S&P Global

NASHVILLE NOTES

Value restoration underway

Tuesday, October 23, 2018 9:38 AM CT

By Jeff K. Davis

Every quarter there always are a handful of banks whose quarterly results bomb Wall Street's expectations and a few that blow past expectations. This quarter, there seems to be a lot of Bronx cheering for more than a handful of banks. Among those that saw violent negative price reactions last week were Texas Capital Bancshares Inc., Associated Banc-Corp, Western Alliance Bancorp. and Bank OZK.

It is not always clear what the Street is looking for in a given quarter. This quarter, investors may be getting a sense that an inflection point is at hand even though EPS for most banks has been close enough to consensus in my view to call the quarter in line thus far. The half-empty glass narrative is revenue growth over the next year or two may be subdued as ongoing Fed rate hikes cause the expansion in NIMs that has occurred over the past 18 months or so to turn negative as deposit competition intensives. Loan growth looks to remain tepid for the time being, too.

Of course, nothing will cause investors to question future bank earnings like asset quality issues. Bank balance sheets are warehouses for assets, most of which are not marked-to-market; hence, a negative CRE-related credit surprise by Bank OZK got a lot of national press that would not be expected for a regional bank. The logical question is: How many more CRE-related shoes are to drop for Bank OZK and its competitors? Some call it the cockroach theory of loan portfolios when a few problems emerge.

While I think Bank OZK CEO George Gleason deserves the benefit of the doubt that the two CRE loans that were written down sharply are not representative of the portfolio, the market does not. The bank's shares dropped nearly 27% on Oct. 19, which pushed the year-to-date loss to 47%.

Bank OZK is an extreme example, but bank stocks this year are exhibiting the "early cyclical" label that many ascribe to the sector in which the shares tend to turn down when the economy and earnings are strong and turn higher when the economy is weak. The inflection point for bank shares usually coincides near an inflection point in the economy that is not observable until it is well in the rear view mirror.

Their underperformance this year relative to the broader market is consistent with an aging economic expansion and bull market run. Confirmation can be found in the poor performance of other early cyclicals such as home builders and auto stocks.

Inflection points in an economic expansion do not necessarily presage recession; or if a recession occurs a deep one. The market appears to be is in the process of resetting asset values, or at least some asset categories, in anticipation of a future downshift.

A cursory review of current bank prices relative to 52 week price ranges indicates many are trading close to their 52 week lows. Values can go lower of course. The obvious catalyst presently would be ongoing Fed rate hikes that slow the economy and cause real estate and other asset values to correct from what appear to be very high levels; however, for new capital that is invested, price paid matters a lot in determining future returns.

At the very least, value restoration is occurring for the shares of most banks provided broad based asset quality issues do not develop anytime soon.

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.