NASHVILLE NOTES

Price Paid Matters

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By Jeff K. Davis

No doubt there were sighs of relief in Washington, DC, and Albany, NY, once the Steven Mnuchin-led investor group announced its intention to inject $1.05 billion of equity capital into New York Community Bancorp Inc.

My assumption was that the collapse in the company's stock price in February reflected investor calculus about the amount of dilution a capital raise would entail, not the risk of an imminent failure of subsidiary Flagstar Bank NA. Nonetheless, the deteriorating situation was a political liability for the Federal Deposit Insurance Corp., which approved the March 2023 purchase of the failed Signature Bank, and the New York political establishment in Albany, which passed the Housing Stability & Tenant Protection Act of 2019 that eviscerated the value of rent-controlled apartments.

The other sigh of relief was from the holders of NYCB's preferred equity, trust preferred securities and sub debt, as the new common and convertible preferred equity sits below the other securities in the parent company's capital stack.

The cost to NYCB shareholders was steep, but capital is always expensive when a company has to have it. Year-end tangible book value per share (BVPS) of $10.03 declined by one-third to $6.65 per share on a pro forma basis given the addition of roughly 525 million common share equivalents to the existing 722 million common shares. Plus, the investors received seven-year warrants exercisable for an additional roughly 315 million shares, with a strike price of $2.50 per share that, once exercised, will create additional dilution to ownership and tangible BVPS.

Time will tell if Mnuchin's group obtained a bargain purchase or if the group signed up for a contingent liability if more capital is required to cover future loan losses. However, price matters a lot in determining investment returns — as price paid is the one factor an investor exercises absolute control over — and the purchase price is low relative to pro forma tangible BVPS.

> ***What is New York Community Bancorp's long-term earning power, and how big will the losses in the loan portfolio be over the next several years?***

As I write this, NYCB's shares are trading in the vicinity of $3.75 per share as investors ponder two big questions: What is the company's long-term earning power, and how big will the losses in the loan portfolio be over the next several years?

The more important question of the two is the amount of future loan losses. During the call to review the transaction, analysts quizzed management about the potential size of the first-quarter loan loss provision. It is a natural question to raise, especially when the slide deck includes pro forma additions to the allowance for credit losses of $500 million and $750 million. However, provision expense is an accounting entry that shifts equity to the reserve, whereas charge-offs are an economic loss.

No one, including the new investors, knows for sure what the losses will be given a multitude of variables — including the trajectories of the economy and interest rates, and even the question of whether the New York legislature would repeal or modify the 2019 legislation in a way that supported the value of rent-controlled apartments.

What is known is that NYCB's consolidated capital ratios and Flagstar Bank's capital ratios as of year-end 2023 were outwardly OK, with the bank reporting leverage and total risk-based capital ratios of 8.5% and 11.6%, respectively. Over a two-year horizon, the company will have more than $2 billion of capital to absorb losses via the $1 billion raise and roughly $1.5 billion of pretax, pre-provision operating income to be generated in 2024 and 2025 based upon the consensus analyst estimates.

> ***The company has a sizable cushion to absorb losses, but I suspect some think it will not be enough, given the size of NYCB's real estate loan portfolios.***

While $2.5 billion seems like a sizable cushion, I suspect more than a few reading this think it will not be enough, given the size of the rent-controlled multifamily portfolio — $18 billion — with additional risk in the $3.4 billion office portfolio.

Of course, without risk there is no return. I assume the Jefferies team that advised the investor group generated eye-popping internal rates of return, based upon capital invested at 30% of pro forma tangible BVPS for perhaps three to seven years, after which an exit occurs at or above tangible BVPS.

Aside from a low entry price, the investors have one additional asset that an IRR analysis cannot capture: big-time political connections. Mnuchin is a former US Treasury Secretary; CEO Joseph Otting is a former Comptroller of the Currency; and the OCC regulates Flagstar Bank. I would expect regulators to extend grace as management grapples with the loss content question this year, while investors ponder that and the earning power question.

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