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Sub debt prices for community banks hitting lows

By Joe Manton **July 14, 2017**

The debt markets are open for community banks, and they keep getting cheaper.

TowneBank announced July 12 that the notes in its $250 million unsecured subordinated debt deal have a five-year fixed annual rate of 4.50%, before they turn into floating rate securities for five years. Sandler O'Neill & Partners LP was the sole book manager on the deal, and Jacques de Saint Phalle, a principal in capital markets for the investment bank, said the deal marked the lowest range coupon on sub debt for a bank with a BBB rating from Kroll Bond Rating Agency.

For comparison, Union Bankshares Corp., a similar-sized institution to TowneBank that also had a BBB rating from Kroll, completed a $150 million unsecured subordinated notes offering in November 2016 that had a fixed annual rate of 5.00% for five years before they became floating rates for five years.

Coupons have come down for banks partly because the investor demand has increased, de Saint Phalle said. He said that insurance companies and banks have been interested in the product since issuance activity from community banks picked up in 2014. Within the last year, however, money managers and mutual funds have also expressed interest in the product.

"The investor base has steadily increased and broadened," de Saint Phalle said in an interview.

Even though the rates that community banks pay have come down, the coupons on their debt are still higher than corporate bonds from similarly rated larger banks or companies in other sectors, said Matthew Resch, co-founder and managing principal of Ambassador Financial Group, which also works on the debt deals for depositories. Given the low interest rate environment, the yields from the community bank paper is attractive to investors, Resch said.

"There continues to be insatiable demand amongst investors for community bank sub debt, and that continues to drive the issuance cost down," he said in an interview.

Investor participation is also growing because the market has matured. Historically, community banks were not that active in the debt markets partly because they had a hard time attracting attention from rating agencies.

However, the debt markets opened in recent years after Kroll started an initiative that focused on community banks. Kroll saw an opportunity because it believed other rating agencies viewed community banks as being too small to garner their attention or too much of a default risk.

The increased activity has led to business opportunities for some investment banks in the space, and Sandler O'Neill has been the most active. Since 2014, Sandler O'Neill has worked on more than 80 subordinated debt issuances for depositories, and that total more than doubles the number of deals from any other investment bank in the space, according to SNL Financial data.

The team from Sandler that is working on the deals was focused on private equity capital raising opportunities for community banks in wake of the credit crisis, de Saint Phalle said. But as the industry recapitalized, the need for equity dissipated while the debt market stabilized with the emergence of Kroll.

"We just retrenched, focused on the debt opportunity as it came upon us and have tried to find good opportunities for our investors," de Saint Phalle said.

Initially, many community banks issued sub debt to exit the Treasury Department's Small Business Lending Fund before the cost of being in the program increased. Most community banks have addressed their SBLF concerns, but de Saint Phalle said the activity should remain robust going forward. He expects banks to use the issuances for M&A, loan growth and refinancing.

Resch noted that subordinated debt, which counts as Tier 2 capital for bank holding companies, can help reduce the weighted average cost of capital because it is cheaper than common equity. Given the low cost to issue sub debt, Resch believes it is a good time for banks to explore an issuance.

"The market sentiment is so strong that it really makes sense in some cases to layer in subordinated debt," he said.

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