Bank Stock Analysis Beyond the SSG

- THE BUSINESS OF BANKING
- BANKING INDUSTRY TODAY
- PERTINENT CHARACTERISTICS OF GOOD BANKS

Business of Banking

- Banking is a simple business
  - Deposits and Loans
- DEPOSITS:
- Primary funding source
  - May represent 80% of liabilities
- Low Cost - Insured
- Key competitive advantage

LOANS

- Primary asset class in community banks
  - May represent 80% of assets.
- Generate interest income – primary revenue source.
- Banks dependent on interest rates.
- PRICING IS A KEY MANAGEMENT SKILL.

LOANS

- Overhead – other expenses.
- Bank must earn enough to cover overhead and funds cost.
- What happens when rates rise? – banks earn more.

LOANS

- The QUALITY of loans is primary.
- The quality of a bank's loans is a KEY MANAGEMENT SKILL.
- A bad loan is expensive.
- Banks that lose less than 1% of loans are preferrable.

LOANS

- Loans are assets. Loan runoff.
- To increase revenue and income, a bank must increase it's loans.
- The best bankers are also good marketers.

RECAP

- <u>So far we know that the best bankers</u>:
- Deposits are key, low cost funding and the best bankers use them well.
- The best banks control their costs well.
- The best bankers make good loans and price them well.

RECAP

- The future for banking is likely pretty good and probably for a long time to come.
- We want banks that make good loans and maintain the best profitability.
- Two numbers to pinpoint good banks:
- Loan Loss Provision expense
- Return on Assets (ROA)

LOAN QUALITY

- Loan Loss Provision – Value Line
- Compare to Loans two lines above.
- If loan losses are well below 1% of loans for the entire V-L array, we have a good lender.

Example: VALUE LINE

Note line 4 (Loan Loss Provision) and the second line (Loans). A little calculation or comparison is needed to find percent of loans lost in a given year. This is for National Bankshares (NKSH).

2009	2010	2011	2012	2013	2014	
281176	307786	340122	353855	*365000*	*380000*	Total Assets ($mill) A
190329	191751	205082	218905	*233000*	*243000*	Loans ($mill)
8518.0	9579.0	10123	10745	*10600*	*11000*	Net Interest Inc ($mill)
5557.0	4356.0	2343.0	1882.0	*1500*	*1700*	Loan Loss Prov'n ($mill)
7952.0	8360.0	8760.0	9319.0	*8975*	*9200*	Noninterest Inc ($mill)
8281.0	9383.0	9911.0	10456	*10100*	*10300*	Noninterest Exp ($mill)
2237.0	3317.0	4872.0	5647.0	*5650*	*5875*	Net Profit ($mill)
15.0%	22.3%	27.8%	28.9%	*29.0%*	*29.0%*	Income Tax Rate
.80%	1.08%	1.43%	1.60%	*1.55%*	*1.50%*	Return on Total Assets

Return on Assets (ROA)

- Defined by Value Line as earnings divided by total assets.
- Combines good cost control and good pricing.
- We want banks that *consistently* exceed over 1% earned on assets.

Return on Assets

- Over 1.25% is good, only 9% of banks can do that.
- Over 1.5% is VERY good, less than 4% of banks can do that.
- A high ROA is indicative of good management.

Recap

- A bank with consistently high returns on assets and low loan losses can be deemed well managed.
- Such a bank can sustain good earnings well over time.
- Banks, especially well managed ones, may well benefit from improving industry conditions.

Recap

- Questions????
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