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Quarterly Earnings Review | 2016 | Q3

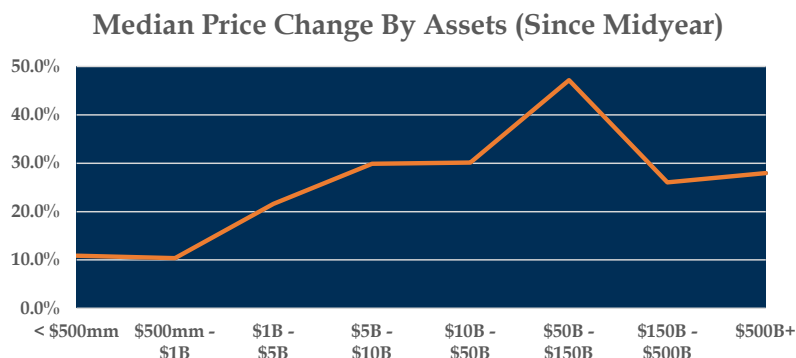
By: Nancy A. Bush, CFA
NAB Research, LLC
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WELL...WHAT NOW?

Wow—that's all we can say. Just wow. We went to bed on the evening of November 8 and awoke the next morning in an alternate universe—one in which the Republican Party had emerged not only triumphant but dominant throughout all levels of national government, that guy with the unlikely hairdo was President, and there were people all over the media who were wiping massive amounts of egg off of their faces. And most strangely of all, it seems thus far to be a universe in which the prospects for economic growth and for the fundamentals of the banking industry have materially brightened overnight. President Trump good for the economy and the banks? Who knew?

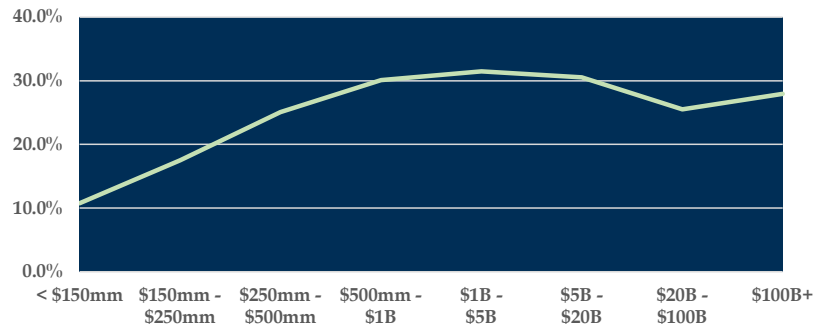
All of this is yet to be determined, of course, but it does seem that—at least for the moment—animal spirits have again been unleashed, both on Wall Street and on Main Street. The Dow Jones Industrials futures dropped 800 points in the wee hours of November 9 as it became apparent that Mr. Trump would take the Electoral College vote—and not by a little—but the stock market turned the next morning and has scarcely looked back. But with this renewed enthusiasm for stocks (the Dow is up 3% in the trading sessions since) has come a sudden disdain for bonds, and the result has been one of the most dramatic rises in yields in decades.

Public Banks Price Change, 06/30/16 - 11/18/16		
Asset Class	Number of Companies	Median Price Change
< \$500mm	89	10.9%
\$500mm - \$1B	112	10.4%
\$1B - \$5B	187	21.6%
\$5B - \$10B	61	29.9%
\$10B - \$50B	47	30.1%
\$50B - \$150B	10	47.2%
\$150B - \$500B	7	26.0%
\$500B+	4	27.9%



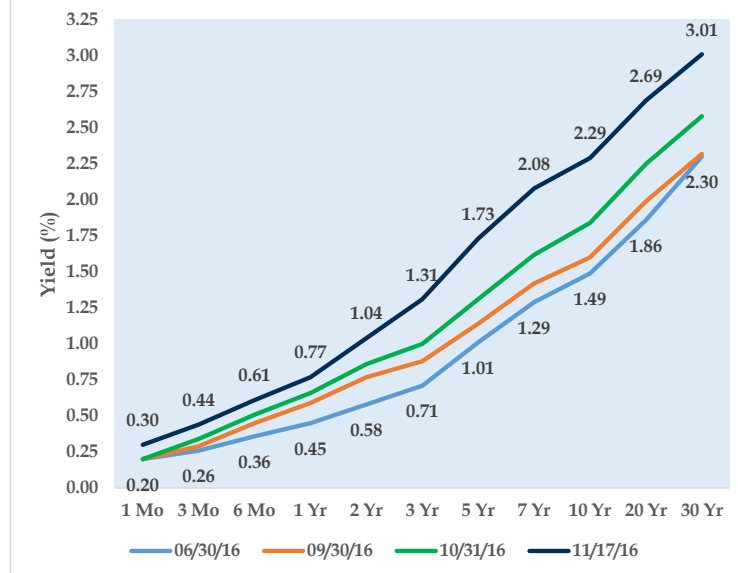
Public Banks Price Change, 06/30/16 - 11/18/16		
Market Cap Band	Number of Companies	Median Price Change
< \$150mm	225	10.8%
\$150mm - \$250mm	49	17.5%
\$250mm - \$500mm	63	25.1%
\$500mm - \$1B	59	30.1%
\$1B - \$5B	90	31.5%
\$5B - \$20B	19	30.5%
\$20B - \$100B	8	25.5%
\$100B+	4	27.9%

Median Price Change By Market Cap



The 10-year Treasury yield has risen from 1.86% on the eve of the election to 2.34% in less than two weeks—a massive and dislocating move—and the promise of more to come has led to what is being called a “rout” in the bond market and a massive inflow into stock ETFs (estimated by Zacks to be about \$26 billion into the SPDR ETFs since the election.) And the big winner has been the financial sector, with about \$4 billion flowing into the Financial Select Sector SPDR (XLF) in Election Week alone. (The XLF was up 11% from November 8 through November 15.) The reasons for this sudden enthusiasm are pretty straightforward—the anticipation of infrastructure-fueled GDP growth and rising rates, as well as lessened regulation—but it remains to be seen how completely and how quickly all of this will play out.

A Steepening Yield Curve



The positives of this seismic political change are pretty easy to imagine. The banks have been begging for a steeper (and higher) yield curve, and now they’ve got it, and the very real possibility now exists that a Donald Trump-mandated “infrastructure program” will lift GDP growth out of its present moribund state and encourage business investment spending to come off the sidelines. In short—higher net interest revenues

(possibly dramatically higher) after many quarters of slippage, a factor that should be especially positive for the more lending-dependent community banks.

Rising equity markets should give some boost to fee income for those banks engaged in asset management, and a more relaxed regulatory environment—especially on the part of the CFPB—should result in some lessening of compliance costs. And important changes in the leadership of the SEC and (possibly) on the board of the Federal Reserve may give the banking industry—and investors—greater confidence that the capital standards for the industry will not continue to be ratcheted ever-higher and that the banks will not continue to be the convenient political punching bags (and generators of stiff regulatory penalties) that they have been in the years since the Financial Crisis.

Our thought—be careful what you wish for, because there are almost always complications to any rosy scenario. For one thing, a dramatic and quick shift in the rate environment is seldom without its downside complications and jolting outcomes, and we would point to the mortgage market as the obvious Achilles heel of higher rates. What will be the psychological reaction of home buyers to a 30-year mortgage rate that suddenly begins with a “4”—in spite of the fact that such a rate is still far below the long-term historical level? Will rising rates be just one more issue that persuades the notoriously purchase-averse Millennial generation to not buy a home but to continue to rent? Will housing affordability—which had begun to skew away from renting—become an issue for potential buyers yet once again?

We would also point out that the extraordinary asset quality results that we have seen in recent years have been at least in part a function of low borrowing costs, and that the cracks that we are beginning to see in some segments of the market—commercial real estate, most notably—may be exacerbated as these loans roll over at higher rates. Indeed, as the *Wall Street Journal* pointed out in a recent piece (“Trouble Brewing in Commercial Real Estate”), defaults are increasing in the CMBS market as the 10-year, pre-crisis paper comes due, and at the same time rising vacancy rates are being reported in multi-family housing throughout the nation. It’s not for nothing that the regulators have warned about overexposure to CRE (the 100/300 guidelines), and the impact of rising rates may show itself in short order in further CRE stress and even greater regulatory concern.

On the regulatory front, we would also hope that cooler heads will prevail when it comes to the fate of Dodd-Frank, and that the wheat will be separated from the chaff. While parts of this signature legislation have admittedly been a massive headache for the banking industry and have undoubtedly hindered lending and profitability, we should not lose sight of the fact that some parts—most notably the DFAST/CCAR regimen for the largest banks and DFAST for banks over \$10 billion in assets—have been seen globally as the seal of approval for the safety and soundness of the American banking system. The GAO report that was issued last week pretty much ensured that changes were coming to the stress test process anyway—the Fed got dinged pretty good about issues like transparency and consistency in its modeling—but it seems to us that this annual testing process should be continued and further refined for banks of all sizes.

Given that so much of the current enthusiasm for bank stocks is based on a view of a changed future, is it still worth looking at present trends and recent results? Well, yes. Earnings still do count, after all, and it may be some time before all of this expected largesse for the banks comes to pass. As we said earlier, the possibility of negative near-term outcomes in the mortgage markets and in credit quality will mandate that banks continue with their present strategies and reshape their balance sheets in order to maintain profitability (and to buttress tangible book value) in the face of possible dramatic headwinds in credit markets and in demand.

Having said that, the only way that we can characterize the results of the third quarter is that they were bifurcated—and somewhat odd. While most of the companies that we follow met or exceeded their estimates, there seemed to be a wide dispersion of how those results were achieved. Among the largest banks, the degree of capital markets activity—especially in the fixed income, commodities and currency revenue lines—made the difference between wildly positive surprise and earnings that were just so-so. In the mega-community group—those banks between \$5 billion and \$15 billion in assets—strong (mid-teens) loan growth was the driving force, combined with early cost saves from recently completed deals. And in the smaller community group, loan growth was solid (high-single digits) and when combined with miniscule loan losses (or net recoveries, in some cases), produced results that were largely stable and high-quality.

For the largest banks—and this was true not only of those located in the Southeast—there was a noteworthy slowing of loan growth in the commercial and industrial segment, and the uncertainty surrounding the presidential election and Brexit in the U.K. were most often cited as the reasons. Overall, sequential quarter loan growth for these companies was pretty moribund—1% in the third quarter, versus an already not-great 3% in 2Q16—and we would have to posit that more than “uncertainty” was the cause. Energy loans at these banks continued to run off as these portfolios were culled, and larger corporate loans seemed to be down as well. We also continue to believe that these larger banks are deliberately pulling back on CRE—especially construction loans—as a result of heightened regulatory scrutiny and are increasingly ceding this business to the larger community banks.

It’s a good thing that the Trump-inspired rate rise has arrived, because banks need the help. While net interest margins did not see big declines in the Southeast and indeed can be said to have stabilized, they’re doing so at levels that would have been unimaginable only a couple of years ago. The major banks continue to record the region’s skinniest NIM levels (2.93% on average, a 2-bps decline from the prior quarter) as the need to carry high levels of liquid assets and intense loan pricing competition continues to weigh on this segment. The mega-community segment has the highest NIM in our coverage (3.69%, a 4-bps sequential decline), but it must also be noted that this select group of companies also enjoys the highest level of accreted yield due to its past history of deal-making. And the smaller Southeastern banks continue to hold their own with an average NIM of 3.61% (down 2 bps) as they continue to enjoy unique positioning within their communities.

The issue of the future direction of NIM leads to an interesting question—one that has not been asked in some time now. As retail consumers become more aware of rising rates—and those who are seeking mortgages will quickly do so—is it time to revisit the issue of deposit beta? Deposit growth has been considerably stronger than loan growth in the banking industry for some time now, and most banks are flush with liquidity. But will the anticipated stronger economic and lending growth dictate that banks take measures to lock in core deposits and become more competitive with both deposit rates and product offerings? How quickly will interest-starved savers begin to look to CDs again as a major part of their deposit holdings? And will deposit pricing wars break out here in the Southeast particularly as we continue to enjoy the nation’s highest rate of growth?

There is another issue that should be considered now, and that is whether a changing revenue outlook for the banks will lead to any changes in the ongoing expense reduction programs that have been a feature of the last few years. We fervently hope not, but we must also reflect our 30-plus year experience is that growth creates its own spending in the banking industry and that the lessons of lean times are quickly forgotten. And if lending volume picks up materially, there will be a need to spend on the relationship managers and support personnel to accommodate the additional volume on the commercial side. But this time around may be different, as the central focus of ongoing cost reduction in the industry concerns the delivery of retail banking and how

consumer preferences may be changing as the younger generation looks to bank differently than their parents. It's hard to see a return to branch-building no matter what the robustness of the environment, and with the continued evolution of digital delivery should come continued progress on the expense reduction frontier.

It's hard at this juncture to judge how lean the banking industry actually is, due to the overall quiet revenue environment, but it is directionally correct to say that overhead ratios came down throughout our coverage universe in 3Q16. The leanest companies remain the mega-community banks, where the overhead ratio declined materially from 59.6% in the second quarter to 58.3% in the third. The major Southeastern banks continue to show progress (down 8 bps, to 62.1%), but these banks continue to be burdened with large branch systems that need further rationalization and ongoing legal "clean-up" expenses. And the smaller community banks—operating at a 62.8% average overhead ratio in 3Q16, down from 64%—will continue to show progress on expenses as companies like **Park Sterling (PSTB)** and **Atlantic Capital (ACBI)** get beyond the growing pains of mergers and business build-outs.

As for asset quality, as we and others have said for many quarters—it's hard to see how it gets much better, and yet it does. But that oft-repeated mantra may indeed be growing near fruition as the rate environment changes and the business expansion grows longer in the tooth. The major Southeastern banks charged off 31 bps of loans in 3Q16—a number that was heavily influenced by the 40 bps net loss level at **Bank of America (BAC)**—and we still can't believe that either of those numbers was attainable after the harrowing loss experience of 2008-2009. As for the community banks, the mega-communities experienced 10 bps of losses in 3Q16 (down 2 bps sequentially) while the smaller community segment had 6 bps of losses (down from 9 bps.) Yes, indeed—it's hard to see how it gets much better, and if the warnings about CRE asset quality are correct, it probably won't.

What is coming in 4Q16? At this point, our crystal ball is decidedly cloudy, but we would be prepared for surprises as the impacts of the presidential election play out and the banking world reorders itself. (As Bette Davis so memorably declared in *All About Eve*: "Fasten your seat belts. It's going to be a bumpy night.") The reality is that a 180-degree change in the banking environment will be accompanied by a few sharp turns, and these are likely to play out in 4Q16 and 1Q17 as the new regulatory structures become better known and companies large and small make plans for the Newest New Normal. But for us here in the Southeast—where we have growing banking icons like **South State (SSB)** and **Pinnacle Financial (PNFP)**—it all looks like gravy (and continued growth) from here.

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