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NASHVILLE NOTES

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Window on agribusiness

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Citizens Financial Group Inc. is expected to price its IPO soon. I think the pending IPO for Great Western Bancorp. Inc., a Sioux Falls, S.D.-based institution with $9.3 billion of assets, is a much more interesting investment than behemoth Citizens. In an earlier post, I remarked that Citizens could be described as a "big ugly," a term some institutional investors use to describe large cap banks that have uninspiring returns and little growth. Many institutional investors will be drawn to Citizens because its market cap is expected to be $13 billion to $14 billion based upon the contemplated pricing range of $23 to $25 per share. A large-cap company entails share liquidity that a small-cap company does not; it also does not typically offer the growth potential of a small-cap company.

Assuming the IPO occurs, Great Western would be the 10th commercial bank IPO this year. Eight have priced through Sept. 11; Citizens would be the ninth. Last year, four bank IPOs occurred, which followed four bank IPOs in 2012. The increasing number of IPOs is impressive, I think, because the outlook for earnings growth — at least for most banks — is just fair, while valuations are uninspiring if one cares about capital appreciation. Great Western may be an exception.

Great Western is wholly owned by National Australia Bank Ltd. via a sub-tier entity with the moniker National Americas Holdings LLC. NAB announced in late August that it intends to divest Great Western in order to focus on the Australian and New Zealand franchise. It acquired Great Western in 2008 for $798 million of cash. If I am analyzing parent National Americas Holdings' changes in equity schedule derived from the Y-9 correctly, an additional $200 million was injected into the parent in 2010 versus $200 million of dividends paid during 2010 through June 30, 2014.

Management has been acquisitive. Total assets were $3.1 billion at year-end 2006; they were $9.3 billion at June 30. The largest acquisition was the FDIC-assisted deal for Lincoln, Neb.-based TierOne Bank in 2010, which added $2.5 billion of assets. As an aside, TierOne was an early beacon for investors of troubles to come. In 2007 CapitalSource Inc. entered into an agreement to acquire TierOne because it needed deposit funding. In early 2008, CapitalSource terminated the deal and then agreed to acquire Fremont Investment & Loan in April to gain deposit funding.

Assuming a valuation of 14x to 16x last-12-months net income of $103 million, Great Western will be valued at $1.4 billion to $1.6 billion, or 1.9x to 2.2x June 30, 2014 tangible common equity of $733 million. Maybe the math answers my question, "why IPO?" Answer: No one goes broke taking a profit.

The IPO will not result in the full divestiture of NAB's ownership. Follow-on offerings may occur to eventually fully divest the interest. Unless I am missing something obvious, the divestiture process raises another question: Why not sell Great Western to a larger bank such as San Francisco-based Bank of the West; Kansas City, Mo.-based Commerce Bancshares Inc.; Wayzata, Minn.-based TCF Financial Corp.; or Houston-based Prosperity Bancshares Inc.? The short answer may be there was not the interest, or not at a price level that made sense to NAB vis-à-vis what an IPO may bring. Plus, management may use a public currency to grow through M&A before NAB divests the balance of its interest. A larger organization then may have more interest, or maybe a better valuation in follow-on offerings.

IPO versus selling the company aside, I think Great Western is an interesting stock for bank investors. The company does not offer dominant market share in any of its smallish markets. According to SNL's deposit market share analysis, Great Western has the No. 6, No. 7 and No. 5 positions in Omaha-Council Bluffs, Neb-Iowa; Des Moines-West Des Moines, Iowa; and Boulder, Colo., MSAs. Nevertheless, the financial metrics for Great Western are good. Loans are growing. ROA for the nine months ended June 30 was 1.12%, ROE was 7.3% and ROTCE was 17.1%. The adjusted NIM excluding swaps was relatively stable at 3.73% compared to 3.78% in 2013. Apparently, management knows how to run a lean organization. The efficiency ratio runs in the low 50s, which accounts for the good profitability metrics.

Thematically, Great Western represents a play on the Great Plains and agriculture. The region is sparsely populated, but it is the breadbasket to the world. According to the American Bankers Association, Great Western was the eighth largest farm lender as of June 30. Wells Fargo is the largest lender, but farm loans represent only 1% of its portfolio. Agribusiness represents about 25% of the $6.4 billion loan portfolio and about 35% including C&I and owner-occupied CRE loans that are agriculture-related according to the S-1. Commercial, CRE and agribusiness loans accounted for 85% of the portfolio. Maybe that is logical because there is no mass market to bank in the Great Plains.

Agriculture and its derivation agribusiness are of course cyclical. After a number of years of rising farm incomes and significant appreciation in farmland values, the farm economy may be cooling. Whether it cools a lot may depend upon the Fed and whether it really raises short rates. My bet is no, but further weakening may cause investors to discount Great Western's valuation a bit. When Paul Volcker aggressively raised rates in the early 1980s to contain inflation, it was not just Latin America and Mexico that could not make debt service payments; U.S. farmers struggled after accumulating debt to finance inflating land during the 1970s.

Great Western is not a big ugly, which may allow the underwriters to price the IPO aggressively as may have been the case with ServisFirst Bancshares Inc. when its IPO priced in May. Growth investors may pay up because there are few small- and mid-cap growth banks to add to a portfolio, but there usually is a gap between where growth investors will value a growth-oriented bank and where value investors will do so. That gap can lead to choppy after-market trading even if the long-term growth prospects are good because value investors, who are far more numerous in terms of the pool of institutional bank investors, sometimes are needed to support the shares, too.

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