UNLOCKING SUCCESS

by Steve Brown

Back in 1991, there were quite a few banks that could be purchased for as little as 5x price to earnings. Today, banks are selling at some of their highest valuations in about 20 years (12x or greater). Despite the expense, in an effort to continue to grow, bank acquisition activity continues to accelerate. Regardless of which side of the acquisition transaction one is on, there are a few key considerations bankers will need to know if they want to open the door marked "Top Performing Bank" ("TPB"). Again, while regional areas can have a significant impact on growth and profitability, there are some general trends equity investors seek when defining a bank as top performing. We have spoken at length that purchase multiples are 65% correlated to organic growth, cost of funds and interest rate sensitivity. However, we have been asked to update other metric levels as we look forward through 2007. To begin, TPBs have produced a 5Y to 7Y trend of ROE above 16% with an expectation of 15% for 2007. In short, banks that consistently exceed 14% ROE in both up and down markets can consider themselves generally successful. Next, TPBs will also generally see their stock price appreciate by at least 25%, with some at the very top banks seeing gains of 32%. Another key metric, of course, is ROA. TPBs manage their ROA to approximately 1.10% year in and year out and 2007 is no exception even taking into account thinner margins and lower credit quality. While ROA does not provide as strong a linkage to long-term stock price performance as ROE, it is nonetheless important as it measures how efficient management has been at creating an earning balance sheet. Another consideration is the level of capital. Largely ignored over the past few years (due to a superior credit environment), capital levels are becoming more and more important. For this factor, banks have to walk a fine line between having too much capital (and risking pressure from shareholders to utilize it faster) and having too little. Shareholders expect TPBs to be good stewards of their capital and to leverage their balance sheets appropriately. One exception we found, however, was that investors do not seem to care much about overall loan-to-deposit ratios. Perhaps this is partly due to complacency, as some of the TPBs of the past cycle also have carried some of the highest ratios. In addition to the primary factors laid out above that equity players will monitor when reviewing independent banks, there are also some secondary metrics. While not as important as the first group, the data points that follow are usually examined within the context of the overall institution. On this front we begin with the percentage of fee income to total revenues. While independent banks have less opportunity in this area than the big national banks, TPB run at about the 25% level. Once achieved, these banks have more flexibility on loan pricing and stability of long-term earnings across multiple interest rate environments. The efficiency ratio is also important. TPB will target a sub-60% level over time. While doing so won't necessarily pop the stock by 10%, TPB tend to show continual improvement and remain below peer averages usually see faster appreciation. Finally, as the credit cycle appears to be slowly turning, equity investors are slowly refining their metrics. Some of those gaining favor as of late include the percentage of core deposits to total deposits (TPBs target 65% or more) and risk adjusted return on equity (TPB target above 14% for all loan types and structures). While these are but a few of the keys, we thought you might like to revisit them.

Related Links:

Lending Survey

BANK NEWS

Branch Sales

Regions and AmSouth agreed to sell 52 branches, containing more than $2.7B deposits in AL, MS and TN as part of the Dept. of Justice's anti-trust merger review.

Lending Survey

The OCC's latest survey shows items that are disconcerting for us when it comes to independent banks. The #1 area of loosening credit standards was in construction lending and the top reason cited was competition. Finally, the top 2 methods cited for loosening were reduced pricing and less restrictive covenants. This is a bad trend for all the wrong reasons and clearly reiterates the risk of getting too married to NIM vs. consistent earnings. To see the survey follow the link at the bottom of the page.

CEO Pay

A recent study by USC's Marshal Business School finds that 81% of board members think that CEOs need their pay closer tied to bank performance.

Underserved

The FDIC is preparing a major initiative to encourage banks to develop products and services that are alternatives to payday loans. In addition to education, the agency will work to form private-public partnerships in order to decrease risk and distribution costs in an effort to lower pricing.

Consistency

The OCC urged state regulators to monitor non-traditional mortgages since this sub-segment makes up about 30% of current production. As the OCC institutes tougher examination procedures, the fear is that the risk would be shifted to state banks and thrifts if they are not mindful of proper disclosures and solid underwriting of these products.