Money in the Bank: How to Find Opportunities in a Fallen Sector

By John Deysher

In the past year or so, bank stock prices have fallen sharply, reflecting a negative shift in sector prospects.

Since summer 2007, the Value Line Bank Index is down 25% and the Thrift Index is down 30%. Some banks have reduced or eliminated their dividends, a sure sign of stress. The causes include:

- ***Declining loan quality.*** Non-performing assets and loan charge-offs are rising across most loan categories—real estate/home equity loans, credit cards, highly leveraged transactions and others. At year-end 2007, about 1.4% of all loans were delinquent, according to the FDIC. That's the highest level since 1992, but still below the 2% level reached in 1990–91.
- ***Net interest income is down.*** Banks are tightening credit standards and lending terms and making fewer loans. Consumer and business confidence is the lowest in years, resulting in lower loan demand.
- ***Fee income is also down.*** Fewer loans means less fees, and a reduced securitization market inhibits banks' ability to flip new loans to the secondary market for a gain.

However, with declining stock prices comes opportunity. Many good banks have been tarred with the same brush as the troubled banks. And many high-quality issues we've been monitoring for years are coming into range.

How do you analyze a bank? Here's a brief look at how we do it.

How to Case a Bank

Banks are fairly easy to understand. Generally, they collect deposits and make loans to individuals and businesses. They have employees to pay and buildings and IT systems to maintain. They pay fees for deposit insurance and their share of income taxes.

Many types of banks and thrifts compete in the financial services sector. These include:

- ***Universal banks:*** The repeal in 1999 of the Glass-Steagall Act has resulted in giant financial institutions and the blurring of commercial and investment banking activities. These supermarkets are often involved in deposit gathering, loan making, credit cards, securities brokerage and underwriting, insurance, mortgages and mutual funds. Examples include JPMorgan Chase, Citigroup, Bank America and Wachovia.
- ***Super-regionals:*** These are banks that have grown in size and geographical reach to become major lenders throughout multiple geographic regions. Examples include SunTrust Banks, Wells Fargo and U.S. Bancorp, all of which Berkshire Hathaway owns.
- ***Community banks:*** These are banks that focus their deposit gathering and lending in a particular region. Examples include many of the banks shown in Table 1.
- ***Thrifts:*** These are savings & loans (S&Ls) and savings banks. S&Ls are federally chartered and tend to hold higher balances of housing-related loans. Savings banks (often located in the Northeast) are state chartered and often hold more commercial and consumer loans.

This discussion centers on the analysis of super-regionals, community banks and thrifts (I'll use the term bank to include all three). Universal banks, with their many business lines, are beyond the scope of our discussion.

Table 1: Well-Run Community Banks Meeting Many Listed Requirements

	Market	5-Year Average (2003–2007)						Current		
Institution	Cap. $ Mil	E/A (%)	ROE (%)	ROA (%)	R/L (%)	NIM (%)	ER (%)	P/B (x)	P/E (x)	Yield (%)
CNB Financial (CCNE)	120	9.1	13.3	1.2	1.2	3.6	64	1.8	13	4.6
Center Financial (CLFC)	150	8.8	18.4	1.4	1.1	4.0	53	0.9	7	2.3
Harleysville National (HNBC)	420	8.9	13.7	1.2	1.0	3.3	59	2.0	14	5.7
Horizon Financial (HRZB)	130	11.5	13.2	1.5	1.5	4.1	49	1.0	7	4.9
National Penn (NPBC)	1,400	9.6	13.3	1.2	1.8	3.2	64	1.4	13	3.9
Peapack Gladstone (PGC)	220	8.3	13.0	1.1	1.0	3.1	61	2.0	18	2.2
Preferred Bank (PFBK)	80	10.0	15.6	1.6	1.1	4.3	38	0.6	7	4.5
Trico Bank (TCBK)	250	8.8	15.0	1.3	1.2	4.8	61	1.3	11	3.3
Wilber Bank (GIW)	90	8.8	12.3	1.1	1.6	3.5	58	1.2	12	4.4
Yadkin Valley (YAVY)	150	11.2	10.9	1.2	1.3	3.8	55	1.1	11	3.7

Notes:
E/A: Equity/Assets; ROE: Return on Equity; ROA: Return on Assets; R/L: Loan Reserve/Loans; NIM: Net Interest Margin; ER: Efficiency Ratio; P/B: Price-to-Book-Value Ratio; P/E: Price-Earnings Ratio

Quantitative Factors

Several key ratios are helpful in understanding banks and thrifts. Some deal with profitability, some with loan quality, and others with capital adequacy. Professional investors look at all in evaluating the merits of a particular idea, compare how these ratios are trending versus the peer group, and attempt to understand any differences.

Profitability Ratios

Return on assets (ROA)

Assets are to financial institutions what sales are to non-financial institutions. The amount of net income those assets can generate is a primary indicator of a bank's health. Generally, ROAs of 1% or greater are considered strong.

Generally, smaller banks tend to have higher ROAs than larger ones.

Return on equity (ROE)

Net income as a percentage of shareholder's equity is another important indicator of financial health. ROEs of 12% or higher are considered good.

Net interest margin (NIM)

Net interest income is the difference between what a bank collects on its interest-earning assets (loans and investments) and what it pays on its interest-bearing liabilities (deposits and borrowings). Net interest margin is net interest income divided by average earning assets.

Higher margins are better, and net interest margins above 4% for banks and above 3% for thrifts are impressive.

Fee income/average assets

Fee or non-interest income is an important source of steady long-term profits, and includes everything from service charges on checking accounts to trust fees to safety deposit rentals. It may also include servicing income, which is income generated from servicing loans that are sold to others.

Fee income is less volatile than net interest income, and is highly prized and sought after in the marketplace.

Efficiency ratio (ER)

This is non-interest expense divided by the sum of net interest income and fee income. Just as important as interest expense are non-interest expenses like salaries, facilities and telecommunications.

Lower ratios are usually better, but reducing expenses too much might cause service to slip, resulting in customers going elsewhere.

High levels of fee income and high expense levels often go hand in hand. For example, it costs money to offer sophisticated trust services. An ER below 50% is very good.

Loan Quality Ratios

In general, banks make loans to individuals and businesses.

Individuals may borrow on a secured basis to fund the purchase of a home, auto, boat or other big ticket item. They may also borrow on an unsecured basis (via credit cards for example) for smaller purchases.

Businesses may borrow to finance acquisitions, capital expenditures, working capital like accounts receivable and inventory, real estate purchases and construction. These types of loans are almost always secured and tend to be higher risk, but also higher return.

Home mortgages are the most stable and lowest risk, but generally earn banks their lowest returns. This is the reason thrifts, with their large percentage of home mortgage loans, usually trade at lower multiples than commercial banks.

Interest rates may be fixed or ad-

justable, which float with an underlying index. Banks generally like to borrow short term at lower rates and lend longer term at higher rates, pocketing the difference. This formula worked well for many years, but is vulnerable if short-term rates rise or long-term rates fall, resulting in a net interest margin squeeze.

A squeeze might also occur if loans are maturing faster than deposits in a falling interest rate environment, or if deposits are maturing faster than loans in a rising rate environment.

Needless to say, there are lots of moving parts to be aware of.

Loan loss reserve to total loans

All banks have loan loss reserves designed to smooth out the negative effects of borrower defaults. They are found on the balance sheet as a reduction of gross loans (gross loans – reserve = net loans). The reserve is usually increased quarterly as an income statement item (loan loss provision) which may apply to a specific loan or to the loan portfolio in general. It is reduced quarterly by net charge-offs that actually write down or write off a loan that becomes non-performing.

This ratio should be 1.3% or higher.

Loan loss reserves have trended down in recent years, and many are worried that reserves have become too low. Several good years with minimal charge-offs have resulted in banks setting aside less in reserves for the inevitable "rainy day." At year-end 2007, the average loan loss reserve was about 1% of average loans, down significantly from a peak of 1.6% in 1992. Going forward, banks will almost certainly be required to increase reserves as more loans become questionable, resulting directly in lower earnings.

When a loan becomes bad, what happens?

When a payment has not been made for 90 days, the loan is considered past due and placed on non-accrual status, meaning the bank can no longer accrue interest income on it. The loan loss reserve is increased via a loan loss provision that reduces earnings by the same amount.

Once the loan is on non-accrual status, the bank will work with the borrower to make the loan performing, usually by increasing the term and/or lowering the interest rate. Sometimes this works. If not, the bank will write down the loan's value to the underlying collateral value and charge-off the difference.

If after several months the loan is still in default, the bank may have no choice but to foreclose on the property and transfer it to the bank's books. An additional charge-off (write down) may occur. At this point the property becomes Other Real Estate Owned (OREO), which is a separate line item on the bank's balance sheet.

Non-performing assets/total loans

Non-performing assets are non-performing loans plus OREO (discussed above). Banks don't like being in the real estate business, and generally view foreclosure as a last resort.

This ratio provides an indication of how much of the loan portfolio might be impaired. It should be as low as possible—above 4% to 5% isn't good, and above 8% to 10% can be life threatening.

Loan loss provision/net charge-offs

In a given year, the loan loss provision should be at least 100% of the net charge-offs (gross charge-offs less any recoveries of previously charged-off loans). That is, the amount expensed for bad loans should at least equal the amount of loans actually charged off.

Loan loss provisions consistently exceeding net charge-offs is very conservative.

Loan loss reserve/non-performing assets

This should be at least 100%, meaning the value of every bad asset is covered by a reserve. However, a lower ratio is not necessarily bad if you have confidence that a bank's management is capable of collecting on the non-performers. Some banks take more collateral and have better work-out teams than others.

Higher is always better.

Capital Ratios

As regulated entities, banks and thrifts are required by the Federal Reserve and the Office of Thrift Supervision, respectively, to meet certain net worth requirements. This provides the bank with the ability to absorb the impact of bad loans that inevitably occur.

There are many different capital ratios. The key one is common equity relative to total assets, which should be at least 8% or better. If the capital structure includes convertible preferreds or debt, count each toward equity if the conversion/strike price is less than the stock price.

Many analysts include tangible equity only and exclude goodwill and other intangibles from common equity.

Goodwill can be significant at banks that make many acquisitions. It represents the amount of the purchase price in excess of the acquiree's book value. Accounting standards allow this to be carried on the acquirer's books as long as it earns a reasonable return. However, goodwill is subject to a yearly impairment test and should it become impaired, it must be written off immediately, reducing common equity by the same amount.

Non-Qualitative Factors

Insider ownership and insider buying

As with other industries, we're encouraged when the insiders have large positions that align their interests with ours.

Insider buying on the open market is usually a sign of bullish prospects.

Acquirer or acquiree?

Banking sometimes seems in the state of perpetual consolidation. A large bank seeking to expand into a new area will often view the acquisition of a small well-run community bank as more economic than starting a branch network from scratch. Once the transac-

Casing a Bank: Key Ratios and Other Factors

Profitability Ratios

- ***Return on Assets (ROA)***
  ROA = Net Income ÷ Total Assets
  ROAs of 1% or greater are considered strong.

- ***Return on Equity (ROE)***
  ROE = Net Income ÷ Shareholder's Equity
  ROEs of 12% or higher are considered good.

- ***Net Interest Margin (NIM)***
  NIM = Net Interest Income ÷ Average Earnings Assets
  Higher margins are better; margins above 4% for banks and above 3% for thrifts are impressive.

- ***Fee Income/Average Assets***
  Fee income is less volatile than net interest income, and is highly prized.

- ***Efficiency Ratio (ER)***
  ER = Non-Interest Expense ÷ (Net Interest Income + Fee Income)
  Lower ratios are usually better, but reducing expenses too much might cause service to slip. An ER below 50% is very good.

Loan Quality Ratios

- ***Loan Loss Reserves to Total Loans***
  Loss reserves are found on the balance sheet as a reduction of gross loans (gross loans – reserve = net loans). Ratio should be 1.3% or higher.

- ***Non-Performing Assets/Total Loans***
  Non-performing assets are non-performing loans plus other real estate owned.
  Provides an indication of how much of the loan portfolio might be impaired; should be as low as possible (greater than 4% to 5% isn't good, and above 8% to 10% can be life threatening).

- ***Loan Loss Provision/Net Charge-Offs***
  Loan loss provisions should be at least 100% of the net charge-offs. Loan loss provisions consistently exceeding net charge-offs is very conservative.

- ***Loan Loss Reserve/Non-Performing Assets***
  Should be at least 100% (the value of every bad asset is covered by a reserve); higher is always better. But a lower ratio is not bad if bank's management has good workout-teams capable of collecting on non-performers.

Capital Ratios

- ***Common Equity/Total Assets***
  The key capital ratio, and it should be at least 8% or better.

Non-Qualitative Factors

- ***Insider ownership and insider buying:*** The more insider ownership, the better; insider buying is bullish.
- ***Acquirer or acquiree?*** You can make money with either a well-managed growth-by-acquisition strategy, or a strategy of investing in small well-run banks likely to be acquired.
- ***Deposit growth:*** 8% to 10% annually is good.
- ***Dividend payout ratio:*** Many banks offer attractive yields, but if dividends per share consistently exceed earnings per share, a dividend cut may be coming.

tion is complete, the acquirer will often reduce expenses to earn a return on its investment. Service often suffers and customers look elsewhere (perhaps some of you know the feeling). It's not long before a small "friendly" bank starts up to compete with the "impersonal" big bank. And so it goes….

Try to identify whether your bank is an acquirer or an acquiree. You can make money with either. A well-managed growth-by-acquisition strategy can generate solid returns. So can a strategy of investing in small well-run banks likely to be acquired.

Deposit growth

Banks typically fund their loans with deposits or borrowings. Deposits tend to be a cheap and stable source of funds.

Most checking accounts pay no interest; money market funds and CDs pay around 2% to 3% today. Banks must pay nearly double that to borrow if credit is even available.

Deposit growth of 8% to 10% annually is good.

Dividend payout ratio

Many banks offer attractive yields these days. But remember, over time, a bank can't pay out more than it earns without dipping into capital, which will reduce financial strength.

If the dividend per share consistently exceeds earnings per share, this may indicate a dividend cut may be coming.

Banking on Bank Stocks

Bank stock performance is driven by loan quality and earnings—both of which mirror the underlying economy. In today's slowing economy, it's often difficult to know how bad the loans are, or how low the earnings will go.

To maintain a margin of safety, stay with banks that have a history of rock-solid balance sheets, high returns, strong credit cultures and low-cost operating infrastructures.

Start your search now using the metrics we discussed above. That way, you'll be ready when prices are right.

Coming out of an economic slowdown, banks usually do very well as the economy expands. Be ready. ▲

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