SNL Blogs

Friday, May 09, 2014 7:54 AM CT

Are branch deposit premiums worth it even if the buyer gets a bargain?

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

I have never covered the Puerto Rican banks. I watched from afar when things began to unravel in 2007 (or thereabouts) in what seemed to be a mini-version of the U.S. in which speculative mortgages were underwritten and marked to hoped-for-outcomes. While the crisis has subsided with the consolidation and closure of some banks and capital issuance by others, some legacy issues remain. San Juan, Puerto Rico-based Doral Financial Corp. continues to struggle. Its shares fell nearly 18% on May 6 and more than 83% over the past year. The catalyst appears to be a decision by the FDIC to reject its capital plan and subsequent ratings downgrades by Fitch Ratings and Standard & Poor's Ratings Services. General banking issues on the island are overlaid on a highly levered government that has become the Street's next candidate to follow Detroit into some form of bankruptcy or other legal maneuver to reduce the debt load. Whatever may occur on that front, I probably am not on a limb speculating that it will be bad for the island's banks.

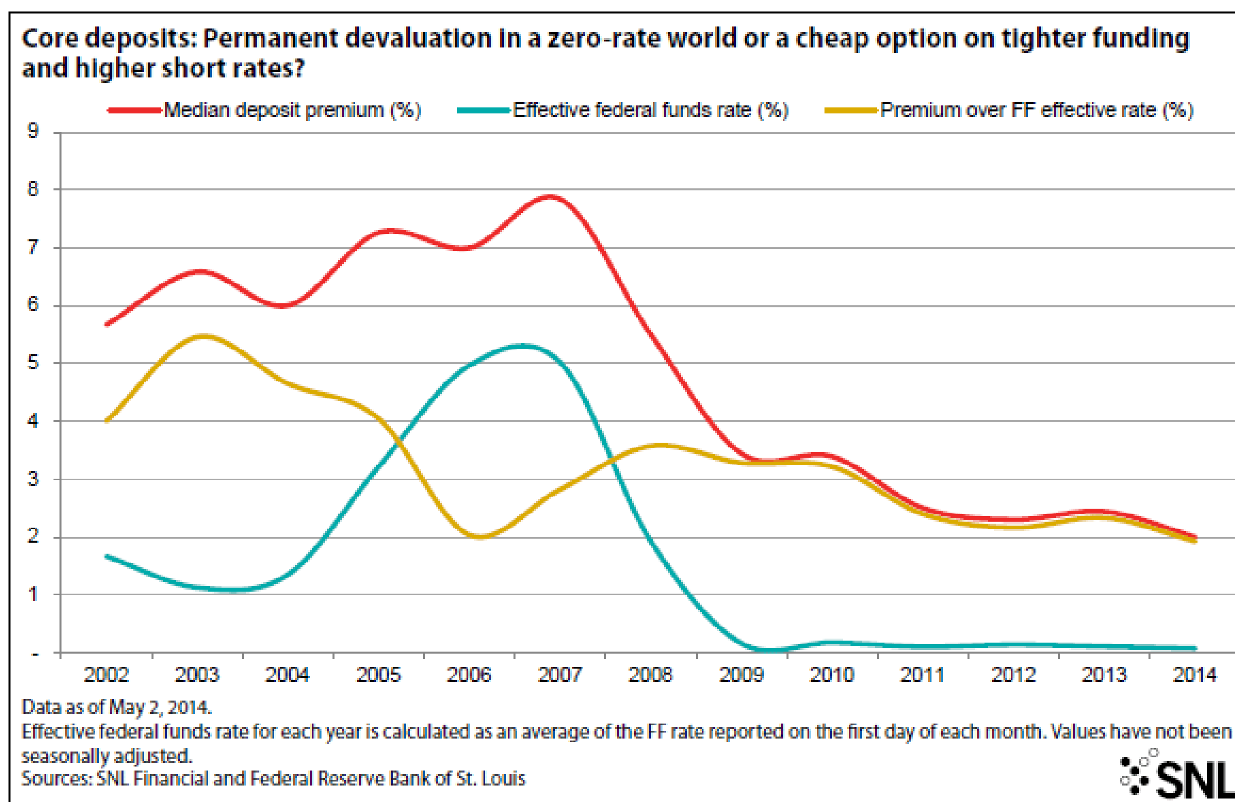
But what caught my attention about the island's banks was Hato Rey, Puerto Rico-based Popular Inc.'s announcement on April 23 that it has entered into agreements with three U.S. banks to sell 41 branches with $2.1 billion of deposits and $1.8 billion of loans in California, Illinois and Florida. Pricing — and I admittedly do not have an intimate knowledge of what Popular is selling — speaks to how much core deposits have been devalued in the Federal Reserve's zero interest rate policy world.

Irvine, Calif.-based Banc of California NA will acquire nearly half of the $2.1 billion divested deposits by acquiring Popular's California branch network for a deposit premium of $5.4 million, or just 0.5% of the $1.1 billion of deposits. If the pricing seems ridiculously low, Banc of California's pricing metrics appear to confirm your suspicions.

The IRR is projected to be +30%, with +20% year-one EPS accretion; and less than one year to earnback dilution to tangible book value per share inclusive of the restructuring charge. Banc of California's slide deck notes that only 26% of the $1.1 billion of deposits are CDs and that the overall cost of deposits including the CDs is just 0.48% compared to its cost of deposits of 0.77%. The buyer also gets $1.1 billion of performing loans that yield 4.8% and do not include nonperforming loans, nonaccruals and consumer loans with CLTVs over 80%. Popular also is covering 150 basis points of credit losses for the first two years after the first 50 basis points of losses is incurred.

Itasca, Ill.-based First Midwest Bancorp Inc. is acquiring 12 branches with $750 million of deposits and $525 million of loans. The deposit premium is closer to the national median at 2.5%, which in turn pales in comparison to deposit premiums that existed prior to the financial crisis. Still, entry price is the key investing variable that buyers control in determining the expected and ultimately realized return in my view. First Midwest's key metrics of 3.5 years to earnback dilution in tangible book value and a "high-single-digit" year-one EPS accretion seem more like that of a traditional bank deal. Unlike Banc of California's in-market deal, First Midwest's apparently has very limited consolidation opportunities.

Maybe pricing says Popular was under some pressure to get a deal done. Long-time observers will have a concise view that I do not. Aside from whatever deal pressures existed, what pricing says to me is that core deposit franchises have been devalued, maybe radically, in the zero interest rate world where liquidity is abundant and lending opportunities are not as robust vis-à-vis the amount of liquidity sloshing around the banking system.



As shown in the accompanying chart, deposit premiums paid for acquired branches have plummeted since the Fed reduced the target federal funds rate to between zero percent and 0.25% in late 2008. Aggregate national median deposit premiums, as reported by SNL, ranged from approximately 6% to 8% during 2002 to 2007. Since then, low-rates pursued by the Fed have slashed the national median deposit premium to 2%-3%.

I do not know how much of this is attributable to the quickening pace of the demise of the traditional branch and how much is attributable to a system that has plenty of liquidity. Nevertheless, it shows the reduced value of deposits that are a key variable in a bank's net interest margin in addition to loan spreads. A friend, who is a CFO of a regional bank, had an interesting remark to me a few years ago about FDIC-assisted deals. His question was what does the buyer do with the deposits (i.e., cash) once the loans pay off or the FDIC reimburses the buyer. Ultimately, his institution never bought a failed institution. The same thought may apply to branch deals, but in the case of the Popular deal the buyers got loans to go with the deposits, yet the deposit premiums were modest.

For Banc of California, First Midwest and Indiantown, Fla.-based Harbor Community Bank, the branch deal may represent a cheap call option should the Fed ever begin to raise short rates and liquidity in the banking system tighten as it is prone to do in a cyclical fashion. If so, no matter how obsolete branch systems may be in a digital world, the purchases may represent bargain purchases for the three acquirers, especially Banc of California.

Published with permission.
Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial.
He can be reached at jeffdavis@mercercapital.com or 615.345.0350.