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Privately-held banking organizations — Shareholder liquidity, ownership succession, and the search for strategic optionality

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Privately-held banking organizations, typically founded on the principles of local ownership and local relationships, occasionally face an inflection point when shareholders demand liquidity. What to do? A bank sale is one solution, but if just a few minority shareholders are demanding liquidity, a sale may not be necessary or possible.

For the shareholder of a privately-held bank or bank holding company, an illiquid stock has long been understood to be part of the ownership bargain.

Below we outline actions that privately-held bank organizations can take in anticipation of, or in the face of, the need for shareholder liquidity.

Ownership succession and liquidity pressure

For the shareholder of a privately-held bank or bank holding company, an illiquid stock has long been understood to be part of the ownership bargain. Founders and first-generation shareholders accepted limited liquidity in exchange for dividends and local influence. But the ownership bargain becomes strained when the shareholder base ages, estate planning needs emerge, and/or family branches multiply.

Ownership succession is often the catalyst that turns a background liquidity concern into a board-level priority. Founders and first-generation shareholders may view the bank as a community institution and long-term family asset. Later generation shareholders may view the same stock as a concentrated, illiquid financial asset.

A banking organization with a divided shareholder base (and potentially a divided board) may find it harder to evaluate and approve strategic alternatives, including whether to remain independent.

An important element of any board strategic planning exercise for a privately-held banking organization is an analysis of its shareholder base. Who holds the shares today? Who is likely to hold them in five years? Are there family trusts, estates, or ESOPs with different time horizons or goals? Is there any history of shareholder (or board) disputes? Are there shareholder agreements or other arrangements that affect share transfers?

Understanding these facts early can ensure the board is aligned on the strategic plan for the organization and prevent liquidity (or other shareholder) demands from coming as a surprise.

A sale transaction: One solution, but not always the right one

One route to shareholder liquidity is a sale of the banking organization for cash, publicly-traded stock, or a combination of the two. But if the issue at hand is that a few minority shareholders need or want liquidity, a sale is not necessary, and if the board and majority shareholder base do not agree, it is not possible.

Even if a sale transaction is the preferred mechanism for generating shareholder liquidity, finding the right buyer can be a challenge. Potential acquirers must satisfy not only traditional strategic and financial considerations, but also the liquidity objectives of the selling shareholders. That requirement often limits the buyer universe to institutions that are able to offer cash consideration or an actively-traded stock.

Creating a public market for shares: IPO, uplisting, OTC quotation

Recent IPO activity has sparked renewed interest in the IPO as a path to liquidity for privately-held banking organizations. A successful IPO that results in an expanded shareholder base and publicly-traded shares can facilitate future capital raising, and create a currency for future acquisitions, in addition to providing eventual liquidity for existing shareholders.

But an IPO is not suitable for every banking organization.

First, to be listed on a national securities exchange, an entity must meet specific listing requirements, including certain financial, shareholder, and governance thresholds.

Without an active market, a board must determine a fair price or range, often by reference to an appraisal and/or a fairness opinion.

Further, an IPO results in the entity being subject to SEC reporting and compliance, a not-insignificant burden, and a more visible market price that can itself become a source of pressure. A smaller banking organization may find that the costs of going public outweigh the benefits, particularly if its stock remains thinly-traded post-IPO.

A banking organization that meets the listing requirements for a national securities exchange may choose to list its outstanding securities on the exchange and register shares of its stock with the SEC without offering additional shares of its stock. This is known as an "uplisting."

Although an uplisting is a potentially more cost-effective way to list shares on a national securities exchange, it brings the same potential downsides as an IPO and does not provide the organization with the additional capital that an IPO brings through the offering of additional shares.

Short of listing securities on an exchange, privately-held banking organizations can look to having their stock quoted on an over-the-counter (OTC) market, which enables trading in the stock while avoiding the burdens of SEC reporting compliance.

However, OTC quotation is not a panacea for a banking organization looking for liquidity, as many OTC-quoted stocks are thinly-traded, and some OTC markets have disclosure requirements, albeit fewer than those applicable to public companies.

Other private company liquidity tools

Other liquidity tools available to private institutions include (i) private sales by shareholders to other shareholders or to third parties, or (ii) share repurchases or tender offers by the bank or bank holding company.

Private sales by shareholders to other shareholders, without involvement by the bank or bank holding company, are often straightforward, as both parties are equally familiar with the institution. But if the shareholder base is concentrated, existing shareholders may not want to acquire additional shares of voting stock due to Change in Bank Control Act or Bank Holding Company Act control considerations.

Private sales by shareholders to third parties can be difficult to execute in practice. The selling shareholder must find a buyer willing to purchase an illiquid security.

To that end, a banking organization may use a secondary trading platform to help facilitate these sales, or compile a list of unsolicited inbound inquiries that that it has received from individuals looking to buy shares and, if a shareholder indicates that they are looking for a buyer, the institution can share the list.

Typically, the institution cannot do more without implicating broker-dealer or other securities regulations. As with private sales to existing shareholders, third parties may also be limited in purchasing shares due to control considerations under the Change in Bank Control Act or Bank Holding Company Act.

If a banking organization engages in a series of share repurchases from individual shareholders in a short period of time, there is a heightened risk that the repurchases will be viewed collectively as a tender offer.

Share repurchases by a company, in a series of one-off transactions with individual shareholders, allow a banking organization to provide liquidity directly. But repurchases require careful attention to contractual restrictions and federal and state law, including disclosure and anti-fraud considerations.

A privately-held banking organization whose shares are not publicly-traded cannot rely on the SEC's share repurchase safe harbor rules and therefore must ensure that each repurchase complies with state and federal law and, importantly, that it is not a tender offer.

If a banking organization engages in a series of share repurchases from individual shareholders in a short period of time, there is a heightened risk that the repurchases will be viewed collectively as a tender offer. As a result, share repurchases are a viable tool to provide liquidity to a limited number of shareholders.

Finally, with any share repurchase, the banking organization runs the risk that other shareholders, upon learning of the repurchase, demand that the banking organization also buy their shares.

Tender offers are useful when a company wants to offer the same opportunity for liquidity to all shareholders. But tender offers generally require formal disclosure documents, a fixed offer structure, withdrawal rights, a minimum offering period, and careful coordination. If oversubscribed, selling shareholders may not achieve full liquidity.

In the case of both share repurchases and tender offers, pricing is a delicate issue. Without an active market, a board must determine a fair price or range, often by reference to an appraisal and/or a fairness opinion. If the institution later pursues an IPO or sale at a materially higher valuation, earlier share repurchase pricing can become a source of shareholder dissatisfaction.

In addition, banking organizations should engage as appropriate with their regulators before any share repurchase or tender offer.

Practical takeaways

First, understand your shareholder base, likely ownership succession events, concentrated ownership positions, contractual transfer restrictions and expectations around dividends, repurchases and sale alternatives.

Second, develop a liquidity playbook that lays out which tools are available, which tools are preferred, what approvals and disclosures may be required, how pricing would be determined, and how the company would communicate with shareholders. Having a plan in place ahead of time avoids ad hoc decisions that create fairness concerns.

Conclusion

As discussed above, privately-held banking organizations are operating in an environment where shareholder liquidity, ownership succession and strategic optionality are increasingly intertwined. A sale transaction remains a potential path, but the required shareholder and board buy-in, valuation gaps and limited buyer pools can constrain outcomes.

IPO markets appear more open than they have been in recent years, but becoming a publicly-listed institution is demanding, costly, and requires an institution to meet certain criteria and prepare in advance.

Liquidity programs can help, if carefully designed and managed to remain within the boundaries described above.

Boards and advisors should not wait for liquidity (or other) shareholder demands, generational transitions, or unsolicited proposals to begin planning.

Institutions that understand their shareholder base, evaluate alternatives early, and prepare for multiple paths will be better positioned to preserve value, whether the ultimate answer is independence, a sale, a public listing, or a more tailored liquidity solution.

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