Federal Finance Bank
75

GOING PUBLIC

Directed

Federal Finance Bank was founded in 1965 in Sun City, Arizona, to serve "snowbirds" (retirees wishing to escape harsh northern winters). The bank specializes in friendly and personal service and has been successful in persuading customers to transfer their life savings to Federal Finance and to consolidate banking activity at the bank. Because of this, the institution has a strong savings base and a large portfolio of low risk automobile and home loans. In the late 1980s, the bank opened a branch in a neighboring suburb and began to aggressively market commercial loans. The tremendous economic growth in the region, accompanied by new and expanding businesses and an increasing population, has heightened the demand for funds to finance new commercial business and home construction. As a result, Federal Finance Bank is the state's fastest growing financial institution in terms of both assets and earnings. Table 1 provides the basic balance sheet for the close of the most recent fiscal year. In addition, Federal Finance has an existing allowance for loan losses of $2,680,000.

Although Federal Finance is profitable and has had consistent earnings growth, the company's quick expansion has resulted in financial strain. The bank uses retained earnings to help fund growth, but the bank's capital asset or leverage ratio and total risk based ratios have been declining. The FDICA legislation requires regulators to take "prompt corrective actions" whenever a bank falls below the requirements for a well-capitalized institution (see Table 2 for requirements). The bank is concerned about the possibility of dropping below the well-capitalized leverage and risk-based asset ratios.

TABLE 1

Federal Finance Bank
Balance Sheet for Year Ended December 31, 2000
(Dollars in Thousands)

ASSETS	
Cash	$ 7,387
U.S. Treasuries	12,477
Agency mortgage-backed securities	110,684
General obligation municipal bonds	25,970
Government agency securities (low default)	34,740
Total Cash and Marketable Securities	**$191,258**
Residential mortgage loans	189,164
Consumer loans	36,583
Business loans	77,693
Total Loans	**$303,440**
Fixed assets	31,128
Total Assets	**$525,826**
LIABILITIES	
Passbook savings	$ 58,693
Non-interest checking	10,654
N.O.W. accounts	36,581
Money market accounts	115,268
Certificate of Deposits	185,561
Total Savings	**$406,757**
Borrowed money	68,701
Other liabilities	23,878
Total Liabilities	**$499,336**
Capital stock ($100 par value)	$ 12,155
Retained earnings	14,335
Total Equity	**$ 26,490**
Total Claims	**$525,826**

TABLE 2

Requirements for a Well-Capitalized Institution

5 Percent—Leverage or Capital Asset Ratio (book value of core capital/assets)
Core capital includes:
common stockholders' equity
+ qualifying cumulative and noncumulative perpetual preferred stock
+ minority interest in equity accounts of consolidated subsidiaries.

10 Percent—Total Risk Based Capital Ratio (total capital/risk adjusted assets)
Total capital includes:
core capital
+ allowance for loan loss reserves
+ perpetual preferred stock
+ hybrid capital instruments, perpetual debt, and mandatory convertible securities
+ subordinated debt and intermediate-term preferred stock
+ revaluation reserves
– acceptable deductions

Risk adjusted assets are based on the following weights:

0 percent	weight for items with no default risk (such as cash, reserve balances, U.S. Treasuries, some sovereign debt)
20 percent	weight for items with low default risk (such as inter-bank deposits, some government agency securities, general obligation municipal bonds, agency mortgage-backed securities, claims collateralized by the U.S. Treasury, and cash in the process of collection)
50 percent	weight for residential loans and revenue municipal bonds
100 percent	weight for other assets (such as commercial paper, consumer loans, commercial loans, and fixed assets)

Source: FDICA.

The bank has been approached about buying a branch from another institution. The bank recently conducted a feasibility study of the acquisition that was positive. The report demonstrated that the new branch could generate profitable new loans and deposits and further increase the company's growth. However, in order to fund new loans the company first needs to generate additional capital. An inflow of deposits and money into other accounts would increase the bank's liabilities causing the leverage and risk-based capital ratios to fall below acceptable levels. Therefore, Federal Finance is considering raising approximately $8 million of additional equity funds to open the new branch.

Federal Finance's common stock is privately held and three major stockholders dominate ownership. Sue Brown, president and chairman of the board, owns 33 percent of the stock; Barry Zudlum, the bank's chief operating officer, owns 31 percent of the stock; and Sara Jones, the widow of the original founder, owns 20 percent of the stock. In addition, Security Investment Company owns 10 percent of the stock, and the bank's eight outside members of the board of directors own 6 percent. Both Sue Brown and Sara Jones have substantial outside financial interests; however, most of Barry Zudlum's net worth is represented by his stock in Federal Finance. Although Brown, Zudlum, and Jones agree that Federal Finance must obtain additional equity funds in order to implement the branch expansion, they do not agree on how the additional funds should be raised. The three inside shareholders are not in a financial position to invest additional funds into the com-

pany and two alternatives have been proposed. 1) Sell newly issued Federal Finance shares to a few friends and associates, and 2) sell newly issued shares to the general public.

Brown favors the private sale. She points out that she, Zudlum, and Jones have been receiving substantial amounts of ancillary, or indirect, income from the bank's operation. These three jointly own a holding company that operates an insurance agency that writes insurance for many of the homes financed by Federal Finance and a title insurance corporation that is involved with a number of the properties secured by bank loans. These operations are fully disclosed and approved by the regulatory authorities. Also, Brown owns a small interest in a construction company that obtains loans from the bank. Although Brown is comfortable with the soundness of these business deals, she is concerned that the arrangements may trigger questions of conflict of interest if the new capital is raised by selling stock to the general public. If the shares were sold to a few individuals, concerns could be easily satisfied. She also opposes a public offering because of the high flotation cost required for a public sale of this type. However, high flotation costs may be offset by lower rates and would be minimal if the new stock were sold to a few individual investors.

Zudlum disagrees with Brown. He feels that it is in the bank's best interest to sell the stock to the general public rather than to a limited number of investors. He acknowledges that higher flotation costs on the public offering are a consideration and that possible conflict-of-interest issues may arise if shares of the company are sold to the general public. However, he argues that the following advantages of publicly traded stock offset the disadvantages. 1) The existence of a market-determined price would make it easier for stockholders to borrow money, using their shares in Federal Finance as collateral for loans. 2) The existence of a public market would make it possible for shareholders to sell some of their shares on the market if they needed cash for any reason. 3) Publicly traded stock would make executive stock-option plans more attractive to key employees of the company. 4) Establishing a market price for shares would simplify problems of estate tax valuation in the event of the death of one of the current stockholders. Selling stock to the public at the present time would 5) facilitate acquiring additional equity capital in the future, 6) facilitate buying back stock to adjust the leverage if needed, and 7) lower the required rates for equity capital.

Jones, whose 20 percent ownership of the company gives her the power to cast the deciding vote, is unsure whether she should back the public sale or the private offering. Jones also has heard rumors that Zudlum wants to diversify his holdings, and believes he will sell half of his stock if the company goes public. She is uncertain about how this will affect the company. She would like additional information to help clarify the issues so she can make an informed decision on how to raise the needed funds. Therefore, at her request, the board instructed Linda Grayston, Federal Finance's chief financial officer, to study the issue and to report back in two weeks. As a first step, Grayston obtained the data on Federal Finance's earnings given in Table 3. Grayston then collected information on four publicly traded financial institutions; this data is shown in Table 4.

TABLE 3

Federal Finance Bank
Selected Information
(In thousands)

YEAR	ASSETS	NET PROFIT
2000	525,826	7,863
1999	461,119	6,732
1998	402,667	5,959
1997	360,954	5,450
1996	312,172	4,745
1995	273,617	4,077

TABLE 4

Data on Other Publicly-Traded Financial Institutions
Year end December 31, 2000

	ASSETS	EQUITY PER SHARE	BOOK VALUE (1,000)	PRICE (1,000)	NET PROFIT (1,000)	ASSETS 1995
Maryland Financial	**220,000**	11,800	31.35	34.68	3,322	109,400
Great Northern Bank	**476,000**	23,700	21.08	20.84	6,172	241,600
First Bank of California	**305,000**	15,400	40.56	36.54	2,745	239,000
Omaha Federal	**238,000**	12,900	25.75	30.36	3,546	123,609

Grayston wants to get a good handle on the company's current and relative positions with respect to asset growth, book value of stock, and the requirements of a well-capitalized institution. She realizes that investment bankers generally like to offer the initial stock of companies that are going public at a price ranging from $10 to $30 per share. She is interested in how a $20 share price would affect the number of shares outstanding before considering a new stock issue and decisions about raising $8,000,000 through a new stock issue. She believes that in order to come up with a good recommendation she must understand the process of taking the company public. Therefore, she would like to include information about this process in her report. You have been assigned to help Grayston prepare the report and put the presentation together. In order to help you focus on the issues she feels are important, Grayston has provided you with the following questions.

QUESTIONS

1. Using information contained in Table 1, Federal Finance's balance sheet at the end of 2000, calculate Federal Finance's capital asset ratio, risk based capital ratio, number of shares of stock outstanding, and book value per share of common stock. Based on the ratios, explain the banks capital adequacy.

2. Using the data in Table 3, calculate Federal Finance's 2000 ROA and average annual growth rate in assets from 1995 to 2000. (Hint: In your calculations, use only the data for 1995 and 2000.)

3. For the four Bank's listed in Table 4, calculate the following:
   a. The Capital Asset Ratio for 2000.
   b. Compound annual growth rates in assets for the five-year period 1995–2000.
   c. The ROA ratios in 2000.
   d. The market value/book value ratios for 2000.
   e. How does Federal Finance compare with the Capital Asset Ratios, ROA, and growth rates of assets for these institutions?

4. Considering your answers to Questions 1 through 3:
   a. Develop a range of values that you think would be reasonable for Federal Finance's market/book ratio if it were a publicly held company.
   b. Discuss the valuation differences between a privately held and publicly traded firm.

5. Regardless of your answer to Question 4, assume that 1.15 is an appropriate market value/book value ratio for Federal Finance. What would be the market value per share of the company?

6. Investment bankers generally like to offer the initial stock of companies that are going public at a price ranging from $10 to $30 per share. If Federal Finance stock were to be offered to the public at a price of $20 per share, how large a stock split would be required prior to the sale? How many shares of stock would be outstanding following the split but before new shares are issued?

7. Assume that Federal Finance chooses to raise $8 million through the sale of stock to the public at $20 per share.
   a. Approximately how large would the percentage flotation cost be for such an issue? Base your answer on available published statistics.
   b. How many shares of stock would have to be sold in order for Federal Finance to pay the flotation cost and receive $8 million net proceeds from the offering?

8. Assume that Zudlum decided to sell half of his stock.
   a. How many shares of stock and what total amount of money (assuming that the stock split occurred and that these shares were sold at a price of $20 per share) would be involved in this secondary offering? (A secondary offering is defined as the sale of stock that is already issued and outstanding. The proceeds of such offerings accrue to the individual owners of the stock, not to the company.)
   b. What is the impact on percentage flotation cost if the investment bankers were to combine the major stockholders' secondary offering with the sale by the company of sufficient stock to provide it with $8 million?

9. Assume that the major stockholders decide that Federal Finance should go public. Outline in detail the sequence of events from the first negotiations with an investment banker to Federal Finance's receipt of the proceeds from the offering.

10. Explain why Brown and Zudlum might have personal differences of opinion on the question of public ownership.

11. The analysis was based on the comparability of Federal Finance with four other banking institutions. What factors might tend to invalidate the comparison?

12. All things considered, do you feel that Federal Finance should go public? Fully justify your conclusion.