NASHVILLE NOTES

Tomorrow never arrived

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By Jeff K. Davis

About two years ago I asked an investment banker with whom I was working on a project about his business. He said he thought the coming year, 2023, would be great for either capital raises or M&A. Neither was the case from an industry perspective, though his business may have been good. Of course, he offered the outlook before Silicon Valley Bank failed in March 2023 and the rate cycle peaked later in 2023.

Around the same time I posed my question, I got a call from a Wall Street professional to help an unnamed client value a large pool of securities and loans in which the holder was under duress. The yield on the 10-year US Treasury the day of the call had recently pushed above 4%, from just below 2% at the beginning of the year. Whatever pressure the undisclosed holder faced diminished over the next several weeks as rates pulled back and bond prices rose.

I offer these two vignettes as a backdrop to the pick-up in common equity raises by banks this year to absorb losses and restructure balance sheets. Tomorrow never arrived — or has not yet — where a sufficiently large rally in the bond market would allow banks to unload low-coupon bonds acquired when rates were at microscopic levels without materially denting capital.

> ***Investors are willing to fund capital raises at a modest discount, providing capital for issuers to take bond losses, reinvest and position themselves for better earnings.***

Since the election, Associated Banc-Corp, Dime Community Bancshares Inc. and Valley National Bancorp took advantage of the rally in bank stocks to raise $825 million of common equity excluding over-allotments for assorted purposes, but most notably to restructure the balance sheets and/or reduce CRE concentrations. Pre-election issuers for the same purposes include Amerant Bancorp Inc., MidWestOne Financial Group Inc. and Merchants Bancorp.

Also, KeyCorp was a winning issuer of sorts even though its $2.8 billion issuance to The Bank of Nova Scotia looks to be a marriage of convenience. Key issued shares at a premium to the market price and tangible book value per share at the time, to fund a restructuring of its balance sheet while retaining excess capital for future opportunities. Scotia obtained a roughly 15% stakeout position for a possible future US acquisition that presumably would be more costly than the $17.17 per share purchase price.

Aside from Scotia's strategic investment, I think many institutional investors long ago accepted the cost of realizing losses. Hence, there is a willingness to fund capital raises at a modest discount in order to provide capital for issuers to take bond losses, reinvest and thereby position for better earnings on a go-forward basis.

> ***I expect more banks to opt to move on by taking restructuring losses rather than realizing losses slowly via holding underwater positions.***

I get that it is a tougher call for management and boards to do so. Issuance entails ownership dilution and a current-period loss that usually takes several years to recoup from reinvesting at higher yields — and it may negatively impact compensation. I also recognize that the "duration" question is tough to navigate: Mortgage-backed security duration has extended as prepayment rates have collapsed, while many municipals entail far-off maturity dates. These are tough losses to swallow versus bonds that will mature within a few years.

However, the banking model entails leveraging capital to produce net interest income. Holding low-yielding assets that entail little or negative carry because funding costs approximate or exceed the yield makes little sense on a stand-alone basis. I expect more banks to opt to move on by taking restructuring losses rather than realizing losses slowly via holding underwater positions.

Overlaid on the common raises to fund balance sheet restructurings are common raises by acquirers to support M&A opportunities. Assuming the equity and bond markets are reasonably cooperative, 2025 may be the year in which there is a substantial pick-up in M&A activity and common raises as earnings per share resume an upward trend after three years of flat to lower results for many banks due to net interest margin pressure.

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