

## De Novo Bank Investing

### A Guideline for Investors

#### —Risks, Rewards and Expectations

By Jim Miller

With due respect to Charles Dickens, this might have been titled “*Great Expectations*.” The expectations of De Novo bank investors are not just of the monetary sort. There is a qualitative element also. There is a feeling of participating and owning a part of a new business in the community that will be beneficial to the total local economy. An investor can walk down the street and into the bank, talk with management, meet friends and network for their business all in the same place. How is their bank doing? They can not only read the published financials released by the bank under the auspices of Governmental review but they can simply ask management how it is going. The community bank becomes a focal point of the local economy and investors in that bank have the opportunity to enhance their profile financially and as a member of the shareholder group.

A De Novo bank is a community bank *in organization* that is in the process of raising capital to open the business. The money to start the bank is raised in the community through the efforts of a group known as the bank organizers. Typically there are 15 to 25 organizers involved in the start-up of the bank. They are business community leaders and proposed bank management personnel who have invested money and time into the process to bring the bank into being. The money is raised primarily in the community that the bank will serve. Many times there are also outside investors involved. Savvy money types know the successful history of community bank investing and look to participate in attractive situations. In today’s demographic situation a bank forming in a major metropolitan area will be required to raise \$20 to \$30 million dollars. In lesser populace areas the minimum may drop to the \$12 to \$15 million range. As a point of interest these ranges are double and triple the requisites of 10 years ago.


There are approximately 7,500 banks in the United States today. This number is down from over 12,000 at a peak over a decade ago. The banking business is not unlike a crop cycle. Banks come into existence (seed planting), develop their business (growing season) and reach a point where they mature or are acquired by another institution (harvest). As community banks are harvested by larger banks it leaves a void in the service provided in the community. It is not uncommon for the acquiring bank to be headquartered thousands of miles from the town in which the bank is located. The result is that decision makers who used to

be neighbors are now not available. That is frustrating and not acceptable to the businesses in the community who need on-site service. That void in service and accessibility is the catalyst for the formation of a new bank in the area. It is a never-ending demand cycle that repeats time and again.

Before outlining the risks and rewards of investing in a De Novo bank let’s take a look at the process. As previously stated the bank information has an organizer group who have invested in the bank and worked to get all the governmental and agency filings accomplished (no small task). Additionally these individuals have been subjected to the intense scrutiny of background checks by multiple agencies including the FBI. The bank, in organization, has now been cleared to raise money under an offering circular and subscription document. When an investor decides to buy shares in the bank he fills out and signs the subscription documents, attaches a check and returns the package to an escrow agent. The funds are held in an escrow account until the full amount has been raised. When that occurs escrow is broken, the funds are released to the bank and investors receive their share certificates. The bank is now open for business.

—Before outlining the risk and return prospects of investing in De Novo banks let me give this overriding caveat. The risks of investing are presented in the offering documents of each bank. Investors *must* read this material! Every bank *in organization* is a unique entity and anyone when reading in this piece about “average returns” and “perceived risks” know that these are historic result guidelines and may or may not be typical to any given bank. Additionally while it is true various governmental agencies are involved in the offering process, none guarantee or warrant any investment results. Investors will own shares of a small capitalization company with limited market liquidity and no assurances of success.—

What may an investor expect from his commitment to a De Novo bank? The short answer is that history shows a very successful return to investors over a three to five year time frame. A recent study I performed showed that annualized rates of returns for investors in de novo community bank shares were commonly 15% or better. An investor in a community bank is by definition a small capitalization value investor. As



such one focuses on the fundamental progress of the bank and not the short term pricing vagrancies of the share price. My research shows the following fundamental progress to be a modal experience for new banks; From the day the bank opens until about the 7th quarter of operation there is a cash flow outflow (loss) in operations. During the next 5 or 6 quarters the bank is earning back the capital drawdown experienced through a positive cash flow so the original capital level is achieved. So at approximately the 36th month the bank is earning money and established as a profitable business. How does this translate for investors? Again with all caveats in place here is a modal profile. The successful community bank investor is one with a longer term time horizon and also is aware that the bank will need some operational time under its belt to achieve profitability. Therefore even though the bank is losing money at the onset, many times the share price will hold its original value or even accrete. At the estimated 36th month when the profile model is an earning entity and original capital has been regained in today's market environment that bank is selling for 150% of book value. So if the original share price investors paid at the offering is \$10 per share the market valuation would be \$15 (a 50% gain). Now as the bank matures the investor can monitor his investment in the market place and make his investment decisions based on his opinion on the bank's performance (it would be advisable to have the counsel of an expert in this process).

What are the risks involved in investing in a De Novo community bank? There are real areas of concern. Some are generic to investing and some unique to De Novo banks. A general concern is that one is investing in a small company whose shares may be subject to severe fluctuations in the market place. This is due to the restricted liquidity of the bank's shares. Upon issuing shares to stockholders the bank may have 1.5 to 2 million shares outstanding and those in the hands of 300 to 500 individuals. The vast majority of those individuals are in the investment for the long haul and not prone to trading. However, it is probable that for one reason or another a few people need to sell their newly acquired holding. If this is not done properly the quoted price of the shares could fluctuate dramatically. For instance if someone decided to sell at the market a few thousand shares it could on a short term basis drive the price of the stock down 10% or more. This is a "comfort zone" risk for investors. It is disconcerting to see the value of one's holdings drop so sharply. However, if it is due to the sudden influx of selling in the market it should be a short term aberration and have nothing to do with the fundamental progress of the bank. There is of course real business risk in the progress of the bank. If the bank does not do well and not meet the expected profile of progress real value deterioration is possible. Banks can and do make bad loans from time to time. Banks can and do make branch location mistakes, etc. Here's some great news for investors. You have a partner in monitoring your bank. Government! There

are multiple governmental agencies both federal and state keeping a close eye on new banks. A bank in its first three years of operations may be one of the most agency scrutinized businesses in the country. In their first three years of operation banks must perform to budgets and business plans submitted to multiple agencies such as the OCC, FDIC, and State Banking authorities. While the activity of observation does not ensure success it certainly provides a flow of information from which investors can base decisions.

What is the expected life of one's De Novo bank investment? It can be anything the investor chooses as the shares are available to trade in the market place at any given time. A better focus is, what does experience show as successful strategies? Success has been achieved by investors who were short term in attitude scalping a few points as soon as possible to the Warren Buffett buy and hold forever philosophy. As usual one is probably well served somewhere in the middle of that spectrum. Historic performance shows it is necessary to allow the bank to fundamentally progress and succeed before investment gains can be realized, typically three to five years. Thereafter the bank will continue its fundamental progress and the shares will reflect pricing in the market place. Sometimes extremes in pricing occur in the market that are obvious un-links from the economics of the business. Over exuberance drives prices up to over valued status and contrarily an emotional response sends the share price to unwarranted low levels. In the case of over valuation it may make sense to take some profits off the table. On the other hand it could be a good decision to purchase shares of the depressed stock of a solid bank. Another potential for the patient investor is that his bank is acquired in a merger by another institution. Typically this is a nice boost to shareholder value (referring to discussion earlier in this piece a crop cycle has been completed).

Data supports the conclusion that investors in De Novo banks make money (see general caveats previously outlined). Individual investor experiences support this conclusion. Also there are professional and institutional investors who are dedicated only to the niche. Great Expectations are indeed fulfilled by the successful investors participating in De Novo bank investing.

## De Novo Bank Survey Discussion

The data sampling chosen for this survey reflects a cross section of banks started between 2000 and 2003 in populace states. The subject banks reflect both urban and suburban locales. The sampling is too small to project meaningful means, modes and medians but it does show the pricing of banks with varying degrees of success.

What can be said from observing the numbers in this survey and those of randomly selected performances of other banks started in the same time frame is; It is not unusual to see that investors in the IPOs of community banks shares have realized a 50% return on that investment within 36 months. This is not to say it is the average and certainly one must be aware that each situation is unique and must be dealt with as such. There are no guarantees and investors must realize and accept the risks inherent in investing in micro and small cap companies. Additionally it may be observed that some of the valuations attributed in today's market may be overvalued when compared to traditional models.

A fair statement can be made that given the historic performance of community bank shares in their first 48 months, the small cap value investor would be well served to investigate current available opportunities.

## De Novo Bank Share Price Performance Survey

The following data is a presentation of a selected sampling of Community Banks that have been formed over the past few years, 2000 through 2004. The purpose of this phase of the study is to select a few banks to survey and observe their share price movement since their offering date and include current Total

Assets and Net Income progress by presenting the most recent reported results. The sampling has been chosen primarily from those areas of focused activity including California, Florida, Oregon, Texas, and Washington.

Later segments of this study will explore and break down in more detail the elements that contribute to the successful progress of new banks such as cost of funds, gross rate spreads, loan to deposit ratios, efficiency ratios and others.

Banks in survey	
Optimum Bank Holdings	OPHC
Commercest Bank	CWBC
Premier Valley Bank	PVLY
Premier Service Bank	PSBK
Mission Oaks Bancorp	MOKB
Discovery Bancorp	DVBC
Northwest Commercial Bank	NRTW
Orange County Business Bank	OCBB
County Commerce Bank	CNYB
Ventura County Business Bank	VCBB
Marco Community Bancorp	MCBN
San Diego Trust Bank	SDBK
Bank of Florida Corporation	BOFL

Bank	State	Date IPO	Assets	LTM EPS	Bk val/Sh	Px/EPS	Px/Bk Val	IPO Px	Cur. PX	% chg IPO
OPHC	FL	2000	\$248mm	\$0.58	\$7.39	15x	118%	\$7.50	\$9.00	20%
CWBK	CA	2001	\$233mm	\$0.92	\$8.75	22x	240%	\$7.50	\$21.00	180%
PVLY	CA	2001	\$446mm	\$0.42	\$4.85	23x	190%	\$2.50	\$9.25	270%
PSBK	CA	2001	\$148mm	\$1.03	\$9.90	18.5x	192%	\$10.00	\$19.00	190%
MOKB	CA	2002	\$193mm	\$0.45	\$4.16	22x	240%	\$2.50	\$10.00	340%
DVBC	CA	2002	\$193mm	\$0.63	\$13.32	27x	125%	\$10.00	\$16.70	67%
NRTW	WA	2002	\$62mm	\$0.85	\$12.77	21x	140%	\$10.00	\$18.00	80%
OCBB	CA	2002	\$199mm	\$0.24	\$10.67	67x	150%	\$10.00	\$16.00	60%
CNYB	CA	2003	\$104mm	\$1.17	\$9.75	21x	251%	\$10.00	\$24.50	145%
VCBB	CA	2003	\$89mm	\$0.53	\$6.22	22x	185%	\$7.50	\$11.50	53%
WMCB	OR	2003	\$49mm	\$0.52	\$8.88	26x	160%	\$10.00	\$13.75	37.50%
MCBN	FL	2003	\$170mm	\$0.62	\$7.26	23x	194%	\$8.00	\$14.00	75%
SDBK	CA	2003	\$95mm	\$0.64	\$7.10	50x	450%	\$10.00	\$32.00	220%
BOFL	FL	2003	\$938mm	\$0.30	\$14.26	60x	128%	\$10.00	\$18.25	82.50%

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James R. Miller is a securities analyst, market-maker, advisor and buy-side strategist for private client groups, specializing in independent examinations for community banks. He has over 25 years of experience in the banking industry, giving him a clear vision of where the market is headed. He educates banks about the securities market, implementing service packages that produce tangible results. These services have the capacity to assist in the day-to-day structure of the trading activity as related to the Bank's shares in the marketplace.