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Bank Watch

ARTICLES

What Are Bank Stocks Telling Investors?

AND

First Republic Bank & The Asymmetry of Banking

In This Issue

What Are Bank Stocks Telling Investors?

What was expected to be a prosaic first quarter was anything but that. It was punctuated by the failures of SVB Bank and Signature Bank, the wind down of Silvergate Bank and the near(ing) failure of First Republic Bank (NYSE: FRC; see the article on page 4). Ironically, failures that were precipitated by deposit runs were triggered by fears of unrealized losses in bond portfolios that occurred five months after Treasury yields peaked.

Year-to-date (through April 26) the Nasdaq Bank Index declined 28% compared to 13% for the S&P Bank Index as deposits flowed into the presumed safety of "too big to fail" institutions. JPMorgan Chase & Co. (NYSE: JPM) is an outlier among banks in that its shares are up slightly YTD. Also notable is the outperformance of Technology Select Sector (NYSE: XLK) this year in a reversal of 2022 when tech stocks underperformed in the market.

Figure 1: Banks Underperform the Broad Market Indices

	4/26/23	3/3/23	12/30/22	4/26/22
Nasdaq Bank	2934	-29.3%	-27.5%	-32.3%
S&P 500 Bank	286	-18.6%	-12.7%	-17.9%
JPMorgan Chase	$135.23	-5.9%	0.8%	9.9%
S&P 500	4056	0.3%	5.6%	-2.9%
S&P Technology	*146.1*	*4.3%*	*17.4%*	*4.5%*
S&P Energy	*83.5*	*-4.3%*	*-4.5%*	*13.2%*
Nasdaq Comp	11854	1.4%	13.3%	-5.1%
Russell 2000	1730	-10.3%	-1.8%	-8.5%

Source: S&P Capital IQ Pro

To the extent falling stocks are foreshadowing poor earnings or dilutive equity raises at low share prices, it was not evident in first quarter earnings among community banks ($1-$10 billion of assets) and regional banks ($10 billion to $50 billion of assets) reports as of April 25. Earnings were fine, albeit down from the fourth quarter as is often the case given the 90 days to accrue interest compared to 92 days in the fourth quarter.

- The median year-over-year increase in EPS was 2% for community banks compared to 14% for regional banks.
- The median decrease in EPS from 4Q22 was 9% for both community and regional banks – a much larger than normal seasonal decrease between the two quarters.
- Both groups reported a median return on tangible common equity of about 15%, boosted somewhat by the mark-to-market losses net of taxes in AFS investment portfolios as reflected in GAAP equity.
- The median NIM for community banks was 3.61%, down 16bps from 4Q22 and up 44bps from 1Q22.
- The median NIM for regional banks was 3.37%, down 28bps from 4Q22 and up 49bps from 1Q22.
- Loan growth for community banks was up 1% from year-end compared to 2% for regional banks, while deposit growth for both was close to nil.
- Asset quality metrics continue to reflect very low net charge-offs and a modest uptick in NPAs.
- Though not a trend, several banks reported losses on corporate bonds held in investment portfolios.

The quarter was hardly a disaster, though the severe underperformance of bank stocks before SVB failed portends problems to come with likely some amount of overreaction by investors.

Ultimately, stocks follow earnings (or cash flow) over time, while valuations ebb and flow with changes in interest rates, an industry's profit cycle, and expected earnings growth. Quarterly earnings do not matter much other than what the current quarter implies about earnings expectations over the coming year or two and how those updated expectations get expressed in sell-side analysts estimates.

As shown in Figure 2, Wall Street banks posted upside surprises as a group with JPMorgan producing blow out results as a result of deposit inflows and because trading was very strong as market volatility exploded. Otherwise, most banks missed what were already low expectations due to NIM pressure from rapidly rising cost of funds ("COF").

Figure 2: 1Q23 EPS Surprise and Trend in FY23 Consensus EPS

	1Q23 EPS	*FY23 EPS Consensus Revision*		
As of 4/26/2023	**Surprise**	**90 Days**	**6 Months**	**1 Year**
Wall St Banks	13%	-5%	-14%	-19%
Trust Banks	-2%	0%	-4%	-20%
Wealth Mng't Banks	8%	-22%	-16%	-13%
Card Banks	-10%	-1%	-3%	-8%
Super Regionals	-4%	-2%	-6%	-3%
Regional Banks	-3%	-2%	-6%	1%
Assets $1B - $10B	-2%	-5%	-8%	-4%
OTCQX Listed	-12%	1%	3%	15%
Thrifts	-5%	-2%	-4%	10%

Source: S&P Capital IQ Pro

Figure 2 also partially explains why bank stock prices have fallen as consensus EPS expectations have declined over the past six months as a once benign rising rate environment has transitioned to a headwind. As shown in Figure 3 (on the next page) the gap between banks' cost of funds and the quarterly average 3-month T-bill yield is unusually wide for a rising rate environment. The gap is now narrowing as banks have been forced to aggressively raise deposit rates and excess funds shift to interest bearing accounts.

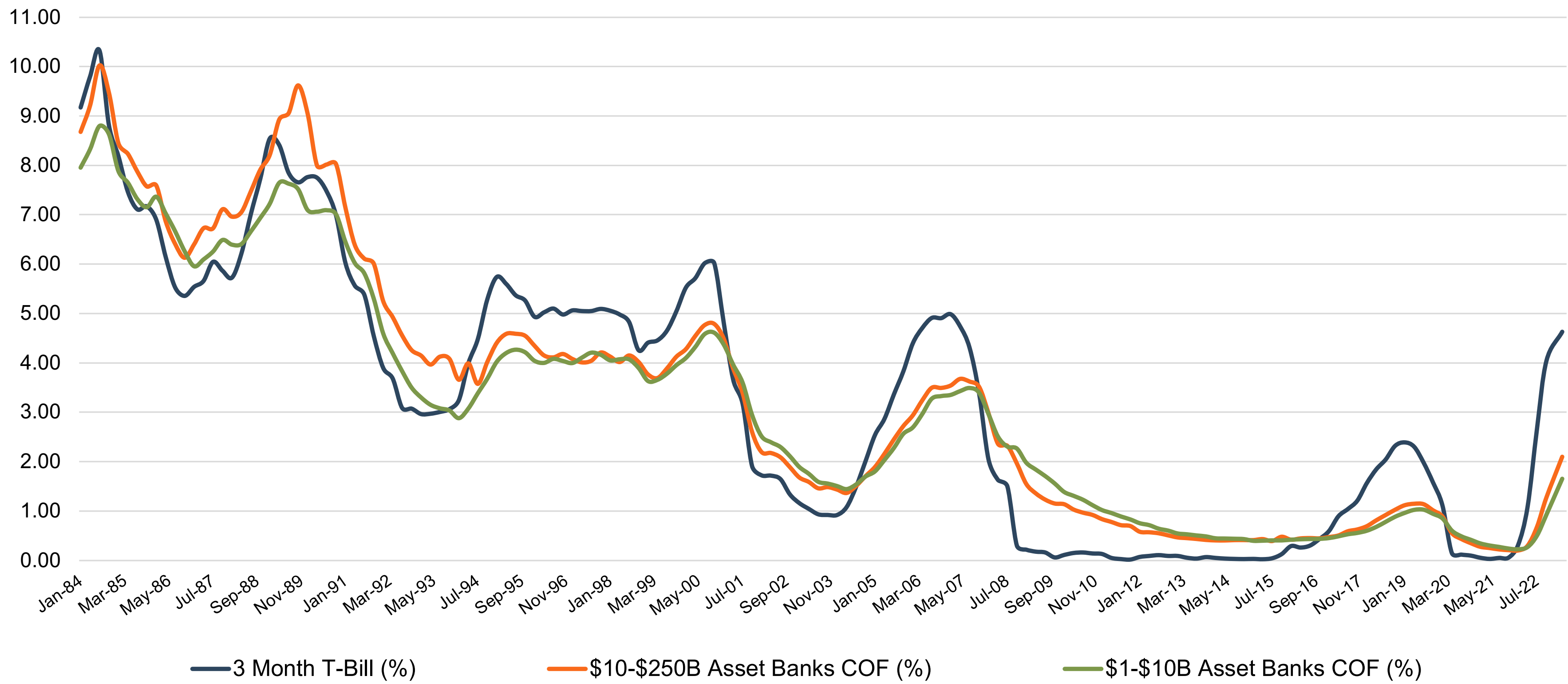
Once analysts fully update estimates over the coming weeks, we suspect 2023 EPS estimates will show a much sharper reduction than what is reflected in Figure 2. However, the poor performance of bank stocks since the failure of SVB and SBNY implies investors have more worries than the COF/NIM dynamic on forward earnings.

To paraphrase the late Donald Rumsfeld, the known unknown is credit unless there is an unknown unknown that is troubling stocks. Inverted yield curves typically precede recessions by about 18 months compared to ten months of inversion so far in this cycle as measured by the 10/2 spread. Further, the failure of SVB/SBNY has tightened the availability of credit as banks seek to increase liquidity.

So far, leading credit indicators are mostly benign. Past dues and non-accrual loans within the banking system are low, and the option adjusted spread ("OAS") on the BofA High Yield Index over U.S. Treasuries was 463bps compared to the 10-year average of 443bps. CMBS is showing some strain, however, with 5.6% of commercial mortgages remanded to special servicing though among subsectors retail remains very elevated, office is climbing and lodging has declined sharply over the past year.

Valuations are very low with community and regional banks trading for 8.1x and 8.7x consensus 2023 estimates and comparable multiples based upon flattish 2024 estimates. Super regionals trade for about 7x earnings. The long-term average based upon one-year forward earnings ranges from 12x for super regionals to 14x for community banks.

Figure 3: 1Q84 – 1Q23 Cost of Funds vs 3-Month T-Bills



Source: FDIC, Federal Reserve's FRED database and Mercer Capital

Whether the current environment proves to be a tremendous buying opportunity or a sell-off in anticipation of a sharp recession or prolonged period of stagflation is to be determined. Banks are characterized as "early cyclicals" on Wall Street — meaning they turn down well in advance of a recession and turn up when the recession is in full force. Nonetheless, we expect most community banks to perform well or well enough given low-cost deposit franchises — provided they have not over-invested in long-duration assets and/or operate with high-cost structures.

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First Republic Bank & The Asymmetry of Banking

First Republic Bank's first quarter 2023 earnings release said little, yet little needed to be said. The balance sheet "repositioning" induced by the deposit run is almost incomprehensible. Deposits at March 31, 2023, excluding the $30 billion placed by the biggest U.S. banks, fell to $74 billion, which is modestly below FRC's year-end 2018 deposits. That is, four years of deposit growth was reversed in three weeks. Noninterest-bearing deposits dropped to $20 billion, thereby falling to a level last reported in 2016.

FRC illustrates the asymmetry of banking. Rising shareholder value results from the slow, grinding agglomeration of decisions made over years. The business model does not create overnight riches. However, that accumulation of value can unravel in an instant. The downside exposure results, in part, from the leverage inherent in banking's business model. It is difficult to identify a more pure of this asymmetry between the gradual creation of value and its precipitous destruction than FRC.

FRC did not disclose its post-run cost of funds, nor has the rate paid on the $30 billion deposited by large banks been disclosed to our knowledge. Using FRC's paltry disclosures and our best estimates, the table on the right provides a rough approximation of FRC's current cost of funds. We caution that, among other uncertainties, further contraction of noninterest-bearing deposits would cause even more funding cost pressure.

FRC's yield on earning assets expanded by 15 basis points to 3.66% in the first quarter of 2023, as a 20 basis point expansion in the yield on loans (to 3.73%) was offset, in part, by an unexplained 29 basis point decline in the securities portfolio yield.

	4Q22 Average	1Q23 Average	3/31/2023 Spot Balance	Estimated Range of Current Cost of Funds
Cost of Funds				
Noninterest-Bearing DDAs	0.00%	0.00%		0.00% - 0.00%
Interest-Bearing DDAs	1.63%	2.14%		3.30% - 4.00%
Borrowings	2.79%	4.33%		4.70% - 4.90%
Funding Mix				
Noninterest-Bearing DDAs	36%	27%	10%	
Interest-Bearing DDAs, Excl. Large Banks	56%	51%	26%	
Large Bank Deposits*	0%	2%	14%	
Borrowings	7%	20%	51%	
Cost of Funds (Incl. NIB DDAs)	**1.13%**	**1.98%**		**3.70% - 4.10%**

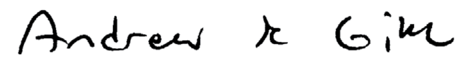
** Assumes $30 billion outstanding for two weeks in 1Q23*

Source: First Republic Bank 1Q23 Earnings Release and Mercer Capital analysis
Actual results could differ materially from the cost of funds estimates, given FRC's limited disclosures

The current yield on earning assets presumably is higher than in the first quarter of 2023 due to the continued (slow) repricing of loans and higher balances held at the Federal Reserve, but any such yield expansion is likely inadequate to produce a current net interest margin significantly greater than zero.

Interestingly, FRC did not recognize a valuation allowance against its net deferred tax asset, implying that it continues to believe the tax assets will be recoverable. Also, it maintained the held-to-maturity classification of most securities, indicating that recent events have not affected its intent and ability to hold the investments to maturity.

At the larger banks that funded the $30 billion deposit, we imagine that corporate development staff have been furiously creating scenarios over the last few weeks to preserve as much value as possible at FRC. The circumstances surrounding FRC are a throwback to the S&L crisis in which abundant—and quite creative—financial engineering was deployed. Remember supervisory goodwill? We will see what's pulled out of the toolbox this time, if it's not emptied entirely, to develop a solution for FRC's woes.



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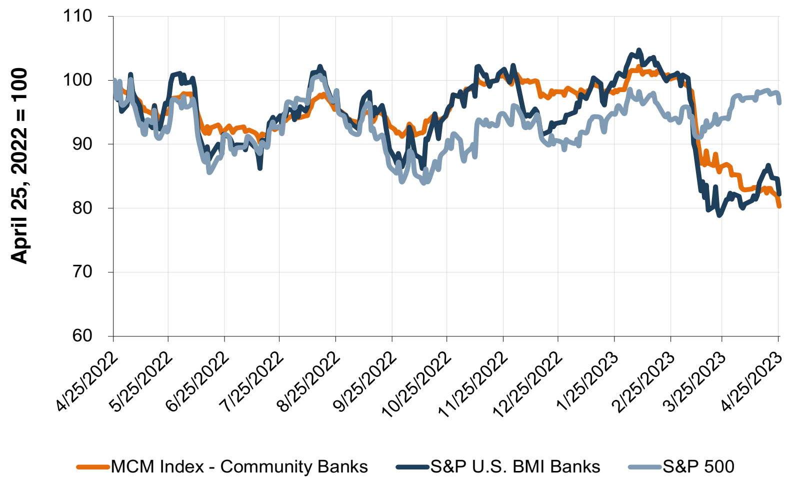
WHAT WE'RE READING

Unique insights into **U.S. market dynamics**, investment strategies, and economic indicators of 1Q23 U.S. bank performance.

Lessons learned from the **Silicon Valley Bank** collapse and a **commercial real estate** update, with specific focus on the banking industry.

The highly anticipated earnings release from **First Republic Bank** following a first quarter filled with drama and uncertainty.

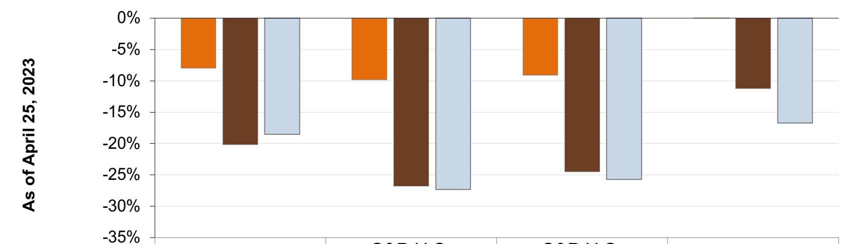
Mercer Capital's Bank Group Index Overview



Source: S&P Capital IQ Pro.

Return Stratification of U.S. Banks

by Market Cap



	S&P U.S. Banks Market Cap Under $250 Million	S&P U.S. Banks Market Cap Between $250 Million - $1 Billion	S&P U.S. Banks Market Cap Between $1 Billion - $5 Billion	S&P U.S. Banks Market Cap Over $5 Billion
Month-to-Date	-7.99%	-9.82%	-9.07%	1.32%
Year-to-Date	-20.15%	-26.80%	-24.50%	-11.23%
Last 12 Months	-18.54%	-27.34%	-25.72%	-16.74%

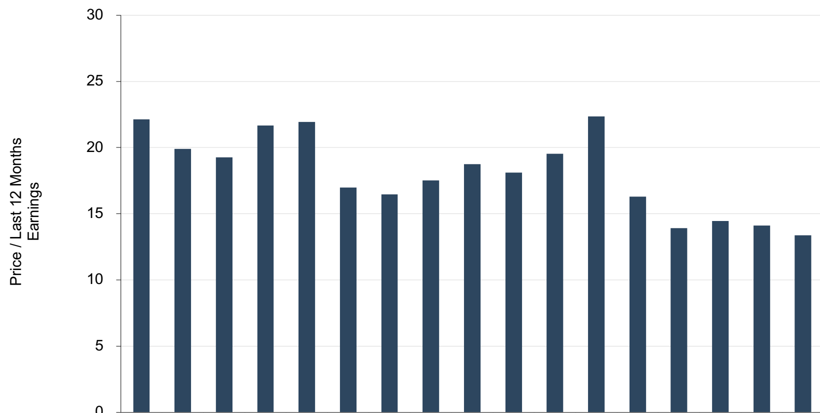
Source: S&P Capital IQ Pro.

	Total Return			Regional Index Data as of April 25, 2023					
	Month-to-Date	Year-to-Date	Last 12 Months	Price / LTM EPS	Price / 2023 (E) EPS	Price / 2024 (E) EPS	Price / Book Value	Price / Tangible Book Value	Dividend Yield
Atlantic Coast Index	-6.1%	-19.3%	-25.1%	9.2x	7.3x	7.2x	96%	105%	3.3%
Midwest Index	-7.3%	-17.9%	-17.3%	8.3x	7.4x	7.6x	94%	105%	3.8%
Northeast Index	-4.6%	-17.3%	-16.7%	7.5x	7.4x	7.9x	98%	105%	3.8%
Southeast Index	-3.0%	-20.2%	-23.6%	7.5x	8.2x	9.2x	94%	104%	3.0%
West Index	-6.6%	-21.0%	-21.7%	7.7x	7.6x	6.5x	92%	97%	3.5%
Community Bank Index	-5.8%	-18.7%	-19.7%	7.8x	7.6x	7.3x	95%	104%	3.6%
S&P U.S. BMI Banks	0.0%	-13.1%	-17.8%	na	na	na	na	na	na

Source: S&P Capital IQ Pro.

Median Price/Earnings Multiples

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

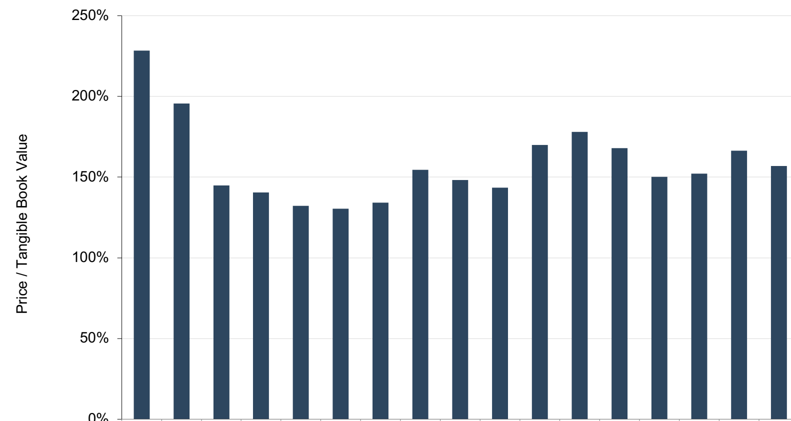


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	22.1	19.9	19.3	21.7	21.9	17.0	16.5	17.5	18.8	18.1	19.5	22.4	16.3	13.9	14.5	14.1	13.4

Source: S&P Capital IQ Pro.

Median Price/Tangible Book Value Multiples

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

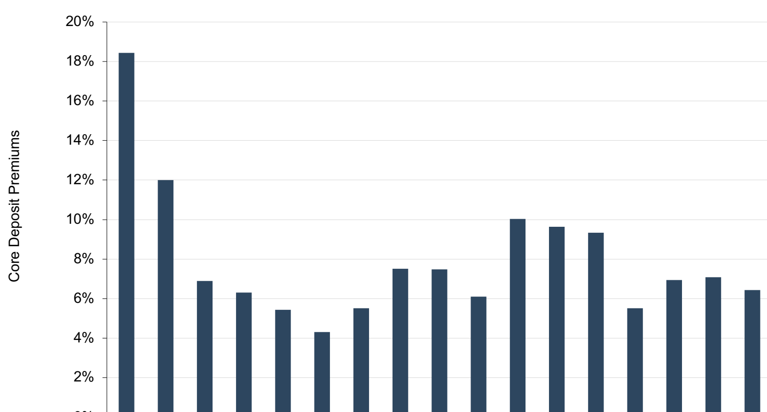


	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	228%	196%	145%	141%	132%	130%	134%	155%	148%	143%	170%	178%	168%	150%	152%	166%	157%

Source: S&P Capital IQ Pro.

Median Core Deposit Premiums

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



	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	LTM 2023
U.S.	18.4	12.0	6.9%	6.3%	5.4%	4.3%	5.5%	7.5%	7.5%	6.1%	10.0	9.6%	9.3%	5.5%	6.9%	7.1%	6.4%

Source: S&P Capital IQ Pro.

Median Valuation Multiples for M&A Deals

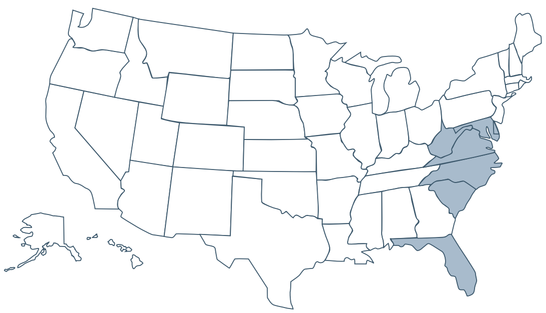
Target Banks' Assets <$5B and LTM ROE >5%, 12 months ended April 27, 2023

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	12.1x	173%	9.3%	15	117.7	689,345	11.7%
Midwest	12.8x	145%	5.7%	45	65.7	191,145	10.3%
Northeast	13.1x	128%	3.4%	7	59.6	544,087	9.3%
Southeast	13.8x	176%	7.6%	16	150.1	336,509	13.1%
West	17.6x	190%	9.0%	9	109.0	324,449	11.8%
National Community Banks	13.4x	157%	6.4%	92	86.2	327,206	11.0%

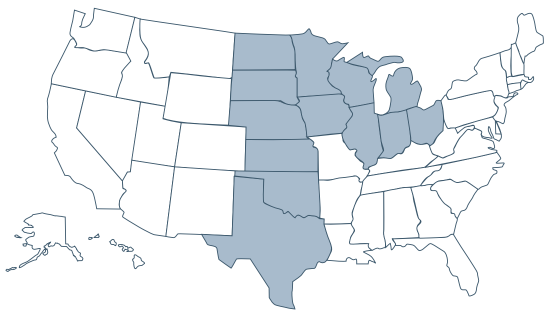
Source: S&P Capital IQ Pro.

Mercer Capital's Regional Public Bank Peer Reports

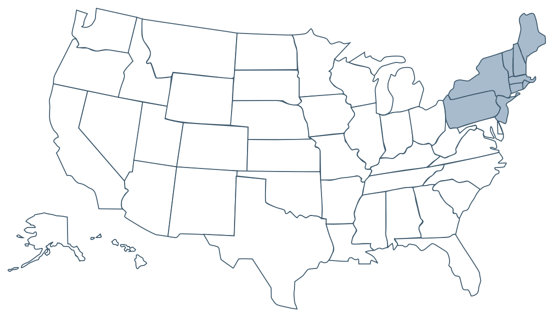
Updated weekly, Mercer Capital's Regional Public Bank Peer Reports offer a closer look at the market pricing and performance of publicly traded banks in the states of five U.S. regions. Click on the map to view the reports from the representative region.



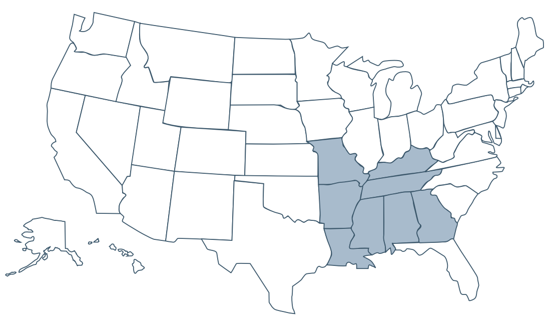
Atlantic Coast



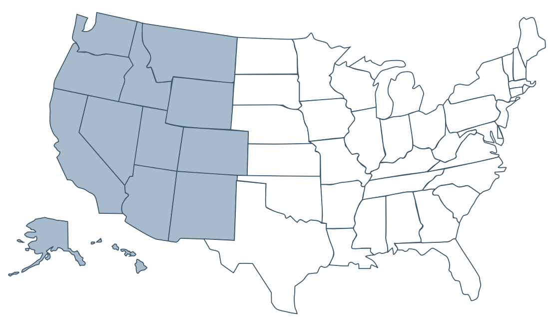
Midwest



Northeast



Southeast



West

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