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Bye to two banks

James Robertson, Jr. writes:

The most protracted selloff in U.S. Treasurys since 1787 is properly raising concerns that the March regional banking crisis never ended but only took the summer off. Since mid-July, the KBW Banking Index has shed 15% in the bearish wake of deposit flight, compressing margins and unrealized Treasury and mortgage losses.

Altogether, it's time to take profits in the preferred shares of PacWest Bancorp (PACW on the Nasdaq) and Western Alliance Bancorporation (WAL on the New York Stock Exchange) before they—the profits, not the banks—disappear. Since we had our bullish say in the issue of *Grant's* dated April 7, the PacWest and Western Alliance shares have rallied by 38% and 15%, respectively.

Neither company was tagged in a wide-ranging August downgrade of regional banks, though the bell could yet toll for them. "Amid higher-for-longer interest rates," S&P analysts led by Brendan Browne opined, "we expect further asset-quality deterioration. Banks with material exposures to commercial real estate . . . could see some of the greatest strains on asset quality."

As for mark-to-market losses on the U.S. banking industry's security holdings, they climbed by 8.3%, to $558 billion, in the second quarter, and if Christopher Whalen's *Institutional Risk Analyst* crystal ball is in its customary sound working order, losses on aggregate security portfolios will rise by 20% in the third quarter.

There was deliverance on July 25 when the Banc of California (BANC on the NYSE) announced a merger with PacWest in an all-stock deal. The combined company expects to count $36.1 billion in assets after the closing and 72 branches in the Golden State.

Banc will pay 0.66 of its shares for each share of the four-times-larger but storm-tossed PacWest. PacWest will subsist as the core of the integrated California mortgage bank, even while losing its name. Management, now led by the BANC team, expects commercial real estate to make up the largest component of the loan book, at 28%. And while PacWest ditched its house-flipping lending business in May, venture-backed loans will still amount to 7% of the post-merged institution.

While the merger rights the ship, we no longer see an appropriate risk-adjusted value in the preferred shares (which will be converted to Banc of California preferreds after the closing at identical terms and rates). The 7.75% Fixed-Rate Reset Noncumulative Perpetual Series A preferreds currently change hands at $19.50 to yield 9.9%.

Neither do we want to assume the risk for Western Alliance's 4.25% Fixed-Rate Reset Noncumulative Perpetual Series A preferred shares, which trade today at $15.54 to yield 6.9%. Though senior to the common equity, preferreds sit near the bottom of the capital structure. And with a possible recession in the wings, exposure to commercial real estate and start-ups ought to fetch a higher yield, in our opinion.

Phoenix-based Western Alliance op-

Profits for the taking

source: The Bloomberg

erates 38 branches, primarily in Arizona, California and Nevada. Commercial and industrial loans make up 34.8% of the loan book, followed by residential and consumer loans (31.4%) and commercial real estate loans (24.5%). The company also has exposure to venture capital funds, private equity and technology companies, amounting to 7% of loans held for investment.

While deposits seem to have stabilized, net interest margin has tumbled to 3.42% in the second quarter from 3.98% at the end of 2022, a consequence of costly brokered deposits. That's versus an average of 3.64% for its peers, according to the Federal Deposit Insurance Corp.

Meanwhile, JPMorgan & Chase Co.'s 6% preferreds trade at $24.34, a price to yield 6.2%. JPM last quarter brought in $14.5 billion in net income versus $215.7 million for WAL. And while Tier 1 capital amounted to 10.8% of risk-weighted assets for Western Alliance, that same indicator of financial strength registered 15.4% for JPMorgan. So for all the added risk with Western Alliance, the preferred investor only gets an extra 70 basis points. Not compelling.

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