B | S | Perspectives

August 10, 2016

Quarterly Earnings Review | 2016 | Q2

By: Nancy A. Bush, CFA
NAB Research, LLC
Distributed by Banks Street Partners, LLC

WHATEVER HAPPENED TO THAT RECESSION, ANYWAY?

"A damn good second quarter." That was how CEO Joe Evans of **State Bank Financial (STBZ)** described his company's second quarter results, and while his description may have been unusually colorful, it was by no means exceptional. The 2016 second quarter results turned out to be so NOT what we had expected for all of our banks (large, small and in-between) as it had been widely expected that earnings would be moribund as net interest margin pressures would overshadow any possible quarterly positives. The credit cycle was also expected to begin to turn inexorably for the worst and cost control would have mostly run its course—and thus bottom line results would be flattish at best. It was also received wisdom that earnings guidance for future quarters would grow increasingly grim, thus casting a pall over the future prospects for bank stocks.

Well, we're not exactly kicking up our heels and singing "Happy Days Are Here Again", but we're not crying in our beer, either. Instead, we are marveling at the ability of many of the Southeastern banks to continue to grind out positive earnings surprises in what is inarguably one of the toughest periods for banks since the Financial Crisis. While part of this durability is undoubtedly due to the regional economy—which seems to be strengthening after an episodic and erratic recovery—part is also due to the remarkable amount of consolidation that has taken place in the Southeast thus far and the ability of Southeastern community banks to use deal-generated cost saves and purchased asset accretion to literally "springboard" into new investments in revenue-generating products and personnel.

In a quarter which produced a positive earnings surprise even for the nation's most-maligned bank—yes, that would be **Bank of America (BAC)**—you know that something good must be going on. That company's positive surprise ($0.42 operating per share versus $0.36 expected) is worthy of special mention, as it marks something of a milestone for the banking industry as a whole—i.e., the full recovery from the damage wrought by the events of 2007-2008—and it also cements BAC as a company that is now better equipped to become more competitive in some segments in the Southeast. Additionally, the company's attainment of an adjusted return on tangible common equity (ROTCE) of 10.9% puts the returns of even this challenged company at or above its

cost of capital—so the industry critics should stop with the "banks are not earning their cost of capital" whine at last.

The outstanding characteristic of the second quarter results was a straightforward one—loan demand strengthened from first quarter levels, and it seemingly strengthened across most lending categories and across most geographies throughout the nation. Indeed, while we do not closely follow the stock of **U.S. Bancorp (USB)** (we await hopefully their entry into the Southeast through a meaningful deal someday soon), we do listen in on their earnings calls and monitor their growth trends as being indicative of the industry as a whole. Loan growth has accelerated at USB for the last five quarters and commercial loan growth has exceeded 10% (year-on-year) for the second quarter in a row, with the growth expected to be similar in the third quarter. And the consumer segments are growing "slowly but surely"—and as USB goes, so goes the industry.

The community banks that we monitor are producing some extraordinary loan growth, and one need only look at companies like **ServisFirst (SFBS)** (18% annualized loan growth), **Pinnacle Financial (PNFP)** (17%), **Ameris Bancorp (ABCB)** (organic growth exceeding 20%), **Atlantic Capital (ACBI)** (approaching 12% annualized), and on and on to see the growth potential in these mid-sized and smaller franchises. While a large part of that growth results from the strength of a few extraordinary Southeastern markets—like Nashville, Charlotte, Charleston, and yes, even Birmingham—it's also hard not to see the loan growth at the community banks as the reason that some of the larger Southeastern banks (like **BB&T (BBT)**, for one) reported loan growth in the mid-single digits, at best, and we firmly believe that material market share is being moved by the community segment.

We heard a lot in the second quarter conference calls about the hiring of new producers as one factor in community bank loan growth, and we wonder how many of these relationship managers are leaving the very large banks for the greener pastures (and less bureaucracy) of the smaller bank cadre. Pinnacle Financial especially targets the hiring of the best competing producers in its markets as a growth strategy, and CEO Terry Turner said that his company is already 75% of the way toward hiring as many lenders as it acquired in all of 2015. Jimmy Tallent of **United Community (UCBI)** highlighted the addition of 26 lenders in the first quarter and nine in the second quarter—most in UCBI's specialty lending and mortgage areas—as one reason for their double-digit annualized loan growth, and similar mention was made at **Park Sterling (PSTB)** and Atlantic Capital as well. We can only conclude that this is a very, very good time to be a well-producing lender with a loyal following in good Southeastern markets, and that these folks are hot commodities indeed.

However, all of this loan growth is not producing uniformly great results in net interest income growth, and it is hard to see how that reality changes very much over the near-to-intermediate term. While declines in net interest margin levels were not universally grim—a few banks managed to staunch the bleeding to 1-2 bps or so—declines in the 5 bps or higher range were more common and there seems to be no end in sight to the erosion, with competitive loan pricing and the general decline in earning asset yields remaining the culprits. But we also sensed from the questions of analysts on the earnings calls a bit more acceptance of this reality and a greater realization that there is little to be done to alter the course of this important metric in the near term.

If good loan growth was the most prominent feature of second quarter earnings, credit quality ran a close second, and we remain astonished at the length and durability of this credit cycle. In the wake of first quarter earnings, it seemed that a pall had settled over the whole topic of credit quality and that there was a belief that the turn for worsening credit conditions had arrived. In retrospect it seems that perhaps we were all overly

influenced by the topic of loan losses in the energy patch, but that is an issue that is more or less confined to the larger banks and even there has not been as bad as expected. (That fact may change as oil prices head downward again.)

For most of the companies that we follow, credit quality metrics remained positive and indeed even seemed to strengthen in the second quarter. Bank of America CFO Paul Dinofrio cited an improvement in that company's asset quality as one of the most positive elements of the quarter and added that that improvement was across almost all asset classes, including credit cards. The overwhelming sentiment is that "the consumer is in good shape", according to **SunTrust (STI)** CEO Bill Rogers, and apparently is in such good shape that some banks—**J.P. Morgan Chase (JPM)**, most notably—have stated their intention to go further into the "near-prime" segment in some consumer products. (Note—Bank of America CEO Brian Moynihan stated emphatically that BAC would hew to its prime and super-prime strategy in consumer lending. Period.)

There is one issue that came to the fore repeatedly in the community bank calls, and that was the issue of exposure to commercial real estate. It is very clear that the recent regulatory attention to this topic is being strongly heeded by all banks and it was discussed at length on several conference calls, including that of **Synovus (SNV)**, where CRE exposure is a topic of intense historical interest. CEO Kessel Stelling said that the company is "emphasizing growth in other areas" and has "pulled back on construction" in order to rebalance the balance sheet toward consumer growth. Pinnacle Financial CEO Terry Turner said his bank was "within the thresholds" of the regulatory guidance—which is no more than 100% of capital exposed to ACD (acquisition, construction and development) loans and no more than a 300% exposure to commercial real estate in total. **Capital Bank Financial (CBF)** CEO Gene Taylor mentioned that his bank has a 150% exposure to CRE overall and sees that level of concentration as an opportunity to do more. And especially noteworthy was the revelation from State Financial that they are in excess of those guidelines (at 150% and 400%, respectively) but that they have "demonstrated risk management practices that are consistent with regulatory guidance." We expect we will be hearing much more about this topic in the future, and we hope that disclosure can become a bit more consistent across the industry.

Bank of America CEO Moynihan is fond of saying that "we focus on what we can control", and that factor for his bank and every other one is expense growth. We would love to be able to report more progress on this front than we saw in 2Q results, but our sense is that the industry is in an expense-cutting lull as it waits to see if there might be a near-term change in the rate environment and focuses instead on acquiring producers, which can be an expensive proposition in the short run. Bank of America remains the Southeastern standout in bringing down costs—with a 62% normalized overhead ratio, they have little choice but to do so—and they excited the analyst community by stating that they would take an additional $3 billion out of their $56 billion annual expense base by the end of 2018. On the other end of the cost control spectrum was SunTrust—the perennial expense apologist—where management tried to present their 60% tangible overhead ratio as a sign of progress but then revealed under questioning that the ratio adjusted for special items was really in excess of 61%, and back to the expense control doghouse they went.

Two final 2Q16 earnings issues come to mind. We noted in our questioning of United Community CEO Jimmy Tallent that his stock remains the lowest valued of the $5 billion to $10 billion community bank group—a group of companies that are admittedly richly valued relative to their larger peers—and we received a thoughtful answer that is worthy of contemplation. He first said that he is acutely aware of his stock's valuation hurdles and that he and his team devote their attention daily to improving returns. But he also pointed out that his

analysis shows that when Purchase Accounting Accretion (PAA) is excluded from the results of this segment, his company's performance is on a par with those more highly valued companies. Since PAA is not a permanent phenomenon—it decreases with each quarter unless replenished by more accretive deals—it is worth considering if these highly valued stocks will become less so over time and whether stocks like UCBI represent exceptional value as a result.

Our second thought is that as we listen to these quarterly calls and talk to other industry participants, we find real enthusiasm for the "specialty" names like Atlantic Capital and **First Citrus (FCIT)**. Both of these companies specialize in providing lending and services to commercial borrowers, and we think that this "specialty model" is both attractive and a way for banks to differentiate themselves in the future. We hope that we see more of these types of companies—and more community banks that offer private banking and wealth management to their customers as the ultimate "customer retention" tool—and we continue to look forward to the continued evolution of ACBI, FCIT and any others who choose to join them in the specialty space.

So yes—it was a very decent quarter, and the irony was that so little was expected of the banks as the talk in the last few months had turned to a possible global economic slowdown and the possibility even of a new U.S. recession. That recession was NOWHERE evident in second quarter results, but we do feel obliged to throw in a word of caution for possible third quarter trends and results. Second quarter normally represents an unusually active quarter in mortgage banking with the resultant earnings lift from this important business, and those revenues will diminish seasonally as we go further into the year. We would also point out the news of recent days from the auto industry, where both Ford and G.M. have warned of slowing sales, so we face the possibility that the very important auto lending category may be less robust for U.S. banks in coming months.

It also bears repeating (yet once again) that the impacts of a strengthening economy will not be felt equally across the banking industry, and that there remains a tier of banks—those community banks under $1 billion in assets that lack a specialty strategy or strong fee-income businesses—that will remain challenged, no matter what economic environment prevails. The regulatory burden remains intense for these banks and the yield curve is unlikely to steepen sufficiently in the near term to provide much relief for severely squeezed net interest revenues. We would expect that these companies will continue to seek a way out of their dilemma and that consolidation in this segment is likely to pick up steam in the months ahead as a stronger economic environment provides little relief for lack of scale and the demands of technological innovation.

And yes, there will be an election in a fewer than 100 days, and one can only guess at this point where this chaotic and crazy presidential campaign may go from here. (A plague of raining frogs and locusts? A duel with pistols at 100 feet? Who knows?) There is valid concern that the economy will slow in advance of the election, and that will of course be reflected in bank stock performance. And after the election, the topic of Glass-Steagall-like regulation will inevitably arise and confusion and uncertainty are likely to be the result. So we recommend that we all enjoy the afterglow of the second quarter's decent bank results—which have just been validated by strong jobs growth numbers for July—and prepare for what may be a bumpy ride ahead.

Nancy A. Bush, CFA
NBush@BushOnBanks.com
(706) 438-3098

To read NAB Research's disclosures for the preceding commentary, please follow this link:

http://www.BushOnBanks.com/disclosure.shtml

This commentary was provided by Nancy A. Bush, CFA of NAB Research, LLC and is being distributed by Banks Street Partners, LLC. The views of the author do not necessarily represent the view of Banks Street, and Banks Street has neither directed nor had editorial oversight over the content. Material in this report is from sources believed to be reliable but no attempt has been made to verify its accuracy. Past performance is no guarantee of future results. Banks Street Partners, LLC actively seeks to conduct investment banking in the financial institutions sector, including with the companies listed in this report. To learn more about Banks Street, please visit www.BanksStreetPartners.com.