GRANT'S
INTEREST RATE OBSERVER®
Vol. 37, No. 21j 233 Broadway, New York, New York 10279 • www.grantspub.com NOVEMBER 1, 2019

Community activists

Fabiano Santin writes:

Community-bank stocks have marched in place for almost three years. Since Dec. 30, 2016, the Nasdaq Bank Index, which tracks 338 regional institutions and which also gives an honest indication of how the small fry fare, has produced an annual return of 1.6% vs. 13.7% for the S&P 500. The bank index trades at 12.3 times earnings, a 36% discount to the price-to-earnings ratio of the S&P 500, the deepest since 2000.

Now under way is an upbeat survey of the community-banking business. Valued at an average of 1.3 times book value, lower than the 20-year average of 1.6 times but twice the crisis level recorded in March 2009, the Nasdaq banks are, in general, profitable, sound and well-capitalized, even if not commandingly and absolutely cheap. A separate allurement consists of a potential regulatory action that could hasten the long-existing trend toward banking consolidation.

OFG Bancorp, Peapack-Gladstone Financial Corp., TGR Financial, Inc. and Heartland BancCorp. (OFG and PGC on the Big Board and Nasdaq, respectively, and TGRF and HLAN in the pink sheets) are the apples of our eye. All but one, OFG, a Puerto Rico name, are microcaps, with trading liquidity in proportion to size.

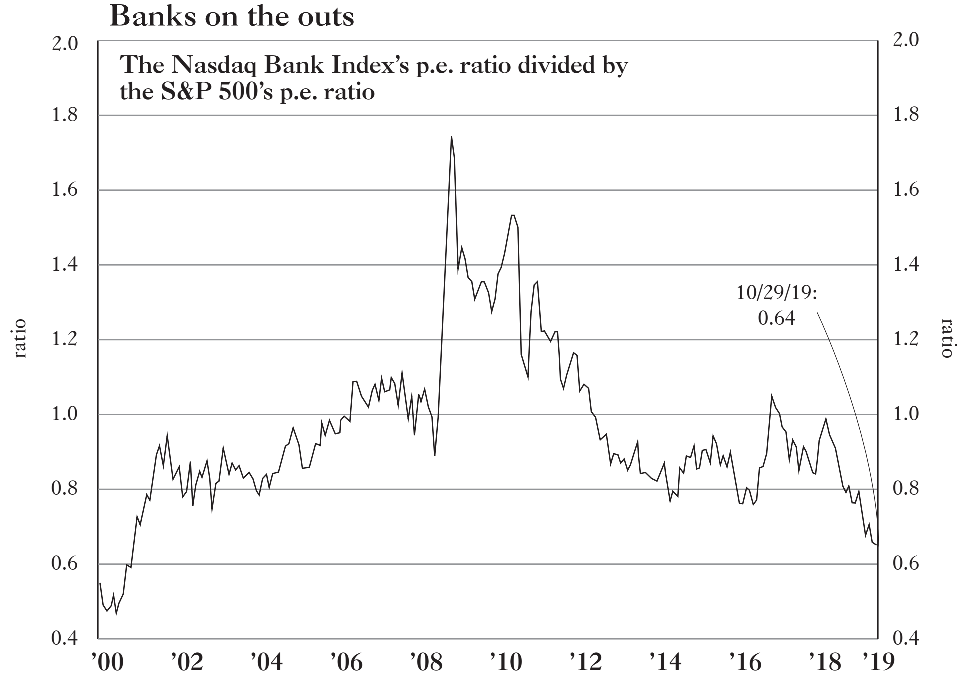
"Balance sheets are in really good shape from a capital perspective," Christopher McGratty, managing director and equity-research analyst at Keefe, Bruyette & Woods, Inc. tells me. "We're at generationally high capital [and] the underwriting has gotten a lot better." Even so, low interest rates are pressuring margins, which leads to what McGratty calls "limited engagement by the buy side," or what otherwise might be characterized as nobody much caring.

Joseph Stilwell cares a lot. The eponymous general partner of Stilwell Partners, he has been in the business of small-bank investing—from thrift conversions to community-bank investments—for more than 30 years. "There are too many banks [in America], and they are too small, not economically well-organized," Stilwell says. "We've gone from 30,000 to 20,000 to 10,000 to 5,000. We're going to 500 or less. If you look at a country like Canada, they have one-tenth as many people and they really only have 10 banks."

On April 23 the Federal Reserve invited public comment on a proposal to loosen the strictures on activist investments in bank stock. As it is, an outsider must stop accumulating shares before he reaches 10% and is typically able to elect only one director. If the new proposal becomes a rule, the limit would rise to 25%, and the activist could elect not quite 25% of the board.

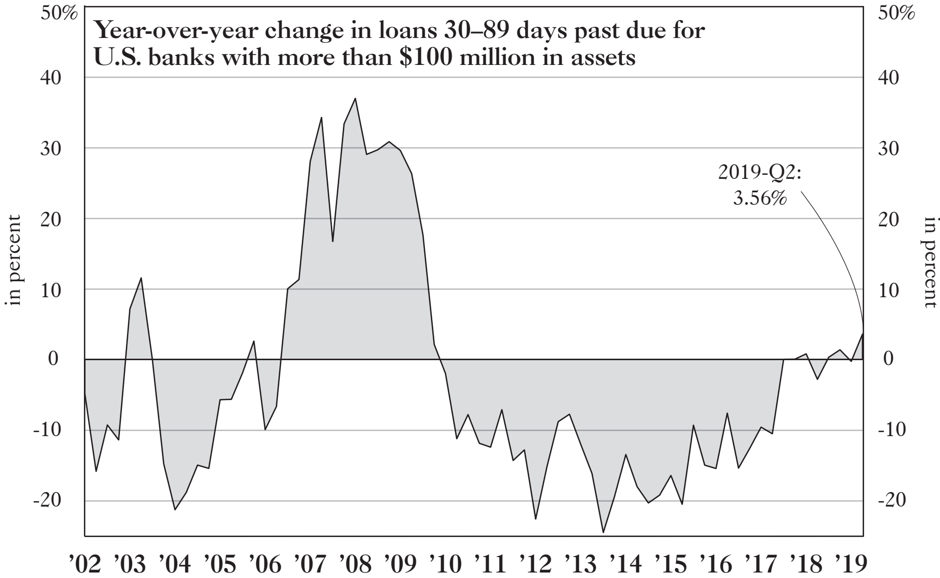
Whether or not the Fed obliges, the would-be investor must analyze. What does a community bank bring to the competitive party?

Banks on the outs



source: Factset

Past-dues up a pinch



source: S&P Global Market Intelligence

"The biggest competitive advantage that they have is understanding who is in what business, who is expanding, who wants to expand," says Ben Mackovak, co-founder and managing member of Strategic Value Bank Partners, LLC, a partnership focused on community banks in Cleveland, Ohio. Such as a situation like this: "They've got 50 car washes, and they want to build a new car wash, and they've been in the car-wash business for 25 years. It's not worth it for the big banks to fool around with a $5 million or a $10 million loan, so there's really an underserved area for small-business owners that community banks fill."

Bedminster (N.J.)-based Peapack-Gladstone Financial is one of the fund's picks. The shares change hands at 1.1 times book value and 12.8 times earnings for a $570 million market cap. Peapack generated an average return on equity of 7.69% in the five lean years ended Dec. 31, 2016 and roughly 10% in 2017 and 2018, according to data from Bloomberg. For comparison, community banks registered a median ROE of roughly 9% in the past two years, according to data from S&P Global Market Intelligence.

On Sept. 30, Peapack carried $4.1 billion's worth of loans, including $0.7 billion of commercial mortgages, $1.6 billion of commercial loans (secured by accounts receivable, inventory, vehicles and equipment), $1.7 billion of residential mortgages and a dollop of consumer and home-equity loans. Nonperformers comprised 0.71% of the portfolio. Tier 1 capital weighed in at 13.2% of assets compared with the regulatory minimum of 6.0% and a big-bank average of 11.3%.

Peapack, too, owns a prosperous wealth-management unit that, on Sept. 30, looked after $7 billion and—by extrapolating third-quarter fees—was on track to contribute $40 million in annual fee income.

Mackovak's other picks are smaller and less liquid even than Peapack. They include Naples (Fla.)-based TGR Financial (11.6 times earnings, 1.3 times book value, $195 million market cap) and Columbus (Ohio)-headquartered Heartland Bank (10.6 times earnings, 1.1 times book value, $136 million market cap).

Mackovak judges that, for the sector as a whole, credit quality is under control. By the Federal Deposit Insurance Corporation's tally of 2,900 banks with assets of more than $100 million, the aggregate change in loans 30–89 days past due rose by 3.6% in the second quarter.

Stilwell's funds, meanwhile, own 4% of OFG Bancorp's common. The stock trades at 11.7 times earnings, or 1.1 times book value, for a market cap of $1.1 billion. ROE jumped to 8.6% in 2018, up from an average of 6.1% in the prior five years.

The Sept. 30 loan book totaled $4.4 billion's worth and comprised $1.8 billion of commercial loans, $1.1 billion of residential mortgages, $384 million of consumer loans and $1.3 billion of auto loans. Two percent were nonperforming, down from 3.4% one year ago. The Tier 1 capital-to-assets ratio stood at 20.4%, 14 percentage points above the minimum.

"The only place in America that is not over-banked is Puerto Rico," observes Stilwell, pointing to last week's announcement of FirstBank Puerto Rico's acquisition of Banco Santander's operations in that region. "Even though all the news articles kept talking about how terrible things were in Puerto Rico, if you just looked at the numbers that came out in the 10Qs and 10Ks, things turned after Doral [Financial Corp.]'s 2016 bankruptcy, and they've only been getting better, and it is not well appreciated. . . . Ninety-five percent of the deposits after [the FirstBank] deal will be in three banks' hands, where capacity is no longer in excess of what it should be."

•