94/04-Bank On It

The author, perhaps the most famous stock picker ever, tells how to profit from one of the best opportunities he has witnessed during a 30- year career of beating Wall Street

By Peter Lynch

My first column for Worth appeared in the August/September 1992 issue. The subject was the great investment opportunities in the scores of mutual savings banks and thrifts (a.k.a. savings and loans that were going public). Perhaps you know what's happened since then: The share prices of many of these new public companies have doubled, tripled, and even quadrupled in the period following the initial offerings. In my 30 years of looking at stocks, I've rarely seen a group do as well as this one has.

During good times for packaged foods, insurance, or retailers, not every food packager, insurance company, or retailer is going to share in the prosperity. An investor may find the right sector but choose the wrong stock and lose money. But among the mutual savings banks, it's hard to find a wrong stock. Of the 13 that began trading in 1991, the worst performer is up 89 percent.(For more on that year's conversions, see "Class of 1991" on this page.) Out of 46 new issues in 1992, there's only one loser to date. And of the 57 initial offerings in 1993, there are no losers; 30 have gained more than 30 percent.

I'm not telling this old story to exercise my hindsight--who cares about the wonderful investments we all might have made in years past? What causes me to revisit the topic is the 1,231 mutual savings banks that haven't yet converted to public ownership. On top of those, a sizable number of prior converts are trading in the market at bargain prices.

The savings banks have recently made headlines, but not the kind I'd like to see. It seems that a small number of officers and directors have been enriching themselves on their own conversions by issuing themselves free shares or options to buy shares at a discount. There's a move afoot in Congress to put a stop to the insiders' profiteering, and the Office of Thrift Supervision has slapped a moratorium on all future deals while it studies the matter. Meanwhile, the Treasury Department has halted all direct sales of savings banks to larger commercial banks.

I'm no fan of insiders getting more than they deserve. If that's the situation, it ought to be corrected. But to my mind, the prospering of insiders is not the biggest tragedy with conversions. The biggest tragedy is that millions of depositors, average people with CDs or savings accounts, also could have prospered but have not. When given the chance to participate in the scores of recent offerings, only 2 percent of the depositors have taken advantage. The rest have turned down what may be the opportunity of a lifetime.

My guess is that this moratorium on thrift conversions will be lifted sooner or later. Some way has to be found to bring the remaining mutuals into the system of public ownership, or else they'll be unable to compete with the other banks and thrifts that enjoy access to public capital. And unless the rules are drastically revised in the wrong direction, there will be more good deals to come. I only hope that more individuals will enjoy the benefits.

So we know what we're taking about here, mutual savings banks, thrifts, and savings and loans are varieties of the same species. Some are chartered by the states and others by the federal government. Many began in the 19th century as neighborhood associations, similar to electric co-ops or food co-ops. They aren't owned by anyone in particular, except the mass of depositors. This mass ownership is what creates a windfall for the new shareholders, as I'll explain in more detail below.

It's ironic that mutual-savings-bank conversions are branded in the press as unfair to the little guy. Actually, conversions are the rare exception where the little guy gets to buy shares at the initial offering price. In nearly any other kind of IPO, the Wall Street gorillas (institutions, mutual funds) grab all the shares, while the average person is shut out. I often wonder why we bother to call these events public offerings at all; generally, the public has nothing to do with them.

But the offerings of savings banks are truly democratic. Widows, blue- collar workers, and kids with paper routes get a crack at the shares. Although the actual requirements for conversion vesting (that is, eligibility for buying shares at conversion) vary from bank to bank, in most cases a passbook balance of $100 to $500 will give you the right to purchase as much stock as you can afford, up to several hundred thousand dollars' worth.

When a savings bank decides to convert, one of the first things it does is send out letters to all depositors informing them of these rights. Most of these letters, and most of the announcements that follow, end up in the trash along with the junk mail. People are used to getting toaster ovens and calendars from banks--not stock solicitations. They think there's something fishy about a bank's inviting them to put up money in advance to buy its own shares. They've all read the stories about Charles Keating.

This rejection by its own customers usually forces the bank to extend its offer to an ever-widening group of outsiders: residents of the county, residents of neighboring counties, or even all residents of the state. Some of the shares will end up in the hands of professional investors like me who open accounts in a variety of banks and thrifts with the sole purpose of hitting upon a possible conversion. I know about this from personal experience. Seven years ago, my wife, Carolyn, and I bought CDs in several different mutuals in our vicinity.

Becoming a serial depositor is not everybody's idea of an exciting time, and keeping track of the paperwork can be a minor hassle. On the plus side, it only takes one conversion to make all your troubles worthwhile. We have been fortunate enough to have stumbled into four: three in the area around greater Boston, where we live, and one in Maine, where the family goes skiing. Given the remarkable performance of so many other conversions around the country, I only wish we had spent the latter part of the 1980s traveling from coast to coast, sticking money into thrifts.

On second thought, the kids would have mutinied in the back seat. Anyway, the vesting requirements have been tightened to discourage the long-distance carpetbaggers. That's just as well. I'm all for keeping the profits in the neighborhood where savings banks are located, and with 1,231 possible conversions waiting to happen, the odds are excellent that at least one candidate can be found in a city or town where you live or work.

It can't hurt to ask local bankers how many unconverted thrifts exist in your area. Leave a small deposit or purchase a small CD in each one, and even if nothing happens, you'll collect your interest payments. The 100 most likely and most attractive candidates for conversion are identified in "Get Ready," a list that comes courtesy of SNL Securities, a highly regarded advisory service in Charlottesville, Virginia. There are opportunities here in 32 different states. Shown in italics are the 29 thrifts that SNL predicts are most likely to convert within two years. No guarantees, of course.

CASH IN THE TILL

What makes conversions such exceptional investments? It's not simply the bull market that has lifted these stocks. It's the fact that mutual savings banks have no formal owners. A normal company has founders, early investors, and venture capitalists, all of whom claim a share of the proceeds from a stock sale when the company goes public. But a mutual savings bank has only depositors. There are no sellers to compensate. Officers and directors may get free stock, as we've noted, but all the cash that's raised in the offering, minus the underwriting fee, is returned to the company till.

The effect is quite magical. Let's say PennyWise Mutual Savings Bank, which has a net worth of $10 million before conversion, announces a public offering: 1 million shares at $10 per share. The underwriters take their small cut, but for the sake of this exercise, we'll ignore that. So the entire proceeds of $10 million revert to PennyWise. This doubles the value of the company, from $10 million to $20 million. The lucky buyers have just paid $10 million for a $20 million property. Another way of looking at it is they've bought the company for zero.

It's hard to think of another transaction where the value of the merchandise doubles the minute it changes hands. Imagine it this way. You've just paid $10,000 in cash for a new car and driven it home, where you open the glove compartment and discover your $10,000 has been placed there, along with a note from the car dealer: "We don't need this. You keep it."

As long as you leave that money in the glove compartment, your $10,000 car is a lot more valuable than it was before you bought it. Is it any wonder then, that the stock price of a mutual savings bank rises quickly as soon as it starts trading on the open market? Indeed, first-day gains average more than 30 percent. For depositors who are used to getting 3 percent on their CDs, that's ten years' worth of interest, paid overnight. The initial price surge is usually followed by a second, more gradual increase. On average, the 384 thrifts that trade on the major exchanges sell for 104 percent of book value in today's market. Usually, it takes the newer conversions several months or even years to reach this plateau. Investors who miss out on the quick 30 percent profit from the offering can get in on the next 50-70 percent by purchasing shares later.

The example of Green Point Savings is instructive. This is the New York bank (publicly trading as its parent, GP Financial) that was at the center of the fuss about the insiders' unfair advantage. The original plan was to sell Green Point to Republic New York Corp., and when that deal didn't pan out, the directors decided to take their bank public. In typical fashion, the stock was offered at $15 and quickly rose to about $20, where as of this writing it now sits. The book value is $27, and if the earlier pattern holds, the price will creep up to that level eventually.

But let me repeat myself: no guarantees. In spite of the built-in advantage of cash in the drawer, it's a mistake to think that one savings bank is as good as another. Some are highly profitable, others less. Some have "clean" loan portfolios; others are plagued with defaults and foreclosures. While most are solvent, a few of the shaky ones are forced into conversion by the government so they can meet minimal capital requirements with the infusion of new money. These so- called supervisory conversions can be hazardous to investors. I wouldn't invest in any thrift without asking some basic questions.

-- Is there enough equity? Equity is important for two reasons. If a bank lacks sufficient equity, it puts itself in a precarious situation with regulators and becomes a candidate for bailout or liquidation. The S&L; casualties of the 1980s didn't have enough equity to cover the losses from bad loans.

The proceeds from a public offering are counted as equity, which is why converted savings banks excel in this category. The equity-to-assets ratio is the standard measure of financial strength, and an e/a of 5 percent is considered good. J.P. Morgan, one of the nation's strongest commercial banks, has an e/a of 7, while the average e/a of the 384 publicly traded thrifts is 9 percent. Green Point Savings has 20 percent equity to assets after adding the new capital from the conversion.

A couple good things can happen to a bank that's cash rich. The more equity it has, the more loans it can make; the more loans it makes, the more it increases its earnings.

Or if it doesn't want to make loans, it can invest the money in Treasury bills and earn a nice living. Better yet, it can buy back its own stock. Fewer shares outstanding means more earnings per share, more book value per share, and a higher stock price.

-- Is there a high-quality portfolio of loans? Bad loans, a.k.a. nonperforming assets, can break a bank very quickly as it channels more money into its loss reserves and into the management of properties in foreclosure. I look for thrifts that have a low percentage of nonperformers. Less than 0.5 percent is comforting.

-- Is the thrift making money? The common measure of a bank's profitability is return on assets. You get the ROA by dividing the bank's income by its assets over a specified period. A 1 percent ROA is average, and that's a good benchmark to use. Anything above that is a plus. Another useful measure is the price-to-earnings ratio. I look for thrifts with p/e ratios below 10. I'd be wary of investing in any thrift that is losing money (zero or negative earnings) at the time it goes public.

-- What's the book value? You can get this number from a bank officer, the investor-relations department (if there is one), an annual report, an S&P; report, or a variety of other research services. Its importance has already been noted.

If bank officers have begun the conversion process, your investigation is a snap: Everything you need to know can be found in the prospectus. Here, you'll find the offering price of the stock, the earnings history, the makeup of the loan portfolio, the percentage of nonperforming assets, the equity-to-assets ratio, the resumes of officers and directors, the number of shares they are buying, and at what price. This last detail is an important one. Corporate insiders are not known to be self-destructive. They don't buy company stock unless they expect to make money on it. So when you pay the same price they do, you're in with the right crowd.

I also look for a couple of other things. If a bank owns its own branches, it's a plus. Real estate is carried on the books at cost and can be a valuable hidden asset. Another plus is what bankers call cheap deposits. A bank that has few branches and large concentrations of deposits tends to be more cost effective than one with many branches and smaller deposits.

After you've read the prospectus, you can ask all the questions you want and clear up any remaining confusion at a meeting with bank officers and others in the know, to which every would-be investor is invited. The hosts will probably serve donuts and coffee or sandwiches and Coke, and still only six or eight people will show up. This is another rare opportunity for the average person to learn from the horse's mouth--and it's astounding how few take advantage. They're too busy listening to their brokers and watching for the latest hot tip from CNBC.

WINNERS AND LOSERS

What can we learn from 2 savings banks out of the 116 that converted since 1991 whose share prices have lagged behind the rest? The biggest disappointment is First Federal Savings & Loan Association of San Bernardino, which at this point is the only outright loser in the group. It has suffered from being in the wrong place at the wrong time: California in its worst recession in the modern era. The other disappointment, although not a loser at the moment, is < wam-co NASD:PTRS>Potters S&L; of East Liverpool, Ohio. Potters's stock followed the usual pattern--it was offered at $10 a share in 1993, then jumped to $10.88 on the open market. But from there, it drifted downward, reaching a low of about $9. However, it rebounded and today it sells for around $11.

Maybe Potters is jinxed by having virtually the same name as the villainous banker in It's a Wonderful Life. But from what I can gather, the basic problem is earnings. Potters wasn't making much money when it converted, and it's barely profitable today. With 6 percent nonperforming assets, it's not hard to imagine where the profits have gone.

Anyone who asked the key questions about Potters would have avoided the stock. It flunked the test on loan quality. Until you get hard evidence that the delinquency rate is in decline, you're better off putting your money elsewhere. There's plenty of opportunity.

In the column I wrote on this subject in 1992, I included a list of ten savings banks with favorable characteristics. That group is up some 58 percent (see "Scorecard"). A new list of good candidates appears in "Prospects." I'm not suggesting that you run out and buy these, only that they appear to be worth consideration. (I personally own many thrifts including three on this list: Pamrapo , Fidelity New York, and North Side Bank.) Investigate before you invest.

Another word of warning: The perfect conditions banks have enjoyed for several years won't last forever. It's been an extremely happy time for bankers, something they can tell the grandchildren about: declining interest rates, an accommodating Federal Reserve, an improving economy, and a beautifully shaped yield curve. With short rates low and long rates high, a banker can lend money at 6 percent, borrow at 3 percent, and feast on the spread.

Eventually we will have another period of tight money. The first tiny increase in the Fed's lending rate in early February caused bank stocks to stumble. Rising interest rates are profit killers. During 1.5 years out of every 10, on average, we get an inverted yield curve, when short rates are high and long rates are low. This is a calamity for banks.

So it may be that the steady upward rise in bank stock prices will be interrupted sooner or later. But long-term there's another reason to be bullish: consolidation.

In the past five years, nearly 37 percent of the thrifts and savings banks have been acquired through mergers and buyouts. When this happens, the stock prices are pushed to a third tier, far above book value.

Even with the buyouts temporarily put on hold, consolidation is inevitable because we have too many deposit takers in this country. If you count credit unions there are more than 20,000 separate institutions where we can park our money. Each one has its own advertising jingle, board of directors, auditors, software system, and headquarters. The last time I wrote about this, I mentioned the six banks in my town of 19,000 people, as compared to nine in all of Canada. My little town still has six banks.

The record levels of cash that has piled up in the commercial banks is another stimulus to mergers. The industry today looks like it did after World War II--bankers have more cash than they've seen in decades and no place to lend it. By acquiring smaller banks and thrifts, they can expand their deposit bases and eventually increase their earnings.

So we're seeing a double trend: Many mutual savings banks and thrifts are going public, while others are being bought out. Many of the takeover targets are attractive to larger institutions because they, too, are full of cash. On our list of good prospects, Queens County, Pamrapo, and Sunrise Federal can be put in the cash-rich category, along with Green Point, with its incredible 20 percent equity-to-assets ratio.

You may have noticed that seven of the banks on the recommended list are from New York and three from California. On the last list, two were from New England. I've always found the biggest bargains in the thrift group in regions that are recovering from recession. But you have to be careful to buy the ones where loan delinquencies are in decline, and where the situation--the health of both the bank and the community or region--is getting better and not worse.

New York banks are especially ripe for takeover, because the regulations in New York make it easy for out-of-state banks to make acquisitions. Wherever these takeovers have occurred, the target has been bought out at a premium to book value.

SNL Securities (these people keep themselves very busy) did a recent study of the 16 thrifts acquired by larger institutions in 1993. The average acquisition price was 1.5 times book. Not a single one was acquired at a price less than 300 percent of the initial offering price for the shares.

By this measure, our fictional PennyWise, which went public at $10 with a $20 book value, would be worth $30 in a takeover. Of the three phases in the life of a mutual savings bank or thrift, this last one is the most rewarding of all.

Ask the residents of Hattiesburg, Mississippi; Wilmington, North Carolina; Bay City, Missouri; Lakewood, Colorado; New Smyrna Beach, Florida; Covington, Kentucky; or Hometown, La Grange, and Tinley Park, Illinois. They've already tripled their money by investing in the places where they cash their paychecks. That's my kind of insider's edge.

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