Fixed-Income Focus: Going against the grain

January 12, 2006
By Tim Zawacki

With no shortage of speculation about the potential for a downturn in the residential real estate market, the present would not seem to be the opportune time for a bank holding company to pursue an acquisition of a lender that specializes in financing single-family homebuilders.

But Marquette Financial Cos., which on Jan. 6 announced the purchase of Fredericksburg, Va.-based Silver Construction Capital LLC, is not the typical bank.

Marquette COO Bert Colianni told SNL Financial that the company's ownership structure and strong balance sheet allows it to function in a manner that is somewhat similar to a private equity fund — only with a long-term investment posture and without some of limiting factors characteristic to those vehicles. The Minneapolis-based company is a privately held entity with a dozen operating subsidiaries engaged in a variety of financial pursuits.

"We don't have the limited partners, nor do we have the requirements to cause liquidity events in six or seven years," Colianni said. "A private equity buyer tries to buy somebody in a good financial formula, but they also have to create liquidity. For us, we've got our own private equity fund: we have a very, very strong balance sheet that we're able to use to buy and put companies into portfolio without the need for a firm exit. We're looking to create good, long-term growth and income for our investors."

The company's unique business model can be particularly advantageous as all financial institutions wrestle with the challenges provided by the flat yield curve.

"We have a very strong tangible net worth, so we're able to bring a good level of capitalization to our businesses and not have the exposure that an over-leveraged operation would have," Colianni said. "Secondly, we're able to take advantage of a strong national bank and the funding opportunity that offers for our operating subsidiaries."

With units like Silver Construction Capital offering loans that remain on the books for a duration of only six to nine months, on average, Marquette is able to avoid borrowing short and lending long.

"Obviously, we are benefited when the yield curve is a little steeper, but we feel we can make a fair return even in this cycle," Colianni said. "We're able to manage our liabilities through both the maturities of our liabilities along with the use of swaps, et cetera, to be able to pretty well match the liability side and lock in a spread that we think we can take advantage of."

Interest rate trends notwithstanding, the Silver Construction Capital acquisition was largely strategic in nature as Marquette looks to expand its successful residential construction finance business beyond existing operations in the Minneapolis area, Southern California and the Phoenix area.

"They've built a really super business. They've got a great management team and they've had very good financial success," Colianni said. Also included in the deal was Silver Title Co., a title insurance agency affiliated with Silver Construction Capital.

The lender, founded in 1999, targets independent, local homebuilders through three Virginia offices, and it has loans outstanding of $266.9 million. Two of Silver Construction Capital's three offices are situated in areas that are located in rapidly growing "exurbs" of Washington, D.C. — Winchester, Va., and Fredericksburg. The sustainability of the housing market around the nation's capitol factored into Marquette's decision to do the deal, Colianni said.

"We really like the Virginia market," he said. "Virginia seems to have a really stable employment base and, over a long period of time, a really solid underpinning of demand for residential construction finance. We just saw it as an area that we hope is less susceptible to cyclical economic swings than other areas of the country."

Colianni said that characteristics of Marquette's customer base in the construction finance business varies by market, with Silver Construction Capital bringing what he described as "a nice blend" of single-family, small multifamily, urban and exurban projects. The company has also financed some rehabilitation work. And, importantly, asset quality is strong.

Marquette is cognizant of the potential for a pullback in new construction and an increase in the time it takes builders to sell newly completed homes. But Colianni said that the outlook for the real estate cycle in specific regions is only one factor that the company is considering as it continues to expand in residential construction finance. Among the markets in which Marquette and its subsidiaries currently operate in that business, the Phoenix-Mesa-Scottsdale MSA saw the nation's highest rate of home-price appreciation through the third quarter of 2005 on a year-over-year basis, according to the Office of Federal Housing Enterprise Oversight. The Minneapolis-St. Paul-Bloomington MSA ranked No. 145 out of the 265 markets measured.

"I don't think we bought [Silver Construction Capital] as an offset to what we perceived as existing risk as much as a more strategic desire to expand our footprint," Colianni said. "But it does diversify the risk characteristics of our builder finance portfolio in a way that is pretty positive. … We've done a fair amount of research around the long-term demand for housing, and we believe that in the style of lending that we do — over a long investment horizon — this is going to be very good. It made sense for us."

With its unique platform, Marquette is no stranger to M&A, having closed seven acquisitions between 2003 and 2005.

Deals range from Arizona's Valley Bancorp Inc. in July 2003 to an asset-backed loan portfolio from Regions Financial Corp. unit Capital Factors Inc. in February 2005. In August 2005, the company acquired California residential construction lender Contractors Financial Services Inc.

Colianni describes Marquette as a cash buyer, though deal values have not been disclosed in five of the company's last seven deals, including the Silver Construction Capital transaction.

"We do have to convince ourselves that whatever price we pay that there's going to be an appropriate cash return on our investment," Colianni said.

During the integration process, Marquette typically brings the acquired business online with its risk-management software, begins to share certain back-office functions and provides attractive funding costs through unit Meridian Bank NA. In Silver Construction Capital's case, Colianni said, "they're able to take advantage of a lot of services that, frankly, a company their size wouldn't be able to buy or access at the same level of sophistication."

All the while, Marquette's strategy allows acquired management teams to maintain "a strong sense of local involvement and ownership: they're accountable for their P&L, they set their one- and five-year plans, and they get rewarded accordingly," he said.

Colianni would not rule out the potential for additional acquisitions of finance companies and/or portfolios in business platforms Marquette is seeking to grow. The company has also launched lending operations in various business lines and markets on a de novo basis.

"We want to acquire or start businesses that are built around great management teams," Colianni said. "Our appetite is really driven by how well [a target] fits with us strategically."

And, by all accounts, Silver Construction Capital seems to be an ideal match. *i*

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