

How Repurchase Plans Can Boost Performance



By Bill Sammon

The current operating environment has put significant pressure on the fundamental performance of community banks. Some of the key ratios that investors look at when analyzing a company have suffered over the last 10 business quarters. Meanwhile, continued contraction in net interest margin has slowed earnings-per-share growth and brought returns on equity for the 1,380 listed banks and thrifts to below 10 percent. (See Chart I, II and III on page 100.)

You'd expect these trends to be followed by an increase in merger and acquisition activity, and they have—given the number of deals announced in the first quarter of 2007 versus 2006. Unfortunately, many community banks that will look for a

number of ways this can be achieved, but the most prevalent route in the community banking space is via share repurchase programs—activity that is expected to only accelerate as publicly traded markets continue to be under pressure. While Chart IV on page 100 shows the activity in the public market, many privately held banks have been active in repurchasing their stock as well.

Accessing the Options

There are three primary ways for community banks to buy back stocks:

Ongoing/In-the-Market Buy-back—For many publicly traded companies, an in-the-market buy-back is a good way to manage capital. Putting an order out with a market maker or

Determining the financial effect that a buy-back will have on the company has everything to do with price.

partner in the coming months will now be selling against weaker fundamentals.

For banks that want to remain independent, especially publicly traded banks, proactively finding ways to build value for shareholders away from operational enhancements or organic growth will be important. There are a

specialist and buying shares on a given day accomplish such a buy-back. Companies can also purchase “blocks” of stock in addition to their daily allotment. Share repurchase activity is covered by SEC Rule 10b-18, which provides issuers with a “safe harbor” from liability for manipulation. Any company

executing a buy-back needs to be aware of these rules and ensure that all who are a part of the transactions are following said guidelines.

Fixed-Price Tender Offer—With a tender offer the company makes a direct offer to shareholders to purchase a specified number of shares at a single, fixed price. The price offered to shareholders can vary, but typically it is at a premium to the current market to encourage shareholder participation. Timing is more efficient than an ongoing repurchase plan in that the tender offer is typically open for 20 to 30 business days. Also, the transaction is commission-free for the shareholder because brokers are not involved.

Dutch Auction—As an alternative to pursuing a tender offer, the company can make a direct offer to buy a specified number of shares, but instead of a fixed price, the price is given as a range. This process identifies the depth of shareholder interest and the price necessary to entice shareholders to sell. After receiving tendered shares at the termination of the offer, the company buys the shares at the lowest price offered until the desired number of shares is purchased. In this instance, a shareholder who gives an indication at the high end of the range risks being left out of the process.

The Pros and Cons

While there can be many positives to a repurchase program, buying back stock will reduce capital and could ham-

per a community bank's ability to grow in the future. This is especially important if the bank does not have easy access to other sources of capital like trust preferred or debt for smaller banks.

For publicly traded companies, taking shares out of the

market will reduce liquidity which could shrink the pool of potential investors or could hurt the company's chances of making acquisitions using stock. Also, when buying back stock, you may be eliminating members of the local community.

The Case for Share Purchases

Over the past 10 business quarters, industry net interest margins have slowed earnings-per-share growth and dropped returns on equity for 1,380 publicly traded banks and thrifts to below 10 percent.

Chart 1 Median Net Interest Margin (%)

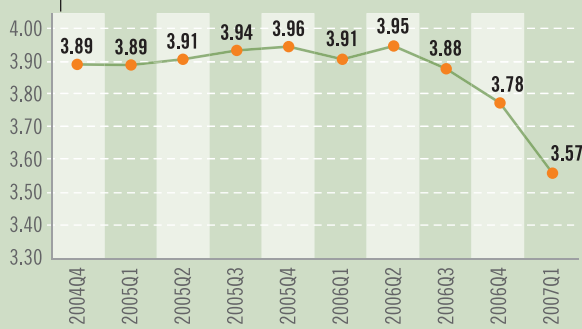


Chart 2 Median Core Earnings Per Share Growth (quarter/quarter) (%)

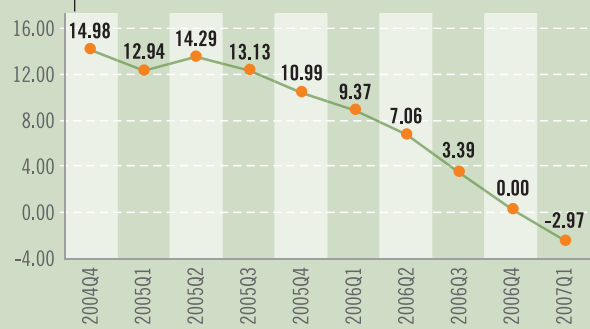


Chart 3 Median Return on Average Equity (%)

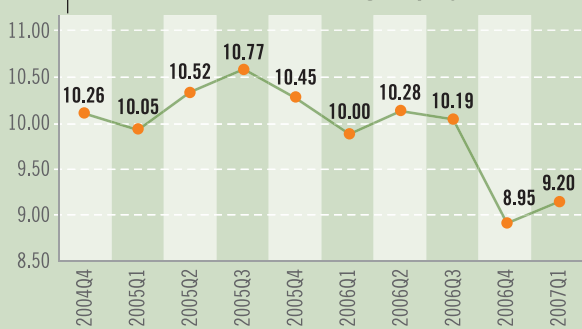
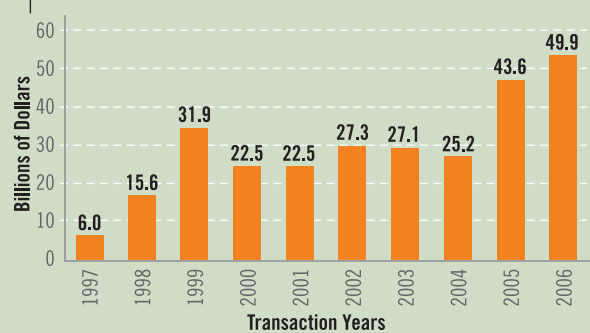


Chart 4 Aggregate Value of Total Share Repurchase Activity



Source: SNL Financial, LC and Howe Barnes Hoefler & Arnett, Inc.

If these shareholders are also customers, they may feel less compelled to continue doing business with your bank. Finally, paying the premium-to-book value will dilute repurchased shares to book value.

On the positive side, buying back shares is an effective way to optimize equity capital. Using excess capital to repurchase shares accretes the earnings per share and allows for higher returns on equity.

For more illiquid companies, a buy-back provides an opportunity for shareholders to sell

large blocks of stock they would not have otherwise enjoyed. This could be especially important for companies that have large shareholders thinking about estate issues. For companies looking to reduce their number of shareholders, a buy-back can be an effective way to stay under the all-important 500-shareholder rule that puts a company under SEC scrutiny.

Finally, announcing a buy-back is a strong indicator to the market that the company feels the stock is a good value.

Consideration Caveat

There are specific considerations that need to be addressed when looking at any type of repurchase. A buy-back will increase ongoing shareholders percentage-ownership of the company. Management needs to understand if a buy-back will cause any shareholder to own more than 10 percent, which can lead to additional filing requirements for that shareholder. The board also needs to ensure that voting control of the bank will not be changed through this process. For

companies looking to reduce the number of shareholders to either go private or to elect Subchapter S corporation status, determining the exact number of shareholders is critical.

A good buy-back always comes down to execution. Determining the financial effect that a buy-back will have on the company has everything to do with price. Shares must be repurchased at a price that will benefit long-term shareholders and reward people for continuing to hold. Understanding the exact impact a repurchase plan will have on a company's return on equity and how it will enhance earnings-per-share growth will point you to a sensible pay range. This can only be done if management takes the time to carefully model out the effects the buy-back will have on the institution. If your bank does not have these capabilities, there are a number of firms that can help in this process.

As long as the operating environment makes it more difficult for community bankers to enhance shareholder value, more and more community banks will look to repurchase activities. If well thought-out and executed, a buy-back is one way to effectively manage capital and create stronger returns for shareholders. **ib**

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