***E*-Memo**

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and Scott McCallum
DATE: February 28, 2017
SUBJECT: *De Novo:* Déjà Vu?

In our December 2016 E-Memo, we mentioned that regulatory reform may be one of the most positive environment changes banks couldn't begin to dream about before The Election. We didn't discuss regulatory moderation for *de novo* (start-up) banks that might be coming down the pike based on new guidance recently proposed by the FDIC. That new guidance included a return to a three-year business plan horizon down from seven-year plans which had been in place since August 2006. Those "straight-jacket" rules included limits on compensation and letting the FDIC know when there were deviations from that business plan. Oftentimes those plan deviations required regulatory concurrence.

New Guidance: The proposed new guidance, **"Applying for Deposit Insurance – A Handbook for Organizers of *De Novo* Institutions"** was published by the FDIC and released for public comment on December 22, 2016. The essence of the proposed guidance shortens the planning horizon from 7 years to 3 years. No "brightline" minimum amount of capital raise is specified; rather, there is a minimum of 8% tier 1 leverage that must be maintained at each quarter-end for the first three years. The plan cannot be contingent on additional capital raises, and, of course, no dividends may be paid during that period.

Compensation still has restrictions, but "reasonable" base salaries and benefits can be paid. Incentive compensation and stock benefit plans can be used as long as they don't constitute unsafe or unsound practices, and institutions should maintain safeguards to prevent payment of compensation, fees and benefits that are excessive or could lead to material financial loss. Stock plans with exercise rights must be exercised at no less than Fair Market Value at the time the stock right was granted. Severance is generally limited to one year of base salary. Employment agreements cannot exceed three years in duration.

A public comment period ended on February 20, 2017. We haven't seen anything from the FDIC indicating an extension of the comment period, so we are awaiting publication of final guidance.

History and Background: During 2016, a total of eight organizing groups filed applications with the FDIC, two of which were approved in the fourth quarter. By comparison, the peak year for applications was 2005, when 299 were filed.

Prior to 2008 a couple of critical factors drove *de novo* formations:

1) Availability of community or regional bank executive teams that had successfully sold to larger bank interested in doing it again in the same geographic market.
2) Sourcing investor capital was bifurcated: i) local, high net worth individuals who wanted to buy into a local community banking play or who knew organizers and future board members, and ii) the emergence of institutional/private equity investors looking for a home to deploy capital at roughly book, and sell 5-7 years later at 2.5-3x book. Buying into existing private or public banks was too expensive for these investors, making *de novo* economics relatively more attractive.

A variation on a pure *de novo* was the purchase and recapitalization—and subsequent transformation—of an existing small bank, allowing executive teams and investors to sidestep *de novo* restrictions on business plan and compensation. The economics were similar, in terms of buying at close to book value, but often had a faster turnaround to profitability. Sometimes initial capital needed or raised was higher than a typical $15-$20 million retail raise for a traditional *de novo*. While some of the true start-up risk of any *de novo* could be avoided or lowered by buying an existing charter and operations, execution risk in a recap still remained high due to the purchased problem loans and the transformation of the bank into a profitable, growing and more valuable franchise.

In the post-crisis period from 2010 through 2015, recap investments became opportunities to put money in at well-below book, provided that new investors could get their arms around asset quality that drove losses and some failures. These recaps often involved issuing new equity and substantially diluting original or existing investors. Consequently, the time table and exit valuation expectations were much shorter and smaller than for traditional *de novo* or buy-and-hold investors. Buying at 0.5-0.8x book and selling at 1.5x in 2.5 years, with growth in earnings, balance sheet and exit multiples could drive big IRRs, at least for a while.

Bank Investing Economics: The fundamental economic analysis drivers for ***any*** bank investment:

- How much capital is needed and for what purpose?
- What is the entry purchase price, in relation to earnings and book value, and in relation to other banks?
- What are the expenses associated with the capital raise?
- What are the liquidity and/or exit strategies?
- What is strategy and business plan for growth and profitability?
- What are the risks in the business plan, and are the rewards worth it?
- Asset generation: Loan growth and quality
- Core deposit funding generation: the lifeblood of a bank's valuation
- What is the degree of alignment of the board and investors with the executive team?

***De Novo* Economics:** Add to that list the following unique factors for *de novos*:

- What are the organizational expenses?
- What are the capital raising expenses?
- What are the other pre-opening costs and capital expenditures?
- What are the post-opening and ongoing expense burdens?
- How much and for how long does the *de novo* lose money?
- What is the availability of talent in and attractiveness of this particular local market (economic health, demographics and competitors)?
- When is the capital (or losses) finally recouped (cumulative payback period)?

The basic proposition is to invest at 1x book value (BV), grow but lose money for two years (so effectively 1.15 BV), then get to breakeven, recoup losses and sell in 5-7 years at 2x BV to a much larger bank with a valuable earnings stream.

As bank stock valuations (Price to Earnings Ratio (P/E) and Price to Tangible BV P/TBV), traded and M&A multiples rise above BV, the relative attractiveness of *de novo* banks increases. If the start-up can quickly limit organizational and pre-opening outlays, and the business plan can be executed to drive revenue growth quickly enough to breakeven, then the value of the franchise can be worth more both as a standalone and to someone else.

We'll watch to see what happens to the 8 *de novo* applications currently on file, as well as the final rules. As investors we'll be following the "economics" roadmaps and so should you.

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