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Bank Watch

ARTICLE

Net Interest Margin Trends and Expectations

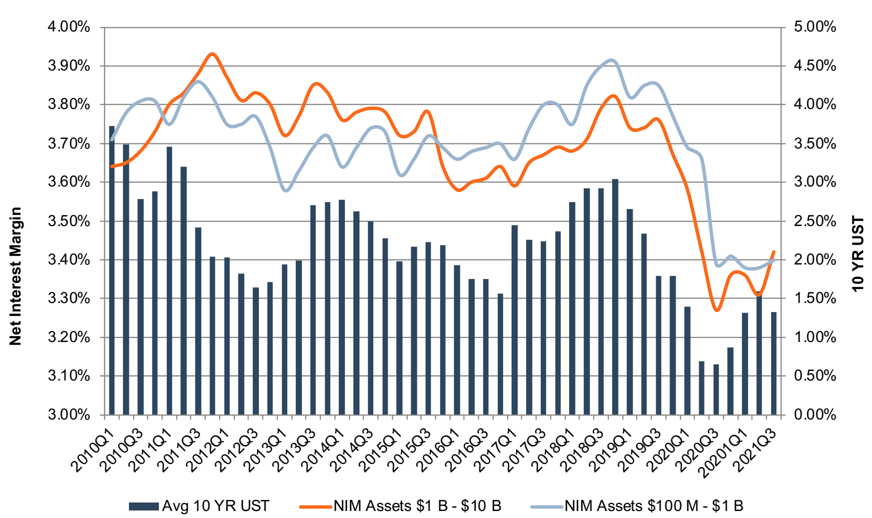
In This Issue

Net Interest Margin Trends and Expectations

Much has transpired since ***Bank Watch's* last review** of net interest margin ("NIM") trends in May 2019. The emergence of COVID-19 in early 2020 resulted in economic shutdowns that led to emergency rate cuts from the Federal Reserve and unprecedented monetary and fiscal stimulus. While the economic recession that followed COVID-19 proved to be short-lived, low rates and excess liquidity lingering in the system have weighed on margins.

As 2022 gets underway, the industry is hopeful that rate increases and loan growth, stemming from continued economic recovery, will deliver a boost to margins. This potential inflection point provides a good opportunity to review recent margin trends and examine how banks may be impacted by rising rates this year.

Figure 1 :: Net Interest Margin Trend



Source: FDIC Quarterly Banking Profile

As shown in Figure 1, NIMs contracted sharply in 2020 and have remained depressed relative to long-term averages. With deposits accumulating on the balance sheet and a lack of attractive lending opportunities, many banks' asset composition shifted in favor of short-term, lower-yielding assets. According to FDIC data, the loan to deposit ratio for community banks reached record lows in 2020 and 2021, reported at 73% as of the third quarter of 2021. This compares to an average 83% from 2012 to 2019.

Aside from the earning asset mix and deposit base, NIMs reflect a lending margin over a base rate determined based upon competition. The base rate has been severely depressed, and excess liquidity in the system has squashed any additional lending margin to be had.

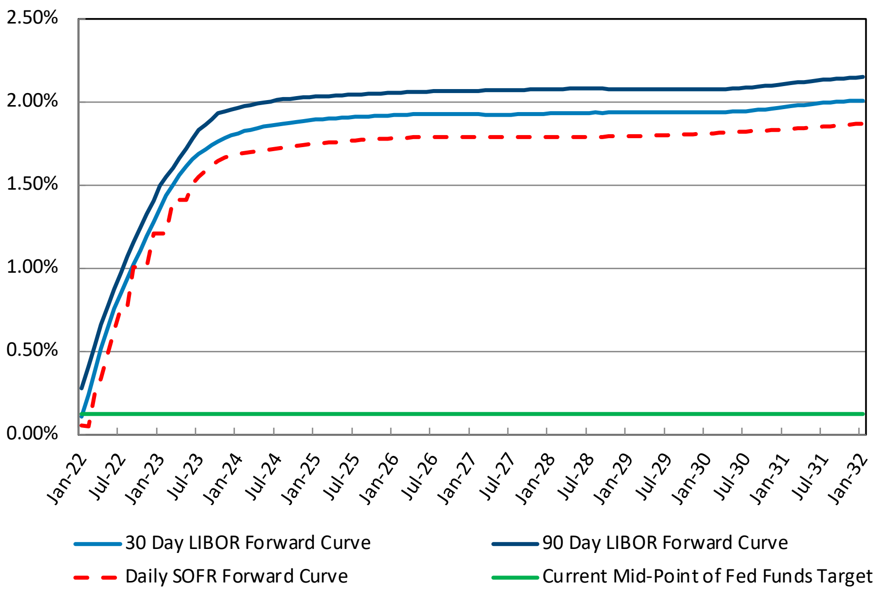
NIMs for small community banks (assets $100 million to $1 billion) fell 39 basis points from the fourth quarter of 2019 to the second quarter of 2021, while banks with $1 billion to $10 billion in assets experienced margin compression of 36 basis points over the same period. We would note that margins have been somewhat distorted by PPP loans and the associated fee income.

The third quarter of 2021 showed some positive trends for NIMs, with both small and large community banks reporting modest expansion of 2 to 11 basis points. Margins could expand further in the fourth quarter if loan growth materializes and payoffs subside. Lower premium amortization expense should provide another tailwind for banks with MBS exposure as prepayments speeds decline.

2022 Expectations

Banks are optimistic for 2022 with the Fed winding down its asset purchases and potentially raising rates as early as March. The 30 day and 90 day forward curves for LIBOR imply the Fed will raise rates three to four times by the end of 2022. The 10-year Treasury yield spiked to start the year, settling at 1.78% as of January 25, up from 1.52% at year-end.

Figure 2 :: 30/90 Day LIBOR Forward Curve @ 1/26/22



Source: Chatham Financial

The absolute level of rates is an important factor on the deposit side of the equation, specifically rates out to about 3 years. Higher rates increase the value of non-interest bearing and very low-cost deposits as they provide more lift to the NIM. Banks with a higher proportion of non-interest bearing deposits stand to benefit more from a rising rate environment.

Deposits accumulated during the pandemic have proven to be stickier than many initially thought, and 2022 should provide a good test of that stickiness. As a percentage of total assets, deposits have increased each quarter since Q2-20 for both small and large community banks.

Some banks are concerned about the possibility of deposit run-off with rising rates, but the prospect of deposit run-off significant enough to hinder lending opportunities seems unlikely. Deposit rate adjustments by banks in periods of rising rates tend to lag Fed rate movements. There is reason to expect, given banks' liquidity, that deposit rate adjustments will have a longer than normal lag in this rate cycle.

Banks that were hesitant to deploy excess cash at low yields should have some opportunities to invest at higher yields in the bond market this year. Anecdotally, some banks reporting Q4-21 earnings have mentioned shifting a greater proportion of funds to the securities portfolio. For example, Independent Bank Corp. (INDB) expanded its securities portfolio by $445 million in Q4-21 and plans to be "aggressive" with securities investments in 2022.

Rising rates notwithstanding, margins may still not return to historical levels due to excess liquidity. For one, loan growth may not be enough to absorb the sheer amount of cash that banks accumulated in 2020 and 2021. In addition, loan pricing reflects a base rate plus a lending margin, as mentioned previously. The base rate will come up, but the additional margin could remain challenged if would-be lenders remain flush with liquidity and the intensity of competition for loans does not wane.

These challenges will likely be a driver of M&A activity this year. Sellers face profitability challenges with continued margin pressure, the loss of PPP fees, and normalization of mortgage income. Buyers may find it more attractive to acquire targets with legacy loan books at better rates versus trying to grow loans organically in the current environment or investing in securities at low yields.

Public Market Perspective

Bank stocks have outperformed since mid-September when investors concluded the Fed was likely to raise rates in 2022 rather than 2023. As of January 26, the KBW Nasdaq Bank Index is up 6.1% from September 15th compared to the S&P 500's 2.9% decrease.

Analysts are anticipating margins to bottom out in the first quarter of 2022. Smaller rate increases may have a limited near-term impact on loan yields. For example, Bank OZK (OZK) announced in Q4-21 that 63% of its variable rate loans would still be subject to rate floors after a 50bps change in the base rate.

Margins are forecast to begin increasing in subsequent quarters and pick up steam in early 2023. However, margins will likely remain below pre-pandemic levels for the foreseeable future. The chart below shows historical and forecast margin performance for a group of public regional banks.

Figure 3 :: Historical and Forecast Margin Performance for Public Regional Banks

	Actual			*Projected*						
Historical and Projected NIMs	**2021 Q1**	**2021 Q2**	**2021 Q3**	**2021 Q4**	**2022 Q1**	**2022 Q2**	**2022 Q3**	**2022 Q4**	**2023 Q1**	**2023 Q2**
Cadence Bank	3.10%	2.99%	2.89%	2.87%	2.87%	2.88%	2.90%	2.90%	2.96%	2.99%
Comerica Incorporated	2.26%	2.28%	2.24%	2.09%	2.04%	2.07%	2.17%	2.29%	2.39%	2.47%
Cullen/Frost Bankers, Inc.	2.65%	2.61%	2.45%	2.32%	2.31%	2.35%	2.41%	2.49%	2.53%	2.57%
FB Financial Corporation	3.14%	3.17%	3.22%	3.18%	3.21%	3.27%	3.37%	3.44%	3.52%	3.59%
First Horizon Corporation	2.60%	2.46%	2.42%	2.36%	2.35%	2.40%	2.45%	2.49%	2.55%	2.59%
First Mid Bancshares, Inc.	3.13%	3.22%	3.42%	3.15%	3.07%	3.05%	3.07%	3.08%	3.11%	3.13%
First Midwest Bancorp, Inc.	2.99%	2.96%	2.93%	2.90%	2.78%	2.80%	2.86%	2.91%	2.90%	2.95%
Hancock Whitney Corporation	3.06%	2.95%	2.96%	2.89%	2.78%	2.80%	2.85%	2.91%	2.97%	3.04%
KeyCorp	2.57%	2.51%	2.48%	2.41%	2.40%	2.40%	2.43%	2.46%	2.52%	2.58%
Pinnacle Financial Partners, Inc.	2.98%	3.08%	3.06%	2.99%	2.94%	2.94%	2.95%	3.01%	3.04%	3.09%
Regions Financial Corporation	2.98%	2.80%	2.79%	2.85%	2.82%	2.84%	2.89%	2.94%	3.05%	3.11%
Renasant Corporation	3.33%	3.18%	2.95%	2.86%	2.80%	2.80%	2.86%	2.89%	2.99%	3.01%
Synovus Financial Corp.	2.96%	2.98%	2.99%	2.97%	2.98%	2.98%	3.02%	3.05%	3.11%	3.15%
TowneBank	3.02%	2.93%	2.80%	2.74%	2.69%	2.71%	2.78%	2.83%	2.91%	2.96%
Trustmark Corporation	2.77%	3.16%	2.59%	2.53%	2.52%	2.53%	2.56%	2.60%	2.71%	2.74%
Average	**2.90%**	**2.89%**	**2.81%**	**2.74%**	**2.70%**	**2.72%**	**2.77%**	**2.82%**	**2.88%**	**2.93%**
Median	**2.98%**	**2.96%**	**2.89%**	**2.86%**	**2.78%**	**2.80%**	**2.86%**	**2.90%**	**2.96%**	**2.99%**

Source: S&P Capital IQ Pro.

Banks with assets between $5 billion and $10 billion traded at 12.6x projected 2022 earnings and 1.60x tangible book value as of January 26. Banks with assets from $1 billion to $5 billion traded at 11.1x projected 2022 earnings and 1.29x tangible book value. Valuations presumably capture the impact of three rate hikes in 2022. As noted earlier, this has been the case since September when investors shifted their expectations for Fed rate actions.

Conclusion

Ultimately, rate increases on the horizon and economic recovery should provide a tailwind to margin expansion in 2022. However, excess liquidity still presents a challenge, and uncertainty remains as to further impacts from COVID-19.

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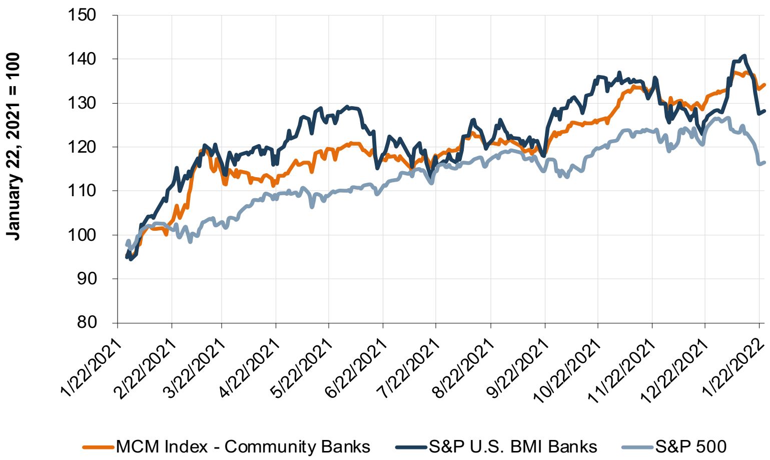
WHAT WE'RE READING

Existing home sales **rose** 8.5% year-over-year in 2021 to 6.1 million, a 15-year high. Many of the factors that fueled activity in 2021 remain in place for 2022, but rising rates could cool demand in the second half of the year. (subscription required)

Fourth quarter earnings **reports** from the largest banks sent **mixed signals** with upbeat guidance for interest income due to rising rates and a pickup in lending activity, but higher expenses over the next year resulting from tech spending and wage pressure. (subscription required)

FDIC Chair Jelena McWilliams is set to **resign** on February 4th following conflict among directors on merger rules. Martin Gruenberg, former chair and current board member, will replace McWilliams.

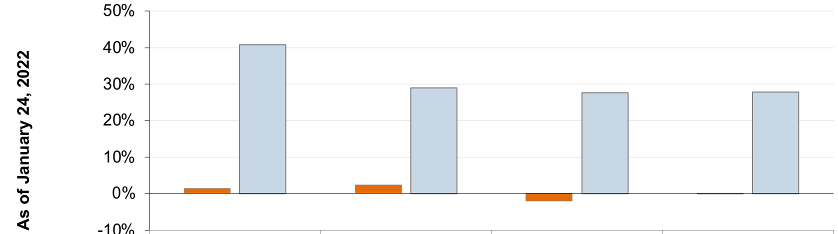
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



	Dow Jones U.S. MicroCap Banks	S&P U.S. SmallCap Banks	S&P U.S. MidCap Banks	S&P U.S. LargeCap Banks
Month-to-Date	1.28%	2.36%	-2.05%	-0.20%
Last 12 Months	40.75%	28.93%	27.63%	27.84%

Micro Cap: < $250 Million
Small Cap: $250 Million - $1 Billion
Mid Cap: $1 - $5 Billion
Large Cap: > $5 Billion

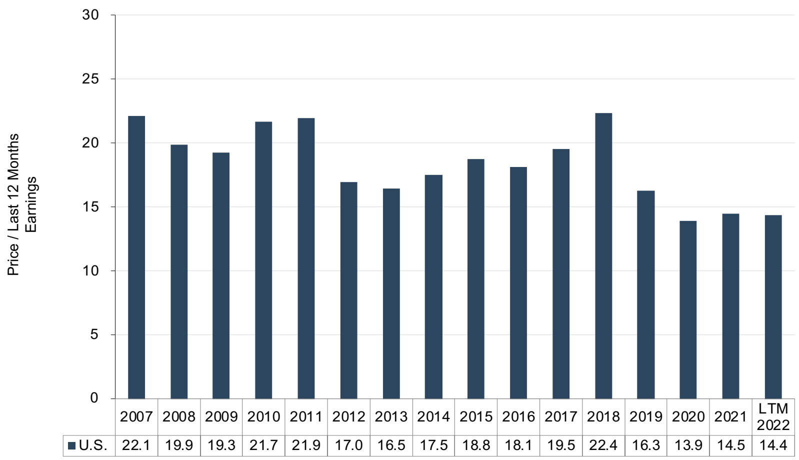
Source: S&P Capital IQ Pro.

	Total Return		Regional Index Data as of January 24, 2022					
	Month-to-Date	Last 12 Months	Price/LTM EPS	Price / 2022 (E) EPS	Price / 2023 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	0.5%	42.8%	10.5x	11.3x	12.7x	120%	129%	2.4%
Midwest Index	1.4%	25.7%	10.0x	9.8x	11.2x	109%	125%	2.3%
Northeast Index	0.9%	31.9%	9.6x	9.6x	10.3x	109%	121%	2.8%
Southeast Index	0.6%	36.3%	10.8x	11.2x	10.7x	115%	129%	2.1%
West Index	2.1%	40.3%	10.1x	10.1x	10.9x	118%	120%	2.1%
Community Bank Index	1.1%	34.2%	10.1x	10.5x	11.2x	113%	126%	2.5%
S&P U.S. BMI Banks	0.2%	28.2%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

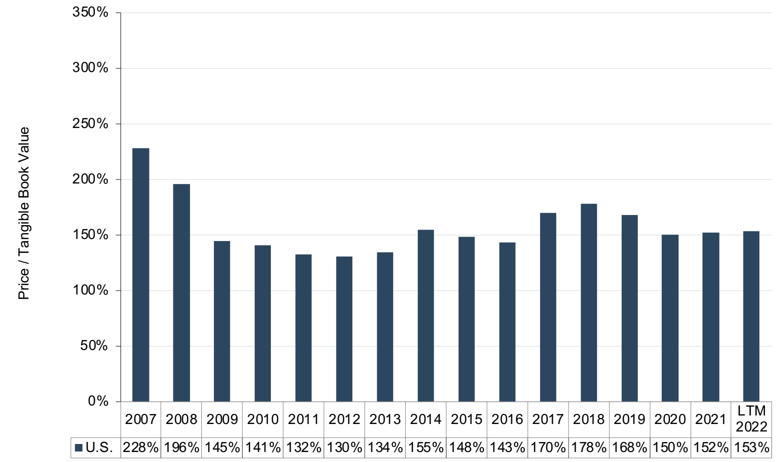
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

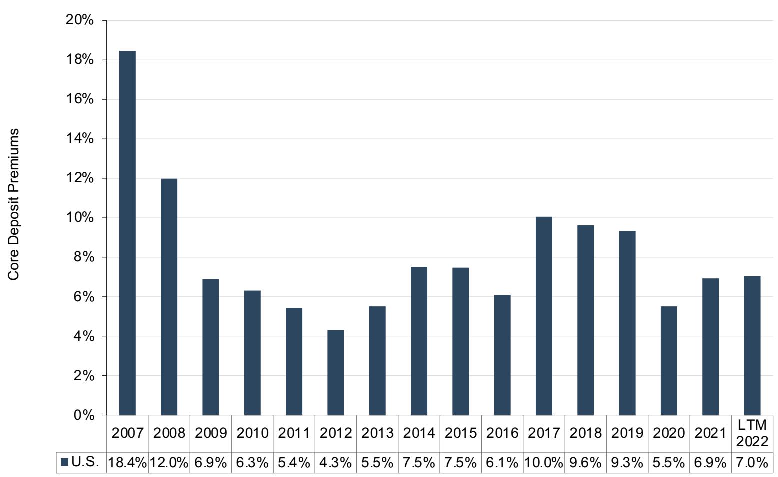
Target Banks' Assets <$5B and LTM ROE >5%



Source: S&P Capital IQ Pro.

Median Core Deposit Premiums

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



Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

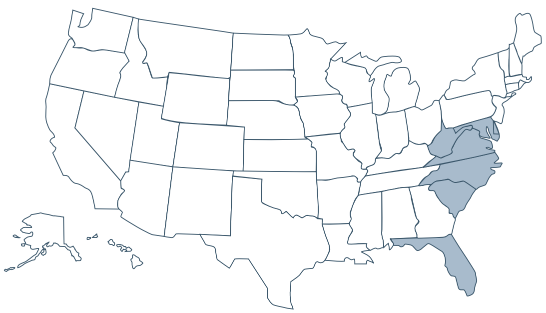
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended January 25, 2022

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	17.2x	181%	9.4%	14	130.6	594,679	10.0%
Midwest	17.9x	152%	7.3%	51	116.6	211,555	9.0%
Northeast	14.3x	144%	4.5%	5	220.2	1,214,741	10.3%
Southeast	13.6x	153%	7.8%	31	84.0	431,545	10.6%
West	13.5x	153%	6.6%	21	85.3	497,312	11.7%
National Community Banks	14.4x	153%	7.0%	122	118.0	389,695	10.4%

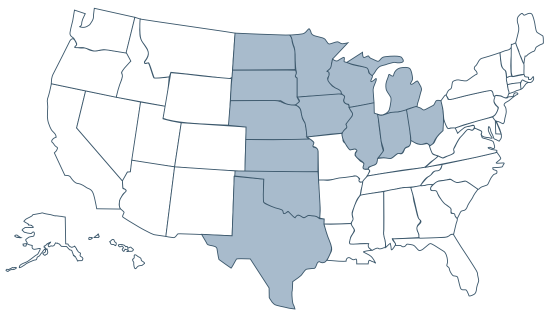
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

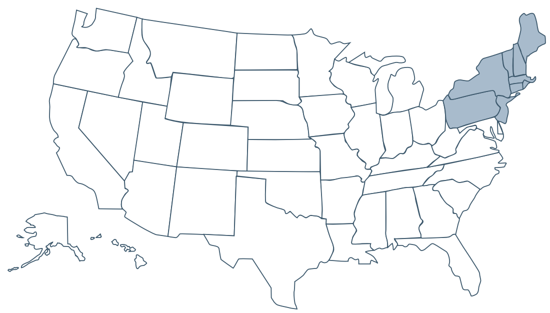
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



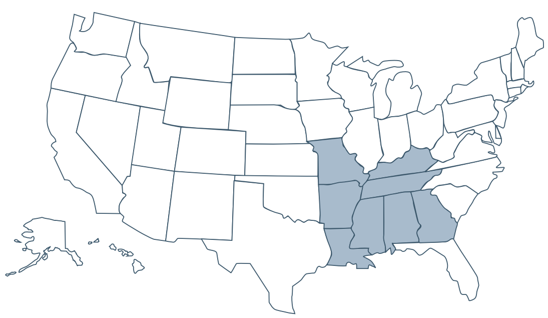
Atlantic Coast



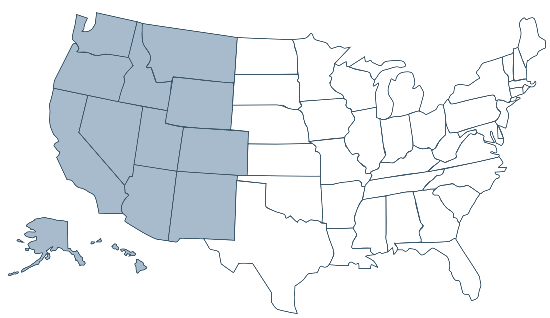
Midwest



Northeast



Southeast



West

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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.

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