

Op-Ed

Community Bank Capital an Investor's Sanctuary

U.S. Banker | Sunday, March 1, 2009

By Jacob Eisen and Tad Gage

Nearly all publicly traded financial services companies have seen their stocks pummeled in the last year, but a case could be made that many community banks are being unfairly punished. Well-run banks with strong capital levels that resisted the temptation to load up on construction loans or brokered deposits have been inappropriately devalued because the market, the media and the general public tend to lump all banks together these days.

So how do you recognize if a bank is undervalued? One characteristic of an undervalued bank is that the bank is still profitable even if it has increased its loan-loss provision in recent quarters. However, loan losses must have remained a small percentage of total loans.

Maintaining profitability even in a very severe downturn demonstrates a clear ability on the part of senior executives to manage operations efficiently. A number of savvy investors are carefully examining pre-tax and pre-loss reserve earnings, while at the same time examining current underwriting practices and loan quality. They believe that if a bank is growing operating earnings while it is shaking off troublesome legacy loans, there's a good possibility it may be able to deliver more value than its stock price reflects.

Another key for investors is banks that "stuck to their knitting," avoiding types of loans (especially construction- and real estate development-related) that were not a historical core strength and focusing on customers and markets they understand. Steven Gardner, the CEO at the \$754 million-asset Pacific Premier Bancorp Inc. in Costa Mesa, CA, says an important characteristic of a well-run community bank is a management team that has demonstrated discipline during the past expansion and did not take on unknown and undue risk.

Investors shopping for good bank deals are also looking at geography. Some banks grew too fast by expanding into areas outside of their core markets, either by acquiring banks or opening loan production offices or full-service branches. Investors these days prefer banks whose senior lenders have deep and lasting ties to the markets in which they operate.

Similarly, they are unlikely to invest in any bank that largely used brokered deposits to fund loan growth. Brokered deposits are an interesting phenomenon. Obviously, banks need to grow deposits to grow loans, and, used correctly, brokered deposits can be a crucial component of the funding mix.

That said, brokered deposits make investors nervous, and it's easy to see why. A number of the banks and thrifts that have failed in the last nine months had disproportionately high ratios of brokered deposits to total deposits. Commenting on brokered deposits, Craig Dwight, the CEO at the \$1.3 billion-asset Horizon Bancorp in Michigan City, IN, explained that "funding is only one variable in the overall risk of a bank. In addition, long-term brokered deposits - say, maturities of longer than one year - have less risk than short-term funding. So the average duration of a brokered deposit portfolio could be an important consideration when making a decision to invest in a bank with a high concentration of brokered deposits."

Other issues related to managing brokered deposits are liquidity, price and matching duration with assets, he added. "A bank can minimize its liquidity risk by going long-term on brokered deposits, say two to three years. Price and duration risk are subject to the management team doing a good job of managing interest rate spreads and matching the funding term with term of an asset." Horizon Bancorp has only a small portfolio of brokered deposits and produced record company earnings in 2008.

Perhaps the most important metrics investors are looking at these days are capital ratios. Currently, a bank is considered to be well capitalized if its Tier 1 leverage capital ratio is at or above 5 percent of assets; its total risk-based capital ratio is at least 10 percent; and its Tier 1 risk-based capital ratio is at 6 percent or higher.

While some bank investors we talk to aren't sure how much capital is really enough these days, their general feeling is that they are far more comfortable with the capital structures of community banks than they are with regional or national players.

It was not long ago that the darlings of the investment community were fast-growing banks in high-flying markets, but times have quickly changed. Now the stars are the "old-school" banks; the ones with experienced lenders who never deviated from sound banking practices, and who have weathered their share of ups and downs. If this sounds like your bank, now is the time for you to go out and tell your story. Investors are listening.

Mr. Eisen and Mr. Gage are, respectively, the president and executive vice president of Capital Insight Partners