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True Growth?

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Good earnings have seemed not to matter much…

We must admit that we found the 2Q19 earnings season to be—well, a bit of a dud. It's not that earnings were bad—quite the contrary. Bottom-line results were generally in line or better than expected, and the ingredients of those earnings were mostly pretty positive, with loan growth continuing to trend in the mid-single digits (annualized) and deposit growth growing at a rate slightly better than that. There was no—zilch, zero—indication of any problem with credit quality in any lending segment, and most banks managed to continue to produce positive operating leverage even as the task of cutting the next layer of expenses necessarily grows more difficult.

Perhaps the most surprising aspect of management commentary in the quarter was a positive view of the future, at least in the immediate months ahead. The near-universal view (with one or two notable exceptions) was that the doom and gloom currently being promulgated by pundits and politicians alike is not being reflected in conditions on the ground—indeed, banking clients seem to be mostly ignoring the noise and concentrating on hiring new employees and expanding their investments in plant and equipment. There is no sign of looming recession or indeed of any disruption to a generally bright scenario—the advent of CECL and the widely predicted negative impacts of the rate environment notwithstanding.

Admittedly there are going to be headwinds, but the American banks as they are constructed today seem to be in very good shape to handle them. And indeed, the recently announced CCAR results will enable the nation's largest banks and investment banks to pay out more than 100% of earnings in the coming year in dividends and expected share buybacks. So what's not to like about the prospect of owning well-valued, healthy-yielding bank stocks?

Apparently plenty, if the collective shrug shown by investors in the last few weeks is any indication. Good earnings have seemed not to matter much. The stocks have had an initial pop or an initial drop, depending upon the circumstance, and then settled back into their recent range and into a trading torpor. (We do note, however, that the period after earnings announcements has produced a bit of a bounce in several of these stocks. Fingers crossed.) There is not widespread sponsorship for bank stocks in spite of the health of the industry, and the roots of this collective market indifference are worth exploring.

Table 1

Banks On Sale: Current Valuations Of Southeast Public Bank Holding Companies, $5B-$25B In Assets

Southeast Public BHCs $5B - $25B In Assets			Total	Pricing Data As Of 07/29/19:					
Company	Ticker	State	Assets (MRQ)	Price/ TBVPS (%)	Price/ Reported BV	P/E (x), LTM EPS	P/E (x), '19 Estimate	Dividend Yield (%)	Price Change, LTM (%)
Synovus Financial Corp.	SNV	GA	$47.3B	149.1	131.0	11.2	9.5	3.15	(23.7)
First Horizon National Corp.	FHN	TN	$42.2B	171.9	112.2	9.1	10.3	3.44	(7.8)
BankUnited Inc.	BKU	FL	$33.1B	118.3	113.6	12.0	12.0	2.46	(13.0)
IBERIABANK Corp.	IBKC	LA	$31.4B	151.2	102.0	10.1	10.9	2.32	(7.1)
Hancock Whitney Corp.	HWC	MS	$28.8B	145.3	106.8	10.4	10.3	2.61	(18.4)
Pinnacle Financial Partners	PNFP	TN	$26.5B	200.0	111.5	12.2	11.6	1.06	(3.3)
Bank OZK	OZK	AR	$23.0B	118.3	97.9	9.5	9.1	3.17	(25.9)
United Bankshares Inc.	UBSI	WV	$19.9B	209.7	114.6	14.9	14.7	3.63	(0.1)
BancorpSouth Bank	BXS	MS	$18.9B	194.2	127.4	13.5	12.9	2.51	(11.4)
Simmons First National Corp.	SFNC	AR	$17.9B	169.2	100.6	11.0	10.1	2.56	(16.6)
Atlantic Union Bkshs Corp.	AUB	VA	$17.2B	204.9	122.3	16.2	13.5	2.67	(7.9)
CenterState Bank Corp.	CSFL	FL	$17.0B	197.7	107.8	13.1	11.7	1.83	(16.7)
South State Corporation	SSB	SC	$15.7B	203.8	112.8	15.3	14.5	2.07	(11.8)
Home BancShares Inc.	HOMB	AR	$15.3B	231.1	135.8	11.4	11.5	2.65	(15.7)
Trustmark Corp.	TRMK	MS	$13.5B	183.2	139.2	15.6	14.9	2.63	(1.0)
Renasant Corp.	RNST	MS	$12.9B	186.4	97.1	12.0	11.6	2.49	(21.2)
United Community Banks Inc.	UCBI	GA	$12.8B	190.9	143.6	12.9	12.4	2.39	(5.9)
WesBanco Inc.	WSBC	WV	$12.5B	172.1	96.2	12.2	11.8	3.40	(25.1)
TowneBank	TOWN	VA	$11.9B	184.8	126.7	14.3	14.7	2.59	(14.6)
Ameris Bancorp	ABCB	GA	$11.9B	188.6	120.7	11.4	10.3	1.02	(20.8)
ServisFirst Bancshares Inc.	SFBS	AL	$8.7B	235.6	231.3	12.8	12.9	1.78	(19.9)
Seacoast Banking Corp. of FL	SBCF	FL	$6.8B	197.7	149.3	17.5	14.1	-	(13.3)
First Bancorp	FBNC	NC	$6.0B	194.4	133.9	11.9	11.6	1.31	(12.4)
FB Financial Corp.	FBK	TN	$5.9B	222.5	164.2	15.7	13.8	0.84	(10.3)
Republic Bancorp Inc.	RBCA.A	KY	$5.7B	141.1	137.8	12.2	13.0	2.19	0.5
Origin Bancorp Inc.	OBNK	LA	$5.1B	147.3	139.2	15.6	14.8	1.08	(14.8)
			PEER GROUP MEDIANS:	**187.5**	**121.5**	**12.2**	**11.9**	**2.47**	**(13.2)**

Southeast defined as AL, AR, FL, GA, KY, LA, MS, NC, SC, TN, VA, WV

Source: S&P Global Market Intelligence, as of 07/29/19

Yes, we are in the late innings of a very extended business cycle and the rate environment is not ideal for financial services companies (or for savers, for that matter), but our belief is that there is more to it than that. We started thinking about this issue after hearing a July 22 discussion on ***Bloomberg Surveillance*** between host Tom Keene and a portfolio manager guest (Brian Levitt of **Invesco**) on the subject of investing in the banks. Mr. Levitt and his portfolio managers are looking for "true growth" stocks and have no interest in the banks, which he rightly pointed out make up the bulk of present holdings in value portfolios.

This is a fact (and a challenge) with which we have struggled during our 37-year career, but Mr. Levitt's curt dismissal of the prospects for bank stocks seems to us to be especially noteworthy at a time when growth stock valuations have become ever more extended. Were bank stocks ever regarded as growth stocks? Well, yes—but that designation generally came during periods of rapid consolidation within the ranks of the nation's large regional and money center banks, with the manic deal period of 1998 coming most readily to mind. And while that late-1990s view of banks as growth companies may in retrospect seem to have been both mistaken and naive, it must be remembered that there were considerable benefits to be seen for the banks like **NationsBank**,

Banc One, **First Union** and a host of others to diversify into new markets and to cut operational costs with the goal of reinvesting in the many banking technologies that were just beginning to come into widespread usage.

It should also be recalled that this period of massive consolidation was happening against the backdrop of the "dot-com bubble" that was forming in the equity markets, and the banks were in some instances ("clicks, not bricks" in the infamous words of Bob Gillespie of **KeyCorp (KEY)**) seen as low-P/E tech stock proxies. It's interesting that today's heavier and more focused investment by banks into fintech applications and an increasing evolution toward digital and mobile banking applications—which will not to be reversed by economic circumstance—has not produced a similar investor enthusiasm for the technological aspects of banking.

A 'Once-In-A-Decade' Opportunity?

Are there growth bank stocks today? Certainly there are banks that are "growthier" —and several reside within the mega-community segment here in the Southeast. The most obvious of these is **Pinnacle Financial Partners (PNFP)**, and we can only say that this bank's growth strategy was put in place 19 years ago and has not been subject to revision—it involves a relentless focus on the commercial lending segment, a focus on the hiring (and rewarding) of proven producers, acquisitions of in-market community banks where the Pinnacle culture may be successfully (and accretively) deployed, and an emphasis on the well-being of employees. These same strategies are being employed on a smaller scale in the Atlanta market by a refocused **Atlantic Capital Bancshares (ACBI)**, and there are several other Southeastern community banks (like **South State Corp. (SSB)** and **CenterState Bank Corp. (CSFL)**) that are consolidating recent acquisitions and will soon be back on a higher-growth path.

We will admit that the focus of the market is unlikely to be soon diverted from the stocks like **Amazon**, **Alphabet**, **Apple**, **Facebook**, et.al., in spite of the well-known regulatory and reputational challenges that some of these companies face. But perhaps there is hope on the investment horizon, as we noted in a July 23 ***Bloomberg*** article titled "Value Stocks Haven't Traded This Low Since the Dot-Com Bubble." The article pointed out that value stocks went on to massively outperform growth stocks after the bursting of the dot-com bubble in 2000, "surging more than 50% against their opposing cohort in the next 12 months, MCSI indexes show."

Bloomberg reporter Justina Lee goes on to write: "A similar story for value…is prompting **JPMorgan Chase & Co. (JPM)** to declare a 'once-in-a-decade opportunity' to bet on the unloved factor. The yawning gulf represents 'the largest relative valuation bubble in modern equity market history,' bank strategists wrote in a recent note."

Ms. Lee's article goes on to cite the varying theories against a return to value investing—most notably, the view that the value factor has fallen into permanent decline as "Technology is evolving so rapidly that it's turned traditional sectors like financials and industrials into permanent laggards…" But as we have learned the hard way in 37 years in the business, "this time is different" is the phrase most often used right before a turn in the markets and most likely to be proved wrong.

Our solution is simpler and more elegant. We're going to make up a new investing segment and call it the "just enough growth" stocks. We're going to populate it with the stocks of banks that are growing loans and deposits at a modest and sustainable pace, have ample liquidity, are mindful of credit quality, and have enough capital and liquidity to amply reward their shareholders, and are smart and nimble enough to do the occasional accretive deal. And we're going to remind the investors in these stocks—as well as ourselves—that there will be times in the cycle when banks must show restraint and that the "truest growth" will be no growth at all.

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