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Clock still ticking at First NBC

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A lot of digital ink has been spilled around the First NBC Bank Holding Co. saga. I am offering a little bit more as a follow-up to a Nov. 8, 2016, post I had about the company, providing a primer for what can go wrong for bank investors, especially when a parent company is levered. I again commend HoldCo Asset Management's Oct. 25, 2016, letter as an excellent read for investors, whether one agrees with their conclusions or not. HoldCo is a special situation investor that was long the parent company's sub debt and was short its common stock when it released the October letter.

I do not know which way the chatter among bank investors is trending, but it appears to me that Sandler O'Neill has done a super job helping First NBC stabilize for now what was a rapidly deteriorating situation by arranging the sale of $1.3 billion of loans and nine branches to Hancock Holding Co. subsidiary Whitney Bank. The transaction was announced on Dec. 30 and is expected to close by March 31. It is a topic for another post, but Hancock is proving to be adept at being a value investor in New Orleans.

The cash outlay to Hancock (actually subsidiary Whitney Bank) from buying First NBC Bank assets will be reduced through the liability assumption of $511 million of deposits and $605 million of FHLB advances. Shrinkage of the First NBC Bank balance sheet combined with a $44 million premium will increase regulatory ratios by 300 to 400 basis points according to management.

Although the increase in the capital ratios will be reflected in the consolidated financials, the transaction occurred at the bank-level, which is important. First NBC Bank entered into a Consent Order with the FDIC on Nov. 10. The order stipulates that the bank achieve minimum leverage, tier one risk-based and total risk-based capital ratios of 10%, 13% and 15%. As of September 30 the respective ratios approximated 7.3%, 7.7% and 9.0%.

Perhaps the ratios will increase a bit when the year-end Call Report is filed next week, given presumed efforts to reduce the asset base. Plus, the bank has made money the past three quarters, although it did so through booking tax benefits as quarterly pretax earnings were negative or nominally positive. Once the Hancock transaction closes, the leverage ratio may exceed the 10% threshold when the March Call Report is filed, but the tier one and total risk-based capital ratios presumably will fall short given the 7.7% and 9.0% ratios at Sept. 30.

My back of the envelope capital calculations exclude any further write-downs to $170 million of tax-related investments and a $254 million deferred tax asset (both as of June 30). These assets undoubtedly will be subjected to intense scrutiny by the company's new auditors before the Call Report, Y-9 and 10-K are filed this quarter. HoldCo proposed sharp write-downs to these assets in its October letter. A prospective reduction in corporate tax rates if the Trump Administration and Congress can agree on a tax bill will not be helpful to the value of these assets either.

Sandler presumably is working on the next step to further boost capital. Another asset sale is the likely course, in my view. Hancock did not acquire the company; it cherry-picked the balance sheet. In doing so it may have expressed a line of thinking I heard 25 years or so ago that was attributed to a banker at Morgan Keegan & Co.: don't let other peoples' (banks') problems become your problems. I think a common raise is a tough proposition, too, even though the first-round asset sale narrowed the capital deficit. The pending asset sale will crimp if not cripple the company's earning power until new asset generation replaces what was sold, and tax laws limit the utilization of NOL carryforwards when sizable amounts of capital are raised.

The default option therefore is another asset sale; however, a second round may not be as capital accretive as the first round because Hancock presumably bought the best loans. Of note from the first transaction was the 4% credit mark Hancock applied to the loans with a 5.1% yield it acquired. If the next tranche of assets to be sold are of a lesser quality and/or have a lower yield, the likelihood of a gain on sale goes down, in my opinion.

The capital impact of a second-round asset sale, if it occurs, will be disclosed in time. The bigger short-term issue is the ticking clock related to the semi-annual coupon payment on the parent company's 5.75% $60 million sub debt that is due in February. HoldCo and other sub debt investors hold the pin on this grenade. They will be entitled to pull the default event pin if the payment is missed.

Although the Hancock transaction will boost capital and create over $200 million of liquidity once it is completed, it does not create liquidity at the parent company. As of Sept. 30, the parent company had just over $2 million of cash, which is enough to cover the coupon; however, the Federal Reserve Bank of Atlanta deemed First NBC to be in a "troubled condition" and among other things precluded it from making interest payments on the debt.

As a result, the board will have to petition the Fed to allow the parent company to make the February payment to avoid default while it attempts to complete its capital raising actions. I do not know the Fed's thoughts, but common sense dictates approval if requested, given the initial asset sale has narrowed the capital deficit. Doing so would allow the company to succeed (or fail) at whatever additional actions are being taken to meet the capital thresholds without having to deal with a default event in which sub debt holders may pull the pin to initiate bankruptcy proceedings.

The Fed, of course, knows all of this. Granting approval for one coupon payment would extend the timeline to mid-August. By then either the company meets the capital minimums, or it does not meet the requirements at which point a default event occurs with the missed August coupon payment. The Fed could up the pressure on the board by requiring the directors to make an unsecured loan or buy enough newly issued common to fund the February coupon.

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