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PacWest-CapitalSource may be the company to watch in 2014

By Jeff K. Davis

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Assuming the Federal Reserve approves the [merger](#) with Los Angeles-based [CapitalSource Inc.](#), Los Angeles-based [PacWest Bancorp](#) may be the company to watch in 2014. The quasi-MOE (45%/55% relative ownership) is transformative for both companies because it marries PacWest's core deposit franchise with CapitalSource's high-yield asset origination platform. An additional benefit will be more diversification of the loan portfolio at a time when many banks remain wed to CRE-related lending.

Success is not guaranteed, but if execution is okay PacWest may have found an antidote to the Fed's zero-rate policies that seem likely to stay with us for years. I say this because loan yields have been grinding lower for five years due to the refinancing of loans that were originated at higher rates and more recently a hyper-competitive lending environment that seems to be pushing a broad swath of C&I yields toward 3%. Or maybe lower. The CEO of a Tennessee-based bank recently told me he lost two nonprofit loans when a regional bank offered rates of LIBOR+185bps and +200bps. CRE portfolios may still yield 4%, but what the yield-volume table in the quarterly release does not tell us is if banks are offering fixed-rate loans well beyond the old three-year standard. The same thought applies to loan structures, too.

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PacWest is an exception. Because of past acquisitions that have included [government-assisted deals and specialty finance companies](#), PacWest's yields exceed those of peer banks by a lot. The 2013 third-quarter yield on non-purchased credit impaired (PCI) loans was 6.35%, while the yield on PCI loans was 11.9%. The overall loan portfolio yield was 6.90%; it was 6.67% excluding accelerated accretion on payoffs and other items. I do not know where PacWest's loan yield will settle once purchase accounting, accelerated accretion and the like run their course. I assume lower.

The third-quarter yield on [CapitalSource Bank's](#) loan portfolio was 6.30%, which included 39bps of fees and discount accretion. CapitalSource is largely a senior, secured lender that makes loans that are at the top of a borrower's capital stack. It focuses on niches such as lending to commercial finance companies, equipment leasing, health care, technology and multifamily. When commenting on the 2013 first-quarter results last April, management noted the [all-in yield](#) for new loans was about 5.50%. Presumably, the all-in yield for loans originated toward the end of the year was lower.

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The merger with CapitalSource is a bigger strategic move on a relative scale than any other that I remember in the industry other than Mellon Financial Corp.'s [1994 acquisition](#) of the Dreyfus Corp. CapitalSource in a sense is a commercial finance company in a bank wrapper; however, the company has been gradually evolving into a traditional commercial bank over the past few years and had planned to apply with regulators had the PacWest announcement not occurred for the parent to become a bank holding company and for the bank to obtain a California commercial bank charter.

I use the commercial finance company in the bank wrapper moniker because CapitalSource obtained a California Industrial Bank charter in 2008 when it [acquired](#) the retail deposits and certain assets from Fremont General Corp. The benefit of the industrial charter was evident almost immediately given the access to deposit funding as markets froze. While it appears the PacWest deal will reduce CapitalSource's funding costs by 30bps-50bps, one synergy that is hard to quantify will be the ability of CapitalSource to offer transaction accounts, treasury services and other commercial banking products that it could not do so with an industrial charter. There may be a substantial reservoir of deposits that will flow to the new PacWest once CapitalSource operates within a commercial bank charter.

So, will commercial banks become more active in acquiring specialty finance companies? Maybe, but cultural differences are real. PacWest seems to be comfortable with the proposition. It acquired Celtic Capital Corp. and Marquette Equipment Finance, two small [specialty finance](#) lenders, in 2012. Also, much of CapitalSource Bank's bank management has commercial bank and thrift roots.

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For some banks, specialty finance may be a tough sale. CapitalSource reportedly [tried to sell](#) in early 2011, according to *The New York Times*' DealBook blog, but nothing came of the report. Maybe CapitalSource had too many problem assets at a time when commercial banks were still dealing with their own asset quality issues. More recently, Boston-based [NewStar Financial Inc.](#) was reported to be [exploring a sale](#), according to Bloomberg News. Four months since the report [first surfaced](#), there has been no announcement.

If the report is true — and it may not be — the lack of an announcement is somewhat surprising. NewStar management, which has a commercial banking background, periodically highlights the attractiveness of the middle-market leveraged loan market that is its focus. The yield on its new loans in the 2013 third quarter were 5.8%, which was just below the 6.1% rate for December 2013, as reported by Thomson Reuters for middle-market leveraged loans. (As an aside, the impact of massive institutional liquidity flows into leverage lending can be seen via the large corporate yield for new loans in December 2013 of just 4.6%.)

I do not know how PacWest and CapitalSource's daily operations will change once the merger is consummated. In the near term, probably not too much as the merger integration gets underway. Whatever cultural issues exist may take longer to sort out. The ultimate test, I think, will be credit performance in the next downturn and not whether CapitalSource can maintain its current pace of loan growth. Presumably, both companies will stick to credits they know best. Changing strategies can be dangerous. CapitalSource's prior CEO, John Delaney, remarked to me in mid-2010 that the company's deeper push into CRE lending in 2005 was a disaster. Deals that were thought to have 25%-35% equity to absorb losses before the lenders were impacted produced large losses for CapitalSource. Conversely, the company's core commercial finance franchise weathered the recession relatively well — though hold positions for some transactions may have been too large.

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