The New Breed of Investors in Community Banking

By Bill Sammon

and Dave Papritz

Less than a year ago, as representatives of ICBA Securities and of Howe Barnes Hoefer & Arnett Inc., we discussed in this column the growing role of private equity in the community bank markets. More recently, in a capital markets symposium at the ICBA National Convention and Techworld in Orlando, Fla., we provided an update on some trends that should be of interest to industry executives. Given the growing importance of capital adequacy and availability in today's challenging economic and credit environment, we'll summarize some of those issues here.

At one end of the spectrum, some community banks are finding it increasingly difficult to access capital markets at a critical time. This challenge relates to *de novo* institutions, which continue to form at a surprisingly active pace. It also affects existing community banks needing recapitalization as a result of loan quality deterioration and write downs. Simply stated, the old adage seems to apply that capital is hardest to get—and the most expensive—when you need it the most.

At the other end, an informal survey yields a rather lengthy list of deep-pocket investment funds and investor groups that sense an opportunity to acquire stakes in both healthy and temporarily distressed banking franchises at unusually discounted pricing levels. As active players in this space, ICBA Securities and Howe Barnes Hoefer & Arnett are among the groups actively scouting the landscape for just such opportunities.

For those community banks that are public or otherwise listed, stock values have been beaten down in a fairly indiscriminant manner. With valuations falling 30 percent or more in key benchmark indices over the last 12 months, the decline has taken down quality names along with those perhaps more deserving of such market discipline. The stock of dozens of listed companies that still exhibit sound fundamentals, solid franchises and good growth prospects are available at low price levels not seen in years.

As noted last May, equity capital access for privately held community banks has typically come from existing majority holders, those around the board table or from other influential members in the local community. Such banks were not trading on any public markets and were therefore limited in their abilities to obtain additional capital for growth purposes. In recent months, we have observed an increased interest and participation of various funding vehicles focused specifically on the community bank market, and we believe that this trend will accelerate rapidly during 2008.

Just in the last few months, various industry news sources have noted a wide variety of new entrants coming on the scene purporting to have significant resources available to invest in opportunistic situations. Many of these investment vehicles are headed by names familiar to those in the business, and the sums mentioned are truly notable. If those news sources are to be believed, there are literally billions of dollars being raised by investment vehicles and available as dry powder, waiting to be put in play.

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In an ironic twist, where the major, brand-name private equity firms have become somewhat locked out of the general corporate takeover market—due to the lack of leverage financing to close deals and where more traditional corporate buyers are able to take advantage of the liquidity gridlock—it appears that private investment vehicles in the bank space may have the upper hand over traditional bank buyers in gaining entry at discounted levels. That's because many of the traditionally acquisitive regional banks are dealing with their own internal issues. While it is true that most of these nontraditional players are interested in taking non-control positions in banking companies, we believe this phenomenon bears close watching by all involved in the business.

Of course, true takeovers are limited unless an investing entity is willing to create a bank holding company structure, which some have already done or are committed to doing. We will likely begin to see "club" deals where funds combine resources and efforts to raise equity for special situations. There will almost certainly be recapitalization opportunities as banks in some parts of the country incur loan losses but still possess valuable local franchises with strong potential for recovery and subsequent value creation. Short of full recaps, there may be discounted "bridge" equity opportunities where a bank needs to raise just enough capital to get over a rough spot and then position itself for a more substantial subsequent offering under more favorable market conditions.

Having said all this, we should not be surprised by these developing events as capital always flows to opportunities where outsized returns can be realized in an efficient market economy. As is also the case, prudent early entrants usually reap the greatest rewards until equilibrium is reestablished and investment returns gravitate back to historic norms.

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Taken within the context of the current fundamentals in the banking industry, it is anyone's guess how long this "window" will be open. However, over the next several months, look for a variety of new participants, investment approaches and strategies to emerge across the community bank equity structure landscape. ib

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