What's the Real Reason Square 1 Is Selling to PacWest?

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Square 1 Financial's decision to turn over its keys to PacWest Bancorp in Los Angeles left me scratching my head at first. Given Square 1's promising earnings trajectory, why would one of the most successful startup banks in a generation decide to sell?

Niche banks are a growing part of our financial institutions landscape. I often cited the Durham, N.C.-based Square 1 for their focus and success. In their own words, "Square 1 is a financial service company focused primarily on serving entrepreneurs and their investors." A bank with a focused strategy! Brings a tear of joy to my eye.

It had one banking office (in Durham), and twelve loan production offices located in key innovation hubs across the U.S. Its chairman and chief executive, Doug Bowers, was a 30-year Bank of America vet and more recently a member of a private equity firm. So the niche Square 1 adopted made sense.

So why sell, Doug?

An industry reporter hypothesized that it was the price: 22 times earnings, 262% of tangible book. But that was close to where Square 1 was trading at announcement. So there was no price premium. In fact, if Square 1 had remained independent, their stock price would soar past the value received in this merger.

Like most projected performance, the devil's in the details. I assumed that Square 1's three-year compound annual growth rate in earnings per share (86%) linearly came down to earth to 12% by the end of the projection period, which is PacWest's three-year earnings per share CAGR. I assumed PacWest's 12% CAGR would continue throughout the projection period. If all that were true, it would have been more beneficial for Square 1 to go it alone. It is what I term "earning their right to remain independent."

So if future valuation wasn't the reason for the sale, what was? Usually in a merger, the seller receives a larger pro forma ownership stake because they receive a premium on their stock and they are relinquishing control. But as I mentioned above, Square 1 did not receive a price premium from PacWest. Their pro forma ownership of PacWest is pretty much in line with their contribution.

Bowers offered his own explanation for the sale in a press release, writing, "Square 1 offers PacWest a complementary line of business and significant core deposit growth. As part of PacWest, we will maintain our steadfast commitment to the entrepreneurial and venture communities, will be able to offer clients a wider array of products and will be well-positioned to continue to serve them through all stages of their growth."

But this seems to tell us why PacWest bought Square 1, not why Square 1 sold to PacWest. So with Doug silent on the issue, here are my opinions on why one of my darling niche banks went on the block.

1. Institutional Ownership. Square 1 went public last March, raising $52 million at $18 per share from primarily institutional owners. The company was 70% institutionally owned by such names as Patriot Financial Partners, Castle Creek Capital, Endicott Opportunity Partners and other notables. Some had 5%-10% stakes, or about two million shares. Square 1 traded about 30,000-40,000 shares per day until around February 24th, when volumes soared (a fact that will not be lost on the Financial Industry Regulatory Authority, although increased volumes prior to a merger announcement are not uncommon due to speculation). With such significant institutional ownership and relatively light normal trading volume, it would have been very difficult for those investors to lock in the trading gains experienced by Square 1 from November through February. How do you lock it in? You sell. Even if you are paid no premium. You can still lock in the price appreciation since you bought into the initial public offering.

2. Law of Large Numbers. As Square 1 grew larger, it would have to generate larger and larger amounts of business volume just to keep pace. For example, they had a $1.3 billion loan portfolio, the vast majority of which was commercial business loans. If 25% of that portfolio turned over every year, and I suspect it was more because business loans churn faster than commercial real estate loans, they would have to originate more than $400 million of new and renewed loans per year to *keep pace*. Never mind growth. Which brings me to my third potential reason for selling.

3. Growth Trajectory. Square 1 was trading at 22 times earnings when they sold. Banks their size typically trade around 13-14 times earnings. The premium was most likely the result of their balance sheet and earnings growth. Perhaps Doug and his senior management team were staring down the barrel of normalized growth. As investors began to recognize the slower growth, multiples would intuitively come down to planet earth, suppressing stock price appreciation until the multiple normalized. That could have meant trading in a tight price range for a number of years. Why not lock in your tremendous gain since the IPO, and move on?

Square 1 was truly an extraordinary financial institution and I am sorry to see them go. I held them up as a premier example of how focused effort can lead to superior results.

If Doug Bowers and team were facing normalized growth and stock price appreciation, they could have decided to "cash cow" the bank, turning over a significant part of their earnings to investors in the form of dividends. In 2014, they enjoyed a 1.25% return on assets and a 12.85% return on equity. A great candidate for a cash cow.

But alas, that possibility may have been foreclosed when they backed up the truck to the institutional investor loading dock. They were numbers on a spreadsheet, and they were supposed to deliver the fund managers a big win.

They did.

What else could Square 1 have done to satisfy their investors?