NASHVILLE NOTES

Butcher, Bank Stocks and FTX

Thursday, November 17, 2022 11:10 AM ET

By Jeff K. Davis

Jeff Davis CFA is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

Last week brought the news of another cryptocurrency exchange bankruptcy that has added to a string of such failures this year and perhaps more to come if the bank-like contagion spreads. The failure of FTX Trading Ltd., Alameda Research Ltd. and other affiliates appears to involve over-the-top digital fraud, managerial incompetence and diligence failure among the private equity investors that bestowed a $32 billion valuation on the company with its last fundraising.

The drama in the cryptocurrency ecosystem had me thinking about a transaction I worked on in the 1990s in which we were retained to sell a bank. The majority shareholder said she wanted cash, not stock. It was an odd preference because stock swaps then allowed buyers to use pooling-of-accounting in which the balance sheets were combined without fair value marks or goodwill. The net result was that buyers usually could pay a materially higher price.

When we received the first round of letters of intent, the highest offer did not include a cash alternative. I called the CEO and told him we needed a cash proposal too. He said OK, but you will not like the number compared to the value of the offer based upon the bank's publicly traded common shares.

A colleague and I flew to Florida to review the various offers, including the wide gap between the highest stock-swap proposal and the cash alternative. Just a couple of minutes into explaining why we thought she should pursue the stock-swap proposal, she cut us off and said the CEO is a crook (he was not). The backstory is that her family was (or felt) swindled after they bought a "Butcher Bank" in the 1980s that had more problems than the diligence apparently identified. My partner quipped that bank stock and Butcher were interchangeable nouns for her.

The Butchers owned banks in Tennessee and Kentucky, most of which were acquired in the late 1960s and early 1970s. It was described as an "empire" here in Tennessee, though those of you reading this in financial centers such as New York City would disagree. Like Sam Bankman-Fried, the Butchers carried a lot of sway with politicians and had political aspirations themselves.

Like FTX, the Butcher empire imploded. I suspect rapid growth funded with leverage, rising inflation and interest rates, and poor management led to issues at the banks that were magnified in the deep recession of the early 1980s after Federal Reserve Chair Paul Volcker pushed short-term rates to around 20% in March 1980.

On Nov. 1, 1982, the Federal Deposit Insurance Corp. sent 180 examiners to conduct simultaneous examinations rather than sequential examinations. Over the next two years the banks were declared insolvent and sold. The FDIC estimated losses of $382 million. Around the same time, Penn Square Bank of Oklahoma failed, which in turn contributed to the failure of Continental Illinois Bank & Trust Co. and sizable losses by other banks that had purchased too many energy-related loans as the oil patch bust was gaining steam, following the boom of the 1970s and early 1980s.

By chance, I worked on an engagement in the early 1990s, where we performed a post-mortem review of the banks' financials for the FDIC. Aside from a room full of boxes with endless files, the one aspect that struck me was how management was able to keep the banks afloat. Weak credits were sold among the affiliated banks, and some of the banks would raise capital by issuing shares to an investor-backed entity that obtained a loan from an affiliate bank to fund the purchase. I do not recall how much equity, if any, these entities were capitalized with, but the shares served as collateral. It all ended badly in time.

The failure of FTX and those banks share the common characteristics of (apparent) fraud combined with unsound banking practices such as too much leverage, asset concentration, too little liquidity and overvalued assets.

Another common characteristic is the tipping point in asset values that was triggered by rising rates. Sharply higher rates during 1980-1982 led to a bust in many asset prices such as farmland, oil and gas, and other assets that inflated in value during the 1970s with debt used to fund the assets.

We are witnessing a similar bust today in speculative assets. Leverage and illiquidity are deadly combinations when the tide rolls out. So far, U.S. banks are weathering the shift well, though funding pressures are intensifying and the impact of higher interest rates for borrowers is not reflected yet in credit metrics. It will be evident by the second half of 2023, though "how much" is unknowable. Analysts and investors are focused on these issues.

Another area that I think is worthy of enhanced scrutiny is "investments" given the amount of venture funding that has occurred across industries. That sophisticated private equity investors were taken to the cleaners by Bankman-Fried may be a one-off, but I think the $32 billion valuation speaks to vast sums of capital that have been invested at inflated valuations. Further, sidecar investments can use leverage to fund an array of assets, whether new economy ventures or mundane low-yielding securities, that may create issues in a deteriorating market.

Sell-side and buy-side analysts should explore these nonoperating assets that reside on corporate balance sheets that I suspect have not received much scrutiny.

____

This S&P Global Market Intelligence news article may contain information about credit ratings issued by S&P Global Ratings. Descriptions in this news article were not prepared by S&P Global Ratings.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global.

Published with permission. Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.