

Q&A: Hovde Capital CEO Eric Hovde

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By Matt Hirst

It is pretty safe to say that when it comes to banking, Eric Hovde knows what he is talking about. Along with his brother, Steven, Eric founded the businesses that share the brothers' namesake. First, there is the investment-banking firm, Hovde Financial, where Eric formerly served as CEO and is now chairman, with Steven heading up day-to-day operations. Eric now manages Hovde Acquisitions, a merchant banking operation that buys controlling stakes in banks and finance companies, and Hovde Capital, the general partner for a family of financial-services oriented hedge funds run under the Financial Institution Partners banner.

Recently, the merchant banking operation launched a \$250 million private equity fund targeting a variety of financial services sectors, a process Hovde termed "institutionalizing the business," which in the past was funded by the firm or capital raised from certain investors for specific transactions. Hovde says the new fund should "allow the firm greater breadth and depth to pursue deals."

Not too surprisingly then, Hovde is passionate when it comes to the subject of banks and thrifts, whether it is a discussion of fundamentals in a changing economic and interest rate environment, the prospects for continued consolidation, or why certain stocks have outperformed others in the past year and why they will not continue to do so in the future.

Recently, SNL Financial had the opportunity to interview Hovde. An edited transcript of that conversation follows.

SNL: Jumping right in, what are your thoughts on the consolidation marketplace for banks and thrifts?

Hovde: I see consolidation continuing at a fairly brisk pace. Obviously, you saw a marketable turn-up in consolidation at the end of 2003, which has carried into 2004. I think

that will continue throughout the bulk of this year. The primary reason is the difficulty companies are having in maintaining their earnings. I think you're seeing the consequence of overcapacity in the banking industry. You have margins, because of what happened with rates but also because of that overcapacity, getting squeezed tremendously. As a result, a lot of companies are going to run into increasing difficulty to see any earnings growth.

At the same time there is the notion out there that as the economy improves, you will see stronger C&I loan growth and line utilization, and as rates tick up, margins should expand as well. Is this a valid take on things?

Here is the problem and what you don't hear a lot of people discussing. The banking industry has come to look so much like the thrift industry over the last 14 years, and this has been driven by the disintermediation of commercial credits outside of the banking industry. At first, you had the commercial paper market that came into existence back in the 1970s and boomed throughout the 1980s. Then you had the securitization market also come into play, and you've had the Wall Street investment houses come into the commercial side as well through syndicated loans. So what has happened is you have had C&I loans getting stripped away from the banking industry in a huge way. As a result, the banks, to get their loan growth, have really come to look like quasi-thrifts, half a bank and half a thrift. The largest single asset class in the banking system today is single-family mortgage loans. The second largest asset class is commercial real estate loans. The third largest asset class is C&I loans. So, my view is that if you look back at the past few years, most of the growth has been coming through commercial real estate or through construction lending on residential or just permanent single-family

lending. As a result, with rates starting to move up — and I think you'll see the housing market cool off at the latter part of this year and certainly throughout 2005 as rates increase — I don't think you're going to see enough of an increase in C&I loans to offset the slowdown in loan originations out of the real estate sector.

My personal opinion then is that it is going to be very difficult for banks to try to generate really strong top-line loan growth, even if you do see the economy recovering to some degree — well, I shouldn't say the economy recovering to some degree, we have obviously had some fairly strong growth through the second half of 2003, but then again, so much of the growth we've had has been stimulated by the Federal government. I frankly think that once you start seeing a lift in rates and some of that government stimulus comes out, I think you are going to have some difficulty with the underlying economy as well. So I'm concerned both about . . . the outlook for the economy as you get into 2005 with a rising rate environment, as well as just the fact that even if you did get an uptick in C&I loan growth, it's not going to offset what you will lose from the real estate side.

Are you at all concerned that, in addition to what you've laid out thus far, the real estate market could be overheated, at least in certain parts of the country, and that the consumer will finally weaken?

I think one of the big single issues we're going to have to address, and I think Greenspan is very concerned about it, is that he's utilized the housing market, and through the housing market the consumer kept the economy propped up because of the massive overcapacity that business has spent on throughout the latter half of the 90s. So, we kept the economy propped up through the housing market and through the consumer balance sheet. Well, residential real estate val-

ues had their highest five-year level of appreciation over the last five years, in history or at least in any time we have recorded in this country. And this was largely driven by the fact that you collapsed interest rates down to a 45-year low level and had massive liquidity injections into the system.

Then, if you look at the consumer and the consumer's balance sheet, they're loaded up to the gills with debt. In fact, if you look at any aspect of the consumer balance sheet, be it total debt or bankruptcies or even the household debt service burden, which Greenspan keeps talking about to say, 'Oh, the consumer is not in that bad of shape,' but when you consider that it has remained at all-time high levels and at the same time, interest rates have collapsed by 70%, that leads me to conclude that as you get into a rising rate environment, you're going to see some real high levels of consumer deterioration.

At banks, we've seen the credit situation improve over the last couple of years, but with consumers so highly leveraged at this point, you argue that it is going to catch up to them?

You've had massive refinance activity. Any time you refinance a credit, it will make it look better for a period of time, a 12 to 24 month period of time, because in many cases people extract cash that then gives them the cash to continue the payments on the debt.

In conjunction with that then, and this is perhaps part of a larger story, but New York Community recently misplayed rates with its securities portfolio, and I'm curious as to whether or not you think there are other folks out there with outsized securities portfolios relative to their assets who could run into similar problems or is this a one-off event?

I find it curious that you ask me about New York Community, and the reason why I say that is that I have probably been

the number one party who has disliked that name. It has amazed me how many parties have played New York Community to the long side. If you look at what they've been doing from a balance sheet perspective and from an earnings perspective, it was just going to be a matter of time before these guys ran into problems, and frankly, if they can't get themselves sold, I think they are in a really severe situation of seeing a significant unwinding in their stock price.

First of all, they were playing a massive carry trade game, which a lot of financials have, and yes, there are others out there, but I would have to say New York Community is the one that played it biggest in bank and thrift land. I'm shocked the regulators even allowed them to do it to the degree that they were doing it. If you look at their interest rate analysis, I don't even think their assumptions are correct, because if you look at how they're repricing their deposits and saying their savings and money market accounts will have a five-year duration in a rising-rate environment, I can tell you that would not be the case. If you look at their earnings stream, they've been juicing a lot of their earnings, because when they refinanced their borrowers' credits, they not only took the prepayment penalty but an origination point and cycled that through earnings in a 12 to 18 month time frame, so it was hyper-inflating their earnings with all of this refinance activity. Once you get into a rising-rate environment, it's not only going to cool that but it will turn off the prepayment fees they are bringing in, it will slow down their mortgage production and, as we talked about, they've been playing the carry trade not only with the mortgage-backed, but look at their own loan portfolio. They make a claim that 77% of their loans are adjustable. That is partially true. They are adjustable after five years. Most of their multi-family loans are 10-year loans where the first five years are fixed. So, if you get in a rapidly-

rising interest rate environment where they are pricing loans at very skinny margins over the 5-Year Treasury, and then you get rates rising, you could see their margin just get destroyed by their loan portfolio, not just because of their mortgage-backed portfolio.

They talk about somebody buying it. Whoever would buy that company would have to have rocks in their head at this point in the interest rate cycle, unless they are going to buy them for a significant discount to where they are trading at today.

And you can go back and say, 'Are there other companies out there?' Yes, there are other companies out there. But I haven't seen any of them playing at the carry trade to the severity at which New York Community did. Look, inherently thrifts are negatively gapped, and when you are negatively gapped from an interest rate standpoint, you will do better in a falling rate environment and you will do worse in a rising rate environment. There are a lot of thrifts out there that are carrying a fair amount of single-family mortgage loans that are either fixed or they again have a five-year fixed feature and then adjust after that point. On top of that, they are carrying a lot of mortgage-backed. So when you get in a rising-rate environment, even if a lot of those loans will reprice after five years, you will have significant margin compression in the first five years. So when we see rates move up on the short end of the curve, 150, 200, or as some people are predicting, 300 basis points, you will see a lot of these thrifts go to the point where they are just hemorrhaging money.

We have been in a very unique time frame where we have had rates and a cycle where we have never seen them in my lifetime or in your lifetime before — you'd have to go back to the early 50s — and if you get rates moving back up to kind of normalized levels of the last 25 to 30 years,

which is almost a doubling of the past rate environment or a tripling of the short-term rate environment, the pain that it's going to cause to a lot of the thrifts and mortgage banking companies and to a lot of banks is going to be very profound, and I really don't think people understand the consequences that are going to unfold.

So what financials do you see performing well through this changing of the guard?

Those that have maintained quality funding structures, that have a fair amount of non-interest bearing demand accounts or just demand accounts period, and companies that truly do have value through a mix of assets or an over-weighting in business-type credits will do fine, as well as those companies that have maintained high credit quality standards.

The problem with last year is that the 'junkier' the company you were, the poorer credit quality assets you were originating, the higher your stock valuation lifted, or the more you played the carry trade, the higher your stock valuation lifted. So, those types of companies did exceptionally well in 2003. That was really the only time in the last nine and a half, 10 years that I have been managing money where I've seen that dynamic take place. I certainly wouldn't want to be positioned in that structure through 2004 and 2005, because, let me stand corrected, you did have one brief period in the very end of 97 and beginning of 98 where you saw all the sub-prime finance companies, be it sub-prime mortgage finance, sub-prime auto finance, those stock valuations really lifted. But once the dynamics changed, you saw a lot of those companies go bankrupt and be blown away. As a result, I think you are going to see something of the same dynamic. Those companies that are well positioned from a credit standpoint and from an interest-rate standpoint will do rela-

tively well and in some cases do better. Those companies that were rewarded last year for underwriting high yielding, poor credit quality assets or who were playing the carry trade, I think a lot of those companies are going to be blown apart over the next 18 months.

And then for the thrift industry as a whole, any thrift that still maintains a fairly traditional thrift model is going to be under significant pressure. That, I think, is going to cause a lot of consolidation.

Given that so many thrifts posted strong earnings growth on the strength of the refinance boom and saw their valuations, as reflected in their stock prices, go higher and higher, wouldn't you have expected to see more consolidation at that point, when they were sort of hitting on all cylinders in terms of earnings and stock prices, when they were arguably at the peak of their powers in terms of the price they could command in a sale?

A lot of executives were getting caught up with the fact that they were still increasing their earnings and things were going relatively well. They weren't understanding the fact that the housing market was overly heated because of the rate environment we were operating in, and they also had a wide yield curve. Those are two dynamics that are perfect for a thrift institution. Once those dynamics change, once the yield curve tightens as short-term rates move, as well as once rates move period, to the upside, most of those companies are, again, negatively gapped from an interest rate standpoint. You'll see their margins compress, you'll see a reduction in fees through their mortgage production arms, and you're going to start seeing credit issues, because if a credit was going bad even with us running at 1.5 million bankruptcies per year, once a credit started to turn, the person that had bad credit could always

turn around and sell their home because home values were appreciating so much. So, the bank was getting paid out in full without having to go through an extensive legal battle. Once housing valuations flat line and there is no appreciation or even a little bit of a pullback, the dynamics are going to change, so you'll see an uptick in credit problems, higher expenditures on those problem credits and a vast reduction in mortgage banking income and a squeezing of margin.

So again, if you're a traditional thrift operating out of a traditional thrift model, you're going to have very great difficulties going forward. My recommendation to them would be that it would be better to sell today, when somebody who would want to buy them could go in there and restructure the company instead of waiting until the dynamics have changed and you are selling at a big discount.

So in terms of investing, a fair amount of value has come out of bank and thrift indexes in the last couple months, but what you are saying is that the correction, if you want to call it that, is by no means over?

Absolutely. All you've done is move the 10-Year. You haven't moved short-term rates. You haven't even had the Fed make one rate movement. Wait until one rate movement happens, you'll take the 10-Year up another 25, maybe 50, basis points, and then once you get into the second, third, fourth rate move—even if the Fed just goes up 150 basis points, you're only taking LIBOR to 2.5%, but that's doubling or taking to 150% of what it has been at for the last 18 months. There are a lot of companies that have been out there playing the carry trade, not just with mortgage-backed securities but also with their own loans that have been embedded into their balance sheet. Look at commercial real estate. So many of the borrowers in commercial real estate have

been doing five-year deals. If rates move tremendously, even if those loans repriced after five years or come due after five years, you're still sitting there suffering for three, three and a half, four years, having your margin get destroyed if Greenspan chooses to raise rates in the second half of this year, because they've been funding it with money market or savings accounts or short-term CDs. And money markets have played a huge roll.

And what will happen is that when rates start moving, not only will money market rates move up, but you'll also see a lot of money come out of markets, so the funding issue will become even more difficult. This is just the first little ripple. The big wave hasn't even hit.

And when will that be?

It is when Greenspan really decides to start moving the rate. I think you'll see some rate move, a very modest one, because I'm not predicting any big, strong rate move until after the election, but I think he will be forced to make some sort of rate movement in June or before the election. But I think it will be a fairly small move. He has given enough signals to the market.

But after the election, because Greenspan is a politician as much as anybody, I think you are going to see rates move, and they are going to have to move rather tremendously in order to deal with the inflationary pressures that are now starting to come through the economy. And as short-term rates move, you're going to see a lot of margin compression and, again, an uptick in credit issues.

Correct me if I'm wrong, but this is a pretty bleak picture you're painting for some folks...

For some folks. For traditional thrift models — it's going to be a bleak future. For those banks that have become much more thrift-like and have been relying on mortgage banking income and on single family construction lending and permanent commercial real estate lending, they are going to have a lot of problems. For those folks that have been playing the higher risk, higher yielding, poor credit quality assets, I think you are going to see an uptick in credit problems. I think they are going to have problems.

So, you could basically take all the names that did well last year, all the C and D companies — Merrill Lynch, Sanford Bernstein and a number of other firms all did studies that showed that those companies with the lowest stock ratings of C and D far outperformed the quality names — and those companies are going to get devastated in the next 18 months in many cases. And it is the high-quality names, the ones that have diversified funding structures, diversified asset bases, a lot of their assets in adjustable rate loans, have more of a focus on the commercial and industrial lending — because I do think businesses have gotten themselves better positioned over the last 18 months, improving on the balance sheet, whereas the consumer has gotten worse over the last three years — that will do well.

To bring it full circle then, while on the one hand, deterioration in fundamental performance could drive consolidation; at the same time, we have been existing in a perfect environment for loading up on debt because cash is so cheap. Basically, folks can go out there and do a bunch of trust-preferred issues, things like that to fund acquisitions. That fund-

ing base will not be as robust or as easily accessible further down the line, especially when companies begin to see some deterioration in their fundamentals. And that is going to hit stock prices as well.

So I guess the question then is that if there is less currency with which to do deals and yet deals will need to occur as a matter of necessity, how is that going to work? Will it simply be a matter of decreasing pricing metrics?

Consolidation and pricing have absolutely been driven by the fact that capital and cash is so cheap right now, because of how you can fund it through trust-preferreds or then a lot of people are using the give-up yield on the cash on their balance sheet, because what are they going to invest in, 5-Year Treasury notes? So yes, it will make cash much more dear and precious as rates rise, there is no question about that. And you could have a pullback in M&A multiples as a result of that. Again, I don't think that's going to happen until Greenspan starts moving rates, and I don't think that is going to happen until the end of 2004 or beginning of 2005.

My advice to any CEO that wants to sell over the next three years: You should sell right now. You're not going to get better M&A pricing when you start having a rising-rate environment, unless you are a bank that is purely a business bank with a great funding structure and all prime-based or LIBOR-based assets, where your earnings will really explode as rates move up. But for that exception, every other bank or thrift, if they want to sell in the next three years, they should do it now.