

# GRANT'S

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## Canary in the coal mine of credit

The 7¾% yield attached to the new preferred shares of PacWest Bancorp is an event that deserves the front-page treatment it is hereby accorded. We write to describe what happened last week and to speculate on the place of these shares, and of the bank that sold them—and, for that matter, of the banking system of which that bank is part—in the emerging phase of the credit cycle. We mean the contractionary phase.

In the considered judgment of Fitch Ratings, the PacWest Bancorp Fixed-Rate Reset Non-Cumulative Perpetual Preferred Stock, Series A is a businessman's risk. The shares are "deeply subordinated in the capital structure," and unpaid dividends, if any, will remain unpaid, as opposed to piling up for future distribution in arrears (hence, the descriptor "non-cumulative"). Double-B-minus is the rating, three notches below the triple-B-minus rating affixed to the subordinated debt of PacWest Bancorp (PACW on the Nasdaq), holding company of wholly owned Pacific Western Bank.

Because 7¾% yields don't grow on trees, the PacWest issue commands a saver's attention. One could—and we will, below—compare it with the slightly lower-yielding fixed-rate preferred on offer from AGNC Investment Corp. (AGNC on the Nasdaq), a mortgage real-estate investment trust. In both cases, the source of the relatively lofty payout is risk: in PacWest's case, a combination of credit and duration risk; in AGNC's case, more or less pure duration risk. A mortgage REIT holds the perversely structured bonds that stay when you want them to go and go when you want them to stay.

PacWest owns its share of mortgage-backed securities, too.

PacWest, founded in 1999, based in Los Angeles and showing assets of \$39.2 billion on March 31, chose to raise money for two reasons that fit in one sentence: to shore up an undersize capital account and to support additional lending.

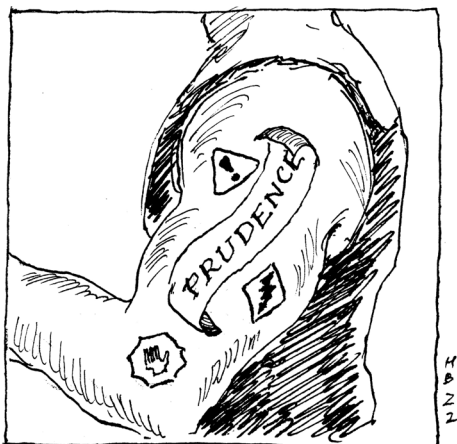
The bank has been expanding for as long as it's been in business, which, for the most part, has been the high-cotton era of falling interest rates and expanding credit (excepting 2007–09 and the occasional rocky quarter). The question before the house is how it will cope now that financial conditions are tightening and, as it seems to us, the great bull bond market is ending.

PacWest is a regional bank with distinguishing characteristics. As the accompanying table highlights, it is more

heavily exposed to credit risk than its banking peers, or near peers, are, with a loan-to-deposit ratio 10 percentage points higher than that of the average state-chartered, FDIC-insured institution. Compared with the pack, it is more operationally efficient but less amply capitalized (a shortcoming that management is beginning to address with the new preferred). Its net interest margin is fatter, and its credit quality is better than those of its peers.

Typical for a regional bank, PacWest is heavily exposed to real estate: 64% of its year-end assets had something to do with buildings or the land underneath them. Also typical is that PacWest is feeling the shock of the close of the era of EZ money and falling rates. As to the latter, in the three months to March 31, the \$10 billion PacWest fixed-income investment portfolio swung to a \$519 million unrealized loss from a \$90.9 million unrealized gain. It's no mystery why, given an average yield of 2.18%. It's no mystery, either, why tangible book value per share declined to \$18.42 from \$21.31—or why bank book values in America are broadly under pressure.

When you think about it, Ben Mackovak, co-founder and managing member of Strategic Value Bank Partners, which invests in smaller banks (not including PacWest), muses to colleague James Robertson, Jr., "the Fed created the perfect trap for the banking system." Direct pandemic-era stimulus checks wound up in people's bank accounts, and what were the banks to do with the money? "You couldn't find yield anywhere. So you would get a call from a bond salesman or investment banker saying, 'Hey, you got to optimize your



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## PacWest vs. the field

FDIC-insured commercial banks with a state charter  
versus PacWest Bankcorp (as of March 31, 2022)

	FDIC	PacWest
net interest margin	2.78%	3.43%
net charge-off to loans and leases	0.19	0.02
non-performing assets/assets	0.38	0.27
loan-to-deposit ratio	63	73
tier-1 capital*	13.23	9.07
efficiency ratio*	56.23	50.1

\* For all FDIC-insured commercial banks with assets between \$10 billion and \$100 billion

sources: Federal Deposit Insurance Corp., company reports

balance sheet. Here are some 30-year mortgages at 3%.’ And they would tell the banks that, in reality, these aren’t 30-year instruments. The average duration is like seven years, because people move, get jobs, refi.” Except, with mortgage rates racing higher, they are not refinancing, and one’s putative seven-year-duration mortgages have suddenly acquired two or three (or more) years’ worth of duration.

Unlike its generic banking peers, PacWest operates a clutch of specialty businesses, including a bridge lending segment that caters to real estate investors. Civic Financial Services, LLC, a 2021 acquisition, will accommodate the opportunistic purchase of a property with a short-term loan before the nimble buyer/borrower can secure a permanent mortgage. It will lend up to 80% of the equity value of one’s property investment. It will accommodate, too, the bullish speculator: “Do you need a short-term loan so you can fix and flip a house?” the Civic website beckons.

Civic’s business model obviously appealed to the acquisitive, fast-growing PacWest, which has boosted the size of its assets by 50% in the past two years alone (thanks in part to the Civic acquisition) and has completed 31 acquisitions in the past 22 years. Management is funding this growth—for now—with deposits that cost a grand total of seven basis points per annum.

Looking back on the era of quantitative easing and zero-percent funding costs, posterity may wonder how anybody went broke in 2020–21. Indeed, few were allowed to. On March 31, PacWest effectively showed no bad loans. Charge-offs net of recoveries in the first quarter, measured as a percentage of

the overall \$24.4 billion loan and lease portfolio, summed to two basis points; nonperforming loans, to 27 basis points. “[O]ur credit has been pristine,” William J. Black, Jr., executive vice president of strategy and corporate development, observed on the June 1 investor call.

In PacWest’s case, as in the case of many a regional institution, “credit” chiefly means real estate credit: At year-end 2021, California property secured 39% of total loans and leases; apartment buildings, 25%; commercial real-estate construction projects, 4%. Equipment finance loans, “lender finance loans” (revolving and term-note credit facilities) and a smattering of consumer loans filled out the PACW portfolio.

Venture-related lending, which summed to \$2.1 billion, or 9% of the loan

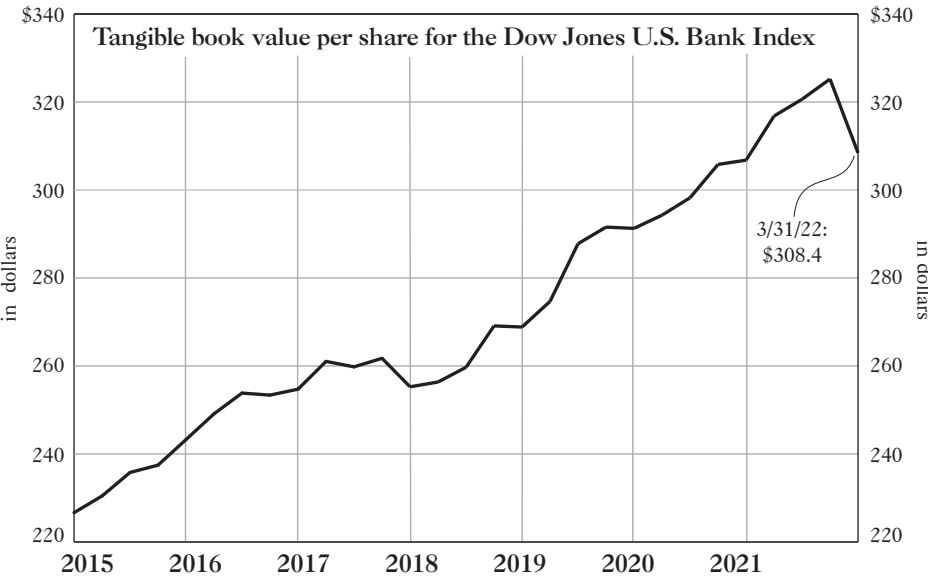
and lease book on March 31, is a PacWest calling card. Most of that exposure, according to Mark Yung, the bank’s chief operating officer and overseer of its venture segment, is “capital call” lending. It boils down to “lending against the committed capital of limited partners into a fund,” he told the investor-call audience. “[S]o very short-term, very bridge kind of stuff...we’re really bridging lending into the next equity round.”

This commitment to “entrepreneurial and venture-backed businesses” earned itself a paragraph in the risk-factors section of the Dec. 31, 2021 10-K report:

We derive a significant portion of deposits, including large deposits, from these companies and provide them with loans as well as other banking products and services. In many cases our credit decisions are based on our analysis of the likelihood that our venture capital-based clients will receive additional rounds of equity capital from investors. If the amount of capital available to such companies decreases, we could suffer loan losses, which could have a material adverse effect on our deposit balances, net earnings, allowance for loans and lease losses, financial condition and results of operations.

To a degree, such language is boilerplate. Lawyers draft it as if to mimic the portion of a TV prescription drug ad in which the narrator recites the life-threatening side effects of the life-saving sponsored medication. But this particular bit of disclosure comports

### Bank book value dwindles



source: The Bloomberg

with what the non-lawyers have lately been saying at Sequoia Capital, Y Combinator, Lux Capital, Lightspeed Venture Partners, et al. Thus, Lightspeed in May: "The boom times of the last decade are unambiguously over.... Many CEOs will make painful decisions in order to keep their companies afloat in choppy waters."

PacWest made no such declaration on the recent investor call, but it forthrightly acknowledged that the venture business is softening. Thus, said Black, "the 1Q market environment was very difficult for our venture business and in large part due to the lack of any material capital markets activity, as we saw a \$1.5 billion deposit decline. The overall market conditions have remained very similar in the second quarter."

The new preferred issue doesn't come cheap. Dividend checks at the 7¾% rate on \$500 million of outstanding stock will cost \$38.8 million per annum (at least until the coupon rate is adjusted in five

years' time), or more than a year's worth of growth in net interest income at the first-quarter rate of \$8.3 million.

Like the rest of us, bankers pick their poison. There must be risk—you can hardly run a leveraged financial institution without it—and you choose among the kinds you are willing to bear. AGNC bears interest-rate and mortgage-duration risk for a living, and it has the scars to show for it. In the 12 months from March 31, 2021, the REIT's tangible book value per share fell to \$13.12 from \$17.72.

As of March 31 this year, the AGNC balance sheet showed \$1.5 billion of preferred and \$7.4 billion of common stock against an investment portfolio of \$68.6 billion—the portfolio would have to suffer another 10.8% drawdown before the preferreds were impaired. Excluding both realized and unrealized losses, net interest income after operating expenses covered the interest cost of the preferred shares by 17.1

times. The \$25 par value of the AGNC 6½% are quoted at \$22.79 to yield 7%.

The trouble, in this time of rising interest rates and asset-price depreciation, is that the financial risks bleed together. In the particular case of PacWest, the carrying value of its mortgages depreciates as its VC lending volumes dwindle and the house flippers stay away because there's nobody left to flip to. PacWest didn't write the script of the so-called everything bubble any more than AGNC did the bond bubble, but both institutions rode the rise in asset values to more-than-presentable financial results.

"Expect to complete a climate risk impact assessment in 2022," says the "Update on Our ESG Journey" page in PacWest's first-quarter slide deck. Interest rate impact, on both sides of the balance sheet, and credit risk from many directions, are the more pressing agenda items, we would say.

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