B | S | Perspectives

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Quarterly Earnings Review | 2015 | Q4

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INSTEAD OF THE QUARTER MARKING THE ADVENT OF SOME NEW BRIGHTER AND SUNNIER DAY FOR THE BANKING INDUSTRY, WE WOULD NOW SAY THAT THE OUTLOOK IS SOMEWHAT CLOUDIER—A CONDITION OF UNCERTAINTY THAT THESE STOCK PRICES HAVE REFLECTED MIGHTILY IN THE LAST FEW WEEKS. OUR GUT FEEL IS THAT WE ARE GOING INTO A YEAR THAT WILL BE INCREDIBLY CONSEQUENTIAL FOR BANKS BOTH LARGE AND SMALL.

Ah, yes, the fourth quarter of 2015—it already seems like the good old days. Think about it—the Federal Reserve had moved to start the "normalization" of interest rates, bank net interest margins and net interest revenues would begin to rise, and our economy would begin to return to something that looked more like normal as job growth continued and wage growth accelerated. Yes, there was that pesky little problem in the oil patch, but almost everyone conceded that it was a mostly isolated issue—one of oversupply that would eventually reach a state of equilibrium—that could be absorbed by the largest banks with minimal damage to earnings. The outlook for the banking industry in 2016 wasn't exactly rosy—but it wasn't exactly grim, either.

Fast forward a few weeks and here we are. The yield curve has collapsed, the Federal Reserve is talking about the possibility of (gasp!) negative interest rates, and the global markets are going to heck in a hand-basket. The growing consensus seems to be that central bank policies everywhere have become ineffective in countering what are dangerous deflationary trends around the globe, and some countries (Japan, most notably) are countering their own worsening economies by engaging in creative monetary policy that (at least for a few days) results in currency weakening and risks sparking de facto currency wars. And here in America, the possibility of worsening trends for near-term economic growth are fueling a vicious presidential campaign—on both sides—with the "too big to fail" banks becoming political punching bags yet once again. In succinct economic and societal terms—it's a hot mess.

There is one very good thing about the banking industry—not all banks look alike, and what are lousy prospects for one can fuel gains for another. The thing that struck us most clearly in fourth quarter earnings calls was the very clear bifurcation between the outlook for the largest banks and the prospects for the community banks,

most particularly in the outlook for credit quality and the over-representation of some of the major banks in the energy patch. These impacts will become more evident as oil reserves are assessed and revalued this spring, but the issue of asset quality in the banking industry is once again coming back into focus after having been a non-issue in recent years.

However, the major focus and the major concern around banks generally remains the magnitude and the direction of the industry net interest margin, and this focus will only be heightened in coming quarters as the Fed continues to opine on the possibility of negative rates and continues to give off conflicting signals on its program for rate "normalization." At this point, there is only one blanket statement that can be made on the subject of the NIM—and that is, despite the heroic efforts on the part of the banking industry, the overall direction of the NIM will continue to be DOWN.

The sequential decline in net interest margins from 3Q15 to 4Q15 was modest across the board—from 2.93% to 2.92% for our five covered major Southeastern banks; from 3.89% to 3.86% for our eight banks within the "sweet spot" of $5 billion-$10 billion in asset size, and from 3.50% to 3.49% for our group of smaller community banks. While community bank margins especially may be influenced to some degree by the amount of accretable yield (from past deals) available on a quarterly basis, the reality is that the biggest influence on the NIM in the industry is simply falling yields across all asset portfolios, and while the events of December and the (very) short-lived steepening of the yield curve may have given banks a bit of a respite in 4Q15, that good fortune has not persisted into the current quarter.

If there was one ray of sunshine in 4Q15, it was that very decent loan growth was registered during the quarter and indeed was robust for a number of our Southeastern banks. While some of the larger banks like **Bank of America (BAC)** are still struggling to show overall positive loan growth in the face of "legacy asset" runoff, the more normal experience was mid-to-high single digits (sequential) annualized growth in loans, with both retail lending and commercial real estate (CRE) lending showing the strongest metrics. (We found that year-over-year growth numbers were very distorted by deal activity, particularly in the large community segment.) In any case, the year ended on a note of optimism about growth, and it will be interesting indeed to see if this positive outlook persists in the 1Q16 commentary in mid-April.

Which Southeastern markets were hot? In reviewing our notes from the various conference calls, it was hard to find a major market that was NOT. Charleston and the adjacent coastal markets still seem to be getting the most mention for strong loan growth, but we would also note the commentary from **Pinnacle Financial (PNFP)** CEO Terry Turner about Chattanooga seeing "phenomenal" lending trends in 2015. (That PNFP would see a "great year" in Nashville growth is pretty much a given.) **Synovus (SNV)** CEO Kessel Stelling mentioned not only Charleston but also Birmingham (who knew?) as being bright spots for his company. Even our hometown of Atlanta—which has experienced a maddeningly erratic recovery from the financial downturn—seems to have found a more solid loan demand footing, with (what else?) commercial real estate lending most often cited as the primary area of loan growth.

We would also note that deposit growth ended 2015 much as it had begun—strongly. Fourth quarter annualized deposit growth equaled or exceeded loan growth for almost every company that we follow, and some of our banks like **United Community Banks (UCBI)** have even been able to continue to bring deposit costs down, largely as a result of the normalization of rates at acquired banks. **Park Sterling (PSTB)** of Charlotte, which had captured analyst (and depositor) attention in their 3Q15 call with their discussion of a

"high rate" strategy in their recently acquired Richmond franchise, found that program so successful that they raised $60 million by October and cut off the campaign, deeming it a "successful experiment" (one not to be repeated in the near term) in their 4Q15 commentary.

In short, there does not yet seem to be any lessening of the tsunami of core deposits flowing into the banking system—in spite of the Fed's best efforts to drive Americans into risk assets—and thus the issue of "deposit beta" that we mentioned in our 3Q15 Perspectives would seem to us to be dead, dead and DEAD. While **JPMorgan Chase (JPM)** did see fit to share some of the December Fed rate increase with select commercial customers—after CEO Jamie Dimon had earlier walked back his comments on the need to do so—the experience throughout the industry has been distinctly different, with deposit rates largely unchanged for both consumer and commercial depositors. Indeed, we expect a distinctly different conversation in April, when the possibility of negative rates and the many unknowns surrounding that possible condition will be the absolute top-of-mind topic.

A few further thoughts on the topic of asset quality. While the need for the major banks to raise reserves to cover their oil and gas exposures has been a hot topic in the financial press, that does not seem to us to be the most pressing matter extant for the banking industry. When we looked at the reserve levels across our covered companies, the thing that struck us was that loan loss reserve levels are at (or below) the magic 100 bps level at a number of companies, even as the decline in NPAs flattens (or reverses, in a few instances.) At what point will the regulatory agencies become concerned enough about the possibility of a recession in the U.S. to begin to look critically at these coverage trends? And will the looming advent of the new CECL loan-loss accounting methodology prompt regulators to jump-start the process of loss recognition?

So instead of 4Q15 marking the advent of some new brighter and sunnier day for the banking industry, we would now say that the outlook is somewhat cloudier—a condition of uncertainty that these stock prices have reflected mightily in the last few weeks. It now seems that the 4Q15 results and outlook were just one more data point along the long road from financial crisis to fully realized profitability for American banks, and even as the industry continues to outshine its global peers, that much-longed-for time at which the yield curve and loan demand will finally no longer be at cross purposes has been pushed further out into the future. In the meantime, banks (especially community banks) must continue to focus upon expense control as the tool most readily at hand, and even the most efficient (once again, those larger community banks, with an average overhead ratio of 61%) must continue to probe how low costs can be driven.

Our gut feel is that we are going into a year that will be incredibly consequential for banks both large and small. The Fed has already indicated that they will subject the largest banks to perhaps the most stringent CCAR process yet, with the persistence of negative rates for nine quarters as one of the adverse scenarios and with extra attention to operational risks being factors that are expected to result in a very limited opportunity for these banks to return additional capital this year. With the knowledge that Fed dictates often flow downhill, we would ask—will that growing rank of community banks becoming subject to the DFAST regimen also begin to encounter similar questions about operational controls and similar regulatory concerns about rapid growth?

We also have to ask (again) the perennial question about community bank consolidation—has the time finally come for the small-bank wave of consolidation that has been so often predicted to materialize? Will those banks that are materially under $1 billion in assets and have no hope of getting there soon finally read the handwriting in the yield curve and decide that the time has come to seek another solution? Will we see a wave of sales—or

a wave of mergers-of-equals—as a result? And will those community banks that will pass the magic $10 billion mark this year or next any longer have an interest in these smaller franchises—at any price?

And we also have a hope for the discussions to take place in April—that we can begin to touch the “third rail” question that is increasingly being asked of banks both large and small: Are you earning your cost of capital, and if not, when? With the growing investor view that several of the country’s largest banks may never reach that point, we may soon be in for a reordering of the banking industry the likes of which has not been seen in many decades. Banks everywhere need to be contemplating that question, and senior managers need to have a thoughtful and well-articulated plan in place for what may be another chaotic and evolutionary time.

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