RUNNING FROM THE BULL

by Steve Brown

From July 7 to 14 each year, the Fiesta of San Fermin kicks off in Pamplona, Spain. Every morning during that time at around 8am, bulls are released into the streets and crazies from around the world try to outrun these 1,500 pound beasts without being gored. Many companies throughout the world, feeling pressure to hit profit and growth targets in a rough market environment, may feel like they have been running from angry bulls as of late. As a result, many companies have actively looked for mergers or acquisitions. Diversification is happening across industry and country, as players look for deals throughout the world. Too much capital, elevated levels of private equity money and corporations with strong balance sheets, frothy stock prices and access to very cheap long-term debt (lowest in 10Y) are driving the M&A boom. In fact, the last time things were anywhere near this favorable for M&A activity was in the 1980's and long-term yields were about 2x current levels. Even more interesting, back then there were only 5 private equity firms with money to invest of more than $1B, compared to 115 such firms today. Things are so hot in fact that the value of transactions this year has already broken the $2T level and is more than 70% above last year's pace at this time. So too, the banking industry is feeling the effects of these and other significant changes. Driven by heavy deposit and loan competition, technological advancements, tight margins, a crushing regulatory environment, credit deterioration and an inverted yield curve, banks are jumping into M&A in droves. In particular, banks that have become dependent on construction lending and are now facing a slowdown are finding M&A to be a good alternative to sustain growth and profitability. The industry in general is finding that low cost deposits are harder and harder to come by, pushing even more bankers to get into the act. In short, bankers are realizing that making money is becoming more difficult, so mergers provide an attractive alternative to organic growth and sustained profitability. Should organic growth continue to slow and these pressures remain, the more bankers will consider acquiring or merging with a competitor down the road. Many banks have also ramped up stock buybacks in an effort to counter such challenges. As equity investors get nervous about the industry, bank equity values have softened as of late. That, combined with high levels of excess capital, has pushed many banks to launch or renew stock buyback programs. In fact, these programs are so prevalent that 100% of the top 10 banks in the country (and hundreds of independent banks as well) have either announced or are in process of an equity repurchase. Whether buybacks or acquisitions will turn out to be a sound long-term strategy remains to be seen, but bankers have clearly shown up dressed and ready to run. Our advice is to keep your mind sharp and your eyes focused straight ahead because in this race when you mess with the bull it is very easy to get the horns.

BANK NEWS

Asset Quality

Official asset quality rates for the industry have been released for 1Q. Loan delinquencies 30 days or more increased from 1.69% in 4Q to 1.72% in 1Q. More concerning is the increase of loan defaults from 0.40% to 0.53%. For delinquencies, residential was up 10bp to 2.04%, CRE was up 8bp to 1.37%, consumer loans held steady at 2.96%, C&I was stable at 1.18% and agriculture decreased 6bp to 1.14%. Meanwhile, defaults in residential loans were up 3bp to 0.16%, CRE was up 2bp to 0.07%, consumer jumped 26bp to 2.44%, leasing was up 10bp to 0.24%, C&I was up 8bp to 0.39% and agriculture was down 7bp to 0.07%.

Pandemic Testing

The Treasury will conduct a 3-week voluntary test in September to see if banks are ready for consistent operation during a pandemic outbreak. The online exercise will combine private and public entities and consist of surveys, scenario role-play and education. We plan to be involved and encourage other banks that work with us to play (if nothing else, as to reduce our risk). More information on how to sign up will be available after June.

Coast Woes

Coast Financial ($834mm, FL) is a classic case of a bank that focused on loan growth (37% last year) instead of the core competencies of liability structuring and credit quality. Running with an 80bp loan loss reserve, the bank has 50% of their loan portfolio in construction and sky-high operational costs. Combine that with few DDA balances, no brokered funds and a high level of promotional CDs and it is no wonder that the bank has sub-3% margins and negative ROE.

Sterling Woes

Sterling Financial ($3.3B, PA) said it will take up to a $165mm charge associated with a sophisticated loan scam that included officers and employees. Staff within the bank's equipment finance unit colluded to conceal loan losses, falsify contracts and subvert internal controls. Five people have been fired, including the COO.Sterling Woes