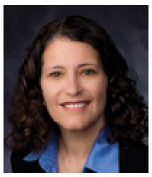
Wealth creation and U.S. banks



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Key takeaways

- Banks' ability to compound book value—and, by extension, shareholder wealth—is on a secular upswing.
- Capital actions, including merger activity and share buybacks, are largely accretive to bank earnings.
- Bank valuations are below long-term average levels; combined with positive fundamentals, this presents a compelling case for investing in U.S. banks today.

Executive summary

Banks across the capitalization spectrum have a long history of generating wealth for investors. Beyond paying dividends, they've shown an enduring ability to compound their book value, creating attractive return on equity for shareholders. In this article, we investigate this fundamental driver of banks' ability to generate wealth and consider the current attractiveness of bank stocks in the context of long-term valuation metrics.

Compounding book value is the key to wealth creation

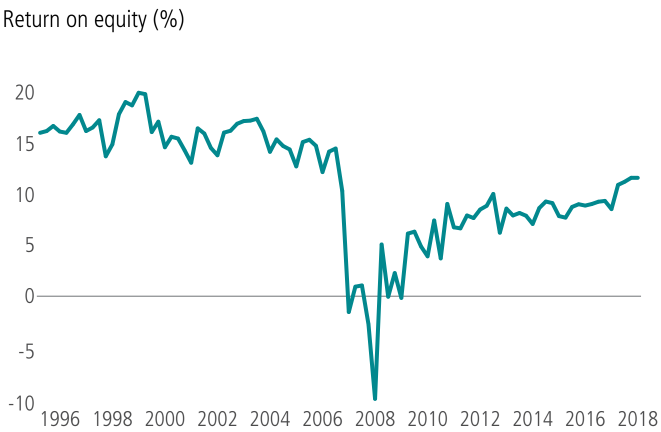
The U.S. banking industry has been a significant wealth creator for long-term investors. A primary driver of this return has been the industry's compounding of book value—which is a function of its return on equity (ROE)—coupled with dividends paid to shareholders.

Book value is one of the most important measures of valuation available to investors. It offers a view of the worth of a company's net assets—what the company's shareholders would receive today if all of the company's assets were sold and liabilities repaid. In this way, it can serve as an index to potential shareholder wealth.

The compounding of book value, by extension, maps the trajectory of a company's or industry's ability to create shareholder wealth over time. The primary source of compounding book value is ROE, which tells us how much profit a company generates as a percentage of equity. A bank with higher ROE will compound book value at a faster pace.

Over the long term, the banking industry has managed to generate attractive ROE. Although the global financial crisis was an obvious low point, the ROE for the industry as a whole has improved much since then. In the first quarter of 2018, banks' ROE crossed above 11% for the first time in over a decade.[1] This improvement, coupled with attractive valuations, provides a favorable backdrop for investors in the space.

Banks' ROE continues to rise in the postfinancial crisis era



Source: SNL Financial, as of 12/31/18.

ROE, dividends, and buybacks

At its most basic level, ROE compares the profit a company earns relative to the company's shareholder equity value. Shareholder equity is calculated by subtracting a company's liabilities from its total assets. When profits rise, that raises a company's ROE. The roughly 11% ROE being generated by the banking industry today is sustainable, in our view, and we think it can grow in the years ahead.

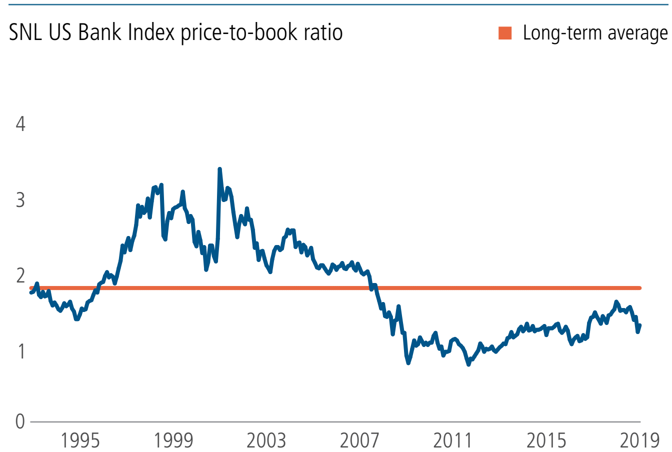
However, banks don't just simply compound their book value by their annual ROE; they frequently opt to deploy profits through capital actions, particularly by paying out dividends to shareholders and buying back stock. While diminishing the growth in book value, these actions are generally positive for shareholders. First, dividends put money directly in shareholders' pockets. Second, while buybacks may dilute book value in the short run,[2] they generally will increase future earnings potential, benefiting shareholders over time.

ROE sustainability

As for the sustainability of the current level of banks' ROE, the key factor to consider is the credit environment. Happily for banks and their investors, the credit environment is currently benign. We believe it should remain so for some time to come given our outlook for continued steady growth (albeit at a slower rate than 2018) in the U.S. economy. We also think it's likely to remain solid in light of the vastly more robust credit underwriting standards and risk management practices that have been in place in the postfinancial crisis era. Additionally, capital levels in the banking industry are at all-time highs today, with the Federal Deposit Insurance Corporation (FDIC) Chairman Jelena McWilliams recently declaring that banks are "superbly well capitalized."[3] This fortress-like nature of bank balance sheets also signals that higher bank profits and ROE are not simply being driven by increased leverage.

The growth outlook for banks' ROE is also bright. Currently, the industry is drawing support from several tailwinds that should lead to improved returns over the next few years. First, the normalization of interest rates has improved bank net interest margins and, correspondingly, bank profitability. This trend should persist even if the U.S. Federal Reserve slows its rate-tightening pattern in 2019, as we anticipate. Second, as the economy continues to expand, that will support continued loan growth and solid earnings for banks. Finally, we expect to see continued positive operating leverage in the industry due to the benefits of regulatory reform and technological advances. Further, we believe the long-term trend of industry consolidation to remain intact.

Bank valuations are at historically low levels



Source: SNL Financial, as of 1/31/19. SNL US Bank Index is a custom index provided by SNL Financial.

Diversified and regional banks have compounded their book value over the long term

Beyond considering industry returns on a macro level, it's also helpful to consider specific examples that showcase the growth of book value and dividends.

Our first example is US Bancorp (USB). Based in Minneapolis, Minnesota, USB is a superregional bank with $465 billion in assets as of the end of 2018 that has a presence throughout the upper Midwest and West Coast of the United States. The bank has significantly grown its book value and paid a healthy dividend over the last 15 years; over this period, USB has grown its book value by 180%, a 7.1% compounded rate. When adding in dividends paid to shareholders, book value growth plus cumulative dividends paid generated a compounded annual return of 10.2%.[4]

This capital compounding phenomenon doesn't just apply to large banks like USB. If we examine a smaller regional bank, such as Hancock Whitney Corporation (HWC), a Gulfport, Mississippi-based regional bank with $28 billion in assets, we find comparable results. Over the same 15-year period, HWC grew book value by 175%, a 7.0% compounded rate. And as with USB, when dividends are included in the analysis, the returns are more impressive. HWC's book value growth plus cumulative dividends over this period compound at a 9.3% annual rate.

This long-term compounding is the main driver of value and wealth creation in the banking industry. Today, with fundamentals in favor of banks, we expect to see banks across the spectrum continue to compound book value and grow dividends for, potentially, many years to come.

Current valuations suggest banks are on sale

Despite the improved ROE of the banking industry and healthy fundamentals, the sector trades at an attractive valuation, particularly in the wake of 2018's steep market decline. As of the end of January 2019, banks were trading at 1.32X price-to-book (P/B) value—a meaningful discount to their long-term average valuation of 1.81X P/B since 1992. Even on a price-to-earnings basis, banks now trade at 65% of the S&P 500, which is one standard deviation below their historical level of 76%.[5]

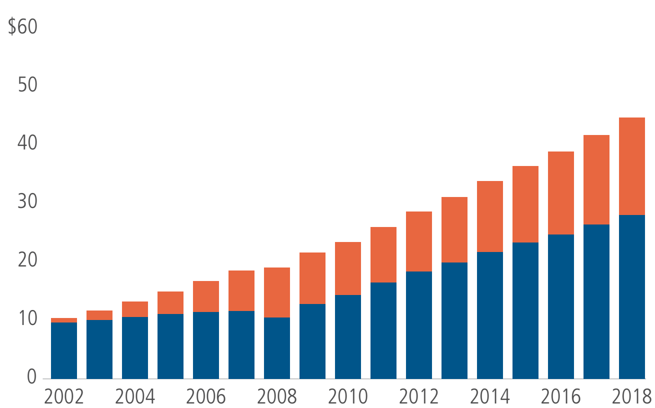
Critics might say that banks should trade at a discount to their long-term average P/B, given that an 11% ROE, while much improved relative to financial crisis-era levels, is still well below ROE thresholds generated before the financial crisis. We don't disagree with this argument; in fact, we think the lower-return profile of banks in 2018 suggests the industry is unlikely to see valuations rise in the near term to the peak levels it achieved pre-crisis. However, we do believe there is plenty of room for valuations to rise if fundamentals continue to improve as we expect.

Case studies in wealth creation

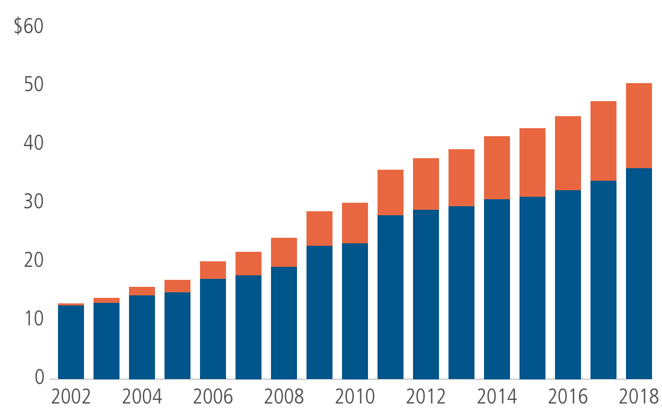
Book value and cumulative dividend progression

■ Book value per share ■ Cumulative dividends per share

U.S. Bancorp (USB)



Hancock Whitney Corporation

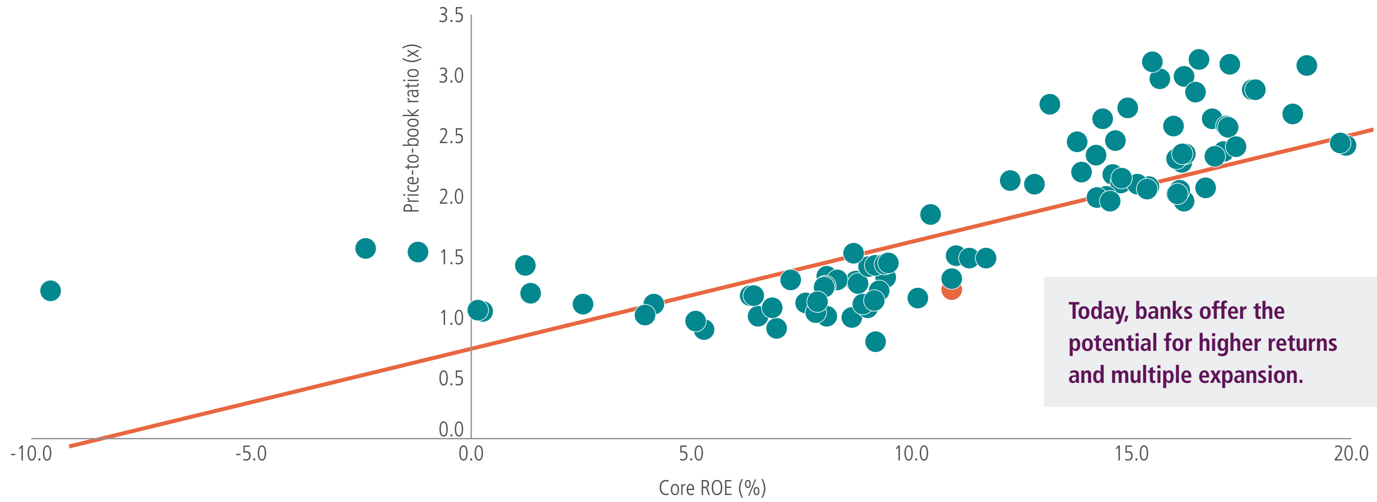


Source: SNL Financial, as of 12/31/18.

Taking a closer look at the relationship between P/B measurements of valuation and ROE, we plotted P/B versus core ROE[6] since 1996. We highlighted the most current data point with an 11.7% ROE and 1.32X P/B in red. This point is below a best fit line drawn for the time series relative to current returns being generated, which implies an attractive entry point for equity investors today.

Banks are currently offering attractive ROE at a low relative cost

Quarterly observations (3/31/96–12/31/18) and most recent month-end (1/31/19)



Source: SNL Financial, as of 1/31/19.

With the healthy fundamental backdrop providing the prospect for sustainable and improving returns, we believe the likelihood is high that banks will continue to compound book value while growing their dividends over the next few years. Coupling this trajectory of wealth creation with an attractive valuation makes now an opportune moment to be an investor in U.S. banks.

1 Core ROE of the SNL Bank Index, as of 12/31/18. **2** Assumes that stock is repurchased at a premium to book value. **3** Cited by Reuters, 1/3/19. **4** SNL Financial, 12/31/02–12/31/18. Simple analysis includes book value growth plus cumulative common dividends paid. This does not assume dividends are reinvested, which would increase the return to investors. **5** FactSet, 12/31/18. **6** Core ROE excludes elements such as goodwill impairments and certain tax consequences.

Price-to-book ratio is the ratio of a stock's price to its book value per share. Price to earnings (P/E) is a valuation measure comparing the ratio of a stock's price with its earnings per share. The views expressed are those of the author(s) and are subject to change. No forecasts are guaranteed. Past performance does not guarantee future results.

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