THE TIMING OF A STRATEGIC MOVE

by Steve Brown

Here in CA, we have "spiritual awakening retreats" that charge you $3,300 a week to help you fast. No phones, TVs or in-room dining are allowed, as attendees experience just a room and a couple of counselors to help in "realignment of the soul." Now, granted these retreats come with a couple of hours of meditation, but this still works out to almost $700 per night. That is a lot of cash to drop in order to starve oneself. When we hear of people spending money like that in a recession, we think one thing - How can we cash in on that trend?

Most likely, you are more caring, but our point is that with so much turmoil in the financial markets, opportunities abound. As banks head into their strategic planning sessions and there are rudimentary signs that we may be coming out of the recession, an important question to ask is - Do you acquire a bank/branch now or wait for clear signs of a lasting recovery? The answer to the question largely revolves around how your bank views the future. However, the answer to the question is easier to answer than you might think.

One dynamic at work is the fact that in an initial downturn, bank values deteriorate more rapidly than during the final part of the downturn. Similarly, during the beginning of a recovery, community bank values jump faster than at the final phase. In other words, banks that purchase assets now may not hit the bottom of the market, but if they are wrong, the probability is that the downside risk of having another 20% deterioration of asset prices is not as great as missing out on a 50% run up in asset prices (should the recovery take hold and we bounce back from here). Conversely, if you assume a slow recovery, then the present cash flow of gaining a bank below book will most likely offset an additional loss in asset value.

To clarify, let's look at some scenario planning. Let's assume 2 possible conditions in the world - either we are at the bottom or we have another 20% of declining asset prices to go. Further, let's assume that we have 3 investment options: we can invest now, in 6 months or in 1Y. Finally, let's assume that we will return to a normal expectation of a 15% ROE for banks in 3Ys. In this simplified set of assumptions, there are 6 possible outcomes. If you assume we are at a trough now, then your bank only loses money by waiting. Not only would your bank miss out on a run up in asset prices (like bank stock or loan quality), but it would also forgo the additional cash flow that comes with making an acquisition now. In the other scenario where asset prices could still be declining for another 6 months, waiting another 6 months to invest would be the best of all outcomes. However, waiting a year and missing 6 months of appreciation and cash flow, would basically put you in the same situation as investing today. While you would watch prices decline, you would also miss an initial bounce-back, plus miss out on a year's worth of cash flow. In other words, of the 6 possible outcomes, a bank is better off investing today in all but the scenario where a bank times the bottom perfectly.

While admittedly, these are simplified assumptions, the net present value approach can be tailored to analyze a variety of other scenarios. Uncertainty in banking abounds, but management waiting for clear evidence of a bottom are most likely to find that data 6 to 12 months in arrears. During that time, they could find that they missed out on opportunities, appreciation and cash flow. Asset prices for banks are down about 60%, which is greater than 3 of the past 5 recessions and equal to the 1982 experience. Only a further downturn similar to the Great Depression would hurt an investment now instead of later.

While every bank must decide its own timing based on the investment and views, given where current asset prices are, waiting too long could come with more risk than moving too early. Jumping on that once-in-a-lifetime opportunity can capture steady appreciation and cash flow and may be the best "spiritual awakening" you can give your shareholders.

BANK NEWS

Bank Closures #65 to #69

The FDIC closed Peoples Community Bank ($706mm, OH) and transferred all deposits (at a 1.5% premium) and most assets to First Financial Bank ($3.8B, OH) in a loss-share agreement. Integrity Bank ($119mm, FL) was also closed and Stonegate Bank ($360mm, FL) acquired all deposits (for a 0.20% premium) and $52mm in assets. First State Bank of Altus ($103mm, OK) was placed into receivership and all deposits and $64.4mm in assets were acquired by Herring Bank ($471mm, TX). First BankAmericano ($166mm, NJ) was also closed by the FDIC and Crown Bank ($343mm, NJ) agreed to purchase most of the failed bank's assets and all deposits. Finally, Mutual Bank ($1.6B, IL) was closed and the FDIC entered into a purchase and assumption agreement for all of the assets and deposits with United Central Bank ($1.2B, TX). In total, the closures will cost the FDIC fund about $912mm, bringing the total cost to $15.1B this year (compared to $17.6B in all of 2008).

Cash For Clunkers

The program is a dramatic success and will drive auto sales (and other related indicators) sharply higher. As a result, look for 3Q GDP to turn positive.