GRANT'S
INTEREST RATE OBSERVER®
Vol. 28, No. 21a | Two Wall Street, New York, New York 10005 • www.grantspub.com | OCTOBER 29, 2010

# The thrifts are coming! The thrifts are coming!

It's no state secret, though it might as well be, that mutual savings banks and credit unions are converting to stock ownership by the score. Distracted by the mega-banks and their mega-fouled-up foreclosure procedures, Wall Street is paying no attention to the associated investment opportunities. Not so *Grant's*: Count us intrigued.

"What we're seeing now is almost too good to be true," Joseph Stilwell, eponymous general partner of Stilwell Partners, advises his limiteds. "Clean, overcapitalized thrifts, with less competition than they've faced in years, are coming public at less than one-half of their value to private buyers. And they seem to be coming en masse."

Stilwell, who has invested in demutualization strategies for more than 20 years, does not exaggerate. Newly converted thrifts are coming to market at discounts of up to 40% and 50% from tangible book value. For the most part, these are unsophisticated institutions. In their innocence, they lent against the collateral of single-family residences on conservative terms and retained the loans on their balance sheets. Not knowing any better, they stood aloof from the securitization frenzy. As a further sign of their ignorance of 21st-century financial practices, they have suffered only modest levels of nonperforming assets. Their managements never got rich—they never gave themselves the chance.

Formal ownership of mutual savings banks and credit unions resides with the depositors (that of mutual life insurance companies with the policy holders). Practical ownership attaches to the sometimes self-perpetuating managements. In any case, mutual institutions exist not to turn a profit but to serve a supposedly broader interest. Following conversion to investor ownership, managements have their chance to maximize revenue, minimize costs and make a little money for themselves. They seem eager for the opportunity.

Of all things, the imminent shuttering of the Office of Thrift Supervision is one of the motive forces behind the charter conversion drive. OTS-regulated thrifts will find themselves under the wing of the Office of the Comptroller of the Currency next summer, in keeping with the provisions of the Dodd-Frank Act. Better the sleepy devil you know than the possibly energetic devil you don't, the converting thrift managements seem to be reasoning. So they're seizing the opportunity of regulatory realignment to convert to stock ownership under the rules before they change, or may change, in 2011.

Perhaps 20 mutual thrifts are in the wings waiting to issue public equity, Stilwell says, and another 30 might be queued up behind them. Mutuals first offer stock to their depositors. Others get their chance to buy whatever shares the depositors decline. In the day, the depositors clamored for every share. These days, there's lots of stock for everyone. Thus, for instance, a clean and overcapitalized Capitol Federal Financial, of Topeka, Kan. (CFFN on the Nasdaq), sold 14.3 million shares in the community-offering phase of its recent conversion and another 6.8 million shares to its employee stock ownership plan. The local interests having had their fill, the company is offering between 118 million and 160 million to the public in a syndicated offering run by Sandler O'Neill & Partners, L.P. For monthly updates on the thrift conversion calendar, consult SNL ThriftInvestor ($495 a year through SNL Financial).

Value-seeking investors will applaud the timing of these initiatives. Conversions are appraised with reference to quoted banks, which have been in a four-year bear market. The Russell 2000 Value Banks Outside New York City Index, for instance, is down 59% from its peak. The component parts of such swooping averages are the small public banks that fell for the high-margin bait of commercial real estate lending. Note, Stilwell observes, the mutuals are mainly innocent of the public banks' sins. Slow and steady won the race.

Many are the drawing cards of the 2010-11 thrift-conversion wave. Not the least is that you, the outside public minority shareholder, invest side by side with the insiders. Everyone gets the same price. "It is not like the usual situation where insiders are selling and trying to get a higher price," says Stilwell. "Here, they are buying with you. And they are also moving the mechanics of the process to get the best price."

There can be no mistaking the run-of-the-mill thrift for Apple Inc. Single-digit returns on equity are the norm, while returns on assets usually fall short of 1%. In management, mediocrity is the standard. In sub-mediocre cases, the president has inherited the bank as

he or she might have done the family silver. In the best cases, says Stilwell, the CEO is a decent manager who now, for the first time, has the opportunity to show his or her inner capitalist.

To manage a financial institution in a zero interest-rate world is no cakewalk. Then, again, Stilwell remarks, "You are buying something at less than half of its private market value. . . . You could argue that things do get cheaper at the bottom of the cycle, which is nowhere near, apparently, it seems to me. But what do they go down to? One-third [of tangible book value]? At the same time, they are going to keep growing value. Most of their competitors have been wiped off the map. The world is changing. These are the politically favored entities right now—small community banks. People hate Wall Street. People hate Bank of America. Nobody hates First Federal Savings & Loan of Wichita. So you are likely to see things relatively more favorable for these folks than for the banking industry in general."

A mutual thrift is a latent little bank, Stilwell goes on. The transition to bank from thrift is what many a mutual management hopes for, and works toward. They find it's a long, hard road. "Along the way," says Stilwell, "for one reason or another, say within three to five years—that's our rule of thumb—half of the thrifts that have come public through mutual-to-stock conversion will sell themselves to somebody else. They can't do it, they're tired, they need a lot of fancy systems and the big brother catty-corner to them on the street can do it better, and why not join forces? Half of them are gone, usually at a decent profit, depending on when you first invested in them, within three to five years."

Of course, some will be gone to the happy hunting ground, the consequence of poorly executed expansion plans. Stilwell says he's all for growth, but only the wholesome kind. "If you grow real fast, that is not a great way," he says. "If you spend on acquisitions, that is a pretty bad way. But if you—over two, three, four, five years—take your share count down so that you are then properly capitalized, you've increased your book value, and you've increased your franchise value per share. That's brilliance. And if, at the same time. . .you're cutting your costs and becoming more efficient, and the parking lot doesn't empty out at 4:59 p.m. every day, you have a chance to be a decent community bank, which, historically, is a 12% to 15% return on equity, which any sensible bank investor was thrilled with. Because that is sustainable; they're not reaching, they're not going crazy."

A purely passive investment is one way to proceed. Stilwell, however, prefers to accumulate a greater-than-5% investment and, with the authority a filing position imbues, exercise "adult supervision." "I just filed on two in western Pennsylvania that recently converted," he continues: "First Federal Savings & Loan (FFCO, of Monessan, Pa.) and Standard Bank (STND, of Murrysville, Pa.). Both are little thrifts. I've bought 7% or 8% positions in them, and we've filed 13Ds. They are both cheap. One has a book value of 18ish and the other has a book value of 19ish. We paid 11 and change. They both have earnings. They both have capital—in equity-to-assets after the deal of 15% or so. And they both have nonperformers sub 1%. They are thrifts, banks in potential. We've gone out and met with both of them. They both seem like decent folks. We've told them what we expect: 'That you've done a good job. You've managed through this. You have no nonperforming problems. You've managed to come public at the absolutely right part of the cycle. Please keep doing what you're doing. When you can buy back some stock, please do so. And you'll have a very happy largish shareholder. [But] if you decide to use the money you've taken to buy your competitor or do something, and [you] put out some pabulum about long-term shareholder value, we're going to come in and unemploy you.'" Stilwell modified the verb to "unemploy" with a strong, Anglo-Saxon gerund.

Stilwell lays out the same set of expectations for both banks in his 13D filings: "We hope to work with existing management and the board to maximize shareholder value," the language says. "We will encourage management and the board to pay dividends to shareholders and repurchase shares of outstanding common stock with excess capital, and will support them if they do so. We oppose using excess capital to 'bulk up' on securities or to rapidly increase the loan portfolio. We will support only a gradual increase in the branch network. If the issuer pursues any action that dilutes tangible book value per share, we will aggressively seek board representation."

"This is one of those times when all of the stars line up," Stilwell winds up. "They've all lined up here. So, you know, frankly, a down market here would only help me at this point to make good investments in these because they come against the comps. This is the fourth year of a bear market in this sector. Will there be a fifth or sixth year? Maybe. But these are not on-edge institutions."

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