

# Blazing BDC To Boring Bank? The Newtek Controversy Explained

Aug. 29, 2021 7:00 AM ET | NEWT, NEWTI... | A, ALLY, ARCC... |

106 Comments | 89 Likes

## Summary

- Newtek shocked investors with an announcement they'd be converting from a BDC to a bank holding company. A similarly surprising event occurred in 2014 when Newtek converted to a BDC.
- Newtek's stock collapsed by roughly 30% intraday and has only modestly recovered. Opinions are sharply divided and this article seeks to provide a balanced analysis of the situation.
- Let's explore how Newtek arrived at this decision, how the company might look in the future, and if an investment in the transformed company makes sense.
- This idea was discussed in more depth with members of my private investing community, iREIT on Alpha. [Learn More »](#)



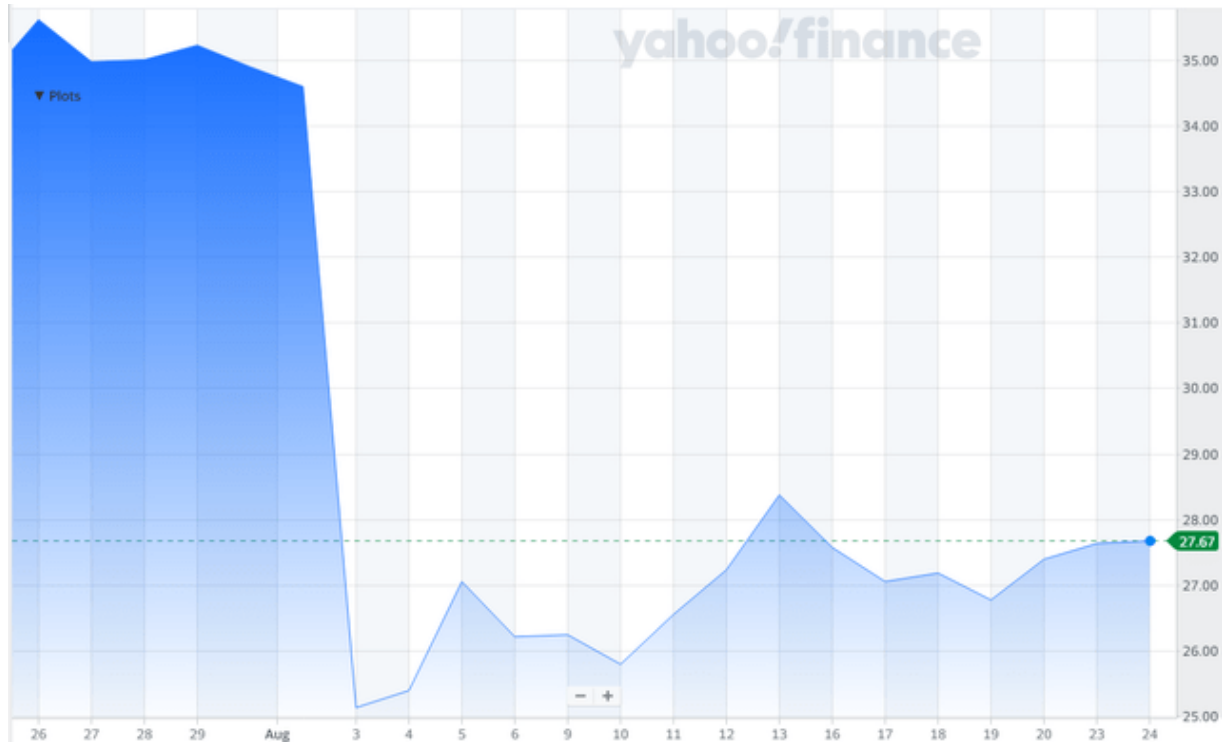
Nikolay Pandev/E+ via Getty Images

*This article was co-produced with Williams Equity Research ("WER").*

More market-moving news was announced for **Newtek Business Services Corp.** ([NEWT](#)) in the month of August than in several past years combined.

That encompasses more than the proposed conversion from a Business Development Company ("BDC") to a bank holding company, but that is seemingly what moved the stock.

Don't take my word for it; take a look at the below one-month chart of NEWT.



Source: Yahoo! Finance

You guessed it, the fall from \$35 to \$25 per share was the day the announcement was made. Dire articles suggesting a minimum dividend cut of 40% were quick to follow.

This was not the only recent news we should pay attention to, however. *Today's article will be a little different than the typical quarterly update as we are going to tackle three questions simultaneously.*

First, what are the pros and cons of the proposed conversion from a BDC to a bank holding company?

Second, we'll discuss what are the theoretical motivations for the change and whether these theories make sense.

Lastly, we'll evaluate how Newtek performed in Q2 and what are our expectations going forward, regardless of the company's structure.

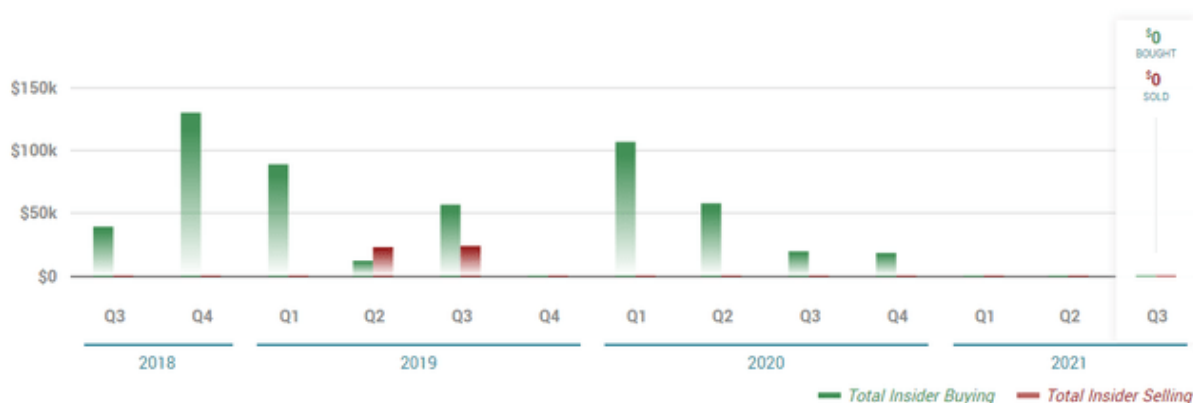
## **Who Was More Surprised, Management or Shareholders?**

There are often valuable nuggets of information and perspective buried in the wasteland of website comment sections, Seeking Alpha included. In this case, the comments surrounding the conversion of NEWT away from a BDC aligned perfectly with the ~30% intra-day drop in the stock price: *extreme displeasure*.

If these comments were the only available information, you would have bet, and with high confidence, that the stock experienced a serious decline.

This begs the question: *why would management voluntarily take action that caused nearly one third of their company's market capitalization to evaporate?* It could be that an unethical external manager devised a plan to extract more fee income from the company long-term. It wouldn't be the first time. Not the case here - NEWT is one of the few internally managed BDCs.

INSIDER BUYING AND SELLING BY QUARTER



Source: [MarketBeat](#)

Not only that, but insiders purchased shares in every single quarter of 2020 and the last sell transaction occurred in Q3 of 2019. Maybe it's everyone but the decision maker picking up shares without knowing the full story?

#### NEWTEK BUSINESS SERVICES (NASDAQ NEWT) INSIDER TRADING HISTORY

Transaction Date	Insider Name	Title	Buy/Sell	Number of Shares	Average Share Price	Total Transaction	Shares Held After Transaction	Details
11/18/2020	Barry Sloane	CEO	Buy	1,000	\$17.95	\$17,950.00	1,055,094	
9/9/2020	Barry Sloane	CEO	Buy	1,000	\$19.23	\$19,230.00	1,054,094	
5/18/2020	Barry Sloane	CEO	Buy	1,000	\$15.28	\$15,280.00	1,052,594	
5/15/2020	Richard J Salute	Director	Buy	500	\$14.35	\$7,175.00	16,344	
5/14/2020	Barry Sloane	CEO	Buy	1,000	\$13.00	\$13,000.00	1,052,094	
5/13/2020	Gregory L Zink	Director	Buy	500	\$13.91	\$6,955.00	13,304	
5/12/2020	Barry Sloane	CEO	Buy	1,000	\$15.03	\$15,030.00	1,050,594	
3/20/2020	Barry Sloane	CEO	Buy	1,000	\$10.64	\$10,640.00		
3/18/2020	Barry Sloane	CEO	Buy	1,000	\$8.19	\$8,190.00	1,048,594	
3/18/2020	Richard J Salute	Director	Buy	1,200	\$10.19	\$12,228.00		

Source: MarketBeat

The CEO, Barry Sloane, is listed more than anyone else and that's the case no matter how far you go back (part of that is due to his compensation structure, but it is still true). He owns over 1,000,000 *shares* of Newtek stock. Mr. Sloane has been the CEO of Newtek since 1999 and his last reported total annual CEO compensation was around \$1.5 million.

This all to say that on the day the news was announced, *Mr. Sloane personally absorbed a hit to his net worth of \$10 million or over six years of his average annual total compensation*. It's recovered a little since then as the stock has traded back to \$27, but not much. [In aggregate](#), senior management and the Board own over 5.0% of all outstanding shares.

So, if it isn't in the CEO and Chairman's personal best interest, and there isn't any behind-the-scenes scheme involving an external manager, why on earth would management take this course?

There are only two options, and one assumes management is incompetent (or worse). That's hard to get on board with given Newtek is one of the best performing BDCs in history, and is even a top performer among small cap stocks (it has easily surpassed the performance of both the Russell 2000 and S&P 500 for well [over a decade](#)).

For context, as of August 5th, Newtek was up 42% year-to-date ("YTD"). Not bad against the S&P 500, and massive outperformance relative to BDCs (or most banks). Its three-year return of 71% is even better, as that absorbs all of the pandemic panic of 2020.

▪ **Total return as of August 5, 2021 (including reinvested dividends)**

10-Year Total Return <sup>(2)</sup>		5-Year Total Return		3-Year Total Return		1-Year Total Return	
NEWT	754.7%	NEWT	222.7%	NEWT	71.8%	NEWT	50.3%
S&P 500	352.1%	S&P 500	125.1%	S&P 500	64.7%	S&P 500	35.1%
Russell 2000	258.2%	Russell 2000	93.7%	Russell 2000	38.9%	Russell 2000	46.1%

<sup>(1)</sup> Source: total return data from Bloomberg as of August 5, 2021

<sup>(2)</sup> Includes the period before becoming a BDC

Source: Newtek Q2 2021 [Earnings Release](#)

The five-year return of 222% is where things start to get a little silly, but the icing on the cake is the *10-year return figure of 755%*. As the CEO pointed out in the most recent [earnings call](#), a 10-year return of a company paying a steady 10% annual dividend is 200%.

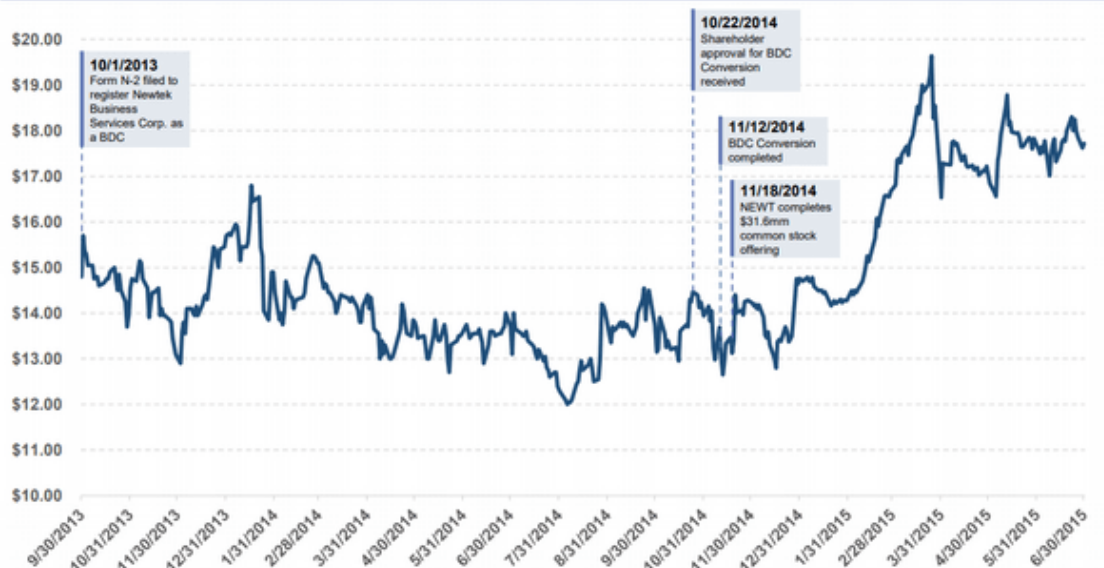
NEWT has generated an excess return of 554% *above and beyond* a company paying a 10% annual yield. The company *shattered* expectations in 2020 and continues to do so in 2021 (as we'll discuss later). It is hard to reconcile that kind of consistently impressive revenue and cash flow growth with a management team that doesn't know what they are doing.

The other option is management did not anticipate this kind of reaction and or expects it to reverse over time. Otherwise, it makes no sense. You can probably guess which we think is the case.

## Stock Performance: Rotation of Our Shareholder Base Upon Conversion to BDC in 2014

**Newtek**  
Your Business Solutions Company

NEWT Closing Stock Price: 9/30/2013 – 6/30/2015<sup>(1)</sup>



Source: Newtek [Second Addendum](#) to August Earnings Report

This same management team made the decision to convert to a BDC in November of 2014. As shown in Newtek's own chart, it took a few quarters before the "rotation of our shareholder base" completed and the stock saw new highs.

The same management team, by the way, grew the \$3.15 dividend projected for 2021 by 53% *year-over-year*. That's on top of a similarly impressive growth metric from 2019 to 2020. With that, let's move on to the first of the three major items for this article.

## What Is A Bank Holding Company, Why Is Newtek Becoming One, And Is It Really Better Than A BDC?

Those are excellent questions and we'll walk through each one. First, a [bank holding company](#) is what it sounds like: a corporation that owns a controlling interest in a bank but does not function as one.

For example, Bank of America (NYSE:[BAC.PK](#)) and JPMorgan Chase & Co. (NYSE:[JPM](#)) are banks but are operated by holding companies. Bank holding companies fall under the domain of the Federal Reserve while banks without an overseer are primarily regulated by the Office of the Comptroller of Currency.

A good example of a well-known holding company is Berkshire Hathaway (NYSE:[BRK.A](#)) (NYSE:[BRK.B](#)).

[Upon the acquisition](#) of National Bank of New York City, Newtek had no choice but to become a bank holding company.

It is worth reiterating a couple points. Newtek decided to become a bank holding company the instant it agreed to buy National Bank of New York City - there was no separate decision.

Additionally, the conversion away from a BDC *does not automatically result in nor require any changes* to its current business activities outside of what's involved in managing National Bank of New York City. Newtek already operates more like a bank than a BDC and that's evident from a five-minute review of any quarterly filing.

So why did the stock price fall dramatically and fail to recover?

As a BDC, Newtek is required to distribute 90% of taxable income to investors. There are numerous misconceptions about BDCs and REITs suggesting they cannot retain earnings because of this rule.

Without exception, these individuals do not understand or at least do not convey an understanding of what taxable income represents from an accounting or tax perspective.

Many REITs and BDCs have annual cash flow payout ratios in the 60-80% range - this immediately indicates that there is significant retained income.

Oddly, I've seen the same individuals claim REITs and BDCs have "unsustainable" business models because they must pay out all their cash flow in distributions then go on to criticize companies of those types for having payout ratios above 80%. Then again, we live in a confusing world.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2021	2020	2021	2020
Investment income				
From non-affiliate investments:				
Interest income - PPP loans	\$ 25,512	\$ 34,657	\$ 49,720	\$ 34,657
Interest income - SBA 7(a) loans	6,248	6,189	12,197	13,511
Servicing income	2,787	2,777	5,527	5,492
Other income	1,269	303	2,383	1,209
Total investment income from non-affiliate investments	35,816	43,926	69,827	54,869
From non-control investments:				
Interest income	124	—	248	—
Dividend income	21	20	47	40
Total investment income from non-control investments	145	20	295	40
From controlled investments:				
Interest income	576	480	1,109	937
Dividend income	51	2,268	51	6,650
Total investment income from controlled investments	627	2,748	1,160	7,587
Total investment income	36,588	46,694	71,282	62,496
Expenses:				
Salaries and benefits	5,926	3,740	10,376	7,187
Interest	4,968	4,604	10,040	9,788
Depreciation and amortization	79	104	164	219
Professional fees	819	1,207	2,047	2,171
Origination and loan processing	2,998	2,722	5,969	4,546
Origination and loan processing - related party	4,510	3,095	7,653	5,733
Change in fair value of contingent consideration liabilities	—	—	—	54
Loss on extinguishment of debt	—	—	955	—
Other general and administrative costs	1,706	1,475	3,341	3,333
Total expenses	21,046	16,947	40,545	33,031
Net investment income	15,542	29,747	30,737	29,465
Net realized and unrealized gains (losses):				
Net realized gain (loss) on non-affiliate investments - SBA 7(a) loans	11,414	(1,214)	18,807	3,299
Net unrealized appreciation (depreciation) on SBA guaranteed non-affiliate investments	(1,983)	(200)	2,410	(383)
Net unrealized appreciation (depreciation) on SBA unguaranteed non-affiliate investments	198	(1,633)	1,585	(6,144)
Net unrealized depreciation on controlled investments	(7,920)	(82)	(5,545)	(10,871)
Change in deferred taxes	1,356	29	723	2,940
Net unrealized appreciation (depreciation) on non-control investments	(3)	—	524	0
Net unrealized depreciation on servicing assets	(1,193)	(1,180)	(1,706)	(92)
Net unrealized depreciation on derivative transactions	(37)	—	(37)	—
Net realized and unrealized gains (losses)	\$ 1,832	\$ (4,280)	\$ 16,761	\$ (11,251)
Net increase in net assets resulting from operations	\$ 17,374	\$ 25,467	\$ 47,498	\$ 18,214
Net increase in net assets resulting from operations per share	\$ 0.77	\$ 1.22	\$ 2.12	\$ 0.88
Net investment income per share	\$ 0.69	\$ 1.42	\$ 1.37	\$ 1.42
Dividends and distributions declared per common share	\$ 0.70	\$ 0.56	\$ 1.20	\$ 1.00
Weighted average number of shares outstanding	22,524	20,893	22,431	20,815

See accompanying notes to consolidated financial statements.

Source: SEC.gov

Speaking of accounting, this is the income statement from Newtek's Q2 10-Q filing. I highlighted all line items mentioning depreciation, the only non-cash expense of any importance.

Unlike REITs and some BDCs, there isn't much here.

The chief "Depreciation and amortization" line item is \$79,000. Not \$79 million, \$79 *thousand*. Because Newtek doesn't usually have a material amount of non-cash charges, its taxable income is relatively high compared to its operating income. *As Newtek has rapidly expanded its business, it has been necessary to increase its dividend payouts proportionately.*

As a bank holding company, this rule will no longer apply and Newtek can retain as much of its earnings (in the literal sense, not necessarily per U.S. GAAP) as it likes.

This strikes fear into the heart of income investors, and the stock sold off as a result. This reaction makes little sense long-term, however, as Newtek's intrinsic value *does not change* based on its dividend payout ratio. The value to an arbitrary income investor certainly might, but not its *market value*.

Provided NEWT was reasonably priced at \$35 as a BDC, it is very difficult to argue that it is now worth \$27 simply because it no longer must pay out 90% of taxable income to investors.

This is especially true because Newtek has an excellent return on equity, as suggested by its almost unrivaled three-, five-, and 10-year performance statistics (more on that in the valuation section). *Over time, we'd expect other types of investors to fill the gap created by income investors fleeing their ownership interests.*

There has been speculation that Newtek is moving toward a traditional corporation independent of the bank acquisition and constraints of the BDC structure. I won't attempt to cover all the theories (there are some interesting ones...), but a popular one revolves around cost of capital.

The idea is that the cost of capital for BDCs is more expensive than what Newtek could achieve as a bank. This isn't without some merit, as the mere existence of [NEWTL](#) and [NEWTI](#) confirms. Newtek has issued several tranches of baby bonds over the years with coupons between 5.50% and 6.25%.

The problem with this thesis is there is no evidence to support it. In an article focused on Golub Capital BDC ([GBDC](#)) published in [March of 2021](#), we noted that BDC issued \$400 million in unsecured notes maturing in 2026 at a 2.5% fixed interest rate. Ares Capital Corp. ([ARCC](#)), another BDC, has bonds maturing [in the same year](#) with a 2.150% coupon (the bonds now trade above par too, meaning their effective yield is even lower). Unambiguously, the BDC wrapper is not a roadblock to cheap debt financing.

*The idea that NEWT must convert from a BDC to a bank to raise cost efficient capital doesn't hold water in our opinion.* NEWT's cost of capital is based on its liquidity, credit profile, asset base, and the durability of its ability to service debt obligations. None of that changes except a potential improvement in its ability to service debt by loosening the requirements of its required distribution to investors.

We've read our fair share of S&P and Moody's credit reports, and that's not a reason why companies are upgraded or downgraded because the distribution can always be cut as needed.

For the last piece of this specific puzzle, some have said management has been unable to issue equity and that has strangled CapEx. Shares outstanding increased by roughly 8% in the past year from 20.82 million to 22.43 million.

As of June 24, 2020, the company had sold 1,716,517 shares of its common stock under the Amended 2019 ATM Equity Distribution Agreement and received net proceeds of \$37.6 million.

Per the [latest 10-Q](#), Newtek only sold 1.72 million of the 3.0 million shares available under its previous equity issuance program. As of June 30, 2021, there were still 1,546,951 shares of common stock under the 2020 ATM Equity Distribution Agreement.

The following table summarizes the total shares sold and net proceeds received under the 2020 ATM Equity Distribution Agreement:

	Six Months Ended June 30, 2021		Year Ended December 31, 2020	
Shares sold		430,470		1,022,579
Net weighted average price per share	\$	20.93	\$	17.95
Net proceeds	\$	9,011	\$	18,334

The Company used the net proceeds for funding investments in debt and equity securities in accordance with its investment objective and strategies.

Source: Newtek Q2 2021 10-Q

At least until this ATM program is exhausted, there's no evidence that management can't acquire permission to issue more shares. Since NEWT trades at or near the highest premium (~70%) to NAV of the BDC sector (even after the recent drawdown), the ATM equity issuance makes significant accounting and economic sense.

Every share sold well above NAV is *immediately* accretive from a financial perspective. That's not to say it's the perfect way to raise capital in every scenario, but there's nothing here that explains the desire to convert away from a BDC.

Management could be reacting to a future situation in which they believe issuing shares will no longer be economical or possible, but now we are digging several layers into speculation. As a side note, in Q2 of 2021, Newtek purposefully kept earnings at the portfolio company level at the portfolio companies and did not pull them "up" into the BDC.

That has the effect of reducing the current required distribution, increasing future distributions, and increasing cash available for general purposes. Newtek has levers to pull to manage its distribution requirements and CapEx needs.

Another potential driver of the move away from the BDC company structure are the restrictions it places on corporate activities. Outside the often-discussed regulated investment company ("RIC") 90% rule, BDCs are also subject to **much lower** leverage limits than banks.

The types of businesses they can engage in, while still broad, are narrower than a bank holding company. The 70% minimum of a BDC's assets that must be invested in private companies comes to mind, as does the same minimum required to be invested in U.S. companies.

Mr. Sloane mentioned in the **quarterly call** he anticipates the conversion to a bank holding company to:

*...potentially broaden our investor base to include more institutional stock ownership, investors that invest in index funds comprised of companies included in indices such as the Russell and S&P, and investors that have been discouraged from investing in BDCs due to the acquired fund fees and expenses (AFFE) rule.*

There is at least some merit to this expectation, but we won't have hard data until after the conversion takes place. As it stands now, many BDC investors indisputably ran for the hills but investors *dependent on* the conversion's completion cannot yet take their place.

To be fair to Newtek, I don't see any practical way to avoid this temporary conundrum. In fact, this is the same situation Newtek faced when it originally converted to a BDC in 2014.

The double taxation of the traditional C-corporation is a significant potential negative compared to the one layer of taxation attributable to BDCs (and REITs), but C-corp investors may qualify for lower tax rates on their dividend income.

That won't matter if you are investing qualified money only, but the ordinary tax rate on BDC income received in a retail/individual account can really put a dent in after-tax returns.

## **If You Can't Beat Them, Join Them, & Q2 Results Analysis**

This is one of those axioms that is easy to say but rarely implemented. Most humans prefer to fight a losing battle rather than admit defeat, much less join the other side. In the case of Newtek, a good portion of their business activities, particularly in 2020, are directly tied to the government.

Newtek is actively and successfully capitalizing on the expansion of SBA 7(A) small business and PPP loans. As the government seemingly encroaches on more and more areas of the economy (whether you are a big fan or have a different take), Newtek is happy to step in and collect a new revenue stream.

As much as it personally annoys WER, the trajectory of the government's influence in the economy is growing at a trillion-dollar pace. The money claimed to be spent on the coronavirus alone is [nearly \\$3 trillion](#). That's on top of the estimated [\\$1 trillion](#) in projected federal infrastructure spending.

In all, the estimated \$6.6 trillion spend by the federal government in 2020 equates to 31.6% of that year's [Gross Domestic Product](#) ("GDP"). Trillions of dollars are being moved around by the federal government, and an investment in Newtek allows us the possibility of receiving a few dollars of that tax money back in our pockets.

The acquisition of 100% of National Bank of New York City equity cost Newtek \$20 million and was valued at 1.0x tangible book value. That's an *excellent evaluation* in today's market.

Newtek paid for NBNYC in cash and expects to close on the deal in six to 12 months. NBNYC's Board of Directors will resign (Newtek's will be control) but senior management will remain in place and continue to operate the company.

### Illustrative Bank Subsidiary and Consolidated Capital Summary

#### Newtek

*Holding Company Level - Consolidated*

#### Newtek Bank & Trust

*Banking Subsidiary*

TOTAL ASSETS	~\$1.4 billion		TOTAL ASSETS	~\$865 million	
TCE RATIO	~17.8%	$\left( \frac{\$213\text{mm}}{\$1,201\text{mm}} \right)$	TCE RATIO	~17.7%	$\left( \frac{\$153\text{mm}}{\$864\text{mm}} \right)$
TIER 1 LEVERAGE RATIO	~17.8%	$\left( \frac{\$213\text{mm}}{\$1,201\text{mm}} \right)$	TIER1 LEVERAGE RATIO	~17.7%	$\left( \frac{\$153\text{mm}}{\$864\text{mm}} \right)$
CET1 RATIO	~21.5%	$\left( \frac{\$213\text{mm}}{\$992\text{mm}} \right)$	CET1 RATIO	~19.2%	$\left( \frac{\$153\text{mm}}{\$796\text{mm}} \right)$
TOTAL CAPITAL RATIO	~22.8%	$\left( \frac{\$226\text{mm}}{\$992\text{mm}} \right)$	TOTAL CAPITAL RATIO	~20.5%	$\left( \frac{\$163\text{mm}}{\$796\text{mm}} \right)$

Source: Newtek Second Addendum to August Earnings Report

The publicly traded stock is described by the data on left of the above chart. The \$1.4 billion in total assets represents significant growth for what remains a small company.

Total investment income ("TII") for Q2 2021 was **\$36.6 million** or a 21.6% decrease compared to Q2 of 2020. Adjusted net investment income ("ANII") held up better and saw a decline of 12.3% over the same period. These are still strong numbers compared to past years, but particular quarters in 2020 included non-recurring revenue that bolstered results.

If we compare the first half of 2020 to the first half of 2021, the metrics smooth out. TII for the first half of 2021 was 14.1% greater than TII in the same period last year. NII rose 4.4% over the same period but declined 3.5% on a per share basis due to equity dilution.

ANII, the final earnings metric we like to use when evaluating Newtek, was **\$2.25 per share** in the first half of this year or an increase of 42.4% on a per share basis compared to the first half of 2020.

As you skim over those data points, it becomes evident that nuance is necessary to see the forest for the trees as results are more volatile (mostly due to **uneven distribution** of PPP income) than your typical BDC invested almost exclusively in stable first lien loans. Overall, Newtek continues to rapidly grow cash flow and NAV per share.

Pro forma leverage was **1.16x debt-to-equity** and the total investment portfolio increased by 7.4% to \$696.1 million. This is slightly above the peer average for BDCs at the moment, but is not elevated or worrisome.

Critically, the **net asset value** per share grew by 6.0% from \$15.45 at the end of 2020 to \$16.38 per share last quarter. Shares outstanding have risen modestly from 20.815 million to 22.431 million in the past year, as noted previously.

## **Valuation As A BDC Or Bank**

Whether a bank holding company or BDC, Newtek will be valued based on its projected cash flows and its market value compared to its book value. 2020 was an unusual year for most companies, but it that was even truer for Newtek.

We do not anticipate certain business silos, like PPP loans, to meet last year's numbers. That said, we'll start this exercise assuming NEWT remains valued as a BDC, as that's the prudent thing to do. We'll finish the section with adjustments if the conversion to a bank holding company occurs.

Newtek [reaffirmed](#) the 2021 annual dividend to \$3.0-\$3.30 per share or an *11.6% current yield* at the midpoint using today's stock price. This same data indicates that there is \$1.05 per share in remaining dividends for 2021 - that's an *eye-opening 123.4% increase* over the Q4 2020 dividend of \$0.47 per share. Management stated in the [last quarterly call](#) that they'd provide "additional transparency and forecast a dividend for Q1 2022."

Given Newtek's cash flows have a strong correlation with their dividend, this will tell us a lot about their expectations regarding next year. In aggregate, we think applying a moderate 10-20% growth rate on *2019 financials* is the conservative and correct play in our view. 2020 is too much of an anomaly and future performance is more likely to resemble 2019, regardless of whether the bank acquisition is approved.

We are going to tackle valuation three ways: *cash flow yield*, *price/book value*, and *premium/discount to NAV*.

*Cash flow yield* is nothing more than the distribution rate adjusted for the payout ratio. Focusing strictly on a dividend yield as an indication of value is akin to determining how fast a vehicle is based on the number of cylinders. It appears to be a good short-cut but doesn't mean anything without other key pieces of information.

Using the more conservative ANII measure, Newtek will generate around \$3.25 per share in cash flow in 2021 or a 12-13% cash flow yield at today's share price of \$27.50. We land at the same number by instead taking the expected annual distribution of \$3.15, dividing it by the payout ratio, and dividing the output by the same share price.

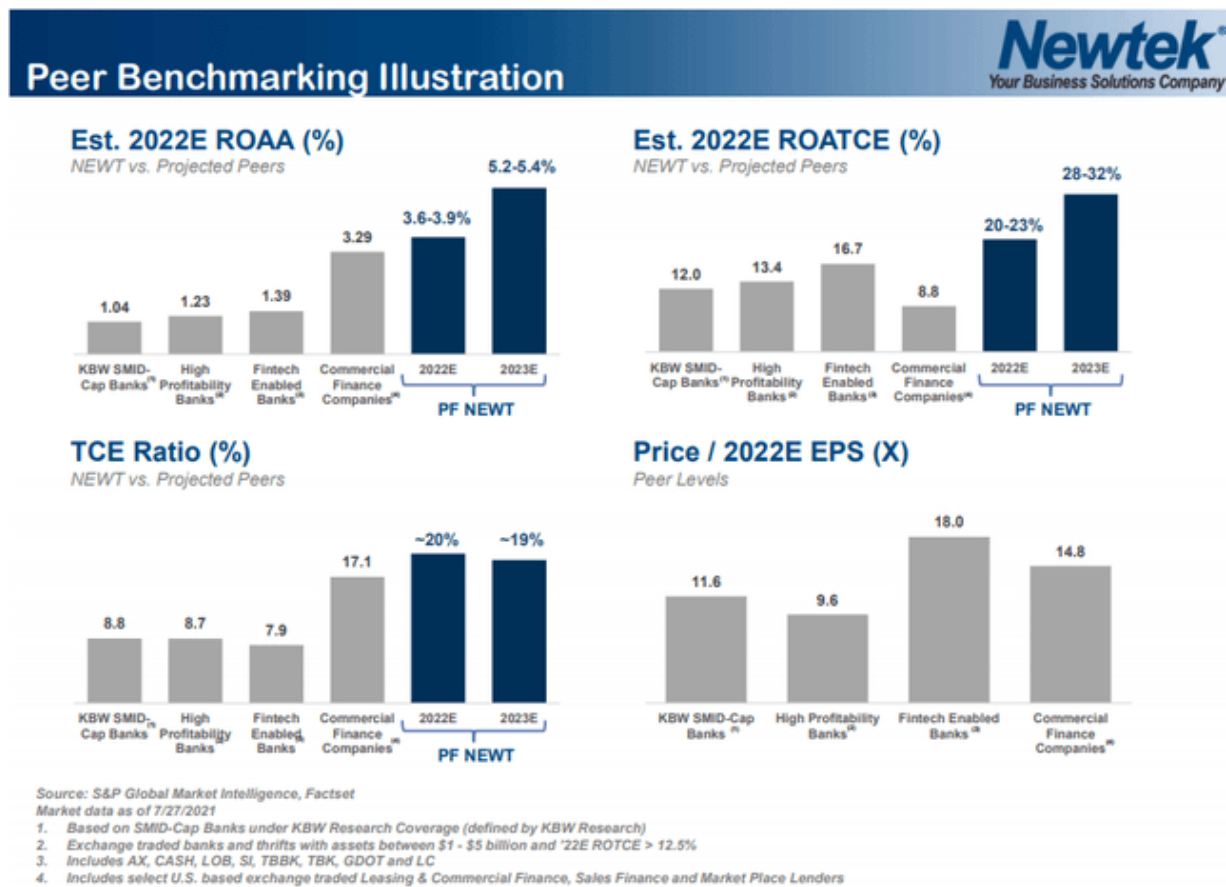
Looking back to 2016 to 2019 when Newtek's share price was relatively stable, the stock traded with a cash flow yield of 12-18%. In what will become a pattern, *Newtek was expensive* by this metric when it was trading in the \$32-\$35 range applicable prior to the August 2nd acquisition announcement. It's also fairly valued based on cash flow yield at today's share price closer to \$27. The same applies to cash flow yield on book value, which is another worthwhile metric but not one we'll cover in detail here.

According to SEC filings and our institutional data provider, FactSet, in recent years prior to 2021, *price/book value* was steady in the 1.2-1.3 range. It jumped to 1.7 at the end of Q1 of 2021 then to 2.2 by the end of June. This was one of the main reasons we took profits on our Newtek position in the low \$30s and again in the mid-\$30s.

*As painful as it is* to reduce our stake in an amazingly fast and high quality income stock, it must be done when the valuation becomes too extended. The current price/book ratio is right at the level of Q1 2021, meaning it is 30-40% higher than historical norms. Newtek has also been growing cash flows more rapidly in recent years, so part of this premium is justified.

Moving on to *premium/discount to NAV*, the most reliable metric for BDC valuation in my opinion, Newtek trades a lot like Main Street Capital ([MAIN](#)) in that a 20-30% premium to NAV is usually an excellent entry point and anything over 80% signals elevated risk.

NEWT trades with a 68% premium today, down considerably from Q2's 100-120% premium. Once again, today's pricing is about average for Newtek with last quarter's valuation squarely in overheated territory.



Source: Newtek Second Addendum to August Earnings Report

Now let's consider if the conversion to a bank holding company occurs. This chart was created by Newtek and we'd be naïve not to take this with a grain of salt and perform our own independent assessment of the data. The classifications used are not the easiest to verify (e.g. what exactly defines a "high profitability bank" or "fintech enabled bank") but we did find a few examples and none were collectively so out of line that they suggested this data was inaccurate.

As one example, Ally Financial Inc. ([ALLY](#)) is a good example of a fintech enabled banking institution (albeit with a mixed reputation), and it trades at a surprisingly modest 6.5x forward earnings.

On the other hand, SoFi Technologies, Inc. (SOFI), a leader in that segment, doesn't have a dime of earnings and is worth \$11.5 billion as of August 25th's close. The 18x price to 2022 EPS assumed in the above chart is associated with Axos Financial (AX), Meta Financial (CASH), Live Oak (LOB), Silvergate (SI), The Bancorp (TBBK), Triumph (TBK), Green Dot (GDOT), and LendingClub (LC).

**Earnings Illustration:  
Consolidated NEWT in FHC Structure**



	Profitability Targets		Stress Case: +100bs Cost of Deposits	
	FY 2022	FY 2023	FY 2022	FY 2023
ROAA	3.6 – 3.9%	5.2 – 5.4%	3.5 – 3.7%	4.9 – 5.1%
ROATCE	20 – 23%	28 – 32%	19 – 23%	27 – 31%
Cost of Funds	~2.0%	~1.4%	~2.4%	~2.0%
Deposits / Total Funding	~60%	~70%	~60%	~70%
After-tax Net Income	\$45 – \$50mm	\$77 – \$82mm	\$43 – \$48mm	\$73 – \$78mm
Earnings Per Share	\$2.00 – \$2.20	\$3.45 – \$3.65	\$1.90 – \$2.10	\$3.25 – \$3.45

Source: Newtek Second Addendum to August Earnings Report

Our independent earnings guidance is somewhat dependent on management's estimates, which is not usually the case, but it nonetheless reconciles with their conclusions. Using Earnings Per Share ("EPS") for the combined entity of \$2.10 in 2022, fair value for the new company is between \$20.16 (assuming it is classified as a traditional but highly profitable bank) and \$37.80 (assuming it is priced as a fintech enabled bank).

To give Newtek credit, its projected and likely return on average tangible common equity ("ROATCE") and return on average assets ("ROAA"), two common measures of bank's profitability and asset quality, are above even the most richly valued peer group. Add in expected growth in 2023, and a \$40 share price is reasonable. That wasn't an attractive proposition back when the stock traded at \$35, but that's a 45% capital gain from today's level *plus dividends*.

It's only prudent to expect the distribution to be halted or reduced after the conversion takes place. Unlike what a headline including that suggests, that is not an indication there is anything wrong with the business. It does suggest that Newtek is taking a different approach, and one that may be more attractive to a total return seeker than the BDC company structure provided.

In conclusion, we are not running from Newtek, and despite a considerable amount of due diligence, did not find a single good reason to do so. The stock isn't terribly inexpensive, but the recent sell-off was a blessing for those looking to initiate a position in the stock.

*Investors expecting the company to remain a BDC are best suited to look for an entry point closer to \$25.* For those that think the bank conversion is imminent and will be a long-term plus, today's share price is situated to provide at least 50% total returns over the next couple years.

Note: Since posting this article on the iREIT on Alpha marketplace I have attempted to reach out to NEWT's CEO for an interview (for iREIT on Alpha members).

Author's Note: Brad Thomas is a Wall Street writer, which means he's not always right with his predictions or recommendations. Since that also applies to his grammar, please excuse any typos you may find. Also, this article is free: written and distributed only to assist in research while providing a forum for second-level thinking.

## Get My New Book For Free!

Join [iREIT on Alpha](#) today to get the most in-depth research that includes REITs, mREIT, Preferreds, BDCs, MLPs, ETFs, and we recently added Prop Tech SPACs to the lineup. We are also adding an all-new NAV tool this week called NAV-igate to help members screen for value. [Nothing to lose with our FREE 2-week trial.](#)



**ASK THE REIT EXPERT**

*“What REIT should an income seeking investor buy in the current market?”*

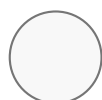
**Start Your FREE Trial Today** [SIGN ME UP](#)

*“My team and I are here day and night to answer any investor questions. We can help guide you on the road to an income filled retirement.” -Brad Thomas*



And this offer includes a [2-Week FREE TRIAL](#) plus my [FREE book](#).

This article was written by



**Brad Thomas**

96.92K Followers

Author of [iREIT on Alpha](#)

The #1 Service For Safe and Reliable REIT Income

**Disclosure:** I/we have a beneficial long position in the shares of NEWT, ORC either through stock ownership, options, or other derivatives. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.

**Additional disclosure:** WER has a beneficial long position in the shares of ARCC, NEWT, GBDC, and ORCC either through stock ownership, options, or other derivatives.

89 Likes

106 Comments

## Comments

Sort by

Newest

