TAKE THE CAPITAL

by Steve Brown

Watch it. Not in the mouth. Look anywhere else, but in the mouth. We are talking about the gift horse; the same one the Federal Gov't has tied up outside your lobby. Specifically, we are referencing capital under the Treasury's new Capital Purchase Program (TCPP). If there were any doubts whether this was a good deal, let's put them to rest. It is and you should take advantage of it if you can. Normally, we would put in a bunch of qualifiers, but in this case, this is one of the most clear cut decisions in banking. Let's start with the coupon of 5% for the first 5Ys. That is cheaper than Goldman received, cheaper than Morgan Stanley, Wachovia, Citigroup, 5th 3rd, Freddie Mac and almost every other financial institution throughout recent history. That is a big statement and we admit we don't have a complete history, but looking back over the last 10Ys at some 300+ transactions you would be hard pressed to find cheaper capital (save for a 3 month period back in 2005 when spreads on trust preferred capital were at an all-time record tight at +1.26bp) Back then, interest rates were low, leverage was in vogue and the result was a handful of banks received sub-5% pricing. Spreads are much wider now and that capital, (even if it was available) would come at a 5Y fixed cost of somewhere north of 8.30%. Given the threat of inflation, a 5% fixed rate is going to seem unfathomable in a couple of years, especially given the fact that the issuance comes without underwriting costs.

But, it keeps getting better. The non-voting senior preferred has a call feature after 3Ys. While we don't think banks will be able to easily find less expensive replacement equity at that time, if it happens, banks have the option of repaying the Treasury's money. This is a credit and an interest rate option that can be modeled. We find that the call feature gives you a lower adjusted cost of approximately 4.74% (assuming a 5Y life of the preferred and using the forward volatility of 24%). Remember, trust preferred and most every subordinated debt issue required a 5Y non-call feature.

What about the warrants? A warrant for 15% of the par amount of the preferred (to purchase common at their 20-day average price immediately prior to the investment) is comparable to the standard 15% over-allotment rights which underwriters get on most public offerings. Most banks would be paying this anyway to issue capital. However, issuing banks are going short an equity option, so it does come at a cost that we can also help model. Assuming an average publicly traded bank, a share price of $10, a strike price of $10 for 10Ys (at 30% volatility), no dividends, a 4% risk-free interest rate and a 5Y amortization period, the value of those warrants equate to approximately 14bp per annum of cost. This brings the all-in, option and warrant adjusted rate of the potential issue to about 4.88% - Plain cheap.

What if you don't need the capital? What about the message it sends to the market? Do you know how bad the economy is going to get? We don't either, which is why no one will Monday morning jockey your decision to protect the bank in possibly the 2nd worst deterioration of credit, liquidity and asset valuation the world has ever seen.

While you can probably survive without it, why take the chance for a mere 4.88% for the next 5Ys? To be clear, the Treasury's offering steps up to 9% after 5Ys, but we assume for the sake of this analysis would be able to replace it by then. Yes, there are some other elements of this capital offering which may seem restrictive (stock dividend limitations, stock repurchase limitations, a prohibition against excessive risk-taking and executive compensation features), all these are of secondary importance when we are talking about survival or a bank's ability to take advantage of historic low valuation conditions to purchase other institutions. Community banks can't find available capital in the market right now and we don't see that changing any time soon. We have never heard of a bank CEO getting fired for having too much capital, but plenty will get let go in the coming year for not having enough.

To start the process, click and fill the short application out. http://www.treas.gov/press/releases/reports/applicationguidelines.pdf . Of course, we recognize that we can lead a horse to water, but we can't make him link....(OK, we know that was bad).

BANK NEWS

M&A

National Bancshares ($121mm, WI) agreed to purchase First Wisconsin Bank & Trust ($98mm, WI) for $13.5mm or about 1.5x book price.

Mutual Funds

Yesterday, the Fed invoked its emergency authority and purchased assets from several money market mutual funds in order to aid redemptions.

Direct Investment

France will invest $128B into its 6 biggest banks. In total, Britain, France, Germany, Spain, and other countries have pledged more than $2.65T in bank loan guarantees and direct equity stakes in financial institutions.

Higher Limits

In an effort to add more support to the mortgage market, the Mortgage Bankers Association will vote today on a recommendation asking for an increase in the limit for FNMA and FHLMC loan purchases or guarantees of residential mortgages to $625,500 (from the current $417,000).