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Like Money in the Bank

By DAVID ENGLANDER

Financial-overhaul legislation is spurring a new wave of mutual savings banks to convert to stock ownership. With most deals priced below book value, bargains abound.

Amid a four-year bear market in small-capitalization financial stocks, a welcome investment trend is unfolding at savings-and-loan associations: a wave of mutual-bank conversions to stock ownership. Twenty-two thrifts have changed in structure this year, and another five deals are pending, compared with 26 that converted in 2007, at the height of the bull market. Investors would be wise to take note, as the new issues are coming to market at deep discounts, in some cases at 50% of book value.

Converted thrifts have outperformed the broad market significantly in the past 20 years, and that could remain the case. In the 10 years ended Dec. 1, the SNL Thrift MHC Index, based on 30 partially converted thrifts, returned 188%, versus a return of just 63% for the small-cap Russell 2000. And fully converted thrifts such as **Fox Chase Bancorp** (ticker: FXCB), **Oritani Financial** (ORIT), **Heritage Financial Group** (HBOSD) and **Kaiser Federal Financial** (KFFG) could reward investors nicely in coming years.



Newscom

George Bailey (played by Jimmy Stewart) knew the value of a savings-and-loan in the Christmas classic It's a Wonderful Life. Would he demutualize today?

well as changes in the favorable treatment now accorded to management in thrift conversions.

Discounts of today's magnitude could represent a once-in-a-lifetime investment opportunity, as regulatory changes are spurring the latest conversion wave. Under financial-overhaul legislation passed last summer, the Office of Thrift Supervision, which has overseen S&Ls for the past 20 years, will be eliminated. The Office of the Comptroller of the Currency, which now regulates larger banks, will assume its role. The switch could mean the end of certain dividend policies favorable to minority shareholders, as

Given the uncertainty, some S&Ls are opting for conversion before next summer, when such changes could take effect.

Mutual savings banks have been around since the early 1800s, and were created to encourage the middle class to put its cash in banks. Depositors own these banks and have voting rights, as well as first rights to participate in any stock offering, with unsubscribed shares then offered to the public. Investors would do best to wait for the issues to trade before buying in.

Since the 1970s, when the industry was deregulated, thousands of mutuals have converted, raising more than \$40 billion. Today, roughly 600 remain.

A mutual bank can convert to stock ownership in a single step, known as a standard conversion, or in stages. In a staged, or "first step" conversion, the mutual sells about half its stock to the public and retains the rest in a mutual holding company, or MHC. "Mutuals viewed the MHC structure as a gradual entry into public life," says Matthew Kelley, a banking analyst at Sterne Agee. "It was the best of both worlds, allowing [management] to raise capital and still retain ownership." The two-step process also has helped the banks to keep activist investors at bay.

Now, however, the MHC structure is set to disappear. As a result, there have been no first-step conversions this year. Twelve deals were standard conversions, while the other 10 were so-called second-steps, in which a hybrid stock/MHC institution dissolved the MHC and became fully owned by shareholders. In second-steps, current shareholders receive sufficient new stock to maintain their positions, but the value of their shares might decline if the conversion is priced below book value, as has been the case lately.

WEAK PRICING SHOULD COME as no surprise, as the thrifts' rush to market couldn't be more ill-timed. The supply of new bank stock is enormous, as the largest U.S. banks have sold billions of dollars of stock this year. But demand for thrift shares has withered. Depositors, who heartily subscribed to thrift offerings in the past, now have little interest in the shares, while many institutional investors don't have the funds to participate.

"Institutional investors with portfolios of \$50 million, \$100 million, \$200 million have had their portfolios decimated in the last few years, and there aren't many people left to buy these," says Joseph Stilwell of New York-based Stilwell Value. A long-time thrift investor, Stilwell has been buying converted thrifts this year, enticed by historic discounts.

According to SNL Financial, four of the five cheapest thrift deals since 1995—for Versailles Financial, Harvard Illinois Bancorp, Fairmount Bancorp and Madison Bancorp—occurred in 2010, at an average price of 42.9% of tangible book value. Midland, Mich.-based, Wolverine Bancorp, whose standard conversion is expected to close this month, will be the cheapest in 15 years if the deal values the bank at the low end of its expected price-to-tangible-book-value range of 40.23% to 52.41%. The range depends on the number of shares bought in the offering, as pricing for thrift deals often is set at \$10 a share.

Such sharp discounts, says Sterne Agee's Kelley, are "bringing all the deep-value people out of the woodwork." *Barron's* subscription newsletter, the Daily Stock Alert, profiled three conversions in recent months—Fox Chase (Nov. 4), Oritani (Nov. 11) and **ViewPoint Financial Group** (VPFG), on Dec. 6.

THE DISCOUNTED VALUATIONS on most converted thrifts belie strong fundamentals. Most mutuals avoided the securitization rush that consumed the industry's giants, and their balance sheets are among the cleanest in banking. Those converting to stock ownership also boast excess capital, which can be used for loan growth.

One concern for thrift investors is that acquisitive management teams might blow their newfound cash by acquiring competitors at premiums to book. But as more activist investors buy in, that becomes less of a risk.

Some 15 conversions are pending, filed or announced. Among the largest deals expected to close this month are **SI Financial Group** (SIFI), which expects to be priced between 63.14% and 82.64% of book value, and **Alliance Bancorp of Pennsylvania** (ALLB), at 57.8% to 77.4% of book. Both are second-step transactions. The largest deal, **Capitol Federal Financial** (CFFN), is expected to close this month at 83.9% of tangible book value.

There are plenty of attractive stocks among thrifts that already have converted, including Fox Chase, which trades for 10.75, or 79% of book, and Oritani, which fetches 11.89, and trades at 103% of tangible book. Fox Chase, based in Hatboro, Pa., has \$1.1 billion in assets and a stock-market value of above \$157 million. Oritani, based in Washington Township, N.J., is bigger, with assets of \$2.5 billion and a market cap of \$672 million. It yields 3.34%. Both banks completed their second-steps in June.

The Bottom Line

Converted thrifts historically have outperformed the stock market. That could also be true for recently converted banks, such as Fox Chase and Kaiser Federal.

Another undervalued issue is Albany, Ga.-based Heritage Financial, which closed its \$65.9 million second-step conversion on Nov. 30. It has \$715 million in assets, according to SNL, and trades at 10.75, or 81% of tangible book. Nonperforming assets are a low 2.19%,

and the bank has excess capital. The stock yields 3.4%.

Covina, Calif.-based Kaiser Federal also is worth a look. With \$920 million in assets, it closed its \$63.8 million second-step on Oct. 29. The bank has \$878 million in assets, trades at 66% of tangible book value and yields 2%. Nonperforming assets are 3.36% of assets, but Kaiser Federal has plenty of excess capital.

Stock buybacks, permitted after the shares have been trading a year and a day, eventually could boost the shares of converted thrifts. And many of these institutions have been takeover targets. According to SNL, 286, or 59%, of the 488 thrifts that converted since 1982 later were acquired at a premium to book. Sales can start three years after the conversion date.

Given the woes of the nation's big banks, old-fashioned community banks are likely to enjoy a renaissance. Investors, buying into newly converted thrifts could profit nicely as the trend plays out.

Thrifts for the Thrifty

These banks completed the transition to stock ownership in 2010, and trade at or below book value. All but Fox Chase also sport juicy yields.

Company/Ticker	Recent Price	Assets (bil)	Price/TBV *	Div Yield
Oritani Financial /ORIT	\$11.89	2.5	103%	3.3%
Heritage Financial /HBOSD	10.75	0.7	81	3.4
Fox Chase Bancorp /FXCB	10.75	1.1	79	NA
Kaiser Federal Financial /KFFG	9.97	0.9	66	2.0

*TBV=Tangible book value. Sources: Bloomberg; SNL; company reports

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