PARLIMENT
CONSULTING SERVICES

Challenging Financial Paradigms

Over-Capitalized? Struggling With A Low ROE?

Get Control: Focus On Increasing EPS

By: Thomas J. Parliment, Ph. D.

Is having too much capital a curse or a blessing?

If youqe a regulator or a pundit from academe, extra capital may seem to define the very hallmark of safety and soundness. But if youqe one of the many thrift institutions that have recently converted from mutual to stock ownership, or a bank that has been accumulating profits, the flip-side of excess capital is chronically low ROE. Why? Because the institution hasnq put all the capital to work supporting a portfolio of earning assets.

So now nervous management teams look across the boardroom table at nervous directors who are reading reports written by pontifical analysts and answering the questions of expectant shareholders. The question in everyoneqs mind is %How long does the institution have to figure out what in the world itqs going to do to produce a competitive 10-12% ROE?+

Bear in mind that Iqm not referring to the situation facing financial institutions already producing competitive ROEqs. In the last issue of this newsletter, we took up the issue of leveraging a bankqs balance sheet to maintain a competitive ROE. ROEqs are under downward pressure due to a variety of forces. Some of these forces include: increased capital ratios from past %fat+earnings years, a current as well as a projected earnings squeeze stemming from narrowing interest margins, and evaporating fee income from mortgage banking operations.

The challenge of generating a competitive ROE can appear downright scary when the problem is viewed from the perspective of an institution that already has a double-digit capital ratio.

Letqs look at an example.

The Problem: The Single-Digit ROE

Assume weqe looking at a $500 million institution with $75 million of equity. It has a capital/assets ratio of a whomping, stomping 15% resulting in a miserable equity multiplier of 6.67! The institution has after-tax earnings of $5 million and 4 million shares of stock outstanding, yielding an earnings per share of $1.25. The market price of the stock currently is $15.00 per share.

Now the profitability equation (that venerable icon of capitalism, that immutable financial relationship which we must teach the Russians) tells us ROE = ROA x LEVERAGE. So our institution, with an ROA of 1.0% and an equity multiplier of 6.67, is producing an ROE of 6.67%. Not good, folks, not good at all. In a market that demands 10-12% return on equity, this 6.67% ROE presents management with troublesome alternatives.

P.O. Box 148 | Key West, FL 33041-0148 | 508.881.7002 | FAX 508.881.7004
www.parlimentconsulting.com

Management could seek to achieve a 12% ROE by increasing ROA from 1.0% to 1.80%. You really think so? An 80% improvement in ROA? Not likely. Some cutting here, some pruning there can help but usually changing the return on average assets occurs with the speed of a turning oil tanker.

The Problem:	An Overcapitalized Institution Struggles With Generating A Competitive ROE
Assumptions:	$500 million assets, $75 million capital, i.e. C/A ratio of 15% $5 million in after tax earnings, 4 million shares of stock, i.e. an EPS of $1.25 and a market price of $15 per share.

The Profitability Equation:

ROE	=	ROA X Equity multiplier (inverse of C/A ratio)
6.67%	=	1.0% X 6.67

YOW! In a market that demands 10-12% ROE, this 6.67% ROE presents some very scary strategic alternatives:

To Achieve an ROE of 12%, DO I:

A) Increase after-tax ROA to 1.8%. Good Luck! If you have trouble locating high margin assets, call me!
or,
B) Immediately grow the institution to $900 million in size, increasing the equity multiplier to 12 while decreasing the C/A ratio to 8.3%.

Acquisition fever? For a fee I can arrange bidding wars for branches, even entire institutions.
or,
C) Freak! Look to sell the institution because the problem appears overwhelming. Need I say anything?

In fact, it's probably time to control expectations about continuing increases in ROA. In the short-term, mortgage origination fees from the boom are out the window, while interest margins will vary depending on the institution's Current asset sensitivity to rate increases. But in the long-term, narrower interest margins will be the likely result of the increasing securitization of the balance sheet. More mortgage securities, more asset-backed securities of all kinds, will narrow spreads to the treasury yield curve. Even the liability side of the balance sheet is competing with increased securitization. After all, what's a mutual fund if it's not a "securitized liability", at least from the institution's perspective?

Since significant improvement in the ROA of an already well-performing institution is likely to be marginal, the chance to achieve a competitive ROE will depend on the capability of management to grow the institution via either loans or investments. I'm biased toward retail growth, if it can be achieved sanely. Tactics to achieve retail growth through loans will be discussed shortly. But can our institution achieve $400 million in retail growth quickly? Unlikely, unless it can do an acquisition of part or all of another institution. However, the market for acquisitions is one heck of a competitive market. After all, M&A is the lifeblood of bank holding companies. Acquisitions are nice when they can be worked-out, but do you want to tell your investors that it's the only horse you have to ride?

Oh weqre going to leverage the bank all right, we have to. But the leverage will occur over time, with a focus on the marginal improvement in earnings per share, and a focus on retail loan growth supplemented with investments. Youqll see.

With no quick and easy solutions to increasing ROE available, are we ready to settle in for the long haul? Well, some investors simply may not be so inclined. They may expect you to recognize your limitations and sell the bank. But donqt be so hasty. Iqve already written one article in our newsletter, %When to Hold and When to Fold+, which discusses the proper approach for managers and directors to take when either pursuing or being pursued by an acquirer. There is one whale of a difference between an institution that has a low ROE because of an excess of capital, and an institution whose low ROE comes with marginal capital and operating deficiencies. The difference is the potential earnings of the unused capital.

Listen, acquirers donqt like to pay much of a premium for unused capital. Someone has to start putting your capital to work, so it might as well be you. Hereqs a more reasoned approach Iqd like to suggest.

The Solution: Focus On Steadily Improving EPS

Management needs to demonstrate a commitment to improving shareholder value through achieving incremental earnings per share. Focusing on EPS will permit the highly capitalized institution to break down the task of increasing ROE to a series of manageable steps.

My CFOqs are out there saying, %Come on Parliment, ROE, EPS, whatqs the difference? All youqve done is divide earnings by total equity on the one hand, while dividing earnings by the number of outstanding shares of stock on the other hand.+Oh, oh, oh, just one minute ±O Wizards of the Bottomed Lineq the difference is in front of your face. ROE represents just that, the return on TOTAL equity. EPS represents a measure of the return on the investment (ROI) of the shareholder, which is where managers should concentrate their focus.

You see, when measuring ROE, all of the equity in the bank is counted, even that equity not contributed by the shareholders. Remember that converted mutual institutions begin with a treasure chest of mutual capital. Of course, itqs the earnings potential of the existing mutual capital that attracted the investor in the first place, giving the original investor in the initial public offering a ROI substantially greater than the pro-forma ROE. And yes, investors want to see all of the capital eventually put to profitable use. But first and foremost, the investors want to see the value of their specific investment (the price they paid per share of stock) earn a competitive ROT.

If the earnings per share targets of the financial institution are consistently set to meet competitive norms, an orderly process toward achieving a competitive ROE will be in place. In fact, while conceptually similar to ROE, EPS profitability targets are expressed in terms most readily

understood by shareholders, and in terms by which managers can most clearly correlate to the marketqs valuation of performance.

Setting EPS Targets

The institution in the example is earning $5 million for 4 million shares of stock that is $1.25 per share. Is this good, bad, or what? While a whole host factors impact the price investors are willing to pay for stock, most analysts believe that consistently produced core earnings will be the deciding factor for most investors. Of course such things as takeover rumors will drive acquisition value, and general stock market trends will also put pressure on market prices. But one can look at the price to earnings (P/E ratios) multiples of financial institutions with relevant, similar characteristics to come-up with a P/E ratio that is competitive.

Recently, a P/E multiple of 10 times earnings could be considered reflective of a competitive market price for thrift earnings. So, based on an EPS of $1.25, a competitive bid for this stock would be $12.50 per share. Well, phooey. The market price of the stock is currently $15.00, representing a P/E multiple of 12 times earnings. There may be some other factors creating the willingness of investors to pay $15.00 for this stock, but itqs not solely earnings. And whatever it is, managers probably donqt have much influence on it. Managers should get the EPS to a level where the %market average+ P/E ratio of 10x will support the stock price of $15.00. Donqt worry about the other factors.

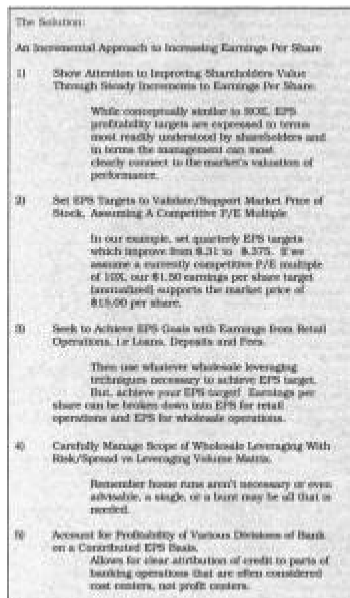
In this case an EPS of $1.50 is needed to support the market price of $15.00 given the P/E ratio of 10x. To increase the current EPS of $1.25 to $1.50 QUARTERLY EPS targets need to be increased from $.34 to $.375. This strategy produces a consistent upward trend. The market will respond to a consistent improvement in earnings by moving the bid price for stock to a competitive multiple of earnings.

By the way, nothing is stopping you from choosing a higher EPS target in an attempt to put your stock at a premium to the market averages.

Key On Retail Leverage

The most powerful tool to increase earnings (either ROE or EPS) is to grow the institution. But, since the market places greater value on core earnings and increasing the deposit base to support those earnings, our attempts will focus on growing the retail bank. Letqs assume that our goal is to increase quarterly EPS by $.02 in the next quarter. In our example institution, this would represent an increase in net income of $80,000. The institution will do the best it can to achieve this increase in earnings through the retail side of the balance sheet.

In the next issue, a retail loan pricing methodology will be developed that will help institutions price loans more aggressively, thereby achieving an optimal rate of retail growth.



The Solution:

An Incremental Approach to Increasing Earnings Per Share

1) Show Attention to Improving Shareholders Value Through Steady Increments to Earnings Per Share.

While conceptually similar to ROE, EPS profitability targets are expressed in terms most readily understood by shareholders and in terms the management can most clearly connect to the market's valuation of performance.

2) Set EPS Targets to Validate/Support Market Price of Stock, Assuming A Competitive P/E Multiple

In our example, set quarterly EPS targets which improve from $.31 to $.375. If we assume a currently competitive P/E multiple of 10X, our $1.50 earnings per share target (annualized) supports the market price of $15.00 per share.

3) Seek to Achieve EPS Goals with Earnings from Retail Operations, i.e Loans, Deposits and Fees.

Then use whatever wholesale leveraging techniques necessary to achieve EPS target. But, achieve your EPS target! Earnings per share can be broken down into EPS for retail operations and EPS for wholesale operations.

4) Carefully Manage Scope of Wholesale Leveraging With Risk/Spread vs Leveraging Volume Matrix.

Remember home runs aren't necessary or even advisable, a single, or a bunt may be all that is needed.

5) Account for Profitability of Various Divisions of Bank on a Contributed EPS Basis.
Allows for clear attribution of credit to parts of banking operations that are often considered cost centers, not profit centers.

Supplement With Wholesale Leverage

Whatever you can't achieve via the retail bank, earn with wholesale leveraging. In fact, there may be some times when little retail growth can be achieved profitably, or indeed, retail shrinkage may be necessary. The investment function now comes into play.

Assume an additional $40,000 can be earned from retail operations. This leaves $40,000 to make from leveraging via investments and borrowings. The amount of leveraging necessary to achieve $40,000 in earnings will depend on the amount of risk that the institution chooses to take with investments. For instance a conservative approach aimed at earning 50 basis points after-tax would require $8,000,000 in investments to achieve $40,000 in earnings. Taking on additional credit risk or interest rate risk to increase the after-tax spread to 1% would reduce asset growth requirements to $4 million.

You get the idea. A matrix of net spread vs. leveraging volume alternatives can be developed to achieve a $40,000 earnings objective. The point is don't be greedy. If you have the excess capital to leverage you will be better-off minimizing the risk of the leveraged investments: You'll get your capital back quicker.

And quicker return of capital permits continued use for retailing at a higher margin, or leveraging via investments.

The leveraging of the wholesale bank serves as an earnings shock absorber, helping the institution to achieve its EPS goals.

Of course, there are more aggressive souls who would say this bank should be leveraged immediately by $400 million in the wholesale markets. And as the bank is able to grow retail loans and deposits, the leveraged investments can be replaced. These people would agree that even $1.00 of unused capital is a financial sin. Philosophically, I agree. I just question the practical viability of implementing such an aggressive management strategy. It's a challenge to get regulators, directors, and yes, even market analysts to understand your objectives and believe in your ability to control the process.

Achieve Divisional Accountability

Several of my clients really like the way in which EPS goal setting permits attribution of profitability even to those divisions of the bank not seen as profit centers. For instance, suppose in a rising interest rate environment, a conservative deposit pricing strategy can be shown to add more to interest margin by holding down funding costs than a pricing policy which keeps deposits by chasing rates. The funds acquisition people, often bearing the brunt of some customer dissatisfaction, are never too enamored of a pricing policy that forces depositors out the door. But you can demonstrate the decline in EPS that would have accompanied a more permissive pricing policy · a kind of shadow EPS. These people can be shown the direct benefit to EPS from using all of their marketing and salesmanship talents to sell the non-rate features of the bank and retain as many of the lower cost deposits as possible.

Strategic Earnings Per Share targets. I like it. Think about it.

P.O. Box 148 | Key West, FL 33041-0148 | 508.881.7002 | FAX 508.881.7004
www.parlimentconsulting.com