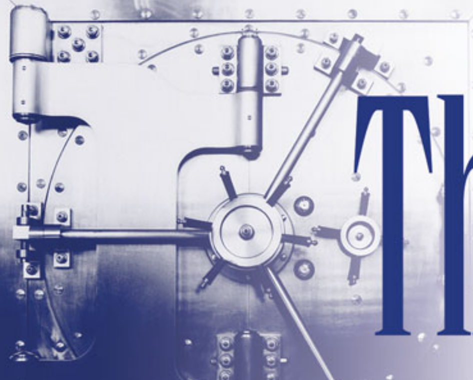

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There may be a silver lining for mutuals in the cloudy market for bank and thrift stocks

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Community bank and thrift stocks continue to be battered by the housing slump, deteriorating asset quality and weak earnings reports. More importantly, the market has painted financial stocks with a broad brush by not distinguishing healthy banks and thrifts from those that are suffering from credit quality or funding concerns.

At December 31, 2007, the SNL Thrift Index was down nearly 40% from its level at January 1, 2007, and despite the Federal Reserve Board's decision to lower interest rates by 75 basis points on January 21, 2008, and again by 50 basis points on January 30, 2008, community bank and thrift stocks may see more red before they experience a sustained rebound. While existing publicly traded bank and thrift stocks have been struggling, the current market may present unique opportunities for well-capitalized mutuals that want to go public.

Follow-on offerings and second-step conversions may have to wait for better market conditions

No doubt, this market is no time for most stock banks and thrifts to raise capital by selling additional stock. Even publicly traded mutual holding companies (which are mutually controlled) have hit very rough waters in their attempts to go fully public with second-stage conversions.

Recently, **Atlantic Coast Federal Corp. (MHC)** (ACFC) and **K-Fed Bancorp (MHC)** (KFED) terminated their second-step conversions. These offerings were valued at 95.3% of pro forma tangible book value and 94.8% of pro forma tangible book value, respectively, at the minimum of their offering ranges. **United Financial Bancorp (MHC)** (UBNK) barely finished its second-stage conversion in December 2007, and was valued at a more modest 80.5% of pro forma tangible book value at the minimum of its offering range.

The only other mutual holding company that was able to complete its second-stage conversion in the last quarter of 2007 was **Home Federal Bancorp Inc.** (HOMED), which sold $102.0 million of additional stock to new investors at 88.36% of pro forma tangible book value. Finally, **BCSB Bancorp Inc.** (BCSB) announced in December that it did not receive sufficient orders to complete its second-stage conversion and will attempt to do so at a lower valuation in the first quarter of 2008. Contrast these moderately priced second-stage 2007 conversions to the average second-stage price of 112.9% of pro forma tangible book value for deals done or filed in 2006.

Concurrent conversion mergers may be too risky right now

Mutual-to-stock conversions and first-step MHC offerings historically have been attractive to investors because they present an opportunity to buy the stock of an established community bank at a discount to their publicly-traded peers. With the abundance of well-capitalized mutuals and the robust conversion valuations mandated by federal banking regulators, a number of mutual thrifts have tried to acquire stock banks concurrently with a standard conversion or mutual holding company offering - a so called "conversion-merger". In other words, the converting mutual offers stock to its depositors on a priority basis, but at the same time offers stock to the shareholders of the target bank for all or part of the deal value. The upside to the target's stockholders is that they receive stock which, in theory, has more appreciation potential compared to the stock they would have received from a fully public bank.

The upside to the converting/acquiring mutual is that it has a ready use for most of the capital raised in the conversion. (The regulators have approved these transactions so long as the converting mutual remains in control immediately after the conversion and merger.) The downside to these deals has always been that there is greater execution risk (since a successful conversion may be required to complete the merger), significant goodwill may be created, and they are more expensive to investors compared to other conversions on a pro forma tangible book value basis.

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The recent termination of the **Bradford Bancorp Inc.** and Patapsco Bancorp Inc. conversion-merger illustrates this execution risk. . Bradford had agreed in early 2007 to pay Patapsco shareholders $23.0 per share, or 278.0% of tangible book value per share (when the price to tangible book value of the SNL Thrift Index was approximately 248% versus 159% at December 31, 2007), and Bradford's shares were being offered at 116.8% of tangible book value at the minimum of the offering range. In December 2007, Bradford terminated its merger with Patapsco as a result of not raising the minimum amount of capital in the conversion offering to complete the deal.

In addition to the failure to raise the minimum amount of subscriptions, Bradford had to pay a substantial termination fee to Patapsco. While termination fees are typical in a merger transaction, they are much tougher to swallow when you do not have a successful capital raising transaction or merger to offset the payment.

While conversion-mergers can still make a great deal of sense for well-capitalized mutuals that are looking for a ready use of conversion capital if they are priced right, one cannot ignore the greater risks they present in today's market. Well-capitalized mutuals may be better off reducing transaction risk associated with current market conditions by undertaking a standard conversion first, and then pursuing an acquisition opportunity with the capital raised in the conversion. It will also give them an opportunity to potentially use a more valuable currency (appreciated stock) to complete the transaction.

A good time for standard conversions or MHC conversions

There is no question that the overall market malaise has adversely affected the initial public offering market for thrifts. According to *ThriftInvestor*, only two mutual thrift institutions have announced either a full conversion or mutual holding company offering since December 1, 2007. While several transactions are pending, the number of deals in the pipeline is well below levels experienced in the past few years.

On the surface, the downturn in new deals is not surprising in the context of a weak market. On closer examination, however, mutuals may be missing a significant opportunity. Very simply, in strong markets, conversion valuations are high, leaving less potential for capital appreciation. In weaker markets, conversion valuations are lower, leaving greater potential for capital appreciation and a successful offering.

A brief review of regulatory effect on thrift valuations and market cycles may help illustrate this point.

In 1994, both the FDIC and OTS changed their conversion appraisal guidelines with the objective of significantly reducing after market price appreciation, or the "pop." Since then, conversion valuations have been stubbornly high, and converting thrifts often have raised far more capital than needed. Indeed, the combination of high capital levels for thrifts, a bull stock market for bank stocks for most of the years since 1994 (the SNL Thrift Index increased by approximately 200% from January 1994 through February 2004), and the regulatory penchant for insisting on valuations that substantially exceed the intrinsic value of most converting savings banks, forced converting thrifts to raise far more capital than necessary. This made the mutual holding company a more attractive alternative to standard conversions for many thrifts. While everyone agrees that capital is good, too much capital is problematic since it tends to deflate key performance ratios, such as return on equity, and places greater pressure on management to obtain an attractive return on the excess capital.

Most mutuals are well capitalized, and for well-capitalized mutual thrifts, the current market presents pricing opportunities that we have not seen in quite some time.

Specifically, the average price to pro forma tangible book value of thrifts doing standard conversions and mutual holding companies has dropped significantly from a high of 85.0% and 85.8% (of fully converted book value), respectively, during 2006 and we expect that it will continue to decline in 2008.

This means that many thrifts can convert or do MHC conversion stock offerings without becoming too overcapitalized. Moreover, the impact of the declines in thrift valuations will be dramatic if the market for bank and thrift stocks rebounds over the long-term. In short, conversions done in the current down-market could prove to be bargains for investors.

Thrift boards and management should understand the opportunities presented by a weak market. After all, management and boards will presumably be significant investors in their converting thrift.

To illustrate the investment potential of a more favorable appraisal, it is worth looking at aftermarket performance of conversions completed in the soft market of 2000 to 2001 compared to conversions completed in the heady markets of 2004 to 2006. The average value of standard conversions completed between 2000 and 2001 was 57.9% of pro forma tangible book value, and the average one-year aftermarket price appreciation was a solid 75.3%. The average value of standard conversions completed between 2004 and 2006 was 78.4% of pro forma tangible book value, but the average one-year aftermarket price appreciation was 36.4%, according to RP Financial.

Similarly, the average appraised value of all thrifts that completed their conversions in 2007 was 79.3% of pro forma tangible book value, and the aftermarket price appreciation through early January 2007 was less than 5%, as this latest group of thrifts converted at the peak of the current market cycle and, in some cases, ran into a bear market in the middle of their offerings. Transactions that will be priced in the next month or so should expect pricing substantially below the deals that closed in late 2007 and early 2008.

Cyclical markets present opportunities

Surely, no one can time the market perfectly, and bear and bull markets will come and go. However, there is no better way for converting thrifts and MHCs to get a good start as a public company than to get a fair and realistic valuation that offers plenty of upside appreciation even if markets remain lethargic. Most mutual thrifts have conservative underwriting standards and few asset quality problems compared to their larger commercial bank bretheren, so now may be a unique opportunity to create value for employees, management and customers by completing a stock conversion or mutual holding company offering at an attractive valuation.

If there is one constant in the bank and thrift stock market, it is that cycles have occurred and will continue to occur. The exact duration and depth is anyone's guess. The bottom line is that if you believe the market for bank and thrifts stock will rebound as it has over the last 15 years, then investing in new conversion and mutual holding company offerings today seems to be a pretty good bet. **TI**

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