# The Private Equity Market Option for Community Banks

By Bill Sammon

Anyone who regularly picks up *The Wall Street Journal* understands how important private equity is in the world of mergers and acquisitions. Already in 2007 some of the biggest deals ever announced have been driven by private equity money. Two examples include the KKR and Texas Pacific Group proposed acquisition of TXU Corp. for $32 billion and the proposed acquisition of Equity Office Properties Trust by an investor group for $25 billion.

The term "private equity" became widely used in the late 1980s as leveraged-buyout funds came to dominate the merger and acquisition landscape. True private equity has a much longer history than the last 20 years. While there are many definitions for "private equity," the term simply means any type of equity investment in an asset where the equity is not trading on any public exchange. The different classes of private equity are very broad and include leveraged buyouts, venture, mezzanine and angel. While these different classes may mean nothing to a community banker, scores of businesses in many industries have been built using these sources.

Private equity in the community banking market has historically meant something very different. The only true private equity available to most community banks has been from the people sitting around the board table, the members of the local community or the family that owned the majority of the bank already. Banks were not trading on any public market and were very limited in the ways in which they could bring in additional capital to facilitate growth.

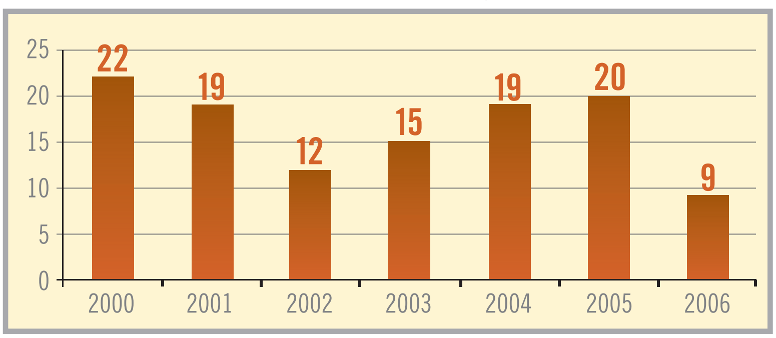
For many community banks, the inability to grow directly hinders their power to create shareholder value. This inability to grow and drive shareholder value has in some cases led banks to look for merger partners.

## New Opportunities

The good news is that the private equity market for community banks has developed rapidly in the last few years. Many funds and partnerships have been created specifically to invest in well-run community banks that are privately held. And there are a number of factors driving these investors.

First, there are less new opportunities in the public

**Bank Initial Public Offerings since 2000**




Source: SNL Financial

market. A look at the chart at left shows the number of new public offerings since 2000. Investors are always looking for new ideas and opportunities, and with fewer companies tapping the public market many investors are looking to private companies to find those opportunities. As long as bankers view the cost of being a public company as prohibitive because of regulatory costs, this trend is likely to accelerate.

Second, for the long-term investor pricing in the private market is typically more attractive than the public arena. This is due in part to the liquidity discount that is usually placed on investments that have no public outlet. Also, more due diligence is required before the investment is made by a potential investor because private companies are not required to make filings with the Securities and Exchange Commission.

Finally, as these companies mature and grow, investors realize a number of liquidity channels could be available to investors. These include an initial public offering, a merger or acquisition with a public company, or a listing of the shares on the over-the-counter market.

## Market Model

A great example of a non-SEC reporting company tapping the private market for capital recently is Katahdin Bankshares Corp. in Patten, Maine. Katahdin, an ICBA member since 1984, recently completed a private placement of $5 million of its common stock. The company, a $393 million-asset bank holding company, has performed well for its shareholders. In 2006 it

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achieved a 17 percent return on equity and a 1.08 percent return on assets. The ICBA Capital Markets Private Equity Fund I was one of the investors in the transaction.

Just as important as raising investment capital is making sure the potential investors have the same investment philosophy as the bank. Attracting investors whose investment horizon does not match up with the vision of the company can lead to problems down the road.

Private equity can also play a role for companies that are publicly traded. Many community banks have executed going-private transactions over the past several years to de-register with the SEC. In a number of instances, these banks tapped funds that provided capital and exchanged a large number of shareholders for just one.

While private equity funds are not likely to become a dominant player in the mergers and acquisitions market for community banks, their importance in the capital markets is likely to grow. Many community banks still enjoy strong local support and can continue to count on members of their community to provide additional capital when needed, but CEOs of privately held community banks need to be aware there are other options available to them for raising equity. ib

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