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Western Banking

Planning for better stock performance

by **Gray Medlin**

Community bank executives rightly spend much time formulating strategies to enhance the operating and financial performance of their institutions. They may, however, overlook a critical step in converting those results into benefits for their shareholders. This link between financial results and value for shareholders is stock performance. Specifically, improving stock performance means: a) increasing the liquidity of the capital investment; and b) realizing a valuation that adequately reflects the bank's historical and potential financial performance.

Whereas most bankers are willing to be held accountable for financial performance, many believe that stock performance is largely outside their control and "just happens." Although market valuations certainly reflect uncontrollable factors, our view is that a well-performing stock is no accident and can be meaningfully influenced by a thoughtfully conceived plan consistently executed by management.

What are the benefits of good stock performance? These are numerous and include:

- **Shareholders are often also directors and customers.** Pleasing all three groups means good bank business, an energetic board and

continuing investor support while management works its game plan.

Meaningful stock liquidity recognizes a basic fact of life — individuals have differing needs and their circumstances change. Allowing individual investors the opportunity to exit at attractive valuations gives management the chance to stay the strategic course and avoid triggering a dire event such as the forced sale of the bank.

“A well performing stock is critical in aligning the interests of owners and employees.”

A well-performing stock is critical in aligning the interests of owners and employees. It can be key to successfully motivating employees with the tools of modern management such as ESOPs and stock options.

Valuation can be the key to success in growing by merger. More and more, independent banks are the buyers of choice. In competition to win the deal against larger banks, there is simply no substitute for a highly valued stock. Arguments for "undervalued currencies" and "double dips down the road" generally lose to

current market value. Also, community bank peers have the chance to build good franchises by merging. However, it is very difficult to merge two banks with relatively equal financial characteristics that have widely divergent market valuations.

Are there risks associated with good stock performance? From time to time, we hear bankers express fears that there are, but we believe their fears are more imagined than real. For example, some bankers think a high stock price might draw the attention of acquirors and corporate raiders. We believe, on the contrary, that it is the weak performers and the undervalued that attract the sharks. In the information age, it is really hard to hide poor results, but relatively easy to inform those interested that the bank performs well and cannot be bought cheaply.

Another thing community bankers worry about is that although their banks don't trade much, they have

high stock prices and a more liquid stock could drop if the market declines. We believe that a high valuation for an illiquid investment is relatively meaningless for shareholders. Realistically priced investments with meaningful liquidity go up and down with the market cycles. Shareholders can be educated to understand this fact of financial life. It is management's job to make the bank perform better than its peers and make sure the investment community is aware of the results.

What are some of the factors that influence stock liquidity? These may include:

- Shares outstanding, especially in the hands of non-insiders (so-called

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float);

- Number of shareholders;
- Number of active market makers;
- Research coverage; and/or
- Change in the stock price (up or down).

What are some of the factors that influence stock price? These may include:

- Consistency and direction of change in financial performance;
- Investor relations efforts;
- Research coverage;
- Institutional ownership/interest (after all, they are sophisticated, right?); and/or
- Franchise value.

A word about the last stock price factor. By franchise value, we mean the scarcity value of the bank's business: how attractive the bank's business and markets are to other institutions that are not already there or are there and would desire to eliminate the bank as a competitor. The level of franchise value is a function of the time and cost required by a potential acquiror to replicate the

bank's business in its markets. It may be the intention of the bank's owners and management never to sell their business. No matter — plenty of banks have enjoyed long and successful lives and high valuations that included some takeover premium, though they never seriously considered a sale. They and their shareholders benefited from the increased valuation along the way.

The numerous factors driving stock performance work together, and they take time to produce results. A brief outline for enhancing stock performance follows:

- **Set objectives for better stock performance**

- A. Trading volume: plan to reach reasonable targets over time
- B. Valuation: plan to be at or above an established peer percentile, regardless of the inevitable market cycles

- **Investor communications**

- A. The story: what is the bank's unique niche? How do you explain it?
- B. The bank's public reports: are

they better than your peers? Do they give investors all they need to understand the bank's progress in reaching its unique goals?

- **Broker education and participation**

- A. Equity research: seek research coverage, don't just wait for it (the bank may pay for it at first, until the market for the stock builds and brokers are paid through trading volume)

- B. Listing: does not instantly create a market, but is one piece of the program

- C. Corporate finance activities
- D. Share repurchases
- E. Dividend reinvestment plans
- F. Cash dividend policy
- G. Stock dividends and splits

- **Review and adjust objectives and the program**

The bank can customize its own program to improve stock performance, selecting from the many tools that are available. **WB**

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