

BANK and REAL ESTATE INVESTMENT OPPORTUNITIES FOR PRIVATE CAPITAL

Perspectives, Experiences and Thoughts for 2010

Douglas M. Thompson, CFA

Historical Background

After two decades of overly abundant capital and easy credit, the US economy experienced an overly excessive run up in hard asset values during the mid-2000's. Within the banking industry geometrically rising real estate asset values lured many regional and community banks to shift away from their historical lending focus toward heavier concentrations of C&D and CRE lending. By the end of 2009 the FDIC reported that banks held \$1.08 Trillion of CRE loans. For many small to mid-sized banks this meant having real estate loans comprise upwards of 80% of the banks total loan portfolio, many of which were underwritten at the top of the market.

By December 2007 the US economy had officially fallen into a recession. The favored reason for its cause was a boom and bust in asset prices, especially houses. Real house prices almost doubled between 1997 and 2006. BY 2006 prices were more than 50% above the highest level they had reached in the 20th century. Consumers responded to such wealth increase with more spending and reduced savings. This spending was facilitated by low interest rates and easy credit, with household borrowings rising faster than incomes.

Financial institutions invested heavily in assets whole worth was tied to the value of mortgages. The complexity of some of these instruments meant that US financial institutions held more exposure to risk than most people recognized – that is, until borrowers to default. These large ensuing losses caused a loss in confidence in the ability of some of the world's largest financial institutions to honor their obligations. What followed was a rush to liquidity and retrenchment. Risk spreads shot up to extraordinary levels and the value of all asset types declined precipitously. Between December 2007 and December 2008 20% of household and non-profit net worth dropped was wiped out, nearly \$13 Trillion. This had a severe impact on consumer spending, which accounts for nearly 70% of the economy.

The fall of national housing prices starting in early 2007, and the associated declines in the value of mortgage backed bonds led to a slow-down in the growth of consumer spending, increases in mortgage defaults and home foreclosures, significant strains on financial institutions and reduced available credit. By early 2008 the economy was contracting. In December of 2007, the US economy officially fell into recession along with the rest of the world - for the first time for which records were kept the world experienced negative growth in GDP. Employment fell by an average of 137,000 jobs per month over the first eight months of 2008. GDP was essentially flat from 3Q07 to 2Q08. In September 2009 things got dramatically worse with the collapse of Lehman Brothers and the near collapse of AIG. This led to a seizing up in the financial markets and plummeting consumer and business confidence. Parts of the financial system froze, credit spreads spiked, and the stock market plunged. From October 2008 to January 2009 the economy lost on average 544,000 jobs per month. Real GDP fell at an increasingly rapid pace at an annual rate of 2.7% in 3Q08, 5.4% in 4Q08 and 6.4% in 1Q09.

Economic recession and severe job losses translated into a significant decline in the demand for commercial real estate space, and, correspondingly, CRE values fell. Moody's/REAL Commercial Property Index reported that CRE values fell 43% from their peak in October 2007 to September 2009.

As values declined property owners faced ever increasing challenges to refinance their current debt since existing debt levels equaled or exceeded the value of their property. In 3Q09 almost 50% of the banks surveyed by the Senior Loan Officer Opinion Survey reported that they continue to tighten underwriting standards on CRE loans. Tight credit and the increase in sales of distressed properties have fed into further price declines, generating a negative feedback loop between property values and conditions in the sector.

As CRE values fell, capital levels at every bank with significant concentrations in real estate, followed suit. At first, banks did their best to hide their deteriorating asset issues and declining capital ratios, and the regulatory bodies helped. A move away from mark to market to mark to model accounting, TARP, SCAP testing based on projected cumulative losses, etc. Eventually, the hits became so significant the political pressure to “clean up the mess” caused the regulatory bodies to take action. However, their actions against the banks were far different than those during the RTC days. With the FDIC’s balance sheet showing no strength the regulators directed failing banks into the hands of relatively healthy banks possessing savvy management teams with experience handling troubled real estate assets. The acquirers took over the failing bank’s deposits and most of their assets under very lucrative loss share agreements with the FDIC. Such agreements called for the acquiring bank to pay small premiums for deposits and substantial discounts on book value of the assets. In the vast majority of cases the acquiring bank’s bid was “negative” meaning the acquiring bank actually got paid to take the bank off the FDIC’s hands.

For the most part, all investors were precluded from this failed bank acquisition strategy other than banks. Two private equity acquisitions did manage to “slide through the cracks”, but by and large this was a playground for banks only. In 2009 the FDIC issued guidelines on its policy to allow private equity to invest in banks. Onerous terms discouraged these investors and left them at a competitive disadvantage to banks wanting to buy the same failed banks. By restricting the free flow of capital to the industry, some have argued, the FDIC has pulled many of the relatively healthy banks into the ranks of those attempting to survive. Instead of going after failed banks themselves, surviving banks are now focused on reducing concentrations of CRE, C&D and NPA’s, while it looks for any creative possibility to raise capital.

During the course of 2009 140 federally insured institutions failed, with an estimated losses of \$52 Billion, and in the process wiping out the FDIC’s Deposit Insurance Fund (DIF). The political pressure for the FDIC to not draw down on its line of credit with the Treasury has forced it to relook and reconsider its harsh stance on private equity purchasing failed banks. Just recently the FDIC has reportedly met with various sources of alternative capital to explore potential solutions. The near future should prove telling as the pressure builds for the FDIC to find acceptable capital to handle known future bank problems.

The Opportunities

From the wreckage outlined above came investment opportunities for liquid and well positioned real estate investors, and especially for those blessed with an understanding of the banking industry and its regulatory bodies. More specifically, astute real estate investors have an unprecedented opportunity to own significant positions in banks at values well below historical norms, and in so doing position itself to access superior real estate investing opportunities. In order to take full advantage of these opportunities the real estate firm must position itself to a bank partner as able to perform a wide variety of “value-add” functions.

Opportunity Identification
Source and negotiate additional bank investment and partnership opportunities.
Portfolio Underwriting and Structuring
<ul style="list-style-type: none">➤ Loan Pool Underwriting➤ Asset Valuation based on available financing options➤ Loan Level Due Diligence➤ Investment Structuring & Contract Negotiation➤ Transaction Closing
Asset Purchase Financing
<ul style="list-style-type: none">➤ Public-Private Investment Program (PPIP)➤ Loss-Share Agreements➤ Traditional Capitalized Purchases
Asset Management
<ul style="list-style-type: none">➤ Develop Asset Business Plans➤ Property Financial Analysis➤ Loan Workouts<ul style="list-style-type: none">▪ Loan Restructuring▪ Deed In Lieu▪ Foreclosure Processing
Servicing through Affiliations
<ul style="list-style-type: none">➤ Affiliations with best in-class loan servicers➤ Payment Processing & Investor Reporting➤ Loan Administration & Records Management
Asset Disposition
<ul style="list-style-type: none">➤ Loan Packaging & Marketing➤ Process Management➤ Closing Coordination

Investing into Core Banking Operations. Bank stocks are significantly under pressure today for two main reasons: a) investors don't believe institutions have taken sufficient write-downs on their asset portfolios, and b) the banking industry as a whole is experiencing significant loan burn-off with little prospect of originating new loans. The result is bank valuations below 1 times book value, compared to more normal times of 2-2.5 times book value. As the economy recovers and, in particular, jobs are created vacant real estate space should absorb and real estate capital markets should stabilize. This combination should eventually lead to an appreciation of bank asset portfolios, and the opportunity to grow the loan portfolio through newly originated loans. We are beginning to see this play out with the hedge funds whom are actively plowing money into banks because they believe the US is in the early stages of economic recovery. Especially appealing to the hedge funds are the banks healthy and sophisticated enough to acquire failed banks with FDIC assistance. Bank stocks have popped overnight with an S-1 filing and a notion of taking down failed banks.

Banks with capable and willing management, sufficient capital, above average credit quality and regional opportunities will fare the best in rolling up FDIC failures. The private real estate investor's opportunity here is that traditional bank management wants to acquire failed banks for their deposits, branch locations and their performing loan portfolios, and not for their failed CRE. However, regulators are increasingly demanding whole bank solutions for their foreclosed banks, meaning that a takeover must include a solution for the defaulted CRE and OREO portfolio. The traditional bank management teams are happy to off-load these responsibilities as well as rewards for properly managing these assets to a real estate partner.

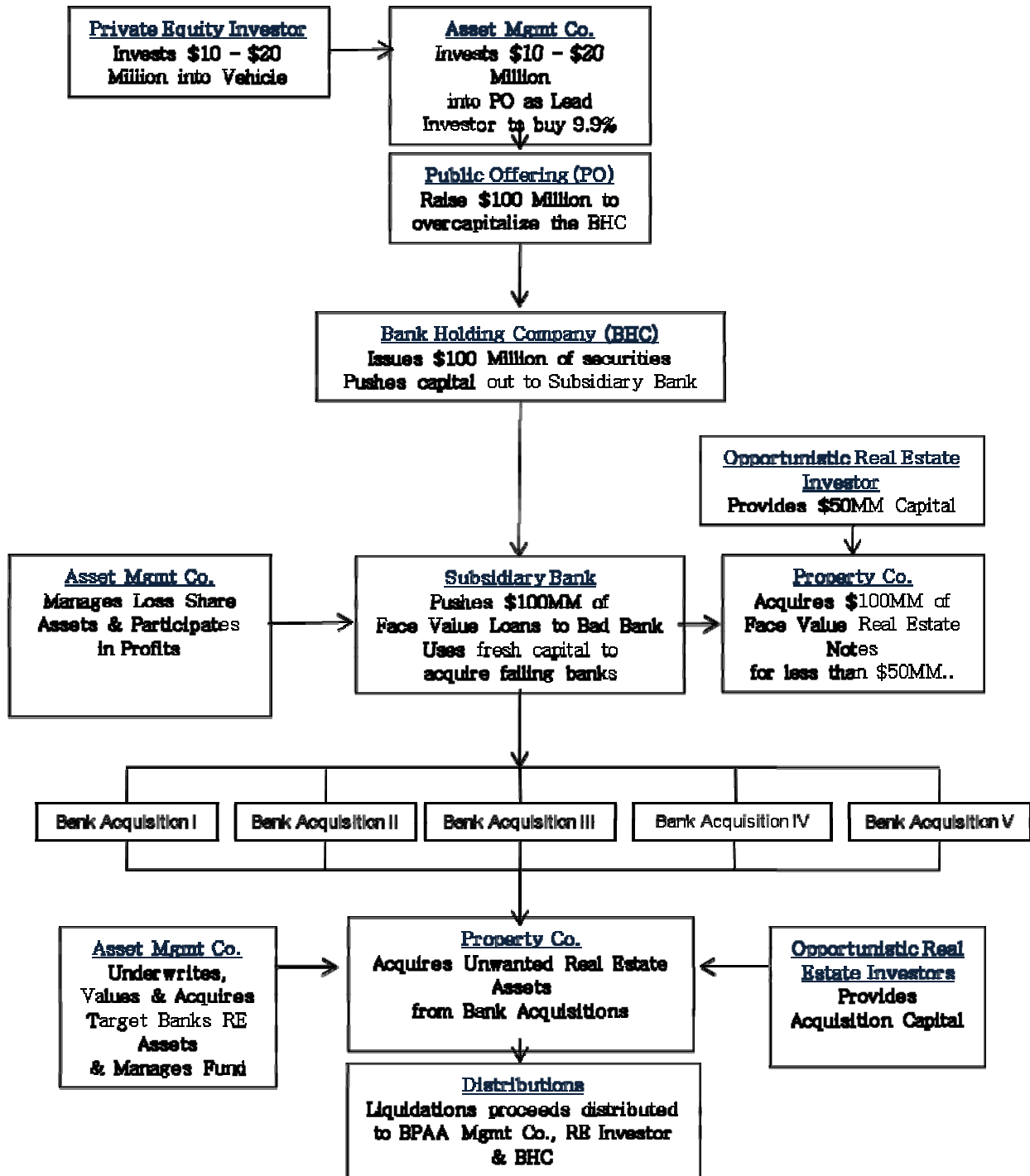
As bank asset portfolios begin to firm, and new lending opportunities begin to emerge, bank stocks should begin to appreciate as a multiple of book value. While bank owners await the improving economy and jobs picture there remains the failed bank acquisition strategy. While providing the healthy acquiring bank an opportunity to grow its balance sheet with earning assets in the near term, it also gives the acquirer the opportunity to earn the multiplier effect on its stock value to book value based on having additional assets on its books.

Real Estate Asset Acquisition. Although acquisitions of real estate related assets by private equity investors are taking place outside of the banking industry, they are done so in a burdensome environment and are for the lesser grade assets. Most public acquisitions done today are in an auction format where the buyers are numerous and the information is limited. Furthermore, the FDIC mandate has clearly been to merge failing banks into healthier brethren and then to support those failed institution's assets with the FDIC balance sheet. As a result the only assets "leaking" out of the banking system are the dregs of the balance sheet the acquiring bank refused to accept. From this set of circumstances private real estate investors have identified an opportunity to team with banks possessing strong management teams (and with histories of M&A activity) to jointly pursue failing banks heavily invested in real estate related assets. In this fashion the parties are helping each other, since some sophisticated banking teams don't necessarily possess the various real estate skills to properly deal with half constructed projects sitting in the middle of a deeply depressed market. Most private equity participants see two real estate opportunities with the bank as their partner. First, the private equity real estate management team can assume the duties associated with managing assets acquired

with federal assistance, namely Loss Sharing arrangements with the FDIC. This opportunity has been abundant with the FDIC entering into 94 of such agreements in 2009, covering more than \$122 Billion of assets. Second, and more importantly, is the opportunity to be thrust in front of other banking institutions as well as the FDIC as a prospective purchaser of unwanted real estate assets. As a member of the banking world these private equity investors expect to be welcomed instead of shunned. For the private equity investor it's all about seeing good deal flow.

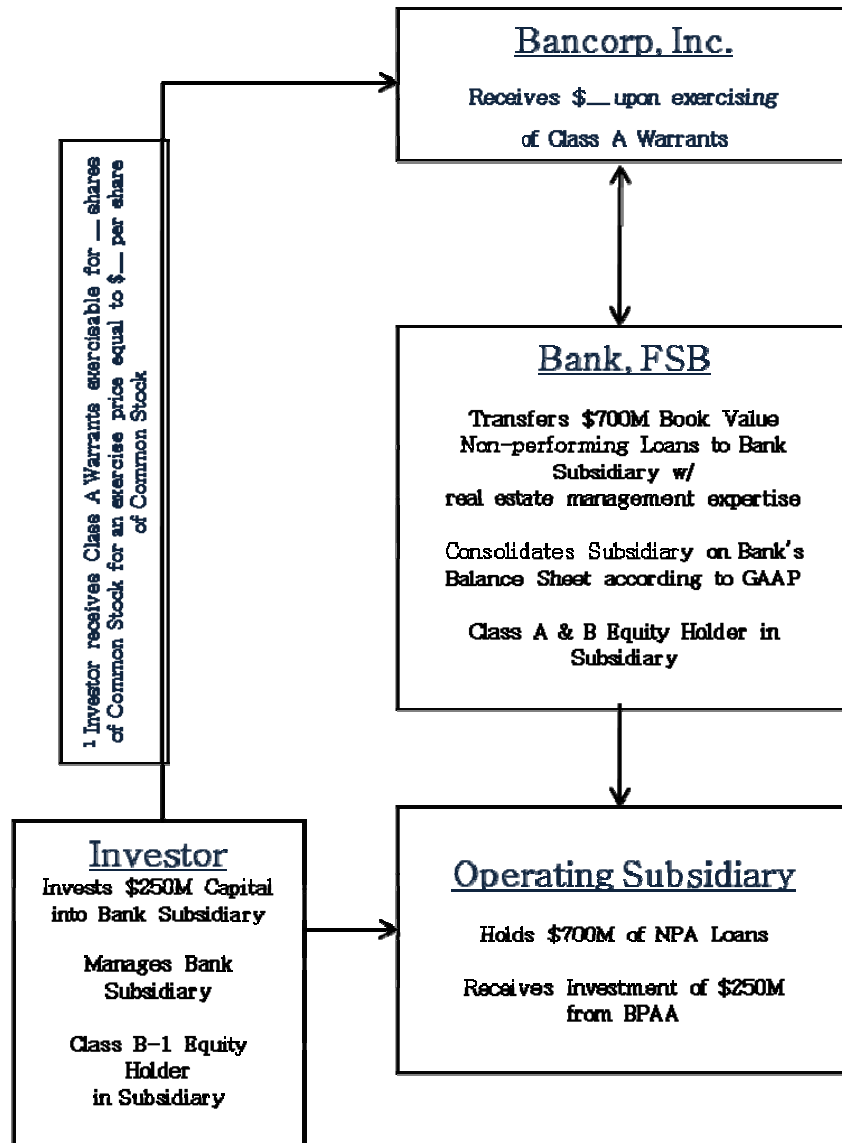
The Strategies

Investing into a Healthy Bank or Bank Holding Company (BHC). The diagram below outlines an investment into a healthy bank whose business plan is to acquire FDIC foreclosed banks as well as purchase assets from other banks performing balance sheet cleansing.



A relatively healthy bank will prepare itself to be an acquirer by simultaneously reducing its own NPA levels and raising fresh capital from outside investors. New capital investors typically want all legacy loan issues resolved, eliminating the concern of having to do additional capital raises in the future. If the necessary fresh capital translates into something more than 24.9% of the outstanding common stock there will be a need to raise such necessary capital from more than one unrelated parties, which may even include a public offering.

Good Bank/Bad Bank. In certain circumstances there may be an opportunity to inject a large amount of capital into a bank, avoid ownership concentrations, and structure your return of capital through the asset portfolio:



The intent of this structure is to focus a capital investment more into the real estate portfolio of the bank than it is into a bank's future operating plans. Although it's not possible to separate the real estate portfolio from the bank itself, the investor can have his capital returned through the efficient operations

of the operating subsidiary as it liquidates its portfolio of NPA's over time. This is an alternative form of capital repatriation compared to selling shares of stock in the bank when the investment is made directly into the bank or the holding company. In exchange for saving the bank from foreclosure, the investor is typically able to negotiate warrants to purchase shares of the bank in the future at a prescribed price. This allows the investors to reap the upside rewards of the improved bank operations and do so without violating any ownership concentration rules upfront. When the stock of the operating bank has sufficiently appreciated the idea is to execute a public offering simultaneous with the exercising of the warrants. The same ownership concentration limits apply, so the investor would exercise 24.9% for its own account and the balance of the warrants would be sold to a broadly diversified group of investors.

The Execution

The execution is not dissimilar for the acquisition of a bank, its assets, or the minority investment into a bank that desires to develop a business plan that includes the acquisition of failed banks. In each case the execution requires approaching a bank in order to propose your ability to help it accomplish its goals and objectives. Because of the regulatory oversight, private equity investing in this arena is not easy and cannot be forced.

Aligning with Savvy Team Members. To have the best chance of accomplishing something with a bank and their various regulatory bodies the team should be comprised of individuals who: a) possess relationships with regional and national regulatory offices; b) have current working knowledge of a specific region; c) a track record of turning around banks under PCA's; and d) previous approvals to own a bank charter.

Aligning with Humble Capital. The financial rewards of investing in the bank industry are potentially great at the current time, but they come at the expense of being heavily regulated by the FDIC, OCC, OTS, and the various state banking commissions. Transactions are not consummated under the guiding philosophy of more traditional open market commerce, where "the money rules". Instead the regulators rule, and what makes perfect sense in general commerce may not have applicability in dealing with the regulators. As such, it is important that egos not get in the way of a great opportunity. Keep your team's eye on the bigger picture.

Knowing What to Look For. It appears the greatest opportunities for private equity real estate investors in the banking space is with banks that possess the following financial statement characteristics: a) Total CRE loans in excess of \$500 Million and comprising at least 50% of the bank's total loan portfolio; b) NPA's in excess of 3% of total loans; c) Tier 1 capital between 6-9%; d) Loan loss reserves in excess of 25% of NPA's; and e) Located in geographic regions that show more promise for earlier and stronger rebounds in the property and credit markets. Banks possessing these parameters are more willing and able to deal with their problem loan portfolios, and have more cushion in working with the regulators.

Using the Investment Bankers. One would be hard pressed to find a bank today that did not need to consider putting additional capital on their balance sheet. As a result, a significant number of banks today have investment bankers under mandate to advise them on capital raising efforts. Building relationships with investment bankers specializing in the small to mid-sized bank industry is an effort well worth your time.

Properly Presenting Team. Any bank in excess of \$1 Billion in assets is being inundated with calls from vulture investors wanting to take advantage of their weakened position. Many of those calls are fishing expeditions by unknowing investors, naïve to the complexities of getting any deal done with an under-capitalized bank. As a result, it is of utmost importance to have your team introduced to the bank by a party that already carries credibility. If you have a relationship with the bank's legal counsel, or with its investment banker, those two are great places to start. A relationship with a board member or in executive management is another. A referral from one bank to another is also an effective introduction.

DOUGLAS M. THOMPSON - Douglas Thompson, CFA, is a graduate of Stanford University and has been a real estate investor and market participant for more than twenty-three years. His experience includes the disciplines of capital markets, commercial, residential and land development, property and loan analysis, asset management, mortgage banking/brokerage as well as consulting.

Mr. Thompson's corporate real estate experience includes employment with such real estate firms such as Coldwell Banker Commercial (now as known as CB Richard Ellis), SunCor Development Company (a subsidiary of Pinnacle West, and NYSE firm), the Howard Hughes Corporation (then a subsidiary of The Rouse Company), and Buchanan Street Partners, a west coast based real estate investment banking firm.

As a real estate consultant to a number of private and institutional investors, Mr. Thompson advised on the underwriting, structuring and acquisition of both land for development and income producing properties and portfolios. Consulting clients included Morgan Stanley Realty, EJM Development, National Government Properties, First Commercial Corporation and many other small to mid-sized investment groups.

While consulting for National Government Properties, Mr. Thompson developed a financial model to fairly value single tenant office buildings under long-term leases to various governmental agencies across the US, which was later adopted by Bear Stearns to take the company public. The overall mandate was to recommend to the Board of NGP a strategy for growing the company to critical mass.

While consulting for First Commercial Corporation, Mr. Thompson led a team of professionals sourcing, underwriting and acquiring troubled and non-performing commercial loan portfolios from the Resolution Trust Corporation and stressed financial institutions.

As a real estate investor, Mr. Thompson led teams of professionals in the capitalization, acquisition and development of multiple residential and commercial parcels throughout the United States. His most recent development projects include the development of a 14-story, \$85 million condominium tower on the beach in Fort Lauderdale, Florida, and the development of a 240-acre master-planned community in San Antonio, Texas.

He is the author of the blog The Current Cycle <http://www.thecurrentcycle.com> where he shares some of his experiences in his daily pursuits of new investment opportunities. His full resume can be seen on LinkedIn at: <http://www.linkedin.com/pub/douglas-thompson-cfa/6/585/540>.