# AWARDING GOOD DIVIDEND POLICY

by Steve Brown

We didn't see too many of the movies nominated for last night's Academy Awards, largely due to the fact that our viewing habits are driven by our young daughters. As such, they are restricted to a genre technically classified as "Movies with talking animals." Much to our daughters' chagrin, many of these movies just missed receiving an Oscar. Regardless, the Academy Awards continues to underscore our long-held belief that there should be a high-quality awards show for banking. "Best justification of loan loss allowance to an auditor," "Most convincing explanation of why the bank missed its earnings targets," and "Sincerest rationalization for paying 3.8x book" would be just some of our categories. One area that we could give an award is the "Most productive use of cash dividend." This category is similar to Oscar awards for art direction and sound, because it really doesn't get much thought, but it is vitally important. Cash dividends are derived from retained earnings, which is a form of capital. Independent banks that are more than 5Ys old are paying a dividend of approximately 43% of earnings. This percentage can vary widely depending on growth, risk and strategic initiatives of the bank. Many banks treat dividends as a "thank you" to shareholders and set a percentage based on past performance. When times are good, they tend to pay out more and when growth slows down, they usually cut back. This could be a disservice to the firm, as from a financial standpoint, the distribution of capital should occur if management feels that it can't match or better the returns of other alternative investments available to shareholders. The point is that the amount of dividend that gets paid out should be based on a forward-looking assessment of the amount of capital required to meet strategic objectives in the future. Oftentimes, when growth is good, management should hoard capital (in order to support objectives and lower its risk profile). Conversely, when earnings growth slows, management may want to increase dividends, as it may have little use for excess capital. This is usually the exact opposite behavior that takes place in many banks and the result is an inefficient use of resources. Once management determines its required capital given the objectives, the next question that should be asked is - can the bank obtain capital from cheaper sources? Given that the average cost of equity for independent banks is estimated at a tax-adjusted 10% to 15% for 2007, some banks may want to pay a healthy dividend and then replace the capital with trust preferreds (but call us before you do). Trust preferreds have a cost closer to a tax-adjusted rate of 5.0%. We will be discussing this topic more in the future, as we look at different dividend payout ratios given different growth rates and other capital options (such as changing asset mix, stock repurchases and taking on subordinated debt). In the meantime, if we get around to hosting a banking awards show, you can bet we will not have Ellen dressed as Shirley Partridge; will not have so many cut aways to Jack Nicholson; and will give more air time to Steve Carell and those shadow dancers. Then again, what do we know, we thought Happy Feet should have taken Best Picture.

## BANK NEWS

**M&A**

Ridgewood Savings Bank ($3.3B, NY) will acquire City & Suburban Financial ($670mm, NY) for $119.1mm in cash, or roughly 2.2x book

**M&A**

SouthCrest Financial ($544mm, GA) will buy Bank of Chickamauga ($68mm, GA) for $18mm, or about 1.3x book.

**M&A**

Fulton Financial ($15.7B, PA) will buy international payment service company Global Exchange Group (NJ) for an undisclosed sum. Global provides companies, law firms and other professionals with international payment services.

**Charter Transfer**

Mainsource Financial Group ($2.4B, IN) will sell the charter of its subsidiary savings bank (and our favorite bank name) to Moolah Holding Corp (TX) for an undisclosed sum. The transfer is for the charter only and does not include any branches or personnel.

**Subprime Blues**

Financial stress is becoming evident in the subprime mortgage market, which accounts for 13% of the $10T in home loans outstanding. Studies indicate over 19% of subprime loans issued during 2005-2006 will fail and that as many as 2.2mm people could eventually lose their homes, as $164B in total foreclosures work their way through the sector. The news has left subprime lenders reeling, as some have seen share prices fall as much as 50% in the past few weeks.

**Prime Blues**

Given all the talk of a subprime market meltdown, bankers may find it interesting to note that delinquencies on adjustable rate mortgages to prime borrowers climbed to a 3Y high of 3.1% in 2006. This news has worried lenders, given there is nearly $1.5T in ARMs expected to reset in 2007.

**Economy**

A survey of 47 economic forecasters predicts GDP will grow at 2.7% this year, the slowest pace in 5Y. Falling energy prices will restrain inflation, while stronger consumer spending will help offset the slowdown in housing. GDP was 3.4% in 2006.