IS IT TIME TO EXPAND YOUR SHAREHOLDER BASE?

BY **KIAH LAU HASLETT**

Broadening your bank's shareholder base to include institutional investors offers significant advantages, but it's a long-term process that might not be for everyone.

With growth often comes new shareholders.

When Steven Shelton helped form California BanCorp in 2007, most of the initial capital came from businessmen in the community surrounding Oakland, California. There was only one institutional investor in the mix.

But when it came time to raise more capital seven years later, most of the original investors were content with their initial stake, says Shelton, the bank's president and CEO. So instead, executives turned to additional institutional investors. California BanCorp's growth and success led to two more capital raises, in 2016 and 2018. Again, the holding company tapped institutional investors.

The evolution of California BanCorp's shareholder base is an experience that hundreds of community bankers have grappled with: managing a changing investor demographic and the expectations that come along with those changes. The growth opportunities for community banks coincide with increased investor interest in the years since the financial crisis. The need for additional

capital or greater liquidity often serves as a catalyst for changes in a bank's shareholder base and presents new challenges, opportunities, and expectations for boards and executives that are willing to make the leap.

It has become easier than ever for community banks like California BanCorp, with $1.1 billion in assets, to find receptive investors outside of their communities. The demand for a stake in high-performing community banks has created a "subculture" of investors searching for "diamonds in the rough," says John Roddy, managing director and head of financial services for the investment bank Raymond James Financial.

"We actually find that many times it's easier to get meetings [with investors] for the $1 billion bank than the $10 billion bank," he says, referring to an institution's asset size.

Since the financial crisis, bank investors are willing to reach deeper into the market-cap barrel for smaller companies that could get on the radar of a potential acquirer or could reach a broader audience in the future, says Joseph Fenech, managing principal and head of research at the investment bank Hovde Group. Fenech covers California BanCorp, along with a number of smaller names, including some banks that are illiquid and trade on over the counter, or OTC, markets.

Bank executives and boards need to plan for this potential change, along with the two common events that tend to precede it: the need for new capital to support growth or to accommodate existing shareholders that want liquidity. Firms have a variety of options to choose from, including private placements, direct listings, initial public offerings (IPOs) or secondary offerings.

Planning for future liquidity requirements also helps executives prepare for initial conversations with institutional investors. Community bankers need to understand what motivates different investors and what they may expect once they take a stake in the bank.

"You need to make sure [as an executive] that whatever investors you're bringing in, their expectations align with what your plans are for the bank in the coming years," says Josh McNulty, a partner at the law firm Bracewell LLP. McNulty works with banks and boards on corporate governance, shareholder matters and capital market transactions. He recommends that boards conduct their own research about potential investors, including what other banks they may have stakes in and those outcomes, in addition to consulting with advisors.

"Community banking is a small world. You can probably find other banks that [an investor has] invested in or an investment banker that has dealt with them," McNulty says. "You can do some background [checks], some due diligence — the same as they're doing on you."

These conversations are just the start of the evolution and management of a new set of shareholders. And for some community banks, this is a natural outcome of their growth and success. Fenech says he looks for companies that "walk, talk and act like they are an institutionally relevant bank" and have the performance to back it up. For every 10 community banks he reaches out to, fewer than half are a good fit for research coverage at the moment.

"But every once in a while, you'll come across a company ... that should be on stage for all to see right now, not two years from now," he says.

For Fenech, California BanCorp is one of those banks. The company is currently listed on OTCQX Banks, a five-year-old market for community bank stocks run by OTC Market Groups. Many small-cap companies and some international firms choose not to list on an exchange and instead trade directly among investors. OTC Market Group's predecessor used to publish share prices for these companies on pink pieces of paper, giving these trades the moniker of "pink sheets." Today, this group of companies are called the pink market.

The OTCQX market gives banks greater visibility, tradability and some credibility of being traded with similar names, while avoiding the expense of an exchange listing or compliance requirements from the U.S. Securities and Exchange Commission. It leverages the disclosures that banks file with financial regulators as a way to provide transparency for investors, says Jason Paltrowitz, executive vice president of corporate services at OTC Markets Group.

The OTCQX has some light corporate governance requirements, like having a board-level audit committee. It also requires banks to have an approved corporate broker that introduces the firm and can provide guidance. Companies must also have a transfer agent, which Paltrowitz says relieves executives from potential involvement in their stock. There are currently 90 banks on the OTCQX Banks market, ranging from institutions with $100 million in assets to more than $4 billion, according to the group.

“Whatever the bank’s needs are from a capital markets perspective — even if they’re thinly traded — the best thing for them is to be thinly traded but public, and traded on a quality market,” he says.

California BanCorp’s executive team has begun weighing its next options for furthering its shareholder base. Shelton says similar-sized banks often consider whether or not they should register with the SEC and join the Nasdaq exchange.

A Nasdaq listing could create additional liquidity that would benefit existing shareholders, he says, with an improved valuation that would be “more reflective” of the bank’s value outside of a sale price. But the move is not without costs, including more time spent on heightened reporting requirements and increased listing fees.

Larry Mazza, CEO, MVB Financial Corp.

"If you're not willing to work hard at what you're doing, don't go on Nasdaq. Stay in your office and trade shares out of your desk drawer."

“There’s an embedded cost there, if [banks choose to] go this direction, which reinforces the need to continue to grow and scale to absorb that cost structure,” Shelton says.

Paltrowitz at OTC Markets Group says some banks do move from the OTCQX onto the Nasdaq, because they’ve become more attractive to investors and believe they could be added into the Russell 3000 Index. The Russell 3000, commonly called “the Russell,” is made up of the largest 3,000 stocks by market capitalization and is sub-divided into the smaller “2000” group and top “1000” group. Companies are required to have a Nasdaq listing to get into the Russell index, which is run by FTSE London and rebalanced yearly based on market caps.

But the potential windfall for community banks from an inclusion could be immense: FTSE London said in June that more than $9 trillion in investor assets are benchmarked to or invested in products based on the Russell US Indexes. The stock purchases following the addition to the Russell “demonstrably” improves a bank’s valuation, increases liquidity and activity in shares, and can create greater awareness among institutional investors, Fenech says.

Joining the Russell was a 10-year endeavor for MVB Financial Corp., which entered in summer 2018 and remains after the 2019 rebalancing, says President and CEO Larry Mazza. The Fairmont, West Virginia-based bank conducted a private placement with the investment bank Keefe Bruyette & Woods at the end of 2016 to sell additional shares to institutional investors. The bank, with $1.8 billion in assets, was aiming for a market cap that would be “strongly” above the Russell’s market cap cut-off, he says.

Entering the Russell had a dramatic impact on the bank’s shareholder base. Now, 25% of MVB Financial stockholders are institutional, including mutual and index funds. “It’s a lot different,” he says.

Institutional shareholders are a breed apart from the local business people, friends and family that often make up a community bank’s shareholder base.

Both Shelton and Mazza point out the sophistication level of institutional investors, their understanding of bank metrics and models, and their ability to compare a company’s performance to peers as key differences compared to other community bank investors.

“They certainly remember what you told them. I think the lesson is be consistent with your message and your strategy,” says Thomas Sa, chief financial officer at California BanCorp. “If you’re varying from that, make sure that that comes forward transparently and [in a timely fashion].”

Executives also need to be mindful of having con-

"You can run your bank fantastically, and be one of the best bankers in the country. ... But dealing with a new institutional investor, or dealing with the market as a whole, is a different skill set."

sistent communications with these shareholders, given the increased accountability and additional SEC regulations. Mazza says there's "no embellishment" during these conversations and that all the information needs to be accurate, because these investors will hold executives accountable for delivering on them.

One way executives can prepare for these sessions is through practice meetings. Fenech recommends that private or thinly traded banks interested in this investor base set up meetings well in advance of needing to tap the market. Executives can gain valuable experience telling the bank's story and establish relationships with potential stockholders early in their firm's capital journey, which can make it easier to raise capital from a select group of shareholders when they need it.

At California BanCorp, Shelton prepared specifically for conversations and questions about the bank's readiness and ability to execute its strategy. Mazza at MVB Financial rehearsed telling the bank's story, listened to other firms' investor and earnings calls, and read research reports published by bank analysts.

"We attended investor conferences, we watched presentations," he says. "It's a dress rehearsal — you just don't step onto the stage."

For both banks, the benefits of the changed shareholder base and new investors have outweighed the additional costs and growing pains. But they cautioned the move isn't for all banks or all management teams.

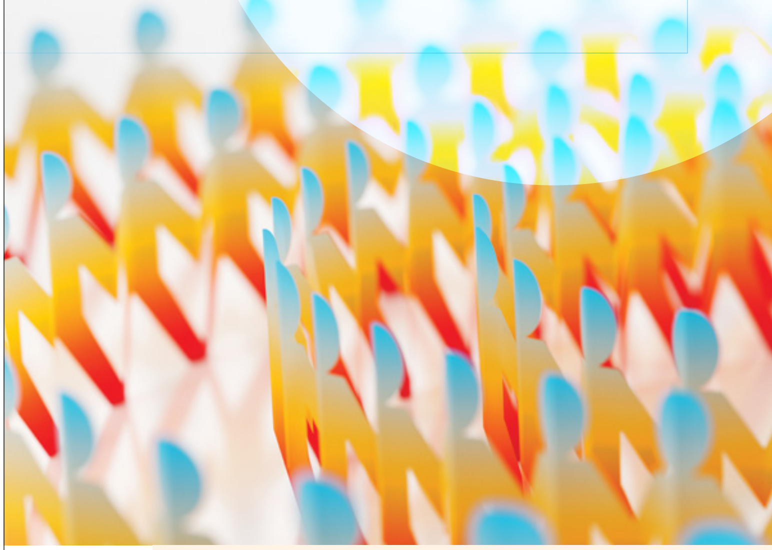
Mazza says he is proud he can offer the 1,200 original MVB Financial shareholders better liquidity and higher valuations following the Russell inclusion, although he would like to see greater trading activity.

"We still don't trade enough for my taste right now, but we've gone from a few hundred shares a day to several thousand shares a day," he says. "Any large shareholder can get in and out now much easier."

The additional liquidity provides a variety of options for the bank. It can use it to attract and retain executive talent through equity-based incentive compensation, and could offer another institution's shareholder base greater liquidity in an acquisition. Mazza is also saved the stress and risk of dealing with shareholders when they to unload their illiquid stock.

"You've got to be arm's length, but you don't want your shareholders to be left out there holding your stock if you're illiquid," he says. "Those were stressful days for us. I didn't like it at all."

Both banks see a Nasdaq listing as an important external signal. It "underscores a credibility" for



a company like California BanCorp with capital markets firms and could lead to more options as the bank executes its strategy, Sa says. Mazza says it resonates with existing and potential clients as well.

"[Customers] don't want a little bank that's going to come in here without the credibility of Nasdaq," he says.

Preparing for a Nasdaq listing can be an intense and lengthy process that requires a bank to make important internal changes. Mazza says the SEC and Nasdaq reporting requirements necessitate a "professional accounting department" for community banks.

MVB Financial's shares traded on the OTC Bulletin Board before the bank applied for a Nasdaq listing in fall 2017; executives stated at the time that they were aiming for inclusion in the Russell. It received approval for the major-exchange listing before the end of the year.

"If you're not willing to work hard at what you're doing, don't go on Nasdaq. Stay in your office and trade shares out of your desk drawer," he says. "It's not for the weak at heart or the JV team. This is a varsity-team move."

Mazza recommends that banks interested in a Nasdaq listing seek directors who have experience at publicly traded companies. Directors will also need to become familiar with expectations about good governance practices and hot topics like diver-

Josh McNulty, partner, Bracewell LLP

sity within the executive ranks. Companies must also be aware that they will potentially be open to activists should their performance falter.

Another major change for executives is more travel and more time in general devoted to shareholder communications. Executives from both MVB Financial and California BanCorp are on the investor conference circuit, because they see value in personal conversations about strategy and insights.

"I think it's important that [shareholders] see you, they know you, and you're able to articulate your story to them," Mazza says. "To me, maybe it's old school, but it's much better face-to-face."

Firms that want to follow the path these and other community banks have charted have their work cut out for them. Mazza and Shelton recommend starting with alignment and support from the boards of directors to management, before undertaking the preparations and other potential internal changes.

"It's different than just running your bank on a day-to-day basis. You can run your bank fantastically, and be one of the best bankers in the country," says Bracewell's McNulty. "But dealing with a new institutional investor, or dealing with the market as a whole, is a different skill set."

Boards need to support any effort to expand a bank's shareholder base. California BanCorp's growth was envisioned and guided by its board of directors from its founding, Shelton says. The bank invested heavily in hiring seasoned executives, who have guided its growth in sustainable ways while investing in systems that would position it for the next stage of growth. The investments have increased noninterest income, trade-offs that the board has supported.

"We've been very fortunate [to have] the support and understanding and skills of the board since we started the bank," Shelton says. "This isn't something where management wanted to grow and had to convince the directors to do that, or vice versa. We've been lockstep in the vision of what we want to do here."

From there, executives may need to dedicate more resources and time to education, heightened requirements, public reporting, presentations and shareholder communications. They should identify knowledge or experience gaps in their teams, and seek out additional training and education — or find new people with the relevant experience. Those can be painful but necessary conversations.

"The same board member, the same management, that took you to a certain level may not be the same to take you to the next level," Mazza says.

California BanCorp wanted to find a CFO who had worked at an SEC-reporting company and undertook a formal search that ended with the hiring of Sa in May. Sa had gone through the process of San Jose, California-based Bridge Capital Holding becoming a Nasdaq-listed bank before it agreed to be acquired in 2015.

"I think a company is better served by having people with experience, having done that, versus a team that lacks that experience," Shelton says.

McNulty recommends that community banks identify if any executives or directors have worked at public companies — even if it wasn't at a financial institution — or dealt with institutional investors or capital markets, and leverage that experience.

The challenge of growing and managing a bank's shareholder base isn't for all banks or all bankers. But it could be a potential opportunity for community banks that are diligent and profitable operators now. McNulty says the long-term objectives of an evolved shareholder base, with a higher profile and better liquidity, are goals "in the back of the minds" of executives he talks to.

"For a lot of community banks that go public, it's going to take a substantial amount of time and steady, consistent growth to get there," he says. "It's one of the things: 'If we just handle our business every day, then we'll get there.' It's not, 'Let's take some shortcuts just to get there.'" **|BD|**

Kiah Lau Haslett is managing editor of Bank Director.