PE Investors Settle for Small Slices

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By Joe Adler

The story of private equity's quest to capitalize on the financial crisis is still being written.

Few deals have been done to date, and the Federal Deposit Insurance Corp.'s tough restrictions on private equity have turned off some potential bidders. But investors continue to form pools of private capital aimed at buying banks.

"Despite the regulatory restrictions, people still view this as a viable way to make money," said Lawrence Kaplan, a counsel at Paul, Hastings, Janofsky & Walker. "You have to basically take a smaller piece of the pie in order to participate, but the view is that [a] smaller piece is still going to be worth your while."

Indeed, many investors have scaled back their hopes of quickly taking the reins of a failed bank and are instead focusing on stakes of less than 5% — the threshold for triggering the FDIC restrictions. Others are joining groups of investors in so-called "blind pools," and still others are teaming up with one or two large investors that have a solid relationship with regulators.

Only six deals involving nonbank capital have occurred since the latest wave of bank failures began in 2008.

But regulators, though wary of private equity and preferential toward traditional bank buyers, are expected to warm to private equity as bank failures increase.

"The FDIC's clear preference is to sell the bank along with the bulk of its assets to another bank or to an experienced group that is forming a bank," said William Isaac, a former FDIC chairman now arranging a team of investors to bid on failed banks.

Isaac is among those who believe the FDIC will open its arms to less traditional bidders.

"There [is] a limited amount of buyers in the banking industry. … The FDIC is receptive to groups that are willing to come in and form banks to do some acquisitions," he said. "The longer the high failure rate goes on, the more supply there is in relationship to demand. That's why the FDIC, I think, is open to groups that will come in and play by the bank rules."

It has been a year since private equity made a splash in the failed-bank market when a small team of big-name investors bought **IndyMac Bank** in California from the FDIC. That was followed in May 2009 by a similar deal for **BankUnited** in Florida. In both deals, the recapitalized bank's leadership came from one of the private-equity funds participating.

The need for a consistent private-equity policy emerged after the BankUnited deal; firms wanted clarity about what deals the FDIC would accept, and regulators were wary of letting more private equity — which usually holds investments for a short time — in the door.

Though observers speculate that regulators may grow more open to private equity as failures mount, they say the FDIC guidelines — and how they are being applied — have made it difficult for private-equity bidders to win failed-bank bids.

They point to the few failed-bank acquisitions that have involved private equity and the longer approval process for private-equity acquirers, compared to the smoother process for bank acquirers.

Besides the purchases of BankUnited and IndyMac (renamed **OneWest Bank**), the only other big private-equity deal involved OneWest's owners buying two more failed institutions.

"It's been a struggle for the traditional private equity," said Jason Langan, who runs the financial services mergers and acquisitions team at Deloitte & Touche LLP. "After BankUnited, we haven't seen many of the traditional club deals taking over banks. … The [FDIC] policy is pretty onerous on a private capital investor."

Michael Krimminger, a senior official at the FDIC, said the application of the agency's restrictions since their inception has been a learning process for both the FDIC and bidders. He signaled the agency may tweak the policy, and more deals could come as the agency provides more "clarity" to investors.

"Clarity and a more transparent process by us will encourage more people to come in and bid," said Krimminger, the deputy to the FDIC chairman for policy.

"It's important for open institutions as well as in failing bank situations to get more capital in the banking system. As we've learned how to apply the statement and the types of structures that the market is interested in pursuing, we can provide increasing clarity to potential bidders about the requirements that will be imposed on them."

Despite there being few deals, investment teams are still being formed, many with the help of former bankers. Examples are **Aquiline Capital Partners LLC**, which includes former Wachovia Corp. chief executive Ken Thompson, and **North American Financial Holdings Inc.**, which was started with the help of the private-equity firm **Crestview Partners** and former Bank of America Corp. vice chairman Gene Taylor.

A key strategy now is to try to get around FDIC restrictions by investing in less than 5% of the voting stock, the trigger for complying with the agency's rules.

"We're all purposely structuring" deals "to not meet the threshold test of those rules," said Donald J. Musso, the chief executive of the consulting firm FinPro Inc. "We've seen some modest private-equity involvement. … There's no great magnitude here. I think the money is sitting by waiting for the FDIC and others to get more desperate."

The dearth of dominant private-equity buyers has given rise to the use of blind pools. Under these structures, investors of all stripes — including private equity, hedge funds, institutional investors and others — band together and each take a small piece of the bank being acquired. The pools are typically formed before a target bank is identified.

Private-equity firms are "desperately trying to come up with a creative way to get into this market," said Langan of Deloitte Touche. "If they feel like the club deals — where maybe four private-equity firms each own 25% of the business — are not going to work right now, they either might participate in some of the blind pools, or maybe they'll co-invest with someone who is more of a strategic buyer but doesn't have the capital to take over a bank."

Kaplan, the lawyer, said blind pools have become the "natural outcome" of there being too few big deals offered by the FDIC so far.

"Everyone is less than 5% and are not triggering any thresholds and therefore do not need any approvals. They're just getting the economic interest," he said. "We've seen an evolution over the last year of going from 100% control, to 24.9%, to say[ing], 'The heck with it; let's just get something,' because there's so much money to be made here."

But deals involving blind pools have an even sparser track record. Only one such transaction has been completed. **Bond Street Holdings**, based in Delaware, bought two failed banks from the FDIC in January.

Getting around the FDIC rules is not a slam dunk. The agency has said teams of small investors — even if each owns less than 5% — still must prove they are not working in a "concerted action" to be exempt from the policy.

In a January "questions-and-answers" document on its guidelines, the agency said it will "presume concerted action" if the proportion of investors who individually own less than 5% of an acquirer's voting stock make up more than two-thirds of the total voting power.

Musso said that, to be safe, he is advising clients to keep the share of capital coming from private-equity investors to less than 30% of the acquirer's total.

"Even in a blind pool, it's a matter of where the power is centralized," he said. "The deals that are getting done … have all been structured to avoid any kind of individual or aggregate private-equity accumulation."

Isaac said the FDIC also is uninterested in structures that include only small stakes. The agency wants investors to be willing to contribute enough capital to ensure the bank's strength.

"The FDIC has made it plain in the policy statement that it wants some investors to be above" 5%, Isaac said.

Others say the FDIC's policy guidelines give an incomplete picture of what the agency will allow and that the regulator is essentially considering deals on a case-by-case basis.

"The FDIC has made it a little more difficult and uncertain because they've certainly retained complete discretion in applying their rules," said Ralph "Chip" MacDonald 3rd, a partner in the Jones Day law firm in Atlanta.

Krimminger said the policy statement is subject to an ongoing review that could result in changes.

"We will be putting out additional Q&As very shortly to clarify how the statement of policy applies to different types of transactions," he

said.

Many observers suspect the FDIC will ultimately become more willing to work with private-equity firms as the wave of failures builds. Some 702 institutions were on the agency's "problem list" at Dec. 31. After 140 banks were closed last year, most observers expect a much higher total this year.

"There is a lot to be written over the course of the next three to six months," said Paul Legere, a principal in the financial services practice at Deloitte Consulting LLP.

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