FORTRESS PARTNERS
E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss & Ed Depenbrok
DATE: June 21, 2019
SUBJECT: The Landscape of Midwest Community Banking is Changing

The foundation of a strong, free economy is a diverse and competitive banking system. We believe interested, proactive shareholders promote efficiency and good performance, while fostering a healthy banking and economic system.

Since the Financial Crisis much has been made of the rapid consolidation of the U.S. banking industry. In fact, during this decade the number of FDIC-insured commercial banks and savings institutions has declined from 8,012 at the end of 2009 to 5,362 at December 31, 2018, fully one-third (33%) of the banks in existence at the end of 2009 or 2,650 were gone as of the end of last year. Granted some of the decline was caused by bank failures—to be exact, 383—have failed and been shut down. That's 14% of the 2,650 that have ceased to exist!

While there has recently been a movement to start up banks in areas where the lack of community bank alternatives has been noted, the number of new bank charters is certainly not approaching the pre-financial crisis 10 years' average of 205 mergers that were being announced each year, so the reduction in banks will continue.

This trend has also been seen in four states in the Midwest, namely Wisconsin, Iowa, Minnesota, and Illinois. However, the preponderance of community banks in this region indicate that there is still significant opportunity for further consolidation of the industry. Below is a table summarizing the number of FDIC insured financial institutions in this region:

State	December 31, 2009	December 31, 2018
Wisconsin	281	201
Iowa	367	288
Minnesota	414	292
Illinois	631	436

While the population of these states make up only slightly more than 8% of the U.S. population, they have nearly 23% of the total financial institutions. In contrast, there are states where the consolidation of community banking has already resulted in very few remaining local competitors. For example, North Carolina, which has nearly 3.5 million more people than our home state of Wisconsin, has only 47 financial institutions while Arizona, with 1.3 million more people than Wisconsin, has only 15. To no ones surprise, it is markets like these that are attracting the interest of entrepreneurial bankers who are attempting to organize new charters to fill the community banking gap.

So, given that there are still over 1,200 financial institutions in these four midwestern states, it is to be expected that the M&A trend will continue for some time. In fact, in Wisconsin alone, nine community bank mergers have already been announced in 2019.

Since the key drivers of the consolidation—management succession issues, the aging of the shareholder population, the need for shareholder liquidity, scale and leveraging of fixed costs, and attractive deal pricing--appear to be ongoing, the continuation of the trend should be expected.

How we see consolidation taking place. On a nation-wide basis, we've observed three approaches to bank consolidation.

- Much maligned—by bankers—**credit unions** have made their interest known and have acquired a handful of banks located in Wisconsin, Illinois and Minnesota and Wisconsin banks in the past few years. Since January 1, 2012 there have been twenty (20) banks acquired by credit unions, 8 of which were announced so far in 2019.

Of that number credit unions have acquired four Wisconsin banks, one bank in Minnesota and two in Illinois. On June 18, *Verve, a Credit Union* announced its agreement to buy South Central Bank in Chicago, a $300 million asset bank. That will set the *hair-on-fire* of many bankers who have fought for decades to stem the incursions of credit unions into "our business". If you think its OK, just remember that credit unions don't pay taxes. We do. So guess how credit unions can pay top prices for banks all across our nation!

- We are also seeing a trend across the country in the **acquisition of *platform* banks**. A platform bank is a small bank with $100 million or less in assets which is being acquired to be used as a platform to "roll-up" other community banks into a bank that has scale to compete and access to capital markets allowing them to grow larger. Their size will make them more attractive candidates for larger banking organizations that are looking to expand their geography or enhance their core deposit funding.
- Finally, the third form of consolidation is the outright **acquisition of a community bank** for cash or stock **by a larger bank.** This too will lead to improved economies of scale allowing it to better compete and have access to capital markets not currently available. In some cases, a merger of equals (if there is such a thing. We remember the old bromide "All men are created equal but some are more equal than others") such as the merger of SunTrust Bank and BB &T Bank in the mid-Atlantic and Southeast will occur.

The consequences of consolidation. These three forms of acquisition and their permutations will ultimately reduce the number of community banks serving the Midwest to a far smaller number than 1,200. This consolidation will continue to stir the pot of disruption creating opportunities for smaller community banks such as those in which we invest, to acquire dissatisfied customers and their bankers to create more organic growth than the markets being served ordinarily provide. Consolidation is truly the gift that keeps on giving by providing incremental growth to acquirors, allow competing banks to absorb disrupted customers and their bankers and ultimately, inspiring the latent entrepreneurial spirits in bankers to start new banks in unserved or underserved markets.

In any event, it is highly likely that we will continue to see market disruption as M&A activity continues in this region of the country. And, for the remaining local community banks in the markets, as we pointed out in our April *E*-Memo disruption often brings opportunities to add customers and talent to further strengthen their own ability to serve their marketplace and to grow.

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