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Dear Banker,

In Virginia, and nationwide, new banks are more meaningful than ever as the total number of banks has decreased dramatically and most of the historic local leaders have been replaced by large out-of-area banks. As a result, new banks are increasingly the local banking alternative to the giant banks.

This enhanced role has been accompanied by capital being raised in amounts that were previously unimaginable and sale prices that are eye-catching to say the least. Initial capital raised by new banks is routinely now in excess of \$10 million, and they are frequently back for more within a year or two. When it comes time to sell, many of these banks are getting prices in excess of three times book.

This report written by Arnold Danielson talks about the new banks in Virginia and puts them in a historical perspective. As the report shows, the new bank "craze" of today is not all that new with the openings in the 1990s being down from the previous three decades, but with less mid-sized, local competition and extensive capital, today's new banks are not taking as long to make their presence felt.

Respectfully yours,



David G. Danielson
President



November 23, 2005

Virginia Banking Report

New Banks: More Meaningful Than Ever

By:
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For more than twenty years I have been writing banking reports about the changes in the state and regional banking structures. Usually the reports have been about the spread of interstate banking, the disappearance of local banks and, for a time in the early 1990s, the battle for survival of banks and thrifts in a difficult economy. These reports almost wrote themselves each year up through 2000 as the disappearance of local banking leaders had a major impact on the local banking structure. Since 2000, BB&T has added some spice to the story by acquiring F&M National and First Virginia. In so doing, it turned a regional “big three” into a “big four”, but chronicling the battle at the top between a big four of Bank of America, Wachovia, SunTrust and BB&T is not that exciting, and probably of little interest to most readers.

So what are the interesting stories in Virginia banking? A couple of candidates are the arrival of Commerce with its seven-days-a-week banking and waiting for either BB&T or SunTrust to sell. The Commerce story, though, will take time to develop, and its immediate impact is limited to Northern Virginia. As to the eventual sales of BB&T and SunTrust, it could be tomorrow, but at least one of them is likely to be around for the next five years. Thus, the most interesting local banking story has become the rising importance of new banks, particularly in Virginia.

This is hardly a new story as bank openings and sales were much more common in the 1960s, 1970s and 1980s than in the last fifteen years, but what is different today is the amount of money involved. Since 2004, the eight new banks in Maryland, the District of Columbia and Northern Virginia have raised about \$110 million. One bank alone open less than ten years has gone back to the market to bring in more than \$100 million in new capital, and another more than \$50 million. On the sales end, Community Bank of Northern Virginia, which was opened in 1983, was sold this year for \$211 million – about one-third of the Riggs sale price – and 343% of book. In 2003, the Virginia Beach-based Resource Bank that opened in 1989 was sold for \$195 million, which was 336% of book. These are attention-getting numbers.

Today, banks opened since 1995 represent 36% of all Virginia-based banks and are more than half the total in the highly-urbanized portions of the state. The growing importance of new banks is a national phenomenon in growth states with similar percentages of new banks in neighboring North Carolina and Maryland.

There also is lot more to the new bank story than how many have started and the sale prices they have received. Two of Virginia's four largest banks, TowneBank and Cardinal Financial, have each been open less than eight years, and the seventh largest, Virginia Commerce, opened in 1988. TowneBank already is number one in market capital and Virginia Commerce number three. Five other Virginia new banks – Alliance; Premier Community, the holding company formed in the equal merger of Marathon and Rockingham Heritage; Highlands Union; James Monroe and New Peoples – also are represented among the twenty largest banks in Virginia.

A couple of years from now, it is possible, and some might say more-than-likely, that the internal momentum of TowneBank and an acquisition by Cardinal could make them the biggest banks in the state. As for Virginia Commerce, it seems well on its way to being number two in market capital and in the top five in assets. Some of the other five in the top twenty should find their way into the top ten.

Leading Virginia Banks

	<u>Net Assets*</u> (in millions)	<u>Market Value**</u>	<u>Net Income***</u> (in thous.)	<u>Year Opened</u>
1. First Community	\$1,988	\$375	\$25,162	1920
2. Union Bancshares	1,791	404	22,245	1902
3. TowneBank	1,765	489	16,350	1999
4. Cardinal Financial	1,540	257	8,621	1998
5. Virginia Financial	1,505	278	17,275	1900
6. FNB Corporation	1,458	212	16,546	1905
7. Virginia Commerce	1,449	404	17,981	1988
8. Burke & Herbert	1,371	393	22,068	1852

*September 30, 2005.

**November 11, 2005.

***Twelve months ended September 30, 2005.

Source: SNL Financial, Charlottesville, Virginia

This rapid rise of new banks in the rankings also has created a new economic dynamic – new banks being the primary buyer of other new banks. In 2003, TowneBank bought Harbor Bank for \$81 million, and in 2000, just three years after opening, Cardinal bought a struggling Heritage Bank. The buying continued in 2005, but rather than TowneBank or Cardinal doing the buying, Millennium Bank in Northern Virginia acquired Albemarle First of Charlottesville for \$27 million.

Historical Perspective-National

New banks have long been an important part of the American banking scene replacing tired banks that were sold, with more energetic entities that usually were more in-tune with the banking needs of the time. In the 1960s and 1970s, more banks were opened than were sold nationwide, and, as a result, the number of banks in the country increased by more than 1,000 in these years – although many of the new banks in those years were opened by holding companies taking advantage of new state laws that let them open separately chartered banks across county lines, but not branches. Virginia

along with Texas and Florida led the way in holding company inspired new bank activity.

It was in the 1980s, though, that bank openings hit an all-time peak with 2,700 new banks, and, except in Texas, these were legitimate new banks – not holding company expansion. That decade also set a new high for mergers at 4,271, and, as a result, despite the accelerated opening of banks, the total number of banks fell by more 1,600.

Change in the Number of Banks, 1950 to 2002

	<u>New Charters</u>	<u>Conversions</u>	<u>Mergers</u>	<u>No. of Institutions*</u>
2000-02	412	51	1,110	7,887
1990-99	1,315	284	5,413	8,581
1980-89	2,700	205	4,271	12,715
1970-79	2,224	58	1,366	14,364
1960-69	1,552	236	1,391	13,473
1950-59	763	385	1,429	13,114

Note: Does not include failures and FDIC classification of “other”.

*End of period.

Source: FDIC: Historical Statistics on Banking.

The 1990s seemed like a continuation of the 1980s relative to bank openings, but nationally there was a fairly steep drop in such activity. The number of new charters fell from 2,700 in the 1980s to 1,315 in the 1990s – a drop of more than 50%. Much of the slippage, though, was the result of a bad banking environment that existed from 1990 to 1993 that dampened the interest in new banks until the late 1990s. From the start of 1997 through 1999, there were 614 banks opened across the country, and if these openings were extrapolated across a full decade, this would have been more than 2,000 new banks.

This relatively small number of openings in the 1990s received more attention than their numbers may have merited partly because of the decline in the overall number of banks. Bank openings were halved relative to the

previous decade, but the number of banks exiting by mergers increased by more than 1,000. There were 5,413 banks sold in the 1990s, which, even with more than 1,300 new banks opening and 284 thrifts converting to bank charters, reduced the total number of banks from 12,715 in 1989, to 8,581 at the end of 1999. This increased the importance of most new banks in their home markets.

The FDIC data on new charters and mergers only goes up to 2002, but the pattern of bank openings in the first three years of the new millennium was similar to the late 1990s. Bank sales also were still running ahead of bank openings by an almost three-to-one margin, but if the first three years are an indication of the entire decade, then there will be another 1,300 banks opened. It does not take a mathematical genius to see the rising importance of new banks as the banking alternative to the large out-of-region banks that now account for more than 60% of the regional deposit base – a percentage that is almost 70% and rising in the Washington area.

Historical Perspective-Virginia

The new bank activity in Virginia has generally reflected the national trend since 1980, but the fall-off since the 1980s has not been as dramatic. There were 40 banks opened in the state from 1980 through 1989, and the 33 in the 1990s was only seven less. A dozen banks have opened in Virginia in the first six years of the new millennium, and it seems likely that the total for the decade may be down sharply from the 1990s; but the total number of openings should still be close to 20.

Most of the new banks in Virginia, as elsewhere, open in urban areas, particularly the faster growing suburbs of the largest cities. Of the 85 new banks in Virginia since 1980, 72 were in the state's six major metropolitan areas. This includes all but one that opened since 2000.

While new banks are part of the regenerative process within the banking system, most are sold within twenty years – and often much sooner. Of the 40 banks opened in the 1980, only nine are still around. Those opened in the urban areas had an even greater propensity to sell with just five of the 33 banks opened in the 1980s remaining.

Virginia Banks – New and Existing

	<u>Banks Opened</u>		<u>Existing Banks</u>	
	<u>Total</u>	<u>Urban*</u>	<u>Total</u>	<u>Urban*</u>
2000-05	12	11	12	11
1990-99	33	28	25	20
1980-89	40	33	9	5
1970-79	n/a	n/a	13	5
1940-69	n/a	n/a	4	-
1900-39	n/a	n/a	31	12
1800's	<u>n/a</u>	<u>n/a</u>	<u>9</u>	<u>4</u>
	85	72	103	57

*Northern Virginia, Hampton Roads and the Charlottesville, Lynchburg, Richmond and Roanoke metropolitan areas.

Source: Various sources.

The 1990s' new Virginia banks have shown a lot of staying power with only eight of the thirty-three opened during this period having disappeared. This, though, is a timing issue as all five of the Virginia banks opened first half of the decade have been sold. If history is any guide, most of the banks opened in the latter part of the decade will be sold prior to 2010.

Rising Cost of Entry

What makes the new banks of today so different from those of the past is the amount of initial capital raised – and the pressure this puts on these new banks to produce. In the 1960s, a new bank could open with capital of \$1 to \$1.5 million, and some started with even less. The cost edged up in the 1970s, but only slightly to \$1.5 to \$2 million, and even in the early 1980s the initial capital needed was less than \$3 million. This was a lot of money in those days, but far below the \$10 million plus that is commonplace today.

By the late 1990s, \$7 to \$10 million had become the norm for starting capital, but this was only the norm. For TowneBank, norms did not apply as it opened in 1999 with more than \$37 million. Bank of Richmond also was well above the median with \$14 million from initial investors.

Virginia New Bank Starting Capital

2001-05	\$10 to \$13 million
1996-00	\$7 to \$10 million
1984-95	\$4 to \$6 million
1980-83	\$2 to \$3 million
1970-79	\$1.5 to \$2 million
1960-69	\$1 to \$1.5 million

Source: Various sources.

After 2000, the normal starting capital for new banks was up only modestly to the \$10 to \$13 million range, but there was one big exception and a flood of secondary offerings by banks less than five years old that were as big, or bigger, than the initial investment. The exception was SonaBank in Charlottesville that opened with more than \$33 million in capital. The king of secondary offerings was Cardinal, which raised more than \$100 million in new capital from 2002 to 2005. TowneBank, during this same period, added another \$56 million, Millennium raised \$40 million, Alliance \$32 million and Access National \$18 million.

Why this rapid rise in the initial capital of new banks reaching levels that would have been hard to imagine only a few years ago and secondary offerings that often made initial offerings look modest? Inflation caused most of the increase in the 1970s and 1980s, but certainly not in the most recent years. Some of the recent rise came via regulatory requirements and a willingness of new banks to accept much larger early losses than in the past, but that is only part of the story since regulators usually only require a new bank to have about \$8 million in starting capital.

What triggered the higher capital investment in new banks since 2000 was a booming real estate market that facilitated rapid new bank growth, and sale prices that created investor returns that were not matched in many other sectors. The trend toward increasingly large cash components in sale prices also made more money available for the next investment. Investors who have been successful investing in new banks tend to recycle their money into the next new bank.

New Bank Sale Prices

In 2003, Resource Bank broke new ground for new banks in Virginia with a sale price of almost \$200 million, and in 2005, Community Bank of Northern Virginia broke the \$200 million barrier when it was purchased by Mercantile for \$211 million. For both banks the price was in the 340% of book range. Across the river in Maryland in 2005, Columbia, a bank opened the same year as Resource, was sold for \$311 million. These records, though, are just waiting to be smashed as TowneBank and Virginia Commerce already have market values of over \$400 million without a sales premium.

Virginia New Bank Sales

<u>Buyer/Seller</u>	<u>Deal Value</u> (in mill.)	<u>Price/</u>		<u>Year Annc'd</u>	<u>Year Opened</u>
		<u>Times Earnings</u>	<u>Percent of Book</u>		
Union/Prosperity	\$36	24.5X	336%	2005	1986
American Nat'l./Comm. First	33	30.0	211	2005	1999
Millennium/Albemarle First	27	-	236	2005	1998
Mercantile/Comm. Bk.-N. Va.	211	23.0	343	2005	1983
Argentum/Smith River	7	-	152	2005	2000
TowneBank/Harbor	81	40.7	327	2003	1996
Fulton/Resource	195	18.2	336	2003	1988
First Comm./Commonwealth	25	28.2	214	2003	1986
First Bancorp/First Common.	10	22.2	155	2002	1983
MountainBank/Comm. Nat'l.	14	22.1	169	2002	1994
Southern Fin./Metro-County	17	-	201	2002	1997
SouthTrust/Bank of Tidewater	69	20.3	317	2001	1985
Cardinal/Heritage	14	-	160	2000	1987
Southern Fin./Horizon	22	36.3	233	1999	1990
MainStreet/Bank of N. Va.	20	23.9	264	1998	1988

Source: SNL Financial, Charlottesville, Virginia.

The size of the sales price does not tell the whole story as some of the gain by the initial investors was diluted by the raising of additional capital. This additional capital, though, was needed to grow the bank to a size that

justifies those prices. Harbor Bank's sale to TowneBank in its sixth full year of operation for \$81 million and 327% of book may have been a better deal for investors when time value is considered.

It is not all easy money, however, for new bank investors. Cardinal's original investors absorbed \$24 million in losses before new management and new capital turned it around. Heritage Bank opened a year before Resource and Columbia, but was sold in 2000 for just \$14 million. These were not the only disappointments, but they also were the exceptions. Four new banks that were represented by Danielson Associates in the last three years in the Middle Atlantic states had returns that were at least five times the original investment.

What Does the Future Hold for New Banks?

New banks will continue to sprout up as long as capital is readily available. There is no shortage of bankers that would like to run their own show if someone gives them the financial backing, and there is a real demand for banks that understand local commercial real estate markets and small business lending. As for capital availability, it will be there as long as banks are being sold for prices upward of 20 times earnings, and probably for a couple of years after pricing multiples fall as bank investors are usually slow to recognize, or even believe, there has been a downturn in sale values. Bank sale prices appear to have peaked in late 2003 and 2004, but they are holding at, or near, this level in 2005.

Since bank sale prices tend to move in tandem with bank stock prices, there should not be a big drop in sale values until economic conditions bring bank earnings and stock prices down. These are events that normally reflect rising interest rates and/or a depressed economy. Today's rising interest rate environment has done some damage to bank stock prices, but whether this impacts new bank start-ups depends on just how high interest rates go and how it affects loan demand, particularly in the real estate area.

Banks Opened in Virginia Since 1980*

	<u>Opened</u>	2005 <u>Assets**</u> (in millions)
<u>1981</u>		
Business Bank, Vienna	10/81	\$195
Citizens Bank of Tazewell	2/81	Sold
Dickenson-Buchanan Bank, Haysi	4/81	Sold
<u>1982</u>		
Miners Exchange Bank, Coeburn	7/82	\$71
Bank of Alexandria	7/82	Sold
<u>1983</u>		
First Commonwealth Bank, Wise	9/83	Sold
Community Bank of Northern Virginia, Sterling	10/83	Sold
<u>1984</u>		
Sailors & Merchants Bank & Trust, Vienna	8/84	Failed
<u>1985</u>		
Highlands Union Bank, Abingdon	4/85	\$580
South Boston Bank (Community National)	10/85	247
Peoples Bank of Chesterfield	1/85	Sold
Hallmark Bank & Trust, Springfield	2/85	Sold
Bank of Tidewater, Virginia Beach	7/85	Sold
Fairfax Bank & Trust, Fairfax City	7/85	Sold
Princess Anne Commercial Bank, Virginia Beach	8/85	Sold
Bank 2000, Reston	10/85	Sold
<u>1986</u>		
Community Trust, Petersburg	1/86	Sold
Commerce Bank, Richmond	4/86	Sold
Commonwealth Bank, Richmond	4/86	Sold
Security Bank, Manassas	7/86	Sold
County Bank of Chesterfield, Midlothian	9/86	Sold
Prosperity Bank & Trust, Springfield	10/86	Sold

Banks Opened in Virginia Since 1980 (Cont'd.)*

	<u>Opened</u>	2005 <u>Assets**</u> (in millions)
<u>1987</u>		
Bank of Hampton Roads, Chesapeake	12/87	\$386
Coastal Virginia Bank, Virginia Beach	4/87	Sold
Regency Bank, Richmond	6/87	Sold
Heritage Bank, McLean	8/87	Sold
BankFirst, McLean	12/87	Sold
<u>1988</u>		
Virginia Commerce Bank, Arlington	5/88	\$1,393
Marathon Bank, Winchester (Premier Comm.)	12/88	380
Bank of Loudon	4/88	Sold
Hanover Bank, Mechanicsville	4/88	Sold
Peoples Bank of Virginia Beach	4/88	Sold
Virginia Heartland Bank, Fredericksburg	6/88	Sold
Resource Bank, Virginia Beach	9/88	Sold
Bank of Northern Virginia, Ballston	10/88	Sold
Bank of the Potomac, Herndon	10/88	Sold
First Security Bank, Roanoke	11/88	Failed
<u>1989</u>		
George Washington Bank, Alexandria	5/89	Sold
Peninsula Trust, Gloucester	7/89	Sold
New Atlantic Bank, Norfolk	12/89	Sold
<u>1990</u>		
Patriot National Bank, Reston	4/90	Sold
Horizon Bank, Merrifield	10/90	Sold
Rockingham Heritage Bank, Harrisonburg	11/90	Sold
<u>1991</u>		
Tysons Bank, McLean	7/91	Sold
<u>1994</u>		
Community National Bank, Pulaski	8/94	Sold

Banks Opened in Virginia Since 1980 (Cont'd.)*

	<u>Opened</u>	2005 <u>Assets**</u> (in millions)
<u>1995</u>		
Valley Bank, Roanoke	5/95	\$424
<u>1996</u>		
Patriot Bank, Fredericksburg	7/96	\$259
Mountain National Bank, Galax	7/96	230
Shenandoah National Bank, Staunton	7/96	117
Central National Bank, Lynchburg	7/96	\$112
Harbor Bank, Newport News	7/96	Sold
<u>1997</u>		
First-Citizens Bank, Roanoke	6/97	\$205
Metro-County Bank, Mechanicsville	5/97	Sold
<u>1998</u>		
Cardinal Bank, McLean	6/98	\$1,455
Alliance Bank, Fairfax	11/98	691
James Monroe Bank, Arlington	6/98	526
New Peoples Bank, Honaker	10/98	480
Virginia National Bank, Charlottesville	7/98	283
First National Exchange Bank, Roanoke	5/98	230
Potomac Bank, Fairfax	8/98	211
First Capital Bank, Glen Allen	12/98	180
Albemarle First, Charlottesville	12/98	122
<u>1999</u>		
TowneBank, Portsmouth	4/99	\$1,653
Access National Bank, Chantilly	12/99	475
Millennium Bank, Reston	4/99	414
Monarch Bank, Chesapeake	4/99	265
Bank of the James, Lynchburg	7/99	186
Village Bank, Midlothian	12/99	170

Banks Opened in Virginia Since 1980 (Cont'd.)*

	<u>Opened</u>	2005 <u>Assets**</u> (in millions)
<u>1999 (Cont'd.)</u>		
Bank of Richmond, Richmond	7/99	122
Citizens Community Bank, South Hill	12/99	107
Bank of Williamsburg	2/99	Sold
Shenandoah Valley National, Winchester	5/99	Sold
Community First Bank, Lynchburg	10/99	Sold
<u>2000</u>		
Bank of Powhatan	3/00	\$73
Smith River Community Bank, Martinsville	7/00	Sold
<u>2001</u>		
Freedom Bank, Vienna	7/01	\$55
<u>2002</u>		
Peoples Bank, Richmond	4/02	\$202
Franklin Community Bank, Rocky Mount	9/02	133
<u>2003</u>		
SuffolkFirst Bank	1/03	\$94
Colonial Virginia Bank, Gloucester	11/03	51
Citizens National Bank, Windsor	4/03	27
<u>2004</u>		
MainStreet, Herndon	5/04	\$61
Bank of Virginia, Midlothian	1/04	52
River City Bank, Mechanicsville	7/04	38
<u>2005</u>		
Sonabank, Charlottesville	4/05	\$45

*New bank is defined as a bank opened by an investor group and not an existing bank holding company.

**June 30, 2005.

Source: SNL Financial, Charlottesville, Virginia.