

95/10-Still Tough to Beat

Some thought this investment opportunity was too good to last. They were wrong. The local S&L; is still a heck of a place to put your money.

By Peter Lynch

When last we looked into it, investing in the local savings and loan when it went public was the closest thing to printing money that ever came a stock picker's way. Between 1991 and 1994, some 300 new S&Ls; issued shares that gained an average of 30 percent on the first day of trading and 60 percent within three months, on their way to doubles, triples, and even a few quadruples. (It's also remarkable that fewer than a handful of these are trading below their offering prices.) But in early 1994, regulators put a temporary stop to this bonanza.

What created the bonanza in the first place was a quirk in the way these institutions took shape. Founded many decades ago (and in many cases a hundred years ago), America's thrifts were organized along the lines of a co-op. They were run for the benefit of depositors, but they weren't owned by anyone in particular.

So when the thrifts (the term covers S&Ls;, mutual savings banks, and some other creatures) began to go public, there were no previous owners to pay off, as happens in most public offerings. Instead of a big chunk of the proceeds ending up in the pockets of the company's founders, all the money was returned to the company till.

For the lucky buyers of the shares, the result was the same as buying a new car for cash, then discovering that the dealer has left the cash in the glove compartment as a car-warming present. Let's say the local S&L; had a book value of \$20 million, the result of decades of earnings built up inside the company. Then it went public and sold \$20 million worth of shares in the offering. That \$20 million invested by the shareholders became their thrift-warming present to themselves; in effect, they were buying the business for nothing. And because their \$20 million was injected into the S&L;, the book value doubled overnight, from \$20 million to \$40 million. Theoretically, each share was now worth twice as much as the investors had paid for it.

This explains the big "pop" on opening day, when the newly issued shares began to trade on the stock exchanges. The price almost always took a jump to catch up to the fact that the value of the company had doubled in the act of going public. There were no former owners to cry foul, as they surely would have in a traditional offering had their company been sold for half price to public buyers who stood to make a greater profit than the previous owners.

In these hundreds of thrift "conversions," as it's known when a thrift goes public, every person with a savings account in the institution was invited to buy shares at the initial low price! Twice in the past four years (in a column and a Worth cover story), I attempted to describe the merits of investing in S&Ls; as they went public or, for that matter, investing in S&Ls; that had already gone public and were still selling at what seemed to be bargain rates. Reviews of the publicly traded thrifts I suggested researching last year and in 1992 are shown on this page.

Sadly, only a small percentage of depositors nationwide took advantage of the opportunity to buy shares in the public offerings in their own neighborhoods. The vast majority of the shares (98 percent by some accounts) were scooped up by professional investors who roamed the country opening savings accounts so they would get the right to participate in as many conversions as possible. The loyal customers who had maintained savings accounts at the local S&L; for decades turned their backs on these deals while the outsiders took home the spoils.

There were a few notorious cases where the managers and directors of the local thrift gave themselves an ample supply of free stock or stock options going into a conversion. To stop this profiteering, the Office of Thrift Supervision slapped a moratorium on conversions in early 1994. As soon as the moratorium was announced, a chorus of industry watchers proclaimed that the game was over, but four months later the moratorium was lifted.

Once again, the regulators would allow conversions, subject to new restrictions. Insiders could no longer reward themselves with bushfuls of free shares and options, and the underwriters who took these companies public were pressured to raise the offering prices to take some of the pop out of these stocks

Though the game wasn't over, it had definitely changed. In 1994, 100 thrifts went public. The stock prices of the 68 that traded on Nasdaq gained 17 percent on average on the first day, but by the end of the year, they were up only 16 percent.

There were two reasons for this disappointing performance: a lackluster stock market in late 1994 and the confusion surrounding the new regulations. Since that confusion has now been resolved, the 1994 conversion class is up 48 percent from the initial offering prices. The table on page shows the top-performing thrifts that went public in 1994, as of mid-1995. [Tables and graphs are not included in the Worth OnLine archives.]

For last year's article ("Bank on It," April 1994), the staff at SNL Securities, a Charlottesville, Virginia, research firm that is our favorite authority on the subject, gave us the names of 100 thrifts that were not yet public but were likely candidates for eventual conversion. Eight of those have converted thus far, with an average one-day pop of 18 percent and an average gain of 34 percent as of this writing. Seven more thrifts on that list have conversions pending

In 1995, we've seen 53 thrifts go public, with an average gain of 14.7 percent on the first day of trading and 27 percent after three months. These results don't quite measure up to the bonanza of years past, but a 27 percent gain in just 90 days is a better return than you'd get from a savings account in five years.

One reason for the return of the bigger pops is that shares in the recent offerings have been priced at an average of 64 percent of book value, as opposed to the 73 percent in 1994, when the Fed was leaning on underwriters (who price the shares) to make the thrift conversions less lucrative.

It still makes sense to do what I suggested a year ago in these pages: Scout the area where you live or work for thrifts that haven't yet gone public, and open a savings account in each. In most cases, if you maintain an account for six months, you'll be able to buy shares if a conversion occurs. If the conversion never happens, you haven't lost anything, and you'll collect interest along the way.

The number of unconverted institutions has dropped from 2,524 ten years ago to 1,036 today, and at the rate they've been going public, they may all be public by 2005. Although many of the remaining thrifts are small (many have only one branch), my sources at SNL Securities estimate they represent between \$1.5 billion and \$2 billion in "embedded gains" that could end up in the pockets of the pioneer investors.

SNL's update on likely conversion candidates is shown at left. We offer our special thanks to Paul Doherty and Bill Kerkam for providing us with this data.

Before you purchase a single share in a thrift going public, you'll receive (as an account holder) a prospectus with all the details about what you may be buying__this is one gift horse whose mouth ought to be looked into. Here are some of the important points: * At minimum, you want the thrift to be profitable. You're getting it for nothing, but unless it's a profitable and healthy enterprise, it may be worth less than zero. * You want it to have a solid balance sheet and not be saddled with problem loans. You want the price-to-earnings ratio to be relatively low (last year I suggested p/e's of 10 or below), the equity-to-assets ratio to be relatively high (5 or above), and the percentage of nonperforming assets to be on the decline. * You want to see insiders buying the shares and paying the same price as you. Insider buying must be fully reported in the prospectus, so you can easily find out whether the managers and directors are risking their own money on the future success of the thrift. If they believe in the deal as much as you do, it's a good sign. * You also want the amount of money raised in the offering to roughly correspond to the book value of the company before the offering. If a local thrift with a book value of \$10 a share plans to raise \$100 a share in the IPO, the buyers will be paying \$100 to get \$110 in assets__hardly a bargain. But if that same thrift with a \$10 book value plans to raise \$10 a share in the IPO, the buyers will be paying \$10 to get \$20 in assets, the kind of favorable math that produces a nice pop. * If you don't like what you see in the prospectus, you don't have to participate in the offering. Nobody is forcing you to invest. A special note about so-called "mutual holding companies." A small number of thrifts have adopted this form of organization because it allows them to sell a minority interest in the business, with the insiders keeping permanent control and preventing a potential takeover. These deals are less attractive for investors. The real earnings power and real book value of the banks are understated, and the stocks don't have much lift.

In years past, even if you never bought shares in a single conversion, you could make a good living buying shares in recently converted, profitable S&Ls; that were selling at modest p/e ratios and below book value. But the pickings are much slimmer than they were a year ago. As you can see in the table below, [Tables and graphs are not included in the Worth OnLine archives.] the S&Ls; I've put on the current research list are quite expensive compared with those on my earlier research list. Of the thrifts on this list, I own Astoria Financial, Cameron Financial, Carver Federal Savings, GP Financial, and Quaker City.

In 1994, 13 of the 15 publicly traded thrifts on my list had p/e ratios of 10 or below, whereas 7 of the 15 on my new list have p/e ratios above 10. On the 1994 list, 14 of the 15 were trading below book value, but on this latest list, nine are trading above book. It's hard to find real bargains in today's higher-priced market.

Before the moratorium, the typical thrift stock would advance in three phases: the original pop, the gradual rise to book value, and a secondary pop when the thrift was acquired by a larger institution at a premium to its book value. In recent years, these secondary pops have been quite spectacular, taking the stock prices to new heights__150 to 170 percent of book value. The possibility of a takeover gives us another reason for investing in thrifts, although in the near future, we may not see as many takeovers as we've seen in the recent past.

While 1995 has been a banner year for bank mergers__a trend that is expected to continue__the number of thrifts acquired by banks has been declining. Of the active buyers from 1991 to 1994 (including AmSouth, < wam-co NASD:FITB>Fifth Third, Bank of Boston, First Fidelity, First Interstate, Fleet, PNC, and Shawmut), only First Union has continued to buy thrifts. Measured by assets sold, the takeover rate in the first half of 1995 is 60 percent behind the 1994 rate. The experts at SNL Securities tell us this is because thrifts are currently too expensive.

We've gone through a period of bankers' nirvana, several years of steady interest rates and a decent economy, and banks have used these good conditions to eliminate problem loans and strengthen their balance sheets. If these conditions continue, so much the better, but if they don't, sooner or later we may see a sell-off in the thrift-banking stocks, which would create new opportunities all over again. There are two additional factors, one short-term and one long-term, that make thrifts attractive. In the short term, regulators are nearing an agreement that would lower the premiums on deposit insurance. There is already a surplus in the Bank Insurance Fund, which covers savings banks. The Savings Association Insurance Fund, which covers S&Ls, is undercapitalized, and the government is considering hitting SAIF-insured institutions with a one-time charge of \$6 billion to bolster the reserves. Following that infusion of money, the premiums on S&L; deposit insurance would be reduced as well.

For thrifts covered by the BIF, the drop in premiums could increase earnings by 10 percent or more. Those covered by SAIF will have to pay their share of the \$6 billion, which might cost them 85 cents on every \$100 of deposits. This one-time hit would cause them to suffer an immediate drop in book value, but the lower insurance premiums would boost their earnings for years thereafter.

In the long run, what keeps me interested in the banking and thrift business is the likelihood of future takeovers and mergers. As the government relaxes the prohibitions against interstate banking, we're bound to see more consolidation. There are too many banks and too many chicken restaurants in this country already. I've said this before, but Great Britain has a population of 58 million and only seven different banks, while we've got almost five times the crowd and more than 20,000 banks__if you count the credit unions, thrifts, national banks, regional banks, and so on.

We don't need all these separate buildings, software systems, boardrooms, and highly paid administrators. Every time a thrift is taken over, the acquiring bank can cut costs upstairs and increase productivity downstairs. The acquiring bank can make better use of the thrift's deposits by lending them to a wider range of borrowers over a larger geographical area and by making numerous types of loans where they have a lot of experience and expertise. The entire industry will become more efficient__just like the phone companies, drug companies, and a whole gamut of other companies already have.

Written with John Rothchild. Peter Lynch is vice-chairman of Fidelity Management and Research and the coauthor, with Rothchild, of two books on investing. Beating the Street, the latest, is published by Simon and Schuster.

1992 RESEARCH LIST UPDATED

Bell Bancorp (BELL) \$16.94 \$30.75 82% Charter FSB Bancorp1 15.18 33.57 121 Liberty Bancorp (LBCI) 15.75 26.25 67 Germantown Savings2 21.50 62.00 188 People's Savings Finan (PBNB) 13.25 19.50 47 Bankers Corp (BKCO) 9.47 17.38 83 NS Bancorp (NSBI) 22.13 33.00 49 UF Bancorp3 16.75 38.70 131 Ameriana Bancorp (ASBI) 12.33 16.25 32 Eagle Financial (EGFC) 13.12 22.00 68

Source: SNL Securities, L.P. Recommended prices as of 7/21/92. Recent prices as of 8/15/95. 1) Charter FSB Bancorp was acquired by Sovereign Bancorp 11/1/94. Recent price reflects the exchange of Charter's stock. 2) Germantown Savings Savings Bank was acquired by CoreStates Financial Corp for \$62 cash per share on 12/2/94. 3) UF Bancorp was acquired by Citizens Bancshares Inc. 8/4/95. Recent price reflects the exchange of UF Bancorp's stock.

1994 RESEARCH LIST UPDATED

Astoria Financial (ASFC) \$29.13 \$37.25 28% Ameribanc Investors Group1 1.44 3.00 108 Bay View Capital (BVFS) 20.50 25.00 22 California Financial (CFHC) 15.75 16.50 5 CENFED Financial Corp (CENF) 17.50 20.13 15 Brooklyn Federal (BRKB)2 34.00 37.25 10 FFY < wam-co NASD:FFYF>Financial Corp (FFYF) 14.62 21.31 46 Fidelity New York, FSB 3 16.63 29.00 74 GP Financial (GNPT) 19.87 24.75 25 < wam-co NASD:LVSBL>Lakeview Savings Bank (LVSBL) 11.04 17.38 57 < wam-co NASD:MIFC>Mid-Iowa Financial (MIFC) 7.18 10.50 46 North Side Savings Bank (NSBK) 16.78 27.25 62 Pamrapo Bancorp Inc. (PBCI) 14.00 22.88 63 Queens County Bancorp (QCSB) 24.83 33.25 34 Sunrise Federal (SUNY) 21.00 30.13 43

Source: SNL Securities, L.P. Recommended prices as of 3/1/94. Recent prices as of 8/15/95. 1) Ameribanc Investors Group was bought out by First Union of Charlotte, NC for \$3 per share in cash on 4/1/95. 2) Crossland Savings changed its name to Brooklyn Federal. 3) Fidelity New York was bought out by Astoria Financial for \$29 per share in cash on 1/31/95.

SUCCESS STORIES OF 1994

IPO recent percent Thrift DATE Price price gain

(The five most successful initial public offerings of thrifts last year)

Harbor Federal Savings Bank (HARB) 1/6/94 \$10 \$23.00 130% Security Capital Corp (SECP) 1/3/94 25
52.63 111 First Kent Financial Corp (FKFC) 6/27/94 10 21.00 110 Bay Ridge Bancorp, Inc. (BRBC) 4/6/94
10 20.88 109 Financial Corporation (GTFN) 3/31/94 10 20.38 104

Source: SNL Securities, L.P., Charlottesville, VA. Recent price as of 8/ 1/95.

THRIFTS TO RESEARCH FOR 1995 Publicly traded savings banks and S&Ls; deserving of a closer look

THRIFT STATE Equity Price P/E Assets to Assets to Book (\$ billions)

Albank Financial Corp (Nasdaq: ALBK) NY \$28.75 11% 114% 12 \$3.0 Astoria Financial (Nasdaq: ASFC) NY
37.25 9 96 8 6.4 Cameron Financial (Nasdaq: CMRN) MO 13.00 28 79 12 0.2 Carver Federal Savings
(Nasdaq: CARV) NY 7.00 10 47 12 0.4 Charter One Financial (Nasdaq: COFI) OH 26.75 6 155 8 6.3 First
Federal Financial Corp (NYSE: FED) CA 15.00 4 86 9 4.2 GP Financial (Nasdaq: GNPT)1 NY 25.25 11 128 9
14.4 Home Financial Corp (Nasdaq: HOFL) FL 15.00 26 115 15 1.2 ISB Financial (Nasdaq: ISBF) LA 15.00
21 90 13 0.6 Leader Financial (Nasdaq: LFCT) TN 32.75 8 154 9 2.7 Portsmouth Bank (Nasdaq: POBS) NH
12.25 25 107 11 0.3 Quaker City (Nasdaq: QCBC) CA 12.75 10 78 12 0.6 Queens County (Nasdaq: QCSB)
NY 34.00 18 105 9 1.2 Standard Federal Bank (NYSE: SFB) MI 34.50 7 152 8 13.0 Washington Mutual
(Nasdaq: WAMU) WA 23.25 6 141 9 20.3

Source: Prices as of 8/17/95. 1) All data incorporates the pending branch purchase from H.F. Ahmanson & Co.

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