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Normal in Slow Motion

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*** Economic Cycle Now Supporting Further Growth in Financials**

*** Loan Demand Continues to Broaden and Deepen**

*** Deposits Gaining More Relevance and Value**

*** Size Matters Even More – A "Magic Middle" Emerges in Consolidation**

The financial cycle's pattern has been surprisingly "normal" when compared to past cycles, with the overpowering exception of its tediously slow pace. Financial flows mirror the economy, of course, which has been anything but similar to past recoveries in terms of strength.

Credit demand, slow to recover since the recession, was restricted to business borrowing for several years but has since broadened to real estate and recently consumer credit. The sequencing pattern across borrowing categories is no different than in past cycles. It was simply elongated to five years instead of five quarters.

With borrowing finally broadening by sector, ultra-competitive pricing in commercial and industrial loans is reportedly showing nascent signs of improvement. This development is anecdotal and visible only in limited geographies for the moment.

Financial margins are clearly more damaged than in past cycles, but this is ultimately a function of the slow economic cycle that has left Fed policy stuck on full ease. Here, too, there is a positive development. The average net interest margin for banks and thrifts was sequentially flat in the latest quarter, ending years of margin erosion.

Finally, deposits are no longer being taken for granted. Deposits relative to loans are at their highest since the 1960s, following a universal resistance to leverage since 2008. While still substantially in excess, their resilience as rates eventually rise is being debated. Their value has already risen in consolidation metrics.

Taken together, we would continue overweighting bank stocks, considering most earnings factors point upward for coming quarters while the sector has underperformed this year. The earnings cycle continues to advance, albeit in slow motion pending improving economic growth and higher rates. We are more optimistic about the latter as GDP remains on a 2-2.5% trend line with moderate consumer spending growth which dominates GDP. That said, commercial bank ROA is 84% recovered and ROE over risk-free rates is 77% recovered (see exhibits at end). The cup is beginning to look more than half full and rising.

Excess Deposits? Taking our main points in reverse order, two worries have surfaced regarding banking system deposits. The most recent is the idea that as the Fed shrinks bank reserves from its balance sheet, which itself is not a foregone conclusion, there is concern that banking system deposits will fall as well. Knowing that Quantitative Easing is about to end, it is understandable that unknown consequences in its aftermath are being thoroughly explored.

The second concern is not new. The eventual rise in interest rates is thought to hold a challenge for banks to maintain deposits. This is a more understandable concern. But history suggest deposits hold up well in periods of rising short rates.

Regarding the first concern, we think some analysis is off the mark. The Fed balance sheet was already at $2.3 trillion by yearend 2008 and expanded another $2 trillion through the first quarter of this year. Treasuries held at the Fed rose $1.8 trillion during this period, mortgage backed securities by another $1.6 trillion, offset by a roughly $1 trillion elimination of special funding corporations set up during the crisis and discount window borrowings.

On the liability side, depository institution reserves at the Fed grew $1.6 trillion since 2008, the bulk of the expansion taking place since 2010 as excess reserves paid interest. Reserves are currently $2.4 trillion. Importantly, required reserves are merely 3% of that amount. Repos made up the rest of the Fed's liabilities expansion.

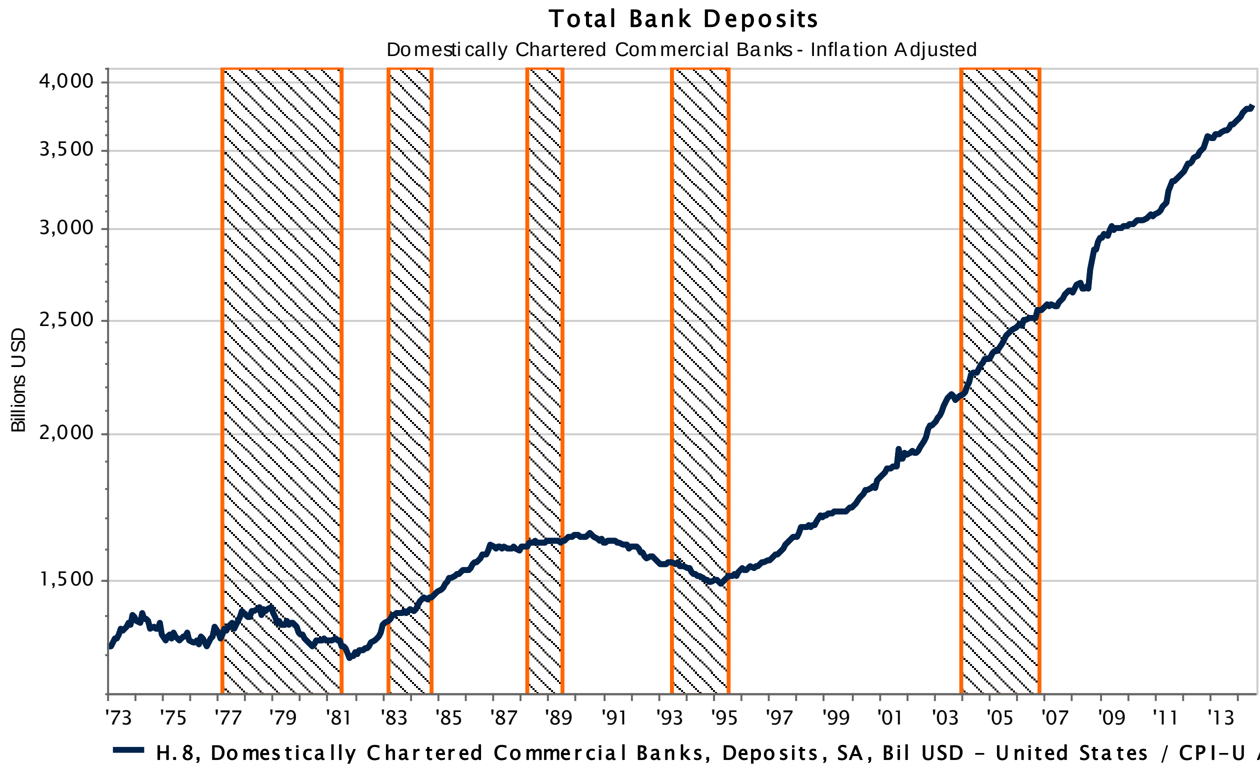
Banking system deposits have risen $2.4 trillion since the end of 2008, in a more-or-less steady fashion, evenly split between interest-bearing and noninterest-bearing. Roughly $1.1 trillion funded new bank "credit," the bulk in securities not loans, with another $1 trillion in net Fed funds sold and RPOs.

The important point is that the vast bulk of depository reserves are not required for the deposit base advance. They are excess reserves that, at 25 basis points, offer an alternative short-term return akin to short term Treasuries. Reserves do not create bank deposits. It is the other way around.

All indications are that the Fed will reinvest the proceeds for its maturing Treasuries and Agencies. Should it at some point begin reducing its balance sheet, it is almost axiomatic that it would do so gradually. This would remove so-called liquidity in the form of excess reserves and cash equivalent assets at banks gradually, but would have very limited impact on deposits. It is also important to realize that half of Treasuries outstanding are held by foreign investors. If the Fed were to actually sell its Treasuries, bank deposits associated with foreign investors would decline offshore so that the impact on domestic reserves would be muted.

Deposits currently exceed loans by well over $3 trillion. There is enormous slack between credit and funding in the banking system. Likewise, there is enormous space between the Fed's removal of extraordinary monetary ease and any actual tightening of credit availability. Bank lending is just recently growing above 8% annualized, a welcome development but far away from depleting deposit funding in any significant way. At the current pace of lending, it would take up to five years to reach a 100% L/D ratio assuming deposits remained flat.

Deposit behavior during periods of rising interest rates can be easily seen in the following graphs, which show system deposits in real terms on a 40-year historical log plot. Shaded areas represent periods of



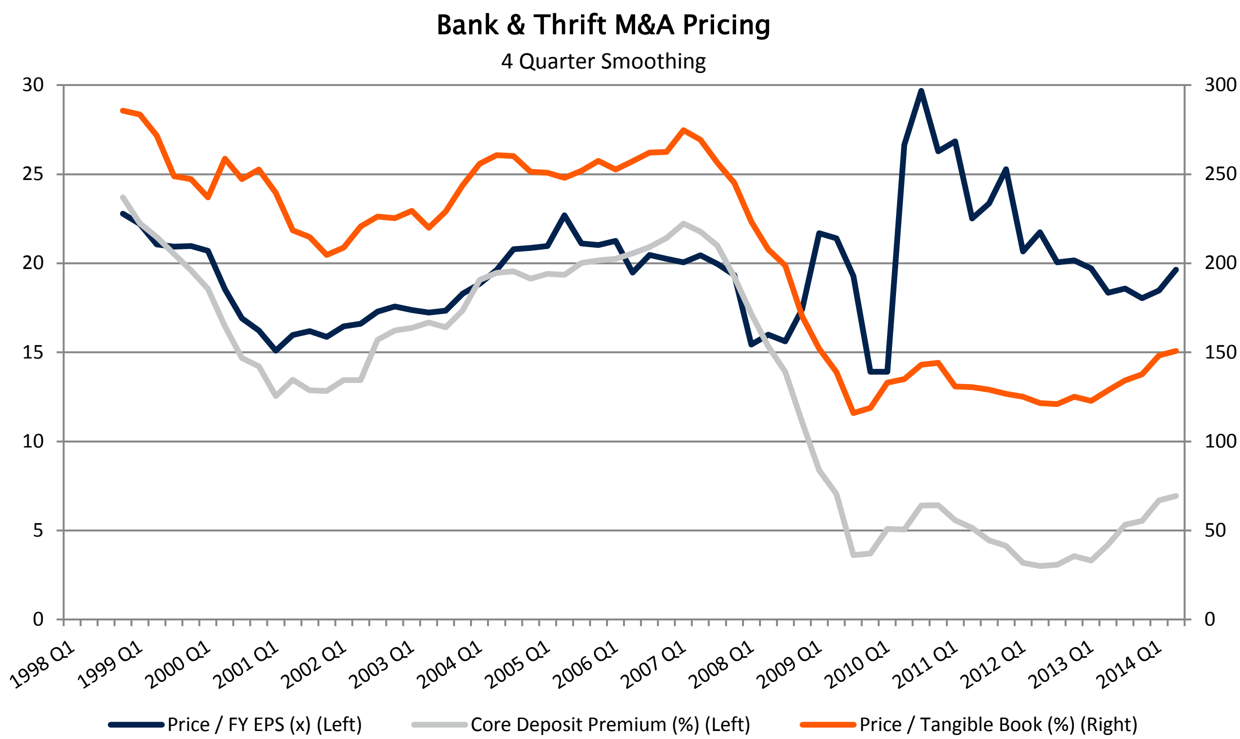
Source: Federal Reserve System, FactSet

sustained rise in the Fed Funds rate. None of these periods show any inflection or departure from the trends during similar time periods prior to the onset of rising rates. The last period shows deposit trend growth unfazed by rising rates. Deposit trends are largely rate insensitive.

Since we are presumably departing from a period of exceptionally low rates, it is fair to ask if noninterest-bearing deposits may be more vulnerable to a rate rise and/or if time deposits become more robust. Since the 1980s, there is some mix shift consistent with this logic. Unsurprisingly, as rates rise, time deposits increase more while interest free deposits increase less. This was most pronounced during 2004-2006 with time deposits gaining 7% share relative to total deposits while interest free lost 2% in the mix. As rates began their rapid descent since 2008, interest free deposits gained 7% in the mix reaching an all-time high weighting. We can conclude that overall deposit resilience will be reliable once again, but the mix will be unfavorable to cost of funds.

Having said all the above, it should be noted that while deposits have less franchise value during periods of low interest rates, their importance will be reflected as rates rise. This is already happening.

Core Deposit Premiums: The generic valuation ratios for M&A transactions contain an interesting but indirect proof. M&A pricing is generally driven by ratios to book value, presumably because book reflects franchise value after considering various other factors including geographic, demographic, business mix, management and balance sheet integrity. Three valuation ratios are shown below.



Includes all nationwide bank and thrift deals with announced deal value greater than $15mm as of 8/29/2014
Source: SNL Financial

Price to tangible book value averaged 2.5x in the eight years prior to the financial crisis and the recession. This valuation ratio has only recovered to 1.5x for all deals with transaction size greater than $15 million.

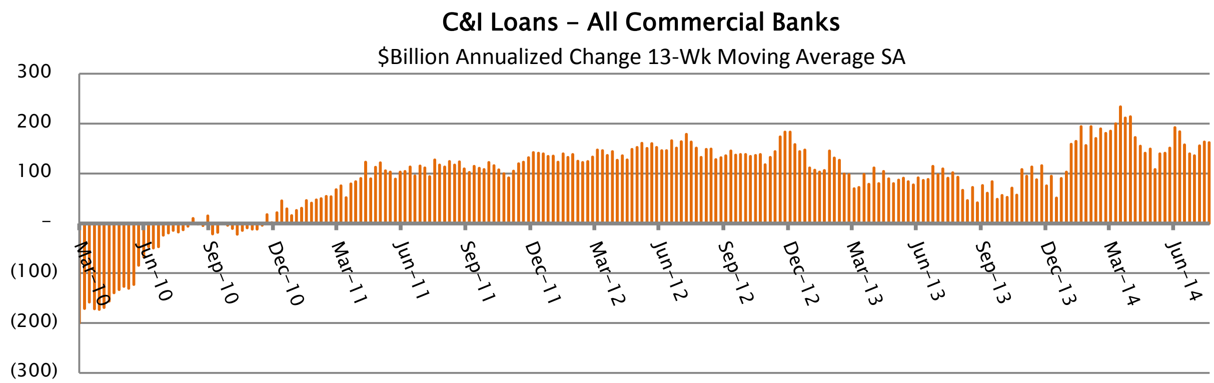
Core deposit premiums averaged approximately 18% prior to 2008 in a 13-23% range, occupying the upper end of the range during rising interest rates. The core deposit premium plummeted to 3% but has recovered to 7% over the last year. Some would argue this is primarily due to improved pricing to book value, but we would argue M&A valuations are really the result of multiple factors, depending on their validity or visibility.

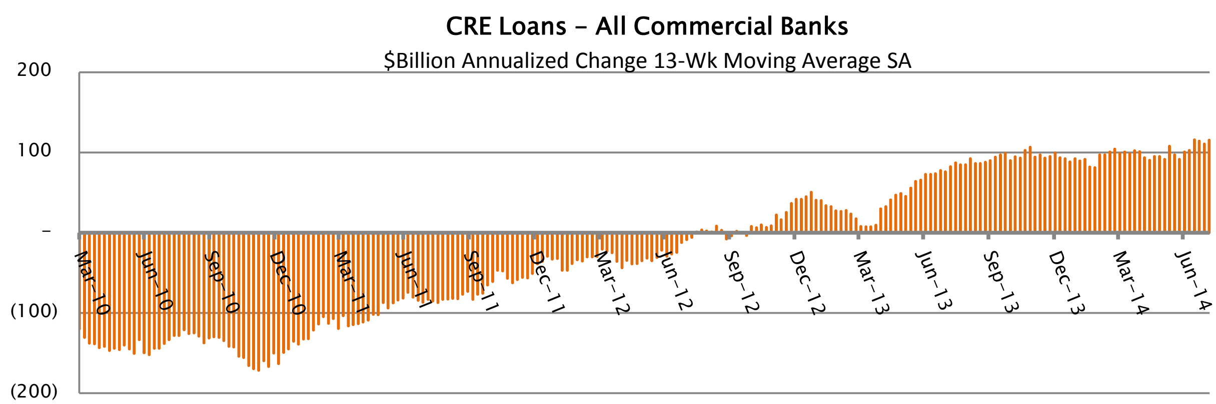
We would also argue that earnings power should ultimately be the more important determinant for investors as well as in M&A transactions, remaining hidden during weak or uncertain earnings periods, but returning as bank equity valuations eventually revert to sustainable earnings. During periods of abnormal, uncertain or dubious quality earnings, balance sheet ratios are the common default. It is very telling that, apart from times of great uncertainty, price to forward earnings has remained the same, averaging 18x prior to 2008 and settling back at essentially the same ratio in recent quarters!

Broadening Bank Loan Growth: Bank lending follows a distinct cycle largely in parallel to the economy. The bar charts below show annualized loan growth nationally by sector. The progression is standard, while the timeframe is dramatically elongated.

Commercial & Industrial lending is the first to recover following a recession. It usually takes only a quarter or two. Timing for this cycle was different, of course, but the durability of growth has been impressive. The revival occurred approximately seven quarters after the recession ended. The amplitude was strong and defined, averaging $100 billion (year-over-year) and further accelerating this year.

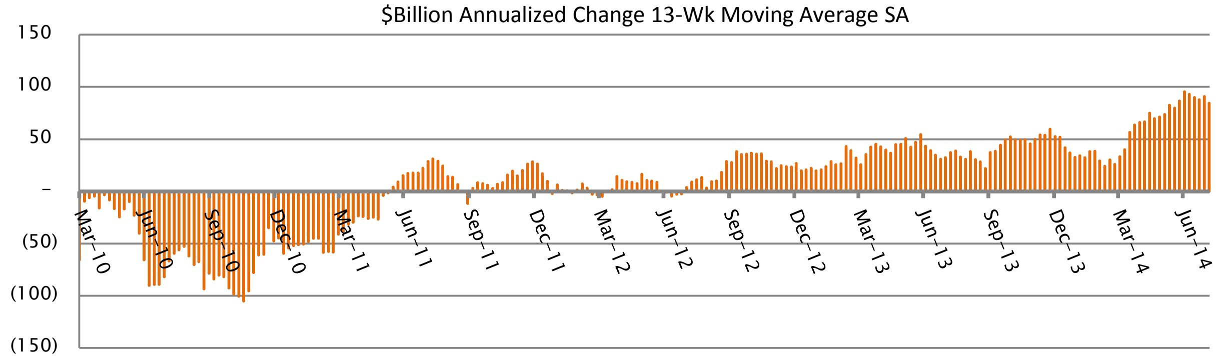
We have long argued that bank loan growth would exceed expectations and this has certainly been the case in business borrowings. While post-recession consumer spending has been sluggish since the recession, fixed investment has been relatively robust. Fixed investment is only 18% of GDP but the year-on-year growth in nominal dollar terms has almost equaled that of consumer spending for the first time in recent memory. Private Domestic Investment (PDI) has averaged 83% of Personal Consumption Expenditures (PCE) change since the recession compared to only 25% during the period preceding the recession!





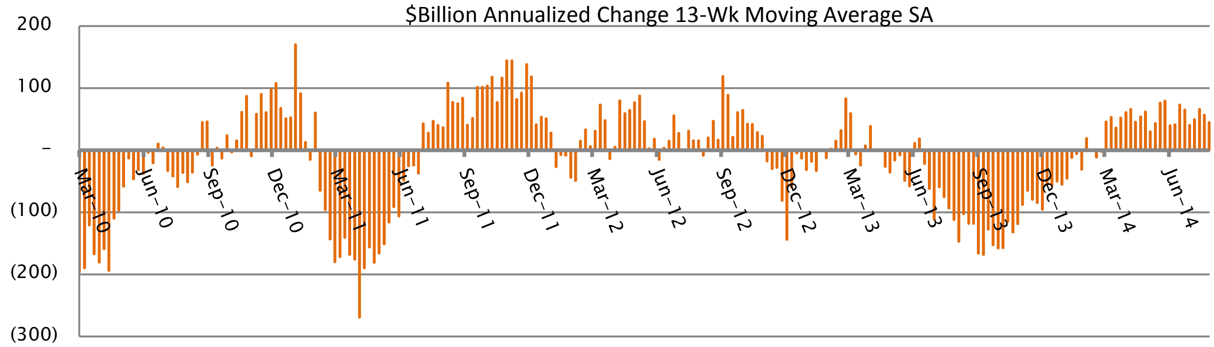
Consumer Loans – All Commercial Banks

$Billion Annualized Change 13-Wk Moving Average SA



Closed-end Residential Loans – All Commercial Banks

$Billion Annualized Change 13-Wk Moving Average SA

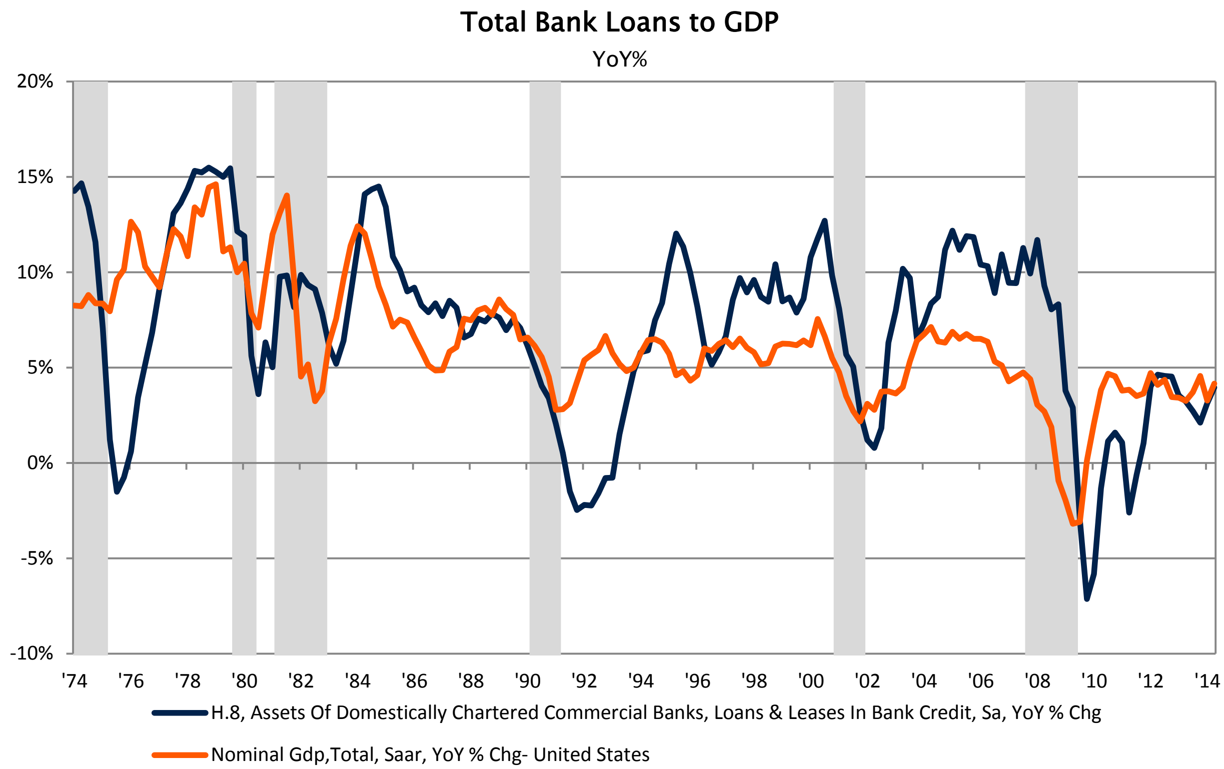


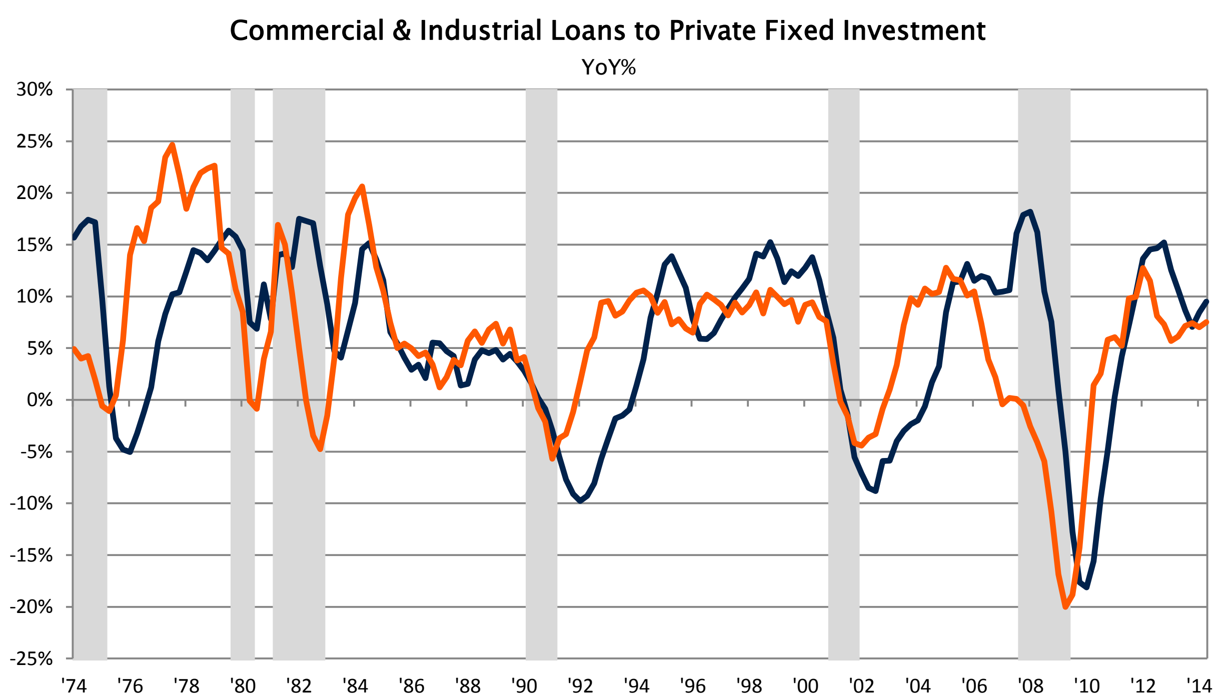
Source: Federal Reserve System

While U.S. GDP growth has "normalized" steadily downward reflecting labor-force constrained PCE growth, the commercial sector is increasingly vibrant reflecting a degree of re-industrialization, particularly in the areas of agriculture, energy, infrastructure and technology.

Commercial real estate remained in decline for an agonizing 14 quarters following the recession, an extraordinary slump reflecting massive but necessary deleveraging. The initial volume surged to $50 billion by early 2013 and has ultimately recovered to a $100 billion level. This was undoubtedly the longest delay in recent history, as was the delay in consumer borrowing which required nearly five years of balance sheet repair before approaching the $100 billion mark! The pattern of these stages is quite similar to previous economic cycles, as mentioned, but the delays were highly abnormal. In the end the bank lending cycle has returned, with the exception of residential mortgages held on balance sheet.

The broader influence of the economic cycle and bank lending can be seen below. The growth in total bank loans follows the GDP growth cycle, although the amplitudes differ. We offer three important observations from the graphs: 1) The term "follows" is to be taken literally. While policy makers, politicians and regulators too often confuse the public by suggesting bank loans drive the economy, history tells us it is the other way around. Lending clearly and consistently *lags* the GDP cycle. Lending supports economic growth but does not drive it! This lag has averaged at least six months for the last six cycles. 2) The amplitude of the overall credit cycle has significantly exceeded the economy from the mid-1990s until the last recession. This reflects the period of excess leverage in both consumer lending



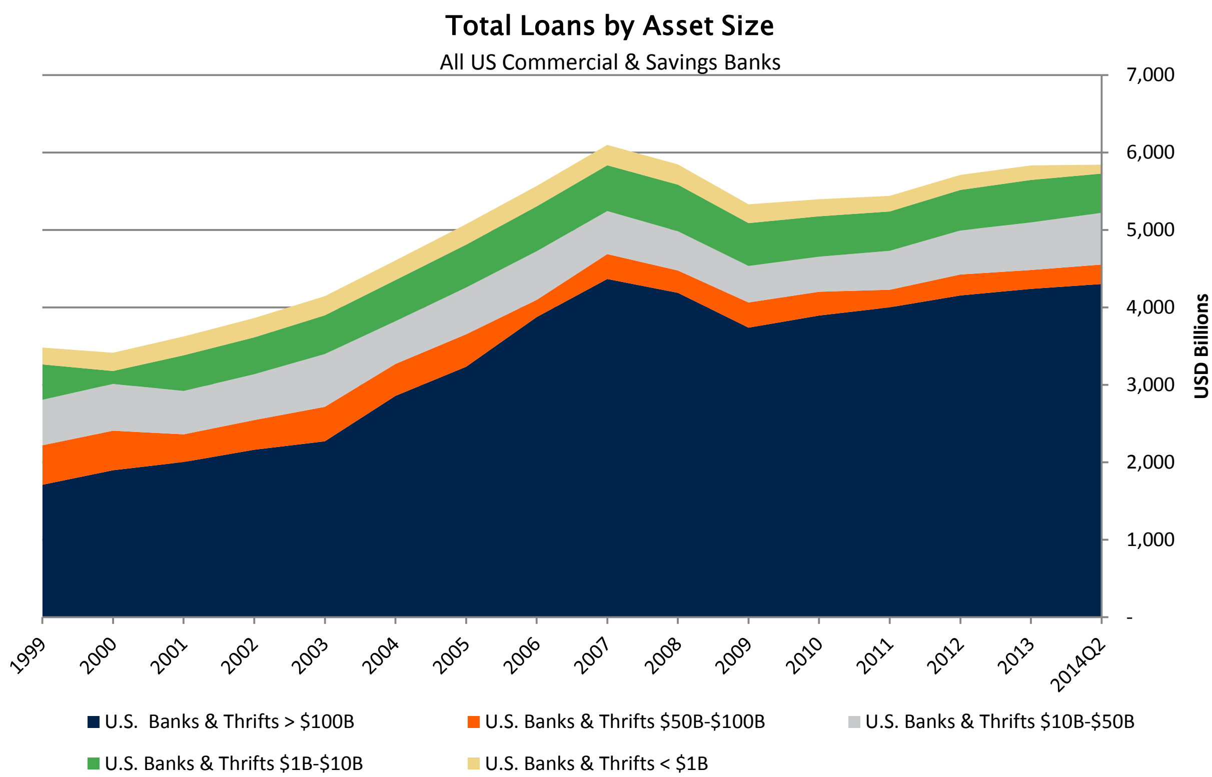


Source: Federal Reserve System, BEA

and real estate. 3) This has largely not been the case for business lending, which was perhaps the only sector that avoided undue leverage. The commercial and industrial (C&I) loan cycle has adhered closely to the fixed investment cycle, which has reached an 8% growth trend. This is in marked contrast to consumer spending, which has not been able to clear 3% nominal growth. This is also why we have consistently favored business banking models.

Size Matters More: We illustrated the importance of bank asset size two years ago. (*Scale Increasingly Matters - July 11, 2012*) by depicting the lackluster recovery in ROE and the inability to tap new capital for banks under $1 billion in assets. The ROA, ROE and capital expansion for larger banks has been dramatically stronger.

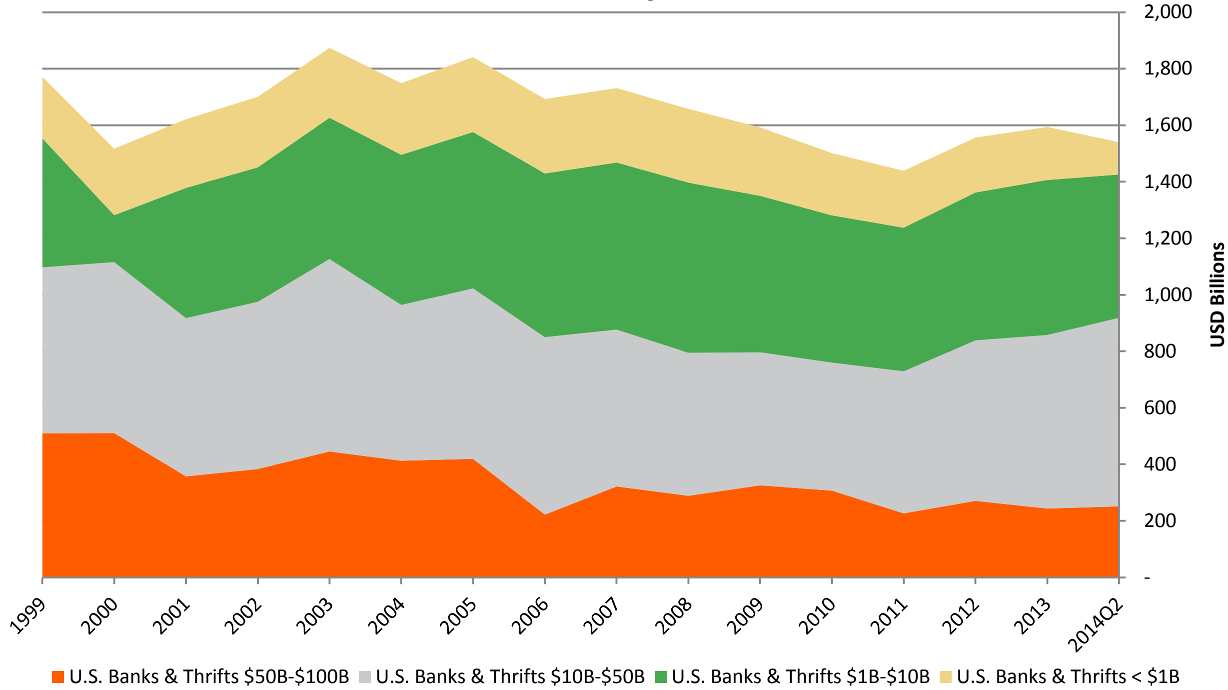
Adding to this contention, the distribution of bank loans by asset category is also revealing and supporting. The charts below show the distribution at yearends by annual re-ranking. Performed this way the resulting data should not be used to track actual growth, which is not comparable from year to year due to both consolidation and category shift in addition to organic growth (Individual banks move across category ranges in these re-rankings). However, tracking the share of loans within asset categories is a valid exercise and illustrates a migration pattern favoring what we would label as an emerging “Magic Middle”. The second chart removes banks greater than $100 billion in assets to more readily display this.



Source: SNL Financial, Sandler O’Neill

Total Loans by Asset Size

US Commercial & Savings Banks < $100B



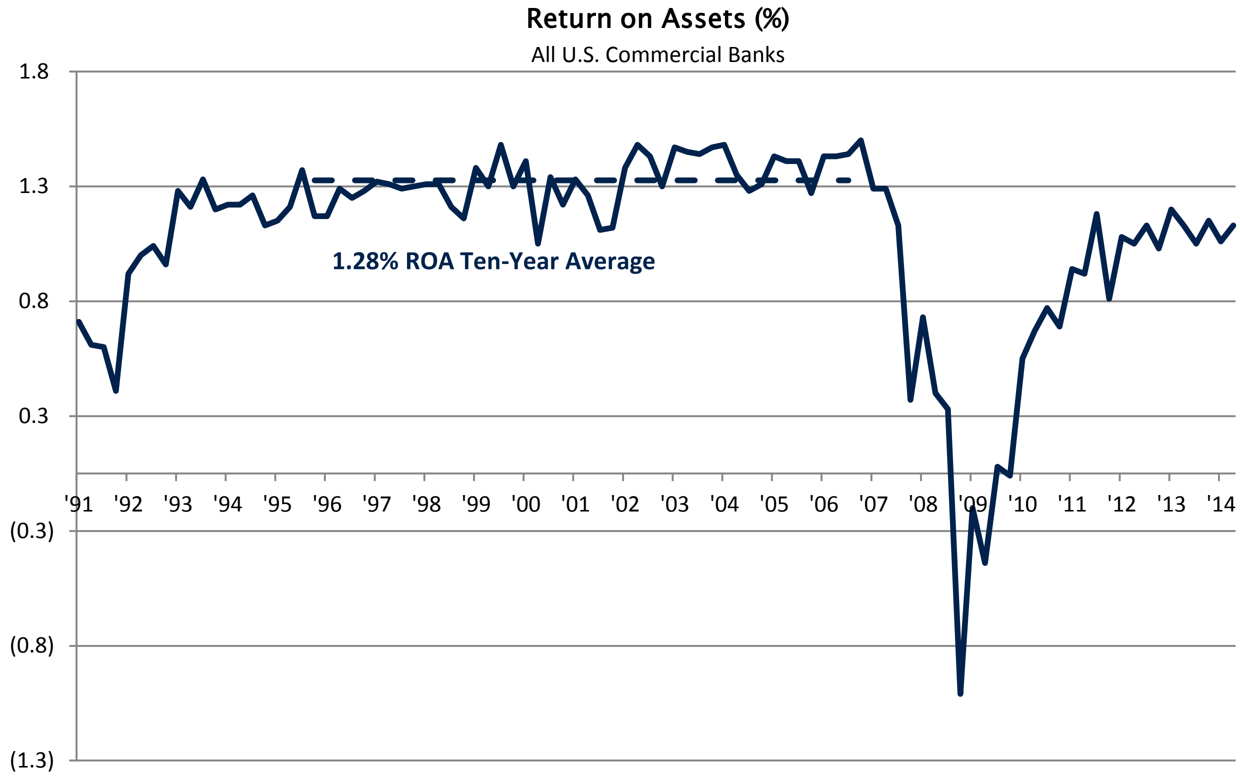
Source: SNL Financial, Sandler O'Neill

While the largest banks have been essentially stable since the recession and the several sizeable consolidations during the crisis, there is some erosion in the next largest category and rather significant erosion in the bottom category of banks with assets below $1 billion. The expansion has been in the $10-$50 billion range while those with $1-$10 billion in assets have held their own.

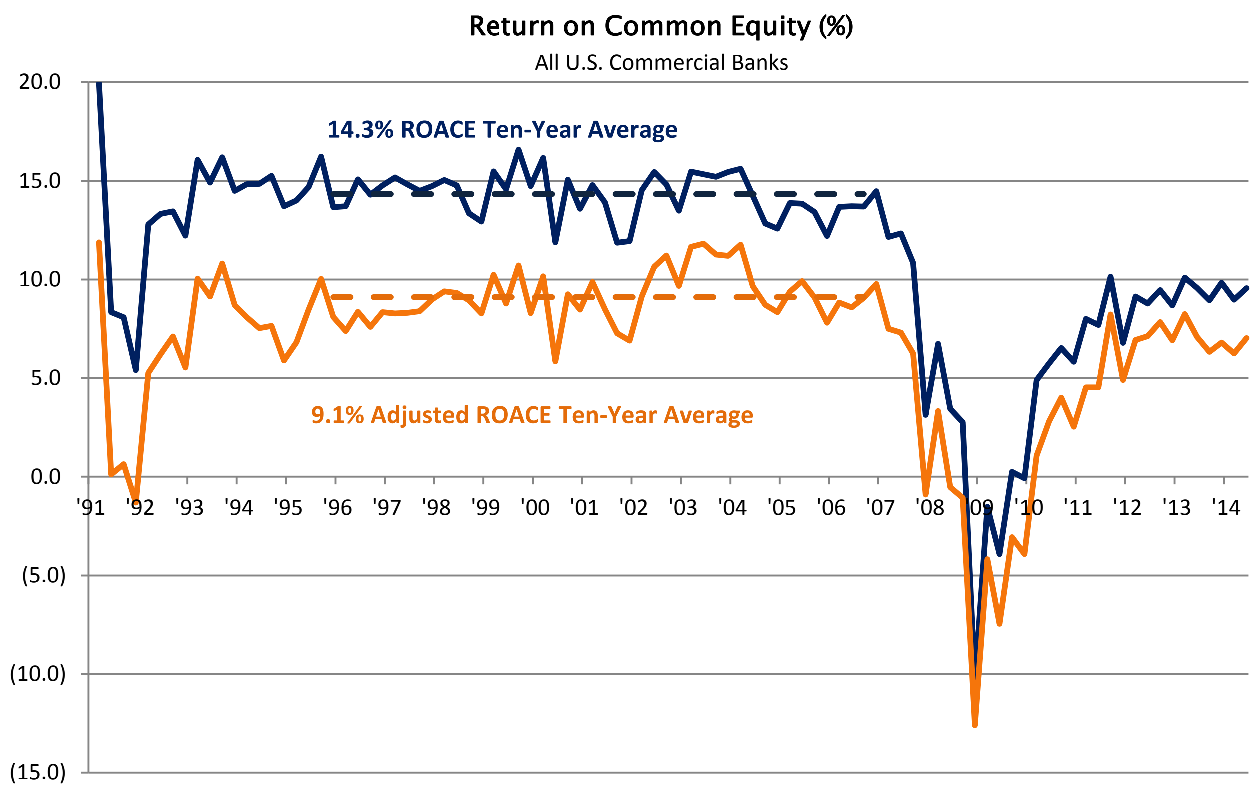
The erosion of loan market share for banks with assets below $1 billion has been the most significant. While once comprising a 14% share of lending, they left the recession at 13% and have fallen to only 9.7% currently. Banks $10-$50 billion have gained roughly half of what the smallest have lost.

This very much conforms with Sandler O'Neill's M&A practice experience. Increasingly bank boards and managements recognize the importance of exceeding $1billion in asset size and ultimately exceeding $10 billion, primarily though further consolidation.

"Normal" Profitability: We provide updated banking ROA and ROE levels of recovery below. As mentioned earlier, average commercial banking ROA is only 16% shy of its historical profitability, despite margin and compliance pressures, while average ROE over the risk-free rate is about 18% shy due to additional capital burden. With the broadening revenue cycle and eventual rise in interest rates which will be only partly offset with higher loss provisioning, we see no reason why the "new normal" for profitability should meaningfully differ from historical performance.



Source: SNL Financial



Note: Adjusted ROACE is defined as ROACE less the UST 10-year yield
Source: SNL Financial, FactSet

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