Private Equity + Real Estate Capital = A Good Marriage For Banks

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Over the past two years the banking industry has struggled with increasing levels of capital inadequacy as a result of write-downs of bad loans. The uncertainties in the commercial real estate market cause pundits to predict even greater losses for banks.

The regulatory authorities continue to make demands that banks raise capital even in the face of those uncertainties. This suggests that the regulators should be encouraging private equity and real estate capital to work in tandem to assist in the recapitalization of the banking sector.

The Corus Bank Split

In particular, the FDIC signaled this type of "split approach." In September 2009 the Corus Bank failure led the FDIC to split the bank's assets in two groups: the core banking franchise, which was sold separately to MB Financial Bank, and the troubled real estate loan portfolio, which was sold to a consortium of real estate investors led by Starwood Financial and TPG.

Thus, splitting a failed bank's core banking activities from its troubled loan portfolio suggested that banking regulators might be open to the possibility of private equity and real estate capital working together on investment opportunities in struggling or failed banks.

In the recent past the banking regulators have been chary of private equity and real estate capital coming together to assist a struggling bank. For example, banking regulators have refused to permit banks to treat as Tier One capital a bank's majority interest in a subsidiary into which troubled assets of the bank were contributed, in exchange for a capital infusion in the subsidiary from, and preferred return for, a real estate investor holding a minority interest in the subsidiary. It remains an open question whether the FDIC would accept a private equity/real estate capital split in a loss sharing arrangement for a failed bank acquisition, although, analytically speaking, such an arrangement should be acceptable.

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Bank Portfolio Sales

While operating banks considered portfolio sales, and some of these have been finalized, selling banks found that a forced write-down of their troubled loans at the time of any sale was a significant deterrent because the ensuing capital hit could not be absorbed by core operating profits in the near term. Operating banks considering portfolio sales are faced with the challenge of bridging the considerable gap between "the bid and the ask" for the portfolio so that the bank's expectations could be met with tolerable pain and suffering and the buyer's investment hurdles could be met. In most cases that difference could not be bridged without a concurrent new capital infusion from existing shareholders or outsiders. In many cases this proved to be elusive. The result was an ever-increasing number of failed banks and the expectation that this trend will continue for the balance of 2010 at a fairly vigorous pace.

FDIC Statement of Policy

Before the Statement of Policy was announced, it was generally thought that there would be many appetizing investment opportunities for private equity in the banking sector. This was suggested by both the BankUnited failure and the IndyMac Bank sale out of the FDIC conservatorship. In the case of IndyMac, its successor, OneWest Bank, quickly became a very successful operation. As a result, it was permitted to acquire First Federal Bank, a $6 billion Los Angeles-based institution, from an FDIC receivership late last year.

The August 2009 FDIC Statement of Policy brought a measure of clarity to the marketplace. The FDIC let it be known that it was not necessarily hostile to private capital players investing in failed banks, just wary of their intentions and commitment. Consequently, it imposed a number of significant conditions to any such investment, among them a minimum capital and financial support commitment, a three-year lock-up period that will force private equity to maintain ownership throughout that period, a cross-support commitment from other banks where there is at least 80% common ownership and transparency as to actual ownership.

Private equity can avoid these restrictions (1) by joint venturing with an established and successful bank holding company, in which the bank holding company has a "strong majority interest" in the resulting bank, i.e., at least two-thirds, or (2) by forming a consortium of investors in which each investor takes a 5% or less interest without any evidence of concerted action. The FDIC has issued additional guidance addressing some of the ambiguities in the original Statement of Policy and continues to contemplate further refinements.

The Statement of Policy has attracted a lot of attention from private equity groups intending to invest in a platform bank or bank holding company with the understanding that this entity will have sufficient capital and management skills to enable it to successfully bid for institutions closed by the regulators. This is most likely to be advantageous and where the failed bank has an attractive core banking franchise even though steep losses in its loan portfolio ultimately caused it to fail.

Help for Struggling Banks

But what about the struggling banks, which have not failed and are operationally profitable in their core banking activities? The recent announcements of significant private equity recapitalizations of Sterling Bank in Spokane, Washington, and Pacific Capital Bank in Santa Barbara, California, suggest that private capital is on the hunt despite the prediction of a continued deterioration in commercial real estate portfolios. This suggests that with disciplined and detailed due diligence, and the appropriate pricing levels, private equity still wants in on the game.

By the same token, strong interest continues to be displayed by real estate capital players attracted to struggling and failing banks in the expectation that if acquired at the right price and terms, the real estate assets can be managed successfully over the medium term for a good return to the real estate capital with perhaps some residual value being returned to the bank that previously held the assets.

So the challenge is to marry the aims of private equity and capable bank management with the aims of real estate capital in a way that meets regulatory requirements, insulates the core banking franchise from further losses attributed to its real estate loan portfolio and presents the opportunity for returns that are attractive to real estate players.

This should be an attainable goal for both operating bank investments and failed bank acquisitions.

Private Equity and Real Estate Capital Working Together

The key element for any potential private equity investor in an operating bank is to be able to reasonably conclude that either current asset values on the books of the bank represent a fair valuation of those assets or that with a rigorous analysis a fair valuation can be ascertained. If those values are susceptible to further deterioration because of the strong possibility of worsening market conditions in the future, that will be reflected in a price determination.

To attract capital, banks need to be able to offer investors a structure that enables real estate capital to gain control of the portfolio of troubled assets in a separate vehicle while the bank’s balance sheet recognizes only a one-time charge for the difference between the bank’s carrying values for those assets and the amount paid to the bank by the real estate capital provider for those assets. Following the portfolio sale to a real estate investor, the bank would need to have a private equity provider that is prepared to cover the bank's recognized loss on the transaction through a capital infusion, and the bank would need certainty that it will not have to recognize further losses arising from a further deterioration in the value of the assets in the portfolio sold to the real estate investor. In other words, any further losses in the value of the assets in the portfolio would need to be borne by the real estate capital provider. In certain cases, the bank might be able to retain a minority interest in the real estate vehicle enabling it to share in recoveries down the road.

In a failed bank situation, under the FDIC's Statement of Policy, private equity is most likely to acquire a failed bank franchise if it has joined with an existing bank holding company. In most instances the FDIC offers some loss sharing arrangement to the acquiring bank. The attraction of a loss sharing arrangement is a significant inducement to the acquiring bank making the successful bid. If that loss sharing arrangement could be made available to a real estate capital provider who has joined with the acquiring bank after it has been recapitalized by private equity, the bid could be significantly higher. If the bid were successful, the acquiring bank would not have the burden of managing the failed bank's troubled asset portfolio and bank management could concentrate its efforts on enhancing the profitability of the failed bank's core banking franchise.

The success of either of these structural solutions needs the cooperation of the bank regulatory agencies involved. Given the likelihood of continuing bank failures in 2010 at a rate in excess of what occurred in 2009, there is some indication that those agencies are prepared to listen to suggested approaches like these and to provide regulatory approval in the appropriate cases.

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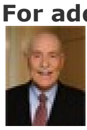
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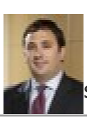
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