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A blue-tinted photograph of a classical bank building facade with columns and a pediment. The word 'BANK' is visible in large, raised letters on the pediment.

Quarterly Earnings Review | 2018 | Q1

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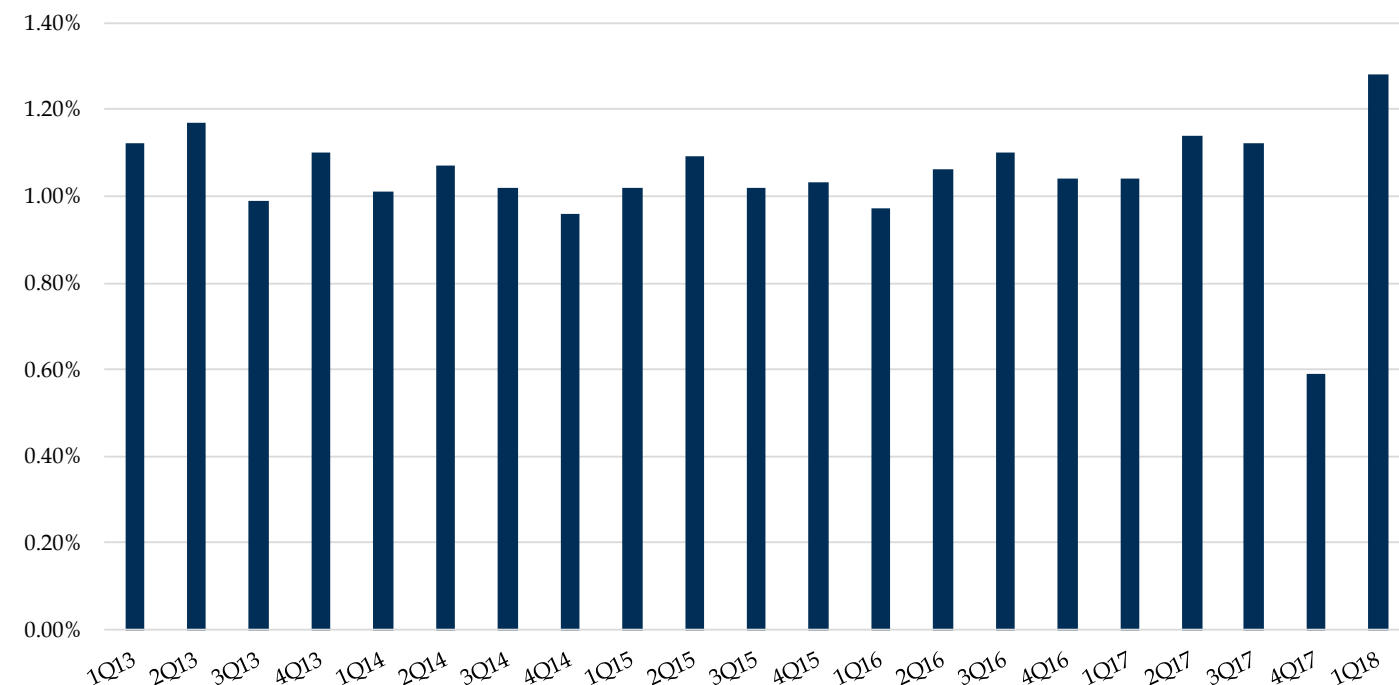
ARE WE THERE YET?

We have decided that being a bank analyst in 2018 is roughly the equivalent of being Bill Murray in some financial services industry version of **Groundhog Day**. Every quarter, we wake up at the beginning of earnings season, dutifully record the results and listen to the conference calls, and it's pretty much the same as the quarter before. Earnings are respectable—not overwhelming, but decent—and the fundamentals behind the numbers remain remarkably consistent. Loan growth is modest—in the mid-single digits on an annualized basis, with a few noteworthy high-growth exceptions in the Southeast—and the net interest margins show stability and perhaps some modest expansion. Credit quality continues to be exemplary, expenses are generally under tight control, excess capital gets dispensed, and life goes on.

Sounds pretty good, right? To someone who has been through the bank wars over the years, it is a scenario that could only have been dreamt of a decade ago. But we acknowledge that there has been a “frustration factor” in the bank stocks since the presidential election of 2016, and the impatience around sluggish loan growth has grown stronger with each passing quarter since that assumed inflection point. The election of Donald Trump resulted almost immediately in an expectation for a stronger economy, less restrictive banking regulation, and better revenue trends for the banking industry, and we would acknowledge that these expectations have certainly taken awhile to be realized.

The industry certainly got one of the biggest items on its wish list in 1Q18, when the corporate tax rate cut enacted late last year was translated into reality and the tax rate for our monitored Southeastern banks fell from an average of 30% in 4Q17 to about 23% in the first quarter. The FDIC remarked upon the impact of the tax law changes in its latest Quarterly Banking Profile, saying that, for the banks as a whole: “Using the effective tax rate before the new tax law, estimated net income would have been \$49.4 billion, an increase of \$5.5 billion (12.6 percent) from first quarter 2017.” Instead, net income under the new rates was \$56 billion, which equates to a whopping additional 13% (roughly) earnings kicker from the impact of lower rates.

Nationwide Average ROAA



Average ROAA is the industry's aggregate performance in each quarter on an annualized basis

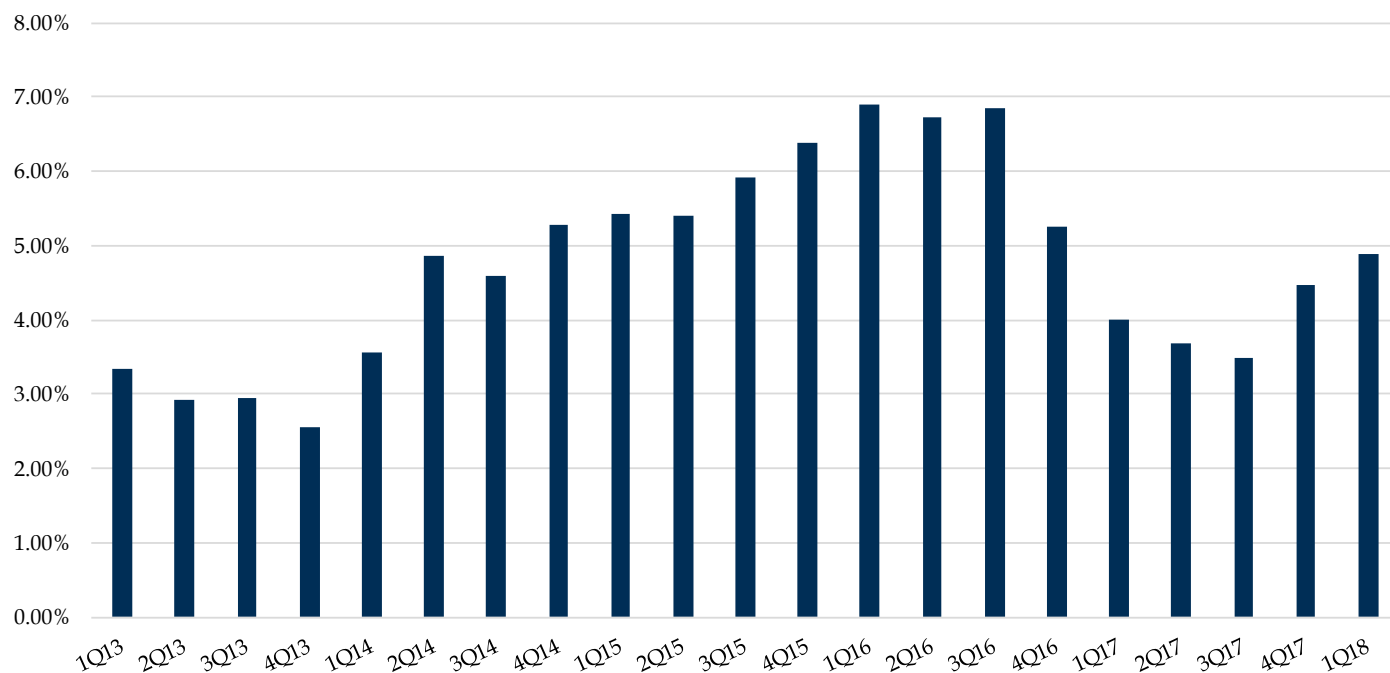
Source: FDIC Statistics At A Glance

The QBP goes on to say: "The average return on assets rose 24 basis points from first quarter 2017 to 1.28 percent. Less than 4 percent of institutions were unprofitable during the quarter, the lowest level since first quarter 1996." While we look at trends on a sequential basis—we believe them to be more predictive than year-over-year comparisons—we can make some similarly strong claims. The Southeast's largest banks saw their ROAA go from 1.12% in 4Q17 to 1.31% in 1Q18, while the South's fastest growing banks—the large community segment—saw returns go from 1.24% to 1.48% sequentially. And while we do not have a large-enough representative subset of small community banks (those with \$1-\$5 billion in assets) to draw any sweeping conclusions, we do think it is safe to say that these banks continued to perform at a high level of returns.

OK, good returns in the present and the ability to earn and return even more capital in the future—so why so glum? There was an overall subdued nature in the 1Q18 management commentary and as we reviewed our notes, we noticed the word "uncertainty" mentioned time after time. That uncertainty was reflected in a continued subdued pace of loan growth at many banks—not all, but most—and the first quarter earnings conference calls saw a fair amount of discussion of why annualized loan growth industrywide seems to remain stubbornly stuck in the mid-single digits range.

Kelly King, CEO of **BB&T Corp. (BBT)**, had one of the more interesting takes on his company's low loan growth rate—less than 1% annualized commercial loan growth reported, 5%-6% when adjusted for run-off in the mortgage warehouse—and it involved the lack of conviction on the part of small business owners, many of whom hail from the Baby Boomer generation. In Mr. King's view, these business owners are optimistic but cautious and are only now gaining the certainty to begin to hire and make investments in their businesses. The experience of the Financial Crisis remains raw for this group, but Mr. King seems to believe that this cadre of business owners is on the cusp of reinvestment and that BB&T's loan growth will accelerate by 3Q18 as a result.

Nationwide YoY Loan Growth



Loan growth is year-over-year as of period end for the industry as an aggregate

Source: FDIC Statistics At A Glance

Well, maybe. We have some sympathy for the Baby Boomer theory – as we belong to that group and caution is certainly our watchword – but we think that the roots of the subdued growth go deeper than that. The political atmosphere in the country is not conducive to certainty – whether it be prospects of foreign conflicts or the prospect of punitive tariffs or the very real possibility of even more political turmoil as a result of the upcoming midterm elections – and we are not optimistic that the situation will improve that much in the second half of the year. We hope that the impacts of the tax changes will lead to heightened business confidence – but color us skeptical that the FDIC’s reported 3.6% year-over-year earning asset growth rate is ready to take a great leap forward.

One thing is an unalloyed positive, and that is the fact that banks are getting better net interest margins on whatever asset growth there is out there. The NIM increased 4 bps (to 3.14%) for the largest Southeastern banks – where continued high levels of liquidity keep the margins thinner – but increased a more meaningful 11 bps (to 3.91%) in the higher growth large community banks. (Note – accretion always plays a part in NIM trends for these companies and is widely variable.) The FDIC cited a 13-bps improvement in year-over-year NIMs, for the industry, and that increase likely reflects the impact of the more-asset sensitive community segment. Given that these banks generally price at the short end of the yield curve and another two or three increases by the Fed are widely expected, we should continue to see higher NIMs (although modestly higher) through the rest of 2018.

That statement brings us to the ever-hot topic of deposit betas, and the story in 1Q18 remained much the same as it has for the last four quarters or so. Deposit betas continue to lag behind their historical rates of change, but with every increase by the Fed the expectation grows that these lagging rates of deposit pricing change will somehow begin to catch up with historical experience. Well, it hasn’t happened yet, although in some markets – like Atlanta, which always at some point in the cycle becomes a hot deposit market – there is anecdotal evidence

that the smaller community banks are beginning to use their tax benefits to aggressively price loans and deposits to keep the revenue machines running and the loan/deposit ratios below the much-feared 100% level.

There was one thing that struck us as we were reviewing our summary tables that may argue for deposit betas overall continuing to lag historical norms. Two of the banks that control a large chunk of Southeastern deposit market share—**Bank of America Corp. (BAC)** and **Wells Fargo & Co. (WFC)**—sit at loan/deposit ratios of 72% and 73%, respectively, and do not need to price aggressively, especially for retail deposits. Indeed, Bank of America's CEO, Brian Moynihan, said in his earnings commentary that he sees no pressure to raise deposit rates as roughly one-half of BAC's deposits are checking accounts and therefore transactional in nature. So it may be—we say hesitantly—that the banking industry (or some large part of it) will benefit from continued well-behaved deposit pricing even as yields on loans and securities portfolios continue to rise.

There was really little else that was remarkable about 1Q18 earnings, except that trends continue to move in largely positive directions. The industry experienced the usual seasonal rise in overhead ratios as early-year employment taxes kicked in, but we can say with some sense of comfort that we find almost every management with whom we speak to be intensely focused on expenses. Perhaps this unprecedented focus is the result of the uncertain revenue outlook or (we hope) that the cost-control practices that prevailed in the immediate wake of the Financial Crisis have simply become second nature in banking industry budgeting and planning. In any case, overhead ratios much in excess of 60%—no matter whether the bank be retail or commercial in nature—are viewed as outliers and are given close attention (ask the management of SunTrust) by the investment community on every quarterly earnings call.

As for credit quality, let us repeat our quarterly mantra: It just can't get much better than this. And while we know that it can't, and that it soon won't, positive credit quality trends are presently holding their own in the Southeast. According to the FDIC, this was largely the case for the industry as a whole, as loan loss provisions increased modestly and a 4.7% year-over-year increase in loan losses was attributable to an increase in credit card losses. For our Southeastern companies—especially those in the community segment—loan losses have been “lumpy” in nature for several quarters now and have been largely the result of one or two large credits that go bad for company-specific reasons. But we also think that it is inevitable that rising rates will lead to a change in the beneficent credit outlook, and that the most leveraged segment of lending—commercial real estate—will show signs of stress first.

Events that have taken place since first quarter earnings may prove more important than earnings trends in determining the performance of bank stocks in the coming quarters. First, there has been a virtual tsunami of deals in the community banking segment, with two important ones here in Georgia. **CenterState Bank Corp. (CSFL)** will enter the state—and will establish its banking presence in Atlanta—through its purchase of **Charter Financial Corp. (CHFN)**, a \$1.7 billion bank with operations in west and central Georgia, Alabama and the Florida Panhandle. In the process, CenterState powers into “mega-community” status and becomes one of the players for Southeastern presence, along with **Pinnacle Financial Partners Inc. (PNFP)**, **South State Corp. (SSB)** and several others. And the Atlanta area saw an even bigger incursion with the entry of **Cadence Bancorp. (CADE)** of Houston through the purchase of **State Bank Financial Corp. (STBZ)** (primarily of Atlanta and Macon, with \$4.7 billion in assets) to create yet another (\$16 billion pro-forma) mega-community Southeastern player.

The Southeast is clearly the place to be, and Atlanta, Charlotte, Nashville, Greenville, and the southeastern coastal cities seem to be on every large-community banker's wish list. Deal pricing has been hefty—State Bank commanded a 2.5X tangible book value price due to its meaningful Atlanta presence—but has not yet become

stratospheric, at least in terms of the impact on the financial metrics of the buyers. However, there has been one recent Midwestern deal that has stopped everyone in their tracks—the purchase of **MB Financial Inc. (MBFI)** of Chicago by Ohio-based **Fifth Third Bancorp (FITB)**—which was done at a 24% premium to MB's closing price and will result in a roughly 6.8 year hit to Fifth Third's tangible book value. It remains to be seen whether we have established some new floor on deal pricing or may have hit a temporary ceiling, but the reaction to this latest deal has been—well, harsh.

And there has also just been one much-anticipated and much wished-for event—the loosening of some of the bite of Dodd-Frank with the just-enacted (and verbosely named) Economic Growth, Regulatory Relief and Consumer Protection Act, which will have several important implications for mid-sized banks. The most important change was the lifting of the \$50 billion cap at which banks were deemed “systemically important”, and this should allow the mid-sized regional banks to become more expansive even as it allows the more aggressive community acquirers—Pinnacle Financial comes immediately to mind—to expand their sights on deal size.

There will be regulatory relief for the under-\$10 billion community banks in mortgage lending requirements, and there may as yet be some relief on stress-testing requirements for the large mid-sized segment. (That bit is as yet unclear and may require regulatory interpretation.) The major banks got little in the bill, but the Fed will be debating some loosening of the Volcker Rule on May 30. The prevailing wisdom is that there will be some additional ability for the large banks to do limited “proprietary” trading. In short, the regulatory stance has been softened for the banking industry, and it will be interesting to see if optimism on the part of the industry will translate into stronger revenue trends as a result.

So—are we there yet? Are we at the point where wishing and hoping for stronger loan demand will finally become reality—even as rising rates translate into stronger interest income? We don't yet have the answer to these questions, but we do know that all the pieces have finally been put into place for the banking industry to emerge from the second-class status into which it was plunged in the wake of the Financial Crisis. Are we getting ready to enter some new Golden Age of American banking—or will “Groundhog Day” keep playing, on an endless loop?

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