

JANUARY 2019

# Bank Watch

Article: Credit Quality at a Crossroads

## In This Issue

---

Credit Quality at a Crossroads	1
Public Market Indicators	7
M&A Market Indicators	8
Regional Public	
Bank Peer Reports	9
About Mercer Capital	10

# Credit Quality at a Crossroads

Last week, the Mercer Capital Bank Group headed south for a scenic trip through the fields of the Mississippi Delta, including the town of Clarksdale located about 90 miles from Memphis. Clarksdale's musical heritage runs deep with such performers as Sam Cooke, John Lee Hooker, Son House, and Ike Turner born there, while Tennessee Williams spent much of his childhood there. Explaining the Delta's prolific artistic output, Eudora Welty, a Mississippi writer, noted the landscape stretching to the horizon and the juxtaposition of societal elements – all these forces churning like the Mississippi river nearby.

Despite its gritty roots, Clarksdale now is experiencing its own hipster renaissance. It may not be Brooklyn, but the Bank Group noticed signs for last weekend's Clarksdale Film Festival. Visitors can stay at a refurbished cotton gin, enjoying their Sweet Magnolia Gelato made from locally sourced ingredients. Presumably, craft cocktails are available as well, this being the Delta.

Beyond these recent additions to the tourist landscape, though, one attraction put Clarksdale on the map – the Crossroads. At the intersection of Highways 49 and 61, the bluesman Robert Johnson (who lived from 1911 to 1938), as the story goes, met the Devil at midnight who tuned his guitar and played a few songs. In exchange for his soul, Johnson realized his dream of blues mastery.

The point of this article is not that Lucifer lurked behind the revaluation of asset prices in the fourth quarter of 2018. Instead, the market gyrations laid bare the dichotomy between bank expectations regarding asset quality and the market's view

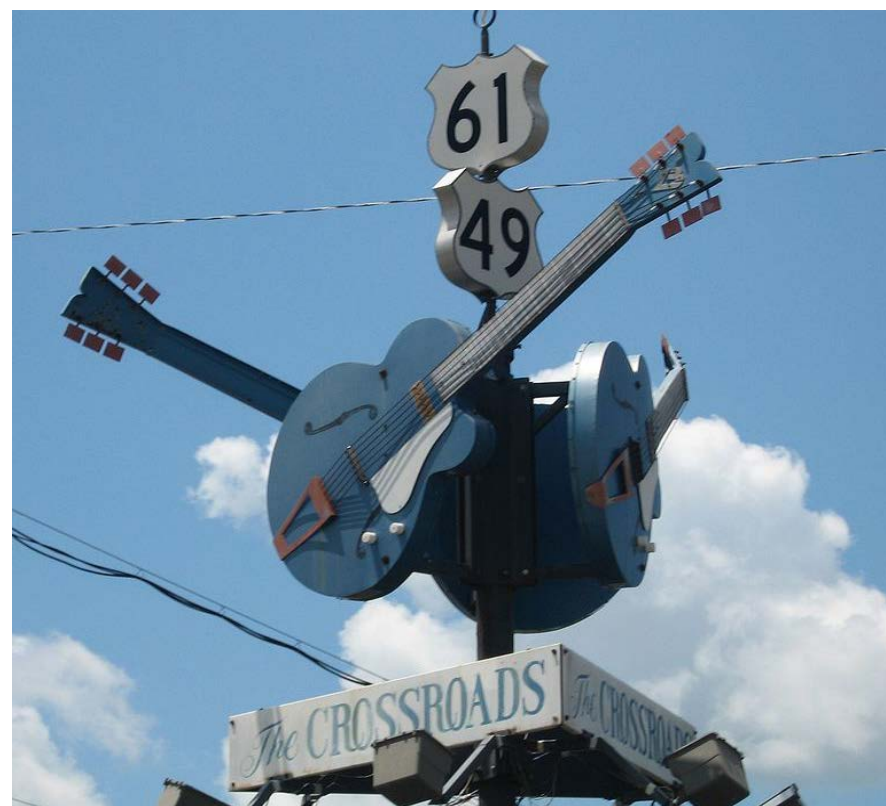


Image by Joe Mazzola via Wikipedia

of mounting credit risk that was overlaid by a need to meet margin calls among some investors. Indeed, credit quality faces its own crossroads.

## Highway 49

Along Hwy. 49 lies the town of Tutwiler, about 15 miles from Clarksdale. There, in 1903, the bandleader W.C. Handy heard a man playing slide guitar with a knife, singing “Goin’ where the Southern cross’ the Dog.” Handy adapted the song, which references the juncture of two railroads, thereby making it one of the first blues recordings.

From Call Report data, which includes 3,644 banks with total assets between \$100 million and \$5 billion, signs of credit quality deterioration remain virtually undetectable.

- » Loan growth continued apace in 2018, maintaining the community banking industry’s recent 10% annual growth rate (Figure 1, which shows the trailing twelve month change in loans). Notably, commercial real estate loan growth decelerated in 2018. Although this presumably pleases the regulatory agencies, competition from non-banks (e.g., insurance companies) and budding risks surrounding certain sectors (e.g., retail) likely explain the slowdown.
- » In absolute terms, nonperforming loans (nonaccrual loans plus loans more than 90 days past-due) declined in each year between 2014 and 2017 (Figure 2 on page 3). As of September 30, 2018, however,

**Figure 1**

% Change in Loans	2018Q3	2017Q4	2016Q4	2015Q4	2014Q4	2013Q4
Construction & Development	13.3%	13.4%	16.5%	17.4%	16.4%	6.0%
Agricultural Real Estate	8.2%	9.4%	10.2%	10.7%	9.7%	8.2%
HELOCs	3.7%	6.5%	7.9%	9.4%	9.1%	0.3%
Closed-End Single Family Residential	7.9%	7.7%	7.7%	8.4%	7.9%	3.4%
Multifamily	12.0%	15.8%	14.8%	15.5%	14.2%	13.8%
Commercial Real Estate	10.8%	12.7%	12.2%	10.3%	8.0%	7.0%
Agricultural Production	3.5%	4.2%	1.3%	7.3%	16.3%	9.5%
Commercial & Industrial	11.4%	11.0%	9.4%	11.2%	11.3%	8.1%
Consumer	7.3%	7.1%	8.3%	7.9%	9.6%	5.0%
<b>TOTAL</b>	<b>9.6%</b>	<b>10.4%</b>	<b>10.2%</b>	<b>10.4%</b>	<b>9.8%</b>	<b>na</b>

Source: S&P Global Market Intelligence and Mercer Capital research

## What We’re Reading

According to data compiled by *S&P Market Intelligence*, M&A activity and pricing climbed in 2018 for **banks** and **fintech companies**. In M&A news, First Midwest Bancorp (NASDAQ: FMBI) announced its **acquisition of Bridgeview Bancorp** for approximately \$145 million. First Midwest recently **moved its headquarters to Chicago**.  
(subscription required)

*The Wall Street Journal* covers the narrowing margin between **rising borrowing costs** and **flat commercial property yields** and what this may portend for the current economic cycle.

Matthew Klein at *Barron’s* briefly summarizes the previous fifty years of housing finance and the residential mortgage market before analyzing **Mark Calabria’s plans to alter the U.S. housing finance system**. Trump nominated Mr. Calabria to head the Federal Housing Finance Agency.

Figure 2

NPLs / Total Loans	2018Q3	2017Q4	2016Q4	2015Q4	2014Q4	2013Q4
Construction & Development	0.68%	0.79%	1.10%	1.59%	2.51%	4.21%
Agricultural Real Estate	1.39%	1.08%	1.00%	0.68%	0.79%	1.06%
HELOCs	0.50%	0.56%	0.63%	0.69%	0.77%	0.95%
Closed-End Single Family Residential	0.94%	1.00%	1.19%	1.39%	1.64%	1.97%
Multifamily	0.24%	0.28%	0.39%	0.57%	0.87%	1.35%
Commercial Real Estate	0.63%	0.69%	0.82%	1.02%	1.37%	1.83%
Agricultural Production	0.78%	0.61%	0.57%	0.28%	0.21%	0.21%
Commercial & Industrial	1.05%	1.05%	1.14%	1.03%	1.02%	1.27%
Consumer	0.56%	0.57%	0.72%	0.56%	0.54%	0.61%
<b>TOTAL</b>	<b>0.79%</b>	<b>0.81%</b>	<b>0.94%</b>	<b>1.05%</b>	<b>1.30%</b>	<b>1.72%</b>

Aggregate NPLs (\$000s)	2018Q3	2017Q4	2016Q4	2015Q4	2014Q4	2013Q4
Construction & Development	\$735,252	\$780,399	\$960,343	\$1,192,528	\$1,602,889	\$2,306,197
Agricultural Real Estate	\$965,727	\$707,617	\$598,687	\$370,395	\$386,084	\$474,614
HELOCs	\$234,712	\$257,640	\$271,599	\$277,284	\$282,599	\$319,513
Closed-End Single Family Residential	\$3,131,638	\$3,124,709	\$3,450,873	\$3,763,661	\$4,086,845	\$4,562,071
Multifamily	\$178,207	\$189,992	\$230,525	\$293,120	\$386,067	\$524,678
Commercial Real Estate	\$2,829,445	\$2,863,104	\$3,016,081	\$3,338,467	\$4,066,852	\$5,033,816
Agricultural Production	\$370,255	\$279,837	\$251,095	\$120,824	\$82,480	\$74,257
Commercial & Industrial	\$2,146,183	\$1,997,301	\$1,946,067	\$1,606,074	\$1,442,295	\$1,605,896
Consumer	\$348,936	\$334,390	\$392,140	\$280,721	\$252,904	\$260,694
<b>TOTAL</b>	<b>\$10,940,355</b>	<b>\$10,534,989</b>	<b>\$11,117,410</b>	<b>\$11,243,074</b>	<b>\$12,589,015</b>	<b>\$15,161,736</b>
Annual Change	3.8%	-5.2%	-1.1%	-10.7%	-17.0%	na

Source: S&amp;P Global Market Intelligence and Mercer Capital research

NPLs increased by 4% over December 31, 2017, led by farmland NPLs (up 37%, or \$258 million), agricultural production NPLs (up 32%, or \$90 million), and commercial and industrial NPLs (up 8%, or \$149 million). Given loan growth, though, the ratio of NPLs to loans continued to decline, falling slightly from 0.81% to 0.79% between December 31, 2017 and September 30, 2018.

- » Annualized charge-offs for the year-to-date period ended September 30, 2018 also compare favorably to the comparable prior year period, foreshadowing a possible post-recession low in the net charge-off ratio for fiscal 2018 (Figure 3).

As they are wont to do, regulatory agencies noted some concerns regarding asset quality. However, consistent with our research into the community banking industry's asset quality trends, the OCC also observed that "credit quality remains strong when measured by traditional performance metrics."<sup>1</sup> Despite its view of building credit risk, the OCC rated 95% of banks' underwriting practices as satisfactory or strong in

2018, virtually unchanged from the 2017 level.<sup>2</sup> Economic growth, corporate profits, and employment trends also support a sanguine view of credit quality.

While also observing weaker underwriting – for example, covenant concessions – rating agencies predict better credit performance among leveraged loans and commercial mortgage backed securities in 2019. For 2019, Fitch Ratings projects a 1.5% leveraged loan default rate, down from 1.75% in 2018. Further, commercial mortgage-backed security delinquencies, which declined by 103 basis points to 2.19% between year-end 2017 and 2018, are expected to range between 1.75% and 2.00% in 2019. The Amazonification of the retail sector, which led to retail bankruptcies and defaults on loans secured by regional malls, contributed to higher delinquency and default rates in 2018 but may subside in 2019.

The view from Hwy. 49, before reaching the Crossroads, looks favorable from the banking industry's standpoint.

**Figure 3**

Net Charge-Off Rate	YTD @ 9/18	Prior YTD	2017Y	2016Y	2015Y	2014Y	2013Y
Construction & Development	0.00%	0.01%	0.04%	0.01%	0.04%	0.13%	0.71%
Agricultural Real Estate	0.02%	0.03%	0.05%	0.03%	0.02%	0.02%	0.10%
HELOCs	0.03%	0.05%	0.05%	0.08%	0.11%	0.19%	0.32%
Closed-End Single Family Residential	0.02%	0.05%	0.06%	0.07%	0.11%	0.16%	0.25%
Multifamily	-0.01%	0.00%	0.01%	0.04%	0.05%	0.11%	0.22%
Commercial Real Estate	0.02%	0.04%	0.06%	0.06%	0.08%	0.15%	0.25%
Agricultural Production	0.13%	0.13%	0.16%	0.19%	0.06%	0.04%	0.03%
Commercial & Industrial	0.29%	0.34%	0.42%	0.35%	0.30%	0.37%	0.41%
Consumer	0.68%	0.74%	0.78%	0.72%	0.68%	0.61%	0.67%
<b>TOTAL</b>	<b>0.09%</b>	<b>0.12%</b>	<b>0.14%</b>	<b>0.14%</b>	<b>0.14%</b>	<b>0.19%</b>	<b>0.31%</b>

Source: S&P Global Market Intelligence and Mercer Capital research

## Highway 61

In the words of the writer David Cohn, the Mississippi Delta begins in the lobby of the Peabody Hotel (in Memphis) and ends on Catfish Row in Vicksburg, Mississippi.<sup>3</sup> While his observation alludes to the economic as well as the geographic extremes of the Delta region, Highway 61 is the Delta's spine connecting Cohn's poles.

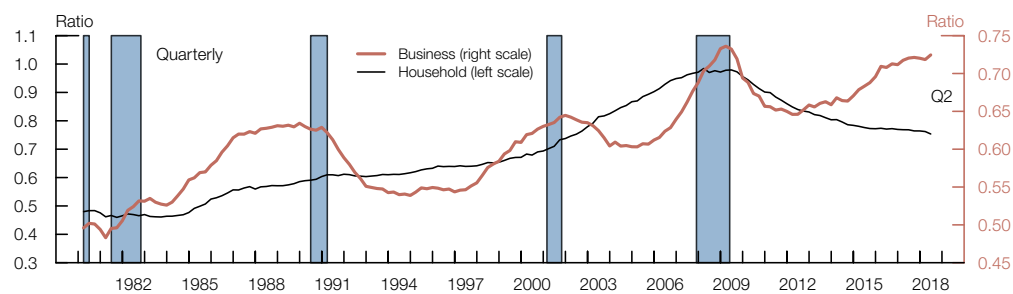
One of the more concerning statistics is the level of corporate debt. Though household debt trended down following the Great Recession (see Figure 4), non-financial business debt has reached near record levels as a percentage of GDP.<sup>4</sup> According to Morgan Stanley, BBB-rated corporate debt surged by 227% since 2009 to \$2.5 trillion. This leaves approximately one-half of the investment grade corporate bond universe on the cusp of a high-yield rating. Moody's migration data suggests that BBB-rated bonds have an 18% chance of being downgraded to non-investment grade within five years, which may overwhelm the high-yield bond market.<sup>5</sup>

Regulatory agencies also observed looser underwriting. For new leveraged loans, the Federal Reserve noted that the share of highly leveraged large corporate loans – defined as more than 6x EBITDA – exceeds previous peak levels in 2007 and 2014, while issuers also are calculating EBITDA more liberally by making aggressive adjustments to reported EBITDA.<sup>6</sup> From the OCC's perspective, competitive pressures from banks and non-banks, along with plentiful investor liquidity, have led to weaker underwriting particularly among C&I and leveraged loans. According to the OCC, community banks are not immune. An example of weaker underwriting cited by the OCC is "general commercial loans, predominately in community banks" for which it compiles a list of shortcomings: "price concessions, inadequate credit analysis or loan-level stress testing, relaxed loan controls, noncompliance with internal credit policies, and weak risk assessments."<sup>7</sup>

Despite unemployment rates below 4% and some evidence of rising wages, consumer loan delinquency rates have risen in 2018 (Figure 5). Some lenders, such as Discover, already have begun reducing exposure to heated sectors like unsecured personal loans.

**Figure 4**

2-2. Business- and Household-Sector Credit-to-GDP Ratio



Note: The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research. GDP is gross domestic product.

Source: Federal Reserve Board staff calculations based on Bureau of Economic Analysis, national income and product accounts, and Federal Reserve Board, Statistical Release Z.1, "Financial Accounts of the United States."

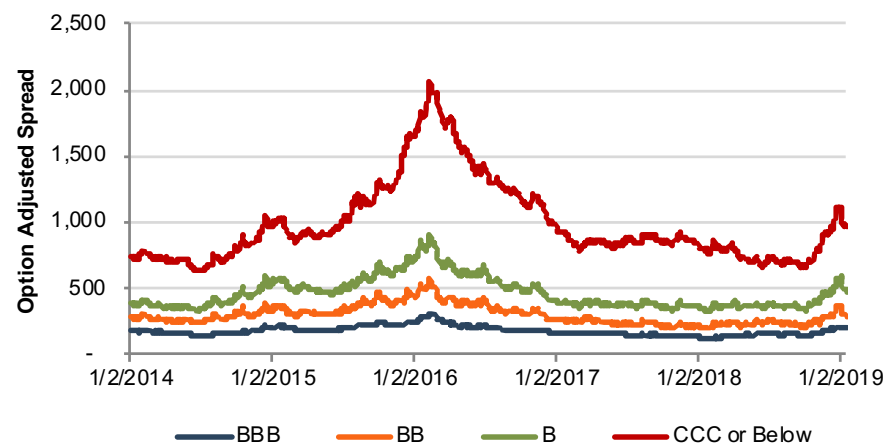
**Figure 5**

	30+ Day Delinquency Rates	
	9/30/2017	9/30/2018
Credit Cards	2.62%	3.05%
Direct Automobile Loans	1.12%	1.16%
Indirect Automobile Loans	1.84%	1.99%
Home Equity Lines of Credit	1.08%	1.14%
<b>Composite Ratio</b>	<b>1.68%</b>	<b>1.87%</b>

Source: American Bankers Association (1/9/18 and 1/8/19)



Figure 6



Source: Bank of America Merrill Lynch

Fears of a downturn crystallized in the fourth quarter of 2018 with the Federal Reserve's December rate increase, trade friction with China, and signs of economic slowdowns in countries such as Germany. Option-adjusted spreads on corporate debt, after remaining quiescent through 2017 and most of 2018, widened suddenly, approaching levels last observed in 2016 when oil prices collapsed (Figure 6). According to Guggenheim, the fourth quarter spread widening implies a 3.2% high yield corporate debt default rate, up from 1.8% for 2018.<sup>8</sup>

The perspective gleaned from Hwy. 61 is not necessarily alarming, but it does suggest that, directionally, risk is rising.

## The Crossroads

Credit lies at a crossroads, consistent with a late cycle economic environment. Reported credit metrics are not improving significantly, nor are they worsening; conditions suggest continued low charge-offs and loan loss provisions in the near-term. However, the market sniffs rising risks in various corners of the economy, most notably in corporate debt. Howlin' Wolf sang, "Well I'm gonna get up in the morning // Hit the Highway 49." Where are banks headed? Macroeconomic conditions ultimately will be determinative, but banks should avoid complacency in this environment marked by conflicting signals and aggressive competition. The poorest loans, in retrospect, often are originated in times such as these.

Andrew K Gibbs

Andrew K. Gibbs, CFA, CPA/ABV

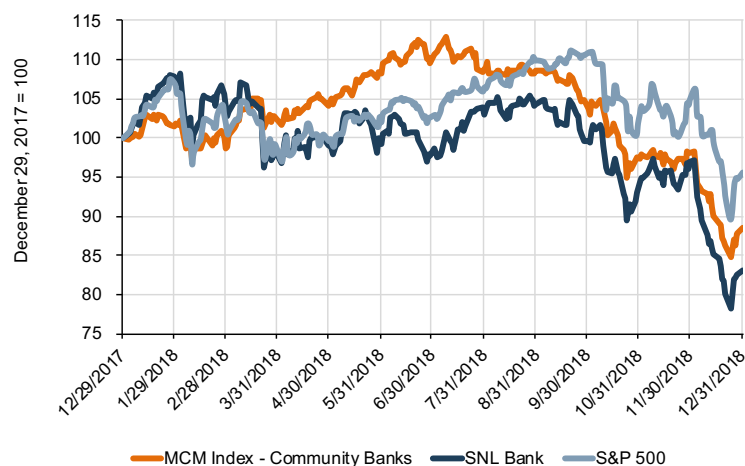
901.322.9726

[gibbsa@mercercapital.com](mailto:gibbsa@mercercapital.com)

## End Notes

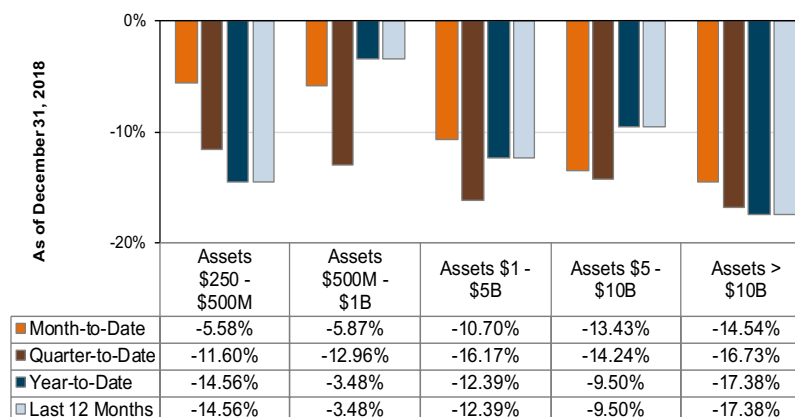
- <sup>1</sup> OCC Semiannual Risk Perspective, Fall 2018, p. 1.
- <sup>2</sup> OCC Semiannual Risk Perspective, Fall 2018, p. 22.
- <sup>3</sup> Cohn, David, *Where I Was Born and Raised*, 1948.
- <sup>4</sup> Federal Reserve, Financial Stability Report, November 2018, p. 18.
- <sup>5</sup> Guggenheim Investments, Fixed Income Outlook, Fourth Quarter 2018, pp. 1 and 8.
- <sup>6</sup> Federal Reserve, Financial Stability Report, November 2018, p. 20.
- <sup>7</sup> OCC Semiannual Risk Perspective, Fall 2018, pp. 11 and 24.
- <sup>8</sup> Guggenheim Investments, High Yield and Bank Loan Outlook, January 2019.

### Mercer Capital's Bank Group Index Overview



### Return Stratification of U.S. Banks

by Asset Size



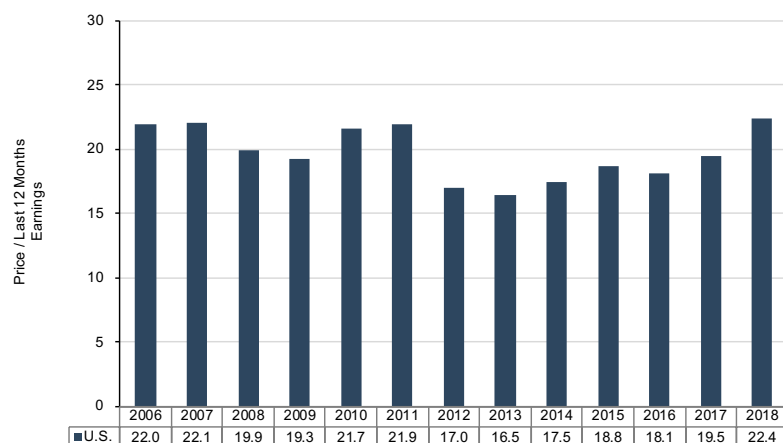
### Median Valuation Multiples

Median Total Return as of December 31, 2018					Median Valuation Multiples as of December 31, 2018					
Indices	Month-to-Date	Quarter-to-Date	Year-to-Date	Last 12 Months	Price / LTM EPS	Price / 2018 (E) EPS	Price / 2019 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	-12.5%	-18.3%	-15.6%	-15.6%	16.9x	12.4x	10.8x	118%	133%	2.4%
Midwest Index	-10.5%	-16.8%	-13.4%	-13.4%	14.4x	11.3x	10.4x	122%	150%	2.6%
Northeast Index	-6.8%	-13.1%	-8.2%	-8.2%	15.4x	11.8x	10.9x	119%	140%	2.6%
Southeast Index	-9.3%	-14.3%	-10.8%	-10.8%	18.4x	13.1x	11.6x	124%	134%	1.6%
West Index	-9.7%	-14.7%	-7.9%	-7.9%	14.5x	11.8x	12.5x	122%	137%	2.0%
Community Bank Index	-9.7%	-15.5%	-11.4%	-11.4%	15.4x	11.8x	10.9x	121%	137%	2.4%
<b>SNL Bank Index</b>	<b>-14.3%</b>	<b>-16.6%</b>	<b>-16.9%</b>	<b>-16.9%</b>						



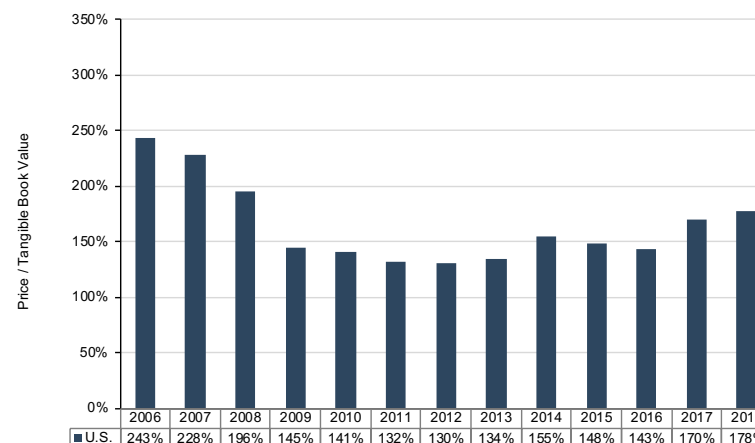
### Median Price/Earnings Multiples

Target Banks' Assets <\$5B and LTM ROE >5%



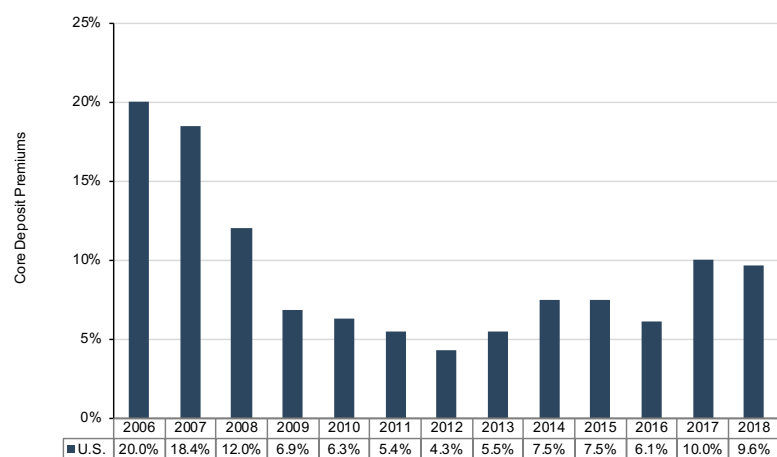
### Median Price/Tangible Book Value Multiples

Target Banks' Assets <\$5B and LTM ROE >5%



### Median Core Deposit Multiples

Target Banks' Assets <\$5B and LTM ROE >5%



### Median Valuation Multiples for M&A Deals

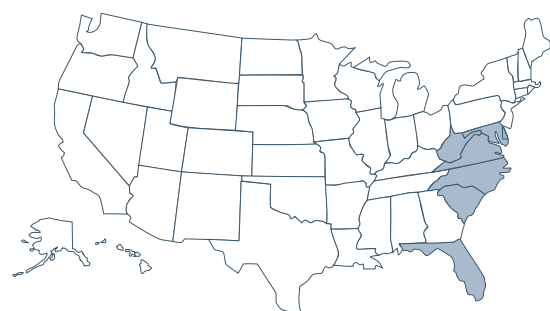
Target Banks' Assets <\$5B and LTM ROE >5%, 12 months ended December 2018

Regions	Price / LTM Earnings	Price/ Tang. BV	Price / Core Dep Premium	No. of Deals	Median Deal Value (\$M)	Target's Median Assets (\$000)	Target's Median LTM ROAE
Atlantic Coast	21.3x	178%	11.2%	10	96.0	519,256	7.7%
Midwest	18.9x	164%	7.6%	82	37.9	137,407	9.9%
Northeast	25.6x	188%	11.6%	11	60.8	487,870	6.7%
Southeast	22.4x	181%	10.1%	27	84.3	273,238	9.1%
West	24.7x	197%	12.6%	22	89.3	327,854	7.8%
<b>National Community Banks</b>	<b>22.4x</b>	<b>178%</b>	<b>9.6%</b>	<b>152</b>	<b>56.3</b>	<b>227,944</b>	<b>9.2%</b>

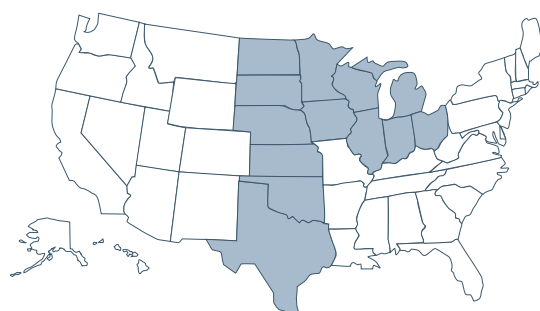
Source: S&P Global Market Intelligence

# Mercer Capital's Regional Public Bank Peer Reports

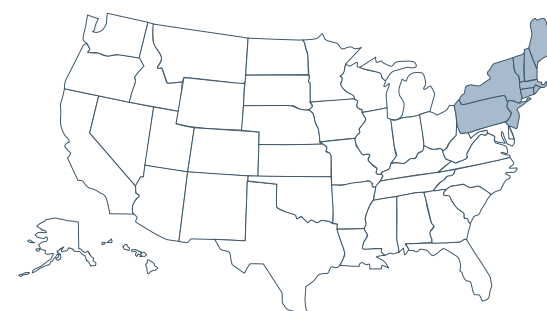
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



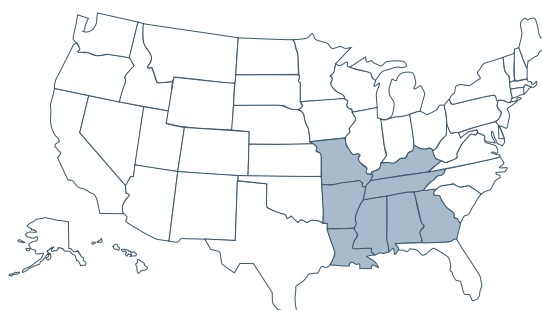
**Atlantic Coast**



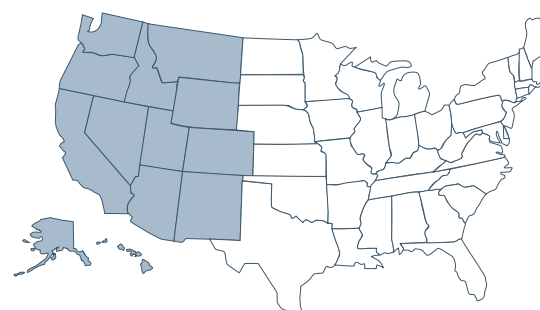
**Midwest**



**Northeast**



**Southeast**



**West**

**MERCER CAPITAL**

# Depository Institutions Services

Mercer Capital assists banks, thrifts, and credit unions with significant corporate valuation requirements, transaction advisory services, and other strategic decisions.

Mercer Capital pairs analytical rigor with industry knowledge to deliver unique insight into issues facing banks. These insights underpin the valuation analyses that are at the heart of Mercer Capital's services to depository institutions.

- » Bank valuation
- » Financial reporting for banks
- » Goodwill impairment
- » Litigation support
- » Stress Testing
- » Loan portfolio valuation
- » Tax compliance
- » Transaction advisory
- » Strategic planning

## Depository Institutions Team



**Jeff K. Davis, CFA**  
615.345.0350  
jeffdavis@mercercapital.com



**Andrew K. Gibbs, CFA, CPA/ABV**  
901.322.9726  
gibbsa@mercercapital.com



**Jay D. Wilson, Jr., CFA, ASA, CBA**  
469.778.5860  
wilsonj@mercercapital.com



**Eden G. Stanton, CFA**  
901.270.7250  
stantone@mercercapital.com



**Mary Grace Arehart**  
901.322.9720  
arehartm@mercercapital.com



**Madeleine G. Davis**  
901.322.9715  
davism@mercercapital.com



**Brian F. Adams**  
901.322.9706  
adamsb@mercercapital.com



**William C. Tobermann**  
901.322.9707  
tobermannw@mercercapital.com

[www.mercercapital.com](http://www.mercercapital.com)



**Mercer Capital**

[www.mercercapital.com](http://www.mercercapital.com)

