GRANT'S
INTEREST RATE OBSERVER®
Vol. 38, No. 15c 233 Broadway, New York, New York 10279 • www.grantspub.com JULY 24, 2020

Bank in New York

Evan Lorenz writes:

Fully one-quarter of apartment-dwelling New Yorkers haven't paid rent since March. A landlord-advocacy group, the Community Housing Improvement Program, is the source of this arresting fact. You don't need CFA credentials to form a hypothesis on what it implies for the value of the city's apartment buildings. Now under way is a bearish analysis of the New York-centric Signature Bank (SBNY on the Nasdaq) along with facts and figures to explain why now, more than ever, Manhattan is the city that never sleeps.

Whatever the reasons for this partial de facto rent holiday (see page one for some possibilities), they seem unique to New York. In comparison, across the 50 states, according to the National Multifamily Housing Council, 87.6% of apartment occupants were making payments in full or in part as of July 13, not far from the 90.1% figure registered in the year-earlier period.

One New York landlord who asks to go nameless tells me that the vacancy rate in his high-end apartments jumped to 20% in July from 3% in February, due to move-outs and tenants canceling their leases. "We didn't lose anyone to any other rental or condo," the landlord says. "It was people moving to Connecticut or New Jersey. We are high-end, and we have higher vacancies than we've ever had.... [and] I think worse is to come."

Thus, while rent-collection rates remain elevated in luxury buildings (Green Street Advisors estimates that around 95% of such tenants are paying on time), top-tier buildings are seeing the quickest erosion in pricing power. Asking rents were down 10% year-over-year in June for the grade-A apartment buildings that real-estate investment trusts own, according to John Pawlowski, head of residential research at Green Street, versus a median decline of 6.6% for all apartments in the city. "That doesn't fully capture incentives, whether it is a landlord giving you a $1,000 Visa card or one month's free rent," Pawlowski tells me. "Often those concessions are above that. On a net basis, market rents [for institutional-quality buildings] are trending worse than 10%."

The exodus of wealthy residents calls into question rating-agency doctrine that New York City real estate is uniquely valuable. Thus, S&P Global confers on generic, class-A Manhattan office buildings a 6.25% capitalization rate for the purposes of analyzing commercial mortgage-backed securities; across the western hemisphere, it's the agency's lowest cap rate (i.e., highest value). In fact, for S&P's money, at a 7% cap rate, a Manhattan class-B office building is the equal of any class-A building in North America with the lone exception of high-end property in Washington, D.C. A downgrade of New York real estate would therefore ripple far and wide.

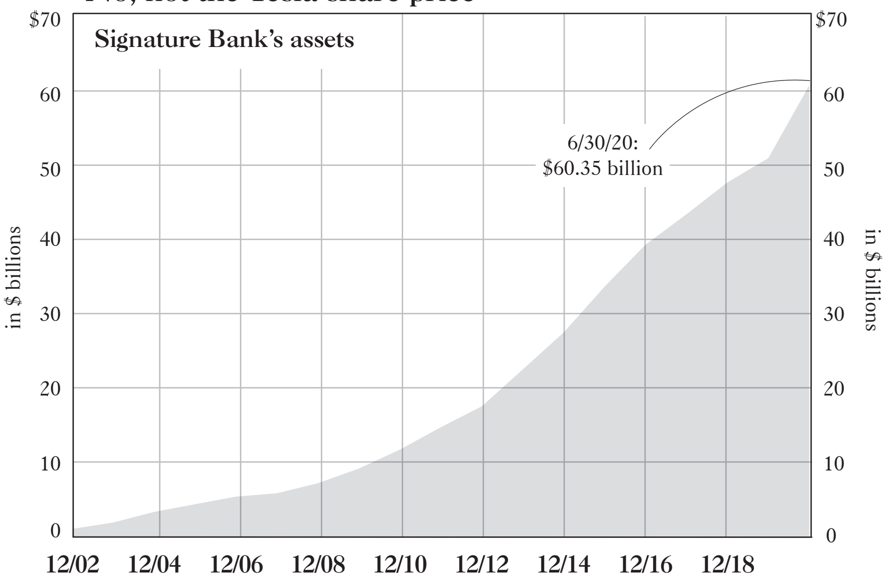
Owning a commercial building is more capital-intensive than you'd suppose, and that is especially true in the age of Covid-19. Retrofitting lobbies, elevators and HVAC systems to meet more-rigid safety standards doesn't come cheap. "There are many things an institutional owner of a class-A building can offer tenants that a local family owning a side-street, B-rated building can't offer," another publicity-shy real-estate investor tells me.

As for the partial de facto New York City rent holiday, I sought out Christopher Whalen, one of the most knowledgeable banking observers, for comment. Said the publisher of The Institutional Risk Analyst: "The whole sector is in crisis, and the banks and investors that support these assets are going to have to figure out what to do."

Although American banks have begun to accrue for bad credits, they've suffered only small actual losses to date. JPMorgan Chase & Co., for one, raised its provisions for losses to $10.5 billion in the second quarter from $1.1 billion in the same period last year. Yet net charge-offs nudged up only to $1.6 billion from $1.4 billion. "You will see the effect of this recession," CEO Jamie Dimon told analysts on the July 14 earnings call. "You're just not going to see it right away because of all the stimulus." Key to the pace and timing of realized losses will be the congressional vote to renew, or not, the supplementary $600 in unemployment benefits that are due to expire at the end of the month.

After a decade of being Dodd-and-Franked, banks have accumulated an impressive amount of capital. On June 25, the 34 banks with assets of $100 billion remained just adequately capitalized even under the Federal Reserve's most draconian stress-test scenario, which includes a 12.4% contraction in output and unemployment rising to 16% (four percentage points lower than the actual New York City reading for June, let the record show).

No, not the Tesla share price



source: The Bloomberg

For reference, real GDP declined a cumulative 4% and unemployment peaked at 10% in the Great Recession.

Bank investors, then, have other things to worry about—net interest margins, for instance. "The real downside risk is if we turn into Europe and are stuck with mid-single-digit ROEs for perpetuity," Christopher McGratty, who rates Signature Bank a buy for Keefe, Bruyette & Woods, Inc., tells me. "That would be the bear case. If you have that conversation with investors, it is not just credit, because they understand this is a cyclical business. They are asking if there is structural impairment to the ROEs because rates are stuck at zero."

Case in point: The KBW Bank Index trades at 84% of book value and last year generated an 11% ROE. The Euro Stoxx Banks Index, in contrast, trades at 43% of book and managed only a 5.7% return-on-equity before the virus struck.

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When HSBC Holdings plc bought Republic National Bank of New York in 1999, Joseph DePaolo faced a dilemma: how to keep offering Republic's trademark high-touch banking inside the walls of a mega-bank? You can't, concluded DePaolo, a Republic executive. Together with John Tamberlane, another Republic officer, DePaolo founded Signature in May 2001 with initial footings of $50 million. Today, DePaolo and Tamberlane, Signature's CEO and vice chairman, respectively, oversee $60.3 billion in assets, the result of a 45% compound annual growth rate over the past 19 years.

As of June 30, Signature's loan portfolio summed to $44.8 billion and was more than 100% funded by $50.2 billion in deposits. We won't get the breakdown of Signature's loan book until the bank files its 10-Q report, but as of March 31 commercial real-estate loans made up 67% of that portfolio. Within CRE, the biggest exposures were to multifamily (55%), general commercial loans (39%), construction (5%) and residential mortgages for the balance. In the $13.7 billion commercial and industrial book, so-called fund banking (capital call lines to private-equity and venture-capital firms) was both the largest subcategory, at $5.9 billion, and the fastest-growing one.

With a ratio of total capital to risk-weighted assets more than double the regulatory minimum—12.1% versus 6%—Signature is hardly undercapitalized. Nor would credit quality appear to be an issue, at least not by a glance at June 30 financials. At the end of the second quarter, 0.1% of loans were in non-accrual status while loan-loss reserves amounted to 0.98% of gross loans.

The typical Signature customer is the small- to medium-size business that might get lost in the shuffle of a universal bank. To staff itself for growth, Signature hires away its competitors' lending officers, rather than buying those competitors outright. New York City is DePaolo's and Tamberlane's stomping ground, and the five boroughs furnish virtually all the collateral for the CRE loan portfolio, a fact to bear in mind when reading such news flashes as Monday's bulletin on the collapse of asking rents for retail space on lower Fifth Avenue around the New York Public Library (down 30% from a year ago, according to Cushman & Wakefield).

Not purely a New York institution, Signature has been building a non-real-estate lending book since 2017 in California, where a brand new team in Los Angeles will complement an existing Signature office in San Francisco. The western push appears to be working. In the three months ended June 30, deposits and loans grew by $8 billion and $4.2 billion, respectively. Government-supported Paycheck Protection Program credits delivered $2 billion of the asset growth.

The bull case on Signature is that its M.O. of service-intensive banking is exportable to the rest of America—and that you can continue to grow as fast as Signature has been growing without blowing yourself up. "There are several areas in the country where there are 800-pound gorillas that dominate the market," David Bishop, who rates SBNY a hold for D.A. Davidson & Co., tells me. "For whatever reason, they don't do a great job of servicing these smaller to medium-sized companies that need a quasi-CFO, and Signature bankers can layer in their subject matter expertise [i.e., their knowledge of other similar small businesses] as a sort of one-stop effort."

While Signature will not be immune to the problems in its home market, the bank expects its customers to weather the storm. "We have some very large clients that are multi-generational, that has been around for decades, that have the wherewithal in terms of cash," DePaolo said on the April 23 earnings call. "They're not ones to give up and say, here are the keys." The typical multifamily-apartment loan on SBNY's books has a 61% loan-to-value ratio and can cover its debt-servicing costs by 1.38 times from earnings, he said.

Trading at 11.4 times trailing earnings and 121% of book value, Signature commands a premium to the KBW Bank Index, which changes hands at a 16% discount to net assets. The

Street deems the fancy valuation well-deserved, as the analytical consensus breaks down thus: 15 buys, four holds, no sells. A 2.2% short interest indicates that the bears have not yet caught the scent (or, the bulls would have it, there's no scent to catch). Over the past 12 months, insiders have contented themselves with the net sale of 500 shares for proceeds of $50,295.

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With its focus on Main Street, Signature stays away from the competition to lend against Midtown trophy office buildings. "We don't see the other too-big-to-fail banks because the other institutions are not interested in a five-story walkup, $2.5 million loan in the Bronx," DePaolo told SNL Financial Extra in 2015. "They're interested in 666 Fifth Avenue, the General Motors building. That's not our space." As far as its exposure to retail properties, Executive Vice President Eric Howell said they are the dry cleaners, hair salons and pizza places of New York, rather than the Bergdorfs.

The pandemic has been especially tough on these types of small businesses. Yelp, Inc. estimates that 66,000 nationwide have shut their doors for good since March 1. Researchers at Harvard University estimate the coast-to-coast toll at nearly 110,000.

In the second-quarter press release, Signature disclosed a whopping $9.38 billion of loans in deferral. This figure represents 21% of the entire loan book and is 1.9 times Signature's capital. This high level of borrower relief also makes it impossible to gauge the health of Signature's loan book.

Multifamily was already struggling in Signature's core market before the virus barged in, partly on account of the New York State Housing Stability and Tenant Protection Act of 2019. The law slashed to 2% the rent hikes that landlords can put in place after a major capital improvement. That's down from 6% for rent-stabilized buildings and 15% for rent-controlled buildings. The economic incentive to spruce up and repair aging structures was thereby proportionally reduced.

"I think that post the rent-law changes, apartment values dropped by 15% to 20%," Seth Weissman, the founder and managing partner of Urban Standard Capital, a firm that owns, lends to and develops commercial property in New York City, tells me. "And the problem is, if you had a 60% loan to value, that value has dropped by 20%. Now, that loan is not $60 on the $100. Right now that loan is $60 on something worth $80, so you effectively have a 75% LTV loan instead of a 60% LTV loan."

The cap on rent hikes following capital improvements will be a particular burden to Signature's clientele, a real-estate investor confides. It's in the public record that half of the bank's multifamily loans are on rent-stabilized buildings. By his own observation (which includes requests from Signature's borrowers, made to him, for junior capital), our source relates, Signature was a ready lender to owners who planned to revitalize older buildings. "I think that Signature Bank has sort of been pretending probably for a year and a half that things are good, and they have one of the most exposed portfolios of all the banks that I've come across," our source, who asks to go nameless, tells me.

This would not be the first time that Signature suffered credit impairment through changing economic circumstances, nor would it be the first time it took the bank a while to acknowledge such a shift. At year-end 2014, loans secured by tax medallions peaked at $847.2 million, representing 34% of Signature's equity. As Uber Technologies, Inc. and Lyft, Inc. proceeded to ravage the legacy taxi business, Signature slowly wrote the value of that portfolio to $6.9 million at year-end 2019.

Nor does the local regulatory environment look ripe for improvement. Last week, Manhattan Assemblywoman Yuh-Line Niou and New York Sen. Julia Salazar introduced a bill to allow renters and homeowners to withhold rent or mortgage payments for a period beginning with the enactment of the legislation and ending 90 days after Governor Andrew Cuomo suspends his Covid-19 state of emergency. Graciously, the bill makes allowance for property-owner relief, but only if the supplicating landlord promises to impose no rent increase for five years and evict no tenant for nonpayment of rent until 90 days after the Covid all-clear.

It's DePaolo's position that wealthy families will spend whatever they must to retain long-held New York real estate rather than turn over the keys to a mortgage lender. I asked a member of one such family for comment. "Why would you ever throw money away to save something that you know isn't worth saving?" our informant replied. "If you are a real bold-face New York real-estate family, then you're not going to have 100 successes out of 100 investments on your track record. There are going to be some losses, and you're going to be forced to walk away from loans sometimes."

Certainly, Donald Trump, a one-time Signature customer (and the father of Ivanka Trump, a former Signature director), chose to take that particular walk from time to time. In the absence of a current Trump presence on its board, Signature counts among its directors one Republican, former Sen. Alfonse M. D'Amato, and one Democrat, former

Signature Bank at a glance
all figures in $ millions

	TTM*	2019	2018	2017	2016
net interest income	$1,401.7	$1,311.6	$1,299.0	$1,237.6	$1,147.2
provision for losses	170.8	22.6	162.5	263.3	155.8
non-interest income	23.8	27.9	23.3	36.0	42.8
profit before tax	686.6	787.6	673.5	575.3	657.4
net income	515.0	588.9	505.3	387.2	396.3
deposits	50,231.9	40,383.2	36,378.8	33,439.8	31,861.3
equity	4,862.6	4,769.8	4,407.1	4,031.7	3,612.3
total assets	60,349.8	50,616.4	47,364.8	43,117.7	39,047.6

* For the 12 months ended June 30, 2020.

source: company reports

Mass. Rep. Barney Frank (the co-author of the previously mentioned encyclopedic regulatory act).

Capital call lines, one of Signature's key growth initiatives, allows private-equity and venture-capital investors to borrow the equity that their limited partners will eventually contribute to a deal. The benefit to L.P.s is flexibility in meeting cash calls. The benefit to general partners is that, by reducing the period that limiteds' money is invested, their reported internal rates of return can be flattered, and, therefore, their performance fees enhanced.

There's nothing wrong with this business line, which accounted for 14% of Signature's loan book as of March 31, but the demand for such credit is a function of deal flow. If the recession winds up curtailing p.e. activity, as previous recessions have reliably done, the capital-call business will likely shrink with it.

In short, why and how Signature commands the valuation premium it does is one of the mysteries of the cycle.

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