



Know What You Don't Know: The Unique Challenges of Community Bank Distressed Debt Portfolios

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Despite the difficulties of the Great Recession, there is some consolation:

1. It could have been worse;
2. There are selective good opportunities to invest in distressed debt portfolios.

With the worst days of the downturn seemingly behind us, investors, lenders and principals are starting to pick up the pieces. It may very well be a good time to invest, with a large number of troubled loan portfolios from community banks likely to come on the market. But these opportunities do not come without risk. They require a careful, nuanced and strategic approach – standard underwriting and valuation alone will just not tell you what you need to know.

The U.S. economy, where recovery always leads to opportunity for new investment capital, is moving into a period where astute investors are able to acquire assets at a discount. After a number of extensions, modifications and renewals of matured obligations, the more troubled community institutions are taking the necessary final steps to divest their devalued portfolios.

The opportunities are considerable. According to the Federal Deposit Insurance Corporation (FDIC), there were more bank failures in 2010 than any year since 1992. If one combines the value of all the assets of failed banks between 2007 and 2010 it totals over \$643 billion. Large as those numbers seem, there is still more to come. The FDIC's most recent quarterly report (2010 Volume 4, Number 4) identified 860 banking institutions on their problem list out of the more than 8,000 they insure with assets valued over \$379 billion. Many of those institutions are community banks.

Jack Mullen, Managing Partner at Summer Street Advisors, (a company that provides valuation and due diligence services for financial institutions and investors who purchase distressed assets and debt), likes to point out that, "It is important to understand that the opportunities available during this recovery are unlikely to be easy or safe. The right kind of due diligence is critical for any prudent investor."

Proper valuation and due diligence is essential to a successful investment strategy. We thought it would be helpful to share our thoughts on how best to mitigate some of the risks associated with making bank portfolio acquisitions in a fast changing market – and perhaps provoke some thought, discussion and insight. That's why Summer Street Advisors is sponsoring a series of articles examining various aspects of underwriting and valuation.

FDIC Bank Failures			
Year	No. of Failed Banks	Total Assets of Failed Banks	Loss to FDIC's DIF
2007	3	\$2,602,500,000	\$113,000,000
2008	25	\$373,588,780,000	\$15,708,200,000
2009	140	\$170,867,000,000	\$36,432,500,000
2010	157	\$96,514,000,000	\$22,355,300,000
Total	325	\$643,572,280,000	\$74,609,000,000

A lack of immediate pressure for banks to divest troubled portfolios allowed many to potentially recover some value and therefore discounts are unlikely to be deep enough to protect investors from hidden surprises. Compounding matters even further, some community banks may have less consistency, transparency or clarity in their record keeping than one would want and many of the best due diligence efforts will have difficulty uncovering all surprises. According to Jack, “The biggest risk facing investors is, you don’t know what you don’t know.”

Investors should take extra care when approaching the distressed portfolios of community banks. “Many look at portfolios from an institutional perspective and assume there is enough data in the documentation to understand a group of assets and their collateral, but a community bank is more complex and often less transparent,” Jack warned. “Imagine, as an example, a 300 asset portfolio. In a community bank, those 300 assets can represent as little as 100 relationships – meaning every loan in that portfolio is connected in different ways to a number of other loans and entities. They may be cross-collateralized, or cross-defaulted, but not always. Most loans are made to single purpose entities (SPE’s) and guaranteed by a variety of guarantors. Understanding the total exposure of those guarantors is sometimes difficult to pin down, but imperative, as a single problem with one asset can cascade into other assets and relationships throughout the portfolio. You have to be able to map out the inter-relationships, understand the larger exposure that every ‘small’ loan has, and build a granular understanding of the portfolio. You just can’t make broad assumptions based on macro market information.”

Stephen Soler, a senior advisor to Summer Street’s bank advisory group agrees that the challenge for valuations and underwriting of community bank portfolios is significant. “It’s difficult, in that your underwriters need to have direct experience with these kinds of assets and, at the very least, have had that experience through at least one major down cycle. They have to know what to look for, and even the best finance and valuation guys will miss the issues if they don’t have direct experience with these kinds of portfolios. A misstep on any one relationship could seriously impact the value of the entire portfolio.”

The relationships become even more complex when there is a connection to the board of directors or senior management of community banks. According to Jack, “Things can

get a little more blurry than they seem on paper. In addition to the complex relationships of multiple loans to single entities, loan approvals could have been influenced by board members or senior management. You have to understand who’s on the board and in the management team, their relationship to the borrowing entities and their interaction with the bank.”

At the asset level, problems can be too obscure, unique or small to be picked up by standard valuation practice. Steve pointed out something he had recently seen in a small bank he valued, “One of the bank relationships owned multiple gas stations in a region – which is a common investment found in community banks. The valuation of these assets is based on the amount of gas that is sold through that store on a weekly basis, even though most of the profit comes from the attached convenience store. Gasoline sales drive consumers into the convenience store and in return drives store revenue and hence the value of the property. In this case, each gas station was valued in excess of \$1 million. On the surface, these were relatively safe investments, all environmental issues had been identified and dealt with, the leverage seemed appropriate to asset value. But when the economy crashed, the local major employer laid off workers and created an unemployment increase in the area. As a result, no one was driving by the gas stations, a lot less gas was sold and convenience store revenues plummeted. Property value dropped by 60% almost overnight – and unless you understood how these businesses work and are valued, you would have missed it.”

Steve added, “You have to understand the business, the real estate, the credit and the relationships at a street level – which is much different than your typical institutional approach. Given the impact of a mistake on identifying the potential risk, there isn’t much room for on the job training.”

Underwriting these portfolios require a level of granularity that most institutional investors aren’t accustomed to. Those that can understand the actual value quickly and accurately will have a clear advantage. It’s important for underwriters to have direct experience with the dynamics of smaller loans found in community bank portfolios. If they haven’t seen it before, they won’t know what to look for. As Jack pointed out, “Many of these banks lacked a well defined credit process and well documented files, but the acquiring institution is forced to address the available

resources (i.e. a half-baked credit file with borrower and financial information that might be six months out of date). You need to be able to know what you don't know. And you need to do it fast.”

There are tremendous opportunities coming to the market from community bank portfolios in the next two years, but it is essential to mitigate the risk of not knowing what you don't know. There is more complexity and less transparency than one might expect. It's important, then, to select a due diligence team that can work strategically in this area, has in-depth experience with these kinds of banks, who knows where to look, understands the relationships, risks and challenges of community banking and can work quickly.

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