NASHVILLE NOTES

# Analyst protection

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By Jeff K. Davis

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A few weeks ago I had breakfast with a friend who was once a sell-side equity salesman. I never worked with him when I was a sell-side analyst, and I asked him how he got business. Without missing a beat, he said he told accounts: "I am here to protect you from our analysts."

I don't know if he is that good, or just quick on his feet (I'm thinking the latter); however, he raises an interesting point about not getting blindsided by a stock when the consensus expectations (or his analysts) are wrong. Sometimes the consensus ignores what the market is saying because of a company's successful track record and/or compelling valuation.

Apple Inc. is a case in point. Although there have been several very large pullbacks in its shares, Apple's chart otherwise looks like an up escalator since 2003 with the lift powered in part by the introduction of the iPod in late 2001, the iPhone in 2007 and the iPad in 2010. Product introduction, upgrades and widespread adoption globally powered the company's revenues, earnings ($60 billion in fiscal 2018 vs. $14 billion in 2010) and huge distributions to shareholders in the form of dividends and repurchases.

Then came a revenue warning after the market closed on Jan. 2 that fiscal first-quarter 2019 revenues would approximate $84 billion compared to the prior guidance of $89 billion to $93 billion. The Street was caught off guard with a consensus of $91 billion. The shares fell about 10% on Jan. 3 to $142 per share. There were plenty of news stories about how the drop in the market cap to $675 billion from $749 billion the day before cost Warren Buffett, the Swiss National Bank (yes, some central banks buy equities) and other notable investors a boatload of money.

Could the market have foreseen this preannouncement, attributed in part to a slowdown in China sales, even though the sell-side apparently was not calling for it? Maybe a specific warning was not foreseeable, but the stock has been forecasting trouble for several months. Share price dropped from a high of $232 on Oct. 3, 2018, to $158 by year-end.

Bank OZK shares have a similar story. CEO George Gleason is not Steve Jobs, but he has been a phenomenal moneymaker for shareholders over the years. I first dealt with him 20-plus years ago when he was negotiating to acquire a client bank. The transaction did not happen, but I was impressed with Gleason and thought he would be someone to watch.

Even in the years before the financial crisis, when OZK was very much a small cap, the shares performed spectacularly. The bank survived the 2007 crisis and saw its shares rise over 10x from the early 2009 lows to over $50 per share by late 2015. The shares were then range-bound between roughly $40 and $55 over the next few years as investors fretted about the company's sizable exposure to commercial real estate, notwithstanding exceedingly high capital and profitability.

Nonetheless, the Street was caught flatfooted in October 2018 when the bank missed consensus by a wide margin after recording a sizable provision to write down two unrelated CRE loans that originated about 10 years ago. The shares fell nearly 27% on Oct. 19, 2018. I was not expecting the earnings miss, but the shares had fallen from a 2018 high of $53 in March to $35 the day before the release. The market knew something was afoot.

I think the same is true for banks as a group, given the poor performance of the industry's stocks since late summer. The market is shouting its opinion that estimates are too high. My assumption is that it is due to credit rather than funding pressures that will crimp net interest margins modestly.

But funding pressure is what will get the press in fourth-quarter 2018 earnings because that is the current stress point in the forever cyclical nature of banking. It is also another reason for slowing loan growth, and why the shadow banking system may be under more pressure than is assumed. Incremental loan growth is expensive to fund, especially for lenders without excess core deposits.

Credit will not get much airtime other than a few banks that will produce negative surprises. I may be overlooking someone, but every bank executive I speak with indicates credit looks fine (especially here in still-booming Nashville). OZK's write-downs, while sizable, theoretically can be explained as older and vintage loans with high loan-to-values in relation to most of the loans within the Real Estate Specialties Group. Stated differently, I do not expect lightning to strike twice at OZK.

It is late in the current economic and therefore credit cycle. The relevant question now is: How deep will the downturn be, and when will it get under way? I expect 2019 will be a tug-of-war between those who believe bank stocks (but not estimates) have largely priced a manageable upturn in credit costs, and those who believe the stocks do not adequately reflect much higher credit costs to come next year.

I am in the former camp: I believe the Federal Reserve will have to stand down from further rate hikes because the global economy is slowing quickly — but that is just an opinion from which my friend can offer no protection.

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