SHARE BUYBACKS

by Steve Brown

Share buybacks are becoming a more appealing and common trend among companies. Given that the average bank's share price is down 9% for the year (compared to up 8% for the S&P), banks are sensing a unique arbitrage opportunity to repurchase shares using excess capital. During the first 5 months of 2007, 14 of the top 20 national banks purchased shares back as did more than 8 independent banks. For the independent banks, the repurchase resulted in an average 4.4% price appreciation after the announcement. This is more than double the amount of buybacks that normally occur for this time period. The reason stock buybacks are becoming so appealing is due to a number of factors. For starters, without any Fed movement, the cost of funds at most banks has risen an average of 31bp due to competition. This rise has affected margins calling into question near-term profitability. Without a better place to deploy capital share repurchases help increase a company's EPS ratio (as well as other performance ratios). In addition, if a bank is being tainted by credit quality or other risk concerns, buying back shares sends positive signals that relay information about the company's economic standing to investors. In essence, the buyback says, management knows better than the public and we are going to put our money where our mouth is. One major consideration a company has to take into account before engaging in buybacks are the corporate tax rates. When corporate taxes are factored in, the company's value does increase (only by a small amount). However, holding excess cash raises the cost of capital by producing sub-optimal earnings. The lower returns, the act as a drag on performance, thereby causing additional costs to raise capital in order to overcome the below optimal performance. Accordingly, since interest income is taxable, companies that maintain a large cash balance, place their investors at a disadvantage. Data shows that banks that participate in small repurchase programs on average see an increase in their stock price of 2-3%. Additionally, companies that partake in large buybacks (15% or more of shares) see stock prices increase up to 16%. Another reason many companies repurchase stock is that it serves as a signaling device to the public. The first signal buybacks portray is that management believes that their stock is undervalued. Executives can bolster this effect by personally purchasing a significant number of shares. The second signal associated with buybacks is that the company does not need the cash to cover future commitments of payments. Conversely, one negative signal is that management sees few investment opportunities in the future. After weighing the positive and negative signals, analysts conclude that the overall response to buybacks results in a positive feeling among investors. However, managers who get involved with buybacks run the risk of promoting short-term positive equity performance at the potential expense of long-term term health and prosperity. Not having the capital immediately available if opportunities present themselves or if credit problems arise is an important consideration. In this age of the flat yield curve, increased competition and a plethora of capital available, more banks should be considering purchasing back a little equity.

BANK NEWS

M&A

PNC Financial Services Group has agreed to buy Yardville National Bancorp ($3B, NJ) for $403 million, or 1.77x book value. The deal is expected to close in 4Q 2007.

Bankruptcy

A new study by the Admin. Office of the U.S. Courts finds the median age for bankruptcy filers increased to 41.2 years from 37.7 years back in 1994. Authors of the study attempt to point out that Baby Boomers make up a larger-than-expected percentage of the bankruptcy filings, which is due to record high debt-to-income levels.

Fed Charge Cards

Citibank, GE, JPMorgan Chase, and US Bank received contracts from the US General Services Administration to supply charge cards to federal agencies. This will be the biggest government charge card ever.

Mortgage Rates

30Y mortgage rates jumped this week to 6.53%, the highest since Aug. 10th. This continued a 4-week rising streak for mortgage rates.

SoCal Homes

A new report says that 3,000 of the 120,000 homes for sale in Southern California are owned by lenders. A year ago the number was 10.

M&A

The Dukes County Savings Bank ($300mm, MA) and Martha's Vineyard Cooperative Bank ($160mm, MA) have agreed to merge. The deal should close within a year. Terms of the merger have not been released.