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Emigrant branch sale points to parent capital structure initiatives rather than NYC consolidation

By Jeff K. Davis

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Emigrant Bancorp Inc. recently entered into an agreement to sell $3.3 billion of its $9.0 billion of deposits and 30 offices to Apple Bank for Savings, which had $7.6 billion of deposits at June 30. Pricing was not disclosed, but presumably the deposit premium for a CD-heavy deposit base was modest. The median national deposit premium is 2% based upon YTD branch sales per SNL. The transaction will leave Emigrant with an internet deposit gathering operation, its main office in Manhattan and a branch in Ossining, New York. Once the deal closes the balance sheet presumably will decline by about $3 billion, leaving $2 billion of securities and $4.6 billion of loans, about 50% of which are residential mortgages, 15% CRE and 10% multi-family.

The company struggled during 2008-2009 due to losses incurred in its securities and mortgage loan portfolios. The cumulative pretax loss of $856 million in 2008 and 2009 primarily was attributable to $762 million of losses incurred in the bond portfolio. While bond portfolio issues appear to have largely passed, NPLs remain high at 10.9% of the portfolio, most of which is attributable to the 1-4 book (17.8%).

While I could be wrong, I do not think the Emigrant transaction heralds immediate further consolidation of the N.Y. bank and thrift market. Investors have been waiting for Astoria Financial Corp., Dime Bancorp Inc., Flushing Financial Corp. and Hudson City Bancorp Inc. among others to sell. New York Community Bancorp Inc. has made several acquisitions, most notably the FDIC-assisted deal for Ohio-based AmTrust Bank. New York Community's management is on record as saying its next transaction will have to be significant. Presumably it took a look at the Emigrant deal, but either was out-bid or passed due to a desire to keep its powder dry for a larger transaction. Speculation regarding consolidation of New York area thrifts is logical. The operating environment for narrowly focused thrifts whose primary assets are residential mortgages, MBS and multi-family loans that are funded with CDs and borrowings is tough. The flattening of the yield curve is causing accelerated asset prepayments and higher costs to unwind fixed rate financing. Unlike some commercial banks, these institutions have limited fee income other than mortgage origination.

Emigrant Bancorp is the parent of six banks, the largest of which is $7.8 billion asset Emigrant Bank. Emigrant Bancorp in turn is a wholly-owned subsidiary (i.e., it is a sub-tier bank holding company) of New York Private Bank & Trust Company. NYPBT is majority-owned by members of the Milstein family, who are known in Manhattan for highly successful real estate investments and philanthropic endeavors. Howard Milstein serves as Chairman, CEO and President of NYPBT. An earlier Milstein generation founded the Circle Floor Company in 1919. Installing floors and ceilings in an expanding New York led to real estate development. In 1986 Emigrant Savings Bank was acquired, which is a thrift that traces its roots to 1850. Apparently, NYPBT was formed for tax purposes in 2004 to consolidate ownership; hence the top-tier and sub-tier holding company structure.

In the case of Emigrant, I think there is a broader story for much of the banking universe, especially private and nominally public traded banks that make up the bulk of the industry. Per press reports in February, Barclays Capital was hired to sell the branches or the online banking operation. The result was an agreement to sell 30 offices and $3.3 billion of deposits. Why was Barclays Capital hired? I think the answer has more to do with the company's capital structure than it does with problem loans and a tough operating environment. The parent's capital structure as of March 31 consisted of: (a) $609 million of common equity; (b) $275 million of TARP preferred; (c) $301 million of trust preferred; and (d) $200 million of 6.25% senior notes due June 2014. The trust preferred and senior notes are obligations of Emigrant, the sub-tier holding company, while TARP is an obligation of NYPBT.

For most bank holding companies, the primary source of cash for debt service, dividends and buy-backs is upstream dividends from the subsidiary bank(s) and any other material operating subsidiaries of the parent company. Liquidity can be generated through raising capital and/or selling parent assets too. I recently watched an analyst on TV talk about how liquid Bank of America Corp. is, noting a large amount of cash. He even equated the cash to a per-share value as if BofA could make a large distribution in relation to its share price. BofA's liquidity may be high, but liquidity at the subsidiary bank, Merrill Lynch and other subsidiaries does not equate to parent company liquidity. Further, only the accountants, rather than the corporate treasurer, consolidate the financials of the subsidiaries and parent company.

Some of you reading this may think, "so what, nothing the sell-side produces or states surprise me." I have news for you. Few equity buy-siders understand parent company liquidity either, though the knowledge base is much better than it was in mid-2008. Many equity investors were burned by parent liquidity issues that morphed into dilution via a need by liquidity-challenged parents to raise capital.

We are all shaped by our history. Mine has made me sensitive to parent capital structures and liquidity, while viewing bank valuations as an enterprise valuation proposition via valuing the subsidiary bank and then considering the parent company's net debt position to derive the value of the parent's common equity. When I started working with banks around 1990, many of our clients were small banks with levered parent companies and an inability to service the debt. Liquidity in the subsidiary bank was irrelevant to the parent unless the subsidiary bank had regulatory and statutory ability to declare upstream dividends. Following recessions, upstream dividends are typically curtailed or eliminated as bank management focus on rebuilding bank-level capital via retained earnings and, if necessary, capital injections from the parent. The FDIC in particular is sensitive to bank-level capital because it insures the deposits, while the parent company's capital structure and cash needs are not among its concerns.

Back to NYPBT/Emigrant Bancorp. I suspect the retention of Barclays Capital was due to a need to deal with the parent's capital structure. During 2014 the TARP dividend will reset to 9% from 5% and the senior notes will mature. The parent will need approximately $480 million if both instruments are redeemed. Plus, cash is needed for ongoing interest expense, which by my estimate approximates $40 million annually for the trust preferred, TARP preferred and senior notes. The Milsteins appear to have very deep pockets, but there probably is a limit to how much capital they will commit to a business. Per press reports, the Milsteins injected $200 million of additional equity into NYPBT during 2009-2010 to offset losses.

Prior to 2012, the last material upstream dividend occurred in 2006 when $86 million was paid to the parent. Since then, TARP and capital contributions created liquidity for the parent to replenish bank-level capital and retain sufficient liquidity for its debt service needs; however, parent liquidity had been trending lower to about $20 million as of year-end 2011. Since then, parent liquidity has improved with the payment of a $90 million dividend by Emigrant Bank to Emigrant Bancorp in 1Q12 ($40 million of which was subsequently upstreamed to NYPBT). As a result, parent liquidity as of March 31 totaled $111 million.

Presumably a return to profitability the past two years at lead bank Emigrant Bank and an improvement in its capital position (13.2% leverage ratio vs. 5.5% at year-end 2009) has resulted in regulatory permission to pay upstream dividends in spite of a 9.0% NPL ratio (and 11.8% for the consolidated company).

Barclays successful efforts to sell part of the retail deposit base and most of the branches may not create much of a gain, but a smaller balance sheet will further increase capital ratios and perhaps increase the amount of capital that Emigrant Bank can upstream to the Bancorp. All else equal, a smaller balance sheet equates to lower earning power too. Regardless, it is conceivable that upstream dividends the next two years will materially reduce the amount of outside capital that NYPBT will have to raise to retire the senior notes and TARP preferred. If so, mission accomplished with remnants of the banking franchise retained following an implosion that began in 2008 with heavy losses in the securities portfolio and NPLs tied to higher risk mortgage originations.

The Milsteins' ordeal the past few years highlights an issue that I believe many small banks face: how to reduce parent company leverage that U.S. regulators and Basel III are mandating? Prior to the financial crisis, bank holding companies used trust preferred as a source of consolidated tier one capital and qualifying debt as tier two capital to create core equity in the subsidiary banks via capital injections. With the need to redeem TARP and the inclusion of small banks in the Basel III calculus that will increase risk weighted assets and shift trust preferred to tier two capital from tier one, bank holding companies will be forced to de-lever. For most small banks, there is little access to capital beyond that which can be raised from directors and local investors. As a result, many of these institutions will be forced to sell — though not all are salable due to rural locations. Further, they will be forced to sell when their earnings will be more depressed than the Street realizes due to the Fed's zero-interest rate policy. Alternatively, lending can be restricted as bank-level earnings are upstreamed to the parents to redeem capital instruments rather than retained to finance growth. Either way, it is not a great outcome for common equity investors, though it may not be bad for debt and trust preferred investors.

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