SNL Blogs

NASHVILLE NOTES

Wednesday, April 23, 2014 6:07 AM CT

The quarter-end downgrade

By Jeff K. Davis

Jeff Davis, CFA, is a veteran bank analyst and SNL contributor. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of SNL or Mercer Capital, where he is the managing director of the financial institutions group.

One of the rules among sell-side analysts is a universal one that I have never seen discussed in *The Wall Street Journal*, Bloomberg, Investors' Business Daily or any other financial media: do not downgrade a stock on the last day of the quarter because a commission paying, performance sensitive client owns the stock. The analyst who does so, knowingly or unknowingly, usually goes into the penalty box for a few quarters, resulting in diminished commission flows from the accounts that owned the shares. This missive is a quarter-end downgrade.

Investors are drawn to equities either because a sector or an individual security offers value — i.e., Ben Graham's "margin of safety" — or long-term growth potential where compounding can work its magic. After reviewing last week's bank results, my take is that the year-over-year comparisons are not encouraging if the focus is on growth. The same goes for value regardless of what the sell-side notes say about how cheap stocks are based upon 2015 estimates. Yes, results a year ago were supported by robust mortgage banking for some banks, but for others mortgage does not matter that much. Besides, I thought linked-quarter comparisons were uninspiring even after allowing for seasonal and day count differences between the fourth and first quarters.

Disappointing operating metrics from early bank releases

	Q1'14 operating revenue ($000)	vs. Q4'13 (%)	vs. Q1'13 (%)	Q1'14 pre-prov net revenue ($000)	vs. Q4'13 (%)	vs. Q1'13 (%)	Q1'14 net interest margin (%)	vs. Q4'13 (bps)	vs. Q1'13 (bps)
Bank of America	21,406,000	3.8	-5.2	2,969,000	-15.8	-10.1	2.29	-15.0	-7.0
Citigroup Inc.	20,478,000	12.9	0.6	7,995,000	44.3	4.5	2.90	2.0	2.0
JPMorgan Chase	22,565,000	6.2	-9.3	8,222,000	40.3	-14.1	2.20	0.0	-17.0
US Bancorp	4,753,000	-1.6	-1.2	2,265,000	2.7	-5.6	3.35	-5.0	-13.0
Wells Fargo & Co.	19,695,000	-1.6	-6.7	7,964,000	-2.4	-10.3	3.20	-7.0	-29.0
Associated Banc-Corp	238,116	-1.2	-0.5	75,114	12.7	-3.1	3.12	-11.0	-5.0
BB&T Corp.	2,256,000	-2.4	-6.0	897,000	-0.3	-12.7	3.52	-4.0	-24.0
Comerica Inc.	618,000	-4.5	-1.4	211,000	22.0	1.9	2.77	-9.0	-11.0
Fifth Third Bancorp	1,495,000	-2.0	-5.9	540,000	0.9	-10.6	3.22	1.0	-20.0
Huntington Bancshares Inc.	669,021	-1.5	-1.8	230,316	-8.7	-5.7	3.27	-1.0	-15.0
KeyCorp	974,000	-4.0	-2.6	318,000	2.3	-2.2	3.00	-1.0	-24.0
M&T Bank Corp.	1,080,994	-3.4	-1.9	384,668	0.7	-19.5	3.52	-4.0	-19.0
PNC Financial	3,715,000	-6.4	-5.3	1,489,000	-0.9	-6.7	3.26	-12.0	-55.0
Average		**-0.5**	**-3.6**		**7.5**	**-7.3**		**-5.1**	**-18.2**
Median		**-1.6**	**-2.6**		**0.9**	**-6.7**		**-4.0**	**-17.0**

As of April 18, 2014.
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Source: SNL Financial

Among the twelve larger banks that have released results so far, only Citigroup Inc. reported an increase in core revenues. The increase was nominal at 1%. Comerica, which has little mortgage origination income, joined Citigroup as the only bank to post a nominal increase in pretax, preprovision revenue as defined in SNL's database.

For the investors among you who are reading this missive, I do not mean to be too negative. More than five years of the Fed's zero-rate policy has produced much better credit quality than most of us would have envisioned possible in 2009. U.S. Bancorp and Wells Fargo & Co. produced ROEs of 14%, or over 11% above the current yield on the 10-year U.S. Treasury bond. But the reality of the situation is that bank earnings — as a group — are not going anywhere after posting a strong credit-fueled recovery the past few years that was accentuated in 2011 and 2012 by a mortgage banking environment that none of us are likely to ever see again in our lifetime.

Associated Banc-Corp CEO Phil Flynn got to the root of the essence during the company's conference call on April 18. He noted that loans that are being booked today are inherently dilutive to the margin because new yields remain below portfolio yields. It is not a dramatic phenomenon, rather a very gradual grind lower. He went on to say that new (commercial) loans are priced at LIBOR plus 250 to 300 basis points. With 30-day LIBOR at 15 basis points, new commercial production is yielding approximately 2.7% to 3.2%. I do not think Associated's origination metrics are any different from other regional banks.

Flynn did not add that the other aspect of the grind in the net interest margin is the devaluation of core deposits — especially non-interest bearing deposits — from the zero rate environment.

Associated's first-quarter net interest margin was 3.12%, down from 3.17% in the year-ago quarter. The yield on the $6.1 billion "commercial and business lending" portfolio was 3.42%, down 5 points from the fourth quarter and 24 basis points from the year-ago quarter. About 5 basis points of the reduction in the yield over the past year is attributable to LIBOR moving lower, but otherwise this single loan category illustrates Flynn's point about gradual erosion in yield and incremental margin pressure. KeyCorp directionally reflected the same phenomenon. The yield on its $25.4 billion "commercial, financial and agricultural" portfolio was 3.29% in the first quarter, down 18 basis points and 49 basis points from the prior and year-ago quarters. CRE yields may be stickier, but an increasing number of banks may be extending fixed-rate lending terms to ten years.

The byproduct of this from the Street's perspective, I think, is two-fold. One is that net interest margins for those banks that are comfortably above 3% will go much lower than the Street realizes in time unless short rates rise. And I am not convinced that if the environment does not change that a bank like KeyCorp with a net interest margin of 3.00% cannot experience a sustained move lower. The other is that the Street keeps selling next year as the year that a given bank's earnings will increase more than a few percentage points and by a means other than share repurchases. This is especially true for the asset sensitive banks such as City National Corp. and Hancock Holding Co. It just does not seem like that is going to happen; the Street has more or less predicted some variation of this every year since 2010.

My prediction is that, with regional banks trading for almost 17x trailing twelve month earnings and super regionals trading for 14x last-12-month earnings, the group is going to disappoint in 2015. Credit, the ultimate arbiter for bank stocks, is in good shape, but growth is negligible and valuations look full to me on a P/E basis. Valuations look cheap based upon tangible book value multiples, but ROTE reflects secular pressure when compared to the pre-crisis years. Translation – the stocks may prove to be dead money in 2014 given what appear to be full valuations and little revenue-driven earnings growth potential.

Article updated at 12:43 p.m. ET on April 28, 2014, to replace a chart.

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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.