GRANT'S

INTEREST RATE OBSERVER®

Vol. 42, No. 20e | 233 Broadway, New York, New York 10279 • www.grantspub.com | OCTOBER 25, 2024

Banking as a risk

Evan Lorenz writes:

Commercial real estate prices were actually up—by three full percentage points—in the first nine months of 2024, according to Green Street, but distressed credits in CRE-backed collateralized loan obligations reached 13.1% in September, an all-time high. Yes, office towers, with an 18.5% distress rate, led the rise, but hotels (8.5%), retail properties (11.1%) and apartments (13.7%) were also bedeviled.

Perhaps the trouble lies less in the buildings than in the financing. In preview, *Grant's* is bearish on The Bancorp, Inc. (TBBK on the Nasdaq), a fast-growing lender with a large exposure to troublesome CRE loans.

In the summer of 1965, a prestigious Philadelphia-based law firm decided not to offer a job to a promising law clerk and soon-to-be graduate of the University of Pennsylvania law school. After all, she was a woman. "I told [the senior partner] what I was really thinking, which was, 'I think it's your loss,'" Betsy Zubrow Cohen recounted to *Forbes* two years ago.

Just to show them, Cohen cofounded her own law firm in 1969 and (as the sole founder) her own bank, the Jefferson Bank, in 1974. She sold Jefferson to Hudson United Bancorp for $370 million and applied the proceeds to the founding of Bancorp in Wilmington, Del., in 1999. While she stopped managing Bancorp's day-to-day operations in 2014, the first female bank CEO in Pennsylvania history hardly slowed down. She dove into the SPAC boom in 2016, bringing more than a dozen special-purpose acquisition companies into the world.

Bancorp was born different. For instance, it chose not to build out an extensive branch network to gather deposits, but rather partnered with such companies as PayPal Holdings, Inc. and Chime Financial, Inc. The tech firms, which lack bank charters, would bring Bancorp deposits, and Bancorp, which is regulated by the Office of the Comptroller of the Currency, would empower its tech partners to offer checking accounts, debit cards and credit cards. "Banking as a service," or BaaS, is Wall Street lingo for this profitable reciprocal division of labor.

It may surprise you to learn that Bancorp, managing an $8.1 billion balance sheet, or just 0.03% of the assets in the U.S. banking system, owns the title of America's No. 1 issuer of prepaid debit cards. The so-called Durbin amendment to the 2010 Dodd–Frank Act explains the paradox. The amendment strictly limits the interchange fees that lenders with balance sheets of more than $10 billion in assets can charge on debit transactions. Thus did the senior senator from Illinois assure that the smaller lenders, Bancorp not least, would command the pricing power.

At a glance, Bancorp is well-financed, strongly capitalized and highly profitable. As of June 30, the bank's $5.8 billion loan book was funded with $7.2 billion in deposits and its Tier-1 common equity footed to 14.1% of risk-weighted assets. In the second quarter, Bancorp generated a 27% return on eq-

REBL without a loss . . . yet

source: The Bloomberg

uity, or more than double the 12.3% average for U.S. banks in the same period. As of June 30, nonperformers amounted to 0.34% of the total loan book and reserves covered problem loans by 1.5 times. (These ratios exclude a problem credit slated to be sold at the end of this year.)

As of June 30, the $5.8 billion loan portfolio comprised "real estate bridge lending," denoted by the acronym REBL (39% of the total), loans secured by a borrower's investment portfolio or insurance policies (27%), business loans (many of which have guarantees through Small Business Administration lending programs, 16%) and commercial fleet leasing (12%). The $1.6 billion securities portfolio featured Fannie Mae and Freddie Mac paper (78% of the total), securitized student loans (17%), munis and Treasurys.

Real-estate bridge loans fund needy properties. They may require capital improvements, tenants or both. Bancorp's specialty is apartments built for lower-income households ("workforce housing," management calls them) in such Sunbelt states as Texas (34%), Georgia (11%) and Florida (11%). Bancorp issues REBL loans with a three-year initial tenor and options to extend maturities by one or two years. As the loans pay floating-rate interest, the bank requires borrowers to purchase interest rate caps for the first three years of the term.

At the generational lows in yields, Bancorp built its adjustable-rate loan book while competitors like Silicon Valley Bank chose to bet on fixed-rate bonds. The REBL book grew rapidly, to $1.7 billion by year-end 2022 from zero in the second quarter of 2021. Moreover, the interest rates on REBL loans rose rapidly, to 9.2% in the second quarter of 2024 from 4.2% in the third quarter of 2021. Ergo, the great leap in Bancorp's return on equity, to 27% from 18% over the same charmed span.

. . .

"Bancorp is, in my opinion, a very high-quality, strong, fast-growing bank," Tim Switzer, who rates TBBK a buy for Keefe, Bruyette & Woods, Inc., tells me. "On the credit side, only about 50% of the balance sheet has any sort of credit risk—and 50% is close to zero-credit risk." Switzer refers to the securities portfolio and to loans backed by stocks, bonds and insurance policies.

Not content with a 27% return on equity, Bancorp says it's gunning for 40% by 2030 even as it continues to cap its balance-sheet size at the $10 billion Durbin threshold. Management says it means to achieve these seemingly disparate goals by brokering fintech deposits to other banks and securitizing consumer loans whenever its own balance sheet approaches the asset ceiling conceived by the senior senator from Illinois. It's the jump in anticipated fees that's intended to drive the ROE moonshot.

In the 12 months ended June 30, Bancorp repurchased $201.3 million's worth of stock on a current market capitalization of $2.7 billion, shrinking the share count by an impressive 9.8% over the period. CEO Damian Kozlowski explained the corporate M.O. on the Jan. 26 earnings call: "It's not our money. We are borrowing it from our shareholders. It's their money." At current valuations, he contended, the best use of that cash is buybacks.

Nevertheless, shares tumbled by 30% between Jan. 30 and April 30 as management fessed up to a $39.4 million delinquent bridge loan and short activist fund Culper Research issued a condemning report (on which, more later). However, TBBK subsequently rallied to a 45% year-to-date gain following a second-quarter announcement that the dud loan, now on the auction block, would not detract from year-end earnings results.

Bancorp is a controversial institution. Though loved by the Street, with all three analysts on the case saying buy, it has attracted a short interest summing to 15.3% of the equity float. Over the past 12 months, insiders have purchased a net 32,739 shares at a cost of $1.1 million.

The Bancorp, Inc. at a glance
all figures in $ mns except per share data

	TTM*	2023	2022	2021	2020
interest and fee income	$534.1	$509.5	$308.3	$222.1	$210.8
pre-tax profit	272.4	256.8	177.9	144.2	108.3
net income	204.3	192.3	130.2	110.4	80.1
earnings per share	3.83	3.49	2.27	1.88	1.37
shares outstanding	51.3	55.1	57.3	58.8	58.4
loans	5,842.3	5,666.5	6,053.6	5,056.3	4,447.1
deposits	7,155.7	6,680.9	7,030.1	5,976.9	5,462.1
equity	777.0	807.3	694.0	652.5	581.2
total assets	8,145.4	7,705.7	7,903.0	6,843.2	6,276.8

*12 months ended June 30, 2024.

sources: company reports, the Bloomberg

. . .

Depending on how you approach Bancorp, it's either reasonably valued, at 14.6 times trailing earnings versus 13.1 times for the slower-growing KBW Bank Index, or downright expensive, at 3.5 times book value versus 1.3 times for the KBW gauge. On the quality of the REBL book hangs the answer.

The bridge-loan asset class, of which REBL loans are a subset, has had its troubles in the post-Covid era. Rents escalated during lockdowns and thereby led to a surge in multifamily construction. By July 2023, the pipeline of new apartments had reached 1 million, the most since at least 1970.

Naturally, what followed the building boom was a pricing bust, especially in the Sunbelt states where Bancorp's REBL portfolio is concentrated. In September, rents fell by 4.1% year over year in Atlanta, Ga., 5% in Jacksonville, Fla. and 8.1% in Austin, Tex., according to RealPage, Inc.

Operating costs have shot higher. It costs more to refurbish units between tenant leases, and insurance, personnel, maintenance and interest expenses have also climbed. "So you have this perfect storm of rents not coming where you thought they would, and the cost of repairs is way too high," an anonymity-seeking short seller tells *Grant's*. "Then, all of a sudden, the sponsor can't deploy the capital to put on a fresh coat of paint because they're getting hit by debt-service expenses."

Bancorp provides few data points on its bridge-loan portfolio, but it does vouchsafe two. The first is the loan-to-value ratio for when the loan was originated (70%). The second is the LTV for when the property that secures the loan was "stabilized," i.e., after the borrower has spent the proceeds of the loan he raised with which to clean up, fix up and paint up the apartments (61%). Unfortunately, the company doesn't say what proportion of loans, if any, has been stabilized.

Other lenders, like Arbor Realty Trust, Inc., have securitized their REBL portfolios into collateralized loan obligations. The CLO structure itself mandates the disclosure of additional information in the public record. Thus, according to an Oct. 16 report by short-selling activist Viceroy Research, LLC, 70% of the loans in Arbor's 2021–22 vintage REBL CLOs have been modified. However, despite these extensive workout attempts, 15% of the portfolio remains delinquent and the credits that stock the CLOs show an aggregate debt-service coverage ratio of just 0.48.

To investigate the status of Bancorp's REBL portfolio, Culper says it has pored over liens, deeds and local property records. The fruit of this research was a report, dated March, which identified a half-dozen loans with 2024 maturities and outstanding principal balances of $141.6 million, or one-half of the $283 million's worth of REBL loans maturing this year. Another two loans, in the sum of $62.3 million, fall due next year.

The fact that Culper homed in on 2024 loan maturities is important. First, the interest rate caps that the borrowers were required to purchase around three years ago are about to expire. Second, after the lapse of 36 months, the debtors ought to have had enough time to effect the improvements they said they intended to make. What the firm said it found instead was striking: "These properties are, quite literally, crumbling: ridden with crime, shootings, lootings, [bug and rodent] infestations, fires and even full-on condemnations, while vacancies remain high and rents have remained stagnant."

The borrowers in this cohort of loans appear to be unsophisticated. They have limited resources with which to inject new equity into their properties. Sumners Capital Properties, LLC, the obligor on a $13 million loan, for example, raised money from retail investors. Think Multifamily ($15.5 million loan) took this one step further, using crowdfunding site OwnProp to sell blockchain-enabled tokens for part of its equity check.

Both bulls and bears agree that Bancorp is under-reserved for the problems in its REBL book. Where the two sides fall out is over the significance of that fact. "I would argue that any sort of reasonable or even catastrophic loss on the REBL book could basically be covered by shifting money that you were otherwise going to use for buybacks," Frank Schiraldi, who rates TBBK a buy for Piper Sandler & Co., tells me. After all, he points out, the bank is generating a 27% ROE, a level of profitability that can accommodate more than a few bad loans.

Of course, it all depends on the quality of the loan book. If rot there be, how deep does it go? In the second quarter, Bancorp modified $77.3 million's worth of loans (excluding the aforementioned property slated for sale) from $12.8 million in the fourth quarter of 2023—and this is before any of the REBL loans reach their maturity date or the borrowers' interest rate caps expire. If the problems are even half as bad as Arbor's, Bancorp's book value and earnings may take a significant hit. In the second quarter, the REBL portfolio was 2.7 times larger than Bancorp's capital position and delivered 35.3% of the bank's interest and fee income.

In the past, the bank has faced fines from the Securities and Exchange Commission for mismarking loans: once for understating loan-loss reserves by $138.6 million between 2010 and 2013 and a second time for misvaluing interest-only strips from commercial real estate securitizations between 2017 to 2019 (the bank tested the securities with assumptions of 5% prepayment rates when prepays came in at over 30%). In March, Bancorp switched auditors to Crowe, LLP from Grant Thornton, LLP.

The TBBK share price did rally after the company said it would sell the $39.4 million dud loan at no loss, but there may be less to that superficially bullish news than meets the eye. The unnamed buyer has only put up $125,000 (with an additional $375,000 required by the end of the year), while Bancorp is responsible for making improvements to the building that Culper found to be just 47% occupied.

"If you told me," our anonymous source tells us, "'Hey, you can pay a half-million as an option to buy this building and you don't have to do any work; if it doesn't work, well, you can walk away,' then I think that's not the worst deal for the buyer. They didn't actually buy the property. They bought an option to buy the property."

And, of course, Bancorp and its shareholders are short that option.

Bancorp, which is slated to report third-quarter earnings after the close on Oct. 24, declined to comment.

•