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BANKERS FIND THEIR NICHE

Specialization has come to the lending business, but doing it well requires planning for the worst

BY **STEVEN YODER**

The recession of 2008 and its aftermath reordered the landscape across industries. In banking, the most obvious effect was to tighten the rules on mortgage lending after passage of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

The act created strict new underwriting and capital regulations for federally insured financial institutions. But for community banks, those were big asks, with small banks required to hire new compliance teams, which ate into revenue. For Sacramento-based Five Star Bank, the changes meant getting out of the mortgage business altogether. "We just thought our time is not best spent

here," says president and CEO James Beckwith. "There are other (banks) that do this and can do this a lot better than we can."

Instead, Five Star has focused on specific niches. One is loans to faith-based organizations. In assessing the finances of religious bodies, the bank knows the credit metrics to look for that others might not: the tenure of the leader, how long the organization has been around, whether its membership is growing and whether there's concentration in who gives.

Five Star's move reflects a national trend. In the financial sector, sell-offs of operating units and asset portfolios — an indicator of specialization — almost doubled since 2011, according to a report from Deloitte, an audit, consulting and financial advisory company. Around the country, the loan slices have narrowed to slivers: yachts, medical equipment, septic systems, Amish farms and more. Banks find an industry, product or customer with potential, study it, and sink resources into working with a sector.

For Five Star, that meant loans to finance such things as mobile-home parks, government projects and agriculture — particularly almond orchards, says Beckwith. "We get into these particular markets in which there aren't a lot of players: It's still competitive but not as competitive as for mortgage loans," he says.

But if it's the wave of the future, niche banking also demands that lenders balance their portfolios in a few different ways to limit risk.

When Robert Emerick went to Golden Pacific Bank in 2011 to see about a loan, he didn't have much hope. He'd built a successful engineering business and now dreamed of renovating a Sacramento landmark — the downtown Crest Theatre. By that point, in the wake of the recession, banks were pulling back, and he'd already been rejected by five or six. But he'd heard that Golden Pacific was interested in lending. He recalls telling them, "Hey, look, I've built a company and sold a company. I've never bought a theater before, but this is how it pencils out, and I've got great credit."

The bank approved the loan, and Emerick bought the building. Eight years later, he says there are some months in the summer when the Crest has a booking every day. In 2014, Emerick went back to Golden Pacific for another loan when he wanted to convert the

basement screening rooms to a restaurant. Another bank had turned that idea down, but Golden Pacific said yes, and the Empress Tavern has been running for nearly five years.

Golden Pacific made those loans because it focuses on two areas: small businesses and multifamily apartments, says Malcolm Hotchkiss, executive vice president and chief operating officer. Its maximum loan amount is $2.1 million to a borrower, and Hotchkiss says relatively small offerings like those are a critical market opportunity not being filled by other banks. That's because as banks have consolidated — there are fewer than 5,000 commercial banks today, down from about 14,000 in 1984 — the remaining larger companies want to make big loans to maximize efficiency. That sends many small businesses to online lenders, like peer-to-peer lending platforms, where they end up paying interest rates as high as 21 percent, he says.

And it's not just decent interest rates that come with specialization: When banks know their industry, they can move fast. Beckwith says that a customer considering buying a mobile-home park who's dealing with a nervous seller and needs to close fast can get a loan done in a month because the bank knows the metrics that matter in manufactured housing.

Still, niche areas also mean more risk if a bank has loans too concentrated geographically or by industry. Texas banks in the 1980s went in big on energy, which meant huge profits as oil prices rose. Even when they lent outside the industry, their loans were concentrated in the state. So when oil prices fell after 1981, nine of the 10 largest Texas banks either failed or were bought under distress conditions.

Five Star's loan portfolio is spread across at least 13 niches. Some aren't as vulnerable to sudden downturns — like

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government and health care — while others have a stronger upside when the economy is good — like construction and manufacturing. And Golden Pacific systematically manages geographic risk. In its multifamily lending, for example, the bank divides the state into five economic regions and keeps a balance of lending in all, Hotchkiss says.

Golden Pacific's small-enterprise niche likely will always be in demand. "Our hope is that (our small-business borrowers) will be so successful they'll outgrow us and have to go to a bigger bank," he says. "And then we'll redeploy that capital to another entrepreneur who's growing." C

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