Small banks, big problem

Industry officials warn: If you're under $200M in assets, you could be forced to grow

BY BRETT JOHNSON

In just about every examinable statistic, the Garden State's banking ecosystem is improving.

Within the past year, the industry has grown to more than $16 billion in capital and $106 billion in deposits across all Jersey-based institutions — both slight upticks from 2013 — according to a March estimate by the **Federal Deposit Insurance Corp**.

It's been a plentiful environment for the roughly 60 institutions with more than $200 million in assets, and especially so for about 20 food-chain-topping institutions in the $1 billion or more range.

But, in spite of its bounty, industry experts say it's not a habitat suitable for the remaining 22 institutions that are below the $200 million in assets threshold, which they say have long been an endangered species.

Now these institutions are close to extinction.

Don Musso, CEO of the Warren-based bank consulting firm **FinPro Capital Advisors**, had a succinct assessment of how many institutions with less than $200 million in assets the state's market will support within 10 years:

"Few to none."

"You've got to hit some minimal size (above $200 million in assets) to hit profitability," he said. "And then to really be efficient you need to be at $700 million to $2 (to) 3 billion."

Numbers from the state's Department of Banking and Insurance speak to an urgency to reach that efficient level: In the past two years, nearly 10 in-state banks were absorbed into larger New Jersey-chartered banks through merger and acquisition activities.

In the two years prior to that, only a combined total of three of those deals were closed.

Don Musso, CEO of FinPro Capital Advisors: Small banks may be all gone within 10 years. -AARON HOUSTON

But there's still been enough activity in the past for the number of separate banking entities that exist within the state's borders to shrink to one-third less than what it was in 2000, according to **John McWeeney**, CEO of the New Jersey Bankers Association.

He admits that this isn't news: Consolidation has been going on for decades. Nationally, there were around 17,000 banks in the 1980s, a figure that has since dwindled to fewer than 7,000.

But, he said, there's a difference.

"What's new is how much of today's consolidation is being particularly forced upon the smaller, community banks; it's becoming a more and more challenging environment — not necessarily to survive, but to make money," he said.

What drives concerns about earnings among small banks' boards of directors — and what is driving more to seek a partnership — can be traced to a still-hurt economy.

"While banks from a capital and liquidity perspective are strong," McWeeney said, "most banks generate a majority of revenue through loan activity. Loan demand remains soft, as we're seeing businesses and consumers still being conservative."

McWeeney, who helms a trade association that advocates for New Jersey banks on legislative issues, also cites the increasing regulatory costs, which require an investment that few small banks are able to earn enough to comfortably offset while still appeasing shareholders.

The cost of complying in today's regulatory framework is something even one of state's largest institutions winces at.

"It's not a small cost," said **Gerald Lipkin**, CEO of **Valley National Bancorp**. "We approximate that it costs us $75 million a year to meet our regulatory expenses. If you're a small bank, that gets smaller, but it doesn't disappear.

"If you take those costs and spread them over a larger base, it makes it easier to generate a profit for your shareholders. There's a desire on the part of all banks to get larger."

While smaller institutions have been looking to scale up as a response to that burden for some time, the decision to be on the seller side of M&A activity has only recently become as attractive as it now is.

Merger mania

This compilation of the mergers and acquisitions completed so far in 2014 illustrates the flurry of New Jersey-centric M&A activity that is further consolidating the market. Not necessarily a bad thing — considering that during the same period in 2007, the list included five out-of-state banks that purchased New Jersey-chartered banks.

Bank being acquired	City	Acquiring bank	City	Date
GCF Bank	Sewell	Investors Bank	Millburn	01/10/2014
Rumson-Fair Haven Bank & Trust	Rumson	1st Constitution Bank	Cranbury	02/07/2014
Heritage Community Bank	Randolph	First Bank	Hamilton	03/07/2014
Franklin-St. John's Community Development Credit Union	Newark	XCEL Federal Credit Union	Bloomfield	04/04/2014
Bureau of Parole Employees Credit Union	Trenton	First Point Federal Credit Union	Hamilton	04/24/2014
Team Capital Bank	Bethlehem, Pa.	The Provident Bank	Jersey City	05/30/2014
Union Center National Bank	Union	ConnectOne Bank	Englewood Cliffs	07/01/2014

Source: New Jersey Department of Banking and Insurance

An increase in valuations is playing a part in that. **Investors Bank**, a Millburn-based institution that has acquired eight other regional banks since 2008, has witnessed the trend.

"Since the recession of 2009-10, we've seen trading multiples increase substantially," said **Domenick Cama**, chief operating officer of Investors. "Banks are finally back to a point where a price that they could get paid in an acquisition is more palatable to them."

Also, the way M&A activity is now being billed is making it more appealing for small banks. More often, such transactions are being labeled "merger of equals," according to **Frank Sorrentino**, CEO of **ConnectOne Bank**.

"People don't want to be bought or sold," Sorrentino said. "So I think (merger of equals) on paper doesn't have the same connotations that selling your company might."

Even if the end result is the same.

"It's all semantics," Sorrentino said. "At the end of the day, (they are) transactions in which two companies come together for the same goal: to create a bigger balance sheet that has better efficiencies, create operating leverage and combine the best of both companies."

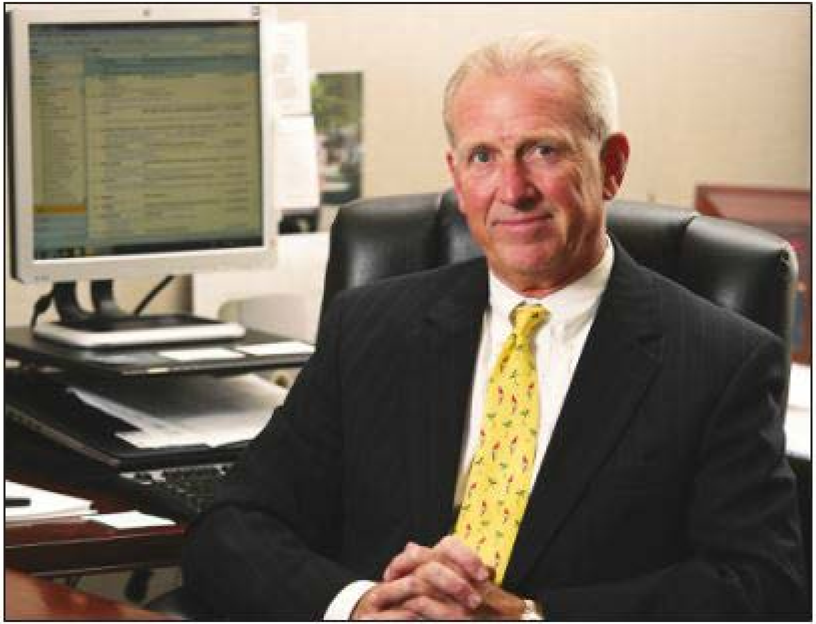
The Englewood Cliffs-based ConnectOne Bank had a planned merger with **Union Center National Bank** approved by shareholders in June. The two banks combined to form a banking institution that ranks among the four largest banks in the state.

The move paired ConnectOne Bank's organic loan growth with a 92-year-old institution's deep deposit base. Being a newer institution, ConnectOne Bank struggled with deposits.

That's why Sorrentino says continued consolidation is inevitable: It helps a bank account for areas of slight weakness.

"There are institutions that are good at certain things, but not at others; they can gain some of whatever it is they lack by performing a merger," Sorrentino said.

Though not in the $200 million danger zone alluded to by others, the approach of a smaller institution such as **Bancorp of New Jersey** — with $600 million in assets — agrees with that.



N.J. Bankers Association CEO John McWeeney: Consolidation is being forced on small banks. -AARON HOUSTON

Michael Lesler, CEO of the Fort Lee-based community bank, said if his institution were to participate in M&A activity, it would be to bolster what it has already done to grow organically — not necessarily to save it from financial distress.

He's sure that approach extends to other players in the market.

"More of the merger activities you're starting to see has been the combination of healthy banks," he said. "You're seeing the ability for banks to be interested in merging based on geographic growth, reducing expenses and adding pieces to a business."

Most experts agree the market, though extremely competitive, leaves some room for institutions even below Bancorp of New Jersey's size.

But, like any endangered species, they're going to have to band together.

"There will always be community banks and somewhat smaller-sized banks," McWeeney said. "Over time, what we're seeing is those banks having to become a little bit larger."

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Dealmakers and breakers

Investors Bank climbed to the top of New Jersey's banking industry partially because of its aggressive M&A activity. And while the company says it is holding off on acquiring other banks while it pauses to modernize its technology platform, don't think its leaders aren't intently watching the market.

Here are three things **Domenick Cama**, COO of Investors Bank, said the institution keeps in mind when looking at making an acquisition:

LOAN-TO-DEPOSIT RATIO: "We look for banks that are deposit rich — that is, they have more deposits than loans. As a result, it could provide a good funding source for our good loan growth."

BUSINESS MODEL: "We were a traditional thrift, and we're transitioning to be commercial bank-like. As a result, what we look for is institutions that are commercial banks. They can lend expertise to us."

POTENTIAL DILUTION: "Ultimately, it needs to make sense; it needs to be a transaction in which you haven't diluted shareholder value with a long, protracted payback period."