July 8, 2014

BofI Holding: The Worst is Yet To Come -- Price Target $40 Near Term.

Can't Anyone Connect the Dots?

Bank of the Internet (NASDAQ:BOFI) has been a controversial stock of late, with momentum investors taking long positions, while bloggers point out its rich valuation relative to peers. The stock has nearly tripled since the beginning of 2013. But things have changed – for the worse. Citron believes that many investors in the stock may have missed recent developments which have huge implications on the future of the BOFI. Last month, we saw The Bancorp stock (TBBK) down 30% in one day on a regulatory action that we expect could soon hit BOFI.

While the company will deal with its obvious regulatory issues, investors will be stuck owning a bank that has been playing fast and loose with their book, while showing metrics that should concern any investor concerned with a closer examination.

Huge Regulatory Risk to Stored Value Card Competitors

BOFI operates in a unique niche called the Stored Value Card business. **There are only three major players in the Stored Value Card space**.

BOFI's pending acquisition of H&R Block bank would make it a major player in the Stored Value space. Last month, The Bancorp Bank (NASDAQ:TBBK) became the **second bank to be hit with a Cease & Desist order**, causing a 30% selloff in its stock, a loss it has not recovered.

In 2010 - 11, Meta Financial was issued a C&D order over the same issues. As the storm about this concern intensified, the stock fell by half.

BOFI has just completed its OCC exam, and there is a huge short term risk of a C&D being issued.

Why are regulators so alarmed about Stored Value Cards? Here's a good summary of the issue and the underlying concern about **stored value cards being used to fund terrorist activities.**

http://compliance.csiweb.com/resources/newsletters.aspx?id=148&section=infocus#.U6Gguvmwlas

The Government crackdown on the stored value card business is real and not going anywhere. In a banking industry article published TODAY, we read

> "I would think this action sends a message to every other prepaid issuer that they better be buttoned up on AML processes and work very closely with their clients," Colgan said.

http://www.pymnts.com/in-depth/2014/fdic-takes-action-against-bancorp-and-discover/#.U6JVNtq9KK0

Citron notes that we are not saying that BOFI either supports illicit activities or even that stored value cards do not offer useful service. What we are observing is this area of the business will soon get disrupted and stay disrupted for a long time.

BOFI added to their risk of regulation with their recent acquisition of H&R Block bank. Citron notes that The Street's initial euphoria over the H&R Block deal has completely worn off – the stock rallied from 75 to 100, but has now retraced all the way back to where it was before the deal was announced. The reason? The Street wised up to the reality that nobody else wanted H&R Block's bank because of the regulatory risk – principally, becoming a major player in the stored value card space.

Here's the issue, according to the CFO of a huge credit union who didn't want to be named in the article:

> "It's very difficult for a bank in the Stored Value Card business to comply with the Bank Secrecy Act (BSA - the banking regulation on money laundering) because the bank needs to verify every person who buys a Stored Value card. For example, if they give that card to someone else there are possible compliance problems. Without an over-the-counter deposit and withdrawal system, tracking the stored value cards is difficult. The government is highly concerned with terrorism activity right now and Stored Value represents a high-growth potential problem that needs tight regulation. "

So How Long Would it Take BOFI to Become Compliant After a C&D?

Metabank has spent much of the last three years beefing up its compliance capabilities in this space. It now has well over 100 employees focused on the Bank Secrecy Act. It's taken them three years to install a state-of-the-art system to meet this compliance burden.

BOFI is just getting started in the Stored Value business; the H&R Block acquisition will dramatically increase its exposure. While Metabank has over 100 employees responding to compliance demands, and Bancorp has 20 and is adding 20 more, to comply with its new regulatory order, **BOFI has just 3 employees in compliance**.

All of this has two major implications for BOFI – both of which are highly probable if they are treated similarly to Bancorp and Metabank:

1) Growth in this area will not materialize as fast as expected as it will take time to comply with the order before they can go find new customers
2) Profit margins will be pressured with costs to comply increasing by multiples

How Does BOFI Measure Up Beyond the Regulatory Risk?

1) Credit Cycle Positions in Run-Off

BOFI generated sizeable income by taking on various duration mortgage assets at the bottom of the credit cycle at deep discounts. But the earnings from these assets are now waning. As these assets are run-off, we expect Net Interest Margin to drop by 30bp next year. **With increasing competition in its preferred niche (jumbo stated income [eg "liar"] loans)**, we see EPS starting to shrink – by 10c this coming quarter and 40c in 2014. Citron comments that the resurgence in jumbo "stated income" loans will be left for another day and another story

2) Floodgates of Competition Just Opened in BOFI's Breadbasket Market

BOFI was enjoying a unique market position in the jumbo mortgage niche, but in a little noticed regulatory change, mortgage REIT's now have access to the same borrowing power, and will be entering this space.

3) Interest Rate Risk

Unlike traditional banks, BOFI has fueled its growth by structuring its business based on a massive bet on low interest rate risks. That of course only works as long as …. Interest rates remain low. This warning does not have to be said from Citron. We have recently heard the Fed chairwoman advising investors not to take ultra-low rates for granted.

http://www.marketwatch.com/story/fed-stays-confident-sees-slightly-faster-pace-of-tightening-2014-06-18?link=MW_home_latest_news

Duh! But when that environment turns, it is extremely difficult for BOFI to turn with it. Since BOFI is paying some of the highest rates in the industry for CD's to build its deposit base, the margins are razor thin and the risks are commensurately higher than a traditional bank.

4) Crazy Overvaluation … and In the Bank World (unlike tech) that Means Something.

Despite all this risk, the bank is valued at 3.3x its Book Value, **which is double the industry norm for banking**. If BOFI had an unassailable competitive advantage, maybe such a high valuation could be justified, but in this case, its business model is highly flawed, laced with extraordinary risks, profits are likely to be waning, and the company is being way too aggressive with its extremely low reserve rates.

5) High Profit Portfolios in Runoff

The best days of BOFI profit is behind them as they made a big bet on non-agency mortgage debt when the credit cycle was at its lowest. That turned out to be a profitable gamble, as the credit markets have stabilized and interest rates have remained low. But that strategy is simply not sustainable. There's much more competition at every point in the credit market, and BOFI simply can't make a higher-risk higher-reward bet than its competitors in this environment. In lieu of a superior strategy for generating profits that are immune to competitive factors, it has simply placed a high-risk outsized bet on low interest rates. See below.

6) Floodgates of Competition Opened in Jumbo Mortgages

BOFI had a sweet niche to itself – the jumbo mortgage stated income loans. But as of June 12, the mortgage REIT's now have access to the same funding source – the Home Loan Bank. This makes their cost of capital much lower than BOFI's, and BOFI's position as the prime writer of these loans, based on K-1 or 1099 income.

http://www.snl.com/irweblinkx/file.aspx?IID=103579&FID=24035429

> "Many FHLBank members currently can't offer high-balance, fixed-rate loans to their customers or are forced to sell the loans to a competitor and risk losing the customer relationship," said John Stocchetti, Executive Vice President & Group Head, Mortgage Partnership Finance Program at the FHLBC, which operates the MPF Program for the FHLBank System. "MPF Direct was designed to offer superior execution to the members in a manner that allows them to retain the customer relationship and their deposits. In addition, MPF Direct will add private capital to the secondary mortgage market."

7) Interest Rate Risk: Not a Strategy Worthy of 3.5x Book Valuation

In a nutshell, banks are not supposed to take on interest rate risk any more than a Vegas Sports Book is supposed to bet on one horse in a race. They are supposed to be structured so that most of their rate risk is hedged.

Instead, BOFI sports a staggering -157% Negative Gap Ratio. Most banks are within 10% or 20% of zero. Any steep interest rate rise would obliterate earnings.

Because it is an internet bank, customer loyalty can be deemed to be far lower than brick-and-mortar banks. A few months ago, if you were shopping for the highest possible rate of return on your risk free assets, BOFI CD's appeared at the top of the list. For example, if you went to bankrate.com a couple of months ago and clicked on "Best CD rates" in the country, BOFI may have come out on top, sporting some of the best rates for a given CD or checking account. But if you go there now, BOFI doesn't even show up in the Top 10, and oftentimes not in the Top 20. BOFI has clearly backed off the market and this may affect deposit growth dramatically. BOFI Is clearly cutting back, probably because it realizes it has too much interest rate risk.

If BOFI continues this strategy, then its high growth rates are a thing of the past, and BOFI's price multiple should come way down to reflect this.

This appears to be a strategy devoid of strategy. Online depositors are likely to be far less "sticky" as customers. They choose an online bank based on returns, not features or services like branch networks. **Higher cost made up 49.8% of BOFI's deposits on a recent quarter. Compare that to Wells Fargo, whose ultra low-cost "core deposits" comprise over 80% of its asset base, at a net cost of 0.17%.**

Here is a brief comparison table:

Bank	Savings and Checking Deposits as a Percentage of Total Deposits	Cost of All Deposits
Bank of America	83%	0.17%
Wells Fargo	80%	0.14%
Everbank	69%	0.76%
BofI Holding	**50%**	**1.07%**

Another risk of a strategy tilted completely towards a low-rate environment is that when these rates rise, BOFI's inducement rates don't seem so compelling. Put another way, a 0.71% interest rate on checking looks generous compared to zero or 0.10%, but 1.7% compared to 1.1% doesn't seem so compelling.

8) The growth in accounts is not only slowing, it's reversing. This should be alarming to investors

Below are the total number of Deposit Accounts from BOFI's 10-Qs for each of the last nine quarters.

Total number of Deposit Accounts

	Total	**Quarterly Change**
3/31/12	32,833	
6/30/12	32,272	(561)
9/30/12	33,312	1,040
12/31/12	35,196	1,884
3/30/13	35,414	218
6/30/13	34,670	(744)
9/30/13	40,943	6,273
12/31/13	39,091	(1,852)
3/31/14	38,629	(462)

But in June 2013, BOFI acquired 8,400 accounts from Principal Bank. Adjusting for these produces the following stream of organic-based growth in accounts:

Total adjusted for Principal Bank Deal

	Total	**Quarterly Change**
3/31/12	32,833	
6/30/12	32,272	(561)
9/30/12	33,312	1,040
12/31/12	35,196	1,884
3/30/13	35,414	218
6/30/13	34,670	(744)
9/30/13	32,543	(2,127)
12/31/13	30,691	(1,852)
3/31/14	30,229	(462)

Over the last 4 quarters, the number of organic-based accounts has dropped 15% - from 35,414 to 30,229! How does this reconcile with the growth in deposit amounts over this time period? What does this say about the business model and BOFI's ability to continue to grow at a breakneck pace?

9) Crazy Bank Valuation Considering the Business

Over the past several quarters, BOFI has reduced its reserves for Non-Performing Loans (NPA's) to 60 basis points. How they could be so aggressive? Has BOFI become dependent on reducing reserves to make its quarterly numbers? Why do most brick-and-mortar banks, who arguably have every reason to have better knowledge of their customers and better underwriting, typically reserve 180 basis points? **At 60 basis points, there is virtually no room for error.**

In fiscal 2013, which ended June 30, the company pocketed $22.9 million in mortgage banking fees, a nearly 500% increase since 2011. This goosed EPS growth, which increased by a more modest but still impressive 55% during the same period. Put another way, as mortgage banking income increased by $18.2 million in the last two years, income before taxes increased by $34 million. Clearly, mortgage banking has been an important part of the company's recent growth story. **A 35% decline in total originations across the industry versus the first half of the year along with continued headwinds in 2014 will make it difficult for the company to repeat this performance.**

Another issue is the structured settlements business, which they mostly keep on balance sheet. We believe that the OCC may at some point have issues with life settlements business (which Citron was covered in great detail in the past via: Life Partners Holdings). There is a reason most conservative banks don't touch loans in this sector.

While the earnings growth numbers may have been "goosed" by high deposit rates, and non-traditional lending models have been high, it seems the building blocks of this institution are less than solid. There is a reason why successful banks grow slowly. Each loan is looked at as a contributor to a long-term relationship. A customer is not an algorithm.

Finally we compare book values of competitors to BOFI.

Price/ Book Value Comparison: 2x to 3x the book value of any traditional competitors

	P/BV
Bank of Internet	**3.3**
Wells Fargo (WFC)	1.7
Pacific Premier (PPBI)	1.3
Banner (BANR)	1.4
Wintrust (WTFC)	1.2
Umpqua (UMPQ)	1.1
Provident (PROV)	1.0
Everbank (EVER)	1.6

Price/ Book Value Comparison 2x to 3x the other "Stored Value" competitors:

	P/BV
Bank of Internet	**3.3**
The Bancorp	1.2
Metabank	1.6

While it is easy to rapidly increase assets through this model, non-performing loans always tick up when credit turns. However, in this case there is the potential of a double whammy. If credit turns, the bank has problems; if interest rates go up, the bank has big problems; if regulators have an issue with the aggressive growth or stored value, the bank has huge problems. Citron believes that at 3.3 times book and 25 times earnings, an investment in Bank of The Internet, with a high possibility of a regulatory action on the way, does not justify the risk.

Conclusion: Why Now?

We all know that nobody cares about valuation in a bull market. So what justifies Citron's opinion that BOFI stands teetering on a cliff? The precipitating event, in Citron's opinion, will be the Cease and Desist Order from their regulators. Will this cause BOFI to renege on the H&R Block acquisition, or just bite the bullet and pay up for a real compliance program?

Either way, this adverse event is going to cause a lot of pencils to sharpen with regard to the other metrics of this fast and loose bank. And when they do, they will be shocked at the way BOFI has indulged in all sorts of outlier transactions in order to goose short-term earnings, at the expense of building a "real" bank.

As a final observation, Citron notes that these risky portfolio choices are not occurring outside of a context. BofI's CFO Andrew Micheletti served as Controller, and Vice President, Financial Reporting for **Imperial Savings**. – which was seized by the Government in 1990, awash in a defaulted junk bond portfolio, the second largest in the nation.

And its little comfort that CEO Gregory Garrabants lists on his bio "senior vide president and the head of corporate business development at the naton's seventh largest thrift …" while failing to mention that that was no ordinary bank – it was **IndyMac**, the nation's fifth largest bank failure ever. While neither can be blamed directly for the failure of their institutions, there is no substitute for disclosure.

And the inspiration for this kind of edge-play certainly seems to have its roots in history.

Cautious Investing to All