Bauerle's Bank Notes

Key to the Kingdom

September 8, 2014

Former New York City Mayor Rudy Giuliani, visiting Pittsburgh Friday, opined that greater exports of American shale gas from Appalachia could strengthen Western Europe's hand against Russian territorial ambitions by reducing European NATO members' dependence on imported Russian natural gas. A colleague who is particularly knowledgeable about the Syrian conflict, and who just returned from a six week visit to China, observed China will never let Bashar al-Assad lose the civil war because China's economy depends on Syria's oil production.

If those remarks seem unconnected, one only need remember how nations have fought over Middle East oil concessions since 1908, when British Petroleum brought in the first successful well in present day Iran. BP and its American rivals battled through the 1920's to carve up Middle East oil claims they won by defeating Germany and the Ottoman Empire in the Great War. Arab leaders in the 1930's sought alliance with Hitler's resurgent Germany as a counterweight to Western domination. Hitler's ethnic animus got the better of him though and he spurned the Arabs. Instead, in Operation Edelweiss, he pursued capturing oil in the Caucasus, diverting troops that were needed elsewhere if victory was to be had against the Soviet Union in Operation Barbarossa. Seventy-two years later, oil and gas remain resources that engender armed conflict and whose control confers wealth and power.

Present day estimates place the economic value of shale gas development in the Appalachian Basin at $1 trillion. The scale of the opportunity, and its full impact on the region, are difficult to imagine. The same was true in the Middle East originally. The Mellons' first Middle East oil concession, the 1927 purchase of all the oil in Bahrain, cost just $250,000.[i] Britain controlled neighboring Kuwait and subscribed to the prevailing view among petroleum geologists that Kuwait was devoid of oil. "The Americans are welcome to what they can find there," said the chairman of BP. When Bahrain became a gusher, the Brits reversed course and claimed Kuwait. Negotiations between the two countries led to a 50/50 split of Kuwait oil between BP and Gulf Oil. As Ambassador to Great Britain, Andrew Mellon conveniently represented both the U.S. and his family oil company.

Today in Ohio, Pennsylvania and West Virginia, advance royalty payments are plumping household balance sheets of farmers, merchants and others. The gathering shale gas boom is good news, mostly, for banks and bankers. The challenge is to capitalize on the opportunity in ways that confer lasting benefit, socially as well as economically. A century ago, New Yorkers mocked those they derisively called "Pittsburgh Millionaires," whose sudden wealth New Yorkers believed could not obscure a lack of culture, good taste and manners. Likely, the unkind view reflected a tinge of envy. In spite of their self-indulgence, the robber barons funded hospitals, schools and charitable foundations that have seen their native communities through the economic hardship of closed mines and mills.

The next wave of natural resource-fueled American economic expansion will be more broad-based. Stakeholders come from around the world, as evidenced by the businessmen sitting next to me recently at breakfast in Marietta, Ohio, who conversed in French. The economic benefits are therefore also likely to be more diffuse. Harnessing them will require greater thought and more disciplined execution. Below we offer a few suggestions toward that end.

1. <u>A Superior Plan Begins With Superior Intelligence</u>. The Mellons' success in Kuwait flowed from Gulf Oil's having superior geological information. Our partner, Paul Gitnik, will be our featured speaker, Wednesday, September 17, at the Black & Gold Financial Team program. He will demonstrate his ShaleGasUSA software, which enables users to learn details of every oil and gas lease in the region. His application is a powerful tool. Users can identify who has leased property, compare royalty and production rates, and resulting cash flows, map patterns of activity that will shape infrastructure development, and perform many other analyses that offer insight into the developing $1 trillion economy in shale gas in this region. If you have not registered yet for the program, please do so, referencing the attached invitation.

2. <u>Different Strokes . . .</u> Banks' plans to capitalize on the shale gas boom need to be built on their individual strengths. Community banks have strong customer relationships in the locales where they operate; but their trust businesses are seldom profitable because they cannot attain the necessary economies of scale. Many of them should therefore "buy" rather than "build" the investment management capabilities needed to serve customers who have newfound wealth that needs to be managed. Acquiring those capabilities can take many forms. One of the most promising, in our view, is building business partnerships with larger institutions that have strong track records in money management, but cannot economically access local customers. For them, community banks represent a sensible distribution channel, for which they should be willing to pay generously. In other words, correspondent banking has a new purpose in the shale gas economy.

3. <u>Strength in Numbers</u>. Bank mergers in this region of late have been few. Those that have occurred have been premised on cost cutting one's way to prosperity. The premise is false in our view. The shale gas boom offers a viable alternative. New

demand for all sorts of economic activity will give banks a healthy reason to grow and combine in ways that enable them to serve companies that themselves are growing to meet new needs. By its very nature, shale gas development requires heavy capital investment. Banking houses that have the balance sheet heft to provide the debt portion of that requirement are a must. JP Morgan is the nation's largest bank and the one with the greatest volume of business in the Appalachian shale play. There will be plenty of room, however, for regional entrants that meet needs Morgan and its kind are too big to serve.

4. Community Benefits. The 2013 Annual Report for Johnstown, Pennsylvania-based Ameriserv Financial makes a point that is often lost in today's Internet-centric economy. Banks need their communities and communities need their banks. Rapidly industrializing communities built hospitals because industrial accidents were commonplace. In 1913, 300 of every 1,000 coal miners died on the job each year.[ii] The injured and maimed required treatment and rehabilitation. Houses of worship were built using structural steel and stone facing (instead of stone, load-bearing walls), employing techniques pioneered in commercial office buildings. Public schools served twin objectives of educating future workers and socializing children of immigrants to American cultural norms. Hospitals, houses of worship and schools all needed to be financed, have their funds safeguarded and managed, and their employees' financial needs met by banks. So it is today and will be tomorrow.

A public school I attended had carved in stone over its entrance, "New Occasions Teach New Duties." Shale gas-prompted developments offer opportunities and challenges aplenty for us in the coming years. Please plan to join us September 17 to hear Paul Gitnik's presentation, "Key to the Kingdom: ShaleEnergyUSA.com Database as a Business Development Resource." The program will be engaging, informative and offers you an important tool to use to build your business.

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[i] For a brief, informative history of the Mellons' association with Middle East oil exploration, see http://old.post-gazette.com/businessnews/20030316mideast2.asp.
[ii] E. Perry and K. Smith, The Guilded Age & Progressive Era: A Student Companion (2003).

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