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Eye of the yield

James Robertson, Jr. writes:

The mid-March depositors' run remains etched in the security prices of banks deemed not big enough to *not* fail. So while the 4.2% Series MM preferred shares of JPMorgan Chase and Co. carry a yield of 5.3%, the 5.5% Series I preferred shares of the beleaguered First Republic Bank fetch 21.7%.

The high-yielding preferred shares of storm-tossed regional banks are the subject at hand. In particular, we are bullish on issues from PacWest Bancorp (PACW on the Nasdaq) and Western Alliance Bancorporation (WAL on the New York Stock Exchange), though widows and orphans should avert their eyes.

Depositors continue to flee smaller banks for the safety of the federally protected behemoths. The 25 largest banks gained $120 billion in new deposits between March 8 and March 15, according to the Federal Reserve, while all smaller banks lost $184 billion—the biggest drop in the latter category on record.

Money-market funds, which came of age in the 1980s (another era in which banks rates couldn't keep up with Treasury yields), have been attracting depositors from banks of all sizes. According to Refinitiv Lipper, these funds raked in more than $220 billion in the past two weeks.

"So you've got these regional banks," Benjamin Mackovak, co-founder and managing member of Strategic Value Bank Partners, tells *Grant's*, "are they too big to fail? Or are they not too big to fail? Those are the stocks that are down 20% or 30% in the past month with no credit issues. This is not a credit event. It's really a duration event and a confidence event."

The radioactive cloud of the SVB failure continues to hover mainly over regional and community banks rather than money centers. Thus, from their respective February highs, the S&P Regional Banks Select Industry Index has dropped by 33%, JPMorgan shares by only 10%.

In investing, proverbially, you can have low prices or optimism but not both at the same time, and sentiment around regional banks is predictably downbeat. With that understood, the stricken preferreds provide an appealing opportunity to participate in a banking-sector recovery with the benefit of an incremental pickup in safety. In the rank order of credit, shares of the preferred kind are senior to common equity, junior to loans and debt. The upshot is that the preferred holders get their dividends before the common holders see theirs.

Like bonds, preferreds offer a stated yield, fixed or floating. However, unlike bonds, those distributions can be suspended without precipitating a default. The moniker "noncumulative" is one to watch for. It means that, in the event of an interruption in preferred dividends, those distributions will forever remain undistributed. Neither equity nor debt, preferreds exhibit some of the characteristics of each, including, in their equity persona, the chance of greater capital appreciation than most debt instruments afford.

Banks and politics are age-old bedfellows, and there's a political thread in the bank preferred-stock opportunity. Safeguarding the biggest banks while throwing the others to the wolves doesn't appeal much to either party in the year before a national election. Given that the small fry held 77% of small-business loans last year, voters would miss them if they were gone.

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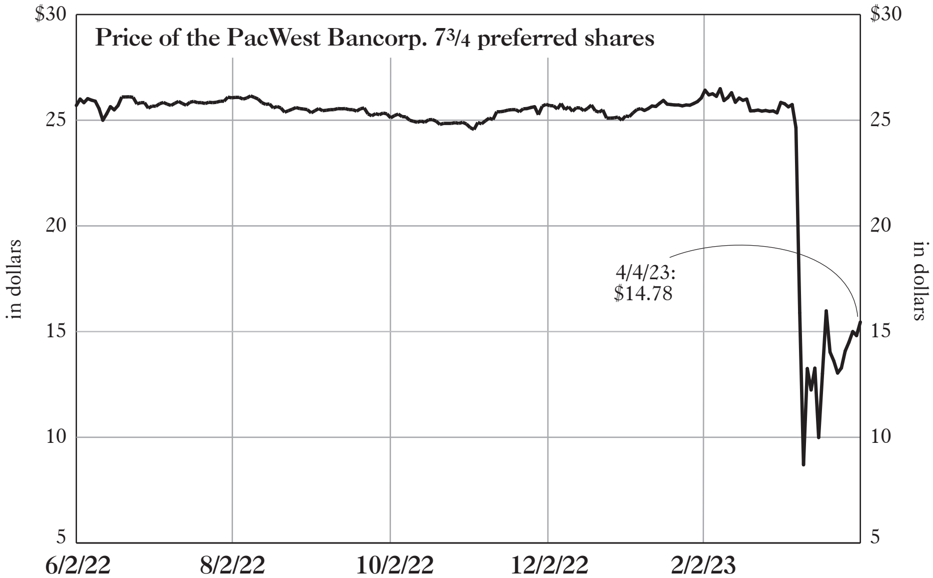
New York Community Bancorp, Inc. (NYCB on the Big Board), with its 6 3/8% Fixed-to-Floating Rate Series A Noncumulative Perpetual Preferreds, provides an example of what can go right. Between March 2 and March 17, the price of this stock plunged by 37%, to $15.65, only to rally back to $23.14, not far from the $25 par value. The shares today yield 6.89%, down from the panic high print of 10%.

New York Community bought its crown jewel, Flagstar Bank N.A., in 2021; it is the second-largest mortgage warehouse lender after JPMorgan. Having closed in December of last year, the combined entity, which boasts total assets of $90 billion, focuses on multifamily loans, in which category it is also No. 2. Flagstar operates 395 branches across New York and Michigan with some exposure to the Southeast and the West Coast.

At year end, New York Community showed a ratio of loans to deposits of 118%, aggressively unconventional when compared with the 75% ratio prevailing among its peers. However, observes Christopher Whalen, founder and creator of *The Institutional Risk Analyst*, by lending more NYCB has invested less, notably less in the type of ostensibly safe mortgages and Treasurys that blew up Silicon Valley. New York Community

Time for a rethink



source: The Bloomberg

carries half the average amount of liquid securities of its peers and denotes what it does carry as available for sale.

While other banks were on the defensive, New York Community went bargain hunting. On March 20, through Flagstar, it bought $38 billion of Signature Bank's assets from the Federal Deposit Insurance Corp., including $13 billion of loans acquired at a discount. The $34 billion increase in deposits drives the loan-to-deposit ratio down to 88%. Meanwhile, Signature's crypto accounts and its portfolio of multifamily, rent-regulated residential mortgages remain in receivership with the FDIC.

As a percentage of year-end Tier 1 capital, New York Community's own rent-regulated multifamily mortgage book represented 34%. Rent-controlled or rent-stabilized buildings in New York State carry the risk inherent in the Housing Stability and Tenant Protection Act of 2019, legislation seemingly intended to decapitalize New York City apartment buildings (*Grant's*, Feb. 24).

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After nine months and a 334 basis-point rise in the federal funds rate, *Grant's* returns to PacWest Bancorp's Fixed-Rate Reset Noncumulative Perpetual Series A Preferreds, which pay 7¾% on the par price of $25. This time, we're bullish.

Established on the eve of the new millennium, PacWest Bancorp, the holding company for Pacific Western Bank, is a California institution with branches in Colorado and North Carolina. Like many another community and regional bank, PacWest is a real estate lender, first and foremost. Unlike some of its peers, it also deals in bridge loans to venture-backed businesses. "Canary in the coal mine of credit," was the headline over a *Grant's* analysis of PacWest dated June 10, 2022. We noted with special disfavor the exposures to venture capital, house-flipping and high-end real estate.

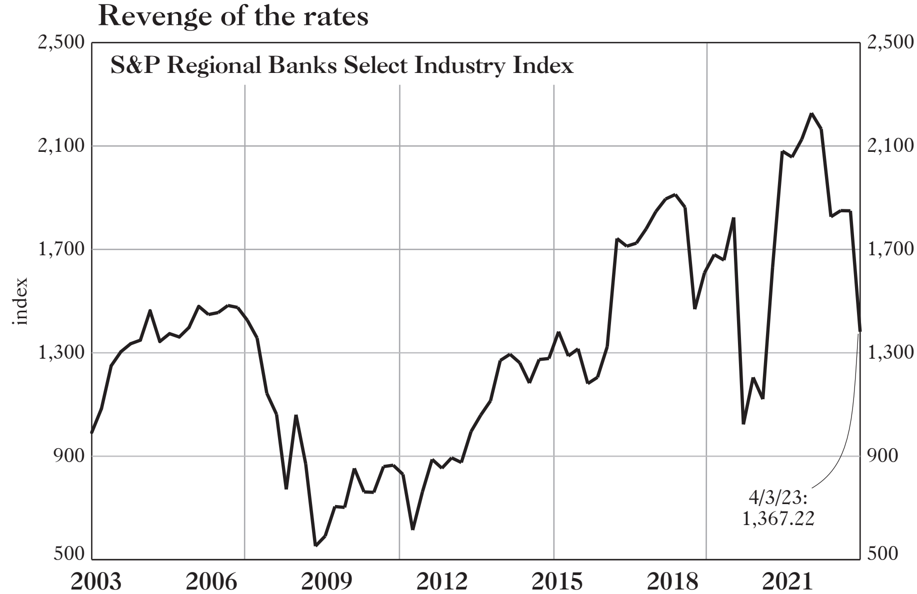
It was the scarlet letter of venture capital that likely accelerated the collapse in the preferreds to a low price of $8.70 from a high of $26.49 in February. When we wrote last June, venture exposure at PacWest made up 9% of the loan book. By year end, it had dropped to 7%. And the house-flipping division, the bank reports, is downsizing. However, from Dec. 31, 2022 to March 20, deposits fell by $6.8 billion, to $27.1 billion, with hive-minded v.c. founders accounting for 72% of that hasty migration.

Along with the risk of a further bleeding of deposits, v.c. or otherwise, regional banks are vulnerable to agency mortgage-backed securities issued with sub-3% yields and durations that nowadays stretch to seven years. For instance, a Ginnie Mae MBS with a weighted average coupon of 2.5% trades at 89. Neither does it help the marketability of these once-coveted securities that seven-year Treasurys change hands at a yield to maturity of 3.4%.

With respect to securities holdings, let it be said that PacWest is no Silicon Valley, which, you'll recall, suffered investment losses of $15.1 billion in its held-to-maturity portfolio on tangible common equity of $11.8 billion. Comparable figures at PacWest amount to $159 million and $2 billion.

How a bank accounts for its bonds and mortgages can make all the difference. On the one hand, assets can be recorded at fair value in available-for-sale portfolios with unrealized losses marking

Revenge of the rates



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down the value of equity through accumulated other comprehensive income. On the other, assets can be recorded at amortized cost in held-to-maturity portfolios, and unrealized losses do not impair equity. But sell $1 of your held-to-maturity portfolio, and you must reprice the entire portfolio.

At year end, PacWest's portfolio of residential-agency MBS, all denoted as available for sale, amounted to $2.2 billion, net of $443 million in gross unrealized losses. Year-end holdings of agency commercial MBS obligations summed to $976 million with unrealized losses of $96.2 million; 56% of those investments resided in the available-for-sale portfolio. At year end, $670 million of Treasurys bore mark-to-market losses of $101 million with 81% held as available for sale.

Availing itself of the hospitality of the Fed's new Bank Term Funding Program, PacWest has borrowed $2.1 billion for up to a full year against the par value of the collateral of the mortgages and Treasurys that are quoted in the market at less than par. It has, as of March 22, borrowed $3.7 billion from the Federal Home Loan Bureau and $10.5 billion from the Federal Reserve discount window, steps taken to shore up liquidity. Some 65% of deposits are smaller than the $250,000 insurance limit; overall, says management, the deposit situation has "stabilized."

Against the average FDIC institution with assets of between $10 billion and $250 billion, $41 billion PacWest had a lower Tier 1 capital rate (10.6% versus 13.1%) and return on equity (10.7% versus 12.8%) as of year-end 2022, though it beat the average on net charge-offs to loans and leases, at 0.04 versus 0.28, thus showing higher asset quality. Its net interest margin was also higher at 3.49% versus 2.49%. Not the least-constructive feature of the post-panic PacWest is its valuation, at $14.78 per preferred share, for a price to yield 13.1%.

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Western Alliance Bancorporation primarily runs out of the Phoenix, Ariz.-based Western Alliance Bank, which also operates in Nevada and California. Residential lending made up 31% of last year's loan book, bolstered by the 2021 acquisition of mortgage originator AmeriHome Mortgage Co. LLC. Of the balance of the loan portfolio, commercial and industrial loans account for 14%, warehouse-mortgage lending for 11% and bridge banking to commercial real estate, private equity and venture capital, 7%.

At last report, Western Alliance's deposit base included a 14% exposure to tech and innovation which (recalling March events) poses an above-average risk of outflow. Of the deposits, 45% were uninsured, though $25 billion in cash covered the uninsured depositors 1:1.

The Western Alliance 4.25% Fixed-Rate Reset Noncumulative Perpetual Series A Preferreds fell 62% on March 13 to $8.01. It changes hands today at $13.90, to yield 7.6%.

"At its core," write Christopher McGratty and colleagues at Keefe, Bruyette & Woods, Inc. in a March 16 analysis, "Western Alliance possesses many attractive characteristics of a differentiated [small- and mid-cap] bank in investment, in our view, notably industry-leading profitability metrics and among the fastest capital accumulation rates in the group."

At year end, Western Alliance's balance sheet showed $68 billion in assets. The bank registered above the 2022 averages of its FDIC class of $10 billion–$250 billion peers in terms of net interest margin (3.98% versus 2.49%), return on equity (20.5% versus 12.8%) and net charge-offs to loans (0.01% versus 0.28%). Its Tier 1 capital ratio of 10% and loan-to-deposit ratio of 99% came in slightly below average.

Western Alliance bore a mark-to-market loss at year end of $177 million in its held-to-maturity portfolio, compared to tangible equity of $4.4 billion. Overall, the bank suffered a $1 billion gross impairment on its investments across both portfolios, with 83% of those losses occurring in the held-for-sale branch. If, then, like PacWest, Western Alliance appears to resemble SVB in its investment difficulties, it would be a case of mistaken identity.

Maybe Fortuna's wheel is changing directions and will spin to the benefit of regional banks. For the week ended March 22, the largest banks saw outflows amounting to $90 billion. The smaller-bank cohort registered inflows of $6 billion.

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