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Capital Sources

Investors' interest piques again in community banks

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Frank Gonzalez

Three major capital infusions in community banks recently are reinforcing the conviction of several industry experts that this could be a year of opportunity for some investors.

With the financial crisis of the past two years having tested the standards for valuation levels, institutional buyers are again gearing up to take advantage of what may prove to be an undervalued market.

Banco Popular de Puerto Rico raised more than $1 billion in April, while there is a pending $500 million investment in California's Pacific Capital Bancorp and $135 million to recapitalize Sterling Financial in Washington state. The deals have headlined the return of big money to the sector.

"The smart money is starting to move," said Derrick Gruner, an attorney at the Pinkert Law Firm in Miami who concentrates his practice in foreclosure, lending and financing. "There are a number of really good opportunities down here for banks that are fundamentally sound."

For community banks desperately seeking capital to sustain themselves, is help finally on the way?

"The answer is yes and no," said Bowman Brown, banking attorney at Shutts & Bowen in Miami. "There are some opportunities and those will for the most part involve community banks that are in reasonably good shape, with good franchises and that have a good prospect of making it through this tough real estate downturn. I must say that is a pretty elite group among the Florida community banks, generally."

Brown said so many community banks are seeking capital that investors will likely be able to negotiate advantageous terms. Some banks, he added, will have difficulty attracting investors even on the most favorable terms.

"Banks took some extremely heavy hits last year over regulatory pressures," Brown said. "I think the jury is out on whether there are further losses that will have to be recognized this year given the state of the commercial real estate market. There's another fairly significant group of banks that have very troubled portfolios of real estate loans."

For investors, that makes it difficult to determine how deep the hole is, where the bottom is and whether there really is anything that's worth acquiring.

"Certainly some of the banks are so small that there is no real franchise, but the problems are huge, so they just don't make very attractive candidates for investment or acquisition," Brown said.

There is a lot of available capital, but people are nervous about whether it's the right time to jump, said Alan Axelrod, chair of Bilzin Sumberg´s Corporate & Securities Group. "Has the whole story been written with respect to the amount of losses these banks have suffered?"

It's still difficult, particularly on the commercial side, to make a determination of the value of the collateral that supports the commercial loans, even for seasoned experts and investors," Axelrod said.

“I have two clients looking at two different community banks and that’s the daunting task to come up with the right number,” he said. “Obviously, you’re getting tremendous discounts. The question is whether it’s a sufficient discount.”

At the same time, investing in smaller community banks will become more attractive once the number of Federal Deposit Insurance Corp. takeovers begins to decline.

Even now, the FDIC’s loss-sharing offers to investors — hoping to pick up failed banks cheaply out of receivership — are drawing more competitors and are not as generous as they have been in the past.

“Unfortunately for those investors, there are very few of those opportunities. In fact, the FDIC has come out and privately said that we’re not going to make the deal quite that fat again,” Miami banking consultant **Dennis Nason** said. “The competition for those types of opportunities is very keen. You have no assurance, if you’re sitting on the sidelines with $10 million or $20 million, that you’re going to be able to pick up one of those sweetheart deals.”

Investors are finding that maybe they have to work with existing shareholders.

“There are half a dozen [South Florida] banks right now that are in such critical condition that I don’t think the buyers want to come in and try to fill the hole,” Nason said. “I don’t think there is going to be a whole lot of bargains out there just because banks have problems. It can’t be just a cursory look, they really have to examine it carefully and that takes a little bit of time. It’s going to be a slow process.”

That has investors looking at another strategy.

“Maybe we’d better start investing in the community banks that are solvent and try and help them through, because the [FDIC] opportunity is not going to be there any more,” said Gary Carman, a GrayRobinson shareholder and banking attorney.

The most important step for banks is to come up with a salable plan for the future.

“If the FDIC and the state see the banks have a viable plan and management is dealing with it, they will back off and give community banks a chance to raise their capital,” Carman said. “Bankers have become more cautious and that increases their appeal to investors.”

Frank Gonzalez, who heads the financial institutions practice Morrison Brown Argiz & Farra in Miami, takes a more bullish position on community banks as an investment.

“It’s a great time,” he said. “Is all the bad stuff out of the way? No, I think 2010 is still a little bit tough. But it’s a good time mainly because of being able to get a good deal. A few years ago, before the crisis started, a lot of the banks down here were going for anywhere from 2½ [times book value] — there was a deal that was four times book value — which were very impressive deals. Now it’s one — at best.”

Gonzalez said he is seeing several investors trying to get into this market — if the bank doesn’t have any issues and the price is right, or if it’s a troubled bank of a certain size that is going to help them enter the Florida market.

“They’re probably getting it at less than book value,” he said. “Foreign investors also are trying to come in. We’ve been approached by Spanish institutions, Venezuelan institutions, that are trying to come in at a time where the price is low.”

He said the state of Florida is making it “somewhat tough” to approve foreign investment deals.

“They scrutinize the foreign investors a lot more,” Gonzalez said. “There are foreign investors looking at banks here, but because of the scrutiny the approval will not come in time for those banks to survive.”

The market for community bank investors is not homogeneous, Nason said.

“You’ve got some banks that have some very serious capital issues. Sort of a walking wounded category in which you’ve got six to 10 banks,” he said of South Florida-based banks.

Nason said investors looking at a bank with serious problems are faced with not one, but two investments.

“The first investment is to fill the hole. The second is to buy a controlling interest,” he said. “If you go into a bank that needs about $10 million just to get it adequately capitalized, you don’t own it. You’ve got to buy the shares. I don’t think those banks present as much of a bargain.”

Nason said he’s skeptical that there are as many investment bargains as some believe.

“A bank’s shareholders are insisting on market value,” Nason said. “But there is a chance for investors to come in and invest in a bank that they would not have had an opportunity to invest in or take control of a year ago.”

He said some investors may come in with a minority position with an option to buy control because they don’t want to plunk down $25 million right now. Some people, he believes, are still waiting for the chance to do an FDIC assisted takeover even as those opportunities dwindle.

“Why pay full price?”

Gruner said so far, there’s been a huge disconnect between what the investors think the value is and what the sellers think the values are. “That’s been a huge problem in real estate. There’s a similar dynamic in the community banking world,” he said. “Some of these banks are very well run and are looking for additional sources of capital. This is a great time to do it.”

Properly funded, he said, a small community bank could be a regional player in 2012 or 2013.

“The folks that survive and come out stronger are going to come out much, much stronger,” he said.

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