CASE STUDY: YOUNGSTOWN BANK

(Adapted from Greenbaum, Thakor, & Boot. 2016. Contemporary Financial Intermediation 3rd Ed.)

Introduction

John Standard has been the CEO of Youngstown Bank since the summer of 1998. Before taking this position, he had been a vice president of operations for Interbank, a large regional bank. One of the primary reasons that he was hired by Youngstown Bank was his experience with a large operating department. At the time, Youngstown Bank had been going through some difficulties related to inefficient operating procedures, and Mr. Standard had acquired a reputation at Interbank for strong motivational and organizational skills. His management of Youngstown has been almost flawless, and the institutional culture of the bank takes great pride in the fact that the bank is a very "tight ship."

Youngstown Bank has been in business in Youngstown, Arizona, since 1910. When John Standard was brought in as CEO in 1998, the stock price was at 4½, down from a high of 10. The previous CEO was the son of the founder, and he had resisted the replacement of legacy systems with more modern information processing infrastructure, allowing the operating departments to languish in mediocrity. Prior to Mr. Standard's arrival, people barely even knew what the bank's policies were on loans! The only kinds of products Youngstown Bank offered were simple fixed-rate loans. John Standard changed all that. He put together a set of standard procedures for loans and loan commitments, and attempted to tailor the bank's policies to the risk and liquidity needs of its customers. And the stock price responded; by the end of 1999, Youngstown Bank's stock price had doubled to $9, and continued to rise through 2000.

But starting in 2001, the bank's stock price has been languishing. Even though the bank's basic structure has not changed and profitability is good, the stock price has simply not moved upward over time, although the stock prices of some competing banks have moved up significantly. The major shareholders in the bank aren't too upset yet, but there have been a few grumblings. Standard realizes that there could be major trouble down the line unless he can find a way to get the share price up. He decides to call in his chief financial officer (CFO), Bryan Shelton, to discuss the stock price situation.

The Initial Meeting

Standard : Come on in, Bryan, and have a seat. Let's get right down to business here. I'm worried about our stock price performance lately. You've been with Youngstown Bank for three years now – what was the stock price when you got here?

Shelton : It was right around 37, I think.

Standard : Well, it is just over 40 now. We closed at 40 ¼ yesterday. That's only 3 dollars in 3 years! What is going on? I don't understand it. Why is our stock price so low? Take a look at how our market-to-book ratio compares with that of our competitors. It is in the dirt! (See Exhibit A). Why?

Shelton : That's a good question. Considering how precisely we control everything, and considering that our profits and cash flows are still looking good, I don't know of any reason why the stock should be down. I'm tempted to just say that the market is failing to recognize our value. Maybe they'll come around when we post good numbers again next quarter.

Standard : Well, you might be right, but I'm uncomfortable. Maybe the market is reacting to something that we don't know about. I think we should look into this some more, and try to get to the bottom of it. [The meeting ends on that note, and Mr. Shelton says that he will look into the matter carefully and report back. He agrees that they should meet a week later to discuss the issue again.]

The Second Meeting

Shelton : Well, I've looked into this some more, and frankly I'm still puzzled. Take a look at these numbers. Our current balance sheet looks good, and compares very favorably with the way it looked during 2000, the heyday of our stock price rise (see Exhibit B). Our key rations look just fine, too, compared to 2000 (see Exhibit C). Moreover, we also seem to be doing well relative to industry averages (see Exhibit D).

Standard : This all looks great, just like I thought it would. Look at this one. (He points at Exhibit D.) Our return on assets is great. So what do you think?

Shelton : Well, one of the people I had helping me to put these numbers together for you suggested that we might want to think about our loan commitments, which don't appear on our balance sheet. Maybe those are dragging our stock price down.

Standard : That doesn't make sense. Our policies on loan commitments haven't changed, have they? What kind of data do you have on those?

Shelton : Well, take a look at these. (He pulls out Exhibits E and F.) These show the history of interest rates and the fees that we charge for loan commitments. I checked on the kinds of borrowers who've been buying these commitments, and the quality of the borrowers seems to be in line with our history. To tell you the truth, I'm still struggling with what all this stuff means. I don't see that anything has changed anywhere. But our stock price. . .

Standard : Well, all I can tell you is keep working on it. See if you can find anything here that will help explain why our stock price is low. Is there something that we've overlooked? Is the bank in some danger that we've failed to realize? [Again, the meeting ends and they agree to meet in a week. This time, Standard has some specific questions to which he wants answers. Shelton plans to go over everything carefully, looking for some explanation for the poor performance of the stock price, an explanation that takes into account all the facts about the bank's situation.]

The Assignment

Mr. Standard gives Mr. Shelton these specific questions:

1. Explain the difference between the bank officer's and the market perception of the the value of the bank's shares. Identify key factors for each position.

2. Does the stock price indicate any dangers the bank may face? If so what strategies could offset those dangers, and which should the bank adopt?