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SNL NASHVILLE NOTES

Tuesday, November 08, 2016 5:35 PM CT

First NBC provides a bank investing primer

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If you have not read HoldCo Asset Management's Oct. 25 letter to the board of directors of First NBC Bank Holding Co., it is a wickedly good read for bank investors and a reminder to pay close attention to a bank's assets and the parent company's liquidity and capital structure. That may be an obvious statement given what transpired during 2008-2010, but greed and fear are powerful emotions, and the fear of the crisis has passed. Carrying the thought a step further, investors should always review a bank's and its parent company's financial statements on a stand-alone basis in conjunction with (or prior to) an analysis of the consolidated statements.

First NBC is in a jam, even though neither the company nor the subsidiary bank is critically undercapitalized. The company's leverage ratio as of June 30 was 6.0% (the Sept. 30 Y-9LP will presumably be filed in a few days), and the bank's leverage ratio as of Sept. 30 was 7.3%. Nevertheless, the Atlanta Fed deemed the company to be in "troubled condition." Among the restrictions the Fed imposed on the parent company was a prohibition to incur debt, make interest or principal payments on its subordinated debt or pay dividends on its preferred and common equity. The Fed, in effect, handcuffed the parent company.

The handcuffs are a problem because the parent company is levered. The parent company capital structure as of June 30 entailed $349 million of tangible common equity, of which $281 million constituted Tier 1 common capital, $60 million of subordinate debt and $38 million of preferred equity. Interest on the sub debt is due Feb. 18 and Aug. 18 each year. Although the parent company had about $5 million of cash as of June 30, the Fed's order precludes the use of that money to make the approximately $2 million interest payment unless the Fed is petitioned and waives the restriction. Missing an interest payment is an event of default.

Parent company capital structure issues typically do not become an issue until asset quality problems at the subsidiary bank preclude upstream dividends necessary for debt service and dividend payments. Rating agencies and debt investors, in theory, focus intensely on this relationship. HoldCo has done so in the case of First NBC. Equity investors, in my view, usually do not, even though parent-only FR Y-9LP and FR Y-9SP financials are readily available. Accounting firms do not help because they seem to only sporadically include "consolidating" and parent-only statements in the audits.

First NBC's parent company capital structure would not be an issue if the bank did not have asset and capital issues. The asset issues have been gestating for a while. Rather than problem C&D and CRE loans, the issue is the value attributable to $171 million of tax credit-related investments and a $253 million deferred tax asset as of June 30. These are big opaque assets in relation to the bank's regulatory capital. HoldCo points out the negative feedback loop in which DTAs curtail regulatory capital under Basel III, while the tax credit investments contribute to the DTA. One may argue with the haircut HoldCo applies to the assets in its analysis, but I think the analysis summarizes the calamity of over-investing in a nontraditional asset that seemed to be predicated upon tax minimization vis-à-vis traditional lending.

HoldCo does not sugarcoat its view of the company's predicament: accept a prepackaged bankruptcy that would wipe out existing common shareholders in which ownership is split among existing sub debt and preferred equity investors and $68 million of new common equity; or risk a worse outcome by "swinging for the fences" to save the existing common.

HoldCo has informed the market where it stands. It is short the common and long the sub debt, which it acquired for 74% of par, and it indicated a willingness to provide up to $30 million of the $68 million of new common equity it believes the company will need in the prepackaged bankruptcy scenario. So far it is a winning trade. The company's shares set a 52-week high on Nov. 30, 2015, of $43.52 per share; they closed on Nov. 4, 2016, at $5.50 per share. If the plan is accepted, the sub debt will be valued at par. The trade is reminiscent of the capital stack arbitrage trades from 2007-2008. Many such trades were big-time winners when common shareholders were wiped out or massively diluted, while an infusion of new capital caused heavily discounted debt and preferred instruments to rebound.

I doubt management and the board views its task as swinging for the fences, and I am sure they are acutely aware of duties to creditors and equity holders. In any event, I think First NBC will find the basic adage of capital markets to be true in that when a company absolutely has to have capital (or a buyer), it is hard to come by or, if available, the price is punitive. Conversely, when capital or a buyer is not needed, plenty of offers can be found.

HoldCo points out correctly that First NBC's capital-raising challenges are magnified by the hoops it and investors will have to jump through to avoid limitations on the NOL carryforwards. The tax issue is tough, though I think it is not insurmountable.

As for selling the company, a buyer would probably put a sizable mark on the investment tax credit-related assets, as it would on the DTA. As an aside, Mike Mayo used to get a lot of press for questioning the value Citigroup Inc. assigned to its DTAs. Regardless, I am not convinced First NBC is a must-have property for other regional banks. Hancock Holding Co. has not gotten any high-fives from Wall Street for its acquisition of Whitney Holding Corp. in 2011. Plus, it appears divestitures would be required because a combination would push Hancock to the No. 1 deposit market share position. IBERIABANK Corp. could be a possibility, but there seemingly would be no reason for CEO Daryl Byrd to bend over backwards. As for a new entrant: why? New Orleans is an American gem, but it is not a high-growth Sunbelt city.

How does it play out? The market has predicted not well with the collapse in the share price. There could be a surprise, however. In HoldCo's analysis, the existing common is wiped out. If the market is assigning a 50% probability to that outcome, then an alternative outcome would be one in which the company successfully raises capital or the company is sold for more than a negligible value. If a handful of investors conclude the hole is not as big as HoldCo thinks it is or the Fed will be agreeable to a resumption of interest payments given a certain amount of equity, then First NBC may have a way out at a price that may be higher than the current share price. Nevertheless, existing shareholders are set to incur sizable dilution or worse.

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