Cashing in on community banks

Returns in the past 10 years have been outstanding for East Bay institutions

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by Jeff Nachtigal

Harvey A. Rowen likes to invest in community banks for a simple reason: Money is a sure bet over the long haul.

An investment adviser and principal of Starmont Asset Management LLC in Danville, Rowen reminds his clients that "everyone wants money, and it never goes out of fashion."

Investing in community banks in the Bay Area has been particularly lucrative for several years.

"The returns on community banks in the last 10 years have been outstanding," said Rowen, a former attorney with the Securities and Exchange Commission. Because community banks establish a presence in a geographic area, and then a larger bank comes along and they buy the bank."

In 2000, when Mt. Diablo National Bank was acquired by Greater Bay Bancorp, investors were rewarded with returns of 12 to 14 times the original buy-in price, said founder Jack Hounsley. Three years later, more than 60 percent of the investors in Hounsley's most recent startup - Diablo Valley Bank - were eager to ante up $50,000 and a place in the Chairman's Circle for the chance at similar returns.

"Historically it takes two or three years, sometimes three to break even," said Hounsley, Diablo Valley Bank's chairman. "But in our case, we're already profitable in our second year. But all community banks will be (profitable) sooner than later."

Tri-Valley Bank, which plans to open branches in San Ramon and Livermore this September, and Bay Commercial Bank, which opened branches in Walnut Creek and Oakland in July 2004, also have been the beneficiaries of enthusiastic investors.

Known as an "alternative investment," a community bank investment requires an "illiquid," or long- term buy-in, usually with a minimum investment of $10,000. In many cases returns come via a buy-out, or public stock offering five to seven years down the road. Returns can fall anywhere from two to five times the initial investment, Rowen said.

In the case of Mt. Diablo Bank, the return exceeded 10 times the initial investment.

But not all community bank investors are get-in, get-out types.

Tri-Valley Bank president Bill Nethercott needed only two "road shows" to gather enough local investors to reach the bank's required $13 million in start-up capital. Nethercott said fundraising wasn't difficult because the San Ramon and Livermore business communities were so pleased, after being served by national banks for eight years, to have a local bank to offer highly personalized service.

Nethercott is well-known in the community; he was the president of the San Ramon Rotary Club and he has lived and worked in the area for the past 20 years.

"The capital campaign has panned out so far, and definitely the community is buying into this idea," said Nethercott, who emphasized the community-style aspect that his bank would provide, complete with first-name-basis service. "It was such a short period of time in only two events we held, and the money just kept rolling in."

Brent Tucker invested in Tri-Valley Bank precisely because of Nethercott's intent to cater to local businesses with personal service. Tucker, president of 35-year-old Tucker Associates Inc., a real estate development company, noted that some larger banks in the Valley don't even have main offices for decision making in California - a serious drawback for local businesses.

"You're investing in the community and possibly in your own business, in a roundabout way, by putting money in the bank, and spending it," said Tucker, who has invested in several community bank startups over the years.

For Stan Smalley, president of MCE Corp., investing in Tri-Valley Bank - from both a business and personal perspective - was an easy decision because he has done business with Nethercott since 1983.

"My personal investment in it is this: I know how he treats local businesses. He's fair and works with the business, and that's important to us," Smalley said.

With an oversubscribed list of investors, the bank raised more than $18.5 million, putting Nethercott in the position of being able to hand-pick local investors for his hometown bank, as opposed to unknown investors from afar.

"There is not one institutional investor in our group, these are all people with liquid investments or who are investing under their retirement account," Nethercott said.

No slow down

In California, there are 20 new banks on the horizon. Currently, seven bank applications are pending approval. Thirteen banks have received approval and will soon open their doors, including Tri-Valley Bank.

Over the past 30 years, bank investments have outperformed the S&P 500 and Nasdaq, making them, without question, a solid investment option. But a basic supply and demand issue has made independent California banks especially sought-after by investors.

In 1990, a total of 485 banks were based in the state. By 2004, that number had dropped to 267, a 34 percent decline.

The paucity of local banks, especially in Northern California, has created unusually positive conditions for community bank startups and their investors, said Ed Carpenter, chairman and CEO of Irvine-based Carpenter and Co., an investment bank specializing in financial institutions. For instance, an investor who bought equal shares in all of California's 157 small-cap banks one year ago would see returns of 42 percent, Carpenter said.

"What's really attractive is there are so few publicly traded companies that you can invest in and then drive by when you're going out to dinner, or that you can do business with and help the value of your investment," said Carpenter, who was involved in the Bay Commercial and Tri-Valley bank startups. "And that just doesn't happen very often in America."

Low risk

With such a high regulatory bar to reach before they can even begin to solicit investors, banks have traditionally been a safe investment.

Nevertheless, it pays to know who's behind the till.

A bank needs to generate depositors and loan demand right off the bat, and that often comes down to the bank board members, management and advisers' ability to "shake the bushes," Rowen said.

"The banks that get into trouble are where there are people running the bank who see it at as a piggy bank, or make preferential loans banks wouldn't otherwise provide, and then they default," said Rowen. "So when we look at a bank to invest in, the policy is to ask about the bank's policy on loans to insiders, and who is enforcing that policy."

Bank of Alameda president Stephen Andrews echoed Rowen's sentiment about how important solid business fundamentals are for long-term success.

"In an era when banks are paying only 1 percent on deposits, it is very easy to attract capital into the bank market. But capital is the easy part. The hard part is the execution," Andrews said.

After the first several years of rapid growth of up to 20 percent, Andrews said to satisfy investors, startup banks typically need at least a 15 percent return on equity, a marker common shareholders use to gauge how well their money is being managed.

Bank of Alameda, which opened in 1998, initially raised $7.6 million in capital. After an additional $4 million capital campaign and two stock splits, the bank has provided shareholders with healthy 450 percent appreciation returns.

"At the end of the day all banks have the same product," said Andrews, president of the California Independent Bankers Association. "So it comes down to execution and how efficient and what type of marketers they are, and what the market offers them."

Discounting the idea of a real estate bubble theory, Rowen said business decisions determine the success of a bank in the long run.

"Most banks are making loans, not to the home buyers but to the home builders, and if those loans are based on the economics of the deal then that's why it's not a problem if the long-term rates go up and real estate slows or declines," Rowen said.

There is some cachet, too, that comes with owning a piece of a bank.

"At a cocktail party a guy can say, 'I own Bay Commercial, or Tri-Valley, or Diablo,' and you hear that this guy owns a piece of a bank and chatter gets started, so it's a very good investment and they can talk about it," Rowen said.

Asked to recall any bank investments that turned out poorly, Ed Carpenter couldn't think of any over the past decade. "I'm a big believer and I've been doing this for a long time."

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