SIFTING THROUGH THRIFTS

Popularized by Seth Klarman's book, *'Margin of Safety'*, thrift conversions provide an interesting opportunity set for investors willing and able to fish in smaller ponds.

WHY IS IT INTERESTING?

Aside from the fact that the idea is advised by Seth Klarman, 'the master of risk-averse value investing', and backed David Chilton[1], 'the wealthy barber', thrift conversions have also produced abnormal returns for decades.

Several studies have shown impressive one-day returns following thrift IPOs - a couple of them are listed in the references section. Perhaps more interesting than single day returns is the long-term performance of thrift conversions. Barron's article, *'Like Money in the Bank'*, published Dec-2010, reported that the SNL Thrift MHC Index, which invests in partially converted thrifts (explained later), returned 188% over the previous decade, outperforming the Russell 2000 by a factor of 3. The performance is even more impressive considering the period encompasses one of the worst financial crises in history, brought by a nationwide housing crash.

More recently, a section in the Oct-2010 issue of Manual of Ideas[2] - *'Thrift Conversions: Is Anyone Paying Attention?'* published a list of 34 partially converted thrifts. The average return for these boring, overcapitalized, regional banks has been 69%, managing to outpace the S&P 500 Index (58%, both returns exclude dividends) even during a fast rising market. Looking at the five cheapest securities as measured by market value to tangible assets, the average return has been 96%.

WHAT IS A THRIFT?

'The term "thrifts" includes a variety of institutions and charter names including savings banks, savings and loan associations, and cooperative banks. Thrifts may be either mutually- or stock-owned, are not exempt from corporate income taxes, are not bound by fields of membership or (under the federal charter) by branching restrictions, and typically face fewer restrictions on their investment and lending powers than credit unions.'[3]

WHAT IS A THRIFT CONVERSION?

Thrift conversion refers to the process of converting a mutually-owned thrift to a publicly traded company, also known as a stock-thrift. There are several tics and kinks in the two common conversion methods that make it such a fertile fishing pond:

1) The Standard Conversion:
In a standard mutual-to-stock thrift conversion, the existing member's claim on retained earnings is not exchanged for shares of stock or cash in proportion to their deposits. Instead, the retained earnings are exchanged for rights to purchase stock. Therefore, a hypothetical pre- and post-conversion balance sheet for a thrift would look something like this:

Mutual-to-stock thrift conversion

Before conversion	After conversion
Assets 100	Assets 100
	New assets 5
Deposits 95	Deposits 95
Retained earnings 5	Retained earnings 5
	New capital 5

Conversion leads to two immediate benefits:
i) investors participating in the IPO immediately receive a net worth per share greater than their own contribution (i.e. through the retained earnings of joint members); and ii) the additional

[1] David Chilton is a Canadian investor and author, with a best-selling personal finance book, 'The Wealthy Barber'.

[2] A monthly newsletter presenting value-based investment ideas.

[3] Wilcox, *'Credit Union Conversions to Banks'*, p. 7.

equity raised through IPO generally leads to healthy capitalization ratios even for previously undercapitalized thrifts.
While standard conversions provide great opportunities to safely deploy capital, the number of conversions is normally limited to a handful per year.

2) The Mutual Holding Company Conversion:

Another method of conversion is known as the mutual holding company (MHC) method. In the process, 100 percent of the mutually-owned thrift shares are first transferred to the MHC. The MHC then sells up to 49 percent of the shares of its wholly-owned thrift subsidiary in a first-step conversion, retaining control. Upon completion of the first-step, these thrifts are referred to as partially converted thrifts or MHC owned thrifts. The impact on the balance sheet is identical to the standard conversion method, with the exception that not all shares have been sold.

Partially converted thrifts present another larger opportunity set with normally 20 to 50 companies falling in this category at any given time. The quoted capitalization of these securities is overstated, and can easily be overlooked. For example, suppose a partially converted thrift is trading at $10 per share, with 1 mln shares outstanding, of which 60% are held by a MHC. While the market capitalization of this company would be $1,000,000, the true market value of the company is $400,000. The MHC held shares are equivalent to treasury shares that may or may not be sold to investors in the future.

Subject to OCC approval and 50 percent of eligible votes, MHCs may engage in second-step conversion, whereby the remaining shares are sold for the appraised value and the MHC is dissolved.

This is intended to be a very brief introduction to thrift conversions and MHCs. I encourage those interested in learning more to read through the material in the references section – the gathered papers and articles do a much better job of explaining thrifts, conversions, and everything in between.

Further, there are several factors that one should consider before investing in any lending institution including: the quality of loan portfolio, capitalization ratios, loan loss reserves, and management incentives.

OPPORTUNITY SET OF PARTIALLY CONVERTED THRIFTS

Below is a list of partially converted thrifts, with their market value adjusted for MHC ownership. Using the framework used by Manual of Ideas, I have sorted the companies by adjusted market value to tangible assets. While investing in a basket of these securities is likely to produce worthwhile results, I have provided brief summaries of companies highlighted below, which I believe present the most compelling investment opportunities.

	Market Summary				Operating Stats				Unadjusted Metrics			**Adjusted Metrics**		
Name / Ticker	Price	MHC Ownership	MV	Adjusted MV	TBV	Tangible Assets	ROE	EPS	TBV/MV	MV/TA	P/E	TBV/MV	**MV/TA**	P/E
SFSB Inc. / SFBI	$0.25	59.1%	$0.7	$0.3	$5	$149	-95.6%	-$3.29	717%	0%	n.a.	1754%	**0.2%**	n.m.
Hometown Bancorp Inc. / HTWC	$2.60	56.3%	$6.1	$2.6	$11	$135	-48.3%	-$3.17	176%	4%	n.a.	402%	**2.0%**	n.m.
Mid-Southern Savings Bank, FSB / MSVB	$11.50	72.4%	$15.0	$4.1	$20	$204	-5.7%	-$0.83	135%	7%	n.a.	491%	**2.0%**	n.m.
Ben Franklin Financial Inc. / BFFI	$2.35	56.0%	$4.6	$2.0	$10	$98	-6.7%	-$0.37	224%	5%	n.a.	508%	**2.1%**	n.m.
FSB Community Bankshares Inc. / FSBC	$7.85	53.0%	$14.0	$6.6	$20	$232	1.4%	$0.16	142%	6%	47.6x	303%	**2.8%**	22.4x
BV Financial, Inc. / BVFL	$6.50	68.4%	$17.2	$5.4	$20	$186	2.5%	$0.27	114%	9%	24.2x	361%	**2.9%**	7.7x
Pathfinder Bancorp, Inc. / PBHC	$15.00	60.4%	$39.3	$15.6	$25	$499	5.7%	$0.96	64%	8%	15.7x	161%	**3.1%**	6.2x
Alamogordo Financial Corp. / ALMG	$15.30	70.4%	$20.0	$5.9	$22	$173	0.0%	-$0.36	109%	12%	n.a.	366%	**3.4%**	n.m.
Magyar Bancorp, Inc. / MGYR	$8.20	55.1%	$47.7	$21.4	$45	$537	0.2%	$0.02	95%	9%	421.8x	212%	**4.0%**	189.4x
PSB Holdings Inc. / PSBH	$6.60	57.0%	$42.2	$18.2	$43	$447	2.3%	$0.18	103%	9%	37.2x	238%	**4.1%**	16.0x
MSB Financial Corp. / MSBF	$8.04	61.7%	$39.6	$15.2	$40	$347	2.0%	$0.16	101%	11%	50.6x	265%	**4.4%**	19.4x
Greenville Federal Financial Corp. / GVFF	$8.00	60.6%	$16.8	$6.6	$19	$149	5.3%	$0.08	112%	11%	98.2x	284%	**4.4%**	38.7x
Ottawa Savings Bancorp, Inc. / OTTW	$9.50	57.8%	$20.1	$8.5	$21	$171	4.4%	$0.45	107%	12%	21.2x	253%	**5.0%**	9.0x
Webster City Federal Bancorp / WCFB	$6.80	75.7%	$20.9	$5.1	$14	$92	4.7%	$0.20	68%	23%	34.0x	278%	**5.5%**	8.3x
Lake Shore Bancorp Inc. / LSBK	$12.50	61.5%	$73.9	$28.4	$65	$482	5.7%	$0.66	88%	15%	19.0x	229%	**5.9%**	7.3x
Kearny Financial Corp. / KRNY	$14.50	76.7%	$952.3	$222.4	$356	$3,150	1.9%	$0.14	37%	30%	103.5x	160%	**7.1%**	24.2x
Greene County Bancorp, Inc. / GCBC	$25.81	54.9%	$108.7	$49.0	$58	$653	11.4%	$1.53	54%	17%	16.9x	119%	**7.5%**	7.6x
Northeast Community Bancorp, Inc. / NECB	$7.26	58.4%	$89.0	$37.0	$103	$457	1.1%	$0.09	116%	19%	78.6x	279%	**8.1%**	32.7x
Oconee Federal Financial Corp. / OFED	$17.72	70.8%	$100.2	$29.3	$75	$361	4.9%	$0.67	75%	28%	26.5x	257%	**8.1%**	7.8x
Meridian Interstate Bancorp, Inc. / EBSB	$24.83	59.2%	$535.0	$218.2	$236	$2,668	6.4%	$0.71	44%	20%	34.8x	108%	**8.2%**	14.2x
Cullman Bancorp, Inc. / CULL	$16.99	54.3%	$42.1	$19.3	$41	$228	5.0%	$0.73	98%	18%	23.2x	215%	**8.4%**	10.6x
TFS Financial Corp / TFSL	$12.99	73.9%	$3,899.5	$1,017.8	$1,862	$11,368	3.3%	$0.20	48%	34%	64.7x	183%	**9.0%**	16.9x
Investors Bancorp Inc. / ISBC	$26.29	61.4%	$3,671.8	$1,418.8	$1,286	$16,316	9.6%	$1.02	35%	23%	25.7x	91%	**8.7%**	9.9x
Beneficial Mutual Bancorp Inc. / BNCL	$13.66	59.8%	$1,046.6	$421.0	$485	$4,452	2.0%	$0.17	46%	24%	82.4x	115%	**9.5%**	33.1x
Kentucky First Federal Bancorp / KFFB	$8.45	55.4%	$72.1	$32.1	$52	$302	3.7%	$0.30	73%	24%	28.4x	163%	**10.6%**	12.7x

Source: Company filings, Capital IQ, FIDC, Federal Reserve Bank of New York.

Acronyms: MHC = mutual holding company; TBV = tangible book value; ROE = return on equity; EPS = earnings per share; TA = tangible Assets; P/E = price to earnings.

Note: Adjusted figures reflect market value adjusted for MHC ownership.

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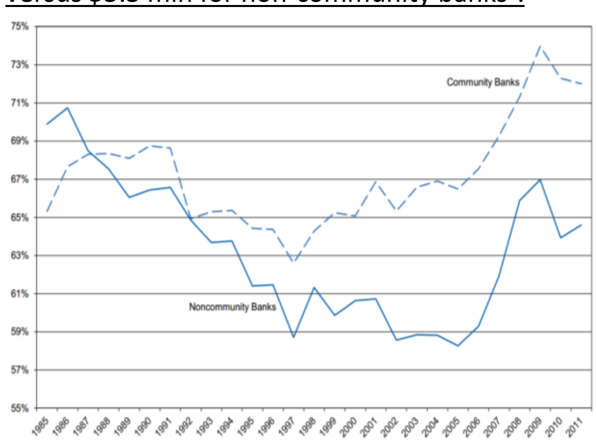
WHY MARKET VALUE TO ASSETS?

Four of the first five securities listed in the opportunity set lost money in the previous year of operations, which begs the question - are these stocks justly cheap?

While it is clear there are some lowly banks on the list, there is still value in their assets. Banks operate a commoditized business – they provide loans at a rate that is able to cover the cost of capital and operating expenses. Economies of scale can be tremendous for smaller banks, making them ideal candidates for consolidation. The following help support this point:

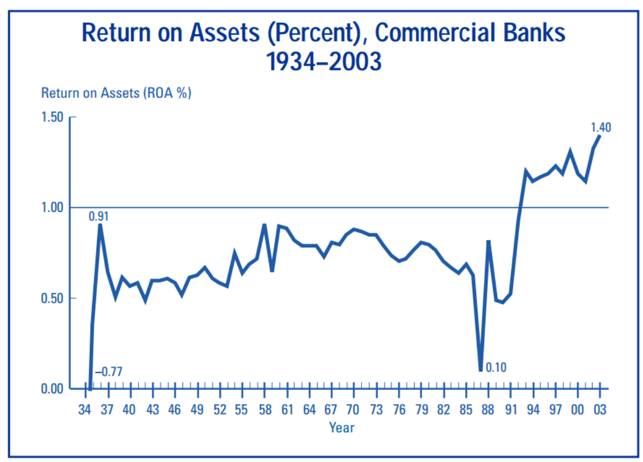
1) Economies of scale:

Efficiency ratios (a measure of a bank's non-interest expense to revenues, higher ratios indicate less efficient bank) for small banks tend to be much higher than for large banks. As banks expand geographically, they are able to grow assets while lowering per unit cost of additional assets such as employee, advertising, and overhead expenses. The chart below, from a FDIC study shows efficiency ratios for community banks and larger non-community banks – average efficiency ratio for community banks lies around 72% versus 65% for non-community banks[4]. Another measure for economies of scale is the <u>assets per employee ratio – which for community banks stands at $4 mln per employee versus $5.3 mln for non-community banks[4].</u>



2) Trend of consolidation:

The industry agrees with the economies of scale argument. <u>Total number of U.S. commercial banks has decreased from 14,495 in 1984 to 6,532 by the end of 2010. The rate of consolidation in smaller banks has been even greater – the number of savings institutions has fallen from 3,566 to 1,128 over the same period[5].</u> Industry consolidation has coincided with increased profitability as measured by return on equity or assets – the chart below shows return on assets for all commercial banks from 1934 to 2003, with an upward trending slope. Generally speaking, consolidation and higher profitability have coincided for banks – hopefully creating better businesses and shareholder value along the way.



Source: FDIC Banking Review, 2005 Vol. 17, *'Consolidation in the U.S. Banking Industry'.*

The short answer to whether unprofitable banks are worth a look is yes – even unprofitable banks can be good investments at the right valuation since their assets can be much more accretive to larger banks. The key concerns however are *the quality of loan portfolio, capitalization ratios, and loan loss reserves.*

[4] Jacewitz, *'Community Bank Efficiency and Economies of Scale'*, p. 4, 14.

[5] Wheelock, *'Banking Industry Consolidation and Market Structure, p. 421.*

HIGHLIGHTED OPPORTUNITIES

1) SFSB, Inc. (OTC:SFBI):

Founded in 1900, the Baltimore based Slavie Federal Savings Bank is by far the cheapest on the list, trading at a MV/TA ratio of 0.2%, and P/TBV ratio of 0.06x. There are reasons for this valuation – the bank's efficiency ratio was 119% in 2013 (meaning for every $1 of interest income earned, it spent $1.19 on operating expenses, excluding cost of capital), and more importantly it has significant nonperforming loans[6]. Loan loss reserves were 4.2% at the end of 2013, and the percentage of nonperforming loans was at 11.3% at the end of 2012 (2013 numbers will be released with annual report in May). Despite the troubles, the asset backed loans and residential focus could make for a fitting candidate in a larger portfolio of loans, especially at current prices.

2) Mid-Southern Savings Bank, FSB (OTC:MSVB):

Operated out of Salem, Indiana, MSVB is a deep-value situation, currently priced for a MV/TA ratio of 2.0%, and P/TBV of 0.2x. During four of the last five years, the bank has grown its assets, generated a profit, and earned a return on equity greater than 3% (4% average). The bank maintains a healthy 10% equity to asset ratio with an efficiency ratio ranging from 45% to 65%. Loan loss reserves stood at 2.39% at the end of 2013, while nonperforming loans were 5.52% of total loan portfolio. The increase in nonperforming loans in 2013 is concerning, however given the bank's valuation, operating efficiency, and healthy loan loss reserves, it is definitely worth a look – based on its trailing 5-year average, MSVB is trading at 5.9x earnings.

3) Ben Franklin Financial Inc. (OTC:BFFI):

Founded in 1893, Ben Franklin Financial is headquartered in Arlington Heights, Illinois. Current MV/TA ratio stands at 2.0%, with a P/TBV of 0.2x. BFFI is a classic example of a small unprofitable bank that could be much more successful in a larger portfolio. With $98 mln in assets, the bank's efficiency ratio tends to hover around 100% with a slowly declining asset base. The good news is that nonperforming loans as a percentage of total loans of 2.8% are fully covered by the loan loss reserves, making it an apt candidate for consolidators.

4) Pathfinder Bancorp, Inc. (NASDAQ:PBHC):

Pathfinder Bancorp, Inc. was founded in 1859, in Oswego County, New York. Despite posting consistent operating results with asset growth, PBHC trades at a MV/TA ratio of 3.1%, P/TBV of 0.6x, and 6.2x earnings. From 2009 to 2013, the bank has grown its assets by 35%, deposits by 38%, and tangible book value per share by 31%. PBHC operates at a 70% to 80% efficiency ratio, which while high, allows it to earn a respectable 6% to 8% return on equity. Nonperforming loans as a percentage of total loans were 1.57% at the end of 2013, well matched by its 1.48% loan loss reserves (suggesting cash earnings could be higher than reported numbers). Pathfinder Bancorp provides an opportunity to buy a well-managed, quality business, at a fair price.

5) Greene County Bancorp, Inc. (NASDAQ:GCBC):

With its annual report titled, "Uncovering hidden opportunities", The Bank of Greene County is a natural fit for this report. The bank was formed as a savings and loan institution in 1889, in Catskill, New York. Currently priced at 7.5% of asset value and 0.8x TBV, GCBC doesn't appear to be a bargain on first sight. The bank is however incredibly efficient at employing its $650 mln book, consistently generating >1% ROA and >10% ROE, backed by an efficiency ratio of under 60%. Nonperforming loans were 1.92% of the portfolio, fully covered by its 1.92% loan loss

[6] Nonperforming loans are defined as any loans currently in arrears.

reserves (again suggesting that cash earnings could be much higher than reported numbers). The company's 7.6x earnings valuation moves from cheap to bargain territory once we consider its growth rate – over the last five years, GCBC has grown its assets by 38%, deposits by 40%, book value by 39%, and earnings by 56% - operating like a well-oiled machine.

6. Oconee Federal Financial Corp. (NASDAQ:OFED):

Established in 1924, Oconee Federal serves Oconee County in South Carolina. The company trades at 8.1% of its asset value, 0.4x TBV, and 7.8x earnings. Another well-run institution, Oconee generates >1% ROA and >5% ROE, with an extremely conservative 20% equity to asset ratio. Over the last four years the company has maintained an efficiency ratio of under 50%. The company does have slim loan loss reserves of 0.35%, versus nonperforming loans of 1.44%. While the bank is not growing its assets, it is effectively growing assets per share by repurchasing 27% of shares issued in its first-step conversion completed in 2011 (repurchase program was started in 2012). Oconee offers a well-run, undercapitalized bank (could effectively double its earnings by increasing its leverage to 10% equity/assets), that is actively repurchasing its shares at a very attractive valuation.

REFERENCES

Apologies to any English majors trying to make sense of this list, I have listed the sources by usefulness in my research process.

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