SNL Blogs

NASHVILLE NOTES

Friday, May 29, 2015 7:19 AM ET

Heartland Financial USA still in the sweet spot

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL Financial contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

I attended Heartland Financial USA Inc.'s annual meeting on May 20. For over a decade I have made the annual meeting trek to Dubuque, Iowa most years. The confab is not like the one to the west in Nebraska, but there are usually good nuggets to walk away about creating value for shareholders.

While chatting with CEO Lynn Fuller, one of the things that struck me is that he has always believed in Heartland as an institution and a money-maker for shareholders. On another occasion he asked me the rhetorical question, "where else would you put your money?" He is a significant shareholder with a 5.0% interest.

Maybe there is something about Iowa that breeds optimism. Heartland's lead bank, Dubuque Bank & Trust Company, was chartered in 1935 two years after President Franklin Roosevelt signed the Emergency Banking Relief Act. At the time, the farm economy and presumably Dubuque's was challenged, too, due to depressed commodity prices, which resulted in another landmark piece of legislation in FDR's first 100 days — the Agricultural Adjustment Act. I remember a high school teacher describing the implementation of the law as mass crop burning, though he probably was exaggerating.

The company was formed in 1981 in order to diversify its then-dependence on Dubuque, which was severely impacted by the recessions of the early 1980s that resulted in Dubuque having one of the highest unemployment rates in the nation. That is ironic because Dubuque the past decade has been thriving as a smallish town of fewer than 100,000 on the Mississippi River that serves as a regional hub to the surrounding farms in Iowa, Illinois and Wisconsin. The formation of the holding company became the launching pad for 17 completed acquisitions going back to 1988, and two pending deals that have diversified the company's banking office geography to 10 states in the Midwest and West.

When I first started covering the company as a sell-side analyst in the early 2000s, I was struck by the geographic and revenue diversification, good profitability and modest valuation. The company was much smaller then and was not on Wall Street's radar. It reminded me of Alabama National BanCorp. given its structure and returns, which was then favored by many small-cap bank institutional investors given a combination of geography, growth, returns and revenue diversity.

The primary pushback I got over the years was that the geography was too big to manage for a small company and the shares were too illiquid to buy and sell. Although the shares remain illiquid by institutional standards (~42,000 share average over the past year), volume has trended higher as the company issued shares to consummate acquisitions. Additional acquisitions that are financed with newly issued shares (shareholders recently approved an increase in authorized shares to 30 million from 25 million) should support better trading activity in time, though the two pending deals are for cash.

As for the "geography issue", I think management has proven skeptics wrong. There have been no major earnings stumbles since 2000. Although the company struggled with asset quality during 2009 and 2010, the situation was manageable. In the years leading up to the financial crisis, ROTCE was in the mid-to-upper teens. In 2009, the return fell to 5.0%, but has trended higher to over 12% in 2013 and 2014 and over 14% for the last-12-month period ended March 31. Compounding matters for long-term investors, tangible book value per share increased 390% to $20.41 per share at March 31 from $5.23 per share at year-end 2000. LTM EPS of $2.59 per share is 4.0x 2000 earnings of 65 cents per share.

Helped over the years have been a few judicious acquisitions and probably some loans that were not made. I think one of the notable events was a well-timed expansion of mortgage banking in 2010 when a well-established mortgage banking group, National Residential Mortgage, joined Heartland. Mortgage banking contributed just $1 million, or 4% of 2011 pretax income; it contributed $19 million or 29% of pre-tax income in 2012 when the yield on the ten-year U.S. Treasury declined to under 1.5% in mid-2012 from around 3.0% in mid-2011. ROTCE jumped to 17.6% in 2012. No doubt the 2012 earnings momentum helped the shares in 2013 and helped management negotiate a couple of acquisitions that supported earnings in 2014 when mortgage was not so robust. True to its cyclical nature, earnings for the first quarter of 2015 were helped by strong mortgage banking (and bond gains) that resulted in a blow-out quarter with EPS of 76 cents, compared to the 55 cent consensus.

Management has been clear that the company will continue to be a consolidator. Unlike some or maybe most bank acquirers, I think shareholders have been well served by the acquisitions, all but one or two of which can be considered smallish. Plus, Heartland's expansion markets and some of its legacy markets such as Dubuque provide good organic growth opportunities.

Fuller has a point about why he has his money in the company's shares. Heartland's total return as of May 28 for one-, five- and ten-years was 43%, 114% and 143%, compared to 10%, 66% and 17% for the SNL Small Cap U.S. Bank Index of the same time periods. In spite of the run in the shares over the past year, they are not especially expensive at 13.3x LTM EPS and 169% of tangible book value per share. That does not mean the stock is undervalued or should trade higher near-term, but it seems to me Heartland is still in a sweet spot to grow and management has proven adept at compounding value over time.

Published with permission.
Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.