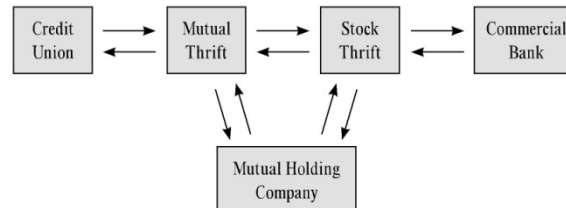


Thrift Conversions: Is Anyone Paying Attention?

Thrift conversions are one of the more conservative, time-tested ways of earning attractive risk-adjusted returns in banking. According to famed value investor Seth Klarman of The Baupost Group, "...the opportunity to buy significantly overcapitalized, conservatively managed thrifts between 50% and 75% of book value and at reasonable earnings multiples offer a low-risk investment with significant return potential."¹⁰

Main Types of Conversions Among Depository Institutions



Sources: James A. Wilcox, "Credit Union Conversions to Banks."

In a first-step thrift conversion, an institution that has been technically owned by its depositors may become a stock corporation and raise capital in an IPO. In these offerings, new investors are essentially "buying" their own capital and getting the existing institution's assets and business for "free." Klarman illustrated the mechanics of a thrift conversion as follows:

"A thrift institution with a net worth of \$10 million might issue one million shares of stock at \$10 per share. ...ignoring costs of the offering, the proceeds of \$10 million are added to the institution's preexisting net worth, resulting in pro forma shareholders' equity of \$20 million. Since the one million shares sold on the IPO are the only shares outstanding, pro forma net worth is \$20 per share. The preexisting net worth of the institution joins the investors' own funds, resulting immediately in a net worth per share greater than the investors' own contribution."¹¹

Meanwhile, in a second-step thrift conversion, an institution that is partly owned by a mutual holding company (MHC) typically completes a transition to full public ownership by offering MHC-owned shares to investors.

Ideally, the vast majority of the stock of a publicly traded thrift is held by an MHC. While those shares are considered to be outstanding, the economics belong entirely to the non-MHC shareholders. The analogy would be treasury stock held by a corporation that had completed a share repurchase. The major difference is that treasury stock is not considered to be outstanding. This MHC-related peculiarity causes many investors to overlook thrift conversions, as the relevant institutions may not appear to be particularly cheap at first glance.

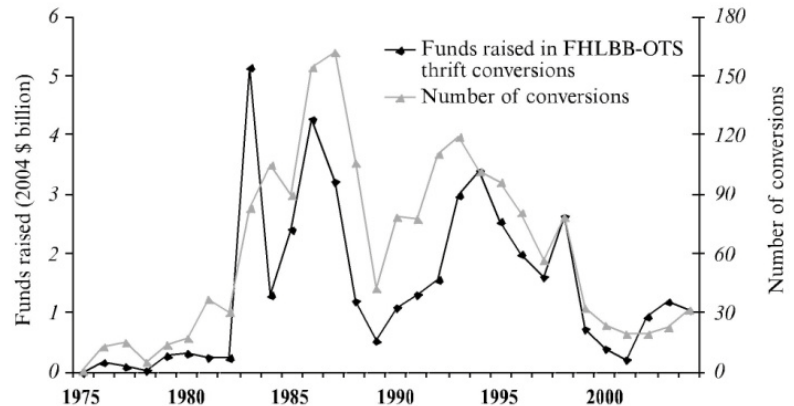
Thrift conversions had their zenith in the 1980s and '90s. Some savvy investors such as Klarman, who had actively participated in conversions, have since moved on to bigger opportunities as their funds have grown in size. In addition, bank-focused investment funds as a category were decimated in the recent financial crisis, making it plausible that thrift conversions may not be as

¹⁰ Seth Klarman, Baupost Group letter, December 1999.

¹¹ Seth Klarman, *Margin of Safety*, p. 183-184.

closely followed as they had been in the past. Writes Klarman, “The arithmetic of a thrift conversion is surely compelling. Yet except for brief interludes when investing in thrifts was popular among individual investors, this area has been virtually ignored. Only a small number of professional investors persisted in identifying this source of value-investment opportunities and understanding the reasons for its existence over a number of years.”¹²

Thrift Conversions: Most Popular in Mid-1980s to Mid-‘90s



Sources: OTS, FDIC, James A. Wilcox, “Credit Union Conversions to Banks.”

As the following table shows, investments in thrift conversions continued to generate “alpha” long after their attractiveness had been recognized by value-oriented investors. While we have not come across reliable recent data on the stock performance of thrifts pursuing conversions, we have no reason to believe that the return profile has changed significantly from the one shown here:

Median First Day Stock Price Increases in Thrift Conversions *

Year	Median first-day pop (%)			Number of		
	Standard conversions	First steps	Second steps	Standard conversions	First steps	Second steps
1995	15.6	10.0	8.3	81	8	5
1996	9.8	20.6	6.2	63	2	7
1997	42.2	28.1	23.4	33	4	7
1998	28.1	12.2	6.3	40	14	11
1999	8.1	1.3	-0.3	18	9	2
2000	10.0	2.5	6.7	11	4	3
2001	20.8	33.4	22.8	10	3	2
2002	22.8	26.2	9.5	6	4	3
2003	37.5	62.9	12.4	6	2	6
2004	13.2	20.0	0.0	3	17	5
1995-2004	18.2	20.3	7.5	271	67	51

* James Wilcox on standard, first and second steps: “First-and second-step conversions each have some conceptual similarities to and differences from standard conversions. Standard and second-step conversions are similar in that they both involve final steps away from mutuality. As such, they typically involve uncompensated transfers of claims from non-buying members to buying members and external investors. First-step conversions differ in that mutual members retain formal ownership of at least 51 percent of the stock subsidiary. Standard and first-step conversions are similar in that they both involve the IPO of shares that then put a market price on the value of residual claims (shares of stock) on their entities. Second-step conversions differ in that shares of stock in their entities (albeit with formally different legal rights) traded prior to the conversion.”

Sources: James A. Wilcox, “Credit Union Conversions to Banks;” Luse and Gorman 2005: 13-14.

¹² Seth Klarman, *Margin of Safety*, p. 127.

Regulators have known about the “windfall” that may be available in thrift conversions for some time, and have tried to address it in a way that makes it easier for depositors to capture a piece of the pie.

We came across the following interesting slide in an FDIC presentation:

Regulators’ Critique of Thrift Conversions

- Incentives are to keep offering prices relatively low! All parties benefit; (insiders /depositors /investors)
- Results may not necessarily be associated with accounting adjustments!
- Underwriters often low ball IPO price especially for small/unknown firms to assure successful subscription offering and capture rents during subsequent trading for insiders /investors
- Stock options to insiders: keep strike price low
- Fighting a “head wind” in the model

Sources: FDIC; Adams, Carow and Perry, “Earnings Management and Initial Public Offerings: The Case of the Depository Industry,” CFR Workshop.

Despite the regulators’ efforts to level the playing field, they have largely failed, in our view. Opportunities for outsized risk-adjusted returns in thrift conversions remain readily available.

OTS-regulated Mutual-to-Stock Conversion Applications; MHC Stock Issuance

Year	Mutual-to-Stock Conversion Applications				Mutual Holding Companies Issuances of Stock		Total New Capital (\$ Millions)
	Number Filed (#)	Number Approved (#)	Number Completed (#)	Amount of Stock Sold (\$ Millions)	Number Completed (#)	Amount of Stock Sold (\$ Millions)	
1972 - 1975	37	6	1	1			1
1976	29	15	13	51			51
1977	25	10	15	30			30
1978	21	4	5	14			14
1979	42	17	14	114			114
1980	51	46	17	141			141
1981	57	39	37	127			127
1982	35	34	31	123			123
1983	115	108	83	2,741			2,741
1984	88	100	96	715			715
1985	55	62	78	1,385			1,385
1986	154	113	86	2,482			2,482
1987	110	126	130	1,957			1,957
1988	80	89	98	767			767
1989	49	35	35	351			351
1990	94	71	69	774			774
1991	74	75	69	955	1	3	958
1992	85	89	91	1,092	9	67	1,159
1993	80	77	77	2,226	10	59	2,285
1994	83	78	65	2,480	16	197	2,676
1995	57	59	75	1,994	4	63	2,057
1996	43	54	54	1,635	2	21	1,656
1997	50	38	37	1,337	3	22	1,359
1998	27	39	38	2,120	9	142	2,262
1999	10	10	12	197	5	447	644
2000	9	9	10	299	3	70	369
2001	9	8	8	161	2	51	212
2002	14	14	9	788	4	94	882
2003	15	9	11	1,013	3	140	1,153
2004	8	4	6	458	16	577	1,035
2005	7	6	7	4,386	12	503	4,889
2006	10	7	5	133	11	448	581
2007	14	13	14	4,580	12	1654	6,234
2008	8	6	4	133	4	52	185
2009	10	6	5	848	1	11	859
TOTALS	1,655	1,476	1,405	38,608	127	4,621	43,229

Sources: Office of Thrift Supervision / 2009 Fact Book.

The table on the previous page reveals an interesting fact: While the number of thrift conversions has dropped sharply since the 1980s, the dollar amount of capital raised has remained relatively stable or has even increased. Recent mutual-to-stock conversions and MHC stock issuances have been materially larger in dollar volume per deal than in the 1980s. As a result, those willing to do the work still have an ability to deploy meaningful amounts of capital in thrift conversion opportunities.

Comparison of Credit Unions, Mutual Thrifts, Stock Thrifts, Commercial Banks

	Federal credit union	Federal mutual thrift	Federal stock thrift	National bank
Ownership	Cooperative	Mutual	Stock	Same as thrifts
Voting	One member, one vote	Voting may be somewhat proportional to deposits	Voting not related to membership or deposits, but to transferable shares of stock	Same as stock thrifts
Dividends (interest)	Proportional to savings (deposits)	Same as credit unions	Depositors receive interest. Non-depositor owners receive dividends	Same as stock thrifts
Managerial compensation	Not linked to stock price	Same as credit unions	May be linked to stock price	Same as stock thrifts
Directorial compensation	No	Yes. Not linked to stock price.	Yes. May be linked to stock price.	Same as stock thrifts
Corporate income taxes	Exempt. Members pay income taxes on their dividends (interest).	Not exempt. Institution pays corporate income tax. Members pay income taxes on interest.	Not exempt. Institution pays corporate income tax. Depositors pay income taxes on interest. Owners pay income tax (at 15 percent rate) on dividends.	Same as stock thrifts
Fields of customers	Yes. In general, only members may borrow and make deposits.	No. Anyone (including corporations) may borrow and make deposits.	Same as mutual thrifts	Same as mutual and stock thrifts. Some branching restrictions apply.
Limits on securities	Government securities only	Investment-grade securities only	Same as mutual thrifts	Few limits
Limits on lending	Cap on business lending	QTL slightly favors residential, credit card, consumer, educational, and small business lending	Same as mutual thrifts	Few limits
Methods to raise capital, other than retaining earnings	Low-income credit unions may use secondary capital	Subordinated debt, other debt-equity hybrids (TPS, etc.)	Subordinated debt, other debt-equity hybrids (TPS, etc.), common stock	Same as stock thrifts
Lead regulators and insurers	NCUA and NCUSIF	OTS and FDIC (BIF and SAIF)	Same as mutual thrifts	OCC and FDIC (BIF)

Sources: James A. Wilcox, "Credit Union Conversions to Banks."

Cheapest Based on Adjusted Market Value to Tangible Assets

The following table shows banks that have completed a first-step conversion and IPO but have yet to complete a second-step conversion, in which shares held by an MHC would be sold to the public. We adjust metrics such as market value by stripping out MHC shares, as the economics associated with those shares belong to the non-MHC current shareholders.

For example, the fourth-ranked bank in the table, Wauwatosa, Wisconsin-based Waterstone Financial (WSBF) has 74% of the common stock held by Lamplighter Financial, MHC. Those shares are not actually “outstanding” for economic purposes, as the economics associated with those shares belong entirely to the holders of the remaining 26% of WSBF shares. As a result, the bank’s “apparent” market value of \$124 million compares to “true” market value of only \$33 million. Given WSBF’s tangible assets of nearly \$1.9 billion, we conclude that the bank’s market value equals only 2% of tangible assets.

Finally, we note that a few banks shown in the table have announced a second-step conversion that has not been completed. As the final terms of such conversions may be unavailable, we have made no adjustments to reflect the pending conversions. For example, first-ranked Atlantic Coast Federal Corporation (ACFC) has commenced a second-step offering in which current shares would convert into new shares at an exceedingly low exchange ratio, thereby hurting existing holders. Despite exceptions such as ACFC, we view the following table as a good list of potentially dramatically undervalued banks.

Institution / Ticker	State	Price	Δ Price Since YE'06	MHC Own.	“Apparent” Metrics (unadjusted for MHC)			“True” Metrics (adjusted for MHC)				Other Data		
					MV	TBV/ MV	Insider Own.	MV	TBV/ MV	MV/ TA	Insider Own.	Tangible Assets	TBV/ Tang.	Assets/ Empl.
Atlantic Coast Fed / ACFC	GA	\$1.82	-90%	65%	\$24	218%	5%	\$9	623%	1%	15%	\$901	6%	\$6
Brooklyn Federal / BFSB	NY	1.85	-86%	72%	24	306%	5%	7	1087%	1%	17%	524	14%	7
Magyar Bancorp / MGYR	NJ	3.49	-75%	56%	20	218%	7%	9	489%	2%	15%	544	8%	6
Waterstone Financial / WSBF	WI	3.98	-78%	74%	124	139%	4%	33	531%	2%	17%	1,881	9%	4
Pathfinder Bancorp / PBHC	NY	8.20	-37%	64%	20	102%	5%	7	282%	2%	14%	393	5%	4
PSB Holdings / PSBH	CT	3.65	-67%	57%	24	153%	10%	10	357%	2%	23%	482	8%	6
Naugatuck Valley / NVSL	CT	5.10	-59%	60%	36	143%	5%	14	354%	3%	13%	565	9%	5
Malvern Federal / MLVF	PA	6.57	n/m	56%	40	171%	1%	18	383%	3%	2%	695	10%	8
Heritage Financial / HBOS	GA	8.38	-50%	76%	87	69%	6%	21	282%	3%	25%	659	9%	5
Hometown Bancorp / HTWC	NY	5.24	n/m	56%	12	160%	3%	5	366%	3%	6%	157	12%	3
Laporte Bancorp / LPSB	IN	7.27	n/m	55%	33	122%	3%	15	270%	3%	6%	429	9%	4
SI Financial / SIFI	CT	6.89	-44%	62%	81	95%	5%	31	249%	3%	13%	885	9%	4
Prudential Banc / PBIP	PA	6.82	-49%	71%	68	82%	3%	20	283%	4%	10%	538	10%	8
FedFirst Financial / FFCO	PA	11.20	-45%	57%	34	128%	4%	14	301%	4%	9%	355	12%	4
Oneida Financial / ONFC	NY	7.45	-42%	55%	53	60%	10%	24	134%	4%	21%	572	6%	2
Lake Shore Bancorp / LSBK	NY	8.03	-36%	60%	49	118%	7%	20	293%	4%	18%	460	13%	5
MSB Financial / MSBF	NJ	7.41	n/m	59%	38	104%	4%	16	252%	4%	10%	359	11%	7
Alliance Bancorp / ALLB	PA	7.35	-67%	59%	49	99%	4%	20	242%	4%	9%	448	11%	6
United Community / UCBA	IN	7.25	-39%	59%	57	98%	9%	23	240%	5%	21%	492	11%	5
Charter Financial / CHFN	GA	8.26	-84%	61%	154	70%	3%	60	180%	5%	6%	1,141	9%	6
Meridian Interstate / EBSB	MA	10.57	n/m	58%	238	82%	2%	99	196%	6%	4%	1,717	11%	11
Roma Financial / ROMA	NJ	10.56	-36%	73%	325	67%	1%	88	247%	6%	4%	1,457	15%	7
Greene County Banc / GCBC	NY	17.17	11%	56%	71	63%	11%	31	143%	6%	24%	495	9%	5
Capitol Federal / CFFN	KS	24.68	-36%	70%	1,826	53%	3%	541	178%	6%	9%	8,543	11%	14
Rockville Financial / RCKB	CT	11.56	-35%	55%	226	71%	4%	102	157%	6%	8%	1,601	10%	8
Kearny Financial / KRNY	NJ	8.90	-45%	75%	605	67%	6%	152	266%	7%	22%	2,258	18%	8
Beneficial Mutual / BNCL	PA	9.00	n/m	56%	733	72%	2%	323	164%	7%	5%	4,747	11%	6
Investors Bancorp / ISBC	NJ	11.86	-25%	57%	1,363	63%	3%	589	146%	7%	8%	8,834	10%	13
Northeast Community / NECB	NY	5.85	-52%	55%	77	137%	1%	35	304%	7%	1%	515	21%	5
TFS Financial / TFSL	OH	9.13	n/m	74%	2,815	63%	0%	741	238%	7%	1%	10,940	16%	12
Clifton Savings / CSBK	NJ	8.55	-30%	64%	224	79%	7%	80	219%	7%	20%	1,114	16%	12
Chevot Financial / CHEV	OH	8.44	-36%	62%	75	94%	8%	29	243%	8%	22%	351	20%	n/m
Northfield Bancorp / NFBK	NJ	11.35	n/m	56%	494	78%	3%	216	178%	10%	7%	2,192	17%	11

Acronyms: MHC = mutual holding company; MV = market value; TA = tangible assets; TBV = tangible book value.

Excludes banks with no MHC ownership and banks with deposits of less than \$100 million.

Source: Company SEC filings, Manual of Ideas analysis.

Cheapest Based on Tangible Book Value to Adjusted Market Value

The following table ranks our universe of MHC-owned thrifts by tangible book value to adjusted market value.

While institutions with relatively higher ratios of tangible book to market may also be relatively more undervalued, such institutions may also be perceived to have greater loan portfolio quality issues or inadequate levels of equity to total assets, potentially necessitating a future capital raise at unfavorable terms. Obviously, the only way to determine whether an institution with a high ratio of book to market is indeed undervalued would be to assess the solidity of book value in light of metrics such as loan loss provisions and the ratio of non-performing loans to total loans.

(\$ in millions, except per share data)				MHC Own.	"Apparent" Metrics (unadjusted)			"True" Metrics (adjusted for MHC)				Other Data		
Institution / Ticker	State	Price	Δ Price Since YE'06		MV	TBV/ MV	Insider Own.	MV	TBV/ MV	MV/ TA	Insider Own.	Tangible Assets	TBV/ Ass.	Tang. Ass./ Empl.
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