B S Pulse

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A Matter of Value…

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With profuse apologies to T.S. Eliot, April is NOT the cruelest month. As any Wall Streeter—or indeed, any investor—knows, that ignominious descriptor belongs to the month of October, which is the period in which stocks generally get clobbered. That is a historical fact dating back to October 1929, when the first real market crash of the modern era began, resulting in a decline that went on for years and gradually reduced the stock market to a paltry 10% of its pre-crash level.

The October that has just passed was not that bad, but it was no barrel of monkeys either, and it was particularly cruel to our group of bank stocks. Of the 18 Southeastern banks that we monitor, only two—**BB&T Corp. (BBT)** and **Wells Fargo & Co. (WFC)**, ironically—did not go down during the month of October, and price declines in the rest of our surveyed stocks ranged from 6.1% for **Ameris Bancorp (ABCB)** to a whopping 18% for **Synovus Financial Corp. (SNV)**, which is obviously still battling the **FCB Financial Holdings (FCB)** merger blues. This markedly subpar performance was particularly noteworthy given the fact that the BKX (KBW Nasdaq Bank Index) declined "only" 5.7% in October, outperforming the 6.9% decline for the S&P 500.

But now that it's early November and the midterm elections are thankfully behind us (without disastrous effect, so far), is it time to treat the experience of October as ancient history and take a new look at these companies? We believe so. There has, after all, been an aura of doom and gloom hanging over the bank stocks for some time now, mostly due to the realization on the part of the markets that the Fed would be true to its word in pursuing a course of "normalization", no matter how many rate increases that might take. The resultant rising costs of deposits for the banks—especially for some of the smaller banks in competitive markets—has become an issue of concern for investors, as has the high level of loan payoffs and the resultant subdued pace of lending activity.

It strikes us that it may be time to drag out an old concept regarding the bank stocks—that of value investing, and indeed whether these stocks may qualify as "value" stocks. And for those who might need a reminder on what value investing is, we quote that unimpeachable source, ***Investopedia***: "Value investing is an investment strategy where stocks are selected that trade for less than their intrinsic values. Value investors actively seek stocks they believe the market has undervalued... Typically, value investors seek to profit off this irrationality by selecting stocks with lower-than-average price-to-book ratios, lower-than-average price-to-earnings ratios and/or higher dividend yields."

We will readily admit that applying the concept of value investing to bank stocks in the past has often been a fool's errand, despite the success achieved by such legendary investors as Peter Lynch and Warren Buffett in championing some of these stocks. Mr. Buffett particularly has made billions on buying stakes in banks when they are down—his purchase of a preferred stock from **Bank of America Corp. (BAC)** in the wake of the Financial Crisis netted him billions a few years ago as BAC and its stock strongly recovered—and he has continued to stand behind his holdings of Wells Fargo's stock even in the face of its well-known challenges to its reputation and profitability. These two exemplary investors have historically seen something in bank stocks that has eluded others and they have been (mostly) handsomely repaid for their vision, and admittedly for their timing as well.

The problem with value investing in bank stocks is contained within the word "intrinsic"; we would admit that intrinsic value is a quality that may be in the eye of the bank stock beholder. Banks are, after all, largely opaque pools of assets that may be of varied quality and whose ultimate performance characteristics may not be fully known at the time of investment. The real value of any bank and its portfolio tend to become known only in times of stress, when the disposition of those assets may come at a steep discount and thus future cash flows are stressed and are likely to decline.

The change in the regulatory regime in the last decade has been such that those negative events—sudden deterioration of asset quality and declines in expected cash flows—have become much less likely than in the run-up to the Financial Crisis, and thus our thought that value investing may (finally) be a concept that is truly applicable to the bank stocks. In our view, the focus on asset quality (enforced through the various stress-testing regimens) and the requirement for strong levels of core deposit liquidity have made much less likely the sudden deteriorations that have been a feature of the banking industry in the past and have given the concept of "value" in banking stocks a decidedly dubious past.

Do these select Southeastern stocks represent a value opportunity now? They are selling at a collective P/E multiple of roughly 75% of the S&P 500's P/E multiple, based on the Street's consensus estimates for 2019. While this is not bargain basement cheap, it is inexpensive relative to the 85%-90% relative valuation of recent months and seems to us to be overly punitive based upon recent earnings trends and future earnings potential. Trends in 3Q18 earnings results were certainly better than respectable and pointed to building momentum in lending volumes—which have been adversely impacted by a high level of loan payoffs in the last two quarters—and a cooling impact of deposit pricing competition on net interest margins. And best of all, the traditional killer of bank stock valuations—deteriorating credit quality—has reared its ugly head in only a few specific (and predictable) instances and in the higher quality banks is notably absent.

How about dividends? As an investor who invests first and foremost for cash flow, we must admit that this group of stocks looks particularly attractive. The problem with buying bank stocks for dividend income and dividend growth has been the tendency of banks to crash and burn (due to a credit quality and liquidity crisis) every decade or so and to cut (or omit) their dividends as a result. In this regard, the rigor of the stress-tests for the major banks and the degree of regulatory oversight for the industry generally has served to keep dividend growth to sane and sustainable levels and to ensure that dividends will remain uninterrupted in coming years.

While we concede that it may take a few more years for the investing public to believe that bank stocks are trustworthy dividend growth stories, we do believe that the likelihood of that happening is greater than at any time in our career. We would also point to attractive dividend yields—in the 3%-plus range—for major Southeastern companies like BB&T (3.3%) and **SunTrust Banks Inc. (STI)** (3.2%) as being particularly attractive presently, and the dividend yields of growth banks such as **United Community Banks (UCBI)** and Synovus (2.4% and 2.6%, respectively) to be also worthy of note.

Perhaps it is best to characterize our view of this group of Southeastern stocks as "value-specific" investing, as there are those that we monitor who are dealing with issues of past strategies and disadvantageous competitive positions that are yet to be overcome. But when we look at some stocks in this group, it is hard to see anything other than histories of high credit quality, conservative management and judicious and measured deal-doing, and we think that the present atmosphere of investor indifference has created attractive opportunities in these names.

Let us close with a look at a company that ticks all those boxes—that of **South State Corp. (SSB)**, which is one of the Southeastern growth banks that we most admire. This company encompasses the credit quality discipline of the old **Wachovia** (the one headed by John Medlin), the attractiveness of strong fee-based businesses (fiduciary and asset management), and thoughtful and careful mergers, most recently **Park Sterling** in Charlotte, NC. For all this quality, investors would pay roughly 1.9x tangible book value, 12x next year's earnings, and receive a dividend (recently increased) of $1.44 per share (for a 2.0% yield.) Well—what's not to like about that?

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