Mueller Prost PC
CPAs + Business Advisors

FINANCIAL LENDING NOTES

Spring 2012

PUTTING LOANS ON THE BOOKS

Targeting Nonprofits and Medical Practices

There's no question that the past few years have been a difficult period for banks — perhaps the most difficult since the Great Depression. But so far in 2012, there have been some encouraging signs, for the broad economy and for community banks in particular.

Given this, many banks are starting to peek their heads out from beneath their shells and resume more aggressive marketing and new business development efforts that have been shelved the past few years while they hunkered down in survival mode. In doing so, some are targeting niche markets for small business lending, including nonprofit institutions and professional practices.

Historically, these have both been profitable niches for many community banks. But taking advantage of new lending opportunities in these niches requires a dedicated focus and unique marketing strategies.

First Step: Cultivate Referral Sources

The first and most basic strategy for targeting these niches is to cultivate referral sources that can make introductions to nonprofits and professional practices (specifically, medical and dental professionals).

This is really no different from your referral source strategy for getting introductions to any type of small business. If you have built up a database of small business referral sources (like accountants, attorneys and other centers of influence for small business owners), comb through it to find the ones that might have relationships with nonprofits and professional practices.

Next, look for opportunities to get actively involved with some of the nonprofit institutions in your community. This may include churches, synagogues and mosques; hospitals; private and charter schools; community food banks; and groups that support wounded veterans, to name just a few. Organizations like these often seek out bankers to serve on their boards of directors, especially in smaller communities.

Some community banks require that their lenders be actively involved in at least one nonprofit, allowing them to choose a cause and organization they want to support and serve on work time. This may help give your bank a foot in the door when it comes to identifying and taking advantage of new lending opportunities at the nonprofits, while also supporting causes that your lenders are passionate about.

Similarly, your bank should look for opportunities to participate in civic organizations like local Chambers of Commerce and Lions and Rotary Clubs. Both nonprofits and professional practices tend to be active in these organizations, so they can provide fertile ground for networking and drumming up new lending business.

Medical and Dental Professionals

In today's post-healthcare reform world, there are more opportunities than ever to market to medical and dental professionals.

For example, you could host a half-day seminar for area medical practices on the impact of one or more provisions of healthcare reform on the practice. For that matter, you can host seminars on anything that's practical, timely and relevant for medical and dental practices: personal financial planning and wealth management, tax law, sales and marketing, or estate planning, just to name a few.

Locate and hire the presenter, book the facility (or maybe you can hold the seminar at your bank if you have the right space for it) and create high-quality, personalized invitations you can send out to qualifying professional practices in your community.

PUTTING LOANS ON THE BOOKS

Targeting Nonprofits and Medical Practices, cont'd.

Seminars like this provide a great opportunity to network and interface with prospective new borrowers without having to compete with other lenders at civic events.

Another idea is to build relationships with companies that provide services to professional practices. Medical record imaging is a good example: Most professional practices today are migrating to Electronic Health Records (EHR) and there are a number of service providers that are helping them do this. Such companies are an excellent referral source to help you get your foot in the door of their professional practice clients.

Dental practices, in particular, have proven to be good borrowers for many community banks. While new practices may carry high levels of debt in order to finance the latest high-tech equipment needed to outfit a dental practice today, default rates for dental practices tend to be low, so they can be attractive if you can make the numbers work.

List vendors like Dun & Bradstreet sell prospect lists that can help you identify nonprofit institutions and professional practices that might be good candidates for new loans. You can get very targeted in your list acquisition efforts, specifying such criteria as sales volume or annual revenue, number of employees, ZIP codes and NAICS codes, and even profitability, among other factors.

Dig into Financial Statements

Beyond marketing strategies like these, you can also uncover potential new lending opportunities with nonprofits and professional practices by digging into their financial statements.

For example, medical and dental practices may have put off the purchase of fixed assets for the past few years while they tried to ride out the recession. One way to spot this is to compare the relationship between accumulated depreciation on the balance sheet with the net book value of fixed assets. If the latter is significantly less than the former, the practice may be in need of an equipment upgrade.

Having this kind of information in hand enables you to be proactive by approaching professional practices about lending opportunities to meet their needs for capital expenditures. Even better, go one step further by pre-approving a practice for an equipment term loan. Otherwise, the equipment vendor may get the first shot at the financing.

Nonprofits and professional practices with maturing balloon payments are another place to look. If they bought or refinanced commercial real estate with a three- or five-year balloon payment back before the bubble burst, these loans will be maturing soon. You can spot loan maturity dates on CPA-prepared financial statements or simply ask the business for a debt maturity schedule. In some jurisdictions, maturing loans can even be identified via public records.

Due to regulatory requirements, the nonprofit's or professional practice's current bank may not be able to refinance the loan - or it may simply choose not to due to a lesser appetite for commercial real estate (CRE) loans. Or maybe the business wants to refinance to lock in a low fixed interest rate. Either way, maturing balloon payments could signify new CRE lending opportunities.

Please contact us at 314.862.2070 if you'd like to discuss these and other strategies for targeting nonprofit institutions and professional practices in more detail.

THE IMPACT OF FINANCIAL REFORM
Are Community Banks an Endangered Species?

When the Dodd-Frank Wall Street Reform and Consumer Protection Act was first passed in the summer of 2010, there was a lot of speculation about what impact the wide-ranging legislation might have on the community banking industry.

Some pundits opined that Dodd-Frank sounded the death-knell for community banks by raising capital and equity requirements, increasing regulatory burdens (and costs) and limiting how much banks can charge merchants in interchange fees, thus lowering non-interest fee income. (Note: While banks with less than $10 billion in assets are exempt from the limitation on interchange fees, these banks may be forced to lower their interchange fees to compete with larger banks.)

Nearly two years have passed since Dodd-Frank became law, during which time many of the law's provisions have been implemented and started to take effect. This makes now a good time to reassess the question: What will Dodd-Frank mean for community banks?

Impact on Profitability

There's little (if any) doubt that Dodd-Frank will have a negative impact on bank profitability. Higher capital requirements combined with lower income and higher compliance expenses will result in a lower return on equity (ROE) for most community banks. (See the chart below for a DuPont analysis of bank profitability.)

So the question becomes: What level of return will bank investors be willing to accept? In one survey, investment bankers and financial industry consultants estimated that the provisions of Dodd-Frank would lower the ROE of community banks with less than $500 million in assets to between 6 percent and 8 percent. However, bank investors generally look for returns in the 11 percent to 14 percent range.

All things being equal, if a bank has to maintain more capital, it will have to earn more money on every dollar of revenue it generates and every dollar invested in assets in order to maintain the same ROE. To do this, return on assets (ROA) must go up.

Bank revenue is driven primarily by interest and non-interest margin. Community banks have traditionally generated interest income through residential mortgages, acquisition and development (A&D) and construction loans, and commercial real estate (CRE) loans. However, a number of factors, including regulatory caps on CRE and construction loans as a percentage of capital, will likely reduce these sources of revenue.

Interest expenses, meanwhile, may rise in the future due to new disclosure and reporting requirements (like the new small business reporting requirements that are similar to HMDA), new lending non-discrimination rules and the repeal of Reg Q. On the non-interest side, income (which consists primarily of fees) will likely fall due to the factors noted above, while non-interest expenses (including incremental compliance costs) will probably rise.

What It All Means

All of this adds up to one inescapable conclusion: Lower revenue, higher capital requirements and higher costs are likely to adversely impact bank profitability in the future. And community banks are especially vulnerable because they usually don't have the scale and alternative sources of fee income across which they can spread incremental compliance costs.

The net result will likely be consolidation of community banks. Banks with less than $1 billion in assets will find it especially difficult to remain independent in the post-Dodd-Frank world.

Some community banks will be forced to either go into acquisition mode or be acquired themselves. Many expected this shakeout to start last year, but it hasn't materialized yet. This is primarily due to the fact that bank stocks remain depressed, and there's still a disconnect between buyers and sellers.

Many sellers believe their bank is worth 1.5x–2x book value, when in reality, it may not even be worth book value. And buyers remain suspicious of the quality of bank earnings - and they realize that it's a buyer's market now, and likely will stay that way for the foreseeable future.

Survival in the post-reform banking world requires a strategic plan. Please give us a call at 314.862.2070 if you'd like to discuss your bank's plans in more detail.

BANK PROFITABILITY
Interrelationship Profitability Measures

ROR		x	Asset Utilization		=	ROA	
$\frac{\text{Profit}}{\text{Revenue}}$	.205	x	$\frac{\text{Revenue}}{\text{Assets}}$	.055	=	$\frac{\text{Profit}}{\text{Assets}}$	1.12%
ROA		**x**	**Leverage Multiplier**		**=**	**ROE**	
$\frac{\text{Profit}}{\text{Assets}}$	1.12%	x	$\frac{\text{Assets}}{\text{Equity}}$	8.78	=	$\frac{\text{Profit}}{\text{Equity}}$	9.83%

Source: New Horizons Financial Group

FASB Offers Guidance on TDRs

Efforts by financial institutions over the past couple of years to modify loan terms for some small business and commercial real estate borrowers have often resulted in the creation of troubled debt restructures, or TDRs.

In order for a loan modification to be considered a TDR, two specific conditions must be present:

1) A concession must be granted by the lender.

2) The borrower must be experiencing financial difficulty.

Note that all loans that have undergone a troubled debt restructuring are considered to be impaired loans. Due to the divergence in how financial institutions determine which loan modifications constitute a TDR, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2011-02 last spring to help clarify and offer guidance. Specifically, the ASU helps financial institutions determine whether a concession has been granted and whether a debtor is experiencing financial difficulty.

According to ASU 2011-02, a concession may have been granted if the borrower does not otherwise have access to funds at a market rate for debt with similar risk characteristics, or if there are more than insignificant payment delays, among other factors.

Indications of financial difficulty may include delinquency on any debt, whether within or outside your bank; a declaration of bankruptcy; substantial doubt as to whether the borrower will continue as a going concern; or a forecast that the borrower's cash flows will be insufficient to service existing debt for the foreseeable future, among other factors.

The standards update also precludes banks from using a borrower's effective interest rate to determine whether a loan modification constitutes a TDR, regardless of whether or not this test was used in the past.

ASU 2011-02 is effective for annual periods ending on or after December 15, 2012, for non-public entities. It should be applied retroactively to the beginning of the annual period of adoption.

Please call us at 314.862.2070 if you have more specific questions about ASU 2011-02.

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