B | S | Perspectives

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Quarterly Earnings Review | 2018 | Q2

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LIFTOFF – FINALLY?

Was this finally it—the quarter which we had long awaited? Was this the quarter when the optimism that had been expressed for months by bank CEOs finally became a reality? Are we at the point when business owners finally have become confident enough to begin to invest in plant and equipment and to draw down long-dormant credit lines? In short, have we reached that long-elusive time when the yield curve will have a positive slope, there will be better-than-modest loan demand and credit quality will remain well-behaved? Is banking Nirvana finally—FINALLY—here?

Well, maybe. But in banking there is seldom a silver lining without a small cloud trailing behind, and there were a couple of small clouds that shadowed the generally sunny management commentary in 2Q18. Among the most ubiquitous of these was the continuing issue of elevated loan payoffs that dampened respectable core loan growth rates—in the 5%-7% annualized range for our monitored universe overall—back to something closer to low-single digits reported growth.

There does not seem to be any one over-arching factor behind this persistent trend, but CEO Robert Hill of **South State Corp. (SSB)** seemed to us to give the most lucid explanation. South State experienced annualized loan growth of 7% in 2Q18 (which still looks pretty respectable to us), but Mr. Hill pointed out the difficulty in predicting future loan growth due to this lingering issue of filling the payoff hole. For his company, the issue has been paydowns and payoffs in the CRE segment, and he sees this as a healthy trend as these loans are being increasingly picked up by "permanent" owners, such as insurance companies and investment funds. We concur with his view—the less capital in the banking industry that is devoted to an historically volatile asset class, the better it will be for continuing stability and soundness (and growth) in the industry.

The all-out hot topic of 2Q18—and this one does not promise to go away any time soon—was that of deposit beta, and it seems to us that a somewhat obscure concept that was scarcely mentioned only a couple of years ago has become the most-discussed topic in banking in record time. We recall that it was only late last year when the overwhelming management consensus was that deposit betas would remain well-behaved and below the industry's historic norms, due both to the amount of liquidity that was still sloshing around in the financial system and to the seeming indifference of retail depositors to rising interest rates.

Well—whatever happened to that? Deposit betas jumped—or more accurately, galloped—in the second quarter as competitive pressures were brought to bear in many growth markets and as senior managers (especially in the mega-community segment) apparently awoke to the reality that they might need additional funding in the months to come, and that they needed to defend their deposit bases to secure this.

As one example, South State recorded a 50%-plus deposit beta (our estimate) in the second quarter (versus a beta we estimate to be in the 20% area in 1Q18) with the admission that they (like most in the industry) "had lagged the first few moves" of the Federal Reserve and now have a need to get ahead of the deposit-pricing curve. As a result, the cost of funds at SSB rose 9 bps sequentially (to 40 bps), which was one factor in an 8 bps decline in the net interest margin, to 4.14%. Nor were the larger banks immune to this "catch-up" reality—**BB&T Corp. (BBT)**, where CFO Daryl Bible had said on April 19 that his company was "outperforming on betas" and that "terminal betas will stay low", changed his tune in the 2Q18 commentary. BB&T's implicit deposit beta was 41% in the quarter, and CEO Kelly King cited "outsized competition in some markets" as one reason for the evolving narrative. Will competitive circumstances change in 3Q18 as was widely predicted in the earnings calls, and will deposit betas moderate as a result? Well—color us skeptical.

As eye-catching as the rising deposit costs may have been in 2Q18, the situation could actually have been worse. The fact remains that two of the Southeast's largest competitors—**Bank of America Corp. (BAC)** and **Wells Fargo & Co. (WFC)**—have loan-to-deposit ratios of 72% and 73% respectively and thus have little incentive to be deposit pricing disruptors. Indeed, Bank of America management cited a 21% deposit beta thus far in this rate cycle and presented the bank's continued strong growth in non-interest-bearing deposits in the consumer segment as one of the reasons that they have not had to be ultra-competitive in rates.

Even in the hyper-competitive large community segment, three major Southeastern competitors—**CenterState Bank Corp. (CSFL)** and **Seacoast Banking Corp. of Florida (SBCF)** in Florida and **United Community Banks Inc. (UCBI)** in Georgia—remain "under-loaned" with LTD ratios of 86%, 84% and 82%, respectively, and thus are not likely to be forced into the deposit pricing maelstrom. And we would note that the recently announced acquisition of **Charter Financial Corp. (CHFN)** of West Point, GA, by CenterState will give that company an even larger base of rural and lower-cost deposits—which it will likely need as it builds out its nascent presence in the hyper-competitive Atlanta market.

There was one other issue that jumped out at us in the course of the 2Q18 earnings season, and that was the degree to which mortgage banking results continue to recede as an earnings driver throughout the banking industry. Wells Fargo, the industry's historical 800-pound gorilla in mortgage banking, saw mortgage banking income fall 18% sequentially, a particularly striking result given that the second quarter is traditionally the industry's strongest for this important fee component. Wells cited a decline in gains on sale margins (from 94 bps to 77 bps sequentially) as pricing competition increased, as well as a decline in mortgage servicing revenues due to elevated mortgage prepayments. (In a late update, Wells Fargo has responded to mortgage market conditions by announcing a layoff of 600-plus mortgage banking personnel.)

The news on the housing front has been somewhat grim of late—existing home sales fell for a fourth straight month in July—as increasing materials costs and shortages of land continue to push up prices for the median home, up 4.5% from year-ago levels. This state of affairs seems to us to be predictable in an environment of rising rates and rising inflation (which will worsen if the impact of tariffs becomes more widespread) but we have heard scant discussion among our banks about an eventual organic slowing of one of the industry's most important businesses. While community banks like United Community are dealing with this new reality by adding experienced mortgage originators and trying to move market share, there will nonetheless be banks both large and small that will need to fill an important fee revenue hole in other ways.

Now for the numbers—which (mostly) improved for our monitored banks (of all sizes) in the second quarter. Returns on average assets and on tangible equity capital were up most significantly for the large community banks (1.51% average ROA and 17.51% ROTCE, up 3 bps and 29 bps respectively) as these banks continued to consolidate recently completed deals and cut costs (as well as to realize accretion) in the process. And the impact of the recent Fed increases were visible—higher deposit betas notwithstanding—in increased net interest margins for most of the banks on our list, with the strongest increase coming for the small community banks, where the average NIM increased from 3.84% in 1Q18 to 3.96% in the second quarter.

But what about the yield curve? The curve has been inexorably flattening in recent weeks and there have been various predictions of doom and gloom as a result. The shape of the curve did not seem to be an impediment to decent banking results in the second quarter, but there were some concerns expressed nonetheless in management commentary. Most notably, the CFO of **Entegra Financial Corp. (ENFC)**, David Bright, spoke of the bank's portfolio restructuring (which has not yet benefited results) but said also that the "yield curve was presenting challenges." While many pundits have pointed out that the long end of the yield curve is not where American banks actually operate—that happens more in the two-year to five-year segment, especially for more commercially oriented banks—we would note that the long end reflects market sentiments and concerns that MAY eventually be translated into growth impacts on banking activity. In any case, if the curve continues to flatten, we expect to hear a lot more discussion of the subject at the time of 3Q18 earnings.

Two other trends were notable. Incredibly for this late in the economic cycle, asset quality continues to be stable in most instances and improve in a few. Nonperforming asset levels declined in all of our banking segments and loan losses were flat for all but a few companies. (Most remarkably, almost all of our small community banks either had no losses or were in a recovery position.) Several CEOs pointed out that future credit issues were likely to be "lumpy"—i.e., the result of one or two credits going bad and showing up as blips on a low base of NPAs—and we have seen that phenomenon at commercial lenders like **Atlantic Capital Bancshares (ACBI)** for the past year or so.

Our other random gleaning from our compilation of quarterly trends concerns the level of expenses, and we can say with some conviction that overhead ratios improved almost everywhere in 2Q18. The major Southeastern banks had an average OH ratio of less than 60% for the first time in many quarters, and while this happy state of affairs may have been due partly to robust revenues in 2Q18, this also remains the banking segment most devoted to reducing expenses through digitization of banking functions and ongoing programs of cost reduction. The most efficient segment remains the large community banks, where sequential improvements at acquiring banks like CenterState, **Pinnacle Financial Partners (PNFP)** and South State brought the segment average below 55% for the first time in a long time. And while the Southeast's smaller community banks continue to struggle under the burden of high expenses, both Atlantic Capital and **Home Bancorp (HBCP)** made important progress on bringing down stubbornly high overhead ratios.

So—it was a good quarter, and better-than-good in some important respects. We also want to throw in a couple of observations from **J.P. Morgan Chase (JPM)** CEO Jamie Dimon, who is the industry's most important spokesperson and one of its best arbiters of banking trends. Mr. Dimon and his CFO, Marianne Lake, were positively effusive in their 2Q18 commentary, saying that the still somewhat subdued loan volumes “did not yet reflect the full impact of tax reforms” and that NIM levels throughout the banking industry were still normalizing as rates rose and that we were “not yet close to normal rates.” And when Mr. Dimon was questioned as to whether we were “late in the game” in this economic cycle, his view that while the cycle may be older the fact that “growth was lower in the past decade” than had been the norm argued for yet longer to go before recession. Add to these views the declaration of Bank of America CEO Moynihan that his company was off to the “best start to the year in the company’s history” and it’s hard not to believe that CEOs throughout the banking industry are ready to take a victory lap.

We would be remiss if we did not mention bank merger activity in the Southeast and how that might proceed from here. The 2Q18 earnings season saw the announcement of one of the more curious deals of our acquaintance—the acquisition of **FCB Financial Holdings (FCB)** by **Synovus Financial Corp. (SNV)** at a below-market price—and while we are unlikely to see that pattern replicated any time soon, we do believe that this deal will set off yet another round of consolidation in the Southeast. Terry Turner, Pinnacle Financial’s CEO and the Dean of Deals in the region, reiterated that his company’s “differentiated model is transportable” and we inferred from that that he is ready to take that model on the road after a brief respite in the wake of the BNC deal. There are attractive targets left in the region’s most attractive markets, and we expect that many of these will be taken off the table in the next 18 months or so.

So—liftoff or a flame-out on the launch pad? It is true that the banking industry is facing some possibly significant challenges—continuing flattening of the yield curve, the as-yet-unknown impact of tariffs on the American economy, and the general atmosphere of chaos in Washington—but as of yet there is no reason to believe that these issues will soon dent a solid outlook for bank earnings. The major question for us is whether this bright future will be sufficient to lift the fortunes of a group of stocks that have lagged the markets thus far this year, and we believe that the third quarter of 2018 will be pivotal in providing that answer.

Institution Name	City	State	Total Assets MRQ	Market Capitalization	Gross Loans HFI Growth (%) LTM	Deposit Growth (%) LTM	Asset Growth (%) LTM	ROAA (%) MRQ	ROAE (%) MRQ	NPAs/ Assets (%) MRQ	LLR/ Gross Loans (%) MRQ	Price/ Tangible Book (%)	Price/ LTM EPS (x)
Hancock Whitney Corporation	Gulfport	MS	27,925,447	4,386.5	4.86	3.70	4.86	1.04	9.79	1.49	1.11	208.4	17.3
Commerce Bancshares, Inc.	Kansas City	MO	24,524,742	7,549.5	2.40	-2.42	-2.21	1.82	16.32	0.45	1.14	304.8	20.5
Pinnacle Financial Partners, Inc.	Nashville	TN	23,988,370	4,957.2	15.48	13.33	14.85	1.50	9.15	0.40	0.44	254.0	19.0
Bank OZK	Little Rock	AR	22,220,380	5,245.6	10.48	10.19	10.74	2.10	12.86	0.15	0.62	180.2	11.1
UMB Financial Corporation	Kansas City	MO	20,531,470	3,735.7	7.22	1.80	0.87	1.08	10.15	0.30	0.84	186.4	13.6
Fulton Financial Corporation	Lancaster	PA	20,172,539	3,175.3	2.91	1.58	2.67	0.70	6.27	0.94	0.99	185.2	19.0
United Bankshares, Inc.	Charleston	WV	19,207,603	4,064.6	0.93	-1.01	0.90	1.42	8.09	0.81	0.56	236.7	20.3
BancorpSouth Bank	Tupelo	MS	17,222,491	3,409.8	12.70	12.89	16.03	1.26	10.54	0.43	0.95	236.0	17.9
Simmons First National Corporation	Pine Bluff	AR	16,165,533	2,842.5	82.60	68.27	78.26	1.38	10.03	0.73	0.47	236.0	17.2
Home BancShares, Inc.	Conway	AR	14,924,120	4,080.1	39.41	38.22	37.27	2.13	13.51	0.49	1.02	310.8	21.4
South State Corporation	Columbia	SC	14,566,488	3,032.7	32.33	28.86	30.59	1.11	6.94	0.29	0.48	238.6	23.5
Trustmark Corporation	Jackson	MS	13,525,265	2,408.0	2.80	6.23	-2.76	1.18	10.07	0.76	0.96	202.2	19.0
Union Bankshares Corporation	Richmond	VA	13,066,106	2,729.6	37.20	44.84	46.56	1.43	10.25	0.38	0.44	250.6	23.1
Central Bancompany, Inc.	Jefferson City	MO	12,638,779	2,433.8	3.30	-0.31	-1.32	1.40	9.67	0.61	1.57	153.8	15.6
United Community Banks, Inc.	Blairsville	GA	12,385,540	2,386.9	16.75	14.08	14.29	1.30	11.58	0.58	0.74	226.9	25.6
FCB Financial Holdings, Inc.	Weston	FL	12,192,299	2,402.3	23.03	28.11	23.14	1.45	12.95	0.00	0.57	201.8	18.2
Ameris Bancorp	Moultrie	GA	11,190,697	2,351.4	49.72	51.23	51.27	0.44	3.85	0.00	0.37	289.1	28.8
Customers Bancorp, Inc.	Wyomissing	PA	11,092,846	781.3	6.79	-2.40	1.92	0.88	10.20	0.35	0.42	111.4	12.7
WesBanco, Inc.	Wheeling	WV	10,946,584	2,682.3	6.30	8.43	10.86	1.22	8.75	0.39	0.70	265.9	20.2
TowneBank	Portsmouth	VA	10,831,653	2,323.3	30.69	21.16	28.53	1.37	9.89	0.47	0.61	240.4	21.9
Renasant Corporation	Tupelo	MS	10,544,475	2,297.4	21.92	16.37	18.85	1.42	9.52	0.38	0.59	247.9	20.5
CenterState Bank Corporation	Winter Haven	FL	10,536,723	2,530.8	51.51	50.16	55.70	1.24	8.42	0.37	0.53	286.5	25.3
Northwest Bancshares, Inc.	Warren	PA	9,562,309	1,876.5	3.46	0.45	0.67	1.11	8.65	0.89	0.72	208.7	19.4
Sandy Spring Bancorp, Inc.	Olney	MD	8,152,600	1,383.0	51.22	50.25	54.68	1.23	9.63	0.38	0.77	206.6	17.3
Eagle Bancorp, Inc.	Bethesda	MD	7,880,017	1,847.5	11.14	6.84	8.77	1.92	14.89	0.33	1.00	201.4	15.7
First Commonwealth Financial Corporation	Indiana	PA	7,648,755	1,676.0	4.94	6.88	3.59	1.71	13.70	0.65	0.91	249.5	20.4
S&T Bancorp, Inc.	Indiana	PA	7,097,346	1,630.7	0.49	-0.30	0.16	1.22	9.50	0.69	1.05	264.4	20.4
ServisFirst Bancshares, Inc.	Birmingham	AL	7,084,562	2,287.7	14.71	12.81	11.93	1.90	20.86	0.42	1.05	357.3	20.7
Seacoast Banking Corporation of Florida	Stuart	FL	5,922,681	1,476.3	19.34	18.16	12.14	1.15	9.56	0.82	0.73	268.3	23.5
Beneficial Bancorp, Inc.	Philadelphia	PA	5,770,311	1,312.2	-1.74	-0.59	-1.01	0.82	4.67	0.36	1.07	154.2	47.3
First Bancorp	Southern Pines	NC	5,717,600	1,235.9	22.91	24.95	26.25	1.60	12.66	0.90	0.56	261.5	16.8
Enterprise Financial Services Corp	Clayton	MO	5,509,924	1,303.4	9.78	8.33	9.35	1.64	15.65	0.28	1.04	291.5	19.7
Republic Bancorp, Inc.	Louisville	KY	5,265,945	1,011.6	7.14	10.83	6.26	1.23	9.45	0.85	1.07	156.4	17.3
TriState Capital Holdings, Inc.	Pittsburgh	PA	5,233,936	846.8	20.73	25.82	21.50	1.15	13.05	0.18	0.34	244.3	18.2
State Bank Financial Corporation	Atlanta	GA	5,012,329	1,264.0	25.14	24.62	18.38	1.52	11.53	0.78	0.91	224.7	22.6

Publicly traded banks between $5B-$30B headquartered in AL, AR, FL, GA, KY, LA, MD, MO, MS, NC, PA, SC, TN, VA, WV

Pricing as of 08/29/18; sorted by asset size

Source: S&P Global Market Intelligence

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