

Investing in Banks: Quality Rules

Brandon Thurber, Financial Services Analyst for Morgan Asset Management

Key Highlights

- As losses on residential and commercial loans continue, serious questions will be raised with regard to the capital adequacy of banks, which could lead to the need for more capital to shore up balance sheets.
- In the current environment, bank failures have become a weekly occurrence, and the larger, well-capitalized banks are simply waiting for weaker banks to fail so that they can be acquired for next to nothing.
- Higher-quality financial institutions have more capital to deploy, and most are nearly free from government involvement, leading to a higher likelihood of share buybacks, as well as dividend initiations and increases. Both of these have historically been harbingers of outperformance.

Executive Summary

In this edition of Capital Ideas, we review the investment opportunities in the U.S. banking sector. We highlight three key areas of focus when investing in bank stocks: 1) bank capital levels; 2) industry consolidation; and 3) the return of capital to shareholders.

We find that regional banks have more ongoing balance sheet issues than the larger money-center banks, and as a result, the smaller regional banks will likely remain dependent upon government support for a longer period of time than the larger money-center banks. Government involvement in the regional banks will make them less attractive takeover targets to the larger, healthier banks, thereby slowing the pace of consolidation in the industry. Overall, regional banks will have less capital to return to shareholders via share buybacks and dividends, as they are forced to divert cash flow to the repayment of government obligations and away from shareholders.

Our research leads us to prefer the large-cap money-center bank stocks

over their smaller regional banking peers for the aforementioned reasons. Large-cap money-center banks will be in a more attractive competitive position coming out of the financial crisis, as capital levels close to all-time highs will allow them to make more profitable loans, make attractive acquisitions at minimal cost, and return excess capital to shareholders.

Capital Adequacy: More Capital Raises Likely for Regional Banks

As the financial crisis gained momentum and loan underwriting standards were called into question, there was an increased focus placed on bank capital ratios as a gauge of a bank's ability to absorb future loan losses. In the past, the Tier 1 risk-based capital

1 Tier 1 risk-based capital ratio is Tier 1 capital divided by risk-weighted assets. Tier 1 capital includes common stock, retained earnings, paid-in-surplus, non-cumulative perpetual preferred stock, and minority interests in consolidated subsidiaries. Subtracted from the sum of those are intangible assets, identified losses, and excess deferred tax assets.

ratio¹ and the tangible common equity to tangible assets (TCE/TA) ratio² have been used as benchmarks to evaluate bank capital levels, but both have been found to have their shortcomings. The TCE/TA ratio offers an adequate representation of the risks associated with being a common shareholder and being in the first-loss position in a bank's capital structure, but it does not account for the riskiness of loans and other securities on a bank's balance sheet. The Tier 1 risk-based capital ratio, on the other hand, takes into account the riskiness of a bank's balance sheet, but it includes preferred stock, which is higher up in the capital structure and acts as a poor gauge of the actual losses experienced by common shareholders.

Therefore, a third ratio was brought into the mainstream. This ratio, known as the Tier 1 common ratio³, was the primary metric used in the government stress tests conducted as part of the Supervisory Capital Assessment Program (SCAP), which tested the capital adequacy of the nation's 19 largest

² TCE/TA Ratio is tangible common equity divided by tangible assets. It is calculated by taking total equity and subtracting goodwill and preferred stock equity and then dividing by the value of the company's tangible assets. Tangible assets equal total assets less goodwill and intangibles.

³ Tier 1 Common Ratio is Tier 1 Common capital divided by risk-weighted assets. Tier 1 Common capital is calculated as Tier 1 capital less non-common elements, including qualifying perpetual preferred stock, qualifying minority interest in subsidiaries, and qualifying trust preferred securities.

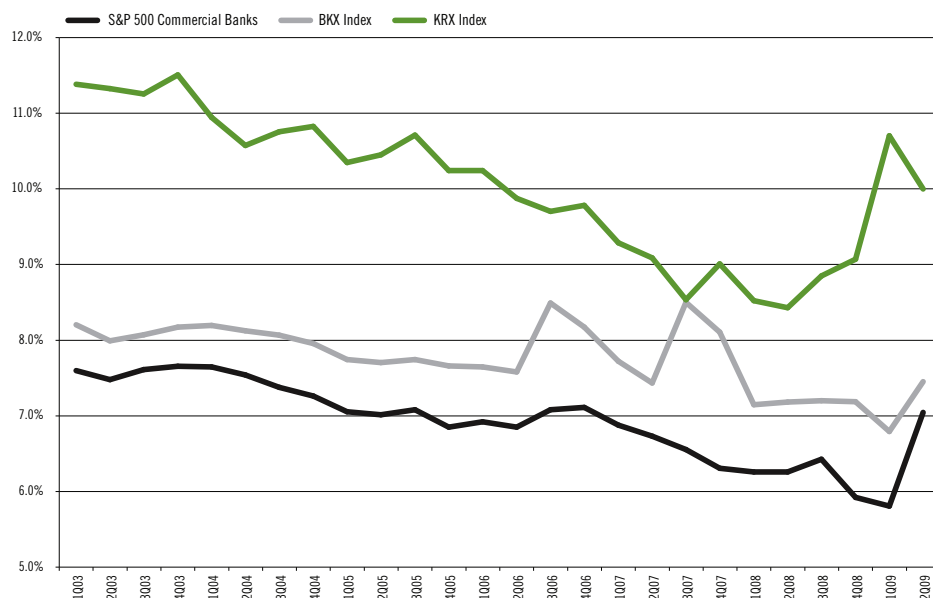
banks. The Tier 1 common ratio is a hybrid of the Tier 1 capital ratio and the TCE/TA ratio, as it takes into account both the riskiness of a bank's balance sheet and the measure of a bank's capital from the standpoint of the common shareholder. For our purposes, we will briefly look at Tier 1 common ratios for both regional banks (KRX) and larger money-center banks (BKX) to see what this ratio is telling us.

Smaller banks, exhibited by the KRX in Figure 1, have typically carried higher Tier 1 common ratios than the larger money-center banks. Investors demand more conservative balance sheets from the smaller banks to offset the greater risk in their businesses. The

loan portfolio of a small bank tends to be geographically concentrated where collateral values can face similar risks. Larger banks can diversify their lending across geographies and businesses; therefore, they have a greater ability to offset losses in one area with gains in another. As a result, a Tier 1 common ratio of 8% would be acceptable for a large well-diversified bank, while it would be unacceptable for a smaller bank with regional emphasis.

As seen in Figure 1, in 2003, regional banks (KRX) had an average Tier 1 common ratio of approximately (~) 11.5%, vs. ~10% today, and at one point this ratio fell to ~8.5%. Whereas larger banks (BKX) had an average

Figure 1: Average Tier 1 Common Capital Ratio



Source: KBW Research, SNL Datasource, Standard & Poor's
 BKX constituents include the 24 largest regional and money-center banks in the U.S.
 KRX constituents include 50 regional U.S. banks, and there will be some overlap with the BKX.

Tier 1 common ratio of ~8% in 2003, vs. ~7.5% today. So there has been a greater decline for the Tier 1 common ratios of the KRX than for the BKX over this time period, due to a de-risking of the balance sheets for larger banks, as well as recent capital raising activities due to SCAP results.

Due primarily to the stress tests conducted on the nation's 19 largest banks, the large-cap banks appear to be ahead of the regional banks when it comes to capital raising. The regional banks may still be forced to raise more capital as commercial loans deteriorate, capital that would be costly and dilutive to shareholders in many cases. Overall, the large-cap money-center banks hold less uncertainty with regard to capital than their regional banking peers.

banks capable of making acquisitions appear to be in no hurry, as many acquisition targets are on the brink of failure. The failure of a bank would force the FDIC to step in and likely attempt to orchestrate a deal in which the well-capitalized institution acquires the deposits and branches of the failed bank for next to nothing.

We believe the pace of consolidation will remain slow for another reason as well. With the government injecting taxpayer dollars into financial institutions, taxpayers are now owners and can dictate how a bank operates on a day-to-day basis, which could potentially affect a bank's culture and profitability. Many of the nation's banks participated in the Capital Purchase

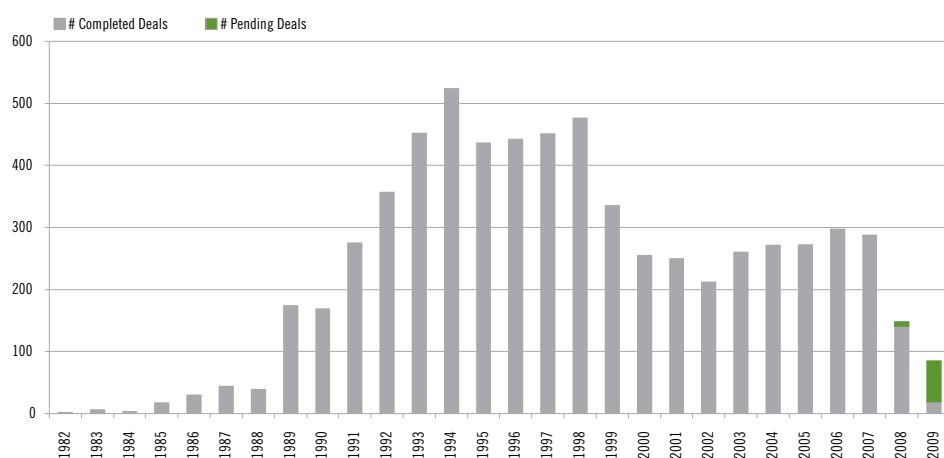
Program (CPP) as part of the Treasury's Troubled Asset Relief Program (TARP), which supplied the banking industry with capital in exchange for preferred stock and warrants. Many of the banks that received TARP funds through the CPP have already repurchased the preferred stock and warrants issued under the program because it became clear fairly quickly that participation in this program would prove to be quite costly.

Banks that participated in the program were responsible for paying dividends on the preferred stock issued, and the government would also have a say in the day-to-day operations of participating banks, including approving upper-level management and their compensation. Banks that partici-

Pace of Consolidation: Government Investment and Economic Uncertainty Will Hamper the Pace of Mergers and Acquisitions (M&A)

In the years before the financial crisis, consolidation was a major theme throughout the investment community, as many investors bought the weakest banks with the belief that they would be acquired at a premium and generate a huge return. Coming out of the financial crisis, the large, well-capitalized

Figure 2: Number of Bank and Thrift Merger and Acquisition Deals



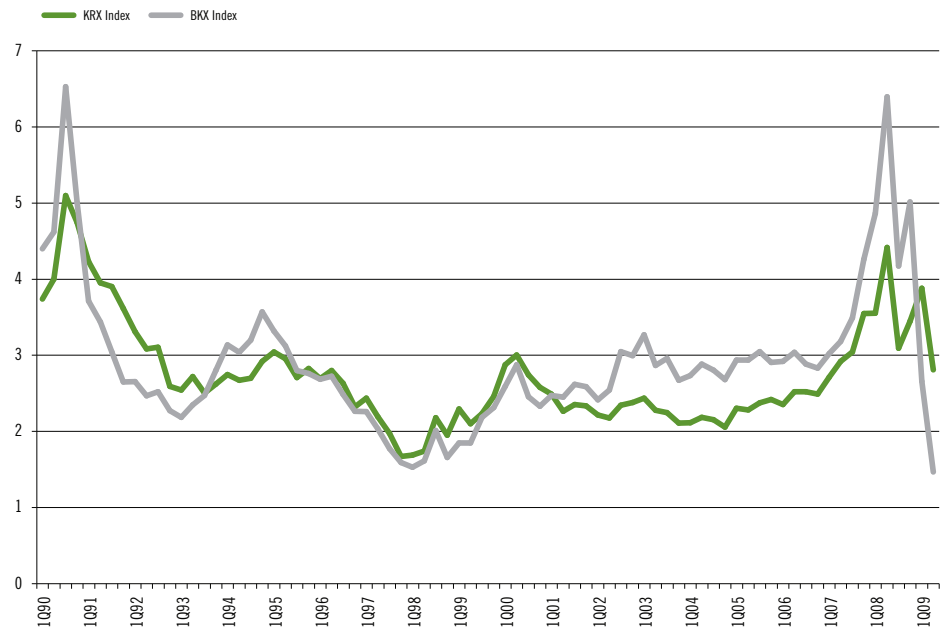
Source: KBW Research, SNL Datasource

pated and wanted out of the program had to repurchase the preferred stock issued. Warrants were also included, making the exit from the program even more capital intensive and expensive than originally expected. It is for these reasons that it is difficult for us to envision stronger banks--that have already paid back their TARP borrowings--purchasing a bank with TARP obligations because they would effectively be going back into the arms of the government.

Typically, coming out of past crisis events, higher-quality franchises took over their lower-quality peers at a fraction of their pre-crisis value. The 1990 recession was a prime example of this. As Figure 2 shows, the pace of mergers and acquisitions picked up substantially as the 1990 recession ended.

We have not seen this rapid consolidation occur this time, as the government is still heavily invested in the lower-quality franchises. These banks would normally have been acquired and, in some rare situations, would have been acquirers. Due to government involvement, they are less attractive to acquiring institutions, and the government is unlikely to allow a weak institution to make an acquisition, as it could further undermine the stability of the banking system. In our opinion, there is little reason to invest in many of the banks that still have government funds, as participation in these programs will continue to eat

Figure 3: Average Dividend Yield



Source: KBW Research, SNL Datasource

BKK constituents include the 24 largest regional and money-center banks in the U.S.

KRX constituents include 50 regional U.S. banks, and there will be some overlap with the BKK.

away at much-needed capital, placing many of these institutions at a competitive disadvantage relative to their peers.

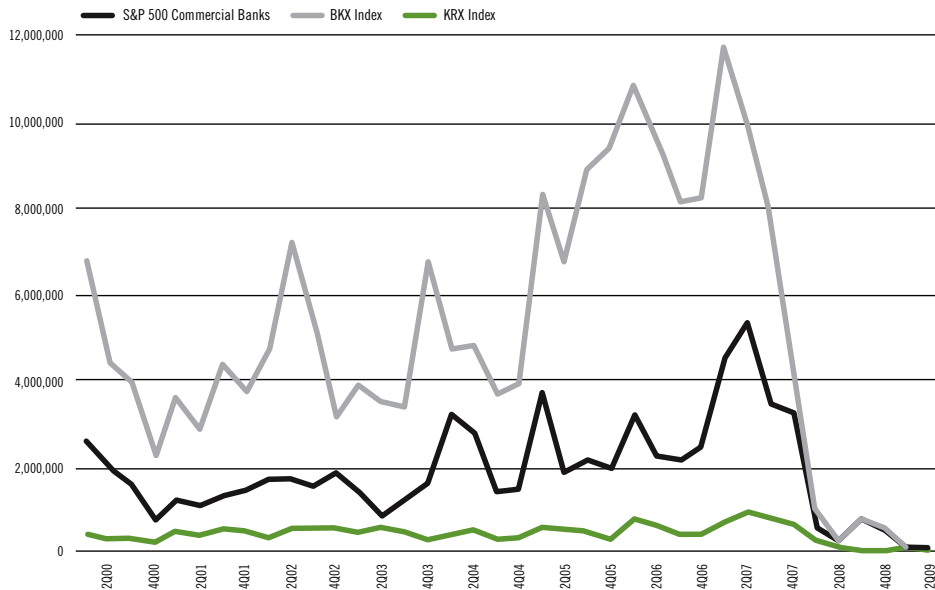
Return of Capital to Shareholders: Less Profit to the Government = More for Shareholders

Historically, bank stocks have been viewed as annuities in stock form. Investors could buy a bank stock and hold it because the yield was safe. During the financial crisis, many banks suspended or substantially lowered

dividends and drastically reduced share repurchase activity in an attempt to conserve much-needed capital.

In the past, banks have been very methodical when it comes to increasing or decreasing dividends, due to the signals that a dividend increase or decrease can send to investors. When a company initiates or increases a dividend payment, it is signaling that it is confident in its ability to generate stable cash flow in the future to pay that dividend. Conversely, when a company decreases its dividend or decides to suspend a dividend payment, it is

Figure 4: Total Shares Repurchased (\$000)



Source: KBW Research, SNL Datasource, Standard & Poor's
BKX constituents include the 24 largest regional and money-center banks in the U.S.
KRX constituents include 50 regional U.S. banks, and there will be some overlap with the BKX.

signaling that cash flows are uncertain and that the preservation of capital is of the utmost importance. Academic studies have shown that stocks of companies that initiate or increase dividends tend to outperform the market, while those that decrease or suspend dividend payments tend to underperform over the next three years⁴.

Share repurchases are viewed positively from a shareholder's perspective, but relative to dividend initiations and increases, there is one important distinction. Share repurchases are

typically viewed as more short-term in nature, and in most situations, it is simply management taking advantage of a short-term mispricing of a company's stock in the marketplace. A dividend initiation or increase is viewed as a longer-term commitment on the part of a company's management to return value to shareholders. This is because of the fear of stock price underperformance that typically takes place once a company decreases or suspends payment of a dividend.

The preferred dividends that banks are required to pay to the government as part of their participation in the TARP program are going to eat into the capital that banks could use to make

loans, repurchase stock, and initiate or increase dividends. Going forward, banks that have repurchased securities issued under the TARP will have more capital to return to shareholders via share buybacks and dividends. In short, the government is no longer in line ahead of shareholders for company profits. The return of capital to shareholders will be one of the primary differentiators between high-quality and low-quality institutions, with the high-quality banks acting in a more shareholder-friendly manner.

The End Game

During the financial crisis, the U.S. government pumped massive amounts of capital and liquidity into the industry to keep it afloat. The problem now is that the government has unwittingly produced a dual-class structure in the banking space: those that have paid back government borrowings and those that have not. From a shareholder's perspective, banks with TARP funds are thought to be in a weaker position than those that had enough capital to buy or earn their way out of the program.

The degree of government involvement will be one of the primary differentiators between high-quality and low-quality banks. High-quality banks, in most situations, will be the banks with capital levels above those of their peers

⁴ *The Journal of Finance*, "Do Changes in Dividends Signal the Future or the Past?" Shlomo Benartzi, Roni Michaely, and Richard Thaler, July 1997.

and those that have no direct government investment. In our opinion, these are the banks that will be in a position

to grow, return capital to shareholders, and benefit investors.

About Morgan Asset Management

Morgan Asset Management is an active investment manager focused on achieving long-term investment goals for our clients through diversified, high quality portfolios. We offer a variety of domestic fixed income and equity strategies as well as several liquidity/cash management products.

We have a proven philosophy and established processes that give us consistent long-term performance. We are committed to building long-term relationships by providing enhanced performance and excellent client service. We have the ability to customize portfolios to meet individual client needs and objectives.

Through our relationship with Regions Morgan Keegan Trust, we are proud to service Individuals, Families and Institutions, including Corporations, Public Funds, Taft-Hartleys and Nonprofits. We have offices throughout 16 states and are able to provide superior local service to all our clients.

We look forward to serving you. For more information, please contact us at 1-866-917-8730.

About the author



Brandon Thurber serves as an Equity Analyst, currently specializing in the Financial Services sector. He began his career with Morgan Asset Management in 2005. As a member of the Equity Analyst team, Brandon participates in the management of the Total Return Opportunity Portfolio. Mr. Thurber earned a Bachelor of Science in Commerce and Business Administration from the University of Alabama in 2003. He is a Level 3 candidate in the Chartered Financial Analyst Program and a member of the Alabama Chartered Financial Analyst Society.

Important Disclosures

The foregoing represents the opinions of the authors and not necessarily those of Morgan Asset Management. Morgan Asset Management is registered with the Securities and Exchange Commission as an Investment Advisor. Although Morgan Asset Management is an affiliated entity of Morgan Keegan & Co., Inc., a registered broker-dealer and member of the New York Stock Exchange, the information contained herein has not been produced or disseminated by Morgan Keegan or its registered representatives. Information contained herein has been derived from sources believed to be reliable but is not guaranteed as to accuracy and does not purport to be a complete analysis of the security, company or industry involved. Opinions regarding any securities mentioned are subject to change at any time. Neither the information nor any opinion expressed, constitute a solicitation for the purchase or sale of any security. In addition, Morgan Keegan & Co., Inc. may have investment banking relationships with these companies or be market makers in these securities. Employees of Morgan Asset Management may have positions in securities or their derivatives that may be mentioned in this letter. Morgan Asset Management does not assume any liability for any loss that may result from reliance by any person upon any such information or opinions.