Private equity gets a banking education, and mostly holds back

David Sandler discusses that issue and nine other industry hot buttons.

Sandler O’Neill principal addressed community banks at ABA’s National Agricultural Bankers Conference

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A year or so back, in the wake of a liberalization of Federal Reserve policy on investments in banking companies, many expected to see an influx of private equity coming into banking, including into the community banking sector. Conferences and seminars held out great promise of fresh capital, legal advisors boosted the concept in client letters. While there have been some notable forays into larger institutions, community banks for the most part haven’t seen the private equity that some hoped for.

An explanation of this trend—and a prediction regarding shape and timing of such investments—came from David Sandler, principal in the community-bank oriented investment banking firm of Sandler O’Neill & Partners, L.P.

Sandler, who works out of the firm’s San Francisco office, told attendees at the ABA’s National Agricultural Bankers Conference, Nov. 15-17 in San Antonio, that private equity interests came into banking undereducated about how banks and the banking system work.

In the most recent period, private equity players came on the scene with the attitude that they could buy banks on the cheap from FDIC, build them up a bit, and then turn them around at a neat profit. Their hope, Sandler said, was that dressing up the acquired banks would be enough to generate interest from other, long-term investors.

“It doesn’t strengthen the system to get that kind of capital to the table,” said Sandler, and FDIC, as gatekeeper of who acquires failed or failing banks, has exercised some control.

By contrast, other players have brought investors into the business with the intent of playing for long-term improvement and gain, said Sandler. As an example, he cited John Kanas, the former chief executive of North Fork Bank. Kanas grew this organization from a small Long Island community bank into a regional powerhouse that pushed into adjoining states and challenged some of New York City’s largest institutions for business lending in Manhattan and other parts of the city. Kanas turned North Fork into an aggressive acquirer and a formidable retail banking presence as well. It was known for high efficiency. (Kansas famously once gathered up all the extra pens at headquarters and held a major meeting, dumping them out of a wheelbarrow, to illustrate sources of waste.) North Fork eventually sold out to Capital One.

Kanas has come out of retirement to build up a Florida-based banking machine, with long-term development in mind, said Sandler. This began with the acquisition by Kanas and another investor of failed BankUnited FSB, Coral Gables. Sandler said the old banking warhorse has sent a letter to Florida institutions inviting them to talk about getting involved with his organization and investors. He is trying to appeal to bankers who are tired of being beaten down by the state’s real estate and related difficulties, who want an opportunity to be part of a group aimed at renewed promise. Sandler said that Kanas’ plan is to fix up acquired institutions, and bring increased efficiencies to the combined entities. (In early November, Kanas reportedly told Florida business leaders in a speech that his organization planned to announce a significant bank acquisition in the state shortly.)

Efficiency and core-relationship banking

Indeed, increased efficiency is one of two strategies that Sandler predicted would help pull community banks back to success in the period ahead.

“A phrase we’re going to be hearing more about is ‘right-sized’,” said Sandler. In some cases, “right-sizing” is going to mean merging with significant community banking players in neighboring counties, to grow to a more efficient size and opportunity to spread out costs. (Consolidation of the banking industry is coming to be a recurring theme in consultants’ road shows these days. However, the severity of the predicted contraction varies from one speaker to another.)

The other strategy that would see growing usage is core-relationship banking, according to Sandler. He predicted that community banks—and other banks taking a cue from their long-time reliance on relationship banking—would increasingly stress building broader and deeper relationships with existing customers.

Looking at industry hot buttons

In the course of his keynote presentation, Sandler touched on major issues and trends of the day.

Overall, he commented, many in banking don’t yet fully appreciate how much things have changed. He pointed to Citigroup as an example. “Citigroup is selling everything that’s not bolted down, right now,” he observed.

This period of upheaval is far from over, Sandler warned. “I don’t think we’re quite done with the unraveling that has to take place,” he said, as American business deleverages and American financial companies simplify.

Here’s a summary of his views:

• Securitization markets are far from returning to normal. Nothing in these markets would be selling without the federal TALF program, Sandler maintains. The government is basically lending money to buyers, chiefly hedge funds, to go out and purchase securitized investments. Without these loans, they would not be buying these securities.

• Government can’t see a way to leave the stage. While there has been much talk about the Fed winding down some of the federal programs introduced to keep things going through the crisis, Sandler said that a government official recently told him that what kept her up at night was the lack of a visible exit strategy. She couldn’t see how government intervention could be removed in such a way that stability remained.

• Mortgage rates will rise as soon as the government leaves the scene. Sandler said that the government has been pouring hundreds of billions into the mortgage market, which has helped keep rates down. However, once that support leaves the market, mortgage rates are virtually certain to start rising again.

• Bank failures and their causes. Sandler said that a maxim was developing among those who track bank troubles: “Credit maims, liquidity kills.” As an illustration of this, he spoke of a West Coast bank failure he’d been tracking. The bank involved had been raising capital towards a regulatory deadline, and was just a few million short of the requirement. A few days grace were requested, and the plea was granted. But by the time management had obtained the remaining capital, Sandler said, the regulators had decided that they felt the bank was too highly leveraged, and closed it down.

• Liquidity challenges front and center. A corollary to Sandler’s prediction that core-relationship banking will return to prominence is his belief that the relative importance to bank funding strategies of nondeposit sources will shrink. Some of this is happening already for banks that regulators are pushing away from wholesale sources. While Sandler says his firm has been a booster in the past of sources such as Federal Home Loan Bank advances, he believes banks need to readjust their usage and perspective of such alternative funding vehicles.

Nondeposit funding can become “the tail wagging the dog,” said Sandler, and that isn’t appropriate now.

• The “smile” and beyond the smile. Sandler said that the typical investor trying to get involved in banks has been looking at a “smile” territory, which he described as a curve of markets running from southern California down through Texas and into the Southeast. He said that their rationale is that these markets have been beaten down the last few years, and stand a good chance of coming back, in stock price, in the near future.

However, Sandler felt such investors were ignoring opportunities with banks in other markets.

“Unless you a sitting on a beach there, there aren’t a lot of reasons to be in California,” the investment banker quipped. In time, he said, there will be returns in places like St. Louis, Ohio, and even Michigan.

He also noted that banks with excess capital had appeal to investors in the current climate. They see such institutions as a safe harbor and reward them with share-price outperformance.

• Peril of latter-day de novo banks. Sandler said that the 2005, 2006, and 2007 classes of de novo banks weren’t terribly well conceived and weren’t needed in their markets. He said their troubles are not an indication that community banks aren’t needed.

• Community banks and “the barbell.” “There’s never a better opportunity for smaller banks than when you main competitors are being raked over the coals on the news every day,” said Sandler. However, he also added that “the bigger you are, the more likely you are to survive, because the government cares more about you.”

He predicted that the industry’s tendency of recent years towards a “barbell” size structure—a large concentration of small banks and a large concentration of huge banks, and little in between, would be accentuated in the times ahead.

• Commercial real estate and regulatory guidance. While expressing some skepticism about the details of the federal regulators’ Oct. 30 “Policy Statement on Prudent Commercial Real Estate Loan Workouts,” Sandler saw it as an overall positive that could do some good at present.

“A rolling loan gathers no loss,” said Sandler.

However, he didn’t believe commercial real estate investors would put new capital of their own into most projects.

“If we can ‘pretend and extend’ and wait for inflation,” said Sandler, “we ought to do that.” BJ

ABA SolutionS: Agricultural banking

This article was based on a presentation from ABA's 2009 National Agricultural Bankers Conference, held in San Antonio, Nov. 15-18. (The 2010 conference is set for Omaha, Neb., from Nov. 7-10.)

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