Community Banking Monitor
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How Big is Big Enough?

Back in the 1990's, it was commonly argued that there are substantial economies of scale in banking, and that it was just a matter of time before the smaller banks recognized this and decided to sell to their larger and presumable more profitable and successful brethren. Consequently, observers have mused about the question of how big a bank needs to be in order to be adequately profitable -- indeed, in order to survive.

As it turns out, however, industry data provides scant support for the basic economies of scale argument. Although some industry veterans have perhaps overstated the case when they argue that there are no economies of scale in banking – one might look at such areas as regulatory/compliance efforts, mass marketing, or accounting/legal for size-related benefits – an analysis of bank performance by asset size makes it pretty clear that whatever efficiencies might be gained in these areas tend to be given back by sub-par results elsewhere. In other words, increasing size does not seem to guarantee increasing profitability.

To take a look at how this might play out within our community banking universe, we downloaded and analyzed some standard performance measurements for a universe of community banks in 9 Midwestern states – 570 banks in all. We should point out that the data are for just the second quarter of 2010, although the ratios in the first quarter were quite consistent with those of the second quarter.

What we found was that, if anything, there was an inverse relationship between size and profitability. As the following table shows, the smaller banks on average had higher net interest margins and returns on assets, lower problem asset and charge-off numbers, and better Texas ratios. It was true that increased size and scale did tend to equate with lower efficiency ratios, but virtually every other performance ratio deteriorated as the bank size increased. Based on these data, at least, we can restate the idea that increased size does not seem to be a pathway to greater profitability. Furthermore, and somewhat to our surprise, there was not a huge correlation between the results and capital ratios, with the exception of the largest group ($4 billion assets to $10 billion assets, which had both lower capital ratios and lower performance). Although the smaller banks did tend to have somewhat higher tangible equity ratios than the larger banks, the large metro banks (see table on next page) in each size category had ratios pretty much in line with their asset-size peer group, and it therefore seems safe to say that capital ratios were not an important driver behind the banks' recent performance.

Midwestern Banks By Asset Size	Return On Average Assets	Net Interest Margin	Efficiency Ratio	Nonperf. Loans/ Gross Loans	Loss Reserve/ Gross Loans	Loss Reserve/ Nonperf. Loans	Net Charge-Offs/ Loans	Nonperf. Assets/ Assets	Texas Ratio	Tang. Equity/ Tang. Equity/ Assets
$4-$10 bil. Median (9 banks)	0.37	3.30	64	4.51	2.76	0.65	1.04	4.16	40	7.7
$2-$4 bil. Median (16 banks)	0.55	3.55	60	2.81	2.23	0.88	0.87	3.21	24	8.6
$1-$2 bil. Median (61 banks)	0.64	3.78	64	3.04	1.88	0.58	0.34	3.01	25	8.9
$500 mil - $1 bil. Median (145 banks)	0.61	3.69	65	2.49	1.72	0.69	0.35	2.83	25	9.2
$200 - $500 mil. Median (435 banks)	0.82	3.84	62	1.97	1.62	0.78	0.21	2.33	18	9.3
$100 - $200 mil. Median (574 banks)	0.89	3.93	65	1.65	1.48	0.86	0.10	1.74	14	9.6

Note: results are for Q2 2010, annualized where appropriate

Source: Highline Financial data, Oak Ridge Financial calculations

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The Siren Song of the City

Part of this disparity might actually be more due to the bank's location and less because of the bank's size, however. As the table below shows, larger-market banks significantly underperform the averages for their size groups, no matter which asset-size category we looked at. In fact, one could argue that the most significant factor leading to the lower profitability of the bigger banks might be that they tend to be concentrated in the major metro markets, whereas the largest number of smaller banks operate in smaller markets.

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$500 mil - $1 bil. Large Metro Median (60 banks)	0.38	3.45	66	4.56	2.01	205	0.46	5.36	38	9.6
$200 - $500 mil. Large Metro Median (131 banks)	0.42	3.63	71	3.88	1.96	0.50	0.31	4.72	37	9.1
$100 - $200 mil. Large Metro Median (115 banks)	0.47	3.81	74	2.65	1.82	0.62	0.23	3.78	28	9.3

Note: results are for Q2 2010, annualized where appropriate

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The reasons for the relative underperformance in metro markets are fairly apparent, albeit inferential. Larger markets are more competitive because of the density of banks; metropolitan consumers value convenience and competitive prices, but neither expect nor are willing to pay much for the personal service that characterizes smaller-town banks; and costs such as land, personnel, and advertising are higher. Consequently, banks need to be larger (i.e., generate more revenue) in order to cover those costs. In contrast, banks in non-metro can know their customers better (which improves credit loss metrics), are able to charge just a bit more for credit and services, and do not need to invest so much in providing convenience via such things as branches and ATM's. From the numbers in the above table, it would appear that these benefits more than compensate for the loss of any economies of scale.

So one wonders why so many bank managements are so anxious to get into the large metro markets. The answer is probably because there is simply so much there – so many customers, so many potential deposits, so many potential loans. The problem lies in what a new bank needs to do to get those customers, such as heavy investments in infrastructure and advertising, or pressure to bend profit requirements or credit standards (either knowingly or because they kid themselves) in order to compete. We are reminded of the old stories about manufacturers that aggressively pursued supply relationships with Wal-Mart, only to find that they couldn't make anything approaching acceptable profits because Wal-Mart's very size gave it such power to negotiate supplier prices down.

This is not to say that smaller-market locations have all the advantages, however. Population and economic growth tend to be significantly less in smaller communities, which of course means that the expected growth of loans, deposits, earnings and book value are likely to be subdued. Moreover, there is the additional risk factor of relatively undiversified economies, although the fact that this economic and banking cycle has been driven by housing-related factors rather than (say) agriculture or manufacturing has caused the stresses on bank results to be worse in larger communities than in smaller and less diversified that might theoretically be exposed to more volatility and uncertainty. Finally, there is less potential for a buyout for small-town banks -- acquirers are attracted to the larger population centers as well. If a bank's owners are primarily focused on growth of and an ultimate monetization of their investment, the appeal of a metro presence is clear. But if solid profitability is the goal, with

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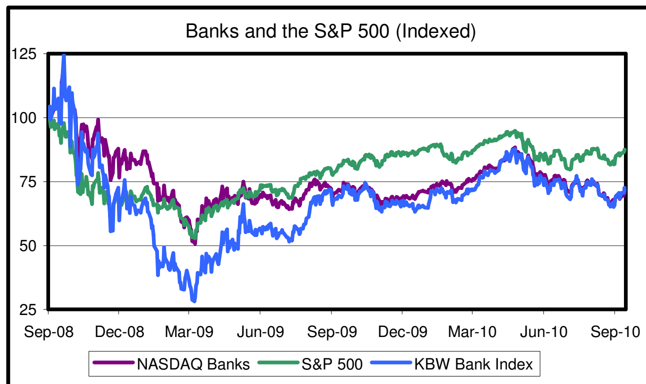
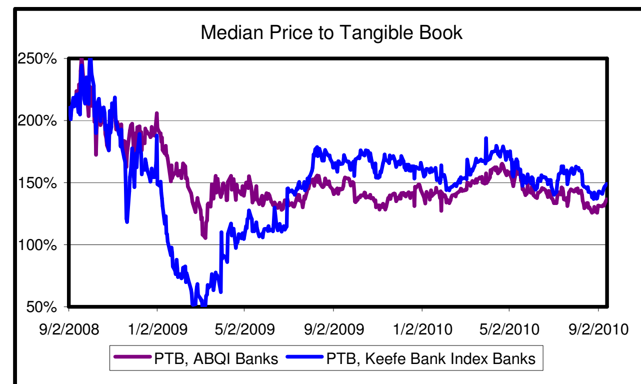
growth and an ultimate buyout being less important, smaller-town bankers might just decide to stay where the living is easier.

Bank Stock Performance Update – Still Little Loved

The past several months have certainly not been a rewarding time for equity investors in general or bank stock investors in particular. The recognition of a slowdown (perhaps even a double dip) in economic activity has led to a broad weakening of stock prices since late spring. Furthermore, the high level of uncertainty about what may be coming out of Washington seems to have pushed investors off to the sidelines. And as the chart on the left shows, bank stocks have been hit harder than the broad market in this slump – not all that surprising, given the industry's high sensitivity to economic trends.



Source: Yahoo Finance



Source: Highline Financial data, Oak Ridge calculations

We are struck by the retreat in bank stock valuations, shown in the chart at right. Clearly, valuations at or above 2x book value have disappeared, and show no signs of returning anytime soon; in fact, there are reasons to suspect that valuations around 150% of tangible book might be "the new normal", but that is the subject of a future newsletter. We are also struck by the fact that bigger bank valuations have given back only a modest amount of their rebound since the early 2009 trough, and their median price/tangible book ratio is still almost 3x what it hit at the low point. In contrast, the community bank group's valuations (which didn't fall so far in 2009) are only slightly higher than their lows, and are very much in line with where they were a year ago.

To us, this reflect more than just the broad equity market slump, but rather two issues affecting bank investor expectations for the intermediate term: that the traditional banking business will be less profitable than we were accustomed to in the past (again, a discussion for a future newsletter), and that bank acquisitions are therefore likely to be less generously priced than we saw in past periods of bank investor optimism and hyperactive M&A activity. And since buyouts are much more of a factor in the prospects for smaller banks than for larger banks, this might help explain why smaller bank valuations have recovered less, and lag those of the large banks. In fact, it may be sort of an M&A "feedback loop" that is keeping community bank valuations so low; since a substantial percentage of bank stock investors are primarily interested in banks for their acquisition potential, the collapse of healthy bank acquisitions (as shown in the following chart) has undoubtedly kept these investors out of the game.

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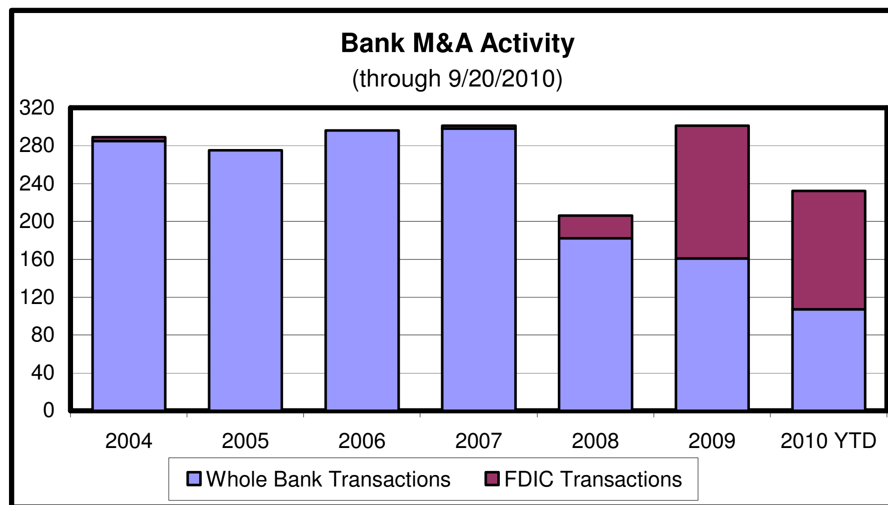

Source: Highline Financial

The data would suggest that FDIC transactions may have stabilized at about 45 per quarter, and we suspect that the mix may gradually shift back toward non-FDIC deals a bit. While there are many more banks to fail, competition is resulting in much smaller (often zero) discounts on the assets of the seized banks; similarly, competition has driven loss sharing arrangements to become much less generous than in the past, and in fact there have been no loss sharing agreements in a substantial portion of recent FDIC deals.

Strategically, the acquisition issue is an interesting one: questions about the true value of a target bank's loan portfolio create considerable hesitation on the part of potential buyers, yet it is clearly during times such as the current one that the true bargains can be had, rather than when all of the clouds have cleared and competition from other acquirers drives acquisition prices up to levels that become uneconomic for the buyers. It takes courage and great discipline, but growth-oriented banks with healthy balance sheets, strong capital ratios, and deep management teams should be looking very carefully for chances to make franchise-enhancing acquisitions in what is pretty clearly a buyers' market.

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