

Banks Owe It to Shareholders To Earn Back Cost of Equity

■ BY DAVID B. MOORE

One of the biggest disappointments I have faced as a bank stock analyst in recent years has been the scarcity of bank chief executive officers who understand the role of equity capital costs in their decision-making.

Though virtually all bank CEOs understand the costs associated with funding sources that require a direct cash outlay, such as deposits, Federal Home Loan Bank bor-

The reason is, of course, that equity capital costs are not cash expenses but rather are implied (and theoretical) and, therefore, harder to measure than the explicit costs of other funding sources.

Put simply, a company's cost of equity capital is the rate of return that investors require to adequately compensate them for the risk associated with owning the company's common equity. For example, if investors, in aggregate, require a 10% annual-

of equity capital. The most widely used is the capital asset pricing model. Without going into all the gory details, this model produces an estimate by taking into account the risk-free rate of return (on government securities), the expected return on the stock market as a whole, and the volatility of a company's stock relative to the market.

However, the methodology used to calculate a company's cost of equity capital is not relevant to this discussion. What is relevant is that the cost of equity capital is determined by the aggregate actions of market participants. What's more, a company that ignores its imputed equity capital costs will probably have to "pay the piper" in the form of an underperforming stock.

In this context, I often talk to

bank and thrift CEOs who are surprised that their company's stock is trading below its book value. If the company's liquidation value is book value, they ask, why is their stock trading below it?

More often than not, it is because the company's return on equity is below its cost of equity capital and the market is (properly) discounting for this reality.

To use a specific example, let's assume a thrift earns 7% on equity and that its cost of equity capital is 10%. Because this company is earning less than its cost of equity capital, and in so doing is destroying shareholder value merely by doing business every day, its stock should trade at a discount to book value.

Liquidation value in this case is somewhat irrelevant. Just as a loan made at a below-market interest rate can only be sold at a discount to the loan's face value, the stock of a bank that earns less than its cost of equity capital should trade at a discount to its book value.

SNL Securities says that 223 of the 668 publicly traded banks and 263 of the 393 publicly traded thrifts earned less than 11% on their equity capital (my estimate of these companies' aggregate cost of equity capital) dur-

ing the second quarter.

Of the 486 companies generating a return of less than 11% on equity capital, almost two-thirds were trading below book value as of mid-September. (Clearly, investors were expecting improvement at the remaining third.) These companies held \$484 billion of assets and \$41.8 billion of aggregate equity at the end of the second quarter.

Think about the magnitude and meaning of those numbers; almost \$42 billion of equity capital is being misallocated in the bank and thrift industries. In my view, this is staggering.

The moral of this story is that directors of publicly traded banks and thrifts should be keenly aware of their companies' equity capital costs and should hold managers responsible for earning up to these hurdle rates.

If their companies cannot earn their cost of capital, these directors have a fiduciary responsibility to shareholders to sell their institutions, liquidate them, or replace management with people capable of generating an economic return for the companies' owners.

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Equity capital costs are difficult to measure, and too many bank CEOs overlook them.

rowings, long-term debt, and preferred stock, many of these same managers have a more difficult time conceptualizing the economic costs associated with their common equity.

ized return from owning a particular company's common stock, then that company's cost of equity capital is 10%.

Several methods are available for calculating a company's cost