B | S | Pulse

January 17, 2017

Is There Still Value Here?

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

Bank analysts everywhere are suddenly confronting a changed reality as we begin the New Year—we are facing a group of stocks that are suddenly and unexpectedly back in investor favor. The jolt to the collective reality of investors and markets everywhere brought about by this massive reversal of sentiment cannot be overstated. We quite literally went to bed on November 8, 2016, with one understanding of the way that the immediate future of the banking industry would progress—with a slow, upward trajectory of interest rates and a regulatory environment that would continue to emphasize higher capital levels and strict adherence to stress-testing regimens—and awoke the next morning to find the banking landscape radically changed and all assumptions suddenly turned on their heads.

It has been a great ride in bank stocks since November 9, 2016. The KBW Major Bank Index (BKX) is up 22.9% in two months, with the NASDAQ Bank Index (BANK) and its cohort of smaller banks up a tad more, increasing 24.5% over the same time frame. The reasons behind this stellar run have been recited, ad nauseam—the likelihood of a large program of infrastructure investment by President Trump and the increase in GDP growth that will likely be the result, the steepened yield curve that will result from the Fed's need to raise more aggressively to stave off higher inflation, a lightening of the heavy hand of banking regulation, and—last but certainly not least—a reduction of corporate tax rates that will especially benefit the heavily-taxed banking industry.

So Wall Street estimates for the banking industry have been adjusted to reflect these coming benefits, and thus the upward move in the stocks—right? Well, not exactly—indeed, it's more like the opposite. The stocks have moved but the pre-election earnings estimates have barely budged, and it's only the price targets that have been raised by analysts—mostly to some level close to where the stocks are trading right now. (Welcome to Wall Street.) And to be fair, the details of the Trump economic plan are little known at this point, the new heads of the various banking regulatory bodies (like the OCC) have not yet been appointed, and our guess is that even bank CEOs are still trying to puzzle through all the intricate details of the new banking framework.

A couple of things are known. The biggest beneficiaries of the regulatory changes to come will be the community banks, not the money center behemoths. While there may be changes to the Volcker Rule that bans

proprietary trading at the Wall Street banks, it's not at all clear that these banks will be willing to rebuild the trading infrastructures that have been largely dismantled at this point. Secondly, the commentary of Donald Trump prior to the election was not at all friendly to the nation's largest banks, and the odds-on favorite Trump pick to succeed Dan Tarullo, the Fed's acting head of banking supervision, is Thomas Hoenig – a banker not noted for a light hand on banking supervision and one who is likely to continue to emphasize high capital levels for the major banks as the strongest bulwark against systemic contagion.

The biggest banks are likely to be the big winners in one category—the impact of rising rates and the positives of a steeper yield curve. These are the banks, after all, that carry around the largest branch networks, and this massive physical infrastructure has been largely uneconomic during the years of very low rates. The return to profitability of plain old-fashioned deposit-taking will aid the banking industry generally and branch-heavy banks to the greatest extent, and this category also increasingly includes the largest banks in the community segment, several of which here in the Southeast encompass growing branch networks spread over several states. We think that we should simultaneously point out, however, that even when branch banking is once again handsomely profitable, we do not foresee an end to the industry's need to rationalize its physical footprint. The move to mobile and digital banking across all customer segments—the Boomers and the Millennials alike—will dictate a continued decline in branches over the years to come, no matter what the interest rate environment may be.

There are a couple of relevant questions that arise with the reality of rising rates. The community banking industry—the largest members of that group, particularly—are already enjoying very healthy lending spreads, and it's hard to see how they increase much from here. The long-term historical average of lending spreads in the banking industry has been in the 300-basis point range, and the largest Southeastern community banks are (in most instances) already at or healthily exceeding that level. But there are a couple of caveats that need to be remembered when pondering this multi-dimensional subject.

It is entirely possible that these greater-than-historical spread levels are simply a reflection of the greater regulatory costs involved in making a loan, and that commercial customers simply accept these greater costs with that understanding. Secondly, spreads in the large community segment are still being goosed somewhat by the purchase accounting accretion that was gained through the acquisitions of failed banks in the immediate wake of the Financial Crisis. While we are at the tail-end of most of these benefits, they will continue to be a feature of the net interest spread/margin landscape for the next couple of years. We also do not foresee—at least in the intermediate term—a need for the banks to dramatically increase retail deposit rates in order to fund stronger loan growth, as banks (both major and community) have ample stores of low-yielding liquid assets that can be tapped even as loan growth accelerates.

It's when we come to the topic of regulation and its many-faceted earnings impacts that things get a lot more squishy. It is generally understood that President Trump is largely in agreement with the regulatory leanings of Congressman Jeb Hensarling, and that his already-existing legislative plan ("The Financial Choice Act") will form the backbone of the Trump regulatory overhaul. Once again, the large community banking sector will be the biggest winners, as they will see (finally) the entirely arbitrary $10 billion-in-assets cap removed from their classification as community banks, and the $50 billion cap that is likely to replace it will allow for an extended period of growth for these companies— several of them have expanded beyond the $10 billion mark since year-end – and will, we believe, give them an opportunity to compete even more seriously with their large regional brethren.

While many of the benefits to flow from this new classification change are as of yet not tangible, there is one that is very much so and will likely begin to be realized fairly quickly. For those large Southeastern banks that have recently crossed the $10 billion threshold—both **United Community Banks Inc. (UCBI)** and **South State Corp. (SSB)** come readily to mind—the eventual day of reckoning on reduced debit card fees (a.k.a., the "Durbin penalty") will be put off indefinitely, and for companies like this, It can be a matter of $10 million-$20 million in revenues that will now not be foregone. In addition, while we do not see foresee the end of the DFAST stress-testing regimen for these larger community banks, it is likely that there will nonetheless be a "lighter hand" on capital requirements than would otherwise have been the case and these companies will not now be forced to ramp up spending yearly on increased staff to manage the DFAST process. One industry observer expressed a belief that the days of "extreme enforcement" are coming to an end and that the principle of "good faith efforts" in issues such as BSA/AML, capital adequacy, etc., will once again prevail. (We also wonder whether the contemplated change at the top of the OCC will soften the 100/300 "guideline" for commercial real estate exposure.)

The other potentially large positive for the banking industry—and once again, this will be a disproportionate positive for the community banks—will be a more focused agenda for the CFPB, but much about this possible large change is yet to be known. While some Republicans have expressed a strong desire to eliminate the CFPB altogether, we think the political blowback on such an effort would be extreme and makes it more likely that the leadership structure will change and the mandate of the agency will be narrowed dramatically. This, according to one of our respondents, is a "big deal" and makes it much more likely that further regulations on overdrafts, mortgage lending, etc., will not be forthcoming, at least for the community segment. Are bankers giddy about the prospect of life without this particular Sword of Damocles hanging over them? As one observer said: "Sometimes pleasure is just the absence of pain..." and the likely absence of this particular pain is indeed being welcomed throughout the industry.

As we said earlier, the prospect of all these positive changes for the community banks has propelled these stocks to lofty heights in the two months since the election, and indeed the valuations of some of these larger banks are approaching nosebleed territory. In our covered group, the "cheapest" of the large community banks is selling at 1.9x tangible book value, and the priciest is eye poppingly valued in excess of 4x TBV. Were we the CEO of one of these banks, we must admit that we would be thinking that it is a good time to take this currency and spend it on a deal that brought greater geographic reach, new products and customers, and diversification of the asset portfolio.

Alas, it's never that simple in banking. While our thought as the CEO of a possible target bank would be "take the money and run," one of our sources for this piece pointed out that it is very likely that the price expectations of the target banks are also being ramped up accordingly and that those smaller banks that had been so challenged in the low rate environment are reassessing their growth prospects in light of the possibility of stronger loan growth and higher rates. And it must be admitted that many banks under $1 billion in assets continue to exist not for economic reasons but for reasons of importance to the community or of the existence of large, long-term shareholders who see their holdings in a fiduciary and protective light. In any case, our contacts cautioned that, while a merger "wave" might be the result of recent developments and the rise in bank share prices, a merger "tsunami" was unlikely.

So we will see the maintenance (or improvement) of healthy lending spreads, a lightening of regulation and the likelihood of slowing growth of expenses related to regulation and compliance, and the ability of companies to retain revenues that might otherwise have been lost should the asset size caps on community banks continued.

And finally—as we said earlier—the proposed change in corporate tax rates from 35% to perhaps as low as 15% will have a major impact on banks, where the effective tax rate for community banks (who do not have the ability to stash earnings overseas, unlike some of the major banks) hovers in the low-30% range. (Note—the change in corporate rates is likely to come with the loss of some existing deductions, so there may indeed be some lessening of the full impact of the cut.) But no matter how you slice it, this is indeed a bullish scenario for bank earnings and bank valuations, and we look forward to hearing more from industry CEOs in coming days as these banks report 4Q16 earnings and offer observations on industry conditions to come.

As with any seismic change in an industry's outlook, the possibility of cracks and fractures in the landscape exists. We lived through the rapid rise in rates in the mid-1990s and well remember the explosions in securities portfolios that resulted. It would in no way surprise us to discover that some banks (both large and small) had stretched for yield in the past several years and will pay a price as they get trapped in a rising rate scenario. And are there very likely uneconomic commercial real estate projects out there that will go nonperforming as these loans reprice? You bet, and the news from the banking industry is unlikely to be wholly positive as this new banking reality takes hold.

So back to our initial premise—is there still value in these stocks? We took a proxy Southeastern banking company in the large community group—one that is well respected, has a high quality loan portfolio and has done few number-distorting deals in recent years—and simply applied the new proposed corporate tax rate, and 3Q16 earnings were increased by 28%. In addition, this company will now not have to forgo roughly $0.40 to the bottom line in 2018 (on a $5.10 estimate) as the Durbin penalty is foregone. (And there will be other benefits to expenses that are inestimable at this time.) Do all of these possible additions to earnings combine to make this a "cheap" stock? No, but as a quality large community bank, this is a stock unlikely to ever be cheap in the classic sense. But there is a big difference in 18x earnings and 15x, and between a 1.5% dividend yield and one that could approach 2% on any possible reasonable dividend increase. In our view—that is a compelling investment rationale, and it will continue to be.

We would note that the bank stocks—including that of our proxy Southeastern bank—have taken a breather since the beginning of the year, and we would not have expected otherwise. The Trump transition is proving to be a rocky one, and there are still great gaps between what we know and what we think we know about the World According to Trump. We expect that these stocks will take a (healthy) breather here and wait for the details of the new banking regulatory structure to be filled in. But it's hard to not foresee further upside from here, and it's hard not to be glad that the light at the end of the tunnel is finally NOT an oncoming train.

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

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