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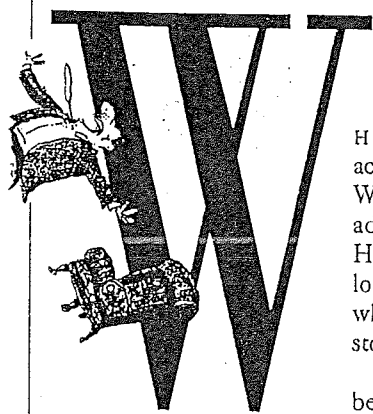


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# MUSCLING IN ON THE BOARD

*The trouble with activist investors is they usually put their mouth where their money is—and with all the subtlety of a charge up San Juan Hill. Who are these guys, and could they make you sell your bank?*

BY JOHN R. ENGEN



WHEN ONBANCORP, INC. acquired Franklin First Savings Bank of Wilkes-Barre, Pa. in 1993, it got an added, if unwanted, bonus: Seymour Holtzman, a Wilkes-Barre native and long-time Franklin First shareholder, who opted to retain his stake after the stock deal.

Holtzman is among a growing number of so-called activist investors who put their money into undervalued bank and thrift stocks, and then poke, prod, and pressure boards and managements to boost shareholder value through stock repurchases, return-of-capital payments, special dividends—or mergers and acquisitions.

Holtzman began his tenure as an Onbancorp investor quietly. Nearly a year after he came on board, however, the Syracuse, N.Y.-based company's securities investments took a hit, leading to a big loss in the fourth quarter of 1994. The bank's stock commenced a two-year slide amidst the century's biggest bull market.

By 1996, Holtzman, the owner of about 200,000 Onbancorp shares, had seen enough and began pressuring the board to seek a buyer for the \$5.5 billion company. When CEO Robert Bennett balked, the investor commenced a nasty proxy fight, complete with estimates that management claimed overstated the bank's sale value and a cartoon showing a group of suit-clad pigs—meant to signify Onbancorp's board—sitting around a long table talking derisively about shareholders.

Apparently, Bennett and his board took the incident personally. They took Holtzman to court, charging the investor with not following proxy rules and disseminating misleading information to shareholders. Holtzman, in turn, countersued. "They maligned and defamed me," he says.

Onbancorp's case was in the discovery stage at this writing, but some would argue that it doesn't matter any more. In late October, Onbancorp agreed to be acquired by First Empire State Corp. in a \$872 million stock-and-cash deal that would create the largest banking company in upstate New York, with assets of \$19.2 billion.

For Holtzman, the announced sale—at about \$69 a share, well

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above his estimates of \$46–\$58 a share that helped spark the lawsuit—amounts to sweet vindication. “I’m thrilled. I’m delighted that the management and board of directors finally took seriously the shareholders’ sentiments and joined up with a larger institution.”

Onbancorp officials declined to talk directly about their ongoing tussles with Holtzman. “That’s the problem,” Bennett lamented in declining an interview request just prior to announcing the sale. “If you’re the one being attacked, you’ve got to keep your mouth shut.... Meantime, the so-called activists say whatever they want.”

But they have vowed to go forward with their suit—even after the acquisition. “Holtzman started this fight,” said one source familiar with the proceedings. “He was incredibly irresponsible, and he made some outrageous allegations.”

Down near the Mississippi Delta, tiny Algiers Bancorp has activist troubles of its own. The \$46 million New Orleans thrift converted from mutual to public ownership in 1996 and has since become a favorite whipping boy for Jerome Davis, one of the industry’s most-feared activist investors.

With a capital-to-asset ratio of more than 20% and low return on equity, Algiers is underperforming the industry by most any measure, recently trading at only about 85% of its book value. Davis, who owns 9.9% of the company’s stock, has kept management’s phone lines and fax machines humming with dispatches urging it to, in his words, “do the right thing” and “implement measures to enhance shareholder value,” including a return-of-capital payment or special dividends. He’s also suggested in no uncertain terms that the thrift consider a sale.

The Greenwich, Conn.-based investor acknowledges that Algiers’ management probably resents his presence but charges that company officials have a “not-so-secret agenda to perpetuate themselves by retaining high capital levels, which make them a less-attractive takeover candidate.

“The steps they need to take are no-brainers, and they have no right to be resentful,” he adds. “They sold their [company] to the public, and now I’m an owner.... The longer they go without doing the right thing, the more reminders they’re going to get.”

Thus far, Algiers’ management has been unmoved. Dennis McClure, the chief operating officer, declined to respond directly, saying only, “We have done what we felt we had to do.” But Algiers lawyer Jerry Heuper called the charges “laughable.”

“Jerry Davis is probably hoping for a quick sale of the company so he can move on to his next investment,” says Heuper, an attorney with the law firm of Elias, Matz, Tiernan & Herrick in Washington, D.C., which represents many banks and thrifts in shareholder disputes. “This is a company that needs to make the best use of its capital, and that’s what the board is doing.”

### Sign of the times

Such acrimonious clashes color the public image of activist investors. Their individual styles may vary—some favor boisterous proxy fights, others passive persuasion—and the initial contacts are

usually couched in friendly, almost charming terms. But the upshot is often the same: boost short-term shareholder gain at any cost, to cash in on the industry’s consolidation fever and sky-high valuations while the getting’s good.

To critics, Davis, Holtzman, and their ilk are little more than vulturistic opportunists—brash, big-money outsiders who descend on banks and thrifts with little regard for history or local markets in search of a quick buck. Supporters (and the activists themselves) counter that they help boost board accountability, bank performance, and the interests of shareholders. Either way, experts agree that they have already helped to change the industry and are here to stay.

“However one defines them and whatever their methods, the outcome is the same,” UBS Securities analyst Thomas Hanley wrote in an October report. “As more tough-minded investors become increasingly involved in the... bank stocks they own, we think consolidation will continue with even greater force.”

So for a board struggling to come up with a workable growth strategy for a fledgling financial institution, the arrival of an activist shareholder can pose a very real threat.

As the aforementioned battles illustrate, the debates and struggles over control that often ensue the first time an activist shareholder bumps heads with management often get personal. They can take on a nasty, embarrassing tone for management and directors, who find their positions as leaders in the local business community suddenly under attack from an outsider. Such pressure can force directors to drastically alter course—or even sell.

Today, literally dozens of small banks and thrifts are fending off outside investors. But larger institutions are not immune. Indeed, one of the largest deals in industry history—the merger of Chase Manhattan Corp. and Chemical Banking Corp.—was reportedly sparked by pressure from activist Michael Price. So, too, was the 1995 sale of Michigan National Corp. to National Australia Bank.

If even the giants can fall prey to activist pressure and sell out, it’s little wonder that many bankers respond with fear and anger when such investors take a stake in their companies. Indeed, that activist investors are some sort of nasty plague on the industry has become an article of faith among bank managers and their advisers.

“If we ran into a bad market, 75% of the activists would be gone,” said Timothy Lavelle, a managing director at Trident Securities, a Raleigh, N.C. firm that helps thrifts convert to public ownership. “If there’s easy money to be made, they’ll throw money [at a stock] without reading the prospectus, [but] when you need them, they’re not there.”

### Profiteer veneer

But are they always as bad as the portrayals suggest? Not necessarily. Jim Long, executive vice president of D.F. King, a New York proxy solicitation firm that has advised both boards and activists in proxy battles, asserts that, overall, activists are good for both shareholders and the industry. “They keep management’s feet to the fire on [shareholder return] issues, and they’ve reaffirmed the idea that the proxy, and therefore the shareholder, means something.”



## STRICTLY BUSINESS

**L**ast May, Cumberland, Md.-based First Financial of Western Maryland was acquired by Keystone Financial Corp. after Seymour Holtzman—owner of an 8% stake in First Financial—helped pressure the board to hire an investment banker and shop the company.

The sale marked the end of a long, sometimes-contentious battle over the company's future, and Pat Coyne, the \$350 million thrift's former CEO, lost his job in the process.

But Coyne says the \$81 million sale price, at 22.6 times trailing earnings, was "a good deal" for First Financial's shareholders and describes the relationship between Holtzman and the board as "very amicable and businesslike. We differed on

specific business points, but he never pushed for more information than other shareholders received, and he always seemed to be concerned with making the institution better."

Coyne's view may sound odd, given that his board was the original subject of the same pig cartoon that so inflamed Onbancorp's management in 1996.

Holtzman first commissioned the illustration for use in newspaper ads during a heated October 1995 proxy battle at First Financial. At that time he opposed board plans to implement a stock-option plan for the thrift's management and was vying for three board seats. (Holtzman defeated the option plan but didn't win any board seats.)

Coyne recalls relations with Holtzman

as spirited, but says they never degenerated into the kind of acrimony that continues to accompany the Onbancorp fight. And he chuckles when recalling the cartoon.

"It was strictly business," he says. "You can't take it personally. Both you and the activist put your best arguments before the shareholders and let the chips fall where they may.... The important thing was that we both had the same end in mind—boosting shareholder returns. We just had different ideas of how to do it."

"To deal with activist investors properly, you've got to put yourself in their place and consider the investment they have made," Coyne concludes. "If I was [Holtzman], I would have been prompting the board to do something for shareholders, too."

Chris Hargrove, president of Professional Bank Services, a Louisville, Ky. consulting firm, agrees. "They're really not bad people," he says. "But they are probably more aggressive than what your typical financial institution's management is used to seeing."

For their part, most activists concede that making money is a primary goal. But they can also sound downright altruistic in explaining their motives, saying bankers and the media unfairly portray them as greedy, short-term players. Davis calls the money he gains from his investments "a way of keeping score more than anything else" and even describes his relationship with Algiers' management as "very amicable."

"I enjoy being a catalyst for something that everyone can benefit from, and everyone benefits from good management," says Holtzman. "I've gotten this reputation as a very aggressive shareholder, and I don't like it.... I'm a very nice guy. I've got three dogs, and they all wag their tails when I come home at night."

"People don't understand us," adds Jerry Shearer, a general partner of Mid-Atlantic Investors. "They'd like to portray us as ogres. But we aren't ogres. We recognized very early on that the industry was going to have to consolidate to survive... The problem is, most bank managements don't recognize this."

Surprisingly, there's no shortage of bankers who agree with this assessment. Arthur M. Swanson, CEO of ComSouth Bankshares in Columbia, S.C.—a holding company that counts Shearer as an investor—says that the industry's continuing consolidation makes the sale of many small banks inevitable. "These acquisitions would be taking place whether the activists were on the scene or not," he says. "Jerry is just taking advantage of economic forces."

But others assert that activists are opportunists who see big profit potential in trying to accelerate the consolidation timetable. "This is a pretty intelligent group. They're sharp and they know what they're doing," says Holly Clark, an analyst for Scott & Stringfellow. "And they seem to be getting more aggressive."

That may be true. But the fact is, activists often invest for the long haul and usually don't push for a sale until other options have been

exhausted. Shearer, who boasts nearly 35 years of banking industry experience, says Mid-Atlantic operates with a "3-P" philosophy: Patience and persistence leads to profits.... Our critics ignore the fact that once a sale is made, we don't bail out."

Holtzman owns stakes in about 20 banks and thrifts (he plans to retain his shares in First Empire), while Davis is a shareholder in almost 50. Both say they are actively pushing for only a handful to be sold and are passive owners in most cases.

This is what David Perlmutter, an attorney with Perlmutter & Associates in New York who represents Davis, jokingly refers to as his client's "dirty little secret."

"He actually writes a lot of letters of praise to [bankers] because they're doing a good job," Perlmutter says. "But this doesn't get reported. It's only when there's a problem that he gets attention."

For those on the receiving end of such applause, a sort of guarded optimism exists. "So far, our relationship with the activists has been very good," said Paul von Gunten, president of Peoples Financial Corp. in Massillon, Ohio.

When Peoples went public in September 1996, Davis and Jeffrey Halis, another investor with a history of pressuring boards, both filed 13Ds indicating their ownership of sizeable blocks of stock. "We had no idea what they would do," von Gunten recalls. "But we were told by our sources in the industry that they would chew us up and spit us out."

Since the offering, however, Halis has been silent, while Davis has peppered von Gunten with plenty of advice—including suggestions that Peoples look for a buyer—but few threats. "Jerry is a very, very active shareholder," von Gunten says. "He sends us articles all the time and is constantly hinting at things that he thinks we should be doing."

On September 12, exactly one year after its IPO, Peoples took Davis's advice and announced a \$5 per-share return of capital, giving shareholders a handsome return on their investments. "Here's a thrift that did the right thing. They're listening to their advisers, and I couldn't be more pleased," said Davis, who wrote to von Gunten

expressing his feelings and subsequently reduced his ownership in the thrift.

### See no evil, hear no evil

For all the bluster that can accompany an activist's 13D filing, outside investors often have a difficult time swaying other shareholders—especially when talk of a sale arises. Managers of many smaller banks and thrifts, with boards comprised of local business leaders, have proven adept at convincing local investors to turn a deaf ear to the arguments of outsiders, even if their institutions aren't performing up to snuff.

Whether this is good for shareholders or an institution is debatable. Long believes boards must guard against conflicts of interest. "If a local car dealer does business with the bank, he'd probably love to see it remain independent because it helps his business. So they've got an interest there beyond shareholder value," he says. "There are still a disproportionate number of friends of existing management on many of these [small bank] boards."

One of the great ironies is that, even if a board tries to ignore it, an activist's mere presence as a shareholder can help drive up stock prices and overall performance, benefiting the same management team that claims to feel victimized by activist pressure.

Why? Many activists have such a strong track record of success, that it fuels investor expectations. They also have plenty of advice to offer on the capital management front—a result of experience garnered with their other investments. "Ninety percent of the things they recommend are things [bank managers] should be doing already," consultant Hargrove says.

Davis says that institutions that listen to him, like Peoples Financial, reap rewards for all shareholders. Not everyone, however, is willing to listen to such counsel. And managers who resist may well find themselves on the losing end of a battle for control.

Consider the case of Aiken, S.C.-based Palfed, Inc. For nearly two years, the \$656 million thrift's board battled Shearer over whether to sell out. Last April, Shearer got a majority of shareholders to pass a nonbinding resolution calling for the company to begin soliciting buyers. But the board and management were unimpressed. "It is a myth that selling our bank is the only way to maximize shareholder value," CEO John Troutman declared in May.

Yet in September, Palfed announced its acquisition by Regions Financial Corp. in a \$150.5 million stock deal weighing in at 2.64 times its book value.

Palfed officials did not return calls for this story but have asserted that Shearer's presence had little impact on their decision to sell. But Scott & Stringfellow's Clark, who follows Palfed, says there is little doubt that Mid-Atlantic, owner of 9.9% of the company's outstanding shares, prompted the sale.

Management has "been saying that they won't sell. But if a fair offer is made, the board has the fiduciary responsibility to consider it," she says. "They have to keep shareholders' interests in mind."

For his part, Shearer is pleased that Palfed finally appears to have come around to his way of thinking, noting that the stock price jumped nearly 30% following the announcement. "All I want is what's best for shareholders," he says.

That activists apparently could force Palfed's board into a sale is just the sort of thing that sets many bankers on edge. While most activists appear innocuous enough when they first take their stake, Heuper says that the threat of aggressive action if they don't get their way always hovers just over the horizon.

"It doesn't matter if they're abrasive or the sweetest people under the sun," says Greg Madding, an investment banking partner at Van

Kasper & Co. in San Francisco. "If you're management and your bank is under attack from one of these guys, you're going to look at him with disdain."

### Positive course of action

If you're a director intent on keeping activists at bay, experts say you need a solid, comprehensive game plan in place to boost performance and shareholder returns.

Activists don't make their investments haphazardly. Rather, they look for opportunities to improve an institution—or at least the shareholders' position in it. And with big institutional investors increasingly snapping up stakes in even tiny banks, the activists' sermons are more likely than ever to find sympathetic ears.

Lack of a strong business strategy or niche can attract attention. So can poor operating performance. When Stephen Gordon was running the now-defunct Genesis Financial Partners, for instance, he looked at return on equity, efficiency ratios, and inside stock ownership when making his selections.

In this light, if an activist is able to garner support for a sale or another tact that goes against the board's wishes, it may be the directors' own fault. "If you throw a party and nobody shows, it wasn't a very good party," Madding says. "Institutional shareholders... are going to listen to an activist if his ideas will improve the returns."

Hargrove has compiled a list of steps that boards should take to remain independent and avoid activist attention. Earnings per share should climb by at least 10% a year, he says, while return on equity targets should be set above 13%. Dividends should be maintained, if not increased, on a regular basis.

Many directors of smaller banks, Hargrove notes, think that shareholders don't like dividend payments because they are taxable. "But if you survey your shareholder base, 100% of the time the No. 1 thing they want is to see if dividends increased," he says, adding that dividends provide investors a tangible reward and "are an excellent method of shareholder communication."

To achieve this kind of growth requires strong operating strategies and good capital management. If needed, return-of-capital payments should be used to reduce equity levels. And Hargrove believes that banks and thrifts must work especially hard to boost net interest margins by growing core deposits at least 7% a year and stretching loan-to-deposit ratios to their limits.

As many CEOs can attest, however, such steps are easier said than done. As banks and thrifts continue to lose deposits to mutual funds and brokerage houses, it impedes their ability to clear these hurdles. But if you want to remain independent, experts argue, it must be done. "It's all tied together," Hargrove says. "You have to grow earnings and ROE, and in order to do that, you have to increase your loans and deposits. It's a circle."

Other key factors include maintaining stock liquidity—an especially big problem for community banks with a handful of big shareholders—and good relations between the board and management.

If these goals are achieved, activists will likely leave you alone. If not, then the institution will be vulnerable. "It's all about beating the market," Hargrove says. "If you can't provide an equal or better return than an acquirer, then an activist will be successful at convincing shareholders to trade your stock for someone else's."

If an activist does come on board, the best strategy may be simple communication and cooperation, keeping a steady eye on the needs of shareholders—even if it results in a sale. "The worst thing you can do is to put your head in a hole and hope they go away, because that's not going to happen," Hargrove says. ■■■■