SNL Financial

Q&A

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PE firm BayBoston plans to 'challenge' banks

By Joe Mantone and Nathan Stovall

Carlos Garcia
CEO, founder and managing partner of BayBoston
Source: BayBoston Managers LLC

Richard Durkes
Managing partner of BayBoston
Source: BayBoston Managers LLC

Carlos Garcia and Richard Durkes aren't just looking to inject capital into community banks. They also want to offer some sage advice.

Garcia and Durkes are managing partners of BayBoston Managers LLC, a private equity firm that is planning to invest in community banks and other financial services companies. Garcia and Durkes believe their varied industry experiences put them in a position to properly advise community bank leaders on how best to grow and thrive through the difficult operating environment.

Garcia, who is also CEO and founder of BayBoston, started his career in financial services as an investment banker and spent 14 years working with Banco Santander SA in various positions including a senior executive for its U.S. operations after the acquisition of Sovereign Bank NA. Garcia said he gained greater insight into the regulatory process when he held a government-appointed position serving as CEO of Government Development Bank for Puerto Rico and presided over a restructuring and stabilization board created in part to safeguard Puerto Rico's credit rating.

Durkes has spent much of his career in investment banking, working about 10 years at Sandler O'Neill & Partners LP, leading the North American investment banking group at ABN AMRO Inc., and helping establish the financial services practice at The Chicago Corp. Before moving to investment banking, Durkes served as the CEO of First City Bancshares, a bank that was based in Dixon, Ill.

Throughout their careers, Garcia and Durkes have seen consolidation in the community bank sector, and they expect it will continue. Garcia said the number of banks in the U.S. could eventually drop to about 2,000 from the current level of about 6,600, and he believes investors such as BayBoston can help speed up the process. Garcia and Durkes also expect to occasionally work with smaller, publicly traded banks that have minimal liquidity in their stocks and plan to encourage those institutions to consider going private in the right circumstances.

Garcia and Durkes recently spoke with SNL about BayBoston's investment strategy, the approach they'll take in working with banks and where they see value.

What follows is an edited transcript of the first part of the conversation. Part two will be published Dec. 23.

SNL Financial: Is your plan to invest in consolidators?

Carlos Garcia: Our plan is to invest on both sides. Basically, we have identified the banks we believe can be consolidators, but we also have identified the banks that are more tired, and they're trying to improve their franchise value and be able to see what are their best options. So we want to be on both sides of the equation. Our focus is going to be regionally, taking meaningfully noncontrolling positions in several banks in a region, which will make us one of the persons you want to be talking to.

That puts a cap on how much you can put into an institution.

Garcia: Yes, 24.9% or below. We debated and did a lot of work. We believe that is the best structure. Our intent is not to take control of the bank. Our intent is to be a partner to the bank CEOs. Our first criteria is to just be sure there is an alignment. Yes, we are going to challenge them to be sure they have all the right ingredients to be independent. If they don't, we're going to challenge them to think what's the best way they can continue to carry on their bank's mission. It may not be in the current state. It may be in some other state. Maybe roll up with someone or a merger of equals with someone else and have the breadth, size and scale that will make you more effective in delivering your mission.

You want to get them ready for offense.

Garcia: Absolutely. The offense is not just shouting out loud how all these regulations are not allowing me to compete. It's really becoming how we bundle together and play to our strengths to continue having a competitive community banking sector, which I think is critical in the community banking sector.

Richard Durkes: They're going to have to make the case for independence. We're fully supportive of independence, but they have to make the case and then deliver. If they don't want to do that, they're not really a likely candidate for us. We want people that are willing to accept that challenge, and they're probably the people who are making acquisitions or are growth oriented.

Garcia: And we're going to be very transparent about that. That meeting of the minds is critical. If there's not a meeting of the minds, you will not be a good candidate for us. Fortunately, there are a lot of candidates that could benefit from working with us.

You're not looking for stodgy bank managers.

Durkes: There may be circumstances where the boards of those companies are looking for help to try and transform. You can probably design 500 different situations that would not be the same that we would be interested in. They could have a manager that is thinking about retiring. Do you go out and hire someone new? Do you think about selling the company? All of those threshold decisions that these boards will be facing over the next two or three years, and they say we want to have you involved in that discussion because we want to create the most value we can for ourselves, for our shareholders.

Garcia: No doubt that our investment will come as an accelerator to the bank in implementing those programs. Part of the things that we're going to be evaluating is not only the quality of the management team but their commitment.

Do you have a size in banks you're looking to target?

Garcia: We're looking to make investments between $5 million and $40 million, up to a 24.9% [stake]. That will give us a nice range. We're typically looking at banks with less than $3 billion in assets because that's where we'll get the value from an investment perspective. If you look at the valuation against tangible book value, there seems to be a permanent impairment just by size. Larger banks are trading at 1.5x, 1.7x, 1.8x. The smaller banks, some are trading below book value.

Because there's a certain amount of fixed cost.

Garcia: The larger banks can dilute most of this cost, and they have a lot [of] resources. The smaller you are some things will move your efficiency ratio several points. You need a new compliance director, five or six analysts to do Know Your Client. Then, you have to do an enterprisewide risk management model, another two or three people. These are things that are trickling down from larger banks, but when you put that into a smaller organization, it puts a lot of pressure on senior management and takes a lot of time away and diverts resources that could be invested into better technology, more products, more connection to your community. If you ask most CEOs of banks how much time they are devoting to regulatory affairs, I bet 100% would say more than 50%, and the majority will say it's more than 75% or 80% of their time. What other time is left to do the strategy, connections with the community and actually work with your people to deploy your plans?

The comp costs alone on the people you mentioned — that's a couple of million dollars, which could be a year's worth of earnings for a very tiny institution.

Durkes: There's cybersecurity too. Banks are targets, and can they afford to build the infrastructure to not be hacked? Probably not.

The mission of regulators is not to create greater shareholder returns. It's safety and soundness. So they're going to say this is what you have to do, and that's all there is to it.

Garcia: And there are unintended consequences from Dodd-Frank and too big to fail. You want to protect the banking system, but the community banks have been the backbone of the U.S. economy for many years. As we all know, they know their communities best, especially the small business side. We want to be a community banking advocate. We want to be sure that we give them the tools and the knowledge and the capital in order to be able to thrive. There will be fewer community banks, but there will be community banks that will be strong in their different regions. You may have to think broader than your current community footprint in order to be able to get that scale, but you can still do it on a regional basis.

Durkes: A community bank can be $5 billion to $10 billion, not $500 million.

Are you going to focus on metro areas?

Garcia: Our view is national. We have done a bottom-up approach in which we tried to identify institutions that match some of the principles we have established. We have narrowed it to 1,500 institutions throughout the U.S. The metro areas are attractive, and certainly, we're going to be looking at the major metro areas. But you can't ignore some of the areas outside of the metro areas, where there are a lot of very valuable franchises. The competition is not that large where most of the larger banks have not been able to penetrate. I think those are some of the most interesting opportunities. If you consolidate around some of those perimeters, you can start to circle some of those metropolitan areas.

And folks like Bank of America are getting out of those areas. So the community banks don't even have the competition they once had from the biggest banks.

Garcia: The approach of most of the larger banks is you only want to be in the top MSA markets, but the top MSA markets are not the whole of the U.S. Some other significant markets have good demographics. A lot of the work we've done is trying to identify not only the top MSAs, but what are the demographics of some of those other MSAs that are on the perimeter. We do see a lot of value there.

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