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## COMMUNITY BANKING

# The Dangers of Buying An Unfamiliar Business

■ BY ROB GARVER

In less than 90 days **Sterling Financial Corp.** in Lancaster, Pa., went from being a well-regarded banking company that delivered strong returns to shareholders to a bargain-basement takeover target.

The \$3.3 billion-asset company disclosed this year that it had uncovered an alleged loan fraud scheme at the leasing subsidiary it bought five years ago. In May, Sterling said it was writing down its fourth-quarter earnings by \$145 million to \$165 million.

Weeks later **PNC Financial Services Group Inc.** announced that it would buy Sterling for \$19 a share. The 80% premium over Sterling's stock price looked like a good deal on its face, but it was still a 15% discount from Sterling's closing price in the days before the troubles at the leasing unit, Equipment Finance LLC, were revealed. Analysts say that any potential acquirer earlier in the year would have had to pay a significant premium over the pre-scandal share price.

Sterling's sudden decision to sell itself is an object lesson in what can happen to a community banking company when executives at the parent do not monitor a



**Robert H. Hartheimer says buyers must check the seller's due diligence before a purchase and solidify internal controls after.**

subsidiary closely, according to industry observers.

Under intense pressure to find new sources of income, small banks can be tempted to venture into unfamiliar business lines, and sometimes the results can be disastrous. Sterling lost more than half its

market value after it said it was restating earnings, and several plaintiffs' attorneys have initiated shareholder class actions alleging that it issued misleading financial information that inflated its stock price.

"At the end of the day, you can beat up companies for not having [other] income sources, but if they buy the wrong company, that can be even worse," said Rick Weiss, an analyst with Janney Montgomery Scott LLC.

Other banking companies are dealing with similar blow-ups at subsidiaries.

In March, **OceanFirst Financial Corp.** of Toms River, N.J., announced that it would need to restate its financials for all of last year to reflect a reserve for the repurchase of subprime loans made by its Valhalla, N.Y., mortgage subsidiary, Columbia Home Loans.

In June, **United Security Bancshares** of Thomasville, Ala., announced that possible fraud in its consumer finance unit, Loan Acceptance Co., might cost the company \$3.8 million, wiping out more than a full quarter's earnings.

Managed properly, of course, a mortgage or consumer finance subsidiary can generate

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significant revenue for its parent company and boost net interest margins. But they can also cause headaches, particularly if the bankers themselves are unfamiliar with the business lines, analysts and consultants say.

Sterling acquired Equipment Financing as part of its effort to diversify its revenue stream. The leasing unit provides financing to the logging and land-clearing industries, primarily in the Southeast, and was one of the company's biggest money-makers, at one point accounting for roughly 40% of its profits, according to analysts.

The problem, according to Matthew C. Schulteis, an analyst with Ferris, Baker Watts Inc. in Baltimore, was that Sterling "let the guys who run the ... [subsidiary] have too much freedom, because they figured, 'We don't know enough about it.'"

In fact, he said, most bankers do not have the expertise to run an equipment leasing operation, because the underwriting model is completely different from that used for a typical bank loan.

"You need to have guys who really understand that business to make those loans, because bankers were trained not to make those loans," Mr. Schulteis said. "They're too risky."

Bert Ely, who runs the Alexandria, Va., bank consulting firm Ely & Co. Inc., said that subsidiaries are often bought, not started from scratch, and that a hands-off approach by the new parent's management is often a condition of the sale.

"A lot of times when businesses get acquired, there is a promise for at least a few years of autonomy," he said. "You give them lots of running room, a long rope, and they hang you while they are hanging themselves."

Another consultant, who asked not to be identified, said that giving subsidiaries autonomy is "absolutely a mistake."

Sterling officials would not discuss the matter for this article, but the company said in May that the preliminary results of its investigation found that a group of five officers and employees at Equipment Finance orchestrated the loan scheme over an extended period. The group concealed credit delinquencies, falsified financing contracts, and subverted internal controls and reporting systems, Sterling said.



Sandy Spring's Caceres said the bank's audit staff makes regular visits to offices of an advisory firm it bought in 2005.

One consultant who asked not to be identified said that there is a temptation for bankers to leave the companies they acquire alone, because the companies often are run by dynamic, entrepreneurial chief executives with track records of making money.

But banking companies are heavily regulated and must answer to shareholders, the consultant said, so bankers who are considering buying a company have two choices: Learn everything there is to learn about the business, or don't buy it.

"What do bankers in Pennsylvania know about logging in Louisiana?" the consultant said.

Mr. Ely also advised against buying companies that do business well outside

of the bank's markets. "If a subsidiary is headquartered 500 miles away, it is hard to know what is going on," he said.

Like Sterling, OceanFirst gave its subsidiary considerable autonomy.

OceanFirst executives did not return calls for comment, but Frank Schiraldi, a vice president with Sandler O'Neill & Partners LP who follows the company, said its management failed to monitor Columbia's activities properly.

"That is the problem with the independent subsidiary — you are buying a company, and if you leave the management in place, you have a hard time keeping an eye on it," he said.

OceanFirst acquired Columbia in 2000, and last year the unit began making subprime mortgages, which it sold to investors with the agreement that Columbia would buy the loans back in the event of an early credit default. Such defaults came in far higher numbers than expected, forcing the ouster of Columbia's president and requiring OceanFirst to take a \$12.1 million charge against first-quarter earnings.

According to Mr. Schiraldi, OceanFirst's management did not have the background to assess Columbia's decision to move into the subprime market.

"At the end of the day, they didn't really know what they were getting themselves into," he said. "They didn't really understand all the risks of the subprime product."

The problems at United Security have not been well publicized, in large part because its managers have not spoken to reporters about the problems at Loan Acceptance Co., issuing only a press release in the name of R. Terry Phillips, the parent's president and CEO, assuring shareholders that it was working "to perform a full and complete investigation."

Analysts cite **Sandy Spring Bancorp** of Olney, Md., as an example of a company that has managed its subsidiaries well.

Lou Caceres, an executive vice president of Sandy Spring, recently outlined the steps his company took immediately after the 2005 acquisition of West Financial Services to ensure that the McLean, Va., registered investment advisory firm's managers were on the same page as the parent company.

West retained its own brand and its management, Mr. Caceres said, but when the acquisition was finalized, his team immediately set up meetings with the "key internal partners" from both Sandy Spring and West. Those meetings produced a list of 140 "integration items" that would need to be addressed.

As part of that effort, Sandy Spring's compliance officer began spending two days a week at West's offices to ensure its compliance regime matched the parent's. Mr. Caceres also had the heads of each division of the company meet with the principals at West to begin developing internal connections between the subsidiary and the rest of the company.

But the close contact with West did not wane once the integration was complete. To this day, Mr. Caceres and other managers at Sandy Spring hold weekly conference calls with the principals at West to remain apprised of developments there. Sandy

Spring's audit department makes regular visits to West, and Mr. Caceres travels to its headquarters for all staff meetings, where he typically speaks.

Sandy Spring also moved all of West's bookkeeping to its own system, to ensure the parent has a full picture of the unit's finances.

The managers of Sandy Spring are comfortable "allowing West to operate as a separately branded sub, as long as the principals have an attitude and philosophy that closely matches our own," he said.

Robert H. Hartheimer, former director of resolutions at the Federal Deposit Insurance Corp. and now a managing director with Promontory Financial Group in Washington, said that after three subsidiary meltdowns in such rapid succession, bank regulators undoubtedly will be paying more attention to internal controls in the immediate future.

"The fact that this is now more on the radar screen of the regulators is going to put a little more pressure on the boards of banks and holding companies to be more diligent — almost suspicious," he said.

How regulators assess a subsidiary's internal controls has everything to do with the corporate structure of the institution. In cases where a banking company is required to file an application to acquire a business, regulators typically assess the buyer's ability to manage the business, and the risk it

presents, during the application process.

However, in the post-Gramm-Leach-Bliley era, many institutions can make acquisitions and receive approval after the fact, giving regulators no ability to step into the process early.

When Federal Reserve Board member banks make an acquisition that concerns Fed officials at the district level, they have the authority to accelerate examination schedules, but there are no statistics available on how frequently this happens.

When a bank is considering purchasing a business, Mr. Hartheimer said, the board "must question management about the diligence that has been done and be sure it is appropriate."

And once a deal is done, solidifying internal controls at the new subsidiary should be job one for the acquirer's CEO, he said. "The internal controls is something that should be done right away. If you have a sub and you are not sure whether its controls are consistent with your own, you need to take a look at that."

The moral of the story, said Mr. Schiraldi of Sandler O'Neill, is that vigilance is always necessary with independent subsidiaries.

"Just be cautious of these independent subsidiaries," he said. "You don't always run into the problem right away."

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