50 SHADES OF GREY - THE PAIN OF GROWTH

by Steve Brown

While this isn't about to be a feminine erotic thriller, we do want to point out how bankers are often sado-masochistic when it comes to growth. Many bankers love to crack the whip to get growth, knowing that it will likely cause their shareholders pain. You might ask - how can growth be bad? To understand how growth can hurt shareholders, consider that every time you earn a dollar, you have a choice. You can pay $1 of the earnings out to shareholders in the form of dividends (or debt holders via interest) and not reinvest the capital or you can reinvest some (or all) back into the capital account to fund future growth. Remember to that the value of your bank is the sum of the after- tax discounted cash flows (priced at either a premium or discount), based on the market's view of the future of your institution (growth, credit, etc.). If you decide to pay a dividend, shareholders receive a portion of their capital back, which they do not expect a future return on. However, if some or all of the dividend is kept at the bank, then it earns a rate equal to the future return on capital. If the rate of return is above the bank's cost of capital, then all is well. If your cost of capital exceeds your earnings, then you are eroding value for each dollar invested. Reinvesting the dividend compounds this problem as can growth. In fact, the more you grow, the more value can be eroded. To better understand this, let's take a $100mm asset bank. We assume that 100% of the capital is composed of debt at a rate of 15%. Let's hold the capital ratio constant. If the bank earns 20%, then it would make sense to reinvest and grow. However, since the bank is only earning 5%, it is losing 10% on that capital. If dividends were reinvested and assets were grown to $105mm, then the bank would have more assets and capital producing a return below the cost of its debt. If you throw in an equity component and taxes, the math changes, but the concept remains the same. As of 2Q, more than 60% of community banks failed to produce a return above their cost of capital, assuming the cost of capital for most community banks is around 11%. This includes investor expectations, alternative investments (like the S&P 500 index or a risk-free rate), plus a premium for liquidity and other risks. If your return on capital is 5%, but your cost of capital is 15%, then keeping that dollar in the bank to fuel growth compounds the risk- adjusted negative returns. Increase growth and value is destroyed. Decrease dividends and value is destroyed. Do both at the same time over several years and it is likely that you have bound your investors to a suboptimal investment, as future returns will probably not be large enough to overcome multiple years of compounded negative excess returns. A common rationalization for growth is that is better for shareholders as the bank becomes larger because it will earn a better multiple or become more profitable through economies of scale. The ironic part is that the opposite usually happens. Multiples are driven more by profitability than by asset size. Once a bank is over about $240mm in assets, economies of scale can be random, as many larger banks operate at a marginal cost structure that is higher than their smaller brethren. Given the industry today, many banks shouldn't even want to grow and should think about returning excess capital to shareholders. The interplay between growth, size and return is admittedly a grey area. Decisions about growth and dividends really come down to a bank's expectation for the future and their ability to execute. So, at your next strategic planning session, decide what the plan is, the probability that you can achieve that plan and what that return will be. Do this before you determine how much to grow and how much to pay out in earnings. Do this well, and your shareholders will have the returns they need to fantasize about anything they want.

BANK NEWS

Big Change

The Treasury announced modifications to the support it provides the FHFA as conservator of FNMA and FHLMC. The changes are designed to help expedite the wind down of both agencies.

Branch Closures & Sales

Old National Bancorp ($8.4B, IN) has announced it will sell 9 and close 18 of its 183 branches, as it looks to cut costs and further reduce it efficiency ratio (69.2% as of 2Q). The move follows 24 branch closures last year.

Mobile Payment Competition

A group of large retailers that includes Wal-Mart, Target and others will join forces to launch a new company called Merchant Customer Exchange. The company will allow customers to use cell phones to make purchases (using coupons, rebates and loyalty programs through the retailers). This formidable group will go head to head with Google, as well as a similar approach already underway by the wireless carriers (Verizon, Sprint, T-Mobile) and one from major credit card players (Visa, MasterCard).

Huge IPO

Reuters reports Spanish bank Banco Santander will sell 25% of its Mexico unit in what is expected to be Mexico's largest ever IPO and that it could raise $4B. Santander will use the capital raised to shore up its bank back home in Spain. This makes sense when you consider the Spanish banking industry reported a record 9.42% of total outstanding loans were delinquent in June.

No QE3

Goldman's chief economist said stronger economic data (retail sales and others) will keep the Fed on hold at the Sept. FOMC meeting, but that he still believes they "will ultimately decide to ease policy further."

Low Inventory

Realtor.com reports the total inventory of single family homes, condos, townhomes and co-ops for sale in the U.S. continued to hover near historic lows, with 1.87mm units for sale in July (a 19.3% drop vs. one year ago).