PARK STERLING BANK – IS THERE a TARP in YOUR FUTURE?

Michael D. Evans, Winthrop University, evansm@winthrop.edu

ABSTRACT

Park Sterling Bank, headquartered in Charlotte, North Carolina, opened for business in October 2006. Initially, $45 million was raised by the Board of Directors to capitalize the bank. This represented the largest capital raise by a North Carolina community bank in history. The bank experienced such rapid growth during 2007 and 2008 that additional capital would be required to fuel further growth. The Board of Directors considered several alternatives to raise additional capital. This paper chronicles the alternatives considered and the ultimate choice made.

INTRODUCTION

Over the years, investing in North Carolina community banks has provided an attractive rate of return. Community banks are smaller institutions that typically have local ownership. They tend to differentiate themselves from the larger banks by catering to small and mid sized businesses and providing more responsive decision making. It has been a common practice for individuals to start a community bank, grow the bank and then subsequently sell it to a larger institution. There are also instances where there is no intent to sell. Instead the goal is to continue to operate the bank on a profitable basis.

Approximately fifteen years ago, a group of individuals came together to start Park Meridian Bank. Park Meridian Bank was sold to Regions Bank after ten years of successful operation. Key management of Park Meridian was hired by Regions Bank. They were subject to a non-compete clause. Once the non-compete expired, Bryan Kennedy, formerly the number two executive at Park Meridian, decided to start another community bank. He approached Larry Carroll, a well-respected investment adviser who had served on the Park Meridian Board of Directors, to gauge his level of interest. Larry was extremely interested in starting a new community bank and agreed to serve as Chairman.

Other business leaders were “recruited” to serve on the board of the proposed new bank. The author was asked to serve as a director and readily accepted. Each proposed director was charged with making an investment in the bank as well as soliciting other investors. The North Carolina Banking Commission required our group to raise a minimum of $27 million and a maximum of $45 million. We were able to raise $45 million in approximately two months without the services of consultants or brokerage firms. In fact, we were oversubscribed by $5 million.

The bank began operations in October 2006 and immediately experienced rapid growth. This was largely attributable to the fact that management hired bankers who had a wealth of experience in the Charlotte market. These bankers already had a book of business and they were able to bring much of this business to the new bank.

The rapid growth in loans led to large losses in the early quarters of operation. As a de novo bank, we agreed to expense 1.5% of new loans for the first three years as a cushion against bad debts. It should be noted that this is a non-cash charge. The bank became cash positive in the second full quarter of operation. Profits were generated in the fifth quarter of the bank's existence.

Typically, capital can be leveraged approximately ten times (i.e. $45 million of capital can support approximately $450 million of assets). As our asset base grew, it became readily apparent that additional capital would be required to take advantage of opportunities in the marketplace.

ALTERNATIVES FOR RAISING ADDITIONAL CAPITAL

During 2008 the board considered two alternatives for raising additional capital.

- Issuing debt
- Issuing additional shares of common stock

The second alternative was quickly rejected. The stock price of banks had declined significantly and ours was no exception. Our shares were issued at $10 per share. They rose to a high of $18.75 before falling back below $10 per share. It should be noted that our stock price fell irrespective of the fact that we were profitable. Further, we did not have a problem with non-performing loans or other real estate owned (OREO) as did a number of our peers. Our shares are thinly traded. One trade can have a tremendous impact on our stock price. A few of our shareholders decided to sell their shares at any price in response to the market decline in 2008. This significantly deflated the price of our stock.

We decided to explore further the alternative of issuing subordinated debt. Management determined that we needed $5 – 10 million of new capital. Research was conducted to determine an appropriate rate of interest for a subordinated debt offering. Discussions were held with investment bankers. We reviewed the deal structure of community banks that had recently raised additional capital. We also considered the local market (i.e. what rate would induce our existing shareholders and others to invest in the debt offering?). We believed that we could market effectively a debt offering with a maturity of ten years and an interest rate of 11%. Investment bankers confirmed that 11% was an appropriate interest rate for the debt offering of a de novo bank. It was suggested that a higher rate would be required to market the shares to institutional investors. Our attorney was instructed to prepare the appropriate documents and offering memorandum.

TARP CAPITAL PURCHASE PROGRAM

In October 2008 the United States Treasury announced the TARP Capital Purchase Program (TARP). The intent of the program is to allow U. S. financial institutions to raise additional capital and to increase lending to businesses and consumers in order to stimulate the economy [4]. Under TARP, banks can receive up to the lesser of $25 billion or 3% of risk-weighted assets. The bank in turn issues preferred stock to the Treasury. The preferred shares carry a 5% dividend yield for the first 5 years and 9% thereafter [2].

Initially, the larger banks participated in order to repair their balance sheet. Community banks balked at participating. There was concern that participation would be viewed as a sign of weakness [3]. Banks were also concerned that the government would become intrusive in daily operations and promulgate regulations viewed as unfavorable.

The Board of Park Sterling Bank viewed TARP as a relatively inexpensive way to raise capital. There are no floatation costs. The dividends cannot be deducted. However, the blended dividend rate was projected to be slightly less than the after-tax cost of the proposed debt offering. Further, we were already well-capitalized and profitable. We were not concerned that the acceptance of TARP money would somehow taint the reputation of the bank.

The Board elected to apply for $10 million of TARP funds. The application was submitted in October 2008.

Only one Charlotte-based community bank, Bank of Commerce, has received TARP funds. Approximately 161 community banks across the country had received TARP funds through February 2009 [1]. We received a few requests for additional information. However, little information regarding the status of our application was received. Given the lack of feedback and uncertainty regarding TARP, the board decided to proceed with the subordinated debt offering while the TARP application was being considered.

SUBORDINATED DEBT

In May 2009 an offering memorandum and subscription offer form was mailed to existing shareholders, select customers and other potential investors. An information meeting for prospective investors was held at a prominent country club. Attendees were informed of our goal of raising $5 – 10 million via subordinated notes with the following terms:

- $50,000 minimum purchase amount
- 11% coupon
- Quarterly interest payments
- Optional redemption at par in 5 years
- Maturity in 10 years

Financial highlights were also shared. It was noted that loans and assets had grown to $387 million and $444 million respectively as of March 31, 2009. Net income for the first quarter of 2009 was $186,000. Net income for 2008 was $1.55 million. This included a benefit from the recognition of a deferred tax asset.

Completed subscription offer forms accompanied by a check for the full purchase amount were requested by June 15, 2009. $6.9 million was raised via this debt issue. Funds received increased risk based capital to 13.5%. 10% is the threshold for a bank to be considered well-capitalized.

MOVING FORWARD

Given the success of the subordinated debt offering and the lack of communication regarding our TARP application, we decided to withdraw the TARP application. We have sufficient capital to weather the current economic storm. Further, we are positioned for further growth, either organically or via an acquisition, as opportunities present themselves.

REFERENCES

[1] "A Statistical Look at Community Bank TARP Recipients." http://www.bankbryancave.com/a-statistical-look-at-community-bank-tarp-recipients/

[2] "New Term Sheet for Private Banks." http://www.bankbryancave.com/new-term-sheet-for-private-banks/

[3] Salow, J. "Community Banks: TARP is Not a Bailout." *Huffington Post*, February 23, 2009, http://www.huffingtonpost.com/2009/02/23/community-banks-tarp-is-n

[4] "Treasury Announces TARP Capital Purchase Program Description." http://www.treas.gov/press/releases/hp1207.htm