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A blue-tinted photograph of a classical building facade, likely a bank, with the word 'BANK' visible in large, raised letters on the front. The image serves as a background for the title.

# Quarterly Earnings Review | 2017 | Q2

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## THE SOUTHEAST HEATS UP...

When we compose these quarterly review pieces, our last task before beginning to write is a review of our notes from the dozen or so conference calls in which we have participated during the latest earnings reporting season. The aim of the exercise is to try to piece together some thematic overview of the quarter—was it positive, was the commentary optimistic or otherwise, were concerns expressed about some particular aspect of earnings, and what were the bulk of analysts' questions focused upon? This is usually an enlightening exercise and one that provides a pretty good insight into the trends and outcomes for the quarter to come.

The aspect of the 2Q17 commentary that was most striking to us was the degree to which it was almost overwhelmingly optimistic and positive, and much more so than we had observed in the first quarter earnings calls. The commentary on results in April had shown CEOs to be somewhat tentative in their outlook for the year—the bloom had clearly come off the post-election rose and there seemed to be a period of retrenchment in the enthusiasm that had been so freely expressed late in 2016.

The curious part of all of this is that optimism has clearly returned, even as the Trump administration and Congress have failed to deliver on some key parts of their agenda (like healthcare reform.) We ascribe this newly renewed positive attitude both to both an organic strengthening in economic activity (likely partly seasonal, but also partly structural) as well as to the near-term likelihood of a regulatory regime that will be more sympathetic to the regulatory burden that has been placed upon banks in the last decade.

In any case, we noted the words “optimistic” and “optimism” a number of times throughout our notes, and we will be anxious to see if this lightened mood is reflected in third quarter loan growth. The loan growth track in most of the industry remains positive although not spectacular—“mid-single digits” annualized loan growth remains the industry norm—but there were pockets of much stronger loan growth in the Southeastern community banking segment, both large and small.

We would note particularly the commentary from mega-community bankers **Pinnacle Financial Corp. (PNFP)** and **South State Corp. (SSB)** on their loan growth in 2Q17. Both companies benefited from recently completed deals, so that apples-to-apples loan growth comparisons in the quarter were somewhat difficult. But both CEOs Turner and Hill affirmed their conviction that their banks could organically grow loans in the “low-to-mid double digits” range over the long term, and ditto for regional peer **ServisFirst Bancshares, Inc. (SFBS)**. That company is doing what so many other community banks are doing—moving into new markets (breaking into Tampa, most notably) and hiring new producers, oftentimes from their larger competitors. Is there a new “growth stock” segment of the banking industry that has seldom been seen before? Sure looks that way to us.

And thus, the description of the lending environment in the Southeast as “hyper-competitive,” and we would concur. This unusually competitive atmosphere seems to us to be partly a result of the natural evolution of a lending cycle—we are late into an unusual and extended economic recovery, and banks are anxious to lend before the present condition of ample liquidity begins to change—but also to the unprecedented evolution of the Southeastern banking scene.

We have written often in the past of the rise of the large community banks, and 2Q17 results seem to us to show the first really visible impacts of this monumental change. The leader of the pack in this movement toward community bank mega-status has unquestionably been Terry Turner, the CEO of Pinnacle Financial in Nashville, and the growth of his company to the \$20 billion-in-assets mark with the recent acquisition of BNC Bancorp of North Carolina is indeed a banking industry milestone. It is apparent that with this achievement Pinnacle has attained not only mega-scale but also mega-desirability as a place to work, and we noted his mention of the addition of 14 new bankers during the quarter—a number of whom came over from his larger Southeastern competitors, especially in the Nashville market—as yet one more sign of the changing of the Southeastern guard.

And with deals and competition and changes in the Fed posture come the impacts upon that all-important banking metric, the net interest margin (NIM). After years of struggle, it looks like NIMs throughout the banking industry have finally begun to get a lift, although the magnitude of the improvement is dramatically uneven across the industry and indeed for some banks may be somewhat short-lived.

Given the asset-sensitive nature of most banks, the Fed increases in December, March and June finally took firm hold in 2Q17 and resulted in better “lift” in margins and net interest revenues than we had seen in the prior quarter. Margin progress was slight among the region’s largest banks—the average NIM ticked up only 2 basis points sequentially, to 3.07% among the regional “majors”—but we would note that these companies tend to be subject to a host of margin pressures, mostly due to the need to maintain liquidity ratios in the face of regulatory requirements. But we would also point to the 9-point NIM improvement (to 3.51%) at Synovus—which, at \$31 billion in assets, shows trends more in keeping with those of the mega-community segment—as more representative of what is happening in the Southeast. Loan pricing was up while the funding mix shifted more toward consumer transaction deposits, which was indeed a magic mixture for NIM improvement.

And if you were a large or small community bank in the Southeast in 2Q17, you were in NIM nirvana, for several reasons. There was the aforementioned upward loan pricing combined with a still-healthy flow of deposits—more on that topic in a moment—but there was also the “special sauce” of a number of recently completed deals that contributed considerable accretion to the quarterly margin mix. (Indeed, the superlative **TowneBank (TOWN)** saw a 31-bps increment to its 3.84% NIM as a result of recent deals combined with a

reclassification of some purchased revolving credits.) Pinnacle Financial is only beginning to see the beneficial interest income aspects of its merger with BNC (but still saw a 14 bps lift in its core NIM, 8 bps of which came from recent Fed moves) and South State will see benefits after the close of its acquisition of **Park Sterling Corp. (PSTB)** later this year.

In short, there is more to come in positive net interest margin and net interest income trends for the banking industry generally and for the community segment particularly, but we would be remiss if we did not point out that improvements in the core NIM will be lessened in 3Q17 for many banks as the effects of the cumulative Fed rate increases fade. We must also mention that the banking industry has as of yet seen little demand from its retail depositors for higher rates and thus has been able to largely avoid the issue of increasing consumer deposit “betas” even as the Fed has raised rates multiple times.

Will this situation persist? The majority of our monitored banks believe that they will be forced to raise retail deposit rates with the next Fed increase—now widely expected to come in December—but as we know, this is an art and not a science. It is indeed possible that retail customers will remain indifferent to deposit rates even as their debt service costs rise. (The same is not true of commercial depositors—they are already demanding and receiving special rate deals dependent upon the profitability and the size of their banking relationships.)

But we would reflect that it is entirely possible that after a decade of abnormally low deposit rates, a significant portion of the banking public may simply be indifferent to rates on their checking and savings accounts. It is also likely that a period of stock market turbulence—exacerbated by any extraordinary global events (like war)—would once again remind the banking public of the safety of bank deposits and would further prolong the present situation of stable core deposit pricing. In any case, we no longer believe that the consumer behaviors of old necessarily provide any guidelines for those of the future—which means that the banks may experience an unusually prolonged period of widening loan spreads.

We were asked during a recent speech to the Consumer Bankers Association what we were most worried about right now, and we must admit that we were somewhat taken aback by the question. We answered that we had not thought a lot about credit quality in some time, and that perhaps it was time to do so. While there have been a number of articles in the press about the rising losses in such areas as subprime auto and “near prime” credit cards, these segments are somewhat isolated to a few banks and are not expected to cause widespread problems. Ditto for multifamily commercial real estate—that segment has been discussed (and has had widespread regulatory attention) for some time now.

The words of ServisFirst CFO Bud Foshee in that company’s 2Q17 earnings call pretty much sum up the industry experience: “We see no credit quality deterioration.” (Period.) And indeed, if one looks at nonperforming asset levels on a progressive quarterly basis, they have continued to fall to levels at most banks that would have been unimaginable in the wake of the Financial Crisis, especially among the nation’s largest banks. While there may be the occasional large credit that pops up and distorts the numbers—the \$9.7 million pre-tax hit from one large credit at **CapStar Financial Holdings, Inc. (CSTR)** in 2Q17 is one such example—the overall trend in troubled assets continues an extraordinary and prolonged downward trajectory.

And as nonperforming assets go, so goes the overall level of the loan loss allowance. We have historically regarded the “1% of gross loans” level as the trigger point for renewed reserve-building, and most of our monitored companies are hovering around that level. However, several of the large community banks have

reserve levels well below that, largely as a result of deals in which they have taken extensive credit marks on large acquired loan portfolios and therefore do not have to provide a loan loss reserve for these assets.

While we understand the issues inherent in the accounting methodology, we do have some concern about the “optics” of these resulting low reserve levels and the degree of reserve building that may be required as these banks continue to show strong loan growth outside of acquired portfolios. We also have some concerns about a possible regulatory “panic” should the credit quality environment begin to deteriorate more quickly than we now anticipate, and downgrades in one segment or another (C&I lending, perhaps?) leads to a changing view in Washington of the overall health of bank balance sheets. In short, this beneficent credit environment cannot go on forever – although it already seems that it has – and we hope that there are no earnings “jolts” ahead as rates increase.

A final few “random gleanings” from the 2Q17 results that caught our attention. First, when we moved back to Atlanta a short three years ago, the metro area was just finally coming out of the recession, several years later than the rest of the nation and later than many other Southeastern cities. Unemployment was still higher than the national average, the overhang of foreclosed real estate had not completely diminished, and the traditional Atlanta “swagger” was not much in evidence. And most notably, few banks that were not already here professed a desire to have any Atlanta presence.

Fast forward to 2017, and – my, how things have changed. Almost every bank in the Southeast that is not in Atlanta has plans to expand or acquire here – along with Charlotte, another town that suffered mightily in the downturn. Whether it is the presence of the fintech industry here, or the exciting development of the Beltline communities, or the attractiveness of city living for millennials, or the new Braves and Falcons stadiums. Whatever – Atlanta is back, baby (that little Super Bowl embarrassment notwithstanding) and we’re happy to be here to see it. We’ll also be happy to see some new banking entrants here, because it’s time to seriously up the banking game in the ATL.

And finally, we sometimes have quarters when CEOs particularly catch our attention with some catchy phrase or other, and this quarter’s prize goes to Terry Turner of Pinnacle Financial. Mr. Turner, who knows a thing or two about doing deals, spoke of the growth potential inherent within his franchise and the qualities that he looks for in possible merger partners. He caught our attention as he quoted management guru Peter Drucker: “Culture eats strategy for lunch.” Well, as Pinnacle’s results have shown us, Mr. Turner has engineered a bank that has both strategy and culture to burn. Come on down, Mr. Turner – the door is wide open.

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