B | S | Perspectives

May 22, 2017

Quarterly Earnings Review | 2017 | Q1

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

TRENDING OPTIMISTIC…

Sitting here contemplating the banking landscape and the most recent flow of headlines coming from Washington, it's hard for market observers and bank stock investors alike to know which way to turn. Bank stocks—which had been the market leaders earlier this year—have retreated to market performance (or worse) in the wake of a now somewhat less certain outlook for steadily rising rates and a loosening of regulatory constraints, as well as an anticipated delay in the much hoped-for cut in the corporate tax rate. As we go into the historically subdued market trends of the late summer months, is there much hope that these stocks can escape their usual seasonal torpor?

Well, maybe. For one thing, the second quarter is historically a strong one for bank lending as home sales pick up and stronger consumer and commercial lending flows from heightened housing activity. In addition, the widely anticipated June rate increase by the Fed should give net interest margins yet another nudge and give interest revenues a modest lift. Also, the incredible wave of consolidation activity (we'll say more on this phenomenon shortly) among large community banks here in the Southeast will provide investors a massively positive counterpoint to the gloom that presently prevails in other sectors of the economy (like retail). And finally, there is an almost universal belief among large-bank analysts that the CCAR results to come in mid-June will be positive for the major banks and that capital distributions from these companies will be allowed to increase from the levels of past years, thus sparking a "relief rally" in the sector as a whole.

As we reviewed our notes on the first quarter earnings of the Southeastern banks, one aspect of management commentary stood out, and that was the (almost) unanimous optimism for better economic and regulatory trends to come from Washington. While a few CEOs had tempered their cheeriness somewhat from their commentary in the immediate wake of the election, there is still a predominant belief in the banking industry as a whole—and in the community banks particularly—that the Trump agenda of tax cuts, healthcare reform and regulatory relief on the more onerous of the Dodd-Frank provisions will still be forthcoming. It will be interesting to see if this positive mood has dissipated in the July earnings calls as bankers and their customers contemplate the seismic political developments of recent days.

First for the fundamentals. The banks—of all sizes—continue to produce decent earnings results or better, but it seems that this message of industry vigor is being somewhat buried under the weight of concerns over the economy and the true direction of interest rates. While sequential earnings trends for our 18 monitored Southeastern banks were more or less flat (mostly due to seasonal expense patterns), the year-over-year comparisons for all these companies were uniformly double-digit, as were their returns on tangible common equity. (Yes, even for **Bank of America Corp. (BAC)**, which had been deemed by some pundits likely never again to reach a 10% ROTCE.)

The greatest positive feature of 1Q17 earnings for the Southeastern banks was a major lift in net interest margins almost across the board, as the impact of the December and March rate hikes finally moved these ratios off the dime. The fact that even the major Southeastern banks were able to move up margins meaningfully—up 11 bps sequentially, to an average of 3.05%--showed that the asset-sensitive strategies of these companies were finally beginning to pay off. Margins were also up in the community segment (up 3 bps to 3.72% for the large community banks and up 7 bps, to 3.87%, for the margin-rich smaller segment) but trends in this group can be much more volatile and strongly influenced by accretion flows and other unusual items.

There were also cautions, however, against expecting similar net interest margin increases in coming quarters, and the need to raise deposit costs at some point was an area of extensive discussion in the earnings calls. There has been little need to raise consumer deposit rates even as a "stealth rate war" is ongoing for the most lucrative corporate deposit relationships, but that reality is likely to change as we approach the end of the year. While the widely anticipated June rate increase may still produce only scant gains for retail savers, it was widely agreed that the next Fed increase after that would force a return to more normal historical "deposit betas" for consumer deposits, which seem to average out around 50% for most of the banking industry. Most CEOs and CFOs on our monitored calls also conceded the possibility that the "glide path" to normal deposit rates might not be as smooth as presently anticipated, given the unprecedented period of ultra-low rates that has prevailed since 2008.

The other item of note in the first quarter results was a sequential slowing of loan growth, and that condition was noted throughout the banking industry. In our group, loans actually declined at **BB&T Corp. (BBT)** (attributed to seasonality) and at **Wells Fargo & Co. (WFC)** (attributed to tightened credit standards in the auto portfolio and the impact of the cross-selling scandal on credit card volumes). Indeed, our monitored large banks saw the slowest sequential growth of all the segments (loans up about 2% annualized on average), with **Synovus Financial Corp. (SNV)** the growth standout with about 5% sequential annualized growth. We would note that neither Bank of America (3% annualized growth) nor Synovus, given their challenges in the wake of the Financial Crisis, are likely to want to produce portfolio growth rates that would tax capital levels in any meaningful way, no matter their ability to do so.

Loan growth trends in the community segment remain very respectable, with the largest banks in the group consistently registering double-digit annual loan growth rates (11%, roughly) and with most reporting production pipeline trends that should allow them to repeat that performance in the coming quarter. For our smaller community banks, growth trends were more subdued—the $85 million decline in loans at **Atlantic Capital Bancshares (ACBI)** (driven by a one-time reduction in mortgage warehouse participations) somewhat skewed our averages—but the overall experience was one of mid-single digits growth or better. We would particularly note the experience of **American National Bankshares (AMNB)**, where the placement of new lending teams in the Roanoke and Winston-Salem markets has begun to pay off and produced strong loan growth (19% annualized) in the first quarter.

On two other important metrics that we monitor—efficiency and credit quality—not much changed from the mostly positive underlying trends of 4Q16. Overhead ratios are always elevated throughout the banking industry in the first quarter due to the resumption of payroll taxes and the need to fund retirement plans for many banks, but for the major banks, the overhead ratio increase barely registered—63% in 1Q17 versus 62% in 4Q16. We would reflect that most of these large banks have been massively successful in expense control and that new cost-cutting "campaigns" are likely to be announced later this year if the path of interest rates does not proceed as expected. Ditto for the community banks—efficiency trends continued upon the same downward trajectory even as recently completed deals (like the acquisition of Southeastern by **South State Corp. (SSB)**) and continued rationalization of lines of business (ongoing at Atlantic Capital, for one) introduce occasional blips into quarterly efficiency ratios.

And while we must acknowledge the angst around the whole topic of credit quality—especially in the areas of auto lending and commercial real estate—we also must say that as of the first quarter, all potential issues seemingly remained quiet on that front. Loan losses fell at our monitored major banks (to a measly 26 bps, down from 33 bps in 4Q16) even as credit card portfolio losses registered their usual 1Q seasonal increase, and nonperforming assets also fell as energy exposures continued to decline or returned to performing status. As for the large and small community banks, where the net loan loss ratios were 10 bps and 7 bps respectively—well, what is there really to say?

And so it goes. But our feeling after absorbing the trends of the first quarter and looking at a plethora of numbers is that we all at this point are likely missing the forest for the trees. We have been looking at this industry for 35 years now, and we feel as we did back in 1998 and again in 2008—that the banking industry is about to be refashioned in ways that it has not been before. While the mega-consolidation periods that came before happened at the top of the asset size pyramid and resulted in the creation of the mega-banks that came to dominate national deposit market share and the ranks of investment banking, the changes of recent months are happening in the larger tier of community banking and will result (we believe) in the entry of some of these banks into regional bank status (i.e., assets greater than $50 billion) within the next two years.

Interestingly, few on Wall Street seem to see this mega-development coming. We attribute this fact to sell-side Wall Street banking coverage that is generally divided into major-bank and community-bank coverage, and our experience has been that seldom the twain shall meet. We see it as more advantageous now to be centered in a region and to look at the range of banking within that region across all size sectors. To that end, the Southeast seems to us to be uniquely positioned now at the center of the transition of a group of banks—we have called them the mega-community banks—that are quickly transforming banking here into an even more competitive landscape, to the advantage of small-and-middle market commercial customers and consumers alike.

For an analyst, the danger to this trend is a list of monitored companies that is in a mode of continuous shrinkage. Of the 18 banks that we monitor, three will soon be leaving that list—**BNC Bancorp (BNCN)** (to **Pinnacle Financial Partners (PNFP)**), **Capital Bank Financial Corp. (CBF)** (to **First Horizon National Corp. (FHN)**) and **Park Sterling Corp. (PSTB)** (to South State). While some of the impetus for these deals may have been management exit strategies that have been in place for some time or the need to monetize private equity investments made in the wake of the Financial Crisis, we see the greater transformative force as being the rise of companies—like South State and Pinnacle—where smart managements have proven track records of success and single-minded focus on their customers, and we think that no Southeastern bank (no matter its size) should fail to heed this trend and the banking powerhouses that are fast rising.

For now, the locus of consolidation is North Carolina, and it's easy to see why. The renaissance of Charlotte as one of the nation's most attractive places to live and work, the ability of the state's strong universities to attract bright young people who will want to stay there (a la Boston), the growth of the technology sector in the Research Triangle, the steady flow of retirees from the North into communities like Asheville, and on and on—it's a happening place from which banks can extend their reach into Virginia, Georgia and beyond. And indeed it seems to us that the next wave of consolidation will be coming to our home state, as the recovery of Atlanta from its meltdown blues is now complete, and the changes taking place in the state's largest city from both a political and a business perspective (the growth of fintech, the massive in-migration of millennials, etc.) mean that bank deals will not be far behind.

We want to put in one final word here in the spirit of "trending optimistic." On days like May 17—when the market fell apart in response to yet more foolishness in Washington and the bank stocks got absolutely clobbered—it's good to keep one thing in mind. Quarter in and quarter out, rising rates or falling rates, Republican or Democrat, the banking industry keeps building value. One need only look at the inexorable rise of tangible book value metrics each quarter—up 5% (annualized) for the largest banks in spite of the AOCI hit from rising rates; up 22% for the large community segment (the magic of book value-accretive stock offerings); and up 15% for the small community banks just on the strength of retained earnings—to see a story that is compelling and does not require a degree in rocket science to understand. Optimistic, indeed.

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

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