

GRANT'S

INTEREST RATE OBSERVER®

Vol. 27, No. 24b

Two Wall Street, New York, New York 10005 • www.grantspub.com

DECEMBER 11, 2009

Banks for free

There was a familiar name at the top of one of the press releases flying around last Friday disclosing the details of the latest round of FDIC-orchestrated bank closings. Southern National Bancorp of Virginia (SONA on Nasdaq), said the handout, was acquiring the \$203 million of assets and \$179 million of deposits of the failed Greater Atlantic Bank of Reston, Va. The terms—as sweet as sugar for the acquirer—are a tale for these times. Sonabank's place in the banking firmament is another story worth telling.

Sonabank, you'll recall (*Grant's*, May 15) is a profitable, well-capitalized and ambitious institution (\$462 million in assets as of September 30) that happens to have a lot of commercial real estate loans on its books. It has ample capital and manageable credit problems—or, more exactly, credit problems that, up until the latest financials, have been capably managed. Its niche collateral is owner-occupied commercial property, properties too small to have been caught up in the dragnet of last cycle's securitization frenzy. It invests in agency-sponsored mortgage-backed securities, agency collateralized mortgage obligations, corporate debt rated Aa2/AA-minus or better and trust preferred securities (TRUPs). The commercial real estate is not management's main credit headache at the moment. The TRUPs are, in the fair-value amount of \$9.6 million.

But TRUPs aren't the news. "Sonabank," management an-

nounced in its own press release on Friday, "will be acquiring the assets and liabilities of Greater Atlantic at a \$20 million discount and no premium on deposits. In this transaction, Sonabank will be receiving \$179

million in deposits, \$142 million in loans and \$1.8 million in other real estate owned (OREO) from Greater Atlantic. The loans and OREO purchased are covered by a loss share agreement between the FDIC and

Southern National Bancorp of Virginia (in \$ thousands, except per-share data)

	last 12 mos.			
	<u>9/30/09</u>	<u>2008</u>	<u>2007</u>	<u>2006</u>
Interest income	\$ 22,786	\$ 24,326	\$ 21,749	\$ 10,784
Interest expense	9,157	11,983	11,086	4,860
Provision for losses	<u>2,653</u>	<u>1,657</u>	<u>1,290</u>	<u>546</u>
Net interest income	10,976	10,686	9,373	5,378
Non-interest income	455	(54)	357	249
Non-interest expense	9,897	9,109	7,886	4,618
Income taxes	(117)	315	108	-
Net income	1,651	1,208	1,736	1,009
Earnings per diluted share	0.24	0.18	0.25	0.23
Cash and cash equivalents	\$17,056	\$14,762	\$1,308	\$8,126
Securities available for sale	5,133	15,633	40,734	23,328
Securities held to maturity	51,654	59,326	34,267	35,623
Loans	346,232	302,266	261,407	204,544
Allowance for losses	(4,871)	(4,218)	(3,476)	(2,726)
Goodwill	8,713	8,713	8,713	10,423
Total assets	462,006	431,924	377,283	290,574
Non-interest demand deposits	27,592	23,219	18,097	19,216
Interest-bearing deposits	313,096	286,241	247,372	196,588
Borrowings and FHLB Advances	30,000	50,890	40,501	2,033
Stockholder equity	66,331	68,776	69,275	68,227
Nonperforming assets to total assets	1.44%	1.08%	1.07%	-
Allowance for loan losses to total loans	1.41	1.40	1.33	1.33
Share price	\$7.15			
Market cap (millions)	82.9			
Price/book	0.74x			
Price/earnings	29.4			

Southern National Bancorp loan portfolio (in \$ thousands)

Commercial real estate	\$144,624	41.8%
Commercial/other construction	47,975	13.9
Residential real estate	61,057	17.6
Multi-family	10,801	3.1
Home-equity lines	<u>10,790</u>	<u>3.1</u>
Total real estate loans	275,247	79.5
Commercial loans	68,518	19.8
Consumer loans	3,026	0.9
Unearned income	<u>(559)</u>	<u>-0.2</u>
Total loans	\$346,232	100.0%

Sonabank. Under such agreement, the FDIC has agreed to cover 80% of the losses on the disposition of the loans and the OREO up to \$19 million and 95% of losses that exceed that amount. In addition, Sonabank will be purchasing cash and marketable securities of Greater Atlantic. This is the first FDIC resolution in the State of Virginia since 1993.”

For its part, the FDIC said that it did what it did “to protect the depositors.” Actually, up until the FDIC turned the lights out, the Greater Atlantic depositors had been doing just fine for themselves. They were earning 3.22% on their certificates of deposit, whereas the bank was earning 2.83% on the HELOC, or home-equity line of credit, portion of its loan book (39% of the whole). Credit didn’t sink Greater Atlantic; upside-downness did. “Their net interest margin was basically zero,” Rod Porter, chief operating officer of Sonabank, tells colleague Dan Gertner. “And so all their expenses fell to the bottom line and became losses. But the thing with an FDIC acquisition is that . . . you get to reprice the deposits, which we are in the process of doing.”

The plum of Greater Atlantic didn’t just fall into Sonabank’s lap. A month ago, the acquirer closed a 4.8 million-share equity offering worth \$27 million in net proceeds. The funds were earmarked for acquisitions, among other purposes, yet this acquisition required not \$1 of cash outlay. “Our bid,” as Porter observes, “was basically for a \$20 million discount on the value of the assets”—with the aforementioned loss-sharing agreement. Mr. Market was on the beam when, on Monday,

the first trading day after the news, he marked up SONA by a neat 18%. Gertner asked Porter if Sonabank could do another such deal without raising more equity. “I think we could—without any difficulty—if it’s the right situation,” he replied. “We could go for another \$250 million to \$300 million.”

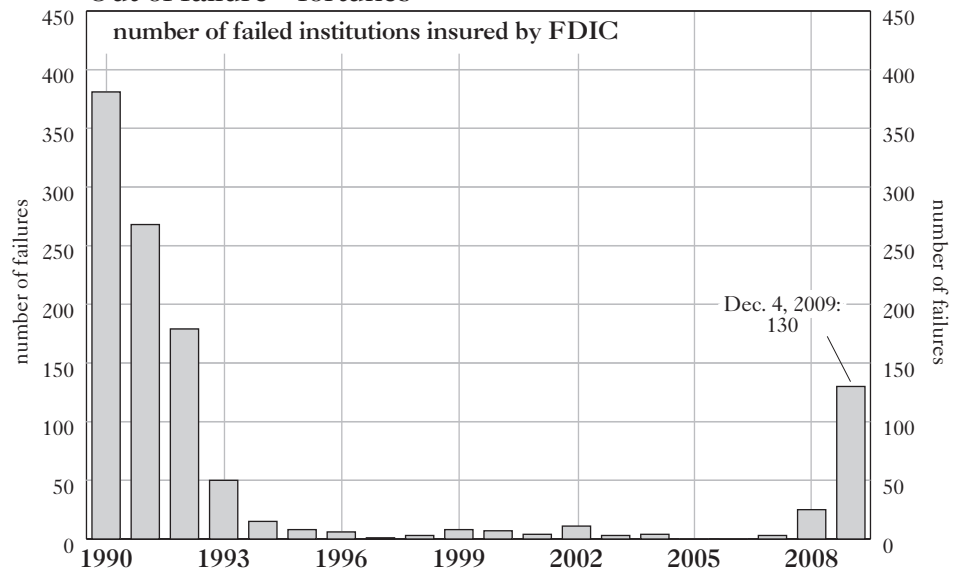
Sonabank has had what might be called a “good” debt crisis. Its ratio of nonperforming assets to total assets stands at 1.44%, less than half the average of its peers. And at 1.41% of total loans, its allowance for loan losses nearly covers its admitted duds. Its peers, in contrast, have reserved an average of 1.65% of loans to cover 3.14% of non-performers. However, Sonabank knows full well that the world is a dangerous place. Its customers tell it so. “We’re in a market that’s still supported by the government, Washington, D.C., and

the close-in suburbs, but that doesn’t mean that people aren’t losing their jobs here as well,” Porter says. “[W]e’re hearing tales of woe every day.”

The FDIC can tell you a story or two—and just did in its latest Quarterly Banking Profile. “Much like every other recent economic report,” Gertner observes, “the third-quarter banking profile contains encouraging signs of a recovery and discouraging signs of continued de-leveraging. ‘Industry Posts Net Profit of \$2.8 billion’ was the heartening first bullet point, but as Charles Wickliffe, managing director of Nomura Securities, points out, ‘Keep in mind that J.P. Morgan alone reported Q3 earnings of \$3.6 billion. So the other 8,098 banks and thrifts insured by the FDIC had combined third-quarter earnings of a negative \$0.8 billion, in what ought to have been one of the most bank-friendly interest rate environments ever.’ Net interest margins rose to 3.51%, the highest since the third quarter of 2005, but the annualized net charge-off rate rose by 15 basis points to 2.71%, and almost doubled from the third quarter of 2008. It was the highest rate in any quarter since its reporting began in 1984.

“Loans that were noncurrent (90 days or more past due or in nonaccrual status) also continued to rise. Noncurrent loans rose by \$34.7 billion in the third quarter, to \$366.6 billion. Noncurrent loans account for 4.94% of all loans and leases, which is the highest noncurrent rate in 26 years.

Out of failure—fortunes



source: Federal Deposit Insurance Corp.

But, the FDIC countered, “The increase in noncurrent loans was the smallest in the past four quarters, as the rate of growth in noncurrent loans slowed for the second quarter in a row.”

As for the national macroeconomic worry list, shrinking bank assets are right near the top. “We need to see banks making more loans to their business customers,” Chairman Sheila Bair admonished her charges at the press conference in which the FDIC disclosed its third-quarter findings. The banks have not been listening. Total assets of insured institutions fell by \$54.3 billion, the third straight quarterly decline, while loans and

leases tumbled by \$210.4 billion, or 2.8%, the biggest percentage drop in loan balances in any quarter since 1984. Choosing not to lend, banks sought safe harbor in securities, \$59.7 billion worth, of which a little less than half were Treasuries, and in deposits at the Federal Reserve Banks, \$142.4 billion. What attracted those tens of billions to the Bank of Bernanke? Required and redundant reserves earn 25 whole basis points, three times the yield on four-week T-bills.

In the third quarter, the population of so-called problem banks jumped by 33%, to 552; assets at those institutions grew by 15%, to \$346 billion.

Also in the third quarter, the Deposit Insurance Fund fell by \$18.6 billion to a negative \$8.2 billion. Fifty banks failed, while 47 were absorbed in mergers.

The most arresting fact of the quarter, to us, was the number of new bank charters granted—just three. It was “the smallest quarterly total since World War II,” according to the FDIC. In such a fear-frozen setting as this, the strategy of acquiring banks for essentially nothing (recalling the generous loss-sharing guarantee) seems just what the doctor ordered. Onward, Sonabank!



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