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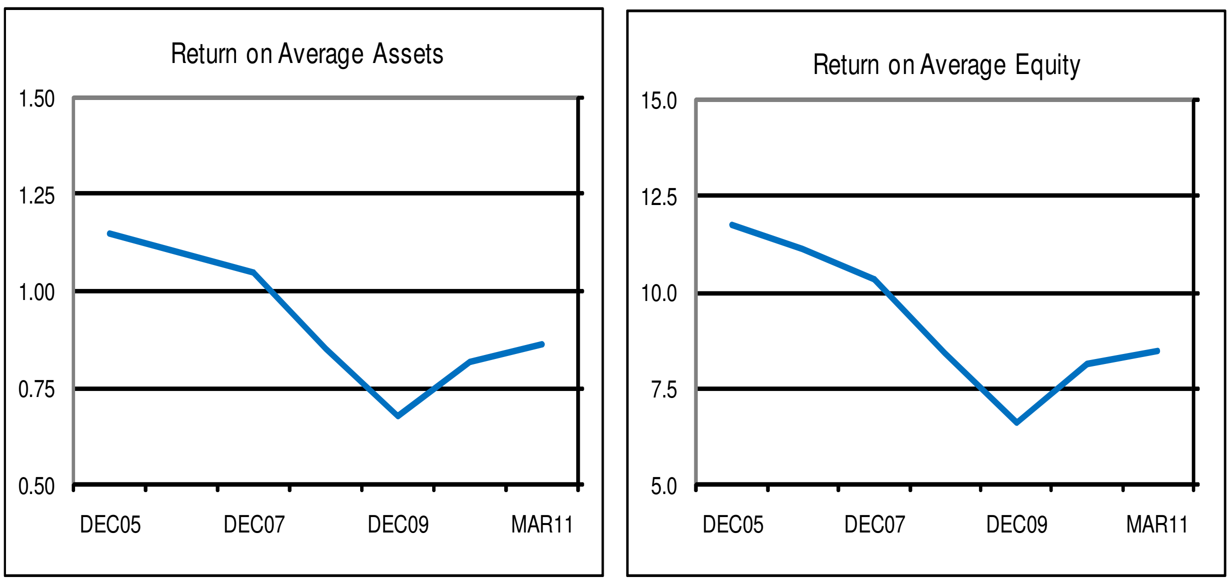
Is This a Good Business to Be In?

We were recently faced with this question from a successful banker and bank owner, and it set us back a bit. This individual has found considerable long-term success in banking, and one would think that he would have a generally positive view of the business. On the other hand, the last few years have been a pretty troubling time for community bankers, what with sharply increased credit costs, slumping loan demand, declining (or evaporating) earnings, and a regulatory environment that could only euphamistically be called difficult.

First of all, let's take a look at a snapshot of recent results; the following charts show the profit erosion that has occurred at the smaller Midwestern banks such as the ones we monitor.

Midwestern Banks $150m million to $500 million of Assets



Source: Highline Financial data, Oak Ridge calculations

While these charts clearly paint a negative picture, one could conclude that the results have not been as catastrophic as the external economic and regulatory pressures (and the mood of community bankers) might have implied; an 8.5% return on average equity is certainly not acceptable over the long term, but it is not a disastrous result given the weak economy.

Nevertheless, these very real fundamental trends can certainly be a depressant, although we suspect that the issue represented by the following chart might also have a lot to do with the malaise affecting many community bank managements:

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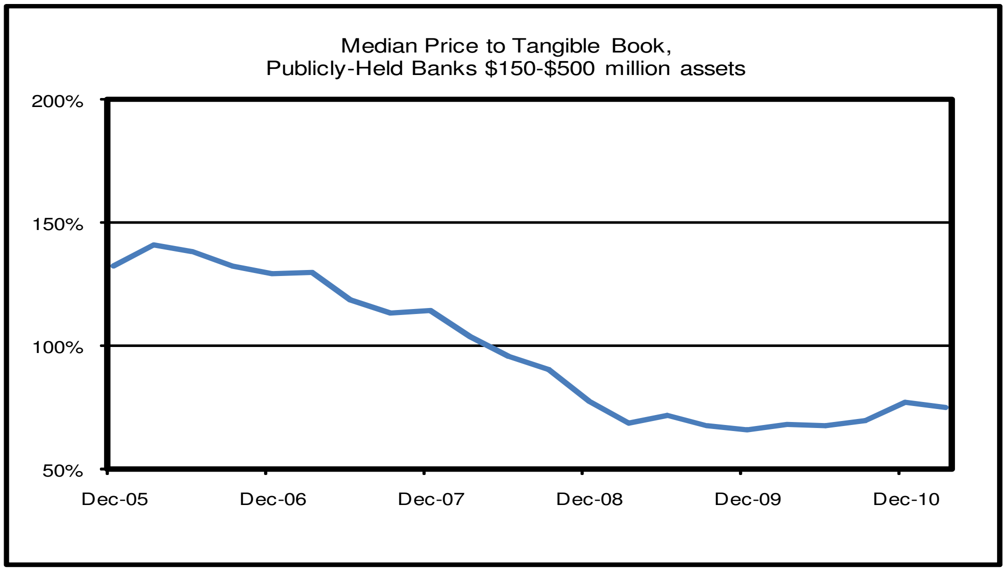

Source: Highline Financial data, Oak Ridge calculations

Given the fact that the median bank in this asset size is trading at less than 80% of tangible book value as of the end of the first quarter, and that the median price to tangible book has not exceeded 100% since early 2008, the "message of the market" seems to be that community banking is not a very good business after all – otherwise the banks would not be trading below liquidation value. And while one could have argued 18 months ago that book value was significantly overstated because it did not reflect accurate valuations of banking assets (particularly loans), a steady drumbeat of relatively harsh regulatory exams and asset write-downs have almost certainly eliminated much of that overstatement.

This same negative tone about the community banking business was quite evident in an opinion piece in a recent American Banker, entitled "Community Bankers Face a Choice: Sell Out, Fold, or Change". Actually, we agree to some degree with this sentiment – the banking business, and the economy, are not as vibrant as they once were (or appeared to be), and bankers who care about their shareholders will need to adjust their business practices to be more rigorous in implementing those business lines where they have some competitive advantage, trimming back in those businesses where they do not, and managing expenses. But if a banker is not willing to take the steps necessary to meet the challenges, then selling the bank is probably the best choice – though perhapps not in the current environment.

We will devote a future Community Banking Monitor to what we expect to be the characteristics of the successful community bank of the future, but the issue of the day is whether these negative views about the industry are correct; is it really fair to say that, since community bank earnings are sub-par, since the banks are not showing any revenue growth, and since there is a limit to how much further loan loss provisions can be reduced, the long term outlook for community banks is pretty cloudy?

Which brings us to our main point: we believe that the negative comments about the outlook for community banking are too pessimistic, and fail to make the proper distinctions between cyclical and long-term trends. Banks are a direct reflection of the economies they serve, and it should be no surprise that bank earnings are restricted when economic activity is under pressure. But the economic cycle is turning (albeit painfully slowly) toward the positive, and charge-offs and loan loss provisions appear to be rolling over. It looks as though we are past the inflection point in

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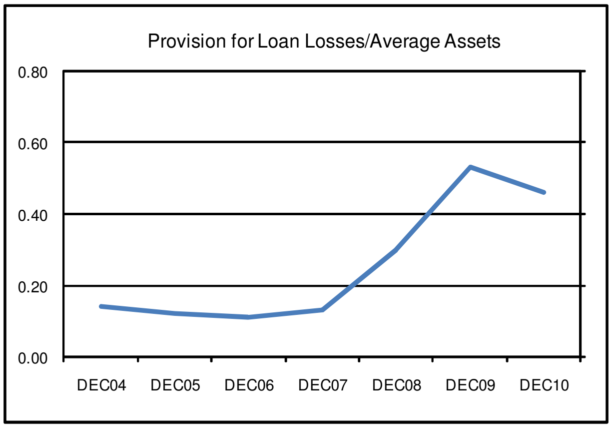
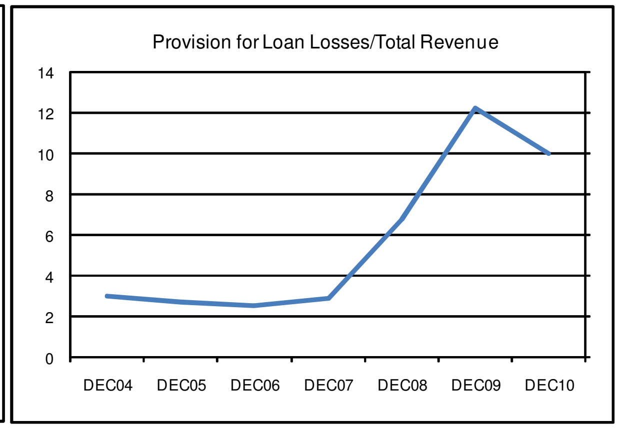
credit costs, as indicated by the following charts:





Source: Highline Financial data, Oak Ridge calculations

In broad terms, both charts are mirror images of the ROA chart. When one realizes that the pretax burden from loss provisions has gone from the low teens (in basis points) to over 50 bps in the past few years, it is not hard to figure out why the after-tax return on assets dropped from the 115 bp area to the current high-70s bp area.

Most importantly, however, both charts suggests how strong the profit rebound should be when credit costs normalize; as the charts suggests, a 50% improvement in profitability should be very achievable.
Admittedly, we can’t pinpoint when this will happen, although it does appear that we are in the process of a gradual rollover in problem assets; we hear from most banks that there are few new problem loans popping up, and that most of the reposessed real estate has been written down to the point where it is beginning to attract buyer interest. We suspect that nonperforming assets and credit costs will be significantly lower, and returns on assets meaningfully higher, a year from now.

There is one longer-term issue to be faced when judging the attractiveness of a community bank’s business: the business model. In our opinion, too many community banks built their business along the line of least resistance in the early 2000’s – real estate loans, primarily loans on investor-owned commercial real estate and loans to developers, with very little of that being funded by core deposits. As we will argue in the previously-mentioned future Community Banking Monitor, banks achieving long-term success will need to apply targeted strategies to focus on business lines with greater franchise value, which is another way of saying long-term risk-adjusted earning power. In other words, not every bank that survives the current storms will actually prosper once the weather clears.

One final comment: Although it must also be disheartening to see the largest banks (the ones which deserve a significant portion of the blame for the turmoil in the financial markets) doing better than the smaller banks, we think this relative strength is heavily influenced by factors that might also be somewhat transitory. For example:

- The stronger relative performance by the giant banks seems due in considerable part to their access to the capital markets, which allowed them to aggressively write down problem assets (with the guidance, more likely insistance of the regulators), allowing them to relatively quickly move to a position of significantly lower loan loss provisions. The community banks have also worked their problem assets down, but the process is taking longer, in large part because they do not have access to signficiant amounts of new capital to re-fill the holes made by aggressive loan loss provisions.

- The giant banks' capital markets businesses, which are not characteristic of even the mid-sized banks, put them in position to generate substantial fee income and bond trading revenues as their corporate clients recapitalized in order to take advantage of very low intrest rates. Moreover, capital markets revenues are volatile and obviously pretty sensitive to the vitality of the capital markets, and the sluggish equity markets and reports of Wall Street lay-offs might suggest a less positive trend going forward.

As the U.S. economy continues its gradual rebuilding and as we continue to whittle down on our excess debt and our excess real estate holdings, the smaller banks should catch up in terms of relative growth. This will of course be dependent upon the economic vitality within an individual bank's geographic footprint, but a substantial percentage of smaller banks should be able to show revenue growth that is comparable to that of the giants.

Furthermore, it seems as though the regulatory winds might be shifting. Not that regulators are easing up on the small banks, but it appears as though their attitude toward the largest banks is becoming less lenient. It seems significant that regulators have designated the largest banks as "systemically important"; this might not precisely mean too big to fail, but it's something close to that. As a consequence, the giant banks are facing tougher capital requirements than are smaller banks, which should lead to some limitation on return on equity for these banks. Also, we expect continued close scrutiny of such business lines as derivatives, mortgage banking, and proprietary trading. This suggests to us that the profitability of the largest banks is closer to its full potential than is true for the smaller banks.

So our answer to the question is that community banking should again be a good business, once the economy gets more vigorous. Returns on assets of at least 1.0% should be quite achievable, and despite higher capital standards, returns on equity in the low 'teens should also be attainable, with moderate growth and good predictability. We do believe, however, that adequate profitability is likely to be more dependent upon good strategies and good execution than it was 5-10 years ago. More on this in the future.

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