NASHVILLE NOTES

Timing matters

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Timing matters, a lot.

A year ago, I had a post about longtime banker Joe Evans selling Georgia banks near the top. With the benefit of hindsight, it looks like Evans and other board members probably made the right cyclical call to sell State Bank Financial Corp. However, the decision to partner with Cadence Bancorp. does not look like a great call thus far.

When the transaction was announced May 13, 2018, the all-stock deal was valued at $1.5 billion based on Cadence trading around $30 per share. When the deal closed Jan. 1, 2019, the value was only $834 million, even though the merger agreement provided a mechanism whereby the exchange ratio increased to 1.271 from 1.16 at announcement. Cadence shares fell nearly twice as much as the 22.6% reduction in the KBW Nasdaq Bank Index between May 11 and year-end, closing at $16.78 on Dec. 31, 2018.

The shares had slightly outperformed the index year-to-date through July 19 when the bottom fell out with the release of second-quarter earnings on July 22. The shares dropped 19% on volume of 11.9 million shares as investors reacted to a handful of credits that were written off, while a few others were placed on nonaccrual status. As of Aug. 1, 2019, Cadence shares had fallen 47.1% from their May 11, 2018 levels. By comparison, the broader bank index was down 11.3%.

No doubt it is a bitter pill for State shareholders who did not sell their shares immediately after the merger announcement. Of course, no one knows what tomorrow holds, and I assume few expected Cadence shares to underperform to the degree that they have — even among those that expressed skepticism about the transaction.

From a big-picture perspective, the deal with State was struck about the time bank stocks were peaking. That was not knowable then, but over the past year or so, banks have behaved as the classic early cyclical stocks that many investors view them to be, meaning the shares tend to peak when the economy is humming and bottom at the depths of a recession.

The market is now putting a modest multiple on current earnings in anticipation of lower earnings in the future even though the Street's consensus forecasts do not reflect it (yet).

The obvious earnings pressure point is the net interest margin as a result of the inverted yield curve and the potential for rates to fall toward the Fed's "lower bound," which presumably is not a negative number, as is the case in Europe.

A bigger earnings risk than margin is a broad-based deterioration in credit. Inverted yield curves precede recessions, at least in the post-World War II era. The unanswerable question today: How bad will credit losses be whenever the next recession arrives? This question is always asked before the onset of a recession, but this time may be more problematic given significant asset inflation in the years since the financial crisis and the increase in corporate leverage.

S&P Global Market Intelligence recently published an analysis with the headline 'One-off' credit issues continue to pile up at US regional banks. Cadence featured prominently in the article, along with Texas Capital Bancshares Inc. and Wintrust Financial Corp. Cadence's net charge-offs and additions to nonaccrual were not a game-changer in my view, unless this marked the start of a pronounced trend. The market's concern is that it may be. If so, reporters will be writing more stories about credit issues that are no longer one-offs.

I am not part of the Street's informal flow of information and views between the sell-side and buy-side as they relate to specific stocks and asset classes. Judging by the violent reaction to Cadence's second-quarter earnings release, I am guessing there was a lot of debate this year about the riskiness of the leveraged loan portfolio generally and the restaurant, energy and healthcare portfolios specifically. Doubters were vindicated by the release; defenders probably felt jilted, especially because management apparently did not give a heads-up at an investor day held in early May.

For what it's worth, I am not in the camp that believes big credit losses in the next recession are a forgone conclusion. Liquidity matters. Ironically, as the Fed is forced to cut rates due to economic weakness, capital allocated to private credit may increase dramatically and thereby boost the likelihood that problem credits will be restructured and refinanced. It is perverse logic, but a potential outcome of falling rates.

Back to State Bank Financial: The board may have gotten the big-picture call right (i.e., sell) but the tactical question wrong (to whom). Or, a rough start could be forgotten within a few years because the U.S. economy did not fall into recession and Cadence's credit performance proved to be no worse than regional peers. If so, the risk-reward must be enticing today to those who are not in the deep recession camp with shares trading at less than 9x consensus 2019 and 2020 earnings and a yield that tops 4%. Price paid is the one attribute of the investment process that investors have total control over, but there are no guarantees once a commitment is made.

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