HHR Consultants

A Canary in the Mine? Blackstone Acquires Promontory Interfinancial Network

Henry Heitman, HHR Strategy Consultants September 27th 2019

News broke last week that hedge fund giant Blackstone acquired Promontory Interfinancial Network (PIN) for a reported 2.2 billion in cash. PIN is the largest provider of Brokerage Sweep product services, which fundamentally amalgamate the un-invested cash balances of brokerage customers and place them as FDIC insured deposits with banks. ***The purchase premium Blackstone paid, and the nature of Promontory's business model may be indicators of Blackstone's posture toward equity markets.***

Based on 2011 publicly filed information with the FDIC, when PIN claimed $100 billion in such balances from about 10 brokerage firms of size, a reasonable estimate of PIN's current AUM is between 150 and 200 billion, placing the purchase premium as a percentage of deposits between 1.2 and 1.5%.

For context, purchase prices for Banks over the past 5 years have averaged about 3%, but have trended up to 7% as of 2017 (see exhibit 1), so viewed through that lens, Blackstone found a cheap source of deposits, the fuel that banks run upon.

On the other hand, as a percentage of earnings bank purchase premiums are 18 to 22 x times net earnings (2). By a rough estimate the PE of the Blackstone/ PIN deal to be 25 + times NIAT, roughly 30% more than the bank valuation, when *those* valuations *already* contain a premium. The basic economics of the brokerage sweep business provides a pretax revenue of roughly 8 basis points on average of average assets. Using $175 billion as an estimate of the PIN AUM, revenue would be about 140 million annually, and after expenses and taxes no more than $90 million, producing a P/E of 25x . Blackstone has paid an excess premium of roughly $500 million compared to buying a bank with the same amount of deposits.

In the absence of any comments of any kind by Blackstone as to the strategy behind the deal, trying to fathom what they will do with $175 billion in deposits is a speculative exercise. However, some logical possibilities can be outlined. This author holds the view that given the premium paid, it is unlikely Blackstone will operate PIN under the pre purchase business model for very long.

Here are three theories

1. They believe for some reason they can double or triple assets and leverage the relationships PIN has with what they claim to be 3000 banks. Because there is a finite number of Brokerage firm sweep customers, and nearly all already have a product, this implies new products that fit the PIN business model**.** Products that fit that profile include an entry into the $1 trillion retirement plan Capital Preservation marketplace with an ***FDIC Insured Alternative***.

2. Blackstone may believe they can leverage the position with banks and BDs that PIN has created to get higher deposit rates from banks and/or asking for higher fees from BD's for placing such deposits in their brokerage sweep programs. This two-sided squeeze could materially improve pretax revenues. The success of such a move depends upon the supply and demand for FDIC

insured deposits, and, would imply Blackstone foresees the value of such deposits increasing. Indeed, a good number of banks fund their operations with such brokered deposits and simply cannot sustain their business models without them. ***Blackstone controls at least 25% of the supply*** if we exclude the deposits flowing from BD's to their affiliated banks.

3. Blackstone will buy or start a bank and divert PIN deposits away from other banks and use them to fund the new bank. An exit strategy for Blackstone would be the public capitalization of this enterprise, recouping a large fraction of the purchase price and leaving Blackstone in control of an ongoing enterprise with much more flexibility, including the ability to make and broker loans. ***Blackstone Bank would be the 18th largest bank in the U.S*** and roughly the size of American Express and Ally. UBS, Morgan Stanley, Schwab and Raymond James all operate sizable banks funded in large measure with brokerage cash sweep deposits. Goldman has created a direct bank that was funded in part by Goldman cash balances.

   https://www.bankrate.com/banking/reviews/marcus/

Analysis

In order to place a probability upon each of the three theories as the actual Blackstone plan , it is necessary to place the deal in the context of current and expected market conditions. Economic expansion cannot last forever, and there are a sufficient number of world economic and political exogenous conditions that can trigger a U.S recession. We are already seeing analyses that the FED will have difficulty managing any kind of concomitant fiscal crisis because the key tool of interest rate manipulation has been set to where expansionary impacts by lowering already low rates isn't feasible. In addition, some strange things have been happening in short term financial markets, and essentially a Repo market liquidity crisis two weeks ago triggered the last rate cut. Some analysts think that all feels like the spring of 2008.

Arguably, there is a growing consensus that expects a significant equity market correction sometime between 6 months and 2 years from now. Were such to occur, would any subsector of our financial system be particularly vulnerable, and where liquidity in the form of bank deposits would be a major factor in ongoing viability? Could Blackstone exploit that situation with any of the three tactics above?

Impact on Brokerage Sweep Products

Historically, equity market adjustments disrupt cash and fixed income markets as customers run to safety and downside protection. For example, documents filed in testimony to the FDIC illustrate that brokerage sweep program such as those run by Promontory and now by Blackstone, see a near doubling of account balances (exhibit 2). While brokerage sweep programs are generally very profitable for the BD's, the infrastructure most important is bank capacity, meaning the ability to place customer cash with banks to secure a rate and the FDIC insurance customers expect.

All of a sudden all of the BD sweep programs will need to double their capacity or turn balances away. Deposit rates will have downward pressure and BD's will be incented to pay more for them either through a lower rate on the deposit, and a potential loss of spread in their sweep programs , or in the form of fees to firms like BS/PIN for finding banks that will hold rates or reduce them less. BS/PIN is in a good position to squeeze the brokerage sweep programs, and improve margins at the same time AUM will grow from the increase in balances because ***PIN has existing contracts with banks that lock in deposit spreads to the Fed Funds rate*** for in some cases years to come, providing a hedge against declining deposit rates. Such contracts become very valuable.

Impacts on Retirement Plan cash products

In a similar manner, an equity market adjustment will cause reallocations of retirement program balances from equities into cash products. Stable Value Funds provide roughly $800 billion in cash capacity and Government Money Market Funds about another $200 billion. Assuming similar hydraulics occur in retirement programs as in brokerage programs, Stable Value Funds will need to nearly double their capacity. Stable Value Funds have a special privilege under ERISA regulations that allow for book value valuation versus market price valuation despite the fact that the investments retirement money is invested in are essentially mid-term bond portfolios. The magic ingredient is that an insurance firm (typically) provides a guarantee of both the liquidity of the SV fund to honor redemptions and exchanges, and against any losses from the default of the SV funds holdings.

The number of firms offering such wrap contracts are relatively small in number (less than 20), and some of those also run their own Stable Value Funds and wrap themselves so to speak secured by the general account of the company. During the fiscal crisis wrap capacity dried up, and notable insurance firms like AIG, that were major providers of wrap capacity became insolvent. Stable Value funds had capacity problems, and a number of them closed their doors for new or exchange money, and one even went out of business.

https://www.kiplinger.com/article/investing/T041-C000-S002-stable-funds-in-chaotic-times.html?rid=SOC-email#.XEdzXUn0Drk.email

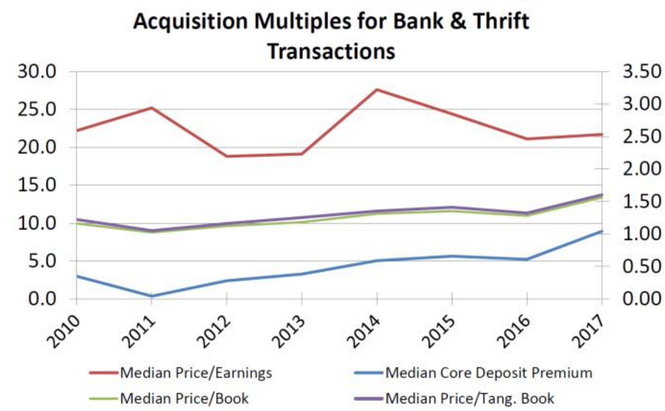
While the fiscal crisis caused the equity correction that led to the spike in cash demands on the SV funds, a less severe economic crisis can still trigger an equity plunge of similar proportions because of the historically stratospheric levels of equity market prices now compared to then. The impact on the SV funds could be quite similar and wrap capacity will need to expand rapidly. Fiduciaries to retirement plans should be skeptical about the wrap markets willingness and ability to meet these demands.

One remedy if wrap capacity can't expand is for the SV funds to place money into cash i.e. bank deposits. Bank deposits instead of wrap capacity are insured by the FDIC, and do not require any special accounting provisions. SV funds can load up on deposits and avoid paying up for wrap capacity they would have to buy instead if cash were invested in fixed income products. Deposits with a favorable spread to Fed Funds would bring ***a premium to whomever controlled the contracts***, which in this case would be Blackstone/PIN for a significant fraction of the supply.

Conclusion

Blackstone's PIN purchase looks to be a solid platform for product expansion if conditions remain much the same as they have been and are now, and an interesting hedge that produces a value if equity markets should experience a major correction. Starting a bank that would rival Goldman's Marcus fueled by deposit contracts now allocated to PIN Brokerage clients seems less likely and would be disruptive to the pre purchase PIN business model. However, paying a premium implies a strategy to recoup it, disruptive or otherwise. Some BD sweep program product executives must be curious what Blackstone's plans are, and so far, Blackstone isn't saying.

Merger &Acquisition Pricing Trends- U.S. Banks & Thrifts



	2010	2011	2012	2013	2014	2015	2016	2017
Median Price/Book (x)	1.16	1.02	1.12	1.18	1.27	1.35	1.26	1.56
Median Price/Tang. Book (x)	1.22	1.05	1.16	1.25	1.34	1.41	1.30	1.60
Median Price/Earnings (x)	22.2	25.2	18.8	19.1	21.4	24.4	20.0	21.7
Median Core Deposit Premium (%)	3.0	0.3	2.4	3.3	4.8	5.7	4.9	8.9

Source: SNL Financial

14

VINING SPARKS
COMMUNITY BANK ADVISORY GROUP

Perspective: FDIC Insured Capital Preservation Products Perform well under pressure

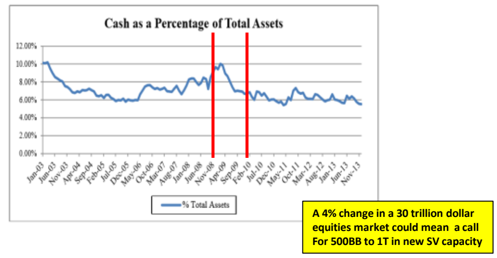
FDIC Deposit Market is 1 trillion in size and resilient

- FDIC Insured Brokerage Cash products have placed an estimated $1 trillion in deposits with hundreds of banks. Such programs grew despite the fiscal crisis

- ***Source: FDIC Website regarding Brokered Deposits***

Cash Moves Quick: Can Stable Value Handle $500 bb More?

- Brokerage cash balances increased 60% amidst market corrections during the financial crisis to 10% from avg of 6%



- During the last major market move several SV funds went under , wrap capacity shrunk when it needed to expand, leaving participants without a true capital preservation product