

PRIVATE EQUITY, VENTURE CAPITAL, AND COMMUNITY BANKS

What are the appropriate funding roles for insured deposits?

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Near the center of our current political discussions are the subjects of venture capital and private equity. These are often mentioned in the same breath and somewhat interchangeably.

But they are not the same thing. The question to consider today is what roles community banks should appropriately play in either activity-if any.

Let's take a look at each activity's role.

Role of venture capital

Venture capital is most commonly associated with the idea of funding business startups, which are usually new businesses with unproven track records. They are most often owned and operated by entrepreneurs who have no demonstrable experience in running businesses.

Banks of all sizes normally shun such "opportunities." They are difficult to analyze; have high proportions of debt in their capital structures; and reflect high loss ratios as a class of business activity.

Dun and Bradstreet has noted for years that 80% or more of startups fail within the first ten years of their existence.

Community banks are not exactly strangers to this sort of lending. But perhaps unsurprisingly, the biggest single sources of business startup credit have been from bank-funded credit cards and home equity lines of credit-not explicit bank commercial credit granted after review of a business plan. I've not seen any numbers reflecting the effects of the current downturn on startup activity, but anecdotally we all know that it's more difficult than ever.

Big venture capital operators, including Bain Capital, Mitt Romney's former firm, invest in startups looking for good opportunities. The returns can be high. On the other hand, there are statistically more losers than winners. But the big wins that do occur make it worthwhile to take the risks, with firms spreading them over several deals in a venture capital portfolio.

Nowadays, eligible investment opportunities are not comprised of the "mom and pop" types of operators. Rather they are often inventions or ideas with large commercial applications that require funding much beyond the equity in the owners' home or personal credit sources. I've seen many such "industrial" opportunities arising from within the national laboratories that operate in New Mexico.

The investments by venture capitalists in the specific opportunities almost always take the primary form of equity. To maximize returns, debt is used as well. That debt is specifically and individually negotiated with lenders, including large banks, based on normal credit due diligence by such institutions.

Leverage is often a characteristic of these deals but the sources are varied. The funders are not typically community banks. First, that's because the risks tend to be larger. In addition, the actual aggregate size of the loans is much larger than the typical lending capacity of a community bank.

Role of private equity

Private equity is the investment activity that seems to be generating the most comment in the current political season and not all of the comments are favorable. Bain Capital has also been a participant in this activity.

Private equity's goal is to improve the efficiency of invested capital as measured primarily by the return on equity ratio. This is the ultimate capitalistic calculation of what the owners of the business earn on their investment, i.e., their equity.

More return is better. But even the most junior credit analyst understands that the quickest way to "juice" return on equity is to increase the proportion of debt in the funding sources.

More debt means less equity, and all other things being equal, less equity with the same level of earnings produces a higher return on that equity. In that sense, equity becomes more efficient. It earns more. The deal is also more "efficient" as it returns more with less (more return with less equity).

But less equity in a given situation means more debt--and that always means more risk.

There's the financial (balance sheet) leverage of having less equity available to absorb losses. There is also the operating (income statement) leverage owing to the higher fixed costs incurred in servicing debt over time.

So here is the inevitable tension in private equity deals: More debt brings more opportunity for better returns on equity--but also comes with a higher level of risk both on the balance sheet and the income statement.

Some observers see abuse and greed in private equity deals. Yet private equity deals are often targeted at companies that are not outstanding performers. Investors see opportunities to put excess cash or underproductive assets to work, earning better returns. To the extent that the processes of redeploying assets are successful and enhance earnings streams and dividends to equity owners, then the activity is deemed to have been successful.

The possibility of unsatisfactory outcomes is always present.

Does the funding source make a difference?

Redeploying assets often means structural changes in an existing business. This process necessarily involves risk and as lenders we've all seen varying degrees of success in the execution of business strategies.

Business news in recent days has included the bankruptcy filing of Kodak, an iconic company of the 20th century.

Arguably, Kodak was a company that tried, but failed, to reinvent itself for the 21st century. What differences might private equity strategies have produced for Kodak's stockholders and employees if undertaken, starting 15 or 20 years ago?

Kodak's employment in its headquarters city of Rochester, N.Y., fell from 60,000 in 1982 to 7,400 today. That's a lot of pain for the workforce and for the community to absorb.

Could bank credit have stepped in, in some way, to bring efficiency back?

Private equity, with its highly entrepreneurial orientation, outsized proportions of debt, and the deliberate leveraging of earnings is not an appropriate activity for community banks that derive their funding primarily from insured deposits.

There's also the appropriate question of whether bank lending in situations that exclusively benefit the shareholders is productive in a way benefitting a local community. Each circumstance must be judged on its merits from multiple points of view, including the community's.

In the current discussions we can see how different the perspectives of lending participants can and should be. Once again we see how regulation impacts us differently due to size and purpose of the transaction. We also need to be clear

as community banks why these different sorts of activities are not always appropriate for our stockholders, communities, or the Deposit Insurance Fund.

Did you catch Ed's recent book review of *Optimising Distressed Loan Books*. He found it a very helpful guide to loan workouts. [Read the review now](#)

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts [here](#). You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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