

The debt force awakens for small banks

By John Lachica and Nathan Stovall December 10, 2015

More small banks are opportunistically tapping the debt markets to refinance higher-cost capital and help support growth.

Banks under \$1 billion in assets have issued more debt and relied less on common equity when raising capital in 2015, with many institutions taking advantage of the expansion of the small bank holding company policy statement to raise the asset threshold to \$1 billion from \$500 million. Institutions falling under the \$1 billion asset threshold now are able to hold greater leverage at their holding companies and downstream funds to their bank subsidiaries and effectively lower their cost of capital.

Thomas Killian, principal at Sandler O'Neill & Partners LP, said that if a bank does not expect to grow above the \$1 billion asset mark within its planning horizon, it is prudent to consider issuing debt at current rates. While the change in the small bank holding company policy statement occurred in spring of this year, Killian said it probably took a month or two or more for banks to fully get their arms around the issue and speak with their boards. Banks also needed to see that there was investor appetite for their debt, he said.

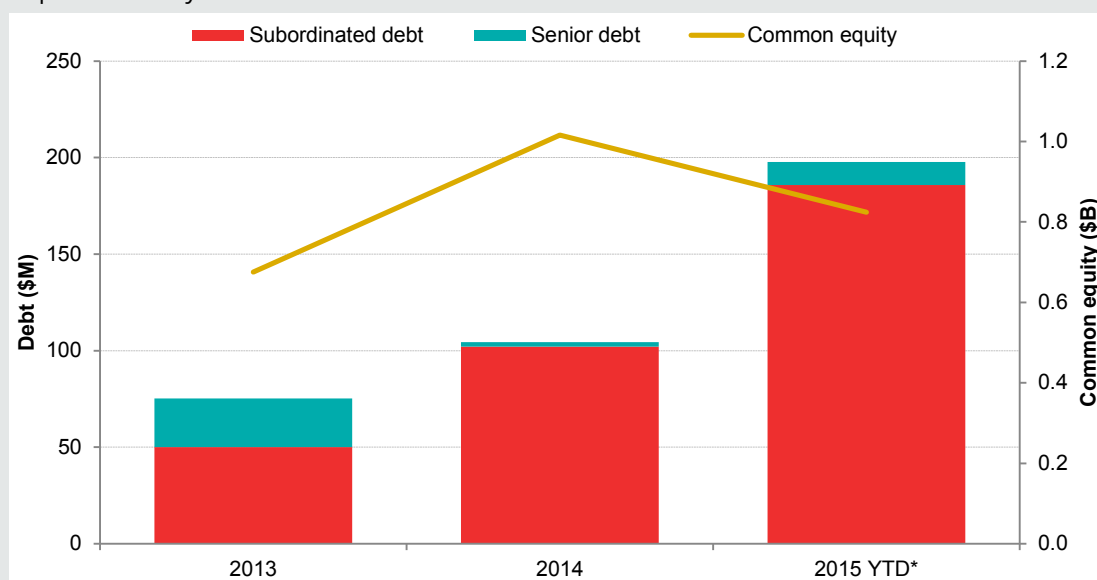
"As more debt deals have gotten done and the market has absorbed them, there's more positive reinforcement that banks should consider it," Killian said.

Kroll Bond Rating Agency's launch of bank ratings in 2012 helped community banks more readily issue debt, but many of the issuances in recent years have come from banks with assets above \$1 billion. The adjustment to the small bank holding company policy statement and the re-emergence of pooled bank credit offerings have allowed a far greater number of banks to issue debt.

Regulators have been clear that banks can harness leverage to finance growth as long as they communicate with their regulators early and often through the process, and offer a clear plan on how they intend to manage their debt service. That regulatory support helped pooled bank credit offerings surface once again. Recent and ongoing transactions facilitated by the likes of StoneCastle Partners LLC and EJP Capital LLC could help scores of community banks raise three-quarters of a billion dollars in capital. Some of the banks participating in the pooled offerings are as small as \$75 million in assets and likely would struggle to issue debt on their own. Single-name debt issuances by small banks have picked up as well.

Small banks increasingly tapping debt markets

Capital raises by banks under \$1B in assets



Data compiled Dec. 2, 2015.

* 2015 data is year-to-date as of Dec. 1.

Includes capital offerings made by banks with less than \$1 billion in assets at the end of the most recent period prior to the issuance.

Source: SNL Financial



Small banks facing rate increases on SBLF funding in the next 3 months

Company name	SBLF outstanding (\$M)	SBLF issue date
Nicolet Bankshares Inc.^	12.2	09/01/11
Banc of California Inc.	42.0	08/30/11
Salisbury Bancorp Inc.	16.0	08/25/11
Veritex Holdings Inc.^	8.0	08/25/11
Enterprise Financial Services Group Inc.	5.0	08/25/11
Liberty Bancorp Inc.	16.2	08/23/11
Carolina Alliance Bank*	5.0	08/23/11
Codorus Valley Bancorp Inc.	12.0	08/18/11
Blue Ridge Bankshares Inc.	4.5	08/18/11
Redwood Financial Inc.	6.4	08/18/11
Tri-County Financial Group Inc.	20.0	08/16/11
Jonestown Bank and Trust Co.*	4.0	08/16/11
AmeriServ Financial Inc.	21.0	08/11/11
First Savings Financial Group Inc.	17.1	08/11/11
SBT Bancorp Inc.	9.0	08/11/11
Heritage Bankshares Inc.	7.8	08/11/11
Two River Bancorp	6.0	08/11/11
Island Bancorp Inc.	2.0	08/11/11
Equity Bancshares Inc.	16.4	08/11/11
Kinderhook Bank Corp.	7.0	08/09/11
SmartFinancial Inc.	12.0	08/04/11
DNB Financial Corp.	3.3	08/04/11
Hopewell Valley Community Bank*	11.0	07/28/11
Birmingham Bloomfield Bancshares Inc.	4.6	07/28/11
Redwood Capital Bancorp	7.3	07/21/11
Catskill Hudson Bancorp Inc.^	9.7	07/21/11
Centric Financial Corp.	7.5	07/14/11
Founders Bancorp	4.2	07/14/11

Data compiled Dec. 2, 2015.

SBLF = Small Business Lending Fund

For banks still holding SBLF funding 4.5 years after issuance, the rate will increase to 9%.

* Does not have a holding company. Only banks with holding companies and with assets below \$1 billion can take advantage of the change in the small bank holding company policy statement.

^ Total assets used are from the most recent quarter-end following offering completion date for the commercial bank subsidiary.

Sources: SNL Financial, U.S. Treasury



SNL found that at least \$197.8 million of debt has been issued by banks with less than \$1 billion in assets in 2015 through Dec. 1, compared to \$104.4 million in all of 2014 and \$75.2 million in 2013. Those institutions are on track to issue less common equity

this year, coming to market with \$823.9 million in common equity in 2015 year-to-date, compared to \$1.02 billion in 2014.

Matthew Resch, co-founder and managing principal at Ambassador Financial Group Inc., said issuing debt represents a far cheaper way for banks to raise capital. For instance, he noted that many small banks are issuing debt around 6.5% to 7%, or at an after-tax cost of 4.3% to 4.6%. That is much less expensive than issuing common equity.

Resch said "the big catalyst" for recent small bank debt issuance has come from a number of institutions looking to refinance outstanding funds raised through the Small Business Lending Fund. The cost of SBLF capital could be as low as 1% for banks that grew their small business portfolios considerably, but the coupon on any outstanding SBLF funds will reset to 9% early in 2016, which equates to roughly 13% on a pretax basis.

Resch said a number of banks are also issuing debt purely to support growth. He said there could be a scenario in which a publicly traded small bank is trading at or even below book value and raising common equity would not be economically feasible. That same institution could potentially raise capital by issuing much more cost-effective debt.

"It's much, much less dilutive than common and lowers their overall weighted-average cost of capital," Resch said.

Banks issuing debt have found an array of willing buyers. Advisers say that buyers of bank debt can vary from local investors and mutual funds to insurance companies and even commercial banks.

Killian said the buyers in each transaction ultimately depend on the size and ratings of the bank issuing debt. He said the buyers can range from high-net-worth and local investors involved in small, unrated transactions to institutional investors and insurance companies buying the paper in publicly registered and rated deals.

Resch said there is now broad interest in the asset class in the investment community. While issuing debt represents a cheap source of capital for banks, the yields on the instruments are relatively attractive in the current low interest rate environment.

"When they compare the ability to invest into a plain vanilla community bank who is a solid performer where they can capture 400, 500 basis points over

the 10-year Treasury, it's a tremendously attractive asset class," Resch said.

Resch believes that will hold true as comfort with the asset class grows among banks and the investment community. He expects banks will continue to issue debt; they

see the transactions as shareholder-friendly since they lower the cost of capital.

"Barring anything unforeseen, we think the asset class is here to stay and the instrument as a source of capital for the banking sector is here to stay for some time," Resch said

Debt issuances by banks under \$1B in assets

Year-to-date 2015

Issuer name	City, state	Total assets (\$M)	Tier 1 ratio (%)	ROACE (%)	Gross amount offered (\$M)	Completion date	Coupon (%)	Placement agent
Blue Ridge Bankshares Inc.	Luray, VA	257.9	15.29	12.75	10.0	11/23/15	6.75	Sandler O'Neill & Partners
Kinderhook Bank Corp.	Kinderhook, NY	403.1	NA	7.89	10.0	11/19/15	NA	Ambassador Financial Group
Oconomowoc Bancshares Inc.	Oconomowoc, WI	881.7	10.91	9.42	12.0	11/18/15	NA	Ambassador Financial Group
Avidbank Holdings Inc.	Palo Alto, CA	576.7	NA	9.50	12.0	11/12/15	6.88	Sandler O'Neill & Partners
First National Corp.	Strasburg, VA	688.9	NA	3.51	5.0	10/30/15	6.75	
BNCCORP Inc.	Bismarck, ND	904.9	20.59	10.94	10.0	10/19/15	6.35	
Country Bank Holding Co. Inc.	New York, NY	555.0	NA	NA	1.5	10/15/15	NA	
Country Bank Holding Co. Inc.	New York, NY	555.0	NA	NA	6.0	10/15/15	NA	
First Resource Bank	Exton, PA	193.2	11.80	9.53	2.0	10/15/15	6.50	
FS Bancorp Inc.	Mountlake Terrace, WA	568.6	14.30	16.30	10.0	10/15/15	6.50	
Highlands Bancorp Inc.	Vernon, NJ	298.8	NA	10.03	7.5	10/15/15	NA	FIG Partners
FCB Bancorp Inc.	Louisville, KY	499.4	9.43	NA	10.4	10/14/15	6.00	Sandler O'Neill & Partners
Patriot National Bancorp Inc.	Stamford, CT	628.9	11.80	4.60	2.0	09/30/15	1.75	
Stewardship Financial Corp.	Midland Park, NJ	701.2	13.21	9.23	16.6	08/28/15	6.75	Sandler O'Neill & Partners
Coast Bancorp	San Luis Obispo, CA	130.4	3.43	6.12	2.5	08/04/15	6.00	
First Resource Bank	Exton, PA	193.2	11.80	9.53	2.0	07/31/15	6.50	
Guaranty Bancorp Inc.	Woodsville, NH	403.8	14.03	NA	5.0	07/31/15	6.25	Griffin Financial Group
Eagle Bancorp Montana Inc.	Helena, MT	559.4	13.98	2.82	10.0	06/19/15	6.75	FIG Partners
Xenith Bankshares Inc.	Richmond, VA	992.7	11.23	3.65	8.5	06/19/15	6.75	SunTrust Robinson Humphrey
Bay Banks of Virginia Inc.	Kilmarnock, VA	393.6	NA	3.86	7.0	05/28/15	6.50	FIG Partners
Country Bank Holding Co. Inc.	New York, NY	526.0	NA	NA	6.0	05/15/15	NA	
First Bank	Hamilton, NJ	677.5	10.96	7.61	22.0	04/30/15	6.75	Sandler O'Neill & Partners
York Traditions Bank	York, PA	300.2	13.11	5.16	5.0	03/27/15	6.25	Ambassador Financial Group
DNB Financial Corp.	Downingtown, PA	723.3	14.90	11.32	9.8	03/05/15	4.25	
Cornerstone Community Bancorp	Red Bluff, CA	149.1	10.09	7.51	5.0	03/02/15	NA	

Data compiled Dec. 2, 2015.

Financial data given for the most recent quarter-end following offering completion date.

Gross amount offered includes exercised overallotment options.

NA = not available

ROACE = return on average common equity

Senior debt offerings are highlighted.

Source: SNL Financial