Industry Perspectives
A MONTHLY RESEARCH ANALYST SERIES

DIAMOND HILL | CAPITAL MANAGEMENT

Banking in the Time of a Global Pandemic

November 2020

John Loesch, CFA
Research Analyst

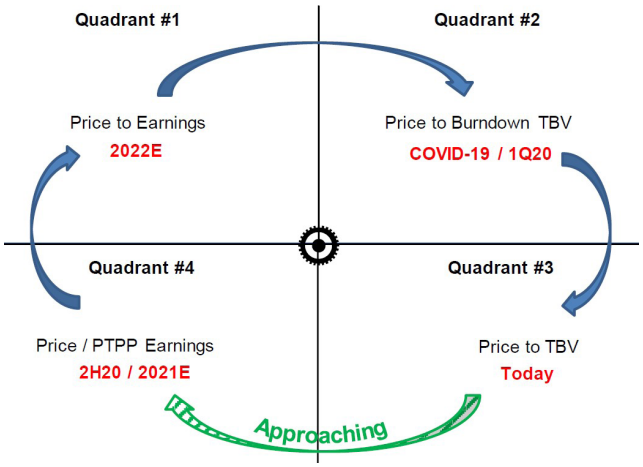
Having survived the global financial crisis of 2008-2009 as a new banking analyst, I often wondered what the next cycle would look like and where it would originate. That's the thing about cycles: We always know there will be another one.

There is an idea that military generals are always prepared to "fight the last war." With the experience and scars of the financial crisis seared into my brain, I wanted to be prepared if market participants began "fighting the last war" when the next credit cycle emerged. I held a strong belief that it wouldn't be real estate-led like the last cycle, but never contemplated a global pandemic on a scale the world hasn't seen in over 100 years.

During the March selloff, the median multiple for banks was below March 2009 levels, and roughly 60% of the industry was trading below tangible book value. The market was pricing in substantial capital impairment for bank balance sheets. Thanks to the work done over the last decade, banks entered the pandemic in a much healthier state than at the beginning of the financial crisis. Capital levels were more robust, they'd been operating under intense regulatory scrutiny for 10 years, underwriting standards had improved and much of the riskiest lending had been pushed out of the commercial banking system.

This highlights the benefit of experience and our long-term perspective. Having covered the industry closely during the financial crisis and for the subsequent decade, we witnessed how investor psychology evolved through that crisis and what that meant for bank stock valuations. Exhibit 1 illustrates how investor psychology progressed through the COVID-19 crisis and what we expect in the quarters ahead. Today, we believe we are currently hovering somewhere between quadrants three and four.

EXHIBIT 1: THE WHEEL OF BANK STOCK VALUATION



Source: KBW, a Stifel company. PTPP: Pre-tax, pre-provision profit, TBV: Tangible book value.

The financial crisis also taught us to sweat the small stuff. Through that cycle and other recent mini-cycles, such as the energy downturn, we developed a finer appreciation that not all loan books are created equal. Just because two banks have exposure to the same loan category does not mean they will experience similar losses. This allows us to remain invested or increase our investments when panic overtakes the market and treats all banks the same.

To up the complexity factor for the industry while navigating the pandemic, banks also had to implement a new accounting standard for loan losses in Q1'2020, referred to as CECL for the current expected credit loss methodology. This change forced banks to take most of the pain of elevated loan loss provisions up front, dramatically impacting industry profitability in the first half of 2020. Whereas in past cycles when elevated provisions could last for multiple quarters or even years, this new accounting standard compressed much of the provision expense for this cycle into two quarters. We believe the market still doesn't fully appreciate the snap-back effect this will have for bank earnings as provision levels normalize.

With many banks still trading at or near tangible book value levels, the market remains highly uncertain about the near-term outlook. With the additional data points from third and fourth quarter earnings for 2020 and outlooks into 2021 that management teams provide, we believe we will move into quadrant four of Exhibit 1 as investors gain confidence that tangible book values are sound and growing. Then, with a clearer line of sight into the normalized earnings power of the industry, the gravitational pull of strong—and growing—tangible book values should exert itself on the shares of bank stocks.

Out of crisis often comes opportunity, and this crisis is no different. The economic shutdowns and work-from-home trends accelerated technological adoption in the industry by several years, with many of the slow adopters forced into new technologies by the pandemic. This will drive many banks to further rationalize their branch footprints, and we've subsequently seen countless announcements of branch reductions by banks, often by as much as 10%-20%. We believe this trend will continue for years, allowing banks to squeeze additional savings out of their expense base.

This isn't to say that there aren't still potential headwinds. In addition to the economic uncertainty caused by the pandemic, the recent election could turn what has been tailwinds for the industry into headwinds. Joe Biden's win could lead to higher corporate tax rates, which will squarely impact the banks given their primarily domestically sourced earnings. The level of regulatory scrutiny could also be dialed up on the industry after four years of stable, if not modest, relief. Lastly, the future path of interest rates and their impact on bank net interest margins will challenge revenue growth.

Using tangible book value growth plus dividends paid as a rough proxy for growth in intrinsic value, the industry has generally delivered high single-digit growth over rolling five-year periods. With much of the industry becoming commoditized—where the only differentiator is how much they pay on deposits or charge for loans—we strive to identify unique franchises that have demonstrated an ability to meaningfully outperform the industry over long periods of time and, importantly, do so consistently. Franchises such as First Republic, SVB Financial Group, Live Oak Bank and Bank OZK have developed expertise that separates them from the other commoditized institutions.

Good and defensible banking franchises led by strong and experienced management teams generally improve their market positions in times of uncertainty and market disruption. While uncertainty is high and the range of potential economic outcomes is wide, we remain confident that this cycle is different than the financial crisis in that it is more of an income statement issue than a balance sheet one, meaning that the elevated provision expense experienced particularly in the first half of 2020 impacted quarterly earnings but did not impair bank balance sheets like we saw during the financial crisis. We're optimistic that the combination of strong balance sheets, uniquely positioned franchises and capable management teams will lead to attractive investment returns for our bank holdings.

As of October 31, 2020, Diamond Hill owned shares of First Republic Bank, SVB Financial Group, Live Oak Bancshares, Inc. and Bank OZK.