Capitalizing on the Banking Industry

An In-depth Look Into Bank Capital and Strategies for the Future

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As we do so, the recurring theme is that “we haven’t been here before.” Per the FDIC “Failed Bank List,” there were 25 bank failures in 2008, with 15 failures occurring in the last 120 days of the year. Only three banks failed in the three years prior to 2008. On September 25, 2008, Washington Mutual became the largest failure in U.S. history with $307 billion in assets. WaMu’s failure dwarfed the previous record set ignominiously by Continental Illinois in 1984 at a mere $40 billion in assets. And that’s just a start. Fannie Mae and Freddie Mac effectively became wards of the state, the world’s largest insurer AIG was nationalized, and Lehman Brothers was allowed to go bankrupt – all in a nine-day period.

It would be misguided to blame the banking industry for the recession in which the U.S. economy is currently mired. The headwinds that face the banking industry are clearly due to other factors, which will be addressed throughout this article.

The Elephant That Whimpered

The condition of the housing industry plays an important role in determining the health of the rest of the economy. About 70 percent of U.S. houses are occupied by their owners. While that number has been fairly stable over a generation, the size of house, cost of house, and mortgage debt load on the typical family’s budget have increased.

Demand for larger houses, and a willingness of non-bank investors to purchase securities backed by questionable credits that were based on skyrocketing housing values, created the well-documented bubble that began deflating in late 2005. Chart 1 displays year-over-year changes in median home prices.

As housing values declined, refinance and sale opportunities shriveled. Coincidentally, many billions of dollars of mortgages began resetting above their initial teaser rates during the same time period. As a result, the level of delinquencies and foreclosures increased at a pace not seen in a generation. By December 2008, the percentage of all residential loans that were delinquent or in foreclosure was a tidy 9.94%. Payments on one-third of subprime loans were also late, to some degree.
Collateral Damage
Anyone with exposure to this situation has been compromised. This includes Fannie Mae and Freddie Mac, who are the largest investors of mortgage-related assets in the world. Even though the majority of these organizations’ assets were conforming, performing single-family loans, there was enough nuclear junk on their balance sheets to create liquidity issues, which led to investor confidence problems, and finally resulted in a government bailout.

It may be years before Fannie and Freddie are cast off on their own. The U. S. Treasury’s near assumption of these prodigal twins’ debt has for the time being maintained some liquidity in their bonds. However, the common and preferred shareholders were not so lucky.

The underpinnings of the slide in overall bank valuations began, then, with the irrational run-up in housing prices. This next chapter will examine the performance of the community banking industry since the year 2000.

The Great Community Bank Bull Market
Following the bursting of the dot.com bubble in the early part of the decade and through the end of 2006, bank stocks experienced an unprecedented level of price appreciation as investors flocked to the sector drawn by companies with transparent operations, positive earnings growth, and attractive valuation levels. From the beginning of 2000 until the end of 2006, the NASDAQ Bank Index more than doubled, increasing by approximately 102%, compared to a decrease of approximately 3% for the S&P 500 Index over the same timeframe. Healthy bottom line earnings momentum, fueled by a strong economic backdrop and what can only be defined as the golden age of credit quality, and robust M&A activity set the stage for this period of relative prosperity for banks. See Chart 2 on the right.

Value investors historically dominated the bank sector, as they were attracted to modest premiums to book values, reasonable price to earnings multiples, and conservative regulated business models. Many of these investors took advantage of the depressed multiples in 2000 of 11.6 times last twelve months earnings and 120% of tangible book value, for banks under $2.5 billion in total assets. These value investors struggled as the multiples for these banks rose to 17.8 times last twelve months earnings and 183% of tangible book value in 2004 (see Chart 3). The benefit for value investors seeking liquidity is that the increase in multiples lured growth investors to the bank sector.

Growth investors are attracted to companies and industries that have the ability to grow earnings and revenue. They typically are willing to pay a high price-to-earnings multiple since they believe that a company has the ability to “grow” into that multiple. During 2002, community banks under $2.5 billion in total assets showed strong earnings per share growth. This new growth dynamic, joined by consistent double digit Return on Equity (ROE) and attractive Return on Assets (ROA),
coupled with virtually no asset quality problems, brought many new investors to the community bank sector and helped further increase bank stock prices to new highs. By the middle of 2006, banks witnessed share price increases by an average of 150% versus 2000.

M&A Bull Market of 2002 to 2006

As bank and thrift stocks began a multi-year bull run in 2002, merger and acquisition activity increased. Banks trading at high stock multiples used stock as the primary currency to acquire other banks. As competition among buyers heated up, a “seller’s market” began to emerge in 2002 and 2003. Potential buyers flooded the market, resulting in M&A valuation multiples increasing each year. As shown in the Chart 4 above, the median price-to-tangible book value paid for community banks and thrifts increased from 168% in 2002 to 225% in 2006. Core deposit premiums increased as well, doubling from 8.8% in 2002 to 17.6% in 2006.

Areas of the country considered as “high growth” – California, Florida, Georgia, Nevada, Arizona, etc. – witnessed even higher levels of pricing. The median price-to-tangible book value paid for community banks in California and Georgia was over 300% in 2006.

In addition to unprecedented stock valuations, another phenomenon was occurring that helped drive up M&A pricing as more banks and thrifts were attempting to acquire “out of market” peers to access higher growth markets and expand their franchises. Several publicly traded banks in the Midwest paid higher premiums to purchase banks in Florida and Arizona in order to reshape their images of slow-growth, Midwestern banks. As noted in Chart 5, the number of “market expansion” deals as a percentage of total M&A deals increased 11% from 2001 to 2006.

The Sell-Off

Prosperity quickly turned to adversity beginning in 2007 as easy credit and the collapse of a white hot housing market led to significant credit quality issues. Industry headwinds compounded matters and these factors combined to cast doubts about the ability of banks to act as a reliable source of profitability and dividend income. Exacerbating matters was an abrupt slow down in M&A activity, fueled by currency devaluation and skepticism surrounding the credit quality of banks for sale. When all was said and done, the NASDAQ Bank Index declined 22.1%, compared to a 3.5% increase for the S&P 500 Index, during 2007.

Lack of clarity on the credit quality front resulted in additional pressure on the NASDAQ Bank Index during 2008, as the index declined another 27.2%. However, the malaise that infected the banking sector spread to the broader market as the S&P 500 Index declined by a precipitous 39.5% during 2008. While the NASDAQ Bank Index outperformed the S&P 500 Index on a relative basis during 2008, the Bank Index is currently trading at levels unseen since year-end 2000.
Pooled TPS Spigot Closes

The credit crisis also caused the pooled Trust Preferred Securities (“TPS”) market to close. Pooled TPS were an extremely important funding source for banks. Beginning in 1999, the emergence of pooling vehicles allowed community banks and thrifts access to the TPS market, in order to raise Tier 1 capital in an efficient and cost effective manner. Initial interest rate spreads on TPS issued through pools was typically 300 to 400 basis points over 3-month LIBOR. As investors became more comfortable with collateralized debt obligations (“CDOs”) backed by pools of bank and thrift issued TPS, demand for CDO tranches increased and credit spreads for TPS issuance declined. By 2006, new issue pooled TPS yielded as low as 125 basis points over 3-month LIBOR. Lower spreads and looser credit standards allowed robust TPS issuance through just over the first half of 2007 (see Chart 6).

In the fall of 2007, the credit crisis caused the securitization markets to close. Buyers of CDO tranches disappeared, so banks could no longer fund growth by issuing additional pooled TPS. In 2008, a handful of community banks publicly issued fixed rate TPS between 9.45% and 10.75%. However, as the bank market continued to deteriorate throughout the year, TPS investors demanded coupons that made the issuance of TPS cost prohibitive. The government then announced the TARP Capital purchase program, which effectively shut down the public issuance of TPS.

Anemic M&A Activity in 2008

M&A activity declined substantially in 2008. As seen in Chart 7, there were more than 200 M&A transactions each year from 2003 to 2007. However, several factors led to a dramatic decline in the number of mergers and acquisitions in 2008, with total deal volume declining by 46% from the previous year. The primary driver of lower activity was the significant declines in potential buyer’s stock valuations over the last 24 months. It became much more difficult for an acquirer to justify paying 200% of a target’s book value when its own stock was trading at or below book value. In addition, banks and thrifts were forced into capital preservation mode as credit quality deteriorated and buyers for bank stocks fled the sector.

The shift to a “buyer’s market” in 2008 brought M&A valuations to levels last witnessed in the early 1990s. As shown in Chart 4, there has been a steady decline in the price-to-tangible book multiples and core deposit premiums paid for community banks and thrifts since 2006.

This buyer’s market continues in 2009. Banks and thrifts with excess capital (including those with TARP capital) should be able to continue to acquire banks at attractive levels going forward. As Warren Buffett once put it, “Cash combined with courage in a crisis is priceless.”

Equity Capital Raises

On the capital raising front, 2008 could be considered a banner year with over $50 billion of public equity capital raised, excluding thrift conversions. This compares to approximately $8 billion of public equity capital that was raised in aggregate between 2000 and 2007. However, much of this volume in 2008 was due to the distress in the large cap universe, as many banks were forced to raise capital in an attempt to fortify their balance sheets and strengthen their capital ratios. Of the 22 underwritten public capital raises in Source: SNL Financial LC
basis into nine banks and primary dealers. The lucky nine, B of A, Citigroup, JP Morgan Chase, Wells Fargo, Bank of New York Mellon, State Street, Merrill Lynch, Goldman Sachs, and Morgan Stanley, were chosen for their reach into far-flung corners of the global financial services arena. Their business lines include products and services that barely touch traditional commercial banking. For example, State Street is known mainly for its securities clearing and custodial operations. Likewise, Merrill Lynch manages hundreds of thousands of separate retail brokerage accounts.

While the effectiveness of these dramatic steps will take some time to quantify, there is little argument that the availability of this Capital Purchase Program, or CPP, came at a time when there was precious little new capital to be found, as the previous section makes clear.

**CPP Give and Take**

The CPP’s attractiveness to the banks that applied is primarily two-fold: (1) Tier 1 and risk-based capital ratios improve immediately, and (2) the additional capital allows the banks to lend more freely or consider potential acquisitions.

Most banks, however, chose not to apply for or not accept TARP capital, and seemed to fall into one or more of three camps. The banks in the first camp opted not to have the Federal government become a shareholder in their banks. This group also had concerns about Section 5.3 of the CPP, which gives Treasury the ability to retroactively change the terms of the program if Congress were to enact new laws that impacted the overall Act or its successors.

Next are those who were satisfied with the status quo. These banks typically had excess capital already and/or were situated in markets with few growth prospects in the near future.

In the final camp were the banks that could not wrap their arms around the math that accompanied the CPP. These banks were unaccustomed to making capital raising decisions away from their traditional sources.

**Capital Math**

Many privately held banks struggled with the decision to apply for TARP funds. Their questions revolved around the true cost of capital and how to fund it. The following example will walk through the US Treasury’s (UST) capital injection by using the dividend and warrant figures from the CPP’s term sheet for non-public institutions. (The variables are somewhat different for public banks and S Corps, but this acts as a serviceable model.)

The bank must be able to cover the annual cash flow obligation, which is a five percent dividend on the investment. The dividend increases to nine percent in year six. For a $1 million injection, the bank must pay the government $50,000 in dividends each of the first five years. Remember that this is an after-tax number.

The bank must also account for any costs related to warrants. The UST is entitled to an additional five percent ownership, which is immediately exercisable, and on which a nine percent dividend is owed. Assuming that this warrant is immediately exercisable, and on which a nine percent dividend is owed. Assuming that this warrant is redeemed in five years, this adds another 1.45 percent to the annual dividend cost. On a tax-equivalent basis using a 34% effective tax rate, the all-in annual cost to the bank is roughly 9.77%.

How does a bank cover these costs responsibly? In a word, leverage. Let’s assume that a bank has $250 million in assets and $20 mil-
lion in Tier 1 capital. That is a capital ratio of eight percent and a leverage ratio of 12½ times. If the bank receives another $5 million in capital, and turns that into $50 million in new assets, the banks new numbers are as follows: $300 million assets, $25 million capital, capital ratio of 8.33 percent, and a leverage ratio of 12 times. Even a 10-to-1 multiplier on the new capital, which is fairly aggressive, causes capital ratios to improve.

Of course, two questions must be addressed. Can a bank grow the balance sheet with quality assets that further fit into its asset/liability risk profile? Also, can it leverage itself profitably enough or find additional funding to cover its dividend and warrant costs?

**Spread Matters**

Continuing with our example, assume our sample bank adds $50 million in assets (which can be loans, securities, or another institution or branch), paid for by borrowing $45 million through wholesale deposits of FHLB advances. Remember that the capital injection lessens the borrowing needs. Further, assume that the durations of the assets and liabilities are fairly equal, the assets do not default or become impaired, and the assets yield five percent versus a three percent cost of borrowings.

Our pre-tax improvement is $1,150,000, which leaves about $759,000 after taxes. The dividend/warrant cost is $322,500 annually ($5 million x 6.45%). So, we cover our cost of capital by $436,500 and improve our bottom line. The ROE on the new capital using these assumptions is 8.7 percent, which may or may not be an improvement. However, what is at least as relevant are the improved capital ratios and perhaps a bigger market footprint.

If a bank uses sources of capital other than the CPP, there will be variations on this model, such as differing dividend obligations, warrant arrangements that are unique to the situation, and perhaps different priorities to assets in the case of liquidation.

**What Does the Future Hold?**

Capital markets and the economy have always been cyclical businesses. While the capital markets are challenging for many banks at the time of writing, the situation will not last indefinitely. Even during the last six months, quality banks with fewer issues and the potential to capitalize on the weakness of competitors have been able to tap the market. As the economy stabilizes and asset values firm, the capital markets should gradually re-open to community banks, beginning first with those with the fewest issues. We would not be surprised if a window emerges later this year that will allow groups of banks to raise capital for growth and/or to defease the TARP repurchase obligation and reduce the attached warrant. In any event, capital preservation and strategic planning will serve those who can plan past the current morass to better times.

For the banks that accepted TARP capital, the unintended consequence will be to increase the number of bank and thrift M&A transactions. The US Treasury has effectively provided a litmus test for financial institutions by approving TARP for the “healthy” banks, and not approving funds for the “unhealthy” banks. Many “unhealthy” banks will be forced to sell or merge with another institution. While the UST and other government agencies continue to state that the intended purpose of TARP capital is to enhance lending, allowing banks that have participated in the program to acquire their troubled peers would not only save the regulators from potentially shutting down failing institutions, but it could save the FDIC billions of dollars. This process has already played out with the PNC purchase of National City in November 2008, and will continue throughout 2009.

In spite of the negative articles, headlines and continued downward pressure on asset values, some analysts believe the stimulus package proffered by the Obama administration, with all its bells and whistles, will eventually put a floor under housing prices. When that time comes, and few are brave enough to place a time line on the process, bank profitability will return. It may be that the banking industry never sees again the ROA/ROE performance produced in the middle part of this decade. Still, risk diversification strategies will almost ensure that investors large and small will return to the banking sector, in significant volume, for the long haul.

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