THE KAFAFIAN GROUP

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Banking On: The Inflection Points

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Using the Rearview Mirror to Drive Forward

The shot heard 'round the world is a reference to the homerun hit by Bobby Thomson of the Brooklyn Dodgers to win the 1951 National League pennant. That's the triumphant version of a widely used phrase.

In banking, the shot heard 'round the world took place sometime on the afternoon of March 8th or 9th , 2023 as a run on deposits at Silicon Valley Bank started, ultimately leading to the loss of $42 billion in deposits in a matter of hours. Which led to the FDIC being appointed Receiver on March 10, 2023. In a blink of an eye, the banking industry changed forever. This is the more harrowing version of the shot heard 'round the world.

To this day (a mere eight months later), nothing that led to that event or has transpired from that event has surprised me. Other bank collapses shortly thereafter? Nope. Continued interest rate hikes by the Fed? Nope. Some bank net interest margins collapsing towards zero? Nope. Depressed valuations for bank stocks? Nope. Angry Boards? Nope. The list could go on but you get the gist. It reinforces my belief that many in the banking industry were using their rearview mirror to drive forward and develop strategy. The past is gone and it's time to truly look forward, so we ask two questions (i) when does banking return to "normal" and, (ii) what key metric or metrics will signal that the banking industry is returning to "normal"?

A Cloudy Crystal Ball (More Like the Christmas Snow Globe)

We at The Kafafian Group, Inc. are actively involved in a myriad of strategic planning and capital planning engagements and seemingly never-ending merger and acquisition analyses. If there is one common theme among these engagements, it's uncertainty about the future. Bankers are shaking the Christmas Snow Globe and can't see the house with all the white flakes flying around.

The one refrain we hear constantly is that the poor performance in the banking sector is due to the rapid rise in interest rates There is no doubt that interest rates and the inverted yield curve are obvious culprits for waning performance. But in my mind there are underlying causes that have practically nothing to do with interest rates.

At the root of the deposit runoff was that many bankers took excess liquidity, and their customers that placed that liquidity in their banks, for granted. The banking industry did so well as economic first responders with PPP loans and now wiped out the customer goodwill as rates increased. It would have been so much better to be proactive in pricing to keep loyal deposit customers. Now banks have raised rates to "market" anyway. And now banks will have the added cost of reacquiring customers and reestablishing brand loyalty.

The Internal Inflection Point: Net New Customers

Many ALCO models had so many bad assumptions about customer behavior – it's almost as if we knew nothing about human behavior in general and customer behavior specifically. Changing ALCO model assumptions is not the inflection point – understanding customers' behaviors is an inflection point and measuring changes in net new clients is the metric.

Somewhere along the line, many banks lost touch with their customers. Post failure of SVB, we have seen a resurgence of bank CEOs connecting with their customers – it's the "customer experience" that is highly valued as it is the people part of the business. Customer relationships are still fragile eight months later and need to be

CONFERENCES, CONVENTIONS & OTHER EVENTS

Long Island Bankers Holiday Celebration
Wheatley Hills Golf Club
East Williston, NY • November 28

Virginia Bankers Women in Banking Conference
Hermitage Country Club
Manakin Sabot, VA • November 30

FMS NY/NJ Holiday Gala Celebration
Il Villagio
Carlstadt, NJ • December 6

IFI Luncheon
1912 Club
Plymouth Meeting, PA • December 7

FMS Philadelphia Annual Holiday Party
The Inn at Villanova
Radnor, PA • December 7

Northern New Jersey Community Bankers Annual Christmas Meeting
The Brick House
Wyckoff, NJ • December 14

Maryland Bankers First Friday Economic Outlook Forum
Hilton Baltimore BWI
Linthicum Heights, MD • January 5

Virginia Bankers Association & Virginia Chamber Financial Forecast
Greater Richmond Convention Center
Richmond, VA • January 11

FMS NY/NJ January Dinner Meeting
Il Villagio
Carlstadt, NJ • January 17

Bank Director Acquire or Be Acquired Conference
JW Marriot Phoenix Desert Ridge
Phoenix, AZ • January 28-30

FMS NY/NJ February Dinner Meeting
Il Villagio
Carlstadt, NJ • February 21

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nurtured. We have thought for many, many years that banks need to do a better job of understanding their customer data and more importantly, what customers want and need in their relationship with their bank. Going forward, measuring net new customer relationships and the characteristics of these new relationships should be a priority. When there are more new customers that are bringing "sticky" relationships to your bank, you'll know that the tide is turning for the good. So far this is not occurring en masse and feels like several years before it will.

External Inflection Points: Shareholder Value Creation Metrics

The Nasdaq Bank Index – only one of many bank-oriented indices – was soaring back in the summer of 2021. Since then, the index value has been halved and today is at the same level it was towards the middle of the Great Recession in 2008 or the post-technology led recession in the fall of 2021. In other words, the Nasdaq Bank Index has gone back in time.

As of the writing of this newsletter, there are 722 publicly traded banks in the U.S. Of those 722 banks, 275 are covered by security analysts that provide one year price targets and eps estimates for 2024 and 2025. The median change in one year price targets today is 26% lower than it was at the beginning of 2022 and has come down nearly 23% since the start of 2023. The median change in EPS between 2023 and 2024 is a decline in EPS of 7% whereas the median change in EPS estimates for 2025 are only 1.7% higher than 2023. None of those metrics portend a rapid increase in the Nasdaq Bank Index. The "when" using the Nasdaq Bank Index as the measure may be two to three years into the future – or more.

Industry wide, in Q2 2023 banks' ROA was 1.21% and ROE was 12.60%. ROE also has been helped by lower "E" (equity) as unrealized losses on AFS securities overstate ROE. If ROE were adjusted to add back AOCI, the industry ROE is closer to 11.2%. So what?

With the cost of equity and cost of capital rising and outlook for earnings muted, many banks have a return on equity in the current environment that is well below their cost of equity; we refer to this as negative economic value. In Q1 2021 for example, if the adjusted ROE for banks was 13.98% and the cost of equity was 8.00%, then the economic spread was 5.98%. In Q2 2023, with an adjusted ROE of 11.20% and the cost of equity closer to 10.00% (or more), the economic spread is 1.20%. Banks need to generate returns on shareholders' capital. Making this more challenging is regulators want even more capital. Having a lot of unused capital leads to the destruction of shareholder value. The metric we are watching for is an increase in the industry's economic spread, which I think could be at least three years into the future.

The Elephants in the Room

The outlook for a return to "normal" for banking performance generally ignores two elephants in the room: (i) credit quality and, (ii) U.S. fiscal policy. So far the banking industry has not experienced credit quality problems during the current cycle, which is amazing seeing that corporate bankruptcies are near all-time highs as is credit card debt. What if credit quality deteriorates in this environment and banks need to cut cash dividends? Not good for bank stocks.

There is an even bigger elephant in the room: U.S. fiscal policy. While the Federal Reserve makes headlines with monetary policy decisions that materially dictate interest rates, the staggering level of U.S. debt, an increasing deficit, a nearly never-ending cycle of stop-gap measures to keep the U.S. government operational and U.S. debt rating now on "negative" watch after the first ever downgrade earlier this year, the market may have something to say about interest rates. For the first time in my lifetime, there is truly a credit risk element that will need to get priced into U.S. debt – which may drive interest rates higher for longer and is also not good for bank stocks.

The Thing About Inflection Points

The longer the current environment remains the new "normal", the more likely we are to see bank M&A activity pick up – regardless of valuation metrics. While absolute prices for bank acquisitions are down, relative valuations have not changed much over the last two decades. While not an inflection point – more like a capitulation point – we see bank M&A picking up materially in 2024 and 2025.

If interest rates decrease rapidly, my greatest concern is many bank management teams think that a decrease in interest rates and a positively shaped yield curve will be the panacea for bank performance. Many bankers will cut interest rates on deposit accounts quickly as rates fall and hope loans will reprice upwards as the yield curve steepens. I think that many loans will reprice at rates below those expected by bank management teams. Cutting rates on deposits too quickly will place even greater pressure on liquidity.

The thing about inflection points is that change can occur unexpectedly and quickly in a positive direction after negative events, which is what I wish for the banking industry. Change will have to come from within banks before it is visible externally; either way, a return to normal seems like a long way off. Candidly I'm not sure the banking industry will ever be the same as it was before March 2023. And that may not be a bad thing at all.

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