

TheDeal Magazine

Voice of the deal economy

The bank next door

By Jacob Eisen and Tad Gage, Capital Insight Partners

[SHARE](#) [E-MAIL](#) [RETURN TO FULL STORY](#)

Published May 8, 2009 at 2:10 PM

From the largest to the smallest, banks need capital. The confluence of challenges and opportunities in this sector presents a unique opportunity for private equity firms to generate potentially attractive three-to-five year return on investment by investing in community banks, which are broadly defined as institutions with \$100 million to \$5 billion in assets. This opportunity is particularly attractive with publicly held, exchange-traded banks, which offer the most options for investors to monetize their investments.

For many PE firms, community banks are unfamiliar territory. In many ways, their income statements and balance sheets profile much like any corporation. However, valuing a bank also presents less familiar issues to the private equity investor, such as CAMELS ratings (the 1-5 scale measure of a bank's overall strength), the challenges of valuing investments and the fact that banks operate in a regulated environment.

Still, careful analysis of public and internal documents should enable a knowledgeable investor to develop an accurate assessment of net present value. One reason bank investing has never been more attractive is a Federal Reserve rule change in September making it possible for private equity investors to take a larger position without triggering bank holding company (BHC) and reporting requirements. Some private equity investors that specialize in banks are already BHCs. However, that's not every PE investor's cup of tea.

Previously, a minority investor could hold no more than a 15% stake in a bank. Now, minority investors may: acquire up to one-third of the outstanding voting securities of a banking organization, provided the investment includes only 15% of the outstanding voting securities of any class; appoint up to two directors of the banking organization (subject to ownership percentage and other limitations); and engage in expanded communications and discussions with management of a banking organization without becoming a BHC or being exposed to government regulation issues.

Well-managed community banks are particularly attractive opportunities because their reporting and structure tend to be relatively transparent. As a general rule, community banks did not develop or invest in exotic financial instruments. Their exposure to financial derivatives is usually minimal or nonexistent, and this exposure can easily be analyzed by reviewing the detailed schedules on monthly call reports required of banks by the Federal Reserve, Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency.

CAMELS ratings are shared only with a bank's senior management, but a non-disclosure agreement with the institution will give an investor access to this and other internal information. Generally, banks' regulatory requirements facilitate initial due diligence. SEC-reporting banks add another layer of disclosure that can help a private equity investor initially determine the viability of a particular bank as a potential financing recipient.

Another reason community banks represent a unique investment opportunity is because we've seen the greatest devaluation of the financial sector since the Great Depression. The market -- not necessarily knowing or caring to know the difference between a megabank plagued with questionable assets and a tightly-managed community bank -- has simply marked down the entire sector. It's very possible many large national and regional banks will be unwinding their bad investment and loan portfolios for several quarters, if not years.

However, because of their relatively simple structure and transparency, many community banks have already identified and addressed their biggest problems. This isn't to say certain community banks won't face additional issues related to economic conditions, which continue to pressure even what were thought to be rock-solid customers, but in many cases, the biggest clunkers in loan and investment portfolios have been identified. Whether private equity investors believe a bank's worst problems are behind it is their decision, but in many cases, it seems community banks' cards are on the table.

Many community banks maintain risk-averse, tightly managed loan and investment portfolios. Senior management is frequently involved with significant lending or investment decisions, and that often means poor underwriting practices and unwise investment decisions were kept to a minimum. Because of their local or regional market focus and expertise, and a higher level of personal interaction with customers, it's more likely that a community bank generally exercised sound due diligence in most of its lending activities, and did a reasonably good job of managing its participation in real estate development and construction loans -- an area where many of the biggest problems have emerged.

That said, most community banks have to a degree been left holding the bag as a result of poor loan underwriting decisions, investments that may turn out to be good but are currently under water and loan participations that have soured. Many community banks have tightened underwriting procedures, refined their focus, adjusted their loan portfolio mix, and fiercely managed interest rate issues to address margin compression.

For many community banks, the first few months of 2009 appear to have been encouraging. Despite some deposit shrinkage due to customers' reduced cash positions, both business and retail lending activity for community banks appears to be on the upswing. If anything, there seems to

be a change in how people view banking. They seem to be looking for superior service and stability without excessive concern about a basis point here or there. This is particularly true for small business customers, who tend to value relationship banking and convenience over cherry-picking rates and products among a number of banks. This would be a positive trend for community banks, since most have never tried -- or been able -- to compete on price with the largest institutions.

The potentially positive outlook for community banks doesn't obviate their need for additional capital to fund growth and enhance their capital adequacy. Regulators have ratcheted up their capital requirements and pushed hard for banks to re-price investments and provide aggressively for potential loan losses.

Accounting-related and regulatory adjustments such as mark-to-market revaluation of investments and noncash goodwill devaluations based on market pricing may be relative nonevents for the average corporation. However, these adjustments have had a profound impact on banks' capital adequacy requirements. These noncash devaluations diminish a bank's capital position, further creating pressure for additional capital. While these adjustments have little to do with a bank's core operating numbers, they do affect the company's overall financial performance and capital requirements. This is the reality, but it also represents an opportunity for savvy private equity investors who can look past the noncash charges and focus on a bank's operating stats. These factors have put pressure on banks to seek fresh capital. Although there has been a great deal of discussion about making regulatory and reporting requirements less onerous and more appropriate for smaller banks, the pressure for capital will remain.

Banks that have taken TARP funding will be looking for options to replace this capital, perhaps sooner rather than later. Traditional investment banking opportunities have diminished. The markets don't, and probably won't for some time, have much appetite for follow-on equity offerings. Many banks have maxed out certain debt alternatives and traditionally popular hybrids like trust-preferred securities. Yet many are still in a position to offer something attractive to private investors.

A capital infusion of \$5 million to \$60 million can go a long way for a community bank. Banks need capital, but most aren't desperate for it. They also represent significantly lower risk than many equity investments-and they're priced right.

Many community banks are trading at a fraction of their tangible book value. A few years ago, various bank indices might have pegged the average multiple for community banks between 1.4 and 2.5 times book. Today, a bank trading under book is more the rule than the exception.

There has been significant discussion around how accurate book value is, particularly with questions about certain investments. However, at some point, a financial institution trading at some fraction of its intrinsic value -- even with liberal discounts for concerns about asset quality -- represents a very attractive price point for an investor. Simply a return to full value could represent a 30% ROI. A bank with a proven strategy to grow core deposits and build its loan portfolio can offer even greater potential ROI.

The economy has provided a litmus test of management and business strategies. Those that have held their own in this challenging period would seem to have an inside track on growth in an economic recovery. The past year's economic turmoil has provided a severe test of banks' market strategies and underlying operating strength. Although investing in community banks offers some unique challenges, it is not the daunting prospect it might have been in the past.

Jacob Eisen is president and Tad Gage is executive vice president of Capital Insight Partners, an investor and financial strategies consulting firm with a specialty in serving publicly traded community banks.