community Bank M&A Transaction Pricing by County Quartile

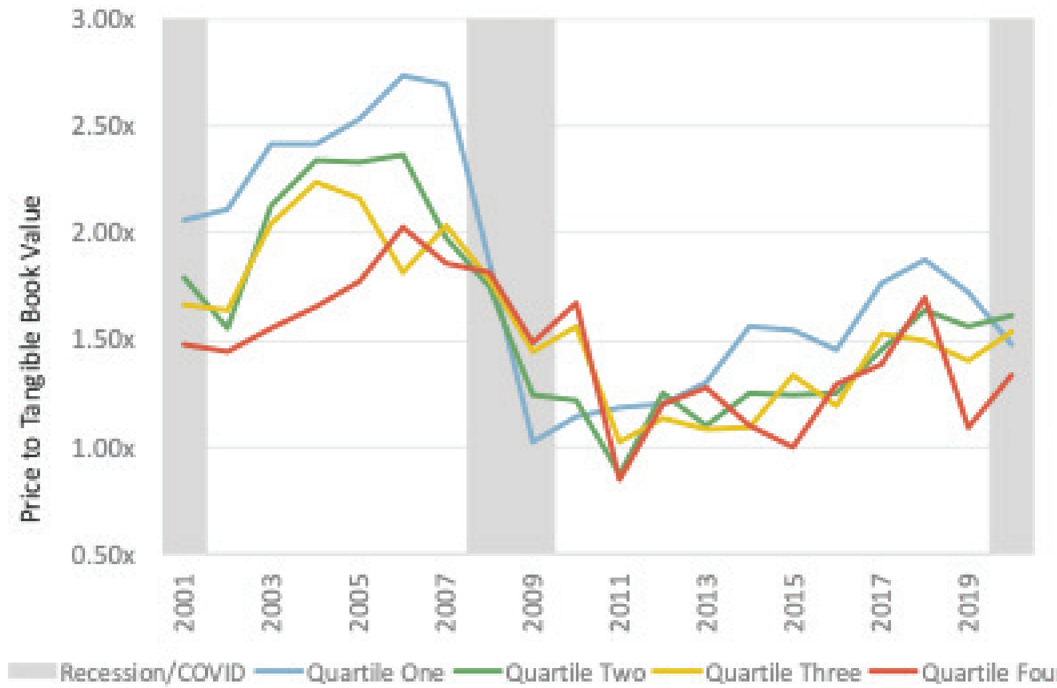

Table 1: Deal Volume by County Quartile 2001-2020

	2001-2007	2008-2010		2011-2016		2017-2019		2020 (annualized)	
	Avg deals/yr	Avg deals/yr	% Δ	Avg deals/yr	% Δ	Avg deals/yr	% Δ	Avg deals/yr	% Δ
Quartile One	131	77	-42%	123	61%	133	8%	53	-60%
Quartile Two	40	25	-39%	45	82%	47	4%	17	-64%
Quartile Three	29	17	-42%	21	26%	28	30%	22	-22%
Quartile Four	15	10	-37%	17	72%	18	8%	7	-60%
Total	**216**	**128**	**-41%**	**206**	**61%**	**225**	**9%**	**98**	**-56%**

Hospitals Financially Impacted by COVID-19

By Ryan Cochran, Waller, and Mitch Galloway, Galloway Consulting

As the nation's healthcare industry grapples with the impact of COVID-19, many hospitals are facing financial pressure. This article will address how COVID-19 impacts the finances at hospitals, and some immediate ways hospitals can respond.

Struggling providers fall into two categories. One, hospitals that are or were partially overwhelmed with COVID-19 patients, experienced shortages of Personal Protective Equipment ("PPE") and significant staff stress. Two, facilities that were forced to shut down strong margin-producing services, and spent money stocking up on supplies and urgently preparing for COVID-19 patients that never came.

Elective surgeries are a significant portion of hospital revenue. During the early days of COVID-19, many hospitals were ordered to stop performing elective surgeries to preserve PPE and capacity for COVID-19 patients. In addition, even as orders to stop elective surgeries are lifted, some surgery candidates may delay surgery due to fears of continuing exposure to COVID-19. Both the shutdown orders and patients' preference to put-off elective surgeries delay the receipt of revenue. Further, shutdown orders may come and go. Recently, Texas Gov. Greg Abbott suspended non-urgent procedures in four of Texas's largest counties. Other states may follow with shutdown orders in COVID-19 hot-spots.

At the same time, hospitals are also facing additional COVID-19 related costs. All employees will need gloves, masks, gowns and possibly face shields to prevent or mitigate the spread of COVID-19. Staffing costs also rise. Staff also get COVID-19. Ill staff must quarantine. As a result, facilities must pay overtime to staff covering additional shifts or use more expensive staff from an outside staffing agency.

In many markets, demand for staff has outpaced the supply. Staffing agencies charge higher hourly rates for temporary labor. In addition, facilities may increase pay of current staff for "hazard duty" or pay "hazard bonuses" to retain staff or encourage staff to be present. Cleaning and housekeeping costs increase. There is an increase in costs for cleaning supplies that are used more frequently, and potentially an increase in labor costs for more frequent and "deeper" cleaning. Training costs may increase. Outside consultants may be hired to provide additional training on COVID-19 guidance on new requirements from the WHO, CMS, CDC and state regulations. Staff must be paid to attend training sessions which results in additional paid time. It is counter-intuitive, but the current health crisis may negatively impact the hospitals' financial ability to respond to the crisis.

The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") has provided funding to hospitals to respond to the pandemic. However, the CARES Act funds will not be here forever, and when the relief funds are depleted, the financial impacts of COVID-19 will still exist. The impacts of COVID-19 prevention, mitigation and treatment will leave some organizations short of cash. The hospital industry as a whole is estimated to have lost $50B per month between March 2020 and June 2020. One hospital known to the authors who normally has $330M in annual revenue experienced losses of $30M per month during that time. Without a strong balance sheet, it is difficult for organizations to survive those types of losses. An organization on a short cash runway should consider the following action steps. Start with a detailed, weekly cash flow forecast which outlines specific sources and use of cash to highlight potential vulnerabilities. A 13-week cash flow model is the general practice. A cash flow forecast can inform the need to stop or delay all non-essential cash payments, request forbearance of debt payments, restructure debt, sell assets or close services. A cash flow forecast can also reveal the need to make changes to future business plans and models.

The healthcare industry is facing unprecedented times that are challenging the most talented hospital executives. Many hospital leaders have never had to face such difficult financial projections or such rapid change. To facilitate this review, hospitals may need to supplement their existing finance department's abilities with an outside turnaround professional or a financial expert who has specialized experience in quickly anticipating and addressing financial challenges and then assisting with the timing and implementation of difficult changes.

As a lender to one of these institutions you may be called upon to permit the funding of financial, turnaround, public relations and legal consultants. Their involvement should occur early in the process. They can provide an objective opinion on what services the revenue can support, a projection of how changes in the services will impact expenses and revenues, and can be invaluable in implementing critical next steps. Further, sometimes an outside party is the better choice to communicate the struggles and challenges facing a hospital to its lender. The cost of experienced professionals early in the process will almost always save all constituencies money in the long-term – often saving crucial medical care for an entire community, and jobs while offering the most flexibility for future stability. Those organizations who start the process early will be best positioned to implement a strategic plan that results in a better performing organization, and, thus, a better performing borrower.

Ryan Cochran leads Waller's Finance & Restructuring practice. In his role as Practice Group Leader, Ryan oversees strategic initiatives, including client service and case management for the firm's Finance & Restructuring practice. Mitchell Galloway with Galloway Consulting is among the country's foremost authorities on organizational strategy. He built his reputation helping healthcare executives transform their organizations, often achieving landmark results on seemingly impossible timetables.

Keep an Eye on Your Capital

by Charles Moore

Banks have played a crucial role these last few months as the COVID-19 pandemic has swept across the world. Through Paycheck Protection Program loans, payment deferments, and other initiatives, banks have provided significant assistance to people and businesses of all types. The banking industry has worked incredibly hard, and bankers across the country should be proud.

Unfortunately, this good work does not make banks immune to the same pressures that have confronted many of America's other businesses recently. That being the case, bank capital has become an increasingly hot topic as we've moved through the pandemic, particularly at the large bank level. Many national and super-regional banks made springtime decisions to suspend their stock repurchase programs. Recent Federal Reserve stress tests have brought about large bank dividend limitations, too.

Like the large banks, community banks also need to keep a close eye on their capital positions. There are several reasons a community bank might want or need more capital as we move forward. Some reasons relate to addressing problems, like shoring up credit losses or bracing for general uncertainty. Other reasons are more positive, including beefing up to position for an acquisition or other growth opportunity. Whatever the reason, it's a good time to think about the steps your institution might take if a capital need were to arise.

Here are the basics of bank capital in today's market:

1. **Common Stock**. Common stock is the most widely-utilized bank capital instrument. It is a gold standard of sorts, serving as "common equity tier 1 capital" and driving every major metric of the agencies' capital adequacy standards. For many institutions seeking to raise capital, common stock is the first consideration. However, common stock is sometimes considered an "expensive" form of capital, and it can be dilutive of ownership percentages and earnings per share.
2. **Preferred Stock**. Next on the list is preferred stock. Preferred stock is a flexible instrument that can include not only dividend and liquidation preferences over common stock, but also special voting privileges, board representation, conversion features, and other unique rights. Generally speaking, preferred stock that is non-cumulative (i.e., the issuer's dividend payment obligations do not accumulate if a scheduled payment is missed) and perpetual (i.e., the instrument has no maturity date) can qualify as "additional tier 1 capital," and other types of preferred stock can qualify as tier 2 capital, all depending on the specific terms of the instrument. A careful look at the agencies' capital criteria is a must for any proposed issuance of preferred stock.Notably, preferred stock was the mechanism the U.S. Treasury used to make most of its TARP Capital Purchase Program and Small Business Lending Fund investments during the late 2000s and early 2010s. If COVID-19 brings about new government programs to bolster bank capital, preferred stock may be part of the package again.
3. **Subordinated Debt.** Subordinated debt, which is senior to stock in a liquidation setting, is a relatively common capital alternative for banks. If its terms are right, it will count as tier 2 capital. If the issuer is a bank holding company, it can contribute the debt proceeds down to its subsidiary bank as tier 1 capital. For subordinated debt to count as tier 2 capital, the debt must (a) be subordinated to depositors and general creditors of the issuer, (b) be unsecured, (c) have a maturity of at least five years, (d) not be callable by the issuer during the first five years of its term, (e) not be subject to acceleration upon default, except in the event of a receivership or similar proceeding, and (f) not have a credit sensitive feature, such as a dividend or inter-

est rate that is reset periodically based on the institution's credit standing. In addition, at the beginning of each of the last five years of the life of a subordinated debt instrument, the amount that is eligible for tier 2 capital treatment is reduced by 20% of the original amount of the instrument, meaning that none of the subordinated debt will count as tier 2 capital in the final year of its term. The agencies' capital adequacy standards contain certain other characteristics that subordinated debt must have to get tier 2 capital treatment, and issuing institutions should follow those standards carefully.

4. **Senior Debt / Bank Holding Company Loans.** As its name suggests, senior debt carries higher priority in liquidation than subordinated debt. Senior debt is almost always issued at the bank holding company level. Senior debt can be particularly useful to an institution with a "small" bank holding company, which generally means a holding company that has consolidated assets of $3 billion or less. A "small" bank holding company typically can incur senior debt and contribute the proceeds to its subsidiary bank in the form of tier 1 capital, without regard to the normal capital adequacy standards at the holding company level.

Before a "small" bank holding company incurs debt, whether senior debt or subordinated debt, it should keep several things in mind. First, dividends from its subsidiary bank are the most likely source of repayment for its debt, and applicable law typically restricts a bank's ability to pay dividends if its recent earnings (or its cumulative retained earnings) do not support the payments. Thus, holding company loans can become very problematic for distressed institutions. Second, a third-party lender might require a pledge of the subsidiary bank stock to secure the loan. A stock-secured loan can put additional pressure on an institution in a distressed situation. Third, a "small" bank holding company must comply with the Small Bank Holding Company Policy Statement at Appendix C of 12 C.F.R. Part 225, which itself includes leverage requirements, capital adequacy requirements, and dividend restrictions under certain circumstances.

As an institution evaluates these capital alternatives, it should carefully consider the following:

- **Organizational Documents.** Before issuing stock, an institution should check its organizational documents. Most importantly, an institution's articles of incorporation will speak to the classes of stock and the number of shares the institution is authorized to issue. If the institution does not have enough authorized but unissued shares of the desired class of stock, the institution generally will have to ask its shareholders to approve the issuance. Organizational documents might include other limitations or considerations, as well.

  Debt instruments typically don't give rise to organizational document considerations, but an institution should check its organizational documents for debt issuances, too. There's always a chance an organizational document limits an institution's ability to incur debt, reserves related rights to the shareholders, or imposes another type of limitation.

- **Securities Laws.** An institution should be careful to comply with securities laws. Most notably, although the issuance of bank stock generally enjoys an exemption from registration under Section 3(a)(2) of the Securities Act of 1933, the issuance of bank holding company stock does not. A bank holding company needs a transaction-related exemption, such as a private placement exemption, to keep from having to register its securities with the Securities and Exchange Commission and/or state securities agencies. Private placement exemptions can come with size limitations, investor limitations, and restrictions on transferability of the stock, and it is vital that an issuing institution be aware of the issues.

  Securities laws also come into play for certain types of debt issuances. In particular, widely marketed subordinated debt can involve significant securities law considerations. Before issuing any equity or debt instrument, an institution should be sure it understands the relevant securities laws.

- **Fairness Considerations.** An institution should always be mindful of fairness considerations, especially if it issues equity or debt to a small group of people with heavy participation from board members. Transactions between an institution and its directors can invite scrutiny, particularly from shareholders. The Alabama Code provides certain protections to a corporation when the transaction is approved by its disinterested directors, when the transaction is approved by its shareholders, or when the transaction is "fair" to the corporation. An institution should navigate these issues carefully.

- **Contractual/Regulatory Limitations**. An institution might be party to an agreement, or perhaps even subject to a regulatory limitation, that prohibits or limits debt or equity issuances. For example, if a bank holding company already has a loan, its loan documents might prohibit the incurrence of additional debt, including subordinated debt. Similarly, communications between an institution and its federal or state regulatory agency might require the institution to obtain agency consent prior to incurring debt. Of particular note for sales of voting stock (common or preferred) are the implications of the Change in Bank Control Act and similar state statutes, which can impact the timing and terms of a stock offering and require agency approval. An institution should review its contracts and records, and it should consider federal and state "control" rules, for these purposes.

There are many ways for a bank to raise capital, and this article covers only the basics. If your institution decides to go forward with a capital raise in the near future, we hope this information will be useful to you.

Charles Moore is a partner at Bradley law firm. His practice focuses on community banks and commercial lenders and borrowers. In his commercial finance work, Charles has had substantial experience in mortgage warehouse lending, mortgage servicing rights lending, real estate finance, bank holding company lending, syndicated lending, loan participation transactions, and Article 9 of the Uniform Commercial Code. In his community bank work, he has handled bank merger and acquisition transactions, Change in Bank Control Act matters, Bank Holding Company Act matters, formation and capital raising activities of banks and bank holding companies, and various other bank regulatory matters.

Thoughts on the Main Street Lending Program

by Michael Odom

Relying on the CARES Act, the Federal Reserve Board (Fed) established the Main Street Lending Program (MSLP) to facilitate lending to small and medium-sized businesses in order to help maintain operations until conditions normalize. The program provides a relatively low-risk mechanism for banks to stretch beyond their traditional credit boxes and make funds available to borrowers struggling with the effects of the COVID-19 pandemic. And while MSLP is totally different and far more restrictive than its cousin the Paycheck Protection Program (PPP), like the PPP, used appropriately, MSLP may benefit borrowers and lenders alike.

Program Overview

Under the MSLP, a Fed-established special-purpose vehicle (SPV) will purchase a 95% interest in qualifying loans made by participating lenders. MSLP borrowers must have been in sound financial condition prior to the COVID-19 outbreak, and must otherwise meet program criteria. The SPV will purchase up to $600 billion in MSLP loan participations from participating lenders, with qualifying loans ranging from $250,000 to $300 million. Qualifying borrowers may have up to 15,000 employees and up to $5 billion in annual revenue, and include not-for-profit organizations.

Loan Terms

The MSLP is made up of five facilities, each with similar terms: 5-year term, interest at LIBOR plus 3%, 2 years' deferred principal, and one year's deferred interest. Principal must be reduced by 15% at the end of years three and four, and the balance must be paid at the end of year five. The loans may be repaid early without penalty, and may be secured or unsecured (depending upon the MSLP facility).

Loans are subject to full underwriting by the lender, and are documented on the lender's standard terms and conditions. In addition, however, borrowers must agree to certain program restrictions established by the CARES Act, including, among other things: enhanced financial reporting, limitations on distributions to owners, headcount reduction, and utilization of foreign supply chain. As a trade-off for these additional burdens and limitations, however, borrowers may achieve more leverage than they might under traditional loan facilities (in most cases, up to 6 times Adjusted EBITDA).

Program Fees and Mechanics

MSLP-participating lenders must pay a per-loan "transaction fee" of 1% of the principal loan amount at the time of origination, which fee may be passed on to the borrower. However, lenders may also charge and retain an origination fee of 1% of the principal loan amount at the time of origination.

Participations will be sold to the SPV at par value, and the lender will retain servicing. Unlike the 100% SBA guaranty under the PPP, Fed will only take 95% of the exposure on any given MSLP loan; the lender must retain 5% of the loan until it matures or the SPV sells all of its participation, whichever comes first. The SPV and the lender will share any losses on a pari passu basis. For servicing the loan, the SPV will pay lenders an annual fee of .25% of the SPV's participation amount.

The lender is expected to service MSLP loans in accordance with the terms of Fed's standard servicing agreement, which generally requires the lender to exercise the same duty of care it would exercise had it retained ownership of the entire loan.

Program Risks

One of the primary program risks – apart from the increased risk of default due to enhanced borrower leverage – is the relationship risk posed by the SPV. That is, under the terms of the MSLP Participation Agreement, the SPV has a multitude of opportunities to transfer its participation to a third-party without the lender's consent. Lenders should expect to have no control over the selection of co-lenders or subsequent participants. Similarly, the terms of the Participation Agreement limits the lender's ability to exercise ordinary servicing discretion. Whether to grant a covenant waiver, for instance, is generally reserved to the SPV, and failure to obtain consent may trigger the SPV's right to transfer its interest. This approach may subject borrowers to stricter compliance than that to which they are used to lenders imposing, or even to which they may be subject on other loans with lender.

Does MSLP Make Sense For You?

The MSLP is not the PPP; MSLP loans are "real" commercial loans. They require traditional underwriting and an ongoing commitment by the lender to service the credit. In exchange, however, the MSLP allows lenders to extend emergency funding to needy borrowers while transferring 95% of the credit risk. Whether the benefits offset the burdens is – of course – a case-by-case decision, but this new Fed program could be just the lifeline needed for the present time.

Michael Odom is Of Counsel in McGlinchey's Birmingham office, where he provides a full range of industry-leading real estate finance, litigation and transactions counsel to banks, other lenders and title insurance companies.

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