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What to make of the bank stock rally?

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Banks and most financials have been frustrating since rebounding from the depths of the financial panic, which broadly spanned from the second half of 2007 through the first quarter of 2009. Periods of outperformance have been followed by stretches of underperformance. The current cycle is one of outperformance, following a steep sell-off in the third quarter of 2011 as a result of the Washington debt ceiling debacle and a near Lehman-moment in Europe when the intra-bank funding markets locked up. Since October 1, 2011, the SNL Small Cap U.S. Bank Index has produced a total return of 49% through Feb. 8, versus 45% for the Russell 2000. The SNL Large Cap U.S. Bank Index had a total return of 63%, versus 38% for the S&P 500.

The rally is less impressive if it is dated back to year-end 2010, with large-cap banks rising only 11%, compared to 26% for the S&P 500; small-cap banks lagged the Russell 2000 at 16% versus 20%. Viewed from a bit longer horizon, returns for bank stocks similarly lag if the starting date is March 31, 2010, which coincided with a peaking of many large-cap bank stocks following the rally that began on March 9, 2009, when Secretary Timothy Geithner indicated there would be no nationalization. Between March 9, 2009, and March 31, 2010, large-cap banks posted a 202% total return, versus a mere 101% return for the S&P 500. This rally followed a brutal 21-month sell-off that got under way in mid-2007 when housing was clearly rolling over and securitization markets froze.

I think one aspect of the bigger swing in the large-cap banks since the third quarter of 2011 reflects the direct and indirect European exposure of JPMorgan Chase & Co., Citigroup Inc. and a few other large banks that dominate the index. It was the ECB's announcement in early November 2011 that it would address the funding issues (European banks are much more reliant on wholesale funding than U.S. banks) through the longer-term refinancing operations (LTRO) that became a catalyst to rally European banks and global equities. Also, housing found a bottom in 2012 and has been improving in many markets since then. The turn in housing and attendant demand for distressed assets was important in driving NPAs lower at high NPA banks such as Regions Financial Corp. and Synovus Financial Corp. and thereby aiding last year's rally.

So what to make of the current rally? Valuation is never a catalyst, but it usually is the most important determinant in the return equation, especially over an intermediate-to-long-term investment horizon. For investors, the one critical attribute that they control that impacts their return is the entry price; the lower the better. While valuation is not a catalyst, reversion to the mean is a powerful concept.

As shown in the accompanying table, bank stocks are cheap based upon price/tangible book value multiples in relation to their 20-year average. The publicly traded universe of banks is sorted into three groups: those with assets of $100 million to $1 billion; $1 billion to $10 billion; and greater than $10 billion.

Recent trends in bank pricing multiples

	06/30/10	12/31/10	06/30/11	12/31/11	06/30/12	12/31/12	02/08/13	Long-term average
Median Price/TBV (%)								
Assets of $100 million - $1 billion	75.3	76.6	75.9	66.7	75.3	81.6	82.0	116.3
Assets of $1 billion - $10 billion	106.9	122.3	109.8	105.0	116.7	120.2	122.7	166.3
Assets > $10 Billion	140.6	155.1	147.0	132.3	136.6	141.8	141.4	221.7
P/TBV as a % of the long-term average[1]								
Assets of $100 million - $1 billion	64.7	65.9	65.2	57.3	64.7	70.1	70.5	
Assets of $1 billion - $10 billion	64.3	73.5	66.0	63.1	70.2	72.3	73.8	
Assets > $10 Billion	63.4	70.0	66.3	59.7	61.6	64.0	63.8	
Median P/E (x)[2]								
Assets of $100 million - $1 billion	14.2	13.6	12.6	11.8	12.0	11.6	12.8	13.5
Assets of $1 billion - $10 billion	15.4	14.8	13.7	12.9	12.9	12.9	13.3	14.2
Assets > $10 Billion	15.1	17.5	15.8	13.4	13.4	12.9	13.7	14.8
P/E as a % of the long-term average								
Assets of $100 million - $1 billion	104.6	100.1	93.1	86.9	88.6	85.7	94.4	
Assets of $1 billion - $10 billion	108.4	104.3	96.8	91.1	91.1	90.9	94.0	
Assets > $10 Billion	102.1	118.3	107.2	90.7	90.8	87.4	92.9	
Acquisition multiples								
Average P/TBV (%)	122.0	109.0	109.0	97.0	111.0	110.0	104.0	
Median P/E (x)	NM	NM	NM	51.2	NM	21.6	27.6	

1 Long-term average P/TBV and P/E is based upon quarterly period-end pricing since March 31, 1992.
2 P/E is based upon trailing 12 month earnings per share.
Data excludes banks that have been acquired or failed.
Data is for current public banks and thrifts as of Feb. 8, 2013.
NM = not meaningful
Source: SNL Financial

As of Feb. 8, 2013, the median P/TBV ratio ranged between 64% and 74% of the 20-year average multiple for each respective group. Bank stocks are not as cheap when based upon last-12-month earnings. As of Feb. 8, the median P/E ratios ranged from 12.8x for the smallest group to 13.7x for the largest banks. The current P/E multiples equate to 93% to 94% of the 20-year average.

The conclusion that banks look really cheap in terms of P/TBV multiples may not be the right takeaway even though it dove-tails well into the reversion to the mean concept. Investors, acquirers and sellers tend to state bank multiples in terms of P/TBV multiples first and earnings second for a couple of reasons. One is that earnings are volatile (after credit costs), and tangible book values are not. Also, the business model is predicated upon leveraging tangible equity to produce net income. Absolute P/TBV multiples notwithstanding, bank investors usually acquire equities because: (a) they believe value will track earnings growth; (b) valuation multiples are expected to expand over time for any number of reasons; (c) tangible book value is expected to compound at a competitive rate over time; and/or (d) the yield and/or prospects for dividend increases are favorable.

Broadly, value defined as P/TBV can be expressed as the product of profitability, leverage and the earnings multiple. And P/E multiples are positively correlated with long-term earnings growth expectations.

(Net Income / Assets) * (Assets / Tangible Equity) = (Net Income / Tangible Equity); or,

ROA * Leverage = ROTE

and

(Price / Net Income) * (Net Income / Tangible Equity) = (Price / Tangible Equity); or,

P/E * ROTE = P/TBV

Historically, when bank multiples rose above the 20-year average, returns tended to be poor over the ensuing 1- to 2-year period and vice versa. For instance, valuations were below average during the 1990s until 1997, when they began to climb sharply, reflecting an accelerating level of M&A and a robust U.S. economy. Returns from mid-1998 through early 2000 faded as valuations compressed in response to a shift by investors into growth stocks as the dot.com mania peaked. Investors at the time were disgusted with poorly executed, high-priced deals such as First Union-CoreStates. While growth stocks rolled over in March 2000, banks, industrials and other value-oriented stocks staged a strong rally. Following the shallow recession of 2001 and the Fed's eventual cutting of the fed funds target to 1.0% in 2003, banks began a climb that peaked with above trend ROEs and valuations. As of year-end 2006, P/Es were 109%-123% of the 20-year average and P/TBV multiples were 134% to 135% of the 20-year average. From there it was all downhill for over two years for large banks and three years for small banks.

So what do we make of current valuations? I tend to view them as not as cheap as they appear given the context of the current operating environment. Those who have followed my musings on this blog know that I think the Street has not gotten its mind around how low NIMs will be in 2014 absent a change in the rate environment as loan portfolio yields are poised to plummet for most banks. Also, mortgage refinancing that has supported earnings will eventually ebb even if long rates do not move much. The same applies to waning credit leverage. I think banks are going to have to work to maintain the current 0.90% ROA that represents the approximate median performance today. Overlaid upon this is the depressive effect on ROE of reducing leverage through using

more common equity in the capital structure.

One perspective of how distorted returns were last decade can be seen from comparing ROEs versus 10-year U.S. Treasurys. During 2000-2007, the average ROE for banks with greater than $10 billion per the FDIC was 13.6%, which exceeded the yield on the 10-year U.S. Treasurys by 9.1%. Smaller banks did not produce as robust an ROE, but their returns likewise were significantly higher than Treasurys. The average excess ROE during 1984-2012 was 5.0% for banks with $100 million to $1 billion of assets and 7.1% for banks with more than $10 billion of assets. Based upon YTD ROE and Treasury yields through September 30, 2012, the ROE spread was 5.9% and 7.2%. Stated differently, today's ROEs are not so low in the context of the Fed's zero-rate policies and a through-the-cycle view of profitability.

Where from here? I do not think valuations are so high that bank stocks face a sharp correction; however, the downward earnings revision that I expect will represent a headwind for most since valuations on a P/E basis are not cheap to history. The margin of safety may exist among dividend payers with a history and capacity to increase the dividend. Also, so far credit spreads are not signaling danger. Historically, credit spreads have been an excellent indicator for bank stock investors. Spreads are tight today, indicating caution, but they show no sign of a material widening move. One could argue that credit spreads have been distorted by the Fed's actions, but the same can be said about most asset values, including equities.

Secondly, where the best price action for bank equity investors may be is in the micro-cap group. These banks have always tended to trade at a varying discount to larger banks due to lack of visibility with investors and less liquidity. Some of these banks are growth stories that are relegated to the value sector. Some will be acquirers, many more will be sellers in time. Notably, First M&F Corp. produced a five-day gain of 45% prior to the announcement on Feb. 7 that Renasant Corp. would acquire the company for a price that equates to 122% of TBV. Likewise, Virginia Commerce Bancorp Inc. produced a 27% return since Jan. 13 (and 50% since Jan. 1) when the company confirmed that it had initiated a strategic review that culminated with the announcement that it would be acquired by United Bankshares Inc. on Jan. 30. In effect, the boards of many these banks may have to force reversion to the mean through selling the company as the earnings outlook will not be an upside catalyst.

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