AMERICAN BANKER ONLINE
THE FINANCIAL SERVICES RESOURCE

Viewpoint: Start-Ups Yielding Strong Returns — Will That Change?

From: American Banker
Friday, May 12, 2006
By David B. Moore

De novo, or start-up, banks have been gaining popularity in recent years with investors willing to trade the risks associated with illiquidity for the prospect of high returns over the long term.

During the 1990s investors capitalized 620 domestic banks requiring at least $4 million of initial equity capital. The average amount of start-up capital raised for these banks was $6.5 million.

In comparison, thus far in the new millennium investors have already capitalized almost 600 banks requiring at least $4 million of initial equity capital. Furthermore, the average amount of start-up capital raised for this group of banks is $9.8 million. During the last three years alone 55 banks have been started with equity of at least $15 million, compared with 37 started over the previous 13 years.

Until the late 1990s, most de novo investors were friends and family members of the banks' organizers and executives. In recent years, however, the sector has begun to garner interest from institutional investors as well.

Why has de novo investing become so popular in recent years? The simple answer: high risk-adjusted returns.

Such returns are a function of three characteristics of start-up banks. First, the initial pricing is, by definition, a small premium to book value (after adjusting for modest losses in the start-up phase). Second, the typical de novo has historically had little difficulty increasing book value per share at a mid- or high-single-digit annual rate over its first 10 years. Finally, reasonably profitable community banks tend to trade at meaningful premiums to book value. Consequently, the return mathematics can be quite compelling.

To use a specific example, the internal rate of return on an investment in a de novo bank that averages an 8% return on equity over a 10-year period and ultimately trades at two times book value is approximately 16% (8% ROE plus 8% annual change in the multiple of price/book value).

Moreover, many banks started over the last decade have generated annual returns of over 20%.

In addition to offering high returns, the investments also tend to be relatively low-risk. The primary reason is that the average de novo is overcapitalized for its first three to four years of operations - as the bank's balance sheet grows into its capital base - thus providing a capital cushion in times of economic stress.

In fact, of the 1,300-plus banks started since 1990, only a handful have failed.

Aside from the obvious economic risk, the primary risk associated with de novo investing is illiquidity. Most bank stocks don't achieve meaningful trading volume until after the banks have been operating for several years, assuming they trade at all. Consequently, investors should enter the investments with a five-year minimum time horizon in mind.

The biggest danger for the investments, excluding economic and illiquidity risks, is overinvestment in the sector.

Clearly, the de novo bank sector is attracting new investors and attendant incremental capital. Are lower returns around the corner?

Probably not ... just yet. Despite all the recent start-up activity, acquisitions of community banks continue to dramatically outnumber start-ups, whether measured by the number of deals or the amount of equity involved.

Since the beginning of 2000 acquisitions of banks with less than $2 billion of assets have outnumbered start-ups with more than $4 million of equity by over 550. Moreover, the amount of tangible capital acquired in these acquisitions has exceeded the amount of capital invested in start-ups by over $11.6 billion.

Consequently, it appears that the de novo gravy train still has legs. Having said that, if institutional investment money continues to march into the sector at its recent relatively torrid pace (e.g., a few more $100 million private equity funds focused on the sector), the days of low-risk double-digit returns could be in danger.

Mr. Moore is an organizer and proposed director of Embarcadero Bank (in organization), a San Diego start-up awaiting regulatory approval. He is also the president of Marathon Capital Holdings Inc.

© 2006 American Banker and SourceMedia, Inc. All rights reserved.