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Valuations and the Banking Industry – More than a Feeling

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"It's more art than science."

When describing valuation, this is probably the most common phrase we hear and use.

We hear it from the management teams and Board members when the numbers and desired outcome in terms of valuation for their institution do not fit together neatly. We use the phrase in the context of disclosure … or cover … to basically convey the message that while we are using formulas to estimate the value of something, valuation goes beyond numbers. Valuation includes how each one of us differently views risk and return … in other words, the "art" part really means how we feel about an investment.

However, it's fairly safe to say that regulators aren't overly concerned about shareholders' feelings. At the end of the day, despite a regulatory framework that is focused on safety and soundness, managing or investing in a stock corporation is about return to shareholders. Without shareholders' capital, there may be no institutions for regulators to oversee. Without shareholders, there is no capital upon which an institution can take in deposits and make loans. Without shareholders, well … the rest of this article about valuation is pretty much moot.

Here we are, almost seven years into the recovery and the total return of the SNL Bank Index still lags the total return of the S&P 500 by nearly 50%. That hurts!

What also hurts shareholders is the inequity in return across the banking sector. Sure, stock prices of some big banks ("SIFIs" as they are now called) are exceeding pre Great Recession highs. For example, on April 28, 2016 JP Morgan was trading at $63.35, or about 120%, of its pre Great Recession 2007 stock price. But on price/book basis, the stock today is at 103% price/book, or only 67% of pre Great Recession price/book multiple of 155%. Even worse, however, smaller institutions today trade at price/book multiples that are still at about 50% of pre Great Recession levels.

One of the most material inequities we see is that the SIFIs of the world have fully recovered in terms of net income while smaller institutions … not so much. Since the low point of the earnings cycle (2009), net income earned by FDIC insured institutions has increased by $63.5 billion. And nearly 90% of that increase has been generated by SIFIs. Digging a bit deeper, much of the increase in SIFI earnings has been driven by lower expenses, not so much by revenue growth.

And unfortunately, top line revenue growth for smaller institutions, has been even slower. As a result, already hurt investors have been reluctant to pay premiums for slowing top line revenues and accumulating excess capital. That's more science than feeling.

The valuation drivers in today's banking environment– expense control and consolidation,–are in stark contrast to the hey-days of banking when growth and expansion produced strong total returns and was measured by valuation multiples nearly twice what are seen today.

And given today's fact set surrounding the industry, top line revenue growth is hard to come by for many smaller institutions, and solely cutting expenses does not create sustainable earnings. As we on occasion say to clients, an institution cannot cut its way to creating shareholder value.

Let's also tackle one of the other comments we frequently hear from management teams and Board members: "we think our bank is definitely worth more than its trading value". We occasionally hear and see compelling rationale to support this belief. The compelling rationale generally takes the form of a "stretch" strategic plan that is proven capable of producing sustainable growth in the revenue and earnings stream.

Unfortunately, much of the time the implied value for an institution based on even a "stretch" strategic plan simply does not match the shareholder value that could be generated through a business combination. Indeed, the current acquisition landscape offers proof, as it is dotted with transactions where an institution sold for a value far below the institutions' all-time high in stock price: in other words, the management and Board felt that the chances of returning to or exceeding the all-time high in stock price was practically zero. And a bird in hand is better than two in the bush.

Your strategic planning process should always focus on an important valuation topic: being realistic in your expectations for the future. But remember, expectations are always a combination of numbers, facts and feelings. While there is a wide spread feeling that the banking industry is faced with a long-line of challenges sprinkled with rays of optimism, as an industry flush with capital—but regulator belief that there cannot be too much capital– constrained prospects for growth amid increasing shadow banking competition, and considerable technological,

socioeconomic and demographic shifts, the numbers for many institutions simply do not yet support a case for valuation metrics for the banking industry returning anytime soon to pre Great Recession levels.

And that is, unfortunately, more than a feeling.

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