Newbanco (31/12/2011)

Eighteen percent of the fund's capital is invested in the Newbanco tenet. There are five investments that populate this idea ranging in size from micro to large capitalisation companies located in Australia, UK and the US. The investments include banks and financial services businesses.

The common traits we perceive amongst these businesses are:

- They are well capitalised, they have strong balance sheets and liquidity positions, and limited or no loan exposure dating pre-2007. We perceive their capital positions enable them to organically grow their businesses in the current environment. Minimal loan exposure pre-2007 gives us greater transparency as to the nature and composition of their balance sheets;
- They have existing operations, systems and infrastructure to build from; and
- Good management. We have made a subjective judgement that we are prepared to back management's ability to reinvest capital in the current environment - whether through building their businesses organically or through acquisitions. We formed this view from observing the individuals through the GFC, meeting with them, and gauging their current results / progress.

We believe a loan written today should be very profitable due to the repricing of assets over the past three years, an increased focus on credit risk and a reduction in the amount of available credit. We also regard a strong balance sheet and liquidity position as being a key differentiator, allowing these businesses to focus on organic growth rather than being consumed by managing legacy problem loans.

Often we come across a business or situation that strikes us as interesting but are unable to find a suitable investment. We maintain a watch list of these businesses in case we get an opportunity in the future. It also acts as a prompt to help us identify associated ideas.

BankUnited came onto our radar in May 2009 when it was acquired from US federal regulators by a group of private equity investors led by John Kanas. BankUnited is a Florida based bank that has the dubious honour of being the country's second largest bank failure in the GFC. At the time it failed, the bank had $13 billion in assets, $8.5 billion in deposits and 85 branches. 73% of their loan portfolio was residential mortgages, 60% of which were option Adjustable Rate Mortgages sourced predominately from brokers.

The bank was seized by federal regulators on 21st of May 2009 and immediately transferred to Mr Kanas and the private equity group to reopen the next day. The loan portfolio was written down to a market value, the FDIC (Federal Deposit Insurance Corporation) injected $2.2 billion and the private equity group invested $900 million. More importantly, the private equity group also entered into a loss sharing agreement with the FDIC under which they would recover in excess of 100% of the written down loan valuation under worst case credit performance – that is, the FDIC covered 100% of any loan losses.[1]

In essence the private equity capital appeared protected under a worst case credit scenario. They also have an enviable base to build from including the banking infrastructure and footprint of the largest Florida based lender. Further, the management team has a strong track record, notably from building North Fork Bank in New York which grew organically and through acquisition from 1986 to its sale in December 2006.

In retrospect the timing of the private equity acquisition of BankUnited was also outstanding. It coincided with capitulation of the sector globally. This transaction, greatly augmented by the loss sharing agreement, essentially met our ideal investment under the Newbanco tenet. We added BankUnited to our watch list and felt a great degree of respect and some envy for the position Mr Kanas and the private equity group appeared to have secured for their investors.

In early 2011 BankUnited listed on the NYSE and the private equity group sold one-third of their holdings. At the time, it had net tangible assets of $1.3 billion, market capitalisation at IPO of $2.5 billion and was priced at 14 times trailing earnings. The business came to market with a tier 1 ratio in excess of 40%.

The valuation looks absurd at first glance versus the incumbent US banks but what the market seems to be recognising is the investment offers a:

- Clean platform, with scale, to start lending from;
- Capital position that puts them in a position to aggressively grow their loan portfolio and acquire as they see opportunities; and
- Management team with a history of successful execution of both organic and acquired growth.

As a part of our US trip in October 2011 we met with management in Miami Lakes and visited a number of their branches in the area. We had an underlying concern that the dynamic may be the New York bankers, backed by their private equity partners, were essentially looking to build something quickly and then onsell it. Our overriding sense after spending some time with management was quite the opposite. It appears a traditional, almost old style, regional banking franchise. Their focus seems to be genuinely on building relationships and a business longer term. To an extent this view is supported by the fact that they have not made a significant acquisition to date despite their surplus capital position and strong market expectations to do so.

The current management team relocated the head office into an existing non-descript operations / processing centre well outside the central business district. The layout of the executive office space is modest and small. We were early for our meeting and sat in a meeting room for 15 minutes where we could observe the layout, interaction and activity level – this left a favourable impression before the meeting had even started. Below are pictures of BankUnited's former and current office buildings.

[1] The agreement is conditional on, among other things, BankUnited staying in compliance with the servicing and reporting requirements of the agreement.

Former office: 255 Alhambra Circle, Coral Gables, Florida

Current office: Miami Lakes

We established a position in BankUnited at $24.40 and it now represents slightly more than 3% of the fund. We are valuing the business as a multiple of book plus the NPV of the loss sharing agreement unwind. At $24.40, this represented 1.3 times book value plus the value of the unwind. The share price is currently $22.10. We are clearly paying a premium to the private equity entry price and a premium to the peer group valuation. We think this is warranted given the unique position the business holds. We expect that as they gain traction in their lending activities there is the opportunity to drive these gains considerably given their relatively modest market share. Ultimately the key item we are focussed on is their ability to organically grow the lending activities of the bank, which if done successfully will flow through to a growing book value. Given the nature of the business, we expect there will be hiccups in this quarterly trajectory but over time we perceive that they are well placed to build a meaningful, valuable banking franchise.

<u>Terms and conditions</u>

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