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Chicago-based Podesta & Co. harries Midwestern institutions with sale calls

By Todd Fletcher

Podesta & Co.'s Chris Raffo isn't an activist investor. But he could have been mistaken for one at the April annual meeting for First Midwest Bancorp Inc.

First Midwest, a community bank operating in some of Chicago's high-growth markets, should seek a sale, Raffo told the assemblage. The company is well-run, but there are other institutions that could operate the bank even more profitably — and the end of pooling-of-interests accounting could siphon off the number of buyers that would be willing to acquire it, he argued.

First Midwest's CEO, Robert O'Meara, reportedly responded, "Who are you?"

That's been the question on a lot of Midwest minds of late. And for Chicago-based Podesta, answering that question is part of an ongoing plan to create a new player on the bank-and-thrift research scene.

To partially answer O'Meara's query, Podesta's clients own roughly 2 million shares of First Midwest stock, according to Raffo. That equates to a stake of just under 5% based on the bank's shares outstanding at March 31.

Podesta itself owns no stake in companies, primarily functioning as a mouthpiece for its clients, pledging its allegiance to its institutional investor base that, according to Raffo, are "stuck in the stock" of the companies in question. In the case of First Midwest, the stock is off about 30% from its all-time, split-adjusted high of 34.583 on April 30, 1998.

Podesta's role, according to Raffo, is to fill a research niche missing on the Street and to provide "unbiased" coverage. "Sell-side bank specialty firms, their real business comes from the bank, not from individual investors. They don't want to chance the possibility that they're going to impact their relationship with the bank." Raffo contends that the lack of an investment banking affiliation with any of the institutions that it covers allows Podesta to be more aggressive, since spouting off doesn't jeopardize investment banking business.

Naturally, these sentiments have an off-putting effect on those on the sell-side that have affiliations with the institutions in their range of coverage. Ronald Peterson, vice president of equity research at the Chicago office of Sandler O'Neill & Partners, is one in particular.

"I don't think its fair to assume that [sell-side] research is biased because it may not be as blunt …To say that ours or other investment banking firms' research is biased is not a good assumption," Peterson said.

Timothy Willi, a banking analyst at A.G. Edwards, said while there are conflicts of interest in the bank research game, to correlate automatically analyst ratings with the preservation of future investment banking business is not always an accurate portrayal. "In defense of a lot of these people that are being questioned, they're looking out a year or two and saying that this is probably a good time to be buying that stock." A "suspect" positive rating may actually be attributed to a longer-term view taken by the analyst.

Raffo says that his firm is considering investment banking for down the road. According to Willi, adding an investment banking arm means that comprises will have to be made. "If they do go out and decide to build an investment banking operation, they'll have to play the same game that everybody else does," he said. "[Podesta] won't be able to lay that claim that they don't have these conflicts of interests, because they're there [in a research/advising structure] and they always will be, and you manage that as best as you can. You're always going to be questioned about it, it's always going to be something that sort of hangs over your ratings, but there's no way to get around it."

For now, the "independent thinker" card is one Podesta can play. Charlie Cranmer, who manages a financial services hedge fund for Bryn Mawr Capital, is a Podesta client. Podesta's compelling draw, from his perspective, is coverage he says helps fulfill "a real need for research, whether it's of an activist nature or not, that really focuses on valuations and on making money for shareholders that's independent of corporate finance biases." He said spending time dissecting research from the smaller shops that are given less attention provides a value-added component that in many cases is superior to "some of the traditional Street research."

Raffo, who serves as vice president and head of institutional sales, and research analyst David B. Moore have been a unit for little over a year. They formed a research and sales platform at Podesta, focusing primarily on Midwest and California-based community banks. Much of the income Raffo and Moore bring in is trading commissions in the stocks they cover.

While maintaining a perky outlook on several of the banks and thrifts it tracks, Podesta is becoming known far more for those on its hit list. And that, too, is part of the answer to O'Meara's question.

Raffo said that for a sell-side firm to offer criticism publicly of bank management is "newsworthy these days, and as such, we haven't hesitated to leverage our research in the press." But leveraging the press also serves the purpose of getting out Podesta's name — and creating a bulldog reputation with investors. Since Raffo and Moore are attempting to build a business for Podesta, stirring up more dust could be the ticket to their success. And the ongoing weakness in bank and thrift valuations creates a hospitable environment for that.

With the end of the current economic expansion seemingly closer than the beginning, Moore said he and Raffo have focused mainly on bank and thrifts that are takeout candidates. "That allows you to get into the investment and get out of it before things go to hell in a hand basket," he said. "This is more of where we are in the investment cycle rather than our basic beliefs about banks in general."

Over the course of the past few months, several Midwest banks and thrifts have made their way onto the firm's "takeout" target list. Some recent examples include AMCORE Financial Inc., Associated Banc-Corp, Home Federal Bancorp and PS Financial Inc. Management at each company declined to be interviewed for this article.

Once a company makes the Podesta list, Moore and Raffo aggressively agitate through letters to the board, attending annual shareholder meetings to pressure management to sell, and seeking out publicity from the financial press. Raffo explains that "one of our basic questions to these guys is, 'Tell me why as a shareholder, I don't want you to give me a 40% premium and stock in a better performing bank.' … The names that we're pushing publicly, it's pretty clear the path they should be taking."

Of course, getting a 40% takeout premium these days is a tall order — depending on the price to which you peg it. According to the SNL M&A DataSource, the median one-day premium for publicly traded banks and thrifts so far in 2000 is 31.29%, but the one-year median premium is just 16.60%. Compared with previous all-time highs, this year's bank and thrift deal values represent about a 12% median discount.

Regulatory filings related to mergers have increasingly shown that fewer acquirers are sniffing around offers to sell. But Raffo and Moore contend that big payouts are still possible, standing by their notion that suitors are out there, looking to acquire some of the companies in their coverage universe. For instance, Raffo speculated in his speech at the First Midwest annual meeting about rumored negotiations with Fifth Third Bancorp that reportedly had fallen through.

Removing premiums from the discussion of the merits of selling, Raffo said, "If you can't outperform your logical acquirer by some reasonable margin within a reasonable time frame, then you have to consider selling."

The analysts have been more successful in getting their name out than in effecting change to this point.

In mid-1999, Raffo and Moore met with CEO John Keach Jr. of Home Federal Bancorp., and pressured him to hire an investment banker and to seek a sale of the thrift. They contended that Home Federal's operating structure was far too simplified to continue in the low-growth markets in which it operated and had by passed a golden opportunity to merge with CNB Bancshares, which they claimed had a serious interest in Home Federal. CNB was later bought out by Fifth Third in June 1999. A merger with CNB would have allowed shareholders to "double dip" into a higher return, the analysts argued, and would have given Home Federal the exposure to Indianapolis that it otherwise would have had to build via de novo branching or acquisition. A second meeting with Keach and a subsequent letter to the thrift's board did nothing to change the outcome. Raffo's next move was to leverage the public spotlight to question Keach's alignment with shareholder interests — something the analyst accomplished through an interview in the Indianapolis Business Journal in January.

Podesta's recent attention has been divvied up between several other institutions in the Midwest. In March, Podesta doubled up for a joint attack of PS Financial Inc., a $121-million-asset Chicago thrift, with Paul J. Duggan, an activist investor who manages Jackson Boulevard Partners LP. Podesta's clients own just over 5% of the stock. The bulk (74.5%) of the thrift's overall loan portfolio consists of 1-4 family mortgage loans, and the main allegation of its dissident base is that the company has neither the personnel nor the strategy in place going forward to grow earnings at a rapid clip. "One of their major initiatives was issuing CDs over the Web. It's a marginal business, marginally profitable. No one is going to give you any earnings credit for it," Raffo said. "At best, it would be a good branch for somebody."

Another battle has been with Rockford, IL-based Amcore Financial Inc., being among the first to express displeasure with the bank's performance. At the May 9 annual meeting, Podesta spearheaded a group of anxious investors who expressed displeasure with the bank's recent returns, as well as "complacency" on the part of management. This dissident shareholder base, according to Raffo, holds a little less than 40% of total Amcore shares. Of that, he estimates, 10% deal directly with Podesta. Moore is willing to bet that a sale is in the foreseeable future. "The parties who are pressing Amcore, from what I know, are willing to at some point take legal action if it's necessary," he said.

In the current interest rate environment, Amcore is just one of a long list of banks that has suffered from margin compression. In the first quarter, Amcore's net interest margin stood at 3.44%, as down from 3.54% in the fourth quarter of 1999 and 3.48% for the year earlier period. Podesta believes the bank's most logical acquirers are Firstar Corp., Marshall & Ilsley Corp., Old Kent Financial Corp. and Wells Fargo & Co.

Dan Bandi, director of value equity and manager of Armada's Equity Income and Small Cap Value Fund, oversees a stake in Amcore and invests directly with Podesta. According to Bandi, Amcore is "one of these positions that we hold that I feel like they should sell … but you never know whether management's going to do the right thing or just run it into the ground, and so far they've just been running it into the ground."

Associated Banc-Corp, the third-largest franchise in Wisconsin with approximately $12 billion in assets, has two likely prospective suitors in Wells Fargo and Marshall & Ilsley, according to Moore. Associated has been rumored as a takeover candidate since the fourth quarter of 1998. Its buyout of First Financial Corp. hit some snags, and it had to digest a heavy $89.8 million restructuring charge, as well as a drag in the integration process, which resulted in considerable deposit run-off.

Podesta's particular annoyance with Associated is with its liberal use of taking non-operating gains that trickle down through the income statement. Recently, the gains have come in the form of branch sales. That, Moore says, is misleading, because the solid return on equity numbers and EPS growth is being achieved through capital management as opposed to growth of actual core operations at the bank. The problem with the continuous branch selling is that it's "not sustainable, because eventually, if you keep selling branches, you don't have a company anymore." In addition, he said, "The next quarter there's going to be a gain of about $12 million from the sale of their credit card portfolio. So here we're going to have three quarters in a row where they have non-operating gains. … From a core operating standpoint, they are growing earnings at 5% to 6% a year."