A LESSON IN POOR CAPITAL RAISING BY BOFA

by Steve Brown

One question we have been repeatedly asked lately is our thoughts on the Buffet / Bank of America deal. Our take is different than the media and we believe the transaction merits a quick review for a lesson in capital planning. To recap, Bank of America's stock was getting hammered, falling to $6.40 per share given market uncertainty, bank risk premium, potential Countrywide credit exposure and potential legal exposure associated with mortgages. The Bank's CEO, Brian Moynihan went to the public and announced that the Bank was basically strong and core operations were fine. He also announced cost cuts by reducing headcount by 3,500 employees and said capital levels were sufficient. The market didn't believe it and a few days later, Warren Buffet came in with a big equity investment. At this point, it would be good to state for the record, that in our humble opinion, Warren Buffet's reputation as a protector of Main St. America is overblown. The man is a great investor, perhaps even a shark, but he has repeatedly out Wall Street-ed Wall Street. We say this with the utmost respect, but we get tired of Uncle Warren always being held up as the antithesis to what is wrong with Wall Street. Buffet used his power and influence to strike a very lucrative transaction for himself because that is what he does. For further proof, consider the terms of The Oracle's BofA deal: Buffet purchased $5B of preferred stock with a 6% cumulative dividend that can be redeemed at a 5% premium to face value. In order to protect Buffet from regulatory restrictions of dividends or from a further downturn, Buffet negotiated an 8% premium that accumulates in the event that BofA cannot repay the 6% stated rate. If that deal wasn't good enough, Buffet also got a 10Y option to purchase 700mm common shares at $7.14 per share. To recap, Buffet's worst case is that he makes $300mm per year plus the option's value. Using a standard Black-Scholes option model, a 40% volatility (half of current) and a 2% risk-free rate, that comes out to a base case estimate of about $3.2 per option, or about $2.2B in profit. Should the stock maintain its current volatility, or go past $12 per share, the profit could easily be doubled. Depending on what you think Buffet's hold period is, it is likely around a 14% to 25% return on investment - far above what Main St. is likely to ever achieve. That return is made even better, as Berkshire Hathaway gets taxed on only 30% of the dividend, due to the inter-company dividend loophole. Finally, because of the large position in preferreds, Buffet essentially holds veto power over future dividend declarations and stock buybacks, ensuring he gets his money before any common shareholders. On the other side of the coin, the deal from the BofA perspective is interesting for what it does not get. Given the costly nature of the deal, you would think the Bank would at least get Tier-1 capital treatment or be able to leverage a tax savings. Unfortunately, the Bank gets neither because of the cumulative preferred status. The Bank also loses flexibility in their dividend policy, as now it essentially has to either pay off Buffet or get his vote in order to issue further dividends to common shareholders. While BofA does get some Tier-2 capital to support the organization, what it really bought was a vote of confidence from the "Buffet Bump." Now, given the lucrative terms of the deal and the fast nature in which the deal was cut (Buffet claims it was negotiated in less than 24 hours), we can assume 2 things. Either Moynihan isn't being completely transparent on the quality of BofA's balance sheet or he thought it prudent to pay the dividend and the warrants to give current shareholders a short term event to cheer about. If it is the former, Buffet is an enabler, as the Bank should have received Tier-1 treatment for the price it paid. If it is the latter, that is even crazier and also flies against many of Buffet's stated investment principals. Either way, Buffet saying that "BofA is a strong, well-led company." doesn't make us all that comfy.

BANK NEWS

M&A

First PacTrust Bancorp ($864mm, CA) will acquire Beach Business Bank ($304mm, CA) for $37.2mm, following another recent deal to buy Gateway Business Bank ($180mm, CA) for $17mm. After the acquisitions, First PacTrust will have about $1.3B in total assets and 18 branches.

BONY

CEO Robert Kelly unexpectedly stepped down and was rumored to be pushed out due to his attitude, his handling of FX transactions for its pension fund clients and his move to charge high value clients for their deposits.

Branch Sale

Croghan Bancshares ($397mm, OH) will buy 4 branches with $111.7mm in deposits from the parent company of The Home Savings and Loan ($2.1B, OH) for a 4% premium. Home Savings is selling the branches to raise capital.

SBLF Watch

The Treasury announced 50 more banks have received SBLF funding for $767mm. Overall, 130 community banks have received more than $1.8B in SBLF funding. Distributions end on Sep 27.

Nonsense

Bloomberg reports S&P has assigned a higher rating to securities backed by subprime home loans (borrowers have below average credit scores and almost no equity in their properties) than it assigns the US government.