NASHVILLE NOTES

Is lending money at less than 3% worth it?

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By Jeff K. Davis

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Among the market quips ascribed to Warren Buffett and his mentor Ben Graham is "the market is a voting machine in the short run, but in the long run it is a weighing machine." My interpretation is fundamentals matter long term, although any number of factors may influence share prices in the short run.

Time will tell if the market sell-off on Friday, Nov. 26, was a speed bump in the post-March 2020 bull market or an inflection point that leads to some reversal of the big gains since central banks and governments opened the money spigots. The NASDAQ Bank Index declined 4.7% on Nov. 26 and 2.3% on Nov. 30, but is up 48% for the one-year period ended Nov. 30, 2021. Measured from the halcyon world two years ago, the index has risen 25%.

There is never any clarity when contemplating the future, but markets have more to consider than usual when "voting" today. The two interrelated big issues are whether the latest COVID-19 variant will blow over or upend the economic rebound and the impact of Fed tapering on asset prices and interest rates.

I think one of the more interesting developments the past few months is long-term rates. The 10-year U.S. Treasury bond only yields about 1.5% even though inflation is through the roof and the market is pricing in about four hikes by the Fed beginning next year through year-end 2023. Either long rates will trend higher, or the market will limit the Fed to a few hikes, if any at all.

Absent stronger loan growth and rising short-term rates, earnings for many banks will be lower in 2022 because Paycheck Protection Program fees will be minimal, mortgage banking will be weaker and reserve releases have run their course. Also, competition for loans is incredibly intense. Investors and analysts know this. EPS estimates for many banks are lower for 2022.

Directors and executives as stewards of shareholder capital are charged with prudently deploying the capital and earning an acceptable return. It is not a legal opinion (I am not a lawyer), but I believe most corporate attorneys would advise boards that they are not obligated to maximize value in the short-term; rather boards should have a long-term plan to create value.

That earnings may decline next year for reasons outside the control of management is not a reason to deviate from a long-term plan. Nonetheless, I think one question boards will (or should) debate is whether an acceptable return on capital can be generated if rates do not rise. It is a question that many directors who began their careers years ago when inflation and interest rates were much higher cannot fathom, but the bond market is saying they should consider it.

Stated differently, does it make sense to leverage shareholder capital to lend money fixed for a multiyear period at less than 3% even if an institution has a boatload of non-interest-bearing deposits? Does it make sense to shareholders to lend at a floating rate of less than 3%? Many would say no, absent an ultra-low-cost structure, but will take a wait-and-see stance regarding potentially rising rates and the positive impact on return on equity.

Nonetheless, the outlook for M&A should be very good next year provided bank stocks do not decline too much. Buyers' public market multiples are what I would characterize as supportive of M&A. The price/tangible book value and price/earnings multiples for the S&P U.S. Smallcap Bank Index were 2.0x and 13.7x as of Nov. 30. The bank M&A market tends to ebb and flow with the performance of the public market since a significant form of consideration is often the buyer's shares.

For transactions in which the primary consideration will consist of the buyer's shares, the rate outlook should not matter that much. If the Fed raises rates, the net interest margin and earnings of both buyer and seller will increase, though not necessarily by the same amount. Sellers would provide more earnings to the buyers, but the accretion calculation will be based upon the buyers' higher EPS.

The number of shares that will be issued to the seller as the merger consideration is the issue; price is a function of the issuance and the buyer's public market price. Sellers who take the buyer's shares retain optionality to rising rates and the positive impact that would have on EPS and ROE.

Cash deals and deals in which a material amount of the consideration consists of cash are different. Here, there is no relative measure of earning power between seller and buyer. If rates rise, the seller's earning power increases. For boards that are thinking about selling in cash transactions, waiting on the Fed for a while may be a prudent decision for shareholders.

Probability of rate hikes and actualities are not the same thing, however. Markets — equities and rates — will do whatever they will do. Next year is shaping up to be an interesting year for bank stock investors.

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