CSBS
SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

2017 Journal of Community Bank Case Studies

vol. 2

Preface

Journal of Community Bank Case Studies

Volume 2

The Journal of Community Bank Case Studies is an independent, adjudicated journal of case studies authored by undergraduate college students. The goal of this journal is to showcase the work of the top undergraduate student teams that participate in the annual Community Bank Case Study Competition, a national competition facilitated by the Conference of State Bank Supervisors. The competition partners undergraduate student teams with community banks to conduct original case studies focused on various topics.

This second volume of the Journal of Community Bank Case Studies includes the top three written submissions from the 2017 Community Bank Case Study Competition. The authors of the papers represent student teams from The University of Akron, Iowa State University, and Texas Tech University.

About

Conference of State Bank Supervisors

The Conference of State Bank Supervisors (CSBS) is the nationwide organization of banking and financial regulators from all 50 states, the District of Columbia, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands.

Established in 1902 as the National Association of Supervisors of State Banks, CSBS is uniquely positioned as the only national organization dedicated to protecting and advancing the nation's dual-banking system.

For more than a century, CSBS has given state supervisors a national forum to coordinate supervision and develop policy related to their regulated entities. CSBS also provides training to state banking and financial regulators.

CSBS SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

Letter

from John W. Ryan

President & CEO
Conference of State Bank Supervisors

On behalf of the Conference of State Bank Supervisors, I am pleased to present the *Journal of Community Bank Case Studies, Volume II*.

This publication showcases the outstanding work of the top undergraduate student teams from the 2017 Community Bank Case Study Competition. With this year's focus on succession planning, the work of the students is both important and timely; at any point in time, between 30 to 40 percent of senior executives at community banks are "at risk" to retire in five years. These case studies provide us firsthand insight into how community banks are preparing for and managing these risks.

One of the greatest benefits we can provide our youth is an opportunity to engage and excel outside of the classroom. At its core, the Community Bank Case Study Competition is about enriching undergraduate students with an experience that will better prepare them for a professional career or post-graduate studies. The competition is a practical and engaging learning opportunity for the students as they interact with their local community banks.

I am encouraged to see continued student interest in local community banks, and I'm excited that the Conference of State Bank Supervisors can provide a forum for students, professors, universities and community bankers to collaborate on a common objective.

I am pleased to be able to present these student papers in this *Journal of Community Bank Case Studies.*

Sincerely,
John W. Ryan

President and CEO
Conference of State Bank Supervisors

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Executive Summaries

The University of Akron

This paper seeks to profile Peoples Bank, Marietta, OH from a financial perspective, evaluate its current recruitment, retention and development practices as they relate to succession planning, analyze the methods with which Peoples Bank ensures an active succession of executive leadership, and offer suggestions as to how the bank can continue to improve.

- Peoples Bank has adopted a strategy of organic growth paired with external acquisitions since the arrival of CEO Chuck Sulerzyski in 2011.
- Despite initial negative effects on ROA and ROE, acquisitions have led to favorable increases of late thanks to record revenue levels in 2016.
- Operating in Ohio, West Virginia, and Kentucky, Peoples Bank pursues a multi-channel recruitment strategy that makes use of both conventional university recruitment and less common practices, such as sponsoring their own case competition.
- Peoples Bank has created a Professional Development Program to rotate entry level hires throughout the organization and eventually into a permanent role, which has been highly effective at identifying talent.
- The current succession plan makes use of a combination of internal development and external hires.
- One of the primary responsibilities of the board is the development of a formal, confidential succession plan that is core to their overall succession strategy. While not shared with us, it has been made available to regulators.
- Based on our regression analysis and other academic studies, we find that the size and independence of the board of directors does not significantly impact bank performance.

Recommendations

- Formalizing the career path of employees completing the Professional Development Program in order to assist the bank both in recruiting and developing a deeper internal talent pool to promote from.
- Placing a higher emphasis on internal hires for upper level management positions to potentially boost the company's performance and streamline transitions.
- Continuing to seek board diversification to substantially reduce gaps in knowledge within the bank.

Ames National Corporation (ANC) is a bank holding company consisting of five subsidiary community banks operating in central Iowa with total assets of $1.3 billion. Over the past 15 years, ANC has consistently outperformed similar community banks in the Midwest, achieving a higher net income and total assets per employee and a lower percentage of non-operating loans than their peers. ANC leadership attributes the organization's success to a culture that produces a committed workforce that is knowledgeable about the local market and the company's customer base. This workforce has helped ANC originate loans with a low risk of default, allowing them to operate with unusually low operating costs per dollar of operating revenue. The quality of loans the bank originated by this workforce is reflected in ANC's asset management strategy. ANC retains a higher fraction of its loans in-house than peer banks as they tend to be higher quality than those originated by other banks.

ANC's book of business is heavily weighted toward markets which allow for long-term lending relationships. Compared to peer banks, ANC has an atypically large share of loans in agriculture, commercial ventures, and larger residential developments. This longer-term focus requires talent that is committed to the organization. An important factor that incentivizes employees to stay is the ability for career growth. In this area, ANC's bank holding company structure allows employees opportunities to advance both within and across banks. The bank holding company framework also economizes on back-of-the-bank tasks such as auditing, regulation, and marketing while insuring that the front-of -the bank loan origination and customer service tasks are well-staffed.

The bank's succession planning philosophy emphasizes the development and retention of local market knowledge as embodied in its employees. Ninety-three percent of the short-term leadership succession positions and 50% of the long-term succession positions are reserved for internal candidates while only 29% of the long-term positions are expected to be filled by an external hire. The desire to maintain a culture of employees endowed with superior knowledge of local borrowers and market conditions extends to ANC's mergers and acquisitions strategy. The bank will only consider acquiring another bank if it believes its employees have the requisite commitment to the local market.

We demonstrate the effectiveness of their strategy using two case studies of ANC acquisitions: a profitable bank whose parent company was in trouble and a bank on the verge of FDIC closure. ANC took over both banks because it believed the employees fit into the ANC culture. Despite the differences in economic circumstances across the two banks, ANC kept all employees in the first bank and all but one employee in the second, reassigning workers whose jobs were made redundant. Both cases produced very successful growth for the acquired banks and serves as testimony to the effectiveness of the ANC culture.

Texas Tech University *Executive Summary*

Succession planning is more than filling vacancies. Our broader definition of succession planning also includes employee development and talent retention. Successful succession planning is as much about improving employees as ensuring that a board member or executive will have a sufficient replacement. Succession planning is vital to the long-term success and viability of a bank.

Centennial Bank, headquartered in Plainview, Texas has fourteen locations throughout the Texas Panhandle and Texas Hill Country. Centennial is a family-owned bank with a long history of serving customers. Centennial is a community bank with $720 million in total assets. Centennial has a strong track record, suggesting that the bank has done well in succession planning in the past.

Centennial has begun the process of formal succession planning, but does not have well-defined, written plans yet. Without written plans, we consider Centennial's succession planning regarding management incomplete.

Centennial has also recognized the need for replacement of existing board members, but has not taken any action to introduce new members to the board. The bank is in the very early stages of succession planning for the Board of Directors.

Our team believes Centennial Bank is making strides towards formalized plans and is getting closer to a satisfactory succession plan. In addition to this, we recognize that Centennial's long history of strong performance is the result of strong leadership in the board and executive management positions. With additional formalization, Centennial could significantly improve its succession planning.

1st PLACE

The University of Akron

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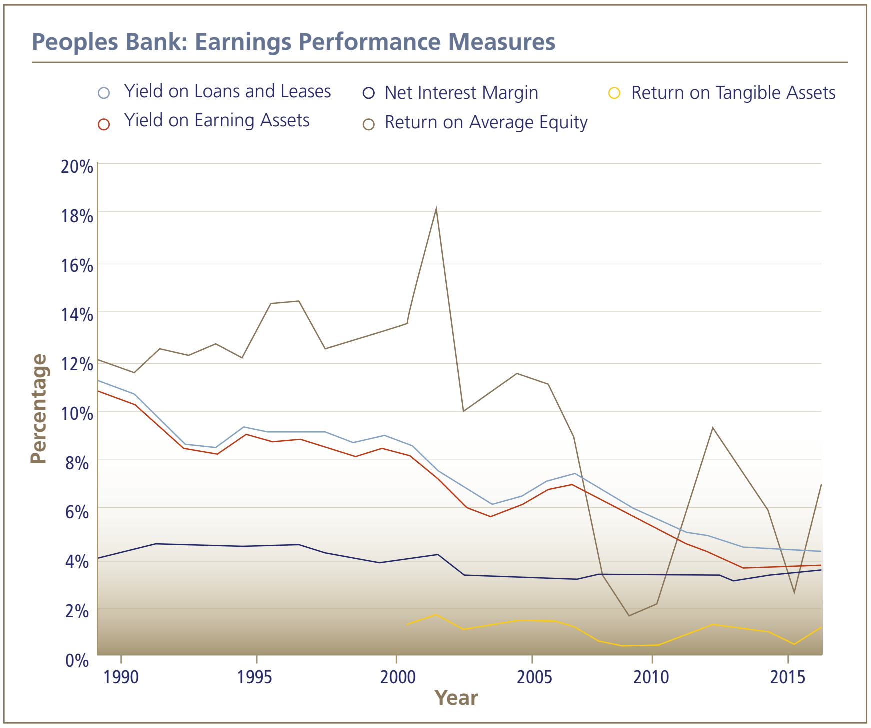
Leadership and Succession Planning at Peoples Bank, Marietta, OH

I. Introduction

On the banks of the Ohio and Muskingum Rivers is the small town of Marietta, Ohio, one of the first settlements in Ohio and its first capital. Originally chartered by the Continental Congress after the Revolutionary War, Marietta is nestled in the southeast corner of the state, serving as a gateway into the Appalachian south. One of the town's most prominent institutions is Peoples Bank, a publicly traded community bank with assets totaling over $3 billion serving communities in Ohio, Kentucky, and West Virginia. Established in 1902, Peoples Bank has the distinction of surviving both the recent financial crisis and the Great Depression. While the bank has experienced significant growth in recent years, thanks in no small part to excellent leadership, its heritage and future success rest on the preparedness of the bank to pass on the reins of power to future leaders.



II. Financial Performance Analysis

A. Earnings Performance

Peoples Bank has adopted a two-pronged strategy of organic growth paired with growth through acquisitions, particularly since CEO Chuck Sulerzyski joined the company in 2011. Because of these recent acquisitions, year-over-year (YOY) earnings are a misleading gauge of performance in the case of Peoples Bank. For example, Peoples Bank experienced declining net income each year from 2012 to 2015 despite increasing operating revenue in each of those years.

Peoples Bank has adopted a two-pronged strategy of organic growth paired with growth through acquisitions.

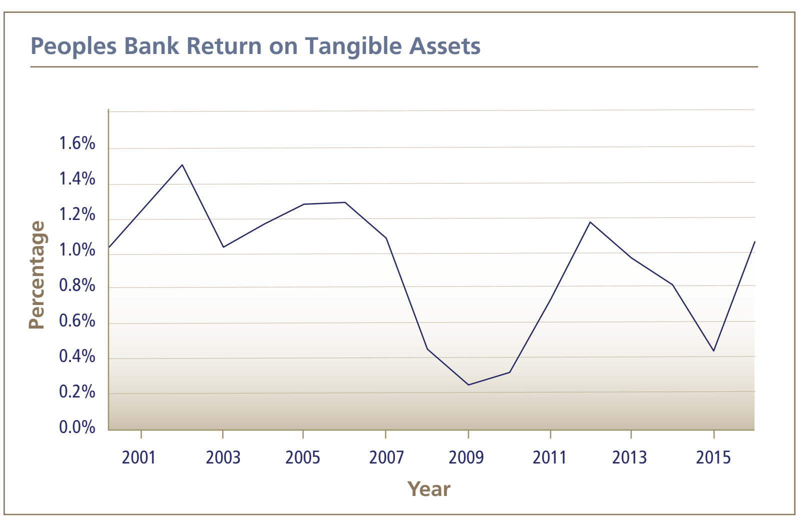
Additionally, they experienced a significant increase in YOY earnings in 2016, mainly because 2015 earnings were dragged down by a one-time cost associated with the acquisition of NB&T Financial Group, Inc., a deal worth over $104 million, and a huge spike in Provision for Loan Losses (PLL) associated almost entirely with the removal of one borrower from the balance sheet.

2016 was a record year for Peoples Bank, recognizing the highest net income level in company history and capping off six consecutive quarters of revenue growth exceeding the rate of expense growth (year over year). Mr. Sulerzyski attributes that 2016 success to loan and revenue growth in the neighborhood of 9.3% and 7.5% respectively, as well as improved asset quality and a commitment to expense management (Peoples Bank 2016 Annual

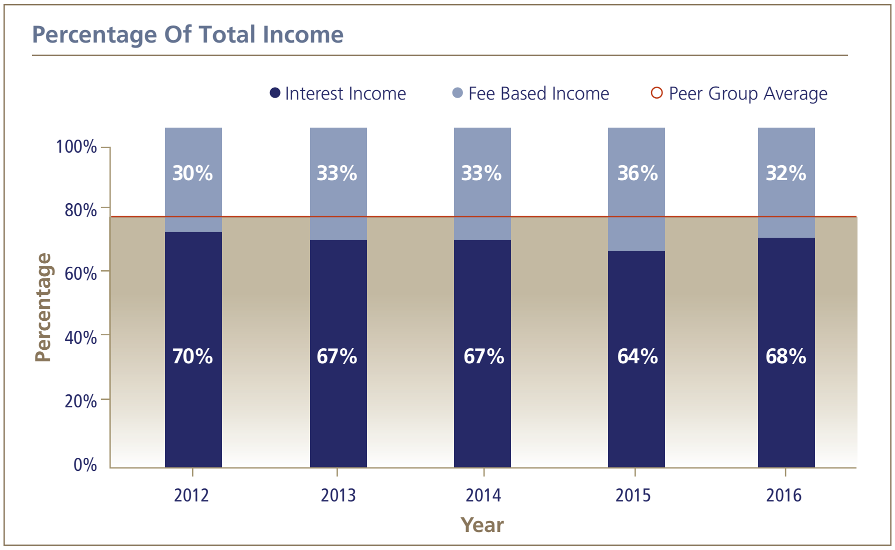
Report). However, he believes that there is still work to be done, citing that as the return on total assets is below average for its size, currently at 0.94% compared to the 0.99% average. Peoples Bank aspires to be much more than average, however, and would like to see ROA closer to 1.15% or 1.20%. They have set a timeline of three years to meet that goal, and they believe that this can be accomplished through further loan growth, positive operating leverage, and acquisitions, which have been a huge part of their strategy over the past five years to achieve economies of scale (Sulerzyski).

According to Mr. Sulerzyski, revenue retention on an acquired bank is in the neighborhood of 97%, while costs are cut by about 40% and opportunities for further revenue growth are introduced (Sulerzyski). This has led Peoples Bank to perform 6 acquisitions since his arrival, adding nearly $1.3 billion of assets to the company. The largest of these deals have included NB&T Financial Group, Ohio Heritage Bancorp, and North Akron Savings Bank.

Peoples Bank has seen volatility in their return on assets (ROA) and return on equity (ROE) as they have placed an increased emphasis on their acquisition strategy and have had to issue new equity to do so. Their ROA increased significantly coming out of the 2008-2009 financial crisis as both their interest and fee-based income began to return to pre-recession levels, in addition to loan losses coming back down, even recovering some commercial real estate loans that had previously incurred charge-offs. The increase in ROA reversed sharply in 2012 as they began to increase their assets through acquisitions, accounting for an additional $1.14 billion in assets over five years. This continued until 2016 when Peoples Bank recorded record revenue levels that allowed ROA to bounce back to near-2012 levels. Return on equity has shown similar patterns, increasing coming out of the financial crisis, reversing as the firm issued new equity to purchase other banks and savings institutions, and spiking again in 2016 in accordance with record earnings levels.



Peoples Bank would like their fee income to be a more significant part of their operations, with a target revenue structure being between 35 and 40 percent fee-based (Sulerzyski). Prior to their recent acquisitions they were historically near, if not within, that range, but the buy-outs have diluted that number down to 31.98% in 2016 as only one of the acquired companies had a wealth management practice.



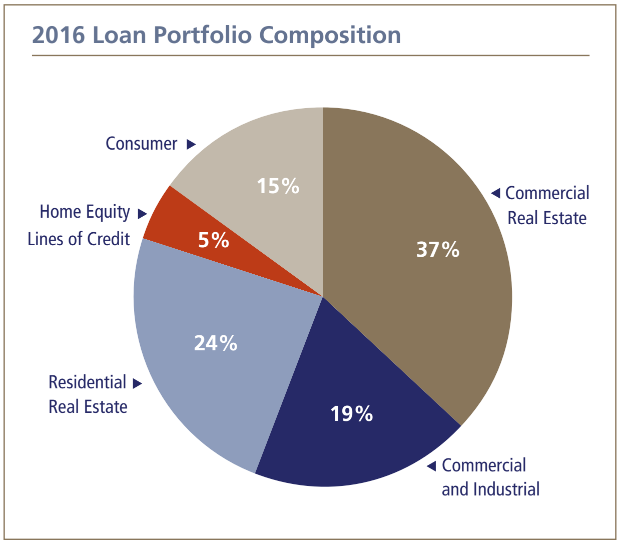
taken out against homes account for another 29.1%, and consumer loans round out the portfolio with the remaining 14.5%.

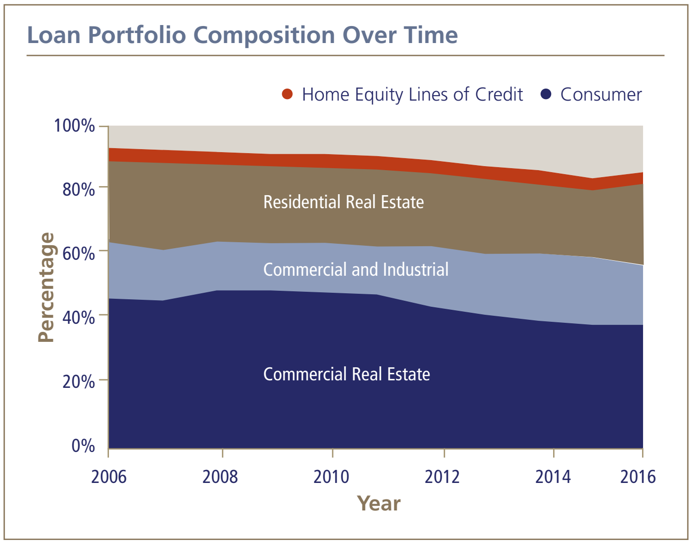
Even with the dilution, they are still well above the peer group average of 23.37% of revenue coming from fees, which is certainly by design.

B. Loan Portfolio Composition

The majority of loans currently being serviced by Peoples Bank are commercial loans, with commercial real estate (CRE) loans making up 37.36% of their portfolio, and commercial and industrial (C&I) loans making up 18.99%. Residential real estate loans and lines of credit

Peoples Bank's loan portfolio composition is highly concentrated in CRE loans, which tend to carry higher credit and concentration risk due to larger balances per account than consumer loans, with repayment often being dependent on the success of the borrower's business. Recognizing these risks, Chief Credit Officer Robyn Stevens points out that they have consistently decreased their position in commercial real estate loans and increased consumer and C&I loans since the 2008 financial crisis. We found that Peoples Bank has decreased the commercial real estate portion from 48% of their total loans in 2008 to 37.3% in 2016, and increased their weightings

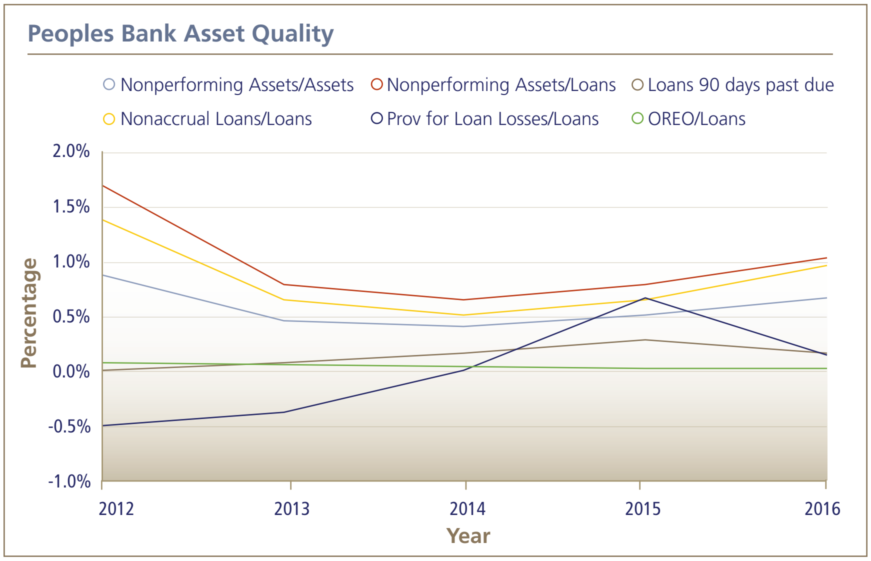


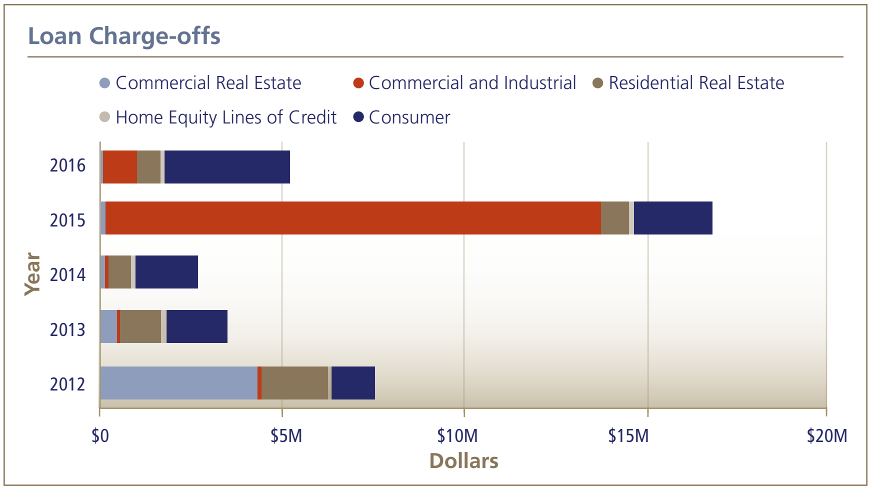


in residential real estate and consumer loans concurrently. It is also worth noting that in addition to trying to reduce the risk of the loans on the balance sheet, the company has decreased their "off-balance sheet" risk as their residential real estate loans being serviced for others due to securitization of mortgage loans has decreased from 17.24% of assets to 11.34% of assets in that time.

C. Asset Quality

In general, Peoples Bank has a reasonable loan portfolio from an asset quality standpoint, with only 0.68% of assets not performing. Some of this may be attributable to their diversification strategy of late, though no loan category is



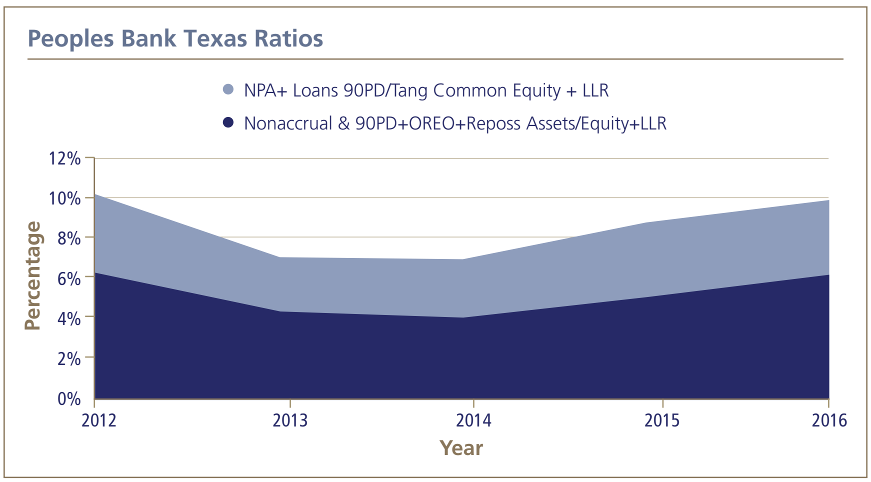


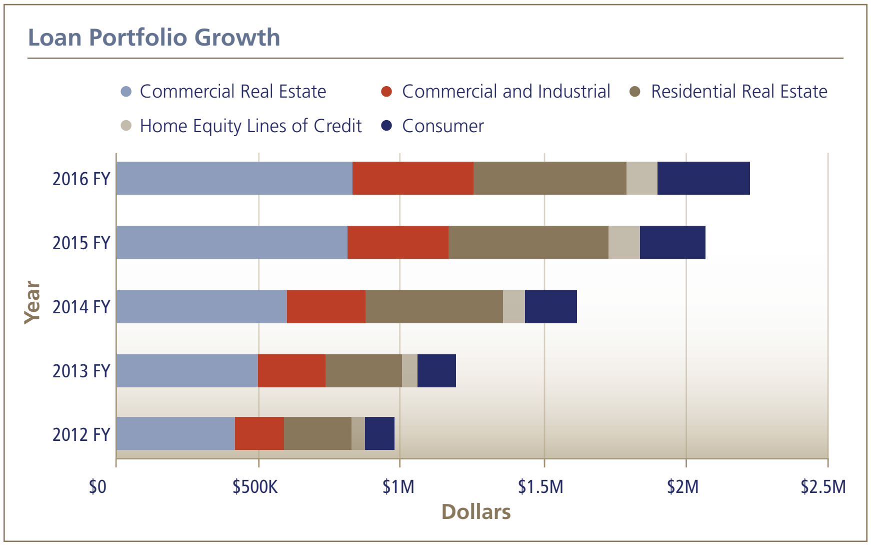
Peoples Bancorp, Inc. Asset Quality Ratios

	2012	2013	2014	2015	2016
Nonperforming Assets/Assets	0.88%	0.46%	0.41%	0.51%	0.68%
Nonperforming Assets/Loans	1.69%	0.79%	0.65%	0.79%	1.04%
Loans 90 days past due	0.02%	0.08%	0.17%	0.29%	0.17%
Nonaccrual Loans/ Loans	1.38%	0.66%	0.52%	0.65%	0.96%
Prov for Loan Losses/Loans	-0.48%	-0.37%	0.02%	0.68%	0.16%
OREO/Loans	0.08%	0.07%	0.06%	0.04%	0.03%
Prov for Loan Losses/Revenue	-4.37%	-4.21%	0.28%	9.08%	2.12%
Nonperforming Assets/(LLR+Tier 1)	8.69%	5.00%	4.75%	5.61%	7.46%
NPA+ Loans 90PD/ Tang Common Equity + LLR	10.23%	7.06%	6.98%	8.81%	9.95%
Nonaccrual & 90PD+OREO+Reposs Assets/ Equity+LLR	6.31%	4.36%	4.06%	5.03%	6.22%

exempt from risk. For example, Peoples Bank recorded a C&I charge-off in 2015 totaling $13.1 million, which accounted for nearly 86% of their charge-offs that year and drastically increased their allowance for loan losses. This tangibly illustrates the riskiness of commercial loans, even beyond real estate, and the reason why Peoples Bank is being intentional about diversifying their loan portfolio. This significant charge-off, and the drastic increase in the 2015 provision for loan losses that came as a result, represent two of the aforementioned outliers that dragged down earnings in that year (Peoples Bank Form 10-K 2015).

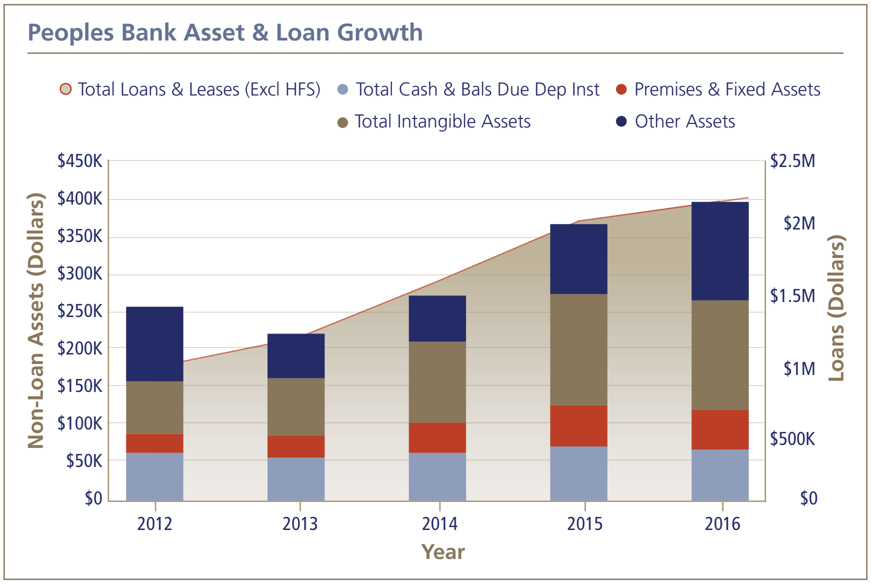
A common industry practice in determining the overall credit risk of financial institutions is the Texas Ratio, an indicator of how much capital a bank has available compared to the total value of loans considered at risk. The capital position of Peoples Bank is very strong, with a Texas Ratio at 6.22%, which Mr. Sulerzyski named as one of the main attributes that attracted him to the company, and Ms. Stevens cites as one of the most notable strengths of the company. She went on to explain how this was crucial for Peoples Bank's ability to endure the 2008 financial crisis, saying, "The bank had a very strong capital position, and that's really how we survived. We had significant charge-offs throughout that period, but really that capital position is what helped us through. Capital is key to the survival of banks during crises."





D. Asset Growth

Peoples Bank has seen their overall loan portfolio grow 127% from 2012 to 2016, averaging nearly 23% growth per year with 7% to 8% of that growth being organic according to Mr. Sulerzyski. Substantial growth in assets in 2014 and 2015 point to four acquisitions during that time,

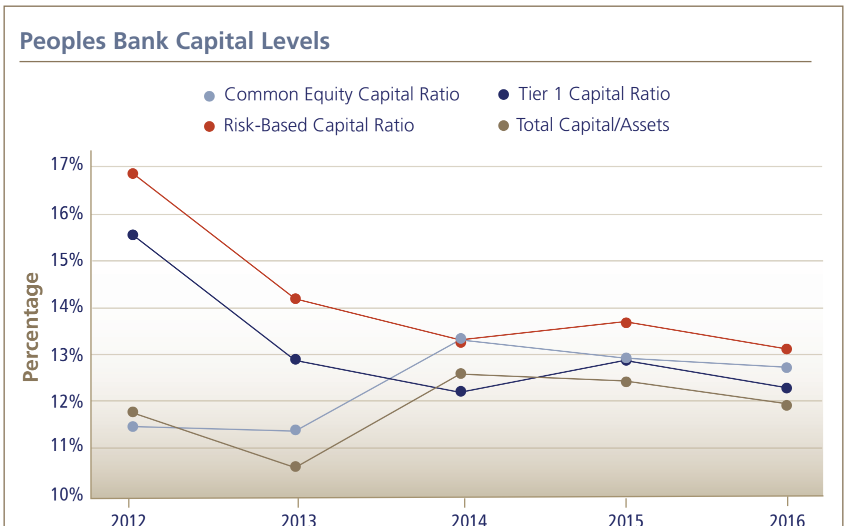


which added $1.14 billion in assets, accounting for 94.73% of their total asset growth over that span. The growth in both of these areas highlight the overarching growth strategy of the company: strong, organic growth supplemented by acquisitions.

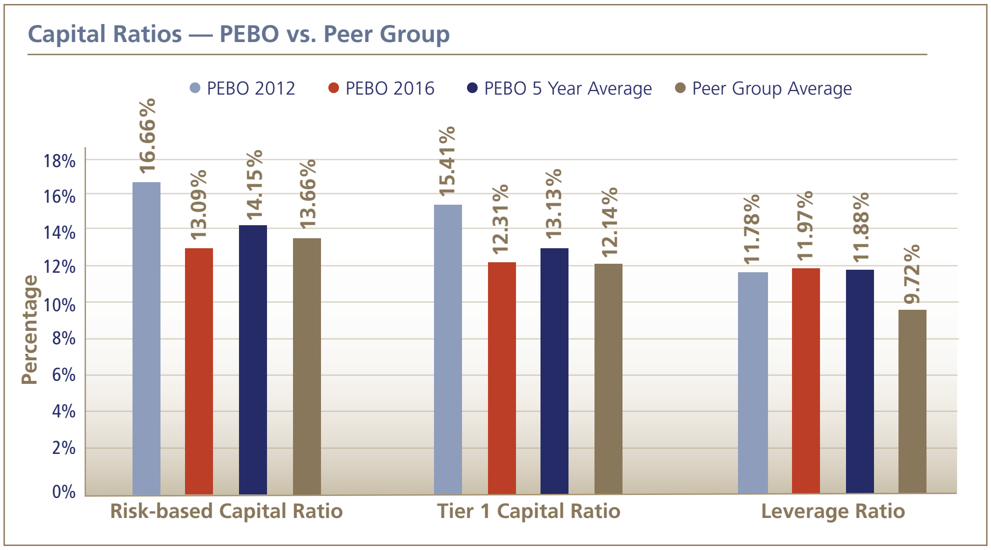
E. Capital Levels and Planning

Peoples Bank was the first bank in Ohio to gain insurance licensure, and remains one of about 400 banks in the country that sells insurance, ranking 17th largest in a market generally uncommon for community banks (Sulerzyski). Their insurance division represents a significant part of their business in line with their emphasis on fee-based revenue, accounting for more than 30 percent of their non-interest income and 10 percent of their total income. Mr. Sulerzyski, who has experience in the insurance business, mentioned that Peoples Bank is more heavily weighted on the commercial end of the insurance business, but over time they would like to be a little bit more balanced between personal lines, commercial casualty, and benefit-based insurance. Allen and Jagtiani conclude that insurance and wealth management reduce overall risk of the firm, but increase systematic risk.

Even after the significant capital expenditures associated with the buy-outs over the past few years have decreased their capital ratios from exceptional 2012 levels, the company's capital



2012	2013	2014	2015	2016
11.53%	11.40%	13.30%	12.89%	12.73%
16.66%	14.12%	13.26%	13.63%	13.09%
15.41%	12.87%	12.20%	12.86%	12.31%
11.78%	10.65%	12.58%	12.43%	11.97%



and leverage ratios are still comparable to the peer group, if not outperforming. A strong capital position provides Peoples Bank with a high level of flexibility, a vital tool in an industry that is highly sensitive to economic conditions. The company has larger proportions of quality common equity capital.

During 2016, Peoples Bank' total stockholders' equity increased due to higher retained earnings, which were offset slightly by the repurchase of 279,770 shares of common stock. Capital levels remained substantially higher than the minimum amounts needed to be considered "well capitalized" under Basel III banking regulations (Peoples Bank 2016 Annual Report 13).

A strong capital position provides Peoples Bank with a high level of flexibility.

III. Succession Planning: Recruiting, Development, and Retention

A. Overview of Peoples Bank Recruiting Practices

The FDIC defines community banks using an array of different definitions. Generally, community banks can be described as those which receive most of their deposits and also make most of their loans to local businesses. As this is the case, often times community bankers are known as relationship bankers, as opposed to the conventional title of transactional bankers. Because of this, community banks will tend to specialize in the geographical area they cover and the local customers they serve. Establishing connections in the community can build a stable customer base which the bank can build on in the future, but there is always a challenge to keep these customers over time. Just as building and developing the customer base can pose a challenge to some community banks, growing and retaining some of the talent used to run these banks can also pose a challenge of sorts. Community banks, partially by definition, are those which are embedded in more rural areas, thus serving more tightly knit communities. These banks are not normally located in the larger metropolitan areas around the United States. These banks, like Peoples Bank, tend to have long established roots in smaller cities that are not always looking to grow in size, but rather focused on maintaining the ground they currently hold. Given the nature of their location, these banks don't usually benefit from the draw of being in close proximity to a major metropolitan area, and this may be an obstacle for those community banks trying to continuously draw talent for the future of the company.

To attract talent in the immediate area of its branches, Peoples Bank tries to establish itself as an "employer of choice" by using different methods to establish their name. As noted by Mr. Sulerzyski, Peoples Bank recruits at colleges throughout the bank's territory in West Virginia, Ohio, and Kentucky by attending career fairs and various on-campus recruiting events. While many other companies and competing banks may do the same, Peoples Bank makes effort to go beyond the traditional recruitment stage. For the past five years, Peoples Bank has fostered its own undergraduate case study competition, drawing teams from sixteen universities annually from Ohio, West Virginia, and Kentucky. Hosted at facilities at the nearby Marietta College, this competition draws self-motivated students from some of the area's best universities.

Peoples Bank attempts to promote its image of company culture and it's Professional Development Program in the hopes of becoming an employer of choice.

Peoples Bank is also eager to participate in other student-lead competitions, such as the CSBS Community Bank Case Study competition, in order to broaden and deepen their image to nearby universities. Although many of these students will pursue opportunities at other places, hosting and participating in these competitions allows Peoples Bank to expose themselves to a self-selecting talent pool of soon-to-be college graduates. Through all of these methods, Peoples Bank attempts to promote its image of company culture and it's Professional Development Program in the hopes of becoming an employer of choice. Peoples Bank also offers very competitive benefits to their employees, including health insurance, flexible spending accounts, retirement savings, and compensation for continuing education. Peoples Bank highly encourages advanced degrees and certifications, with an offer to pay for a third of an advanced degree out of pocket, a third out of what amounts essentially to a subsidized loan which can be forgiven, and leaving the remaining third up to the employee (PEBO). In this way, Peoples Bank stands toe-to-toe with many much larger organizations.

B. Bank's Size and Location as Factors in Recruiting

The prominent players in the banking industry may benefit from their name familiarity when trying to draw customers and talent to their organization. Smaller community banks have a much less powerful regional outreach and tend to focus their efforts within the boundaries they serve. Aside from obvious strategic differences and financial capabilities, banks that differ in size also have different methods for attracting their next employees from the available talent pool. Located usually in larger cities, more well-known banks can rely somewhat on the fact that millennials are easily drawn to the amenities that the urban environment offers. In some ways, the lure of the urban environment itself can attract a sufficient amount talent on its own. For this reason, smaller community banks in cities like Marietta may have to adjust their pitch to the next wave of talent. While Marietta, Ohio may not offer many of the same urban amenities as Columbus or Cincinnati, it should be known that smaller cities may bring a much different aspect of attraction to new talent. Not everyone desires the congestion and fast-paced lifestyles often associated with these metropolitan areas, and smaller rural places can offer advantages of their very own.

Senior Vice President and Director of Human Resources Matt Edgell noted that the Marietta area is great for those who enjoy outdoor activities that may not be available in more urban environments. He also noted the presence of Wayne National Forest close to Marietta, as an attraction to outdoor enthusiasts. Mr. Sulerzyski also noted the opportunities associated with cheaper costs of living. The Marietta-Parkersburg area is much more affordable than other large Ohio metropolitan areas, making it easier for employees to own homes earlier in their career. While the affordability might be a benefit to those just beginning their careers, it was another point of interest throughout the interviews that smaller cities are also attractive to those looking to settle down toward the end of their careers. More rural places such as Marietta and the surrounding area may be attractive to those looking to settle down or even raise a family, as opposed to its urban counterparts.

Despite the fact that Peoples Bank has branches scattered throughout Ohio, the majority of branches lie in southeast Ohio or on the western part of the state between Cincinnati and Dayton. The branch presence in West Virginia and Kentucky is limited to the northern-most portions of the states near the Ohio border. Much of the area they serve is located in the Appalachian regions of these states. To take a closer look at this region, we can use Appalachian Ohio as a benchmark. The Appalachian region as a whole covers parts of 12 other states, but covers 32 counties in the southeastern and eastern parts of Ohio. Much

Metropolitan Statistical Area	Population
CINCINNATI	2,137,406
CLEVELAND	2,077,240
COLUMBUS	1,836,536
DAYTON	799,232
HUNTINGTON-ASHLAND	361,580
PARKERSBURG-MARIETTA	162,056

SOURCE: 2010 US Census

of the region's economy once relied heavily on manufacturing, agriculture, and mining, but has slowly tried to diversify its economy with time. However, this region ranks as one of the poorest regions of Ohio, without the presence of many high-income jobs. In 2011 this Appalachian region had a poverty rate of 17.50%, more than 1% more than the state as a whole, and nearly 2% greater than the nation as a whole. The 2011 per capita income was $29,269 compared to Ohio overall average of $37,836 and the US figure of $41,560. The unemployment rate for Marietta's Washington County stands at 7.9% compared to the Ohio average of 5.9%, as of February 2017 (Appalachian Counties Profile). Appalachian Ohio also has lower educational attainment averages than non-Appalachian Ohio. For example, 16.4% of Appalachian Ohio's population over 25 has less than a high school diploma as opposed to 12.5% for the rest of Ohio. Also, only 14.9% of Appalachian Ohio's population over 25 has at least a bachelor's degrees, whereas the rest of the state is much higher at 25.4% (Pollard and Jacobsen).

While many branches of Peoples Bank are located in these more rural portions of the states they serve, many are still close to major metropolitan areas. Many of the branches are located less than an hour from the top four metropolitan areas by population, so although branches tend to serve less urban environments than some larger banking counterparts, in many cases the customers and employees of Peoples Bank can still enjoy the attractions and amenities of these larger cities from suburbs or outlying towns just as many others do.

C. Professional Development Program

Once talent has been attracted and is ready to begin the early career stages, Peoples Bank will often put them through a career development program to further enhance the workers' abilities as well as further grow the base of human capital. The Professional Development Program of Peoples Bank is one of the keystones to developing and training employees for future leadership positions within the bank. There have been numerous examples of movement within the company from recent Professional Development Program graduates, but as of recent, some of the recent C-suite hiring has come from external sources. Three of the five current executive officers have been hired externally from other banks or organizations. Current CEO Chuck Sulerzyski brought experience from Cleveland-based KeyBank upon his arrival in 2011. John Rogers, the standing Chief Financial Officer and Treasurer, came from PNC Bank of Pittsburgh, PA in 2011 and Chief Commercial Banking Officer Daniel McGill brought over a decade of experience from First Merit Bank in Akron, Ohio. The Chief Credit Officer Robyn Stevens and Chief Administrative Officer Carol Schneeberger have both had extensive experience at Peoples Bank before being named to their executive positions.

In interviews at Peoples Bank's headquarters in Marietta, Ohio, CEO Chuck Sulerzyski had noted that the bank would like to have much less external hiring in the next five years than it had done in the previous five. It should be noted, however, that there are times when the fresh leadership, knowledge, and perspective of an external hire can be necessary and even prove beneficial for the company, namely in the case of specialized positions or newly-created positions such as Chief Information Technology Officer. Mr. Sulerzyski noted that he himself is another example of this as his hiring was specific to the circumstances of the time and the nature of the problems that Peoples Bank faced after coming out of the recent financial crisis. While the problems at the time made for somewhat of a 'fire drill' transition, Mr.

The bank would like to have much less external hiring in the next five years than it had done in the previous five.

Sulerzyski noted that his skills and experience in the banking industry helped to get the company back on steady ground. In the future, Mr. Sulerzyski noted that Peoples Bank would ideally like to consider the long-term strategy of the bank and the preservation of its cohesive culture in addition to recruiting someone who has the skills and experience needed to adjust to the ever-changing market. As for the next wave of C-level executives, Mr. Sulerzyski expects more of these hires to come from within the bank, as Ms. Stevens and Ms. Schneeberger have done in the past. Peoples Bank has definitely proven to be capable of developing and establishing talent to take control of these positions in the future (Sulerzyski).

IV. Board of Directors

A. Board Overview

Mr. Sulerzyski describes the board of directors as being one of the strengths of the company as well. "We have a good, strong board. It continually refreshes itself, and I've been very pleased at how it's developed over my tenure." In the Peoples Bank board, the roles of CEO and chairman of the board are separate, with the chairman, currently Mr. David L. Mead, being an independent director. As per section 4 of Peoples Bank's Corporate Governance Guidelines, "This structure enhances independent oversight of management performance, which is a key component of efficient corporate governance and overall risk management." The recent news that United Airlines CEO Oscar Munoz will not be promoted to chairman and CEO is evidence that what Peoples Bank is doing is one of best practice, though this separation is not unambiguously positive, and there is little research to support the required separation of these roles (Larcker & Tayan).

The company has to comply with regulations associated with their corporate governance and regulatory bank ratings. Some of these regulations include Sarbanes-Oxley, Dodd-Frank, NASDAQ listing requirements, SEC regulations, and management ratings in the CAMELS rating of banks. We wanted to interview the chairman of the board or any one of the other board members to discuss the impact of these regulations on corporate governance and succession planning, but we were informed that the chairman did not think it is appropriate for the board to be directly involved in our discussions. It is for this reason that much of our findings are based on the publicly available information and what Mr. Sulerzyski and other executives in the company shared with us during our recorded discussion, which is in accordance with section 3(d) of their Corporate Governance Guidelines, which states that “the Chief Executive Officer and other members of senior management are responsible for speaking on Peoples’ behalf.”

B. Board Diversity

Diversity and experience are clear priorities in board member selection. The age of directors range from 43 to 65 years, with the average age being 57. They have a superannuation age of 70 years, which is the reason for the retirement of two of their board directors last year who had served since 2004, including Richard Ferguson, the former chairman of the board. There are also four females on the board of directors, something that Mr. Sulerzyski describes as being unique. “We’re proud of the fact that we have four females on our board. That’s very unusual. Females are underrepresented on boards in general, which makes no sense to me.”

Besides the demographic diversity of the board, and perhaps more important, is the diversity in professional experience. Represented in the board are directors who have had successful careers in a variety of industries, including an attorney who has served as special counsel to the Ohio Attorney General’s Office since 1994, a retired physician who spent 24 years in ophthalmology, and their newest board member, Terry Sweet, who brings 30 years of public accounting and financial services experience to the board. Mr. Sulerzyski thinks that the role of the community bank board has changed and continues to change. “Historically, people who were on community bank boards were large customers or ‘who’s who’ in the community or in the market and the movement is much more to skills – so ‘Who’s the financial expert? Who has an understanding of cyber? Who has an understanding of emerging technologies?’ That is an indication of what you’re looking for. It’s really the skills and the background.” Mr. Sulerzyski went on to mention Terry Sweet specifically, who was a partner at KPMG, one of the big four accounting firms, as well as David Dierker, who ran the administrative functions of SunTrust Bank, as examples of the abundance of quality and diverse talent represented on the board of directors.

Management believes they will continue to have a say in what skills they desire to see added to the board as directors are identified and recommended by the Peoples Bank's Governance and Nominating Committee, per section 4 of the bank's Corporate Governance Guidelines. Management believes that whomever that committee appoints will be supported by shareholders, assuming that the bank continues to be a steady, dependable performer for its shareholders with returns superior to those of its peers regardless of operating conditions (Peoples Bank 2016 Annual Report). Peoples Bank has a staggered board, upon which directors are elected for a three-year term, delivering continuity to the upper-level management. Those up for re-election this year include Tara M. Abraham, James S. Huggins, and Brooke W. James, and their re-election will be done at the bank's Annual Meeting on April 27, 2017. (Peoples Bank 2017 Proxy Statement)

There are no term limits for directors based upon the belief that there is value in acquired experience and insight over time.

C. Board Size and Independence

The overall size of Peoples Bank board is to be between nine and 15 board members, with 13 members on the board currently. Per NASDAQ listing requirements, the board must have a majority of independent directors. There are no term limits for directors based upon the belief that there is value in acquired experience and insight over time (Peoples Bank 2017 Proxy Statement).

The board meets no less than nine times each year, though Mr. Sulerzyski says that they typically have 12 meetings – six face-to-face and six telephonically. The Executive session of independent directors is held at least twice a year, and no members of Peoples Bank management is to be present at these sessions (Peoples Bank 2017 Proxy Statement).

D. Compensation

Independent directors are compensated for their contributions to the board, and this is done in a few ways: cash payment or fees earned, common stock awarded, and pensions or nonqualified deferred compensation being the main ones. Their compensation packages for 2016 ranged from $53,304 to $74,514 in fair value, with the median director earning $57,849, which is just below the median board compensation for a bank their size of about $60,000 (Mahlum 20).

The board has an actively managed succession plan in place that is revisited and reviewed annually in detail.

E. Committees

The board has five standing committees, each chaired by a different independent director: Audit, Compensation, Executive, Governance, and Nominating and Risk. The Audit Committee and the Risk Committee's primary functions are the oversight of risk of the board. The Risk Committee provides the primary oversight of significant risks on an enterprise-wide level while the Audit Committee looks more closely at management's actions to address compliance, legal, and operational risks. The Compensation Committee works in conjunction with regulators to evaluate all risks posed by the bank's compensation programs and attempts to limit any unnecessary risks these programs pose both to the bank and program participants. Through these committees and strong working relationships with management, the board is able to actively oversee and manage the key aspects of risk to which Peoples Bank is exposed (Corporate Governance Guidelines).

The role of members in the committees is critical, particularly in view of the developments related to Wells Fargo's recent scandal where there is a movement not to reelect 12 of the 15 board members by the shareholders (particularly from the Audit and Compensation committees). The Governance and Nominating Committee of the Peoples Bank board is responsible for making recommendations regarding the assignment of directors to various committees and who should chair each committee. After reviewing the recommendations from the Nominating Committee, the board will appoint chairs and members to committees on an annual basis, and will review annually with a focus on balancing the benefits of continuity against those of diversity of experience and viewpoints (Corporate Governance Guidelines).

F. Board Responsibilities

Mr. Sulerzyski describes the responsibilities of the board of being primarily twofold: succession planning in terms of CEO selection and management, and the strategic direction of the company as a whole. The board has an actively managed succession plan in place that is revisited and reviewed annually in detail. They spend time talking through the top 25-30 professionals in the company and what succession and development looks like for them. Though this plan is highly confidential and was not shared with us, it is provided to regulators (Sulerzyski). Because of its confidentiality, it is difficult for us to assess the alignment of this strategic plan with their long-term goals. Regardless, it seems clear that this plan has been a driving force behind their recent success in recognizing, developing, and retaining talent. The board also has a strategic plan in place that was created in 2011 that is refreshed every other year. It is a guiding method for the management of Peoples Bank, and from it is drawn their highly emphasized strategy of strong organic growth paired with external acquisitions.

V. Correlation Analysis: Performance, Succession and Leadership Preparedness

In an attempt to relate the changes in leadership at Peoples Bank to the changes in bank performance, we ran a regression of historical leadership data from 1990 through 2016 on performance measures such as return on assets (ROA) and net interest margin (NIM). To discover what effects, if any, leadership has on the bank's performance, we also account for some of the major environmental characteristics of both the bank and the general economy. The dependent variables of the two models, ROA and NIM, give a performance valuation of the bank over the studied period. GDP growth is included to account for general economic conditions, meaning larger negative figures indicate relatively harsher conditions than the year before and vice versa. NPA/Loans90PD represents non-performing assets plus loans that are 90 days or more past due as a percentage of tangible common equity and reserves. NPA/Loans90PD could be a way to categorize the bank's risk-taking strategies and may also reflect on the customer base the bank interacts with. To capture the effect of technological improvements, we use the ratio of intangible assets to total assets as a proxy. Since 2012, more accurate expense categories such as software expense or electronic banking expense are available, but we do not have those specific numbers for the entire time period over which we wish to see leadership effects on performance. The other three categorical variables present in the model all represent changes in upper-level management. The CEO1 variable represents the first serving CEO, Robert Evans. CEO2 represents Mark Bradley and his succeeding interim CEO, David Mead and current CEO Chuck Sulerzyski is omitted to serve as the reference group. For the CFO position, CFO1 represents John Conlon, CFO2 represents both Carol Schneeberger and Donald Landers because of their short, one year term lengths, CFO3 shows Edward Sloan, and current CFO John Rogers is omitted as the reference group. The variable for board hire indicates whether a new member was added in that year.

The regression results table shows the results of our two regressions, with the Net Interest Margin model having less variables due to potential multi-collinearity issues. We see that the coefficients, or intercept adjustments, for CEO and CFO are positive in one model and negative in the other. Most of the coefficients were not statistically significant, except for those of the CEO, CFO, and intangible assets. The signs of the coefficients on the other variables, however, tend to be consistent with what we would expect theoretically. We would expect banks to perform better in periods of higher overall economic growth, and it might be reasonable to assume that riskier loans (NPA/

90 day past due) would be associated with lower performance indices. The intangible assets figure was included in hopes that this might capture items such as customer relationships, trademarks, and other patented technologies, but we see a sign opposite of what would be expected if increased use of technology helped the bank to perform better. Although the coefficient of intangible assets suggests that higher intangible assets lead to lower performance, this variable may be capturing the effects of mergers and acquisitions. As the major changes to software and payment systems have occurred in the past few years, we may have to wait for the effects of those technology investments in the future. In 2015, Peoples Bank updated its core banking system to enhance the customer experience. In addition, other technology improvements such as a streamlined digital banking and a wider network of surcharge free ATMs are also expected to allow Peoples Bank to improve performance and increase customer satisfaction.

The coefficients for CEO suggests that at least some of the CEO variables are statistically significant in both regressions. Also, five out of six CFO categorical variables were significant on some level, possibly indicating an observable difference of performance based on their hires. Additionally, the variable for board member change was found to have no statistical significance in the model. Our model results, albeit simplified and non-significant, are consistent with several academic studies that suggest board size or independence do not affect performance (Boone et al.; Pathan and Skully). Adams and Mehran also examine bank board structure and performance using 34 years of data, and find that the composition of the board has little relationship with performance, which is also consistent with past research on non-

Regression Results

Dependent Variable	Net Interest Margin		Return on Assets	
Variable	**Coefficient**	**t-statistic**	**Coefficient**	**t-statistic**
GDP growth	5.9149	1.59	0.0164	0.67
NPA/Loans90PD	-0.0195	-1.27	—	—
Intangible Assets	-32.2900	-6.12**	—	—
CEO1	0.5998	1.73*	-0.0053	-2.41**
CEO2	0.3171	1.29	-0.0051	-3.68**
Board HIre	-0.0848	-0.96	-0.0006	-0.86
CFO1	-0.9857	-2.66**	0.0095	3.69**
CFO2	-0.9080	-2.68**	0.0095	4.31**
CFO3	-0.3302	-1.74*	0.0021	1.42
R2	0.90		0.77	
Adjusted R2	0.85		0.68	
N	27		27	

*Note: ** and * denote statistical significance at the 5% (or better) and 10% levels, respectively.*

financial firms. Our results regarding the CEO and CFO variables would suggest that different executive changes affect the performance measures of ROA and NIM differently. Of course, due to model simplicity and a very low number of observations, these conclusions must be interpreted with caution.

VI. Primary Recommendations

Peoples Bank employs a succession strategy that relies on developing internal candidates and supplementing them where necessary through external hires. This process is vitally important to the strategic direction of the firm, and can also have a significant impact on bank performance. Our conclusions and recommendations take a two-pronged approach: improvements to professional development and retention and improvements to C-suite position and board succession planning.

A. Improvements to Professional Development and Retention

While many firms offer rotational programs such as that offered by Peoples Bank, it seems less common in community banks. In fact, Peoples Bank is the only community bank we have encountered with such a program. Peoples Bank offers this program in an effort to groom candidates for positions throughout the company, with a strong focus on the branch manager position. Based on our discussion with Matthew Edgell, the Senior Vice President and Director of Human Resources, it became clear to us that Peoples Bank exercises rigorous planning to determine the permanent assignment of candidates who complete the rotational program, while deliberately not planning what their future would look like after that position. After a candidate has completed their rotation and taken on a permanent role, whether as a branch manager or in an internal position, their path forward is thus more ambiguous. In Mr. Edgell's words, "the sky's the limit" for what one might do after taking on a permanent role. This opportunity for growth is exciting, but it exposes Peoples Bank to two potential risks. First, it can create ambiguity surrounding the career path a prospective employee may take. For some young people this may be exciting, but for others it can be frightening. One could easily posit that there are essentially two types of prospective employees: those who are willing to accept high risk for a higher reward, and those who prefer a steady and more predictable future. Considering that Peoples Bank tends to recruit a high proportion of their candidates from rural areas, such as the nearby Marietta College, it seems safe to say that many of those candidates will likely fall in the latter category. Second, it could pose a possible retention problem. Employees without a clear idea of their career path may find it tempting to make a lateral move to a different company in an effort to minimize uncertainty. An additional recommendation we would make is the development of a written talent management program. Currently Peoples Bank sends staff members to acquired banks in order to smooth the integration process, and eventually staff members from acquired banks are incorporated into the overall talent pool of Peoples Bank. As this process continues, formalizing a written talent management program would allow Peoples Bank to more holistically visualize the available talent that they possess.

B. Improvements to C-suite Position and Board Succession Planning

The final suggestions that we would make relate directly to the planning of upper-level management and the board of directors. In a paper on CEO succession planning, Zhang and Rajagopalan explain that while external hires of CEOs are seen as superior and are thus slightly more common, they actually have a negative impact on ROA after three years when compared to internal hires. While the current CEO of Peoples Bank is an obvious exception to this, this seems consistent with the idea that internal hires, particularly those coming to a C-suite position within the firm, are best suited to comprehend all of the issues facing it and hit the ground running. Considering that the board of directors already has a formalized process for succession planning for upper-level management, we recommend exercising a special emphasis on the internal hires that Peoples Bank has expressed a desire to make in our conversations with them. Finally, the board should continue to diversify its members, particularly in regards to recruiting members with backgrounds in information security, insurance management, and personal financial planning.

In conclusion, it is our recommendation that Peoples Bank attempt to absolve some of the ambiguity surrounding climbing the career ladder by creating a more structured pathway and extend current CEO hiring practices to other C-suite executives, while also seeking to continue adding to their already well-diversified board. This will allow them to more smoothly channel rising stars into roles that translate more naturally into leadership positions, and safeguard Peoples Bank's impressive history and performance for many years to come.

Formalizing a written talent management program would allow Peoples Bank to more holistically visualize the available talent that they possess.

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Ames National Corporation: A Culture of Success

1) Community Banks and Bank Holding Companies

A Bank Holding Company (BHC) is broadly defined by the Bank Holding Company Act of 1956 as "any company that has control over a bank." The BHC structure provides several advantages that has driven the proportion of banks owned by a BHC to rise from 34.3% in 1980 to 84%. Perhaps most importantly, a BHC can raise capital more easily than can a stand-alone bank. It can allocate capital across its subsidiary banks in response to expected returns or to pool risk. Empirical studies have found that banks affiliated with a multi-bank holding company are significantly more resilient to financial distress and recover more readily than stand-alone banks (Ashcraft, 2008).

The multi-bank BHC structure allows for community banks to take advantage of economies of scale while retaining the personal quality of their front-end business. Cost savings can be achieved by centralizing the back-of-the-bank functions including accounting, regulation, and human resources. The subsidiary banks, which have closer connections to the customers, specialize in the front-of-the-bank operations. They manage customer financial services, originate loans, provide local brand recognition, and maintain relationships with customers in their communities.

The BHC structure also allows for coordinated personnel actions across subsidiaries, allowing greater flexibility in succession planning. Lines of succession and promotion can exist across banks as well as within banks, providing more career advancement opportunities than at stand-alone banks.

2) Community Banks and Relationships

The community bank's main competitive advantage over large national banks is its knowledge of the local market and its customer relationships. Contracting theories suggest that small banks have their center of decision making authority closer to the source of information collection than the larger banks, allowing them to act better on "soft information" (Berger, 2005). On the contrary, larger banks base lending decisions heavily on financial and credit information analyzed through statistical methods. Their reliance on statistical analysis simplifies the decision-making process, allowing repeatability across many clients and many loans. Statistical information, however, does not fully reflect customer attributes, many of which are unobservable without one-on-one contact with customers. This additional soft information can reveal opportunities the statistical methods of larger banks cannot. Community banks fill this niche. Community banks develop personal relationships with their clients that allow them to understand their customers' financial needs and dependability to better predict their potential as borrowers (Petersen and Raghuram, 1994). This relationship can also benefit borrowers, as the community bank can then confidently react to help their clients succeed. Given the importance of these relationships to a community bank's success, leadership with a strong understanding of and attention to the local community is of paramount importance. Future leaders must be groomed to understand and exploit the community banks' comparative advantages.

Future leaders must be groomed to understand and exploit the community banks' comparative advantages.

3) Succession Planning

Succession Planning is defined as a structured process to facilitate the identification and preparation of prospective talent to fill future vacancies. Succession plans not only allow future leadership to achieve their full performance immediately after assuming a position, but they also provide insurance against unexpected deaths. Davidson and Worrell (1990) examined 60 cases of unexpected CEO deaths and found that firms with an immediately available successor were more resilient to unanticipated loss of a key manager. Behn et al (2005) found that firms with a designated heir apparent had higher cumulative returns in the case of the CEO's death. The analysis of CEO deaths points to the broader implication that planned succession assures continuity. Investors have an assurance that the firm will outlive the CEO. Despite the unambiguous benefits of having succession plans in place, Garman and Glawe, (2004) estimate that only 40% - 65% of firms have established succession plans.

Many companies have adopted leadership development programs or talent pools to facilitate the development of future leadership.

Succession planning is not just about providing contingency plans. It is planning for the long-term success of the organization. The broader literature on succession planning outside of banking advises adopting a mindset of continually "identifying and developing promotable individuals" as opposed to "finding an individual to promote when the need arises." Many companies have adopted leadership development programs or talent pools to facilitate the development of future leadership. Designated successors are provided assignments with the greatest opportunity for learning and visibility including planned rotations to learn the full range of company lines of business and strategic initiatives. When a position becomes available, company leadership has access to a pool of prepared candidates for promotion. For the position of CEO, however, only one potential successor is typically identified to prevent uncertainty about the future transitions.

To identify potential candidates for leadership development, the set of desired skills and characteristics must first be clearly defined. The skills and characteristics of interest vary across industries, business models, and organizational structures. In our application, community banks prefer leadership with strong personal connections to the community while large national banks de-emphasize personal relationships with customers while focusing on portfolio management. For example, the current

CEO of Citigroup, Michael O'Neill, spent most of his early life in Europe and Asia and doesn't have deep roots with any local community.

Studies have found firm size to be a significant factor in determining successor preferences. As a rule, smaller firms more strongly prefer external successors than do larger firms. That is not the case with community banks. The importance of lasting relationships in the community bank business model leads to a preference for internal successors.

4) Financial Performance of Ames National Corporation

Ames National Corporation (ANC) is a multi-bank holding company located in central Iowa. ANC is composed of First National Bank, Ames, IA; State Bank & Trust Co., Nevada, IA; Boone Bank & Trust Co., Boone, IA; Reliance State Bank, Story City, IA; and United Bank & Trust, Marshalltown, IA. With total assets of over $1.3 billion as of December 31, 2016, ANC is the 6th largest Iowa-based commercial bank holding company based on total deposits.

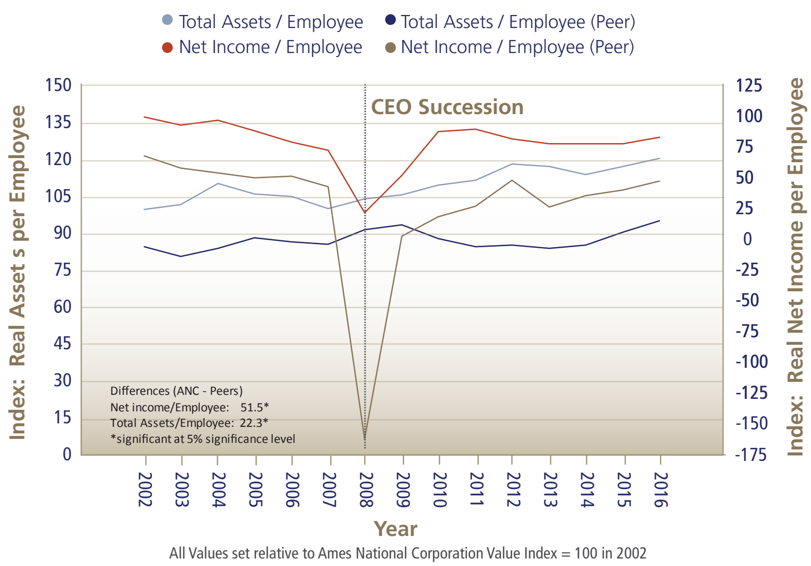
Before we delve into ANC's corporate personnel strategies, we want to compare its financial performance with that of comparable peers. Our control group includes six bank holding companies or large individual banks that operate exclusively in the Midwest. They are listed in Table 1. ANC had assets of $1.37 billion at the end of 2016, 62% lower than the peer group average. We will look at ANC's productivity, performance, loan portfolio composition, and capital levels and planning compared to its peers.

Table 1: Descriptions of the Bank Peer Group[2]

Security National Bank of South Dakota is a Bank Holding Company with 3 subsidiaries headquartered in Dakota Dunes, SD. It has $1.38Bn in assets and its loan portfolio is primarily comprised of Real Estate (53%; 22% domestic and 13% farm) and agriculture production loans (28%).
West Bancorporation, Inc. is a standalone bank that is headquartered in West Des Moines, IA. It has $1.85Bn in assets focused on commercial lending. Only 0.02% of its loan portfolio is agricultural. The bank is highly levered with a high Loan to Deposit ratio of 91%.
MidWestOne Financial Group is the holding company of MidWestOne Bank which operates in Iowa, Minnesota, Wisconsin and Florida. They had $3.08Bn in assets at the end of 2016.
Great Southern Bancorp is the holding company of Great Southern Bank which is headquartered in Springfield, MO. It operates 104 retail banking centers with retail branches in throughout the Midwest and commercial lending offices in Tulsa, OK, and Dallas, TX. It has $4.55Bn is assets.
Hills Bancorp is the holding company of Hills Bank & Trust Company. All of its operations are within the state of Iowa. They had $2.66Bn in assets.
Heartland Financial is a Bank Holding Company with 10 subsidiary banks spread over 108 locations throughout the West and the Midwest. It has $8.25Bn in assets.

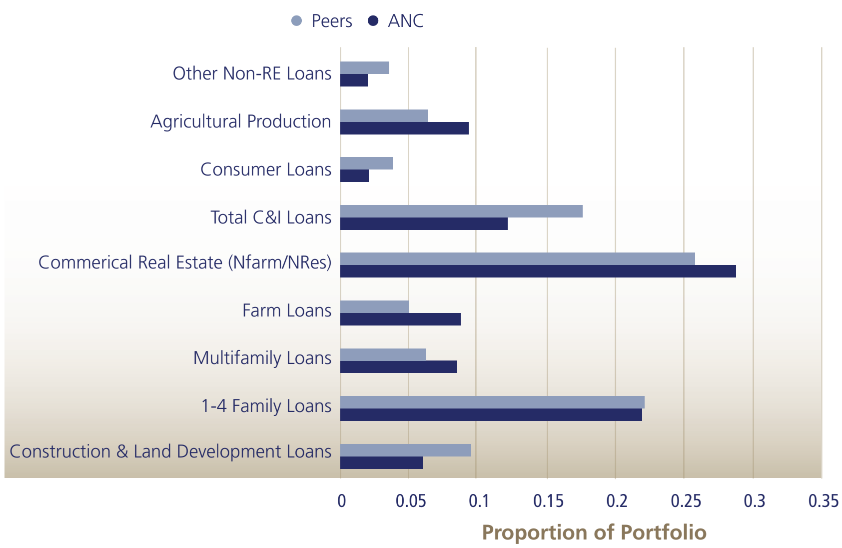
ANC is far more productive than its peers. While it has 44% lower asset growth over the past 15 years compared to its peer banks, ANC has been able to grow assets per employee at a much higher rate: 1.4% versus 0.8% annually. Consequently, ANC consistently sustained a statistically significant advantage in net income per employee through both cyclical expansions and contractions, as shown in Figure 1.

Figure 1: Real Assets and Real Income per Employee for Ames National Corporation and Peer Banks, 2002-2016



The difference in productivity is due partly to a difference in loan focus compared to the peer banks, as illustrated in Figure 2. ANC's loan portfolio places greater weight on agricultural and commercial real estate loans and larger residential developments. In contrast, peers place a greater weight on shorter-term consumer, construction and industrial loans. The longer-term business loans and the agricultural loans arguably require greater knowledge of the borrower and of local business conditions than would shorter-term, smaller loans.

Figure 2: Loan Portfolio Composition, 2002-2016, Ames National Corporation and Peer Banks



The ANC loan mix is a result of a long-standing strategy. There have been no significant changes in ANC's loan portfolio composition over the past 15 years. This loan portfolio requires expertise in the local agricultural and commercial markets. ANC's human capital and succession strategies provide a comparative advantage in identifying and retaining employees who are knowledgeable about their borrowers and local market conditions.

ANC's superior productivity is reflected in ANC's Return on Average Assets (ROAA) as well. As illustrated in Figure 3, ANC has achieved significantly higher ROAA than its peer banks throughout the past 15 years, while limiting the losses during the recession. Part of ANC's advantage is achieved by limiting costs. ANC averaged 6.4% lower operating expenses per dollar of operating revenue, referred to as the efficiency ratio. The link between high ROAA and low costs is evident in the -0.59 correlation between ANC's efficiency ratio and its ROAA.

Figure 3: Return on Assets and Operating Expenses Relative to Operating Revenue, Ames National Corporation and Peer Banks, 2002-2016

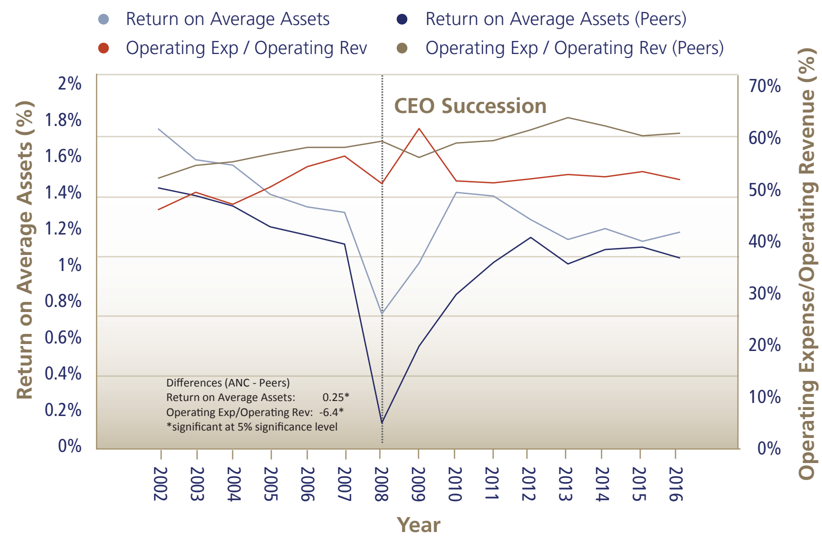
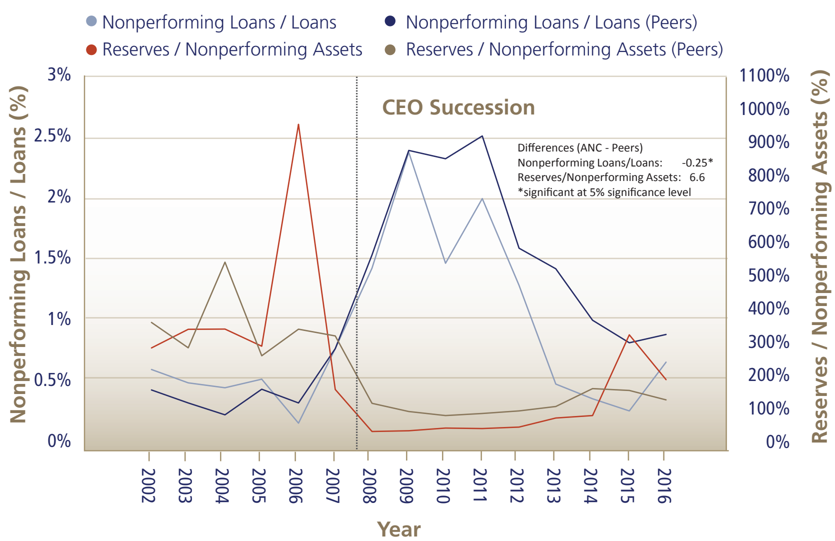


Figure 4: Percent of Loans that are Nonperforming and Reserves per Dollar of Nonperforming Assets, Ames National Corporation and Peer Banks, 2002-2016



ANC achieves this lower cost and greater productivity while maintaining asset quality. Its high underwriting standards and knowledge of its borrowers are apparent in Figure 4. While ANC had the same percentage of nonperforming loans as its peers through the first years of the Great Recession, it has had lower rates of nonperforming loans since 2010. Over the past 15 years, ANC has had a 22% lower rate of nonperforming loans. Meanwhile, there are no significant differences between

ANC is more conservative than its peer banks. ANC holds much more capital while maintaining similar or superior asset quality.

ANC and the peer banks in the ratio of reserves to nonperforming assets.

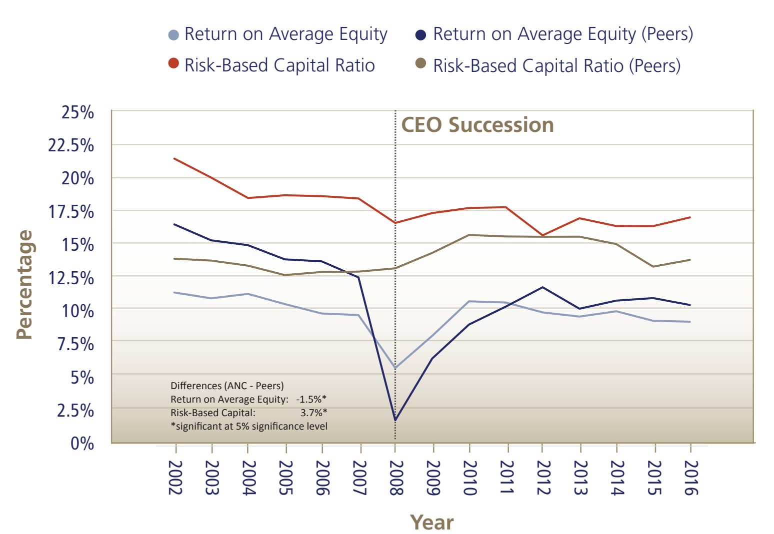
As illustrated in Figure 5, ANC is more conservative than its peer banks. ANC holds much more capital while maintaining similar or superior asset quality. In the past 15 years, ANC has had a 27% higher average risk-based capital ratio than the peer banks. The additional reserves give ANC a cushion in the event of a bad shock. More importantly, the added reserves provide a potential source of liquid funding if an acquisition opportunity appears. The additional security also allows ANC to issue a dividend relative to net income that has been 80% higher than its peers on average.

The charts demonstrate that ANC outperforms its peers through greater efficiency of its staff, lower costs per dollar of revenue, and lower default rate on originated loans. The higher quality of loans originated by ANC is consistent with the presumption that ANC staff are highly informed of their local markets and the reliability of their borrowers. The subsidiary banks retain many of their loans rather than selling them, ANC leadership explains their reluctance to sell loans because they expect that their loan origination is atypically profitable.[1] Next, we will review how ANC's personnel policies aim to attract and retain employees who are knowledgeable about the local communities.

5) ANC Succession Planning and Human Resource Policies

ANC's human resources staff are committed to working with employees on their professional development to help them succeed and incentivize them to stay. ANC has achieved low employee turnover rates which allows it to develop and maintain knowledge of the

Figure 5: Percent Return on Equity and Risk-Based Capital Operating, Ames National Corporation and Peer Banks, 2002-2016



local community and to foster long-term relationships with clients. The firm believes that staff with extensive experience in the local market will be able to originate higher quality loans with low default rates. These beliefs represent a culture that has been fostered at ANC since its founding in 1975.

Given its growth, ANC adopted a formal succession plan in 2016. The succession plan is designed “to identify and prepare employees for high-level management positions that become vacant due to retirement, resignation, death or new business opportunities.” Succession planning at ANC is a coordinated activity between managers and employees. Both are responsible for insuring the succession plan works. Every January, each subsidiary bank president is charged with providing a review of the key positions of the bank delineating the following:

- Leadership positions that likely will need to be replaced
- Employees who show potential for progression into leadership
- Actions to prepare identified talent to develop
    - Leadership skills
    - Interpersonal skills
    - Demonstration of ANC core values

In addition, management is charged with continually assessing each employee’s potential, having honest discussions with the employees about their futures, and working on career development plans with the employees

While management holds the power to decide whom to promote, leadership development is not a unilateral process and needs employee engagement. Employees are responsible for expressing their interests in pursuing new roles, creating and keeping up-to-date career development plans, working with managers to identify career development opportunities, and being open to and acting on feedback. These interactions benefit both parties. They enable managers to better understand the skills of their employees and to identify better promotion prospects for the future within and across constituent banks. The process also demonstrates that the company values its employees and wants them to stay with ANC. ANC’s demonstrated commitment to the employee’s future success in the firm lowers the chance the employee will be attracted to positions in other banks.

Succession planning at ANC is a coordinated activity between managers and employees.

To see the process in action we interviewed Nick Johnson, a recent MBA graduate of University of Iowa, who is now working as an Investment Analyst at ANC's First National Bank. He attests to the commitment of bank leadership in developing future talent: "I have the ability to say, 'John (Nelson, CFO), my goal is to be CEO, train me." He experienced the flexibility of the ANC leadership immediately when he started as his position of Investment Analyst did not exist until he started at the bank. His position was tailored to his specific skills and interests, which the leadership realized benefits the bank. CFO Nelson has also been continually engaged in helping Nick develop his skills. CFO Nelson recently helped Nick purchase a $3 million asset. "That is not something I would want to do the first time without John," says Nick.

As mentioned previously, the leadership development process works best when both employee and employer are putting in effort.

The leadership development process works best when both employee and employer are putting in effort.

Employees are encouraged to ask themselves the following questions:

- "What are my career goals? Am I interested in a leadership position within this department? Which position?"
- "Are my career goals and target dates realistic?"
- "What are my strengths?"
- "Are there additional competencies, technical, or leadership skills for a desired future role that need my attention?"
- "What types of career development opportunities do I prefer?"

In larger firms, the Human Resource division is much more engaged in the succession planning process, as they typically operate the leadership development programs. In the case of ANC, however, the focus is shifted to the interactions between employees and management, with HR playing a supportive role in completing clerical tasks.

There are two primary objectives that succession planning addresses, one being insurance in the case of an unexpected loss of leadership, the other being strategic development of leadership for the future. ANC addresses these two separate objectives of succession planning by identifying both a short-term and a long-term successor, who may not be the same individual. In the event of an unexpected loss of leadership, the short-term successor takes over the tasks for a transition period while the long-term successor is prepared and trained. The short-term successor needs to be immediately ready to fill the position, therefore at ANC they tend to be more senior members of the organization. While we traditionally think of succession involving a lower-level employee taking on a higher position, the short-term need of finding a successor led ANC to designate some higher-level employees as the successor for their subordinates. However, it is generally desirable for a long-term successor to be younger and groomed to lead the organization strategically into the future. The contingent short-term successor allows the organization to act judiciously and avoid rushing to a premature decision on who will fill the position.

Table 2: Summary information on the Ames National Corporation Lines of Succession

Internal Candidates

Bank	Short Term	Long Term	Positions
AMES NATIONAL CORPORATION	80%	60%	5
BOONE BANK AND TRUST	100%	50%	4
FIRST NATIONAL BANK	100%	43%	7
RELIANCE STATE BANK	100%	80%	5
STATE BANK AND TRUST COMPANY	100%	66%	3
UNITED BANK AND TRUST COMPANY	75%	0%	4
Total	93%	50%	28

External Candidates

Bank	Short Term	Long Term	Positions
AMES NATIONAL CORPORATION	20%	20%	5
BOONE BANK AND TRUST	0%	25%	4
FIRST NATIONAL BANK	0%	29%	9
RELIANCE STATE BANK	0%	20%	5
STATE BANK AND TRUST COMPANY	0%	33%	3
UNITED BANK AND TRUST COMPANY	25%	50%	4
Total	7%	29%	30

Internal or External Candidates

Bank	Short Term	Long Term	Positions
AMES NATIONAL CORPORATION	0%	20%	5
BOONE BANK AND TRUST	0%	25%	4
FIRST NATIONAL BANK	0%	29%	9
RELIANCE STATE BANK	0%	0%	5
STATE BANK AND TRUST COMPANY	0%	0%	3
UNITED BANK AND TRUST COMPANY	0%	50%	4
Total	0%	22%	30

Past research advises against identifying multiple individuals for the role of CEO/President. Being composed of several subsidiary banks, ANC is in a unique situation where it has many internal presidents. This allows ANC to fully utilize its potential executive talent by moving targeted future leaders across its subsidiary banks to positions that will groom them for advancement. For example, three of the five current subsidiary bank presidents with ANC were once officers of State Bank and Trust. Because there are several president positions in the bank holding company structure, there can be multiple subordinates under consideration for future presidential roles. The main presidential role of the parent company, however, has a sole internal candidate for its successor and thus follows literature recommendations.

The succession plan for ANC is summarized in Table 2. Most of the long-term and short-term candidates are taken from positions in the bank. For the short-term succession planning, over 90% of the future vacancies will be filled by candidates already in the company. The remaining short-term successors will be filled by external candidates. For long-term succession, 50% of the positions will be filled exclusively from internal candidates. Another 20% of long-term successors will be either internal or external candidates. The final 30% of long-term successors will be sought from external candidates. ANC's preference for internal successors reflects its preference for keeping its current personnel, which allows it to retain the relationships already established by the bank. ANC does note that for certain positions, external candidates can bring a fresh perspective, improved techniques and skills that benefit the bank.

6) The Leadership Transition Process

The importance of a smooth transition when changing leadership cannot be understated. The ability for the successor to begin effective leadership immediately contributes strongly to an organization's financial success. The literature regarding this transition process encourages detailed preparation long before the transition occurs. Garman and Glawe

The importance of a smooth transition when changing leadership cannot be understated.

(2004) suggest that the best practices include having training programs tailored toward the one person taking over as well as having post-succession assessments to identify future potential problems. Another major part of the process centers on the person leaving the position. Garman and Glawe (2004) believed that it is essential to have a clear exit strategy in place to assure that there is never uncertainty about who is in the role, the leaving or the new individual. In a study of small firms, Sambrook (2005) found that a common problem for CEO or high level succession is transferring the knowledge stored only in the leaving individual's mind to the incoming successor. This problem could potentially occur in small community banks that have had one person in charge for a large number of years.

In the case of ANC, this transition process is a situation that will take place in the very near future. Its current CEO will be stepping down with the current CFO taking over the position. This strategy of identifying one successor well in advance has been found to be the most effective and reliable mode of action. Previous literature also emphasizes further preparation through training and during the transfer of responsibility, which ANC has already begun. Employees of lower positions have started training to take over some of the CFO's responsibilities as seen in the previously stated training of Investment Analyst Nick Johnson. If not already instituted, some form of assessment on the way the transition process plays out after completion could be very beneficial to ANC as it pertains to other future leadership successions.

There has been only one transition of major ANC leadership (CEO and CFO) since 2000. It occurred when the bank's CEO retired and was replaced by a subsidiary bank president. This transition occurred in 2008 at the start of the Great Recession, so it is possible that the transition succeeded even as the measured financial performance of the bank deteriorated. Nevertheless, we can use the peer banks as controls for the changing financial environment in the banking industry and examine if there is a change in ANC's returns when it changed leadership. Consider the regression

(1) $y_{At} = \alpha_0 + \alpha_P\, y_{pt} + \beta_S\, D_{08} + \epsilon_{it}$

Where y_{At} is a measure of ANC bank performance in year t, y_{pt} is the corresponding performance of the peer group in year t, and D_{08} is a dummy variable that takes the value of 1 after the new CEO is installed. The coefficient α_P will measure how sensitive ANC's performance is to average market conditions for the Midwest banking sector. The peer banks should capture common cost and revenue trends in the area.

The coefficient β_S will capture the change in performance that coincides with the tenure of the new leadership. If the succession from old to new leadership results in continuity of performance, we will not reject the null hypothesis that $\beta_S = 0$.

Results are reported in the first panel of Table 3. We use three different measures of bank performance: real net income per employee; return on average assets; and the efficiency ratio. All are converted into natural logs. We report the results without (column A) and with (column B) the succession dummy variable. The coefficient on the peer measures are always positive but less than 1, suggesting that ANC responds to the same average cyclical profitability that affects its peer banks, but more moderately. ANC's returns rise slower than its peers when business conditions improve, but its costs also rise slower when market operating expenses are rising. Our primary interest is in the coefficient on succession. For the first and third measures, the coefficient is not significantly different from zero, meaning that the change in CEO had no discernible effect on bank net income per employee or efficiency. The second measure does show some evidence of reduced performance compared to the peers on return on average assets. The coefficient implies that ANC's advantage over its peers in return on average assets, apparent in Figure 3, shrank by 12% after the change in CEO.

We were also able to run equation (1) for two of the subsidiary banks experiencing transition in leadership: First National Bank and Reliance

Table 3: Estimation of Equation (1) Explaining the Performance of Ames National Corporation Compared to its Peer Banks

	ln (Real Net Income/ Employee)		ln (Return on Average Assets)		ln (Efficiency Ratio)	
	A	B	A	B	A	B
Dependent Variable is the Performance of Ames National Corporation, 2002 – 2016						
Constant α_o	2.90*	2.95*	0.258*	0.320*	2.14	3.00
p-value	< 0.001	< 0.001	< 0.001	< 0.001	0.14	0.16
Succession β_S		-0.03		-0.12*		0.03
p-value		0.64		0.048		0.56
Peer α_p	0.32*	0.31*	0.308*	0.261*	0.45	0.23
p-value	< 0.001	< 0.001	< 0.001	< 0.001	0.21	0.65
Adj R-Sq	0.79	0.78	0.74	0.79	0.12	0.14
Dependent Variable is the Performance of Subsidiary First National Bank, 2002 – 2016						
Constant α_o	1.27*	1.20*	0.238*	0.295*	-0.60	3.39
p-value	< 0.001	< 0.001	< 0.001	0.002	0.74	0.14
Succession β_S		0.04		-0.10		0.15*
p-value		0.60		0.34		0.02
Peer α_p	0.08*	0.812*	0.709*	0.671*	1.08	0.09
p-value	< 0.001	< 0.001	< 0.001	< 0.001	0.28	0.86
Adj R-Sq	0.92	0.91	0.85	0.85	0.27	0.50
Dependent Variable is the Performance of Subsidiary Reliance State Bank, 2002 - 2016						
Constant α_o	4.08*	3.57*	0.228*	0.280*	4.68*	1.97
p-value	< 0.001	< 0.001	< 0.001	< 0.001	0.004	0.25
Succession β_S		0.268*		-0.10		-0.10*
p-value		0.01		0.22		0.04
Peer α_p	0.048*	0.147	0.07	0.028	-0.22	0.46
p-value	< 0.001	0.06	0.30	0.67	0.52	0.27
Adj R-Sq	-0.05	0.50	0.01	0.06	-0.04	0.22

*Note: * indicates significant at the 0.05 confidence level*

Bank. The promotion of the First National Bank president to CEO of the holding company resulted in a change of presidency in First National Bank in 2008. Using the methodology outlined above, the results in the second panel of Table 3 show no change in subsidiary bank performance as measured by net income per employee and returns on average assets following the change in leadership. But operating expenses relative to operating revenue rose by 15% after 2008, narrowing ANC's efficiency advantage in that bank. Reliance Bank also had a succession in 2008. As shown in the 3rd panel of Table 3, there was a significant improvement in net income per employee and a reduction in operating costs relative to revenues following that change. There was no significant change in return on average assets.

All in all, ANC's recent leadership successions show a general tendency of continued steady performance. Bank performance declined in only 2 of the 9 estimates of β_S and rose or stayed constant in the other 7. Where significant

While the physical capital comes with the purchase contract, retaining human capital is a bigger challenge through any transition process.

changes are observed, they are not sufficiently large to alter ANC's performance advantage over its peers.

The immediate availability of a successor positively affects a firm's financial performance in the event of a disturbance. ANC's 2016 succession policy is too new for us to evaluate, but its past leadership transitions have been successful on the whole. It is reasonable to assume that ANC's more comprehensive succession plan will generate even more stability in firm performance with future successions.

7) Board of Directors

ANC has a current Board of Directors made up of its CEO and CFO, along with a diverse range of other individuals from many different sectors. This includes CEO/Presidents from different firms, a farmer, a retired veterinarian, who is the chairman, and an attorney. Board members are chosen and replaced with a nominating committee for the Board of Directors. The responsibility of the committee is to identify and select individuals to fill board vacancies. The committee first identifies the competencies, experience, and personal attributes needed to enhance the existing mix of talents on the Board and then identifies individuals who have the desired attributes. The mandatory qualifications include a sound understanding of business and finance, community involvement, and high moral and ethical standards. Board members are also expected to reinforce the bank's culture as along with maintaining its financial success.

The Board must include a minimum of three members independent of the organization. This external membership on the committee is in place to assure an outside perspective is heard when bank decisions are being made in the ever-changing financial environment. The Board also tries to include a mix of demographic groups. The nonprofit 2020 Women on Boards recently singled out ANC for its inclusion of women on their Board.

The Board of Directors is particularly important in fostering a smooth leadership transition for its CEO and other leadership positions across ANC's subsidiary banks. It also is tasked with maintaining the bank culture as it decides on mergers and acquisitions. As ANC expands into new communities, the succession plan for the Board will need to accommodate a broader group of potential future leaders who will continue the tradition of strong community involvement in those new geographic areas.

At ANC, the process of acculturalization is a pre-merger and not a post-merger activity.

8) Mergers and Acquisitions

Ames National Corporation incorporates its human capital policies into its strategy for acquisitions they pursue. ANC views mergers and acquisitions as an opportunity to strengthen not just its physical capital, but also its human capital. The presumption is that the targeted bank's employees have the necessary locational knowledge to assure the profitability of the acquisition. While the physical capital comes with the purchase contract, retaining human capital is a bigger challenge through any transition process.

Goyal and Joshi (2012) identified three stages to the merger and acquisition process; pre-merger, acquisition, and post-merger. They suggest that the pre-merger stage involves assessing the financials of the target bank while also checking with shareholders and customers on the overall culture of the bank. The acquisition stage is a time when the bank is actually acquired, the necessary information transfers occur and developing relationships with new customers takes place. The post-merger stage is one of the most important in terms of the long-term success of the acquisition. This stage is where the employees of the newly acquired bank must be integrated into the new bank culture. Goyal and Joshi (2012) heavily emphasize that behind all these business processes there are people whose lives are being greatly affected by the change. Therefore, it is important for the bank to assure that these new employees are taken care of and thought about on a personal level.

This leads to a broadening of the view of succession planning, namely, what is ANC's philosophy regarding succession of employees in banks that they acquire? Because ANC will provide the back-of-bank support for marketing, auditing, regulation, and other centralized operations, some positions in the acquired bank will be eliminated. However, ANC does not want to lose the accumulated community-specific skills and knowledge embodied in those workers. At ANC, the process of acculturalization is a pre-merger and not a post-merger activity. When ANC is looking to acquire a bank, a prerequisite for acquisition is that the personnel fit the ANC culture and that they will remain with the company after acquisition. The operational belief is that keeping the experienced employees in the acquired bank is key to the successful acquisition. Employees whose tasks are no longer required will be moved to other functions where their locational experience will be most profitable. ANC has opted out of a prospective acquisition when if felt the employees of the acquired bank lacked the client relationships or location-specific knowledge that would generate the competitive advantage in originating quality loans and customers.

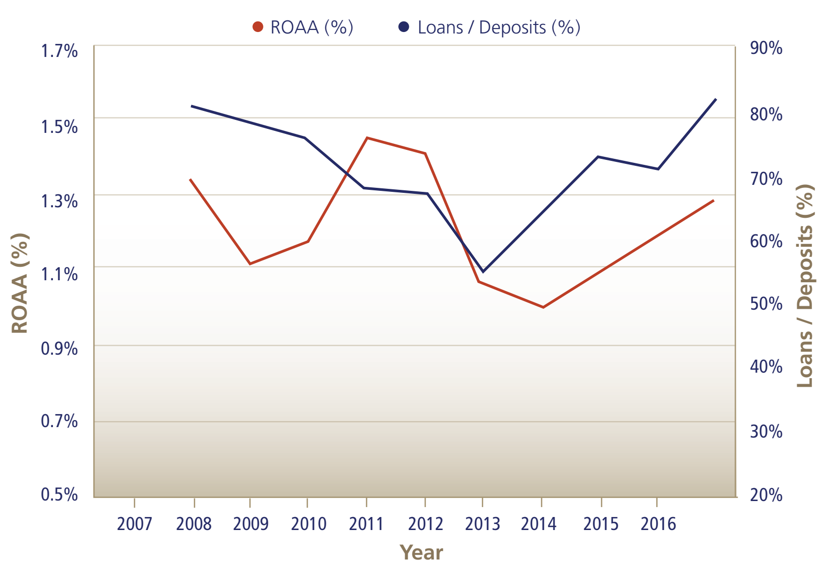
Because ANC's acquisition strategy depends on retaining the employees in the acquired bank, it must deal with the personnel challenges that arise during a merger or acquisition. ANC addresses this issue by first interviewing every employee in the acquired bank. It is then assessed where each person would fit into the organization and even where they might fit in the succession plan. The benefit of being a bank holding company allows ANC to have the option of placing the person in a position of need at a different bank, thus keeping as many of the same employees and their locational knowledge as possible.

9) Two examples of Acquisitions

ANC has made two acquisitions since the Great Recession. In April 2012, Reliance State Bank, a subsidiary of ANC, acquired two branch banks located in the Iowa towns of Garner and Klemme totaling \$98 million in deposits and \$47 million in net loans. The seller, Liberty Bancshares, was facing financial problems and was in the process of reducing its assets from \$1.2 billion in Q3 2010 to \$267 million in assets by Q3 2013. However, the acquired banks were considered well-managed, and ANC made retention of the existing leadership a requirement for the transaction to be consummated. Through incentives and contracts agreed to with the Liberty Bancshares employees before the acquisition, ANC was able to retain all experienced employees in the acquired banks. This acquisition grew Reliance's assets by 107%, its loans and leases by 90% and its employee base by 138%.

The second occurred in August 2014, First National Bank of Ames, a subsidiary of ANC, acquired First Bank of West Des Moines, IA. The acquisition added \$80 million in deposits and \$49 million in loans. The transaction increased First National Bank's asset base by 7.0% and its liabilities by 14.0%. This acquired bank was in financial trouble and was on the verge of being shut down. However, after ANC interviewed all the employees, it determined that the bank's problems were not due to poor employees but to poor economic circumstances

Figure 6: Performance of Reliance State Bank Before and After Acquisition of Two Liberty Bancshares Banks in April 2012



related to the recession. ANC retained all but one of the employees in the bank, reassigning back-of-the-bank employees to its loan origination, trust, and other client-based functions.

Both acquisitions have been relatively recent, and both are considered successful thus far. We have enough time elapsed since the Lincoln Bancshares acquisition to evaluate bank performance after the takeover. We illustrate the results in Figure 6. Both return on average assets and loans relative to deposits have grown since the April 2012 acquisition.

With these, other bank acquisitions, and business practices, ANC believes that its employees will be able to generate a more reliable book of business than would larger, more impersonal banks. Both of these specific examples clearly demonstrate ANC's human resources strategy when it is looking to acquire a bank. As noted earlier, ANC does not want to lose the accumulated community-specific skills and knowledge embodied in the employees of the acquired bank and believes they will be key components of a successful acquisition. The strength of the ANC culture is exhibited in the success of both acquisitions.

10) Conclusion and Recommendations

As we have shown in this paper, ANC is an efficient and well-functioning organization with a stable culture and robust plans for the future. The bank holding company consistently outperforms similar banks on many measures of efficiency and financial performance. Their succession planning strategy is consistent with established best-practices, and their human capital strategy has produced a highly effective staff. In acquiring other community banks, they introduce their strategy and corporate culture while retaining the connections with the local community it serves. Both recent acquisitions that we analyze including one well-performing and one poorly-performing bank have proven successful.

We do recommend Ames National Corporation explore adopting college programs. Its hometown, Ames, is home to Iowa State University, the largest university in the state. There are also several community colleges and Drake University in some of the communities ANC banks serve. These colleges could serve as a talent pipeline of highly educated members of the local community. If college students are identified early on as future employees, this also presents the opportunity for ANC to integrate students into their culture before becoming full-time staff after graduation.

MLA Citation

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For information on the Liberty Bancshares operation, go to http://www.businessrecord.com/Content/Finance---Insurance/Finance---Insurance/Article/Patience-will-pay-off-in-bank-acquisition/171/833/63598

Endnotes

1 From interviews with Tom Pohlman and John Nelson, CEO and CFO of ANC.

2 All assets are valued on December 31, 2016.

3rd PLACE

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Centennial Bank Succession Planning: Preparing for the Expected and Unexpected

Overview

Centennial Bank was founded in 1934 in Plainview, Texas, a small town located between Lubbock and Amarillo, Texas. The bank was originally chartered as Hale County State Bank (HCSB). In 2002, the bank expanded to Kerrville, Texas to grow commercial and residential lending. In 2013, the bank merged with Citizens Bank of Slaton and changed its name to Centennial Bank. This rural community bank started primarily as an agriculture bank, making loans to West Texas farmers, but has moved into other geographic markets, diversifying lending and growing the business. Centennial Bank now operates in three markets: Lubbock, the Panhandle and South Plains, and the Texas Hill Country.

The decision to expand into new geographic areas was a shift in strategy for Centennial Bank. The Texas Hill Country, 320 miles away, was chosen after management identified growth opportunities in

> *"We are all about people, they are our greatest asset."*

the area. The expansion has been successful and Centennial now has several locations in surrounding areas such as New Braunfels and Fredericksburg, Texas. Today, Centennial Bank operates nine locations in West Texas and five additional locations in the Hill Country. Centennial Bank currently has $720 million in assets and has a strategic goal of reaching $1 billion in five years.

Centennial Bank is a closely, family-held organization. Specifically, the shareholders have elected the S-Corp entity to minimize federal income tax exposure. S-Corps are pass through entities and thus have tax advantages over traditional C-Corp banks. As an S-Corp bank, Centennial is not taxed at the corporate level, but its shareholders are responsible for paying taxes on the bank's net income. Like most S-Corp banks, Centennial pays dividends to cover shareholder taxes.

Centennial Bank recognizes the importance of people. In the Centennial Bank Story, management states that "We are all about people, they are our greatest asset." The bank's board and management believe that succession planning is closely aligned with investing in employees. Centennial Bank has recently initiated a "KSOP plan", which is similar to an Employee Stock Ownership Plan (ESOP), but investments in the company are held in employees' retirement accounts. We see this as a good example of Centennial investing in its employees.

Analyzing the financial characteristics and historical trends of the bank

Asset Growth

During the past five years, Centennial Bank has seen a growth in total assets, however, much of this growth came from a bank merger in 2013, which effectively doubled the size of the bank. (Figure 1) Prior to the merger (year end 2012), Centennial had total assets of $412 million. After the merger (year end 2013), the bank had total assets of $719 million. The largest area of growth has been in net loans and leases. Net loans and leases totaled $264 million at the end of 2012, and by the end of 2016, it had increased to $490

Figure 1: Centennial Bank Key Assets (in thousands of dollars)

	2012	Growth	2013	Growth 2	2014	Growth 3	2015	Growth 4	2016
AVERAGE ASSETS	412,005	74.61%	719,388	3.16%	742,139	-2.20%	725,791	-0.73%	720,498
REAL ESTATE LOANS	165,437	80.15%	298,028	4.14%	310,357	7.28%	332,966	0.50%	334,634
AG LOANS	30,114	116.59%	65,224	26.40%	82,446	-8.99%	75,031	-16.92%	62,333
NET LOANS AND LEASES	264,500	75.13%	463,226	8.00%	500,272	2.66%	513,555	-4.46%	490,656

million. As is consistent with the bank's modern strategy, real estate loans accounted for the vast majority of this growth. Real estate loans grew from $165 million in 2012, to a total of $334 million in 2016.[1]

Although the bank has had significant growth the past five years, most of it can be attributed to the 2013 merger. Since the merger, however, the value of average assets has only grown by about $1 million. However, real estate loans have had significant growth. Real estate loans totaled $298 million in 2013, and they have grown to $334 million by year end 2016. The bank told us that the recent sluggish growth in the overall portfolio can partially be attributed to their focus on succession.[2] In recent years, the bank has had some turnover in management, which has caused the bank to put a relatively significant amount of time into formalizing more in-depth succession plans and executing those plans. In addition to the time and resources that have been put into succession planning, Centennial also suggested that fluctuations in commodities have contributed to the deaccelerated growth.

Currently, the bank has net loans and leases of about $490 million.

Currently, the bank has plans to grow to $1 billion in total assets in five years. The bank believes that they can grow assets significantly and appear willing to decrease the dividend payout to achieve this growth. Centennial plans to generate the majority of growth internally, but the bank is not completely opposed to acquiring assets through an acquisition. Management has stated that they wouldn't turn away an acquisition, but don't see one happening at this time.[3]

Loan portfolio composition

Throughout Centennial Bank's history, there has been a shift in the bank's loan portfolio composition. As mentioned, Centennial had a major focus on agricultural lending when it started in the West Texas area. However, in the early 2000s this started to change. Centennial realized that growth opportunities were relatively stagnant in West Texas. The bank looked for other areas in Texas to grow the bank, and, as stated previously, moved into the Hill Country. The bank started a branch in Kerrville, Texas in 2002, and their loan composition started to shift.

The Texas Hill Country has experienced significant growth over the past fifteen years, particularly around the edges of major cities like San Antonio and Austin. Since 2002, the bank has stated that a majority of the bank's growth has been in the Hill Country. Currently, the bank has net loans and leases of about $490 million. Real estate loans currently make up about 68% of that figure. Commercial loans

Figure 2: Net Interest Income to Total Assets

	2012	2013	2014	2015	2016	Average
CENTENNIAL BANK	4.13%	4.01%	4.05%	4.07%	4.11%	4.07%
PEER GROUP 3	3.56%	3.49%	3.53%	3.51%	3.53%	3.52%
PERCENTILE	86	83	84	86	86	85.00

Figure 3: Noninterest Income to Total Assets

	2012	2013	2014	2015	2016	Average
CENTENNIAL BANK	0.72%	0.57%	0.69%	1.11%	0.66%	0.75%
PEER GROUP 3	0.78%	0.78%	0.75%	0.76%	0.76%	0.77%
PERCENTILE	52	38	51	79	47	53.40

make up around 17% of the bank's total loans, and agriculture loans are around 13%. This composition might be a far cry from the bank's historical numbers, but it also shows that the leadership at Centennial Bank is aware of and able to adapt to where growth opportunities might appear.

Earnings performance

Comparing Centennial Bank in terms of the bank's earnings as a percentage of total assets, the bank outperformed Peer Group Three with regards to net interest income (Figure 2). Centennial Bank has had an average net interest income as a percentage of total assets of 4.07%. Peer Group Three has had an average of 3.52% in the same time period. This placed Centennial Bank in the 85th percentile, on average, the past five years.-

Centennial Bank performed very well in net interest income (Figure 2) to total assets, but it did not fair nearly as well in terms of generating noninterest income and controlling expense the past five years. The bank had an average noninterest income, as a percentage of average assets, of 0.75% during the time frame, while Peer Group Three had an average of 0.77%. This means that Centennial is average at generating noninterest income, which usually is made up of income from fees and services a bank offers. The bank has considered a few ways to improve their performance regarding noninterest income. In terms of non-interest income, Centennial Bank has considered getting into secondary mortgage operations. The bank has also stated that there were opportunities to generate fee income electronically, but the bank passed on these opportunities so far[4].

Centennial Bank, however, performed less favorably regarding noninterest expenses. Centennial had an average noninterest expense to average total assets ratio of 3.38% compared to the peer group's 2.89% average (Figure 4). This placed the bank in the 75th percentile, on

Figure 4: Noninterest Expense to Total Assets

	2012	2013	2014	2015	2016	Average
CENTENNIAL BANK	3.41%	3.42%	3.54%	3.39%	3.12%	3.38%
PEER GROUP 3	2.93%	2.93%	2.89%	2.86%	2.84%	2.89%
PERCENTILE	76	76	81	77	67	75.40

Figure 5: Return On Assets (Adj. Sub S)

	2012	2013	2014	2015	2016	Average
CENTENNIAL BANK	0.97%	0.69%	0.73%	1.10%	1.01%	0.90%
PEER GROUP 3	0.83%	0.86%	0.91%	0.93%	0.94%	0.89%
PERCENTILE	76	49	48	82	77	66.40

average, the past five years. The bulk of the expense was associated with high levels of fixed overhead expenses, such as improvements of the bank's facilities.

We further analyzed earnings by looking at the return on assets (ROA) and return on equity (ROE) for Centennial Bank. It is important to note the net income that was used for the ROA analysis was tax adjusted (Figure 5). Koch (2014) states that "Without a federal corporate tax obligation, an S Corp bank will report a higher ROA that uses after-tax net income, holding everything else constant. It is thus inappropriate to compare the performance of S Corp banks with otherwise comparable C Corp banks."[5] Our adjusted ROA uses the tax rates assumed by the UBPR. Since Centennial is a Subchapter S bank, taxes are paid exclusively by the shareholders. The bank's adjusted average ROA, over the past five years, was 0.90%, while Peer Group 3 had an adjusted average of 0.89% over the same time period. However, the bank has performed very well the past two years. The bank was in the 82nd and 77th percentile the past two years respectively. Years 2013 and 2014 were below average due to additional expenses related to the merger.

Unfortunately, the Uniform Bank Performance Report does not have the same adjustment for the return on equity of the bank. However, it is possible to solve for a tax adjusted ROE for Centennial Bank and its peers. Centennial's ROE was adjusted based on the tax rate they would pay if they were not an S Corp bank (28%). The adjusted ROE for the peer group was based on the ratio of adjusted ROA to unadjusted ROA, multiplied by the unadjusted ROE.[6]

In terms of unadjusted ROE (Figure 6), the bank has performed well the past five years. Centennial had an average ROE of 12.18% over the past five years. Peer Group Three, on the other hand, had an average ROE of 9.48%.

Figure 6: Return On Equity (Unadjusted)

	2012	2013	2014	2015	2016	Average
CENTENNIAL BANK	13.31%	9.80%	10.12%	15.02%	12.64%	12.18%
PEER GROUP 3	8.68%	9.27%	9.81%	9.80%	9.86%	9.48%
PERCENTILE	79	59	58	84	75	71.00

Figure 7: Return On Equity (Adj. Sub S)

	2012	2013	2014	2015	2016	Average
CENTENNIAL BANK	9.58%	7.06%	7.29%	10.81%	9.10%	8.77%
PEER GROUP 3	7.63%	8.14%	8.62%	8.61%	8.66%	8.33%

Centennial Bank, on average, placed in the 71st percentile within Peer Group Three.

After analyzing the unadjusted ROE, we conducted an analysis of Centennial Bank's adjusted ROE (Figure 7). Over the past five years, Centennial Bank has performed slightly above average compared to Peer Group Three. The bank's average adjusted ROE was 8.77% over the past five years, while the peer group had an average adjusted ROE of 8.33% over the same period. The bank still performed well, but the advantage over the peer group was not as significant. Since the adjusted method considers the tax advantages of subchapter S banks, we favor the adjusted method over the unadjusted method in our earnings analysis.

The bank has performed relatively well with earnings in comparison to Peer Group Three. Centennial performed particularly well in net interest income and return on equity. However, the bank did not perform as well in terms of noninterest income or expenses. This was to be somewhat expected though. In our meetings with various members of the bank, there was an emphasis that the bank was loan-driven. Loan-driven banks typically focus more on generating interest income than noninterest income.

Over the past year, Centennial Bank has paid out 100% of its earnings in dividends.

Capital Levels and Planning

Centennial Bank made it their goal to abide by BASEL III capital standards even before it was a requirement. The current requirements include the following: a tier 1 capital leverage ratio of 4%, a common equity tier 1 capital ratio of 4.5%, a tier 1 capital to risk weighted assets ratio of 6%, and a total capital to risk weighted asset ratio of 8%. For this analysis, we will focus on the first two ratios stated above. These two ratios are, in our opinion, more important because if the bank were to not meet the threshold for these, the bank would not meet the thresholds for the other ratios. Centennial Bank currently has a tier 1 capital leverage ratio of 10.63%, easily exceeding the requirements established by BASEL III. In comparison to its peer group, the bank places in the 64th percentile. The bank's common equity tier 1 capital ratio was above the regulator's threshold as well. For Centennial Bank this ratio was 13.53% at the end of 2016, placing it in the 50th percentile within Peer Group 3. In conclusion, Centennial Bank is a well-capitalized bank regarding regulatory requirements as well as in comparison to banks in their peer group.

Over the past year, Centennial Bank has paid out 100% of its earnings in dividends. The bank's view is that excess capital is not necessarily a good thing. J. David Williams, the chairman of the board for Centennial Bank, stated the following regarding capital, "a prudent banker wouldn't increase capital. Excess capital isn't a sound idea".[7] The bank also decided the dividend payout was appropriate because of the slowed growth they have experienced. However, the bank plans to grow significantly in the upcoming years. This growth would potentially require capital if acquisitions are needed to reach desired growth levels. The bank plans to accommodate asset growth by reducing the dividend payout to a minimum of 45%.

Analyzing the strengths and weaknesses of the bank's leadership succession plans

Centennial Bank spent 15 months talking to consultants and other experts to develop the bank's succession plan. The bank hired a consulting firm to assist in bank succession planning for management and the board. The consulting firm showed the bank executives and board members what the bank can do and how to handle different situations related to succession planning. Also, consultant Keith Hughey had the executives and senior management take leadership and personality assessments to examine individual leadership skills and temperament for jobs. These assessments included the Strengthsfinder 2.0, the 360 Degree Assessment, and the Kolb Learning Survey.[8]

The bank has spent nine months assessing employees to determine areas in which there was a qualified internal replacement, as well as areas that would need outside replacement. This has allowed the bank to form plans to guide the replacement search when the need arises. Centennial Bank has formally written out their plans on how to proceed if the Chief Executive Officer vacates office, whether the departure is expected or not. Per the plan, if the Chief Executive Officer leaves suddenly or passes away, the Board will designate current Chairman J. David Williams as interim Chief Executive Officer. Centennial will then begin searching for a new Chief Executive Officer. If it is a planned departure, the Board will determine if they can hire from within. If departure is unexpected, a search committee or outside firm will find suitable candidates, and a new Chief Executive Officer will be chosen from that group by the Board.

Centennial Bank developed ideas on what to look for in the Chief Executive Officer candidates and how to find an individual. The Board of Directors has identified and compiled a list of qualities and skills for the Chief Executive Officer that are considered "critical to the mission" as well as other important qualities.[9] The critical qualities include integrity, priority setting, composure, ethics and values, and business acumen. Other important qualities include negotiating, problem solving, planning, and approachability. The ideal candidate will possess nearly all the desired qualities and be a good fit for the organization.

Centennial Bank has had some success in implementing plans for an executive transition. When the former Chief Executive Officer decided to step down the board was able to hire internally in a timely manner. We see this as a successful implementation of succession planning.

However, not all senior executive replacements have been handled as efficiently. The Chief Operating Officer position had been vacated prior to having a replacement identified, as the previous executive decided to retire suddenly. The departure was expected to happen at some point, but no immediate replacement had been found before the departure. At this time, a replacement has yet to be found. However, the bank has designated this as not an emergency. Centennial does not want to build a position around someone, but the bank needs someone who can bring experience into important areas of operations, like cybersecurity. The bank may create a Chief Risk Officer in addition to having a Chief Operations Officer. The bank is still deciding what characteristics the Chief Operating Officer position should have.

The next part of the bank's succession plan will happen in the coming months. The current Chief Financial Officer will retire on July 1st, and a replacement from inside the current team of executives has already been identified and will be ready to take over the role as soon as the current one leaves. This means that the current Chief Investments Officer will be replacing the outgoing Chief Financial Officer. Centennial Bank then plans to consolidate the two positions of Chief Financial Officer and Chief Investments Officer once the change has happened. To our knowledge, this planning has not been formally written out, but management has agreed upon this course of action. The new Chief Financial Officer has held the position before when he worked at Citizens Bank of Slaton before the merger. As well, the former and new Chief Financial Officers have worked together for quite some time to make sure that the transition is as seamless as possible.[10]

When hiring externally, Centennial Bank wants to ensure that they are not diluting the bank's culture. Some of the bank's executives came from other local community banks or from larger commercial banks. In addition to this, Centennial Bank today is made up of several different acquired banks in different regions of Texas. The bank has to manage these subcultures and ensure that the bank's new employees fit in, know what to expect, and know how to represent the bank. In our opinion, this poses significant challenges for Centennial, considering the bank's large geographical footprint. Due to this, Centennial has some extra hurdles to cover when nurturing the culture of the bank is involved.

When hiring externally, Centennial Bank wants to ensure that they are not diluting the bank's culture.

Overall, the bank is strong in determining what to do when senior executives need to be replaced, but the bank is weaker in consistently carrying out those plans every time they are executed. If Centennial is not able to improve their execution of succession plans in the future, as seen in the bank's inability to replace the Chief Operating Officer, the quality of executives could be adversely affected.

Analyzing the bank's process to identify, advance and prepare employees for future leadership positions, with consideration towards appealing to millennials

Centennial Bank does not have an established training program for college graduates to become credit analysts, and eventually loan officers. Rather, Centennial Bank hires people who have already been trained from other banks. As mentioned before, this can be an issue, regarding the dilution of culture. However, Centennial Bank wants to modernize and grow the bank's customer base. The bank seeks out millennials, both as new customers and new employees. In order to do this, the bank needs to hire new employees that specialize in information technology, such as coding, app development, and cybersecurity. This will make it easier to show customers that the bank is working on keeping banking with Centennial Bank modern and innovative.

Regarding millennials, Centennial Bank has participated in mentorship programs, but has admitted that it has not worked for them yet.[11] These relationships have tended to fall apart

The bank seeks out millennials, both as new customers and new employees.

as mentors and mentees get busy, promoted, or moved. Problems with mentoring can often arise from differences between a mentor and mentee, as well as issues with matching the right people together. Some suggestions may be to allow mentoring relationships to grow organically by matching groups of people who go well together and then letting pairings find themselves. We also suggest expansion of leadership assessments, as mentioned previously, to look at leadership and personality for lower level employees. This should help the bank to promote or move people into positions more suited to them and to retain employees whose leadership skills and specialist skills help the bank grow.

Identifying quantitative or qualitative correlation between the bank's profitability and performance, leadership succession preparedness, and the development of new products, revenue sources and technology adoption

Although Centennial has performed well over the past several years, continued vacancy of executive positions could adversely affect future performance. The bank's Chief Operations Officer (COO) position is currently vacant, and the bank is still in the process of searching for a replacement through a recruiter.[12] This position has been vacant for a couple of months, and there have been no indications that someone will be hired soon. Currently, other Chief Executives are taking on the duties originally done by the Chief Operating Officer.

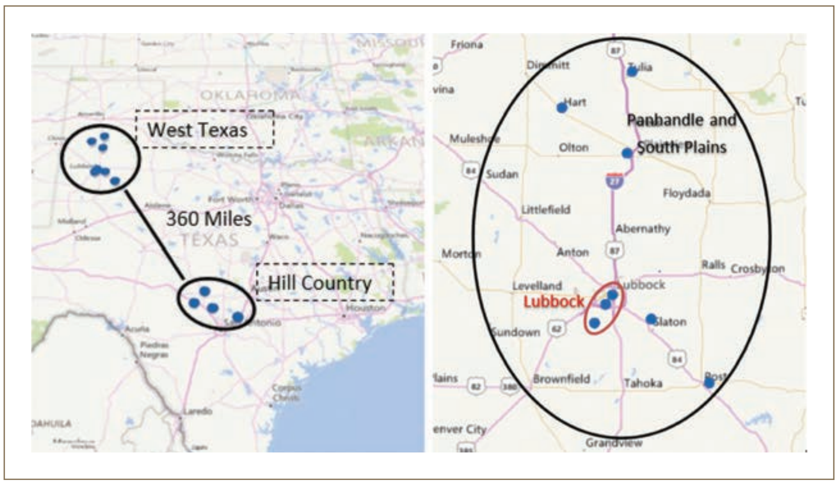
Centennial Bank has been adopting more technology to increase performance. Senior management has bridged the geographical gap by using teleconference technology to communicate between Lubbock and Kerrville. Centennial Bank has also developed online and mobile banking systems for its customers. This is valuable to attract business from millennials, but the bank could do more technological innovation. This includes focusing more on peer-to-peer transactions, investing more into online and mobile app platforms, and implementing Interactive Teller Machines (ITMs) into the bank's branches. Centennial Bank has talked about the use of ITMs, but has yet to seriously consider the option.[13] Implementing these machines could lead to higher profitability for the bank by increasing efficiency. The efficiency and capability offered by these machines could make the bank more competitive by attracting millennial customers. Although these machines can do much of what tellers can do, they do not provide the relationship that sets community banks apart from large banks. ITMs could help the bank cut expenses and attract younger customers, but there is a risk that it could hurt the business that they do with older and commercial customers.

Centennial Bank has been adopting more technology to increase performance.

Centennial Bank has been creating other revenue sources by opening new branches and loan offices in the Austin, Texas area. The bank is also looking for opportunities to expand into San Marcos and Georgetown and currently building a banking center in New Braunfels. Centennial Bank's philosophy is to focus on the process rather than product. Centennial realizes the need to expand mobile offerings and to hire IT experts to grow. The bank has not been looking to introduce any new products, but rather expand on the products already offered.[14] Because the importance of technology is likely to continue to grow in the future, Centennial Bank should look for opportunities to innovate while also focusing on succession planning. The bank should specifically focus on recruiting people who can provide the expertise to help the bank progress.

Considering the bank's size or location as advantageous or disadvantageous to the bank's succession planning

Centennial Bank now has fourteen locations spread over a large geographic area in "West Texas" and the "Hill Country". In addition to this, the team further subdivides the West Texas area into those banks that are in Lubbock as opposed to those serving rural markets outside



of Lubbock (Panhandle and South Plains) Although these two groups are relatively close by distance, they are serving vastly different markets and customer bases. The majority of customers in the Panhandle and South Plains locations are rural, and a greater percentage of these loans are agricultural.[15] The Lubbock locations serve a more urban customer and more loans are commercial and real estate.

Centennial Bank is also serving a different set of customers in the Hill Country than West Texas. While Centennial has long had a presence in West Texas and knows their customers well in this area, Centennial's presence in the Hill Country is relatively new and the relationships are with younger customers. Management attributes this strategic expansion as the reason that Centennial Bank has been able to grow its loan portfolio.[16]

The geographic structure of Centennial is unique and presents both advantages and disadvantages. The main benefit of expansion into the Hill Country is the advantages that it provides the loan portfolio. Having loans spread over different geographic areas provides diversification benefits that would be hard for most community banks to attain. Loans in the West Texas area tend to be adjustable rate loans for agriculture while many of the loans in the Hill Country are fixed rate Commercial Real Estate loans. This helps the bank manage its interest rate risk exposure more efficiently than competing community banks.

Although there are potential benefits for the loan portfolio, having geographic separation also presents significant operational and logistical concerns. Not only is there a large geographical footprint, but there is also a large area between regions that there is no presence by Centennial Bank. With such a wide geographic footprint, members of the management team are rarely in the same locations at the same time. Although Lubbock serves as the headquarters for many of the executives, the President/CEO, as well as the Chairman, work in the Hill Country. As previously discussed, Centennial Bank has invested significantly in technology allowing video conferencing to overcome some of the issues associated with distance.

Another disadvantage of expansion is the increased burden of establishing and preserving a common culture. Establishing a common culture throughout the organization is important since relationship banking is a significant part of the community banking experience. Cultures were merged when Centennial Bank was formed from the merger of HCSB and Citizens Bank of Slaton.[17] When mergers take place, it can be difficult for employees and customers to adapt to differences in culture. In many ways, the operations from the Hill Country serve customers that are different from those of West Texas and tend to promote a different culture. Managing and ensuring that these cultures are consistent across the organization can be difficult. For many customers, the culture of a community bank is extremely important, so it is vital that a common culture is established and maintained. In our opinion, this is a disadvantage for Centennial and should be closely monitored.

Having multiple locations and regions presents unique opportunity, but also risks if not properly monitored.

Both the West Texas and the Hill Country regions offer opportunities for recruitment of employees. The Lubbock locations offer a good opportunity to recruit qualified graduates from Texas Tech University, but Centennial Bank does not currently have the ability to train lenders and typically hires from outside (as previously discussed.) The inability to train new lenders jeopardizes the ability of the bank to attract and retain quality talent. The Hill Country is one of the fastest growing areas in Texas and has experienced both population and economic growth that is likely to attract qualified and talented workers. Both regions offer potential to attract qualified job applicants.

Overall, we see Centennial's wide geographic footprint as an advantage, however; there are also potential risks that should be monitored. To effectively implement succession planning, Centennial Bank must ensure that qualified employees are being given opportunities throughout the organization. It is imperative Centennial Bank works to implement common culture throughout all locations. This could be especially difficult given the geographic spread of locations. Having multiple locations and regions presents unique opportunity, but also risks if not properly monitored.

Describing the bank's Board of Directors succession plan – the recruitment, onboarding, and demographics of potential board members

Centennial Bank's Board of Directors consists of ten corporate directors and five advisory directors. Centennial Bank is a very closely held bank with fewer than twenty-five shareholders. Being such a closely held bank, can make the board of directors' succession plan an even more sensitive subject. Although succession planning can be sensitive, Centennial Bank recognizes that having a plan is important to the long-term success of the bank. The bank began a more formal succession planning process and is in the early stages of execution of the plan.

BOARD OF DIRECTORS

CORPORATE	ADVISORY
J. David Williams, **Chairman**	Harold P. Brown, Jr.
Brian Pohlmeier, **Vice Chairman**	Matt Kelley
Gregg Appel	Gary C. Lawrence
Cecil Atkission	James E. "Pete" Laney
Carolyn Baker, CPA	Monty Long
Richard Kimbrough	
Kevin Malone	
C. Brett McDowell	
Craig Reeves	
Terry Teague	

Centennial's management is following guidance for succession planning (both management and directors) from the bank's consultant, Keith Hughey. Our team was able to interview Mr. Hughey. He described succession planning as a three-step process: 1) Define expectations, 2) Self-evaluation, and 3) Peer evaluation. The bank is currently in phase 1 of this process.[18] Each member of the board took part in a survey which required them to define what a director's role should be. The bank has also evaluated personnel internally through a variety of personality trait assessments to identify other potential directors.

Although the bank is generally satisfied with its current board of directors, it does recognize a need for greater diversity within the board. The average age of the current board of directors is 65 years old. There is also only one woman, Carolyn Baker, Chief Financial Officer, currently on the board. Making matters worse in this regard, Carolyn is set to retire this summer.

The bank expressed its desire to diversify the board in the broad areas of age, gender, and expertise. As the average age of the directors increases, the need for a solidified and formalized succession plan is becoming increasingly crucial. To be successful, the board needs to be able to identify with the customer base of the bank. As millennials continue to enter the workforce, the number

The bank has also expressed a desire to recruit directors with diverse backgrounds and skills.

of millennial banking customers will increase. As trends typically associated with millennials, such as placing less emphasis on "brick and mortar" centers and more focus on mobile banking needs, the board will need to be able understand and address these needs. Without younger directors on the board, the bank may struggle to implement strategies to address the changing needs of its customers effectively and efficiently.

The bank has also expressed a desire to recruit directors with diverse backgrounds and skills, with an emphasis in information technology and information security (IS/IT). As mentioned above, the transition away from "brick and mortar" to mobile and online banking applications will be crucial to the long-term success of the bank. Having a director on the board with IS/IT expertise will be a valuable addition. The bank is also seeing a trend to "New-Agriculture." New agriculture loans must deal with a rapidly changing environment as equipment and the application of technology have become both more advanced and more expensive. A shift from labor-intensive to more capital-intensive operations is likely to continue in the future and will affect agricultural customer's financial needs. As the younger generation in agriculture become customers, the bank has expressed the desire to have board members that are able to relate to that culture. The bank has also expressed its desire to recruit a director with a commercial real estate background, especially in the Hill Country.

As discussed, Centennial Bank has a widely diverse geographical footprint in Texas. With this diversity comes opportunities for recruitment of board members. The Lubbock region revolves around Texas Tech University. Being so close to Texas Tech not only provides great opportunity to obtain talented employees as students graduate, but also provides opportunities to recruit new board members. As mentioned above, the bank has expressed needs within the board such as IS/IT, New-Agriculture, and Commercial Real Estate. The bank could potentially recruit professors as new board members in these areas. By recruiting from Texas Tech University, for example, the bank would gain individuals with not only technical expertise, but also an understanding of the Lubbock culture and business environment.

Another part of the plan by the bank is to identify, recruit, and onboard new board members through Community Advisory Boards, possibly in different geographic locations. Although this plan is still in the early stages, the bank is highly interested in the pursuit of this goal. Community Advisory Boards would consist of five or six individuals who would meet a couple times a year to take part in substantive discussions, tasks, and ad hoc research. The bank also expressed the desire to have these boards attend one of the corporate board of directors' meetings each year. The individuals on the Community Advisory Boards could be rotated much more frequently than the board of directors. One of the main benefits of these boards would be to identify potential individuals to fill board seats or grow the board as deemed necessary.

Describing how the board's succession plan aligns and relates to the long-term goals of the financial institution

Centennial Bank, at both the executive management and board level, is focused primarily on achieving moderate and sustainable asset growth, while maintaining adequate capital. Centennial also seeks to continue its conservative tendencies within risk management strategies. As a family owned bank, another one of the goals is to remain independent. Current board Chairman, David Williams is an innovator and seeks growth at every opportunity. This focus on growth opportunities has been the mindset of the family since the beginning. Although the bank has expressed needs and the desire to fill those needs within the board to meet its long-term goals, the sensitive nature of board succession within a family owned bank may create significant roadblocks when trying to formalize and execute board succession.

Moderate and sustainable growth continues to be at the forefront of the bank's strategic objectives when formulating plans for future success of the bank. Brett McDowell, Executive Vice President & Chief Lending Officer, has been the primary voice of enthusiasm and optimism regarding future growth of the bank. Brett, along with many others, has expressed the strategic goal of achieving organic growth of the bank to $1 billion in assets within the next 5 or 6 years. Although growth is a key goal of the bank, reaching the $1 billion threshold comes with new regulations that are recognized by all within the bank. There was not a unanimous opinion among key individuals within the bank as to whether the bank was willing to undertake the additional regulations. Without a clearer vision regarding future conditions the bank is willing to undertake, aligning board succession to long-term goals could lead to conflicts between management and the board, among other problems.

Another primary goal of the bank is to retain independence and continue the family-owned culture and operations. To achieve this goal, the board's succession plan will likely involve family successors in some form. This could present issues in the future since J. David Williams is the only family member currently involved in the bank. Although no formalized succession plan for the chairman of the board has been made, there seems to be a general understanding of a plan of action if a situation arises in which Mr. Williams was unexpectedly unable to perform his duties as chairman. Although Brian Pohlmeier, Vice Chairman, would likely step in as interim chairman if necessary, a more permanent decision regarding the future of the bank in this leadership position would be made by the family.

Analyzing how the board's current structure and succession plan impacts, or could impact, the bank's involvement and lending in the business community

Centennial bank is a family-owned entity. It has been operated as such for decades and will continue to be operated in the same manner. As a family-owned bank, Centennial faces a unique set of challenges. It is likely that the Williams family will continue to play a significant role in the guiding of the bank. On one hand, having a family owned bank is beneficial because family members are likely more familiar with the business and culture of the bank than many outsiders. However, the ownership structure could be threatening to future success if family members are unwilling to adapt.

The bank's Board of Directors' current structure is self-described as a "Legacy" Board, meaning that many board members are long time board members, and that the makeup of the board is not frequently changed. Although most board members represent the Lubbock and Panhandle South Plains region, each region in which the bank operates is represented by someone on the board. The bank has seen significant profitability historically, which is evidence of the bank's ability to adapt to the ever-changing financial landscape. Although the bank has proven its ability to adapt historically, past results do not guarantee future results. The current structure of the board and lack of diversity poses concerns for our team. Interestingly, the bank seems to have also recognized needs that it is actively pursuing to maintain and improve its current level of involvement and lending within the communities it serves across Texas.

Our team is especially concerned with the lack of age diversity on the board.

Although the bank has expressed its recognition of needs within the board and is currently in the early stages of execution, our team would like to see the process move faster. Our team is especially concerned with the lack of age diversity on the board, which poses two concerns. First, without replacing aging directors proactively, the opportunity to train younger directors diminishes. Second, if the bank does not proactively input more youth into the board, the board may struggle to relate to customers' needs because of generational differences. It is crucial for the bank's board to be able to identify, relate to, and address customers' needs within the rapidly changing financial environment.

Another concern regarding the current "Legacy" board is the potential of the board to sacrifice long-term growth of the bank for larger dividend payouts. Throughout the past year, the board has elected to pay out 100% of its earnings. One of the reasons that the bank expressed was to cover estate tax liability for the bank's shareholders which arose from the death of E. W. Williams, a major shareholder, in 2014.[19] Another reason for the 100% payout is that the bank was not seeing enough asset growth to retain capital in large excess over the regulatory requirements. Although the bank anticipates lowering its dividend payout to accompany increased growth, the potential risk for conflicts of goals is apparent to the team.

Over the past year, Centennial Bank has paid out 100% of its earnings in dividends.

Summary and Recommendations

As a group, it is our observation that Centennial is beginning to develop a more sustainable plan for expected changes in management, but our concern relates to the lack of planning for unexpected changes or losses of key members of the management team. We are encouraged by the bank's efforts to develop a more concrete succession plan for both executive management and the board regarding upcoming expected changes, but we are also encouraging the bank to dive deeper into the possibility of unexpected changes or losses.

Centennial Bank should start by better formalizing their succession plan. The bank has taken initiative to discuss succession planning and has hired a consultant to help, but they need to take it a step further. A formal succession plan for management and the board would help the bank prepare for uncertainty.

Centennial Bank should also focus on better training employees and promoting internally. The bank does not currently have the resources to train employees internally, so they should work towards finding alternative vehicles such as professional education offerings. Centennial hiring from outside the organization has affected the bank's culture in a negative way. Focusing more on both training and retaining current employees will help to maintain a cohesive culture that is important in community banking.

Centennial should also create a formal board of directors' succession plan that focuses on future goals of the bank. This plan should focus on bringing younger members onto the board that have experience in a diverse set of areas such as technology, fintech, and fraud protection, as well as board members that can help develop new products, processes, and services that competitors are not providing.

Centennial Bank needs to continue to move forward with replacing board members. We recommend that the bank move under-performing board members from a voting position to a non-voting position such as an Emeritus Board Member. We believe that this would be a way to keep long time board members involved without risking the future of the bank.

In our view, Centennial Bank has not done enough to attract millennials or to keep up with technological changes. We recommend that the bank focus on expanding technological capabilities such as peer-to-peer and business-to-consumer transactions to attract new customers. Peer-to-peer transactions should be made a priority because they may be useful in attracting and retaining deposits, especially from millennials. To compete, the bank will have to offer peer-to-peer transactions for free, but they can charge a fee to the business for business-to-consumer transactions. In addition, the bank should consider investing in the technology that would allow depositors to pay for goods and services directly from the bank's mobile application.

Centennial Bank has a long history of strong performance. Certainly, past success is attributable to strong leadership in both management and the board. By formalizing succession planning further, Centennial Bank can better protect its future by ensuring that the right people are selected for leadership positions in management and on the board.

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Mr. Keith Hughey

Dr. Mark Moore

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Board of Directors

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Centennial Bank Board Policy: Management Succession Policy. 2016.

Endnotes

1 Numerical information regarding financial statement information was obtained through the Uniform Bank Performance Report.

2 Information obtained through in-person interview with Centennial Bank on 3/22/17.

3 Information obtained through in-person interview with Centennial Bank on 3/22/17.

4 Information obtained through in-person interview with Centennial Bank on 3/22/17.

5 Koch, Timothy. Community Banking from Crisis to Prosperity. 2014.

6 Adjusted ROE for peer group is calculated as (Adjusted ROA)/(Unadjusted ROA) × Unadjusted ROE

7 Information obtained through in-person interview with Centennial Bank 2/6/17

8 Information obtained through in-person interview on 2/6/17.

9 Per the Centennial Bank Board Policy for Management Succession.

10 Information obtained via interviews from current Chief Financial Officer and Chief Investments Officer

11 Information obtained through in-person interview on 2/6/17.

12 Information obtained through in-person interview with Centennial Bank on 2/6/17.

13 Information obtained through in-person interview with Centennial Bank on 3/22/17.

14 Information obtained through in-person interview with Centennial Bank on 3/22/17.

15 Information obtained through in-person interview with Centennial Bank on 3/22/17.

16 Information obtained through in-person interview with Centennial Bank on 3/22/17.

17 Information obtained through in-person interview with Centennial Bank 2/15/17.

18 Phone interview with Keith Hughey on 3/31/17.

19 Information obtained through in-person interview with Centennial Bank on 3/22/17.

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