SPERM, DIRECTION AND THE COST OF CAPITAL

by Steve Brown

It is a well documented fact that men will not stop and ask for directions. Nature compensates for this fact and is the reason why it takes million of sperm to find an egg (despite that fact that the egg is the relative size of Mississippi). Under the microscope you can see hundreds of sperm head off in a different direction unable to let their ego roll down the window and ask for guidance. In similar fashion, many bank managers do not stop and ask what their weighted cost of capital is telling them. Understanding the weighted average cost of capital ("WACC") is vitally important for the creation of value. WACC is the measure of how much a bank pays to finance its long-term operations and is the volume weighted cost of its equity, debt, subdebt and trust preferred capital. The average community bank runs about 75% equity and 25% debt with an average cost of 10.50% and 4.10%, respectively. By applying the allocations to the respective costs, we find that the average community bank has a weighted cost of capital of around 9%. To put this in perspective, WACC for community banks range from 6% to 12% depending on the size and mix of debt to equity. National banks, the lowest being Citigroup and Bank of America, have a WACC of around 5.04%. Now, there are a couple of important points here, as understanding WACC gives direction as to bank performance. For starters, since debt is so much cheaper than equity, moving the mix of debt to equity to the highest allowable debt ratio, reduces the cost of capital (this is why we like trust preferred debt so much). Just moving to 50% equity to 50% debt ratio, the cost of capital would be reduced to near 7%. To a much less extent, increasing liquidity also helps bring down volatility further reducing the cost of equity, and hence, capital. There is a paradox here because when a bank is very thinly traded, it trades at a fraction of the market's volatility. In the parlance of the market, this means having a beta below 1.00%. Very thinly traded community banks normally have calculated betas of 0.70, or volatility that is 70% that of the market. Ironically, as the CEO works with analysts and institutional investors, volatility increases to a point before it decreases. A typical thinly traded (as opposed to very thinly traded, as in our earlier example) has a beta of 1.35 or 35% more than the market. As bank stock moves from thinly traded to liquid, beta comes back down to 1.00%. Most large community banks have betas of around 1.10%. One key take away here is using the WACC to figure out if you are adding value to your shareholders or not. By calculating your net operating profit after taxes ("NOPAT") and then deducting your bank's average cost of capital in dollars, the difference is the risk-adjusted excess return above the cost of capital, or your economic value added ("EVA"). If EVA is negative, this gives management direction that they should either return equity to their shareholders (thereby lowering their cost of capital) or increase earnings. When a majority of banks produce negative EVA (as is currently the case), the WACC points in the direction that return expectations must come down for bank investors. Getting directions is never easy, but taking the time to understand what the environment is telling you could result in a birth of better earnings down the road.

BANK NEWS

M&A

Investors Bancorp ($5.4B, NJ) will purchase Summit Federal ($123mm, NJ) for an undisclosed sum.

Fined

Amex was fined $65mm by federal regulators for failing to develop an adequate program to identify and report money laundering.

Shrinking Deficit

Surging tax receipts coupled with steady job and income growth will allow the U.S. Treasury to auction just $22B in long-term debt this week, the smallest amount since 2001.

Hacking Attempts Rise

The top intrusion-detection services provider, SecureWorks Inc., reported the number of hacking attempts on bank systems is up 81% from last year.

Countrywide

The nation's biggest mortgage lender reassured the market by saying it has "significant" sources of short term funding to finance its daily operations. Earlier in the week, credit-default swaps on the company rose as competitors doubted Countrywide's ability to stay in business.

Savings

According to a recent study by Capital One, retail accounts are far more likely to use a piggy bank (42% have one) or change jar (65%) than a high-yield money market account (35%).

Fees

According to our research, as of June, the average monthly fee for business checking accounts at community banks was $22.95, up 25% over June 2006. Interestingly, the average fee at community banks is 24% lower than the average fee at the largest 10 major banks.