NASHVILLE NOTES

Reset in motion

Tuesday, March 10, 2020 9:45 AM CT

By Jeff K. Davis

Jeff Davis CFA is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where he is the managing director of the financial institutions group; or StillPoint Capital, where he is a registered representative.

I do not mean to downplay whatever risks lay ahead or to minimize the impact the coronavirus has had on those who have and will be infected, but human beings since the dawn of time have faced a multitude of crises yet managed to survive and later thrive. I assume we will pull through the coronavirus and whatever aftermath follows.

That said, I am penning this on a flight from Nashville to Panama City, reminding me of 12 years ago when Bear Stearns collapsed. At the time, my family was on spring break in the Florida Panhandle when Bear Stearns was forced into a fire sale to JPMorgan Chase & Co.

An unfolding recession turned into a deep recession because liquidity in markets evaporated due to the failures of Lehman Brothers and other financial institutions, which were reported on the front page of *USA Today* rather than buried in the business section. Forgotten among the dramatic headlines was a run-up in oil prices to well over $100 per barrel by midyear 2008 that helped spawn the term "staycation."

Like the spring of 2008, markets today are trying to find a new equilibrium that reflects the reality of slower or negative economic growth, radically lower interest rates, and possibly an extended period of very tight credit for levered companies. For bank investors, the silver lining is that energy investors — both debt and equity — are in a much worse spot after Saudi Arabia launched a price war on fellow producers.

I see several takeaways for banks.

The obvious is that net interest margins are headed lower. I think, based on initial earnings revisions I have seen, that the damage will be worse than what the Street believes. That is not to say bank stocks do not somewhat reflect this, but the setup may be for a series of estimate cuts from the Street, as I suspect the first cut will not be sufficient. Unlike 2008 and 2009, loan and bond portfolio yields are much lower today. As was the case in 2008, there is little room now to reduce core deposit rates. Plus, credit was very tight then, with elevated London interbank offered rates and lenders able to extract premium margins over Libor and other benchmark reference rates for those that choose to do so.

Second, credit costs are headed higher. My bias had been for a moderate increase, with the exception of energy and travel credits specifically and leveraged borrowers more generally. Today, I am not as optimistic, as a deflationary shock to the global economy has been unleashed that might yet be contained. The adoption of the current expected credit loss model will provide cover for banks to pad the increase in reserves that otherwise would have occurred, but loan loss reserves are an accounting entry that moves equity (Tier 1 capital) to reserves (Tier 2 capital). What matters will be loss rates.

Liquidity provided in the leveraged loan and high-yield markets will be an important variable. These markets are nearly shut to non-investment-grade borrowers. Companies in need of cash near-term due to maturing debt and other obligations not funded from cash flow will have to look to commercial banks, business development companies and private credit funds.

Presumably, creditworthy borrowers will obtain bridge financing at a penalty rate until bank debt can be refinanced in the capital markets. However, many marginal companies — those with weak business models and capital structures, and too much debt — will fail. Our system is designed to quickly move the assets to creditors and stronger competitors. Any actions by governments that impede this will only delay recovery. Besides, one could argue that there are too many marginal companies today because yield-starved investors have been willing to buy the debt of weak companies to obtain some semblance of a reasonable coupon.

I fully expect commercial banks to step into the breach and lend where the market will not for the time being; however, a secondary casualty of rising loss rates will be share repurchases. During the past few weeks, a number of banks have announced new share repurchase programs. Given falling asset prices and the need to protect capital, prudence requires curtailment. I think this will apply to the broader market, too, in which corporate America will move to harbor liquidity for now and thereby remove the significant crutch that repurchases have provided to the market.

Finally, M&A will become more imperative among commercial banks as NIMs structurally go much lower. While banks such as Zions Bancorp NA have announced and will announce major expense reduction initiatives, such actions will not be sufficient to sustain a competitive return on equity. I suspect the executives of Truist Financial Corp. are quietly relieved that the respective boards of directors of SunTrust and BB&T had the courage to combine. Truist is executing a plan to combine two superregional banks and extract significant cost savings on what will be a lower run-rate of revenues than originally envisioned when the deal was announced.

As for investors and M&A participants, the challenge, as always, will be first to think about earning power, rather than next year's estimate, and what is a reasonable valuation in terms of earning power. That, of course, is easier said than done when markets are rapidly repricing for a new order.

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